

# **NEXT STEPS FOR MEANINGFUL OVERSIGHT OF THE PROXY ADVISORY FIRM INDUSTRY**

Hearing on Legislative Proposals to Enhance Capital Formation,  
Transparency, and Regulatory Accountability  
Subcommittee on Capital Markets and  
Government Sponsored Enterprises

House Committee on Financial Services

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Written Testimony of  
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Chairman Garrett, Vice Chairman Hurt, Ranking Member Maloney and Members of the House Financial Services Committee:

My name is Tim Bartl, and on behalf of the Center On Executive Compensation, I am pleased to provide our views on the role, influence and impact of proxy advisory firms and to express our strong support for the Proxy Advisory Firm Reform Act. These issues have been a top concern of the Center's for several years, as referenced in my testimony before this Subcommittee in 2013. My comments today reinforce many of the findings and conclusions I articulated at that hearing, but focus particularly on the regulatory and practice developments since that time that reinforce the need for continued and specific Congressional and SEC oversight of the proxy advisory firm industry.

The Center On Executive Compensation is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy and practice. The Center is a division of HR Policy Association, which represents the chief human resource officers of over 365 large companies, and the Center's more than 125 subscribing companies are HR Policy members that represent a broad cross-section of industries. Because chief human resource officers support the compensation committee and board of directors with respect to executive compensation and related governance matters, and many are involved in engaging with institutional investors, we believe that our Subscribers' views can be particularly helpful in understanding proxy advisory firm influence and the positive impact regulatory oversight can have.

In sum, my testimony makes the following points:

- The two major proxy advisory firms, Institutional Shareholder Services and Glass Lewis, play an essential role in the proxy voting process and thus have significant influence. However, the time constraints and profit objectives inherent in the business often result in a cursory, check-the-box analysis, which in turn requires substantial additional engagement between companies and investors.
- Conflicts of interest within the two largest proxy advisory firms require ongoing scrutiny, especially in terms of the following:
  - Institutional Shareholder Services' claim of providing "independent" analysis on one side of its operation, and providing consulting services to corporate issuers on the other side of the operation;
  - ISS's consulting with certain institutional investors – particularly those aligned with certain social or policy objectives on shareholder proposals sponsored by the investors – and then making so-called independent recommendations on those same proposals with only cursory disclosure of the relationship; and
  - Conflicts in the ownership structures of Glass Lewis in light of its partial ownership by the Ontario Teachers' Pension Plan, a major labor pension fund and activist private equity investor, as well as ISS, which is owned by a private equity investor.

- The SEC's December 2013 Roundtable on proxy advisory firms was an encouraging development that put many of these issues on the record. Staff Legal Bulletin 20, which followed, signaled greater regulatory oversight, but only addressed a small subset of concerns, especially with respect to conflicts.
- For these reasons, the Center supports the framework for registration, oversight and withdrawal of the opinion letters that are included in Chairman Duffy's bill, the Proxy Advisory Firm Reform Act, as a way of reinforcing the need for oversight and focus on the role that proxy advisory firms play in the proxy voting system.
- The Center also supports Chairman Garrett's efforts to strengthen the SEC's cost benefit analysis regime and to periodically revisit regulations consistent with the SEC's mission.

## **I. Additional Oversight of Proxy Advisory Firms Is Necessary**

The Center On Executive Compensation believes that regulation of the proxy advisory firm industry is necessary to facilitate needed industry change. Since 2013, the Securities and Exchange Commission has taken steps aimed at improving perceived wrongs in the proxy advisory firm industry. The 2014 SEC staff legal bulletin on proxy advisory firms requires proxy advisory firms to disclose conflicts of interest and describe the nature and quality of certain business relationships with certain issuers and shareholder proponents in order to avoid significant and onerous filing requirements under the Investment Advisers Act. The required disclosure was not public and applied to a small subset of relationships, and also placed the onus on the investor-client of the proxy advisory firm to police proxy advisory firm practices. As a result, the SEC's guidance has not had a significant impact on the proxy advisory firm industry.

The Center supports the Proxy Advisory Firm Reform Act because it provides a framework for greater SEC oversight and creates a public disclosure regime. As is detailed below, public disclosure of proxy advisory firm issues can be an effective method of regulation, and informal oversight has been successful in facilitating changes in the past. The most important aspect of the bill, however, is the repeal of the two SEC no-action letters, again detailed further below, which provided the industry framework which has facilitated the proxy advisory firm status quo. The Center believes that the repeal of the no-action letters and greater SEC oversight would pave the way for a broader stakeholder debate on how the SEC should oversee proxy advisory firms as well as the role of investors in the process.

## **II. The Role of Proxy Advisory Firms**

Proxy advisory firms fill an important role for institutional investors. As the share of institutional investor ownership has grown from roughly 46 percent in 1987 to over 70 percent today,<sup>1</sup> the volume of proxy votes which investors are responsible for casting has

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<sup>1</sup> THE CONFERENCE BOARD, 2008 INSTITUTIONAL INVESTMENT REPORT: TRENDS IN INSTITUTIONAL INVESTOR ASSETS AND EQUITY OWNERSHIP OF U.S. CORPORATIONS (Sept. 2008).  
[https://www.sec.gov/News/Speech/Detail/Speech/1365171515808#P18\\_1663](https://www.sec.gov/News/Speech/Detail/Speech/1365171515808#P18_1663)  
<http://www.businessinsider.com/stock-market-ownership-2015-1>

grown into the billions. In order to assist them in fulfilling their fiduciary duty to vote their proxies in the best interests of their clients, most institutional investors retain the services of Institutional Shareholder Services (“ISS”), the largest proxy advisory firm, or Glass Lewis & Co., the other major proxy advisory firm. Together, these firms cover about 97 percent of the U.S. market for proxy advisory firm services.<sup>2</sup>

Both ISS and Glass Lewis provide proxy voting research and analysis and make voting recommendations to their clients. Both companies provide an electronic proxy voting platform in which investors can instruct advisors on how they want their votes cast and the proxy advisory firms will execute the votes on investors’ behalf. Both allow investors to customize their standardized proxy voting guidelines. ISS will also determine votes for its clients. Based on ISS comments and anecdotal experience from our Subscribers, many medium and smaller investors delegate their proxy voting duties directly to ISS, following the ISS standard proxy voting guidelines. Glass Lewis does not determine votes on behalf of its clients, but is also less forthcoming about its voting policies and their application, although it now also makes its reports available to companies once they are completed.

As discussed in detail below, while most investors take their proxy voting responsibilities seriously, and the largest investors have their own governance departments responsible for independent analysis, the delegation of proxy voting analysis to ISS and Glass Lewis by a large share of institutional investors inserts a significant opportunity for influence over the proxy voting system.

The Center continues to be concerned that lack of sufficient resources on the part of the proxy advisors leads to a check-the-box mentality, driven in part by the desire of investors to have a uniform, condensed version of corporate pay disclosures, even though pay programs are individualized, complex and lengthy. The speed with which proxy advisors must analyze 100-page proxies, combined with the aforementioned lack of resources, leads to errors, inaccuracies or questionable characterizations. (Over 75% of annual meetings of the S&P 500 occur between March and June, and that is just in the U.S.) To understand and summarize pay programs well requires time, resources and diligence. The irony is that issuers are responsible for ensuring the accuracy of proxy advisory firm reports, even though proxy advisory firms are supposed to be the experts providing information that investors rely on to execute a fiduciary duty. This calls into question the legitimacy of the model, or at least its effectiveness.

### **III. Proxy Advisory Firm Influence**

Both academic research and experience demonstrate that proxy advisory firms have significant influence over the proxy votes cast by institutional investors and over the compensation practices adopted by companies. This is a concern because unlike directors or institutional investors, proxy advisory firms have no economic interest in the company for which they are making recommendations. This removes the consequences of an inaccurate or incorrect recommendation from the recommendation itself.

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<sup>2</sup> James K. Glassman and J.W. Verret, How to Fix Our Broken Advisory System, Mercatus Center (2013), <http://mercatus.org/publication/how-fix-our-broken-proxy-advisory-system>

*Influence of Proxy Advisory Firms Over Proxy Votes.* As of May 13, 2016, S&P 500 companies holding say on pay votes which experienced a change in the proxy advisory firm recommendation on their say on pay proposal from “For” in 2015 to “Against” in 2016 experienced a decrease in support of over 31 percent, while companies receiving a positive recommendation received over 93 percent approval on average. This is nearly identical to the results from the complete 2015 proxy season. The data shows a strong link between the ISS recommendation and the resulting votes.

Several research reports and academic studies have catalogued the influence of proxy advisory firm recommendations on votes on shareholder proposals. For example:

- Opposition by a proxy advisor resulted in a “20% increase in negative votes cast” according to a 2012 study by David F. Larcker, Allan L. McCall and Gaizka Ormazabal.<sup>3</sup>
- An academic study found that a negative vote recommendation by ISS on a management proposal resulted in a reduction in affirmative votes by 13.6 percent to 20.6 percent.<sup>4</sup>

One of the most notable changes in proxy votes over the last six years has been the introduction of annual nonbinding votes on executive compensation. The Larcker research mentioned above found that among 2,008 firms in the Russell 3000, “firms that received a negative recommendation by ISS (Glass Lewis) obtained an average 68.68% (76.18%) voting support in SOP proposals. In contrast, firms that did not receive a negative recommendation from ISS (GL) obtained an average of 93.4% (93.7%) support in those proposals.”<sup>5</sup> The Larcker research is generally consistent with Center research.

*Influence of ISS Voting Policies on Corporate Executive Compensation Programs.* The voting results do not fully capture changes that companies make to their compensation policies in order to “score” better under proxy voting policies, particularly those of ISS. In a 2014 survey conducted by the Center, 74 percent of respondents said they had changed or adopted a compensation plan, policy or practice in the past three years primarily to meet the standard of a proxy advisory firm. This is consistent with a 2012 survey by the Conference Board, NASDAQ and the Stanford University Rock Center for Corporate Governance which found that over 70 percent of directors and executive officers stated that their compensation programs were influenced by proxy advisory firm policies or guidelines.<sup>6</sup>

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<sup>3</sup> David F. Larcker, *The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policies*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION, November 12, 2012, <http://blogs.law.harvard.edu/corpgov/2012/11/12/the-economic-consequences-of-proxy-advisor-say-on-pay-voting-policies/> (last visited May 3, 2016).

<sup>4</sup> Jennifer E. Bethel & Stuart L. Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting*, FINANCIAL MANAGEMENT 29, 30 (Winter 2002).

<sup>5</sup> Larcker *supra* note 3.

<sup>6</sup> The Conference Board, *The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions* (2012), <https://www.conference-board.org/retrievefile.cfm?filename=TCB-DN-V4N5-12.pdf&type=subsite>.

#### **IV. The Regulatory Framework Has Reinforced Proxy Advisory Firm Influence**

Proxy advisory firms have grown influential due in large part to two regulatory pronouncements, one by the U.S. Department of Labor, which announced the proxy voting duties of ERISA retirement plan sponsors in a 1988 opinion letter, and one by the SEC, which published rules related to proxy voting in 2003. The DOL letter, commonly known as the “Avon Letter,” stated that shareholder voting rights were considered valuable pension plan assets under ERISA, and therefore the fiduciary duties of loyalty and prudence applied to proxy voting. The Avon Letter stated:

In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock. For example, it is the Department’s position that the decision as to how proxies should be voted ... are fiduciary acts of plan asset management.<sup>7</sup>

The Avon Letter further stated that pension fund fiduciaries, including those that delegate proxy voting responsibilities to their investment managers, had a responsibility to monitor and keep accurate records of their proxy voting.<sup>8</sup>

The SEC further reinforced the concept of fiduciary duties related to proxy voting in 2003 by adopting a rule and amendments under the Investment Advisers Act of 1940 pertaining to mutual funds and investment advisers designed to encourage funds to vote their proxies in the best interests of their shareholders.<sup>9</sup> The new regulations required mutual funds to: 1) disclose their policies and procedures related to proxy voting and 2) file annually with the Commission a public report on how they voted on each proxy issue at portfolio companies.<sup>10</sup>

Similarly, investment advisers were required to: 1) adopt written proxy voting policies and procedures describing how the adviser addressed material conflicts between its interests and those of its clients with respect to proxy voting and how the adviser would resolve those conflicts in the best interests of clients; 2) disclose to clients how they could obtain information from the adviser on how it had voted proxies; and 3) describe to clients all proxy voting policies and procedures and, upon request, furnish a copy to them.<sup>11</sup>

As part of the 2003 regulations, the SEC also commented on how investment advisers could deal with conflicts of interest related to proxy voting that might arise between advisers and their clients, stating that “an adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party.”<sup>12</sup> In practice, this commentary provided a considerable degree of fiduciary “cover” to

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<sup>7</sup> Letter from Allan Lebowitz, Deputy Assistant Sec’y of the Pension Welfare Benefits Admin. at the U.S. Dep’t of Labor, to Helmuth Fandl, Chairman of the Ret. Bd., Avon Products, Inc. (Feb. 23, 1988).

<sup>8</sup> *Id.*

<sup>9</sup> Sec. Exch. Comm’n, Final Rule: Proxy Voting by Investment Advisers, Advisers Act Release No. 1A-2106, 17 C.F.R. § 275 (Jan. 31, 2003).

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

investment managers who chose to follow the voting recommendations of proxy advisory firms and reinforced the value of using such firms. In a letter to Egan-Jones Proxy Services in May 2004, however, the SEC articulated a duty for investment advisers to monitor and verify that a proxy advisor was independent and free of influence:

An investment adviser that retains a third party to make recommendations regarding how to vote its clients' proxies should take reasonable steps to verify that the third party is in fact independent of the adviser based on all of the relevant facts and circumstances. A third party generally would be independent of an investment adviser if that person is free from influence or any incentive to recommend that the proxies should be voted in anyone's interest other than the adviser's clients.<sup>13</sup>

As discussed below, this was reinforced in Staff Legal Bulletin 20, issued in 2014.

The Egan Jones letter also addressed whether the SEC would consider a proxy advisory firm to provide independent advice to investors if it receives compensation from an issuer for providing advice on corporate governance issues. In reply, the SEC Staff stated, “We believe that the mere fact that the proxy voting firm provides advice on corporate governance issues and receives compensation from the Issuer for these services generally would not affect the firm's independence from an investment adviser.”<sup>14</sup> This opinion reinforced the business model that ISS has employed, and which has arguably encouraged the proxy advisor’s consulting arm to engage in aggressive and perhaps even misleading marketing techniques.

Although the intent of the SEC’s 2003 rules was to provide a flexible means for mutual funds to execute proxy votes in the discharge of their clients’ fiduciary duties, in reality it allowed mutual funds to shift that duty to proxy advisory firms. This led then Delaware Court of Chancery Vice Chancellor Leo Strine to remark that “[t]he influence of ISS and its competitors over institutional investor voting behavior is so considerable that traditionalists will be concerned that any initiative to increase stockholder power will simply shift more clout to firms of this kind.”<sup>15</sup>

## **V. Conflicts of Interest and Inaccuracies Undermine Confidence in Proxy Advisory Firm Processes**

Proxy advisors are currently afforded a considerable degree of deference under SEC interpretations because superficially they are considered “independent” of the investment advisors that use their services. Yet proxy advisory firms have significant conflicts of interest in the services they provide and in how they are structured. These conflicts have been the subject of two reports by the federal government’s auditing arm, the U.S.

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<sup>13</sup> Letter from Douglas Scheidt, Associate Director and Chief Counsel, Sec. Exch. Comm’n, to Kent Hughes, Managing Director, Egan-Jones Proxy Services (May 27, 2004) available at <https://www.sec.gov/divisions/investment/noaction/egan052704.htm>.

<sup>14</sup> Egan-Jones Proxy Advisory Services (May 27, 2004) available at <https://www.sec.gov/divisions/investment/noaction/egan052704.htm>

<sup>15</sup> Leo E. Strine Jr., *Toward a True Corporate Republic: A Traditional Response to Lucian’s Solutions for Improving Corporate America*, Harvard Law School John M. Olin Center for Law, Economics and Business, Discussion Paper Series, No. 541, 11 (2006), [http://lsr.nellco.org/harvard\\_olin/541](http://lsr.nellco.org/harvard_olin/541).

Government Accountability Office (GAO), and they have been frequently criticized by companies and institutional investors. They also were the subject of questions in the SEC's concept release on the U.S. proxy system.

*ISS Provides "Independent" Analysis of Company Practices While Offering Consulting Services to Those Same Companies.* Despite frequent criticism by the government and others over the past 19 years, ISS, the largest and most influential firm, continues to provide analyses and voting recommendations of proxy issues to be put to a shareholder vote while also providing consulting services to corporations whose proposals they evaluate. This led the GAO to note that "corporations could feel obligated to subscribe to ISS's consulting services in order to obtain favorable proxy vote recommendations on their proposals and favorable corporate governance ratings."<sup>16</sup> Similarly, a report by the Yale Millstein Center for Corporate Governance stated that many companies believe that "signing up for [ISS] consulting provides an advantage in how the firm assesses their governance" despite ISS disclaimers to the contrary.<sup>17</sup>

ISS also provides consulting to its institutional investor clients who wish to offer a shareholder proposal on how to tailor the proposal.<sup>18</sup>

These practices have been criticized by both institutional investors and corporations because ISS determinations and related consulting often drive what is considered best practice, even if the practice may not be in the best interest of the companies or their shareholders. ISS acknowledged this fact in its FY 2013 10-K filing, stating "when we provide corporate governance services to a corporate client and at the same time provide proxy vote recommendations to institutional clients regarding that corporation's proxy items, there may be a perception that the Governance business team providing research to our institutional clients may treat that corporation more favorably due to its use of services provided by ISS Corporate Services."<sup>19</sup>

ISS has argued that it provides a firewall between its corporate consulting and its advisory businesses, but the separation can only go so far. For example, ISS seeks to reinforce the separation by telling corporate clients that when they meet with proxy analysis staff, they should refrain from discussing whether the client has received consulting services from the other side of ISS.

*Despite Claims of a Firewall, Examples Reinforce How ISS Consulting Uses Its Relationship With ISS Research to Sell Business.* The ISS firewall may not be as impenetrable as it is made to seem—at least if documented examples regarding the marketing techniques of ISS Corporate Solutions continue to hold. In September 2013,

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<sup>16</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING, GAO-07-765, 10 (2007).

<sup>17</sup> Meagan Thompson-Mann, *Voting Integrity: Practice for Investors and the Global Proxy Advisory Industry* 9 (Yale Sch. of Mgmt. Millstein Ctr. for Corporate Governance & Performance, Policy Briefing No. 3, 2009).

<sup>18</sup> *Id.* at 12.

<sup>19</sup> MSCI Inc. Annual Report (Form 10-K) at 37, February 28, 2014, <https://www.sec.gov/Archives/edgar/data/1408198/000119312514077882/d640965d10k.htm>. ISS was then owned by MSCI, Inc., which provides financial data and ratios. ISS is now owned by a private equity firm and therefore no longer files public financial statements.



ISS Corporate Solutions sent an email to a company, referencing the fact that in the spring of 2013, when the research side of ISS recommended its clients vote against the company's say on pay vote (in its non-custom voting recommendation), the company's say on pay resolution received the support of just above 68% of its shareholders. The email said that ISS research would be subjecting the company to a higher level of scrutiny in 2014 and solicited a meeting with the consulting side, stating:

“We were going to provide you with a better understanding of the reasons for ISS's negative vote recommendation on your 2013 Advisory Vote on Executive Compensation and what you expect [sic] in terms of additional scrutiny from ISS's Research side on this issue next year.”

A call was set up, during which the ISS consulting representative referenced very high success rates (over 90%) in say on pay votes for companies that engaged ISS Corporate Services after receiving a low vote. The exchange left the impression that by engaging ISS Corporate Services, the company would receive advice and information unavailable elsewhere and that it would give the company an advantage when the ISS research side analyzed its 2014 proxy, similar to the concerns expressed by GAO and other observers. (The full description of the exchange is reproduced in Appendix A).

When confronted with the example at the SEC's December 2013 Proxy Advisory Firm Roundtable, ISS President Gary Retelny said “I'm disappointed they used those words,” denying that there was any breach of the firewall, but acknowledging that the representative was supposed to “drum up business.”<sup>20</sup>

The Center is aware of other similar examples of very aggressive marketing that confused clients of the ISS consulting arm into thinking that it was the ISS research arm.

*Potential Conflict Related to Proxy Advisory Firms Providing Recommendations on Shareholder Initiatives Backed By Their Owners or Institutional Investor Clients.* Some proxy advisory firm clients are also proponents of shareholder resolutions. According to the Government Accountability Office, “[t]his raises concern that proxy advisory firms will make favorable recommendations to other institutional investor clients on such proposals in order to maintain the business of the investor clients that submitted these proposals.”<sup>21</sup> Other than boilerplate language, there is no specific identification that a shareholder proponent is an ISS client.

*Conflicts in Ownership Structure.* Glass, Lewis & Co. (the second largest advisor) is owned by the \$170 billion Ontario Teachers' Pension Plan Board which engages in public and private equity investing in corporations on which Glass Lewis makes recommendations. Although Glass Lewis states that it will add a note to the research report of any company in which the Ontario Teachers' Pension Plan has a significant stake, the lack of transparency in the Glass Lewis model and the fact that it does not share draft reports with corporations has raised concerns about potential independence issues.

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<sup>20</sup> See Transcript, U.S. Sec. & Exch. Comm'n, Proxy Advisory Firms Roundtable, Dec. 5, 2013, at 56 available at <https://www.sec.gov/spotlight/proxy-advisory-services/proxy-advisory-services-transcript.txt>

<sup>21</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING, GAO-07-765, 10 (2007).

The potential ramifications of a proxy advisory industry with readily recognizable conflicts of interest that wields great power over capital markets and the market for corporate governance and control, which is subject to little regulatory oversight, mirror those that occurred in the credit ratings agency industry before the 2008 economic meltdown.

*Policy Setting: Is It Truly a Reflection of Investor Clients' Views?* Of the two major proxy advisory firms, ISS has by far the clearest and most transparent policy development process. However, the process ISS follows to develop and refine the policies by which it analyzes thousands of company proxies involves a survey which is often relied upon in making changes but that typically does not have robust investor involvement. Last year's survey incorporated feedback from only 109 institutional investors (42% under \$10 billion in assets) and 257 corporate issuers.<sup>22</sup>

ISS notes that in addition to the survey, its Policy Board incorporates input from "roundtables with industry groups and ongoing feedback during proxy season" as well as informal discussions.<sup>23</sup>

Although analyses by proxy advisory firms have improved in recent years, the overall concerns remain with the policies through which proxy advisory firms exert significant influence over proxy voting and executive compensation and governance practices. The SEC's Concept Release on the proxy advisory system took a positive step to review concerns with proxy advisory firm practices, but with other rulemaking items likely to take priority, further legislative and regulatory oversight is in order.

*Inaccuracies in Proxy Advisory Service Reports and Lack of Transparent Methodologies Add to Skepticism Over Analytical Rigor.* In addition to questions about pay for performance methodologies and conflicts of interest, a serious concern lies with the issue of inaccuracies. This is significant because inaccurate information could lead institutional investors to voting decisions that are not supported by the facts.

A 2014 survey of Center On Executive Compensation Subscribers – chief human resource officers of large companies -- found that of those responding, 55 percent said that a proxy advisory firm had made one or more mistakes in a final published report on the company's compensation programs. Half of those Subscribers reported receiving multiple instances of erroneous or inaccurate information.

Unfortunately, such errors are not uncommon, and it is the issuer that bears responsibility for checking the quality of the "expert" proxy advisory firm's assessment. For example, the Center is aware of one case where a proxy advisory firm issued its research report on a company to investors using the prior fiscal year's financial data. Although the firm issued a revised report to investors, given that many investors file their votes very shortly after a proxy advisory firm report is issued, the potential for harm clearly existed. In addition, as we have previously reported, the Center is aware of

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<sup>22</sup> Institutional Shareholder Services, 2015-2016 Policy Survey Summary of Results (Sept. 28, 2015), at 3.

<sup>23</sup> Institutional Shareholder Services, <https://www.issgovernance.com/policy-gateway/policy-formulation-application/>.

another company that found a significant error by a proxy advisory firm. It took some time before the proxy advisory firm responded. Although the error was corrected and the proxy advisory firm changed the recommendation, the change was made within a week of the say on pay vote, and majority of shares had already been voted. The revised report did not draw investor attention to the change, and the clients would have had to review the minutia in the report to see that the recommendation had been altered.

Two principal reasons for such inaccuracies appear to be the workload pressures caused by the tremendous growth in the length of proxy disclosures and inadequate quality control as proxy advisory firms seek to reduce costs, including by outsourcing proxy analysis. Another reason for the inaccuracies is the unreasonably short time proxy advisors give large companies to review drafts of reports and to suggest corrections before a final report is issued, and the fact that companies outside of the S&P 500 do not have that opportunity.

The Center believes that proxy advisory firms should ensure to the greatest extent possible that accurate information is transmitted to institutional investors. Where information is found to be inaccurate, the proxy advisors should be required to correct their analyses and clearly point out the correction to their clients the correction. Where there is a disagreement between the advisor and the company, the advisor should include a statement from the company discussing the rationale for its disagreement. Additionally, institutional investors should be required to closely monitor the output of proxy advisory firms, and the SEC should be required to do periodic reviews of advisor reports for accuracy and clarity.

*Questionable Conclusions From Research on CEO/Chair Separation Serve As Illustration for Why Oversight Is Needed.* Another reason regulatory oversight would be helpful is the questionable nature of certain proxy advisory firm research. For example, in March 2016, ISS research released a short report looking at S&P 500 companies that had independent Board Chairs and CEOs, those that had combined chairs and CEOs, and those for which the board was an “affiliated outsider” and a chair that was an insider, but not the CEO. The report concluded that “it appears that independent board chairs may provide the most effective check to the CEO, at least in terms of compensation determination.”<sup>24</sup> As pointed out by a Jones Day analysis, the conclusions, which were based on an analysis of compensation data for the company’s three most recent fiscal years, masked the fact that the most significant influence on CEO pay level was company size as measured by revenue, which had a correlation that was 2.5 times greater.<sup>25</sup> It also ignored the fact that compensation decisions are still required to be approved by an independent compensation committee. The timing (beginning of proxy season), rigor and conclusions of the report make it appear as if it was submitted to encourage support for shareholder proposals seeking independent chairs, despite the data.

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<sup>24</sup> Steven Silberglied and Zachary Friesner, Board Leadership Structure: Impact on CEO Pay, Institutional Shareholder Services, Mar. 9, 2016, available at <https://www.issgovernance.com/library/2016-board-structure-and-ceo-pay>.

<sup>25</sup> Jones Day, Questioning Recent ISS Study on the Impact of Board Leadership Structures on CEO Pay, April 2016, <http://www.jonesday.com/questioning-recent-iss-study-on-the-impact-of-board-leadership-structures-on-ceo-pay-04-20-2016/>.

## **VI. The Role of Regulatory Oversight in Reinforcing Proxy Advisory Firm Accountability**

The Center has consistently believed that regulatory approaches to address the shortcomings discussed above should be carefully pursued. In 2013, we used the example of significant concern by issuers and investors that the peer groups ISS was using to determine its pay for performance comparisons did not fit with the size or industry of the company's business.<sup>26</sup> Attention and oversight by the Division of Corporation Finance and press exposure resulted in ISS making material changes in the methodology it uses to determine and refine peer groups for the purposes of assessing company pay plans.

The Center had hoped that the Staff Legal Bulletin 20<sup>27</sup> would facilitate greater responsiveness of the proxy advisory firms and oversight by institutional investors, as well as the SEC. The interpretations in SLB 20 were welcomed in that they reinforced the role of institutional investors taking affirmative steps to ensure that proxy advisory firms have the capacity and competency to make accurate recommendations. However, in practice, the staff's interpretations with respect to addressing the conflicts of interest inherent in the research and recommendations provided to most clients were not materially affected by the bulletin.

## **VII. The Proxy Advisory Firm Reform Act Would Facilitate Ongoing Regulatory Oversight of Proxy Advisory Firms**

The Center supports the Proxy Advisory Firm Reform Act as a means of taking a more deliberate approach to regulatory oversight of the proxy advisory firm industry and formalizing the way the SEC monitors the industry. In addition to registration of proxy advisory firms, the most important aspect of the bill is the mandated withdrawal of the two no-action letters which have facilitated the market status quo for proxy advisory firms while also stating there is not a conflict of interest for proxy advisors to provide consulting while simultaneously providing so-called independent research and analysis. Addressing such conflicts are especially important where a proxy advisory firm consults with an investor client that is also a shareholder resolution proponent and the proxy advisory firm is making voting recommendations on the investor's shareholder resolution.

As explained above, the Center believes that the practice of providing consulting services and research under the same entity should be carefully evaluated and addressed. Financial relationships and conflicts in the proxy advisory industry should be made transparent to investors. Targeted conflicts should include significant financial or business relationships between proxy advisory firms (or their parent or affiliate firms) and public companies, institutional investors or shareholder activists. Such disclosure

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<sup>26</sup> See Testimony of Timothy J. Bartl, President, Center On Executive Compensation, House Subcommittee on Capital Markets and Government Sponsored Enterprises, June 5, 2013, <http://financialservices.house.gov/uploadedfiles/hhrg-113-ba16-wstate-tbartl-20130605.pdf>

<sup>27</sup> Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms, SLB No. 20, June 30, 2014, available at <https://www.sec.gov/interps/legal/cfs1b20.htm>.

would throw open to public scrutiny and academic study a wealth of information about potential conflicts of interest in the industry. Investors and academic researchers could study whether corporate shareholder votes are being “bought and sold” and the extent to which fees paid to proxy advisory firms are, in fact, influencing vote recommendations. Such scrutiny would quickly provide concrete evidence as to whether the “firewalls” and other safeguards the industry has instituted are effective in mitigating the conflicts.

The Center believes that by adding an annual review of the proxy advisory firm industry through an annual report to the SEC, concerns such as those raised in 2012 with respect to ISS’s peer group determination and concerns which gave rise to the 2013 SEC proxy advisory firm roundtable would be surfaced and addressed more quickly.

In sum, the Center believes that the services provided by proxy advisory firms are an important part of the proxy process that helps investors discharge their duty to vote their proxies. Yet, we agree with former SEC Commissioner Dan Gallagher and many other commentators that a more thoughtful approach to the regulatory structure of the industry is necessary, given the substantial influence that proxy advisors have in the proxy process. The Center supports the Proxy Advisory Firm Reform Act to begin that process of reshaping the oversight of the industry.

## **VIII. Conclusion**

The Center appreciates the opportunity to provide its views on this extremely important policy matter. We look forward to working with you and members of your staffs to ensure that the proxy voting system and advice by proxy advisory firms are increasingly transparent and consistent.

## **Email Exchange Between ISS Corporate Services and Motorola Solutions Demonstrates Why Conflicts of Interest Must Be Addressed**

### *Exchange Leaves Perception That ISS Consultant Had Unique Insight Into ISS Research Team Approach*

One of the core criticisms of proxy advisory firms is the existence of conflicts of interest in their business or ownership structures. With respect to Institutional Shareholder Services, the Center On Executive Compensation and other observers have criticized the conflict of interest between providing consulting services to some of the same issuers on which ISS provides “independent” proxy voting research and recommendations to institutional clients. Despite assurances that the research and consulting arms are separate, the attached recent email exchange between an ISS Corporate Services client representative and a securities counsel at Motorola Solutions demonstrates how the marketing of ISS’s consulting services blurs those distinctions.

- In 2013, Motorola Solutions received a no vote recommendation from ISS on its say on pay resolution. Just over 68 percent of Motorola Solutions’ shareholders voted in favor of say on pay.
- On September 17, 2013, Motorola’s ISS client representative sent an email to his contact in the securities law department of Motorola Solutions stating:

“[D]ue to the 2013 negative vote recommendation for [other company’s]<sup>1</sup> Advisory Vote on Executive Compensation and/or the fact that the proposal received less than 70% voting support (ballot item #2 in the attached analysis), ISS’s Research division will be subjecting your next executive compensation proposal to a greater level of scrutiny.

I did want to offer you a chance to talk with one of our senior corporate advisors in order to better understand what this scrutiny will entail. If you’d like to do this at some point, please let me know.”

- On September 25, the Motorola Solutions contact responded and asked to set up a call for October 8.
- On September 26, the Motorola Solutions contact requested that someone from the research side of ISS responsible for analyzing the company join the call.

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<sup>1</sup> It appears that the representative had sent several emails to companies that had received negative ISS recommendations or say on pay votes below 70%. The representative intended to use Motorola Solution’s stock ticker here but forgot to change the email. As a result, the ticker referred to another company that also received a no recommendation and had a low say on pay vote. The Center has confirmed that that company also received a similar email.

- ISS Corporate Services did not arrange for a representative from the research side to be on the call; however, the ISS representative did make it appear as if Corporate Services had unique insight into how the research side analyzed the company in 2013 and the additional scrutiny it would apply in 2014:

“We were going to provide you with a better understanding of the reasons for ISS’s negative vote recommendation on your 2013 Advisory Vote on Executive Compensation and what you expect [*sic*] in terms of additional scrutiny from ISS’s Research side on this issue next year.”

- Although not articulated in the email exchange, during the phone call the ISS representative made reference to very high success rates (over 90%) in say on pay votes for companies that engaged ISS Corporate Services after receiving a low vote.

The exchange leaves the impression that by engaging ISS Corporate Services, Motorola Solutions would receive advice and information unavailable elsewhere and that it would give the company an advantage when the ISS research side goes on to analyze its 2014 proxy. In essence, some companies view retaining ISS Corporate Services as giving them a guaranty or at least a greater chance at receiving a favorable evaluation from the research side. The full email is attached. Despite the provocative language hinting at an inside view of ISS research, it contains no disclaimers or warnings that ISS Corporate Services is separate from ISS research and that there is no exchange of information between the two entities.

The exchange is a good example of why such conflicts of interest should be addressed either by the SEC or by a code of conduct.

**From:** [REDACTED] [mailto:[REDACTED]@isscorporateservices.com]  
**Sent:** Tuesday, September 17, 2013 12:41 PM  
**To:** [REDACTED]  
**Subject:** Alert for MSI due to ISS Negative Vote Recommendation in 2013

Hi [REDACTED]:

Just wanted to be sure that you were aware that, due to the 2013 negative vote recommendation for [REDACTED] Advisory Vote on Executive Compensation and/or the fact that the proposal received less than 70% voting support (ballot item #2 in the attached analysis), ISS's Research division will be subjecting your next executive compensation proposal to a greater level of scrutiny.

I did want to offer you a chance to talk with one of our senior corporate advisors in order to better understand what this scrutiny will entail.

If you'd like to do this at some point, please let me know.

Best Regards,

[REDACTED]

ISS Corporate Programs

301-[REDACTED]-[REDACTED]

**From:** [REDACTED] [mailto:[REDACTED]@motorolasolutions.com]  
**Sent:** Wednesday, September 25, 2013 2:00 PM  
**To:** [REDACTED]  
**Subject:** RE: Alert for MSI due to ISS Negative Vote Recommendation in 2013

[REDACTED], thank you for the offer to discuss. We would be interested in speaking with your team regarding this matter. It appears that all necessary MSI participants are available on the afternoon of Tuesday, October 8<sup>th</sup> after 1 p.m. Central Time. If your corporate advisor has availability that day, please let me know and we can schedule a call.

Thank you.

[REDACTED]

Corporate, Securities and Transactions  
**Motorola Solutions, Inc.**  
[motorolasolutions.com](http://motorolasolutions.com)

**O:** [REDACTED]  
**M:** [REDACTED]  
**E:** [REDACTED]@motorolasolutions.com





**From:** [REDACTED] [mailto:[REDACTED]@motorolasolutions.com]  
**Sent:** Thursday, September 26, 2013 11:14 AM  
**To:** [REDACTED]  
**Subject:** RE: Alert for MSI due to ISS Negative Vote Recommendation in 2013

[REDACTED],

Thank you for your response. If possible, we would also like to have someone from the Research side familiar with our company attend the call and also [REDACTED], if he is available.

Thank you.

[REDACTED]

[REDACTED]

Corporate, Securities and Transactions  
**Motorola Solutions, Inc.**  
[motorolasolutions.com](http://motorolasolutions.com)

**O:** [REDACTED]  
**M:** [REDACTED]  
**E:** [REDACTED]@motorolasolutions.com

**From:** [REDACTED] [mailto:[REDACTED]@motorolasolutions.com]  
**Sent:** Monday, October 07, 2013 5:42 PM  
**To:** [REDACTED]  
**Cc:** [REDACTED]  
**Subject:** RE: Alert for MSI due to ISS Negative Vote Recommendation in 2013

Great, thank you. We can use my dial in: 1-877-[REDACTED]-[REDACTED]; passcode [REDACTED]

Also, can you please provide a brief outline of the discussion topics so that we are fully prepared?

Thank you.

[REDACTED]

Corporate, Securities and Transactions  
**Motorola Solutions, Inc.**  
[motorolasolutions.com](http://motorolasolutions.com)

**O:** [REDACTED]  
**M:** [REDACTED]  
**E:** [REDACTED]@motorolasolutions.com

**From:** [REDACTED] [mailto:[REDACTED]@isscorporateservices.com]

**Sent:** Tuesday, October 08, 2013 8:22 AM

**To:** [REDACTED]

**Subject:** RE: Alert for MSI due to ISS Negative Vote Recommendation in 2013

Hi [REDACTED]:

Glad to help!

We were going to provide you with a better understanding of the reasons for ISS's negative vote recommendation on your 2013 Advisory Vote on Executive Compensation and what you expect in terms of additional scrutiny from ISS's Research side on this issue next year.


Best Regards,

[REDACTED]

United States House of Representatives  
Committee on Financial Services

“TRUTH IN TESTIMONY” DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

<b>1. Name:</b> Timothy J. Bartl	<b>2. Organization or organizations you are representing:</b> Center On Executive Compensation
<b>3. Business Address and telephone number:</b> 1100 13th St. NW Suite 800 Washington, DC 20005 202-408-8181	
<b>4. Have <u>you</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2012 related to the subject on which you have been invited to testify?</b>  <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	<b>5. Have any of the <u>organizations you are representing</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2012 related to the subject on which you have been invited to testify?</b>  <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
<b>6. If you answered “yes” to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.</b>	
<b>7. Signature:</b> 	

*Please attach a copy of this form to your written testimony.*