February 3, 2011

Office of Regulations and Interpretations
Employee Benefits Security Administration
Attn: Definition of Fiduciary Proposed Rule
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

RE: Comments on Definition of Fiduciary Proposed Rule

Dear Sir or Madam:

The Center On Executive Compensation (the "Center") is pleased to submit comments regarding the Department of Labor's (the "Department") proposed regulation ("Proposed Regulation") under the Employee Retirement Income Security Act of 1974, as amended ("ERISA") that will redefine the term fiduciary under section 3(21) of ERISA and section 4975(e) of the Internal Revenue Code of 1986, as amended (the "Code"). We appreciate the opportunity to provide comments.

The Center is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy from the perspective of the senior human resource officers of leading companies. The Center is a division of HR Policy Association, which represents the chief human resource officers of over 300 large companies, and the Center's more than 70 Subscribing Companies are HR Policy members that represent a broad cross-section of industries. Because senior human resource officers play a unique role in serving on or supporting ERISA plan committees and also in advising compensation committees on compensation and related governance issues, we believe the Center's views can be particularly helpful in understanding the implications of the Proposed Regulations on the proxy voting process for ERISA plans and other institutional investors.

This comment letter narrowly focuses on the issues raised in the Department's Proposed Regulation with respect to the fiduciary status of proxy advisory firms. The Center does not endorse the broad definition of fiduciary in the Proposed Regulation. While the Center supports the intent behind the Proposed Regulation to protect ERISA plan participants, we believe that the far-reaching effects of the Proposed Regulation would have unintended consequences, including increasing plan costs. At the same time, the Center is very concerned that proxy advisory firms are insufficiently regulated and that the current lack of oversight of proxy advisory firms has permitted alarming conflicts of interest and material inaccuracies in the reports provided to institutional investors, including ERISA plans, and that these practices also harm plans and participants.

The Center therefore urges the Department not to broadly expand the definition of fiduciary in the Proposed Regulation, and instead **undertake a comprehensive review of proxy advisory firms**, as outlined in our comments below.

Our detailed comments on these issues and request to testify at the hearing on the Proposed Regulation follow. We would also be pleased to meet with the Department separately to discuss the proxy voting process as it affects employee benefit plans.

I. Proxy Advisory Firms

A. Background

Proxy voting recommendations were introduced by proxy advisory firms in the mid-1980s to satisfy a demand that had grown in response to dramatic changes in the nature of share ownership. Institutional investors now own 76.4 percent of the 1,000 largest American corporations, a dramatic increase from 1987, when they held less than 47 percent, while over this period retail share ownership has declined. At the same time, the volume of proxy votes has grown tremendously as the Securities and Exchange Commission (the "SEC") has expanded the categories of subjects that shareholder proposals could address. Together, these factors have meant that institutional investors, including many ERISA plans, which hold thousands of equity securities in their portfolios, are required to vote exponentially more proxy votes.

Retirement plan fiduciaries, bound by ERISA's fiduciary duties, must vote proxies solely in the best interests of their plan participants and beneficiaries. To properly exercise their duties, institutional investors must have conducted due diligence and become informed on the topics on which they are voting. In order to discharge their responsibilities, institutional investors have sought outside assistance in researching and analyzing the proxy statements of the companies in which they have a stake and, as a result, have purchased analyses and voting recommendations from proxy advisory firms.

Given the dramatic increase in the volume of proxy votes, institutional investors have increasingly relied on the recommendations of proxy advisors in determining their proxy votes. Most industry observers agree that proxy advisors have a significant influence on vote outcomes. Delaware Court of Chancery Vice Chancellor Leo E. Strine, Jr. commented 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."[1] Academic research has shown that if ISS, the dominant proxy advisory firm, issues a negative recommendation on a management proposal, it can reduce

[1] 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.

the support of institutional investors by up to 20 percent thereby setting up ISS as the *de facto* pay and governance police for American corporations.[2]

B. Current Regulatory Environment

Given the tremendous influence that proxy advisory firms wield, one would think that they are a heavily regulated industry. In fact, however, proxy advisory firms are overseen by a patchwork of regulation and, where regulation exists, it is unclear that it is effective.

The Investment Advisers Act of 1940 (the "Act") is the principal regulatory scheme that would apply to proxy advisory firms. The SEC has stated that it considers proxy advisory firms to be investment advisers "because they, for compensation, engage in the business of issuing reports or analyses concerning securities and providing advice to others as to the value of securities."[3] Although the SEC has asserted that proxy advisory firms meet the definition of advisers under the Act, proxy advisory firms may elect whether to register under the Act. Additionally, the Act contains a prohibition against registering if the firm has less than $25 million in assets under management.[4] This prohibition applies to proxy advisory firms since they do not manage client assets. Moreover, the prohibition is subject to several exemptions, including one that allows firms to register if they serve as consultants to pension plan clients with a minimum of $50 million in assets. Currently only one of the two predominant proxy advisory firms, ISS, is registered with the SEC as an investment adviser using the pension consultant exemption.[5]

There are some provisions of the Act that apply to proxy advisory firms regardless of whether they are registered with the SEC as an investment adviser. The provision of greatest importance prohibits a proxy advisory firm from engaging in "any transaction, practice or course of business which operates as a fraud or deceit on any client or prospective client."[6]

This prohibition against fraud or deceit governing the proxy advisory industry is one relating to fiduciary duties. The SEC has stated that a proxy advisory firm owes fiduciary duties to its clients, which entails a "duty of care requiring [the proxy advisory firm] to make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information."[7] The impact of this regulation has led many to question whether these duties serve as any real restraint on the behavior of the proxy advisory industry. As outlined below, the business model and ownership structure of the proxy advisory industry are riddled

---

[2] Jennifer E. Bethel & Stuart L. Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting,* FINANCIAL MANAGEMENT 29, 34 (Winter 2002).
[3] Sec. Exch. Comm'n, Concept Release on the U.S. Proxy System, Release No. 34-62493, 110 (July 14, 2010).
[4] National Securities Markets Improvements Act of 1996, Pub. L. 104-290, 110 Stat. 3416 (1996).
[5] A third proxy advisory firm, Proxy Governance, Inc., ceased operations as of December 31, 2010, and the second largest proxy advisory firm, Glass Lewis, which is not registered with the SEC, assumed the contracts of the firm's clients.
[6] Investment Advisers Act of 1940 § 206-2, 15 U.S.C. § 80b-6(2).
[7] Sec. Exch. Comm'n , Concept Release on the U.S. Proxy System, Release No. 34-62493, 119 (July 14, 2010).

with conflicts of interest. There are conflicts between the clients that proxy advisory firms serve and there is seemingly no obligation to ensure the accuracy of the analyses and voting recommendations that those firms offer to their clients.

C. Problems with Current Practices

The current practices of proxy advisory firms are riddled with several problems. These include conflicts of with respect to clients and ownership, and material inaccuracies that could impact the outcome of proxy votes.

i. Conflicts of Interest

The most pressing problem with the proxy advisory industry is the existence of significant conflicts of interest. Proxy advisors are afforded considerable deference by the SEC because they are considered to be providing "independent" opinions and voting recommendations to their institutional clients. Yet, this independence is only superficial since there are conflicts of interest in the services that are provided and how these firms are structured. These conflicts of interest affect the integrity of the proxy advisors' analyses and voting recommendations.

Proxy advisory firms research and review the required proxy disclosures filed by public companies in order to make recommendations to their clients on how to vote. This service, which is intended to be "independent," allows institutional investors to more efficiently discharge their voting responsibilities as it is extremely difficult for institutional investors to adequately conduct the research necessary to make educated decisions to vote proxies for the hundreds of companies contained in their portfolios.

ISS, the largest and most influential proxy advisory firm, engages in the worst form of conflict by providing so-called independent analyses of company practices while also offering consulting services to the same companies. The U.S. Government Accountability Office ("GAO") has studied this issue and has noted 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."[8] This vicious cycle is routinely criticized by both institutional investors and corporations, because ISS determinations and their related consulting shapes what is considered to be best practice, even if that practice may not be in the best interest of the companies or their shareholders. Graef Crystal, a former prominent compensation consultant turned author and compensation critic, has noted: "[ISS has] a severe conflict when they work both sides of the street. It's like the Middle Ages when the Pope was selling indulgences. ISS is selling advice to corporations on how to avoid getting on their list of bad companies. There's a veiled sense of intimidation."[9] The Center believes it is impossible

---

[8] 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).

[9] Wayne Leslie, *Have Shareholder Activists Lost Their Edge?*, N.Y. TIMES, Jan. 30 1994, at C7.

for a proxy advisory firm to offer both of these services and meet their fiduciary obligations under the Act to institutional investors.

ii. Ownership Structure Conflicts of Interest

There are conflicts of interest in the ownership structures at all proxy advisory firms. For example, the second largest proxy advisory firm, Glass, Lewis & Co., is owned by the Ontario Teachers' Pension Plan, which invests in companies on which Glass Lewis provides proxy voting recommendations. ISS is owned by MSCI, Inc., which provides other financial services to both corporate issuers and institutional investors.

These ownership structures certainly present situations where the interests of the parent company's clients diverge from that of the proxy advisory firm's clients. Moreover, when a parent company owns a significant stake in or has an ongoing business relationship with the companies on which the firm is making proxy voting recommendations, there is a cause for concern that the recommendations cannot truly be independent. It is reasonable to assume that the parent company would favor or lean on the proxy advisory firm to favor the public companies that they own or with whom they have a business relationship. Proxy advisory firms are not currently required to disclose these conflicts of interest; therefore, institutional investors are incapable of making informed decisions whether there is an impermissible conflict of interest or if the proxy advisor's recommendation or analysis has been compromised.

iii. Material Inaccuracies

The SEC has asserted that a proxy advisory firm owes fiduciary duties to its clients, holding a proxy advisory firm to a "duty of care requiring it to make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information."[10] In a 2010 survey of HR Policy Association members and Center On Executive Compensation Subscribers, 53 percent of respondents said that a proxy advisory firm had made one or more mistakes in a final, published report on the company's compensation programs in 2009 or 2010. The most common inaccuracies related to improper use of peer groups or peer group data in determining whether executive compensation levels were appropriate, erroneous analysis of long-term incentive plans and discussions of provisions that were no longer in effect. Companies are extremely concerned that these inaccuracies lead to voting decisions by institutional investors that will adversely impact the company and ultimately shareholders.

Industry cost pressures are most likely the cause of the material inaccuracy problem. The size of proxy disclosures and the volume of data and information that must be analyzed have grown exponentially in recent years as a result of changes in SEC proxy disclosure rules. Under pressure to increase profitability, some proxy advisory firms have resorted to outsourcing "data

[10] Sec. Exch. Comm'n , Concept Release on the U.S. Proxy System, Release No. 34-62493, 119 (July 14, 2010).

mining" and research functions to low cost labor countries. ISS, for example, has established a branch in the Philippines. Other proxy advisory firms hire third-party contract firms to procure and extract proxy statement information. For in-house work, a considerable amount of data collection is handled by seasonal, temporary employees. The fact that a substantial share of proxy analysis and voting recommendations is being done by foreign outsourced labor and temporary employees with limited business or proxy experience is extremely troubling and may serve as a partial explanation of why material inaccuracies have become such a problem.

Moreover, proxy advisory firms generally do not give most companies an opportunity to review their draft reports prior to the issuance of a final report. When a proxy advisory firm does allow a company to review a draft report, the company is given an unreasonably short period of time for review – typically, one to two days – to point out inaccuracies and suggest corrections before the final report is issued. Even then, there is no established process for making those corrections and no opportunity for an institutional investor to know of a disagreement between the proxy advisory firm and the company.

Inaccurate information in proxy advisor reports is capable of causing significant harm to companies and their investors. The recommendations of proxy advisors, which are heavily relied upon by institutional investors, can result in the failure of a compensation plan to be approved or votes against boards of directors. When these recommendations are made based on inaccurate information, both companies and shareholders alike are damaged. Moreover, companies often adjust their policies based on the actions of proxy advisory firms in order to ensure approval of plans and directors. Because these analyses and voting recommendations carry such significant influence, it is critical that they be based on accurate information. Additional regulation and oversight is necessary to ensure significant inaccuracies do not occur.

II. ERISA Fiduciary Analysis

A. Background

Section 3(21) of ERISA provides that a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

The Department has historically taken the view that the fiduciary act of managing plan assets includes exercising the legal rights that accompany ownership of securities and other property. Under ERISA, those rights may be exercised by the plan's trustee (including at the direction of a named fiduciary), or by an "investment manager" who has been properly appointed by the plan's named fiduciary. Specifically, section 402(c)(3) of ERISA provides that a named fiduciary may appoint an investment manager to manage plan assets. Section 3(38) of ERISA defines an

"investment manager" as (A) any fiduciary who has the power to manage, acquire or dispose of any plan asset, (B) who is (i) a registered investment advisor under the Investment Advisers Act of 1940 (or a state law in certain circumstances), (ii) a bank, or (iii) an insurance company; and (C) who has acknowledged in writing that he is a fiduciary with respect to the plan. In connection with proxy voting responsibilities, the Department has opined that an investment manager is not relieved of its own responsibilities and related liabilities merely because it followed the direction of some other person, or delegated its voting responsibility to some other person.[11]

The Center believes that a proxy advisory firm may properly be viewed as a fiduciary to the extent that the proxy advisor effectively exercises discretion over the proxy decision.[12] This would include, for instance, where the proxy advisor is acting as an "investment manager" and where a properly appointed investment manager has delegated its proxy voting responsibilities to the proxy advisor. In this regard, the Center also believes that an investment manager who merely follows the direction of such adviser would continue to be liable for the proxy voting decision.[13]

Although the Center agrees that proxy advisors may, in some circumstances properly be viewed as fiduciaries, the Center does not endorse the broad redefinition of fiduciary in the Proposed Regulation. The Center is concerned that the Proposed Regulation could significantly expand the circumstances under which numerous persons supporting the management of plan assets, but not exercising discretion over fiduciary decisions, would be deemed to be fiduciaries, and thus significantly increase plan costs and harm plan participants, fiduciaries, and sponsors.

B. <u>Proposed Regulation</u>

Under the Proposed Regulation, a person who "provides advice or makes recommendations as to the management of securities or other property" of an ERISA plan may be an ERISA fiduciary. The Preamble to the Proposed Rule provides that "[t]his would include, for instance, advice and recommendations as to the exercise of rights appurtenant to shares of stock (e.g., voting proxies)."[14]

---

[11] Department of Labor's letter to the Chairman of the Retirement Board of Avon Products, Inc. (February 23, 1988); Department of Labor's letter to Robert A.G. Monks of Institutional Shareholder Services, Inc. (January 23, 1990); DOL Interpretive Bulletins 94-2 and 2008-2.

[12] "While the ordinary functions of consultants or advisers to employee benefit plans (other than investment advisers) may not be considered as fiduciary functions, it must be recognized that there will be situations where such consultants and advisers may because of their special expertise, in effect, be exercising discretionary authority or control with respect to the management or administration of such plan or some authority or control regarding its assets." H.R. Rep. No. 93-1280, at 323 (1974) (Conf. Rep.).

[13] Department of Labor's letter to the Chairman of the Retirement Board of Avon Products, Inc. (February 23, 1988); Department of Labor's letter to Robert A.G. Monks of Institutional Shareholder Services, Inc. (January 23, 1990); DOL Interpretive Bulletins 94-2 and 2008-2.

[14] Dep't of Labor, Preamble to Definition of the Term "Fiduciary," 75 Fed. Reg. 65.263 (proposed Oct. 22, 2010) (to be codified at 29 C.F.R. § 2510).

The Center agrees with the Department's longstanding view that voting of proxies is an important fiduciary activity. Moreover, the Center strongly believes that retirement plans and other institutional investors responsible for voting proxies need to have access to accurate, unbiased information, provided free from conflicts of interest.

The Center is, however, concerned that the Proposed Regulation could potentially brand as fiduciaries numerous individuals and entities that provide basic services to plans that have not traditionally been considered fiduciary in nature. In particular, by expanding the category of investment advice to include any "advice or . . . recommendations as to the management of securities or other property," the Proposed Regulation could conceivably sweep in as a fiduciary any person who provides input to a plan, a plan fiduciary, or a plan participant or beneficiary regarding plan investments or plan assets.

It is the view of the Center that a person who merely provides information that supports a fiduciary decision relating to the management of plan assets should not, without more, be deemed a fiduciary adviser. Otherwise, we fear that a multitude of other activities undertaken to support plan investment activities could also be deemed fiduciary advice. For example, plan sponsor employees supporting a fiduciary investment committee's investment decision could, under the Proposed Regulation, be deemed to be providing investment advice. We do not think that this result will benefit plans, participants, fiduciaries, or plan sponsors.

In the case of proxy advisory firms, the Proposed Regulation fails to recognize that such firms offer a variety of services and play a number of different roles with respect to ERISA plans and other institutional investors. For example, a proxy advisory firm may provide services based on the firm's base proxy voting policy or based on a customized policy provided by the institutional investor. A proxy advisory firm also may simply provide specific information with respect to a particular vote. Moreover, one of the two predominant proxy advisory firms, ISS, is registered with the SEC as an investment adviser while the other, Glass Lewis, is not. Due to the variety of roles and services offered by proxy advisory firms, the Center believes that the Department's approach in the Proposed Regulation unevenly impacts proxy advisory firms.

In sum, the Center is concerned that the Proposed Regulation could significantly increase plan costs and harm plans, participants, fiduciaries, and plan sponsors, and would not provide an even playing field for proxy advisors. Instead, as discussed in greater detail below, the Center requests that the Department carefully review the activities of proxy advisory firms to determine the appropriate course of action and oversight as well as provide much needed guidance to plan fiduciaries with respect to how to evaluate the information provided by proxy firms.

C. Need for Comprehensive Review

Ideally, institutional investors, consistent with their fiduciary obligation to vote proxies, would have adequate information to ensure that the recommendations made by proxy advisors and the votes that are based on those recommendations are consistent with the creation of long-term shareholder value. As a consequence of many institutions having a very large number of

security holdings, however, coupled with the ever-larger volume of material that issuers are required to disclose in proxy statements, it is perhaps somewhat naïve to expect that institutional investors will rely less heavily on proxy advisory firms.

The Center believes that any proxy advisory firm that effectively exercises discretion over a proxy decision should be deemed a fiduciary. Further, we believe that there are circumstances in which proxy advisory firms currently are exercising discretion over proxy decisions. In this regard, the Center requests that the Department investigate whether the practices of proxy advisory firms should be deemed, under existing regulations, to constitute discretion over proxy voting decisions.

In cases where a proxy advisory firm is not exercising discretion, the Center believes that such firms play an important role that can help institutional investors fulfill their fiduciary duty to vote their proxies in their clients' best interest, provided the information provided by the proxy advisors is reliable. However, without a more rigorous regulatory and oversight process, we are concerned that the integrity of the proxy system may be undermined by growing evidence of material inaccuracies and conflicts of interest by proxy advisors that could seriously impact the proxy voting process.

III. Recommendations for Greater Regulation of the Proxy Advisory Industry

The Center believes that the influence of the proxy advisory firm industry requires greater oversight by the Federal regulatory agencies having authority over them. This includes regulation by the SEC under the Act and oversight and investigation by the Department.

A. A Call for Greater Regulation/ Oversight

The current regulatory framework is largely responsible for the influence that proxy advisors wield over institutional investor voting. The Center believes that the most effective approach for mitigating and addressing the issues surrounding the conflicts of interest and inaccuracies with the proxy advisory industry, among other issues, requires a series of regulatory and market reforms.

The Center has asked the SEC to impose greater and more consistent regulations across proxy advisory firms – and will continue to advocate to the SEC that such regulations not be optional. The proxy advisory industry needs uniform standards that address conflicts of interest and inaccuracies that undermine the very services they provide. The Center believes that enlisting the Department in this regulatory effort can only help in ridding this service industry to ERISA plans of serious problems, which will ultimately benefit plan participants.

B. Request for Department of Labor Investigation into Proxy Advisory Firm Practices

In order to ensure that plan fiduciaries have accurate and reliable information upon which to base proxy voting decisions, the Center requests that the Department undertake a comprehensive review and investigation of proxy advisory firm practices.

The most serious issue facing the proxy advisory firm industry is at the largest, most influential proxy advisory firm, ISS. ISS currently provides consulting services to corporate issuers while simultaneously providing "independent" analyses to institutional investors on those same companies. The Center believes it would be impossible to provide both of these services and still meet their fiduciary obligations to the institutional investors. For this reason, there should be a ban on proxy advisory firms, or their affiliates from this practice. Until the change is effective, the Department should mandate disclosure of the fees paid and services obtained from proxy advisors in the proxy statement, similar to the disclosures currently required for compensation consultants.

Proxy advisory firms should also be required to make the financial relationships that underpin the most controversial aspects of the proxy advisory industry transparent to institutional investors. Specifically, the Center recommends that proxy advisory firms be required to disclose, in any report containing voting recommendations about a specific issuer, whether the firm has received consulting fees from either the issuer, or the proponent of a shareholder resolution on the ballot at that issuer, in the previous year and the amount of those fees. This disclosure should be located where it is easily accessible to any investor who is relying on the recommendation in the report.

Furthermore, proxy advisory firms should be required to disclose their analytic processes, methodologies and models utilized to derive their voting recommendations. Although ISS currently provides some of this disclosure, it is still not sufficiently transparent. Glass, Lewis & Co., its major competitor, provides virtually no disclosure as to processes and methodologies. Additional disclosure would allow issuers and institutional investors to effectively assess the merits and weaknesses of such models and to provide feedback to proxy advisory firms on these models.

C. Additional Information

For further information on this topic, we have attached a copy of the Center's white paper, *A Call for Change in the Proxy Advisory Industry Status Quo*, as well as policy briefs that summarize the major issues with the proxy advisory industry. We hope to utilize this opportunity to start a dialogue on how best to regulate an industry that wields tremendous power but is currently operating without sufficient oversight.

IV. Conclusion

Rather than finalize the Proposed Regulation, the Center strongly urges the Department to undertake a comprehensive review of proxy advisory firms and work with the SEC and other agencies that also are investigating the regulation of proxy advisory firms, to identify areas where focused and comprehensive regulation will provide real benefits to the users of proxy advisory services, including ERISA plans. The Center would be happy to meet with the Department and to provide information on our concerns regarding the significant influence over institutional investors that proxy advisory firms exercise, and the fact that there are serious conflicts of interest issues in the proxy advisory industry.

V. Request to Testify at Hearing

The Center requests the opportunity to testify at the hearing on the Proposed Regulation and expects to file a separate outline of testimony in the near future.

* * * *

The Center On Executive Compensation appreciates this opportunity to provide comments on the Definition of Fiduciary Proposed Rule and the specific role of proxy advisory firms. If you have any questions about these comments, please contact me at tbartl@execcomp.org.

Sincerely,

Timothy J. Bartl
Senior Vice President and General Counsel

Attachment