

Corporate Governance Commentary

March 2011

Proxy Advisory Business: Apotheosis or Apogee?

Highlights

- Congress significantly enhanced the role and importance of proxy advisory firms through the Dodd-Frank Act requirement of Say on Pay votes at all but the smallest public companies — a vote that, according to early returns from the 2011 proxy season, will be an annual event at most companies.
- The impact and reach of corporate governance activism in the functioning of public companies continues to grow and should provide additional business for and momentum to the proxy advisory industry.
- The influence of proxy advisory firms in corporate governance extends well beyond their direct impact on institutional shareholder voting. The firms also play a key role in the development and validation of what are commonly viewed as corporate governance “best practices.” The firms don’t merely administer voting policies arrived at independently by institutional investors, they are critical in the development and proliferation of these voting policies.
- Viewed in this light, apotheosis is an apt description of the approaching status of proxy advisory firms, particularly that of ISS and Glass Lewis, which have a combined market share of over 90 percent.
- There are, however, a number of countervailing factors that might make apogee a more accurate description of the proxy advisory industry’s role and influence on corporate governance. These include:
 - The sheer volume of shareholder votes requiring recommendations each year, numbering in the tens of thousands, which is straining the capacity of the proxy advisors’ production system and jeopardizing the integrity and credibility of the output. The large and growing number of annual voting recommendations, largely crammed into a four-month proxy season, dictates that proxy advisors automate their decision-making processes to the greatest extent feasible and that both inputs and outputs be as simple as possible, making consideration of each company’s particular circumstances infeasible.
 - Growing discontent on the part of companies and company advisers with the one-size-fits-all analytics used by proxy advisory firms, as well as with the lack of transparency of the firms’ analytics and the lack of satisfactory processes for correction of errors and of opportunities for questioning conclusions.
 - The SEC’s Concept Release on the US Proxy System, which raises important issues regarding the need and desirability of subjecting proxy advisors to a more structured regulatory environment (including imposition on them of fiduciary duties to their customers and their customers’ clients) that could well threaten their current business model in fundamental ways.
 - The pending proposal by the Department of Labor (DOL) to amend its ERISA rules to impose fiduciary duties on proxy advisors which, if adopted, would also dramatically change the playing field by subjecting proxy advisors to ERISA liability for breach of their duties of care and loyalty.

- A fundamental rethinking of the conventional view that an investment adviser's fiduciary duty requires the adviser to vote all portfolio shares on all ballot issues. The reevaluation is resulting in a growing sentiment, reinforced by a 2008 DOL interpretation, that an investment adviser's fiduciary duty requires it first affirmatively to conclude that the potential economic benefits to share value arising from the act of voting outweighs the costs of voting (including the risk that the vote could decrease share value), with voting being appropriate only for those matters at a particular company that are determined to have greater benefit than cost.
- A revised interpretation of an investment adviser's fiduciary duty that would give each investment adviser the freedom not to expend the time and money to vote shares on ballot issues which it judges do not have positive economic benefit would liberate the institutional investor community from the tyranny of the current model of having to vote all portfolio shares on all matters.
- This, in turn, would deprive proxy advisors of the inexorable business generator resulting from currently perceived mandatory voting requirements. Such a development could undermine the necessity for institutional investor dependence on proxy advisors and lead to a diminution of the corporate governance community's hegemony over institutional share voting.

Introduction

Proxy advisory firms, particularly the two dominant players — ISS and Glass Lewis — seem to many observers to be in the proverbial cat-bird seat.¹

- The closure of Proxy Governance, Inc. at the end of 2010 gave these two firms a duopoly, which should be good for their businesses.
- The number of shareholder votes at public companies, which is the bread and butter of the proxy advisory business model, has increased markedly over the past decade, and will continue to grow with the advent of mandatory Say on Pay and Say on Pay frequency votes, not to mention proxy access if it survives its pending judicial review.
- The combined influence of these two proxy advisory firms on shareholder voting is often determinative of the outcome, particularly in contested vote situations.²
- The voting policies of the two firms drive company decision making on at least three critical fronts:
 - Companies and compensation consultants increasingly tailor their compensation policies, particularly incentive compensation plans, annual discretionary bonuses and severance plans and contracts, to fit the two proxy advisors' voting policies and metrics.³
 - Companies' responses to shareholder proposals are often determined by a desire or need to conform to the voting policies of the two proxy advisors, particularly the hovering threat of a vote no campaign if a company ignores a successful shareholder proposal.
 - Companies frequently adjust their governance policies to fit the governance policies espoused by the proxy advisory firms in order to avoid withhold vote and vote no campaigns against some or all of the directors.
- The proxy advisory firms are a critical part of the process of establishing corporate governance best practices and standards within the corporate governance community. Their adoption of new "best" practices as part of their voting policies validates the practice as being truly "best," and gives the practice additional weight and legitimacy.
- In addition to their key role in the creation and implementation of corporate governance policies, proxy advisory firms dominate critical proxy "plumbing" mechanics for institutions throughout the US and in many foreign markets through their voting services platforms.

Conventional wisdom holds that corporate governance principles will continue to evolve and become ever more sophisticated and pervasive for all US public companies of size (approximately 7,300 public US companies are subject to Dodd-Frank mandated Say on Pay

votes, of which approximately 1,500 are covered by the two-year deferral for smaller reporting companies with less than \$75 million in public float). The existing volume of shareholder votes and the projected future development of more corporate governance policies as grist for the proxy advisory mill seemingly assure the continued vitality and growth in influence of the proxy advisory industry.

But, like so many other industries that have benefitted from rapid growth, there are increasing signs that the very success of the proxy advisory function may contain the seeds of its future decline. The issue we address in this *Corporate Governance Commentary* is whether proxy advisory firms are about to reach their apotheosis as the dominant force for establishment and enforcement of corporate governance best practices or, on the contrary, whether their recent successes mark an approaching apogee and will it be all down-hill from there?

Gathering Clouds

Although it may be too soon to predict with certainty that the proxy advisory firms' dominance in setting and enforcing corporate governance standards is peaking, a number of recent considerations raise doubts as to the continued growth of the firms' sway and may well presage a contraction of their reach and influence.

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Practical Limitations of Proxy Advisor Business Model

- There are simply too many voting recommendations to be made in too concentrated a time period. In 2009, ISS issued proxy research and voting recommendations for more than 37,000 companies on a world-wide basis, and Glass Lewis provided similar services for more than 16,000 companies around the world.
- Even assuming that only 6,000-7,000 of these companies are US-based, the task is still Herculean by any standards.
 - The vast bulk of the US companies have calendar fiscal years and hold shareholder meetings in the spring, between March and June, compressing the bulk of the US proxy advisory work into a short four month time span and imposing an extraordinary seasonal burden on the proxy advisors.
 - The election of directors, even when not contested, implies individual voting decisions for each nominee. Multiply the number of individual determinations by a minimum of two or three nominees at companies which have a relatively small classified board up to a maximum of as many as 20 for large annually elected boards and then multiply the number of individual director evaluations at each company by the universe of covered US companies of something between, say, 6,000 and 7,000. And this deals only with uncontested director votes for US companies.
 - Many companies have additional company proposals on their ballots, ranging from “simple” approval of auditors to complicated incentive compensation plans, restructurings, acquisitions or dispositions.
 - Many companies also have one or more shareholder proposals on their ballots.
 - The advent of universal Say on Pay votes will add thousands to the number of annual votes, particularly if, as seems likely, the prevailing frequency of Say on Pay votes is annual, not biennial or triennial.
 - Moreover, while some votes may be relatively easy to deal with through application of one-size-fits-all voting policies, others, at least theoretically, are more complex, such as:

- Incentive compensation plans
- Director votes where, presumably, each nominee is analyzed individually in the context of background and particular skill sets, fit with other directors and with the company's business and strategic goals, and performance record, including attendance.⁴
- Say on Pay votes where the company's compensation and benefit policies and payments, as set for in the Compensation Discussion and Analysis and accompanying tables, are theoretically to be evaluated.
- Election contests where choices among candidates are required and the analysis of each candidate's merits is more fraught than in uncontested elections.
- Merger, sale of assets and other reorganizations and restructurings which require complex analysis in terms of value creation and alternative courses of action.
- As a result of the large number of voting recommendations that must be made in a short time period, it is inconceivable that proxy advisors' recommendations can or will be based on a thorough analysis of the facts and circumstances of each company in the context of each voting decision.
 - Rather, as everyone connected with the institutional shareholder voting process knows or should know, proxy advisors' voting recommendations are driven by inflexible, one-size-fits-all voting policies and simplistic analytic models designed to utilize standard and easily accessible inputs that can be derived from readily available data and to avoid any need for particularized research or the application of meaningful judgment.
 - In essence, proxy advisory firms cope with their problem of large numbers and seasonality through automation of as large a portion of the vote recommendation process as feasible.⁵
 - While proxy advisors may claim that each company and each vote is arrived at individually and reflects the particulars of the situation, this is true only in the most superficial sense. The analyses, in fact, are driven by checking boxes or inputting readily obtainable and relatively simple-to-find data, running this data through simplistic models and sticking inflexibly to whatever outcome is "spit out" of the process.
 - Mistakes in input are common, but hard to find unless specifically mentioned in a voting recommendation and still harder to correct.⁶ Moreover, there is no effective process for companies to engage proxy advisory firms in a constructive dialog about why application of certain voting policies to the company may be inapposite.⁷
- Not only is the proxy advisory voting recommendation process mechanical, and sometimes flawed in terms of accuracy of inputs and cogency of analytic models, but also the process is anything but transparent in its operation or outcome.⁸
 - There is statistical and anecdotal data that institutional investors don't always understand the way in which proxy advisory firms weight various considerations in reaching their voting recommendations. As a consequence, clients who use proxy advisory services may not understand the corporate governance philosophy applied internally by the proxy advisory firms to reconcile competing governance objectives.⁹
 - There is no compendium of a proxy advisory firm's voting recommendations, so there is no way to tell if a proxy advisory firm is consistent in its voting recommendations across the thousands of companies for which it issues voting recommendations
 - Because there is no compendium of voting recommendations, there is also no way to track the efficacy of voting recommendations in determining voting outcomes and no way to link voting policies with creation or destruction of shareholder value.
 - In sum, not only is most of the methodology of the proxy advisory firms opaque and redolent of the proverbial "black box," but also the output of the black box is opaque and impossible to test for accuracy, consistency and value creation.
- Finally, and hardly least important, there is evidence that proxy advisory firms, even with the stripped down, pipe rack proxy advisory services they currently provide, are not particularly profitable.¹⁰ As a consequence, investments to improve the substantive quality of their

processes and output seems unlikely given the proxy advisory business model of making recommendations on each voting decision at each shareholders' meeting for each company in the universe covered by the proxy advisory firms and the obvious fact that most investment advisers place a low to virtually non-existent financial value on those recommendations and are unwilling to pay for a more complicated analysis.

- Some of the consequences of the sheer volume of proxy vote recommendations required under the proxy advisory firms' business model were summarized by Michael Ryan, former President of Proxy Governance, Inc. in a "farewell" letter to clients announcing that Proxy Governance was closing its doors:

"In a world where institutions have many hundreds or thousands of securities to vote on in a short period of time, it has simply become impossible for many institutions to read and digest analyses or consider thoughtful research. By requiring everything to be important, nothing is important.

As a result, as proxy voting has evolved for at least some customers to become a non-value-added compliance requirement — where quality and depth is less important than cost-savings — we determined we could no longer add significant value."¹¹

Federal Regulation

In the summer of 2010, the SEC issued its long awaited concept release on the US proxy system, commonly referred to as the Proxy Plumbing Release.¹² Notably, one major portion of the section of the release focused on proxy advisory firms and solicited comment on a number of issues, including whether proxy advisory firms should be regulated by the SEC and, if so, in what ways, whether the proxy advisory firms' existing procedures result in research reports that are accurate and complete, and whether proxy advisory firms should disclose the process and models used to generate their voting recommendations.¹³

The SEC received a large number of responses to its inquiries about the role and functioning of proxy advisory firms. A significant number of the comments recommended that proxy advisory firms be regulated by the SEC, that they be required to allow companies to review and comment on their research before it is issued, at least to permit correction of factual errors, and that they be required to be far more transparent about their internal decision making processes and outcomes in ways that would permit observers to test not only the quality and consistency of their recommendations, but also the qualitative impact of shareholder adoption of their voting recommendations.

While it is impossible at this stage to predict whether, when and how the SEC might choose to regulate proxy advisory firms, any significant regulatory initiative would likely change the firms' current business model. Moreover, if as advocated by many, SEC regulation takes the form of requiring increased transparency and a process for correction of factual errors, let alone a mandatory hearing for aggrieved companies, the pressure on the current business model could be intense. If nothing else, it could unmask for all to see the mechanistic approach now being used and subject that approach to increased criticism.

More fundamentally, the DOL has issued a proposed revision of its rules under ERISA that would make proxy advisory firms fiduciaries with respect to all ERISA plans for which they provide voting or other advice. Imposing the fiduciary standards of ERISA on proxy advisory firms would open them up to questions about whether their internal decision making practices and policies comport with the rigorous ERISA fiduciary duties of care and loyalty.¹⁴ A critical question would be whether the mechanistic, one-size-fits-all approach now used by proxy advisory firms squared with their fiduciary duties or whether a more case-by-case approach, tailored to the facts and circumstances of each company, would be required. Additionally, factual and analytical errors, flawed methodologies and models and inadequate processes for detection and correction of error and mistake might also raise serious fiduciary duty issues.

Moreover, as some of the comment letters on the SEC Proxy Plumbing Concept Release advocate,¹⁵ the SEC might conclude that proxy advisory firms should be charged with fiduciary duties to their clients and to their clients' account holders under the Investment Advisers Act. An imposition of fiduciary duties by the SEC, unlike by the DOL, would apply to the proxy advisors'

entire client base, not just ERISA pension plans. It thus would be farther reaching in its application than the proposed DOL redefinition of an ERISA fiduciary and, for the reasons mentioned above, would pose significant challenges to the business model of the proxy advisory firms.

Reevaluation of Interpretation That Investment Advisers' Fiduciary Duty Requires Voting All Portfolio Shares on All Matters

Another significant (and perhaps fatal) fault line for proxy advisory firms is a possible reevaluation of the common understanding that investment advisors subject to ERISA and/or to the Investment Advisers Act of 1940 have an affirmative fiduciary duty to vote all portfolio shares on all matters. This understanding is based on the principle enunciated by both the DOL, as interpreter of ERISA plan advisers' fiduciary duties, and the SEC, as regulator of investment advisers under the Investment Advisers Act, that an investment adviser's fiduciary duty of care includes its actions with respect to voting its portfolio securities.¹⁶ The interpretation that an investment adviser's fiduciary duty requires it to vote all portfolio shares on all matters, of course, is the foundation on which most of the edifice of institutional voting as we know it today is built, including, most importantly for the purposes of this *Commentary*, the proxy advisory business.¹⁷

Recently, however, some regulators and commentators have begun to question the validity of this interpretation of an investment adviser's fiduciary duty. This questioning is a natural product of the current morass facing institutional investors large and small — the overwhelming number of votes that need to be cast every proxy season, year in and year out. To date, the investment advisory industry has dealt with this burden by trying to find the most cost effective solution. Facing the wide-spread, if not universal, belief of investment decision makers (as opposed to corporate governance specialists hired to implement a cost effective voting system) that most company votes just don't matter to share value and portfolio performance, the industry has done what it had to do — create the lowest cost system it could to deal with the vast majority of votes that investment decision makers do not view as affecting share value.¹⁸

The obvious problem with the current institutional voting system, of course, is that it is not designed to and cannot embrace case-by-case distinctions based on the different circumstances of the thousands of public US companies to which it is applied annually (not to mention thousands of additional foreign companies). As a matter of logic, its one-size-fits-all premise can only be defended as complying with a fiduciary duty of care by an argument that:

- Most shareholder votes do not much matter economically, and therefore how and why shares are voted on non-economic issues shouldn't matter to the hypothetical prudent investor, or
- The one-size-fits-all foundation of today's version of corporate voting will in the long run create more shareholder value than any other system.

The first argument, of course, is circular because there should not be a fiduciary duty to vote if the vote does not matter. The second argument, at least as the evidence now stands, is also faulty because it lacks convincing empirical support and, at least to many, is counter-intuitive.

Importantly, the DOL in October 2008 issued a critical, but seemingly little noticed, interpretation of the application of ERISA fiduciary standards to the exercise of the shareholder franchise.¹⁹ This interpretation categorically rejects the prevailing belief that ERISA fiduciary duty standards

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require an investment adviser to vote all portfolio shares on all matters. Rather, it sets forth a far more nuanced analysis of the application of ERISA fiduciary standards to the voting of portfolio shares.

“The fiduciary duties described at ERISA Sec. 404(a)(1)(A) and (B), require that, in voting proxies, regardless of whether the vote is made pursuant to a statement of investment policy, the responsible fiduciary shall consider only those factors that relate to the economic value of a plan’s investment and shall not subordinate the participants and beneficiaries to unrelated objectives....If the responsible fiduciary reasonably determines that the cost of voting (including the cost of research, if necessary, to determine how to vote) is likely to exceed the expected economic benefits of voting, or if the exercise of voting results in the imposition of...other restrictions, the fiduciary has an obligation to refrain from voting.

“The fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the economic value of the plan’s investments. However, fiduciaries also need to take into account costs when deciding whether and how to exercise their shareholder rights, including the voting of shares. Such costs include, but are not limited to, expenditures related to developing proxy resolutions, proxy voting services and the analysis of the net effect of a particular issue on the economic value of the plan’s investment. Fiduciaries must take all of these factors into account in determining whether...the voting of a proxy...is expected to have an effect on the economic value of the plan’s investment that will outweigh the cost of exercising such rights.”²⁰

The DOL interpretation regarding the application of fiduciary duty standards to the voting of portfolio securities coincides with a similar view of the SEC, expressed more succinctly, as follows:

“We do not suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the client’s best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client.”²¹

The DOL interpretation continues by making a number of corollary points, including:

- An ERISA plan, or its managers, may adopt a share voting policy as part of a statement of investment policy for the plan. Moreover, investment advisers hired to manage investments for a plan subject to a statement of investment policy are bound by that policy, including any share voting policy. However, “Such guidelines must be consistent with the fiduciary obligations set forth in ERISA Sec. 401 (a)(1)(A) and (B) and this interpretative bulletin, and may not subordinate the economic interests of the plan participants to unrelated objectives.” Moreover, an investment adviser would not be discharging its ERISA fiduciary duties if it adhered to a voting policy that did not comply with the DOL interpretation.²²
- An investment policy may “contemplate activities intended to monitor or influence management” of portfolio companies, but only if the ERISA fiduciary “concludes that there is a reasonable expectation that such monitoring or communication with management...will enhance the economic value of the plan’s investment...after taking into account the costs involved....In creating an investment policy [which includes such monitoring or influencing], a fiduciary shall consider only factors that relate to the economic interest of plan participants and their beneficiaries in plan assets, and shall not use an investment policy to promote myriad public policy preferences.”²³
- Finally, “Plan fiduciaries risk violating the exclusive purpose rule when they exercise their fiduciary authority in an attempt to further legislative, regulatory or public policy issues through the proxy process....The mere fact that plans are shareholders does not itself provide a rationale for a fiduciary to spend plan assets to pursue, support or oppose...proxy proposals. Because of the heightened potential for abuse in such cases, the fiduciaries must be prepared to articulate a clear basis for concluding that the proxy vote... or the activity to monitor or influence management of the corporation is more likely than not to enhance the economic value of the plan’s investment before expending plan assets.”²⁴

The implications of the DOL interpretation of the application of ERISA fiduciary duty standards to investment adviser voting of portfolio shares (as well as that of the SEC in the more general context of the Investment Advisers Act) are several and profound.

- First, both the DOL and SEC interpretations are consistent with at least three different basic approaches to institutional investor portfolio share voting, each of which would comply with the prudent man rule under a conventional reading of the fiduciary duty of care:
 - Rather than being required by fiduciary duty to vote all shares on all matters, an institutional investor is required to balance the economic cost of casting a vote on a particular matter (which would include the costs of analysis and casting the vote, as well as the risk the vote would have the undesirable effect of reducing, not enhancing, shareholder value) against the potential economic benefit to be gained by voting the shares. If the investor concludes that voting on a specific issue or type of issues is not cost effective, its duty to its investors is not to vote and thereby waste the investors' assets. If it concludes that the cost of the vote is outweighed by the potential economic benefit of the vote, its duty is to vote. Different fund managers will reach different conclusions as to the cost/benefit analysis on specific types of votes and on specific votes, but that merely recognizes their considered, but different, judgment, as prudent investors of how best to create value in their clients' accounts.²⁵
 - Other prudent investment advisers might conclude they should vote all portfolio shares on all matters as they do today, using one-size-fits-all, low cost voting policies and simple-to-apply analytics, based on their considered judgment that in the long run application of what they consider to be good corporate governance policies will, on balance, create more value for their portfolio stocks than not voting. This, in effect, is a justification commonly advanced by quantitative investment advisers for their utilization of today's voting model. When confronted with the lack of consensus among academics and other observers that today's voting model does create shareholder value in the aggregate, prudent investors of this ilk would counter that the evidence today's voting model destroys shareholder value is equally inconclusive, but that good governance on the whole should be better than not so good or affirmatively bad governance.
 - The third iteration of a prudent investment adviser would be one with a relatively small number of portfolio companies or a system utilizing red flags to identify portfolio companies in need of governance reform. Either case, presumably, should justify a reasoned conclusion by the adviser that the economic benefits of voting its portfolio shares or its red-flagged portfolio shares based on a case-by-case application of its view of good governance policies, and taking into account the particular facts and circumstances of the company, outweigh the economic costs. The third iteration, of course, would achieve the case-by-case analysis advocated by many of the critics of the current proxy advisory dominated model of voting portfolio securities by "rote" so to speak, but in a manner that avoided the economic infeasibility of a meaningful case-by-case vote for thousands of portfolio securities.
- Importantly for investment advisers, they would be freed of the tyranny of having to vote all portfolio shares on all matters, if they concluded that do so incurs greater economic costs than economic benefits to their portfolios. The other side of the coin, however, would be inevitable damage to the proxy advisory business model. No longer could proxy advisors count on the law of large numbers of companies and votes to insure their preeminent position in determining voting outcomes and to create an ever expanding business base as the number of shareholder votes continues to increase. Rather, presumably, the proxy advisory firms would have to justify their simplifying one-size-fits-all analyses as creating more economic value than cost, a burden which, as a practical matter, they do not bear in today's world of required voting of all shares on all matters.
- Moreover, under the DOL interpretation, pension fund trustees (whether public employee and union pension funds or privately sponsored pension plans) could not simply impose a one-size-fits-all set of voting policies on its investment managers without the latter's concurrence that those voting policies did indeed confer economic value on the plan assets they were charged with investing. At least in the view of the DOL, those charged with the actual investment

decision making would have to reach an independent conclusion as to whether and how to vote portfolio shares.

- Finally, the functional dichotomy between invest decision makers and voting decision makers that permeates today's world of institutional investing raises significant issues when viewed against the consistent emphasis of the DOL and SEC interpretations on requiring an economic justification for each vote of shares of each portfolio company. If the insistence on applying a purely economic test would not disable the corporate governance community from dominating, and in some cases monopolizing, the voting process, it would at least call into question the prevailing marginalization of investment decision makers and their views as to the presence or absence of positive economic value to be gained by most shareholder ballot votes.²⁶

Conclusion

Apotheosis or apogee is the question for the proxy advisory industry and, more generally, the institutional investment world. The answer is not clear. But it is not far-fetched to conclude that the very success of today's corporate governance voting model carries within its own seeds of destruction. Too many votes on too many issues exposes the current model for what it is — a low cost, largely mechanistic answer to a perceived governmentally mandated requirement that institutional investors vote all portfolio shares on all matters.

As the reality of the current institutional voting model becomes more apparent under the pressure of more shareholder votes on more issues,²⁷ it will lead to increased frustration, certainly on the part of companies and company advisers and quite probably on the part of at least many investment decision makers in the institutional investor community. More important, the inevitability mechanistic current voting model seems to be leading to a fundamental reappraisal of the underpinnings of the current model — the belief that an institutional investor's fiduciary duty to its clients requires it to vote all of its portfolio shares on all matters regardless of cost, complexity or potential to increase share value. In its place we might well get a recognition that different prudent investors would make different decisions about share voting under their particular investment thesis, and that, like so many other things in life and the law, there is no one "right" answer to dealing with the tens of thousands of annual votes that confront the investment advisory industry. This recognition would free investment advisers to cope with public company share voting in the way each determined best served its investment principles and style and thus the true interests of its investors.

Endnotes

1. *Center on Executive Compensation*, "A Call for Change in the Proxy Advisory Industry Status Quo: The Case for Greater Accountability and Oversight" (Jan. 2011) (hereinafter cited as "Center on Executive Compensation White Paper") at 3 (ISS "controls the market, with a 61 percent market share,...Glass, Lewis & Co. controls approximately 37 percent of the market")(footnotes omitted). There are several other small domestic proxy advisory firms, including Eagan-Jones Proxy Services, Marco Consulting Group, Sustainable Investments Institute and Proxy Impact.
2. See, e.g., *id.* at 3-6 and 19-27.
3. See, e.g., *id.* at 24-25.
4. As corporate governance activists, usually supported by proxy advisory firms, continue to press for additional substantive information about individual directors and their functions and strengths in the board room, the amount of information available for voting decisions on directors, and directors in the context of the strengths and weaknesses of other board members, increases and becomes more complex and nuanced, making the evaluation process increasingly more time intensive. Nor does it behoove proxy advisors to ignore the plethora of available information, if they are to claim that their voting recommendations for directors are based on anything more than the absence or presence at a company of governance practices that the proxy advisory firms deem sufficiently negative to warrant no vote or withheld votes.
5. See, e.g., *Center on Executive Compensation White Paper* at 32 ("In recent years, ISS has made a major push to reduce its cost structure by locating much of its data collection and research activities outside the United States, particularly to the Philippines"); 56 ("To cope with the massive amount of data collection and analysis required to analyze proxy issues at thousands of companies, the proxy advisory firms have...largely outsourced their own "data mining" operations.").

6. The difficulties include that ISS affords only very large issuers an opportunity to review its recommendations prior to publication, and Glass Lewis has no review process. The lack of a transparent and effective process for correcting errors in a recommendation prior to publication and an extreme aversion to correction after publication at both ISS and Glass Lewis further compounds the problem. The result is that some number of recommendations (there are no meaningful statistics, only anecdotal evidence) is based on incorrect facts or misinterpretation of corporate governance documents and disclosure materials, some of which recur year after year. See *Society of Corporate Secretaries and Governance Professionals* Comment Letter to the Securities and Exchange Commission on Concept Release on the US Proxy System and Appendix A thereto, File No. S7-14-10 (Dec. 27, 2010)(hereinafter cited as "Society Proxy Plumbing Comment Letter"); Center on Executive Compensation White Paper at 55-59. See also Letter from Headwaters Incorporated to ISS Proxy Advisory Service, Feb. 22, 2011, available at <http://www.sec.gov/Archives/edgar/data/1003344/000119312511042128/dex9933.htm>.
7. ISS affords large cap companies a limited review of a draft voting recommendation of usually 24-48 hours (sometimes including weekends or holidays), but apparently is inconsistent about correcting factual errors and only rarely changes its recommendations based on a company's arguments about why they are inappropriate. ISS provides no review to mid cap and small cap companies, and Glass Lewis has no review procedure for its voting recommendations. Moreover, both proxy advisers are frequently faulted for repeating errors in fact or analysis year after year, notwithstanding company attempts to seek correction. See, e.g., Society Proxy Plumbing Letter, particularly Appendix A; Center on Executive Compensation White Paper at 58-60.
8. See, e.g., Society Proxy Plumbing Comment Letter; Center on Executive Compensation White Paper 60-61; *Committee on Federal Regulation of Securities of Business Law Section of American Bar Association*, Comment Letter on Concept Release on the US Proxy System, File No. S7-14-10 (Dec. 17, 2010)(hereinafter cited as ABA Proxy Plumbing Comment Letter") at Part III. B.
9. *Choi, Fisch & Kahan*, "Director Elections and the Role of Proxy Advisors", 82 So. Cal L. Rev. 101 (2009).
10. See, e.g., Center on Executive Compensation White Paper at 10, 32.
11. Letter of Michael J. Ryan, President, Proxy Governance Inc., dated December 23, 2010 (hereinafter cited as Ryan Letter).
12. Concept Release on the US Proxy System, SEC Release Nos. 34-62945; IA-3052; IC-29340; File No. S7-14-10.
13. See, e.g., ABA Proxy Plumbing Comment Letter at Part III. B.; Society Proxy Plumbing Comment Letter; Center on Executive Compensation, Comment Letter to Securities and Exchange Commission on Concept Release on the US Proxy System, File No. S7-14-10 (Oct. 25, 2010)(hereinafter cited as "Center on Executive Compensation Proxy Plumbing Comment Letter").
14. See Department of Labor proposed regulation under Employee Retirement Income Security Act of 1974 redefining the term fiduciary under Section 3(21) (available at <http://www.federalregister.gov/articles/2010/10/22/2010-26236/definition-of-the-term-fiduciary>).
15. See, e.g., Society Proxy Plumbing Comment Letter; ABA Proxy Plumbing Comment Letter at Part III. B.; Center on Executive Compensation Proxy Plumbing Comment Letter; Center on Executive Compensation White Paper at 67-73.
16. See, e.g., Letter from Allan Liebowitz, Deputy Asst. Sec'y of Pension Welfare Benefits Admin. of US Dept. of Labor to Heimuth Fandl, Ch. of Retirement Bd. of Avon Products, Inc. (Feb. 23, 1988)(commonly referred to as the "Avon Letter") ("In general, the fiduciary act of managing plan benefits...would include the voting of proxies...the Department's position is that the decision as to how proxies should be voted...are fiduciary acts..."); Investment Advisers Act Release No. 2106, "Proxy Voting by Investment Advisers," (Jan. 31, 2003).
17. See, e.g., Center on Executive Compensation White Paper at 17-19; *Latham & Watkins Corporate Governance Commentary*, "[The Parallel Universes of Institutional Investing and Institutional Voting](#)" (April 2010) (hereinafter cited as "Latham & Watkins Parallel Universes"); *Latham & Watkins Corporate Governance Commentary*, "[The Future of Institutional Voting: Three Paradigms](#)" (July 2010) (hereinafter cited as "Latham & Watkins Three Paradigms"). See also Ryan Letter ("...the current regulatory structure has transformed the corporate governance function, certainly not for all but for many, into a need to satisfy a compliance burden as opposed to a value-added pursuit of better governance thinking and research. The implication from the current regulatory environment is that regulated institutions would "vote on all issues, all of the time.").
18. See, e.g., Center on Executive Compensation White Paper at 55-57; *Latham & Watkins Parallel Universes*; *Latham & Watkins Three Paradigms*
19. See Department of Labor interpretation of the legal standards imposed by Sections 402, 403 and 404 of Title I of ERISA, codified in 29 CFR Part 2509.08-2
20. *Id.* at Section 1. Indeed, if an investment adviser was bound to vote all portfolio shares on all matters, without regard to a meaningful cost/benefit analysis, it would be difficult, perhaps impossible, to justify not recalling all lent shares in advance of the respective record dates for all shareholder meetings. Only an economic cost/benefit analysis that concluded the revenues achieved by a share lending program outweighed the potential economic benefits of recalling lent shares prior to record dates to enable their being voted would justify a fiduciary's decision to forego the voting franchise. See *Committee on Federal Regulation of Securities of Business Law Section of American Bar Association*, Letter to Securities and Exchange Commission on Reporting on Proxy Votes on Executive Compensation and Other Matters, File No. S7-30-10 (November 22, 2010)(hereinafter cited as "ABA Proxy Vote Comment Letter") ("Under any circumstances, an...[investment manager] is entitled to determine (explicitly or implicitly) that the value of lending securities exceeds the value of voting on proposals.")
21. Investment Advisers Act Release No. 2106, *supra* n.15 at text acc.n.18.

22. *Id.* at Section 2 (“...ERISA Sec. 401(a)(1)(D) does not shield the investment manager from liability for imprudent actions taken in compliance with a statement of investment policy”).
23. *Id.* at Section 3.
24. *Id.* at Section 4.
25. It is notable that the Committee on Federal Regulation of Securities of the Business Law Section of the American Bar Association supported this interpretation of an investment adviser’s fiduciary duty in two recent comment letters to the SEC. See ABA Proxy Plumbing Comment Letter (“For example, we submit that costs should not be imposed on advisers that vote investors’ shares that are out of proportion to what investors are willing to pay for those services. The possible spectrum of the fiduciary duties of those advisers should be informed by this calculus. It is worth considering...whether...[a fiduciary] should be required to vote...on all or particular matters against the backdrop of the economics to investors.”); ABA Proxy Vote Comment Letter (“...we believe that those [investment] managers that decide their investment strategies are not affected by the outcome of proxy votes, and therefore do not devote the time or resources to vote proxies on an informed basis on behalf of their clients, should not be required to report on proxies they do not vote if they conclude that not voting the proxies does not violate their fiduciary duties to affected clients.”)
26. See Latham & Watkins Parallel Universes for a more complete analysis of the functional dichotomy between investing and voting and dominance of voting decision makers in the voting process. See *also* Latham & Watkins Three Paradigms.
27. Although very early in the game, it appears that the now mandatory Say on Pay vote in the US will be greatly influenced, if not dominated, by ISS voting recommendations, which (notwithstanding an ISS claim that they will be “holistic”) so far seem to be solely a function of whether under ISS’ model there is a pay and performance “disconnect.” If the ISS model finds a disconnect, ISS recommends a no vote and if it doesn’t find a disconnect ISS recommends a yes vote. This is a far cry from the concept of Say on Pay, as formulated by the SEC, which is a shareholder vote based on the entirety of the company’s CD&A and accompanying charts, presumably in the context of comparative peer company compensation and performance. In addition, at least the cynics among us might question the impartiality of the ISS consistent recommendation of annual, rather than biennial or triennial, Say on Pay votes. If a business model is based on a fee for every voting recommendation, it is reasonable to suppose that recommendations increasing the number of shareholder votes might be favored.

If you have any questions regarding this *Commentary*, please contact any of the attorneys listed below or the Latham attorney with whom you normally consult.

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