

December 19, 2013

VIA EMAIL

Dr. Dirk Andreas Zetsche, L.L.M.
Chairman
Drafting Committee
The Best Practice Principles for Governance Research Providers Group
Public Consultation on Best Practice Principles for Governance Research Providers

RE: Center On Executive Compensation Comments in Response to Draft Best Practice Principles for Governance Research Providers

Dear Dr. Zetsche:

The Center On Executive Compensation (“the Center”) is pleased to submit comments in response to the Public Consultation on Best Practice Principles for Governance Research Providers. Issues regarding oversight and accountability of proxy advisory firms and related providers are a top priority for our organization.

The Center On Executive Compensation is a US-based 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, a trade association, headquartered in Washington, DC, which represents the chief human resource officers of over 350 large companies, most of which conduct business globally. The Center’s more than 100 subscribing companies are HR Policy Association members that represent a broad cross-section of industries. Because senior human resource officers play an important role in supporting the compensation committee, we believe that our Subscribers’ views are particularly helpful in better understanding how executive compensation plans are developed and executed, especially in the era of say on pay.

Since its founding, the Center has been engaged in gathering information from its Subscribers regarding proxy advisory firm policies, practices and recommendations. The Center regularly engages with Institutional Shareholder Services, Inc. (ISS) and Glass Lewis & Co. in the US. Because the Principles cover governance research firms that are reviewing practices of US-based companies, these comments provide our perspective on the issues particularly with respect to proxy advisory firm accountability and mitigation of conflicts of interest, as well as disclosure. The following points are organized in the order presented in the Principles.

The Comply or Explain Framework

As a matter of best practice (in contrast to relevant legal and regulatory requirements in specific jurisdictions), the Center agrees generally with the comply-or-explain approach set forth in the document. However, we believe that to be effective, in addition to publishing their statements of compliance with the Best Practice Principles Group website, governance research service providers should be required to post the statements on their own websites. In addition, the providers should supply the detailed compliance statements to their institutional investor clients. The compliance statement should highlight those areas in which the providers deviate from the Principles and include a detailed explanation for such deviations. This recommendation is consistent with the statement in the Principles that “Irrespective of the type of services used to support ownership and voting activities, the ultimate responsibility to monitor investments and make voting decisions lies with institutional investors,”¹ and reliance on a third-party service generally does not shift the responsibility.

The Governance and Monitoring Process

The Center believes that using a principles-based approach in this context allows for agreement on the foundational issues on which research, analysis and dialogue are based. However, it should be made clear in the Principles that governance research providers should base their analysis and recommendations on an individualized, thorough and nuanced evaluation of each issuer’s filings. The Principles should not be viewed as endorsing or encouraging a “check-the-box” approach that is frequently used by the largest proxy advisors in the US. Although a brief mention is made of such issues, the Principles should explicitly state that governance research providers’ recommendations will be based on a detailed and thoughtful analysis of a company’s specific compensation programs and governance structures, rather than a mechanistic processing of research or voting recommendations.

The Center strongly agrees with the point that the Principles should not substitute for the laws or regulations of local jurisdictions. The Principles should not be global. However, given the increased oversight that proxy advisory firms are receiving in several jurisdictions, including the US and Canada, the Principles will provide a helpful point of reference on the issues and potential approaches to greater transparency, accountability and oversight.

Service Quality

Principle One states that a duty to provide relevant, accurate and reliable analysis is owed by governance research providers to the investors that are their clients. However, this duty of quality and accuracy is also owed to the issuers that will be directly affected by the institutional investors’ use of the providers’ research. This duty should be explicitly recognized in the Guidance accompanying the Principle. As part of this duty, the provider should take into account and reference data and information that are contradictory to its ultimate recommendation.

¹ *Public Consultation on Best Practice Principles for Governance Research Providers*, at 10, ESMA, Best Practice Principles for Governance Research Group (2013) 212 (Oct. 28, 2013).

The Guidance accompanying Principle One should explicitly state that proxy advisory firms should disclose their methodologies and the data on which their analysis is based to issuers to allow issuers to validate the accuracy of proxy advisory firm analysis.² The information that relates to specific issuers should also be provided or made available to institutional investor clients to enable them to validate the governance research provider's assessment.

The Guidance states that signatories should "implement organizational features to achieve *adequate verification* . . . of the quality of the research that is provided."³ The Center believes that governance research providers should also validate whether the Principles and related Guidance are consistent with positive shareholder returns (or at least not consistent with negative shareholder returns). On an ongoing basis, the research service providers should assess whether research and recommendations to clients regarding issuers with similar circumstances are consistent, and if they are not consistent, explain the reasons why or the changes that need to be made to the research process to ensure greater consistency. The validation assessments conducted by governance research service providers should be distributed to both issuers and investors and made available to the media and the public. The Center recommends that the data should also be made available for external validation by academics or others that can conduct independent assessment of the relationship between research and recommendations and shareholder return.

Conflicts of Interest Management

Principle Two urges disclosure of conflict of interest policies, but this is insufficient given the widespread concerns regarding potential conflicts at some proxy advisory firms that provide consulting services to issuers while providing "independent" research and recommendations on those same issuers to institutional investor clients. Conflicts of interest generated by simultaneously providing consulting and research/recommendation services should be prohibited, as should conflicts that arise from the ownership of proxy advisory firms by institutional or activist investors.

If the preferred approach of prohibiting such conflicts is not adopted, providers should be required to disclose in each report whether the provider also provided consulting services to an issuer, even if this requires procedures to be put in place to protect their research staffs from the knowledge of such potential conflicts. A blanket disclosure about potential conflicts of interest and/or providing a general list of issuers that may receive consulting services does not sufficiently put investors on notice about potential conflicts. This may require providers to have two versions of a report -- one that goes to institutional investor clients and one that is available for broader distribution.

Principle Two, or at least the Guidance accompanying it, should also require providers to recuse themselves from making recommendations on shareholder proposals submitted by clients of the proxy advisory firm (such as proposals issued by pension funds that are also clients of the proxy advisory firm). If a recusal policy is not adopted, at a minimum, the fact that an

² *Id.* at 15.

³ *Id.*

institutional investor is a client of the firm should be disclosed in all reports where the client's proposal is analyzed and a recommendation on it is made.

As discussed above, providers should be required to perform assessments of their corporate governance research and/or voting policies to validate that those policies are consistent with positive total shareholder return. The methodologies and recommendations should be provided to academics and other third-party researchers to validate the analysis conducted by the proxy advisory firms. This would dispel the actual or perceived conflict of interest that the methodologies are designed to promote the providers' views of compensation and governance issues rather than being based on advancing shareholder interests.

Communications Policy

A draft of the provider's analysis and recommendations should be provided in a timely manner to the issuer prior to being issued to clients with sufficient time for the issuer to review and assess the information. This would allow a constructive dialogue between the issuer and the proxy advisory firm and allow sufficient time for checking the accuracy of proxy advisory reports. In the US, one provider currently provides this information for large issuers, but allows just 48 hours for the issuer to respond. Although the opportunity to review the information is helpful in mitigating potential inaccuracies, the short turnaround time is insufficient. Further, many smaller issuers do not even receive a copy of the analysis and report before it is published to clients. The Principles and/or the Guidance should include a requirement that proxy advisors provide an appropriate opportunity for issuers to review the information to reduce inaccuracies and conflicts of interest.

The Center supports the inclusion in the Guidance of the opportunity for consultation and dialogue between the provider and the issuer. These discussions should focus on enhancing the provider's understanding of why the issuer adopted specific practices and policies and whether those policies are supportive of the issuer's strategy and shareholder value creation. The focus should not be on whether the issuer's practices deviate from the provider's guidelines/policies that underlie the "check the box" approaches that are often employed. Even where custom voting policies are applied on behalf of an institutional investor, the Guidance should stress that the provider's analysis should focus on the rationale for the issuer's actions.

Conclusion

Thank you for the opportunity to provide the Center On Executive Compensation's perspective on the proposed Principles. If you have any questions, please do not hesitate to contact me at tbartl@execcomp.org.

Sincerely,



Timothy J. Bartl
President