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December 20, 2013

Dr. Dirk Andreas Zetzsche  
Independent Chairman  
Drafting Committee of the Best Practice  
Principles for Governance Research Providers  
c/o University of Liechtenstein  
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VIA ELECTRONIC MAIL  
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Subject: Public Consultation on Best Practice Principles for Governance  
Research Providers

Dear Professor Zetzsche:

The Shareholder Communications Coalition (“Coalition”), based in Washington, D.C., is pleased to provide its comments regarding the draft Best Practice Principles (“Principles”) developed by (and for) Governance Research Providers in Europe and globally.

The Coalition comprises three associations based in the United States: Business Roundtable ([www.businessroundtable.org](http://www.businessroundtable.org)), National Investor Relations Institute ([www.niri.org](http://www.niri.org)), and Society of Corporate Secretaries & Governance Professionals ([www.governanceprofessionals.org](http://www.governanceprofessionals.org)). More information about the Coalition and its advocacy activities can be accessed at [www.shareholdercoalition.com](http://www.shareholdercoalition.com).

The Coalition’s comments relate to providers that make recommendations on shareholder voting—so called proxy advisory firms—as a subset of those entities providing governance research services.

Proxy advisory firms have considerable influence in the shareholder voting process for public companies, yet operate today with little regulation or oversight. As discussed at the U.S. Securities and Exchange Commission’s Roundtable on Proxy Advisory Services on December 5, 2013, a number of concerns have been raised over the years about the use of these firms by institutional investors and the manner in which individual proxy advisory firms operate:

- It is unclear whether institutional money managers are exercising appropriate oversight over the proxy advisory firms they retain, consistent with their fiduciary responsibilities;
- There is a lack of transparency in the way proxy advisory firms operate, with insufficient information available to the public markets about their policies, procedures, guidelines and methodologies;
- It is unclear whether proxy advisory firms are taking appropriate steps to see that their analysts responsible for making voting recommendations have the requisite experience, qualifications, and training in current corporate governance issues, particularly compensation issues, and board policies and practices;
- Several of the practices employed by proxy advisory firms raise conflicts of interest concerns and are not adequately disclosed to their clients; and
- Proxy advisory firms sometimes use incorrect factual information in developing specific voting recommendations for shareholder meetings, and these firms do not have consistent processes in place to identify, correct, and disclose these factual errors.

The Coalition notes the conclusion by the European Securities and Markets Authority (“ESMA”) that no clear evidence exists of a “market failure” in relation to how proxy advisory firms interact with institutional investors and public companies. We believe, however, that market failure is not the proper measure and misses the point. In the U.S. markets at least, the proxy advisory firms have significant influence over proxy voting by virtue of particular laws and regulations that encourage investors’ reliance on their services. The Coalition supports a comprehensive solution, including the consideration of a uniform regulatory framework that applies to these firms and reflects the unique role that they play in the proxy voting process.

In that regard (and in response to question #3 of the Consultation), the Coalition does not believe that a comply-or-explain approach with respect to these Principles is practical or appropriate. The principal objective of a comply-or-explain framework is to grant flexibility for companies to deviate from a code to accommodate company-specific circumstances. This approach is appropriate for corporate governance practices, to acknowledge differences in organizational and governance structures and processes. However, we do not believe it is appropriate for what is, in effect, a baseline standard of conduct governing providers of vote recommendations (and who sometimes provide a direct voting service) that are used by many investment advisers, sometimes without full review or analysis.

Nevertheless, the Coalition does believe that the draft Principles are an important first step in addressing some of the concerns that have been raised. If the Principles are

followed, they will provide for improved transparency and disclosures regarding the internal processes that proxy advisory firms use to develop voting recommendations and decisions for their institutional investor clients. They do not, however, address other significant concerns, such as:

- A lack of disclosure of specific conflicts that exist routinely as a result of certain business practices engaged in by proxy advisory firms;
- The integrity of data collection and verification practices for the wide-range of company and market data that is central to arriving at a thoughtful and well-reasoned voting recommendation;
- The use of incorrect factual information by these firms in formulating specific voting recommendations; and
- Inadequate disclosures to the public markets about how proxy firms operate and how they develop voting recommendations.

What follows are comments by the Coalition on specific matters contained in the draft Principles and the questions raised in the accompanying Consultation.

#### **A. Principle One: Service Quality**

1. Research Policy and Methodologies. The Coalition strongly supports more transparency and disclosure to clients, companies, and the public markets of the research policies and “house” voting guidelines used by proxy advisory firms. It also believes that these policies and guidelines should be developed with a greater opportunity for companies and investors to provide input into their development.<sup>1</sup>

Beyond the opportunity for public input regarding policies and guidelines, information about the internal processes and methodologies used by proxy advisory firms to develop proxy voting recommendations should be disclosed publicly on their respective websites. This is necessary to ensure that the public markets have confidence in the conclusions that these firms reach on specific shareholder voting issues.

Additionally, given their influential role in the proxy voting process, each proxy advisory firm should be required to establish, maintain, and enforce an effective internal control structure governing the implementation of, and

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<sup>1</sup> While Institutional Shareholder Services (“ISS”) does seek comments on some of its draft voting policy changes each year, it is unclear how the comments and inputs from different constituencies are used in crafting the policies. Additionally, the ISS comment period is very short, typically two weeks, and does not provide adequate time for most public companies to analyze and provide comments on the draft policies.

adherence to, the policies, guidelines, and methodologies used to provide proxy voting recommendations to persons with whom the proxy advisory firm has a client relationship.

2. Quality of Research. The Coalition supports the intent of the draft Principles to encourage proxy advisory firms to take steps to ensure the reliability of the information they use in the research process, but believes the Principles should be more specific. In order to ensure that company reports are factually accurate, proxy advisory firms should provide each company with an advance draft copy of any report that includes a proxy voting recommendation about such company. This would permit each company to review and comment on the accuracy of factual statements made, or omissions, in a report before it is issued to clients, before any of the proxy advisory firm's recommendations become public, and before any institutional investors vote their shares based on information that might be erroneous.

At least one proxy advisory firm—Institutional Shareholder Services—provides draft reports in advance for this purpose to companies that are listed in the S&P 500 index. This practice should be required of all proxy advisory firms and cover all companies for which they are making voting recommendations, so that a uniform approach to fact-checking by companies is achieved.

After receiving public company comments on specific reports, proxy advisory firms should promptly correct any factual error(s) identified. Firms should also disclose when comments have been received by a public company and permit investor access to such comments.

In order to improve the discourse in public markets about the research, analysis, and conclusions by proxy advisory firms regarding individual companies and permit academic study, each firm should disclose on its website (or through a regulatory filing) a copy of each report that contains a proxy voting recommendation about a public company, sometime after the shareholder meeting to which the voting recommendation relates.

3. Employee Qualification & Training. The Coalition agrees with the draft Principles that proxy advisory firms should evaluate and improve employee qualifications and training, to ensure that "staff members are trained on the relevance and importance of their activities and on how they contribute to service delivery." In addition, analytical staff should have an understanding of specific corporate governance policies and board practices, so they can appreciate the unique circumstances of each individual company they evaluate. This is particularly true with respect to compensation matters and the say-on-pay vote. Indeed, the Coalition believes that experienced,

qualified, and well-trained staff should be a central tenet of any Best Practice Principles, and, therefore, could be given much greater prominence.

Additionally, to ensure the highest quality work product possible, the Coalition believes that proxy advisory firms and their clients should evaluate workflow management policies and procedures, the quality of the analyst work product, and whether technology is being used most effectively within these firms.

4. Client & Supplier Understanding. The Coalition believes that the responsibilities of the institutional investors that retain proxy advisory firms should be addressed.<sup>2</sup> Each institutional investor with fiduciary responsibilities should be exercising appropriate oversight over its proxy voting process, including its use of proxy advisory firms, to ensure that its voting decisions are in the best interests of its clients and beneficiaries. In addition, institutional investors should provide more disclosure to their beneficiaries and the public about their proxy voting policies and how they utilize the advice of proxy advisers. Further, proxy advisory firms should disclose to the public markets any framework that they have developed to facilitate oversight efforts by their institutional investor clients. Our comments and recommendations are aimed, in part, at enabling investors to exercise an appropriate level of oversight.

Whether as a part of the Principles or otherwise,<sup>3</sup> oversight of proxy advisory firms by institutional investors should include, at a minimum, an evaluation of the following: (1) conflicts of interest; (2) internal standards, methodologies, and controls; and (3) quality of analytical staff and work product.

## **B. Principle Two: Conflicts of Interest Management**

1. Conflicts of Interest Policy and Disclosure. The draft Principles identify the most important potential conflicts that may arise in the course of the day-to-day operations of a proxy advisory firm. The Coalition agrees that these are some of the proper conflicts to address, but does not believe the development of a general conflicts of interest policy is alone sufficient. It is important that specific conflicts relating to matters to be voted upon be disclosed to the other clients of a proxy advisory firm in connection with voting recommendations. Examples include:

- Disclosure by any firm providing corporate governance and/or executive compensation consulting services to a company, while at the same time providing voting

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<sup>2</sup> See, e.g., question #12 in the Consultation document.

<sup>3</sup> See, e.g., the U.K. Stewardship Code.

recommendations to institutional investor clients on proxy matters involving the same company;<sup>4</sup>

- Disclosure by any firm providing voting recommendations on shareholder proposals submitted to companies by any of their investor clients; and
- Disclosure by any firm that has a business or professional relationship with a company and/or investor client that transcends a client relationship.

The Coalition questions the assertion made in the draft Principles that the public disclosure of specific conflicts may create problems with the use of information barriers by some proxy advisory firms. These information barriers, it is argued, can prevent a potential conflict from becoming an actual conflict.<sup>5</sup> In the Coalition's view, however, the use of information barriers is a separate issue from the disclosure of a specific conflict. Institutional investors and other public market participants involved in making voting decisions should be specifically informed of every conflict, as they weigh the voting recommendation(s) made by a proxy advisory firm, including the conflict that arises when the firm is paid by an investor that advances a shareholder proposal or has an item on the company's proxy upon which the firm makes a recommendation.

### **C. Principle Three: Communications Policy**

Dialogue with Issuers, Shareholder Proponents & Other Stakeholders. The Coalition supports additional opportunities for dialogue between proxy advisory firms and public companies, as well as with other participants in the proxy process. In addition to the transparency and disclosure measures noted earlier in this comment letter, the Coalition reiterates its comment that all proxy advisory firms provide public companies with advance copies of their individual reports for review of factual statements. Any factual errors should then be corrected promptly and the proxy advisory firm should disclose in its reports that public company comments were received and permit investor access to such comments. The Coalition also believes that the public markets

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<sup>4</sup> The Coalition understands from the recent SEC Roundtable that ISS discloses to its investor clients, upon request, a list of those companies subscribing to its corporate governance and/or executive compensation consulting services.

<sup>5</sup> This theoretically would arise in the case where a corporate consulting client was known to a firm analyst making a recommendation. Knowing the fact that the corporate consulting client purchases services from the firm could, in fact, cloud the judgment of the analyst and cause him or her to be prone to make recommendations favorable to the company.

would benefit greatly from the disclosure of all company reports by each proxy advisory firm, at some point after a shareholder meeting.<sup>6</sup>

**D. Other Issues**

As noted earlier, the Coalition believes the draft Principles are an important first step in addressing some of the concerns that have been raised regarding the role of proxy advisory firms. However, a more comprehensive approach is necessary to address these concerns, including consideration of a uniform regulatory framework that applies to these firms and reflects the unique role that they play in the proxy voting process.

Thank you for the opportunity to provide comments on the draft Principles and for considering our views. Please feel free to contact me at [nholch@holcherickson.com](mailto:nholch@holcherickson.com), or through our Coalition website ([www.shareholdercoalition.com](http://www.shareholdercoalition.com)), with any questions, or if you need additional information.

Sincerely,

A handwritten signature in black ink, appearing to read "Niels Holch". The signature is fluid and cursive, with the first name "Niels" and last name "Holch" clearly distinguishable.

Niels Holch  
Executive Director

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<sup>6</sup> The Coalition also believes that a delayed disclosure of these reports would not adversely impact the competitive or proprietary interests of individual proxy advisory firms.