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**Filed Electronically**

February 2, 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 Ave., N.W.  
Washington, D.C. 20210

Re: *RIN 1210-AB32, Definition of the Term "Fiduciary" Under ERISA*

Dear Madam or Sir:

Institutional Shareholder Services Inc. (ISS) appreciates the opportunity to comment on the Department's proposal to amend 29 CFR 2510.3-21(c).<sup>1</sup> This rule defines the circumstances under which a person rendering investment advice to an employee benefit plan or a plan's participants is deemed to be a "fiduciary" for purposes of section 3(21)(A)(ii) of the Employee Retirement Income Security Act of 1974 (ERISA). While ISS generally supports the Department's efforts to review this regulation, ISS is concerned that the current proposal could have unintended consequences that will harm, rather than protect, participants in employee benefit plans and their beneficiaries by depriving them of access to critical professional guidance regarding their proxy voting decisions. ISS also believes that the Department should co-ordinate its rulemaking in this area with the Securities and Exchange Commission (SEC), which is currently studying similar issues.

***Background***

ISS, an indirect, wholly-owned subsidiary of MSCI Inc.,<sup>2</sup> is a federally registered investment adviser with more than 25 years of experience in helping institutional investors meet their fiduciary responsibilities related to proxy voting. More than 1,300 clients -- including employee benefit plans, investment managers, hedge funds and mutual funds -- rely on ISS' expertise to help them make more informed proxy voting decisions, manage the complex process of voting their shares, and report their votes to their stakeholders and regulators.

***Governance Research and Recommendations***

Through its governance research and proxy voting recommendations, ISS helps institutional investors understand corporate governance policies and practices at their portfolio companies and take these practices into account in their proxy voting. ISS offers a wide range of proxy voting policy options to institutional investors, including vote recommendations based on a client's specific customized voting guidelines. In addition, ISS provides enhanced analysis of contentious meetings (M&A and proxy

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<sup>1</sup> "Definition of the Term 'Fiduciary'," 29 CFR Part 2510, RIN 1210-AB32 (October 13, 2010), 75 Fed. Reg. 65263 (October 22, 2010) ("Proposing Release").

<sup>2</sup> MSCI is a provider of investment decision support tools to investors globally. MSCI's products and services include indices and portfolio risk and performance analytics tools.



contests) as well as governance data and analytics through its Governance Risk Indicators (GRid) product.

### *Voting Services*

ISS' ProxyExchange application and experienced account managers provide end-to-end management of the proxy voting process. ISS clients can control their voting policy and final vote decisions while outsourcing the processing and data management elements to an experienced service provider. To this end, ISS receives clients' proxy ballots, works with custodian banks, executes votes on clients' behalf, maintains vote records and provides comprehensive reporting. By outsourcing the administrative tasks associated with the voting process, our clients free themselves to devote their internal resources to making more informed investment decisions.

### *Disclosure and Other Services for Institutional Investors*

In addition to developing proxy voting policies, making vote recommendations, and processing votes, ISS also offers a Vote Disclosure Service to help investment companies comply with their regulatory disclosure obligations. Other ISS offerings include corporate governance services focusing on environmental and sustainability issues.

### *Services Provided to Issuers*

Apart from ISS' core business of analyzing the proxies of corporate issuers and making vote recommendations for the benefit of institutional investors, ISS' wholly-owned subsidiary, ISS Corporate Services, Inc. (ICS), serves the corporate issuer community by providing products and services that enable issuers to understand and implement corporate governance best practices. These products and services include web-based tools, advisory services and publications that assist issuers with executive and director compensation modeling, capital structure planning and other governance issues.

### *ISS' Approach Regarding Conflicts of Interest*

As an investment adviser registered under the Investment Advisers Act of 1940 (Advisers Act), ISS fully appreciates the fiduciary duties of care and loyalty it owes to its clients. It also understands that these duties entail a responsibility to eliminate potential conflicts of interest where possible and to manage and disclose those conflicts that cannot reasonably be avoided. To this end, ISS takes a number of steps to safeguard the integrity of the research and services it provides to institutional investors so that it can fulfill its important role in the dialogue between corporations and their shareholders.

#### Policy-Based Approach

At its core, ISS is a transparent policy-based organization; its use of a series of published voting policies provides a very practical check and balance that ensures the integrity and independence of ISS' analyses and vote recommendations. While these policies allow analysts to consider company- and market-specific factors in generating vote recommendations, the existence of a published analytical framework, coupled with the fact that vote recommendations are based on publicly-available information, allows ISS clients to continuously monitor the integrity of ISS' advice.<sup>3</sup>

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<sup>3</sup> Each ISS analysis includes a URL for a direct hyperlink to ISS' summary voting guidelines for easy access by users of our research.



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○ Compliance Program: Code of Ethics, Training, Monitoring and Firewall

In addition to the practical check and balance supplied by the policy framework, the independence and integrity of ISS' proxy advice is further ensured by the comprehensive compliance program the company maintains pursuant to the Advisers Act and related rules. One of the primary components of this program is a Code of Ethics that prescribes standards of conduct for ISS and its employees.

The Code of Ethics affirms ISS' fiduciary relationship with its clients and obligates ISS and its employees to carry out their duties solely in the best interests of clients and free from any compromising influences and loyalties. The Code also contains restrictions on personal trading designed to prevent employees from improperly trading on, or benefiting from, inside information, client information and/or ISS' voting recommendations. The Code emphasizes the requirement that all research for clients be rendered independently of employees' personal interests.

In order to ensure compliance with the Code of Ethics, ISS conducts periodic training sessions for employees and requires employees to affirm their commitment to compliance on an annual basis. Furthermore, ISS regularly monitors the sufficiency of the Code and the effectiveness of its implementation.

Another critical component of the ISS compliance program is the firewall it maintains between its institutional business and the corporate services performed by its ICS subsidiary. This firewall includes the physical and functional separation between ICS and ISS, with a particular focus on the separation of ICS from the ISS Global Research team. A key goal of the firewall is to keep the ISS Global Research team from learning the identity of ICS' clients, thereby ensuring the objectivity and independence of ISS' research process and vote recommendations.

The firewall mitigates potential conflicts via several layers of separation:

1. ICS is a separate legal entity from ISS.
2. ICS is physically separated from ISS, and its day-to-day operations are separately managed.
3. ISS Global Research works independently from ICS.
4. ICS and ISS staff are prohibited from discussing a range of matters, including the identity of ICS clients.
5. Institutional analysts' salaries, bonuses and other forms of compensation are not linked to any specific ICS activity or sale.
6. ICS explicitly tells its corporate clients that ISS will not give preferential treatment to, and is under no obligation to support, any proxy proposal of an ICS client. ICS further informs its clients that ISS' Global Research team prepares its analyses and vote recommendations independently of, and with no involvement from, ICS.

As is the case with the Code of Ethics, ISS maintains a robust training and monitoring program regarding the firewall. This program includes quarterly tests of the firewall's integrity, new-hire orientation, and review of certain marketing materials and disclosures. In addition, there is an ethics hotline available to both ICS and ISS staff for reporting issues of potential concern.



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## ○ Disclosure Regarding Potential Conflicts

ISS provides its investor clients with an extensive array of information to ensure that they are fully informed of potential conflicts and the steps ISS has taken to address them. In addition to making full disclosure in the Form ADV brochure it delivers to each client, ISS supplies a comprehensive due diligence compliance package on its Web site<sup>4</sup> to assist clients and prospective clients in fulfilling their own obligations regarding the use of independent, third-party proxy voting firms.<sup>5</sup> This package includes a copy of ISS' Code of Ethics, a description of other policies, procedures and practices regarding potential conflicts of interest and a description of the ICS business.

Moreover, each proxy analysis and research report ISS issues contains a legend indicating that the subject of the analysis or report may be a client of or affiliated with a client of ISS, ICS or another MSCI subsidiary. Each analysis and report also notes that one or more proponents of a shareholder proposal may be a client of ISS or one of its affiliates, or may be affiliated with such a party. Clients who wish to learn more about the relationship, if any, between ICS and the subject of an analysis or report are invited to contact ISS' Legal and Compliance Department for relevant details. This process allows ISS' proxy voting clients to receive the information they need without revealing the identity of ICS clients to research analysts as they prepare vote recommendations and other research.

ISS believes that these extensive measures provide employee benefit plans and other clients with a high degree of comfort that ISS has eliminated or is effectively managing the potential conflicts of interest its business entails.

### ***The Department's Proposal***

#### *The Definition of "Fiduciary" Under ERISA*

ERISA generally defines a "fiduciary" to include a person who renders investment advice for a fee or other compensation with respect to moneys or other property of an employee benefit plan, as well as any person who has authority or responsibility to do so.<sup>6</sup> In its current proposal, the Department seeks to amend a thirty-five year old rule that establishes the circumstances under which a person is deemed to render "investment advice" within the meaning of ERISA's fiduciary definition.<sup>7</sup> In proposing this change, the Department notes that the existing regulation is narrower than the statute and hampers regulatory efforts to police the conduct of persons who advise plans about their investments.<sup>8</sup> Due to changes in the retirement plan industry and the financial marketplace since the rule was adopted, the

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<sup>4</sup> [www.issgovernance.com/practices](http://www.issgovernance.com/practices).

<sup>5</sup> In 2004, the SEC staff issued guidance to registered investment advisers concerning their due diligence obligations with respect to the use of third-party proxy voting firms. See *Institutional Shareholder Services* (September 15, 2004); *Egan-Jones Proxy Services* (May 24, 2004). See also, SEC Release Nos. IA-2106 (January 31, 2003)(Adopting Advisers Act Rule 206(4)-6), and IC-25922 (January 31, 2003) (adopting Rule 30b-1-4 under the Investment Company Act of 1940).

<sup>6</sup> ERISA, Section 3(21)(A)(ii). The term also includes anyone who exercises discretion over the management of the plan or its assets, as well as anyone who has discretionary authority regarding the administration of the plan.

<sup>7</sup> 29 CFR 2510.3-21(c).

<sup>8</sup> Proposing Release, 75 Fed. Reg. at 65264-65.



Department suggests that the narrow interpretation of investment advice may no longer afford sufficient protections to plan participants and their beneficiaries. The Department expresses particular concern about plan advisers who operate with undisclosed and unmitigated conflicts of interest.<sup>9</sup>

The Department proposes to address these concerns by broadening the circumstances under which a person would be deemed to render investment advice for purposes of ERISA section 3(21)(A)(ii). Under the amended version of the rule, the statutory definition would generally be met if the person performs at least one of three specified functions and satisfies at least one of four specified conditions. Of particular interest to ISS is the proposal to include as one of the triggering functions providing advice or recommendations as to the management of securities or other property; according to the Department, this would include "advice and recommendations as to the exercise of rights appurtenant to shares of stock (e.g., voting proxies)".<sup>10</sup> Also of interest is the proposal to include as one of the qualifying conditions being an investment adviser within the meaning of section 202(a)(11) of the Advisers Act.<sup>11</sup>

ISS understands the need to ensure that ERISA regulations keep pace with changes in the retirement plan community and the financial markets, and ISS appreciates the Department's concern that some parties who render investment advice to plans and participants may not be acting in their clients' best interests. Nevertheless, ISS is concerned that the current proposal could ultimately harm, rather than protect, plans and their participants.

#### *Unintended Consequences of the Current Proposal*

As a registered investment adviser, ISS already owes fiduciary duties of care and loyalty to its clients.<sup>12</sup> Therefore, we see no impediment to imposing ERISA's affirmative fiduciary duties on proxy advisers to the extent those duties are relevant.<sup>13</sup> On the other hand, imposing ERISA's prohibited transaction provisions on proxy advisers could harm plans and their participants if the Department were to consider a proxy vote to be a "transaction." Problems also could arise if the Department were to deem a corporation's interests to be "adverse" to the interests of its shareholders, or if it were to deem issuers and shareholders to "deal" with each other in connection with a proxy vote.

Section 406(b) of ERISA forbids a fiduciary to act in any transaction involving the plan on behalf of a party, or to represent a party, whose interests are adverse to the interests of the plan or its participants or beneficiaries. This section also prohibits a fiduciary from receiving any consideration for his personal account from any party dealing with the plan in connection with a transaction involving plan assets.

ISS submits that a proxy vote is not a "transaction" as that term is used in Section 406, and that providing advice in connection with a proxy vote does not constitute "acting in a transaction" within

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<sup>9</sup> *Id.*, 75 Fed. Reg. at 65265, 65272.

<sup>10</sup> *Id.*, 75 Fed. Reg. at 65266, describing proposed Section 2510.3-21(c)(1)(i)(A)(3).

<sup>11</sup> Proposed Section 2510.3-21(c)(1)(ii)(C).

<sup>12</sup> See Proposing Release at note 15 and accompanying text.

<sup>13</sup> Certain duties enumerated in Section 404 of ERISA, such as the duty to diversify investments, would be irrelevant to a fiduciary whose function is limited to analyzing governance issues and making proxy vote recommendations.



the meaning of that provision. A contrary reading of the statute could deprive employee benefit plans and their participants of access to critical professional guidance regarding their voting decisions.

As noted above, ISS helps many of its clients develop custom proxy voting policies and makes vote recommendations based on clients' specific voting guidelines. Some of these guidelines focus solely on economic factors, while others emphasize environmental, social, faith-based or other issues. Because ISS' advice is tailored to the specific needs and preferences of its clients, ISS may recommend that some clients support a proxy proposal while advising other clients to reject that same proposal. If the proxy vote is deemed to be a "transaction" and rendering advice about that vote is deemed to be "acting in a transaction," Section 406(b) could effectively preclude ISS from offering its services to any client covered by ERISA, because there might not be a way to operate the proxy advisory service without engaging in a prohibited transaction.

Employee benefit plans and their participants also could be harmed if Section 406(b) were read to preclude a proxy adviser from directly or indirectly providing services to issuers. Educating corporations about best practices relating to executive compensation and other governance issues ultimately benefits those corporations' shareholders. If proxy votes are "transactions" and if issuers' interests are presumed to be "adverse" to the interests of shareholders, or if issuers are deemed to "deal" with shareholders in connection with proxy votes, proxy advisers could be forced either to stop providing advice to ERISA plans and their beneficiaries or to stop educating issuers about corporate governance. Neither course would benefit plans or their beneficiaries in the long run.

Indeed, an overly broad reading of the terms used in ERISA Section 406(b) could limit plans' ability to use *any* proxy advisory firm, including even those firms that do not provide customized vote recommendations and/or that do not directly or indirectly provide services to issuers. An adviser that makes a vote recommendation regarding an issuer that owns one of the adviser's institutional clients, or regarding a contested solicitation or shareholder proposal involving an institutional client, could find itself engaging in a prohibited transaction, if the proxy vote is a "transaction" and the issuer is deemed to be "adverse to" or "dealing with" the adviser's other shareholder clients.

The complexity of relationships among parties in the proxy voting chain means that the potential for conflict of interest is always present for all proxy advisory firms. A broad prohibition of these relationships would essentially make it impossible for plans to receive advice of any kind. For this reason, ISS submits that should the Department decide to amend Section 2510.3-21(c), it must do so in a way that ensures that plans continue to have access to professional guidance regarding their proxy votes. The Department could achieve this goal by confirming -- either in the rule itself or in an adopting release -- that a proxy vote is not a "transaction" for purposes of ERISA Section 406(b). In the alternative, the Department could issue a class prohibited transaction exemption contemporaneously with the adoption of the amendment, to permit proxy advisers to continue to serve the employee benefit plan community.

ISS is also concerned about the potential unintended consequences of tying fiduciary status under ERISA to a party's status as an investment adviser under the Advisers Act. At this time, not all proxy advisers are registered as investment advisers, even though the SEC has opined that proxy firms act as such when they provide their clients with advice designed to enable clients to maximize the value of their investments.<sup>14</sup> Including investment adviser status as one of the conditions that might cause a party to be deemed an ERISA fiduciary could create opportunities for regulatory arbitrage, allowing

<sup>14</sup> SEC Release No. IA-3052 (July 14, 2010) at 109-110, 75 Fed. Reg. 42981, 43010 (July 22, 2010).



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proxy advisory firms that refuse to characterize themselves as investment advisers to escape regulatory oversight by the Department under ERISA as well as by the SEC under the Advisers Act. Such a situation would be enormously harmful to plans and their participants and beneficiaries.

In its recent Concept Release on the U.S. Proxy System, the SEC had this to say about the substantial client protections afforded by the Advisers Act and related rules:

Proxy advisory firms that are registered as investment advisers with the Commission are subject to a number of additional regulatory requirements that provide important protections to the firm's clients. For example, registered investment advisers have to make certain disclosures on their Form ADV. Among other things, these disclosures include information about arrangements that the adviser has that involve certain conflicts of interest with its advisory clients. In addition, proxy advisory firms that are registered investment advisers are required to adopt, implement, and annually review an internal compliance program consisting of written policies and procedures that are reasonably designed to prevent the adviser or its supervised persons from violating the Advisers Act. Every registered proxy advisory firm that is registered as an investment adviser also must designate a chief compliance officer to oversee its compliance program. This compliance officer must be knowledgeable about the Advisers Act and have authority to develop and enforce appropriate compliance policies and procedures for the adviser. A proxy advisory firm that is registered as an investment adviser also is required to establish, maintain, and enforce policies and procedures reasonably designed to prevent the misuse of material non-public information. Proxy advisory firms that are registered as investment advisers also are required to create and preserve certain records that our examiners review when performing an inspection of the adviser.<sup>15</sup>

Compliance with the Advisers Act and related rules substantially eliminates the type of unmitigated and undisclosed conflicts of interest that motivated the Department to take this regulatory action. In our opinion, the simple disclosure of potential conflicts is inadequate in the absence of a concrete, written and examined compliance program. The Department therefore should withdraw proposed Section 2510.3-21(c)(1)(ii)(C) in order to remove the incentive for proxy advisers to avoid subjecting themselves to the Advisers Act's robust regulatory regime.<sup>16</sup>

#### *Co-ordinating the Department's Rulemaking with SEC Initiatives*

Among the issues the SEC considered in its Concept Release on the U.S. Proxy System are the role and legal status of proxy advisory firms.<sup>17</sup> In connection with this review, the Commission has sought public comment on the appropriate regulatory treatment of proxy advisers, including the application of the Advisers Act registration provisions to such firms and whether oversight of proxy advisers registered under the Advisers Act should be improved, especially the area of conflicts of interest.

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<sup>15</sup> *Id.*, at 113-114, 75 Fed. Reg. at 43011 (citations omitted).

<sup>16</sup> In this regard, the Department also might consider conditioning any relief it provides regarding the prohibited transaction issue discussed above on the proxy adviser's being registered as an investment adviser under the Advisers Act or similar state laws.

<sup>17</sup> See note 14, *supra*.



Furthermore, pursuant to the Dodd-Frank Act, the SEC has recently undertaken a general study of the legal and regulatory standards of care applicable to investment advisers and broker-dealers.<sup>18</sup> Among other things, this study examines the fiduciary duty imposed on registered advisers when they vote proxies for their clients.<sup>19</sup> The study also explores whether the fiduciary standards applicable to investment advisers should be extended to certain broker-dealer activities as well. Both the Concept Release and the Dodd-Frank study may be followed by rulemaking.

ISS urges the Department to co-ordinate its rulemaking regarding the application of fiduciary standards under ERISA with the SEC's current regulatory initiatives. ISS believes that such a comprehensive approach will lead to more sensible regulation and better and more consistent protections for all investors, including employee benefit plans and their participants and beneficiaries.

### ***Conclusion***

ISS appreciates the Department's efforts to modernize and improve its fiduciary regulations. However, ISS asks the Department to be sensitive to the potential for unintended consequences and to recognize the benefits of inter-agency co-ordination in this area.

We would be happy to supply the Department with additional information regarding any of the matters discussed herein. Please direct any questions about these comments to the undersigned or to our outside counsel, Mari-Anne Pisarri of Pickard and Djinis LLP. She can be reached at 202-223-4418.

Respectfully submitted,

A handwritten signature in blue ink, appearing to read 'S. Friedman', is written over a horizontal line.

Steven E. Friedman  
General Counsel

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<sup>18</sup> SEC Staff, "Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act," (January 2011).

<sup>19</sup> *Id.* at 39 ("The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies. To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subordinate client interests to its own.")(citation omitted).