NATIONAL INVESTOR RELATIONS INSTITUTE

# Statement of the National Investor Relations Institute

**Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate**

**Hearing entitled: “Legislative Proposals to Examine Corporate Governance”**

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Founded in 1969, the National Investor Relations Institute (NIRI) is the professional association of corporate officers and investor relations consultants responsible for communication among corporate management, shareholders, securities analysts, and other financial community constituents. The largest professional investor relations association in the world, NIRI's more than 3,300 members represent over 1,600 publicly held companies and $9 trillion in stock market capitalization.

NIRI submits the following comments in support of two bills, H.R. 4015 and S. 1744, that were discussed during the Committee's June 28 hearing, "Legislative Proposals to Examine Corporate Governance." NIRI shares the concerns about the significant decline in public company ownership that were outlined in the written testimony by Darla Stuckey, President and CEO of the Society for Corporate Governance. NIRI believes that both bills would improve the climate for companies to go and remain public.

## NIRI Support for H.R. 4015

NIRI is pleased the join the broad coalition of organizations, including both national exchanges, that have expressed public support for H.R. 4015, the "Corporate Governance Reform and Transparency Act." NIRI believes that this bipartisan bill would bring much needed oversight to proxy advisory firms, which are not subject to comprehensive regulation by the Securities and Exchange Commission. This legislation will ensure that investors receive more accurate information before they vote their proxy ballots, provide for greater transparency around the proxy firms' potential conflicts of interest, and ensure that all issuers, regardless of their market cap, are treated fairly. NIRI also believes that this bill would help foster more IPOs, as a number of private company executives have indicated that the significant influence of unregulated proxy advisors is a deterrent to going public.

This bill takes a light-touch regulatory approach to proxy advisors; most of the requirements in H.R. 4015 could be implemented without significant expense, as they are based on best practices that one of the major proxy firms already has implemented.

### More Oversight Is Needed Because of Proxy Firms' Significant Influence

Institutional Shareholder Services (ISS) and Glass Lewis & Co., which together control 97 percent of the U.S. market for proxy advisory services, have substantial influence over the corporate governance practices of public companies. Collectively, ISS and Glass Lewis clients may own between 20 and 50 percent of a company's shares. While not all institutional investors follow the advice of the proxy advisors in all cases, many of them do so, particularly small and medium-size institutions that don't have their own in-house corporate governance staffs. Many of these smaller institutions have concluded that it is more cost-effective to completely outsource their proxy voting responsibilities to the proxy advisors. Although the proxy firms' influence

varies by company and subject matter, governance experts have found that a negative proxy advisor recommendation can lead to a 15 to 38 percentage point differential in support for management.

The influence of the proxy advisors has increased since the Dodd-Frank Act required U.S. companies to hold "Say on Pay" votes on executive compensation. While the Dodd-Frank Act allows companies to hold votes every two or three years, a significant majority of issuers now hold annual compensation votes, primarily because the proxy advisors urged their institutional clients to support annual votes when companies first held "Say on Pay" frequency votes in 2011. Annual "Say on Pay" votes have further entrenched the influence of the proxy advisors and deepened institutions' reliance on them, as it is not practical for fund managers to analyze the compensation practices of the dozens (or hundreds) of companies in their portfolios each year.

Despite their significant influence, proxy advisors remain largely unregulated, while substantial concerns have been raised by companies and academics about: (1) a lack of transparency concerning their standards and methodologies; (2) the risk that their voting recommendations may be based on incorrect information; and (3) the conflicts of interest posed by their business practices.

Unlike investors and public companies whose proxy filings are subject to review by the SEC, proxy advisors generally are exempt from regulation. Although ISS has registered as an investment adviser, the SEC does not provide systematic oversight over the proxy firms' research processes, how the firms interact with companies, and how they communicate with investors.

In June 2014, the SEC issued Staff Legal Bulletin 20 that imposed new obligations on institutional investors to oversee the work of proxy firms. While this Bulletin was a helpful first step, it has failed to fundamentally improve the accuracy of proxy reports or how proxy advisors interact with issuers. The reality is that most institutional fund managers don't have the time (or the in-house governance expertise) to double-check the work of their proxy firms. In a May 2016 NIRI member survey, only five percent of IR practitioner respondents reported that their treatment by proxy advisors had improved since the issuance of Staff Legal Bulletin 20.

**More Oversight Is Needed Given "Robo-Voting" by Investors**

The need for greater SEC oversight has increased in recent years as many ISS and Glass Lewis clients have started using automated proxy voting systems whereby votes are cast based on preset voting policies without the institutional investor having to take any further action. The use of these automated systems appears to be growing among small and mid-size investment managers, as public companies have reported that a significant (up to 20 percent) percentage of

their shares are voted within 24 to 48 hours of the issuance of the ISS proxy report.[1] During the 2016 appraisal litigation in Delaware over Dell Inc.'s going-private transaction, it was revealed that an ISS institutional client's shares were inadvertently voted in favor of the transaction (despite this investor's public opposition to the deal), which meant that the investor was barred from obtaining a higher price for its shares in an appraisal action. This institutional investor ultimately took a $194 million charge because of this proxy voting mistake.[2]

In an August 2017 comment letter, NIRI expressed concern over the automated voting systems used by ISS and Glass Lewis and asked the SEC to investigate whether those systems are consistent with Staff Legal Bulletin 20.[3]

**Draft Reviews Would Improve Report Accuracy for Investors**

One of most significant and beneficial reforms included within H.R. 4015 is a draft report review requirement, which would help ensure that all companies are treated fairly and that investors receive more accurate proxy reports.

A draft review process is needed to protect investors because the proxy advisors cannot possibly be expected to produce reports on all the companies they cover without any errors. As Thomas Quaadman of the U.S. Chamber of Commerce pointed out in his written testimony, ISS, which has 1,000 employees worldwide, publishes reports on 40,000 corporate meetings each year. Glass Lewis, which has about 360 employees, covers about 20,000 meetings globally.

Within the United States, an estimated 80 percent of public companies hold their annual meetings during the spring, which results in a significant workload for the proxy advisors in April and May. To handle this heavy work flow, ISS hires temporary employees (some of whom are recent college graduates) and outsources work to employees in Manila. Given the large number of companies that the proxy advisors opine on each year, the inexperience of their staffs,

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[1] This phenomenon of small- and mid-size institutional investors voting in lockstep with the proxy advisors also is troubling because it dilutes the relative influence of retail investors and may discourage their participation in proxy voting. As SEC Chairman Jay Clayton has noted, "The engine of economic growth in this country depends significantly on the willingness of Main Street investors to put their hard-earned capital at risk in our markets over the long term. If our system of corporate governance is not ensuring that the views and fundamental interests of these long-term retail investors are being protected, then we have a lot of work to do to make it so." See Chairman Jay Clayton, Speech: "Opening Remarks to SEC-NYU Dialogue on Securities Markets #4: Shareholder Engagement," January 19, 2018.

[2] See *Forbes*, "T. Rowe Price to Take $194 Million Charge Due to Voting Error on Dell LBO," June 6, 2016, available at: https://www.forbes.com/sites/antoinegara/2016/06/06/t-rowe-price-to-take-194-million-charge-due-to-voting-error-on-dell-lbo/#401ee1af52b0

[3] See NIRI's Letter to the Securities and Exchange Commission, "Re: Proxy Advisory Firms – Shareholder Voting Practices," August 3, 2017, available at: https://www.niri.org/NIRI/media/NIRI-Resources/NIRI-SEC-Letter-PA-Firms-August-2017.pdf

and the complexity of executive pay practices, it's inevitable that proxy advisor reports will contain factual errors, misunderstandings of corporate disclosures, or incorrect assumptions.

Unfortunately, most U.S. companies don't have an opportunity to review draft reports for accuracy before investors start voting. ISS provides draft reports as a courtesy to S&P 500 firms that request drafts. This review opportunity for large-cap issuers often is rushed, as many companies report that they typically have less than 48 hours to review drafts. Glass Lewis does not allow any companies to fact-check draft reports, and charges issuers to see their final reports, which is a deterrent to small-cap companies that want to review their reports for accuracy.

Public companies and their investor relations professionals would clearly welcome a draft review opportunity, which would allow them to more proactively respond to investor concerns and ensure that investors have the most accurate and complete information when they vote. In a 2016 NIRI member survey, 87 percent of respondents said they agreed that the SEC should mandate a draft review process.

The draft review process detailed in H.R. 4015 would not amount to a "corporate veto" or interfere with proxy advisors' relationships with their clients, as some opponents of the bill have argued. Rather, a draft review would provide a critical safeguard to ensure that investors don't vote based on inaccurate information, a misunderstanding of corporate disclosures, or incorrect assumptions.

Investors would clearly benefit from a draft review process and improved report accuracy. As noted above, very few investors have the time during the peak of proxy season to independently verify all the facts in a proxy advisor report before voting.

While reform opponents contend that a draft review process would be costly and impractical, evidence from France and the proxy firms' existing practices indicates these concerns are overstated. In France, the national securities regulator, AMF (Autorité des marchés financiers), heard similar concerns but recommended in 2011 that proxy firms should provide a draft process for all issuers.[4]

ISS itself has touted on its website the important benefit that its investor clients receive from its draft review process for S&P 500 firms: "ISS believes that this review process helps improve the

[4] See AMF, Recommendation DOC-2011-06, March 18, 2011, English translation available at: http://www.amf-france.org/en_US/Reglementation/Doctrine/Doctrine-list/Doctrine?docId=workspace%3A%2F%2FSpacesStore%2F12e1aead-0ff9-4f26-8fd0-d0ebe29d0efe&category=I+-+Issuers+and+financial+disclosure. In extending oversight to proxy advisors, the AMF said it "appears that the voting recommendations issued by one or more such firms can have an impact on certain resolutions passed at General Meetings. This is why the AMF considers it necessary to ensure that this profession is exercised under transparent conditions, by firms that provide high-quality work."

accuracy and quality of its analyses, an outcome that is in the best interests of both the institutional investors for whom the analyses are prepared, as well as for the companies that are the subject of these reports." Several ISS officials have publicly stated at past NIRI events and at a 2013 SEC Roundtable that ISS was considering extending its draft review process to a larger group of companies.

While Glass Lewis has resisted calls to provide a draft review opportunity, the proxy firm has concluded that its investor clients would benefit from greater input from issuers, and Glass Lewis has significantly ramped up its off-season outreach to companies. Glass Lewis also has created a factual database that companies can access. While this database is not an adequate substitute for a full draft review process that includes the proxy firm's analysis and recommendations, it indicates that both proxy advisors could readily develop sufficient procedures to institute a draft review process. The cost of such a review process would be miniscule when compared to the firms' overall revenues, while producing the significant benefit of more accurate reports for investors.

**Greater Transparency Around Potential Conflicts**

H.R. 4015 also would empower the SEC to bring much needed transparency to the proxy firms' potential conflicts of interest, which have prompted concerns among issuers, investors, and lawmakers on both sides of the political aisle. ISS' corporate consulting unit markets advisory services to companies that must obtain shareholder approval for their equity incentive plans.[5] The complex analytical methodology that ISS uses to judge corporate equity plans (which includes consideration of share dilution and burn rates) is not publicly disclosed, so many companies conclude that they have to pay for ISS consulting services to know whether their equity plans will pass ISS scrutiny. The corporate consulting business also gives ISS a leg up when competing with Glass Lewis, which does not have a consulting unit to subsidize its institutional advisory services. While ISS purports that its institutional proxy voting analysts don't know whether a specific issuer is an ISS corporate client, those analysts can easily determine from a company's equity plan that it used ISS consulting services to maximize the scope of its equity incentives while staying just under the non-public limits set by ISS.

In addition, ISS has a number of institutional investor clients—including hedge funds, public pension funds, and other activist investors—who sponsor shareholder proposals, wage "vote no" campaigns against corporate directors, or nominate their own directors. ISS does not disclose these corporate or institutional relationships in its proxy reports, so investors don't have this information about potential conflicts when they are making their final voting decisions.

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[5] The potential conflicts at ISS are not limited to equity plan votes. ISS also markets its consulting services to companies that fail to receive ISS support during their "Say on Pay" votes. ISS also has started selling advice on how companies can improve their ISS ESG scores.

Both investors and public companies would benefit from greater transparency around potential conflicts of interests. Glass Lewis already discloses potential conflicts on the front page of its proxy reports, so it would be quite feasible for the SEC to direct ISS to meet the same standard.

For the reasons stated above, NIRI encourages the Committee to support H.R. 4015, or Senate legislation that would be substantially similar.

## NIRI Support for S. 1744

NIRI is pleased to endorse S. 1744, the "Brokaw Act," which would modernize the SEC's outdated 13D disclosure rules and provide greater transparency around hedge fund activism.[6] IR professionals, who often are the first to learn that an activist fund manager is targeting their company, enthusiastically support this bipartisan legislation. In a 2016 NIRI member survey, 92 percent of respondents agreed that the 13D reporting rules need to be modernized.

The current 13D rules date back to the Williams Act of 1968 and have not been significantly changed since then. Under these archaic rules, an activist fund manager doesn't have to report until **10 days after** accumulating a 5 percent stake and may continue to buy shares after crossing that threshold.[7] Additionally, through the use of derivatives, these activists can cheaply accumulate large positions (often significantly more than 5 percent) in secret at the expense of other investors (who aren't aware of their plans) and then ambush companies. Seeking short-term profit gains, these funds often pressure executives and directors to agree to plant closings, job cuts, reduced R&D spending, and other concessions that may not be in the long-term interests of shareholders, employees, or other stakeholders.

### Growth of Ambush Activism

13D reform is especially needed now because hedge fund activism has risen significantly over the past decade, with more proxy contests being threatened, which creates a greater urgency for companies to engage with their shareholders.

This threat of ambush activism is a significant deterrent to private companies that are considering going public. As Darla Stuckey of the Society noted in her testimony, the number of U.S.-listed

[6] NIRI was encouraged to hear three of the four witnesses (Darla Stuckey of the Society of Corporate Governance, Damon Silvers of the AFL-CIO, and Harvard Law Professor John Coates), at the June 28 hearing speak in favor of 13D reform. In addition, no lawmakers expressed opposition to reducing the current 10-day 13D reporting period.

[7] While a 10-day reporting deadline would have been reasonable in 1968, when securities transactions involved paper stock certificates and there were no fax machines or e-mail communications, it defies logic to maintain the same reporting period 50 years later, given the many advancements in securities trading and record-keeping technologies.

companies is about half of what it was 20 years ago; 13D reform is needed to reverse this trend and help encourage more IPOs.

S. 1744, which would cut the 13D reporting period from ten to four business days, strikes a reasonable balance between improving transparency, while allowing activists more than enough time to gather the data they need to report their positions accurately.

The United States lags behind other major markets in providing for ownership transparency and protecting companies from ambush activism. The United Kingdom (two days), Australia (two days), Hong Kong (three days), and Germany (four days) all have adopted shorter reporting periods.

To be clear, the Brokaw Act would not chill shareholder activism, as hedge funds will continue to take positions in underperforming companies. However, S. 1744 would level the playing field between activists and the companies they target, while also ensuring that other investors have more timely information about activist campaigns and can make more informed decisions about whether to sell their shares or buy more shares.[8]

**S. 1744 Would Address Problem of "Hidden Ownership"**

In addition to shortening the 10-day reporting period, the legislation also would address "hidden ownership" tactics used by some activists. The bill would close a loophole by expanding the definition of beneficial ownership under 13D to include cash-settled equity swaps and other derivative transactions that activists can use to mask their positions. Since the current 13D disclosure rules require the physical possession of the shares, some activists have used cash-settled swaps to evade these disclosure requirements.[9]

One prominent example of hidden ownership arose in a 2008 proxy contest between the CSX Corporation (CSX), a U.S. railroad company, and The Children's Investment Fund (TCI), a British hedge fund. TCI and its hedge fund allies purchased cash-settled equity swaps and

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[8] S. 1744 is consistent with the original intent of the Williams Act, which was adopted to alert "the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control." *GAF Corp. v. Milstein*, 453 F.2d 709, 717 (2d. Cir. 1971), cert. denied, 406 U.S. 910 (1972). In addition, the House and Senate reports on the Williams Act made clear that 13D was enacted "to require full and fair disclosure for the benefit of investors while at the same time providing the offeror and management equal opportunity to fairly present their case." H.R. Rep. No. 1711, at 4 (1968); S. Rep. No. 550, at 3 (1968). The Brokaw Act simply seeks to update the 13D rules to reflect financial market innovations since 1968 so 13D reporting can still fulfill the investor protection objectives of the Williams Act.

[9] Under an equity swap of this type, two parties enter into an agreement that seeks to replicate the positions of a long and a short investor in a particular stock. The long investor receives all of the benefits of an increase in the stock price, along with cash flows that replicate any dividends paid. The short investor receives the benefits of any decline in the stock's price. Any differences are settled in cash, although the counterparty to the short side of the transaction often holds the underlying securities as a hedge against its position.

attempted to elect five new members to the CSX Board of Directors. CSX filed a lawsuit in March 2008, alleging that TCI and its allies violated 13D by using cash-settled swaps to accumulate a 14 percent position, which was not disclosed until 10 months later. CSX argued that the TCI swap agreements should have triggered an earlier SEC disclosure filing because the swap counterparties holding CSX shares were likely to vote these shares at TCI's direction. In June 2008, a federal judge in the Southern District of New York ruled that these equity swaps were subject to the 13D disclosure rules.

The Brokaw Act would close off this "hidden ownership" loophole and ensure that 13D rules cover the modern derivative instruments that are used by activist fund managers to conceal their positions.[10]

**S. 1744 Would Foster Long-Termism**

The Brokaw Act would significantly improve transparency for the benefit of both institutional and retail investors who hold shares for the long term. With more timely notice (under a four-day reporting regime), companies will be able respond more effectively to activists' demands and more thoughtfully consider the potential impact on long-term investors, employees, and other stakeholders.

The Brokaw Act would help give companies, their executives, and directors more breathing room to engage with their long-term investors and resist pressure by activists to take actions to temporarily boost the company's share price but not promote long-term value creation.[11] In recent months, there have been increasing calls by prominent asset managers and CEOs for public companies to devote more attention to communicating and implementing long-term strategies.[12] While there is growing public support for promoting long-termism and greater capital formation, the current lack of transparency around hedge fund activism serves to undercuts these worthy objectives. 13D modernization is desperately needed so that corporate

[10] Other nations are looking to update their disclosure rules to address derivatives. German officials reported that they would seek to tighten reporting rules after a Chinese firm used derivatives to bypass German disclosure requirements and acquired a 9.7 percent stake in Daimler. See *New York Times*, "Germany Weighs Tighter Rules After Geely Takes Daimler Stake," February 28, 2018.

[11] As U.S. Senator Mark Warner and other lawmakers have noted, fewer investors are owning shares for the long term. As of December 2016, the average holding period for NYSE-traded stocks was 8.3 months, down from nearly six years in the 1970s. See MFS, "White Paper Series: Lengthening the Investment Horizon" (July 2017), available at: https://www.mfs.com/content/dam/mfs-enterprise/pdfs/thought-leadership/us/mfse_time_wp.pdf

[12] See, e.g., Jamie Dimon and Warren Buffett, *The Wall Street Journal*, "Commentary: Short-Termism Is Harming the Economy," June 6, 2018; McKinsey Global Institute, "Measuring the Economic Impact of Short-Termism," August 2017. In addition, a number of organizations, including FCLTGlobal, whose members include well-known asset managers, have urged companies to move away from providing quarterly earnings guidance and focus more attention to discussing their long-term strategy and value drivers.

executives and their boards will have greater flexibility to manage their companies for the long-term benefit of investors, employees, and other stakeholders.

For the foregoing reasons, NIRI encourages the Committee to support S. 1744.