Statement of the Society of Corporate Secretaries & Governance Professionals and the National Investor Relations Institute

Before the Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives

Hearing entitled "Legislative Proposals to Enhance Capital Formation, Transparency, and Regulatory Accountability"

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The Society of Corporate Secretaries & Governance Professionals ("Society") and the National Investor Relations Institute ("NIRI") appreciate the opportunity to express their support for the Proxy Advisory Firm Reform Act of 2016, to be introduced by Representative Sean Duffy (R-WI). Together, the Society and NIRI represent approximately 1,800 public companies.

Public Company Concerns with Proxy Advisory Firms

Many of the current Securities and Exchange Commission ("SEC") rules governing the U.S. proxy system have been in place for more than three decades. In July 2009, the SEC undertook an evaluation of its shareholder communications and proxy voting rules, and, in July 2010, released for public comment a Concept Release on these issues. [1]

One of the issues addressed in the SEC's 2010 Concept Release involves the role and activities of the private firms providing proxy advisory services to institutional investors. These entities—called proxy advisory firms—operate with very little regulation or oversight.

[1] Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42,982 (July 22, 2010).

Proxy advisory firms exert undue influence in the proxy voting process, as they generate voting recommendations for their clients, and, in fact, make voting decisions for some of their clients. The clients of these firms are institutional investors, including pension plans, mutual funds, hedge funds, and endowments. Public companies say that they consider the proxy advisory firms as one of their "largest shareholders," given that up to 30% of their shares are voted in line with the firms' recommendations.

Despite their importance in the voting process, proxy advisory firms develop their policies without formal or meaningful input from companies. While the largest proxy advisory firm, Institutional Shareholder Services ("ISS"), does allow issuers to take its annual policy survey, the questions are designed in such a way that permits no viable responses from a public company perspective. The proxy advisory firms then apply these policies using a "one-size-fits-all" approach that imposes the same standards on all public companies, instead of evaluating the specific facts and circumstances of each company they evaluate. This has the effect of homogenizing corporate governance best practices for the benefit of the proxy advisory firms themselves and not for other stakeholders in the proxy process.

Proxy advisory firms operate without providing adequate transparency into their internal standards, procedures, and methodologies. Conflicts of interest exist in a number of their business practices. And concerns have been raised about their use of incorrect factual information in formulating specific voting recommendations.

One of the reasons that proxy advisory firms have become so powerful is that SEC and Department of Labor rules and guidance make clear that a proxy vote is an asset and that institutional investors owe fiduciary duties to their clients, investors, and beneficiaries with respect to the voting process. While some investors have interpreted these rules and guidance to mean they must vote each and every item on a proxy card, this is not the case. Rather, institutions should weigh the cost of voting certain items against the benefits of voting on those items.

Many institutional investors and their third-party investment managers—especially mid-size and smaller firms—choose to reduce costs by not having in-house staff to analyze and vote on proxy items. Instead, these institutional investors and managers typically "outsource" their voting decisions to proxy advisory firms that provide automated voting services. This is a way to fulfill what they believe to be their obligations with respect to proxy voting at the lowest cost; however, in actuality, the result is a transfer of a fiduciary duty to a non-fiduciary.

This is particularly relevant to certain index funds that may hold very small percentages of thousands of individual companies and, therefore, do not spend the resources to read every proxy statement. And sometimes the recommendations by the proxy advisory firms are in fact destructive of shareholder value and, thus, not in the best interests of their clients, investors, or beneficiaries.

SEC Oversight Regarding Proxy Advisory Firms

The SEC has taken a few steps since the issuance of its Concept Release to address these issues. In December 2013, the agency held a Roundtable on Proxy Advisory Services to discuss many of these issues.

The SEC followed up its Roundtable by issuing Staff Legal Bulletin 20 in June 2014, which provided guidance to institutional investors about their obligations under the

Investment Advisers Act and established several standards for proxy advisory firms to adhere to, under the Securities Exchange Act of 1934.

While these were excellent first steps in addressing these problems, more needs to be done.

Proxy advisory firms exist as a result of well-intentioned regulatory action that nevertheless resulted in unintended consequences. One consequence is that the proxy advisory industry is subject to a regulatory framework that can best be described as a patchwork quilt. As an example, ISS has chosen to register under the Investment Advisers Act of 1940. However, the SEC's rules for investment advisers do not reflect the unique role that these advisory firms perform in the proxy voting process. Proxy advisory firms do not select securities for their clients or provide investment advice. Instead, these firms recommend how to vote at shareholder meetings and automate the voting process for their clients.

The second biggest proxy advisory firm, Glass Lewis, is not registered as an investment adviser (or under any other securities statute) and is not currently subject to any regulatory supervision. For example, the SEC sanctioned ISS under the Investment Advisers Act in 2013 for failing to establish or enforce written policies and procedures to prevent the misuse of material, non-public information by ISS employees with third parties.[2] As a non-registered entity, Glass Lewis is not subject to the provisions of the Investment Advisers Act or any other statute enforced by the SEC.

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[2] See Order Instituting Administrative and Cease-and-Desist Proceedings and Imposing Remedial Sanctions and a Cease-and-Desist Order, In the Matter of Institutional Shareholder Services, Inc., Administrative Proceeding File No. 3-15331, May 23, 2013, available at http://www.sec.gov/litigation/admin/2013/ia-3611.pdf.

Additionally, the SEC has created an exemption from its proxy rules for proxy advisory firms, so they are not required to abide by solicitation and disclosure rules that apply to other proxy participants. Thus, their reports, in contrast to company proxy materials, are not always available to issuers unless they pay for them,[3] and they are not subject to any outside review or oversight, even after annual meetings.

This patchwork regulatory system should not be permitted to continue, and these firms should be subject to more robust oversight by the SEC and the institutional investors that rely on them. This can be accomplished by developing a targeted regulatory framework that reflects the unique role that proxy advisory firms perform in the proxy voting process.

Society and NIRI Recommendations Regarding Proxy Advisory Firms

As noted earlier, there is a need for greater transparency about the internal procedures, policies, standards, methodologies, and assumptions used by proxy advisory firms to develop their voting recommendations. There should be greater transparency about the ownership of, and influence on, the policies and positions of proxy advisory firms by union pension funds and other investors, particularly when those investors are proponents of proposals on which the proxy advisory firms are opining.

And there needs to be attention to the problem of inaccuracies in the reports provided by proxy advisory firms. One firm—ISS—provides drafts (on a very short turnaround, i.e., 24 to 48 hours) only to S&P 500 companies; the other major proxy advisory firm—Glass Lewis—does not even do that.

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[3] ISS does allow public companies to see their final reports without charge, but prohibits companies from sharing the reports with outside legal counsel or other advisers.

All proxy advisory firms should be required to provide each public company with a copy of their draft reports, in advance of dissemination to their clients, to permit a company to review and correct any inaccurate factual information contained in these reports. Shareholders should not be voting based on inaccurate information in the reports of proxy advisory firms.

Another problem is that Glass Lewis refuses to provide a copy of its final reports to any public company that does not pay to subscribe to its services. And for those who do pay, both firms are attempting to impose unreasonable restrictions on a company's use of the information. It does not seem right that companies should have to pay a proxy advisory firm to find out what their shareholders are being told about the matters being voted on at a shareholder meeting.

Conflicts of interest within these firms also need to be addressed. ISS, for example, provides corporate governance and executive compensation consulting services to public companies, in addition to providing voting recommendations to its institutional clients on proxy matters for these same companies.

Another conflict that exists involves proxy advisory firms providing voting recommendations on shareholder proposals submitted to companies by their institutional investor clients.

These conflicts should be specifically disclosed on all proxy firm reports so that proxy advisory firm clients may evaluate this information in the context of each firm's voting recommendations.

Along with considering greater regulatory oversight of proxy advisory firms, the SEC and Department of Labor should review the existing regulatory framework applicable to the use of proxy advisory firms by institutional investors. This review should include the guidance and interpretive letters that have been issued over the years on this subject. The SEC and Department of Labor should ensure that institutional investors are exercising sufficient oversight over their use of proxy advisory services, in a manner consistent with their fiduciary duties.

Conclusion

The Proxy Advisory Reform Act of 2016 addresses many of the concerns raised by public companies and other participants in the U.S. proxy system. For these reasons, the Society and NIRI support the Proxy Advisory Reform Act of 2016 and urges its passage through the Committee on Financial Services and the full House of Representatives.[4]

The Society and NIRI also urge the members of this Subcommittee to request SEC action to modernize and update its proxy rules, addressing all of the issues raised in its 2010 Concept Release.

The SEC received more than 300 comment letters in response to this Concept Release, the substantial majority of which expressed the view that reforms to the existing system are necessary.

Unfortunately, more than (5) five years has passed and the SEC has not initiated any rulemakings to follow-up on the Concept Release. The Society and NIRI believe it is

[4] The Society and NIRI do not share the views of other organizations that suggest this bill could erect new barriers to competition in the proxy advisory industry. This argument ignores the reality that ISS and Glass Lewis already control 97 percent of the U.S. market in the absence of any meaningful regulation. The primary barrier to entry in this sector is the significant cost needed to create a system to reliably transmit voting instructions from clients for thousands of corporate meetings each year.

critical that the SEC move forward promptly to modernize and update its rules governing the U.S. proxy system.

Thank you for the opportunity to present the views of the Society and NIRI on these important issues.