JEB HENSARLING, TX , CHAIRMAN

United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

MAXINE WATERS, CA, RANKING MEMBER

M E M O R A N D U M

To: Members of the Committee on Financial Services

From: FSC Majority Committee Staff

Date: May 31, 2013

Subject: June 5 Subcommittee on Capital Markets hearing on "Examining the Market Power and Impact of Proxy Advisory Firms"

The Subcommittee on Capital Markets and Government Sponsored Enterprises (GSEs) will hold a hearing on "Examining the Market Power and Impact of Proxy Advisory Firms" at 10 a.m. on Wednesday June 5, 2013, in Room 2128 of the Rayburn House Office Building. This will be a one-panel hearing with the following witnesses:

- Mr. Timothy J Bartl, President, Center on Executive Compensation
- Mr. Niels Holch, Executive Director, Shareholder Communications Coalition
- Mr. Michael P. McCauley, Senior Officer, Investment Programs and Governance, Florida State Board of Administration
- Mr. Jeffrey D. Morgan, President and CEO, National Investor Relations Institute
- Mr. Harvey Pitt, Chief Executive Officer, Kalorama Partners, on behalf of the U.S. Chamber of Commerce
- Ms. Darla Stuckey, Senior Vice President, Society of Corporate Secretaries & Governance Professionals
- Mr. Lynn E. Turner

This hearing will examine the growing importance of proxy advisory firms in proxy solicitations and corporate governance, including the effect that proxy advisory firms have on corporate governance standards for public companies, the voting policies that proxy advisory firms have adopted, the market power of proxy advisory firms in an industry effectively controlled by two firms, and potential conflicts of interest that may arise when proxy advisory firms provide voting recommendations. This hearing will also examine proposals offered by the Securities and Exchange Commission (SEC) that seek to modernize corporate governance practices in order to improve the communications between public companies and their shareholders.

Background

The SEC requires public companies to provide their shareholders with a proxy statement before shareholder meetings at which the company's shareholders vote for the company's directors and on significant corporate actions. According to the SEC, "the information contained in the statement must be filed with the SEC before soliciting a shareholder vote on the election of directors and the approval of other corporate action. Solicitations, whether by management or shareholders, must disclose all important facts about the issues on which shareholders are asked to vote."[1]

Federal Regulation of Proxy Solicitations

In general, state corporate law governs shareholder voting rights, including the types of corporate actions that require shareholder approval. Section 14 of the Securities Exchange Act of 1934, however, authorizes the SEC to promulgate rules governing the solicitation of proxies for most public companies, and Section 14(a) makes it unlawful to solicit any proxy without complying with the SEC's proxy rules.

SEC Regulation 14A governs proxy solicitations, and sets forth the categories of information that must be disclosed in proxy solicitations. Regulation 14A also provides for shareholder access to certain information in connection with proxy solicitations, sets forth when a company must include a shareholder's proposal in its proxy statement, and prohibits the making of materially false and misleading statements or omissions in connection with proxy solicitations.

The 2013 Proxy Season

The "proxy season" is the period during which public companies hold their annual shareholder meetings to discuss the company's performance, elect board members, and vote on other corporate actions. The 2013 proxy season is now underway, and voting results suggest that shareholders are actively involved in the proxy voting process. As of late March 2013, shareholders have filed more than 600 resolutions, and there has been more engagement between company management and shareholders. This year, shareholder proposals have included resolutions to limit or otherwise restrict executive compensation; to replace staggered boards with annual director elections; to institute majority voting in director elections; to increase board diversity; and to repeal supermajority voting provisions and prohibitions on shareholders' ability to call special meetings.

Among the other significant issues raised this proxy season, 15 companies in the Fortune 250 have held votes on proposals regarding corporate political spending or lobbying; none of the proposals received the support of a majority of shareholders. Fifteen large companies have also held votes on proposals to separate the chairman and CEO roles; none received the support of a majority of shareholders. In May, shareholders voted on a proposal to separate the positions of CEO and Chairman of JP Morgan Chase & Co., which

[1] Securities and Exchange Commission*: "Proxy Statement"* http://www.sec.gov/answers/proxy.htm (2011)

are both currently held by Jamie Dimon; the proposal received 32% of the votes cast, down from 40% when the issue was raised last year. According to data compiled by the Conference Board as of March 2013, of the companies that reported votes on compensation proposals offered by the companies, on average almost 91% of the shareholders that voted on those proposals approved them. Shareholders rejected compensation proposals at only 3 of the 109 companies that reported those votes. Shareholder proposals related to proxy access appear to be down this year compared to 2012.

Proxy Advisory Firms

Institutional investors (including investment advisors and pension funds) typically hold shares in a large number of public companies. To assist them in their voting decisions, these institutional investors frequently hire proxy advisory firms to provide analysis and voting recommendations on matters appearing on proxies. The two largest proxy advisory firms have changed their voting policies regarding shareholder resolutions. As a result of these changes, proxy advisory firms are more likely to recommend that shareholders vote against incumbent directors or "withhold" their votes in director elections if corporate boards fail to adequately address shareholder resolutions that receive either more than 25% support or a majority of all votes cast (depending on the specific firm's voting policy).

In some cases, proxy advisory firms are given the authority to execute proxy votes on behalf of their clients. Some proxy advisory firms also advise public companies on corporate governance or executive compensation matters that require shareholder approval. As the SEC has acknowledged, conflicts of interest may arise when proxy advisory firms both provide voting recommendations on matters subject to a shareholder vote and offer consulting services to the company or a proponent of a shareholder proposal on the same matters. Some proxy advisory firms also rate or score public companies on their governance structure, policies, and practices.

As institutional investment has grown over the last 25 years, proxy advisory firms have played an increasingly important role in corporate governance. That role has grown even larger because many institutional investors have a fiduciary obligation to vote the shares they hold on behalf of their beneficiaries. Proxy advisory firms have also seen the demand for their services rise as the proxy process has become more involved and shareholders become more active in their efforts to control the corporation through the proxy.

The market for proxy advisory services is highly concentrated: two firms—Glass Lewis & Co. and Institutional Shareholder Services—control 97 percent of the industry. Glass Lewis is an indirect, wholly-owned subsidiary of the Ontario Teachers' Pension Plan Board, which raises another potential conflict of interest. The SEC recently settled charges against Institutional Shareholder Services alleging that one of its employees shared nonpublic voting data in exchange for meals and concert tickets. The SEC alleged that from 2007 through 2012, the employee provided a proxy solicitor, a firm that gathers shareholder votes, with nonpublic information revealing how more than 100 of the firm's clients were voting their proxy ballots.

The SEC Proxy System Concept Release

In July 2010, the SEC issued a concept release on the U.S. proxy system "reviewing and seeking public comment as to whether the . . . proxy system as a whole operates with the accuracy, reliability, transparency, accountability, and integrity that shareholders and issuers should rightfully expect."[2] The SEC last conducted a broad review of proxy voting infrastructure around 1980.

The Concept Release addressed various concerns, as well as potential regulatory responses, related to three general topics: (1) the accuracy, transparency, and efficiency of the voting process; (2) communications and shareholder participation; and (3) the relationship between voting power and economic interest. The Concept Release explored specific issues, such as the over-voting and under-voting of shares; vote confirmation; proxy voting by institutional securities lenders; proxy distribution fees; the ability of public companies to communicate with beneficial owners of securities; potential means to facilitate retail investor voting participation; data-tagging proxy-related materials; the role of proxy advisory firms; dual record dates; and "empty voting." The Concept Release propounded specific questions on these issues for public comment. The SEC received over 310 comments in response to its Concept Release, but it has not yet taken additional action.

Proxy Access and the Dodd-Frank Act

Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) included a number of requirements for public companies concerning their proxy statements. Section 951 requires public companies to hold a non-binding vote by shareholders on executive compensation. Section 953 requires public companies to include disclosures in their annual proxy statements that permit shareholders to compare the compensation of the firm's executives to its financial performance.

Section 971 charged the SEC with writing new proxy access rules. In August 2010, the SEC promulgated rules, pursuant to Rule 14a-11, that gave shareholders who owned at least three percent of the total voting power of the company's securities and who have held their shares for at least three years the right to nominate directors on the company's proxy statements. On July 22, 2011, the U.S. Court of Appeals for the D.C. Circuit struck down the SEC's proxy access rules, finding that the SEC had failed to meet a statutory requirement to evaluate the rule's effect on "efficiency, competition and capital formation." The SEC did not appeal the D.C. Circuit's ruling, and former SEC Chairman Mary Schapiro indicated last year that the SEC had no immediate plans to revisit the proxy access rule. Nonetheless, the D.C. Circuit's decision did not vacate the SEC's authority to issue rules pursuant to Rule 14a-8, which allows shareholders who own at least $2,000 of stock for one year to submit proposals for inclusion in the proxy statement, including proposals to determine a process to elect members to the board of directors.

---

[2] Securities and Exchange Commission, Concept Release on the U.S. Proxy System (July 14, 2010), available at http://www.sec.gov/rules/concept/2010/34-62495.pdf.

Finally, Section 972 requires that public companies explain in their annual proxy statements why the corporation has chosen the same person to serve as chairman of the board of directors and chief executive officer or has instead chosen to have different individuals fill those two positions.