

**LEGISLATIVE PROPOSALS TO
ENHANCE CAPITAL FORMATION,
TRANSPARENCY, AND
REGULATORY ACCOUNTABILITY**

HEARING
BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES
OF THE
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U.S. HOUSE OF REPRESENTATIVES
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LEGISLATIVE PROPOSALS TO ENHANCE CAPITAL FORMATION, TRANSPARENCY, AND REGULATORY ACCOUNTABILITY

Tuesday, May 17, 2016

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:57 p.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Hurt, Royce, Neugebauer, Huizenga, Duffy, Fincher, Hultgren, Wagner, Schweikert, Poliquin, Hill; Maloney, Sherman, Lynch, Perlmutter, Scott, Himes, Foster, Carney, and Murphy.

Ex officio present: Representative Hensarling.

Also present: Representative Barr.

Chairman GARRETT. The Subcommittee on Capital Markets and Government Sponsored Enterprises will now come to order. Today's hearing is entitled, "Legislative Proposals to Enhance Capital Formation, Transparency, and Regulatory Accountability."

Without objection, the Chair is authorized to declare a recess—hopefully we won't need another one for votes—of the subcommittee at any time. I thank the panel for their patience.

I now recognize myself for 2 minutes for an opening statement.

Today, the subcommittee meets to examine three important pieces of draft legislation that continue to work over the last 5 years to modernize our nation's securities laws and promote transparency and competition in our capital markets. And basically to bring real reform and accountability to the SEC's rulemaking process.

A recent poll indicates that about two-thirds of Americans believe our country is headed in the wrong direction. And a declining number of people believe that their children will be better off financially than they have been.

So despite the big promises that have come with granting vast and, in some cases, unlimited authority to the Federal bureaucracy in D.C., most Americans aren't buying the argument that a bigger Washington leads to a bigger paycheck at home or even any paycheck at all.

Fortunately, our subcommittee has, for 5 years now, tried an alternative approach which seeks to do what? To empower entrepreneurs and investors and small businesses, but not the bureaucrats. This approach has led to some successes, most notably the JOBS Act of 2012.

But maybe more important than that, it has led Congress and the regulators to think in a different way than they have historically. So today we continue our important work with three pieces of legislation. First, we will consider the SEC Regulatory Accountability Act.

It would require the SEC to determine that the benefits of any regulations they are considering actually outweigh its cost. Even President Obama, through Executive Order 2011, in 2011, has recognized the importance of economic analysis in rulemaking. And this legislation would codify much of what the President's executive order did for the SEC.

Secondly, we add the Investment Advisers Modernization Act, with Mr. Hurt sponsoring it. This is a long overdue piece of legislation that would allow private capital to continue to play a critical role in our economy which reduces many of the unnecessary bureaucratic requirements that have led the effect of starving middle market businesses of the capital they need.

Thirdly and finally, Mr. Duffy has put forward a Proxy Advisory Firm Reform Act of 2016, which would, for the first time in memory, provide some much needed sunlight to the way in which proxy adviser firms develop and distribute their advice.

So this subcommittee has led the charge in Congress for reform of the proxy adviser industry. And this draft legislation is the next step.

So with that being said, I want to thank all of the sponsors here for their hard work on all these bills. And I look forward to our witnesses today.

And with that, I yield to the gentlelady from New York for 5 minutes.

Mrs. MALONEY. Thank you. And I thank the chairman for holding this important hearing and for all of our panelists to being here today. We are considering three bills, all of which deal with different issues.

First, Mr. Duffy and Mr. Carney have a bill that would establish a regulatory regime for proxy advisers. Proxy advisers provide recommendations to institutional investors on how to vote on Board of Director elections and shareholder resolutions.

Big institutional investors are shareholders of thousands of public companies and they simply don't have the time to carefully review every single 100-page proxy statement in detail. Especially because most public companies hold their shareholder meetings in the same 3-month period.

So institutional investors rely on proxy advisers for vote recommendations, which are often tailored to the investor's particular corporate governance preference. This is healthy. Proxy advisers do have the time to carefully read all of the statements and proposals because they have professionals who simply read these statements all day, every day. However, this means that proxy advisers can be very influential in the outcomes of shareholder votes.

Although the evidence on the influence of proxy advisers is mixed, it is probably fair to say that the current regulatory regime for proxy advisers is not ideal. Two advisory firms account for 97 percent of the market, ISS and Glass Lewis.

But for some reason, they are regulated differently. ISS is a registered investment adviser, while Glass Lewis is not. Surely, this is not an ideal setup, so I am absolutely open to the idea of a better and more consistent regulatory regime for proxy advisers. But there are several things in this bill that concern me.

I don't see why companies should have a statutory right to receive and comment on a proxy adviser's draft recommendations before they are sent to investors. Proxy advisors aren't Federal agencies and a notice and comment period for private companies that are providing a valuable service is, in my opinion, is not appropriate at all. I don't recall where this regulation is on any other private company.

I am also concerned about giving companies the right to sue proxy advisers just because they didn't get a meaningful chance to comment on draft recommendations. But I am willing to hear other perspectives on this issue because it is an important one that Congress has not examined for a long time.

The second bill is intended to modernize the Investment Advisers Act for advisers to private equity firms and funds. This bill makes a series of targeted changes to the Advisers Act which are intended to make it more compatible with the private equity business model. I think there is probably space to better tailor the Advisory Act to private equity advisers.

But I am concerned about making sweeping changes to core aspects of a regulatory regime that has been quite successful. We need to think very carefully before we make changes to the books and records rule, the custody rule or the advertising rule. These are core aspects of the Advisers Act and they shouldn't be discarded lightly.

Finally, Chairman Garrett has an SEC cost benefit bill. This is similar to a bill that this committee has considered before. But I am interested to hear if any of the witnesses can offer any fresh perspective on this issue.

I would like to thank our panelists for appearing before us today. And I would like to insert a few statements into the record. These are statements from the Council of Institutional Investors, the Florida State Board of Administration, ISS, and Glass Lewis. And I hope that I will be able to place these statements into the record.

Chairman GARRETT. Without objection, it is so ordered.

Mrs. MALONEY. Thank you.

I yield back.

Chairman GARRETT. The gentlelady yields back.

We now go to the Vice Chair of the subcommittee, Mr. Hurt, for 1½ minutes.

Mr. HURT. Thank you, Mr. Chairman. Thank you for holding this hearing today. I think every member of this committee can agree that with millions of Americans out of work, our top focus in Congress should be enacting policies to help spur job creation throughout our country.

As I travel across my district, Virginia's 5th District, I continue to hear hardworking Americans express concern about the current state of our economy and the economic uncertainty facing their children and their grandchildren.

Today we will discuss several legislative efforts that, if enacted, will encourage economic growth and job creation by reducing unnecessary regulatory burdens. In Virginia's 5th District, thousands of jobs would not exist without the investment from private equity. These critical investments allow our small businesses to innovate, expand their operations and create the jobs that our communities desperately need.

Over the past three Congresses, there has been a growing concern about the burden that Dodd-Frank unnecessarily places on advisers to private equity while at the same time exempting advisers to similar investment funds. Over recent years, many of us have worked together in a bipartisan way to eliminate the registration requirements mandated by Dodd-Frank.

Today, however, among the legislation we are considering is a discussion draft titled, The Investment Advisers Modernization Act. This bill would not change the registration requirement that Dodd-Frank mandated, but rather would update the Investment Advisers Act of 1940, a 76-year-old law, to reflect the current business model of private equity. This bill would go a long way toward facilitating capital formation while maintaining our commitment to investor protection. I believe that it is incumbent upon Congress to look for common sense solutions to problems caused by regulatory structure.

And I believe that this legislation is a pragmatic approach to addressing some of the concerns with the Investment Advisers Act. I look forward to the testimony of our witnesses.

And I yield back the balance of my time. Thank you, Mr. Chairman.

Chairman GARRETT. I thank you, the sponsor.

I now turn to the other sponsor. Mr. Duffy is recognized for the remaining 1½ minutes.

Mr. DUFFY. Thank you, Mr. Chairman. And thank you for holding today's hearing and giving me an opportunity to briefly discuss my bill to foster a greater accountability, transparency, responsiveness, and competition in the proxy advisory firm industry.

Increasingly, institutional investors rely on the analysis and recommendations of proxy adviser firms on key issues facing shareholders and public companies. As the share of institutional investor ownership has grown from roughly 46 percent in 1987 to over 75 percent today, the volume of proxy votes, which investors are responsible for casting, has grown into the billions.

Just two proxy advisory firms control 97 percent of the market. And the writings, analysis reports, and voting recommendations affect fundamental corporate transactions like mergers and acquisitions, the approval of corporate directors, and shareholder proposals.

I have heard from many companies about their frustration with the methodologies used by proxy advisory firms, the inaccuracies and inconsistencies in the information they share with their clients and, most importantly, the concern for conflicts of interest. These

are very powerful firms that have a huge influence in regard to corporate governance.

In 2013, Mr. Chairman, you held a hearing and have been involved in this issue on the subcommittee. And had respected witnesses recommend more oversight of the proxy advisory firm industry, which my bill now provides. So I look forward to the witnesses' testimony on this issue and the other bills.

With that, Mr. Chairman, I yield back.

Chairman GARRETT. Thank you. The gentleman yields back.

We now welcome the panel. Some of you have been here before many times. Others are new here. You will be given 5 minutes for your oral testimony. And without objection, your entire written statement will be made a part of the record.

I now recognize from Mr. Daniel Gallagher. He is the president of Patomak Global Partners, and a former Commissioner with the of the SEC. You are recognized for 5 minutes and welcome to the panel.

**STATEMENT OF THE HONORABLE DANIEL M. GALLAGHER,
PRESIDENT, PATOMAK GLOBAL PARTNERS, LLC**

Mr. GALLAGHER. Good afternoon and thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee for inviting me to testify today. My name is Dan Gallagher, and I am president of Patomak Global Partners.

From 2011 through 2015, I served as an SEC Commissioner. And from 2006 until 2010, I served on the Commission staff in various capacities, ultimately as Deputy Director of the Division of Trading and Markets. I am testifying today in my own capacity.

Let me begin by expressing my appreciation for the work this committee has done over the last 5½ years on legislation to rationalize and remove regulatory obstacles standing in the way of small businesses, as well as your initiatives to enhance investor choice.

During my time as a commissioner, this committee regularly challenged the commission to satisfy its statutory mission to facilitate capital formation, whether through the legislative process or through constructive and insightful hearings and roundtables. In an era of unbridled misguided regulation, this was truly a breath of fresh air. And I deeply appreciated the opportunity to have worked with many of you on both sides of the aisle on these important issues.

Mr. Chairman, having spent 4 years as a commissioner focusing on Dodd-Frank Act rulemakings, it is particularly refreshing to testify today on three bills which I believe will help the SEC get back to the basic blocking and tackling responsibilities of securities regulation that advance the agency's core mission.

First, Congressman Duffy's bill will bring much needed transparency, oversight and accountability to the proxy advisory industry. Due in large part to the unintended consequences of the SEC's own rules, proxy advisory firms now play an outsized role in the shareholder voting process, often to the detriment of public companies, investors, and the American system of corporate governance.

Representative Duffy's legislation would help resolve many issues, which apparently remain unresolved despite recent SEC

staff guidance, through a comprehensive registration and examination regime for proxy advisory firms.

I applaud Representative Duffy for taking an incremental legislative approach that is similar in many important ways to the framework for the Credit Rating Agency Reform Act, which enjoyed bipartisan support and passed the Senate by unanimous consent.

Second, Chairman Garrett's SEC Regulatory Accountability Act would promote and improve economic analysis at the SEC and make the agency even more accountable to the investing public. While the SEC has dramatically improved the economic analysis supporting its rules, there remains room for improvement.

In particular, I believe that in certain mandated rulemakings, the SEC's lawyers have played an outsized role in interpreting congressional intent thereby setting the ground rules by which the economists are expected to operate.

The CEO pay ratio rulemaking is the best example of this. Finding benefits when Congress described none may help get a rule done. But it ensures that the economic analysis is not done right. This trend needs to stop before it becomes the loophole that devours the SEC's 2012 commitment to proper economic analysis. Ultimately, Chairman Garrett's bill will help ensure that economic analysis conducted by economists is firmly entrenched in every rulemaking the SEC conducts under the Federal securities laws.

Last, but certainly not least, Vice Chairman Hurt's Investors Advisers Modernization Act would preserve the registration regime for private fund advisers, while at the same time removing or modernizing some of the more unnecessary and overly burdensome requirements in the Advisers Act that serve only to drive up the costs for funds and investors and hinder the efficient allocation of capital that helps businesses and jobs grow.

Since the passage of Dodd-Frank, the SEC has devoted a significant amount of its limited resources towards overseeing and examining advisers to private funds, who primarily serve sophisticated investors, such as pension funds and endowments.

During this non-recovery recovery, to borrow Chairman Hensarling's words, and given that there are over 11,000 SEC registered investment advisers and just hundreds of SEC staffers to examine them, the SEC should be focusing its attention less on funds serving sophisticated investors who are better able to fend for themselves and more on making U.S. capital markets more efficient and competitive, promoting small business capital formation and protecting mom and pop investors. Vice Chairman Hurt's sensible legislation will help the SEC do just that.

Thank you again for the opportunity to testify today.

[The prepared statement of Mr. Gallagher can be found on page 71 of the appendix.]

Chairman GARRETT. Thank you very much.

Next, from the Center on Executive Compensation, Mr. Timothy Bartl. Welcome. You are recognized for 5 minutes.

**STATEMENT OF TIMOTHY J. BARTL, CHIEF EXECUTIVE
OFFICER, CENTER ON EXECUTIVE COMPENSATION**

Mr. BARTL. Thanks, Mr. Chairman, Vice Chairman Hurt, and Ranking Member Maloney. I appreciate the opportunity to testify.

My name is Tim Bartl and on behalf of the Center on Executive Compensation, I am pleased to share our experience with proxy advisory firms and to testify in favor of the Proxy Advisory Firm Reform Act.

As I think you know, the center is a research and advocacy organization. We represent over 125 companies and the senior human resource officers of those companies across a broad spectrum. And we have daily interaction with those companies and, therefore, have firsthand knowledge of their experience with proxy advisory firms.

You know, at the end of the day, companies seek accurate and fair assessment of their pay programs. And when you look at the fact that, as Congresswoman Maloney indicated, proxy advisory firms do perform a necessary function in the proxy advisory and the proxy voting regime.

But unfortunately the timeframe and the lack of oversight leads to a check the box mentality that is really a poor fit for pay programs which are individualized, complex and lengthy. And, you know, when you look at the influence the proxy advisory firms hold over the regime, I think it is important that we take a look at that as we look at Congressman Duffy's bill.

As of May 13, companies holding say on pay votes this year who received a negative ISS recommendation, experienced a 31 percent reduction compared to the previous year for a mean support of somewhere around 61 percent. Those receiving a positive recommendation had an average result of 93 percent.

A 2014 center survey found that 74 percent of respondents indicated that they had changed or adopted a compensation plan, policy or practice in the previous 3 years primarily to meet a proxy advisory firm policy.

And research that we cite in our testimony by Professor Larcker, McCall and Ormazabal, suggested that the adoption in advance of a proxy advisory firm policy actually had a negative impact on shareholder value.

Both the Congresswoman Maloney and Mr. Chairman, you mentioned the impact of conflicts of interest, as did Congressman Duffy. And because proxy advisory firms are accorded significant deference in light of their independent status, the conflicts are a big deal and need to be addressed.

ISS, the largest and most influential firm, consults with investor clients regarding shareholder proposals that the investors sponsor while at the same time, making recommendations on those same proposals to other investor clients. This leads to the perception that ISS may favor such proposals in making recommendations.

ISS also continues to make recommendations and provide analysis of proxy issues to be put to a shareholder vote on the research side of the operation, while providing consulting services to corporations whose policies and shareholder proposals they evaluate. And that is on the consulting side. The aggressive marketing from the consulting side has left impressions on several occasions that it is privy to the information or the decisions on the research side.

And as an example, back in 2013 there was a company that was contacted by an ISS consulting representative after the company

received a negative ISS recommendation that had a low say on pay vote, around 68 percent.

In an email to the company, the representative said that she would provide the company with a better understanding of the reasons for ISS' negative vote recommendation and what to expect in terms of additional scrutiny from ISS' research side in the next year.

After a call was set up, during the call, the representative indicated that the information provided by the consulting side was not available elsewhere and that the success of companies that had engaged with the consulting side were over 90 percent because of its knowledge of the research side.

At the SEC roundtable, even Gary Retelny, ISS' president, indicated that he was disappointed with the approach the representative had taken. But it indicates the leverage.

In addition to operational conflicts, there are also ownership conflicts. We have talked in this committee before about this, in the subcommittee. Glass Lewis is owned by the \$170 billion Ontario Teachers' Pension Plan Board, which engages in public and private equity investments in which Glass Lewis makes recommendations.

And in addition to that, there are issues around errors and inaccuracies. And a 2014 center survey I cited earlier indicated that a final report had one or more errors.

Mr. Chairman, as I conclude, we believe that a more formal and appropriate regulatory regime, such as that included in the Proxy Advisory Firm Reform Act would help address the conflicts of interest. And we have seen before that where there has been specific oversight of the regime and of the issues, it has had an impact on the conduct of proxy advisory firms.

And I would be happy to talk more about that during the question and answer period. But we believe that the structure is definitely worth considering and a worthwhile initiative. Thank you for the opportunity to testify, and I look forward to your questions.

[The prepared statement of Mr. Bartl can be found on page 48 of the appendix.]

Chairman GARRETT. Thank you.

Next up, from the Vermont Law School, Professor Taub. Welcome. You are recognized for 5 minutes.

STATEMENT OF JENNIFER TAUB, PROFESSOR OF LAW, VERMONT LAW SCHOOL

Ms. TAUB. Chairman Garrett, Ranking Member Maloney, and distinguished members of this subcommittee, thank you for this opportunity to testify today. My name is Jennifer Taub. I am a professor at Vermont Law School, where I teach business law classes, including corporations and securities regulation.

Before joining academia, I was an associate general counsel at Fidelity Investments. I offer my testimony today solely as an academic and not on behalf of any other association.

In this brief opening statement, I will highlight the concerns that I have with each bill. For a more comprehensive exposition, I would refer you to my written testimony.

First, the Investment Advisers Modernization Act allows private funds to retreat into the shadows once again. The word private is

somewhat misleading these days. Consider that one-quarter of the equity in private equity funds comes from public pension retirement funds. And please recall that private funds, including hedge funds, can now be marketed through general solicitations to the public.

It is odd. Just when private equity funds are in the sunlight, thanks to Dodd-Frank, and many have been exposed in SEC examinations as in violation of the law, including for misallocating expenses, you are now proposing that they be able to hide their tracks.

Instead of encouraging a culture of compliance, this bill would provide a loophole for investment advisor record keeping requirements. Subjecting communications to confidentiality agreements, or keeping them in house, would allow advisers to destroy critical investment records.

This bill would also exempt all private equity fund advisers and many hedge fund advisers from submitting a completed Form PF. This information that would be withheld is important to monitor for systemic risk and to protect investors.

This bill would block the SEC from broadly banning materially misleading statements in private fund sales literature, including concerning fund performance. This is backwards. The SEC should be encouraged to, not discouraged from, making rules against fraud.

With Rule 506(c), pursuant to the JOBS Act, private funds can now be advertised through general solicitations to the public. Public offerings were supposed to come with commensurate broad protections against fraud.

This bill would also weaken the SEC's ability to stop false advertising by advisers generally, including to certain retail investors. And it would shockingly eliminate the annual independent audit of certain fund advisers to ensure they actually have the assets and securities they claim to hold. This should be called the Madoff loophole.

Next, the SEC Regulatory Accountability Act would limit the agency's ability to protect the investing public. Prior to issuing most regulations, the SEC would have to engage in a new cost-benefit process. Yet the SEC already conducts economic analysis and the securities laws already require the consideration of the promotion of efficiency, competition and capital formation. The SEC is already subject to the Paperwork Reduction Act, the Regulatory Flexibility Act, the Congressional Review Act, and the APA.

The existing requirements set out several speed bumps. These proposed requirements are tire shredders designed to bring progress to a crashing halt. Notably, this bill would require the SEC to consider endless alternative approaches and only select the one that maximizes net benefits. How could this be measured with any precision? It can't.

As Harvard Professor John Coates notes, it is not possible to specify and quantify all benefits and all costs in a single uniform bottom line metric representing the net welfare effects of a proposed rule. The results are not precise, but instead what he calls guesstimations. What this bill mostly creates is opportunities for litigation and legal fees to be generated.

Finally, the Proxy Advisory Reform Act represents fraternalistic over reaching that is unnecessary and could entrench existing firms. These firms are business success stories. They help institutional investors cast votes on important corporate governance matters at the portfolio companies they own.

The SEC already has the authority to examine and discipline any institutional investors who mindlessly follow advice without considering their fiduciary duty to underlying investors. And the SEC has authority under the Exchange Act and the Advisers Act to address conflicts of interest.

Thank you for this opportunity to speak. I look forward to your questions.

[The prepared statement of Ms. Taub can be found on page 107 of the appendix.]

Chairman GARRETT. Thank you.

From the U.S. Chamber of Commerce, Mr. Quaadman, welcome back to the panel. You are recognized for 5 minutes.

STATEMENT OF THOMAS QUAADMAN, SENIOR VICE PRESIDENT, CENTER FOR CAPITAL MARKETS COMPETITIVENESS, U.S. CHAMBER OF COMMERCE

Mr. QUAADMAN. Thank you very much, Mr. Chairman, Ranking Member Maloney, and members of the subcommittee. Thank you for the opportunity to testify today. The SEC's domain are the public capital markets and its mission is to promote investor protection, competition and capital formation.

By many metrics, the SEC is missing the mark. For 19 out of the last 20 years, we have seen a constant decline in the number of public companies in the United States to the point that we have fewer than half of the public companies today than we did in 1996.

The bills that are before us today are for smart regulation to have appropriate oversight for the benefit of investors and the businesses that they invest in. The SEC Regulatory Accountability Act is based upon the Executive Orders issued by President Reagan, President Clinton, and President Obama. It enshrines those Executive Orders into the SEC rulemaking process.

This bill also has some very innovative means to make rule-making even more successful. As an example, the post-implementation economic analysis allows for the use of precise economic data 2 years after the rule writing to look at exactly what the costs are, what the benefits are, if the rule is working, and, if not, what changes need to be made to the rule.

Additionally, the mandatory look back to reassess major rules allows the SEC to separate the wheat from the chaff. That is, for those rules that are obsolete, to take them off the books. Those rules that need to be tweaked should be tweaked. And for those issues that are looming, have the SEC actually write rules before they become a problem.

So in short, this bill is designed to impose rigor and discipline in the rule writing process for the benefit of both investors and businesses.

The Proxy Advisory Firm Reform Act of 2016 that has been introduced by both Duffy and Congressman Carney is an important step forward. Proxy advisory firms are necessary because we have

institutional investors who can invest in thousands of companies. As has been noted, we have two firms that cover 97 percent of the market share, and they have become de facto corporate governance regulators.

However, proxy advisory firms are also beset by many problems. One firm has 180 analysts looking at tens of thousands of companies globally and making recommendations in 250,000 shareholder proposals and director elections. Proxy advisory firms have been beset by conflicts of interest and lack of process and transparency in how they develop their vote recommendations and voting policies. There are questions about their error rates, as well as lack of input.

Some institutional investors use proxy advisory reports as data points in their independent judgment of how they execute their votes in shareholder proposals. Other investors, however, outsource their corporate governance voting responsibilities in total. For those investors, that becomes a difficulty in determining how they can meet their fiduciary obligation to the people who invest in those funds.

The 2014 SEC guidance, which was only issued as a result of the 2013 hearing of this subcommittee, is a step in the right direction. But this bill provides more oversight. This bill would have proxy advisory firms create transparent processes for the development of voting recommendations and policies. It would allow for further disclosure and management of conflicts of interest. And it would have the proxy advisory firms demonstrate to the SEC that they have the resources needed to meet their due diligence.

Furthermore, to give one example, proxy advisory firms make recommendations on shareholder proposals when a proponent is a client. That is no different than the problems 10, 12 years ago with the conflicts of interest of financial analysts.

Finally, the Investment Advisor Modernization Act by Congressman Hurt is an important step forward. The Dodd-Frank Act requires the SEC to build transparency around private equity firms. However, there has been a regulatory mismatch.

The SEC is imposing public company tools on private equity partnerships. That is like using a meat cleaver when we should be using a scalpel. The bill would allow the SEC to tailor regulations.

So in conclusion, Mr. Chairman, we would have liked to have seen the SEC move forward on these issues on their own. However, we believe that, at a minimum, congressional pressure is needed to make the SEC move forward. But if the SEC is not willing to move forward, we look forward to working with you, the co-sponsors and members of this subcommittee, to have these bills become law. Thank you.

[The prepared statement of Mr. Quaadman can be found on page 92 of the appendix.]

Chairman GARRETT. All right, thank you.

And last, but not least, from Blue Wolf Capital Partners, Mr. Cherry-Seto. You are recognized for 5 minutes.

STATEMENT OF JOSHUA CHERRY-SETO, CHIEF FINANCIAL OFFICER, BLUE WOLF CAPITAL PARTNERS, LLC, ON BEHALF OF THE ASSOCIATION FOR CORPORATE GROWTH

Mr. CHERRY-SETO. Chairman Garrett, Ranking Member Maloney, and members of the subcommittee, thank you for this opportunity to testify today on important legislation that, if passed, provides a modernized regulatory framework that is efficient and meaningful allowing private equity advisers to continue to focus on growing companies, providing important returns to our investors, most importantly, working families counting on a secure pension when they retire while helping to create jobs now and in the future.

On a personal note, good jobs are something that I care deeply about. As I began my career as a union organizer with SEIU and the ability of private equity firms to be strategic partners and investors in creating and sustaining good jobs is what brought me to work in this industry.

My name is Joshua Cherry-Seto. And I am the chief financial officer of Blue Wolf Capital Partners. Blue Wolf provides investment and strategic support to good, small to mid-size companies, often not served well by public markets because of challenges they face.

We take seriously our fiduciary responsibility to our investors, as stewards of their capital and managers of our portfolio companies. We invest responsibly and believe strongly in a culture of compliance and transparency.

I am also honored to be testifying on behalf of the Association for Corporate Growth, a global trade association created to drive middle market growth on Main Street, focused on companies with revenues between \$10 million and \$1 billion. The Association directly serves 90,000 M&A professionals within the middle market. Including more than 1,000 private equity firms like ours, which invest in local communities and help create jobs throughout Main Street America.

Let me briefly share an example. Healthcare Laundry System is a leading provider of hospital-grade laundry service to the Chicago area, spanning more than 550 healthcare providers, including more than 40 hospitals and employing more than 500 people.

Despite the firm's compelling market position, it had challenges precluding it from raising capital from the public markets. Blue Wolf, by working in partnership with management, government, the employees and the multiple unions representing them, we were able to provide capital and strategic support to create a stronger business with more quality and stable jobs.

Having addressed these challenges, Healthcare Laundry System was later sold to a public company, providing long-term stability to the company and its employees. I am here today to support the Modernization Act that would modernize the 1940 Act so that the law better reflects the vast market and technological and structural changes that have taken place over the past 76 years.

Due to the 1940 Act's ambiguity in today's world, firms like ours spend many hours and significant dollars trying to comply with ill-fitting rules for our industry that don't further the intent to protect investors, including on advisers and lawyers trying to interpret regulations not specifically written with our industry in mind.

An example of the bill's common sense approach is the advertising rule, an outdated provision from 1961, designed for public retail marketing. Private equity advisers advertise exclusively to qualified sophisticated investors and already have a robust private placement disclosure process, which should continue to be regulated and reviewed. However, the 1940 Act did not contemplate, and could not foresee, how to regulate technology advances such as websites.

Unlike the retail market, private equity websites are not aimed at investors but are instead used to more efficiently connect with companies and management teams looking for an investment partner. It is important to note that basic anti-fraud provisions of the Federal securities laws would remain in effect for all private fund advisers. Just imagine if you were asked to operate under the House rules of 1940, restricting communications to your constituents to the regular mail.

We recognize and value transparency, accountability to regulators, operating in the open, but most importantly today, we seek to update the regulatory framework to increase our focus on growing companies on Main Street across the country. For Blue Wolf, that means from Madawaska, Maine, to Suwanee, Florida, to Chicago, Illinois, to Santa Barbara, California, creating good, sustainable, American jobs.

Thank you for this time this afternoon, and I look forward to answering your questions.

[The prepared statement of Mr. Cherry-Seto can be found on page 66 of the appendix.]

Chairman GARRETT. Thank you. The gentleman yields back. And I thank all the members of the panel.

At this point we will turn to questions, and I will recognize myself for 5 minutes. I guess I will start with Mr. Gallagher. So you heard my opening comment talking about our legislation dealing with the cost-benefit analysis and what could be the benefit of having such an analysis. What does it do?

It gives the opportunity or the requirement to an agency, which is what the President basically has already asked agencies across the spectrum to do and what the SEC has already said they would do.

And all we are doing is now trying to do what? Codify that and say going forward you always have to do it, to look at every angle, if you will, every permutation, see what can be the benefits and the consequences of a rule. And that is all well and good, but there is another angle to this I want you get into if you can, joint rule-making.

So we have seen some joint rule making for the various agencies in the past. Most notably is in the area of the Volcker Rule. And when that is done, you have various agencies doing it. When that was done, SEC looked at analysis. Other agencies look at it and some don't.

Talk about if this legislation were to pass, or had been passed, what would be an effect on joint rulemaking? Could the agency get out of it or what happens?

Mr. GALLAGHER. Well, thank you for the question, Mr. Chairman. In practical effect, the legislation, as you point out, because

it would make years of guidance and disparate regulatory and legislative requirements binding in the U.S. Code, I think it would cause the SEC, in the context, let us use the Volcker Rule, since you mentioned it, to actually not be able to lawyer the situation in a way that I cautioned in my opening comments.

And so, as you might recall in the Volcker Rule, the Volcker Rule was promulgated even by the Securities and Exchange Commission under the Bank Holding Company Act, not the Securities and Exchange Act of 1934.

Chairman GARRETT. Okay.

Mr. GALLAGHER. So the various disparate legislative requirements, you know, in the Exchange Act, the APA, everything else, didn't apply because the lawyers determined that pursuant to the Dodd-Frank mandate on the Volcker Rule that it was legal and permissible for the agency to promulgate the rule—

Chairman GARRETT. So I guess I want to be clear, and I will go to Mr. Quaadman, if you want to jump in here. If we have this law now and you go into a joint rulemaking territory, and the SEC has to do it—I will throw it at Mr. Quaadman.

Would you say that the SEC has the—they would do the joint rulemaking, but would they have the—they would do the analysis. Would they have the ability basically to stop the joint rule from going forward then?

Mr. QUAADMAN. No. So in fact, we have a situation right now with the Incentive Comp Rules, which are being released, where you have five agencies that have not done any sort of analysis and the SEC has.

I think also, to Commissioner Gallagher's point with the Volcker Rule, no agency did an economic analysis with the Volcker Rule. So what we have now are markets where we have liquidity stresses, which should have been picked up in the economic analysis of that rulemaking.

Chairman GARRETT. Did you have a last point on that?

Mr. GALLAGHER. Yes, I think, so basically this stand-alone statutory requirement would not allow the commission to seek rulemaking authority other than the Federal securities laws. And so where the Bank Holding Company Act did not require cost-benefit analysis, an economic analysis, this standalone would force them to do it, even in the context of Volcker.

And just one little small point, too—

Chairman GARRETT. Yes, sir.

Mr. GALLAGHER. —just so this committee knows to keep an eye on this. The commission still needs to promulgate a rule to make the Volcker Rule enforceable under the Federal securities laws under the Exchange Act.

Chairman GARRETT. Yes.

Mr. GALLAGHER. Now, that would change the baseline of the economic analysis when they conduct that rulemaking because the Volcker Rule exists today. If they had done that back in 2013, it would not have existed, so the baseline for the economic analysis would have been much different than what you are going to get whenever this rulemaking happens.

Chairman GARRETT. Right. And I only have a minute left to hit 10 more questions. So one question is, so oftentimes the charges

that we are trying to do is undo regulations or undo rules or peel things back. If you do a cost benefit analysis, is that really the case?

Or really what you are doing—I will throw it to Mr. Quaadman again. Is that really what you are doing or you are trying to get the most efficient, cost-effective approach and if helping both the industry and investors, or what have you, but also the agency itself to most perform effectively?

Mr. QUAADMAN. Yes. No. And I think what your bill does, it does in two ways, right? One is not only during the rulemaking process do you actually get a sense of what the potential costs and benefits are, and then figuring out the right way to get at the objective of the rule. But then when you take a look at it 2 years post-implementation, you are actually looking at real numbers that will allow you to get to the point of if the rule is working or how you need to change it.

Chairman GARRETT. Okay. I have a whole bunch of questions on proxy advisers and I am not going to go over my time. Maybe we will circle back.

With due deference to the other Members here, I now yield 5 minutes to the gentlelady from New York.

Mrs. MALONEY. Okay. Thank you.

Professor Taub, I would like to ask you about the private equity bill. You noted in your testimony the bill amends the books and records rule, which requires investment advisers to keep key records of transactions they execute for their clients as well as investment decisions.

The bill would provide a broad exemption to the books and records rule. And I am concerned about how that could affect the SEC's ability to examine investment advisers and ensure that they are complying with the law. Can you discuss a little bit more why the books and records rule is important, and whether the bill's exemptions to the rule are too broad?

Ms. TAUB. Thank you. That is a really great question. So the recordkeeping requirements are basic business records, as you have noted. And it includes things like investment advice given. And it includes the way that it would interfere with the SEC's ability to do examinations is that if these communications between employees—they could be communicating by email or they could be communicating in writing concerning transactions that could now be destroyed, for example.

Or even external communications, as long as they were subject to confidentiality agreement, there would be no record of those. And in the first examinations of, for example, private equity funds that began in 2012 resulted, by mid-2014, there were about 150 of the firms examined and over half of them there were either legal problems or problems with controls.

And the SEC found mostly problems with expense allocation and also problems with fee disclosure. And all of that, to be able to discover whether there has been one story told to the investor and a different story communicated in-house, you actually need those records. And this would permit those records to be destroyed.

Mrs. MALONEY. Okay. You also stated in your testimony that the private equity bill's exemption to the custody rule should be called

a “Madoff loophole.” Could you elaborate more? How would this exemption have helped Bernie Madoff?

Ms. TAUB. The reason why I called that the Madoff loophole is because I was recently rereading the Diana Henriques wonderful book called, “Wizard of Lies” about Bernie Madoff. And one of the things that folks failed to check is actually see if the assets and securities he claimed to have were truly there.

And in this bill, there are exemptions from what is now required by the SEC, which is an annual surprise audit. So you have an independent audit firm, doesn’t tell you they are coming in. They are supposed to come in and see if you actually have your clients’ money. And in securities it seems like a very sensible thing.

And the carve-out in this legislation—the reason why I am calling it the Bernie Madoff—the carve out is if you only run money, you manage money and assets for family members, and there is a whole long list. And one is for investors you have a relationship with.

And if you think about Bernie Madoff and other folks, there is this affinity fraud. The definition of who you have a relationship with. These are all built on relationships. It is far too broad.

And moreover, I don’t see why anyone would object to—why any honest investment adviser would not want to assure their investors that their money is actually there. So it is an invitation. It is basically tying the SEC’s hands, and it is an invitation for fraud to flourish in the shadows.

Mrs. MALONEY. Thank you.

Mr. Quaadman, I would like to ask you about proxy advisers. And I understand that there is still disagreement in the academic literature about the influence of these advisers. Some studies find them very influential while more recent studies find that their influence is limited, and even declining.

Some of the biggest asset managers tell me that they use proxy advisers primarily for their centralized data management on all of the shareholder meetings and to help them actually cast the thousands of votes that they have to cast every year and not as much for their vote recommendations.

So I would like to ask you, first, how do you respond to the studies that show that proxy advisers aren’t very influential anymore? And secondly, if proxy advisers’ vote recommendations are less influential than they were a decade ago, is there still a need for aggressive oversight of these firms?

Mr. QUAADMAN. Yes. Let me answer that in a couple of different ways, Congresswoman. Number one, you have the Ertimur study out of the University of Colorado, which shows that ISS and Glass Lewis control about 36, 37 percent of the vote.

You have the Larcker study, which shows that the ISS recommendations are not necessarily geared towards better economic return.

And just lastly, I spoke to a CEO last year who received a negative recommendation on a comp plan, and 33 percent of the shares were voted within 24 hours of ISS and the Glass Lewis recommendations. And 90 percent of those shares were voted against the company. I think that, in and of itself, shows that they are still pretty influential.

Chairman GARRETT. Thank you. The gentleman yields back.

The vice chairman of the subcommittee, Mr. Hurt, is recognized for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman. I had a question for Mr. Cherry-Seto and hopefully be able to get to Mr. Quaadman and Mr. Gallagher.

But I wanted to begin with you, Mr. Cherry-Seto. You are the CFO of Blue Wolf Capital Partners, is that right? And obviously, your firm has to engage in a lot of compliance with regulatory agencies. Is that correct?

Mr. CHERRY-SETO. That is right.

Mr. HURT. You take—is that expensive?

Mr. CHERRY-SETO. It definitely takes a lot of time and attention.

Mr. HURT. And it is time-consuming?

Mr. CHERRY-SETO. Yes.

Mr. HURT. Do you take it seriously?

Mr. CHERRY-SETO. At all levels of the organization.

Mr. HURT. Do you think that the SEC's responsibility for investor protection is important?

Mr. CHERRY-SETO. Absolutely.

Mr. HURT. And do you all take that seriously?

Mr. CHERRY-SETO. Absolutely.

Mr. HURT. I guess my question really deals with a couple of things that Professor Taub said. You touched, in your testimony about the advertising rule and the necessary change that this bill would bring to that rule.

But I was wondering if you could talk a little bit about the custody rule and the recordkeeping and the Form PF? And A, do these changes, these proposed changes, in any way jeopardize investor protection? And B, if they do not, how do they help your company or your firm and the employees that they hire?

Mr. CHERRY-SETO. Let me try to take a stab at the books and records piece of this legislation. Part of the issue here is that engagement with the industry is important so that we can figure out how to come up with regulations that are common sense with the way that the industry operates.

In the case of books and records, I think the intent of that section is really talking about keeping records of investment advice. When the laws were made, it was very clear what you meant by investment advice.

If you engage a broker and that broker comes to you and says, "I think you should buy this stock," they have made an investment recommendation to you. And then the SEC could say, well, let me look behind and see what the research was for them making that recommendation.

In the private funds space, you have engaged a private fund manager like Blue Wolf to work on your behalf to make investments. In this case, we are not coming back to the investors every time we are looking to invest in a company.

We are doing that in our own governance structures where there may be an advisory committee of L.P.s that help look over. But on a day by day basis, we are making recommendations to our investment committee, which is within the firm, on investments that should be made.

I think what this legislation is trying to address is that in the course of doing work, we look at all sorts of investments, many of which don't get consummated. Those investments that don't get consummated are most of the recordkeeping that we are talking about. And where is the investment advice in a prospective investment that never happened?

Mr. HURT. And what does that have to do with investor protection?

Mr. CHERRY-SETO. Well, if the investment is not made, I don't think it is really doing much to protect investors. If an investment is made in a portfolio company, we do have an obligation to keep the investment committee minutes, the information around the investment committee, the investment committee memos that are put together to support an investment. But there are many, many more investments that never make it that far.

Mr. HURT. Okay.

Mr. Gallagher, from your time at the SEC, I would imagine that you have—and I know that you have struggled with a lot of the things that these firms have to go through now that they have to register.

I guess my question is, Ms. Taub couches this as an either/or thing and investment protection is at odds necessary with capital formation. And I guess my question is does it have to be that way? Aren't there ways to promote capital formation and at the very same time maintain investor protection?

Mr. GALLAGHER. Absolutely, Congressman. In fact, you know, one might look at it and say, as I used to when I was on the commission, promoting capital formation is increasing investor opportunity and the ability to choose service providers, the ability to choose products that otherwise wouldn't exist, which is good for the overall economy.

But really good for investors and creates more competitive market in which, you know, the malfeasors might not succeed. Because there is real competition.

And so there is a natural regulatory inclination to reduce opportunity to protect, a very nanny state-like instinct, in the regulatory agencies these days to reduce opportunity. And I think that is the actual detriment and a loss of protection for investors.

Mr. HURT. Thank you. I yield back.

Chairman GARRETT. The gentleman yields back.

Mr. Scott, you are recognized for 5 minutes.

Mr. SCOTT. All right. Thank you, Mr. Chairman. Very good hearing. It seems to me that these bills are sort of put forward to maybe spur a greater concern with the SEC to move faster in doing its job. However, I have a couple of pertinent questions that go to this point.

Back in 2010, for example, there was a staff report from the Federal Reserve Board of New York that argued, and I quote: "Along the chain of intermediaries in the shadow banking system, the weakest link in that chain is the pinch point that can destabilize the entire chain."

Now when that staff report was released in 2010, we were on this committee, finishing up passing Dodd-Frank. And one of Dodd-Frank's main objectives was to fill the regulatory gap that was cre-

ated by this shadow banking system thereby making our chain stronger.

And to that end—and I was a co-sponsor of the Dodd-Frank bill. We were working on the bill. And at that point, we made sure that Dodd-Frank brought private fund advisers with more than \$150 million in assets under management out from the shadows and into the bright light of the oversight of the Securities and Exchange Commission.

So my question is, given all that we have done, what evidence do we have today to suggest that now is the right time to loosen the SEC's grip? Any one of you.

Ms. TAUB. I would be happy to respond to that. And I have read that report. But first, I do want to respond to something that Mr. Hurt said, suggesting that in my testimony I stated that investor protection was at odds with capital formation. In fact, I have always stated the opposite.

And my written testimony indicates that they actually are perfectly aligned. And that it is trust in our financial markets that encourages people to invest and actually can decrease the cost of capital because there can be a premium on capital if you think someone is going to cheat you.

But back to the question about shadow banking and Dodd-Frank and how this bill could affect that. In particular, the provision in the bill that would allow private equity firms and some hedge funds to no longer complete Form PF, I think it is very important.

The Form PF, as you know, is provided to the SEC confidentially and access is given to the Financial Stability Oversight Council. And these data have only started, has only been collected since 2011. And getting a picture of the behaviors in broader market is really important.

And the part of the form we are talking about is Section Four, for the private equity firms. And it provides important information related to leverage and counterparty risk and also geographic and industry breakdown. And the importance of knowing about, obviously, leverage is a key factor in the financial crisis, but counterparty risk is important because of the links that you are talking about.

The second thing, though, that goes really to the heart of shadow banking is Section 1(c). This is a part that is only filled out by hedge funds. If this bill were to pass, hedge fund advisers with between \$150 million and \$1.5 billion assets under management wouldn't—

Mr. SCOTT. I have only—

Ms. TAUB. Yes.

Mr. SCOTT. Sorry to interrupt you, but I have—

Ms. TAUB. It is okay.

Mr. SCOTT. Appreciate that response, but I did have one other question I wanted to get in concerning Mr. Garrett's bill because I have a belief and support a cost-benefit analysis. But I do what to raise the issue because back in, I think, around 2013, SEC Chair Mary Jo White said that she was conducting economic analysis.

And I would just like to clarify your statement, Mr. Gallagher, because it goes to the point that the chairwoman of the SEC made that perhaps Mr. Garrett's legislation would hamper the SEC's

ability to do rulemaking in a timely manner. I wanted to get you on the record to please explain that. At least give some response to the chairlady's concerns of the SEC.

Mr. GALLAGHER. Sure. Thank you for the question, Congressman Scott. I am an end user of economic analysis. I have gone through many rule-makings, mostly Dodd-Frank related, over the last several years. Economic analysis has never once slowed down the process.

In fact, my experience is that it speeds up the process because it provides decision points and optionality for policymakers like myself who need to vote on these rules where you otherwise wouldn't have it. Where it would be one size fits all.

It lends itself to negotiation. There were several Title VII rules on derivatives. My first year in 2012, that but for the economic analysis, we would have had split votes of the commission. Instead, we got 5-0 votes. And we got them in a timely manner.

So I think this bill is actually, to Chairman Garrett's original point, only incremental in its burden on the agency over what the agency's committed to in 2012. What it does is, it clarifies and codifies, which is incredibly important, in a standalone way, these obligations that the agency has mostly already committed to. So I think it is a very positive step.

Chairman GARRETT. The gentleman's time—

Mr. SCOTT. You do understand Chairwoman White's concerns are legitimate? I just want a yes or no on that.

Mr. GALLAGHER. When you run the agency, you are always worried about pressure to get things done, running the agency. The chairman has so many other duties than the other commissioners so any other imposition, any other mandate coming from Congress right now, if you are trying to run the SEC, I can see it would be a burden in her eyes. But I don't think this is a real material one at all.

Mr. SCOTT. Okay. Thank you, Mr. Chairman.

Chairman GARRETT. Thank you both.

The gentleman from Texas is now recognized.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Mr. Cherry-Seto, do you believe that private equity funds represent a systemic risk?

Mr. CHERRY-SETO. Do I personally feel that they are—

Mr. NEUGEBAUER. Yes.

Mr. CHERRY-SETO. I wouldn't say that I was an expert on the matter, but there have been a number of folks that I think are better messengers than me have said that that is not the case.

Mr. NEUGEBAUER. Do you think that private equity firms had any cause to the financial crisis that we had in 2008?

Mr. CHERRY-SETO. I don't think I am an expert to speak on that. But I would say that a lot of private equity firms, especially small ones, look much smaller than any holding company. You have the holding company that happens to not be run by a private equity firm, is either privately held or public, that are much larger than our firm.

I mean, our firm is fairly typical for the middle market. There are thousands of firms of our size, manage under a half billion of capital. We have majority interest in 10 or 12 companies.

Mr. NEUGEBAUER. So I think one of the things I want you to do is maybe explain who is a typical client of a private equity company?

Mr. CHERRY-SETO. Here often pension funds are big investors in private equity assets.

Mr. NEUGEBAUER. So they are sophisticated investors. Is that right?

Mr. CHERRY-SETO. They are definitely investors that have access to legal support. Most of them have advisers, that this is the only business they advise on, not only for investments, but specifically on alternatives in the private equity market, very sophisticated advisers.

Mr. NEUGEBAUER. Mr. Gallagher, would you concur that—what is your position? Do you think that private equity companies are a systemic risk?

Mr. GALLAGHER. Absolutely not.

Mr. NEUGEBAUER. And you don't think they had anything to do with causing the crisis?

Mr. GALLAGHER. Absolutely not. I think they got swept up into Title IV. Lord knows why. I wasn't here for that process, and I don't think the regime fits the business model.

Mr. NEUGEBAUER. And the President signed an executive order, 13579, which requires an independent regulatory agency to perform an analysis of rules that are "ineffective, insufficient, excessively burdensome, and to modify, streamline and repeal them in accordance to what they have learned."

While you were commissioner at the SEC, were you aware whether the SEC took part of any kind of analysis like that to comply with Executive Order 13579?

Mr. GALLAGHER. No. Unfortunately, Congressman, it never happened. There was a lot of talk about it, but it never happened.

Mr. NEUGEBAUER. Why do you think that was?

Mr. GALLAGHER. Well, it was a very regulatory time during my tenure on the commission, and the emphasis was on promulgating rules, not reviewing them, not writing them off the rulebooks.

Mr. NEUGEBAUER. In your testimony I think you said that SEC was "constantly bombarded with pressure from special interest priorities." Could you describe some of the examples of what you see as SEC's missteps in terms of setting its own priorities?

Mr. GALLAGHER. Look, it is since 2010, since Dodd-Frank when the SEC was mandated by Congress to conduct roughly 100 rulemakings, studies and the like, the agenda has effectively gotten away from the agency. As you well know, a lot of those mandates had 2-year timeframes.

Here we are. It will be 6 years I believe here in July since the enactment of Dodd-Frank and the agency still has roughly 35, 40 percent of the final rulemakings to do.

So that the rulemaking agenda has been dominated by Dodd-Frank and, you know, I think within the Dodd-Frank mandates is where I often squabbled with my colleagues on the commission. Prioritizing those mandates I thought were askew.

The best evidence of which is that my first 10 months on the commission a quarter of my time was spent on Sections 1502 and 1504 of Dodd-Frank, conflict mineral disclosure and extractive re-

source disclosure when here we sit today and the Title VII, derivatives rulemakings, remain unfinished.

Mr. NEUGEBAUER. But you talk about the external, I guess, special interest priorities. Do you think that was influencing more of the agenda or are they trying to knock out some of the Dodd-Frank?

Mr. GALLAGHER. Congressman, I think the squeaky wheels got a lot of the grease. So, you know, the 1502 rulemaking here, again, is instructive. That was why did I spend 20, 25 percent of my first 10 months on it? Because it was a steady parade of special interest groups on all sides of the aisle, pro, for, you know, and against the rule coming in to meet with us and push this to the front of the agenda.

The 1502, you know, accept the wisdom of Congress. This was something that had to be done. It is the law of the land. Someone needed to realize that it was not going to happen. You know, that these 100 mandates were not going to be completed within 2, 3 years, and 1502 should have been at the end of the pile not at the beginning.

Mr. NEUGEBAUER. I thank the gentleman.

I yield back.

Chairman GARRETT. The gentleman from Connecticut is recognized for 5 minutes.

Mr. HIMES. Thank you, Mr. Chairman.

I would love to just direct a few questions to Professor Taub and by way of background, I worked with Mr. Hurt on a bill a number of years ago that would have provided exemptions from registration to larger and more leveraged private funds.

And at the time the theory was that they are not systemically dangerous, which I happen to continue to believe. And that limited partners in these funds as sophisticated investors don't require quite the same oversight and assistance that retail investors do.

I look back on that with some ambivalence because I still think that those two things are true, but obviously the SEC used the filing of Form PF to identify a not inconsequential amount of skull-duggery with respect to fees, conflicts of interests.

And many of their exams resulted in some disclosures that were really pretty uncomfortable for the way limited partners in these funds were treated. So I approach these questions with ambivalence.

I continue to believe, Professor Taub, that a private fund is not the same as a mutual fund. They tend to hold private securities as opposed to public securities. They tend to deal with sophisticated investors.

So I am wondering if we can drill in, and as you look at the elements of the proposed Hurt legislation here, I am really interested in your opinion because I think your critique was pretty good. But is everything in here a bad idea?

I mean, let me just rattle off a couple to get your hopefully quick opinion on. You know, the delivery of brochures to clients, that exemption would apply only if a prospectus had been delivered. So I am wondering should I be concerned about that?

The exemption from annual independent audits and surprise examinations is only in the case of limited partners that are insiders,

family members, family offices. You are shaking your head. I will give you a chance because I am asking this honestly. I am not making a rhetorical point here.

And, you know, on the client notification on consent to ownership changes, that strikes me as sort of administrative in nature. So I do, Professor Taub, want to give you the opportunity. Is everything in this bill a bad idea or is it possible that some of these things, including what I have just listed is in fact a tailoring of legislation to the fact that private funds are not in fact mutual funds?

Ms. TAUB. Thanks so much, Congressman. I appreciate those questions. I want to answer it but you also made a comment which I thought was interesting about sophisticated investors. And I did write a paper entitled, "The Sophisticated Investor in the Global Financial Crisis."

And what is interesting is, I am sorry to bring up Bernard Madoff again, but if you think about a lot of his money came through feeder funds. And the feeder funds were giant, sophisticated investors, so themselves.

These were a fund-to-fund structure. So if a sophisticated investor is being lied to and provided false information I am not exactly sure how that benefits capital formation. But seriously, I think—

Mr. HIMES. I don't want to cut you off. Look, I don't think we can build an entire regulatory structure around a Madoff possibility. Obviously Madoff undertook a lot of very illegal activity, but I really am interested in—

Ms. TAUB. Yes.

Mr. HIMES. —whether your opinion is in particular those three areas that I highlighted. Is this a collection of totally bad ideas? Or am I right that some of these things actually may be fairly reasonable tweaks to the regulations?

Ms. TAUB. Well, quickly since you mentioned the brochure, the brochure is basically part two of this Form ADV that has to be filed. And the reason why it is still important even if a prospectus has been given, is that it is written in plain language. It has to be updated. And in this brochure the advisor has to disclose if there has ever been any disciplinary actions.

Listen, there are so many good—

Mr. HIMES. Does that not have to be disclosed in a prospectus though?

Ms. TAUB. It would have to—no, because if a disciplinary action happened after the—not the prospectus, but the offering document, that it would not have appeared. So if they get in trouble I think—like I said, there are so many good advisors. Why shouldn't there be a fair playing field and those that do have disciplinary actions disclose that?

The thing with custody is it is not just for firms that only have the limited partners. It is family members. It is anyone who has a relationship. And the term "relationship" can—it is not defined. So that is of concern.

So I, you know, if you wanted to go line by line I would be happy to define, you know, something in here that I didn't find troubling. I only highlighted the things that struck me as problematic. Thanks.

Mr. HIMES. Okay. Thank you. Let me ask one last question in my limited time. It does seem that Form PF did, and I will look at the whole panel on this, give the SEC some information that it used to find some troublesome behavior with respect to fees in particular and conflicts of interest.

Professor Taub cites in her testimony the work of a Professor Coll who—

Chairman GARRETT. Do you have a question before your time?

Mr. HIMES. —had a \$10,000 cost associated with Form PF. Does the panel disagree that Form PF in and of itself is not outrageously burdensome?

Mr. GALLAGHER. I don't think that these fee issues were discovered through PF if that is my recollection. It was a regular way examination by SEC examiners of the books and records of the advisor. PF is wholly separate information to be provided for systemic—

Mr. HIMES. So we are back to the independent audits and surprise audits. Is that what—

Chairman GARRETT. The gentleman's time has—

Mr. GALLAGHER. It is regular audits. PF doesn't make any sense for private equity.

Mr. HIMES. Okay.

Chairman GARRETT. The time has expired.

Mr. HIMES. Thank you, Mr. Chairman.

Chairman GARRETT. Yes.

Mrs. Wagner?

Mrs. WAGNER. Thank you, Mr. Chairman, and thank you all for joining us today for this important hearing and discussion on reforms we can introduce at the SEC in order to make sure that capital is allocated as efficiently as possible and that shareholder value is prioritized.

Increasingly we have seen government get in the way of our capital markets and the ability of public companies to grow and expand their business on behalf of their employees and shareholders. For small companies that are continuing to expand and grow, this often results in them staying private longer than deal with extraneous issues of being a public company, especially when the cost of going public is estimated to be \$2.5 million at first with continuing annual costs of \$1.5 million.

Mr. Quaadman, welcome back. Good to see you. In your testimony you note that, and I quote: "For 19 of the last 20 years we have seen a number of public companies decline. We now have fewer than half of the public companies than we did in 1996." Could you please explain why you think that this has occurred?

Mr. QUAADMAN. I think you put your finger on one of the reasons in terms of the IPOs and difficulty there. The other, quite frankly, is what is called the Michael Bell problem, where you have an entity that is a public company that is faced with a lot of these costs, burdens, and the annual fights that they have to go through in terms of shareholder proposal and director elections.

And that takes up so much time and effort that—

Mrs. WAGNER. Mm-hmm.

Mr. QUAADMAN. —management actually begins to move away from managing the corporation for the long term. So there you ac-

tually had a company that decided to go from public to private, and Michael Bell said he would never operate a public company again because he would rather manage the company than having to deal with these fights.

So I think if we had, you know, as an example with the proxy advisory firms, if we had more oversight there and we had openness and transparency that we expect in other areas, that might alleviate things. But we do not have a hospitable environment either to create or remain a public company in the United States.

Mrs. WAGNER. Well, moving off of that and expanding a little bit there, for small companies that are looking to go public, they have to see all of these pressures that you have talked a little bit about here briefly that they will encounter from activists and battles on proxy votes that promote priorities.

And this is my biggest concern. They promote priorities that have nothing to do with long-term—

Mr. QUAADMAN. Yes.

Mrs. WAGNER. —shareholder value. How much of a disincentive does this make for those small businesses that are looking at going public and how can we improve, outside of what you mentioned vis-a-vis oversight, this corporate governance climate, so to speak?

Mr. QUAADMAN. Yes. I think we can spend a whole day answering that one question. Number one, I think just creating the small business advocate, which this subcommittee has been in the lead on, is really important to get a voice for capital formation and competition in the SEC, one.

Two, I think it is really important, not only that we get more oversight, but that we have more emphasis on what we need to do in terms of capital formation. So, if we take a look at it and we have a very diverse capital system, we need to have private equity but we also need to have public companies.

So in order to deal with, let us say, proxy advisory issues, that is a very important thing to deal with because companies just will not decide to go public because of issues like that. In fact, if you go to Silicon Valley, the two reasons why they will tell you they will not go public, one, are proxy advisory firms.

Mrs. WAGNER. Right.

Mr. QUAADMAN. Two is the internal control costs placed on them by the PCAOB.

Mrs. WAGNER. Okay. Okay. Let me move on. Mr. Quaadman, thank you very, very much.

Mr. Gallagher, good to see you again. I am increasingly concerned that shareholders' interests are not truly being represented by this proxy system. How has the current complexity of the proxy system contributed to inaccuracies in the processing and reporting of proxy votes?

Mr. GALLAGHER. Congresswoman, I have heard over the years anecdotally so many stories of failings on the part of the proxy advisory firms, whether they be bad recommendations or, you know, mechanical issues and the like. And that is one of the reasons I got so inspired to pay attention to the issue.

As a commissioner you often act as an ombudsman for complaints and the like. And so—

Mrs. WAGNER. In my limited time, Mr. Gallagher, is there any way we can simplify the system to make it more beneficial for the owners and I should say on behalf of the owners for the intermediaries? When was the last time that we did something like this?

Mr. GALLAGHER. You know, I think it is about time that Congress take a look at what I had called as a commissioner of the Federalization of corporate governance.

Mrs. WAGNER. Right.

Mr. GALLAGHER. Find the touch points where the Federal Government has been inserted to which otherwise is a state law system dominated by Delaware in particular, and decide does it make sense? 14(a)(8) shareholder proposal rule is out of control and needs to be revisited. If not the SEC then it should be this Congress. You know—

Mrs. WAGNER. It is past time that we update the process.

Mr. GALLAGHER. It is past time and there are these touch points. And I do favor—

Mrs. WAGNER. All right. Thank you very much. I am out of time. I yield back, Mr. Chairman.

Chairman GARRETT. The gentlelady yields back.

The gentleman from California is recognized.

Mr. SHERMAN. Okay. A couple comments on proxy advice. I think it is an attack on capitalism to tell investors that it is virtually illegal for them to consider anything other than earnings per share in making their investments. That they are silly or that they are not to be given the information they want.

And if investors want to prevent companies from investing in Iran, if they want to be interested in the political contributions that are made with their money, if they want to avoid their companies or at least know how their companies are engaged in blood diamonds and conflict minerals, that investors have a right to that information. And they have a right to even vote on whether the company should engage in those activities or not.

And to say that investors must only consider earnings per share is to say that the investor doesn't own their own money; cannot make decisions that reflect their own values.

So I would say I believe in openness and transparency with proxy advisory firms, but not if the purpose is to prevent openness and transparency by the operating companies which solicit those proxies. And likewise openness and transparency includes a real audit that we can rely upon that includes many times internal controls.

Commissioner or Former Commissioner Gallagher, I want to direct your attention to the bill to deal with the NMS. We have that playing an important role in SEC regulation of the exchanges. The exchanges on the one hand are a regulator.

On the other hand they are market participants. They are for-profit companies who derive most of their money to making sure that some investors know about what is going on a microsecond before other investors know what is going on. So they are profit-driven and they are in favor of transparency but some are more entitled to transparency a millisecond before others.

The NMS includes the exchanges but doesn't include other industry participants such as the consumers of the exchange service, namely the brokers, and also the asset managers, those on the buy side. Does it make sense from the NMS plan to include folks other than the exchanges themselves?

Mr. GALLAGHER. Well, thank you for the question, Congressman. As a commissioner I heard lots of complaints on both sides of this debate. You had the brokers come in in particular complaining that they didn't have a real voice or ability to impact the direction of NMS plan participants. I heard from the exchanges making the exact counterpoint.

Without sitting in these rooms, you know, during the plan debates it was hard for me to actually decide where the truth lied. And I know that this committee and, you know, others in Congress are interested in this issue.

If there is legislation I think it is appropriate actually for Congress to weigh in. This all derives, of course from the 1975 Act amendments.

Mr. SHERMAN. I would point out that certainly if you are going to have an advisory board to a public utilities commission you include people who represent the consumers including the very large consumers of the utility services, not just the utilities themselves.

Mr. Cherry-Seto, there is the bill to change the Form PF to provide some information on the companies. Mr. Himes points out that Form PFs have disclosed certain things about fees. I will point out, though, when it comes to Madoff everything was filed with the SEC and they didn't do anything with it.

Mr. CHERRY-SETO. Right.

Mr. SHERMAN. So does it make sense—our purpose here is to focus—I mean, the reason we passed this was to deal with systemic effects, not to protect, although we always want to protect individual investors and we should have a comprehensive scheme for doing that.

Do the prudential regulators need all the information on that form? And is private equity, dealing with private equity part of dealing with systemic risk?

Mr. CHERRY-SETO. I think in the case of Form PF there is definitely additional information in there. Its primary purpose is to look at systematic risk and that is the lens that one should use to look at the information there.

But I would like to point out this legislation is not looking to exempt anyone from today reporting Form PF. If this was passed, no advisors would have an exemption from reporting Form PF. This is looking at information like you mentioned that is maybe trying to get at the question of systematic risk, and it doesn't serve a purpose for investors.

You look at the private market, I mean, I would also go back to, like, the custody rule. Like when we talked about delivering the brochure to our clients, keep in mind that a client in this context is not what was originally meant when they look at delivering to clients. The client is the fund itself.

So technically the bill is saying you need to deliver the brochure to your fund. And when people want to do that, technically follow

that rule they save it on their network because they delivered it to themselves.

Mr. SHERMAN. Hmm.

Mr. CHERRY-SETO. That is what they are talking about delivering a brochure. And the brochure is extremely important in this case and here we are just saying that it should only be updated when there is a material change. If there are material changes you still need to update your brochure.

Mr. SHERMAN. Thank you.

Chairman GARRETT. Thank you.

Mr. Hill is recognized for 5 minutes.

Mr. HILL. Thank you, Mr. Chairman. I appreciate you and the ranking member holding this important hearing on these issues.

Mr. Quaadman, as you know, last October the Department of Labor released an interpretive bulletin for economically targeted investments and investment strategies environmental, social and governance factors, which now allows these factors and collateral benefits to be considered when selecting an investment in an ERISA plan.

Now, it is been kind of 3 decades in the study of and the participation in the asset management industry, and I have read the document and it is very, very carefully worded. But I still am concerned that this guidance undermines ERISA's mandate that plan assets are invested solely in the interest of plan participants and that these factors, other factors might take precedent and deviate from maximizing returns for beneficiaries.

In passing ERISA, Congress chose specifically not to include any provision that would allow plan assets to be used to pursue any societal purpose other than protecting plan assets. To the contrary, Congress included Section 404(a) which says, "In order to make a law of trust applicable to the plans and eliminate such abuses as self-dealing, imprudent investing and misappropriation of plan funds."

Recently, both of the main proxy advisory firms have partnered with ESG research firms. Glass Lewis announced their partnership with Sustainalytics to integrate Sustainalytics' ESG research and ratings into Glass Lewis proxy research and vote management platforms.

This is an issue that I don't think has received very much attention. And I would be interested in your thoughts on the bulletin, any thoughts and concerns you might have first. And then secondarily, any ties to proxy advisors and their advisors that we are discussing today?

Mr. QUAADMAN. Yes. Thank you very much, Congressman Hill. Let me address that in two separate points. We are very concerned about that bulletin. We had written to Secretary Perez before the bulletin was released where we asked for empirical evidence as to why they were considering some of the changes they were.

Unfortunately with the bulletin today, environmental, social and governance concerns now rank on par with investment return for ERISA pension funds, and that is now migrating out to other areas.

So as an example, the New York State Common Fund, which has an ERISA-type fiduciary duty, issued 75 shareholder proposals last

year on proxy access. But they were very open about the fact they were not going for good corporate governance issues.

They are actually looking to put a pressure point on companies regarding climate change proposals. So rather than having that open debate there it was wrapped up in a corporate governance debate.

You know, the second point to it is when you take a look at the proxy advisory firms, and this is what the 2014 SEC guidance did and where the Duffy bill goes even further, is that the proxy advisory firm guidance or recommendations need to be correlated to the fiduciary duty of their clients, just as the institutional investor that they are providing recommendations to.

So that if we are now beginning to muddy those waters, all the debates that we are having today about enhancing long-term shareholder value are going to go out the water. And we are going to have situations like the Illinois Pension Funds where you have a very active pension fund on things other than good return now suddenly going underwater, and unfortunately it is going to be the taxpayers that are going to foot the bill.

Mr. HILL. Well, this is concerning to I think taxpayers because public pension funds are severely underfunded in this country. And also use, in my judgment, hypothetical actuarial return statements that are far too high to today's market conditions. So I do have a lot of concerns about it.

Commissioner Gallagher, your thoughts on that subject?

Mr. GALLAGHER. Thank you for the question, Congressman. I saw the circular, too, last October. For me, you know, similar reaction to what Mr. Quaadman said. More though it for the first time caused me to think about what I see is a trend or a push for the Federalization of the retirement system, you know, more generally where there seems to be interest with ERISA waivers coming out of DOL.

This policy statement and elsewhere, a move towards, as we have seen very publicly, state-sponsored private sector retirement plans, which, you know, if they add an option if they are in a competitive market you might think that is a good thing. But I am not sure that is the case.

So I do think this is something for the Congress to watch and watch very carefully. That, you know, the track record of, you know, government oversight of retirement plans has been checkered in some ways and expanding it might not be the best thing.

Mr. HILL. Thanks, Commissioner.

Chairman GARRETT. The gentleman's time?

Mr. HILL. Thanks, Mr. Chairman. I yield back.

Chairman GARRETT. All right.

Mr. Carney is recognized for 5 minutes.

Mr. CARNEY. Thank you, Mr. Chairman. Thank you for holding this hearing today, and thank the panelists for coming and for sharing your expertise.

I represent the whole state of Delaware. We have a lot of people at my state with considerable interest in and expertise in corporate governance, corporate law and providing corporate services to three-quarters of the Fortune 500.

And I have been involved as a result of that, that we have a lot of expertise both in the State Division of Corporation within the corporate bar in the state of Delaware, as well as in the provision of corporate services.

And so I pay attention to some of these issues and advice that I receive from folks back home I meet to—my involvement with when we saw the downturn a few years ago and the decline in IPOs, companies doing initial public offering, which led to my involvement with Mr. Fincher and the IPO onramp. We are working on beneficial ownership issues today as we speak.

And it has also led me to my involvement with Mr. Duffy when he came to me to talk about this bill, this draft bill that we have here on proxy advisory firms. And so I would just like to—got to get on the record some of what I think you said earlier, Commissioner Gallagher, about the need for the bill as you see it, in summary please?

Mr. GALLAGHER. First of all, Congressman, I wanted to thank you for your collegiality during my tenure as a commissioner. You know, your positive approach to these capital formation issues and it was always great to work with you, even bothering you on the Amtrak train on your commute home.

Look, I pushed for years as a commissioner to get some movement, some reform of the proxy advisory oversight system to the extent there was one. The culmination of that was SLB 20 in 2014. I think it was a positive step forward.

What I have heard since then, though, it was just simply not enough. And if you look at the legislation that is being debated by this committee, I think it is very incremental in its nature. I think—

Mr. CARNEY. It is pretty straightforward. I mean, not that—

Mr. GALLAGHER. It is very straightforward. It gives us the—if I am the SEC, again, it gives the SEC the look into this industry into the conflicts and into the business practices that this Congress 10 years ago gave the SEC with respect to credit rating agencies.

And now unfortunately that was a little too late in time to stop some of the things we saw in 2005, 2006, 2007 with credit ratings, but I think that sort of incremental step, that transparency is hard to argue against.

And so I do think based on everything I hear, there are academic studies that will tell you one thing on the left and one thing on the right, you know, you look—

Mr. CARNEY. Is there something in the bill that you wouldn't do or something that is not in the bill that you think we ought to think about?

Mr. GALLAGHER. Look, I actually pause and I have said this to Gary Retelny at ISS and others. I don't have, you know, anything against the industry. If they provide a service and it is done in good faith then it is a good quality product, then they should be there in the market.

Where they get the imprimatur of Federal regulation, where the no action letters and the rule interpretations basically give them a monopoly, that is something that you shouldn't abide.

And so I don't see anything in this legislation because, again, I think you could have gone further. I think it is very incremental in its transparency focus.

Mr. CARNEY. Maybe we could talk about those.

Mr. Quaadman, do you have any more to add to that?

Mr. QUAADMAN. Yes. Let me just add, one, you know, we did a survey with NASDAQ and public companies last summer where we wanted to see how public companies were dealing with the SEC guidance. What we found was when companies were looking for a conflict of interest with a proxy advisory firm, they were finding it 45 percent of the time. That is a pretty high and dramatic number.

And I also have an email. I know Mr. Bartl had mentioned an email, but I have an email here from ISS offering services to a company that was issued after the 2014 guidance was issued. And I would like to submit this for the record.

I think there are still significant problems that exist. I do agree with Commissioner Gallagher. SLB 20 was an important step forward. I think the Duffy-Carney legislation is a very balanced way to push the ball forward, to have more oversight, to make sure we have a balanced system that benefits investors and companies, and allows the SEC to do its job.

Mr. CARNEY. Thank you.

Anyone on the panel have something in the bill that they don't like or something that they would like to see us think about in the bill?

Mr. BARTL. Well, Congressman Carney, I was just going to say that I think that the one aspect of this bill that can't be emphasized enough is that where there has been this specific oversight, and I go back to the peer group episode in 2012 which got SEC attention. It got press attention that caused a change and this ongoing, regular oversight will be effective.

Mr. CARNEY. Thank you, sir.

Mr. BARTL. So I think that is the positive side of the bill. I don't have anything that I would change at this point.

Mr. CARNEY. Thank you.

Ms. TAUB. Hi. Yes. I don't like this bill and I am surprised at, you know, this is the free enterprise system that we have sophisticated investors that we spoke about before entering freely into contracts, not required to with these enterprises that provide an important service for them.

And we have regulators who have the tools that they need to deal with those conflicts of interest at advisory firms as well as fiduciary duty at the institutional investor firms.

And reportedly we are doing this because the regulators can't deal with those issues and somehow there is a monopoly if you create this giant complex regime it is going to create barriers to entry.

And secondly, one of the biggest concerns I have with this bill is the private right of action that it gives to issuers if they are not satisfied with the resolution of their complaint when they are given a copy in this very tight, you know, 6-week window to look at the recommendation.

And why wouldn't an issuer be unsatisfied if there wasn't a vote the way we want to recommendation? And so I am deeply confused

why this committee in particular would be either trying to entrench a monopoly or try to shut down a successful business.

Mr. CARNEY. Thank you. Well, we disagree but thank you and I yield back.

Chairman GARRETT. You disagree? Okay.

The gentleman from Vermont—oh, no, from Maine.

Mr. POLIQUIN. There were some people—

Chairman GARRETT. Thought we had a fellow put down. That is—

Mr. POLIQUIN. Mr. Chairman, there are some people who are envious of not coming from Maine, and I do recognize for the record that you are from New Jersey.

[laughter]

And I appreciate very much, Mr. Chairman, this terrific hearing today. I thank all of the witnesses today.

When I was a boy growing up in Maine, our State was dotted with dozens of paper mills, textile mills, shoe factories. And our families could take care of themselves and they had the option of going right from high school directly into working at these mills with good jobs, with benefits that they could keep and take care of their families.

You know, over the past 30 years, a lot of these mills have closed. I don't know if you folks have ever experienced it. I have. When a small town loses a mill it devastates that community, absolutely devastates it. Schools get smaller, some of them close. The collection baskets at church dwindle. Hospitals struggle and a lot of families leave and go down state to New Jersey.

That being said, there are a lot of issues that cause these mills to close. Taxes are too high, regulations are too tough, a lot of which are brought on by us or by the people that set the rules in government.

Now, sometimes you can't control it, like foreign competition or different products that are being offered that are no longer used, like newsprint or catalogs. Now, one of our great paper mills in the state of Maine, which is healthy, is Twin Rivers Paper Madawaska.

Mr. Cherry-Seto, you are from Blue Wolf Capital, invested in our mill, in that mill. Now, this is in northern Maine right against the Canadian border, 600 jobs in the St. John Valley, 600 paychecks, 600 mortgage payments. Thank you sir, very much for that investment in our state.

Now, that mill does not make some of the products that it did, I am sure, a number of years ago. They make paper bags for McDonald's French fries. I love it. Every time I am on the road in that district I go to McDonald's and I buy two bags of fries.

[laughter]

And they make that thin paper that we print medication instructions on. Now, I take pills like everybody else—not that pill—and we should continue to print that paper like you do up there, and also the thin paper that our mutual fund reports are printed on.

Mr. Cherry-Seto, as you know, I would like to ask you a question. You invested in that mill. That mill was in bankruptcy in 2010. You folks invested in it in 2013. Tell me why you invested in that mill, sir, and tell me what changed at the mill that made it so suc-

cessful. It continues to be a thriving employer in that part of our state.

And tell me about the Investment Advisers Modernization Act that Mr. Hurt and Mr. Vargas are putting forward today. Tell me how that can help you and companies like yours invest in paper mills like this and keep those jobs and those communities going?

Mr. CHERRY-SETO. Thank you, Congressman. I think Twin Rivers is a good example of where there is a company that has a strong reason to exist, but there are challenges that they face that make it difficult to invest. As you had mentioned, they came out of bankruptcy in 2010. There were cuts to the pensions coming out of bankruptcy.

There was a lot of animosity and mistrust. People didn't know what the future was going to hold. Coming out of bankruptcy you find situations where there are liabilities left on the companies that nobody knows with certainty of the company surviving.

And I think firms like Blue Wolf and other private equity funds in different parts of the market, they come with a certain expertise. And we felt that we could understand the risks of investing in a business and be a partner to help.

You know, as you mentioned, it is on the border of Maine and New Brunswick. Part of the company is over on the Canadian side of the border.

Mr. POLIQUIN. Right.

Mr. CHERRY-SETO. And you can imagine what the complexities are of coming out of bankruptcy and having both the Maine government and the New Brunswick government involved.

Mr. POLIQUIN. Thank you, Mr. Cherry-Seto. And tell me specifically, tell us specifically how if the Investment Advisers Modernization Act of 2016 offered by this committee would help private equity firms like yours invest in mills like this so we can show compassion for the people that work there and we can grow these businesses and create more jobs?

Mr. CHERRY-SETO. Sure, Congressman. I think the issue is on focus, right? Investors invest their money with us because they believe that we can find good investments like that, create good jobs like that. And so that is what we do best.

I think in some sense it would be analogous to looking at Members of Congress and the unfortunate situation where you are asked to spend a lot of time on fundraising. And if you could free up some more time from fundraising, you would be able to spend more time on what you really want to do here, which is govern and pass legislation.

We look at it somewhat the same way for us. All right. Here we are. Compliance is important. Fundraising is important. It is part of who we are. That is not going to go away.

But we are successful by focusing on investing money. And so I think in this case having the legislation be more rational would help us to focus more time on looking for companies and building jobs.

Mr. POLIQUIN. Thank you very much, Mr. Cherry-Seto, again, for your company, your investment in our great state.

Mr. Chairman, since you picked on my state, I have one more question, and with all due respect—

Chairman GARRETT. Well, we are going to actually do a second round I think here.

Mr. POLIQUIN. My schedule is such that I cannot, but if you can award me another minute or two because of the way you picked on our state, then I would consider it an even fight.

[laughter]

And I would consider it we are even, sir—with all due respect.

Chairman GARRETT. I will look to Mr. Hultgren whether he can hold off and without objection the gentleman is recognized for—

Mr. HULTGREN. Just because Maine is so beautiful.

Mr. POLIQUIN. Thank you. Thank you, Mr. Hultgren. I appreciate it.

Thank you, Mr. Chairman, very much.

Chairman GARRETT. And be forewarned if you say anything against it.

Mr. POLIQUIN. Yes, sir. I will talk quickly.

Chairman GARRETT. The gentleman is recognized for 1 minute—

Mr. POLIQUIN. Thank you.

Chairman GARRETT. —without objection.

Mr. POLIQUIN. Thank you, sir.

Mr. Gallagher, Professor Taub in her written testimony notes that the SEC has the authority to inspect and discipline institutional investors who “mindlessly follow advice without considering their fiduciary duty.” She further states in her testimony that “the status quo is far better than any changes offered by Mr. Duffy.”

Now, you spent some time at the SEC. Do you agree with her?

Mr. GALLAGHER. Thank you, Congressman, and I love Maine. The professor is correct. The SEC does have that authority to discipline the institutional investors through the anti-fraud provisions. Finding that activity though is the real key.

There are 11,400 registered investment advisors with the SEC, a couple hundred examiners, so to find evidence of voting abuse that would implicate the proxy advisory firms, you are going to have to send those couple hundred off into the several thousand as opposed to registering and examining basically two firms that control 97 percent. So it seems pretty logical that you would take the latter route.

Mr. POLIQUIN. Therefore I can conclude that you agree that Mr. Duffy's bill has merit?

Mr. GALLAGHER. Beyond that, yes.

Mr. POLIQUIN. Thank you, sir.

Thank you, Mr. Chair, very much for the additional time.

Thank you, Mr. Hultgren, very much.

Chairman GARRETT. Thank you. And I think we all can agree that we all like the teddy bears that come from—oh, wait. That is the other state, too.

[Laughter]

So Mr. Hultgren is recognized?

Mr. HULTGREN. Thank you, Mr. Chairman.

Thank you all for being here.

Mr. Bartl, I am going to address my questions to you at first, if that is all right? You note in your testimony that the Center on Executive Compensation is, and I quote you, “is concerned that the lack of sufficient resources on the part of the proxy advisors leads

to a check the box mentality.” You also note that “the ability to understand and summarize pay programs, for example, requires time, resources and diligence.”

You testify, however, that the, and I again quote you, “The irony is that issuers are responsible for ensuring the accuracy of proxy advisory firms’ reports, even though proxy advisory firms are supposed to be the experts providing the information that investors rely on to execute a fiduciary duty.”

I wonder if you could please explain this “irony,” as you said, and how can an issuer be tasked with reviewing the accuracy of a proxy advisory vote recommendations?

Mr. BARTL. Well, thank you for the question, Congressman Hultgren, and I think the issue is really currently only one firm gives companies that opportunity. And that is in the S&P 500. They often have a very narrow window, between 24 and 48 hours, and that is assuming that the draft report goes to the right person at the company, because sometimes it does get lost.

For the rest of, you know, publicly held companies, they are, you know, at the mercy of somebody getting a hold of that and then going back and, you know, either dealing with the proxy advisory firm, whether that be ISS or Glass Lewis or more likely going directly to investors.

And if you are a small company, the resources you have to be able to change that within the time you have, because, you know, those reports are typically issued within about 3 weeks of the annual meeting, the barriers are extremely high.

So the opportunity is fairly small for those, you know, investors or those companies, rather.

Mr. HULTGREN. Okay. Following up, Mr. Bartl, Professor Taub references in her written testimony that an article by Professors Choi, Fisch, Kahan, entitled, “The Power of Proxy Advisors, Myth or Reality?” in 2010, that found a substantial degree of divergence, and “a substantial degree of divergence from ISS recommendations, refuting the claim that most firms follow ISS blindly.”

However, you note in your testimony that several research reports and economic studies have catalogued the influence of proxy advisory firm recommendations on votes on shareholder proposals. I wonder if you could please explain your understanding and the claim that proxy advisory firms are capable of influencing shareholder proposal votes?

Mr. BARTL. Yes. I think some explanation of this happened earlier, too, Congressman Hultgren, but I think that if you look at that study, if I recall correctly, the Choi study dealt with the, you know, non-contested director elections, you know, previous to Dodd-Frank. So one, you were dealing with a different subset of votes.

Secondly, she was looking at mutual funds with large governance research arms. The research that is out there, both pre Dodd-Frank and after Dodd-Frank, Bethel-Gillan, for example, talked about I think a 20 percent influence of ISS on director elections.

The Larcker research that talks about significant influence on say on pay votes post-Dodd-Frank. There is a lot of research out there. And then, you know, anecdotal research just from the say on pay votes that shows an influence, definitely an issue.

The other thing to keep in mind is influence is different for different investors. The large investors are going to use this information as a bit of a prioritization. When you get a negative recommendation their research departments are going to pay more attention typically. That is our experience.

For the middle tier they are going to take the recommendation significantly and those that, at least for ISS, have ISS vote on their behalf, will take it absolutely directly. So I mean, you are talking about a wide band of investors that are using this for various forms that are influential.

Mr. HULTGREN. Okay. Thanks.

Mr. Gallagher, if I can ask a quick question to you? You note in your testimony that recommendations provided by proxy advisory firms may be tainted by conflicts of interest. I wonder if you could provide a scenario where a proxy advisor has a conflict of interest that prevents it from providing independent, objective advice? I wonder if there are any specific examples you might be able to provide?

Mr. GALLAGHER. Thanks for the question, Congressman Hultgren. You know, there are two that really come to my mind. One is the more obvious in which a proxy advisory firm also provides consulting services to an issuer that it is providing recommendations about. And that is one that is, again, obvious and one that was addressed in SLB 20, which would need to be disclosed, an obvious conflict.

The other one that we talked about in the SEC Roundtable December 2013 is less obvious and may be one that is more pernicious, which is the control of its certain advisory clients over the substance of the recommendations coming from the proxy advisory firms.

How do you find that? Where is it in the books and records? How do you prove it? That is, you know, a much less obvious question. But it is one that anecdotally I hear exists.

Mr. HULTGREN. Okay. Thank you. My time has expired. Thank you all for being here.

Since the chairman has been very kind to the state of Illinois, I will yield back without asking any further questions.

[laughter]

Chairman GARRETT. There you go. Thank you. The gentleman yields back.

So without objection I am going to suggest we go around for a second round if the panels up to it. Obviously there are not that many here and they all may not use their 5 minutes. And with that, no objection, so ordered.

So just a couple, and it is getting even less people apparently.

[laughter]

Just a couple of quick questions on the proxy advisors. I will go to Mr. Bartl, two or three questions real quick. In your testimony that the Center on Executive Compensation conducted a survey that found inaccuracies in the data and facts that the two predominant firms relied upon with the recommendations. Can you just briefly explain the findings of the survey again?

Mr. BARTL. Yes. So the survey, first of all, found that, you know, about 55 percent of respondents found that they had an error or

an inaccuracy, and about 70 percent talked about actually, you know, changing a recommendation in advance of a recommendation because of a proxy advisory firm policy or practice in the prior 3 years.

So in terms of, you know, the errors and inaccuracies, you have companies that are taking advantage of the research because of this belief, and our study did deal with that as well, because of the belief that there is some influence from the consulting side over to the research side. So you get that fairly regularly.

Chairman GARRETT. Okay. So I got that. So these issues have not been just for a short period of time. We have looked at the issue or the SEC has looked at investment advisors to some extent and knew that they were out there advising for some period of time. And the SEC took some steps, right? They issued guidance 2 years ago, 2014.

Mr. BARTL. That is right. That is right.

Chairman GARRETT. So I guess I will start with Mr. Bartl. So that guidance comes out and that is supposed to be dealing with the problem. I guess a short question very blunt is has that guidance been sufficient? Have you seen changes in the operations of the firms?

Mr. BARTL. Yes. We haven't seen changes, Mr. Chairman.

Chairman GARRETT. Have or have not?

Mr. BARTL. We have not seen changes, Mr. Chairman, and I think the issue is that, you know, the guidance reiterated what, you know, investors needed to do to monitor proxy advisory firms. It then also said that for investors that are using the proxy advisory firms as a direct—you know, incorporating the recommendations and having them vote the proxies on their behalf, there is a higher level, a higher standard that the proxy advisory firms issue.

But when you look at that middle tier that I was talking about or even the lower tier, the SLB does not impact those. And that is where I think where we talked about this impact of ongoing oversight as we saw with, again, I mentioned the peer group issue back in 2012.

And we saw it again when, you know, the SLB was issued and the roundtable happened. There is a lot more attention paid to the processes that the advisory firms use because of that attention. And this would elevate that ongoing attention for what Commissioner Gallagher talked about a minute ago.

Chairman GARRETT. I got that. So, you know, the professor used a word that what we don't want to do anything, you said, that would reinforce the monopoly. And I guess actually the correct term—or duopolies. I think of it as a monopoly, which is your words. That came about. So we do have a monopoly.

So you are saying we have a monopoly, and that is, to me in any framework is a problem when there is no—if you are going to have a monopoly maybe there should be some involvement there for the government to make sure that things are actually running correctly.

The monopoly came about not just because of the nature of the marketplace. My understanding the monopoly came about—somebody said this, maybe Dan Gallagher said this, as far as the no action—I am sorry, Commissioner Gallagher—came about due to

what the no action letter, right? You do the no action letter. That basically gives carte blanche to the firms out there to say, "I guess we don't have to do anything."

This is my simple way of looking at this. We really don't have that responsibility anymore. No one is going to come back at us. We can just abdicate this responsibility out there. And there are two firms out there. It coalesces around them. And is that in a nutshell, Mr. Bartl?

Mr. BARTL. Yes. Mr. Chairman—

Chairman GARRETT. How that came about?

Mr. BARTL. —I think the issue here is that, you know, all of us on the panel I think at one point or another has said you have to be careful about entrenching the current players.

Chairman GARRETT. Right.

Mr. BARTL. But as a practical matter the current players haven't changed over the course of the last, you know, 6 or 7 years. And therefore, you know, we view this as a preferable alternative to the status quo because it has the ongoing approach. The market for proxy advisory firms globally has been condensing not expanding.

Chairman GARRETT. And I am going to throw one last one back on my bill, professor, to—

Mr. BARTL. Yes.

Chairman GARRETT. You are a professor so you have your students. And I will just throw out this question to you. Don't you advise your students when they are looking and trying to make any of the decisions they have to make that they should do what? Look at the pros and the cons of that decision.

And when you make them look at the pros and cons, basically it is the costs and the benefits of the decisions that they have to make in life or in business. And isn't that simply really what we are trying to do?

Ms. TAUB. I am so glad you said that, because I mean to be clear—

Chairman GARRETT. Uh-oh.

Ms. TAUB. —we are not talking about dispensing with cost-benefit analysis.

Chairman GARRETT. Okay.

Ms. TAUB. What I was talking about is what type of cost-benefit analysis—

Chairman GARRETT. Okay.

Ms. TAUB. —should be used, right?

Chairman GARRETT. Yes.

Ms. TAUB. And secondly, whether it should be subject to judicial review by unelected judges who are not experts in the area. So for example, cost-benefit analysis, should I buy this car or that car, is largely going to be economic concerns and some preferences. Cost-benefit analysis, should I marry my husband, isn't going to be, at least for me, an economic question. It is going to have other factors.

And so what we have learned, especially with the D.C. Circuit when we looked at—sorry, the D.C. District Court decision in National Association of Manufacturers, they said you can't compare apples to bricks.

So I do think that agencies including the SEC should engage in a cost-benefit analysis process. And I think it should be of their choosing. It can be conceptual.

My problem is the illusion of precision because it is a Catch-22. If you say reduce this to a number we all know it can't be done. Years later then they can be questioned and mocked—

Chairman GARRETT. Well, thank you, but I think—

Ms. TAUB. —for are not coming up with the right number.

Chairman GARRETT. And Mr. Gallagher's comment was they were able to make decisions not entirely on that, but at least to have that there as your factor. I see my time went way over.

I will now recognize, rather, the gentlelady from New York.

Mrs. MALONEY. We are talking about all these bills, cost-benefit analysis. I would just like to reflect a little bit about why did we pass all these regulations? And that was because of the worst financial crisis certainly in my lifetime.

And I would just like to ask Professor Taub, how much did this, in terms of analysis, how much did this crisis cost the American people? I have heard that everything from 9 million jobs to 9 million people losing their homes. What did this economic crisis cost the American people? How many billions, trillions I guess? Trillions.

Ms. TAUB. You know, the actual dollar figures have been estimated in ranges, but in terms of lost economic output I have heard in the many trillions. And I can't point to a figure. I am not an economist, and there are many different studies that are out there, but in the many trillions.

But the problem is, again, it is not just about things that we can quantify. When more than 7 million people, sorry, 7 million homes are lost to foreclosure or short sales, that has impacts beyond economic ones. There are also other economic impacts.

And the, you know, the run up to the crisis, the bubble, the gains of that were not felt evenly and neither was the crash. And so, you know, the numbers are large. I don't think we can even still quantify the impact at this point.

Mrs. MALONEY. Well, would you generally like to express your belief on how these bills would affect the SEC's ability to oversee and enforce reforms that Congress passed as a result of the financial crisis? Some reported that it was \$21 trillion or \$13 trillion, a range from \$13 trillion to \$21 trillion? It is many people haven't recovered.

Congress put in place reforms to prevent another financial crisis and to better protect Americans from losing their homes, losing their jobs, another economic downturn. I always get reports every now and then that they think the next crisis is on the verge, but do you believe that?

What about these three bills? Do you think that these bills would prevent the SEC from really overseeing and enforcing reforms that Congress put in place to protect the American economy?

Ms. TAUB. So I think what is ironic about some of these bills is there are some really good tools that the SEC has and information they are given and these bills want to take that away.

But then the third bill, then the proxy advisory bill wants to foist onto the SEC without any specific designation of which division

would handle it and not any earmarked money, a structure that I don't know that the agency, or at least I don't know the investors have asked for or need, really need.

Mrs. MALONEY. And like you said, it would take away protections that the SEC has put in place to protect the American economy.

Ms. TAUB. One of the most difficult things is in any cost-benefit analysis you need inputs and estimations. And you need good data, and there isn't yet good data on the incidence of fraud within firms. That could be banks or it could be other types of firms. And there are not good data on the amount of fraud.

So when you look at a cost-benefit analysis it is not as if we are taking precise numbers, putting them into a computer and then boom, there is this precise answer. There are lots of estimations and incomplete data.

And also these—but again, I think the SEC should engage in economic analysis. All I am saying is I don't think the problem with adding this on, creating—you know, it doesn't eliminate a private cause of action.

Even previous iterations of bills might have, but forcing them to go through this particularly quantitative cost-benefit analysis pretending to be able to reduce something to a bottom line figure, then becomes evidence in a APA case and so on.

It may not, as Commissioner Gallagher says, slow the commission down at the beginning, but it certainly slows them down afterward when they are in court.

Mrs. MALONEY. Well, thank you, and I yield back the balance of my time.

Chairman GARRETT. The vice chairman is recognized for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman.

Mr. Gallagher, Professor Taub in her testimony makes reference to a report prepared by Better Markets called, "Setting the Record Straight on Cost-Benefit Analysis and Financial Reform at the SEC." She goes on to state that the organization opines that what sounds like a benign cost-benefit analysis is actually an industry-only analysis.

And I was wondering if you could comment on that and whether you agree with that characterization that a cost-benefit analysis is just an industry-only analysis?

Mr. GALLAGHER. Well, thanks for the question, Congressman. I am not familiar with the Better Markets reports. I don't spend time with special interest group reports like that because they are typically one-sided on their own. And so, you know, I think this all just boils down to, as I mentioned earlier, you know, just good government.

And, you know, we have a disparate body of congressional mandates that the D.C. Circuit has interpreted to require the SEC to conduct an economic analysis today. I think what you are doing, what Chairman Garrett is doing with his bill is tying it all together and making it clear, making it followable and predictable.

It doesn't mean—Professor Taub may be absolutely right that it changes a posture in a litigation that follows a rulemaking, but I don't think it is necessarily for the worst. I think it is such a bowl

of spaghetti right now that it is incumbent upon Congress to clarify it.

Mr. HURT. Thank you. And I yield back the balance of my time.

Chairman GARRETT. The gentleman yields back.

And the gentleman from California is recognized.

Mr. ROYCE. Well, thank you very much, Mr. Chairman, appreciate it.

And I had a question for Mr. Quaadman. You note in your written testimony that rule writing entities, such as the PCAOB and Municipal Securities Rulemaking Board are subject to the same requirements and enhancements contained in the SEC Regulatory Accountability Act. Could you please explain why that is beneficial and also should the SEC require FASB conduct similar cost-benefit analysis when setting accounting and reporting standards?

Mr. QUAADMAN. Yes, thank you, Mr. Royce. So first off, we propose for any subordinate organization of the SEC that if they are involved in rule writing that has a force of regulation, there should be a cost-benefit analysis. So that would include FASB. I believe FINRA has committed to do that.

The PCAOB, as an example, their standards have to go through the SEC rulemaking process before they go final, so you should have a cost-benefit analysis there.

And as one example, the PCAOB, because they could not get standards done over the last several years for a variety of different reasons, had a very aggressive inspections program.

And because they had a very aggressive inspections program 2 years down the line, companies suddenly started to see that their internal control costs were going up by 300 percent.

So that shows, number one, the dramatic impact the PCAOB could have on companies, but more importantly, why you need to have actions go through a formal process so you can understand what the costs and benefits are rather than through a circular route.

Mr. ROYCE. So that is one of my concerns.

Let me go to question Mr. Bartl. I am struck by the inherent conflict of interest that you described in your testimony when the ISS consulting arm uses its relationship with ISS research to sell business. Is this a common occurrence, I would ask? And do investment advisors take this into account when hiring a proxy advisory firm? And should they?

Mr. BARTL. Thank you, Congressman Royce. I appreciate the question. And so I think the answer is we have seen a much more aggressive push by the consulting arm of ISS against the research side.

The one email exchange that we included in our testimony is just an example. In fact, the irony is that that one was actually repeated to another company using the wrong company's ticker in rapid fire succession.

I think what we have seen is that there are certain types of investors, pension funds particularly, that have a tendency to use Glass Lewis because of the lack of consulting arm there, even though there are other conflicts inherent in Glass Lewis, as we talked about in our testimony.

And so I think there is a knowledge. In fact, when Glass Lewis came on the scene back in around 2002, that was one of the things that led to that occurrence. But both proxy advisors suffer from, you know, conflicts of interest that certainly deserve greater oversight and scrutiny. And that is, I think, one of the redeeming factors, one of the best reasons for Congressman Duffy's bill.

Mr. ROYCE. And Mr. Gallagher, so you are saying it is that added transparency Mr. Bartl was saying or knowing a conflict exists as part of the solution here. Your thoughts quickly on how Mr. Duffy's bill helps get at that problem?

Mr. GALLAGHER. Thank you for the question, Congressman. Look, I think it gets right to the heart of the matter with transparency and disclosure, the basic tenets of the securities laws. If there are conflicts, disclose them. If there are conflicts that Congress can't abide you might want to prohibit them, and that has happened, too, in other scenarios.

But just the basic knowledge and disclosure of these conflicts can help investors and voters make better decisions. And we don't have that.

Mr. ROYCE. Maybe, but I think there is more that has to be done here because there should be more competition in the proxy advisory space. But instead what we have created is a government-approved duopoly that is not serving investors.

Do you go back to Mr. Bartl's testimony where he said we now have a check the box mentality with little review of the accuracy of proxy advisory firm reports. What could be done to change this dynamic to really introduce competition given the duopoly?

Mr. GALLAGHER. In addition to the legislation that is being debated here, I think the SEC could rescind the two no-action letters that followed the 2003 rulemaking that basically created that duopoly for the two firms.

And I think after that, I will tell you, Congressman, one positive thing is—a lot of this is couched in the negative. Since SLB 20 we have seen the adviser community pay more attention to these issues.

We have seen the larger asset managers resource their voting function. We see the message trickling down to medium-and small-size advisors that A, you don't have to vote every share every vote, that B, you can do things other than rotely relying. But I would take—

Mr. ROYCE. Yes.

Mr. GALLAGHER. —Mr. Bartl and Mr. Quaadman's word, you know, on its face that this still isn't enough.

Mr. ROYCE. Well, in closing I would thank the chairman for holding this hearing, and I certainly want to thank my colleague for the legislation that he is putting forward here.

Thank you, Mr. Duffy.

Mr. Chairman, thank you.

Chairman GARRETT. Thank you.

And with that, I will now yield 5 minutes to the sponsor of the legislation, Mr. Duffy.

Mr. DUFFY. Thank you, Mr. Chairman. I apologize. I had to step out for a little bit. Rarely have I been in this committee and been

advocating for more regulation. This is, I think, a first for me, so duly noted.

Mr. Bartl, just again, I think you have had several questions about conflicts of interest in regards to proxy advisors. Kind of lay that out for me again. You did it in your testimony, but lay out conflicts of interest in regard to proxy advisors?

Mr. BARTL. Sure. I mean, there are really—and I really appreciate the bill and the question. There are really three or four depending on how you slice it. One is the role of ISS in providing consulting to companies, and on the other side providing research that is so-called independent and this firewall that, you know, so-called firewall that exists.

Mr. DUFFY. It doesn't exist.

Mr. BARTL. Right. Well, and that is again why oversight is necessary. Probably even more importantly is this notion of providing consulting on shareholder proposals by investors, investor proponents and providing cursory disclosure on the fact that they do so because they then provide recommendations on those same proposals. And, you know, hopefully that is—

Mr. DUFFY. So in fact you could be giving advice on a shareholder proposal and then to other investors how they are going to vote on the proposal—

Mr. BARTL. Right.

Mr. DUFFY. —and to the company in which it is effected?

Mr. BARTL. That is correct.

Mr. DUFFY. And does this go to the highest bidder? I mean, if you pay the most money you win the day?

Mr. BARTL. And again, we have the separation—

Mr. DUFFY. Right.

Mr. BARTL. —that is there. But this is, you know, of the issues that probably have the most impact that is probably the one. And then you have beyond the operational side the ownership side, which is on the Glass Lewis front and its ownership by the Ontario Teachers' Pension Plan both a private equity and the—

Mr. DUFFY. Do they give advice on companies in which they invest?

Mr. BARTL. They disclose the fact that they are giving advice on companies in which—

Mr. DUFFY. So they do.

Mr. BARTL. —OTTP exists, or OTTP there.

Mr. DUFFY. Does the panel all agree that this is a problem? That there is a conflict of interest here? Shaking—

Mr. QUAADMAN. Yes. Mr. Duffy—

Mr. DUFFY. So we are—

Mr. QUAADMAN. —I agree with Mr. Bartl's characterization. I would also just add, too, Glass Lewis. They are owned by an activist investor fund. And we had actually written twice to the SEC in 2011 and 2012 asking them to look into the apparent, or at least the appearance of, a conflict of interest with activities by the Ontario Teachers' Pension Fund and also Glass Lewis recommendations as well.

Mr. DUFFY. So we are looking at a lot of companies and a lot of shares. Do these proxy advisory firms have the staff to provide adequate advice, Mr. Quaadman?

Mr. QUAADMAN. As I had mentioned earlier, you have one firm that has 180 analysts looking at tens of thousands of companies globally, making recommendations on 250,000 shareholder proposals and director elections over a very compressed time period. And you would just have to look at that as you can't possibly do the due diligence that you need to do.

The other thing is, as others have mentioned here, there is an extremely high error rate. And I have to say Mr. Retelny at ISS has made some changes over the last year where they are starting to issue new reports where there is an error that has been found and fixed.

But that was not done up until about a year ago.

Mr. DUFFY. So the answer is they don't have the staffs, right? I mean, they are not big enough?

Mr. QUAADMAN. The other—

Mr. DUFFY. Mr. Gallagher?

Mr. QUAADMAN. I would just—

Mr. GALLAGHER. Yes.

Mr. DUFFY. Go ahead.

Mr. GALLAGHER. That question, anecdotally I hear they do not, but again, everything I have heard is just an anecdote. I haven't gone to the physical plant. They are not SEC registrants other than the registered investment adviser subsidiary of ISS.

Mr. DUFFY. So you had a different Chair in the not too distant past at the SEC. Is it your opinion that the SEC can act without legislation or do you think that we have to have legislation here to instruct the SEC to act on this issue?

Mr. GALLAGHER. So this is the metaphysical question I have been wrestling with for years because I was trying to get the SEC to act in a manner that would obviate legislation. I think the SLB 20 was a step forward. You know, rescinding the no-action letters, revisiting the 2003 rulemaking and the interpretation thereof would have been other positive steps, but they were not taken.

But to tell you the truth, at the end of the day even if all of that had been done you would probably be sitting here today debating legislation.

Mr. DUFFY. And do we agree this has a huge impact on corporate governance, that you have two firms that control 97 percent of proxy advice?

Mr. GALLAGHER. Absolutely.

Mr. DUFFY. Two firms?

Mr. BARTL. Yes.

Mr. GALLAGHER. Yes.

Mr. QUAADMAN. Yes.

Mr. DUFFY. And so it would be incumbent upon us to actually take action, instruct the SEC to make rules and let us get this taken care of. Anyone disagree with that?

Mr. BARTL. No.

Mr. GALLAGHER. No.

Ms. TAUB. I do.

Mr. DUFFY. Okay. Go ahead.

Ms. TAUB. I am not an anti-trust expert and I don't recall—

Mr. DUFFY. My time is up. If I could have 1 minute and let her—

Ms. TAUB. Well, so—

Mr. DUFFY. —answer the question—

Chairman GARRETT. If she says she is going to agree—

[laughter]

Now—

Ms. TAUB. I don't want to take your time.

Chairman GARRETT. No, no, I am sorry. You have the additional minute to respond.

Mr. DUFFY. I am sure the ranking member wouldn't oppose either.

Ms. TAUB. Thank you. I mean, I don't recall referring to the two companies as a monopoly. I think that is referencing something someone else had said. But in terms of this, if you are concerned about two firms having a larger share, having the majority of, you know, 90 plus percent share of the market, then I don't see how creating a more complex regulatory regime that would, you know, possibly create barriers to entry solves that particular problem.

Also I am hearing two different things. I am hearing folks say we need more people doing this. And then I am also hearing it is not possible to be done. But what is the status quo if these firms don't exist?

Large institutional investors are choosing to rely on them as one data point. Smaller investors rely on them. What would happen to small investment funds?

Would they have to create, you know, duplicative in-house proxy voting staffs that were going to read all of these, you know, all these proxies? There is nothing wrong with going to a third party and getting investment advice.

As for the conflicts of interest, let me just say—

Chairman GARRETT. Sure.

Ms. TAUB. —other fields there are conflicts of interest and how are they dealt with and whether it is law or finance? The first step is disclosure. And if we look not just at the—

Mr. DUFFY. And you agree with disclosure, right?

Ms. TAUB. I agree with disclosure—

Mr. DUFFY. Disclose conflict?

Ms. TAUB. —and I would also agree with the first step is best practices. And if you look at what is happening in Europe, you look in the U.S., Glass Lewis and others—

Mr. DUFFY. And I want to give Mr. Gallagher—

Ms. TAUB. —are part of—yes.

Mr. DUFFY. —a chance. Are you a lawyer?

Ms. TAUB. Yes, I am.

Mr. DUFFY. As am I. It was pretty tough. I never could represent two clients in the same case. It was a conflict of interest. Invariably they have competing interests and you can't represent both of them aggressively. And that is why we say, listen. You have to pick one.

Mr. Gallagher, want to quickly respond? Do you agree with Professor Taub?

Mr. GALLAGHER. Yes. I agree on that conflict analysis and just want to point out that one of—there are two big things that came out of SLB 20. It was clarification from the commission to the advisory community that despite what you read into the 2003 rule-making, this wasn't Department of Labor. This wasn't the Avon letter.

You don't have to vote every share every vote. Well, that is still not going to be appetizing to most advisors. They are going to feel they need to vote.

The second part was that we said you can predetermine your voting. You can tell your clients, your advisory clients, we are going to vote with management every time. You can tell them we are going to vote with CalPERS every time. It can suit your fiduciary duty, as Mr. Bartl said earlier.

We haven't seen that take up. That would obviate the necessary reliance on ISS and Glass Lewis. We haven't seen it yet, so—

Mr. DUFFY. As always, great point, Mr. Gallagher. Fantastic panel. Thank you for all of your agreement.

With that I yield back.

Chairman GARRETT. Thank you. The gentleman yields back.

I will concur, this was a great panel. Thank you for your input and your information.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

With that being said, thank you again. And this hearing is adjourned.

[Whereupon, at 5:12 p.m., the hearing was adjourned.]

A P P E N D I X

May 17, 2016

NEXT STEPS FOR MEANINGFUL OVERSIGHT OF THE PROXY ADVISORY FIRM INDUSTRY

Hearing on Legislative Proposals to Enhance Capital Formation,
Transparency, and Regulatory Accountability
Subcommittee on Capital Markets and
Government Sponsored Enterprises

House Committee on Financial Services

May 17, 2016

Written Testimony of
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Chairman Garrett, Vice Chairman Hurt, Ranking Member Maloney and Members of the House Financial Services Committee:

My name is Tim Bartl, and on behalf of the Center On Executive Compensation, I am pleased to provide our views on the role, influence and impact of proxy advisory firms and to express our strong support for the Proxy Advisory Firm Reform Act. These issues have been a top concern of the Center's for several years, as referenced in my testimony before this Subcommittee in 2013. My comments today reinforce many of the findings and conclusions I articulated at that hearing, but focus particularly on the regulatory and practice developments since that time that reinforce the need for continued and specific Congressional and SEC oversight of the proxy advisory firm industry.

The Center On Executive Compensation is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy and practice. The Center is a division of HR Policy Association, which represents the chief human resource officers of over 365 large companies, and the Center's more than 125 subscribing companies are HR Policy members that represent a broad cross-section of industries. Because chief human resource officers support the compensation committee and board of directors with respect to executive compensation and related governance matters, and many are involved in engaging with institutional investors, we believe that our Subscribers' views can be particularly helpful in understanding proxy advisory firm influence and the positive impact regulatory oversight can have.

In sum, my testimony makes the following points:

- The two major proxy advisory firms, Institutional Shareholder Services and Glass Lewis, play an essential role in the proxy voting process and thus have significant influence. However, the time constraints and profit objectives inherent in the business often result in a cursory, check-the-box analysis, which in turn requires substantial additional engagement between companies and investors.
- Conflicts of interest within the two largest proxy advisory firms require ongoing scrutiny, especially in terms of the following:
 - Institutional Shareholder Services' claim of providing "independent" analysis on one side of its operation, and providing consulting services to corporate issuers on the other side of the operation;
 - ISS's consulting with certain institutional investors – particularly those aligned with certain social or policy objectives on shareholder proposals sponsored by the investors – and then making so-called independent recommendations on those same proposals with only cursory disclosure of the relationship; and
 - Conflicts in the ownership structures of Glass Lewis in light of its partial ownership by the Ontario Teachers' Pension Plan, a major labor pension fund and activist private equity investor, as well as ISS, which is owned by a private equity investor.

- The SEC's December 2013 Roundtable on proxy advisory firms was an encouraging development that put many of these issues on the record. Staff Legal Bulletin 20, which followed, signaled greater regulatory oversight, but only addressed a small subset of concerns, especially with respect to conflicts.
- For these reasons, the Center supports the framework for registration, oversight and withdrawal of the opinion letters that are included in Chairman Duffy's bill, the Proxy Advisory Firm Reform Act, as a way of reinforcing the need for oversight and focus on the role that proxy advisory firms play in the proxy voting system.
- The Center also supports Chairman Garrett's efforts to strengthen the SEC's cost benefit analysis regime and to periodically revisit regulations consistent with the SEC's mission.

I. Additional Oversight of Proxy Advisory Firms Is Necessary

The Center On Executive Compensation believes that regulation of the proxy advisory firm industry is necessary to facilitate needed industry change. Since 2013, the Securities and Exchange Commission has taken steps aimed at improving perceived wrongs in the proxy advisory firm industry. The 2014 SEC staff legal bulletin on proxy advisory firms requires proxy advisory firms to disclose conflicts of interest and describe the nature and quality of certain business relationships with certain issuers and shareholder proponents in order to avoid significant and onerous filing requirements under the Investment Advisers Act. The required disclosure was not public and applied to a small subset of relationships, and also placed the onus on the investor-client of the proxy advisory firm to police proxy advisory firm practices. As a result, the SEC's guidance has not had a significant impact on the proxy advisory firm industry.

The Center supports the Proxy Advisory Firm Reform Act because it provides a framework for greater SEC oversight and creates a public disclosure regime. As is detailed below, public disclosure of proxy advisory firm issues can be an effective method of regulation, and informal oversight has been successful in facilitating changes in the past. The most important aspect of the bill, however, is the repeal of the two SEC no-action letters, again detailed further below, which provided the industry framework which has facilitated the proxy advisory firm status quo. The Center believes that the repeal of the no-action letters and greater SEC oversight would pave the way for a broader stakeholder debate on how the SEC should oversee proxy advisory firms as well as the role of investors in the process.

II. The Role of Proxy Advisory Firms

Proxy advisory firms fill an important role for institutional investors. As the share of institutional investor ownership has grown from roughly 46 percent in 1987 to over 70 percent today,¹ the volume of proxy votes which investors are responsible for casting has

¹ THE CONFERENCE BOARD, 2008 INSTITUTIONAL INVESTMENT REPORT: TRENDS IN INSTITUTIONAL INVESTOR ASSETS AND EQUITY OWNERSHIP OF U.S. CORPORATIONS (Sept. 2008).
https://www.sec.gov/News/Speech/Detail/Speech/1365171515808#P18_1663
<http://www.businessinsider.com/stock-market-ownership-2015-1>

grown into the billions. In order to assist them in fulfilling their fiduciary duty to vote their proxies in the best interests of their clients, most institutional investors retain the services of Institutional Shareholder Services (“ISS”), the largest proxy advisory firm, or Glass Lewis & Co., the other major proxy advisory firm. Together, these firms cover about 97 percent of the U.S. market for proxy advisory firm services.²

Both ISS and Glass Lewis provide proxy voting research and analysis and make voting recommendations to their clients. Both companies provide an electronic proxy voting platform in which investors can instruct advisors on how they want their votes cast and the proxy advisory firms will execute the votes on investors’ behalf. Both allow investors to customize their standardized proxy voting guidelines. ISS will also determine votes for its clients. Based on ISS comments and anecdotal experience from our Subscribers, many medium and smaller investors delegate their proxy voting duties directly to ISS, following the ISS standard proxy voting guidelines. Glass Lewis does not determine votes on behalf of its clients, but is also less forthcoming about its voting policies and their application, although it now also makes its reports available to companies once they are completed.

As discussed in detail below, while most investors take their proxy voting responsibilities seriously, and the largest investors have their own governance departments responsible for independent analysis, the delegation of proxy voting analysis to ISS and Glass Lewis by a large share of institutional investors inserts a significant opportunity for influence over the proxy voting system.

The Center continues to be concerned that lack of sufficient resources on the part of the proxy advisors leads to a check-the-box mentality, driven in part by the desire of investors to have a uniform, condensed version of corporate pay disclosures, even though pay programs are individualized, complex and lengthy. The speed with which proxy advisors must analyze 100-page proxies, combined with the aforementioned lack of resources, leads to errors, inaccuracies or questionable characterizations. (Over 75% of annual meetings of the S&P 500 occur between March and June, and that is just in the U.S.) To understand and summarize pay programs well requires time, resources and diligence. The irony is that issuers are responsible for ensuring the accuracy of proxy advisory firm reports, even though proxy advisory firms are supposed to be the experts providing information that investors rely on to execute a fiduciary duty. This calls into question the legitimacy of the model, or at least its effectiveness.

III. Proxy Advisory Firm Influence

Both academic research and experience demonstrate that proxy advisory firms have significant influence over the proxy votes cast by institutional investors and over the compensation practices adopted by companies. This is a concern because unlike directors or institutional investors, proxy advisory firms have no economic interest in the company for which they are making recommendations. This removes the consequences of an inaccurate or incorrect recommendation from the recommendation itself.

² James K. Glassman and J.W. Verret, *How to Fix Our Broken Advisory System*, Mercatus Center (2013), <http://mercatus.org/publication/how-fix-our-broken-proxy-advisory-system>

Influence of Proxy Advisory Firms Over Proxy Votes. As of May 13, 2016, S&P 500 companies holding say on pay votes which experienced a change in the proxy advisory firm recommendation on their say on pay proposal from “For” in 2015 to “Against” in 2016 experienced a decrease in support of over 31 percent, while companies receiving a positive recommendation received over 93 percent approval on average. This is nearly identical to the results from the complete 2015 proxy season. The data shows a strong link between the ISS recommendation and the resulting votes.

Several research reports and academic studies have catalogued the influence of proxy advisory firm recommendations on votes on shareholder proposals. For example:

- Opposition by a proxy advisor resulted in a “20% increase in negative votes cast” according to a 2012 study by David F. Larcker, Allan L. McCall and Gaizka Ormazabal.³
- An academic study found that a negative vote recommendation by ISS on a management proposal resulted in a reduction in affirmative votes by 13.6 percent to 20.6 percent.⁴

One of the most notable changes in proxy votes over the last six years has been the introduction of annual nonbinding votes on executive compensation. The Larcker research mentioned above found that among 2,008 firms in the Russell 3000, “firms that received a negative recommendation by ISS (Glass Lewis) obtained an average 68.68% (76.18%) voting support in SOP proposals. In contrast, firms that did not receive a negative recommendation from ISS (GL) obtained an average of 93.4% (93.7%) support in those proposals.”⁵ The Larcker research is generally consistent with Center research.

Influence of ISS Voting Policies on Corporate Executive Compensation Programs. The voting results do not fully capture changes that companies make to their compensation policies in order to “score” better under proxy voting policies, particularly those of ISS. In a 2014 survey conducted by the Center, 74 percent of respondents said they had changed or adopted a compensation plan, policy or practice in the past three years primarily to meet the standard of a proxy advisory firm. This is consistent with a 2012 survey by the Conference Board, NASDAQ and the Stanford University Rock Center for Corporate Governance which found that over 70 percent of directors and executive officers stated that their compensation programs were influenced by proxy advisory firm policies or guidelines.⁶

³ David F. Larcker, *The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policies*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION, November 12, 2012, <http://blogs.law.harvard.edu/corpgov/2012/11/12/the-economic-consequences-of-proxy-advisor-say-on-pay-voting-policies/> (last visited May 3, 2016).

⁴ Jennifer E. Bethel & Stuart L. Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting*, FINANCIAL MANAGEMENT 29, 30 (Winter 2002).

⁵ Larcker *supra* note 3.

⁶ The Conference Board, *The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions* (2012), <https://www.conference-board.org/retrievefile.cfm?filename=TCB-DN-V4N5-12.pdf&type=subsite>.

IV. The Regulatory Framework Has Reinforced Proxy Advisory Firm Influence

Proxy advisory firms have grown influential due in large part to two regulatory pronouncements, one by the U.S. Department of Labor, which announced the proxy voting duties of ERISA retirement plan sponsors in a 1988 opinion letter, and one by the SEC, which published rules related to proxy voting in 2003. The DOL letter, commonly known as the “Avon Letter,” stated that shareholder voting rights were considered valuable pension plan assets under ERISA, and therefore the fiduciary duties of loyalty and prudence applied to proxy voting. The Avon Letter stated:

In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock. For example, it is the Department’s position that the decision as to how proxies should be voted ... are fiduciary acts of plan asset management.⁷

The Avon Letter further stated that pension fund fiduciaries, including those that delegate proxy voting responsibilities to their investment managers, had a responsibility to monitor and keep accurate records of their proxy voting.⁸

The SEC further reinforced the concept of fiduciary duties related to proxy voting in 2003 by adopting a rule and amendments under the Investment Advisers Act of 1940 pertaining to mutual funds and investment advisers designed to encourage funds to vote their proxies in the best interests of their shareholders.⁹ The new regulations required mutual funds to: 1) disclose their policies and procedures related to proxy voting and 2) file annually with the Commission a public report on how they voted on each proxy issue at portfolio companies.¹⁰

Similarly, investment advisers were required to: 1) adopt written proxy voting policies and procedures describing how the adviser addressed material conflicts between its interests and those of its clients with respect to proxy voting and how the adviser would resolve those conflicts in the best interests of clients; 2) disclose to clients how they could obtain information from the adviser on how it had voted proxies; and 3) describe to clients all proxy voting policies and procedures and, upon request, furnish a copy to them.¹¹

As part of the 2003 regulations, the SEC also commented on how investment advisers could deal with conflicts of interest related to proxy voting that might arise between advisers and their clients, stating that “an adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party.”¹² In practice, this commentary provided a considerable degree of fiduciary “cover” to

⁷ Letter from Allan Lebowitz, Deputy Assistant Sec’y of the Pension Welfare Benefits Admin. at the U.S. Dep’t of Labor, to Helmut Fandl, Chairman of the Ret. Bd., Avon Products, Inc. (Feb. 23, 1988).

⁸ *Id.*

⁹ Sec. Exch. Comm’n, Final Rule: Proxy Voting by Investment Advisers, Advisers Act Release No. 1A-2106, 17 C.F.R. § 275 (Jan. 31, 2003).

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.*

investment managers who chose to follow the voting recommendations of proxy advisory firms and reinforced the value of using such firms. In a letter to Egan-Jones Proxy Services in May 2004, however, the SEC articulated a duty for investment advisers to monitor and verify that a proxy advisor was independent and free of influence:

An investment adviser that retains a third party to make recommendations regarding how to vote its clients' proxies should take reasonable steps to verify that the third party is in fact independent of the adviser based on all of the relevant facts and circumstances. A third party generally would be independent of an investment adviser if that person is free from influence or any incentive to recommend that the proxies should be voted in anyone's interest other than the adviser's clients.¹³

As discussed below, this was reinforced in Staff Legal Bulletin 20, issued in 2014.

The Egan Jones letter also addressed whether the SEC would consider a proxy advisory firm to provide independent advice to investors if it receives compensation from an issuer for providing advice on corporate governance issues. In reply, the SEC Staff stated, "We believe that the mere fact that the proxy voting firm provides advice on corporate governance issues and receives compensation from the Issuer for these services generally would not affect the firm's independence from an investment adviser."¹⁴ This opinion reinforced the business model that ISS has employed, and which has arguably encouraged the proxy advisor's consulting arm to engage in aggressive and perhaps even misleading marketing techniques.

Although the intent of the SEC's 2003 rules was to provide a flexible means for mutual funds to execute proxy votes in the discharge of their clients' fiduciary duties, in reality it allowed mutual funds to shift that duty to proxy advisory firms. This led then Delaware Court of Chancery Vice Chancellor Leo Strine to remark that "[t]he influence of ISS and its competitors over institutional investor voting behavior is so considerable that traditionalists will be concerned that any initiative to increase stockholder power will simply shift more clout to firms of this kind."¹⁵

V. Conflicts of Interest and Inaccuracies Undermine Confidence in Proxy Advisory Firm Processes

Proxy advisors are currently afforded a considerable degree of deference under SEC interpretations because superficially they are considered "independent" of the investment advisors that use their services. Yet proxy advisory firms have significant conflicts of interest in the services they provide and in how they are structured. These conflicts have been the subject of two reports by the federal government's auditing arm, the U.S.

¹³ Letter from Douglas Scheidt, Associate Director and Chief Counsel, Sec. Exch. Comm'n, to Kent Hughes, Managing Director, Egan-Jones Proxy Services (May 27, 2004) available at <https://www.sec.gov/divisions/investment/noaction/egan052704.htm>.

¹⁴ Egan-Jones Proxy Advisory Services (May 27, 2004) available at <https://www.sec.gov/divisions/investment/noaction/egan052704.htm>.

¹⁵ Leo E. Strine Jr., *Toward a True Corporate Republic: A Traditional Response to Lucian's Solutions for Improving Corporate America*, Harvard Law School John M. Olin Center for Law, Economics and Business, Discussion Paper Series, No. 541, 11 (2006), http://lsr.nellco.org/harvard_olin/541.

Government Accountability Office (GAO), and they have been frequently criticized by companies and institutional investors. They also were the subject of questions in the SEC's concept release on the U.S. proxy system.

ISS Provides "Independent" Analysis of Company Practices While Offering Consulting Services to Those Same Companies. Despite frequent criticism by the government and others over the past 19 years, ISS, the largest and most influential firm, continues to provide analyses and voting recommendations of proxy issues to be put to a shareholder vote while also providing consulting services to corporations whose proposals they evaluate. This led the GAO to note that "corporations could feel obligated to subscribe to ISS's consulting services in order to obtain favorable proxy vote recommendations on their proposals and favorable corporate governance ratings."¹⁶ Similarly, a report by the Yale Millstein Center for Corporate Governance stated that many companies believe that "signing up for [ISS] consulting provides an advantage in how the firm assesses their governance" despite ISS disclaimers to the contrary.¹⁷

ISS also provides consulting to its institutional investor clients who wish to offer a shareholder proposal on how to tailor the proposal.¹⁸

These practices have been criticized by both institutional investors and corporations because ISS determinations and related consulting often drive what is considered best practice, even if the practice may not be in the best interest of the companies or their shareholders. ISS acknowledged this fact in its FY 2013 10-K filing, stating "when we provide corporate governance services to a corporate client and at the same time provide proxy vote recommendations to institutional clients regarding that corporation's proxy items, there may be a perception that the Governance business team providing research to our institutional clients may treat that corporation more favorably due to its use of services provided by ISS Corporate Services."¹⁹

ISS has argued that it provides a firewall between its corporate consulting and its advisory businesses, but the separation can only go so far. For example, ISS seeks to reinforce the separation by telling corporate clients that when they meet with proxy analysis staff, they should refrain from discussing whether the client has received consulting services from the other side of ISS.

Despite Claims of a Firewall, Examples Reinforce How ISS Consulting Uses Its Relationship With ISS Research to Sell Business. The ISS firewall may not be as impenetrable as it is made to seem—at least if documented examples regarding the marketing techniques of ISS Corporate Solutions continue to hold. In September 2013,

¹⁶ U.S. GOV'T ACCOUNTABILITY OFFICE, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING, GAO-07-765, 10 (2007).

¹⁷ Meagan Thompson-Mann, *Voting Integrity: Practice for Investors and the Global Proxy Advisory Industry* 9 (Yale Sch. of Mgmt. Millstein Ctr. for Corporate Governance & Performance, Policy Briefing No. 3, 2009).

¹⁸ *Id.* at 12.

¹⁹ MSCI Inc. Annual Report (Form 10-K) at 37, February 28, 2014, <https://www.sec.gov/Archives/edgar/data/1408198/000119312514077882/d640965d10k.htm>. ISS was then owned by MSCI, Inc., which provides financial data and ratios. ISS is now owned by a private equity firm and therefore no longer files public financial statements.

ISS Corporate Solutions sent an email to a company, referencing the fact that in the spring of 2013, when the research side of ISS recommended its clients vote against the company's say on pay vote (in its non-custom voting recommendation), the company's say on pay resolution received the support of just above 68% of its shareholders. The email said that ISS research would be subjecting the company to a higher level of scrutiny in 2014 and solicited a meeting with the consulting side, stating:

“We were going to provide you with a better understanding of the reasons for ISS's negative vote recommendation on your 2013 Advisory Vote on Executive Compensation and what you expect [sic] in terms of additional scrutiny from ISS's Research side on this issue next year.”

A call was set up, during which the ISS consulting representative referenced very high success rates (over 90%) in say on pay votes for companies that engaged ISS Corporate Services after receiving a low vote. The exchange left the impression that by engaging ISS Corporate Services, the company would receive advice and information unavailable elsewhere and that it would give the company an advantage when the ISS research side analyzed its 2014 proxy, similar to the concerns expressed by GAO and other observers. (The full description of the exchange is reproduced in Appendix A).

When confronted with the example at the SEC's December 2013 Proxy Advisory Firm Roundtable, ISS President Gary Retelny said “I'm disappointed they used those words,” denying that there was any breach of the firewall, but acknowledging that the representative was supposed to “drum up business.”²⁰

The Center is aware of other similar examples of very aggressive marketing that confused clients of the ISS consulting arm into thinking that it was the ISS research arm.

Potential Conflict Related to Proxy Advisory Firms Providing Recommendations on Shareholder Initiatives Backed By Their Owners or Institutional Investor Clients. Some proxy advisory firm clients are also proponents of shareholder resolutions. According to the Government Accountability Office, “[t]his raises concern that proxy advisory firms will make favorable recommendations to other institutional investor clients on such proposals in order to maintain the business of the investor clients that submitted these proposals.”²¹ Other than boilerplate language, there is no specific identification that a shareholder proponent is an ISS client.

Conflicts in Ownership Structure. Glass, Lewis & Co. (the second largest advisor) is owned by the \$170 billion Ontario Teachers' Pension Plan Board which engages in public and private equity investing in corporations on which Glass Lewis makes recommendations. Although Glass Lewis states that it will add a note to the research report of any company in which the Ontario Teachers' Pension Plan has a significant stake, the lack of transparency in the Glass Lewis model and the fact that it does not share draft reports with corporations has raised concerns about potential independence issues.

²⁰ See Transcript, U.S. Sec. & Exch. Comm'n, Proxy Advisory Firms Roundtable, Dec. 5, 2013, at 56 available at <https://www.sec.gov/spotlight/proxy-advisory-services/proxy-advisory-services-transcript.txt>

²¹ U.S. GOV'T ACCOUNTABILITY OFFICE, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING, GAO-07-765, 10 (2007).

The potential ramifications of a proxy advisory industry with readily recognizable conflicts of interest that wields great power over capital markets and the market for corporate governance and control, which is subject to little regulatory oversight, mirror those that occurred in the credit ratings agency industry before the 2008 economic meltdown.

Policy Setting: Is It Truly a Reflection of Investor Clients' Views? Of the two major proxy advisory firms, ISS has by far the clearest and most transparent policy development process. However, the process ISS follows to develop and refine the policies by which it analyzes thousands of company proxies involves a survey which is often relied upon in making changes but that typically does not have robust investor involvement. Last year's survey incorporated feedback from only 109 institutional investors (42% under \$10 billion in assets) and 257 corporate issuers.²²

ISS notes that in addition to the survey, its Policy Board incorporates input from "roundtables with industry groups and ongoing feedback during proxy season" as well as informal discussions.²³

Although analyses by proxy advisory firms have improved in recent years, the overall concerns remain with the policies through which proxy advisory firms exert significant influence over proxy voting and executive compensation and governance practices. The SEC's Concept Release on the proxy advisory system took a positive step to review concerns with proxy advisory firm practices, but with other rulemaking items likely to take priority, further legislative and regulatory oversight is in order.

Inaccuracies in Proxy Advisory Service Reports and Lack of Transparent Methodologies Add to Skepticism Over Analytical Rigor. In addition to questions about pay for performance methodologies and conflicts of interest, a serious concern lies with the issue of inaccuracies. This is significant because inaccurate information could lead institutional investors to voting decisions that are not supported by the facts.

A 2014 survey of Center On Executive Compensation Subscribers – chief human resource officers of large companies -- found that of those responding, 55 percent said that a proxy advisory firm had made one or more mistakes in a final published report on the company's compensation programs. Half of those Subscribers reported receiving multiple instances of erroneous or inaccurate information.

Unfortunately, such errors are not uncommon, and it is the issuer that bears responsibility for checking the quality of the "expert" proxy advisory firm's assessment. For example, the Center is aware of one case where a proxy advisory firm issued its research report on a company to investors using the prior fiscal year's financial data. Although the firm issued a revised report to investors, given that many investors file their votes very shortly after a proxy advisory firm report is issued, the potential for harm clearly existed. In addition, as we have previously reported, the Center is aware of

²² Institutional Shareholder Services, 2015-2016 Policy Survey Summary of Results (Sept. 28, 2015), at 3.

²³ Institutional Shareholder Services, <https://www.issgovernance.com/policy-gateway/policy-formulation-application/>.

another company that found a significant error by a proxy advisory firm. It took some time before the proxy advisory firm responded. Although the error was corrected and the proxy advisory firm changed the recommendation, the change was made within a week of the say on pay vote, and majority of shares had already been voted. The revised report did not draw investor attention to the change, and the clients would have had to review the minutia in the report to see that the recommendation had been altered.

Two principal reasons for such inaccuracies appear to be the workload pressures caused by the tremendous growth in the length of proxy disclosures and inadequate quality control as proxy advisory firms seek to reduce costs, including by outsourcing proxy analysis. Another reason for the inaccuracies is the unreasonably short time proxy advisors give large companies to review drafts of reports and to suggest corrections before a final report is issued, and the fact that companies outside of the S&P 500 do not have that opportunity.

The Center believes that proxy advisory firms should ensure to the greatest extent possible that accurate information is transmitted to institutional investors. Where information is found to be inaccurate, the proxy advisors should be required to correct their analyses and clearly point out the correction to their clients the correction. Where there is a disagreement between the advisor and the company, the advisor should include a statement from the company discussing the rationale for its disagreement. Additionally, institutional investors should be required to closely monitor the output of proxy advisory firms, and the SEC should be required to do periodic reviews of advisor reports for accuracy and clarity.

Questionable Conclusions From Research on CEO/Chair Separation Serve As Illustration for Why Oversight Is Needed. Another reason regulatory oversight would be helpful is the questionable nature of certain proxy advisory firm research. For example, in March 2016, ISS research released a short report looking at S&P 500 companies that had independent Board Chairs and CEOs, those that had combined chairs and CEOs, and those for which the board was an “affiliated outsider” and a chair that was an insider, but not the CEO. The report concluded that “it appears that independent board chairs may provide the most effective check to the CEO, at least in terms of compensation determination.”²⁴ As pointed out by a Jones Day analysis, the conclusions, which were based on an analysis of compensation data for the company’s three most recent fiscal years, masked the fact that the most significant influence on CEO pay level was company size as measured by revenue, which had a correlation that was 2.5 times greater.²⁵ It also ignored the fact that compensation decisions are still required to be approved by an independent compensation committee. The timing (beginning of proxy season), rigor and conclusions of the report make it appear as if it was submitted to encourage support for shareholder proposals seeking independent chairs, despite the data.

²⁴ Steven Silberglied and Zachary Friesner, Board Leadership Structure: Impact on CEO Pay, Institutional Shareholder Services, Mar. 9, 2016, available at <https://www.issgovernance.com/library/2016-board-structure-and-ceo-pay>.

²⁵ Jones Day, Questioning Recent ISS Study on the Impact of Board Leadership Structures on CEO Pay, April 2016, <http://www.jonesday.com/questioning-recent-iss-study-on-the-impact-of-board-leadership-structures-on-ceo-pay-04-20-2016/>.

VI. The Role of Regulatory Oversight in Reinforcing Proxy Advisory Firm Accountability

The Center has consistently believed that regulatory approaches to address the shortcomings discussed above should be carefully pursued. In 2013, we used the example of significant concern by issuers and investors that the peer groups ISS was using to determine its pay for performance comparisons did not fit with the size or industry of the company's business.²⁶ Attention and oversight by the Division of Corporation Finance and press exposure resulted in ISS making material changes in the methodology it uses to determine and refine peer groups for the purposes of assessing company pay plans.

The Center had hoped that the Staff Legal Bulletin 20²⁷ would facilitate greater responsiveness of the proxy advisory firms and oversight by institutional investors, as well as the SEC. The interpretations in SLB 20 were welcomed in that they reinforced the role of institutional investors taking affirmative steps to ensure that proxy advisory firms have the capacity and competency to make accurate recommendations. However, in practice, the staff's interpretations with respect to addressing the conflicts of interest inherent in the research and recommendations provided to most clients were not materially affected by the bulletin.

VII. The Proxy Advisory Firm Reform Act Would Facilitate Ongoing Regulatory Oversight of Proxy Advisory Firms

The Center supports the Proxy Advisory Firm Reform Act as a means of taking a more deliberate approach to regulatory oversight of the proxy advisory firm industry and formalizing the way the SEC monitors the industry. In addition to registration of proxy advisory firms, the most important aspect of the bill is the mandated withdrawal of the two no-action letters which have facilitated the market status quo for proxy advisory firms while also stating there is not a conflict of interest for proxy advisors to provide consulting while simultaneously providing so-called independent research and analysis. Addressing such conflicts are especially important where a proxy advisory firm consults with an investor client that is also a shareholder resolution proponent and the proxy advisory firm is making voting recommendations on the investor's shareholder resolution.

As explained above, the Center believes that the practice of providing consulting services and research under the same entity should be carefully evaluated and addressed. Financial relationships and conflicts in the proxy advisory industry should be made transparent to investors. Targeted conflicts should include significant financial or business relationships between proxy advisory firms (or their parent or affiliate firms) and public companies, institutional investors or shareholder activists. Such disclosure

²⁶ See Testimony of Timothy J. Bartl, President, Center On Executive Compensation, House Subcommittee on Capital Markets and Government Sponsored Enterprises, June 5, 2013, <http://financialservices.house.gov/uploadedfiles/hhrg-113-bal6-wstate-tbartl-20130605.pdf>

²⁷ Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms, SLB No. 20, June 30, 2014, available at <https://www.sec.gov/interps/legal/cfslb20.htm>.

would throw open to public scrutiny and academic study a wealth of information about potential conflicts of interest in the industry. Investors and academic researchers could study whether corporate shareholder votes are being “bought and sold” and the extent to which fees paid to proxy advisory firms are, in fact, influencing vote recommendations. Such scrutiny would quickly provide concrete evidence as to whether the “firewalls” and other safeguards the industry has instituted are effective in mitigating the conflicts.

The Center believes that by adding an annual review of the proxy advisory firm industry through an annual report to the SEC, concerns such as those raised in 2012 with respect to ISS’s peer group determination and concerns which gave rise to the 2013 SEC proxy advisory firm roundtable would be surfaced and addressed more quickly.

In sum, the Center believes that the services provided by proxy advisory firms are an important part of the proxy process that helps investors discharge their duty to vote their proxies. Yet, we agree with former SEC Commissioner Dan Gallagher and many other commentators that a more thoughtful approach to the regulatory structure of the industry is necessary, given the substantial influence that proxy advisors have in the proxy process. The Center supports the Proxy Advisory Firm Reform Act to begin that process of reshaping the oversight of the industry.

VIII. Conclusion

The Center appreciates the opportunity to provide its views on this extremely important policy matter. We look forward to working with you and members of your staffs to ensure that the proxy voting system and advice by proxy advisory firms are increasingly transparent and consistent.



Email Exchange Between ISS Corporate Services and Motorola Solutions Demonstrates Why Conflicts of Interest Must Be Addressed

Exchange Leaves Perception That ISS Consultant Had Unique Insight Into ISS Research Team Approach

One of the core criticisms of proxy advisory firms is the existence of conflicts of interest in their business or ownership structures. With respect to Institutional Shareholder Services, the Center On Executive Compensation and other observers have criticized the conflict of interest between providing consulting services to some of the same issuers on which ISS provides “independent” proxy voting research and recommendations to institutional clients. Despite assurances that the research and consulting arms are separate, the attached recent email exchange between an ISS Corporate Services client representative and a securities counsel at Motorola Solutions demonstrates how the marketing of ISS’s consulting services blurs those distinctions.

- In 2013, Motorola Solutions received a no vote recommendation from ISS on its say on pay resolution. Just over 68 percent of Motorola Solutions’ shareholders voted in favor of say on pay.
- On September 17, 2013, Motorola’s ISS client representative sent an email to his contact in the securities law department of Motorola Solutions stating:

“[D]ue to the 2013 negative vote recommendation for [other company’s]¹ Advisory Vote on Executive Compensation and/or the fact that the proposal received less than 70% voting support (ballot item #2 in the attached analysis), ISS’s Research division will be subjecting your next executive compensation proposal to a greater level of scrutiny.

I did want to offer you a chance to talk with one of our senior corporate advisors in order to better understand what this scrutiny will entail. If you’d like to do this at some point, please let me know.”
- On September 25, the Motorola Solutions contact responded and asked to set up a call for October 8.
- On September 26, the Motorola Solutions contact requested that someone from the research side of ISS responsible for analyzing the company join the call.

¹ It appears that the representative had sent several emails to companies that had received negative ISS recommendations or say on pay votes below 70%. The representative intended to use Motorola Solution’s stock ticker here but forgot to change the email. As a result, the ticker referred to another company that also received a no recommendation and had a low say on pay vote. The Center has confirmed that that company also received a similar email.

Page 2

- ISS Corporate Services did not arrange for a representative from the research side to be on the call; however, the ISS representative did make it appear as if Corporate Services had unique insight into how the research side analyzed the company in 2013 and the additional scrutiny it would apply in 2014:

“We were going to provide you with a better understanding of the reasons for ISS’s negative vote recommendation on your 2013 Advisory Vote on Executive Compensation and what you expect [*sic*] in terms of additional scrutiny from ISS’s Research side on this issue next year.”

- Although not articulated in the email exchange, during the phone call the ISS representative made reference to very high success rates (over 90%) in say on pay votes for companies that engaged ISS Corporate Services after receiving a low vote.

The exchange leaves the impression that by engaging ISS Corporate Services, Motorola Solutions would receive advice and information unavailable elsewhere and that it would give the company an advantage when the ISS research side goes on to analyze its 2014 proxy. In essence, some companies view retaining ISS Corporate Services as giving them a guaranty or at least a greater chance at receiving a favorable evaluation from the research side. The full email is attached. Despite the provocative language hinting at an inside view of ISS research, it contains no disclaimers or warnings that ISS Corporate Services is separate from ISS research and that there is no exchange of information between the two entities.

The exchange is a good example of why such conflicts of interest should be addressed either by the SEC or by a code of conduct.

From: [REDACTED] [mailto:[REDACTED]@isscorporateservices.com]
Sent: Tuesday, September 17, 2013 12:41 PM
To: [REDACTED]
Subject: Alert for MSI due to ISS Negative Vote Recommendation in 2013

Hi [REDACTED]:

Just wanted to be sure that you were aware that, due to the 2013 negative vote recommendation for [REDACTED] Advisory Vote on Executive Compensation and/or the fact that the proposal received less than 70% voting support (ballot item #2 in the attached analysis), ISS's Research division will be subjecting your next executive compensation proposal to a greater level of scrutiny.

I did want to offer you a chance to talk with one of our senior corporate advisors in order to better understand what this scrutiny will entail.

If you'd like to do this at some point, please let me know.

Best Regards,

[REDACTED]

ISS Corporate Programs

301-[REDACTED]

From: [REDACTED] [mailto:[REDACTED]@motorolasolutions.com]
Sent: Wednesday, September 25, 2013 2:00 PM
To: [REDACTED]
Subject: RE: Alert for MSI due to ISS Negative Vote Recommendation in 2013

[REDACTED], thank you for the offer to discuss. We would be interested in speaking with your team regarding this matter. It appears that all necessary MSI participants are available on the afternoon of Tuesday, October 8th after 1 p.m. Central Time. If your corporate advisor has availability that day, please let me know and we can schedule a call.

Thank you.

[REDACTED]

Corporate, Securities and Transactions
Motorola Solutions, Inc.
motorolasolutions.com

O: [REDACTED]

M: [REDACTED]

E: [REDACTED]@motorolasolutions.com



From: [REDACTED] [mailto:[REDACTED]@motorolasolutions.com]
Sent: Thursday, September 26, 2013 11:14 AM
To: [REDACTED]
Subject: RE: Alert for MSI due to ISS Negative Vote Recommendation in 2013

[REDACTED],

Thank you for your response. If possible, we would also like to have someone from the Research side familiar with our company attend the call and also [REDACTED], if he is available.

Thank you.

[REDACTED]

[REDACTED]
Corporate, Securities and Transactions
Motorola Solutions, Inc.
motorolasolutions.com
O: [REDACTED]
M: [REDACTED]
E: [REDACTED]@motorolasolutions.com

From: [REDACTED] [mailto:[REDACTED]@motorolasolutions.com]
Sent: Monday, October 07, 2013 5:42 PM
To: [REDACTED]
Cc: [REDACTED]
Subject: RE: Alert for MSI due to ISS Negative Vote Recommendation in 2013

Great, thank you. We can use my dial in: 1-877-[REDACTED]; passcode [REDACTED]

Also, can you please provide a brief outline of the discussion topics so that we are fully prepared?

Thank you.

[REDACTED]
Corporate, Securities and Transactions
Motorola Solutions, Inc.
motorolasolutions.com
O: [REDACTED]
M: [REDACTED]
E: [REDACTED]@motorolasolutions.com

From: [REDACTED] [mailto:[REDACTED]@isscorporateservices.com]
Sent: Tuesday, October 08, 2013 8:22 AM
To: [REDACTED]
Subject: RE: Alert for MSI due to ISS Negative Vote Recommendation in 2013

Hi [REDACTED]:

Glad to help!

We were going to provide you with a better understanding of the reasons for ISS's negative vote recommendation on your 2013 Advisory Vote on Executive Compensation and what you expect in terms of additional scrutiny from ISS's Research side on this issue next year.

Best Regards,

[REDACTED]



Testimony of Joshua Cherry-Seto, Chief Financial Officer

Blue Wolf Capital Partners, LLC

On Behalf of the Association for Corporate Growth (ACG)

Before the

United States House of Representatives Committee on Financial Services

Subcommittee on Capital Markets and Government-Sponsored Enterprises

Tuesday, May 17, 2016

Chairman Garrett, Ranking Member Maloney, Members of the Subcommittee: Thank you for this opportunity to testify today on important legislation, that if passed, could help provide meaningful regulatory clarity and more efficient compliance by private equity advisers.

My name is Joshua Cherry-Seto and I'm the chief financial officer of Blue Wolf Capital Partners. Blue Wolf is a midsize private equity firm that targets investments in high quality middle-market companies in niche industries. Although we often invest in companies that face challenges, we strive to create businesses that generate value and have a long term, positive impact on local communities through sustainable growth, innovation, meaningful employment and environmental responsibility. We take seriously our fiduciary responsibility to our investors as stewards of their capital and managers of our portfolio companies. We invest responsibly, and believe strongly in a culture of compliance and transparency.

Private equity is an important participant in our economy. It provides businesses with capital and strategic support to sustain and grow their companies, particularly in complex situations when public companies and the capital markets are unable or unwilling to provide the capital. On a personal note, this is something I care deeply about, as I began my career as a labor union organizer, and the ability of firms like Blue Wolf to be strategic partners and investors in creating and sustaining good jobs is what brought me to work in private equity.

Let me briefly share an example. Healthcare Laundry System is a leading provider of hospital grade laundry service to the Chicago-area spanning more than 550 healthcare providers, including more than 40 hospitals and employing more than 500 people. The company had challenges precluding it from raising capital from the public markets. Working in partnership with management, government, the employees

and the multiple unions representing them, we were able to provide capital and strategic support to create a stronger business with more quality and stable jobs. Having addressed these challenges, Healthcare Laundry System was later sold to a public company providing long term stability to the company and its employees.

I am also proud to be a member of the Association for Corporate Growth, a global trade association representing 90,000 M&A professionals within the middle market, including more than 1,000 private equity firms like ours, which invest in local communities and help create jobs throughout main street America. The organization has worked tirelessly to engage with policymakers and I am honored to be testifying on ACG's behalf.

I'm here to support draft legislation authored by Representative Hurt of Virginia and Representative Vargas of California that would modernize the Investment Advisers Act of 1940 ("1940 Act") so that the law better reflects the vast market and technological and structural changes that have taken place over the past 76 years.

The Investment Advisers Modernization Act of 2016 would make it more efficient for private equity advisers to comply with the Act and improve the efficacy of regulatory oversight by clarifying and focusing resources on reporting relevant to investor protections in today's economy, and staying true to the regulatory framework enacted by the Dodd-Frank Act. Due the 1940 Act's ambiguity, firms like ours spend many hours and significant dollars trying to comply with ill-fitting rules for our industry that don't further the intent to protect our investors, including spending investor resources on advisors and lawyers to try to interpret regulations not specifically written with our industry in mind.

An example of the bill's common sense approach is the advertising rule, an out dated provision from 1961 that is more appropriate for an investment adviser to retail clients. Private equity advisors advertise exclusively to accredited investors, qualified clients and/or qualified purchasers. Private securities have a robust private placement disclosure process for prospective qualified sophisticated investors which should continue to be regulated and reviewed. However, the 1940 Act did not contemplate and could not foresee how to regulate technology advances such as websites. Unlike the retail market, private equity websites are not aimed at investors, but instead used to more efficiently connect with companies and management teams in need of an investment partner. It is important to note that basic anti-fraud provisions of the federal securities laws, as well as the other portions of the advertising rule, would remain in effect for private fund advisers.

A second area for clarification in the 1940 Act is the Custody Rule. The Custody Rule applies to hedge funds and mutual fund companies that buy and sell shares of publicly traded companies, sometimes making hundreds of trades in a single day. Private equity firms like mine generally do not purchase shares of publicly traded companies. Instead, we invest a pool of dollars into private companies acquiring an uncertificated share of the business.

In two separate instances, the SEC through its practical experience with "privately offered securities" has already limited the application of the Custody Rule through interpretive guidance regarding certificated privately offered securities and investment special purpose vehicles. The proposed legislation will codify and further develop the guidance in modest ways to give clear legislative intent towards meaningful compliance and oversight.

Lastly, private equity funds are not systemically important and the specific provision of information to Form PF on underlying private portfolio companies is an unnecessarily burdensome requirement without added benefit to risk management.

The proposed legislation streamlines Section 4 of Form PF for private equity fund advisers, who will still report all of the information required in Section 1 of Form PF, which will provide the Financial Security Oversight Council the information that it needs to examine interconnected market structure and risk.

In closing, the proposed legislation would update an important handful of provisions in the regulatory framework for private equity advisers. If enacted, this bill would provide a win-win solution for investors and investment advisers alike. The proposed legislation provides a modernized, clear and rational regulatory framework for advisers to comply with, given current realities. This will allow for regulatory oversight that is efficient and meaningful, while allowing private equity advisers to continue to focus on growing companies, providing important returns to our investors, and most importantly, creating new jobs, now and into the future.

Thank you for your time this afternoon and I look forward to answering your questions.

Testimony of

**Daniel M. Gallagher
President
Patomak Global Partners, LLC**

Before the

**United States House of Representatives
Committee on Financial Services**

**“Legislative Proposals to Enhance Capital Formation,
Transparency, and Regulatory Accountability”**

Good afternoon. Thank you Chairman Garrett, Ranking Member Maloney, and Members of the Committee for inviting me to testify today.

My name is Dan Gallagher, and I am President of Patomak Global Partners. From 2011 through 2015, I served as a commissioner on the U.S. Securities and Exchange Commission (SEC). I am testifying today on my own behalf.

* * *

Mr. Chairman, as you know, since the financial crisis Washington has buried businesses, consumers, and investors under a sea of costly red tape. Since 2009, federal agencies have issued a record 392 major rules with economic impacts greater than \$100 million annually.¹ At least another forty-seven major rules are expected to roll off the federal government's rulemaking assembly line in the coming months.² The Federal Register has set rule page records six times in the last eight years.³

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) alone imposed at least 100 burdensome rulemaking and related mandates on the SEC, the vast majority of which have nothing to do with the actual causes of the financial crisis. As my colleague, former SEC Commissioner Paul Atkins, previously testified before this Committee, the real tragedy – or inconvenient truth – behind Dodd-Frank and the hundreds of other rules emanating from Washington every year is that small businesses and ordinary consumers and investors end up being harmed the most.⁴ Small businesses, which have fewer resources available to navigate the federal regulatory maze compared to their larger peers, are disproportionately impacted by government regulation. For consumers and investors, more regulation generally means higher prices, restricted choice, and lower returns.

As an SEC Commissioner, I spent a great deal of time and energy trying to re-prioritize the agency's agenda away from the seemingly omnipresent, special-interest priorities that have harmed the SEC's reputation and sapped the morale of its incredible staff since the financial crisis. It is particularly refreshing to testify today on three bills which I believe will help the SEC get back to the basic, blocking-and-tackling responsibilities of securities regulation and advance its core mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation, particularly for the millions of small businesses across the country that need it the most during this tepid economic recovery.⁵

¹ See Nick Timiraos, "Obama Readies Flurry of Regulations," WALL ST. J. (Apr. 7, 2016), available at <http://www.wsj.com/articles/obama-readies-flurry-of-regulations-1460077858>.

² See *id.*

³ See Clyde Crews, *Bureaucracy Unbound: 2015 is Another Record Year for the Federal Register*, Competitive Enterprise Institute (Dec. 30, 2015), available at <https://cei.org/blog/bureaucracy-unbound-2015-another-record-year-federal-register>.

⁴ See, e.g., Ben Gitis & Sam Batkins, *Regulatory Impact On Small Business Establishments*, American Action Forum Research Report (Apr. 24, 2015), available at <http://www.americanactionforum.org/research/regulatory-impact-on-small-business-establishments/>.

⁵ See House Financial Services Committee Chairman Jeb Hensarling Press Release, Hensarling Says Jobless Recovery is Not a Recovery (Oct. 1, 2009), available at <https://hensarling.house.gov/media-center/press-releases/hensarling-says-jobless-recovery-is-not-a-recovery>.

I. The Regulation of Proxy Advisory Firms

As many of you may know, during my time on the Commission I spoke frequently about the need to reform the outdated regulatory regime governing the shareholder voting process and to address the outsized role of proxy advisory firms in this process. Shareholder voting has undergone a remarkable transformation over the past few decades. In particular, developments in investment behavior over the past 20 years have worked fundamental changes to the corporate governance landscape. Institutional ownership of shares was once negligible; now, it predominates.⁶ This is important because individual investors are generally rationally apathetic when it comes to shareholder voting: value potentially gained through voting is outweighed by the burden of determining how to vote and actually casting that vote. By contrast, institutional investors possess economies of scale, and so they regularly vote billions of shares each year on thousands of ballot items for the thousands of companies in which they invest.⁷

For example, an investor purchasing a share of an S&P 500 index mutual fund would likely have no interest in how each proxy is voted for each of the securities in each of the companies held by that fund. Indeed, it would defeat the purpose of selecting such a low-maintenance, lost-cost investment alternative. Ultimately, it is left to the investment adviser to the index fund to vote on the investor's behalf. This enhanced reliance on the investment adviser to act on behalf of investors inevitably results in a classic agency problem: how do we make sure that the investment adviser is voting those shares in the investor's best interest, rather than the adviser's best interest?

A. The Rise of Proxy Advisory Firms

The Commission tackled this very issue in a rulemaking in 2003, putting in place disclosures to inform investors how their funds' advisers are voting, as well as outlining clear steps that advisers must undertake to ensure that they vote shares in the best interest of their clients.⁸ But every regulatory intervention carries with it the risk of unintended consequences.⁹ And the 2003 release has since proved that to be true – to the point where the costs of the

⁶ Between 1950 and 2000, institutional ownership of total U.S. equity outstanding increased from approximately 6% to approximately 50%, where it has since remained. See Matteo Tonello & Stephan Rabimov, *The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition* (The Conference Board, 2010) at 22. Within the top 1,000 U.S. corporations, institutional investors are even more entrenched, holding nearly 75% of the equity. *Id.* at 27. See also Broadridge & PwC, *Proxy Pulse* (2d ed. 2014) at 2 (Proxy Pulse) (noting that, through May 2014, 70% of street shares were owned by institutions – an increase of 2% over 2013).

⁷ See Proxy Pulse at 3 (noting that institutional shareholders voted 90% of their shares through May of 2014, while individual investors voted only 29% of their shares).

⁸ SEC Rel. No. IA-2106, *Proxy Voting by Investment Advisers* (Jan. 31, 2003), available at <https://www.sec.gov/rules/final/ia-2106.htm>. While this release requires advisers to disclose how clients can obtain information about how their securities were voted, actual disclosure requirements were set out in a companion release issued the same day. See SEC Rel. No. IC-25922, *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies* (Jan. 31, 2003), available at <https://www.sec.gov/rules/final/33-8188.htm>.

⁹ This is particularly true where the intervention takes the form of a mandate, as opposed to a market-based solution (e.g., disclosure and explanation of proxy votes to investors, who could then choose to remain in the fund or take their money elsewhere).

unintended consequences now arguably dwarf those benefits originally sought to be achieved. How exactly did this happen?

In its 2003 release, the SEC addressed one specific manifestation of the general agency problem discussed above: that an adviser could have a conflict of interest when voting a client's securities on matters that affect the adviser's own interests (*e.g.*, if the adviser is voting shares in a company whose pension the adviser also manages). To remedy this issue, the release stated that an investment adviser's fiduciary duty to its clients requires the adviser to adopt policies and procedures reasonably designed to ensure that it votes its clients' proxies in the best interest of those clients.¹⁰ The Commission also noted that "an adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, *based upon the recommendations of an independent third party*."¹¹ From these statements, two specific unintended consequences arose.

First, some investment advisers interpreted this rule as requiring them to vote every share every time. This seemed, perhaps, to be the natural outgrowth of the Department of Labor's (DOL) 1988 "Avon Letter," which stated that "the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock."¹² As a result, investment advisers with investment authority over ERISA plan assets – and thus regulated by the DOL as well as the SEC – were already required to cast a vote on every matter. Reading the SEC's 2003 rule, some advisers understandably may have assumed that the Commission intended to codify that result for all investment advisers.

A requirement to vote every share on every vote, however, gives rise to a significant economic burden for investment advisers who may own only relatively small holdings in a large number of companies. For example, one study found that "[m]ost institutional investor holdings are relatively small portions of each firm's total securities."¹³ In this study's sample, "the mean (median) holding [of an individual stock by institutional investors] is 0.3% (0.03%)."¹⁴ Given that institutional investors hold stock in hundreds or thousands of companies (for example, TIAA-CREF holds stock in 7,000 companies),¹⁵ institutional investors – particularly the smaller ones – may not be able to invest in the costly research needed to ensure that they cast each vote in the best interest of their clients. The logical answer is to outsource the research function to a third party, who could do the needed research and sell voting recommendations back to investment advisers for a fee: a proxy advisory firm. While these firms already existed, the 2003 rule gave advisers new incentives to use them.

¹⁰ See SEC Rel. No. 1A-2106, *Proxy Voting by Investment Advisers* (Jan. 31, 2003).

¹¹ *Id.* (emphasis added).

¹² See Letter from Allan Lebowitz, Deputy Assistant Sec'y of the Pension Welfare Benefits Admin. at the U.S. Dep't of Labor, to Helmut Fandl, Chairman of the Ret. Bd., Avon Products, Inc. (Feb. 23, 1988), available at <http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf>.

¹³ David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, Stanford University Rock Center for Corporate Governance Working Paper No. 119 (June 13, 2014) at 10 (Outsourcing Shareholder Voting).

¹⁴ *Id.*

¹⁵ See James K. Glassman and J. W. Verret, *How to Fix Our Broken Proxy Advisory System*, Mercatus Research (Apr. 16, 2013), available at http://mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf.

Second, proxy advisory firms noticed the suggestion in the 2003 rule that soliciting the views of an independent third party could overcome an adviser's conflict of interest. In 2004, a proxy advisory firm requested – and received – “no-action” relief from the SEC staff that significantly expanded investment advisers' incentive to use these firms.¹⁶ Specifically, the staff advised Institutional Shareholder Services (ISS) that “an investment adviser that votes client proxies in accordance with a pre-determined policy based on the recommendations of an independent third party will not necessarily breach its fiduciary duty of loyalty to its clients even though the recommendations may be consistent with the adviser's own interests. In essence, the recommendations of a third party who is in fact independent of an investment adviser may cleanse the vote of the adviser's conflict.”¹⁷ Thus, investment advisers understandably came to view reliance on proxy advisory firms as a litigation insurance policy: for the price of purchasing the proxy advisory firm's recommendations, an investment adviser could ward off potential litigation over its conflicts of interest.¹⁸

Finally, in a second 2004 no-action letter to Egan-Jones, the SEC staff affirmed that a key aspect of some proxy advisory firms' business model – selling corporate governance consulting services to companies – “generally would not affect the firm's independence from an investment adviser.”¹⁹ This determination is somewhat incredible, as it places the proxy advisory firm in the position of telling investment advisers how to vote proxies on corporate governance matters that are the subject of the proxy advisory firm's consulting services—a seemingly obvious, and insurmountable, conflict of interest for the proxy adviser.²⁰

In sum, the 2003 release and the 2004 no-action letters set the stage for proxy advisory firms to wield the power of the proxy, through investment adviser firms that had economic, regulatory, and liability incentives to rely rotely on the proxy advisory firms' recommendations, and through the SEC staff's assurances that this arrangement was just fine, despite the obvious conflicts of interest involved.²¹ But it would take some additional developments for proxy advisory firms to attain the dominant voice in American corporate governance that they have today.

B. Subsequent Developments Augmenting the Power of Proxy Advisory Firms

Since 2003, some features of the SEC regulatory regime have acted to deepen investment advisers' reliance on proxy advisory firms. First, the quantity of company disclosures has

¹⁶ See Institutional Shareholder Services, Inc. (Sept. 15, 2004), available at <http://www.sec.gov/divisions/investment/noaction/iss091504.htm>.

¹⁷ *Id.*

¹⁸ See Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (And Europe) Face*, 30 DEL. J. OF CORP. LAW 688 (2005) (noting that following the recommendation of a proxy advisory firm “constitutes a form of insurance against regulatory criticism”).

¹⁹ See Egan-Jones Proxy Services (May 27, 2004), available at <http://www.sec.gov/divisions/investment/noaction/egan052704.htm>.

²⁰ The audit independence rules, by contrast, flatly forbid an auditor from telling an audit client how to account for a matter, and then providing an audit opinion to investors with respect to that exact same matter. See SEC Rule 2-01(b) & (c)(4) of Regulation S-X. The temptation for one side of the house to rubber-stamp the advice provided by the other side of the house is simply too great.

²¹ Needless to say, staff no-action letters are not approved by the Commission and do not have the legal weight of Commission-level guidance.

increased significantly over the past few years. For example, the SEC in 2006 adopted revisions to the proxy and periodic reporting rules to require extensive new disclosures about “executive and director compensation, related person transactions, director independence and other corporate governance matters and security ownership of officers and directors.”²² The new rule generated reams of new disclosures that were long, complex, and focused on regulatory compliance rather than telling the company’s compensation story. The sheer volume of information that an investment adviser would have to review in order to make a fully-informed voting decision is difficult even to organize, much less to read and digest.

Second, the average number of items on which investors are asked to vote also has been on the rise.²³ This trend is attributable at least in part to the Dodd-Frank twin advisory votes on executive compensation: a vote for how often to approve executive pay (“say-on-frequency”), and a vote to in fact approve (or disapprove) that pay (“say-on-pay”).²⁴ We also have seen a continued increase in shareholder proposals that SEC rules generally compel companies to include in the proxy to be voted on, which in turn reflects increased activism around shareholder voting.²⁵ In 2015, shareholders submitted 943 proposals, an increase of almost 5% from 2014.²⁶ Most of these proposals related to governance and shareholder rights matters (352) – including over 100 proxy access proposals – followed by proposals related to social and environmental issues (324).²⁷ The percentage of requests by companies seeking to exclude shareholder proposals under Rule 14a-8 that were denied by the SEC rose to 39% in 2015, the highest level in four years.²⁸

As a result, the logistical and economic imperatives to use proxy advisory firms that the vote-every-share-every-time interpretation of the 2003 rulemaking created have only deepened over time. According to one 2012 study, for example, over 70% of companies reported that their compensation programs were influenced by the guidance of proxy advisers.²⁹ And, according to a recent survey conducted in 2015, 63% of institutional investors reported that they rely on third-party proxy advisers to make voting decisions.³⁰ These recommendations are of course provided contractually to investment advisers; proxy advisory firms have no fiduciary duty to

²² SEC Rel. No. 33-8732A, *Executive Compensation and Related Person Disclosure* (Aug. 29, 2006), available at <https://www.sec.gov/rules/final/2006/33-8732a.pdf>.

²³ See, e.g., Larcker et al., *Outsourcing Shareholder Voting* at 1.

²⁴ See also SEC Commissioner Michael S. Piwowar, Opening Statement at the Proxy Advisory Services Roundtable (Dec. 5, 2013) (Piwowar Proxy Adviser Remarks), <https://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370542558180> (“Dodd-Frank provisions, such as mandatory say-on-pay votes, make proxy advisory firms potentially even more influential.”).

²⁵ See Gibson Dunn, *Client Alert: Shareholder Proposal Developments During the 2015 Proxy Season* (July 15, 2015), available at <http://www.gibsondunn.com/publications/pages/Shareholder-Proposal-Developments-During-the-2015-Proxy-Season.aspx>.

²⁶ See *id.*

²⁷ See *id.*

²⁸ See *id.*

²⁹ See David F. Larker, Allan L. McCall, and Brian Tayan, *The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions* (Mar. 2012), <https://www.conference-board.org/retrievefile.cfm?filename=TCB-DN-V4N5-12.pdf&type=subsite>.

³⁰ See Stanford University Graduate School of Business, *2015 Investor Survey Deconstructing Proxy Statements – What Matters to Investors* (2015) at 2, available at http://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-survey-2015-deconstructing-proxy-statements_0.pdf.

shareholders, nor do they have any interest or stake in the companies that are the subject of the recommendations. At the same time, serious questions emerged, particularly in the corporate community, about the power being wielded by proxy advisory firms in making their recommendations.

In particular, corporate observers raised two key questions about proxy advisory firms: are their recommendations infected by conflicts of interest, and even assuming they are not, do they have the capacity to produce accurate, transparent, and useful recommendations?

With regard to the former question, as alluded to in the Egan-Jones no-action letter, proxy advisory firms may have other, complementary lines of business. For example, in addition to selling vote recommendations to institutional investors (along with voting platforms, data aggregation, and other auxiliary services), they may also sell consulting services to companies that want to ensure that they have structured their governance and other proxy votes so as to avoid “no” recommendations from the proxy advisory firms. The sale of voting recommendations to institutional investors creates a risk that proxy advisory firms, in formulating their core voting recommendations, will be influenced by some of their largest customers (e.g., unions or municipal pension funds) to recommend a voting position that would benefit them. The sale of consulting services to companies creates a risk that proxy advisory firms would be lenient in formulating voting recommendations for companies that are their clients and harsh in crafting the recommendations for those companies that have refused to retain their services.

With regard to the latter question, proxy advisory firms themselves face the same difficulties as institutional investors faced before they determined to outsource their voting: how to formulate timely, high-quality recommendations for thousands of votes at thousands of companies based on millions of pages of data – all while competing on price with other firms? To put it charitably, they just do the best they can. But their best often is simply not good enough: proxy advisory firms publish some recommendations that are based on clear, material mistakes of fact.³¹ Moreover, they base some recommendations on a cookie-cutter approach to

³¹ See, e.g., Center On Executive Compensation, *A Call for Change in the Proxy Advisory Industry Status Quo* (Jan. 2011) at 58-9 (describing two member surveys conducted by the Center On Executive Compensation and HR Policy Association in 2010 which found significant rates of error in proxy advisory firm research and reports on executive compensation matters), available at <http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf>. See also Letter from Business Roundtable on Proxy Advisory Firms, to Mary L. Schapiro, SEC Chairman (Sept. 12, 2013), available at <http://businessroundtable.org/resources/letter-to-chairman-white-on-proxy-advisory-firms> (in its inquiry, almost all of the twenty companies that responded indicated that they historically have found one or more factual errors in the reports prepared by proxy advisory services). A recent decision from the Delaware Chancery Court sheds additional light on the complex plumbing currently underlying the proxy voting process, as well as the potential pitfalls surrounding reliance on proxy advisory firms. In that case, the Court concluded that certain investors had given up their appraisal rights in connection with a merger transaction based upon an error – albeit apparently inadvertent – on the part of ISS in transmitting voting instructions to Broadridge, the entity ultimately responsible for executing the proxies at issue. The Court held that by relying on ISS to transmit its voting instructions, the investment adviser “accepted the risk” that ISS might ultimately pass along voting instructions that were inconsistent with the adviser’s wishes. See *In re Appraisal of Dell, Inc.*, C.A. No. 9322-VCL (Del. Ch. Ct. May 11, 2016), available at https://www.rlf.com/files/13022_IN%20RE%20APPRAISAL%20OF%20DELL%20INC.pdf.

governance — *i.e.*, in favor of all proposals of a certain type, like de-staggering boards or removing poison pills, even if there is a sound basis for challenging the assumption that an otherwise beneficial governance reform might not be appropriate for a given company. As one academic article has argued:

If the institutional investors are only using the proxy advisor voting recommendations to meet their compliance requirement with the lowest cost, these payments will not compensate proxy advisors for conducting research that is necessary to determine appropriate corporate governance structures for individual firms. Under this scenario, the resulting recommendations will tend to be based on simple, low cost approaches that ignore the complex contextual aspects that are almost certainly instrumental in selecting the corporate governance structure for individual firms.³²

Unfortunately, companies have little access to proxy advisory firms in order either to correct a mistake of fact, or to explain why a generic corporate governance recommendation is the wrong result in the specific instance: letting companies appeal to the advisory firm is time-consuming and expensive, neither of which is consistent with the proxy advisory firm's business model. As a result, while the companies that also hire a proxy advisory firm for the latter's corporate consulting services may have some minimal degree of access (*e.g.*, by being provided an opportunity to make limited comments on draft reports), smaller companies that are not clients generally are not afforded any such rights.

Advisers that rely rotely on the proxy advisory firm's recommendations also tend not to afford companies an opportunity to tell their story. This is unsurprising: if the advisers wanted to make contextualized decisions about casting each vote, they would not have outsourced their vote in the first place. But it is also supremely ironic: under the current regulatory regime, a company that may want to engage in good faith with its shareholders may find that it has no meaningful opportunity to do so. This trend is deeply troubling to me.

The rise of proxy advisers and the outsized influence they wield on the shareholder voting process has real consequences for investors, the vast majority of whom are interested in maximizing the value of their shares. For example, recent research shows that “when public companies implement certain ‘best practices’ promulgated by proxy advisers — in this case with regard to stock option exchange programs — their gains in shareholder value are on average 50% to 100% less than other firms.”³³ Another study analyzed the impact of say-on-pay voting

³² See Larcker et al., *Outsourcing Shareholder Voting* at 3; *see also* James K. Glassman & Hester Peirce, *How Proxy Advisory Services Became So Powerful*, Mercatus on Policy (June 2014), available at <http://mercatus.org/sites/default/files/Peirce-Proxy-Advisory-Services-MOP.pdf> (noting that “one-size-fits-all recommendations miss the nuances of particular corporations”).

³³ Allan L. McCall and David F. Larcker, “Proxy Advisers Don’t Help Shareholders,” *WALL ST. J.* (Dec. 8, 2013), available at <http://www.wsj.com/articles/SB10001424052702303497804579241842269425358>. *See also* Robert Daines, Ian Gow, and David Larcker, *Rating the Ratings: How Good Are Commercial Governance Ratings*, Rock Center for Corporate Governance at Stanford

requirements under the Dodd-Frank Act and found that “compensation changes desired by proxy advisory firms produce a net cost to shareholders, while compensation changes not related to proxy advisors’ criteria are value-neutral.”³⁴ The study concluded that outsourcing voting decisions to proxy advisers appears to have the unintended consequence that boards of directors are induced “to make compensation decisions that *decrease* shareholder value.”³⁵

C. *The Initial Regulatory Response*

Concerns surrounding proxy advisory firms have been on the SEC’s radar for some time now, most notably when they were raised in the 2010 Concept Release on the U.S. Proxy System (Proxy Plumbing release).³⁶ This release outlined the conflict-of-interest and low-quality voting recommendation issues addressed above, and it requested comment on a long list of potential regulatory solutions. In December 2013, the SEC also held a roundtable to examine key questions about the influence of proxy advisory firms on institutional investors, the lack of competition in this market, the lack of transparency in the proxy advisory firms’ vote recommendation process and, significantly, the obvious conflicts of interest when proxy advisory firms provide advisory services to issuers while making voting recommendations to investors. Commissioner Michael Piowar, a vocal and powerful critic of the problems in the proxy advisory industry, correctly pointed out in his opening remarks at the roundtable:

By requiring advisers to vote on every single matter – irrespective of whether such vote would impact the performance of investment portfolios – our previous actions may have unintentionally turned shareholding voting into a regulatory compliance issue, rather than one focused on the benefits for investors. This is an unfortunate result, not merely because it may have served to entrench an anti-competitive duopoly, but more importantly because it is inconsistent with our investor protection mandate. For these reasons, we should rectify this situation immediately.³⁷

A wide range of other parties, including Congress, academia, public interest groups, the media, and a national securities exchange, also have been calling for reforms.³⁸ Indeed, this

University Working Paper Series No. 1 (Sept. 4, 2009) (finding that corporate governance ratings produced by certain proxy advisory firms and other corporate governance rating organizations “have either limited or no success in predicting firm performance or other outcomes of interest to shareholders”).

³⁴ David F. Larker et al., *Outsourcing Shareholder Voting* at 24.

³⁵ *Id.* at 45.

³⁶ I would like to commend the staff of the Division of Corporation Finance for the excellent work on the Proxy Plumbing release, which is all the more impressive given that it was issued so close in time to the enactment of the Dodd-Frank Act.

³⁷ Piowar Proxy Adviser Remarks.

³⁸ See SEC Commissioner Daniel M. Gallagher, Remarks at Georgetown University’s Center for Financial Markets and Policy Event (Oct. 30, 2013), *available at* <http://www.sec.gov/News/Speech/Detail/Speech/1370540197480>. See also, e.g., Yin Wilczek, *If SEC Fails to Move on Proxy Advisors, Lawmaker Promises Congressional Action*, Bloomberg BNA (June 20, 2014) (discussing Congressman McHenry’s promise of congressional action in the absence of three key reforms: repealing the no-action letters; identifying transparency, efficiency, and accountability measures for proxy advisory firms; and permitting portfolio managers to use cost-benefit analysis to determine whether to cast a vote); Comments of the Washington Legal Foundation on Issues Raised at the Proxy

Committee's June 2013 hearing, "Examining the Market Power and Impact of Proxy Advisory Firms," and Chairman Garrett's November 2015 roundtable on corporate governance, have significantly advanced the ball and set the stage for the additional reforms in Representative Duffy's proxy advisers bill (Proxy Advisers Act). There also has been substantial interest and work regarding the role of proxy advisers on the international front, including recent legislation introduced by the European Commission to address the accuracy and reliability of proxy advisers' analysis as well as their conflicts of interest.³⁹

After the SEC's concept release and the roundtable, which provided a wealth of information and perspectives, the SEC staff on June 30, 2014 moved toward addressing some of the serious issues involving proxy advisers. The Division of Investment Management and the Division of Corporation Finance released Staff Legal Bulletin No. 20 (SLB 20), providing much-needed guidance and clarification as to the duties and obligations of proxy advisers, and to the duties and obligations of investment advisers that make use of proxy advisers' services.⁴⁰ This guidance is a good, initial step in addressing the serious deficiencies currently plaguing the proxy advisory process.

In particular, SLB 20 does three important things worth highlighting. First, it clarifies the widespread misconception discussed above that the Commission's 2003 release mandates that investment advisers cast a ballot for each and every vote. The guidance makes clear that an investment adviser and its client have significant flexibility in determining how the investment adviser should vote on the client's behalf, including by agreeing that votes will be cast always, sometimes (e.g., only on certain key issues), or never. SLB 20 also notes that the investment adviser and client can agree to vote consistent with management's recommendations.

Second, SLB 20 cautions against misguided reliance on the two 2004 staff no-action letters. The guidance makes clear that investment advisers have a continuing duty to monitor the activities of their proxy advisers, including whether, among other things, the proxy advisory firm has the capacity to "ensure that its proxy voting recommendations are based on current and accurate information."⁴¹ This is an important issue, as I have heard from many companies that proxy advisory firms sometimes produce recommendations based on materially false or inaccurate information, but they are unable to have the proxy advisory firm even acknowledge these claims, much less review them and determine whether to revise its recommendation in light of the corrected information.

Advisory Firm Roundtable (Jan. 10, 2014), *available at* http://www.wlf.org/upload/litigation/misc/SECProxyAdvisorComments_Jan2014.pdf.

³⁹ See Proposal for a directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement (Apr. 9, 2014), *available at* http://ec.europa.eu/internal_market/company/docs/modern/cgp/shrd/140409-shrd_en.pdf.

⁴⁰ Division of Investment Management and Division of Corporation Finance, U.S. Securities and Exchange Commission, SEC Staff Legal Bulletin No. 20, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms* (June 30, 2014) (SLB 20), *available at* <https://www.sec.gov/interp/legal/cfslb20.htm>.

⁴¹ SLB 20 (emphasis added).

Third, SLB 20 makes clear that a proxy advisory firm must disclose to recipients of voting recommendations any significant relationship the proxy advisory firm has with a company or security holder proponent. This critical disclosure must clearly and adequately describe the nature and scope of the relationship, and boilerplate will not suffice.

D. *The Limits of SLB 20 and The Need for Additional Reforms*

While the increased attention and initial reforms described above are a step in the right direction, more work needs to be done to address the outsized role proxy advisers continue to play in the shareholder voting process. In particular, while I commend the SEC staff for issuing SLB 20, I remain concerned that the guidance does not fully address the fact that SEC rules have accorded to proxy advisers a special and privileged role in our securities laws – a role similar to that of nationally recognized statistical ratings organizations (NRSROs) before the financial crisis. It has become clear to me that, over the past decade, certain segments of the investment adviser industry have become too dependent on proxy advisory firms, and there is therefore a risk that these firms will not take full advantage of the SEC’s new guidance to reduce that reliance. Nearly two years after SLB 20 was released, it appears that many market participants have simply taken a “business as usual” approach. This approach is manifest in the continued market dominance of the two largest proxy advisory firms, ISS and Glass, Lewis & Co. ISS alone advises more than 60% of U.S. institutional investors on how to vote on corporate ballot items.⁴²

Representative Duffy’s Proxy Advisers Act would pick up where SLB 20 left off by providing a comprehensive regulatory regime to address many of the fundamental concerns that still remain regarding the activities of proxy advisers. The centerpiece of the Proxy Advisers Act is a requirement that proxy advisers register with the SEC. The registration regime in the Proxy Advisers Act would significantly improve transparency surrounding the structure and operation of proxy advisers beyond the limited disclosure required under existing rules and guidance. For example, the Proxy Advisers Act would require proxy advisory firms to file an application for registration with the SEC – which also would be made available to the public – disclosing, among other things, the procedures and methodologies used by the firms to advise their clients, whether the firms have a code of ethics, and information on any potential conflicts of interest relating to the firms’ organizational structures or the issuance of proxy advisory services, as well as the policies and procedures the firms use to manage such conflicts.

Registered proxy advisory firms also would be required to provide to the SEC an annual report containing certain information on the number and nature of shareholder proposals the firms reviewed during the prior year, how the firms staffed the review of such shareholder proposals, and the number of recommendations that were made. In addition, registered proxy

⁴² See James K. Glassman, “Regulators Are a Proxy Advisers Best Friend,” WALL ST. J. (Dec. 17 2014), available at <http://www.wsj.com/articles/james-k-glassman-regulators-are-a-proxy-advisers-best-friend-1418863046>. See also James R. Copland, Yevgeniy Feyman, and Margaret O’Keefe, *Proxy Monitor 2012: A Report on Corporate Governance and Shareholder Activism* at 20 (finding that a positive recommendation from ISS increases voting support for a shareholder proposal by 15%), available at http://www.proxymonitor.org/pdf/pmr_04.pdf.

advisers would be required to file with the SEC their policies regarding the formulation of voting recommendations, which would be made available to the public.

In addition to enhancing transparency, the registration regime in the Proxy Advisers Act would improve accountability by subjecting proxy advisory firms to regular examinations by the SEC. Although institutional investors must continue to play an important role in monitoring the advisory services and information provided by proxy advisers, regular examinations by the SEC would both eliminate the need to rely on the limited disclosures currently being provided by proxy advisers and ensure that such firms maintain sufficient policies, procedures, and internal controls regarding their operations and the products and services they provide. And, to further enhance compliance with the federal securities laws, the Proxy Advisers Act would require that proxy advisers designate an internal compliance officer.

On top of the disclosures described above, the Proxy Advisers Act would give the SEC direct authority to regulate potentially harmful proxy adviser conflicts of interest. For example, the Proxy Advisers Act would require proxy advisers to implement written policies and procedures reasonably designed to manage conflicts of interest, and would provide the SEC with the authority to draft rules to prohibit, or require proxy advisers to disclose or manage, conflicts of interest related to, among other things, their compensation; their provision of consulting and advisory services, including voting recommendations; and their relationships with their clients. The Proxy Advisers Act also would prohibit proxy advisers from conditioning, modifying, or withholding (or threatening to condition, modify, or withhold) voting recommendations on an issuer's agreement to purchase or subscribe to other products or services from the proxy adviser.

Finally, in order to address continued concerns surrounding the quality and dependability of proxy advisers' voting recommendations on the thousands of items listed on corporate ballots every year, the Proxy Advisers Act would require proxy advisers to maintain sufficient staff to produce accurate and reliable recommendations. Moreover, the Proxy Advisers Act would require proxy advisers to make draft voting recommendations available to the issuers subject to such recommendations and provide the issuers with an opportunity to comment. This would allow issuers subject to proxy advisers' voting recommendations to provide valuable input into the process of drafting voting recommendations, including by correcting factual errors, and thus improve the accuracy and reliability of such recommendations.

As this Committee considers the Proxy Advisers Act, it bears mentioning that, while generally enhancing transparency and accountability, SEC registration – as with any other regulatory requirement – may have certain unintended consequences. For example, imposing a registration requirement on proxy advisory firms may erect barriers to entry for competitors seeking to enter an industry already dominated by two firms. Despite these reservations, a bipartisan group in Congress has concluded that SLB 20 does not go far enough to address the often negative impacts proxy advisers have had on shareholder voting and American corporate governance. Despite my respect for and appreciation of SLB 20, I believe that this is a logical conclusion and, therefore, the best and perhaps only way forward is to institute a more comprehensive regulatory regime under the Proxy Advisers Act.

E. *Shareholder Proposal Reform*

As Congressman Duffy recently remarked, proxy advisers are susceptible to influence by political activist investors,⁴³ and this combination can be particularly powerful. Therefore, before I address the SEC Regulatory Accountability Act and the Investment Advisers Modernization Act, I also would like briefly to touch on the creeping “federalization” of corporate governance, the rise of political activist investors, and the need for additional reforms to the shareholder proposal process under SEC Rule 14a-8.

Corporate governance involves three traditional actors: shareholders, management and boards of directors. Shareholders provide corporations with capital, management makes use of that capital, and the board of directors supervises management to ensure that it is allocating that capital appropriately. Shareholders, in turn, discipline the board’s efforts. The interests of these three actors are not always aligned.

Traditionally, the law has provided a general framework within which those three actors interact. Regulators are tasked with protecting shareholders yet at the same time allowing management and directors to do their jobs growing the company and thereby creating value for shareholders. In the United States, governments at the state level historically have been the stewards of corporate governance, a distinction which the federal government has typically respected. However, this deference has slowly been eroding and a continuing trend has been developing: “the federalization of corporate law”⁴⁴ and the stripping away of states’ prerogatives with respect to corporate governance matters. This federal intrusion into traditional state law matters generally has occurred in connection with the rush to implement sweeping and prescriptive regulatory solutions – often based on false narratives – to corporate scandals and economic crises, including the Sarbanes Oxley Act of 2002 following the Enron and WorldCom scandals, and Dodd-Frank following the financial crisis.

One area where the SEC’s incursions into corporate governance have had a particularly negative effect is shareholder proposals. As I have stated in the past, aided by new provisions in the Dodd-Frank Act (*e.g.*, provisions addressing proxy access, say on pay, and executive compensation, to name just a few), Rule 14a-8 is being abused by special interest groups to advance idiosyncratic goals that may directly conflict with the interests of most shareholders.⁴⁵ A proponent, often with little to no skin in the game, can force a company to include in its proxy a proposal, which can touch on any of a wide range of issues, including immaterial social and

⁴³ See Andrew Ackerman, House Lawmakers Target Proxy Adviser Firms, WALL ST. J. (May 10, 2016), available at <http://www.wsj.com/articles/house-lawmakers-target-proxy-adviser-firms-1462921077>.

⁴⁴ See SEC Commissioner Kathleen L. Casey, Remarks before the Forum for Corporate Directors (Mar. 22, 2011), available at <http://sec.gov/news/speech/2011/spch032211klc.htm>.

⁴⁵ For example, firms with the largest lobbying expenditures consistently outperform the market. See, *e.g.*, The Economist, *Money and Politics* (Oct. 1, 2011) (discussing Strategas Research Partners’ index where the 50 firms that spend most heavily on lobbying had outperformed the S&P 500 by every year since 2002). Shareholder proposals, by contrast, consistently push for greater lobbying disclosures, in an apparent attempt to name-and-shame companies into reducing such expenditures. See, *e.g.*, Proxy Monitor, 2015 Mid-Season Report Finding 2, available at <http://www.proxymonitor.org/Forms/2015Finding2.aspx> (noting that, despite a drop in 2015, shareholder proposals on political spending were a plurality of all proposals in 2012–2014, along with continuing low levels of shareholder support).

political matters. Or, the company can expend substantial corporate resources seeking exclusion of the proposal through a request for no-action relief from the SEC. The 2015 *Whole Foods* debacle in which by fiat a previously-granted no-action letter was withdrawn, and consideration of all similar letters was deferred by the SEC, shows just how broken the system is for both proponents and companies.⁴⁶

I believe that it is time to get the SEC out of the business of policing shareholder proposals. These proposals are meant to approximate the increasingly antiquated notion of an in-person annual shareholder meeting.⁴⁷ It's like listening to a cassette recording of a Victrola, while everyone else is on their iPhones.⁴⁸ The states would do a much better job creating and policing such mechanisms.⁴⁹

⁴⁶ See, e.g., Andrew Ackerman & Joann S. Lublin, "Whole Foods Dispute Prompts SEC Review of Corporate Ballots," WALL ST. J. (Jan. 19, 2015), available at <http://www.wsj.com/articles/in-reversal-sec-wont-allow-whole-foods-to-exclude-nonbinding-shareholder-proposal-1421450999>.

⁴⁷ Specifically, a shareholder might use his or her state law rights to present a proposal from the floor at an annual meeting. The SEC first determined that companies that were aware of such impending proposals make disclosure of them in the proxy statement, along with how the company intended to vote thereon. In 1942, it first adopted a rule requiring the company to put the proposal in the proxy itself; the "modern" formulation of the rule was issued in 1947. See Amy L. Goodman et al., *A Practical Guide to SEC Proxy and Compensation Rules* at §12.02. It is interesting in this respect that the SEC used its authority over the proxy process to create substantive rights that would otherwise be a matter left to state corporate governance law (namely, the right to attend an annual meeting and put a topic on the agenda). It is even more ironic that the exception has grown to swallow the rule: annual shareholder meetings increasingly are either a spectacle (e.g., Walmart or Berkshire Hathaway) or completely scripted; some are questioning whether we need them anymore. See John D. Stoll, "Are Annual Meetings Still Necessary?," WALL ST. J. (June 9, 2015) (noting the pro forma nature of this year's General Motors Co. annual meeting), available at <http://www.wsj.com/articles/are-annual-meetings-still-necessary-1433880226>.

⁴⁸ I will now wait for the hipsters of the corporate governance community to tell me that my analogy is wrong because the analog nature of the record and cassette recordings makes them preferable to the digital content on an iPhone.

⁴⁹ I am certainly not advocating for the removal of shareholder voice in how a company is governed. But we are far from 1942, when the shareholder proposal rule was first adopted, when shareholders had only a very limited direct say in how their company was governed. Better technology and pressure for better governance practices have made companies much more responsive to the demands of their shareholders. In the meantime, shareholder proposals have become more numerous and increasingly dominated by idiosyncratic social or political policy goals. So their benefit has decreased, and their cost has gone up significantly: in their current formulation, the benefits of the SEC-administered shareholder proposal rule do not justify its cost. I will concede that there may be some vehicle by which shareholders should be able to compel corporate votes on matters, but the contours of that mechanism is best left to the states. The states have much more experience in and are better positioned to conduct a more delicate balancing of the relative rights and obligations of shareholders in the corporate governance space to determine what types of questions can be presented, when, by whom, where those would be located, who would pay for them, and so forth. This is not a new idea; the SEC Staff in 1997 distributed a questionnaire to solicit comment for a report on the shareholder proposal process required by NSMIA that outlined some different approaches for a radical overhaul of the rule, including a state-based or issuer-specific approach to shareholder proposal rules. In a 1997 rule proposal containing some incremental changes to the shareholder proposal regime, the results of that questionnaire were discussed. Companies were evenly split on the question of creating their own shareholder proposal regime, while shareholders were very strongly opposed. See SEC Rel. No. 34-39093, *Amendments To Rules On Shareholder Proposals* (Sept. 18, 1997), available at <https://www.sec.gov/rules/proposed/34-39093.htm>. Of course, the release admits the survey methodology was not scientific; I would not be surprised if few individual or beneficial owners were reflected in those

In a series of speeches during my time on the Commission, I proposed a number of reforms to Rule 14a-8, which I urge this Committee to consider in future hearings and legislative initiatives, including, among others, revising the absurdly low holding requirements needed to submit a shareholder proposal and moving to a percentage test; clarifying and bolstering requirements regarding the substance of shareholder proposals; increasing the thresholds required to re-submit a failed shareholder proposal from one year to the next; and – given the importance of the shareholder proposal process and its impact on corporate governance – converting the current, staff-driven process for determining whether to grant no-action relief to exclude shareholder proposals into a Commission-level advisory opinion process.⁵⁰

II. Economic Analysis at the SEC

The process of analyzing the economic impacts of rules and regulations is a staple of good government. As I have said in the past, smart regulation requires taking the time to understand the problem that needs to be addressed, including not only the proximate cause of the problem but also the often complex and hidden factors underlying that problem. Smart regulation also requires a thorough examination of the costs and benefits of such regulations – before and after they are put in place – on investors, businesses, industries, markets, and the economy, both at an individual level for each rule *and* in the aggregate. And, smart regulation demands a close examination of available regulatory alternatives, including the option to decline to impose additional layers of regulation if the costs outweigh the benefits.

During this period of unprecedented growth in the size and scope of the regulatory state, it is more important than ever that federal regulators comply with their legal duties under the Administrative Procedure Act (APA) and other laws robustly to analyze the economic impacts of their rules and regulations. As noted above, since the financial crisis federal agencies have foisted hundreds of burdensome regulations on U.S. businesses, consumers, and investors with economic impacts exceeding \$100 million annually. With regard to the SEC in particular, mainly as a result of the Dodd-Frank Act, the pace of rulemaking has been unrelenting, and the agency still has yet to complete a large number of Dodd-Frank Act rulemaking mandates on topics ranging from securities-based swaps to executive compensation to stock lending transparency rules, all of which are likely to have profound impacts on U.S. capital markets and our economy.

Fortunately, the SEC has grown by leaps and bounds in its focus on economic analysis over the last five years following several key losses at the D.C. Circuit for failure to give adequate consideration to the economic impacts of the agency's rules. While the D.C. Circuit

responses. But in any event, the problem of shareholder proposals has only worsened over the past two decades; it would be very interesting to see how shareholders might respond today.

⁵⁰ See J. Robert Brown, Jr., *The Evolving Role of Rule 14a-8 in the Corporate Governance Process*, 93 DU L. REV. ONLINE 151, 180 (2016) (“[A] shift in administrative approach would likely require Commission intervention. While this could occur in any number of ways, the Commission could accelerate the process by accepting more appeals. Greater involvement by the Commission would have the potential to bring clarity to the Rule [14a-8]. Moreover, emanating from the Commission, the positions would be more certain and less susceptible to alteration as part of the no action letter process. The result would likely be a reduction in the number of no action requests, saving the resources of the parties and the staff.”), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2767712 (internal citations omitted).

losses gave the Commission an external impetus for reform, the reform the SEC undertook was in fact completely internal: the SEC centralized the economic analysis function in DERA, crafted and adopted publicly-available guidance in 2012 on the contours of economic analysis, and enforced compliance with the guidance internally in the SEC's rule-writing process. Most of the credit for these landmark improvements belongs to my colleague Craig Lewis, who, as Director of the SEC's Division of Economic and Risk Analysis from 2011-2014, did more to transform the agency's paradigm for economic analysis than any other staffer in the Commission's recent history. And due credit also should be given to Michael Conley, who was Deputy General Counsel for Appellate Litigation and Adjudication at the SEC from 2011-2015, and is currently the agency's Solicitor.

While the SEC has taken great strides in the area of economic analysis, it is by no means perfect, and more can and should be done to advance the role and quality of the agency's economic analysis. Chairman Garrett's SEC Regulatory Accountability Act (SEC Accountability Act) contains a number of sensible reforms that would ensure that a more robust form of economic analysis becomes firmly entrenched in the SEC's rulemaking process for *every* rule that it issues. As a threshold matter, although the SEC is required to analyze the economic impacts of its rules under the APA, the federal securities laws, and other federal statutes, the SEC Accountability Act would resolve any lingering dispute that a cost-benefit analysis is statutorily required for every rule the SEC adopts pursuant to the federal securities laws.

The SEC Accountability Act also would memorialize in the federal securities laws many key features of the SEC's 2012 economic analysis guidance. For example, the SEC Accountability Act would require the agency to engage in a more detailed examination of potential regulatory alternatives. In many cases, the SEC appears to approach regulatory alternatives as a check-the-box exercise. In connection with a more rigorous examination of available alternatives, the SEC Accountability Act stresses a key point that regulators in Washington, D.C. often forget, perhaps intentionally: the most appropriate regulatory solution should be the one that imposes the least burden on society while maximizing potential benefits, *even if that means choosing not to regulate at all*.

In addition, the SEC Accountability Act would ensure that a number of critical factors at the core of the SEC's tripartite mission are firmly integrated into the SEC's economic analysis, including the impact of its rules on investor choice, market liquidity, and small businesses. This is incredibly important during a time of unbridled regulatory zeal in Washington. The Volcker Rule, the CEO pay ratio rule, and the DOL's fiduciary rule, are just a few examples. Improving investor choice, market liquidity, and the regulatory environment for small businesses should feature more prominently in the SEC's agenda and the economic analysis underlying the agency's rules.⁵¹

The SEC Accountability Act contains another much-needed provision requiring the SEC to take into account, whenever practicable, the cumulative costs of its regulations. Indeed, the recent wave of regulations come from an alphabet soup of domestic regulators, including the

⁵¹ Similarly, the SEC Accountability Act would ensure that regulations are consistent and written in a way that can be understood not only by the largest financial institutions, but by the ordinary investor and small business owner who can't afford expensive lawyers to interpret bureaucratic legalese.

SEC, and many are related to the edicts of non-accountable international bodies such as the Financial Stability Board. Unfortunately, in promulgating many of these myriad regulations, a robust cost-benefit analysis was not required – and therefore none was performed. Even where a cost-benefit analysis was performed (an exercise for the most part limited to rules adopted by the SEC or CFTC, either independently or jointly with other regulators, given their statutory mandate for cost-benefit analysis), such analysis encompassed only the incremental effects of the rule being considered for adoption. No regulator, as far as I know, has considered the overall regulatory burden on financial services firms when determining whether to impose additional costly regulations. When it comes to the possibility that rules from federal financial regulators are causing death by a thousand cuts, these regulators are the proverbial ostrich – head firmly entrenched in the sand.

We have deep and liquid capital markets, and the SEC makes it relatively straightforward for issuers to access them, but we're steadily attaching more and more strings. It's only a matter of time before, like Gulliver tied to the ground by the Lilliputians, companies that have the misfortune to be public issuers will be unable to move, to innovate, to create. And all investors will be harmed for it.

The SEC Accountability Act would require the agency to conduct a retrospective assessment of the economic impacts of major rules, a critical aspect of responsible regulation that rarely occurs at the SEC and throughout the federal bureaucracy. As Commissioner Piwowar has said, "retrospective review is one of the most important instruments that we have towards ensuring the rules and policies we implement are actually achieving their intended objectives."⁵² In addition, the SEC Accountability Act would require the SEC to review its existing regulations to determine whether they are outdated, ineffective, or particularly burdensome, and take action to eliminate or amend such rules. The SEC generally layers rule after rule on companies and investors until it becomes prohibitively expensive to access the public capital markets. Only rarely does the SEC remove any of its rules, even after they have long since ceased to serve their purpose or have become obsolete or worse.

Chairman Garrett's efforts to improve the SEC's economic analysis function tie in with another thoughtful bill introduced by Senate Banking Committee Chairman Richard Shelby in 2011, the Financial Regulatory Responsibility Act (SEC Responsibility Act). For example, the SEC Responsibility Act would require the SEC to conduct a rigorous economic analysis of its rules, including, among other things, an identification of the need for new regulation and the regulatory objective; an explanation of why federal government action is necessary; a quantitative and qualitative assessment of the rule's costs and benefits; and an assessment of alternatives. Chairman Shelby's bill would require that the data, methodologies, and assumptions behind the SEC's economic analysis be made available to the public. Importantly, the SEC Responsibility Act would prohibit the SEC from adopting any rule where the agency's economic analysis determines that the quantified costs are greater than the quantified benefits. The SEC Responsibility Act also includes important requirements for the SEC to conduct a regulatory impact analysis no later than five years after a rule is adopted, as well as to conduct regular retrospective reviews of existing SEC rules. Together, these two bills form a solid, good

⁵² SEC Commissioner Michael S. Piwowar, Remarks to the Securities Enforcement Forum 2014 (Oct. 14, 2014), available at <https://www.sec.gov/News/Speech/Detail/Speech/1370543156675>.

government blueprint for how to make powerful federal agencies like the SEC more accountable to the public through robust economic analysis.

As Congress moves forward with these bills and related legislation regarding economic analysis, it is worth noting one trend that warrants the full attention of lawmakers. In recent years, when implementing Congressional rulemaking mandates, it has become apparent to me that lawyers at the SEC have played too large a role in developing economic analysis. Indeed, SEC lawyers often have taken the responsibility upon themselves to interpret the supposed intent of Congress behind various rulemaking mandates, and then simply told the SEC's economists to use that interpretation when conducting economic analysis.

The best example of this trend is the SEC's CEO pay ratio rulemaking from 2015, in which SEC lawyers divined legislative intent behind Section 953(b) of the Dodd-Frank Act where there was none, and concluded that Congress must have wanted to help inform investors in their oversight of executive compensation, including say-on-pay votes.⁵³ The SEC's economists apparently were, in turn, supposed to accept this supposedly legitimate rulemaking rationale without question or additional analysis of their own. Of course, to steal a line from the late Justice Scalia, the lawyers' rationale was pure applesauce.⁵⁴ The purpose of this rule – promoted openly by special interest groups like the AFL-CIO – was not to inform a reasonable investor's voting or investment decision,⁵⁵ but to name and shame companies to lower CEO pay and reduce income inequality.⁵⁶ Addressing perceived income inequality is not the province of the securities laws or the Commission.

The Commission must not let its lawyers "interpret" around federal statutes requiring robust cost-benefit analysis. If this problematic trend continues unchecked, the SEC staff's 2012 economic analysis memo will become a dead letter.

⁵³ See SEC Rel. No. 33-9877, *Pay Ratio Disclosure* (Aug. 5, 2015) at 9, 11, available at <https://www.sec.gov/rules/final/2015/33-9877.pdf>. See also Additional Dissenting Statement of SEC Commissioner Michael S. Piwowar on Pay Ratio Rule Disclosure (Aug. 5, 2015), available at <https://www.sec.gov/news/statement/additional-dissenting-statement-on-pay-ratio-disclosure.html> (noting that "the Commission interpreted what it believed to be the congressional intent behind Section 953(b) based on its analysis of the statute and review of comments," but did not disclose this interpretation until adoption of the rule, thus undermining the public notice and comment process).

⁵⁴ *King v. Burwell*, No. 14-114, slip op. at 10 (June 25, 2015) (Scalia, J., dissenting).

⁵⁵ See *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976); *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

⁵⁶ See, e.g., Andrew Ross Sorkin, "S.E.C. Has Yet to Set Rule on Tricky Ratio of C.E.O.'s Pay to Workers," N.Y. TIMES DEALBOOK (Jan. 26, 2015), available at <http://dealbook.nytimes.com/2015/01/26/tricky-ratio-of-chief-executives-pay-to-workers/>; Christopher Matthews, "The Government Regulation Corporate America Hates Most," TIME (Sept. 20, 2013), available at <http://business.time.com/2013/09/20/the-government-regulation-corporate-america-hates-most/>; Peter Schroeder, "Disputed rule intended to shame CEOs," THE HILL (Feb. 2, 2012), available at <http://thehill.com/business-a-lobbying/208161-disputed-rule-intended-to-shame-ceos>.

III. Advisers to Private Funds

According to a recent report, there are over 11,400 registered investment advisers managing an aggregate \$66 trillion in assets.⁵⁷ The number of registered investment advisers has increased nearly 35% during the last ten years, and the assets that they manage have increased more than two-fold.⁵⁸ This increase was fueled in part by the many private fund advisers – mainly advisers to hedge funds and private equity funds – that are now required to register with the SEC as a result of the Dodd-Frank Act’s elimination of the private adviser exemption.⁵⁹ While I was not at the SEC when the registration regime for these advisers was being crafted, I had many meetings during my time on the Commission with various private fund advisers who were alarmed at the looming costs and unintended consequences expected to flow from the wholesale imposition of the SEC’s existing registration regime on previously unregistered advisers.

Although private fund advisers did not cause the financial crisis, the underlying rationale for imposing the SEC’s registration regime on such advisers, like the rationales underlying so many other provisions in Dodd-Frank, was based on a highly questionable narrative – in this case, concerns regarding systemic risks that may be posed by private funds, including the existence and practices of highly leveraged hedge funds. Not only was this regulatory shift based on a shaky (if not altogether false) premise, it also departed from the SEC’s long-standing practice of conserving its resources by allowing the sophisticated clients of private fund advisers to police the conduct of their advisers privately. Today, however, such advisers must bear the burden of the ongoing compliance costs that come with SEC registration and reporting on Form PF. This will continue to impose significant costs and burdens not only on the private advisers, but also on the Commission. And yet, this expansion of our regulatory reach will not serve to protect ordinary retail investors, but rather investors who could, as the Supreme Court so notably said, “fend for themselves.”

Additionally, it is likely that these higher costs will threaten the ability of certain funds – such as certain private equity funds – to promote capital formation through investments in operating companies. And let me be clear: capital formation leads to job creation, which is something we could certainly use right now. Indeed, around 4,100 private equity firms headquartered in the U.S. currently back about 14,300 American businesses.⁶⁰ These private equity-backed companies have hired around 7.5 million employees as of March 2016.⁶¹ Even more troubling is that these new costs are not likely to yield materially enhanced protections for

⁵⁷ Investment Advisers Association and National Regulatory Services, *2015 Evolution Revolution: A Profile of the Investment Adviser Profession* at 7, available at <http://www.nrs-inc.com/EvolutionRevolution2015>.

⁵⁸ U.S. Securities and Exchange Commission, *FY 2016 Congressional Budget Justification, FY 2016 Annual Performance Plan, FY 2014 Annual Performance Report* at 5, available at <http://www.sec.gov/about/reports/secfy16congbudgetjust.pdf>.

⁵⁹ See Investment Adviser Association and National Regulatory Services, *2012 Evolution Revolution: A Profile of the Investment Adviser Profession* at 2, available at <http://www.nrs-inc.com/pagefiles/1207/evolution%20revolution%202012.pdf>; SEC Press Release, *More Than 1,500 Private Fund Advisers Registered With the SEC Since Passage of the Financial Reform Law* (Oct. 19, 2012), available at <http://www.sec.gov/news/press/2012/2012-214.htm>.

⁶⁰ See American Investment Council, *PE by the Numbers* (Mar. 2016), available at <http://www.investmentcouncil.org/private-equity-at-work/education/>.

⁶¹ See *id.*

the private funds' investors, many of whom themselves are sophisticated, large institutional investors, such as pension funds and endowments. Indeed, in many instances, *all* investors in a given private fund are sophisticated enough and possess enough bargaining power to ensure adequate disclosure and other protections as a condition of their investment. In at least some cases, these new registration requirements will do nothing more than have the unintended consequence of draining much-needed resources from funds.⁶²

Vice Chairman Hurt's Investment Advisers Modernization Act (IA Modernization Act) would preserve the registration regime for private fund advisers while at the same time removing or modernizing – in rather modest ways – some of the more unnecessary, outdated, and overly-burdensome requirements of the now 76-year old Advisers Act that drive costs up for funds and investors, and hinder the efficient allocation of capital to help grow businesses and create jobs. For example, the IA Modernization Act would amend one of the many books and records requirements in the Advisers Act to reduce paperwork and costs burdens. The IA Modernization Act also would amend outdated advertising restrictions in the Advisers Act for private fund advisers who advertise exclusively to sophisticated investors. It bears mentioning that both the books and records provisions and the advertising restrictions discussed above, among others, date back decades, a time when the investment advisory industry looked and operated much differently than it does today.

In addition, the IA Modernization Act would eliminate the burdensome requirement for private fund advisers to include in their Form PF filings detailed information on their portfolio companies, a requirement not applicable to other investment advisers. And, the IA Modernization Act would exempt private advisers from the SEC's costly proxy voting requirements where such advisers exercise voting authority with respect to non-public securities only.

Finally, it is important to note that, notwithstanding the modest changes in the IA Modernization Act, registered investment advisers are, and will remain, highly regulated by the SEC. Moreover, the IA Modernization Act in no way diminishes the SEC's existing authorities under the Advisers Act and other federal securities laws to prosecute advisers who engage in securities fraud and other improper conduct.

* * *

I want to thank Chairman Garrett for holding this important hearing, and for his hard work on the SEC Accountability Act. I also would like to thank Representatives Duffy and Hurt for their work on thoughtful legislation addressing real problems impacting businesses and investors – both large and small, institutional and retail – across the country. I believe these three bills will go a long way toward rationalizing and modernizing the federal securities laws; making the SEC more accountable to Congress and the investing public; enhancing the efficiency of U.S. capital markets; facilitating small business capital formation; and protecting investors.

⁶² See Letter from Rep. Robert Hurt, et al., to Mary L. Schapiro, Sec. & Exch. Comm'n Chairman (Jan. 30, 2012) (concerning June 22, 2011 adoption of final rules implementing amendments to Advisers Act).

Over the last five-and-a-half years, this Committee has been committed to removing regulatory obstacles standing in the way of small businesses, strengthening our capital markets, and improving investor choice. I thank you for all of your efforts and for the opportunity to testify here today.



Statement of the U.S. Chamber of Commerce

**ON: Legislative Proposals to Enhance Capital Formation,
Transparency, and Regulatory Accountability**

**TO: House Committee on Financial Services,
Subcommittee on Capital Markets and Government
Sponsored Enterprises**

**BY: Tom Quaadman, Senior Vice President of the Center
for Capital Markets Competitiveness**

DATE: May 17, 2016

1615 H Street NW | Washington, DC | 20062

The Chamber's mission is to advance human progress through an economic,
political and social system based on individual freedom,
incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Testimony of Tom Quaadman
Senior Vice President, Center for Capital Markets Competitiveness of the U.S.
Chamber of Commerce

Before the House Committee on Financial Services, Subcommittee on Capital
Markets and Government Sponsored Enterprise

May 17, 2016

Chairman Garrett, Ranking Member Maloney, and members of the Capital Markets and Government Sponsored Enterprises subcommittee:

My name is Tom Quaadman, vice president of the Center for Capital Markets Competitiveness (“CCMC”) at the U.S. Chamber of Commerce (“Chamber”). The Chamber is the world’s largest business federation, representing the interests of more than three million businesses and organizations of every size, sector and region. I appreciate the opportunity to testify before the subcommittee today on behalf of the businesses that the Chamber represents.

Today’s hearing is entitled “Legislative Proposals to Enhance Capital Formation, Transparency and Regulatory Accountability.” In my view, this hearing is not about more or less regulation but about *smart* regulation. Sound regulatory policy and appropriate congressional oversight of the regulators who implement it are absolutely critical elements of capital markets that support economic growth.

Innovation often outpaces regulation; too often we have seen regulators struggle to keep up with evolving markets. The bills before the subcommittee today address three different regulatory structures that need updating.

1. Proxy Advice and Investing

The economic growth of our nation depends upon an efficient allocation of capital to productive uses and responsible corporate governance. Effective and transparent corporate governance systems that encourage shareholder communication and participation are a key ingredient for public companies to grow and for their investors and workers to prosper. Yet for 19 of the last 20 years we have seen the number of public companies decline. We now have fewer than half of the public companies than we did in 1996. The development and use of proxy advice by investors is an important part of corporate governance. Accordingly, it should regularly be examined in light of our continued struggle with a lack of initial public offerings and the continued outflow of public companies.

Shareholders provide public corporations with capital in the expectation of a return. Their ownership of equity interests connotes gives them voting rights, under the rubric of state corporate law and corporate by-laws, to elect directors and approve or disapprove proposals for the governance of the corporation. Day-to-day management of the corporation is left with the officers of the company and oversight of management is generally left with the Board of Directors.

Individual shareholders, or retail shareholders, have the right to vote, but are not obligated to vote. For a variety of reasons, retail shareholder participation in director elections and shareholder proposals has dropped precipitously and, in some cases, is as low as 5%.

Institutional investors¹, or those who pool large sums of money that is invested with the expectation of return, by law and regulation must generally² vote shares under management in director elections and on other material proposals included in proxy materials and some institutional investors must disclose how they vote those shares.

Institutional investors may invest in hundreds, if not thousands, of public companies. Therefore, the due diligence that is needed to fulfill the fiduciary duties associated with proxy voting—learning and understanding the issues around director elections and shareholder proposals and the best vote to meet the interests of an investor—is complex, costly, and burdensome.

As a result, the proxy advisory industry was created to help institutional investors fulfill these due diligence obligations. Some institutional investors use advisory firms to perform research as part of a robust due diligence operation, while others may outsource their entire voting function to advisory firms. As a result, proxy advisory firms:

- a) research subject companies for issues of relevance to director elections and other management and shareholder proposals;
- b) Provide voting recommendations for their clients; and

¹ Institutional investors may include insurance companies, private or public pension funds, hedge funds, investment advisors, and mutual funds.

² As will be discussed further, Legal Bulletin Number 20, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms* clarified that institutional investors must vote when it determines a matter to be material.

- c) Cast the actual votes for their clients.

Institutional investors may use one or all of these functions.

The proxy advisory industry has been dominated by two companies—Institutional Shareholder Services (“ISS”) and Glass Lewis & Co. (“Glass Lewis”), which control 97%³ of the proxy advice market. It has been estimated that ISS and Glass Lewis “control” 38% of the shareholder vote⁴ because if ISS and Glass Lewis make the same proxy voting recommendation, it moves that percentage of the vote, absent a vocal campaign against that position. This occurs partly because some clients of ISS and Glass Lewis automatically follow their recommendations.

As a result, ISS and Glass Lewis have assumed the role of de facto standard setters for corporate governance policies. One recent example highlights the point.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) included a provision to allow shareholders to have a non-binding advisory vote on compensation, otherwise known as “Say on Pay.” In doing so, Congress explicitly gave shareholders the right to determine the frequency of Say on Pay votes at one, two, or three years. This was done to give shareholders the power to decide on a policy that best fits the needs of a company and the flexibility to match the advisory vote with the length of a compensation package, which is normally three years. ISS and Glass Lewis came out with an iron-clad recommendation in all instances that the Say on Pay frequency vote should be one year. The advisory firms did this without any evidence that one frequency cycle provided better shareholder return than another, or if individual differences amongst companies called for a frequency vote other than one year.

Obviously, a one-year frequency vote means that institutional investors will have to evaluate their portfolio companies’ compensation practices each year and, therefore, will rely on ISS and Glass Lewis to make voting recommendations. But in making one-size-fits all recommendation that Say on Pay must be held every year for all companies, ISS and Glass Lewis thwarted the public policy choice made by Congress and cut off the ability of shareholders to debate and decide the issue. All of this was done without any study of empirical evidence on how Say on Pay frequency vote impacts the bottom line for shareholders. In fact, a recent study by the Rock Center for Corporate Governance at Stanford University Stanford Graduate School

³ There are other firms such as Egan Jones which provides a full array of proxy advisory services and Manifest which provides only research. However, these firms are negligible in their market impact.

⁴ ISS 24.7% Glass Lewis 12.9% Source: Ertimur, Yonca, Ferri, Fabrizio and Oesch, David, *Shareholder Votes and Proxy Advisors: Evidence from Say on Pay* (February 25, 2013). 7th Annual Conference on Empirical Legal Studies Paper.

of Business found that proxy advisory firms' favored compensation policies actually have a *negative* effect on share value.⁵ So, in short, because of ISS and Glass Lewis, we now have nearly universal annual Say on Pay votes.

The lack of transparency and accountability of proxy advisory firms is a troubling trend that can undermine confidence in and stall progress of strong corporate governance. Proxy advisors have not taken steps to ensure their voting recommendations are developed based on clear, objective, and empirically-based corporate governance standards to help management and investors evaluate and improve corporate governance as a means of increasing shareholder value. Proxy advisors are riddled with conflicts of interest and internal processes that have not kept with other changes in the proxy system.

ISS has not delineated a clear process for seeking input and developing a clear and open process for developing policies and recommendations. The almost simultaneous release of the voting policies with the closure of the short comment period leads one to believe that the letters submitted by public stakeholders are not considered, much less read.

Similarly troubling, ISS may give some larger companies only 24 hours to review and respond to its company specific recommendations, while other companies are never given an opportunity to review or respond.

To follow-up on an active dialogue that the Chamber had fostered with corporate secretaries and ISS to correct some of these flaws, the Chamber in 2010 wrote to ISS and the SEC with a proposal to inject transparency and accountability into this system by creating Administrative Procedure Act-like processes for voting policies and recommendations.⁶ This would allow for an open dialogue among all stakeholders and better inform ISS of circumstances material to the interests of its clients. To date, ISS hasn't acted or commented on these recommendations.

If ISS has an inadequate process for input, Glass Lewis has no clear process.

ISS and Glass Lewis have also been accused of having conflicts of interest that cast doubt on the unbiased nature of their proxy voting recommendations. ISS

⁵ See Larcker, David F., McCall, Allan L. and Ormazabal, Gaizka, The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policies (July 5, 2012). Stanford Graduate School of Business Research Paper No. 2105. Available at SSRN: <http://ssrn.com/abstract=2101453> or <http://dx.doi.org/10.2139/ssrn.2101453>

⁶ See Letter of August 4, 2010 to MSCI Chairman and CEO Henry Fernandez; Letter of August 5, 2010 to SEC Chairman Mary Schapiro, *Concept Release on the U.S. Proxy System File Number S7-14-10* RIN 3235-AK43

operates a consulting division to provide advice to companies as to how they can achieve better ISS corporate governance ratings and secure shareholder approval of equity compensation plans, among other things. In fact, ISS' ownership of this consulting arm—accepting fees from both the institutional investors who receive their proxy voting advice as well as from the public companies that are the subject of their voting advice—has been a focal point for criticism of the conflicts of interest inherent in this business model, including criticism from the firm's former CEO.⁷

Although it does not sell consulting services like ISS, Glass Lewis is owned by an activist institutional investor—the Ontario Teachers' Pension Plan. The Chamber has written to the SEC on separate occasions regarding the appearance of a conflict of interest with the issuance of a Glass Lewis recommendation in favor of activist measures undertaken by its owner.⁸ Furthermore, the Chamber wrote to the Department of Labor asking that they also look into these matters, as their policy at the time limited advice ERISA pension funds receive must be linked to shareholder return and free of potential conflicts of interest.⁹

Serious questions have been raised as to the quality and rigor of the research undertaken by proxy advisory firms. For instance, one of the proxy advisory firms employs 180 analysts to evaluate 250,000 issues, spread over thousands of companies, within a six-month period known as proxy season.

All of these issues with proxy advisory firms have caused obstacles to good corporate governance that, if unaddressed, have the potential to reverse the otherwise positive advances in corporate governance, such as increased communications and the empowerment of directors and shareholders that have occurred over the past generation.

2. Chamber Principles on Proxy Advice and SEC Roundtable

The Chamber, in 2013, developed and released developed ***Best Practices and Core Principles for the Development, Dispensation and Receipt of Proxy Advice***, (“Chamber principles”) a set of core principles and best practices to serve as a basis for proxy advisory firms, public companies they report on, and investment portfolio manager organizations they report to, to engage in a dialogue to create a

⁷ *CEO Journal* “Nell Minow Says Governance Has Long Way to Go” (June 26, 2012). Available at http://blogs.wsj.com/cfo/2012/06/26/nell-minow-says-governance-has-a-long-ways-to-go/?mod=wsipro_hps_cforeport

⁸ See Letter of May 30, 2012 to SEC Chairman Mary Schapiro attached as Exhibit x

⁹ See June 25, 2012 letter to Assistant Secretary of Labor Phyllis Borzi

system that brings transparency and accountability to proxy advisory firms and foster strong corporate governance.

The Chamber developed these best practices and core principles to improve corporate governance by ensuring that proxy advisory firms:

- **Are free of conflicts of interest that could influence vote recommendations;**
- **Ensure that reports are factually correct and establish a fair and reasonable process for correcting errors;**
- **Produce vote recommendations and policy standards that are supported by data driven procedures and methodologies that tie recommendations to shareholder value;**
- **Allow for a robust dialogue between proxy advisory firms and stakeholders when developing policy standards and vote recommendations;**
- **Provide vote recommendations to reflect the individual condition, status, and structure for each company and not employ one-size-fits all voting advice; and**
- **Provide for communication with public companies to prevent factual errors and better understand the facts surrounding the financial condition and governance of a company.**

Following the release of the Chamber principles, this Subcommittee held a hearing on proxy advisory firms on June 5, 2013 and the SEC held a roundtable on proxy advisory firms on December 5, 2013. On June 30, 2014, the SEC's staff issued Legal Bulletin Number 20, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms* ("SEC Staff Guidance").¹⁰ With the issuance of the SEC staff guidance the SEC for the first time exerted oversight over proxy advisors while providing institutional investors with valuable guidance on how to use proxy advice and when to vote shares and how public companies can interact with proxy advisory firms.

¹⁰ The SEC Staff Guidance can be found at <http://www.sec.gov/interp/legals/cfsilb20.htm>.

The SEC Staff Guidance provides proxy advisory firms, public companies and portfolio managers with five principles that should be adhered to:

- **Fiduciary duties permeate and govern all aspects of the development, dispensation, and receipt of proxy advice;**
- **Enhancing and promoting shareholder value must be the core consideration in rendering proxy-voting advice as well as making proxy-voting decisions;**
- **The proper role of proxy advisory firms vis-à-vis proxy voting is to provide accurate and current information to assist those with voting power to further the economic best interests of those who entrust their assets to portfolio managers and are the beneficial shareholders of public companies. If proxy advisory firms exceed that role—for example, by effectively exercising (or being granted) a measure of discretion over how shares are voted on specific proposals, or by failing to make proper disclosure regarding specific conflicts of interest afflicting a proxy advisory firm in connection with voting recommendations it is making—proxy advisory firms so employed, and those engaging them, incur serious legal and regulatory consequences;**
- **Clarity is provided as to the scope of portfolio managers' obligations to exercise a vote on proxy issues, and it emphasizes the broad discretion portfolio managers have—subject to appropriate procedures and safeguards—to refrain from voting on every, or even any, proposal put before shareholders for a vote; and**
- **In light of the direction provided, proxy advisory firms, portfolio managers, and public companies need to reassess their current practices and procedures, and adopt appropriate changes necessitated by the SEC Staff Guidance.**

While the SEC staff guidance was an important first step in providing oversight, transparency, and fairness to the proxy advisory industry, problems still remain. This past summer, the Chamber, in conjunction with NASDAQ, conducted

a survey on how public companies were interacting with proxy advisory firms following the release of the SEC staff guidance.¹¹

The survey found that only 25% of companies believed that proxy advisory firms carefully researched all relevant aspects of an issue that a firm provided recommendations on. When companies asked to provide input, the request was granted about half the time and companies were given between one hour and one month to respond, generally given 24-48 hours. While only 13% of public companies took steps to verify proxy advisory firm conflicts, those companies found conflicts 45% of the time. Nevertheless, many companies were unaware of the SEC staff guidance or the duties imposed upon advisory firms.

3. Proxy Advisory Firm Reform Act of 2016

The Proxy Advisory Firm Reform Act of 2016 would build upon the SEC staff guidance and resolve a number of problems that persist within the proxy advisory industry.

As highlighted in the example of Say on Pay frequency votes, ISS and Glass Lewis have the force of a regulator or standard setter, similar to the Financial Accounting Standards Board (“FASB”) or the Public Company Accounting Oversight Board (“PCAOB”), thereby dominating the consideration of corporate governance issues. ISS will typically have a two week comment period of their voting recommendations with an understanding that their recommendations will be released 10 days thereafter. That is not indicative of a fair and open-minded process and, if a regulatory agency were to do so, it would be viewed as being arbitrary and capricious. Glass Lewis does not even have this modicum of a process. Furthermore, the proxy advisory firm recommendations sway a significant portion of shareholder votes without an understanding of methodologies. Instead we have a one size fits all approach and outsourcing of proxy voting by some portfolio managers.

This is not how a fair and informed corporate governance system should work and the rise of this flawed system coincides with the precipitous drop in the number of public companies in the United States.

Under this proposed legislation, proxy advisory firms would need to develop clear procedures and methodologies for the development of voting policies and recommendations. This would allow all for fair due process and prevent the system

¹¹ The full survey can be found at: <http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/2015-Proxy-Season-Survey-Summary.pdf>

from being rigged. All stakeholders would have a voice and proxy advisory firms would also have the certainty they need to ensure that their recommendations are based upon analysis, facts and meet the fiduciary duties and economic best interests of their clients.

The conflicts of interest that exist—one firm owning a consulting service, another being owned by an activist investor, neither disclosing if a proponent of a shareholder proposal or opposing director slate is a client—must be dealt with in a similar way as conflicts were for other industries in the past. Sunlight must be shed for all participants to know where there are conflicts and for the firms and their clients to manage those conflicts. This bill provides such a process. The appointment of a compliance officer will help resolve the issues and provide a point of entry for the SEC into the company to help deal with these matters.

An understanding of the resources available for a proxy advisory firm is also necessary for regulators and the marketplace to understand whether a firm has the ability to adequately research the items in a company's proxy materials and make recommendations to clients in a manner that allows clients to fulfill their fiduciary duties. Having 180 people researching thousands of companies worldwide and making recommendations on hundreds of thousands shareholder proposals and director elections in a compressed timeframe cannot meet those goals.

The behavior prohibited under the legislation would prevent the proxy advisory firms from being used as a tool by third parties to advance a hidden agenda. Those provisions, when coupled with the requirements on process and management of conflicts, will ensure that voting policies and recommendations are made through a thorough factual analysis.

One of the most important parts of the bill will be the ability for companies to be able to review and make commentary on proposed recommendations. Such input is important to ensure that proxy advisory firms understand all of the aspects of an issue and further prevent mistakes from being disseminated to investors. Glass Lewis does not allow such feedback. ISS allows for such feedback, normally for 24-48 hours, but not for companies who are outside of the S&P 500. This will help with accuracy and promote factual based analysis when making recommendations for all covered companies.

The reports by the SEC and Government Accountability Office will help to better inform Congress and the public if the goals of the legislation are being met, if the implementing regulations are working and whether further action is needed.

A transparent and accountable proxy advisory industry that assists investors in meeting their fiduciary duties is critical for investor protection, capital formation, and competition. Efforts to deal with these issues by the industry itself have been partially effective at best. SEC Chair White and Corporation Finance Director Keith Higgins should be commended for taking on an oversight role and shedding the historic SEC notion of benign neglect in this area. While those steps have been helpful, this legislation deals with fundamental structural issues that must be resolved in order to make the public company structure in the United States work as effectively as possible to serve the long-term best interests of shareholders. .

4. SEC Regulatory Accountability Act

The Chamber strongly supports the passage of the “SEC Regulatory Accountability Act.” This bill would institute innovative measures to improve the cost benefit analysis and rule writing by SEC.

The use of economic analysis in rulemaking is a significant issue of public policy, which is why the Chamber in 2013 issued a report, *The Importance of Cost-Benefit Analysis in Financial Regulation* outlining the legal requirements and historic use of cost benefit analysis by financial service regulators.

The SEC Regulatory Accountability Act codifies regulatory reform principles contained in Executive Orders 12866 and 13563, issued by Presidents Clinton and Obama. These bi-partisan principles include:

- Regulators must identify the source of the problem and should promulgate a regulation only if the benefits outweigh the costs;
- Regulators must impose the least burden on society consistent with obtaining objectives;
- Regulators must identify and assess available alternatives to regulation;
- There must be public participation in the regulatory process;
- Regulators must evaluate if a proposed regulation is inconsistent, incompatible or duplicative of other federal regulations; and

- **There should be a periodic review of existing regulations to identify obsolete or ineffective regulations.**

Smart regulation requires a re-thinking of the process for developing and implementing regulations. A final regulation should be the start, not the completion of this process. The current means of producing cost benefit analysis is limited and subject to potential manipulation. An economic analysis must be published during the rulemaking process to provide the public with an opportunity to review the analysis and provide commentary on it. This type of analysis is important for the public to understand a proposal and if it meets the criteria outlined above.

Accordingly, the Chamber believes that the innovative approach contained in the SEC Regulatory Accountability Act, combining a pre-adoption cost benefit analysis with a post-adoption look-back requirement, will allow the SEC to assess the real world impacts of new regulations and address unforeseen consequences quickly.

Under this approach, the SEC would collect data and re-evaluate a rule after a defined period to determine a rule's effectiveness, if it should be modified, or if it is needed at all. Such a periodic check of all rules would also help determine if rules are obsolete. Knowing that rules would be empirically examined would force the staff to develop an internal discipline to carefully weigh important factors in the drafting process. Requiring the examination staff to consider these issues at the outset would cause it to be more proactive in its inspection program, less inclined to focus on after the fact disasters, and provide the SEC with more oversight of its function.

The SEC Regulatory Accountability Act will allow the SEC to better understand the markets and products it regulates, thereby preventing the regulatory dead-zones that were a contributory cause of the 2008 financial crisis.

Rule-writing by entities such as the PCAOB and Municipal Securities Rulemaking Board ("MSRB") are subject to the same requirements and enhancements contained in the SEC Regulatory Accountability Act. These subordinate organizations can develop standards and rules that can have the same effect as regulation. Rules of this sort also have to go through a final SEC rulemaking process and therefore should be subject to the same drafting requirements and cost benefit analysis.

5. Investment Advisors Modernization Act of 2016

An essential element of robust capital markets is the availability of professional investment advice. Unnecessary or duplicative regulatory burdens on investment

advisers that provide negligible investor protection benefits increase the cost of advice. Investment advisers pass those costs on to clients, including private equity and hedge funds, and other types of pooled investment vehicles. The math is simple: the more money a fund spends to obtain advice, the less money the fund has to invest in businesses that create jobs.¹²

The drag on investment caused by outdated regulations has increased in recent years because title IV of the Dodd-Frank Act required more investment advisers to register with the SEC. That is true even though the companies in which private funds invest and funds' investment advisers played *no* role in precipitating the 2008 financial crisis and never posed any systemic risk. The Investment Advisers Act of 1940 ("IAA") was enacted to provide a framework for the regulation of investment advisers but the law and regulations promulgated under it are badly in need of updating.

The Investment Advisers Modernization Act of 2016 would make sensible changes to the IAA to reduce unnecessary burdens on private fund investment advisers without any adverse impact on investor protection. The bill would eliminate not only the paperwork and storage burdens, but also the cybersecurity risks associated with storing troves of data and analysis collected for an adviser's due diligence on a company in which the fund ultimately decides not to invest. It would also simplify the rules relating to the assignment of investment advisory contracts. Without touching the absolute prohibition on misleading statements, which would remain completely intact, the bill would permit funds to use advertisements in their communications with investors possessing a higher degree of sophistication. And importantly, the bill would make sensible changes to the IAA's Custody Rule, which currently imposes unnecessary costs on private fund advisers with respect to privately offered or restricted securities and "friends and family" funds or special purpose vehicles that have only one portfolio company.

While the IAA's current regulatory requirements may yield some investor protection benefit for public company investors, their benefit to investors in private companies is negligible. The cost of compliance, however, is not negligible; it may even present a barrier to entry for smaller firms that specialize in investing in mid-cap companies. The Chamber encourages the Committee to report the Investment Advisers Modernization Act favorably to the House soon so that resources currently spent on compliance with unnecessary, duplicative, and outdated regulations can be redirected to more productive uses, like investments in Main Street businesses that innovate, produce goods and services, and create jobs.

¹² According to the American Investment Council (previously the Private Equity Growth Capital Council), there was \$632 billion in U.S. private equity investment in 2015.

6. Conclusion

The Chamber views these draft bills as critical steps to embrace new, innovative ideas and give our regulatory system the ability to adopt and fulfill its mission in changing times. Therefore, the items under consideration not only address specific issues that can be corrected, they also allow for experimentation and sustained efforts to modernize regulations.

The Proxy Advisory Firm Reform Act of 2016, SEC Regulatory Accountability Act, and the Investment Advisors Modernization Act of 2016 would help provide for more efficient capital markets, give investors additional and more reliable information, and provide the SEC with the capability for better oversight of the capital markets. This is a small but necessary step forward to help businesses access the capital needed to grow.

I am happy to take any questions that you may have at this time.

**WRITTEN TESTIMONY OF
JENNIFER TAUB
PROFESSOR OF LAW
VERMONT LAW SCHOOL**

BEFORE THE
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS
AND GOVERNMENT SPONSORED ENTERPRISES

“LEGISLATIVE PROPOSALS TO ENHANCE CAPITAL FORMATION,
TRANSPARENCY,
AND REGULATORY ACCOUNTABILITY”

MAY 17, 2016
2:00 P.M

WITNESS BACKGROUND STATEMENT

Jennifer Taub is a Professor at Vermont Law School where she teaches courses in contracts, corporations, securities regulation, and white-collar crime. She earned a J.D. *cum laude* from Harvard Law School, and a B.A. *cum laude* from Yale College. Prior to joining academia, she was an associate general counsel at Fidelity Investments.

Professor Taub has published on topics relevant to today's hearing, including proxy voting, private funds, and shadow banking. She has written extensively about the 2008 financial crisis and on the Dodd-Frank Wall Street Reform and Consumer Protection Act. This includes the book, *Other People's Houses*, published in 2014 by Yale University Press.

She remains current on asset management industry issues including by participating on a non-profit board that holds an annual investment fund roundtable. This gathering draws together market participants, practicing attorneys, regulators, and academics to discuss legal developments relevant to the mutual fund and private fund industries.

Professor Taub has not received any compensation in connection with her testimony, nor has she received federal grants or contracts. The views expressed in her testimony are her own and do not represent the positions of her law school or any other organization with which she is affiliated.

EXECUTIVE SUMMARY

Chairman Garrett, Ranking Member Maloney, and distinguished members of this Subcommittee, thank you for this opportunity to testify today. My name is Jennifer Taub. I am a Professor at Vermont Law School where I teach business law courses including Corporations and Securities Regulation. Before joining academia, I served as an associate general counsel at Fidelity Investments. I offer my testimony today solely as an academic and not on behalf of my law school or any other association.

First, the Investment Advisers Modernization Act allows private funds to retreat into the shadows once again. The word "private" is somewhat misleading these days. Consider that one-quarter of the equity in private equity funds comes from public pension retirement funds. And, please recall that private funds -- including hedge funds -- can now be marketed through general solicitations to the public.

It's odd. Just when private equity funds are in the sunlight thanks to Dodd-Frank and many have been exposed in SEC examinations as in violation of the law, you are now proposing that they be able to hide their tracks. Instead of encouraging a culture of compliance, this bill would provide a loophole for investment adviser recordkeeping requirements. Subjecting communications to confidentiality agreements or keeping them in-house would allow advisers to destroy critical investment records.

This bill would also exempt all private equity fund advisers and many hedge fund advisers from submitting a completed form PF. This information is important to monitor for systemic risk and to protect investors. It would block the SEC from broadly banning materially misleading statements in private fund sales literature, including concerning fund performance.

This is backwards. The SEC should be encouraged to, not discouraged from making rules against fraud.

With rule 506(c) pursuant to the JOBS Act, private funds can now be advertised through general solicitations to the public. Public offerings were supposed to come with commensurate broad protections against fraud.

It would also weaken the SEC's ability to stop false advertising by advisers generally, including to certain retail investors. And, it would shockingly eliminate the

annual independent audits of certain fund advisers to ensure they actually have the assets and securities they claim to hold.

Next, the SEC Regulatory Accountability Act would limit the agency's ability to protect the investing public. Prior to issuing most regulations, the SEC would have to engage in a new cost-benefit process. Yet, the SEC already conducts economic analysis. And the securities laws already require the consideration of the promotion of efficiency, competition and capital formation. The SEC is also already subject to the Paperwork Reduction Act, the Regulatory Flexibility Act, and the Congressional Review Act.

The existing requirements set out several speed bumps. The proposed requirements are tire shredders designed to bring progress to a crashing halt. Notably, this bill would require the SEC to consider endless alternative approaches, and only select the one that "maximizes net benefits." How could this be measured with any precision? It can't.

As Harvard Professor John Coates notes, it is not possible to specify and quantify "all benefits and all costs in a single, uniform bottom-line metric (usually dollars) representing the net welfare effects of a proposed rule." Thus results are not precise, but instead what he calls "guestimations." What this bill mostly creates is opportunities for litigation and legal fees to be generated.

Finally, the Proxy Advisory Firm Reform Act represents paternalistic overreaching that is unnecessary and would entrench existing firms. These firms help institutional investors to cast votes on important corporate governance matters at the portfolio companies they own. The SEC already has the authority to examine and discipline any institutional investors who mindlessly follow advice without considering their fiduciary duty to underlying investors. And, the SEC has authority under the Exchange Act and the Advisers Act to address conflicts of interest at advisory firms.

In short, the status quo is far better than the changes on offer here.

I. THE INVESTMENT ADVISERS MODERNIZATION ACT

The Investment Advisers Modernization Act of 2016 is misnamed. Instead of ushering in modernity, it would send the SEC and investors back to the Dark Ages. Like the other bills today, it is misaligned with the hearing's title, "Legislative Proposals to

Enhance Capital Formation, Transparency, and Regulatory Accountability." This bill would not enhance capital formation. Instead it would undermine investor protection and trust, which could inhibit or drive up the cost of capital. It would not promote transparency, but allow certain private equity advisers and other private fund advisers that have been exposed as lacking in recent SEC examinations to hide their tracks. It would not encourage regulatory accountability. Instead it would punish regulatory success, depriving the SEC of the information and tools it has been using to monitor system-wide risks, identify firm-specific risk, investigate fraud, and enforce the law.

A. Don't Punish Regulatory Success

Progress is very recent in this area. With the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), there were two major changes that began to bring private fund advisers out of the shadows. Before identifying those changes, it should be noted that the word "private" is somewhat misleading these days.¹ Consider that according to economists Eileen Appelbaum and Rosemary Batt, 25 percent of the equity in private equity funds comes from public pension retirement funds.² A total of 35 percent comes from public and private pension funds. Also, please recall that private funds -- including private equity and hedge funds -- can now be marketed through general solicitations to the public.³

First, Dodd-Frank closed a loophole that previously permitted private fund advisers to avoid registering with and providing reports to the SEC.⁴ Whereas advisers to mutual funds and the funds themselves had to register with the SEC since the 1940s, these other "private" fund advisers and their funds did not. Yet both the "public" mutual funds and the private funds have significant assets. Mutual funds have about \$16 trillion

¹ It is a label used to refer to investment companies that would be generally considered mutual funds, but for the fact that they fall into an exemption under the Investment Company Act of 1940. Before 1996, under §3(c)(1) such "private" funds could have only 100 persons as investors, but with §3(c)(7), that cap was lifted, but given the 1934, the practical limit was 499. Now, it is 1,999. However, a person is a direct investor, and could be another fund, without the need to look through to the investors in that intermediary fund.

² <https://www.russellsage.org/publications/private-equity-work>

³ <https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539707782>; <http://www.sidley.com/news/us-congress-enacts-jobs-act-increasing-499-investor-limit-for-private-funds-to-1999-and-eliminating-prohibition-against-general-solicitation-in-connection-with-certain-private-offerings-03-28-2012>

⁴ <https://www.sec.gov/news/press/2011/2011-133.htm>; <https://www.sec.gov/rules/final/2011/ia-3308.pdf>

in assets under management ("AUM") and (as the SEC has now learned), private funds have about \$10 trillion in AUM.

Dodd-Frank amended the Advisers Act, and the SEC issued final rules. Effective March 30, 2012, advisers with \$150 million in assets under management in private funds must now register.⁵ Prior to Dodd-Frank, as SEC Chair Mary Jo White noted in a 2013 speech entitled "Hedge Funds, A New Era of Transparency and Openness,"⁶ the agency only saw "a small portion of the financial landscape" of private funds. They only had information on those 2,500 advisers to private funds that voluntarily registered or who had to because they also managed a mutual fund. With the new legal requirement, another 1,500 private fund advisers registered.

And, second, Dodd-Frank permitted the SEC to mandate that advisers file reports concerning the private funds they managed "as necessary and appropriate in the public interest and for investor protection, or for the assessment of systemic risk by the Financial Stability Oversight Council" ("FSOC").⁷ As a result, private fund advisers are now required to report information concerning themselves and the funds they manage on Form PF to the SEC.⁸ This Form PF information is shared with the FSOC, but not with investors or the public.

In a 2015 speech before the Managed Fund Association, Chair White said that "[r]equired registration and reporting have been critical to increasing transparency and protecting investors in private funds." She noted that "[e]xcessive leverage, lack of liquidity, and asset concentrations have in the past been at the root of financial crises, and we now have the regulatory tools to help better identify and appropriately mitigate potential problems." She also stated that "Before 2010, the Commission had relatively limited insight into private funds and the business of private fund advisers. We did not know for example, even how many existed, and we had limited tools to learn more." Chair White also made clear that Form PF has helped the SEC "monitor trends in the

⁵ Generally speaking, private fund advisers with assets under management greater than \$100 million may have to register, and those with greater than \$150 million must register with the SEC. Those with between \$25 million and \$100 million are subject to state registration.

<https://www.sec.gov/divisions/investment/issuances/df-ia-registration.pdf>

⁶ <https://www.sec.gov/News/Speech/Detail/Speech/1370539892574>

⁷ <https://www.treasury.gov/initiatives/fsoc/Pages/home.aspx>

⁸ <https://www.sec.gov/rules/final/2011/ia-3308.pdf>

industry" and that addressing risk that could have systemic impact "is fundamental to our long-standing mission to protect investors, maintain market integrity, and promote capital formation. Simply put, investors are not protected if broad and interconnected segments of the financial system are at risk." (emphasis added).

The benefits of these two Dodd-Frank changes to bring private fund advisers out of the shadows have been considerable and costs minimal. Filing form PF is not expensive. University of St. Thomas School of Law Professor Wulf Kaal gathered data through a survey of private funds. He found that the majority of respondents spent just \$10,000 in their first year of filing and half that the following year.⁹ Altogether, compliance costs associated with Dodd-Frank filing and reporting requirements for private funds ranged from \$50,000 to \$200,000 per year (with 48% of firms spending between \$50,000 - \$100,000).¹⁰ This is minimal relative to management fees and to the investor protection and systemic risk benefits. These costs do not appear to have negatively impacted fund returns. After studying the returns of more than 3,400 private funds, Professor Kaal and colleagues determined that private fund registration and disclosure required under Dodd-Frank had no impact on fund returns.¹¹

B. Let the Sunshine In

With the new requirement to register as an investment adviser with the SEC came 1,500 new private adviser registrants and a spate of examinations. Beginning in October 2012, the SEC Office of Compliance Inspections and Examinations ("OCIE") began examinations of the multi-trillion dollar¹² private equity industry. Immediately, they found problems.

According to a May 2014 speech entitled, "Spreading the Sunshine in Private Equity,"¹³ OCIE Director Andrew Bowden shared the agency's alarming findings with his audience at the PEI Private Fund Compliance Forum. After conducting more than 150

⁹ SSRN-id2447306.pdf

¹⁰ http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2389423

¹¹ SSRN-id2629347.pdf

¹² According to aggregate data provided by the SEC, as of the 4th quarter of 2014, gross asset value of PE was \$1.887 trillion, and net asset value totals \$1.744 trillion.

¹³ <https://www.sec.gov/News/Speech/Detail/Speech/1370541735361>

exams of private equity advisers, many deficiencies were found. Director Bowden explained:

When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time.

He deemed this to be a "remarkable statistic." In addition to hidden fees and misallocated expenses, he also identified serious problems in how these advisers were valuing the funds and how valuations were being improperly represented in fund marketing. The OCIE found many inconsistencies and misrepresentations. He also identified various conflicts of interests and "temptations" endemic to the industry.¹⁴

Director Bowden included in his speech an emphasis on the need for strong compliance programs. He said that when facing risks of "outright fraud, reckless behavior, and conflicts of interests" within private equity advisory firms, a "culture of compliance" would be the "most effective defense." He concluded his remarks with "the hope that our observations are helpful to the private equity industry."

This speech was an eye-opener. Half of the examined firms were doing the right thing. It was time then to get the other half to play by the same rules. But instead of holding the line and encouraging everyone to build that culture of compliance, and abide by the law, it appears that some lawmakers wish to help them hide their tracks, and remove those regulations with which the bad actors do not wish to comply.

C. Specific Concerns

The following highlights particular concerns with the bill's provision. This is not an exhaustive list, however.

¹⁴ Concerns about many private equity firms continues to draw the attention of economists and general public. A recent report by economists Eileen Appelbaum and Rosemary Batt entitled, "Fees, Fees and More Fees: How Private Equity Abuses Its Limited Partners and U.S. Taxpayers," describe various abuses designed to line the pockets of private equity fund managers at the expense, without the knowledge or consent of their investors. They detail what they deem "lack of transparency, misallocation, and fraud" in private equity fee practices. <http://cepr.net/images/stories/reports/private-equity-fees-2016-05.pdf>

Custody Rule Exemption. Under the existing custody rule, an investment adviser that has custody of client assets or securities is required to undergo an annual surprise exam by an independent auditor to ensure they actually have what they claim to. Shockingly this bill would require the SEC to eliminate the surprise audit of certain fund advisers. For example, advisers to funds owned including by people with a "personal relationships" with the investment adviser or its employees would not be checked up on. This should be called the Madoff Loophole.

Record Destruction. In addition, this bill would require the SEC to make a rule permitting all investment advisers to destroy important records that the SEC staff uses during examinations. This would include records that the examiners could use to determine whether the advisers are cheating their clients. Under existing regulations, advisers must keep standard business records. This includes for example, trade confirmations, cash disbursements, and investment advice, and the like.

This bill would permit all investment advisers, presumably including those to mutual funds, private equity funds, hedge funds, and even retail investors, to destroy any communications or materials used while looking into a prospective investment "if the communications or materials are subject to a confidentiality agreement." This is far too broad. It would cover even those investments choices that are made. It could facilitate hiding of front running and hiding of insider trading among other violations. By subjecting a range of communications to confidentiality agreements, advisers could destroy records critical for internal compliance goals as well as SEC examinations. Communications with a client about a prospective investment, communications between an adviser and a potential portfolio company could be destroyed.

There is also another broad loophole for internal communications. Under existing regulations, advisers must keep originals and copies of records relating to recommendations, advice, cash disbursements, and securities purchases for clients, for example. Under this proposal, any such written communication could be destroyed if "sent and received only by supervised persons of the investment adviser." These are the types of emails of great importance. For example, this could permit an adviser to destroy emails between employees where they discuss whether they plan to recommend an investment to a client. If the emails suggest it is a bad choice but the employee makes the

recommendation nevertheless that would be relevant to examiners. Or put differently, knowing such information would need to be kept would encourage building a compliance culture including the training of employees on fiduciary duty and conflicts of interest.

Not Completing Form PF. This bill would promote opacity by allowing private equity funds to retreat into the shadows, gaining exceptions from completing form PF just a few years after they began doing so. This information is important to monitor for systemic risk and to protect investors. If enacted, private equity fund advisers could stop completing section 4 of the form. This section provides important information related to leverage and counterparty risk. It also includes information concerning geographic and industry breakdown of portfolio companies.

In addition, if enacted, section 1c of Form PF would apparently no longer have to be completed by hedge fund advisers with between \$150 million and \$1.5 billion in AUM. The information is very important as it provides insight into trading and clearing of derivatives as well as short-term wholesale funding including bilateral and triparty repo. Given that derivatives and the short-term wholesale funding markets accelerated the financial crisis and still remain a source of risk, it is critical for the SEC and FSOC to gather this information.

False Advertising. In addition, the bill would weaken the SEC's ability to stop false advertising by advisers generally, including to retail investors. It would require the SEC to create a rule exempting all investment advisers from complying with existing advertising rules for certain advertisements. For example, under existing rules it is considered fraud for an adviser to directly or indirectly, publish, circulate or distribute any advertisement which "contains any untrue statement of material fact, or which is otherwise false or misleading." Under the proposal, this would not be fraud if the adviser "publishes, circulates, or distributes" such an ad to four types of investors including certain employees and anyone who is "an accredited investor." Note that an "accredited investor" is just an ordinary person without income of at least \$200,000 per year.¹⁵ No special knowledge or skill is needed for this designation.

This bill also would block the SEC from broadly banning materially misleading statements in private fund sales literature, including concerning fund performance. This is

¹⁵ https://www.sec.gov/investor/alerts/ib_accreditedinvestors.pdf

backwards. The SEC should be encouraged to, not discouraged from making rules against fraud. With rule 506(c) pursuant to the JOBS Act, private funds can now be advertised through general solicitations to the public. Public offerings were supposed to come with commensurate broad protections against fraud.

II. THE SEC REGULATORY ACCOUNTABILITY ACT

The SEC Regulatory Accountability Act would undermine the SEC's ability to act effectively. Prior to issuing any regulation, the SEC would need to undergo a new, extensive cost-benefit analysis process. This bill would require the SEC to consider endless alternative approaches, and only select the one that "maximizes net benefits." Yet this cannot be measured with precision.

As Harvard Law School Professor John Coates noted in his article "Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications,"¹⁶ it is not possible to specify and quantify "all benefits and all costs in a single, uniform bottom-line metric (typically dollars) representing the net welfare effects of a proposed rule." Thus results are not precise, but instead "guestimations." The bill would apply this new requirement not just to rulemakings, but also more broadly to interpretive guidance. Also, the bill would require review of each regulation one year later and then every five years.

Better Markets, the non-profit organization led by Dennis Kelleher, has produced a detailed report entitled "Setting the Record Straight on Cost-Benefit Analysis and Financial Reform at the SEC."¹⁷ The organization has also opined that what sounds like a benign "cost-benefit analysis" is actually an "industry-only analysis."¹⁸ Such a calculation "fails to properly and fully capture the costs and benefits to the public of financial stability and preventing another crash and economic catastrophe." Better Markets notes that, "Indeed, many of those benefits (like stability, risk reduction, etc.) and costs (like human suffering from losing a job or home, etc.) are inherently difficult if not impossible

¹⁶ <http://www.yalelawjournal.org/article/cost-benefit-analysis-of-financial-regulation>;
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2375396

¹⁷ [http://bettermarkets.com/sites/default/files/documents/Setting%20The%20Record%20Straight.p
df](http://bettermarkets.com/sites/default/files/documents/Setting%20The%20Record%20Straight.pdf)

¹⁸ [http://bettermarkets.com/blog/courts-agree-innocent-sounding-cost-benefit-analysis-really-
biased-industry-cost-only-analysis](http://bettermarkets.com/blog/courts-agree-innocent-sounding-cost-benefit-analysis-really-biased-industry-cost-only-analysis)

to quantify." In that way, a cost-benefit analysis "over-weights and prioritizes the more readily identifiable quantitative costs of individual rulemaking on the industry."

Evidence of this bias can be seen in the bill's text itself. It would require the SEC to explain in a final rule the comments it received from industry or consumer groups. However, the SEC would only be required to provide "the reasons that the Commission did not incorporate those industry group concerns related to the potential costs or benefits in the final rule."

The SEC is already required under the securities laws to consider in addition to investor protection efficiency, competition, and capital formation whenever it is "engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest." The SEC also complies with analysis required the Regulatory Flexibility Act of 1980,¹⁹ the Paperwork Reduction Act of 1995,²⁰ and the Congressional Review Act of 1996.

In addition, the SEC voluntarily engages in rigorous economic analysis. In 2012 the Division of Risk, Strategy, and Financial Innovation ("RSFI") and the Office of the General Counsel ("OGC") issued internal guidance regarding economic analysis as part of the rulemaking process.²¹ That guidance asserted that "the Commission considers potential costs and benefits as a matter of good regulatory practice whenever it adopts rules." The guidance made clear that:

It is widely recognized that the basic elements of a good regulatory economic analysis are: (1) a statement of the need for the proposed action; (2) the definition of a baseline against which to measure the likely economic consequences of the proposed regulation; (3) the identification of alternative regulatory approaches; and (4) an evaluation of the benefits and costs—both quantitative and qualitative—of the proposed action and the main alternatives identified by the analysis. As a general matter, every economic analysis in SEC rulemakings should include these elements.

¹⁹ <https://www.sba.gov/advocacy/regulatory-flexibility-act>

²⁰ <https://www.epa.gov/laws-regulations/summary-paperwork-reduction-act>

²¹ https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf

This bill would raise costs for the agency. The CBO estimated that a previous iteration of this bill would cost about \$23 million over a five-year period.²² In addition, it would create opportunities for litigation and generate legal fees. The existing requirements set out several speed bumps for agency. The proposed requirements are tire shredders designed to bring progress to a crashing halt.

III. THE PROXY ADVISORY FIRM REFORM ACT

Finally, the Proxy Advisory Firm Reform Act would be a heavy-handed upheaval of a successful industry. Proxy advisors serve an important function for institutional investors. They provide independent advice and technological services to help institutional shareholders vote at annual meetings. Most of these institutional shareholders are mutual funds²³ and investment advisers²⁴ who are required to maintain proxy voting policies and procedures in relation to voting their shares. Investors voluntarily pay for these services and do not appear to be clambering for this legislation.

In his 2014 article *A Defense of Proxy Advisors*,²⁵ Case Western Reserve University School of Law Professor George Dent examines the "charges leveled against proxy advisors and the new regulations proposed by their critics." His article concludes that complaints are "mostly unwarranted" as "market forces minimize any problems with proxy advisors." In addition Professor Dent cites a 2010 article by NYU School of Law Professor Stephen Choi, University of Pennsylvania Law School Professor Jill Fisch, and NYU School of Law Professor Marcel Kahan entitled "The Power of Proxy Advisors: Myth or Reality?" This research found "a substantial degree of divergence [in voting mutual funds] from ISS recommendations, refuting the claim that most funds follow ISS blindly." While leading firms ISS and Glass Lewis have the vast majority of the proxy advisory market, a onerous new regulatory regime could likely entrench these players by creating barriers to entry.

The SEC already has the authority to examine and discipline any institutional investors who mindlessly follow advice without considering their fiduciary duty to

²² <https://www.cbo.gov/publication/44174>

²³ <https://www.sec.gov/rules/final/33-8188.htm>

²⁴ <https://www.sec.gov/rules/final/ia-2106.htm>

²⁵ http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2451240

underlying investors. And, the SEC has authority under the Exchange Act²⁶ and the Advisers Act to address conflicts of interest. The staff has provided helpful guidance in this area in a 2014 legal bulletin entitled "Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms."²⁷

CONCLUSION

The title of this hearing, "Legislative Proposals to Enhance Capital Formation, Transparency, and Regulatory Accountability" sounds quite promising on the surface. However, dig into the text of the bills, and disappointing results emerge. We find that these proposals are greatly misaligned with this hearing's purported goals.

Taken together, these legislative proposals would substantially weaken one of the central pillars of the U.S. capital markets, the protection of investors.²⁸ It is a curious endeavor to take away authority and information that the SEC and investors need and want, while simultaneously foisting upon the market a costly and bureaucratic processes that investors have not asked for.

Thank you again. I look forward to your questions.

²⁶ <https://www.sec.gov/interps/legal/cfslb20.htm>

²⁷ <https://www.sec.gov/interps/legal/cfslb20.htm>

²⁸ <https://www.sec.gov/News/Speech/Detail/Speech/1370540451723> (SEC Commissioner Aguilar: "Unfortunately. . .when many say capital formation, what they mean is simply capital-raising. That's the wrong goal. The singular act of raising capital does not necessarily result in capital formation—for example, whatever makes it easier and cheaper for issuers to raise money does not necessarily increase the rate of capital formation—and, in fact, can be detrimental to capital formation. In my five years as a Commissioner, I have considered countless enforcement recommendations that involve some very good capital raisers who raised millions of dollars through fraudulent means. Unfortunately, these fraudsters ended up destroying the capital they raised, rather than putting it to work toward economic growth. ")

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”

May 17, 2016

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.

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.

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.

May 18, 2016

Dear Chairman Hensarling and Congresswoman Waters:

I congratulate you and your colleagues for holding yesterday's hearing on "Legislative Proposals to Enhance Capital Formation, Transparency, and Regulatory Accountability." These proposals are critical to increasing U.S. economic growth and employment. I have a strong interest in one aspect of the hearing: the powerful role played by a handful of proxy advisory firms in shaping U.S. corporate governance -- and, thus, capital formation. The hearing addressed the bill submitted by Rep. Sean Duffy titled the Proxy Advisory Reform Act of 2016."

While I take no position on the legislation itself, I have studied the issue and written extensively about it. My own background is as both a think tank fellow and a veteran journalist in the field of investing. I was the chief investment columnist for the Washington Post for 11 years and currently write a monthly investing column for Kiplinger's Personal Finance. I am a member of the Investor Advisory Committee of the Securities and Exchange Commission. (I speak here for myself and not for the IAC or any other institution.)

Below are links to two papers that I co-authored on the subject you are addressing. The first is "How to Fix Our Broken Advisory System," published April 16, 2013 by the Mercatus Center of George Mason University. The co-author is J.W. Verret, a senior scholar at Mercatus and assistant professor law at George Mason who also served as chief economist of your committee from 2013 to 2015 on a leave of absence. The second is "How Proxy Advisory Services Became So Powerful," published by Mercatus on June 18, 2014, and co-authored by Hester Peirce, a research fellow and director of the Financial Markets Working Group at Mercatus.

Both of these papers showed how two firms came to dominate American corporate governance because of a staff interpretation of a Securities and Exchange Commission action. Institutions drew the conclusion that they had to vote on thousands of proxy questions and that they could avoid responsibility for their decisions by relying on the judgment of proxy

advisory firms. In effect, mutual funds and other institutions outsourced their proxy decisions to these firms, which suffer from lack of resources and conflicts of interest.

I urge you to reform the current proxy advisory system. Here are two recommendations that Professor Verret and I offered in our paper:

1. Limit proxy-voting requirements of mutual funds and pension funds so that those institutions will be the sole arbiters of when it makes sense to vote using active analysis of the question at hand. The test should be whether the vote enhances the value of an investment to a significant degree and whether the benefits of the voting process exceed the costs.
2. End the preferential regulatory treatment that proxy advisors currently enjoy in the law. That process must start by rescinding the Egan-Jones letter issued by the SEC staff. Institutional investors would remain free to purchase proxy advisory services if those services are valued for their own merit. Continued resistance by proxy advisors to sharing the empirical foundation for their recommendations suggests demand for their services may decline in the absence of their regulatory advantages.

Please enter the following papers into the record for the hearing:

http://mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf

<http://mercatus.org/publication/how-proxy-advisory-services-became-so-powerful>

Thank you for your consideration. I am ready to discuss these matters with you at any time.

Sincerely,
Ambassador James K. Glassman
Washington, DC

-----Original Message-----

From: [REDACTED] (mailto:[REDACTED]@isscorporateservices.com)

Sent: Monday, September 08, 2014 8:54 AM

Subject: U.S. 2014 ISS Post Season Report Now Available/Equity Plans for 2015 & 2016?

Good morning:

The 2014 ISS Post Season Report is now available. Please let me know if you would like a copy. There's no charge for this.

Also, as you may know, ISS will introduce a new 'balanced scorecard' methodology in 2015 for evaluating equity compensation proposals. The scorecard will consist of a number of weighted factors (such the absolute magnitude of compensation, forward looking compensation program disclosure, equity plan features, etc). Companies could thus exceed the traditional company-specific allowable cap and still receive a positive vote recommendation. ISS corporate services will provide our client companies with full advice and consultation around the scorecard factors.

Any issuer with a pay plan coming in the next few years will benefit from having access now to the ISS Compensation Suite. If you're not a current client here, you can lock in the current/early adopter price for the Suite.

Please let me know if you have any questions here.

[REDACTED]
ISS Corporate Services

tel: [REDACTED]

fax: [REDACTED]

[REDACTED]@isscorporateservices.com

ISS Corporate Services, Inc. (ICS) is a wholly owned subsidiary of Institutional Shareholder Services Inc. (ISS). ICS provides advisory services, analytical tools and information to companies to enable them to improve shareholder value and reduce risk through the adoption of improved corporate governance and executive compensation practices. The ISS Global Research Department, which is separate from ICS, will not give preferential treatment to, and is under no obligation to support, any proxy proposal of a company (whether or not that company has purchased products or services from ICS). No statement from an employee of ICS should be construed as a guarantee that ISS will recommend that its clients vote in favor of any particular proxy proposal.



Biotechnology
Innovation
Organization

James C. Greenwood
President & CEO

May 10, 2016

The Honorable Sean Duffy
1208 Longworth House Office Building
United States House of Representatives
Washington, DC 20515

The Honorable John Carney
1406 Longworth House Office Building
United States House of Representatives
Washington, DC 20515

Dear Representatives Duffy and Carney,

On behalf of the Biotechnology Innovation Organization (BIO) and its 1,100 members, I am writing in strong support of your Corporate Governance Reform and Transparency Act. I want to thank you for introducing this important legislation, which would reform the way that proxy advisory firms interact with small public companies and their investors.

As you are aware, the outsized influence, opaque standards, one-size-fits-all recommendations, and potential conflicts of interest of proxy advisory firms have raised concerns among emerging biotech companies. These small business innovators operate in a unique industry that values a strong relationship with investors, yet they often are held to standards that are not applicable to their company and forced to engage in proxy fights over issues that do not add value for shareholders. Further, emerging biotechs have little-to-no input on the standards set by the proxy firms, nor does the SEC or the public. These issues are exacerbated by the conflicts of interest inherent in some of the firms' business models. BIO believes that proxy advisory firms should be more transparent and open to input in their standard-setting process (particularly with regard to issues unique to small businesses), and that they should take steps to minimize potential conflicts of interest.

Your bill would provide for SEC oversight of proxy advisory firms, ensuring that they operate within appropriate boundaries and can be held accountable to regulators and the public. In particular, the Corporate Governance Reform and Transparency Act would ensure that firms have adequate resources to provide accurate recommendations on emerging companies as well as processes in place to manage potential conflicts of interest. The bill would also require that the firms engage in a dialogue with the companies impacted by their recommendations.

Since the JOBS Act became law four years ago, more than 190 biotechs have gone public as emerging growth companies (EGCs). These now-public companies are still small and pre-revenue, and they face a daily struggle to succeed – both at their life-saving research and at the business challenges faced by any public company. Roadblocks that divert company focus, time, and funds to non-R&D distractions can slow the development of groundbreaking medicines. Your bill would allow companies to focus on advancing their clinical research and achieving company growth that benefits both shareholders and patients.

BIO applauds you for introducing the Corporate Governance Reform and Transparency Act, and we look forward to working with you to advance this important legislation.

Sincerely,

James C. Greenwood
President and CEO

1201 Maryland Avenue SW 202.962.9200 »
Suite 900 202.488.6307 »
Washington DC 20024 bio.org

**STATEMENT FOR THE RECORD FROM
JOHN HAYES
CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER OF BALL CORPORATION, AND
CHAIR OF THE BUSINESS ROUNDTABLE COMMITTEE ON CORPORATE GOVERNANCE**

**SUBMITTED TO THE
SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES**

**HEARING ON
“LEGISLATIVE PROPOSALS TO ENHANCE CAPITAL FORMATION, TRANSPARENCY, AND REGULATORY
ACCOUNTABILITY”**

MAY 17, 2016

Thank you, Chairman Garrett, Ranking Member Maloney and members of the subcommittee, for the opportunity to offer the views of America’s business leaders on the important legislation you are considering today.

I am John Hayes, Chairman, President and Chief Executive Officer of Ball Corporation. With more than 15,000 employees around the world, Ball Corporation is a leading provider of innovative, sustainable packaging solutions for beverage, food and household product customers, as well as aerospace technology, products and services. I am offering my views on behalf of Business Roundtable, an association of CEOs of major American companies operating in every sector of the U.S. economy. I serve as Chair of the Business Roundtable Committee on Corporate Governance.

Business Roundtable CEO members lead companies with \$7 trillion in annual revenues and nearly 16 million employees. Business Roundtable member companies comprise nearly one-fifth of the total market capitalization of U.S. stock markets and invest \$129 billion annually in research and development (R&D) – equal to 70 percent of U.S. private R&D spending. Our companies pay more than \$222 billion in dividends to shareholders and generate more than \$495 billion in sales for small and medium-sized businesses annually. Business Roundtable companies also give more than \$8 billion a year in charitable contributions.

I am going to focus my comments on the *Proxy Advisory Firm Reform Act of 2016*, championed by Representative Sean Duffy of the 7th District of Wisconsin. Business Roundtable strongly supports this legislation because it would improve the efficiency of

U.S. capital markets and improve the quality of information available to shareholders and investors. Let me tell you why.

Background

Institutional investors, such as pension funds, which hold 76 percent of the outstanding shares traded on U.S. public markets,ⁱ rely on proxy advisory firms to help advise them on how best to manage their fiduciary duty to vote their proxies in the best interests of the beneficial owners they represent. By voting their proxies in accordance with the recommendations of a third party, such as a proxy advisory firm, institutional investors can avoid potential conflicts of interest.ⁱⁱ

Two proxy advisory firms, Institutional Shareholder Services (ISS) and Glass Lewis & Co., account for 97 percent of the market share of the proxy advisory businessⁱⁱⁱ and wield enormous influence. ISS clients, for example, directly influence an estimated 20 to 30 percent of the votes of a typical mid- to large-cap public company, while Glass Lewis clients typically influence 5 to 10 percent of the votes.^{iv}

Business Roundtable CEOs are concerned ISS and Glass Lewis fail to avoid conflicts of interest, frequently promulgate factually inaccurate information and are neither transparent in their business dealings nor publicly accountable for the recommendations they provide.

Conflicting Interests

ISS offers proxy voting recommendations while at the same time offering paid consulting services to the companies whose proxies they evaluate – by definition, there are inherent conflicts in this process. Glass Lewis, on the other hand, is owned by the Ontario Teachers' Pension Plan, which invests in companies on whose proxies Glass Lewis makes recommendations.^v The owners, executives and staff of proxy advisory firms are free to invest in, or even serve on the boards of, public companies whose proxies they assess.

Ongoing Issues with Accuracy

In a survey of its CEO members conducted in 2013, Business Roundtable found that nearly all of its member companies have identified factual errors in reports prepared by proxy advisory firms.^{vi}

Business Roundtable CEO members report that ISS generally distributes preliminary copies of its reports to companies, but Glass Lewis does not. ISS generally fixes the errors that are identified to them before the final reports are published, but some members reported that identical or similar factual errors were made in their reports across several years. Moreover, a significant number of members report that ISS has often given them insufficient time, sometimes as little as nine hours, to review their reports before publication.^{vii}

According to a 2010 survey of HR Policy Association members and Center On Executive Compensation Subscribers, 53 percent of the chief human resource officers of large companies say that a proxy advisory firm had made one or more mistakes in a final published report on the company's compensation programs in 2009 or 2010.^{viii}

Lack of Transparency and Accountability

Neither ISS nor Glass Lewis fully discloses the methodologies used to develop their voting recommendations. They also do not disclose the academic research, if any, that is used in formulating their decisions and whether or not such decisions were based on the creation and preservation of shareholder value.

In its 2013 survey, Business Roundtable asked member CEOs about their experience with proxy advisory services. CEOs reported that neither ISS nor Glass Lewis disclose how they arrive at their recommendations, even in those instances where the company pointed out that a proxy advisory recommendation contains factually inaccurate information.

Business Roundtable Recommendations

Business Roundtable has long advocated for increased supervision of proxy advisory firms by the Securities and Exchange Commission (SEC). Business Roundtable also supports efforts to ensure that investment advisers are exercising appropriate oversight over the proxy advisory firms they retain, consistent with their fiduciary duties as registered investment advisers.

Business Roundtable supports reforms that would improve transparency and accountability of proxy advisory firms by requiring:

- ☐ Proxy advisory firms to register under the *Investment Advisers Act of 1940 (Advisers Act)*, under a tailored regulatory framework that reflects the unique role they play in the proxy voting process;
- ☐ Conflict of interest disclosure by proxy advisory firms that describe specific conflicts and not just reliance on generalized statements about conflicts of interest;
- ☐ Proxy advisory firms to provide more transparency involving their internal controls, policies, procedures, guidelines and methodologies;
- ☐ Proxy advisory firms to provide public companies with copies of their draft reports sufficiently in advance of dissemination to their clients, to permit correction of inaccurate information;
- ☐ Proxy advisory firms to publicly disclose the final report about a public company 90 days after a shareholder meeting has occurred; and

- ☐ That new SEC rules or guidance emphasize the responsibility of each registered investment adviser to exercise appropriate oversight over its proxy voting process, to ensure that its voting decisions with respect to client securities are in the best interests of its clients.

The *Proxy Advisory Firm Reform Act of 2016*

Business Roundtable strongly supports the *Proxy Advisory Firm Reform Act of 2016*. It would require proxy advisory firms to register with the SEC and annually provide the agency with material disclosures, including:

- ☐ The procedures and methodologies that the applicant uses in advising its clients;
- ☐ The organizational structure of the applicant;
- ☐ Whether the applicant has a code of ethics; and
- ☐ Any potential or actual conflict of interest related to the ownership structure of the applicant.

The bill details the specific conflicts of interest that would be disclosed, including those related to the manner in which registered proxy advisory firms are compensated by clients, business relationships and ownership interests between proxy advisory firms and clients, the formulation of proxy voting policies by proxy advisory firms (particularly when large clients provide input), and any instances where proxy advisory firms issue proxy voting recommendations at companies where they also provide advisory services.

The legislation would also help resolve problems related to the reliability and accuracy of proxy advisory firm reports. For example, the bill would require that registered proxy advisory firms hire sufficient staff and allow issuers receiving proxy advisory firm recommendations to comment on the recommendations. Registered firms would also be required to hire an ombudsman to receive complaints about the accuracy of voting recommendations and be required to resolve the issues prior to proxy voting.^{ix}

Finally, the bill would prohibit registered proxy advisory services from engaging in unfair, coercive or abusive practices. For example, the bill would prohibit registered firms from conditioning or threatening to condition a voting recommendation on the purchase by an issuer of services or products of the registered proxy advisory firm or affiliate.

Thank you for the opportunity to express the views of America's business leaders on this important legislation. I hope that all members of the subcommittee will support Mr. Duffy's *Proxy Advisory Firm Reform Act*.

ⁱ “A Call for Change in the Proxy Advisory Industry Status Quo,” Center on Executive Compensation (January 2011), 15-16, available at:

<http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf>.

ⁱⁱ “Investment Advisers Act of 1940 – Rule 206(4)-6: Egan-Jones Proxy Services,” SEC letter to Kent S. Hughes (May 27, 2004), available at:

<http://www.sec.gov/divisions/investment/noaction/egan052704.htm>.

ⁱⁱⁱ Tamara C. Belinfanti, “The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight,” *Stanford Journal of Law, Business & Finance* 14 (Spring 2009): 395. See also:

<http://www.sec.gov/comments/s7-14-10/s71410-183.pdf>.

^{iv} See Center On Executive Compensation President Timothy J. Bartl, Remarks Before the House Committee on Financial Services (June 5, 2013), available at: <http://www.execcomp.org/Docs/c13-33%20House%20Subc%20on%20Capital%20Markets%20Bartl%20Testimony%20PAF%206-5-13%20Final.pdf>.

^v Center on Executive Compensation, *supra* note 1, at 8.

^{vi} See the Business Roundtable Letter to SEC Chairman White on Proxy Advisory Firms (September 12, 2013), available at: <http://businessroundtable.org/resources/letter-to-chairman-white-on-proxy-advisory-firms>.

^{vii} *Id.*

^{viii} HR Policy Association, 2010 Summer Chief Human Resource Officer Survey (September 1, 2010).

^{ix} To help ensure compliance with the bill, the bill requires registered proxy advisory firms to designate a compliance officer responsible for administering the policies and procedures related to potential conflicts of interest and data inaccuracies.



Nelson Griggs
Executive Vice President
One Liberty Plaza
New York, NY 10006 / USA
Phone: 212.401.8915

May 16, 2016

The Honorable Scott Garrett
Chairman, Capital Markets Subcommittee
House Financial Services Committee
United States House of Representatives
Washington, DC 20515

Dear Chairman Garrett,

Thank you for holding a legislative hearing on the Proxy Advisory Firm Reform Act authored by Representative Sean Duffy.

Nasdaq is pleased to support this legislation. Proxy Advisory Firms wield enormous influence over the corporate governance landscape, their standard-setting is not transparent, they exercise influence without mitigating conflicts of interest and they may make recommendations based on erroneous information or misunderstanding of public company proposals, while accepting little or no input from the companies they are reviewing.

In contrast, when Nasdaq adopts rules establishing the governance practices for our listed companies, we must do so in a transparent way, subject to SEC oversight, and those rules are subject to public comment. We believe this process benefits the markets and that Rep. Duffy's legislation is a strong step toward bringing similar transparency, fairness and appropriate oversight to the small number of powerful firms in proxy advisory industry. Nasdaq stands ready to work with you as this legislation moves through the legislative process.

Thank you again for holding this important legislative hearing on an issue of serious importance to public companies, investors and the markets.

Sincerely,


Nelson Griggs

AFR Americans for Financial Reform

May 17, 2016

Dear Representative,

On behalf of Americans for Financial Reform, we are writing to express our opposition to the “Investment Advisors Modernization Act of 2016”.¹ Far from modernizing the regulation of investment advisors, this legislation would roll back the clock to the years before private fund advisors were subject to elementary oversight measures, measures that numerous documented abuses have shown to be necessary for investor protection. The laundry list of regulatory exemptions in this bill would enable the exploitation of investors, possibly including outright fraud. It would also reduce the information available to regulators to address systemic risk.

Prior to the passage of the Dodd-Frank Act in 2010, advisors to private funds such as private equity and hedge funds were exempt from core oversight requirements under the Investment Advisers Act of 1940. The Dodd-Frank Act required these fund advisors to provide information to the Securities and Exchange Commission (SEC) concerning the funds they manage and also to comply with various recordkeeping, reporting, and audit requirements designed to protect fund investors. These requirements are helping to take private funds out of the shadows of the financial system.

The results of the Dodd-Frank changes have clearly demonstrated that Congressional concerns regarding regulatory exemptions for private funds were well-placed. Initial SEC examinations found serious investor protection issues at over half of private equity funds examined, an astounding rate of malfeasance.² Many of these issues involved draining resources from portfolio companies through fees without compensating or properly informing investors, and misallocating expenses to investors that should instead have been paid by the advisor. In response to these findings the SEC has already brought a half dozen enforcement actions against private equity funds that have recovered tens of millions of dollars for investors.³

¹ Americans for Financial Reform is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of coalition members is available at <http://ourfinancialsecurity.org/about/our-coalition/>

² Speech by Chief Bruce Karpati, SEC Enforcement Division's Asset Management Unit, 23 January 2013, <http://www.sec.gov/News/Speech/Detail/Speech/1365171492120#.VPDIPE10zew>; and Speech by Director Andrew J. Bowden, Office of Compliance Inspections and Examinations, 6 May 2014, <http://www.sec.gov/News/Speech/Detail/Speech/1370541735361#.VPDkw010zew>.

³ In the Matter of Blackstone Management Partners L.L.C., et al., Release No. IA-4219 (Oct. 7, 2015), <https://www.sec.gov/litigation/admin/2015/ia-4219.pdf>; In the Matter of Kohlberg Kravis Roberts & Co. L.P., Release No. IA-4131 (Jun. 29, 2015), <https://www.sec.gov/litigation/admin/2015/ia-4131.pdf>; In the Matter of Clean Energy Capital, LLC, Release No. IA- 3785 (Feb. 25, 2014), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540849548#.VPDkp010zew>; In the Matter of Guggenheim Partners Investment Management, LLC, Release No. IA-4163 (Aug. 10, 2015),

The investors victimized by these ethical violations are hardly limited to sophisticated Wall Street players. As of 2013, thirty-five percent of the capital in private equity funds came from pension funds, mostly public pension funds – money set aside to provide a dignified retirement for local teachers, firefighters, and police.⁴ In fact, a coalition of 13 state Treasurers, Comptrollers, and public pension funds recently sent a letter to the SEC calling for better enforcement and disclosure of fee practices by private equity funds.⁵

In the area of systemic risk, the new transparency mandated by the Dodd-Frank Act is also paying dividends. The recent report by the Financial Stability Oversight Council (FSOC) on systemic risks in the fund space found that the ten largest hedge funds had levels of notional leverage that could exceed 20 to 1, mostly due to derivatives-driven strategies that could create financial instability during times of market stress.⁶ The FSOC recommended further study and more data gathering on this issue, which would not have been uncovered without the information provided on the Form PF reports mandated by Dodd-Frank. Yet the “Investment Advisors Modernization Act” seeks to remove key elements of Form PF reporting requirements for numerous private fund advisors.

The “Investment Advisors Modernization Act” would act to return private funds to the shadows of the financial system, and would dramatically restrict the SEC’s capacity to effectively protect investors from possible exploitation by fund advisors.

Section 2 of the bill would exclude major elements of the internal records of private equity funds from any requirements to maintain books and records for SEC inspection. This exclusion would cover key communications relating to due diligence on prospective investments, meaning that the SEC could not effectively audit to determine if the advisor had acted in the best interests of the client in making investments, as well as a broad range of internal firm communications, which are often crucial evidence in determining if a firm has behaved responsibly and honestly. Section 2 would also create major new loopholes in SEC rules designed to ensure that representations of fund performance in advertising materials are not false, misleading, or inaccurate – surely a core protection that the public deserves to have.

Section 3 of the bill would reduce transparency into private equity funds for both investors and regulators, enabling numerous possible forms of investor exploitation. The section would create

<https://www.sec.gov/litigation/admin/2015/ia-4163.pdf>; In the Matter of Alpha Titans, LLC, Release No. IA-4073 (Apr. 29, 2015), <https://www.sec.gov/litigation/admin/2015/34-74828.pdf>; In the Matter of Lincolnshire Management, Inc, Release No. IA-3927 (Sept. 22, 2014)

<http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543006673#.VPDkj010zew>

⁴ Appelbaum, Eileen, and Rosemary L. Batt. Private Equity at Work: When Wall Street Manages Main Street. New York: Russell Sage Foundation, 2014, Chapter 8, p. 239.

⁵ Letter from 13 state Treasurers and Comptrollers to SEC Chair Mary Jo White RE: Standardized Private Equity Fee Disclosure, 21 July 2015, http://comptroller.nyc.gov/wp-content/uploads/documents/SEC_SignOnPDF.pdf

⁶ Financial Stability Oversight Council, Update On Review Of Asset Management Products And Activities, 18 April 2016, <https://www.treasury.gov/press-center/press-releases/Pages/jl0431.aspx>.

Americans for Financial Reform
1629 K Street NW 10th Floor Washington, DC 20006 | 202.466.1885 | ourfinancialsecurity.org

major new exemptions from requirements that funds have an annual independent audit of their client funds and securities holdings – a precaution that could be crucial in preventing a fund from claiming to own securities when it actually does not, as Bernie Madoff did. Section 3 also creates significant new exemptions to current requirements that funds provide investors with plain-English narrative reports (“brochures”) that detail fees and compensation, investment strategies, risk of loss, any misconduct, and other financial information, and it would cut back from quarterly to annual the frequency of required reporting on insider securities transactions, an important item of information in determining whether insider trading has taken place.

This Section also eliminates key systemic risk information for regulators by dramatically reducing the number of funds who must report complete information on their leverage and holdings on Form PF, a confidential form used by regulators to track risks to the financial system. The bill would exempt all private equity fund advisors from complete reporting on this form, all hedge fund advisors with assets under management below \$1.5 billion, as well as liquidity fund advisors below \$1 billion. This is especially dangerous given that, as noted above, the information collected on Form PF has been and is being used by the FSOC to identify potential areas of systemic risk, and work to prevent them.

Section 4 of the bill would ban the SEC from applying anti-fraud protections to sales literature distributed to the general public by private funds under the new general solicitation provisions of the JOBS Act. The JOBS Act now allows private equity and hedge funds to engage in general advertising to the public, so long as funds take steps to ensure that all purchasers are “accredited investors,” a category that can include many retirees who have savings but are relatively unsophisticated in investment practices.⁷ Incredibly, this section would ban the SEC from applying even basic protections against fraudulent and misleading advertising to such general solicitation.

By eliminating a wide range of protections against investor abuse and even outright fraud, the “Investment Advisors Modernization Act” would empower private fund advisors to exploit investors in numerous ways. We urge you to reject this legislation.

Thank you for your consideration. For more information please contact AFR’s Policy Director, Marcus Stanley at marcus@ourfinancialsecurity.org or 202-466-3672.

Sincerely,

Americans for Financial Reform

⁷ An accredited investor must have a net worth of \$1 million excluding the primary residence, or a current income of \$300,000 (for a couple) or \$200,000 for an individual.

AFR Americans for Financial Reform

May 17, 2016

Dear Representative,

On behalf of Americans for Financial Reform, we are writing to express our opposition to the “SEC Regulatory Accountability Act”.¹ Despite the fact that the Securities and Exchange Commission (SEC) is already subject to extensive statutory economic analysis requirements, and has greatly increased its investment in economic analysis in recent years, this legislation would impose a host of unworkable new bureaucratic and administrative burdens on the agency. While they are justified using the rhetoric of “cost benefit analysis”, these requirements are patently designed not to improve SEC economic analysis but instead to make effective agency action virtually impossible.

The most prominent new requirement would mandate that the SEC identify every “available alternative” to a proposed regulation or agency action and analyze the costs and benefits of each such alternative prior to taking action. Since there are always numerous possible alternatives to any course of action, this requirement alone could force agencies to complete dozens of additional analyses before passing a rule or guidance. Placing this mandate in statute will also provide near-infinite opportunities for Wall Street lawsuits aimed at halting or reversing SEC actions. It would be a gift to trial lawyers who work on such anti-government lawsuits. No matter how much effort the SEC devotes to justifying its actions, the question of whether the agency has identified all possible alternatives to a chosen action, and has properly measured the costs and benefits of each such alternative, will always remain open to debate.

Like other agencies, the SEC is already required to conduct economic analyses under the Paperwork Reduction Act, the Congressional Review Act, and the Regulatory Flexibility Act. Unlike all other financial regulators, the SEC also has additional statutory requirements to examine how each rule affects market efficiency, competition, and capital formation. The SEC has also issued binding internal guidance on economic analysis for rulemakings that closely follows Executive Order 12866 and OMB Circular A-4, and has more than tripled its spending on economic and risk analysis since 2012.

Despite these already existing commitments to economic analysis, this proposal would burden the agency with a crushing load of additional administrative hurdles before it could take any action. In addition to the enormous task of identifying and analyzing every available alternative to a course of action, the agency would be required to perform over half a dozen new analyses

¹ Americans for Financial Reform is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of coalition members is available at <http://ourfinancialsecurity.org/about/our-coalition/>

Americans for Financial Reform
1629 K Street NW 10th Floor Washington, DC 20006 | 202.466.1885 | ourfinancialsecurity.org

that go beyond its current requirements concerning market efficiency, competition, and capital formation. These new requirements include analyses of effects on small business, market liquidity, state and local government, investor choice, and “market participants”. The SEC would also be required to review every single regulation in effect within one year after the passage of this Act, and again every five years thereafter, with an eye to weakening or eliminating such regulations. Any question concerning compliance with any of these new requirements could become material for a lawsuit.

This legislation is transparently an effort to paralyze the SEC and to empower Wall Street lawyers to overturn its decisions, not to improve its analysis or decision making. We urge you to reject it.

Thank you for your consideration. For more information please contact AFR’s Policy Director, Marcus Stanley at marcus@ourfinancialsecurity.org or 202-466-3672.

Sincerely,

Americans for Financial Reform



Statement of
Ken Bertsch
Executive Director
Council of Institutional Investors
for the
Subcommittee on Capital Markets and Government Sponsored Enterprises
of the
Committee on Financial Services
United States House of Representatives

May 17, 2016

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

Dear Mr. Chairman Garrett and Ranking Member Maloney:

The Council of Institutional Investors ("CII") respectfully requests that the following statement be included in the record for the May 17, 2016, hearing convened by the Subcommittee on Capital Markets and Government Sponsored Enterprises on the "Proxy Advisory Firm Reform Act of 2016" introduced by Rep. Duffy¹, and the "SEC Regulatory Accountability Act" introduced by Rep. Garrett.

As discussed below, we oppose these proposals as drafted.

- The Proxy Advisory Firm Reform Act appears to us to be a solution in search of a problem, and to overreach. We do not believe there is compelling empirical evidence that institutional investors are abdicating and outsourcing their voting responsibilities, and current SEC guidance makes it clear that investment advisors have a duty to maintain sufficient oversight of third-party voting agents. We do believe that proxy advisory firms play a useful role for institutional investors, and that the bill proposes new requirements without clarity on how proxy voting works in practice today, and without sufficient analysis of costs and benefits. Moreover, we believe the proposal could put proxy advisory firms back at the center of corporate governance, after a period of substantial increase in direct engagement between companies (including boards) and their

¹ We note that the two largest U.S. proxy advisory firms, Glass Lewis & Co. ("Glass Lewis") and Institutional Shareholder Services ("ISS"), are non-voting members of CII, paying an aggregate of \$24,000 in annual dues—less than 1.0 percent of CII's membership revenues. In addition, CII is a client of ISS, paying approximately \$19,600 annually to ISS for its proxy research.

shareholders. We also believe the proposal would tend to pose a further barrier to entry for new proxy advisory firms.

- The SEC Regulatory Accountability Act as drafted includes provisions we believe would in practice paralyze the Securities and Exchange Commission's (SEC) regulatory activities, at least in the absence of substantially greater and assured funding. Effective SEC regulation is critical to well-functioning capital markets. We believe the proposal is unnecessary and poses significant risks to effective regulation of capital markets.

As these proposals would have significant impacts on investors, who the SEC is charged to protect, we believe it is important before moving forward that the subcommittee seek strong and current empirical evidence, and consult more thoroughly with investors, including institutional investors who dominate U.S. markets. We understand that this hearing will include direct testimony from an officer of one private equity fund, but believe the subcommittee should seek further broader participation from investors before moving forward on the specific legislation contemplated here.

CII and CII Member's Approaches to Proxy Voting

Founded in 1985, CII is a nonpartisan, not-for-profit association of public, labor and corporate employee benefit funds with assets collectively exceeding \$3 trillion. CII is a leading advocate for strong investor rights and for effective corporate governance standards for U.S. public companies.

CII members are diverse. Our voting members – who vote on CII's corporate governance policies – include a wide range of public, labor and corporate pension funds. Non-voting members include a range of asset managers with more than \$20 trillion in assets under management.

CII voting members are responsible for investing and safeguarding assets used to fund retirement benefits for millions of participants and beneficiaries throughout the United States. They have a significant commitment to the U.S. capital markets. The average CII member invests nearly 60 percent of its entire portfolio in U.S. stocks and bonds.

CII voting members are long-term, patient investors due to the long investment horizons for their pension obligations, and commitment of most to passive investment strategies, which involve investing in the shares making up indexes designed to represent some portion of the capital markets. These passive strategies restrict CII members from exercising the "Wall Street walk" and selling their shares when they are dissatisfied. This puts particular emphasis on corporate governance oversight and accountability to shareholders through the proxy vote.

Owning stock in a company gives CII members and other investors the right and responsibility to vote on important matters concerning corporate strategic decisions, such as significant mergers or acquisitions, and important governance issues, such as the election of directors.

Because of the significance of the issues addressed on corporate ballots, the proxy vote is considered part of the underlying value of a stock. For CII members and others with fiduciary duties, proxy voting is an obligation.

CII's corporate and labor fund members are subject to the 1974 Employee Retirement Income Security Act ("ERISA"), which requires fund fiduciaries to act solely in the best interests of plan participants and beneficiaries. While CII's public pension plan members are not subject to ERISA, many state and local legislatures have adopted standards closely modeled on ERISA rules. And CII member funds sponsored by private trusts and tax-exempt institutions (such as universities and churches) also tend to follow ERISA fiduciary standards.

As fiduciaries, CII members have a variety of specific duties regarding proxy voting, including:

- They must not vote based on their private interests, but rather to maximize the economic value of plan holdings;
- Votes must be cast on each issue that has an impact on the economic value of the stock;
- Voting decisions should be based on a careful analysis of the vote's impact on the economic value of the investment; and
- If proxy voting is delegated, plan fiduciaries have a duty to monitor proxy voting procedures and votes.

The Proxy Advisory Firm Reform Act

Proxy advisory firms have been in business for decades. Today, two firms—ISS and Glass Lewis & Co.—dominate the business, and several other smaller firms provide proxy advice and voting services. Many CII voting and non-voting members are clients of one or more of these firms, which provide research on proxy voting, as well as “back office” support for complex tasks involved in voting at hundreds or thousands of companies globally.

We believe proxy advisory firm influence has been overstated, particularly now, after several years of rapidly enhanced direct engagement between companies, including board members, and institutional investors. Boards have become better at engaging shareholders directly, and the mandates in the proposed bill could potentially reverse some of that progress, putting proxy advisory firms at the center of engagement.

We note that the European Securities and Markets Authority (ESMA) found no clear evidence of market failure in relation to proxy advisors’ interaction with investors and issuers.² ESMA did suggest development of a code of conduct, which led a group of proxy advisors that includes ISS and Glass Lewis to establish a set of Best Practice Principles in March 2014.³ ISS published a principles compliance statement in June 2014, and Glass Lewis did so in August 2014.⁴ ESMA said in December 2015 that the principles generally meet ESMA expectations, although the principles would benefit

² ESMA, “Final Report: Feedback statement on the consultation regarding the role of the proxy advisory industry,” February 2013, at <https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-84.pdf>.

³ See <http://bppgrp.info/>.

⁴ See <http://bppgrp.info/wp-content/uploads/2014/06/BPP-ISS-ComplianceStatement-1406010.pdf> and http://bppgrp.info/wp-content/uploads/2014/05/2014_22-August_Glass-Lewis-Statement.pdf

from better governance and clarity over monitoring.⁵ We believe this type of initiative will be more effective than the requirements included in the proposed Proxy Advisory Firm Reform Act.

We question the rationale for the Proxy Advisory Firm Reform Act, as indicated below.

The view that ISS and Glass Lewis dictate proxy voting results is simply counter-factual.

- For example, ISS recommended against “say on pay” proposals at 12 percent of Russell 3000 companies in 2015, according to Semler Brossy (an independent compensation consulting firm).⁶ But only 2.8 percent of “say on pay” proposals at Russell 3000 companies that year received less than majority support from shareholders.
- To cite another example: fewer than 4 percent of shareholder proposals requesting an independent board chair at 2015 shareholder meetings received majority support, even though ISS recommended in favor of these proposals 36.5 percent of the time and Glass Lewis supported most of the proposals.

⁵ ESMA, “Proxy Advisors Take Steps Towards Increased Transparency,” Dec. 18, 2015; and ESMA, “Follow-up Report on the Development of the Best Practices Principles for Providers of Shareholder Voting Research and Analysis”, Dec. 18, 2015. Both reports are available at <https://www.esma.europa.eu/press-news/esma-news/esma-publishes-report-proxy-advisors%E2%80%99-best-practice-principles>.

⁶ Semler Brossy, “2015 Say on Pay Results: End of Year Report,” January 26, 2016 (<http://www.semlebrossy.com/say-on-pay/entire-2015-proxy-season/>).

Proxy advisory firm influence can be exaggerated by analyses that confuse correlation with causation.

- ISS and Glass Lewis tend to follow investors on governance policy, not lead them. In setting their policy frameworks, the two firms work hard to be in tune with investors (their clients), in part through extensive consultative processes, and to consider empirical evidence. Their franchises are built on credibility with investors. As a result, advisors' views tend to be consistent with those of many funds. Indeed, if there were a sharp divergence, we would expect to see advisors punished in the marketplace.
- Investors and proxy advisory firms that seek to take an investor perspective may tend to come to similar conclusions on some issues. They may do so based on empirical evidence, as well as broader social context. For example, a 2014 study showed that public opinion influences both the voting behavior of investors—as measured by mutual fund voting—and proxy advisors' recommendations.
- That said, as discussed further below, there is diversity of viewpoint among investors on many issues, and the proxy advisory work of ISS and Glass Lewis is dominated by custom policies geared to specific clients.
- On the large majority of votes, ISS, Glass Lewis and investors are in agreement with board recommendations, along with the large majority of shareholder

opinion. Among the minority of proposals that arouse some substantial measure of debate, there are significant differences between the proxy advisory firms and their clients, and indeed between the two proxy advisory firms.

- In areas of convergence of investor views that are in tension with those that tend to be held by corporate managers, we see little evidence for the proposition that ISS and Glass Lewis “advocacy” is the driver.
 - For example, we do not believe that the frequent, overwhelming votes supporting annual election of all directors (and opposing staggered elections) has much to do with the proxy advisory firms. A substantial majority of institutional asset owners and asset managers decided some time ago that they prefer director accountability to shareholders through an annual vote.
 - There are even significant areas of relative convergence among investors in looking at executive pay, a more complex topic. Holders of a large majority of shares in most U.S. public companies have a strong preference that executive compensation structures align pay with performance, and that has tended to create sensitivity to special awards unrelated to performance, and large awards on departure to CEOs who do not have successful performance records.

Discussions of proxy advisory firms often assume that a proxy advisor makes a single recommendation for each ballot item, and clients follow in lockstep. That is not the case.

- Many funds vote internally using their own staff, and proxy advisor research and recommendations are among the data considered in making proxy voting decisions. Even funds that delegate their voting to a proxy advisor are not “outsourcing” their voting. Funds are generally notified of proxy advisors’ recommendations and retain the ability to change the vote cast on their behalf. The client may perform a case-by-case review of certain highly complex proposals, such as a proposed merger, while instructing the advisor to vote in accordance with the fund’s customized proxy voting guidelines for other proposals. These guidelines are fund-driven, not advisor-driven, and have the sophistication to take into account numerous factors relevant to the vote.
- Funds that delegate are not all voted according to the advisory firms’ “benchmark” recommendations, those based on the firms’ own standard voting guidelines. A survey of CII members revealed that more than three-quarters of funds delegating voting to third-party advisors had their own guidelines; thus, the advisors’ recommendations reflected the funds’ judgments regarding the appropriate way to analyze various types of ballot items.
- Each of CII’s 10 largest voting members, with total assets exceeding \$1.2 trillion, votes based on fund-developed proxy voting guidelines, whether they vote

internally or delegate to a manager or voting agent. Similarly, at least 18 of the 20 largest asset management firms, with more than \$26 trillion in assets under management, have their own proxy voting guidelines. There are some areas of significant agreement, and other areas of difference. Most of these investors have internal teams dedicated to governance that inform proxy voting decisions, in tandem with proxy voting committees and/or portfolio managers and analysts.

We believe that the proxy advisory firms' role is less central than it was 10 years ago, as direct engagement of investors and companies (increasingly including corporate board members) has stepped up substantially.

- Asset managers, pension funds and others have taken greater interest in proxy voting, and have developed much greater in-house expertise to address proxy-related issues. For example, BlackRock Chairman and CEO Larry Fink has remarked on the commitment of his firm to “consistent and sustained” engagement with portfolio companies.⁷
- Moreover, investors have become much more active in engaging their portfolio companies on governance issues. Vanguard CEO Bill McNabb said in 2015: “At Vanguard, we’ve been on a journey toward increased engagement over the past decade or so. Our peers in the mutual fund industry have as well.”⁸ And companies and boards have become much more active in seeking engagement

⁷ Letter to leading global company CEOs, including the S&P 500, as reported in the BlackRock blog, April 14, 2015.

⁸ F. William McNabb, “Getting to Know You: The Case for Significant Shareholder Engagement,” Harvard Law School Forum on Corporate Governance and Financial Regulation, June 24, 2015.

with their shareholders on governance matters, leading to many more substantive discussions directly between companies and their shareholders, without intermediaries.

- As a May 2013 article in *The Wall Street Journal* (entitled “For Proxy Advisers, Influence Wanes”) summarized:

The landscape for proxy advisers is getting rockier.

Big firms that sell recommendations on how to vote in corporate elections are losing some of their relevance, as companies more aggressively court key investors ahead of big votes and those investors handle more of the voting analysis themselves.⁹

The bill seeks to micromanage both the SEC and proxy advisory firms.

- The attempt to regulate proxy advisory firms directly by statute, and in some detail, appears to us to be unwise. The draft bill¹⁰ would require each proxy advisory firm to provide draft recommendations to companies in advance of publication of the reports, in “a reasonable time” and with the opportunity for the company to lobby the report writer(s) on the recommendations. Aside from First Amendment issues likely raised by this provision, we note that in the context of financial analyst reports, Financial Industry Regulatory Authority (FINRA) rules specifically prohibit the same type of pre-review – precisely the opposite policy. ISS does share drafts with larger U.S. companies, and we respect ISS’s decision to do so as part of its methodology. But we would urge Congress not to mandate this step. Aside from general concerns on overreach, we believe such a

⁹ *The Wall Street Journal*, May 22, 2013.

¹⁰ As published on the House Financial Services Committee web site page for this hearing (as of May 16, 2016).

mandate could significantly increase proxy advisory firm costs, posing a significant barrier to entry.

- The bill mandates a particular approach to handling concerns from management at subject companies. Each firm would be required to employ an ombudsman to receive complaints on the accuracy of voting recommendations from "the subjects of the proxy advisory firm's voting recommendations," and resolve those complaints prior to the vote date. This would appear to make the proxy advisory firms highly vulnerable to ill-founded, trivial, and even mischievous complaints from issuers. This includes issuers that may seek to disrupt the firms, particularly amidst the highly concentrated spring "proxy season," when time constraints that are dictated by corporate reporting requirements and state law rules prescribe when annual meetings must take place. It is notable that there apparently is no requirement for the ombudsman to hear complaints from investors, who pay for the service, unless and to the extent the "subjects...of the recommendations" (as the proposal frames this) is interpreted to include shareholder proponents. We have concern that this provision would substantially tilt influence in proxy voting toward management, at least in the absence of a proxy fight and direct independent solicitation by a shareholder.

The SEC has been intelligent and effective in its approach to proxy advisory firms, under existing authority.

- CII welcomed the SEC staff's 2014 guidance on proxy advisors, which was largely consistent with CII's views. The staff affirmed that registered investment

advisors are not required to vote all proxies, a view that CII has long shared. CII welcomed the staff's reminder that investment advisors have a duty to maintain sufficient oversight of third-party voting agents. CII believes many investment advisors were already doing this, but the guidance may be prompting some to be more diligent about their oversight processes. We believe the guidance was positive and we do not see the need for further action by the commission.

The SEC Regulatory Accountability Act

We believe the "SEC Regulatory Accountability Act" is not necessary, and would risk significant damage to the SEC's ability to regulate U.S. capital markets.

The proposal is not necessary.

With a membership of long-term shareholders interested in maximizing share values, CII believes it is vital to avoid unnecessary regulatory costs that could hinder the capital markets and the economy. However, we also believe that at best it is not clear how the provisions of the SEC Regulatory Accountability Act would improve the cost-effectiveness of the SEC's existing rulemaking process or benefit long-term investors, the capital markets, or the overall economy. We note in this regard the proposal does not include any provision that would explicitly require the SEC to consider the costs and benefits of a proposal or rule from the perspective of long-term investors.

The commission's rulemaking process is already governed by a number of legal requirements, including those under the federal securities laws, the Administrative

Procedure Act, the Paperwork Reduction Act of 1980, the Small Business Regulatory Enforcement Fairness Act of 1996, and the Regulatory Flexibility Act.¹¹ Moreover, under the federal securities laws the SEC is generally required to consider whether its rulemakings are in the public interest and, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.¹² Since the 1980s, the commission has conducted, to the extent possible, an analysis of the costs and benefits of its proposed rules.¹³

The SEC has further enhanced the SEC rulemaking process in recent years.¹⁴ That process is, and has long been, far more extensive than that of any other federal financial regulator.

The proposal would pose substantial risk of damage to the SEC's regulatory capacity and to U.S. capital markets.

We believe the bill is based on a faulty premise that a generally accepted methodology currently exists that allows the SEC in a cost-effective manner to reliably measure and then balance the costs and benefits of its proposals or rules consistent with its mandate to protect investors. We note it is well established that while some of the costs of some

¹¹ Financial Services and Bailouts of Public and Private Programs: Hearing Before the H. Comm. on Oversight and Gov't Reform, 112th Cong. 2 (2012) (testimony of Chairman Mary L. Schapiro, U.S. SEC), <http://www.sec.gov/news/testimony/2012/ts041712mls.htm>.

¹² *Id.*

¹³ *Id.* at 3.

¹⁴ See for example guidance from the SEC Division of Risk, Strategy, and Financial Innovation (RSFI) and the Office of the General Counsel (OGC) issued in 2012.

SEC proposals or rules can be reliably estimated, the same is generally not true for the benefits.¹⁵

In most instances, the benefits of a commission proposal or rule relating to the financial markets, particularly a proposal or rule designed to protect investors, cannot be reliably measured. Thus, the proposal would appear to impose on the SEC a costly, one-sided, incomplete analysis in which the commission would be hard pressed to satisfy the required determination that the benefits of a proposal or rule "justify the costs of the regulation." As a result, the proposal could, for all practical purposes, prohibit the SEC from issuing any substantive proposals or rules in furtherance of its mission to protect investors—the element of its mission that, in our view, is most critical to maintaining and enhancing a fair and efficient capital market system.

Moreover, the proposal's requirement that the SEC review existing regulations within one year of passage, and at least every five years thereafter, in our view would consume the SEC's existing regulatory resources and likely require substantial additional dedicated resources. We believe this likely would paralyze SEC regulatory capacity.

We urge the subcommittee to thoroughly study the potential unintended consequences and costs from this proposal to effective financial regulation, and to capital markets.

¹⁵ See, e.g., U.S. Government Accountability Office, GAO-13-101, Dodd-Frank Act: Agencies' Efforts to Analyze and Coordinate Their Rules 18 (Dec. 2012), <http://www.gao.gov/assets/660/650947.pdf> ("As we have reported, the difficulty of reliably estimating the costs of regulations to the financial services industry and the nation has long been recognized, and the benefits of regulation generally are regarded as even more difficult to measure.").

Statement of
Michael McCauley
Senior Officer – Investment Programs & Governance
Florida State Board of Administration (SBA)
for the
Subcommittee on Capital Markets and Government Sponsored
Enterprises
of the
United States House of Representatives
Committee on Financial Services
Tuesday, May 17, 2016
Examining Legislative Proposals to Enhance Capital Formation,
Transparency, and Regulatory Accountability

Dear Mr. Chairman Garrett and Ranking Member Maloney:

I am pleased to provide written testimony to the Committee on behalf of the Florida State Board of Administration (SBA). The Florida SBA respectfully requests that the following statement be included in the record for the May 17, 2016, hearing convened by the Subcommittee on Capital Markets and Government Sponsored Enterprises on the "Proxy Advisory Firm Reform Act of 2016" introduced by Rep. Duffy¹, and the "SEC Regulatory Accountability Act" introduced by Rep. Garrett.

My testimony includes a brief overview of the Florida State Board of Administration and its investment approach, an overview of our proxy voting process and procedures and use of proxy advisers to assist the SBA in fulfilling its fiduciary duty and related proxy voting obligations. I will also discuss our rationale for opposing several proposed reforms.

Florida State Board of Administration

The Florida SBA manages more than thirty separate investment mandates and trust funds, some established as direct requirements of Florida law and others developed as client-initiated trust arrangements. In total, the SBA manages approximately \$180 billion in assets, providing retirement benefits for more than 1 million current and former employees of Florida state

¹ The SBA utilizes proxy advisory services from the two largest U.S. proxy advisory firms, Glass Lewis & Co. ("Glass Lewis") and Institutional Shareholder Services ("ISS"), paying approximately \$188,280 annually to ISS and \$135,750 annually to Glass Lewis for proxy research and other corporate governance consulting.

government, public schools, universities and colleges, and many cities and local government districts. One of these funds, the Florida Retirement System Pension Plan ("FRS pension plan"), accounts for approximately 85 percent of the total assets under management. The FRS pension plan provides more than \$6 billion in annual benefit payments to more than 1 million individuals.² The SBA has a long history of successful fund management. Under Florida law the SBA manages the funds under its care according to fiduciary standards similar to those of other public and private pension and retirement plans. The SBA must act in the best interests of the fund beneficiaries. This standard encompasses all activities of the SBA, including the voting of all proxies held in funds under SBA management.

Proxy Voting

Proxy voting is an integral part of managing assets in the best interests of fund clients and beneficiaries. In fiscal year 2015, the Florida State Board of Administration executed votes on thousands of public companies.³ For the trailing twelve month period ending March 31, 2016, the SBA voted 10,280 public company proxies covering 97,724 individual voting items. Individual voting items included director elections, audit firm ratification, executive compensation plans, merger & acquisitions, and various other management and shareowner proposals. Among all voted items during the year, the SBA voted in line with management-

² "State Board of Administration 2015 Investment Report,

http://www.sbafla.com/fsb/Portals/Internet/Reports/2014_2015_AIR.pdf

³ 2015 Corporate Governance Annual Summary, State Board of Administration,

http://www.sbafla.com/fsb/Portals/Internet/CorpGov/ReportsPublications/2015_SBACorporateGovernanceAnnualSummaryV2.pdf.

recommended ballot items 76.8 percent of the time. However, at 7,676 annual investor meetings (approximately 75 percent of all voted meetings), the SBA cast at least one vote against a management-recommended item.

The SBA makes all proxy voting decisions independently. To ensure that the SBA meets its fiduciary obligations, it established the Corporate Governance & Proxy Voting Oversight Group (“Proxy Committee”) as one element in an overall enterprise risk management program. The Proxy Committee is comprised of several SBA staff members including myself, the Deputy Executive Director, the Chief Risk & Compliance Officer, the Co-Senior Investment Officers over Global Equity, and the Director of Investment Risk Management. The Proxy Committee, which meets at least quarterly each year, oversees the SBA’s proxy voting process and reviews and approves significant and contested matters regarding corporate governance and voting.

The SBA developed written corporate governance principles and proxy voting guidelines and used these to cast votes on common issues expected to be presented for shareowner ratification. The SBA’s proxy voting guidelines reflect its belief that good corporate governance practices will best serve and protect the funds’ long-term investments. The voting guidelines are reviewed and approved by the SBA’s Investment Advisory Council and Board of Trustees on an annual basis.

The SBA’s voting policies are developed using empirical research, industry studies, investment surveys, and other general corporate finance literature. SBA voting policies are based both on

market experience and balanced academic and industry studies, which aid in the application of specific policy criteria, quantitative thresholds, and other qualitative metrics. The SBA's proxy voting guidelines cover more than 350 typical voting issues, and we vote at least 80 percent of these issues on a case-by-case basis, following a company-specific assessment. The SBA discloses all proxy voting decisions once they have been made, normally several days prior to annual shareowner meetings. Historical proxy votes are also archived for a period of five years and are available electronically on the SBA's website.

To supplement its own proxy voting research, the SBA purchases research and voting advice from several outside firms, principally from two leading proxy advisory and corporate governance firms: Glass, Lewis & Co. ("Glass Lewis") and Institutional Shareholder Services ("ISS"). The SBA uses additional external research providers for more narrow and specialized analyses covering executive compensation, federal sanctions protocol, as well as environmental, social, and governance (a.k.a. "ESG") rankings and corporate benchmarking. Glass Lewis's research covers the entire U.S. stock universe of Russell 3000 companies and almost all publicly-traded, non-U.S. equities. ISS provides specific analysis of proxy issues and meeting agendas on all publicly traded U.S. and non-U.S. equity securities. Additionally, the SBA currently executes its global equity votes on ISS's voting platform, ProxyExchange.⁴

Effective July 1, 2016, all SBA proxy voting will be conducted on Glass Lewis's ViewPoint voting system.⁵ "Corporate Governance Principles & Proxy Voting Guidelines," State Board of Administration of Florida (2015), http://www.sbafla.com/fsb/Portals/Internet/CorpGov/ProxyVoting/2015_SBACorporateGovernancePrinciplesProxyVotingGuidelines10162015.pdf.

When making voting decisions, the SBA considers the research and recommendations provided by Glass Lewis and ISS, along with other relevant facts and research, and the SBA's own proxy voting guidelines.⁵ Notably, the SBA makes voting decisions independently and in what it considers to be the best interests of the beneficiaries of the funds it manages.⁶ Proxy advisor and governance research firm recommendations inform but do not determine how the State Board of Administration votes. When we have compared the proxy votes cast by the SBA against the recommendations of ISS over the most recent 12 month period ending April 2016, voting correlations ranged between 0 and 100 percent depending on the specific voting issue, averaging 87 percent across all voting items.

On corporate governance practices where the SBA has taken a typically more aggressive policy stance—for example, individual director elections and executive compensation—voting statistics between the SBA and external proxy advisors differ markedly. Other historical reviews of SBA voting correlation have shown both lower and higher correlations with individual external proxy adviser recommendations, depending on both the time period studied and specific voting categories in question. Over the last few years, the SBA has voted with management (the “management-recommended-vote”) approximately 80 percent of the time across all voted portfolios.

⁵ “Corporate Governance Principles & Proxy Voting Guidelines,” State Board of Administration of Florida (2015), http://www.sbafla.com/fsb/Portals/Internet/CorpGov/ProxyVoting/2015_SBACorporateGovernancePrinciplesProxyVotingGuidelines10162015.pdf.

⁶ 2015 Corporate Governance Annual Summary, State Board of Administration, http://www.sbafla.com/fsb/Portals/Internet/CorpGov/ReportsPublications/2015_SBACorporateGovernanceAnnualSummaryV2.pdf

For advisory votes on executive compensation (“say on pay”), one of the most closely tracked proxy adviser recommendations, the SBA clearly charts its own path. Over the last five years, both Glass Lewis and ISS have recommended votes against approximately 15 percent of management say-on-pay proposals. The SBA routinely votes against double to triple the percentage of such voting proposals.

Comments on Proposals for Proxy Advisor Regulations

The Proxy Advisory Firm Reform Act appears to be unnecessary and counterproductive. There is insufficient empirical evidence to suggest that institutional investors are abdicating and outsourcing their voting responsibilities. We believe that proxy advisory firms play a useful role for institutional investors and that the bill proposes new requirements without sufficient understanding of how proxy voting works in practice today and without analysis of costs and benefits. Moreover, an effect of the bill would seem to place proxy advisory firms back squarely at the center of corporate governance debates, amidst substantial increase in direct engagement between companies (including boards) and their shareowners.

As these proposals would have significant impacts on investors whom the SEC is charged to protect, we believe it is important before moving forward that the Subcommittee seek strong and current empirical evidence and consult more thoroughly with investors, including institutional investors who manage a substantial majority of asset within U.S. capital markets. We understand that this hearing will include direct testimony from an officer of only one

investment fund focused on private equity securities, which is ironic given private equity does not routinely make voting decisions that are even covered by proxy advisors. The Subcommittee should seek broader participation from institutional investors before moving forward on the specific legislation contemplated here. We also believe the proposal may pose a further barrier to entry of new proxy advisory firms.

Registration with the SEC

Proposals to require mandatory registration with the Exchange are likely to imbue the regulatory framework with challenges of its own. For example, how would SEC staff go about making a determination of the accuracy of a proxy advisor's recommendation?

Recommendations are opinions based on underlying facts, and it is unclear how proxy advisor recommendations themselves could be determined to be accurate, not to mention the level of integrity. Apart from verifying that the recommendation was based on accurate (and factual) information, SEC staff would have to make difficult, qualitative judgments based on the company in question, the voting item evaluated, and other policy nuances beyond the skillset of an disinterested, outside observer. Legal, accounting, and executive compensation advisors to corporate issuers are not required to pre-disclose their recommendations to investors or register with the SEC; the advisors that investors choose to use to evaluate these issues from the investor perspective should be treated similarly. We believe none of these advisors should be required to register with the SEC or pre-disclose their recommendations.

Conflict Disclosures

The SBA supports full disclosure and management of all conflicts of interest that a proxy advisor may have. We also support appropriate oversight of staff and appropriate separation of proxy advisory and non-advisory services. When services are provided to both proxy advisory clients and the corporate issuer upon such proxy advice is rendered, this should be disclosed to clients. As the largest proxy advisor in the space, ISS has been criticized by some for its Corporate Services consulting, provided to companies on a fee basis. Based on the SBA's 20 plus years as an ISS client, we are not aware of a single case in which a corporate issuer receiving consulting services had their proxy advisory recommendations affected (either positively or negatively) by the consulting services. Changes we have observed are universally caused by tangible changes in corporate governance policy and practices. We remain skeptical of such accusations against the industry.

Separate no-action letters issued by the SEC in 2004 to Egan Jones Proxy Services and ISS are consistent with several of the current proposed reforms, including the management by clients of any conflicts of interest and due diligence of proxy advisor's capacity and competency to adequately analyze proxy issues. Furthermore, on June 30, 2014 the SEC Division of Investment Management and Division of Corporation Finance issued guidance (Staff Legal Bulletin No. 20) for proxy advisers and investment advisers, providing guidance on investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms, as well as on the

availability and requirements of two exemptions to the federal proxy rules often relied upon by proxy advisory firms.

The SEC's bulletin outlined several new requirements affecting both proxy advisors and fund managers. The main changes included requirements for proxy advisors to disclose, "significant relationships or material interests to the recipient of the advice." The SEC also clarified they are not required to register with the SEC and were not required to provide publicly-traded companies time to review proxy advisers' voting recommendations prior to client distribution. For fund managers (institutional investors), the SEC bulletin requires investors to review their proxy voting policies at least annually to ensure proxies are voted in the best interests of investor clients and also requires them to determine whether the proxy advisers they use have "the capacity and competency to adequately analyze proxy issues."

Previous requirements for proxy advisors to disclose "material" interests in relation to companies receiving consulting services were largely positive for clients, although by 2014 the industry was already taking similar steps through the creation of the Best Practices Group (BPG), in response to a final report by the European Securities and Markets Authority (ESMA) in early 2013. In its report, ESMA determined that binding regulation was not necessary but the appropriate approach was for the industry to develop an industry code of conduct. The major proxy advisors operating in Europe formed the BPG to develop just such a code, Best Practice Principles for Governance Research Providers (Principles), which the signatories committed to applying globally. The three Principles, Service Quality (encompassing transparency), Conflicts

of Interest Management and Communications Policy (stakeholder engagement), and seems to address the main issues raised in the proposed bill. The signatories provide information on their websites, in their formal Statements of Compliance, discussing how they comply with the Principles.⁷

Proxy Advisor Influence

Although most proxy advisor clients praise the industry for providing critical analytical research, opponents increasingly claim there are problems. They assert the proxy advisory marketplace is too concentrated, lacks methodological rigor, have too much power over client voting decisions, and should be regulated by the SEC. However, the view that ISS and Glass Lewis dictate proxy voting results is simply counter-factual. For example, ISS recommended against “say on pay” proposals at 12.0 percent of Russell 3000 companies in 2015, according to Semler Brossy (an independent compensation consulting firm).⁸ But only 2.8 percent of “say on pay” proposals at Russell 3000 companies that year received less than majority support from shareholders. Fewer than four percent of shareowner proposals requesting an independent board chair at 2015 shareholder meetings received majority support, even though ISS recommended in favor of these proposals 36.5 percent of the time and Glass Lewis supported most of the proposals.

⁷ <https://bpggrp.info/>

⁸ Semler Brossy, “2015 Say on Pay Results: End of Year Report,” January 26, 2016 (<http://www.semlebrossy.com/say-on-pay/entire-2015-proxy-season/>).

ISS and Glass Lewis follow investors on governance more than lead them. In setting their policy frameworks, the firms work hard to be in tune with their investors, in part through extensive consultative processes and consideration of empirical evidence. Their franchises are built on credibility with investors. As a result, advisers' views tend to be consistent with those of many funds. Indeed, if there were a sharp divergence, we would expect to see advisers punished in the marketplace. On some issues, empirical evidence, similarity of perspective of investors, and other pressures including social context are likely lead to similar voting conclusions. For example, a 2014 study showed that public opinion influences both the voting behavior of investors—as measured by mutual fund voting—and proxy advisers' recommendations.⁹

We do not believe that the frequent, overwhelming votes supporting annual election of all directors (and opposing staggered elections) have much at all to do with the proxy advisory firms. A substantial majority of institutional asset owners and asset managers decided several years ago that they prefer director accountability to shareowners through an annual vote. There are even significant areas of relative convergence among investors in looking at executive pay, a more complex topic. Holders of a large majority of shares in most U.S. public companies have a strong preference that executive pay align pay with performance, and that has tended to create sensitivity to special awards unrelated to performance and large awards on departure to CEOs who do not have successful performance records.

⁹ Reena Aggarwal et al., "Influence of Public Opinion on Investor Voting and Proxy Advisors" (working paper Apr. 2014) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2447012)

Lastly, we believe that the proxy advisory firm role is less central than it was 10 years ago, as direct engagement of investors and companies increasingly includes corporate board members. Asset managers, pension funds and others have taken greater interest in proxy voting and corporate governance of owned firms and developed much greater in-house expertise to address proxy-related issues. Moreover, investors have become much more active in engaging their portfolio companies on governance issues, and companies and boards have become much more active in seeking engagement with their shareowners on governance matters, leading to many more substantive discussions directly between companies and their shareowners, without intermediaries.

Micro-management of Proxy Advisors

As currently written, the bill appears to micromanage both the SEC and proxy advisory firms. The attempt to regulate proxy advisory firms directly by statute, and in some detail, appears to us to be unwise. The draft bill¹⁰ would require each proxy advisory firm to provide draft recommendations to companies in advance of publication of the reports, in “a reasonable time” and with the opportunity for the company to lobby the report writer(s) on their recommendation. Aside from First Amendment issues likely raised by this provision, we note in the context of financial analyst reports, FINRA rules specifically prohibit the same type of previewing. We note that ISS does voluntarily share drafts with larger companies and respect ISS’s decision to do so as part of its methodology. Notably, Glass Lewis provides about 500 US

¹⁰ As published on the House Financial Services Committee web site page for this hearing (as of May 16, 2016).

companies with access to the data to be used in its reports, through its Issuer Data Report sent to companies prior to their report being made available to clients, but not the full analysis or recommendations. But we would urge Congress not to mandate this step. Aside from general concerns on overreach, we believe such a mandate could significantly increase proxy advisory firm costs, posing a significant barrier to entry and impair the timely delivery of research to us and other clients.

While the Florida State Board of Administration acknowledges the valuable role that proxy advisers play in providing pension funds with informative, accurate research on matters that are put before shareowners for a vote, we believe proxy advisory firms should provide clients with substantive rationales for vote recommendations. However, there seems no good rationale for allowing entities that are not paying for such advice and corporate research to gain access (and potentially influence the outcome) ahead of, or concurrent to, a proxy advisor's investor clients.

The bill mandates a particular approach to handling concerns from management at issuer companies. Each firm would be required to employ an ombudsman to receive complaints on the accuracy of voting recommendations from "the subjects of the proxy advisory firm's voting recommendations," and resolve those complaints prior to the vote date. This would appear to make the proxy advisory firms highly vulnerable to ill-founded, trivial, and even mischievous complaints from issuers, including those that may seek to disrupt the firms, particularly amidst the highly-concentrated spring "proxy season," with time constraints that are dictated by

reporting requirements and state law rules on when annual meetings must take place. We have engaged with companies who have complained about trivial or insubstantial “errors” in the ISS advisory that did not impact our analysis and voting decision. This mandate appears entirely misguided, but it is notable that there apparently is no requirement for the ombudsman to hear complaints from investors, who pay for the service, unless and to the extent the term “subjects...of the recommendations” is interpreted to include shareowner proponents. We have concern that this provision would substantially tilt influence in proxy voting toward management, at least in the absence of a proxy fight and direct independent solicitation by a shareholder.

As well, the SBA does not support the disclosure of clientele information without the express written consent and authorization from the client before distribution to any third parties. In addition, it appears that such disclosure would violate existing FINRA rules governing the release of such information.

Conclusion

For these reasons, at this point in time, the SBA believes that proxy advisers should not be required to register as investment advisers under the Investment Advisers Act of 1940. Given the industry’s efforts to improve proxy advisors’ client disclosures, conflict of interest procedures, and related investor-client protections, we don’t believe proxy advisors should be

regulated or required to register with the SEC. We believe there is little to no value, and potential harm, in requiring proxy advisors to conform with the requirements of the Duffy bill.

Proxy advisor disclosures should include material information regarding the process and methodology by which the firms make their recommendations, aimed at allowing all stakeholders to fully understand how an individual proxy adviser develops voting recommendations. This makes adviser recommendations more valuable to institutional investor clients and more transparent to other market participants. Existing industry practices and client disclosures complement the aims of existing securities regulation, which seeks to establish full disclosure of all material information. It is my view that proxy advisor registration is not required, and legislation to place new requirements on the SEC and proxy advisors is unwarranted at this time.

Thank you, Mr. Chairman for allowing me to provide a written statement for this hearing.



Statement of

**Katherine H. Rabin
Chief Executive Officer
Glass, Lewis & Co.**

for the

**Subcommittee on Capital Markets and Government
Sponsored Enterprises**

of the

**United States House of Representatives
Committee on Financial Services**

Tuesday, May 17, 2016



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Dear Mr. Chairman Garrett, Ranking Member Maloney and members of the Capital Markets and Government Sponsored Enterprises Subcommittee:

We have reviewed the draft bill sponsored by Reps. Sean Duffy (R., Wis.) and John Carney (D., Del.), which would result in the enactment of the "Proxy Advisory Firm Reform Act of 2016", and we appreciate the opportunity to provide you with our views on the draft bill, as well as additional information on Glass Lewis and the proxy advisory industry that we believe will be useful to you in this process.

Founded in 2003, Glass Lewis is a leading independent governance services firm that provides proxy voting research, recommendations and custom research and voting services to more than 1,200 institutional investor clients globally. While, for the most part, investor clients use Glass Lewis' research to help them make proxy voting decisions, they also use Glass Lewis research when engaging with companies before and after shareholder meetings. Through Glass Lewis' Web-based vote management system, Viewpoint, Glass Lewis also provides institutional investor clients with the means to receive, reconcile and vote ballots according to custom voting guidelines and record-keep, audit, report and disclose their proxy votes. Based in San Francisco, California, Glass Lewis is a portfolio company of the Ontario Teachers' Pension Plan Board ("OTPP") and Alberta Investment Management Corp. ("AIMCo") with 350+ employees located in San Francisco; New York; Limerick, Ireland; Sydney, Australia; and Karlsruhe, Germany.

Glass Lewis' clients range in size from investors with a few million dollars in assets under management ("AUM") to those with several trillion dollars US in AUM. These clients seek advice on as few as 20 companies a year in a single market to several thousand equities spanning the globe.

In addition to investors, Glass Lewis also sells research reports to public companies and their advisors, such as law firms, consultants and proxy solicitors. Corporate issuers can acquire research reports on their companies directly from Glass Lewis or via Equilar, a provider of executive compensation data. However, all clients of all types – investor, issuer and advisor – get access to Glass Lewis research at the same time, upon publication.

In Glass Lewis' experience, among institutional investors of all types (pension funds, mutual funds, asset managers and hedge funds), the propensity for robust voting and engagement programs has increased dramatically over the past decade. This trend is not particular to those with activist or active-investing strategies. Moreover, investors of all types and strategies are increasingly tapping their proxy advisor for customized research and voting services. Indeed, the majority of Glass Lewis' clients vote according to a custom policy rather than relying exclusively on recommendations developed based on the Glass Lewis policy.

Given the expertise, relationships and investment of time and resources required to constructively engage with issuers, especially for investors with global investments who want



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to exercise their ownership rights across all holdings, it is in the best interest of investors and their beneficiaries for investors to make use of the services offered by proxy advisors to complement their own research. Proxy advisors ultimately help clients manage voting responsibilities in an accurate, timely and efficient manner.

General Comments Regarding the Proposed “Proxy Advisory Reform Act of 2016”

While institutional investors may use proxy advisor research and recommendations in their decision-making processes, Glass Lewis is neither an investment research firm nor does the firm have the authority to make voting decisions on clients’ behalf.

Providing corporate governance services to institutional investors is Glass Lewis’ core business. We do not offer consulting services to corporate issuers, directors, dissident shareholders or shareholder proposal proponents. When an issuer or a shareholder proponent purchases a report from Glass Lewis, the existence of a potential conflict is noted prominently on the front page of the report and a specific description of the purchase is specifically noted in the reports appendix. Detailed information on policies and procedures intended to ensure the independence of Glass Lewis’ research and analysis, as well as information regarding Glass Lewis engagement policies and market-by-market policies and methodologies for evaluating companies, are publicly available at www.glasslewis.com.

Institutional investors have a fiduciary responsibility to vote proxies in a manner that is in the best interests of their beneficiaries. Availing themselves of qualified advisors – such as Glass Lewis – whose interests are aligned with those of their institutional investor clients to help fulfill this responsibility is prudent and by no means undermines an owner’s prerogatives.

Glass Lewis agrees with the aims of the proposed bill in “fostering accountability, transparency, responsiveness, and competition in the proxy advisory firm industry.” In fact, over the past five years, Glass Lewis has actively engaged with regulators, investors, issuers and other market stakeholders regarding the role of proxy advisors to that end. (Information on Glass Lewis’ engagement policies is available in the Glass Lewis Issuer Engagement Portal at <http://www.glasslewis.com/issuer-overview/>.) Moreover, Glass Lewis already meets or exceeds many of the requirements included in the proposed bill, particularly with regard to transparency, conflict management and the adoption of a code of ethics. However, we believe certain assumptions underlying the draft bill are outdated and based on erroneous information. Specifically, there are certain provisions of the proposed legislation that we believe would cause a severe negative impact and detrimental consequences not only on proxy advisors and their investor clients but on the capital markets as a whole.

Specifically, Section 4(h) of the draft bill proposes to require that a registered proxy advisory firm (a) have staff sufficient to produce “accurate and reliable proxy voting recommendations,” (b) have procedures permitting companies to have access to their proxy voting recommendations in draft form and to comment on them before publication



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“including an opportunity to present details to the person(s) responsible for developing the recommendation in person or telephonically”, (c) employ an ombudsman to receive complaints about “the accuracy of voting recommendations” from the issuers that are the subjects of the recommendations, and (d) “resolve those complaints in a timely fashion and in any event prior to voting on the matter to which the recommendation relates.”

Glass Lewis is very concerned that the effect of these provisions, particularly the requirements to disclose our analysis and recommendations to issuers before publication and to meet with issuers about our recommendations, will infringe upon the firm’s ability to independently analyze the issues and to make unbiased voting recommendations to clients.

But, most importantly, we believe this type of dialogue would exacerbate the lingering misconception that companies should be primarily concerned with the views of proxy advisors rather than those of their shareholders. It would also create the perception that proxy advisors are standard setters, or even quasi-regulators, empowered by their clients to negotiate changes to companies’ governance or compensation strategies.

Investors take their fiduciary responsibility to vote shares, engage with companies and operate as good stewards very seriously and placing proxy advisors in between companies and investors in this regard inhibits direct engagement. Investor protection will be better served by preserving and enhancing the independence of proxy voting advisors from undue influences.

Glass Lewis does not see the basis for requiring proxy voting advisors to take these steps. We base our analysis and recommendations about proxy votes strictly on information that is publicly available, whether filed by issuers with the SEC or made available publicly on the issuers’ websites or in other widely available publications. There is no justification for requiring Glass Lewis to, in effect, rely on information provided in such private meetings that may not be public or broadly accessible to shareholders in analyzing the matters on which shareholders are asked to vote.

Glass Lewis strongly believes its analysis, research and recommendations should be based on publicly available information and encourages companies to provide comprehensive and clear disclosure about the relevant issues for consideration by shareholders. For this reason, Glass Lewis often engages in discussions with companies outside the proxy season, but generally does not engage in discussions with companies during the proxy solicitation period unless we decide to conduct a Proxy Talk conference call with the company, which we record for access by our clients. However, we will speak or meet with companies during the solicitation period, if necessary, to discuss purported factual errors or omissions in our reports.

Public companies holding a meeting of shareholders have the opportunity, under the proxy rules, to provide all of the information necessary for shareholders to make an informed voting decision and to make statements in support of management’s recommendations and against initiatives that management opposes. These materials are always available to Glass Lewis’



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clients, no matter whether Glass Lewis recommends voting for or against management's recommendations. However, Glass Lewis is not able to make representations regarding the accuracy or reliability of data and information used to develop its services, as the vast majority of the data and information is sourced from public disclosures. It is not Glass Lewis' responsibility to ensure the accuracy of the information contained in public companies' disclosure.

Requiring proxy voting advisors to accept pre-publication comments and to meet with issuers before publishing their proxy voting analyses and recommendations presents a very real risk of conflict of interest that may detract from the independence with which proxy voting advisors are expected to conduct themselves. We note that FINRA has adopted rules addressing analogous conflicts of interest arising from the publication of research reports by research analysts associated with broker-dealer firms. FINRA Rule 2241 requires broker-dealer firms to adopt written policies and procedures "reasonably designed to promote objective and reliable research that reflects the truly held opinions of research analysts and to prevent the use of research reports or research analysts to manipulate or condition the market or favor the interests of the member or a current or prospective customer or class of customers."

Among other things, these procedures are required to insulate the research analysts and their reports from influence by the firm's investment banking interests, including by prohibiting prepublication review, clearance or approval by any persons not directly responsible for the preparation, content and distribution of the research reports (other than legal and compliance personnel). FINRA permits, but does not require, prepublication review of a research report by a company that is a subject of the report solely for purposes of fact verification, subject to several conditions. Among other things, a member must exclude the research summary, research rating or price target from any such prepublication review, and the research department must obtain legal and compliance authorization if it wishes to make any change to the proposed rating or price target.

Furthermore, requiring by law that proxy voting advisors include input from the subject companies into their analysis of proxy voting issues or recommendations raises serious Constitutional issues relating to freedom of speech under the First Amendment. Glass Lewis strongly opposes any effort to force it to deviate from its independent approach to proxy analysis based on publicly available sources of information. While we recognize that freedom of speech is not absolute, there already exist laws that adequately protect issuers from slander or other forms of harmful speech. Enacting the provisions of Section 4(h) of the draft bill is not necessary to protect issuers from such speech.

The requirements of Section 4(h) also are impractical, considering the realities of proxy voting given that about two-thirds of US companies hold their annual meetings around the same time, i.e. between March and June. Glass Lewis normally publishes its reports on annual general meetings at U.S. companies about three weeks prior to the meeting date. When there



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is a proxy contest, where the situation is more fluid due to potential negotiations and additional filings by both parties, Glass Lewis often publishes its reports closer to the meeting date as it attempts to balance the need to give clients sufficient time to review and digest our analysis with the need to ensure that clients have the complete, up-to-date analysis to support their informed decision-making.

Requiring that all of these steps be taken before voting ignores the fact that Glass Lewis does not decide for clients how or when to vote their shares. Glass Lewis must complete its analysis and recommendations and disseminate them to clients within compressed time frames in order to afford clients sufficient time to consider the information, together with other sources of information they use, and decide for themselves how to vote by the applicable voting deadline. Furthermore, we note that many of our customers are themselves fiduciaries charged with making voting decisions on behalf of their own clients and thus cannot risk missing a voting deadline due to an untimely report.

Moreover, there simply is not enough time from the date a company issues its proxy solicitation materials until the meeting date for proxy voting advisors to prepare their analyses and recommendations, provide access to draft recommendations with an opportunity to comment on them, and also make their employees available to all issuers covered by their recommendations before voting occurs. Glass Lewis provides proxy voting analysis and voting recommendations on 18,000+ companies and 200,000+ voting items every year. If the law were to require Glass Lewis to accept comments on drafts, meet with all issuers, and resolve issuer complaints about the recommendations before publishing its analyses and recommendations to clients, there will inevitably be delays in publication that will interfere with Glass Lewis' ability provide clients sufficient time to consider this information before casting their votes. These sorts of delays would be detrimental to Glass Lewis' business, as it will affect client satisfaction and its ability to fulfill its contractual responsibilities to clients.

Finally, Glass Lewis considers its proxy analysis and voting recommendations to be valuable intellectual property; it charges a fee to clients and issuers wishing to obtain its reports. Glass Lewis believes that forcing it to give away for free its intellectual property, by furnishing all of its analyses and recommendations to issuers prior to publication, would be unprecedented in the area of financial research and would present a risk to the viability of its business.

Inaccuracies of the Proposed Bill

- *While the bill implies that investors "blindly follow" proxy advisors, vote outcomes prove institutional investors make their own voting decisions.*

Since the issuance of the SEC concept release on the proxy system, much of the debate regarding proxy advisors has centered on the perceived influence of their voting advice, based on the belief that institutional investors overly rely on proxy advisor recommendations.



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Proxy advisors help investors execute their fiduciary responsibilities with respect to proxy voting but have no authority to make voting decisions. The majority of Glass Lewis' clients, like the vast majority of the world's largest pension funds and asset managers, vote according to their own custom voting policies. The vote decisions derived by implementing those policies may or may not correspond with Glass Lewis recommendations. When they do correspond, it may be for different reasons. Whether investors elect to follow a proxy advisor's recommendations or derive vote decisions based on their own policy, investors retain the right and ability to oversee the process and vote differently than their policy indicates – which they do quite frequently.

Concerns about overreliance on proxy advisor's advice by some investors are not supported by any evidence and are belied by actual vote results: While Glass Lewis recommended against between 13%-17% of advisory compensation votes since the adoption of the rule in 2010, only about 2% of such proposals are defeated each year. Further, while some investors may have more inclined to be guided or follow their proxy advisor's recommendations in the past, there has been a clear trend toward more customization of voting decisions. In any event, no proxy advisor can control (or in many cases has any knowledge) whether a client is following the recommendation, voting the same way for different reasons or is voting differently than the recommendation.

According to the 2012 study by Tapestry Networks and the IRRC Institute, proxy advisor guidelines and recommendations are used by investors in different ways. Most respondents to the study said they employ custom policies and may use Glass Lewis recommendations as "a point of reference."¹ While some clients may generally or even consistently vote according to the Glass Lewis policy, they regularly review and occasionally override Glass Lewis recommendations. Further, custom policy clients – who represent the majority of Glass Lewis' clients and control a supermajority of clients' assets by dollar value – regularly override the recommendations triggered by their custom policies, as their guidelines are designed to allow for review of many issues on a case-by-case basis. The overrides vary in frequency depending on the client and its approach to the relevant issue.

In the last twelve months (from May 1, 2015 through April 30, 2016), 9.6% of shares voted by clients who generally follow the Glass Lewis policy elected to override the Glass Lewis recommendations on proposals related to political contributions. Nearly 50% of shares of clients voting according to custom policies on this issue overrode their custom recommendations or opted to vote on this issue on a case-by-case basis. In the case of proposals calling for the separation of Chairman and CEO at US companies, 14.9% of shares voted by clients who generally follow the Glass Lewis policy elected to override the Glass Lewis recommendation. Twenty-one percent of shares of clients that vote according to a

¹ Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers, Tapestry Networks and IRRC Institute, Robyn Bew and Richard Fields (June 2012)



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custom policy on this issue overrode their custom recommendations or opted to review and vote on a case-by-case basis.

With regard to the only proposal (the initial compensation vote frequency) specifically raised in the draft bill about the proxy advisor's recommendations having "frustrated congressional intent," the Glass Lewis policy to generally favor annual votes was driven to a large extent through input from investor clients. Therefore, the Glass Lewis policy was a result of investors' preference not the other way around. Further, it is misleading to note that shareholders were "deprived" of the opportunity to decide on the frequency votes since they were indeed given that opportunity and decided, based on their own policies, to favor annual votes. Any commonality between the voting policies of Glass Lewis (or other proxy advisors) and clients' voting policies is generally due to the shared preference for greater shareholder rights including more frequent shareholder input on executive compensation decisions.

The minority of investors that choose to follow the voting recommendations of a proxy advisor do so based on their own decision, after due consideration of the proxy advisor. Investors select an advisor based on a thorough review of the advisor's policy, methodologies, research samples, conflict management policies and procedures, as well as an assessment of the experience and qualifications of the advisor's management and analysts. In all instances, investors retain the right to review and override Glass Lewis recommendations – which they regularly exercise. The right to control the final vote decision rests with the client, not the proxy advisor. In any case, shareholders will again have the opportunity to vote for their preferred frequency since Dodd-Frank requires companies to offer shareholders such a vote at least every six years. (The next vote on this issue at most companies will be in 2017.)

Those raising concerns about the influence of proxy advisors also point to the timing of voting by investors relative to when proxy advisors issue recommendations or corrections as evidence of the purported influence. However, this reflects a lack of understanding of the custom policy implementation processes at proxy advisors; Glass Lewis' clients receive their custom vote only after Glass Lewis publishes its report. Therefore, at the same time that Glass Lewis publishes its own research, Glass Lewis also implements clients' custom recommendations, prompting the clients to review and, if necessary based on the clients' instructions, execute their votes. Also, depending on clients' vote instructions regarding when to submit their votes and/or how close to meeting date a correction is made to the analysis on which client votes are based, any re-voting based on both custom and Glass Lewis policies will happen nearly instantly – as soon as any changes to the research or analysis are published.

Any research that purports to draw conclusions about the impact of proxy advisor recommendations on the vote outcome – based on what information regarding investors' voting decisions is publicly available and the assessment of the timing of votes relative to when proxy advisors publish their reports – is an exercise in conjecture. Only mutual funds are required to disclose their voting activity, on Form N-PX, but they do not disclose the



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rationale for individual voting decisions. In addition, while certain public pensions voluntarily provide similar voting disclosure, only a subset of those provide proposal by proposal vote rationales.

- *While the bill posits that prior review by the subject company would improve the accuracy and quality of proxy advisor analysis, prior review would – in fact – create the risk of additional conflicts and selective exposure to non-public information, as well as compromise investors’ best interest.*

Glass Lewis agrees with the proposed bill’s intention to ensure proxy advisors provide accurate information to clients. However, as explained in great detail above, we believe that providing previews of the full reports including recommendations and engaging in meetings with companies regarding our analysis would open Glass Lewis up to being lobbied by companies during this “consultation” process since companies could use this communication opportunity to push for a change in policy or a specific recommendation against management.

However, issuers can submit queries and notifications of subsequent filings and additional information, as well as what they perceive to be errors, via the Issuer Engagement Portal. When Glass Lewis is notified of a purported error, we immediately review the report and, if there is a reasonable likelihood the report will require revising, the report is removed from its published status so no additional clients can access it. Often what a corporation indicates is an error is ultimately a difference in interpretation or opinion regarding a certain issue and, therefore, requires no correction. For the last 12 months ending April 30, 2016, material errors in Glass Lewis’ research (brought to our attention by the company, its advisors or through subsequent disclosure) that resulted in a change to the Glass Lewis recommendation represented one-tenth of 1% of the items up for vote at US companies analyzed by Glass Lewis. (In each of the circumstances where an error resulted in a change to the Glass Lewis recommendation, we were able to publish the change and notify clients with enough time to evaluate the revised report prior to the vote cutoff.)

In addition to the foregoing, because we recognize the benefits to clients from ensuring the highest level of report accuracy prior to receiving reports, Glass Lewis has developed a program to allow public companies the opportunity to review the data to be used by analysts in drafting reports prior to Glass Lewis publishing the report to investor clients. Issuers review the accuracy of data, via their Issuer Data Report (“IDR”), and have the opportunity to respond, and then Glass Lewis reviews each response and makes any necessary corrections. In 2016, Glass Lewis has provided 500 US companies of varying sizes with their IDR, double the number in 2015. Glass Lewis will continue to expand it to all companies we cover, irrespective of size in coming years. For more information on Glass Lewis’ Corporate Engagement Policy, go to: <http://www.glasslewis.com/for-issuers/glass-lewis-corporate-engagement-policy/>.



From a practical perspective, given the often tight timeframe between the issuance of the proxy statement and the vote deadline, any delay in the distribution of reports to investors would further limit the time available for them to review the analysis, discuss in internal meetings (many clients maintain proxy committees), engage with companies and make fully informed voting decisions.

When Glass Lewis analysts require clarification on a particular issue, they will reach out to companies but otherwise generally refrain from meeting privately with companies during the solicitation period, which begins when the proxy statement is released. Glass Lewis also hosts "Proxy Talk" conference calls, throughout the year, to discuss a meeting, proposal or issue in depth; these calls are open to the public. For example, in April of 2016, Glass Lewis hosted a Proxy Talk to discuss certain environmental shareholder proposals submitted at several US companies.

Outside the proxy solicitation period, Glass Lewis welcomes the opportunity to engage with companies; in 2015 Glass Lewis analysts participated in nearly 1,000 company engagements. Information learned in such engagements is memorialized by the analyst for reference during the report drafting process.

- *While the bill suggests that the integrity of proxy advisors should be measured by its financial condition and through the unprecedented requirement to disclose confidential client information, this is an arbitrary measure that would place a significant barrier to entry on the proxy advisory industry and would compromise the confidentiality of investors.*

Requiring disclosure of a proxy advisor's financials is, like the requirement for prior disclosure of research, unprecedented and not in investor clients' best interests. Such information is confidential, disclosure of which could put proxy advisors, particularly newer, smaller firms, at a competitive disadvantage. Finally, such information is not pertinent for clients to evaluate the quality of a proxy advisor's research; nor have they asked for it to be so reported.

In the case of Glass Lewis, our firm enjoys stable ownership and strong financial backing as a portfolio company of OTPP and AIMCo, pension plans based in Canada with US \$132 billion and US \$69.8 billion assets under management, respectively. OTPP has owned Glass Lewis since 2007 and AIMCo invested in 20% of the firm in 2013. These stable, supportive owners have contributed to the success of Glass Lewis including the ability to attract and retain experienced and dedicated analysts and managers, as well as to ensure high quality and accurate research. Nevertheless, expecting the Commission to be able to gauge with any degree of accuracy whether Glass Lewis or any proxy advisor has "adequate financial and managerial resources to consistently produce proxy advisory services with accuracy and integrity" is problematic at best. Such a requirement would subject proxy advisors' license to



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operate to the Commission's subjective judgments based on undefinable standards, potentially leading to arbitrary and inconsistent decisions based solely on the opinion, however well-founded and well-intentioned, of the SEC staff. We believe a market-based approach is the only way to judge research quality, since the ultimate arbiter of the quality of any research is the end user, i.e. the institutional clients that engage the services of the research provider. Users are free to choose among the various proxy research providers, and hire or fire them as they see fit.

Glass Lewis Has Already Implemented Key Elements of the Bill

- *Transparency in the Research Process: Glass Lewis publicly discloses its guidelines and methodologies.*

Glass Lewis believes in being forthcoming with policies and procedures for analyzing companies on behalf of its clients. Therefore, the firm publicly discloses significant information about its research policies and approach, including our full US guidelines, as well as the voting guidelines for other major countries. The disclosure describes Glass Lewis' case-by-case approach to analyzing issues submitted for shareholder vote at company shareholder meetings and notes the firm's belief that each company should be evaluated based on its own unique facts and circumstances, including performance, size, maturity, governance structure, responsiveness to shareholders, domicile and stock exchange listing.

In addition, Glass Lewis' public Statement of Compliance with the Best Practice Principles for Providers of Shareholder Voting Research & Analysis contains substantially more information about the Glass Lewis research approach and methods including statistics on voting recommendations in conflicted situations including when a client is a shareholder proponent. The publicly available Statement of Compliance also outlines how Glass Lewis develops its proxy voting policies.

Glass Lewis' guidelines can be accessed via the Glass Lewis Issuer Engagement Portal at <http://www.glasslewis.com/issuer/guidelines/>.

- *Organizational Structure: Glass Lewis operates as a company independent from its owners.*

While it is unclear what level of detail would be required under the draft bill regarding disclosure of its organizational structure, Glass Lewis currently provides on its public website significant information about its owners, leadership, senior analysts, office locations, services, subsidiaries and Research Advisory Council.

Glass Lewis is a portfolio company of the Ontario Teachers' Pension Plan Board ("OTPP") and Alberta Investment Management Corp. ("AIMCo"). Glass Lewis operates as an independent



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company separate from OTPP and AIMCo. Neither OTPP nor AIMCO is involved in the day-to-day management of Glass Lewis' business. Moreover, Glass Lewis excludes OTPP and AIMCO from any involvement in the formulation and implementation of its proxy voting policies and guidelines, and in the determination of voting recommendations for specific shareholder meetings.

- *Code of Ethics: Glass Lewis has a detailed code of ethics.*

Glass Lewis maintains a robust code of ethics which addresses personnel conflicts, confidential treatment of client information, insider trading, among many other topics. All Glass Lewis employees and agents, worldwide, must annually review and affirm their commitment to the Glass Lewis Code of Ethics, as well as update Glass Lewis with information on (i) any reportable outside activities (e.g. other employment, involvement in investment clubs, etc.) or any other activities related to the securities industry or the business of Glass Lewis, and (ii) any ownership interest greater than 5% or any position (e.g. director, officer, or executive) the employee or agent, or any of his or her relatives, holds in a publicly traded company. Glass Lewis' Compliance Committee regularly reviews the Code of Ethics and incorporates any revisions required by applicable laws, rules and regulations. In addition, the Vice President and General Counsel, who serves as the firm's Chief Compliance Officer, monitors the disclosure of personal trading accounts, the pre-approval trading process, and all employees' and agents' quarterly personal trading reporting.

- *Conflict Management and Disclosure: Glass Lewis specifically and prominently discloses conflicts of all types in each report and its conflict policy is publicly available.*

Glass Lewis complies with the proposed bill's provisions regarding conflict management, disclosure and oversight. Glass Lewis eliminates, reduces and discloses – proactively, explicitly and comprehensively – potential conflicts, to the greatest extent possible. The firm has a robust, publicly-disclosed conflicts policy that governs the disclosure and treatment of the firm's various types of potential conflicts including those arising from the firm's ownership structure, business partnerships, client-submitted shareholder proposals, employee and outside advisors' relationships and when an investment manager client is a public company or a division of a public company. For example, Glass Lewis specifically and prominently disclosed the potential conflict related to Glass Lewis' ownership by OTPP in its analysis of the 2012 Canadian Pacific Railway shareholder meeting.

Glass Lewis' Compliance Committee meets quarterly and is comprised of the CEO, COO, Chief Policy Officer and the Vice President and General Counsel, the latter of whom oversees the firm's conflict management, avoidance and disclosure procedures with support from Glass Lewis' Operations Department.



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As detailed on the company website (<http://www.glasslewis.com/about-glass-lewis/disclosure-of-conflict/>), Glass Lewis has a formal Conflict of Interest Statement, Conflict Management Procedures, Code of Ethics and several additional safeguards in place to mitigate potential conflicts.

Glass Lewis does not provide consulting services to public companies or directors, nor do we provide consulting to shareholders regarding how to gain support from other shareholders for their proposals or dissident nominees in a proxy contest.

“There Is No Current Market Failure Related to Proxy Advisors Interaction With Investors and Issuers ... Which Would Require Regulatory Intervention.” (ESMA, 2013)

In 2012 the European Securities and Markets Authority (“ESMA”) conducted a comprehensive review of the proxy advisory industry. In 2013, ESMA published its final report containing the analysis of the results of the study, in which it stated that it did not see a need for binding regulation. Further, ESMA said the “appropriate approach” was for the industry to develop a code of conduct, to be applied on a comply-or-explain basis, that would address two areas of concern raised in the public consultation: 1) identifying, disclosing and managing conflicts of interest and 2) fostering transparency to ensure the accuracy and reliability of the advice.

Glass Lewis, ISS and the leading providers in the UK (Manifest and PIRC), France (Proxinvest) and IVOX (a Germany-based firm that was acquired by Glass Lewis in 2015) formed the Best Practice Principles group to develop a code of conduct (“Principles”) for the industry, which the signatories to the Principles said they would apply globally. Similar to the practice for nearly all industries, the participants in the industry, i.e. the proxy advisors, took the lead in drafting the Principles to which they would be subject but in consideration of input from ESMA and other stakeholders, including numerous issuer respondents to the consultation from both Europe and North America.

Following a global, public consultation regarding the proposed Principles, the final Principles were officially launched in March 2014. Since then, Glass Lewis and the other charter signatories to the Principles have each published their Statements of Compliance, featuring detailed information on how the organizations comply with the Principles and all the related Guidance. Glass Lewis applies the code to its activities globally, including in the United States.

Views on Regulation of Proxy Advisors

While Glass Lewis supports effective regulatory oversight of proxy advisors, we believe such oversight should be implemented in a manner that reflects current market practice, i.e. recognizing that institutional investors make their own voting decisions and do not merely follow the voting recommendation of a proxy advisors. In addition, the proposed regulatory framework is duplicative of initiatives that are already in place to protect investors, including the Best Practice Principles developed under the oversight of ESMA discussed above.



Following a public consultation similar to ESMA's, the Canadian Securities Administrators ("CSA") issued its findings regarding the proxy advisory industry. The CSA report contained an assessment of the potential regulatory frameworks considered in their release and determined that (i) proxy advisors should not be required to register as "advisers;" (ii) the work of proxy advisors does not amount to "soliciting" proxies; and (iii) proxy advisors should not be regulated under the framework contemplated for credit rating agencies. While Glass Lewis recognizes that different laws and regulations apply in Canada than in the United States, we believe given the substantial similarities in regulatory approach of the two jurisdictions, the CSA's findings bear consideration.

Glass Lewis believes that any binding or quasi-binding regulation of proxy advisors would be inappropriate and potentially harmful. The reasons for this view include:

- *Investors are fiduciaries that already hold their advisors accountable for the quality and accuracy of the services they provide. The market does work.*

Institutional investors have a fiduciary responsibility to vote proxies in a manner that is in the best interests of their beneficiaries. It has been Glass Lewis' experience – as a provider of research, proxy voting and other governance services to over one thousand investors across the globe – that investors take this responsibility very seriously.

Institutional investors hold proxy advisors accountable for providing objective, accurate and high-quality research services that are developed and delivered in accordance with client instructions. In addition, proxy advisors must meet the requirements set forth by their clients for managing and disclosing conflicts of interest.

If an advisor fails to meet the standards and requirements set forth by the client, that client has the option to select another provider.

- *Proxy advisors are just one participant in a large voting chain, which includes issuers, ballot distributors, custodians, sub-custodians and registrars, among others.*

Research development by proxy advisors is dependent on the activities of several members of the voting chain. It would be inappropriate and potentially harmful to investors if any regulator were to mandate quasi-binding or binding instruments without mandating related instruments for other participants in the chain.

- *A proliferation of differing binding or quasi-binding regulatory instruments in different jurisdictions would be potentially burdensome for both investors and proxy advisors,*



impacting shareholder rights and creating barriers to entry into the proxy advisory industry.

As noted above, Glass Lewis has worked with key members of the global proxy advisory industry to develop an industry code of conduct that governs policy and research development; conflict management and disclosure; and transparency. Glass Lewis applies the code globally and believes a preferred approach would be to encourage other proxy advisors to do the same.

Glass Lewis welcomes the opportunity to work with the Subcommittee and other interested parties to find the appropriate ways to address issues raised in the hearing that relate to the proxy advisory industry in a manner that best serves the needs of long-term investors and the U.S. capital markets. Indeed, we look forward to getting feedback from all stakeholders on the industry code of conduct currently under development.

Thank you, Mr. Chairman and Ranking Member Maloney for providing Glass Lewis with the opportunity to submit this statement.

Sincerely,



Katherine Rabin
Chief Executive Officer



Statement of
Gary Retelny, President and CEO
Institutional Shareholder Services Inc.
to the
Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives
May 17, 2016
Legislative Proposals to Enhance Capital Formation,
Transparency and Regulatory Accountability

To: Chairman Garrett and Ranking Member Maloney:

Institutional Shareholder Services Inc. ("ISS"), a proxy adviser for more than thirty years and a federally registered investment adviser for almost two decades, is pleased to submit this statement for the record in today's hearing with regard to proposed legislation to be known as the "Proxy Advisory Firm Reform Act of 2016."

Executive Summary

Over the past several years, proxy advisers have, themselves, become a proxy for the debate over the proper role of shareholders in corporate governance and the voice that shareholders should have in the companies they own. The Securities and Exchange Commission's ("SEC") 2013 Roundtable on proxy advisory firms highlighted the clear philosophical divide between investors and corporate management on this issue. Investor representatives at the Roundtable emphasized the importance of voting their shares as "a duty of good corporate citizenship"¹ and the critical role proxy advisers play in aggregating, synthesizing and making sense of the vast array of data found in proxy statements.² Participants representing corporate issuers, on the other hand, suggested divestment as an alternative to voting proxies against management,³ and accused ISS of being conflicted because its subsidiary provides services to issuers, while at the same time accusing ISS of being in the pocket of activist shareholders.⁴

¹ Remarks of Eric Komitee, General Counsel, Viking Global Investors, LP, Transcript of Proxy Advisory Firms Roundtable (December 5, 2013) ("Roundtable Transcript"), available at www.sec.gov/spotlight/proxy-advisory-services/proxy-advisory-services-transcript.txt at 74.

² Remarks of Michelle Edkins, Managing Director and Global Head, Corporate Governance and Responsible Investment, BlackRock, Inc., *id.* at 45; remarks of Damon Silvers, Director of Policy and Special Counsel, AFL-CIO, *id.* at 63.

³ Remarks of Trevor Norwitz, Partner, Wachtell, Lipton, Rosen & Katz, *id.* at 66.

⁴ *Id.* at 101-104.

The proxy adviser bill being considered by the Subcommittee today clearly sides in this ongoing debate with self-interested corporate managers and their lobbyists over the interests of tens of millions of hard-working Americans who entrust their retirement and investment dollars to pension funds, mutual funds, asset managers and other fiduciaries who hire proxy advisers. The proposed legislation would move proxy advisers out of a well-established investor-centric federal regulatory regime to a brand new bureaucratic maze that is designed to allow corporate executives and their representatives to pressure proxy advisers to back management positions on issues ranging from CEO compensation and director elections to mergers and insider-led leveraged buyouts. In so doing, the bill would weaken, or perhaps even destroy, the existing fiduciary bond between proxy advisers and their shareholder clients and would disharmonize rules that apply to proxy advisers from those that apply to the investment managers and pension fiduciaries who use their services.

While many aspects of the bill merely duplicate existing regulatory requirements (which ISS, as a registered investment adviser, already satisfies), other aspects would make it impossible, as a practical matter, for proxy advisers to provide timely research on the broad universe of shareholder meetings they cover for their clients today. In this way, the bill would deprive shareholders of the key information they need to make informed voting and investment decisions in accordance with their own fiduciary duties and other mandates. Furthermore, by encouraging meritless litigation from disgruntled issuers, the legislation may undermine the independence, quality, timely delivery and integrity of proxy research.

Finally, in light of the Subcommittee's clear interest in ensuring the cost effectiveness of SEC regulation, we note that directing the SEC to abandon an existing set of regulations and promulgate new rules for a tiny industry comprised of a handful of entities cannot, by any stretch of logic, be considered cost-effective. The proposed mandatory regime for proxy advisers appears to be modeled on the regime established for credit rating agencies 10 years ago. However, that

regulatory model is inapposite to proxy advisers, because rating agency registration is not mandatory, but rather is used only by firms who wish to be known as “nationally recognized.” Moreover, unlike the credit rating agency business model in which issuers select and pay for the research and ratings disseminated about them, it is the *investors* who choose and pay proxy advisers for their research and recommendations. Finally, proxy advisers are fiduciaries, and rating agencies are not.

ISS respectfully submits that if passed, the proposed legislation would inappropriately tip the debate over the proper role of shareholders in corporate governance in favor of entrenched corporate interests at the expense of shareholders and free-market capitalism. It would do so in a very costly, inefficient and counter-productive manner. As a result, shareholders would be deprived of their freedom to choose the tools, services and information they need to be good corporate citizens.

ISS' VIEWS ON THE PROPOSED LEGISLATION**A. *There is No Need for This Bill.***

The litmus test for any federal legislative intrusion into the free market is whether it targets a significant problem and seeks to address it in the most cost-effective fashion. Not only does this proposed bill fail on both of these counts, but it would actually create a costly new problem by hampering institutional investors' efforts to meet their fiduciary responsibilities with respect to monitoring the companies in their portfolios and voting their shares in an informed fashion. The proposed legislation rests on a shaky foundation built from (i) factual inaccuracies about the proxy advisory industry conjured up by corporate lobbyists; (ii) complaints from a small cadre of self-serving corporate executives who would prefer immunity from investor scrutiny; and (iii) failure to comprehend the robustness of the existing regulatory oversight structure that already applies to ISS, as well as the success of ongoing efforts by U.S. and global regulators and the industry itself to foster best practices in the industry.

1. *Shareholders Are Not Overly Reliant on Proxy Advisers.*

Into the first category falls the two-part inaccuracy that investors are overly reliant on the voting advice of proxy advisory firms, instead of relying on portfolio managers who have a fiduciary duty to investors and use independent judgment in exercising shareholder votes.⁵ The lobbyist-promulgated myth that proxy advisers are omnipotent and that the investors who use them are puppets who mindlessly do as they are told was thoroughly vetted and discredited at the SEC Roundtable.

It was evident from the Roundtable that if improper use of proxy advisers even occurs, it is the rare exception rather than the rule. Supporters of more regulation of proxy advisers typically present little more than untraceable anecdotes, unsubstantiated rumors or unrecognizable

⁵ H. R. __, the "Proxy Advisory Firm Reform Act of 2016 (Duffy) (cited hereafter as the, "Proxy Advisory Reform Act"), Sec. 2.(4).

caricatures of “small investment advisers” as their evidence of “abuses” to justify their calls for intervention into the contractual relationships between institutional investors and their selected proxy advisers. In sharp contrast, the real institutional investors featured at the SEC’s Roundtable certainly appear to take their fiduciary responsibilities regarding proxy voting very seriously, and they understand their duty to vote proxies in their clients’ or beneficiaries’ best interests.⁶ With regard to the practices of small investment advisers, Karen Barr of the Investment Adviser Association noted that although some small firms may rely on proxy advisers more extensively than do large advisers with dedicated research staff of their own, thousands of small firms do not use proxy advisers at all.⁷

As the sponsors of the proposed legislation grudgingly acknowledge in their preamble, proxy advisers’ research and vote recommendations are just one source of information used in arriving at the institutions’ voting decisions. Many investors have internal research teams that conduct proprietary research and use proxy advisory research to supplement their own work.⁸ Some investors use third-party proxy research as a screening tool to identify non-routine meetings or proposals. A number of institutional investors use the services of two or more proxy advisory services. These views are consistent with the results of a recent survey of asset managers by Tapestry Networks that found proxy advisory firms’ “role as data aggregators” has become increasingly important to asset managers, and that even if smaller managers are more reliant on such advisory firms, they still acknowledge that responsibility for voting outcomes lies with

⁶ Remarks of Michelle Edkins, Roundtable Transcript at 45 (“BlackRock typically uses research and other data services from proxy advisory firms as one of many inputs in our proxy voting decisions. We use the firms primarily to synthesize the vast array of data that you get in proxy statements, and more than just synthesize it, to put it in a consistent format”).

⁷ *Id.* at 56.

⁸ Remarks of Anne Sheehan, *Id.* at 153-54; remarks of Lynn Turner, Managing Director, LitiNomics, Inc., discussing his experience at Colorado PERRA, *Id.* at 51-52.

investors.⁹ The fact that institutional investors do not blindly take direction from proxy advisers is demonstrated by the fact that these investors often vote against the recommendations of their proxy advisers.¹⁰

Further, while another participant at the SEC Roundtable, Mark Chen, Associate Professor of Finance, Georgia State University, noted a high correlation between proxy advice and vote outcomes, he was unable to state whether that correlation derives from large investors' outsourcing their voting decisions to proxy advisers or from the fact that voting advice brings important new information to the markets.¹¹

This latter view has been endorsed by other academics. In their paper, *The Power of Proxy Advisors: Myth or Reality?*,¹² University of Pennsylvania Law School Professor Jill Fisch, along with colleagues from New York University, analyzed the effect of proxy adviser recommendations on voting outcomes in uncontested director elections. The authors estimate that, after controlling for underlying company-specific factors that influence voting outcomes, an ISS recommendation appears to shift 6 to 10 percent of shareholder votes, but that this influence may stem from ISS' role as information agent:

⁹ Bew, Robyn and Fields, Richard, Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers (June 2012) at 2. Available at SSRN: <http://ssrn.com/abstract=2084231>. ("Across the board, participants in our research said they value proxy firms' ability to collect, organize, and present vast amounts of data, and they believe smaller asset managers are more reliant on those services. Nonetheless, participants emphasized that responsibility for voting outcomes lies with investors").

¹⁰ See, e.g., remarks of Michelle Edkins, *Id.* at 50 (for "say on pay votes" in 2012, BlackRock voted against four percent of the proposals, while their proxy advisers recommended no votes on roughly 16 percent of the proposals); remarks of Lynn Turner, *Id.* at 53 (CoPERA voted against Glass Lewis's director recommendations 52 percent of the time; "Glass Lewis actually voted with management a lot more often than we did."); remarks of Eric Komitee, *Id.* at 75 ("[T]here are certainly times where we disagree with the proxy advisory services"). See also *Id.* at 153.

¹¹ *Id.* at 39-41.

¹² Choi, Stephen J., Fisch, Jill E. and Kahan, Marcel, *The Power of Proxy Advisors: Myth or Reality?* 59 Emory L. J. 869 (2010); University of Pennsylvania, Institute for Law & Economics Research Paper No. 10-24. Available at SSRN: <http://ssrn.com/abstract=1694535>.

[W]e find evidence that ISS's power is partially due to the fact that ISS (to a greater extent than other advisors) bases its recommendations on factors that shareholders consider important. This fact and competition among proxy advisors place upper bounds on ISS's power. Institutional Shareholder Services cannot issue recommendations arbitrarily if it wants to retain its market position. Doing so would lead institutional investors to seek the services of other proxy advisory firms. Thus, ISS is not so much a Pied Piper followed blindly by institutional investors as it is an information agent and guide, helping investors to identify voting decisions that are consistent with their existing preferences.¹³

The investor representatives participating at the Roundtable had their own theories about the correlation between proxy adviser vote recommendations and actual votes cast. Two participants suggested that the large institutional investors and proxy advisers have common views about corporate governance,¹⁴ while another observed that the SEC and the DOL would likely be concerned if institutional investors were spending money on proxy advisory services they found to be of no value.¹⁵

Of course, another reason for the correlation between recommendations and votes cast is that, as explained in the appendix to this statement, proxy advisers in many instances base recommendations to their clients on the clients' own custom voting policies.

The fallacy in the second part of the finding about over-reliance on proxy advisers – that proxy advisers, unlike portfolio managers, do not have a fiduciary duty to investors and do not utilize independent judgment when rendering proxy voting advice – is exposed by the explanation in the appendix to this statement of the Advisers Act regulatory regime. As it stands today, investors have double fiduciary protection, a benefit that would be lost under the proposed legislation.

¹³ *Id.* at 906.

¹⁴ Remarks of Lynn Turner, Roundtable Transcript at 54; remarks of Eric Komitee, *Id.* at 152-53 ("I think it is possible . . . that a lot of the statistics that show a correlation between their recommendations and the outcome of a vote are because the ultimate voters . . . think in the same way that the proxy advisory services do about director performance and other similar subjects, not because we're voting blindly with them and not because we're even necessarily persuaded by their reasoning so much as just because we happen to think that way to begin with.").

¹⁵ Remarks of Damon Silvers, *Id.* at 63.

2. *The Commission Already Has Statutory Authority to Oversee the Proxy Advisory Firm Industry.*

While ISS agrees that oversight of proxy advisers serves a compelling interest of investor and shareholder protection,¹⁶ the proposed legislation's finding that the SEC needs new statutory authority to exercise that oversight is clearly erroneous. Congress gave the SEC that authority over 75 years ago in the Advisers Act. As discussed in more detail in the appendix, the SEC has used that authority to develop a very robust regulatory regime that governs *all* investment advisers, including those whose advice pertains only to proxy votes and other matters of corporate governance.

3. *From an Investor Perspective, Proxy Advisers Have A Salutory Effect on Corporate Governance, the Securities Markets and the National Economy.*

The proposed legislation finds both that the services rendered by proxy advisers have "assumed outsized importance in the national debate over high-quality corporate governance,"¹⁷ and that investor reliance on these services has a substantial effect on corporate governance, the securities markets, and the national economy.¹⁸ ISS respectfully submits that from an investor perspective, the first of these statements is untrue and the second statement describes not a problem to be solved, but a success of private ordering that should be applauded.

Proxy advisers have not "assumed" an outsized importance in the debate over corporate governance, so much as they have been an outsized target in obsessive efforts by a small number of corporate managers and their representatives to discourage institutional investors from using their voice in the corporate governance debate. Because these parties legally cannot stop the investors from exercising their franchise rights, they seek to make it more expensive,

¹⁶ Proxy Advisory Firm Reform Act, Sec. 2.(7).

¹⁷ *Id.*, Sec. 2.(3).

¹⁸ *Id.*, Sec. 2.(5).

cumbersome and time consuming to reach informed voting solutions. Information is equivalent to oxygen for proxy voters, so entrenched managers seek to cut off its supply.

B. The Proposed Legislation Would Impair or Destroy the Fiduciary Relationship Between Proxy Advisers and Shareholders.

Having failed to identify any need to upend the established regulatory framework governing proxy advisers, we next turn our attention to the overall effect the proposed new regulatory regime would have on the millions of hard-working Americans who entrust their retirement and investment dollars to pension funds, mutual funds, asset managers and other fiduciaries who hire proxy advisers. There can be no doubt that this regulatory regime would redirect proxy advisers' focus away from the best interests of investors in favor of placating corporate managers.

Disguised as a safeguard of the "reliability" of proxy advisory services, proposed new Exchange Act Section 15H(h) would compel proxy advisers to furnish the subjects of proxy recommendations "reasonable" access to drafts of those recommendations and an opportunity to provide "meaningful" comment thereon, including the opportunity to present "details" to the person(s) responsible for developing the recommendations. This provision would also require proxy advisers to employ an ombudsman to receive complaints about the "accuracy" of voting recommendations from the subjects of those recommendations, and would forbid voting on the matter in question until those complaints are resolved.

Enforcement of this directive to cede control over the content of proxy reports and recommendations to the subject of those reports and recommendations would not rest solely with the SEC, but would extend to corporate issuers as well. Proposed Exchange Act Section 15H(n)(2) would afford any subject of a proxy adviser's vote recommendation who felt "aggrieved" by the adviser's failure to fully comply with Section 15H(h) and rules thereunder to sue the proxy adviser in Federal district court for equitable relief, money damages or "such other relief determined by the court to be appropriate."

The problems with these provisions are not hard to see.

First, it is impossible from an operational standpoint for a proxy adviser like ISS that annually covers more than 39,000 shareholder meetings to afford each issuer the opportunity to review a draft proxy report for factual accuracy prior to the delivery of that report to clients. As explained in the attached appendix, the window between the release of the proxy statement and the shareholder meeting is almost completely filled with the adviser's analytical activities and shareholder review of the report and recommendation.¹⁹ The limited issuer review process that ISS currently manages to squeeze into this tight timeframe would not begin to satisfy the unrealistic expectations of the proposed legislation. In order to satisfy demands like these, ISS would have to severely limit its coverage, leaving shareholders without access to the critical information and services they need to have a meaningful voice in corporate governance. Smaller proxy advisers could be driven out of the market altogether. However, even if it were operationally possible to offer a draft review to 39,000 companies, the power given to issuers in this bill is disturbing.

Proposed Section 15H(h) seems to be intentionally riddled with highly subjective terms like "reasonable" access, "meaningful" comment and presentation of "details," as well as the opportunity to complain about the "accuracy" of vote recommendations.²⁰ The ultimate power to define these terms would transfer to self-interested corporations, which, for example, could prevent investors from receiving valuable information from a proxy adviser regarding voting on a contested issue simply by refusing to allow the proxy adviser to "resolve" their complaints. As such, the legislation would create a virtually open-ended legal liability that smaller proxy advisory firms would probably be unable to bear.

¹⁹ See discussion at Appendix, Section A.3.

²⁰ ISS is at a loss to understand how an issuer could label a vote recommendation as "accurate" or "not accurate." As explained in the attached appendix, ISS often provides clients with diametrically opposite recommendations, depending on the particular needs and interests of its shareholder clients and the proxy voting guidelines those clients have selected.

Proxy advisers who strive to conduct independent analyses and issue vote recommendations in the best interests of their investor clients (whatever those interests might be), would labor under the constant threat of litigation from disgruntled issuers. The specter of being hauled into Federal court would have a chilling effect on these advisers' independence. Advisers who stand their ground could find themselves sued out of existence.

Given that what issuers consider to be factual errors are often philosophical differences or outright disagreement with voting policies,²¹ it does not take much imagination to see that the proposed legislation is a thinly-veiled effort to give corporations effective veto-power over any vote recommendations they do not like. *Corporate issuers are not now and should not ever be the arbiters of proxy voting advice.*

C. The Proposed Legislation Would Establish a Regulatory Regime That In Some Respects Duplicates and In Other Respects Is Weaker Than the Regime That Governs Proxy Advisers Today.

The proxy adviser regime proposed to be established under new Section 15H of the Exchange Act would entail a formal registration application process with periodic updates and annual certifications; a requirement to make registration information publicly available; the designation of a compliance officer; and the adoption of written policies and procedures to address conflicts of interest. As explained later in this Statement, each of these requirements is already contained in the Advisers Act regulatory regime.²²

In many cases, the protections afforded to investors under the Advisers Act are stronger than those included in the new scheme. The most glaring example of this is that while the proposed regime pays lip service to managing conflicts of interest, it also embeds an inherent conflict into the governing statute. So long as the subjects of proxy advisory reports are given *de*

²¹ See Appendix, note 5, and accompanying text.

²² See Appendix, Section B.2.

facto editorial control over what is said about them, there will be conflicts that will be difficult to mitigate under any proxy adviser's conflict of interest policies and procedures. Registered investment advisers, by contrast, are not statutorily compelled to serve two masters; their fiduciary duties of care and loyalty run only to their clients, the investors.

Furthermore, whereas registered investment advisers are required to maintain codes of ethics establishing standards of corporate behavior and personal trading controls,²³ Exchange Act proxy advisers would be obliged only to state whether they have a code of ethics, and if not, why not.²⁴ Although Exchange Act proxy advisers would have to post their registration information on their own websites, registration documents for all investment advisers are accessible in one location through the SEC's website, making it easy for investors to comparison shop. Finally, unlike the Advisers Act, the proposed legislation entails no market protections against insider trading, or client protections relating to sales and marketing or contracts, and no books and records requirements.

Overall, the proposed regulatory scheme is a pale imitation of the one that exists today.

D. Credit Rating Agency Regulation is the Wrong Model for Proxy Advisers.

The proxy adviser bill appears to be modeled on the Credit Rating Agency Reform Act that Congress passed ten years ago. That law established a registration scheme for credit rating agencies wishing to be designated as Nationally Recognized Statistical Rating Organizations ("NRSROs") so that their credit ratings could be used for a host of regulatory purposes. The NRSRO concept had its genesis in the broker-dealer net-capital rule which the SEC promulgated under the Exchange Act in 1975, and references to NRSRO ratings eventually appeared in a number of laws and rules.

²³ See discussion at Appendix Section B.2.c.

²⁴ Section 15H(b)(1)(B)(iii).

NRSRO designation was achieved historically through a no-action letter process administered by the Staff of the SEC's Division of Market Regulation (now, Trading and Markets). Over time, this process was criticized as opaque and ineffective, and was seen as contributing to concentration in the market for credit ratings. To address this situation, the 2006 rating agency statute provided a formal regulatory regime with a standardized registration process that encompassed many of the same factors that had been used in the no-action letter era.

Although several provisions from the specialized NRSRO regime have found their way into the proxy adviser bill,²⁵ the rating agency regime is completely inapposite to the services provided by proxy advisers. To begin with, NRSRO registration is still voluntary. The only credit rating agencies who must register are those who wish to call themselves "nationally recognized." The proxy adviser bill, on the other hand, would force all proxy advisers into the bureaucratic maze of a brand new set of ill-fitting rules and regulations.

Furthermore, unlike NRSROs who were birthed by the Exchange Act, the regulatory home of investment research providers like proxy advisers has always been the Advisers Act. While the proposed legislation attempts to forge a bond between the Exchange Act and proxy advisers by calling them proxy "solicitors," proxy advisers do not "solicit" proxy votes, as explained more fully in the appendix to this statement.²⁶ In addition, proxy advisers are fiduciaries, which NRSROs are not.

Finally, and perhaps most importantly, NRSROs and proxy advisers operate under completely different business models. NRSROs are paid by the issuers who are, or whose debt is,

²⁵ Curiously absent from the proposed legislation, however, is the rating agency provision that safeguards the First Amendment rights of NRSROs. Exchange Act Section 15E(c)(2) forbids the SEC from regulating "the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings." ISS wonders if this omission is linked to Section 15H(h)'s mandate that issuers get to oversee the content of proxy research and recommendations.

²⁶ See discussion at Appendix, Sections A.1. and B.4.

the subject of the credit ratings, while proxy advisers are paid by the investors they advise.

For all these reasons, ISS respectfully submits that the proposed legislation is not only in the wrong pew, but is in the wrong house of worship altogether.

E. The Proposed Legislation Is Not Cost-Justified

ISS shares the Subcommittee's concerns about runaway costs in federal securities regulation and applauds the Subcommittee's efforts to ensure that benefits always outweigh costs in SEC rulemaking. That being the case, ISS is, frankly, surprised that the Subcommittee would even consider directing the SEC to turn its back on 75+ years of hard work crafting the Advisers Act regime, and launch a new round of rulemaking for an industry that consists in the U.S. of only 2 large and 3 small proxy advisers.²⁷ Requiring proxy advisers who comply with the robust Advisers Act regulatory regime today to pay for a new, untested registration scheme would confer no countervailing benefit on investors, and could very well drive the smaller proxy advisers from the market.

CONCLUSION

For all these reasons, ISS believes that the Proxy Advisory Firm Reform Act of 2016 is not an investor-protection piece of legislation, but rather is a thinly-veiled effort to deprive shareholders of a meaningful voice in corporate governance. ISS further believes that the bill would force

²⁷ Passing laws without a realistic appreciation for economic consequences has led to a situation today in which the congressionally mandated SEC office that regulates NRSROs is roughly five times larger than the number of registrants that office regulates. And the cost of that regulatory regime appears to be limiting the pool of registrants. See Nationally Recognized Statistical Rating Organizations, SEC Rel. No. 34-72936, at 46-47 (Aug. 27, 2014), 79 Fed. Reg. 55078, at 55093 (Sept. 15, 2014) ("As a result of the amendments and new rules being adopted today, the number of credit rating agencies registered with the Commission as NRSROs may decline if current registrants believe that the cost of being registered and being subject to these new requirements outweighs the benefit of registration. The barriers to entry for credit rating agencies to register as NRSROs may rise, discouraging credit rating agencies from registering as NRSROs. . . . Also, if compliance costs significantly erode profit margins for NRSROs, the barriers to exit from being registered as an NRSRO in certain or all classes of credit ratings may lower. The risk for deregistration may likely be higher for smaller NRSROs.")

government regulators to waste resources re-creating rules they already have, and would impose costs on proxy advisers that could drive small firms from the industry.

**Appendix in Support of ISS' Written Statement to the May 17, 2016
Hearing of the Subcommittee on Capital Markets and Government
Sponsored Enterprises Committee on Financial Services of the
United States House of Representatives**

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PROXY ADVISERS AND THEIR REGULATION**A. Background****1. ISS' Proxy Advisory Services**

Founded in 1985, in an era of aggressive financial market practices such as corporate raiding, greenmail and the unilateral adoption of poison pill takeover defenses, ISS responded to a demand by shareholders for assistance in exercising a meaningful voice in the governance of portfolio companies. Today, ISS is the world's leading provider of corporate governance and socially responsible investment solutions for asset owners, asset managers, hedge funds, and asset service providers. As part of its suite of offerings, ISS serves as a full-service proxy adviser that helps institutional investors make informed proxy voting decisions, manage the complex process of voting their shares and report their votes to their stakeholders and regulators. ISS annually covers more than 39,000 shareholder meetings -- every holding in ISS' clients' portfolios -- in over 110 developed and emerging markets worldwide.

All proxy analysis at ISS is undertaken in accordance with a publicly disclosed analytical framework comprised of voting policy guidelines chosen by ISS' clients. ISS offers a wide range of proxy voting policy options, including both a standard benchmark policy focused solely on protecting shareholder value and mitigating governance risk, and a wide array of specialty policies that evaluate governance issues from the perspective of sustainability, socially responsible investing, public pension funds, labor unions or mission and faith-based investing. Case-by-case analytical frameworks, which take into account company size, financial performance and industry practices, drive the vast majority of ISS' vote recommendations, such as those pertaining to the election of corporate directors and compensation matters.

ISS also makes and implements proxy voting recommendations based on clients' specific customized voting guidelines, and may assist clients in developing such custom guidelines as well. In fact, ISS currently implements nearly 500 custom voting policies on behalf of close to 400

institutional investors. Year-to-date, 68 percent of the ballots processed by ISS on behalf of clients globally were voted under clients' custom policies, representing 82 percent of the total shares processed by ISS during this period.

As a complement to its proxy analyses, ISS also serves as a data aggregator, currently capturing and synthesizing hundreds of data points that are used by institutional investors in investment-decision making, engagement with portfolio companies, and other initiatives tied to the discharge of their fiduciary duties as good stewards of working Americans' retirement and other savings.

In addition to advisory services, ISS also provides ballot processing and data management services that allow institutions to outsource these elements of their proxy voting operations. To this end, ISS often receives clients' ballots, coordinates with their custodian banks, processes votes based on client instructions, maintains voting records and provides reporting services. By outsourcing these burdensome administrative tasks, clients free themselves to devote more of their internal resources to making informed voting decisions.

As important as understanding what a proxy adviser like ISS does is comprehending what it does *not* do. First, ISS is generally not a discretionary proxy voting manager. Except in extremely rare situations where a client has an actual conflict of interest (for example, a financial institution that holds and must vote the shares of its parent company), and asks ISS to make a proxy voting decision on the client's behalf, ISS clients control both their voting policies and their vote decisions.

Nor does ISS engage in proxy "solicitation" as that term is used in Section 14 of the Securities Exchange Act of 1934 ("Exchange Act"). As a disinterested fiduciary of its shareholder clients, ISS has no financial stake in the outcome of a particular vote, and is agnostic as to whether its clients support or reject a proxy proposal or abstain from voting altogether. ISS' only job is to analyze proxy statements and provide clients with informed research and vote recommendations based on the policies and guidelines the clients have already selected. Given the diversity of these

policies and guidelines, ISS may issue opposing recommendations on a given issue by, for example, recommending "FOR" to a pension plan voting on a ballot item based on faith-based principles, and "AGAINST" to a client whose proxy voting policy focuses exclusively on maximizing shareholder value. Although as explained in more detail below, the SEC has opined that ***unsolicited*** proxy voting advice would constitute a "solicitation" under the Exchange Act proxy rules,¹ that opinion does not apply where the recipient of that advice has asked for personalized advice in the context of a fiduciary advisory relationship.

2. How ISS Formulates Proxy Voting Policies and Guidelines

ISS formulates its standard benchmark and specialty proxy voting policies and guidelines in a transparent manner. Each year, the policy-setting process begins with a Policy Survey seeking input from both institutional investors and corporate issuers (both executives and board members) in an effort to identify emerging issues that merit attention prior to the upcoming proxy season.² Based on this feedback, ISS convenes a series of roundtables with various industry groups and outside issue experts to gather multiple perspectives on complex or contentious issues. As part of this process, ISS examines academic literature, other empirical research and relevant commentary in an effort to uncover potential links between an issue and financial returns and/or risk. ISS also back tests any proposed changes to understand the possible impact of the various policy options being considered. Such impact assessments often lead ISS to phase-in new policies over a multi-year period to allow corporate issuers adequate time to prepare for any changes.

The ISS Global Policy Board, which is comprised of ISS' market research heads and internal subject-matter experts, uses this input to develop its draft policy updates. Before finalizing

¹ See Section B.4., *infra*.

² In 2015, ISS received survey responses from more than 400 parties, including over 110 institutions and roughly 250 corporations. ISS' 2016 draft benchmark voting policies, meanwhile, solicited feedback from dozens of parties, including trade groups, such as the Society of Corporate Secretaries and Governance Professionals, the Center on Executive Compensation, the National Association of Corporate Directors, the National Association of Manufacturers, and the U.S. Chamber of Commerce.

these updates, ISS publishes them for an open review and comment period (modeled on the SEC's process for commenting on pending rule-making). This open comment period is designed to elicit objective, specific feedback from investors, corporate issuers and industry-constituents on the practical implementation of proposed policies. For the past several years, unless a commenter requests confidential treatment, all comments received by ISS have been posted *verbatim* to the ISS Policy Gateway on its public website, in order to provide additional transparency into the feedback ISS has received. Final updates are published in November to apply to meetings held after February of the following year.

A good example of how ISS' policy formation process works to address emerging issues stems from the implementation of the Dodd-Frank provision which provided shareholders with a non-binding advisory vote on compensation, and further allowed shareholders the ability to determine the frequency of such "Say on Pay" votes (whether annually, biannually or triennially). In developing ISS' policy framework for our initial vote recommendations on the frequency of these "Say on Pay" votes, ISS held many direct engagements with a diverse group of clients over a number of years which provided a clear investor preference for annual votes on the issue to promote transparency and communication with shareholders, and ISS also drew on the policies of umbrella organizations such as the Washington-based Council of Institutional Investors.

Once a company's shareholders had voted on the frequency to be set (which at most companies was voted on in 2011 and set the frequency for a 6-year period), ISS' policies thereafter looked to each company to respect the frequency supported by the majority of its shareholders, whether that was for a "Say On Pay" vote every three years, every two years or annually. For information, there is a long history of strong investor support for annual say-on-pay votes as a matter of good practice, and in 2011, shareholders gave majority support for annual frequency at approximately 80 percent of companies, and supported tri-annual frequency at approximately 17 percent of companies.

In addition to the Global Policy Board, ISS also has established a Feedback Review Board ("FRB"), which I chair, to provide an additional conduit for investors, executives, directors and other market constituents to communicate with ISS.

ISS' outreach is not confined to the policy-setting process. Robust engagement is an integral part of ISS' day-to-day operations. Each proxy season, ISS engages with thousands of corporate executives, board members, institutional investors and other constituents via in-person meetings, conference calls and participation in industry events. The purpose of such engagement is for ISS to obtain, or communicate, perspectives about governance and voting issues, in order to ensure that its research and policy-driven recommendations are based on the most comprehensive and accurate information available.

3. How the Proxy Advisory Process Works

Proxy season in the United States is concentrated primarily between mid-March and early June. This condensed schedule places enormous pressure on institutional investors, who may be called on to vote upwards of 25 - 30 meetings in a single day.³ It also affects the process fiduciary advisers like ISS employ in producing proxy reports and formulating vote recommendations.

ISS collects and organizes data throughout the year on the roughly 39,000 public companies it tracks globally. When a proxy statement is issued -- typically four to six weeks before the shareholders meeting in the United States -- ISS assigns the statement to a member of its research and analytical team, which is organized by industry sector and subject-matter expertise (compensation or mergers/acquisitions, for example), who reviews the statement and begins to perform both quantitative and qualitative analyses on the issues presented. In the course of this process, ISS may communicate with issuers, investors and other interested parties; in contested situations, ISS routinely engages with both sides. Even in situations where ISS engages with

³ Remarks of Michelle Edkins, Roundtable Transcript at 45.

interested parties, ISS relies only on publicly available information in preparing its research reports and making vote recommendations.

Once the review and analytical steps are complete, the analyst drafts the proxy research report. Insights gleaned from communications with interested parties are reflected in the reports if the analyst deems such information to be useful in helping institutional clients make more informed voting decisions. In some cases, ISS may include direct quotations from statements made by interested parties. At the discretion of the analyst, a brief "engagement summary" may be included as part of the analytical report.

ISS has adopted a number of policies and procedures designed to ensure the integrity of its research process. As noted above, ISS' analyses and recommendations are driven by publicly disclosed and detailed policy guidelines and public information about the relevant proxy issues, in order to ensure consistency and to eliminate potential analyst implementation bias. In addition, before being delivered to clients, each proxy analysis undergoes a rigorous internal review for factual accuracy and to ensure that the relevant voting policy has been properly applied.⁴

The entire analytical process, beginning with the receipt of the proxy statement, through the end of the internal review of the proxy report and vote recommendations, must be completed sufficiently in advance of the shareholder meeting to give the investor client adequate time to evaluate the report, conduct any additional analysis it deems necessary, engage with the issuer's executives and board members as needed, make a voting decision and process that decision for voting. In many cases, ISS has a contractual obligation to deliver proxy reports and vote recommendations to clients ten days to two weeks in advance of the meeting.

Despite this extremely tight timeframe, ISS has voluntarily incorporated a limited issuer review step into the analytical process. In the U.S., constituents of the Standard and Poor's 500

⁴ ISS' commitment to quality is further demonstrated by the fact that it conducts periodic SSAE 16 audits to ensure compliance with its internal control processes, including its research process.

Index generally receive an opportunity to review a draft analysis for factual accuracy prior to the delivery of the report to clients, and ISS considers other requests for review and comments on a case-by-case basis. Given the limited time between the hard start of receiving the proxy statement and the hard stop of delivering the report to clients sufficiently in advance of the meeting, there simply is not time to afford all of the approximately 39,000 issuers ISS covers globally the opportunity to review draft reports. However, all issuers may receive a free copy of the published analysis for their own shareholder meetings upon request. This affords issuers the opportunity to bring any factual error in the report to ISS' attention. In many cases, however, what issuers consider to be "errors" are in fact differences in philosophy, interpretation or, simply, outright disagreements with ISS' voting policies.⁵

While ISS strives to be as accurate as possible, ISS' research team does, infrequently, identify material factual errors in research reports, such as those relating to the agenda, data or research/policy application. When this happens, or when ISS learns of a material factual error from the issuer or an investor, ISS promptly issues a "Proxy Alert" ("Alert") to inform clients of any corrections and, if necessary, any changes in the vote recommendations as result of those corrections or updates. Alerts are distributed to ISS' investor clients through the same ProxyExchange platform used to distribute the regular proxy analyses. This ensures that the clients who received an original analysis will also receive the related Alert, which is attached to the relevant company meeting.

⁵ Remarks of Anne Sheehan, Director of Corporate Governance, CalSTRS, Roundtable Transcript at 155 ("What I have found, that many times the errors are really differences of opinion").

B. The Regulatory Regime Governing Proxy Advisers

1. Applicability of the Advisers Act

More than seventy-five years ago, the Investment Advisers Act of 1940 ("Advisers Act") established a principles-based regulatory regime, the essence of which is the fiduciary relationship between an investment adviser and its clients. The statute defines the term "investment adviser" to mean any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities, or as to the advisability of investing in, purchasing or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports about securities.⁶ This broad definition encompasses not only those who manage client portfolios, but also those who advise about ways to maximize the value of those portfolios.⁷

In its 2010 Concept Release on the U.S. Proxy System, the SEC confirmed the applicability of the Advisers Act to proxy advisers, saying:

[P]roxy advisory firms receive compensation for providing voting recommendations and analysis on matters submitted for a vote a shareholder meetings. . . . We understand that typically proxy advisory firms represent that they provide their clients with advice designed to enable institutional clients to maximize the value of their investments. In other words, proxy advisory firms provide analyses of shareholder proposals, director candidacies or corporate actions and provide advice concerning particular votes in a manner that is intended to assist their institutional clients in achieving their investment goals with respect to the voting securities they hold. In that way, proxy advisory firms meet the definition of investment adviser because they, for compensation, engage in the business of issuing reports or analyses concerning securities and providing advice to others as to the value of securities.⁸

⁶ Advisers Act Section 202(a)(11) [15 USC 80b-2(a)(11)].

⁷ Although the statute excludes from the definition of investment adviser a publisher of a bona fide newspaper or news magazine or business or financial publication of general and regular circulation, this exemption is unavailable to parties who tailor their publications to the needs of individual clients. *Lowe v. Securities and Exchange Commission*, 472 U.S. 181 (1985) (in order to qualify for the publisher's exemption, the publication must, among other things, provide *impersonal* advice, as opposed to advice tailored to the individual needs of the customer).

⁸ Concept Release on the U.S. Proxy System ("Concept Release"), SEC Rel. No. IA-3052 at 109-110, 75 Fed. Reg. 42981, 43010 (July 22, 2010).

The SEC went on to explain the fiduciary implications of this characterization as follows:

The Supreme Court has construed Section 206 of the Advisers Act as establishing a federal fiduciary standard governing the conduct of investment advisers. The Court stated that '[t]he Advisers Act of 1940 reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship as well as a congressional intent to eliminate or at least to expose, all conflicts of interest which might incline an investment advisers -- consciously or unconsciously -- to render advice which was not disinterested.' As investment advisers, proxy advisory firms owe fiduciary duties to their advisory clients.⁹

The SEC's views on the fiduciary status of proxy advisers align with the long-standing and recently confirmed views of the U.S. Department of Labor ("DOL") on this topic. In its Release announcing a final regulation defining who is a "fiduciary" of an employee benefit plan under the Employee Retirement Income Security Act of 1974 ("ERISA"), the DOL noted that it

has long viewed the exercise of ownership rights as a fiduciary responsibility because of its material effect on plan investment goals. 29 CFR 2509.08-2 (2008). Consequently, recommendations on the exercise of proxy or other ownership rights are appropriately treated as fiduciary in nature.¹⁰

2. General Requirements of the Advisers Act

a. Registration

The Advisers Act and the rules adopted thereunder regulate virtually every aspect of an investment adviser's business. This regime starts with a formal SEC registration process that includes the filing of detailed information about the registrant's business practices, fees, clients, and conflicts of interest, including those arising from affiliated industry activities.¹¹ Once registration is granted, the registration form is uploaded into the Investment Adviser Public Disclosure ("IAPD") database, where the public can access it online through the SEC's website. On an ongoing basis,

⁹ *Id.* at 110 (internal citations omitted), quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192 (1963).

¹⁰ DOL, Employee Benefits Security Administration, *Definition of the Term "Fiduciary"; Conflict of Interest Rule - Retirement Investment Advice*, RIN 1210-AB32, Final Rule (April 1, 2016) at 77-78, 80 Fed. Reg. 21928, 21939 (April 20, 2016).

¹¹ Advisers Act § 203, SEC Rule 203-1 and Form ADV.

investment advisers are required to file interim updates of any material changes to their registration information, and within 90 days of the end of each fiscal year, advisers must report any other changes to their information and must certify that their registration forms are accurate and complete. All of these additional filings are also available to the public through the IAPD.

b. Brochure Disclosure

Even though clients can access an adviser's disclosure information through the IAPD, the Advisers Act still requires advisers to distribute plain-English brochures to clients at or before the time the adviser enters into an advisory agreement with a client.¹² On an annual basis, an adviser whose brochure has materially changed since its last annual update must provide each client with either a new brochure, or a summary of material changes and an offer of a new brochure. Interim amendments must be given to clients under certain circumstances as well.

c. Insider Trading Program and Code of Ethics

The Advisers Act compels all registered investment advisers to establish, maintain and enforce written supervisory procedures designed to prevent firms and their employees from misusing material, nonpublic information they may learn in the course of their advisory activities.¹³ Advisers typically combine this duty with a separate Advisers Act duty to establish, maintain and enforce formal codes of ethics.¹⁴ Such codes must establish general standards of business conduct for employees, in order to "effectively convey to employees the value the advisory firm places on ethical conduct, and [to] challenge employees to live up not only to the letter of the law, but also to the ideals of the organization."¹⁵ The codes of ethics also must require employees to

¹² Advisers Act Rule 204-3. This brochure is the same one used for Part 2A of Form ADV. All brochures must follow a standardized format, a requirement that is designed to allow investors to "comparison shop" among advisers.

¹³ Advisers Act, § 204A.

¹⁴ SEC Rule 204A-1.

¹⁵ SEC Release No. IA-2256 (July 2, 2004), text accompanying note 8.

comply with applicable federal securities laws and to report violations of law or the firm's code of ethics to the firm's compliance staff.

A third major component of an adviser's code of ethics has to do with personal trading. Because advisers are paid to render disinterested advice, fiduciary concerns arise when an adviser or its employees have a personal stake in the subject of their advice.¹⁶ The Advisers Act Code of Ethics rule, therefore, requires advisers to obtain personal trading records from certain categories of employees, so that the adviser can eliminate, or at least manage and disclose any trading-related conflicts of interest.

Finally, advisers must describe their codes of ethics in their Form ADV disclosure brochures and must offer to furnish clients and prospective clients with those codes upon request.

d. Comprehensive Compliance Programs

Another SEC rule under the Advisers Act requires registered investment advisers to establish comprehensive compliance programs.¹⁷ In this regard, an adviser must (a) designate a chief compliance officer responsible for administering the compliance program; (b) implement and enforce written policies and procedures reasonably designed to prevent, detect and correct violations of the Advisers Act; and (c) review those policies and procedures at least annually to assess their adequacy and the effectiveness of their implementation. Under this rule, advisers are obliged to tailor their compliance programs to the regulatory and business risks posed by their particular advisory activities.

e. Recordkeeping

The Advisers Act imposes extensive recordkeeping requirements on registrants.¹⁸ Among the types of records that an adviser must maintain for a minimum of five years are (1) those relating

¹⁶ This fiduciary concern is the exact *opposite* of proxy adviser critics' suggestion that proxy advisers should have "skin in the game." In fiduciary parlance, "skin in the game" means "conflict of interest."

¹⁷ SEC Rule 206(4)-7.

¹⁸ SEC Rule 204-2.

to the adviser's internal affairs, including financial records; (2) compliance procedures and documents evidencing the adviser's annual testing of those procedures; (3) codes of ethics and employees' acknowledgements of the receipt thereof, as well as records of code violations and any actions taken as a result thereof; (4) documents relating in a general way to the adviser's customers, including advisory contracts; (5) advertisements and marketing materials; (6) records of specific recommendations made to clients; (7) records relating to proxy voting, as described more fully in Section 3 below; (8) documents relating to political contributions where the adviser provides services to certain government entities; and (9) personal trading records for employees with access to sensitive client information.

f. Miscellaneous Requirements

Other aspects of the Advisers Act regulatory regime address advertising and other client solicitation, client contracts and pay-to-play (political contributions related to clients and potential clients). This principles-based regime also governs areas such as social media and cybersecurity.

g. SEC Examinations

All research firms registered under the Advisers Act are subject to periodic examination by the SEC's Office of Compliance Inspections and Examinations ("OCIE"). Without weighing in on the larger debate regarding the funding and sufficiency of the SEC's investment adviser examination program, we note that in 2015, OCIE announced that proxy advisers would be one of the priorities of its National Exam Program:

We will examine select proxy advisory service firms, including how they make recommendations on proxy voting and how they disclose and mitigate potential conflicts of interest. We will also examine investment advisers' compliance with their fiduciary duty in voting proxies on behalf of investors.¹⁹

ISS can state from experience that SEC exams are regular and robust.

¹⁹ OCIE, *Examination Priorities for 2015* (January 13, 2015), available at: www.sec.gov/ocie.

3. *The Treatment of Proxy Voting Under the Advisers Act*

In addition to the general Advisers Act provisions described above, there also are special requirements for advisers who vote or render advice about clients' proxies. The fiduciary implications of proxy voting were first articulated not by the SEC, but by the DOL in 1988. In a letter to the Chairman of the Retirement Board of Avon Products (the "Avon Letter"), addressing proxy voting for employee benefits plans subject to ERISA, the DOL stated:

*In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock.*²⁰

A year after the Avon Letter, the DOL issued a report on the proxy voting practices of investment managers of ERISA-covered plans.²¹ In this report the Department advised that practices such as declining to vote proxies and blindly voting all proxies with management are inconsistent with the fiduciary responsibility provisions of ERISA.

The fiduciary implications of proxy voting were recognized by the SEC in 2002, when in the wake of Enron's unprecedented failure of corporate governance, then-SEC Chairman Harvey Pitt responded to a request for guidance concerning the duty of investment advisers to vote proxies on their clients' behalf. After noting the absence of direct regulation of this issue under the federal securities laws, Chairman Pitt went on to say:

*We believe, however, that an investment adviser must exercise its responsibility to vote the shares of its clients in a manner that is consistent with the general antifraud provisions of the Advisers Act, as well as its fiduciary duties under federal and state law to act in the best interests of its clients.*²²

²⁰ Letter from Alan D. Lebowitz, Deputy Assistant Secretary to Mr. Helmuth Fandl, Chairman of the Retirement Board, Avon Products, Inc. (February 23, 1988), 1988 ERISA LEXIS 19, *5-6.

²¹ Pension and Welfare Benefits Administration, U.S. Department of Labor, Proxy Project Report (March 2, 1989).

²² Letter from Harvey Pitt, SEC Chairman to John M. Higgins, President, Ram Trust Services (February 12, 2002). See also Baue, Walter, "SEC Chair Calls Proxy Voting a Fiduciary Duty" (March 29, 2002) available at: www.socialfunds.com/news/article.cgi/808.html.

Chairman Pitt also noted the Commission's ongoing review of various requests and proposals to address conflicts and enhance disclosure of proxy voting practices under the federal securities laws.

After completing that review, the SEC in 2003 adopted new rules and rule amendments relating to proxy voting by registered investment advisers²³ and registered investment companies.²⁴ In so doing, the agency relied on long-established fiduciary standards. For example in adopting the Advisers Act rule, the SEC said:

*The federal securities laws do not specifically address how an adviser must exercise its proxy voting authority for its clients. Under the Advisers Act, however, an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting. 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 subrogate client interests to its own.*²⁵

Advisers Act Rule 206(4)-6 applies these traditional fiduciary concepts by requiring registered investment advisers to adopt written policies and procedures reasonably designed to ensure that the adviser monitors corporate actions and votes client proxies in the clients' best interests. What the rule does *not* do is require investment advisers to vote every proxy, regardless of facts and circumstances. To begin with, the rule applies only to those advisers who have explicitly or implicitly assumed voting authority over their clients' portfolios. Many small advisers, in fact, disclaim such authority altogether. Even where an adviser assumes such authority, the obligation to vote any particular proxy depends on facts and circumstances. In the Commission's words:

We do not suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the client's best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client. An adviser may

²³ SEC Rule 206(4)-6.

²⁴ See Investment Company Act Rel. No. 25922 (January 31, 2003), 68 Fed. Reg. 6564 (February 7, 2003).

²⁵ Advisers Act Rel. No. 2106 (January 31, 2003), 68 Fed. Reg. 6585, 6586 (Feb 7, 2003) ("Proxy Rule Release") (citations omitted).

*not, however, ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies.*²⁶

In addition to requiring an adviser to adopt proxy voting policies and procedures, the rule also requires the adviser to describe those policies and procedures to clients, and to provide a copy of them upon a client's request. Finally, the rule obliges the adviser to tell clients how they can obtain information about how their securities were voted.

Because the fiduciary duty of loyalty requires advisers to act in their clients' best interests, the Commission, in adopting Rule 206(4)-6, paid special attention to the ways in which advisers could manage conflicts of interest that might arise in the proxy voting process:

*Advisers today use various means of ensuring that proxy votes are voted in their clients' best interests and not affected by the advisers' conflicts of interest. An adviser that votes securities based on a pre-determined voting policy could demonstrate that its vote was not a product of a conflict of interest if the application of the policy to the matter presented to shareholders involved little discretion on the part of the adviser. Similarly, an adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party. An adviser could also suggest that the client engage another party to determine how the proxies should be voted, which would relieve the adviser of the responsibility to vote the proxies. Other policies and procedures are also available; their effectiveness (and the effectiveness of any policies and procedures) will turn on how well they insulate the decision on how to vote client proxies from the conflict.*²⁷

The Commission's recognition that advisers can mitigate conflicts of interest in proxy voting by seeking the advice of an independent third party was hardly radical, since the same approach is widely utilized in other areas of investment management. For example, at the SEC's 2013 Roundtable, one institutional investor explained that advisers may seek independent expert advice on portfolio valuation issues in order to make their valuation decisions "less subject to criticism."²⁸ In

²⁶ Proxy Rule Release, 68 Fed. Reg. at 6587 (citations omitted).

²⁷ *Id.* 68 Fed. Reg. at 6588 (citations omitted).

²⁸ Remarks of Eric Komitee, Roundtable Transcript at 73 ("[I]f we have a conflict of interest potentially with respect to the valuation of a given position, we may go get advice from a third party valuation firm because we believe that the valuation decision we make will be less subject to criticism once we have looked to the

the same vein, the then-General Counsel of the Investment Advisers Association remarked that advisers frequently delegate aspects of their management duties to third parties, but when they do so, they retain ultimate fiduciary responsibility for selecting and monitoring those parties.²⁹

4. SEC Staff Interpretive Guidance On the Advisers Act Proxy Rule

Approximately a year after Rule 206(4)-6 was adopted, an unregistered proxy adviser sought guidance from the staff of the SEC's Division of Investment Management about the meaning of the term "independent third party" as used in the rule's adopting release. After generally discussing the types of conflicts an adviser could face in voting clients' proxies, the staff explained that a third party's independence depends on its relationship to the adviser.³⁰ An investment adviser that retains a third party to make proxy voting recommendations must take reasonable steps to verify that the third party is in fact independent of the adviser based on all of the relevant facts and circumstances.

However, the staff went on to explain that merely determining the independence of the third party is not enough. Because the investment adviser is a fiduciary, the adviser has a duty to scrutinize the independent third party's "competency to adequately analyze proxy issues" and to make "recommendations in an impartial manner and in the best interests of the adviser's clients."³¹ The staff indicated that such due diligence is not a one-time exercise, but must be undertaken on an ongoing basis, for example, by a case-by-case evaluation of the third party's own conflicts of interest.

expertise of a third party that is . . . intended to think about those issues").

²⁹ Remarks of Karen Barr, General Counsel, *Id.*, at 57 ("Outsourcing is perfectly acceptable. It's perfectly acceptable to delegate duties to a third party. Investment advisers do it all the time. They hire, for example, sub-advisers to manage parts of their portfolio's core asset management duties, but what advisers do is retain the ultimate fiduciary responsibility to select those third parties. . . and then [exercise ongoing] oversight . . .").

³⁰ Letter from Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management to Kent S. Hughes, Egan Jones Proxy Services (May 27, 2004).

³¹ *Id.*

In a subsequent letter to ISS, the staff gave additional guidance on the type of due diligence an adviser must conduct to satisfy its fiduciary duty when seeking proxy voting advice from an independent third party. In this regard, the staff explained:

Whether an investment adviser breaches or fulfills its fiduciary duty of care when employing a proxy voting firm depends upon all of the relevant facts and circumstances. Consistent with its fiduciary duty, an investment adviser should take reasonable steps to ensure that, among other things, the firm can make recommendations for voting proxies in an impartial manner and in the best interests of the adviser's clients. Those steps may include a case by case evaluation of the proxy voting firm's relationships with Issuers, a thorough review of the proxy voting firm's conflict procedures and the effectiveness of their implementation, and/or other means reasonably designed to ensure the integrity of the proxy voting process. . . . An investment adviser should have a thorough understanding of the proxy voting firm's business and the nature of the conflicts of interest that the business presents, and should assess whether the firm's conflict procedures negate the conflicts.³²

The Staff also said that because a proxy advisory firm's business and/or conflict procedures could change over time, the investment adviser has a fiduciary duty to monitor the third-party service provider's independence on an ongoing basis.

The Staff's opinion that an acceptable due diligence process for engaging a proxy adviser might entail a comprehensive examination of the proxy advisory service's conflict of interest policies and procedures in lieu of evaluating their conflicts on a vote-by-vote basis comports with the macro-level analysis advisers undertake in conducting due diligence in other contexts.³³ For example, an adviser who mitigates its conflicts regarding portfolio valuation by relying on the expertise of an independent valuation service typically assesses the service's integrity and competence by examining the service's overall policies, procedures and operations, and not by

³² Letter from Douglas Scheidt, to Mari-Anne Pisarri, Pickard and Djinis LLP, Counsel for Institutional Shareholder Services Inc., 2004 SEC No-Act. LEXIS 736 (September 15, 2004) at *4-5.

³³ See Lorna A. Schnase, *An Adviser's Duty to Supervise Sub-Advisers (and Other Advisers)* 18-22 (2012) (noting that initial due diligence of outsourced advisory services should include matters such as a review of the third party's compliance systems, code of ethics, internal procedures, Form ADV disclosures and other information about the party's qualifications to perform in the capacity contemplated. On an ongoing basis, due diligence could include quarterly or annual certifications of compliance with applicable laws and the third party's policies and procedures, periodic meetings with key personnel, confirmation of ADV disclosures and notification of material changes to information previously supplied).

evaluating its conflicts on a security-by-security or price-by-price basis.

Although the two Staff interpretive letters from 2004 were dry, routine administrative guidance regarding a new rule, in the past few years, as the debate over the proper role of shareholders in corporate governance has escalated, corporate lobbyists have created a mythology surrounding these letters in an attempt to deprive investment managers and other shareholder representatives of access to professional proxy voting advice. Grossly exaggerating the impact of the letters and distorting investors' traditional interpretation of them, these lobbyists have attempted to rewrite history by variously charging that the letters "created" the demand for ISS' services, and that the letters invite investment advisers to "outsource" or "offload" their fiduciary duties on to unaccountable third parties.

In order to dispel the myths, a copy of the 2004 letter from the SEC staff to ISS is attached to this Statement. ISS encourages members of this Subcommittee to read the letter carefully before taking the extraordinary step of directing the SEC to withdraw this fiduciary guidance, as the proposed legislation would do.

As you review this letter, note first of all that it is not a "no-action letter," since it does not relieve investment advisers from any of the duties imposed on them by the proxy rule. Consider, too, what investor representatives at the SEC Roundtable had to say about the effect of the Staff guidance. For example, the then-General Counsel of the Investment Advisers Association explained that the staff interpretive letters did not make it easier for investment advisers to rely on third-party proxy advice. In fact, they did just the opposite, by spelling out the extensive and ongoing due diligence required of advisers who use these services. She also observed that, "[IAA] members' experience is not that they've increased their use of proxy advisory firms because of the . . . letters. They've increased the use because of the complexity and number of votes."³⁴

³⁴ Roundtable Transcript at 58.

Another shareholder representative at the Roundtable noted that with or without the Staff letters, advisers have a fiduciary duty to vote proxies as a matter of good corporate citizenship, and that relying on the assistance of outside parties is a common way of addressing conflicts of interest.³⁵

The Staff's admonition that advisers who engage independent proxy advisers retain the fiduciary duty to vote their clients' proxies in the clients' best interests and must monitor and evaluate independent proxy services on an ongoing basis was entirely consistent with what the SEC itself said when it adopted the proxy rule:

*Nothing in this rule reduces or alters any fiduciary obligation applicable to any investment adviser (or person associated [therewith]).*³⁶

And the SEC's statement echoed the position DOL took in the 1988 Avon Letter:

*ERISA contains no provision which would relieve an investment manager of fiduciary liability for any decision he made at the direction of another person. . . . Therefore, . . . to the extent that anyone purports to delegate to another the responsibility for such voting decisions, the manager would not be relieved of its own responsibilities and related liabilities merely because it either follows the direction of some other person or has delegated the responsibility to some other person.*³⁷

The SEC and Staff warnings to the effect that hiring a proxy adviser is not a "safe harbor" from fiduciary duty had very practical consequences in a 2009 SEC enforcement action in which the Commission sanctioned a registered investment adviser for voting all of its clients' proxies in accordance with third-party proxy guidelines without ensuring that those guidelines were in the best interests of all of its clients.³⁸

³⁵ Remarks of Eric Komitee, *Id.* at 72-75.

³⁶ Proxy Rule Release, note 8.

³⁷ Avon Letter, 1988 ERISA LEXIS 19,*8.

³⁸ *In the Matter of INTECH Investment Management LLC and David E. Hurley*, Advisers Act Release No. 2872 (May 7, 2009). In finding a violation of Advisers Act Section 206 and Rule 206(4)-6, the Commission noted that the adviser's choice of voting guidelines was tainted by a conflict of interest, because the adviser chose guidelines that could help it retain and obtain advisory business notwithstanding the fact that those guidelines were unsuitable for certain clients.

As for the notion that the Staff interpretive letters created the market for ISS' services, I can attest that by the time the SEC adopted the proxy rule in 2003 and the Staff issued guidance on that rule in 2004, ISS was already established as the leading provider of reliable, comprehensive proxy research and voting recommendations. Notably, while the SEC did not adopt its formal rules until 2003, numerous favorable comments about the DOL's guidance from Commission officials over the years had led many industry players to describe the Staff's view of proxy voting duties as "creeping ERISA." Because most of ISS' clientele long predates the SEC's involvement in fiduciary proxy regulation, I can say with confidence that ISS' success has been driven more by a dedication to meeting investor needs than it has been by any action taken by the SEC.

-- Staff Legal Bulletin 20

A decade after the Staff issued its interpretive letters on the proxy rule and in the midst of all the noise from corporate interests about what the rule and the interpretive guidance really mean, the Staff of the SEC's Investment Management Division and the Staff of the Corporation Finance Division issued a joint communiqué (Staff Legal Bulletin No. 20 or SLB 20) about proxy voting.³⁹ In the first part of this document, the Investment Management Staff revisited the topic of fiduciary duty and proxy voting under the Advisers Act. In so doing, the Staff confirmed what the Commission said in the rule's adopting release, namely that advisers have no absolute duty to vote every proxy relating to their clients' portfolios.⁴⁰ Instead, the Staff said, advisers and their clients have the flexibility to determine the scope of the adviser's duty to exercise proxy voting authority, which may be limited by time and cost considerations or the type of issue presented.

³⁹ SEC Division of Investment Management, Division of Corporation Finance, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*, Staff Legal bulletin No. 20 (IM/CF) June 30 2014, available at <http://www.sec.gov/interp/legal/cfsib20.htm> (hereafter, "SLB 20").

⁴⁰ See note 52, *supra*. and accompanying text.

The Staff also confirmed the guidance it provided in the 2004 interpretive letters to the effect that an investment adviser who retains an independent proxy adviser has a fiduciary duty to conduct reasonable due diligence to ascertain whether that proxy adviser has the capacity and competency to adequately analyze proxy issues, and sufficient policies and procedures to identify and address conflicts of interest. As it did in 2004, the Staff emphasized that these due diligence obligations exist not just at the time the proxy adviser is engaged, but throughout the life of the engagement.

Finally, the Staff provided guidance on ways in which investment advisers could confirm that their clients' proxies are being voted in accordance with clients' best interests and with the adviser's proxy voting procedures, such as by periodically sampling votes cast. The Staff also reminded advisers of their duty to at least annually assess the sufficiency of their own proxy voting policies and procedures and the effectiveness of the implementation of those policies and procedures, as required by Advisers Act Rule 206(4)-7.

In the second part of SLB 20, the Staff of the SEC's Division of Corporation Finance addressed the interplay between proxy advisory services and the federal proxy rules under section 14 of the Exchange Act. Noting that Exchange Act Rule 14a-1(l) defines a proxy solicitation to include "the furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy," the Staff summarized a long-standing Commission position as follows: "As a general matter, the Commission has stated that the furnishing of proxy voting advice constitutes a 'solicitation' subject to the information and filing requirements of the federal proxy rules."⁴¹ As noted above, however, what the SEC actually said in the Release the staff purports to rely on is, "As a general

⁴¹ SLB 20, note 10, citing *Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally*, SEC Release No. 34-16104 (August 13, 1979).

matter, **unsolicited** proxy voting advice would constitute a 'solicitation' subject to the proxy rules."⁴² This critical omission changes the entire meaning of the SEC's long-standing position, and, in ISS' view, confirms that proxy advisers who supply proxy voting advice based on investor-selected voting guidelines in the context of a fiduciary advisory relationship are not engaged in a 'solicitation' as contemplated by Section 14 of the Exchange Act.

After addressing the definition of "solicitation," the Staff went on in SLB-20 to confirm that proxy advisers who furnish advice in the ordinary course of business, and disclose to the recipient of their advice any significant relationship they have with the subject of the advice or its affiliates, or a security holder proponent of the matter on which advice is given, and who satisfy certain other conditions, are exempt from the information and filing requirements of the Exchange Act proxy rules. The Staff also furnished guidance on how a proxy advisory firm could make the facts-and-circumstances determination of whether it had a significant relationship with a company or a security holder proponent, or whether it otherwise had a material interest in the matter that is the subject of the voting recommendation.

**C. ISS' Compliance With The Advisers Act Regulatory Regime
And Mitigation of Conflicts of Interest**

As a registered investment adviser since 1997, ISS complies with the regulatory reporting, client disclosure, insider trading, code of ethics, compliance procedures, recordkeeping, advertising, pay-to-play and other aspects of the Advisers Act regime applicable to investment advisers who

⁴² *Id.* The Commission's statement in Release No. 34-16104 is consistent with the prior position of the SEC's General Counsel announced in SEC Release No. 34-7208 (January 7, 1964). That earlier Release addressing when proxy voting advice by a broker-dealer could be subject to the federal proxy rules said:

*In our view a broker normally is not engaged in solicitation where he merely responds, whether orally or in writing, to an **unsolicited** request from a customer for advice as to how to vote. Since the broker is merely responding to his customer's request for advice in his capacity as adviser to the customer and is not actively initiating the communication, it may be concluded that he is not engaged in 'soliciting.'*

supply research to investors. At the heart of its regulatory compliance program is a deliberate, carefully crafted, routinely tested and periodically updated series of measures designed to eliminate, or manage and disclose conflicts of interest.

ISS addresses conflicts, first and foremost, by being 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 and consistency of ISS advice.⁴³

Furthermore, as required by the Advisers Act's compliance program rule,⁴⁴ ISS has undertaken a comprehensive risk assessment to identify specific conflicts of interest related to its operations and has adopted compliance controls reasonably designed to manage those risks. One of the primary components of its compliance program is its Code of Ethics, which as required by SEC Rule 204A-1, prescribes standards of conduct for ISS and its employees.⁴⁵

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's voting recommendations. The Code emphasizes the requirement that all research for clients be rendered independently of employees' personal interests.

⁴³ Each ISS analysis includes a URL for a direct hyperlink to ISS' summary voting guidelines for easy access by users of ISS research.

⁴⁴ SEC Rule 206

⁴⁵ See discussion at Section B.2.c., *supra*.

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.

1. Conflicts in Connection with Affiliated Corporate Services

The most talked-about conflict where ISS is concerned relates to the fact that one of its subsidiaries, ISS Corporate Solutions, Inc. ("ICS"), provides governance tools and services to corporate issuer clients. Left unchecked, this conflict could result in vote recommendations that are biased in favor of corporate management. However, the fact that the most vocal critics of ISS are those who speak on behalf of corporate management (like several of the witnesses at today's hearing), and not the investors who rely on ISS' research and vote recommendations, indicates that ISS is managing the potential of this conflict extremely well.

One of the most important components of the ISS compliance program is the firewall maintained between the core institutional business and the ICS business. 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:

- ICS is a separate legal entity from ISS.
- ICS is physically separated from ISS, and its day-to-day operations are separately managed.
- ISS Global Research team works independently from ICS.
- ICS and ISS staff are forbidden to discuss the identity of ICS clients.
- Institutional analysts' salaries, bonuses and other forms of compensation are not linked to any specific ICS activity or sale.
- ICS explicitly tells its corporate clients and indicates in their contracts 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. There also is an ethics hotline available to both ICS and ISS staff for reporting issues of potential concern.

2. Conflicts in Connection with ISS' Owner

ISS is a privately-held company, whose ultimate owner is affiliated with Vestar Capital Partners, a private equity firm. ISS has complete independence from its owner in the application of its voting policies, the preparation of proxy analyses and the formulation of vote recommendations. The Board of Directors of ISS has formally adopted a Policy on Mitigation of Potential Conflicts of Interest. Among other things, this Policy is intended to identify situations that may exist or give rise to actual or potential conflicts of interest, or to the appearance of conflicts of interest, in connection with the work that ISS performs in researching, analyzing and making recommendations regarding publicly-held companies relative to the work of Vestar as a private equity firm, and to take such actions as may be necessary to mitigate any actual or potential conflicts.

3. Conflicts Within the Institutional Advisory Business

Conflicts also may arise where an ISS client is, itself, a public company whose proxies are the subject of analyses and voting recommendations, or other advisory research reports or where the Company is called upon to analyze and vote on shareholder proposals propounded by a Company client. ISS' fiduciary commitment to act in the best interests of each client, its practice of aligning vote recommendations with applicable published or custom voting policies, and the ongoing scrutiny it receives from its institutional clientele effectively address this potential conflict.

4. Conflicts in Connection with Issuers' Review of Draft Analyses

Allowing issuers to review draft proxy research reports presents a risk that the subjects of

ISS' advice will have an undue influence on the content of that advice. In order to ensure the propriety of the interaction between the issuer and the analyst, any decision by an analyst to change a vote recommendation based on an issuer's notification of one or more factual errors in a draft report must be reviewed by a senior analyst and appropriate records must be kept of the communication from the issuer and the voting decision. These records are subject to the Chief Compliance Officer's periodic review.

5. 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 to assist clients and prospective clients in fulfilling their own obligations regarding the use of proxy advisory services. 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. A copy of the ISS Board of Directors Conflicts of Interest Policy related to Director-Affiliated Companies is also available through the ISS web site.

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 ISS 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. Although investment advisers typically disclose conflict of interest information at a macro level,⁴⁶ ISS does more. Any institutional client that wishes to learn more about the relationship, if any, between ICS and the subject of a particular analysis or report may contact ISS' Legal and

⁴⁶ See, e.g. Form ADV, Part 2A, Item 11.

Compliance Department for relevant details. This process allows ISS' proxy voting clients to receive the names of ICS clients without revealing that information to research analysts as they prepare vote recommendations and other research. ISS clients are also provided with details about the amount that each ICS client has paid ICS and the particular products/services they purchased. Were the ICS relationship identified on the face of a proxy analysis or report, this critical information barrier would be destroyed.

In addition to obtaining report-by-report conflict information, institutional clients of ISS can obtain lists of all ICS clients. Some clients receive such lists on a monthly basis, while others receive the lists on a quarterly or annual basis. This is just one of the many steps institutional investors take to reassure themselves that ISS is appropriately mitigating conflicts. They also obtain a range of additional information regarding our information barriers, our data centers, and other aspects of our operations. Many clients meet with ISS staff on an annual basis to discuss conflicts and other due diligence matters.

-- ISS' Response to SLB 20

ISS' response to SLB-20 was two-fold. With regard to the first portion of SLB-20 that reminded investment advisers of the SEC's long-standing position that advisers must exercise appropriate oversight of their third-party proxy advisory firms, ISS reviewed and updated its due diligence materials to provide its clients with the information they need to fulfill that oversight responsibility. Through the materials that ISS makes available online, the facilitation of due diligence meetings and calls with clients and other communication avenues, ISS provides clients with detailed information regarding the capabilities of ISS staff, our capacity to analyze proxy issues, and our ability to formulate voting recommendations in an impartial and accurate manner.

Although ISS does not agree with the Corporate Finance Staff's view that personalized, fiduciary proxy advisory services acquired by institutional investors are "solicitations" under the Exchange Act proxy rules, ISS nevertheless took steps to assess potential conflicts of interest

arising from certain types of significant relationships and then improved the manner in which those relationships are disclosed. To this end, ISS' executive leadership team, in conjunction with ISS' Legal/Compliance team, designed and published in November 2014 a *Policy Regarding Disclosure of Significant Relationships*. This Policy provides our clients with a firm understanding of how we assess and disclose any significant relationships that may exist between ISS and the subjects of our proxy research reports. At the time we published this Policy, we also enhanced our client-facing ProxyExchange platform to provide these disclosures to our clients in a way that both protects the firewall between ISS and ICS seamlessly integrates the disclosure with our clients' workflows.


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U.S. Securities and Exchange Commission
**Investment Advisors Act of 1940 - Rule 206(4)-6
Institutional Shareholder Services, Inc.**
September 15, 2004

Mari Anne Pisarri, Esq.
Pickard and Djinis LLP
1990 M Street, N.W.
Washington, DC 20036

Dear Ms. Pisarri:

In your letter dated September 15, 2004 on behalf of Institutional Shareholder Services, Inc. ("ISS"), you request that we elaborate on the guidance that we provided on May 27, 2004 to Egan Jones Proxy Services (the "Egan Jones Letter") concerning investment advisers that use the recommendations of independent third parties to vote client proxies.¹ You essentially request that we concur with your view that an investment adviser may determine that a proxy voting firm is capable of making impartial proxy voting recommendations in the best interests of the adviser's clients based on the procedures that the proxy voting firm has adopted and implemented to insulate the firm's voting recommendations from incentives to vote the proxies to further the firm's relationships with issuers ("conflict procedures").²

In the Egan Jones Letter, we indicated that, under certain circumstances, a proxy voting firm could be an independent third party for purposes of making proxy voting recommendations for an investment adviser's clients, even though the firm receives compensation from an issuer ("Issuer") for providing advice on corporate governance issues ("corporate services").³ We explained, however, that an investment adviser could breach its fiduciary duty of care to its clients by voting its clients' proxies based upon a proxy voting firm's recommendations because the firm could recommend that the adviser vote the Issuer's proxies in the firm's own interests, to further its relationship with the Issuer and its business of providing corporate services, rather than in the interests of the adviser's clients.

In the Egan-Jones Letter, we stated that an investment adviser should obtain information from any prospective proxy voting firm to enable the adviser to determine that the firm is in fact independent, and can make recommendations for voting proxies in an impartial manner and in the best interests of the adviser's clients. We suggested that an investment adviser also obtain such information on an ongoing basis from any proxy voting firm that it employs. We also suggested that an investment adviser require a proxy voting firm to disclose to the adviser any relevant facts concerning the firm's relationship with an Issuer, such as the amount of the compensation that the firm has received or will receive from the Issuer.

You contend that a case-by-case evaluation of a proxy voting firm's potential conflicts of interest is not the exclusive means by which an investment adviser may fulfill its fiduciary duty of care to its clients in connection with voting client proxies according to the firm's recommendations. We agree. You believe that an investment adviser may instead determine that a proxy voting firm is capable of making impartial recommendations in the best interests of the adviser's clients based on the firm's conflict procedures.

Whether an investment adviser breaches or fulfills its fiduciary duty of care when employing a proxy voting firm depends upon all of the relevant facts and circumstances. Consistent with its fiduciary duty, an investment adviser should take reasonable steps to ensure that, among other things, the firm can make recommendations for voting proxies in an impartial manner and in the best interests of the adviser's clients. Those steps may include a case by case evaluation of the proxy voting firm's relationships with Issuers, a thorough review of the proxy voting firm's conflict procedures and the effectiveness of their implementation, and/or other means reasonably designed to ensure the integrity of the proxy voting process.

The relevant facts and circumstances will dictate what steps an investment adviser should take in evaluating a prospective proxy voting firm.

When reviewing a proxy voting firm's conflict procedures, an investment adviser should assess the adequacy of those procedures in light of the particular conflicts of interest that the firm faces in making voting recommendations.⁴ An investment adviser should have a thorough understanding of the proxy voting firm's business and the nature of the conflicts of interest that the business presents, and should assess whether the firm's conflict procedures negate the conflicts.⁵ The investment adviser should also assess whether the proxy voting firm has fully implemented the conflict procedures.

We also note that a proxy voting firm's business and/or conflict procedures could change after an investment adviser's initial assessment, and any changes could alter the effectiveness of the conflict procedures and require the adviser to make a subsequent assessment. Consequently, an investment adviser should establish and implement measures reasonably designed to identify and address the proxy voting firm's conflicts that can arise on an ongoing basis, such as by requiring the firm to update the adviser of any relevant change in its business or conflict procedures.

Please note that we take no position in this letter regarding whether ISS' conflict procedures, as described in your letter, effectively ensure that its proxy voting recommendations to investment advisers are impartial. Nor do we take any position regarding whether an investment adviser should hire ISS as an independent third party to vote client proxies. The decision to hire ISS as an independent third party and, in particular, the assessment of the adequacy and effectiveness of ISS' conflict procedures rests entirely with the investment adviser. If you have additional questions, you may telephone John L. Sullivan, Senior Counsel, David W. Grim, Branch Chief, or Alison M. Fuller, Assistant Chief Counsel, at (202) 942-0659.

Very truly yours,

Douglas Scheidt
Associate Director and
Chief Counsel

Endnotes

¹ As we noted in the Egan-Jones Letter, an investment adviser may face direct and indirect conflicts of interest in voting its clients' proxies. An investment adviser could, however, demonstrate that its vote of its clients' proxies was not a product of a conflict of interest if the adviser voted the proxies in accordance with a pre-determined policy based on the recommendations of an independent third party. See Investment Advisers Act Release No. 2106 (Jan. 31, 2003) (adopting Rule 206(4) 6). See also Investment Company Act Release No. 25922 (Jan. 31, 2003) (adopting Rule 30b1-4 under the Investment Company Act of 1940).

² In your letter, you specifically request no-action relief under rule 206(4)-6 under the Advisers Act. That rule addresses the adoption, implementation and disclosure of proxy voting procedures that are reasonably designed to ensure that investment advisers vote client proxies in their clients' best interests. You do not, however, request relief from any requirement of the rule. Consequently, we will not respond to your request for no-action relief under the rule. In addition, as a matter of policy, we will not respond to inquiries as to whether any particular policies and procedures are reasonably designed to ensure that an investment adviser votes its clients' proxies in their best interest because those inquiries are factual in nature, and we are not in a position to ascertain, verify or evaluate the requisite factual information.

³ We stated that the mere fact that the proxy voting firm provides corporate services and receives compensation from the Issuer for these services generally would not affect the firm's independence from an investment adviser for purposes of making voting recommendations concerning the Issuer's proxies for the investment adviser's clients.

⁴ For example, when assessing a proxy voting firm's conflict procedures, an investment adviser should consider whether the procedures effectively (a) preclude the natural persons who make the firm's proxy voting

recommendations from obtaining access to information about the firm's business relationships with Issuers and (b) insulate those persons from direct or indirect influence by the firm's employees who know of those relationships.

In addition, an investment adviser should consider, among other things, evaluating the frequency with which the proxy voting firm recommends voting in favor of the management of Issuers that have engaged the firm to provide corporate services.

⁵ As an example, an investment adviser should consider how the conflict procedures address a proxy voting firm's voting recommendation concerning an Issuer that makes payments to the firm for corporate services, which are the single largest source of revenue for the firm.

Incoming Letter

Pickard and Djinis LLP
Attorneys at Law
1990 M Street, N.W.
Washington, D.C. 20036

September 15, 2004

By Hand and Electronic Mail

Douglas J. Scheidt, Esq.
 Associate Director (Chief Counsel)
 Division of Investment Management
 Securities and Exchange Commission
 450 Fifth Street, N.W.
 Washington, D.C. 20549

Dear Mr. Scheidt:

We submit this letter on behalf of Institutional Shareholder Services, Inc. ("ISS") to request assurance that the Division of Investment Management will not recommend enforcement action to the Commission if a registered investment adviser determines the impartiality of an independent proxy voting firm based on the proxy voting firm's overall policies and procedures rather than on an examination of the firm's specific relationships with individual issuers. In particular, ISS seeks a no-action position to the effect that an adviser may satisfy its duty under Rule 206(4)-6 under the Investment Advisers Act of 1940 ("Advisers Act") to determine that an independent proxy voting firm is capable of making impartial recommendations in the best interests of the adviser's clients by examining the procedures that the proxy voting firm has adopted to insulate its voting recommendations from its relationships with issuers.

ISS is a registered investment adviser whose primary business is helping institutional investors meet their fiduciary responsibilities related to proxy voting. It does this by analyzing proxies and issuing informed research and objective vote recommendations for more than 10,000 U.S. and 12,000 non-U.S. shareholder meetings each year.¹ In addition, the company publishes proxy voting manuals, newsletters and proxy season reviews, and maintains various corporate governance databases.

Completely separate from its institutional business, ISS also serves the issuer community with a variety of corporate governance web-based tools, advisory services and publications that can assist issuers with executive and director compensation modeling, capital structure planning and understanding corporate governance best practices. ISS believes that supplying issuers with access to its corporate governance web-based tools, advisory services and publications benefits the firm's institutional clientele, because good corporate governance ultimately results in increased shareholder value. Nevertheless, ISS realizes that serving both institutional investors and issuers could create potential conflicts. ISS has adopted and follows policies and procedures to ensure that the proxy voting advice and services it provides to institutional investors remain independent from the products and services it offers to issuers. These policies and procedures are fully disclosed to ISS' clients.

First, ISS has erected a firewall between its institutional and corporate activities in order to maintain the highest level of objectivity in research and integrity in voting recommendations. This firewall involves functional, physical, and technological separations. For example, the management and

staff of the Domestic and Global Research departments who analyze proxies and formulate voting recommendations are completely different from the management and staff of the Corporate Programs division who supply the web-based tools and publications to corporate clients and provide advice in connection therewith. The sales staffs for the institutional and corporate products are distinct as well.

The Domestic and Global Research staff and the Corporate Programs staff operate out of separate and secure areas at ISS' headquarters, and they maintain separate and secure office equipment and information databases. Furthermore, both the Corporate Programs staff and the sales staff for the corporate products have been trained in the requirement to keep the identities of the issuer clients confidential, and they communicate with those clients in a secure fashion. ISS has also instituted a "blackout" policy pursuant to which the Corporate Programs division refrains from providing any advisory services to issuers or access to the web-based tools from the time a definitive proxy statement is filed and until the date of the issuer's shareholders' meeting.

In addition to its elaborate firewall, ISS has taken other steps to ensure the objectivity and transparency of its proxy voting advice. For example, ISS publishes a Proxy Voting Manual that describes all of the company's policies and the analytical framework it uses to make voting decisions on every major issue. By articulating these policies and analytical framework and requiring that all proxy analyses and vote recommendations be formulated in accordance therewith, the Manual ensures that each individual proxy analysis and voting recommendation is made on an objective basis. Furthermore, ISS requires issuers who buy products and services from the Corporate Programs division to sign an agreement acknowledging that their acquisition of such services will not result in their proxy proposals' receiving preferential treatment from ISS.²

Believing that sunlight is the best disinfectant, ISS also informs its institutional clientele about its business relationships with issuers in a number of different ways. For example, Part II of ISS' Form ADV contains a comprehensive narrative description of all the products and services that ISS makes available to corporations. Similar comprehensive disclosure appears on ISS' website.³ In addition, the standard Master Services Agreement ISS uses with its institutional clients clearly discloses both that ISS' Corporate Programs Division offers products and services to issuers of proxy solicitations and that the Corporate Programs Division employees are not involved in the analysis of filed proxy proposals or the preparation of vote recommendations.

Finally, ISS discloses the existence of its corporate relationships on each proxy analysis, and it does so in a way that protects the sanctity of the firewall:

This issuer may have purchased self-assessment tools and publications from ISS, or ISS's Corporate Programs Division may have provided advisory or analytical services to the issuer in connection with the proxies described in this report. Neither the issuer nor any Corporate Programs Division employee played a role in the preparation of this report. To inquire about any issuer's use of ISS Corporate Programs products please email disclosure@issproxy.com.

ISS affords institutional subscribers the opportunity to inquire about ISS' specific relationship with any individual issuer rather than merely publishing that information, because publicly identifying corporate clients would tip off the proxy analyst as to those relationships, thereby raising the very conflict that the company's information barrier is designed to avoid.

For the reasons discussed below, we respectfully submit that an adviser who subscribes to ISS' Proxy Advisory Services could sufficiently assess ISS' ability to render impartial voting advice on the basis of the firewall, general disclosure and other policies and procedures described herein without inquiring about specific issuer relationships on a case-by-case basis.

DISCUSSION AND ANALYSIS

As fiduciaries, investment advisers owe their clients duties of care and loyalty regarding all activities they undertake on their clients' behalf.⁴ Last year, the Commission adopted Rule 206(4)-6 under the Advisers Act to address advisers' fiduciary duties in the context of proxy voting.⁵ Among

other things, this rule requires an investment adviser who has authority to vote client proxies to adopt and implement written policies and procedures reasonably designed to ensure that the adviser votes those proxies in the clients' best interest.⁶

The required policies and procedures must specifically describe how the adviser addresses material conflicts between its interests and those of its clients with respect to proxy voting. However the rule does not dictate the way in which advisers must address conflicts; nor does it include a list of approved procedures. Instead, the Commission recognized that because advisers come in so many shapes and sizes, the public is best served if advisers have the flexibility to craft procedures tailored to their operations and the particular conflicts they face.

While declining to specify how an adviser must address conflicts of interest, the Commission, in the Adopting Release for the rule, did discuss a number of options an adviser might consider. These include disclosing conflicts and obtaining client consent before voting; having the client engage another party to vote a proxy involving a material conflict; voting securities based on a pre-determined policy, where application of that policy to the matter in question leaves the adviser little discretion; or voting in accordance with a pre-determined policy based on the recommendations of an independent third party. To these options, the Commission added:

Other policies and procedures are also available; their effectiveness (and the effectiveness of any policies and procedures) will turn on how well they insulate the decision on how to vote client proxies from the conflict.⁷

In a May 27, 2004 interpretive letter to Egan-Jones Proxy Services the staff of the Investment Management Division addressed the circumstances under which a third party may be considered "independent" for purposes of Rule 206(4)-6. In particular, the Egan-Jones letter confirmed that a third-party voting service's independence is determined by its relationship to the adviser who hires it to vote client proxies, not by its other business relationships. Thus, the "mere fact that the proxy voting firm provides advice on corporate governance issues and receives compensation from the Issuer for these services generally would not affect the firm's independence" for purposes of Rule 206(4)-6.⁸

However, the interpretive letter went on to explain that in order to satisfy its fiduciary duties, an investment adviser must undertake some due diligence before deciding to follow the voting recommendations of an independent proxy voting firm. In this regard, the adviser must obtain sufficient information to determine, among other things, that the independent voting firm has the capacity and competency to analyze proxy issues adequately, and that it is capable of making voting recommendations in an impartial manner and in the best interest of the adviser's clients. The adviser should also implement procedures to identify and address any conflicts regarding the third-party voting service that can arise on an ongoing basis.

Where an independent voting agent receives compensation from issuers for providing advice on corporate governance matters, the letter suggests various steps an investment adviser could take to ascertain that the agent is still able to make impartial voting recommendations in the best interests of the adviser's clients. These steps include requiring the voting agent to disclose information about its corporate governance activities on an issuer-by-issuer basis, or allowing the independent third party to vote the proxies of only those issuers with whom it has no material relationship. Although the staff did not indicate that these steps were the exclusive means by which an investment adviser could satisfy its fiduciary duties to its clients, some parties have, unfortunately, read the Egan-Jones letter that way.

As noted above, in adopting Rule 206(4)-6 the Commission opined that an adviser can address conflicts of interest in a variety of ways, and that the effectiveness of an adviser's policies and procedures depends on how well they insulate the proxy voting decision from the conflict in question. This means that an adviser can make a determination of an independent proxy voting agent's ability to render impartial advice based on the independent proxy voting agent's policies and procedures to insulate its voting recommendations from its relationships with issuers, without inquiring about the firm's relationships with issuers on a case-by-case basis.

CONCLUSION

Based upon the foregoing, we ask for your assurance that you will not recommend that the Commission take enforcement action for a violation of Rule 206(4)-2 under the Advisers Act if a registered investment adviser determines the impartiality of an independent proxy voting firm based on the proxy voting firm's overall policies and procedures rather than on an examination of the proxy voting firm's specific relationships with individual issuers. If you need any further information on this matter, please do not hesitate to contact me or William D. Edick at 202-223-4418.

Very truly yours,

Mari-Anne Pisarri

cc: John M. Connolly

Endnotes

¹ ISS also votes, records and generates voting activity reports for approximately one-half of its institutional shareholder client base.

² In fact, approximately 25 percent of all issuers who use ISS' products or services subsequently submit proposals that receive a negative recommendation from ISS' Proxy Advisory Service.

³ www.issproxy.com. The home page for this site clearly identifies "Solutions for Institutional Investors" and "Solutions for Corporate Issuers."

⁴ See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).

⁵ See IA Rel. No. 2106 (Jan. 31, 2003) (the "Adopting Release").

⁶ The rule also obligates advisers to disclose information about those policies and procedures to clients and to inform clients how they can obtain information regarding how the adviser has voted their proxies.

⁷ Adopting Release at section II.A.2.b.

⁸ Egan-Jones Proxy Services at 3.

<http://www.sec.gov/divisions/investment/noaction/iss091504.htm>

