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## **WRITTEN TESTIMONY**

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Committee on Financial Services  
United States House of Representatives

Hearing on “Examining the Market Power and Impact of Proxy Advisory Firms”

## **INTRODUCTION**

My name is Jeffrey D. Morgan and I am President and CEO of the National Investor Relations Institute. Founded in 1969, NIRI is the professional association of corporate officers and investor relations consultants responsible for communication among corporate management, shareholders, securities analysts, and other financial community constituents. NIRI is the largest professional investor relations (IR) association in the world with more than 3,300 members representing over 1,600 publicly held companies and over \$9 trillion in stock market capitalization.

NIRI appreciates the opportunity to present our views on the regulation of proxy advisory firms and other ways to improve the ability of public companies (also known as “issuers”) to communicate with their investors. NIRI thanks Chairman Scott Garrett, Ranking Member Carolyn Maloney, and the Subcommittee’s staff for scheduling this hearing on these important issues.

## **BACKGROUND**

NIRI supports transparent, fair, efficient, and robust capital markets, which are essential to promoting innovation, sustainable job creation, and a strong U.S. economy. Vital to such capital markets are ensuring that public companies can communicate effectively with their shareholders and that investors receive accurate information. We need to have an accurate and transparent proxy system that allows efficient two-way corporate-investor communications and ensures equality among shareholders.

Shareholders are the ultimate owners of our public companies and they must have accurate and timely information so they can make informed decisions when they buy or sell a company’s shares or cast their ballots at shareholder meetings. IR professionals play a dual role in this important two-way communication process. They work to ensure that all investors have fair access to the publicly available and material information about a company’s financial results, future prospects, and corporate governance. IR professionals also make sure that shareholders’ views are heard by management and directors.

My testimony will focus on two concerns that relate to the ability of companies to reach their investors: 1) the role of loosely regulated proxy advisory firms and 2) the outdated SEC rules that can prevent companies from effectively communicating with shareholders on a timely basis. NIRI has a long record of seeking reforms on these two issues. NIRI has submitted and also joined other organizations in submitting various comment letters to the SEC on ways to reform the archaic and complex proxy communications system – an outdated system that has not kept pace with globalization, technological innovation, and in general, more modern times.

## **THE GROWING INFLUENCE OF PROXY ADVISORY FIRMS**

Before outlining our suggested reforms on proxy advisory firms, it may be helpful to review how these firms became so powerful. Over the past 25 years, there has been a fundamental shift in who owns shares in U.S. public companies. In 1987, mutual funds, pension funds, and other

institutional investors owned 47 percent of the shares of the largest 1,000 U.S. companies. By 2007, these institutions had increased their ownership to 76 percent.<sup>1</sup> Consequently, these institutions and their proxy advisors now exercise tremendous influence when companies hold their annual meetings each year to seek investor support on director candidates, executive compensation, potential takeover offers, and other material matters.

Unlike many individual investors who vote sporadically at annual meetings, mutual fund and pension fund managers are required to vote all their shares on every matter, a result of various interpretations by the SEC and the Department of Labor. For the largest institutions, that means that they must vote on more than 100,000 ballot items each year. More than 80 percent of U.S. companies hold their annual meetings each spring, which further intensifies the voting workload for institutional investors. In order to manage the costly and time-consuming responsibility of voting all these ballots, many institutions and their investment managers commonly outsource this responsibility to a proxy advisory firm. In a 2004 comment letter, the SEC further encouraged this practice when it noted that investment managers avoid potential conflicts of interest if they followed the advice of an outside proxy advisor.<sup>2</sup> Should they decide to override their proxy advisor, some institutions require an extra level of documentation to support the investment manager's decision, which can later become a key factor in that firm's ability to attract capital from large pension funds and endowments that look to understand each time an investment manager diverges from a proxy advisor's recommendation.

Today, two firms, Institutional Shareholder Services (ISS) and Glass Lewis & Co., dominate the proxy advisory business. While there are varying estimates of their influence, it has been estimated that ISS has a 61 percent market share, while Glass Lewis has a 36 percent share.<sup>3</sup> According to a 2007 General Accounting Office study, the two firms collectively had more than 2,000 institutional clients with \$40.5 trillion in assets.<sup>4</sup>

Today, proxy advisory firms remain largely unregulated and unsupervised, while substantial concerns have been raised by companies and academics about: (1) a lack of transparency concerning their standards, procedures, and methodologies; (2) the risk that their voting

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<sup>1</sup> "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 15-16, available at: <http://www.executivecompensation.org/docs/c11-07b%20Proxy%20Advisory%20White%20Paper.pdf>

<sup>2</sup> "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>

<sup>3</sup> 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. The author, an associate professor at New York Law School, attached the comment to a letter filed with the SEC on Oct. 20, 2010. That letter is available at: <http://www.sec.gov/comments/s7-14-10/s71410-183.pdf>

<sup>4</sup> See Government Accountability Office, *Corporate Shareholder Meetings: Issues Relating to Firms That Advise Institutional Investors on Proxy Voting, a Report to Congressional Requesters*, GAO-07-765 (Washington, June 2007): 13, <http://www.gao.gov/new.items/d07765.pdf>

recommendations may be based on incorrect factual information; and (3) the inherent conflicts of interest posed by several of their business practices.

Given their large roster of clients, the two largest advisory firms can have extraordinary influence on the outcome of director elections and other proxy voting matters. Collectively, ISS and Glass Lewis clients may own between 20 and 50 percent of a large or mid-cap company's shares. While not all institutions follow the advice of their proxy advisors in all cases, many of them do so, particularly the small and medium-size institutions that don't have their own corporate governance staffs. Although the influence of the proxy advisors varies by company and subject matter, governance experts have found that a negative proxy advisor recommendation can lead to a 15 to 30 percentage point differential in support for management. As Leo E. Strine Jr., vice chancellor of the Delaware Court of Chancery, has observed: "Following ISS constitutes a form of insurance against regulatory criticism, and results in ISS having a large sway in the affairs of American corporations."<sup>5</sup>

The influence of ISS and Glass Lewis has increased again when the Dodd-Frank Wall Street Reform and Consumer Protection Act required U.S. companies to hold shareholder "Say on Pay" votes on their executive compensation practices. In 2012, companies receiving a negative recommendation from ISS on executive pay saw their average support levels fall from 94 to 64 percent, according to Semler Brossy, an executive compensation consultant.<sup>6</sup>

Unlike investors and companies whose proxy filings are subject to review and sanctions by the SEC, proxy advisors generally are exempt from regulation. Although ISS has registered with the SEC as a registered investment advisor, the SEC does not provide systematic oversight over the proxy firms' policies and research processes, how the firms interact with companies, and how they communicate with investors and other market participants. In its 2010 concept release on the U.S. proxy voting system, the SEC acknowledged the significant role of proxy advisors, but the Commission has not yet taken any formal action to address their research practices.<sup>7</sup> While Commission officials indicated in June 2012 that they were working on this, it does not appear

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<sup>5</sup> Leo E. Strine Jr., "The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (And Europe) Face," *Delaware Journal of Corporate Law* 30 (2005): 688, available at: <http://ssrn.com/abstract=893940> See also "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 15–16, available at: <http://www.executivecompensation.org/docs/c11-07b%20Proxy%20Advisory%20White%20Paper.pdf>

<sup>6</sup> See Semler Brossy, "2012 Say on Pay Results: Year-End Report" (Dec. 31, 2012) (this report analyzed vote results from the Russell 3000 companies that held pay votes in 2012), available at: <http://www.semlebrossy.com/wp-content/uploads/2013/01/SBCG-SOP-Year-End-Report.pdf>

<sup>7</sup> On May 23, 2013, the SEC announced a settlement with ISS over the firm's failure to adequately safeguard confidential proxy voting information from more than 100 clients. That case resulted from a whistleblower's complaint that alleged that an ISS employee accepted meals, tickets for concerts and sports events, and other benefits from a proxy solicitor in exchange for the confidential information. Without the whistleblower, it is unlikely that the SEC would have uncovered this wrongdoing on its own. While this case did not involve ISS research analysts, it does illustrate that more robust regulation is needed and raises questions about the ability of ISS to manage its conflicts of interest. See "SEC Charges Institutional Shareholder Services in Breach of Clients' Confidential Proxy Voting Information" (May 23, 2013), available at: <http://www.sec.gov/news/press/2013/2013-92.htm>

that this issue is as high a priority as other agency initiatives, including various mandates under the Dodd-Frank Act and the JOBS Act, and resources appear to have been allocated accordingly thus far.<sup>8</sup>

### **Lack of Transparency and Opportunities for Corporate Input**

Proxy advisory firms play a major role in shaping how institutional investors view corporate governance issues, but the advisors' policy development process and methodologies are largely opaque, with limited opportunities for corporate input. In some cases, proxy advisory firms work with their clients to develop unique voting guidelines. However, more often than not, investors accept benchmark voting guidelines policies developed by the proxy advisory firms. While some clients provide input on particular voting policies, the reality is often that the proxy advisory firm suggests the policy; and voting patterns at companies suggest that many institutions vote according to those policies. The end result of this process is not a unique set of voting instructions for each institutional client, but a set of guidelines and policies that have been developed by the proxy advisory firm and are used by most of the firm's clients. As a general matter, the proxy firms do not evaluate the facts and circumstances of each public company with respect to the matters to be voted on; instead, their voting guidelines encourage a procrustean "one-size-fits-all" or "check the box" methodology.

Since the global economic crisis of 2008-09, we believe that proxy advisors have faced increasing pressure from their investor clients to constrain costs. This pressure has further encouraged the proxy advisors to adopt "one-size-fits-all" voting policies that are less costly to apply. We also believe that proxy advisors have responded by cutting their full-time research staffs, hiring temporary employees who have little training in U.S. corporate governance, and shifting work to low-cost labor locations outside the United States.

While ISS and Glass Lewis have responded to corporate complaints and released more details on their policies in recent years, these firms do not fully disclose, as one example, all the methodologies that they use to develop their vote recommendations, including their evaluation of a company's equity incentives or other pay practices.

While ISS now provides a brief comment period (typically less than a month) each fall for issuers to weigh in on selected policy updates, ISS rarely makes significant policy changes in response to corporate input. The proxy advisors could do much more to ensure that their policies and research methodologies are fully transparent. They should also disclose the academic research, if any exists, that demonstrates that their voting policies generate long-term shareholder value.<sup>9</sup> Finally, proxy advisors should be required to publicly file their reports with the SEC, so companies and investors can better judge the value of the advice provided.

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<sup>8</sup> The SEC has designated an official in its Division of Corporation Finance to receive corporate complaints about proxy advisors, but the agency has not publicly disclosed details on those complaints or any official action taken by Commission staff.

<sup>9</sup> Researchers at Stanford University have found that there is a negative correlation between the proxy firms' compensation policies and shareholder value. See David F. Larcker et al., "Outsourcing Shareholder Voting to Proxy Advisory Firms" (working paper, Rock Center for Corporate Governance at Stanford University, May 10, 2013),

## **Most Companies Have No Chance to Review Advisors' Reports for Accuracy**

One of the most serious concerns with current proxy advisor policies is that most companies have no or very limited opportunity to review the advisors' reports on their annual meetings before investors cast votes based on those recommendations. This increases the risk that the advisory firms will make recommendations that are based on inaccurate factual information. This is especially a concern in the area of executive compensation, where pay arrangements are complex and the advisors use different methodologies for calculating the value of certain incentive arrangements. These errors are not surprising given the large volume of proxy statements each spring that are reviewed by the advisors' research teams, who have limited training, work long hours during proxy season, and include temporary and overseas employees. If a company spots an error and contacts the proxy advisor to complain, the proxy advisor may send an "alert" to its clients, but those alerts may arrive too late. Given their heavy proxy season workloads each spring, many institutional investors vote their shares immediately after receiving their proxy advisor's recommendation and some will not bother to change their vote if an alert is issued.

So far, ISS and Glass Lewis have resisted requests to allow all companies an opportunity to review their reports for accuracy before they are released to investors. As a result, many companies are blind-sided by negative recommendations and have limited time to correct that information and make their case to their investors, many of whom have already voted. In response to corporate concerns, ISS does provide a limited opportunity (i.e., 24 to 48 hours) for S&P 500 firms to review a draft copy of their reports. This review process is quite helpful for these large-cap companies because they may spot inaccurate factual information, or notice an improper application of ISS policies to the company's specific circumstances. In addition, a company may be able to easily address the concerns (e.g., by adopting a new board policy on severance pay or providing more disclosure) that led to the negative ISS recommendation. Institutional investors also benefit from this review process because they receive reports that are more accurate and complete and have to change their votes less frequently. Regrettably, ISS has declined to offer this necessary safeguard to mid-cap and smaller companies, which typically are less familiar with proxy advisor policies and could equally benefit from this review process. ISS also has restricted the ability of companies to share final ISS reports with their outside lawyers, pay consultants, or proxy solicitors, a practice that has further hindered the ability of companies to identify inaccuracies and respond quickly. Glass Lewis has declined to make its drafts available to any U.S. company.

In light of the significant role that proxy advisors play in U.S. corporate governance, the SEC should act to ensure that companies have a reasonable opportunity to ensure that their investors receive accurate information.

## **Inherent Conflicts of Interest**

The inherent conflicts of interest posed by the proxy advisors' business practices also need to be addressed by regulators. In addition to assessing corporate disclosure practices and delivering

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available at: <http://www.niri.org/Other-Content/sampledocs/David-Larcker-Stanford-University-et-al-Outsourcing-Shareholder-Voting-to-Proxy-Advisory-Firms.aspx>

voting recommendations to investors, ISS sells corporate governance consulting and executive compensation data to companies. For example, ISS offers a consulting service to help companies determine if their equity plans meet ISS' approval criteria; and it provides a service to evaluate "corporate sustainability," which involves a review of certain environmental and social issues facing a company. While ISS has stated that it maintains an internal firewall between its corporate and institutional businesses, many companies believe that they need to purchase ISS' corporate consulting services in order to get a fair hearing from ISS' institutional research analysts. In addition, it appears unlikely that ISS will abandon its profitable corporate advisory business, given that it has been growing more quickly than its institutional proxy advisory business.<sup>10</sup>

Another conflict of interest arises when an institutional client of a proxy advisor firm is also the proponent of a specific shareholder proposal -- or instigates a "vote no" campaign against directors -- that will be subject to a voting recommendation by that same proxy firm. ISS and Glass Lewis have many clients that are public pension funds or labor union funds, which are among the most aggressive filers of shareholder proposals and organizers of "vote no" efforts. Glass Lewis is owned by the Ontario Teachers' Pension Plan Board, which manages a fund with more than \$100 billion in assets. The influence of activists can be seen in the voting policies of the proxy advisors. As James K. Glassman and J.W. Verret observed in a recent academic paper on proxy advisors, both proxy firms also have shown a tendency toward ideological bias in their recommendations, especially on issues that involve labor union power, executive compensation, and the environment.<sup>11</sup>

Given that proxy advisors are critical intermediaries between companies and their institutional investors, the proxy firms should be required to provide full disclosure on all of these conflicts of interest so investors can adequately judge whether to follow their recommendations.

### **Recommended Reforms for Proxy Advisory Firms**

NIRI, as part of the Shareholder Communications Coalition (which includes the Society of Corporate Secretaries and the Business Roundtable), has urged the SEC for years to take action to address the business practices of proxy advisors. In recent years, there has been a growing chorus of companies and former and current SEC officials who believe that urgent action is needed.<sup>12</sup> Unfortunately, the SEC has failed to act on these critical issues, but we hope that this Subcommittee concludes that these reforms should be a greater priority.

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<sup>10</sup> See MSCI Inc., Form 10-K for the Year Ended December 31, 2012, (March 1, 2013): 54, available at: [https://www.sec.gov/Archives/edgar/data/1408198/000119312513087988/d448124d10k.htm#toc448124\\_11](https://www.sec.gov/Archives/edgar/data/1408198/000119312513087988/d448124d10k.htm#toc448124_11) (MSCI is the corporate parent of ISS).

<sup>11</sup> James K. Glassman and J. W. Verret, "How to Fix Our Broken Proxy Advisory System," Mercatus Research, George Mason University (April 16, 2013), available at: [http://www.shareholderforum.com/e-mtg/Library/20130416\\_Mercatus-report.pdf](http://www.shareholderforum.com/e-mtg/Library/20130416_Mercatus-report.pdf)

<sup>12</sup> Former SEC Chairman Harvey Pitt and former Commissioner Paul Atkins are among the ex-agency officials who have voiced concern over the role of proxy advisors. More recently, Commissioner Daniel M. Gallagher raised a series of thoughtful questions about proxy advisors that regulators and investors should address. See Commissioner Daniel M. Gallagher, "Remarks at 12th European Corporate Governance & Company Law Conference" (Dublin, Ireland, May 17, 2013), available at: <http://www.sec.gov/news/speech/2013/spch051713dmg.htm>

The following is a summary of our recommendations:

1. *Proxy advisory firms should be subject to more robust oversight by the SEC.* All proxy firms should be required to register as investment advisers and be subject to the regulatory framework under the Investment Advisers Act of 1940. In addition, the SEC's Division of Corporation Finance, which oversees corporate disclosures and proxy issues, should play a prominent role in providing oversight.
2. *The SEC should adopt new regulations that include minimum standards of professional and ethical conduct to be followed by the proxy advisory industry.* The goal of a uniform code of conduct -- which should address conflicts of interest, transparency of processes, and accuracy of factual information -- should be to improve the quality and reliability of the analysis and advice provided by proxy advisory firms.<sup>13</sup>
3. *These SEC regulations should require full disclosure of conflicts of interest.* A proxy advisory firm should publicly disclose its relationship with any client who is the proponent of a shareholder proposal or a "vote no" campaign, whenever the proxy advisory firm is issuing a recommendation to other clients in favor of the same proposal or "vote no" campaign.
4. *The SEC should address whether a proxy advisory firm should be allowed to offer consulting services to any public company for which it is providing recommendations on how investors should vote their shares.* If a proxy advisory firm is allowed to offer such consulting services, consideration should be given to ensure there is a complete separation of proxy advisory activities from all other businesses of the firm, including consulting and research services.
5. *Given the tremendous influence of proxy advisory firms, there should be greater transparency about the internal procedures, guidelines, standards, methodologies, and assumptions used in their development of voting recommendations.* This is particularly the case where the advisors apply policies without taking into account company-specific or industry-specific circumstances in making voting recommendations. This increased transparency would enable shareholders and companies to better evaluate the advice rendered by proxy advisory firms. These firms should be required to maintain a public record of all their voting recommendations. The SEC should also consider requiring the disclosure of the underlying data, information, and rationale used to generate specific voting recommendations. These disclosures could be made within a reasonable time after the recommendation has been made and still be relevant and useful to companies, investors, academics, and others who study the influence of proxy firms.

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<sup>13</sup> The concern over the role of proxy advisors is not limited to the United States. As noted in a recent speech by Commissioner Gallagher, the European Securities and Markets Authority has called on proxy advisors to adopt a code of conduct that addresses conflicts of interest and fosters transparency to ensure the accuracy and reliability of the advice provided to investors.



6. *Proxy advisory firms should be required to provide all public companies with draft reports in advance of distribution to their clients, to permit companies to review the factual information contained in these reports for accuracy. Companies should be allowed a reasonable opportunity (such as 48 hours) to conduct this review and to respond to any factual errors. The SEC should consider whether to require proxy advisors to include in their reports any information they receive from a company, or, at a minimum, indicate in that report that a company disagrees with a particular factual assertion.*
7. *Proxy advisory services should disclose publicly and promptly any errors made in executing or processing voting instructions on a particular proxy vote.*

## **MODERNIZING SHAREHOLDER COMMUNICATIONS**

NIRI appreciates this Subcommittee's interest in exploring ways to modernize the current proxy system, including current disclosure practices to improve communications between public companies and their shareholders.

NIRI supports measures to improve the U.S. proxy system, the roots of which were established more than 30 years ago. NIRI believes these principles are critical to ensuring confidence in U.S. capital markets:

- An effective, accurate, and transparent proxy system that ensures equality among shareholders is a fundamental element of healthy capital markets.
- Efficient two-way corporate-investor communications are integral to such a proxy system.

These principles will also ensure that public companies are provided a more modern foundation from which to focus valuable corporate resources on growth and innovation, instead of bearing the expense of an outdated proxy system.

As referenced earlier, the SEC in 2010 issued a concept release seeking public comment on the U.S. proxy system and asking whether rule revisions should be considered to promote greater efficiency and transparency and enhance the accuracy and integrity of the shareholder vote. NIRI submitted a comment letter on this concept release, and although there have been no subsequent regulatory action to improve the proxy system, NIRI and other organizations continue to voice strong support for improved shareholder transparency and communications.<sup>14</sup>

To better understand these issues, it is helpful to review the aspects of our complex and outdated proxy system that prevent companies from knowing the identities of all of their shareholders.

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<sup>14</sup> NIRI, "Comment Letter on the SEC's Concept Release on the U.S. Proxy Voting System" (Oct. 20, 2010), available at: <http://www.niri.org/Main-Menu-Category/advocate/Regulatory-Positions/NIRI-Comment-Letter-re-SEC-Proxy-Concept-Release-Oct-2010.aspx>.

## **The Growing Disconnect Between Companies and Shareholders**

Over the past several decades, the percentage of public company shares held in "street name" -- which are held in the name of a broker, bank, or other financial intermediary rather than being "registered" in the name of the actual investor -- has grown dramatically from 25 percent to more than 80 percent, according to New York Stock Exchange estimates.<sup>15</sup> The benefit of this "street name" system is that it enables an efficient transfer of shares among owners and promotes greater liquidity in our capital markets. However, an important consequence is that it is virtually impossible for companies to know who owns their stock given this migration to shares held in street name (where the name of the investor is shielded from companies), combined with the growing use of alternative trading systems (also known as "dark pools"), and the decoupling of equity listings from their trading venues.

A company's ability to communicate also is hindered by the "Objecting Beneficial Owner" (OBO) versus "Non-Objecting Beneficial Owner" (NOBO) shareholder classifications. Street name shareholders, as part of the process of establishing their brokerage accounts, have the option of allowing their contact information to be released to the company and receiving communications directly from the company (NOBO), or remaining anonymous (OBO). While companies can purchase NOBO information, this information takes several days to compile and quickly becomes out of date as shares are traded by investors each day. Consequently, it is both costly and ineffective for companies to communicate with these NOBO investors. These communication challenges negatively impact all shareholders, particularly "retail" (or individual investor) shareholders who hold almost 40 percent of street name shares, and have been voting less on proxy matters in recent years.

As public companies' mandatory disclosures become more complex and voluminous, retail participation in the governance process may continue to decline. Current statistics indicate that only 14 percent of retail shareholder accounts vote their proxy ballots, according to Broadridge Financial Solutions. While anecdotal, there is a perception among retail shareholders with small or modest positions that their vote doesn't matter. Under the current system, a company's primary tools to encourage voter participation are general educational communications and the retention of a proxy solicitor, which is expensive and may not be effective.

Public companies' communications to shareholders are further hampered by the SEC's outdated ownership disclosure rules for institutional investors. Current SEC rules (Section 13(f)) generally require certain institutional investors to disclose share ownership positions only on a quarterly basis, with an exception made for those who petition the SEC to delay these disclosures on the basis of confidentiality. While not specifically designed to help companies identify their larger shareholders, Congress established this reporting regime in the 1970s to require certain larger investment managers to report their equity positions. The practical effect of this rule is that an investment manager may, for example, buy or sell shares on January 1 and not have to report that

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<sup>15</sup> NYSE Euronext, "Recommendations of the Proxy Fee Advisory Committee to the New York Stock Exchange" (May 16, 2012), available at: [https://usequities.nyx.com/sites/usequities.nyx.com/files/final\\_pfaf\\_report.pdf](https://usequities.nyx.com/sites/usequities.nyx.com/files/final_pfaf_report.pdf)

holding change until May 15, more than 19 weeks after the transaction. Many U.S. companies hold their annual meetings during this period, when shareholder communications are even more crucial. This quarterly reporting scheme was obviously established many years ago before technological advances improved the availability of information. This delayed reporting by investors further compounds the communication difficulties for public companies, given the trends toward greater shareholder anonymity (through street name registration) and the declining rates of retail voting.

Communicating with and educating shareholders is a crucial part of encouraging retail investors to vote their shares. All parties to the proxy system – public companies, exchanges, broker-dealers, regulators, and service providers – play a role in educating investors. NIRI believes that timely, unbiased education will become increasingly important as companies have to provide even more complex and voluminous disclosures to comply with the Dodd-Frank Act and new SEC rules.

### **Corporate Governance Trends Accelerate Need for Improvement**

Recent governance trends and regulatory changes (such as those mandated by the Dodd-Frank Act) give shareholders more say over executive compensation and other corporate governance matters. This shareholder empowerment further increases the need for regulators to address current barriers to corporate-shareholder communication. Public companies must be able to accurately identify and communicate directly with shareholders to ensure they can make informed decisions in the best interest of all shareholders.

It is important to understand the potential ramifications from this increased shareholder influence. Among others, these activities include:

- *Increased shareholder activism:* Shareholder activists have more influence on corporate matters; some of these investors are encouraging proposals that advance their own self-interest, to the detriment of the interests of all shareholders.
- *Growing influence of proxy advisory services:* Institutional investors often base their voting decisions on the recommendations of proxy advisory firms. As mentioned previously, SEC officials, companies, and academics have raised concerns about the influence of these firms, the accuracy of their reports, and the potential conflicts of interest.
- *Greater annual meeting costs:* The cost of annual meetings will likely rise due to an increase in the expenses associated with preparing proxy materials, employing proxy solicitors to identify and communicate with shareholders to meet quorum requirements, and other proxy voting costs. These administrative costs will reduce the amount that companies can spend to hire new employees and grow their businesses.

As we move toward an environment of greater shareholder influence on corporate governance matters, the ability of companies to identify their investors, communicate directly with them, and encourage them to vote will remain a high priority, particularly in close vote situations or even simply to achieve quorum.

## Recommended Proxy System and Shareholder Communications Reforms

The current shareholder voting and communications system is more than 30 years old, and is a product of regulatory evolution rather than a thoughtful forward thinking design. NIRI, alone and together with other groups, has called for the following regulatory reforms to the current U.S. proxy and shareholder communications system:

1. *Improve Institutional Investor Equity Position (13F) Reporting.* The ownership reporting rules under the Section 13(f) reporting scheme should be amended to improve the timeliness of 13(f) reporting from 45 days after the end of the quarter to two days after the end of the quarter. Reporting rules should be strictly enforced with meaningful penalties for non-compliance.

As part of Dodd-Frank, Congress directed the SEC to consider rules for a similar regime for short position disclosure every 30 days, so an evaluation of the entire 13(f) disclosure process follows logically.

NIRI joined with the NYSE and the Society of Corporate Secretaries and Governance Professionals to provide the SEC with a comprehensive slate of related reforms in a Feb. 1, 2013, letter.<sup>16</sup> More timely information is important because it will:

- a. Increase transparency about company ownership for the market overall.
  - b. Improve the dialogue between companies and their investors.
  - c. Help companies to better prepare for their annual meetings.
  - d. Help address corporate governance concerns.
  - e. Better correlate ownership reporting rules to other SEC-based reporting requirements.
  - f. Recognize and capitalize on advances in technology that make timelier reporting possible.
2. *Enhance the U.S. Proxy System.* Despite the SEC's laudable 2010 proxy system concept release, we have seen no action on any comments. NIRI submitted a comment letter with a comprehensive list of recommendations to improve several aspects of the U.S. proxy system, including those that will benefit corporate-shareholder communications.

## CONCLUSION

NIRI is pleased to provide these comments as this Subcommittee considers issues concerning proxy advisory firms and improved shareholder communications. It is critical that we have an effective proxy system that is free from conflicts of interest and that allows for timely, efficient, and accurate shareholder communications. Equally important is a proxy system that is

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<sup>16</sup> NIRI, NYSE Euronext, and Society of Corporate Secretaries, "Petition for Rulemaking Under Section 13(f) of the Securities Exchange Act of 1934" (Feb. 1, 2013), available at: <https://www.sec.gov/rules/petitions/2013/petn4-659.pdf>.

transparent and accurate to ensure equality among shareholders. A modernized institutional disclosure system that allows companies to communicate effectively and efficiently with investors would increase public confidence in the integrity of the U.S. securities markets and potentially help pave the way for accelerated growth and innovation.

As noted in the House Report for the Shareholder Communications Act of 1985:

Informed shareholders are critical to the effective functioning of U.S. companies and to the confidence in the capital market as a whole. When an investor purchases common stock in a corporation, that individual also obtains the ability to participate in making certain major decisions affecting that corporation. Fundamental to this concept is the ability of the corporation to communicate with its shareholders.

NIRI stands ready for further discussion regarding any of the suggestions or comments made in this testimony, or about the shareholder communication practices of investor relations professionals.