Testimony of

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"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.

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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]

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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

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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 Polices 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.

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10 *See* SEC Rel. No. IA-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 Helmuth 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

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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

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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/PublicStmt/Detail/PublicStmt/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-survyey-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

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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 Larker, *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 Piwowar, 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

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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 Piwowar 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, 3014) (SLB 20), *available at* https://www.sec.gov/interps/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 Advisors 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

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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 bi-partisan 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

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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]

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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

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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

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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.

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[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

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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/secfy16congbudgjust.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.

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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.