Council of Institutional Investors®
The voice of corporate governance

Via Email

August 23, 2017

Mr. Craig S. Phillips
Counselor to the Secretary
U.S. Department of Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

Re: Executive Order 13772 on Core Principles for Regulating the United States Financial System─Report on Regulations Impacting the Capital Markets[1]

I am writing on behalf of the Council of Institutional Investors (CII), a nonpartisan, nonprofit association of employee benefit plans, foundations and endowments with combined assets under management exceeding $3 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families. Our associate members include a range of asset managers with more than $20 trillion in assets under management.[2]

The purpose of this letter is to respond to your invitation to CII to provide input to the U.S. Department of Treasury (Department) in connection with the Department's planned issuance of a report on regulations impacting the capital markets in response to Executive Order 13772.[3] This letter supplements the input provided in a meeting with the Department's staff on August 2, 2017. The letter is organized by the topics provided by the Department's staff in connection with that meeting and your invitation.[4]

Capital formation by businesses large and small

We generally believe that the U.S. public capital markets are fundamentally healthy and remain the preferred choice for businesses to seek capital, notwithstanding more robust private markets and access to capital through non-U.S. public markets.[5] The decline in the number of U.S. public

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[1] Exec. Order No. 13772 (Feb. 3. 2017), https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-executive-order-core-principles-regulating-united-states.

[2] For more information about the Council of Institutional Investors (CII) and our members, please visit CII's website at http://www.cii.org/about_us.

[3] E-mail from Craig Phillips, Counselor to the Treasury, U.S. Department of the Treasury to Jeff Mahoney, General Counsel, Council of Institutional Investors et al. (June 22, 2017, 7:00 P.M. EST) (on file with CII).

[4] E-mail from Brian Smith, U.S. Department of the Treasury, to Jeff Mahoney, General Counsel, Council of Institutional Investors et al. (June 23, 2017, 8:15 PM EST) (attachment of EO Capital Markets Public Summary) (on file with CII).

[5] *See, e.g.,* EY, "Looking Behind the Declining Number of Public Companies, An Analysis of Trends in US Capital Markets" 15 ("In our view, US public capital markets are fundamentally healthy and remain the preferred choice for

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companies since the peak of 20 years ago has not in our view significantly diminished the ability of U.S. businesses to obtain capital. We note that key factors in the decline in the number of public companies have been the corresponding growth in the private markets and the related increase in mergers and acquisitions (M&A) activity.

Growth in private markets

Compared to just 15 years ago, companies have many more ways to access significant capital without utilizing the public markets.[6] Venture capitalists, private equity firms, and sovereign funds have considerable capital to invest in private companies.

For example, between 2008 and 2014, while public capital-raising hovered around $250 billion per year, private capital-raising increased from about $700 billion in 2008 to more than $1.25 trillion in 2014.[7] Given the various choices U.S. businesses have for funding, many have chosen to remain private longer.

The U.S. Congress incentivized businesses to remain private longer when it increased the accredited investor limit for registering with the U.S. Securities and Exchange Commission (SEC or Commission) from 500 to 2,000 in the Jumpstart Our Business Startups (JOBS) Act of 2012 (JOBS Act).[8] U.S. businesses that move to a public offering in recent years have tended to be more mature and have more solid business prospects, in contrast to the prior boom cycles, in part because of the JOBS Act.

Growth in M&A activity

A second key and related factor in the decline in the number of public companies has been the increase in M&A activity. Since 2000, leveraged buyouts by private equity firms have surged, accounting for 9% of delistings of public companies, including almost one-quarter of all delistings in 2006.[9]

The increase in the number of leveraged buyouts in recent years is not surprising given the corresponding growth in the private equity firm industry.[10] In 1980, there were only 24 private equity firms and deal volume only modestly exceeded $1 billion.[11] Today there are more than

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U.S. and many foreign companies that seek to go public."), http://www.ey.com/Publication/vwLUAssets/an-analysis-of-trends-in-the-us-capital-markets/$FILE/ey-an-analysis-of-trends-in-the-us-capital-markets.pdf.

[6] *Id*. at 8 ("The private capital market has grown aggressively recently, allowing emerging companies to access more capital without going public.").

[7] *See* Scott Bauguess et al., "Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offering 2009-2014," at 7 (Oct. 1, 2015), https://www.sec.gov/files/unregistered-offering10-2015.pdf.

[8] *See, e.g.*, Elizabeth De Fontenay, "The Deregulation of Private Capital and the Decline of the Public Company," 68 Hastings L.J. 445, 469 (Mar. 29, 2017) ("By increasing the shareholder cap from 500 to 2000, Congress enables extraordinarily large private companies whose stock is widely held by passive investors to avoid becoming public companies."), *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/elisabeth-de-fontenay-deregulation-private-capital.pdf.

[9] Michael J. Mauboussin et al., Credit Suisse, "The Incredible Shrinking Universe of Stocks, The Causes and Consequences of Fewer U.S. Equities" 7 (Mar. 22, 2017), http://www.cmgwealth.com/wp-content/uploads/2017/03/document_1072753661.pdf.

[10] *Id.*

[11] *Id.*

3,000 U.S. private equity firms and assets under management for buyout funds of roughly $825 billion, up from $80 billion in 1996 and less than $1 billion in 1976.[12]

Moreover, significant U.S. private companies have been acquired at a rapid pace in recent years, with the 2014-16 average for acquisitions in excess of $100 million exceeding any previous three-year period in recent decades.[13]

Corporate governance

While federal regulation of U.S. public companies increases the cost of being public, well-designed regulation increases investor confidence. We are unaware of any evidence of a causal connection between federally imposed improvements to corporate governance and the decline in the number U.S. public businesses.[14] The following is a summary discussion of CII views on several current corporate governance related issues that were raised by Department staff at my meeting.

Disclosure Effectiveness

We generally support the Commission's disclosure effectiveness initiatives that have the objective of facilitating "the disclosure of information to investors while simplifying compliance efforts, without significantly altering the total mix information provided to investors."[15] The quality of disclosure at public companies is critical to our members.[16]

More specifically, we generally support the Commission's proposals that would delete or integrate certain required disclosures that are "overlapping."[17] However, for those required disclosures that overlap with U.S. generally accepted accounting principles (GAAP), we would generally not support the elimination of those requirements if GAAP were expected to be

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[12] *Id.*
[13] *EY, op. cit. at 14.*
[14] *Mauboussin, op. cit.* at 20 ("the shrinkage in the population of listed companies started well before . . . [Sarbanes-Oxley Act] was implemented"); *see also* Office of Investor Advocate, U.S. Securities and Exchange Commission, "Report on Objectives, Fiscal Year 2018," at 5-6 (2018) ("recent academic studies demonstrate that it is difficult to establish any causal connection between disclosure mandates and IPO activity"), https://www.sec.gov/files/sec-office-investor-advocate-report-on-objectives-fy2018.pdf; Elizabeth De Fontenay at 448 ("even if public company disclosure requirements had remained constant over the last three decades, there would likely still be a dearth of public companies today, due to the increasing ease of raising capital privately").
[15] Disclosure Update and Simplification, 81 Fed. Reg. 51,608, 51,609 (Proposed Rule Aug. 4, 2016), *available at* https://www.federalregister.gov/documents/2016/08/04/2016-16964/disclosure-update-and-simplification.
[16] *See, e.g.,* Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Brent J. Fields, Secretary, U.S. Securities and Exchange Commission 1 (Sept. 22, 2016) ("The quality of disclosure regarding the public companies in which much of that savings is invested is . . . critical to our members."), http://www.cii.org/files/issues_and_advocacy/correspondence/2016/September%2022%202016%20comment%20letter%20(final%20with%20letterhead)%20KAB.pdf.
[17] 81 Fed. Reg. at 51,615.

substantially changed, including a change in the definition of materiality,[18] resulting in useful information previously provided by SEC disclosure requirements no longer required by GAAP.[19] We also support the Commission's efforts to advance reforms that would ensure that market participants are equipped with tools to "quickly and inexpensively retrieve" disclosure information they seek, including through hyperlinks and other electronic means, and better organization of filings to optimize electronic use.[20] We believe that the solution to improving disclosure effectiveness is, at least in part, to improve the delivery and access of the information required to be provided to investors.

Shareholder Proposal Process

CII and its members have a deep interest in ensuring that SEC Rule 14a-8[21], the "shareholder proposal rule," is a fair and workable standard for shareowners and companies.[22] We believe the current rule provides institutional and retail investors an orderly and cost-effective means to communicate important policy issues to their fellow shareowners, boards of directors, and corporate management.

We are mindful that many positive advances in U.S. corporate governance practices simply would not have occurred without a robust shareowner proposal process in place. For example:

- Shareholder proposals were the impetus behind the practice—currently mandated by major U.S. stock exchanges' listing standards—that independent directors constitute at least a majority of the board, and that all the members of the following board committees are independent: audit, compensation, nominating and corporate governance.[23]

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[18] *See* Letter from Amy Borrus, Interim Executive Director, Council of Institutional Investors to Technical Director, Financial Accounting Standards Board 1 (Dec. 3, 2015) ("object[ing] strongly to the [FASB's] . . . proposal to radically change the definition of materiality"), http://www.cii.org/files/issues_and_advocacy/correspondence/2015/12_03_15_CII_letter_to_FASB.pdf; *see also* Commissioner Kara M. Stein, "Statement on the Disclosure Update and Simplification Proposing Release" 2 (July 13, 2016) ("depending on how the FASB completes its project to redefine materiality, movement could actually, result in elimination of the disclosure"), https://www.sec.gov/news/statement/stein-statement-open-meeting-071316-disclosure-update.html.

[19] *See* Letter from Jeff Mahoney at 3.

[20] *See* Letter from Kenneth A. Bertsch, Executive Director, Council of Institutional Investors to Brent Fields, Secretary, U.S. Securities and Exchange Commission 2 (Oct. 18, 2016), http://www.cii.org/files/issues_and_advocacy/correspondence/2016/10_18_16%20CII%20letter%20to%20SEC.pdf.

[21] 17 CFR 240.14a-8 – "Shareholder proposals," Cornell U. L. School, LII, https://www.law.cornell.edu/cfr/text/17/240.14a-8 (last viewed Aug. 18, 2017).

[22] *See, e.g.,* "Examining the U.S. Proxy Voting System: Is it Working for Everyone?," Corporate Governance Roundtable, Hosted by Rep. Scott Garrett, 114th Cong. 7 (Nov. 16, 2015) (Statement of Amy Borrus, Interim Executive Director, CII), http://www.cii.org/files/issues_and_advocacy/correspondence/2015/11_16_15_cii_Rep%20_Garrett_roundtable_submission_amy_borrus.pdf.

[23] *See* Kenneth Bertsch, Executive Director, Council of Institutional Investors et al., "Joint Statement on Defending Fundamental Shareholder Rights" 2 (June 2, 2016), http://www.cii.org/files/issues_and_advocacy/financial_regulation/Joint%20Statement%20on%20Shareowner%20Rights%206_2_2017%20FINAL.pdf; Ceres et al., "The Business Case for the Current SEC Shareholder Proposal Process" 6 (Apr. 2017), http://www.ussif.org/files/Public_Policy/Comment_Letters/Business%20Case%20for%2014a-8.pdf.

- In 1987, an average of 16% of shareholders voted in favor of shareholder proposals to declassify boards of directors so that directors stand for election each year. In 2012, these proposals enjoyed an 81% level of support on average. Ten years ago, less than 40% of S&P 500 companies held annual director elections compared to more than two thirds of those companies today.[24]
- Shareholder proposals were critical in demonstrating investor support for expensing of stock compensation in financial reports. For example, many companies voluntarily adopted employee stock option expensing before it was required as a result of more than 150 proposals to expense stock options submitted during the 2003 and 2004 proxy seasons.[25]
- Electing directors in uncontested elections by majority (rather than plurality) vote was considered a radical idea a decade ago when shareholders pressed for it in proposals they filed with numerous companies. Today, 90% of large-cap U.S. companies elect directors by majority vote, largely as a result of robust shareholder support for majority voting proposals.[26]
- A proposal that built momentum even more rapidly and influenced the practices of hundreds of companies in the last few years is the request for proxy access. Resolutions filed by the New York City Comptroller to allow shareholders meeting certain eligibility requirements to nominate directors on the company's proxy ballot achieved majority votes at numerous companies. As a result, since 2015, more than 400 public companies have adopted proxy access bylaws.[27]
- Shareholder proposals over 25 years have built support for more diversity on boards of directors. For example, during the current proxy season a proposal at Cognex Corp. requesting that the company's board adopt a policy for improving board diversity received 62.8% of votes cast.[28] In 1993, early on in shareholder efforts to increase board diversity, investors voted on two shareholder proposals to take steps to increase board diversity, and the proposals were supported by an average of less than 8% of shares voted.[29]
- Shareholder proposals were critical in building support over many years for better disclosures on environmental risk in corporate reporting. For example, during the current proxy season proposals requesting disclosure of how climate change could

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[24] *Id.*
[25] *See, e.g.,* Fabrizio Ferri, Harvard University et al., "The Impact of Shareholder Activism on Financial Reporting and Compensation: The Case of Employee Stock Options Expensing," 84 Acct. Rev. 433, 434 (Mar. 2009) ("We find that firms targeted by ESO expensing proposals were more likely to subsequently adopt ESO expensing relative to a control sample of S&P 500 firms."), *available at* https://www.jstor.org/stable/27802659?seq=1#page_scan_tab_contents.
[26] "Joint Statement on Defending Fundamental Shareholder Rights" at 2; Ceres et al. at 6.
[27] "Joint Statement on Defending Fundamental Shareholder Rights" at 2-3; Ceres et al. at 6.
[28] *See, e.g.,* Ronald Mueller et al., "Shareholder Proposal Trends In 2017 Proxy Season: Part 2," *Law360*, July 20, 2017, at 4 (subscription required), https://www.law360.com/articles/946033/shareholder-proposal-trends-in-2017-proxy-season-part-2.
[29] Investor Responsibility Research Center, "How Shareholders Voted on Shareholder Resolutions in the 1993 Proxy Season") (on file with CII).

> affect their businesses were approved by shareowners at ExxonMobil, Occidental Petroleum, and PPL.[30]

Some critics of Rule 14a-8 seek to radically increase the regulatory hurdles for shareholder proposals, limiting a critical tool for private ordering.[31] Their arguments, sometimes based on false or misleading information,[32] imply that proposals submitted by smaller retail shareowners are not effective or successful.[33] However, a recent research study by three academics at Harvard Business School disproves that.[34] The paper concludes that "the idea that bigger shareholders create 'better' proposals is not supported by empirical data."[35]

Restricting the shareholder proposal process is likely to reduce corporate accountability to shareholders, and could create greater conflict between shareowners and public companies. For example, restricting shareholder proposals is likely to lead to shareowners more often availing themselves of the blunt instrument of votes against directors, and increased reliance on hedge fund activists to push for needed corporate changes.[36] Most shareholder proposals are non-binding, and they have provided a critical means for effective communication of collective shareholder voice.

Proxy Research

Proxy advisory firms play a vital and necessary role in assisting many pension funds and other institutional investors in carrying out their fiduciary duty to vote proxies. By law, pension fund fiduciaries have a duty to ensure that their proxies are voted in the best long-term interests of plan participants and beneficiaries. Many pension funds and other institutional investors contract

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[30] *See, e.g.*, Steven Mufson, "Financial Firms Lead Shareholder Rebellion Against ExxonMobil Climate Change Policies," *The Washington Post*, May 31, 2017, at 3, https://www.washingtonpost.com/news/energy-environment/wp/2017/05/31/exxonmobil-is-trying-to-fend-off-a-shareholder-rebellion-over-climate-change/?utm_term=.b4b729506cde.

[31] *See. e.g.*, Center for Capital Markets Competitiveness, "Shareholder Proposal Reform" 4-6 (Summer 2017), http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/023270_CCMC-SEC-Shareholder-Proposal-Reform-Report_Online_Report.pdf?x48633.

[32] *See, e.g.*, Nasdaq, "The Promise of Market Reform, Reigniting America's Economic Engine" 7 (2017) ("The current process is costly, time-consuming and frustrating for companies, which in aggregate must address *thousands of such proposals each year.*") (emphasis added), http://business.nasdaq.com/media/Nasdaq%20Blueprint%20to%20Revitalize%20Capital%20Markets_tcm5044-43175.pdf.

[33] Gretchen Morgenson, "Meet the Legislation Designed to Stifle Shareholders, Fair Game," *The New York Times*, June 16, 2017, at 4 ("the Fiancial CHOICE Act implies that ideas submitted by smaller shareholders are less effective or successful"), *available at* https://www.nytimes.com/2017/06/16/business/wells-fargo-clawback-fair-choice-act-shareholders.html.

[34] *Id.*

[35] *Id.* (quoting Eugene Soltes, an associate professor of business administration, Harvard Business School).

[36] *See, e.g.*, "ONPOINT/A Legal Update from Dechert's Corporate Governance Practice, Shareholder Proposal Reform under the Financial CHOICE Act of 2017: A Welcome Development for Companies or a Trojan Horse?" 2 (May 2017) ("If that outlet for complaints is removed, aggrieved shareholders may have no choice but to resort to more direct, blunt action, such as binding bylaw proposals, withhold vote for director campaigns, or even the ouster of company directors via proxy access or in a conventional contest."), https://info.dechert.com/10/8636/may-2017/shareholder-proposal-reform-under-the-financial-choice-act-of-2017--a-welcome-development-for-companies-or-a-trojan-horse-(1).asp?sid=45fff908-ffb8-4889-9feb-0a5fb8b5eda5.

with proxy advisory firms to obtain and review their research. But most large holders vote according to their own guidelines and policies.

Proxy research is helpful in enabling cost effective proxy voting, particularly when a fund holds thousands of companies in its investment portfolio.[37] We, and many of our members and other investors, believe that the existing SEC regulatory regime adequately protects the interests of long-term shareowners with respect to proxy advisory firms.[38] Moreover, we believe that the regulatory scheme contemplated in the Financial CHOICE Act of 2017 (CHOICE Act) would serve as a barrier to entry to new firms, and likely put some firms out of business, limiting competition.[39]

The CHOICE Act proxy advisory firm provisions would give management and board members greater weight in influencing vote recommendations.[40] This demand for a management thumb on the scale is coming not from investors who pay for and use proxy advisory services, but rather from some corporate executives, who we chafe at criticism on executive pay and at recommendations against management positions on some voting issues.

In fact, the leading proxy advisory services actually endorse management recommendations on the large majority of proxy votes. But notwithstanding this fact and First Amendment speech protections, executives at some companies clearly seek government intervention, motivated by irritation that outside, published reporting agencies take views that on a regular basis differ from management and boards, including in a small number of instances against directors for not being sufficiently diligent.

As the primary customer of proxy advisory firm research, our members tell us that adding new regulations to the industry is unnecessary, overly burdensome, and counter-productive.[41]

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[37] *See* Letter from Jack Ehnes, Chief Executive Officer, CalSTRS to The Honorable Maxine Waters, Ranking Member, Committee on Financial Services 2 (June 5, 2017) ("Proxy advisory firms provide useful research regarding the governance and finance at these companies to supplement our own due diligence and research, and they play an important and helpful role in enabling cost-effective proxy voting with respect to the 7,000 companies in our investment portfolio."), https://www.calstrs.com/sites/main/files/file-attachments/06-05-2017_maxine_financial_choice_act.pdf; Letter from Karen Carraher, Executive Director, OPERS to The Honorable Joyce Beatty, United States House of Representatives 2 (May 1, 2017) ("With holdings in more than 9,300 public companies, it would be more difficult for OPERS to fulfill its fiduciary duty without the research and recommendations of proxy advisors") (on file with CII).

[38] *See contra* Business Roundtable, "Proxy Advisory Firms Need Greater Oversight" (May 18, 2016) (advocating for federal legislation to impose additional regulations on the proxy advisory firm industry), http://businessroundtable.org/media/news-releases/proxy-advisory-firms-need-greater-oversight.

[39] Financial CHOICE Act of 2017, H.R. 10, 115th Cong. § 482 (June 13, 2017), https://www.congress.gov/bill/115th-congress/house-bill/10/text/rfs.

[40] *Id.*

[41] *See* Letter from Jack Ehnes at 2 ("CalSTRS believes Sections 482 of the CHOICE Act that imposes new regulatory burdens and restrictions on proxy advisory firms is wholly unnecessary, could weaken the governance of public companies in the U.S. and does not reflect the needs of the customers of proxy advisory firms who are primarily institutional investors, such as CalSTRS."); Letter from Gregory W. Smith, Executive Director, Colorado PERA to The Honorable Ken Buck, United States House of Representatives 1 (May 8, 2017) ("We believe this new regulatory superstructure is overly burdensome, unnecessarily driving up costs, and gives corporations the ability to hinder and delay the independent proxy analysis process."), http://www.peraontheissues.com/wp-content/uploads/2017/06/POTI_CHOICE-Act-letter.pdf; Letter from Karen Carraher at 1 ("OPERS opposes Section

Our view on this topic is consistent with the view of a former SEC Director of the Division of Corporation Finance who recently commented:

> Part of the problem in the industry is a lack of competition. For example, various sources report that the two largest players, ISS and Glass Lewis, control approximately 97% of the proxy advisory services market. It is unclear how added regulatory burden will help promote competition. Typically, imposing additional regulation is a costly impediment to new entrants, and in turn, may bolster the incumbents' market position.
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> *It is interesting that the clients who use proxy advisory reports don't seem to be complaining*. In fact, they often favor the ease, readability, and comparability of the reports.
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> . . . .
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> . . . *I don't think placing an additional regulatory support superstructure on proxy advisory firms is the solution*.[42]

Mandatory Arbitration Provisions
Our membership-approved Policies on Corporate Governance discourage the introduction of forced arbitration clauses between U.S. public companies and investors.[43] Our policy states: "Nor should companies attempt to bar shareowners from the courts through the introduction of forced arbitration clauses."[44]

That policy is generally consistent with SEC's long-standing position that mandatory arbitration provisions in public company governing documents violate anti-waiver clauses in the federal securities laws.[45] Our policy is based, in part, on the fact that disputes that go to arbitration rather than to the court system generally do not become part of the public record and, thereby, may lose their deterrent effect. As New York University professor Jennifer Arlen recently commented:

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482 of the Act because it would negatively impact the independence, timeliness, and affordability of the proxy advisory research and reports that we use to assist in fulfilling our fiduciary duty of ensuring that each of our proxies is voted in the best long-term interests of our members."); *see also* Financial CHOICE Act of 2017, Hearing Before the H. Comm. on Fin. Servs., 115th Cong. 13 (Apr. 26, 2017) (Testimony of Michael S. Barr, The Roy F. and Jean Humphrey Proffitt Professor of Law, University of Michigan Law School) ("The proposed legislation would . . . burden proxy advisory firms."), https://financialservices.house.gov/uploadedfiles/hhrg-115-ba00-wstate-mbarr-20170426.pdf.

[42] Keith F. Higgins, "Keynote Address at the Practicing Law Institute, Corporate Governance – A Master Class" 2-3 (Mar. 9, 2017) (emphasis added) (on file with CII). "

[43] Council of Institutional Investors, "Corporate Governance Policies," §1.9 Judicial Forum (updated Sept. 30, 2016), http://www.cii.org/files/policies/09_30_16_corp_gov_policies.pdf.

[44] *Id.*

[45] *See, e.g.*, Alison Frankel, "Shareholder Alert: SEC Commissioner Floats Class-Action-Killing Proposal," *Reuters*, July 18, 2017, at 1 ("the SEC has long insisted that corporations cannot impose arbitration on shareholders because mandatory arbitration provisions would violate anti-waiver clauses in federal securities laws"), http://www.reuters.com/article/us-otc-arbitration-idUSKBN1A326T.

> If you take shareholder suits out of the light of day and put them in a dark closet, you lose the deterrent effect . . . . The very reasons why some corporations would like the ability to require shareholders to arbitrate securities fraud claims are the reasons why it would be bad public policy to allow them to do so.[46]

Shareholder Rights

As also discussed in my meeting with Department staff, CII believes that the strength of shareowner rights in publicly traded U.S. businesses directly affects the health and efficient functioning of the U.S. capital markets.[47] The importance of shareholder rights also affects whether directors and management are fully accountable to shareholders for their actions.

Shareholder rights serve the critical function of reducing agency costs associated with the potential divergence of interests between professional managers and dispersed public shareholders.[48] Without adequate shareholder rights, rational investors will reduce the price at which they are willing to purchase shares, capitalizing into the stock price these expected agency costs.[49] This discount implies reduced valuations for firms that are publicly traded and lower valuations than would otherwise be the case for firms considering an entrance into the public markets.[50]

Indeed, without assurances to shareholders, firms that depend on the public capital markets for financing might find it prohibitively expensive to raise necessary capital for funding net present value projects.[51] Even ignoring the entry and exit decisions of firms, public capital markets w*ill be smaller as a result of inadequate shareholder rights*, given the reduced valuations resulting from higher agency costs.[52]

U.S. public companies that list equity securities on the main exchanges in the U.S.— the New York Stock Exchange (NYSE) and NASDAQ Stock Market (NASDAQ) — currently are required to adopt corporate governance guidelines on certain key areas including director qualifications and responsibilities of key board committees, and director compensation.[53] Those listing standards are aimed at maintaining appropriate standards of corporate responsibility, integrity and accountability to shareowners.[54] However, the existing U.S. listing standards fail to include corporate governance guidelines that would require adherence two of the cornerstones of

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[46] *Id.* at 3.
[47] *See, e.g.*, "Interim Report of the Committee on Capital Markets Regulation" 93 (Nov. 30, 2006), http://www.capmktsreg.org/wp-content/uploads/2014/08/Committees-November-2006-Interim-Report.pdf.
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] *Id.*
[53] *See, e.g.*, NYSE Listed Company Manual § 303A.09 "Corporate Governance Guidelines" (Nov. 25, 2009), http://wallstreet.cch.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4&manual=%2Flcm%2Fsections%2Flcm-sections%2F.
[54] *Id.* § 303.00 "Introduction."

a system of shareowner rights (1) majority voting in the uncontested election of corporate directors,[55] and (2) the principle of one-share, one vote.[56]

Majority voting in the uncontested election of corporate directors
Currently directors at most U.S. listed companies are elected by a plurality, rather than a majority, of votes cast.[57] Under a plurality voting process, a director nominee is elected or reelected in an uncontested election as long as she receives a single vote in her favor.

CII's long-standing membership approved corporate governance policy states: "Directors in uncontested elections should be elected by a majority of the votes cast."[58] In contested elections, plurality voting should apply. An election is contested when there are more director candidates than there are available board seats. Our policy reflects the view of long-term institutional investors that plurality voting in uncontested elections makes directors less accountable to the shareowners they represent.

As the Investors Working Group (IWG) observed in its seminal report on U.S. financial regulatory reform, "[p]lurality voting in uncontested elections results in 'rubber stamp' elections."[59] Rubber stamp elections pose no genuine threat of removal, and thus votes cast under a plurality voting system are unlikely to provide shareowners with effective private sector oversight of corporate directors.

One share, one vote
The existing U.S. listing standards also fail to include corporate governance guidelines that would require adherence to the core governance principle of "one share, one vote." That principle was among CII's first membership approved policies when we were founded in 1985.[60] The principle is based on the belief what when a corporation goes to the capital markets to raise money from the public, public investors are entitled to certain protections and basic rights, including a right to vote that is proportional to the size of the investor's holdings.

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[55] "Interim Report of the Committee on Capital Markets Regulation" at 105 ("The Committee believes that majority voting for directors, rather than plurality voting, must be the cornerstone of any system of shareholder rights.").
[56] *See, e.g.*, Douglas Appell, "'One Share, One Vote' Remains Gold Standard Despite Challenges," *Pensions & Investments*, Aug. 7, 2017, at 1 ("'One share, one vote' remains the bedrock principle for corporate governance"), http://www.pionline.com/article/20170807/PRINT/170809923/one-share-one-vote-remains-gold-standard-despite-challenges.
[57] According to FactSet, 9 out of 10 S&P 500 companies have majority voting in place, but just 3 in 10 Russell 2000 companies have it.
[58] § 2.2 "Director Elections."
[59] A report by the Investors' Working Group, "U.S. Financial Regulatory Reform, The Investors' Perspective" 22 (July 2009), http://www.cii.org/files/issues_and_advocacy/dodd-frank_act/07_01_09_iwg_report.pdf.
[60] *See* § 3.3 "Voting Rights" ("Each share of common stock should have one vote. Corporations should not have classes of common stock with disparate voting rights.").

Since 1994, when the NYSE and NASDAQ established their current liberal listing standards on multi-class common stock,[61] investors have seen a deterioration of voting rights.[62] Notably, earlier this year, Snap Inc. had an initial public offering and was listed on the NYSE with zero voting rights as the only publicly-traded shares of the company, the first time since the 1920s that a U.S. company went public offering only non-voting shares.[63]

Stock exchanges serve the long-term interests of a broad range of market participants when they support the alignment of economic rights with voting rights. As those two aspects of ownership diverge, new risks are introduced and profound governance challenges are created. Simply put: corporate directors may be less empowered to actively and effectively oversee management and make course corrections when they can only be elected or fired by the founders/or their descendants, particularly when the founders or their descendants are part of management.

Our repeated requests to the NYSE and NASDAQ to amend their listing standards to require the adoption of a majority voting standard in the uncontested election of directors and the principle of one share, one vote have gone unheeded.[64] Adoption of listing standards in these two core areas would address a long-standing weakness in U.S. shareholder rights, a weakness that is arguably inconsistent with Congressional intent.[65] As described in the U.S. House of Representatives report on the Securities Exchange Act of 1934:

> Fair corporate suffrage is an important right that should attach to every equity security bought on a public exchange . . . Inasmuch as only the exchanges make it

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[61] *See* § 313.00(A) "Voting Rights Policy" ("On May 5, 1994, the Exchange's Board of Directors voted to modify the Exchange's Voting Rights Policy, [to be] . . . more flexible"); NASDAQ IM-5640. Voting Rights Policy (adopted Mar. 12, 2009) ("The . . . Voting Rights Policy is . . . more flexible . . . Nasdaq will consider, among other things, the economics of such actions or issuances and the voting rights being granted."), http://nasdaq.cchwallstreet.com/nasdaq/main/nasdaq-equityrules/chp_1_1/chp_1_1_4/chp_1_1_4_3/chp_1_1_4_3_8/chp_1_1_4_3_8_32/default.asp.

[62] *See, e.g.,* Maureen Farrell, "Tech Founders Want IPO Riches Without Those Pesky Shareholders," *Wall St. J.*, Apr. 3, 2017, at 1 ("About 15% of the tech companies that went public in the U.S. between 2012 and 2016, . . . did so with at least two classes of stock, up from 8% between 2007 and 2011"), *available at* https://www.wsj.com/articles/control-geeks-tech-founders-want-ipo-investors-not-their-input-1491236464.

[63] *Id.* ("Snap was the first major company since at least 2000 to do an initial offering in the U.S. that gave new shareholders no voting rights whatsoever"); s*ee generally* Adolf Berle & Gardiner Means, The Modern Corporation & Private Property 72 (1932) ("Both the New York Stock Exchange and the New York Curb have refused to list new issuers of non-voting common stock; for practical purposes, this would seem to have eliminated the use of this device an any large scale in the immediate future.").

[64] *See* Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Mr. John Carey, Vice President—Legal, NYSE Regulation, Inc., NYSE Euronext 2 (Mar. 27, 2014) (reiterating request for adoption of a listing standard regarding "the fundamental corporate governance principles of one share, one vote and majority voting for directors"), http://www.cii.org/files/issues_and_advocacy/correspondence/2014/03_27_14_CII_letter_to_NYSE_one_share_one_vote.pdf; Letter from Jeff Mahoney, General Counsel, Institutional Investors to Mr. Edward S. Knight, Executive Vice President & General Counsel, NASDAQ OMX 2 (Mar. 27, 2014) (reiterating request for adoption of a listing standard regarding "the fundamental corporate governance principles of one share, one vote and majority voting for directors"), http://www.cii.org/files/issues_and_advocacy/correspondence/2014/03_27_14_CII_letter_to_nasdaq_one_share_one_vote.pdf.

[65] H.R. Rep. No. 1383-73d, at 13 (1934).

> possible for securities to be widely distributed among the investing public, it follows as a corollary that the use of the exchanges should involve a corresponding duty of according to shareholders fair suffrage.[66]

Listing standards to require the adoption of a majority voting standard in the uncontested election of directors[67] and the principle of one share, one vote could avoid the "one size fits all" criticism of some rules by explicitly permitting the SEC to tailor the listing standards based on the size of the issuer, the market capitalization of the issuer, the number of shareholders of record of the issuer, or any other criteria, the Commission deems necessary and appropriate in the public interest or for the protection of investors. For example, the SEC could permit newly listed public companies the opportunity to adopt a one share, one vote structure within a reasonably limited period through sunset mechanisms consistent with CII membership approved policies.[68] In addition, the proposed listing standards could require the SEC to allow an issuer an opportunity to come into compliance with the requirements and to cure any defects that would be the basis for a prohibition from continued listing on an exchange.

Finally, the proposed listing standards could potentially reverse the competition to offer reduced standards around public listings globally.[69] While weakening listing standards in the near term may succeed in attracting additional listings, fallout from the lack of accountability in our view is likely in the longer-term to harm investors, as well as the reputation of the U.S. exchanges as public company listing venues.

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[66] *Id.*

[67] In the near term, CII believes the U.S. Securities and Exchange Commission (SEC) should promptly adopt a final rule in connection with its October 2016 proposal on universal proxy because the proposal includes a "requirement that companies disclose in the proxy statement the treatment and effect of a 'withhold' vote in a director election[;] [t]hat disclosure would make it clearer to investors that uncontested director elections under a plurality voting standard guarantees a victory for all nominees." Letter from Ken Bertsch, Executive Director, Council of Institutional Investors to Brent J. Fields, Secretary, Securities and Exchange Commission 5 (Dec. 28, 2016), https://www.sec.gov/comments/s7-24-16/s72416-1450259-130101.pdf.

[68] Investor Expectations for Newly Listed Companies, http://www.cii.org/ipo_policy.

[69] *See, e.g.*, Letter from Kenneth A. Bertsch, Executive Director, Council of Institutional Investors, to Hong Kong Exchanges and Clearing Limited 2 (Aug. 4, 2017) ("We believe it is a mistake for HKEX to follow other exchanges, including those based in the United States, in a competition to offer reduced standards around public listings, whether through dilution of Main Board and GEM standards or through creation of a new, low-standard board."), http://www.cii.org/files/issues_and_advocacy/correspondence/8-4-17%20CII%20response%20to%20HK%20Concept%20Paper.pdf; *see generally*, Andrea Tan & Benjamin Robertson, "Index Giants Clash with Exchanges Over Shareholder Rights," *Bloomberg Markets*, Aug. 3, 2017 (describing how some of the world's biggest index companies are banning companies that use multiple share classes in response to concerns about corporate governance while some stock exchanges are pushing to loosen rules on such structures to increase their profits), https://www.bloomberg.com/news/articles/2017-08-03/index-giants-clash-with-exchanges-over-shareholder-voting-rights.

Derivatives markets and Title VII of Dodd-Frank
It is widely acknowledged that over the counter (OTC) derivatives played a major part in the financial crisis of 2008.[70] Most agree that the "opacity and complexity of the OTC derivatives market drove much of the run-like behavior that roiled the financial markets.[71]

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act appropriately established a comprehensive framework for the regulation of OTC derivatives that has ensured greater transparency and stability in the derivatives market. We understand that more than a dozen rules to implement the provisions of Title VII have yet to be enacted.[72] We support the prompt implementation those provisions. Moreover, we believe the implementation of those provisions should be guided by the following overriding principle: Standardized derivatives should trade on regulated exchanges and clear centrally.[73] We agree with the IWG that this guiding principle should "allow effective government oversight and enforcement efforts, ensure price discovery, openness and transparency, reduce leverage and speculation and limit counterparty risk."[74]

Central clearing and risk management
As indicated, we support the principle of central clearing of OTC derivatives because it may mitigate counterparty risk through margin requirements, an orderly liquidation of a defaulting member's positions, and the sharing of risk among members through some mutualization of the costs of default.[75] We understand that central clearing may be subject to concentration[76] and liquidity risks.[77] We support the efforts of the federal financial regulators to oversee and monitor those risks. We believe the federal financial regulators should use the full extent of their regulatory powers, in concert with their foreign counterparts and market participants, to ensure a

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[70] *See, e.g.*, A Report of the Investors' Working Group at 10 ("It is widely acknowledged that OTC derivatives contracts, and particularly CDS, played a significant role in the current financial crisis.").
[71] George W. Madison & William A. Shirley, "Dodd-Frank Will Benefit CFOs in the Long Run," *CFO*, July 21, 2017, at 2, http://ww2.cfo.com/regulation/2017/07/dodd-frank-will-benefit-cfos-long-run/.
[72] *See, e.g.*, Carmen Germaine, "SEC Cuts Dodd-Frank Mandates from Rule-Making Agenda," *Law360*, July 21, 2017, at 1 (subscription required) (noting that "nearly a dozen proposed and contemplated regulations related to security-based swaps, some of which were first proposed as early as 2010, were moved to the SEC's long-term agenda"), https://www.law360.com/articles/946827/sec-cuts-dodd-frank-mandates-from-rule-making-agenda.
[73] A Report of the Investors' Working Group at 11.
[74] *Id*.
[75] *See, e.g.*, Governor Jerome H. Powell, "Remarks at the Federal Reserve Bank of Chicago Symposium on Central Clearing, Central Clearing and Liquidity" 1 (June 23, 2017) ("Central clearing serves to address many of the weaknesses exposed during the crisis by fostering a reduction in risk exposures through multilateral netting and daily margin requirements as well as . . . enabl[ing] a reduction in the potential cost of counterparty default by facilitating the orderly liquidation of a defaulting member's positions, and the sharing of risk among members of the CCP through some mutualization of the costs of such a default."), https://www.federalreserve.gov/newsevents/speech/powell20170623a.htm.
[76] *See, e.g.*, Helen Bartholomew, "CCP Study Raises Concentration of Concerns," *Reuters*, July 5, 2017, at 1 ("In a study of 26 CCPs across 15 jurisdictions the committees found that many clearinghouses maintain relationships with the same financial entities."), https://www.reuters.com/article/ccp-study-raises-concentration-concerns-idUSL8N1JW2ZA.
[77] Governor Jerome H. Powell at 2 ("like most other financial intermediaries, CCPs *do* face liquidity risks")

strong, robust, and efficient risk management framework for central counterparties of OTC derivatives.[78]

The current regulatory structure, including the SEC, CFTC, and self-regulatory organizations

We believe that efficiencies may be obtained through the merger of the SEC and the Commodity Futures Trading Commission.[79] If, however, we were to support such a merger it would be subject to several conditions, including that the combined market regulator has: (1) as a primary mission the protection of investors; and (2) the resources and independence to fulfill its mission effectively.

We note that the SEC is the only federal financial regulator whose mission explicitly includes protecting investors.[80] We would oppose any combined market regulator in which that mission was in any way diluted.

In addition, we believe the SEC or any combined market regulator should have the resources and independence to fulfill their mission effectively without political interference or dependence on the companies they oversee.[81] Consistent with that view, we have long supported a self-funding mechanism for the SEC that would provide sufficient resources while bolstering its independence.[82]

Market structure and liquidity, including the effects of technology and regulation on equity, fixed income, repo, and securitization markets

We note that our membership approved policies explicitly provide for "[c]larity and transparency of disclosure of all . . . brokerage arrangements" consistent with members' obligations as plan fiduciaries.[83] We, therefore, generally support regulatory efforts to improve transparency of broker/order routing to assist members in monitoring brokers to better ensure that they are directing orders to secure best execution.[84]

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[78] *See, e.g.*, Helen Bartholomew at 2 (describing new guidelines by the Committee on Payments and Market Infrastructure and the International Organization of Securities Commissioners regarding risk management by central counterparties).

[79] A Report of the Investors' Working Group at 3 ("efficiencies may be obtained through the merger of the SEC and the Commodity Futures Trading Commission").

[80] U.S. Securities and Exchange Commission, "What We Do," https://www.sec.gov/Article/whatwedo.htm (last visited Aug. 18, 2017).

[81] A Report of the Investors' Working Group at 9 ("[a]ll federal financial regulators should have the resources and independence to fulfill their mission effectively without political interference or dependence on the firms they oversee").

[82] S. Rep. No. 111-176, § 991, at 159 (Apr. 30, 2010) (Noting CII and the Investors' Working Group support for SEC self-funding mechanism approved by the U.S. Senate), http://www.cii.org/files/issues_and_advocacy/dodd-frank_act/07_01_09_iwg_report.pdf.

[83] "Guiding Principles for Trading Practices, Commission Levels, Soft Dollars and Commission Recapture" (adopted Mar. 3, 1996), http://www.cii.org/policies_other_issues#principles_trading_commission_softdollar.

[84] *See, e.g.*, Andrew Ramonas, "SEC's Clayton Eyes Trader Access Pilot Fees In 'Coming Months,'" *Bloomberg BNA*, July 12, 2017, at 1 ("Maker-taker critics claim brokers can direct orders to certain exchanges to maximize rebates, rather than securing the best prices or executions for clients."), https://www.bna.com/secs-clayton-eyes-n73014461646/.

Repo & Securitization Markets
Given the role that repurchase agreements and certain securitized products played in the 2008 financial crisis, we support requiring robust disclosures for those instruments.[85] We also continue to support greater use of technology to make the delivery, access, and content of such disclosures more cost effective for companies and investors.[86]

International processes and standard setting bodies
We believe that the federal financial regulators should lead the effort to forge international consensus on key elements of the regulation of global markets, players and products.[87] They should also press for greater sharing of information among national regulators.[88] The overriding goal and focus of our international capital market initiatives should be to raise, rather than lower, the quality of the standards in the U.S. and internationally consistent with serving the needs of investors and the broader financial system.[89]

Accounting and Auditing Standard Setters
Earlier this year, our members approved an update to our long-standing policy on Independence of Accounting and Auditing Standard Setters.[90] That policy includes the following language summarizing our current views on international accounting and auditing standard setters:

> CII supports U.S. accounting and auditing standard setters cooperatively working with their international counterparts toward a common goal of high quality standards. This means maintaining a high degree of on-going communication among domestic and international standard setters to produce standards that first and foremost result in high quality financial reports, and secondarily result in consistent financial reporting outcomes. CII continues to be open to a transition to a single global set of high quality standards designed to produce comparable, reliable, timely, transparent and understandable financial information that will meet the needs of institutional investors and other consumers of audited financial reports. However, at this time CII does not support replacing U.S. accounting or auditing standards or standard setters with international standards or standard setters. Notwithstanding CII's current opposition to replacing U.S. standards or

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[85] *See* Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to Brent J. Fields, Secretary, Securities and Exchange Commission 4-5 (Sept. 22, 2016) (opposing elimination of Rule 4-08(m) of Regulation S-X and noting that the "lack of transparency regarding repurchase agreements was viewed as a contributing factor to the global financial crisis"); Letter from Jonathan D. Urick, Analyst, Council of Institutional Investors to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission 1-2 (supporting enhanced disclosure of asset-based securities and noting that poor disclosures of ABS contributed to and exacerbated the 2008 financial crisis), https://www.sec.gov/comments/s7-08-10/s70810-44.pdf.
[86] *See, e.g.,* Letter from Jonathan D. Urick at 2 ("Comprehensive asset level disclosures available electronically along with computer program simulating the payments 'waterfall' will significantly enhance investor's understanding of extremely complex securitized products.").
[87] *See* A Report of the Investors' Working Group at 4 ("Washington policymakers must lead a fresh effort to forge international consensus on key elements of the regulation of global markets, players and products.").
[88] *Id.* ("U.S. leaders should also press for greater sharing of information among national regulators").
[89] *Id.* ("the focus should be on *raising* standards, not weakening them").
[90] Policies on Other Issues, "Independence of Accounting and Auditing Standard Setters" (updated Mar. 1, 2017), http://www.cii.org/policies_other_issues#indep_acct_audit_standards.

standard setters, in light of the globalization of the financial markets and the fact that U.S investors invest trillions of dollars in securities of enterprises that report their financial results in some form of international standards, we generally support high quality international accounting and auditing standards.

In order to be high quality, accounting and auditing standards must be seen as meeting the needs of the investing public, and the standard setting process must be independent and free from undue influence. Attributes that underpin an effective accounting or auditing standard setter include:

- Recognition of the Role of Reporting – A recognition that financial accounting and reporting and the quality of auditing thereof is a public good, necessary to investor confidence in individual enterprises and the global capital markets as a whole;
- Sufficient Funding – Resources sufficient to support the standard setting process, including a secure, stable source of funding that is not dependent on voluntary contributions of those subject to the standards (for international standard setters, such funding may depend on governmental and stakeholder cooperation from multiple jurisdictions, including the United States);
- Independence and Technical Expertise – A full-time standard-setting board and staff that are independent from prior employers or similar conflicts and possess the technical expertise necessary to fulfill their important roles;
- Accountability to Investors – A clear recognition that investors are the key customer of audited financial reports and, therefore, the primary role of audited financial reports should be to satisfy in a timely manner investors' information needs (this includes having significant, prominent and adequately balanced representation from qualified investors on the standard setter's staff, standard-setting board, oversight board and outside monitoring or advisory groups);
- Due Process – A thorough public due process that includes solicitation of investor input on proposals and careful consideration of investor views before issuing proposals or final standards;
- Adequate Protections – A structure and process that adequately protects the standard setter's technical decisions and judgments (including the timing of the implementation of standards) from being overridden by government officials or bodies; and
- Enforcement – A clear, rigorous and consistent mechanism for enforcement by regulators of the accounting and auditing standards.[91]

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[91] *Id.* (emphasis omitted).

Thank you for considering our views. Please contact me with any questions regarding the content of this letter. I am available at jeff@cii.org or by telephone at (202) 822-0800.

Sincerely,

Jeff Mahoney

Jeffrey P. Mahoney
General Counsel