Council of Institutional Investors®
The voice of corporate governance

Via Hand Delivery

July 10, 2018

The Honorable Jeb Hensarling
Chairman
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Re: July 11, 2018 Markup[1]

Dear Mr. Chairman and Ranking Member Waters:

I am writing on behalf of the Council of Institutional Investors (CII), a nonpartisan, nonprofit association of public, corporate, and union employee benefit funds, other employee benefit plans, foundations, and endowments with combined assets under management exceeding $3.5 trillion. Our member funds include major long-term shareholders 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 $25 trillion in assets under management, most also with long-term investment horizons. CII members share a commitment to healthy public capital markets and strong corporate governance.[2]

The purpose of this letter is to share with you our views on two issues and related bills that we understand will be considered at the markup.[3] We would respectfully request that this letter be included in the public record.

[1] United States House of Representatives, Committee on Financial Services, Notice of Hearing (July 6, 2018), https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=403663.
[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] *See* Memorandum from Financial Services Majority Staff, to the Members of the Committee on Financial Services 2-4 (July 6, 2018), https://financialservices.house.gov/uploadedfiles/071118_fc_markup_memo.pdf.

Improving Corporate Governance

CII has long held that good corporate governance—defined to include market transparency, integrity and accountability of management to boards and shareowners—is in the best long-term interests of shareowners and the U.S. capital markets.[4]

We believe that shareowners, other investors and other stakeholders benefit when rules and regulations provide adequate protections to owners and ensure that important information is promptly and transparently provided to the marketplace.[5]

The value of good governance structures and practices within public companies—such as substantially independent boards,[6] all-independent key committees,[7] and measures to promote board accountability[8]—is backed by common sense and experience. We believe such structures and practices ensure that directors have the necessary independence from management to, among other things, monitor and assess corporate performance; select, monitor, evaluate and, when necessary, replace the chief executive and other senior managers; oversee management succession; and structure, monitor and approve compensation paid to the chief executive and other senior managers. They also ensure that directors are accountable to shareowners.

We are unaware of any evidence of a causal connection between federally imposed improvements to corporate governance and the decline in the number initial public offerings or public businesses in the United States.[9]

---

[4] CII, Policies on Other Issues, Value of Corporate Governance, http://www.cii.org/policies_other_issues#value_corp_gov.
[5] *Id.*
[6] *See* Council of Institutional Investors, Corporate Governance Policies § 2.3 Independent Board (updated September 15, 2017), https://www.cii.org/files/policies/09_15_17_corp_gov_policies.pdf.
[7] *See id*. § 2.5 All-independent Board Committees.
[8] *See id*. § 2.1 Annual Election of Directors; § 2.6 Board Accountability to Shareholders (stating that boards should seek shareholder views on important governance, management, and performance matters and take actions recommended by shareholder proposals that receive a majority of votes cast for and against).
[9] *See* Michael J. Mauboussin et al., Credit Suisse, "The Incredible Shrinking Universe of Stocks, The Causes and Consequences of Fewer U.S. Equities" 20 (Mar. 22, 2017) ("the shrinkage in the population of listed companies started well before . . . [Sarbanes-Oxley Act] was implemented"), https://www.cmgwealth.com/wp-content/uploads/2017/03/document_1072753661.pdf; Office of Investor Advocate, U.S. Securities and Exchange Commission, Report on Objectives 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; "Legislative Proposals to Help Fuel Capital and Growth on Main Street:" Hearing before the H. Subcomm. Cap. Markets, Sec., & Investment, 115th Cong. (May 23, 2018) (Statement of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School at 2) ("the decline of IPO's . . . cannot be blamed on an over-regulating national regulator"), https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-jcoffee-20180523.pdf; Elisabeth de Fontenay, "The Deregulation of Private Capital and the Decline of the Public Company," 68 Hastings L.J. 445, 448 (Mar. 29, 2017) ("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") *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/elisabeth-de-fontenay-deregulation-private-capital.pdf.

We offer the following summary discussion of CII views on specific issues addressed by two of the bills that we understand will be considered by the Committee at the mark-up. In both cases, we believe the proposed legislation, if enacted, would improve corporate governance for the benefit of investors and other participants in the U.S. capital markets.[10]

1. Rule 10b5-1 Trading Plans

Under Securities and Exchange Commission (SEC or Commission) Rule 10b5-1,[11] "directors and other major insiders in the company—large shareholders, officers, and others who are able to access material nonpublic information—are able to establish a written plan that details when they will be able to buy or sell shares at a predetermined time on a scheduled basis."[12]

CII believes Rule 10b5-1 trading plans have been frequently abused for many years. We issued letters on January 18, 2018, to Chair Clayton,[13] May 9, 2013, to Chair Mary Jo White,[14] and December 28, 2012, to Chair Elisse Walter[15] regarding our concerns about these plans. Those letters respectfully requested that the Commission should consider potentially pursuing amendments to Rule 10b5-1 that would *require* Rule 10b5-1 plans to adopt the following protocols and guidelines:

- Companies and company insiders should only be permitted to adopt Rule 10b5-1 trading plans when they are permitted to buy or sell securities during company-adopted trading windows, which typically open after the announcement of the financial results from a recently completed fiscal quarter and close prior to the close of the next fiscal quarter;
- Companies and company insiders should be prohibited from adopting multiple, overlapping Rule 10b5-1 plans;
- Rule 10b5-1 plans should be subject to mandatory delay, preferably of three months or more, between the adoption of a Rule 10b5-1 plan and the execution of the first trade pursuant to such a plan;

---

[10] *See* Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School at 3 ("relaxing disclosure and transparency rules and downsizing important corporate goverance protections (such as . . . the Rule 14a-8 shareholder proposal rule) represent a dubious policy for Congress to follow").
[11] 17 CFR § 240.10b5-1 (Aug. 24, 2000), *available at* https://www.law.cornell.edu/cfr/text/17/240.10b5-1.
[12] Memorandum from Financial Services Majority Staff at 2-3.
[13] Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors, to The Honorable Jay Clayton, Chairman, U.S. Securities and Exchange Commission 1 (Jan. 18, 2018), http://www.cii.org/files/issues_and_advocacy/correspondence/2018/January%2018%202018%20Rule%2010b5-1%20(finalI).pdf.
[14] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to The Honorable Mary Jo White, Chairman, U.S. Securities and Exchange Commission 1-2 (May 9, 2013), http://www.cii.org/files/issues_and_advocacy/correspondence/2013/05_09_13_cii_letter_to_sec_rule_10b5-1_trading_plans.pdf.
[15] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to The Honorable Elisse B. Walter, Chairman, U.S. Securities and Exchange Commission 3 (Dec. 28, 2012), http://www.cii.org/files/issues_and_advocacy/correspondence/2012/12_28_12_cii_letter_to_sec_rule%20_10b5-1_trading_plans.pdf.

- Companies and company insiders should not be allowed to make frequent modifications or cancellations of Rule 10b5-1 plans;
- Companies and company insiders should disclose Rule 10b5-1 program adoptions, amendments, terminations and transactions; and
- Boards of companies that have adopted Rule 10b5-1 plans should (1) adopt policies covering plan practices, (2) periodically monitor plan transactions and (3) ensure that company policies discuss plan use in the context of guidelines or requirements on equity hedging, holding and ownership.[16]

If the above protocols had been in place, the widely reported $39 million sale of Intel stock by CEO Brian Krzanich last November, within 30 days of revising his trading plan for the second time during the year, would have been a clear violation of Rule 10b5-1.[17] We are confident that most retail investors would agree with us that Mr. Krzanich's stock sale, just weeks prior to the public announcement of a design flaw in Intel chips, was unfair to other market participants.

Unfortunately, Mr. Krzanich's sale was not an unusual occurrence. There is a large body of empirical evidence indicating that Rule 10b5-1 plans have been regularly abused in various ways for many years to facilitate trades based on inside information.[18]

Promoting Transparent Standards for Corporate Insiders Act[19]

The Promoting Transparent Standards for Corporate Insiders Act (PTS Act) "requires the SEC to carry out a study of whether Rule 10b5-1 should be amended and, if so, to amend Rule 10b5-1, subject to notice and comment, in a manner consistent with the results of such study."[20] The PTS Act also "requires the SEC to consider certain types of amendments to Rule 10b5-1 . . ."[21] Those amendments are generally consistent with protocols and guidelines that we have recommended to the Commission.[22] We, therefore, generally support the PTS Act.

---

[16] Letter to The Honorable Mary Jo White at 1; *see* § 5.15b Stock Sales ("10b5-1 program adoptions, amendments, terminations and transactions should be disclosed immediately, and boards of companies using 10b5-1 plans should: (1) adopt policies covering plan practices, (2) periodically monitor plan transactions and (3) ensure that company policies discuss plan use in the context of guidelines or requirements on equity hedging, holding and ownership.").
[17] *See, e.g.*, Stephen Gandel, "SEC Needs to Quit Taking Executives' Word on Stock Sales," Gadfly, Wash. Post, Jan. 9, 2017, https://www.washingtonpost.com/business/sec-needs-to-quit-taking-executives-word-on-stock-sales-gadfly/2018/01/09/92cfc61a-f542-11e7-9af7-a50bc3300042_story.html?utm_term=.9e9842673c11.
[18] *See* John Shon & Stanley Veliotis, "Insiders' Sales Under Rule 10b5-1 Plans and Meeting or Beating Earnings Expectations," Mgmt. Sci. 59(9) at 1988 (Mar. 4, 2013) (on file with CII); *see also* Susan Pulliam & Rob Barry, "Executives' Good Luck in Trading Own Stock," Wall. St. J., Nov. 27, 2012, https://www.wsj.com/articles/SB10000872396390444100404577641463717344178.
[19] H.R. ____, 115th Cong. (July 10, 2018) [hereafter PTS Act], https://financialservices.house.gov/uploadedfiles/bills-115-10b5_1-pih.pdf.
[20] Memorandum from Financial Services Majority Staff at 2.
[21] *Id.* at 3.
[22] PTS Act, *supra* n.19 at § 2(a)(1).

2. Multi-Class Stock Structures

When CII was formed in 1985, the first policy adopted was the principle of one share, one vote.[23] The importance of this approach has been underlined repeatedly by market participants since then, including recent moves by index providers to discourage multi-class stock structures.

As long-term investors, we believe a decision to go public with a multi-class structure will undermine confidence of public shareholders in the company.[24] Independent boards accountable to owners should be empowered to actively oversee management and make course corrections when appropriate. Disenfranchised public shareholders have no ability to influence management or the board when the company encounters performance challenges, as most do at some point, particularly where management is accountable only to itself and the board that it appoints.

We acknowledge that in recent years, some technology companies with dynamic leadership and innovative products have attracted capital on public markets despite using multi-class structures. However, the performance record of these companies is decidedly mixed, with some studies finding a substantially lower total shareholder return compared to their one share, one vote counterparts after 10 years.[25]

Another study found that even at innovative companies where multi-class structures correlate to a value premium at the time of the initial public offering, that premium dissipates within six to nine years before turning negative.[26] The evidence against multi-class structures enhancing company value beyond the short-term is also a factor in our support for meaningful, time-based sunsets.

Recognizable companies like Yelp, Fitbit, Kayak, MuleSoft, and Smartsheet all went public with multi-class structures, but with reasonable time-based sunsets. Public shareholders at these companies knew that they would have a say in company matters equal to their ownership interests within reasonable periods of time. In 2016, Groupon collapsed its multi-class structure and adopted one share, one vote after a five-year sunset expired, and in 2017, MaxLinear did the same after its seven-year sunset lapsed.

---

[23] *See* Corporate Governance Policies § 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").
[24] *See, e.g.*, Letter from Kenneth A. Bertsch, Executive Director, Council of Institutional Investors, to Matthew R. Cohler, Independent Director and Member, Nominating and Governance Committee et al. Domo Inc. 1 (June 25, 2018), https://www.cii.org/files/Board%20Accountability/Domo%20Dual%20Class.pdf.
[25] *See, e.g.*, Edward Kamonjoh, "Controlled Companies in the Standard & Poor's 1500: A Follow-Up Report of Performance & Risk," IRRC Inst. 82 (Mar. 2016) ("Controlled companies featuring multiple classes of stock generally underperformed on a broad swath of financial metrics over the long term, are perceived as having more financial risk, and offer fewer rights to unaffiliated shareholders than dispersedly owned firms."), https://irrcinstitute.org/wp-content/uploads/2016/03/Controlled-Companies-IRRCI-2015-FINAL-3-16-16.pdf.
[26] Martijn Cremers, et al., "The Life-Cycle of Dual Class Firms," ECGI (working paper May 17, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3062895.

More companies went public with time-based sunsets in 2017 than in any other year, and 2018 is on pace to set a new record.[27] As SEC Commissioner Robert Jackson said in a February 2018 speech, "If you run a public company in America, you're supposed to be held accountable for your work—maybe not today, maybe not tomorrow, but someday."[28]

Public company investors have demonstrated time and again that they will support innovation and investment for the long-term, as has been the case for many years at Amazon and many other companies. While establishing accountability to new owners does not always maximize comfort and compensation for management, we believe accountability is important for performance longer term, especially through bumps in the road that every company has experienced.

Enhancing Multi-Class Stock Disclosures Act[29]

The Enhancing Multi-Class Stock Disclosures Act (EMS Act) "amends the Securities Exchange Act of 1934 to require issuers with multi-class stock structures to make certain disclosures in any proxy or consent solicitation material with respect to each person who is a director or executive officer of the issuer or who, directly or indirectly, holds five percent or more of the total combined voting power of all classes of stock entitled to vote in the election of directors."[30] We note that the EMS Act amendment is generally consistent with a recent recommendation of the Investor as Owner Subcommittee of the SEC Investor Advisory Committee.[31]

We believe that improving disclosure about public companies with multi-class structures is an important supplement to amending existing U.S. stock exchange listing standards to require meaningful, time-based sunsets.[32] We, therefore, generally support the EMS Act.

---

[27] Council of Institutional Investors, List of Companies with Time-Based Sunset Approaches to Dual-Class Stock (updated May 11, 2018), https://www.cii.org/files/Board%20Accountability/5-11-18%20Time-based%20Sunsets.pdf.

[28] Commissioner Robert J. Jackson, Jr.,"Perpetual Dual-Class Stock: The Case Against Corporate Royalty," Speech (Feb. 15, 2018), https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty.

[29] H.R. ____, 115th Cong. (July 10, 2018), https://financialservices.house.gov/uploadedfiles/bills-115-meeks_057-pih.pdf.

[30] Memorandum from Financial Services Majority Staff at 4.

[31] U.S. Securities and Exchange Commission, Investor Advisory Committee, Recommendation of the Investor as Owner Subcommittee, "Dual Class and Other Entrenching Governance Structures in Public Companies" 6 (Feb. 27, 2018) ("Require public companies that have dual class or other entrenching governance structures to prominently and clearly disclose the numerical relationship between (a) the amount of common equity or its equivalent economic beneficial ownership interest held by any person entitled to control or direct the voting of five percent or more of shares entitled to voting rights in the election of directors or the equivalent body . . . and (b) the amount of voting rights held or controlled by such a person . . . ."), https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac030818-investor-as-owner-subcommittee-recommendation.pdf.

[32] *See, e.g.*, Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors, to Brent J. Fields Secretary, Securities and Exchange Commission 3 (Dec. 20, 2017) ("We believe that improving investor access to information about classes of stock with different or preferential voting rights is an important intermediate step to amending existing U.S. listing standards to adopt the core governance principle of 'one share, one vote.'"), https://www.cii.org/files/issues_and_advocacy/correspondence/2017/December%2020,%202017%20SEC%20FAST%20Act%20letter%20(final)%20.pdf.

Thank you for considering our views. We would be very happy to discuss our perspective on these and other issues with you or your staff at your convenience. I am available at jeff@cii.org or by telephone at (202) 822-0800.

Sincerely,

Jeffrey P. Mahoney
General Counsel