Council of Institutional Investors®
The voice of corporate governance

Via Hand Delivery

July 17, 2017

The Honorable Bill Huizenga
Chairman
Subcommittee on Capital Markets, Securities, and Investment
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

The Honorable Carolyn B. Maloney
Ranking Member
Subcommittee on Capital Markets, Securities, and Investment
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Re: July 18, 2017, hearing entitled "The Cost of Being a Public Company in Light of Sarbanes-Oxley and the Federalization of Corporate Governance"[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 thank you for holding the above referenced hearing and to share with you some of our views on this important topic. This letter has the following four sections: (1) Why has there has been a decline in U.S. public companies?; (2) Why improving corporate governance provides value to the capital markets; (3) How the Sarbanes-Oxley Act of 2002 (SOX) improved corporate governance; and (4) What provisions of H.R. 10, if enacted, would likely weaken corporate governance?

We would respectfully request that this letter be included in the hearing record.

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[1] Financial Services Committee, Hearings, *available at* https://financialservices.house.gov/calendar/?EventTypeID=309&Congress=115.
[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.

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Decline in Number of Public Companies

There are many reasons why there has been a decline in the number of U.S. public companies since 2001 related both to the number of initial public offerings ("IPOs) and mergers and acquisition activity.[3] We agree with those experts that have recently analyzed the issue and have concluded that neither SOX nor required improvements in corporate governance have been key factors in the decline.[4] As we explained in recent joint letter with the Center for Audit Quality and the CFA Institute on this topic (Joint Letter):

> A precipitous drop in . . . IPOs occurred in 2001, *prior to the adoption and enactment of SOX*. Major, macroeconomic factors—such as the "dot-com bust" and the September 11 terrorist attacks—contributed to this decline. Since then, competition from international marketplaces, mergers, acquisitions, and other economic factors, *such as growth in the private equity markets*, continue to drive down IPO activity and have led to a decline in the number of public companies in the United States.
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> These additional factors were explored in depth at a recent meeting of the Securities and Exchange Commission's ("SEC") Advisory Committee on Small and Emerging Companies. Glen Giovannetti, Global Biotechnology Sector Leader at EY, explained that while listing as a public company offers some advantages—such as a lower cost of capital, wider diversity of shareholders, and higher liquidity and brand identity—there are numerous factors that lead companies to remain private. *Compared to just 15 years ago, companies have more ways to access significant capital without utilizing the public markets. Venture capitalists, private equity firms, and sovereign funds have considerable capital to invest in private companies. The amount of capital that these firms have invested in privately-held technology companies has nearly tripled*

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[3] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors et al., to The Honorable Jeb Hensarling, Chairman, House Financial Services Committee et al. 2 (May 1, 2017), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2017/Joint%20Letter%20CAQ%20CII%20CFA%20Institute%20on%20the%20Financial%20CHOICE%20Act.pdf [hereinafter Joint Letter].

[4] *See* Elizabeth 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; 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"), *available at* http://www.cmgwealth.com/wp-content/uploads/2017/03/document_1072753661.pdf.

> *from 2013 to 2015*. This is further highlighted by some cutting-edge, startup companies that are built upon business models that require less capital than resource-intensive industrial-economy companies. Additionally, interest rates have remained at historic lows over the past decade, which could also be a contributing factor to the decrease in IPOs in the United States.
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> *Given the various choices companies have for funding, they can choose to remain private longer*. It is also important to note that the 2012 Jumpstart Our Business Startups . . . Act increased the accredited investor limit for registering with the SEC from 500 to 2,000 persons and excluded employees receiving exempt equity awards, both of which also could be a factor in a private company determining to delay listing as a public company.[5]

<u>The Value of Improving Corporate Governance</u>

CII has long held that good corporate governance—defined to include market transparency, integrity and accountability and specific relationships between boards, management and shareowners—is in the best long-term interests of shareowners.

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.[6]

The value of good governance structures/practices within public companies—such as substantially independent boards, all-independent key committees and other board accountability policies/practices—is backed by commonsense and experience. Such structures and practices ensure that directors have the necessary independence to, among other things, monitor and assess corporate performance; select, monitor, evaluate and, when necessary, fire 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.

Shareowners may employ a variety of tools and tactics, including direct engagement, filing shareowner resolutions, litigating or running director candidates, to encourage public companies to adopt good corporate governance practices. While CII doesn't take formal positions on company-specific campaigns, it fully endorses the rights of CII members and other shareowners to get involved, encourage companies to improve their governance practices and urge the U.S. Congress, including this Subcommittee, the Administration, the SEC, and other legislators and regulators to strengthen the rules and regulations addressing investor rights and protections.

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[5] Joint Letter, *supra* note 3, at 2 (emphasis added and footnotes omitted).
[6] CII, Policies on Other Issues, Value of Corporate Governance, *available at* http://www.cii.org/policies_other_issues#value_corp_gov.

SOX & Corporate Governance

SOX was enacted in response to a shocking series of corporate scandals. The costs of these scandals—from company-specific losses to widespread loss of confidence in the integrity of the U.S. capital markets—were staggering. From the stock market peak in 2000 to the market trough in the third quarter of 2002, the S&P 500 lost almost half of its value. From the start of 2002 through the fall of 2002—a period of widespread corporate scandals and frauds—the S&P 500 lost about 19.5% of its value. All investors in the U.S. markets, from large institutional investors to individuals investing their hard-earned savings, were impacted by these frauds.

The enactment and implementation of SOX played a vital role in restoring investor confidence in our capital markets. Measures to reform the auditing profession and to assure its independence, including the creation of the Public Company Accounting Oversight Board (PCAOB), were central elements of SOX.[7] Complementing them were some strong new corporate governance related provisions relating to public company board and audit committee composition, new and clear responsibilities for internal controls and officer certification of the accuracy of financial reports.[8]

Even considering the aforementioned new corporate governance related provisions, the existing laws that comprised the fundamental principles, duties and standards for corporate governance were left largely unchanged.[9] SOX, however, was revoluntary in terms of the attitudinal and cultural change that it caused to occur within the community of public companies.[10] As explained by a partner for an international corporate law firm:

> The impact of Sarbanes-Oxley isn't necessarily found in the collective impact of its substantive provisions. Rather, it is found in the profound way the law has reshaped attitudes toward corporate governance.
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> The need for fundamental change in boardroom behavior was a message that transcended the text of the Sarbanes law. The old ways weren't working.
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> . . . *[T]he law has been spectacularly successful.* Sarbanes-Oxley has forever changed the landscape of corporate governance. It has increased the accountability expectations we have of directors and officers, and their legal and accounting advisers as well.

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[7] Paul Volcker & Arthur Levitt Jr., Op-Ed., In Defense of Sarbanes-Oxley, Wall St. J., June 14, 2004, at A16, *available at* https://www.wsj.com/articles/SB108717805594936016.
[8] *Id.*
[9] *See, e.g.*, Melissa Maleske, 8 Ways SOX Changed Corporate Governance, Experts Weigh in on SOX 10 Years after It Became Law, IC 2 (Jan. 1, 2012) (registration required), *available at* http://www.insidecounsel.com/2012/01/01/8-ways-sox-changed-corporate-governance.
[10] *Id.*

> Sarbanes-Oxley seized the center of corporate direction from the corner office and returned it to the boardroom, where it belonged. . . . It has raised the public consciousness of corporate governance.[11]

Internal Controls

We note that perhaps the most maligned SOX provision by some public companies has been the requirement (Section 404(b)) that the publicly-held company's auditor attest to, and report on, management's assessment of its internal controls.[12] Ironically, the body of evidence indicating that compliance with Section 404(b) has a positive impact on capital formation is perhaps the most compelling of any SOX provision.[13] As described in the Joint Letter:

> [A]cademic research has demonstrated that the cost of capital for companies that voluntarily comply with Section 404(b) is lower than peer companies that do not, and the cost of capital has decreased for public companies since enactment of SOX, especially for smaller companies.
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> A 2014 study of the seven-year period from 2007-2013 found that companies subject to 404(b), experienced higher credit ratings, which resulted in overall lower costs of debt and higher valuation premiums.
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> Since the adoption of SOX, financial restatements have steadily declined. According to an analysis by Audit Analytics, an independent research provider, the total number of financial reporting restatements decreased in the United States from 756 in 2015 to 671 in 2016. The study also shows that the number of accelerated filers disclosing restatements dropped for the second year, following a four-year trend of increases. From 2010 to 2014, restatements among accelerated filers climbed from 174 to 352, then tapered to 284 in 2015 and 255 in 2016.
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> Recent surveys conducted by independent, third-party research firms . . . show that both companies and investors recognize the value and importance of Section 404(b) and ICFR [Internal Control Over Financial Reporting] audits. An April 2017 poll . . . of publicly traded companies revealed that 85 percent of the CFOs surveyed

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[11] Michael W. Peregrine, Op-Ed., Sarbanes-Oxley Changed Corporate America, N.Y. Times, July 22, 2012, at 1 (emphasis added), *available at* https://www.nytimes.com/roomfordebate/2012/07/24/has-sarbanes-oxley-failed/sarbanes-oxley-changed-corporate-america.
[12] Melissa Maleske at 7.
[13] Joint Letter, *supra* note 3, at 3-4.

> believe the ICFR audit function has either greatly (34 percent) or somewhat (51 percent) helped their company, because it builds trust among stakeholders and customers (26 percent of respondents), helps to produce accurate financial reporting (21 percent of respondents), and makes the process more streamlined (21 percent of respondents).
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> A February 2017 . . . survey of 300 certified financial advisors found that nearly three-quarters of financial advisors support Section 404(b), with 26 percent indicating they "strongly favor" it. Seventy-three percent of financial advisors surveyed also said that it would benefit their clients if all public companies were required to have an independent ICFR audit.[14]

We note that subsequent to the issuance of the Joint Letter a new research paper on Section 404(b) was published by accounting professors at the University of Washington and Georgetown University.[15] The paper provides evidence of the benefits of Section 404(b) compliance for smaller public companies.[16] As described by Dave Michael of *The Wall Street Journal*, the research indicates:

> [S]maller firms are more likely to have ineffective internal controls, . . . [p]oor internal controls deprive managers of good information on which to make operational and investment decisions [and] . . . open the door to errors that lead to accounting restatements or even fraud, which eventually hurts shareholders that absorb the decline in share price.[17]

In April 2017, CII submitted a letter to the Committee on Financial Services (Committee) opposing Section 847 of H.R. 10 because it would further expand the existing exemption for public corporations from compliance with Section 404(b).[18] The current exemption is for public companies with market capitalization of less than $75 million. Section 847 would expand that exemption to public companies with capitalization of less than $500 million or less than $1 billion in assets for banks.

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[14] *Id.* (footnotes omitted).
[15] Dave Michael, WSJ: A Hated Rule that Benefits Investors, Wall St. J., July 5, 2017, at 1 (on file with CII).
[16] *Id.*
[17] *Id.*
[18] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to The Honorable Jeb Hensarling, Chairman, Committee on Financial Services et al. 12 (Apr. 29, 2017), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2017/04_29_17_letter_cmte_fin_serv.pdf.

We note that there are approximately 680 companies currently listed in the Russell 2000 Index with market capitalizations less than $500 million.[19] If Section 847 of H.R. 10 were enacted, investors in those 680 companies, including many CII members, would not have the many benefits of an outside auditor's oversight of the company's assessment of internal controls over financial reporting.[20]

For all the above reasons, we continue to strongly oppose Section 847 of H.R. 10.

Provisions of H.R. 10 that Would Likely Weaken Corporate Governance

In addition to Section 847 of H.R. 10, we would be remiss if we failed to identify for the Subcommittee the other provisions of H.R. 10 that, if enacted, would likely weaken corporate governance at U.S. public companies to the detriment of those who participate in the capital markets. The remainder of this letter summarizes some of those provisions in the order in which they appear in H.R. 10.

SEC Rulemaking

CII would amend Sections 311 and 334 of H.R. 10 to remove the SEC from the costly, time consuming, and incomplete cost-benefit analysis and Congressional review provisions of Title III, Subtitle A and B of H.R. 10, respectively.

As an association of long-term shareowners interested in maximizing share values, we believe it is vital to avoid unnecessary regulatory costs. However, it is not clear to us how Sections 311 and 334 would improve the cost-effectiveness of the SEC's existing rulemaking process or benefit long-term investors, the capital markets or the overall economy.

We note, for example, that Sections 311 and 344 do not contain any language that would explicitly require the SEC to consider the costs and benefits of a proposal or rule from the perspective of long-term investors. Moreover, as we explained in a recent letter to Speaker Ryan and Minority Leader Pelosi regarding similar cost-benefit provisions of H.R. 78:

> The Commission's rulemaking process is already governed by a number of legal requirements, including those under the federal securities laws, the Administrative Procedure Act, the Paperwork Reduction Act of 1980, the Small Business Regulatory Enforcement Fairness Act of 1996 and the Regulatory Flexibility Act. Moreover,

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[19] Letter from Jack Ehnes, Chief Executive Officer, CalSTRS, to The Honorable Maxine Waters, Ranking Member, Committee on Financial Services 4 (June 5, 2017), *available at* https://www.calstrs.com/sites/main/files/file-attachments/06-05-2017_maxine_financial_choice_act.pdf.

[20] *Id.; see* Letter from Gregory W. Smith, Executive Director, Colorado PERA, to The Honorable Ken Buck, United States House of Representatives 1 (May 8, 2017) (opposing § 847 because Section 404(b) "assurance is an important driver of confidence in the integrity of financial statements and in the fairness of our capital markets"), *available at* http://www.peraontheissues.com/wp-content/uploads/2017/06/POTI_CHOICE-Act-letter.pdf [hereafter Smith Letter].

> under the federal securities laws, the SEC is generally required to consider whether its rulemakings are in the public interest and will protect investors and promote efficiency, competition and capital formation.
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> Since the 1980s, the Commission has conducted, to the extent possible, an analysis of the costs and benefits of its proposed rules. The SEC has further enhanced the economic analysis of its rulemaking process in recent years. *That process is far more extensive than that of any other federal financial regulator.*
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> . . . .
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> The [cost-benefit] provisions . . . would create a false and misleading expectation that the SEC can reasonably measure, combine and compare the balance of all costs and benefits of its proposals consistent with its mandate to protect investors. As explained by Professor Craig M. Lewis, former chief economist and director of the SEC's Division of Economic and Risk Analysis: "[W]ith regard to investor protection, the Commission is often unable to reasonably quantify the related benefits or costs."
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> [The cost-benefit provisions] . . . would impose upon the SEC a costly, time consuming and incomplete analysis in which the Commission would be hard pressed to determine that the benefits of a proposal or rule "justify the costs of the regulation."[21]

The application of H.R. 10's Congressional review provisions to SEC rulemaking is perhaps even more troubling for long-term investors. On this issue, we generally agree with the following comments of Broc Romanek of the TheCorporateCounsel.net:

> The "Financial Choice Act" is much more than merely repealing big chunks of Dodd-Frank. There are a handful of provisions that would render the SEC's ability to conduct rulemaking much more difficult. But this provision in particular . . . just blows me away:
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> . . . A joint Congressional resolution to adopt a "major" rule – and even some non-major ones! [Its] goal appears to be neutering the so-called "independent" federal agencies that govern our financial institutions & markets. Talk about putting partisan politics into "independent" agencies. And here I was worried that having

[21] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to The Honorable Paul D. Ryan, United States House of Representatives et al. 2-3 (Jan. 11, 2017) (emphasis added & footnotes omitted), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2017/01_11_17_letter_house_leadership_HR78.pdf.

> Congress involved in the SEC's budget process was too much meddling with a federal agency!
>
> Remember that federal agencies are part of the executive branch of government. Not to mention that members of Congress don't have the expertise, resources or time to understand what the various rules of an agency are. This would be a major windfall for lobbyists who would be able to effectively pay Congress to stop an agency from doing anything. Either the Senate or the House could stop a rulemaking – by simply sitting on their hands. The polar opposite of needing an "Act of Congress" to change something. It's brazen & breathtaking – and a whole lot of other things that I can't mention in this family-oriented blog.[22]

We, and many of our members and other institutional investors, believe that if Title III, Subpart A and B of H.R. 10 are enacted they would unnecessarily constrain the ability of the SEC to issue any substantive proposals or rules in furtherance of its mission to protect investors—the element of its mission that, in our view, is most critical to maintaining and enhancing a fair and efficient capital market system.[23]

Proxy Research

CII opposes Sections 481-483 of H.R. 10 because it would establish an additional burdensome federal regulatory superstructure for proxy advisory firms that institutional investors, the primary customer of those firms' research services, do not want or need.

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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[22] Broc Romanek, Financial CHOICE Act: One Provision Could Destroy the SEC's Rulemaking, TheCorporateCounsel.net Blog (Nov. 17, 2016), *available at* https://www.thecorporatecounsel.net/blog/2016/11/financial-choice-act-one-provision-could-destroy-the-secs-rulemaking-abilities.html.

[23] *See* Letter from Jack Ehnes at 5 ("CalSTRS opposes Sections 311 and 334 that includes the SEC as part of the cost-benefit analysis and Congressional review provisions of the CHOICE Act, which unnecessarily constrains the SEC from fulfilling its mission."); Letter signed by CII and more than 50 investors, to The Honorable Paul Ryan, United States House of Representatives 2 (May 17, 2017) (opposing Sections 311 and 334 of H.R. 10 because it would "[s]hackle the Securities and Exchange Commission . . . with excessive cost-benefit analysis requirements and Congressional review requirements that appear designed to foster the ability of special interests to block needed rules"), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2017/05-17-17%20FinChoice%20Letter%20FINAL.pdf [hereinafter May Letter]; Smith Letter, *supra* note 20, at 2 ("Sections 311 and 334 of the Act would shackle the SEC with excessive cost-benefit analysis requirements.").

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 their investment portfolio.[24] We, and many our members and other investors, believe that the existing SEC regulatory regime already protects the interests of long-term shareowners with respect to proxy advisory firms and that H.R. 10's new regulatory scheme is unnecessary, overly burdensome, and counter-productive.[25]

Last September a letter co-signed by 30 CII members and other organizations expressed concerns about the proxy advisory firm provisions that were subsequently included in H.R. 10.[26] A description of those provisions and specific related concerns include the following:

> Require that proxy advisory firms (1) provide companies advance copies of their recommendations and most elements of the research

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[24] *See* Letter from Jack Ehnes at 2 ("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."); 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) [hereinafter Carraher Letter].

[25] *See* Letter for 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."); Smith Letter, *supra* note 20, at 1 ("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."); Carraher Letter, *supra* note 24, at 1 ("OPERS opposes Section 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."), *available at* https://financialservices.house.gov/uploadedfiles/hhrg-115-ba00-wstate-mbarr-20170426.pdf.

[26] Letter from Kenneth A. Bertsch, Executive Director, Council of Institutional Investors et al., to The Honorable Richard C. Shelby, Chairman, Committee on Banking, Housing, and Urban Affairs, United States Senate et al. (Sept. 6, 2016), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2016/September%206%20Letter%20to%20Senate%20Banking%20on%20Proxy%20Advisory%20Firms.pdf; *see* Letter from Kenneth A. Bertsch, Executive Director, Council of Institutional Investors et al., to The Honorable Jeb Hensarling, Chairman, House Committee on Financial Services et al. (June 13, 2016) (letter co-signed by 27 CII members and other institutional investors strongly opposing H.R. 5311), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2016/06_13_16_FINAL_Letter_on_Proxy_Advisory_Firm_Bill.pdf; *see also* Editorial, Undermining Proxy-Voting Advice, Pensions & Invs., June 27, 2016, at 1 ("A bill pending in Congress would undermine proxy-voting firms and consequently weaken the capability of asset owners and other institutional investors to bring to bear their crucial resources to assist in voting on proxy issues at publicly traded companies") (registration required), *available at* http://www.pionline.com/article/20160627/PRINT/306279998/undermining-proxy-voting-advice.

informing their reports, (2) give companies an opportunity to review and lobby the firms to change their recommendations, and (3) establish a heavy-handed “ombudsman” construct to address issues that companies raise.

This right of pre-review would give companies substantial influence over proxy advisory firms’ reports, potentially undermining the objectivity of the firms’ recommendations. On a practical level, this right of review would delay pension funds and other institutional investors’ receipt of the reports and recommendations for which they have paid.

The requirement that the proxy advisory firms resolve company complaints prior to the voting on the matter would create an incentive for companies subject to criticism to delay publication of reports as long as possible. Pension funds and other institutional investors would have less time to analyze the reports and recommendations in the context of their own customized proxy voting guidelines to arrive at informed voting decisions. Time already is tight, particularly in the highly concentrated spring “proxy season,” due to the limited period between company publication of the annual meeting proxy statement and annual meeting dates.

Moreover, the proposed legislation does not appear to contemplate a parallel requirement that dissidents in a proxy fight, or proponents of shareowner proposals, also receive the recommendations and research in advance. This would violate an underlying tenet of U.S. corporate governance that where matters are contested in corporate elections, management and dissident shareowners should operate on an even playing field.

Require the Securities and Exchange Commission . . . to assess the adequacy of proxy advisory firms’ “financial and managerial resources.”

The entities that are in the best position to make these types of assessments are the pension funds and other institutional investors that choose to purchase and use the proxy advisory firms’ reports and recommendations. In 2014, the SEC staff issued guidance reaffirming that investment advisors have a duty to maintain sufficient oversight of proxy advisory firms and other third-party voting agents. We publicly supported that guidance. We are unaware of any compelling empirical evidence indicating that the guidance is not being followed or that the burdensome federal

> regulatory scheme contemplated by the proposed legislation is needed.
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> The proposed legislation would appear to result in higher costs for pension plans and other institutional investors – potentially much higher costs if investors seek to maintain current levels of scrutiny and due diligence around proxy voting. Moreover, the proposed legislation is highly likely to limit competition, by reducing the current number of proxy advisory firms in the U.S. market and imposing serious barriers to entry for potential new firms. This would also drive up costs to investors. Given these economic impacts, we are troubled that there appears to be no cost estimate on the provisions of this proposed legislation.[27]

A May letter, co-signed by CII and more than 50 institutional investors with collectively more than $4 trillion in assets, expressed opposition to Sections 481-483 of H.R. 10 (May Letter). [28] The May Letter stated that those provisions would "[c]reate an intrusive new regulatory scheme for proxy advisors that provide shareholders with independent research they need to vote responsibly."[29] That view is consistent with the view of former SEC Director of Corporation Finance Keith F. Higgins who recently commented:

> Under this regime, proxy advisory firms would be required to register with the Commission, allow companies to review their reports before issuance, disclose potential conflicts of interest and provide financial reports. Although I don't dismiss concerns about the influence of proxy advisory firms, *I don't think the proposed regulatory regime is the answer*. 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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[27] Letter from Kenneth A. Bertsch, Executive Director, Council of Institutional Investors et al., to The Honorable Richard C. Shelby, Chairman, Committee on Banking, Housing, and Urban Affairs, United States Senate et al. at 8-10 (footnotes omitted & emphasis removed).
[28] May Letter, *supra* note 23, at 2.
[29] *Id.* (emphasis omitted).

> . . . .
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> . . . *I don't think placing an additional regulatory support superstructure on proxy advisory firms is the solution.*[30]

PCAOB Investor Advisory Group

CII opposes Section 833 of H.R. 10 because it would abolish the Investor Advisory Group at the independent, private sector PCAOB.

The PCAOB's mission, as mandated by Congress, is to protect investors. Investors are the primary users of the audited financial reports that the PCAOB oversees. Therefore, we believe, consistent with our membership approved policies that the primary role of the PCAOB should be to ensure that investors' information needs are met.[31] To do this, the board and its staff must actively solicit and carefully consider investor input.[32] We believe the PCAOB's Investor Advisory Group, on which our former Executive Director served, is an important entity in this process, charged with obtaining investors' views and advice on matters that the board must consider when fulfilling its mission to protect investors.[33]

On this issue we agree with PCAOB Chairman James Doty who recently commented:

> "It seems to me quite logical that you want to have an Investor Advisory Group. I don't see anybody who has said it has done any kind of harm. It has not resulted in redundancy."[34]

It remains unclear to us why some in Congress would want to abolish an investor advisory group to an independent private sector organization whose mission is to protect investors.

Say-on-Pay

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[30] 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).

[31] *See* CII, Policies on Other Issues, Independence of Accounting and Auditing Standard Setters (update Mar. 1, 2017) (the primary role . . . should be to satisfy in a timely manner investors' information needs), *available at* http://www.cii.org/policies_other_issues#indep_acct_audit_standards.

[32] *Id.* (indicating the Public Company Accounting Oversight Board should have a "thorough public due process that includes solicitation of investor input on proposals and careful consideration of investor views").

[33] *See, e.g.,* Steve Burkholder, GOP Bill Would Abolish Audit Overseer's Investor Adviser Panel, Bloomberg BNA, Apr. 26, 2017, at 1 ("investor advocates and proponents of strong auditing aren't happy with the draft Fiancial CHOICE Act's planned demise of the relatively obscure panel [because] . . . [t]hey say its advisory work contributes directly to the PCAOB's mission—to protect investors"), *available at* https://www.bna.com/gop-bill-abolish-n57982087331/.

[34] PCAOB Chairman James Doty Criticizes House Bill Abolishing Investor Advisory Group, Thomson Reuters/Tax & Acct. News, May 26, 2017, at 1, *available at* https://tax.thomsonreuters.com/media-resources/news-media-resources/checkpoint-news/daily-newsstand/chairman-doty-criticizes-house-bill-abolishing-investor-advisory-group/.

CII opposes Section 843 of H.R. 10 because it would reduce the required frequency of shareholder advisory votes on executive compensation, commonly called say-on-pay votes. The requirements of Section 951, "Shareholder Vote on Executive Compensation Disclosures," of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), as implemented by the SEC, are generally consistent with CII's membership-approved corporate governance policies.[35] Those policies state:

> All companies should provide annually for advisory shareowner votes on the compensation of senior executives.[36]

While the existing requirement provides for say-on-pay votes to be held annually, biennially, or triennially, to date over 90% of public companies have opted for annual votes consistent with our policy.[37]

Section 843 of H.R. 10 would change the frequency of advisory shareowner votes on executive compensation from at least one every three years to only when there is a "material change" in compensation of executives of an issuer from the previous year. The Section is ambiguous as to what a material change is and a whether a material change would need to be for only one executive or for all executives as a group. In any event, the provision appears to be designed to "limit shareholder's ability to vote annually on 'say on pay' management compensation."[38]

We note that a recent survey of institutional investors found that 68% oppose Section 843.[39] That survey is consistent with the May Letter in which more than 50 institutional investors expressed opposition to Section 843 stating that it would "roll back curbs on abusive pay practices."[40]

We believe an annual say-on-pay vote is critical to investors, in part, because it provides shareowners with the ability to communicate their views on the most recent payouts stemming from the policies used to administer executive compensation practices. Those payouts may

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[35] CII Policies, §5.2 Advisory Shareowner Votes on Executive Pay (updated Sept. 30, 2016), *available at* http://www.cii.org/corp_gov_policies.
[36] *Id.*
[37] *See, e.g.*, Compensation Advisory Partners, Say on Pay Vote Results (S&P 500) 3 (May 15, 2017) ("Through May 15, 2017 . . . (93%) recommended and approved an annual vote frequency . . ."), *available at* https://www.capartners.com/wp-content/uploads/2017/05/2017-SoP_Update_5-15-2017.pdf.
[38] Testimony of Michael S. Barr at 13.
[39] Ben Ashwell, Institutional Investors Split Over Dodd-Frank Rollback, Poll Finds, IR Magazine, June 28, 2017, at 2, *available at* https://www.irmagazine.com/articles/disclosure-regulation/22181/institutional-investors-split-over-dodd-frank-rollback-poll-finds/.
[40] May Letter, *supra* note 23, at 2 (emphasis omitted); *see* Letter from Jack Ehnes at 3 ("CalSTRS opposes the provision of the Act that amends Section 951 of Dodd-Frank Wall Street Reform and Consumer Protection Act . . . by reducing the frequency of say-on-pay votes."); Smith Letter, *supra* note 20, at 2 ("An annual say-on-pay vote is critical to investors, in part, because it provides shareowners with the ability to communicate their views on the most recent payouts stemming from the policies used to administer executive compensation practices."); Carraher Letter, *supra* note 24, at 2 ("OPERS opposes Section 843 because it could reduce the required frequency of shareholder advisory votes on executive compensation.").

change in unforeseeable and unexpected ways due to a policy's complexity, reliance on forward-looking factors and board discretion.

In addition, it is widely recognized that an annual vote on executive compensation has resulted in a number of ongoing improvements to the process in which corporate boards determine executive pay, including:

- Boards are actively and frequently reaching out to shareowners to solicit their concerns about, and their approval of, executive compensation plans;
- Boards are increasing the proportion of executive compensation linked to company performance, leading to potentially greater alignment between the two; and
- Boards are eliminating executive compensation perks such as club memberships that blur the line between personal and business expenses.[41]

Shareholder Proposals

CII opposes Section 844 of H.R. 10 because it would dramatically restrict the ability of shareowners to file proposals on important governance issues.

CII and its members have a deep interest in ensuring that Rule 14a-8,[42] the federal rule that governs shareholder proposals, is a fair and workable standard shareowners and companies.[43] The rule provides an orderly means to mediate differences between managers and owners.

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 now 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.
- 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

[41] *See, e.g.*, Paul Hodgson, Surprise Surprise: Say on Pay Appears to Be Working, Fortune.com, July 8, 2015, at 1-2, *available at* http://fortune.com/2015/07/08/say-on-pay-ceos/; *see generally* Say-on-Pay Laws Are Doing Their Job, UGA Study Finds, Post Searchlight, June 20, 2017, at 1, *available at* http://www.thepostsearchlight.com/2017/06/20/say-on-pay-laws-are-doing-their-job-uga-study-finds/ (reporting on new study issued by the University of Georgia adding to the growing body of evidence demonstrating that say-on-pay requirements enhance shareowner value).

[42] 17 CFR 240.14a-8 - Shareholder proposals, Cornell U. L. School, LII, *available at* https://www.law.cornell.edu/cfr/text/17/240.14a-8 (last viewed Apr. 23, 2017).

[43] *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, Council of Institutional Investors), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2015/11_16_15_cii_Rep%20_Garrett_roundtable_submission_amy_borrus.pdf.

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 these companies today.

- 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.
- 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.[44]

Section 844 of the H.R. 10 would radically increase the regulatory hurdles for shareholder proposals. Current rules set a minimum $2,000 ownership requirement.[45] In contrast, Section 844(b) of the Act would require any shareholder wishing to put a proposal on a public company ballot to own at least 1% of the company's stock for a minimum of three years.

For example, Section 844(b) of the Act would require an investor at Wells Fargo to own approximately $2.7 billion in shares in order to file a single proposal, based on July 17, 2017 share price. At Apple, the largest U.S. company by market capitalization, a shareholder would have to own more than $7.5 billion of stock to file a single proposal.

Even our largest public pension fund members rarely hold 1% of a public company.[46] In fact, based on holdings as of December 30, 2016, the only shareholders with eligibility to propose

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[44] *See* Ceres et al., The Business Case for the Current SEC Shareholder Proposal Process 6 (Apr. 2017), *available at* https://www.ceres.org/resources/reports/business-case-current-sec-shareholder-proposal-process; *see also* Letter from Thomas P. DiNapoli, State Comptroller, State of New York, Office of the State Comptroller, to the Honorable Jeb Hensarling, Chairman, Committee on Financial Services, United States House of Representatives 1 (Apr. 26, 2017) ("It has been my experience over the past ten years as Comptroller that shareholder resolutions are an effective means to voice concerns and propose changes in order to protect Fund investments and encourage sustainable, robust corporate practices at our portfolio companies."), *available at* http://www.osc.state.ny.us/press/releases/apr17/choice-act-letter.pdf; Statement of New York City Comptroller Scott M. Stringer on the April 19th Discussion Draft of the Financial CHOICE Act of 2017 (Act) 3 (Apr. 25, 2017) (describing some of the many achievements "made possible because of the NYC Pension Funds' long-standing right and ability to file shareholder proposals—a right and ability that would be pointlessly eviscerated by the passage of the Act"), *available at* https://comptroller.nyc.gov/newsroom/testimonies/statement-of-new-york-city-comptroller-scott-m-stringer-on-the-april-19th-discussion-draft-of-the-financial-choice-act-of-2017-act/.

[45] 17 CFR 240.14a-8(b) Question 2.

[46] *See* Letter from Jack Ehnes at 1 ("While one percent may sound like a small amount, even a large investor like the $200 billion CalSTRS fund does not own one percent of publicly traded companies."); Carraher Letter, *supra* note 24, at 2 ("Even though OPERS is the 12th largest public retirement system in the United States, none of our current holdings come close to approaching the proposed requirement."); Letter from Thomas P. DiNapoli at 2 ("Such severe holding requirements would effectively deprive the Fund, and most other shareholders of the ability to file

resolutions at Apple would be BlackRock, Vanguard, State Street, FMR, Northern Trust, Bank of New York Mellon, Berkshire Hathaway and T. Rowe Price. To our knowledge, none of these investors has ever presented a shareholder proposal at an annual meeting.

The 1% threshold in Section 844(b) implies that ideas submitted by smaller shareholders are not effective or successful, but a recent research study by three academics at Harvard Business School disproves that.[47] The paper concludes that "the idea that bigger shareholders create 'better' proposals is not supported by empirical data."[48]

In addition, current rules permit a shareholder to re-file a proposal only if it has received at least 3% of the vote on its first submission, 6% on the second and 10% on the third.[49] Section 844(a) of the Act would raise those thresholds to 6%, 15% and 30%, respectively. Those hurdles could also knock out many important governance proposals that, if adopted, could enhance long-term shareowner value. The percentages of proposals since 2000 that are estimated to have fallen below the proposed thresholds are 13.3%, 31.5%, and 50.1%, respectively.

We agree with Anne Sheehan, director of corporate governance at the California State Teachers' Retirement System, the second largest U.S. public pension fund, and a CII member, that the provisions of Section 844 of the Act "would shut down the shareholder proposal process completely."[50] Shutting down shareholder proposals is likely to have unintended consequences, including 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.[51] Recent polling indicates that these unintended consequences of Section 844 are resulting in "issuers that were previously in favor of this amendment . . . beginning to change their minds."[52]

Investor opposition to Section 844 only continues to grow. In the May Letter more than 50 institutional investors expressed opposition to Section 844 stating that it would "set prohibitively costly hurdles on shareholder proposals."[53] In June CII, together with fiduciaries to pension funds with more than $1 trillion in assets and responsibility for providing retirement security for more than 5 million dedicated public employees and retirees, emailed a letter and accompanying

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proposals."); Statement of New York City Comptroller at 1 ("Despite being among the largest pension investors in the world, we rarely hold more than 0.5% of any individual company, and most often hold less.").

[47] Gretchen Morgenson, Meet the Legislation Designed to Stifle Shareholders, Fair Game, N.Y. Times, June 16, 2017, at 4, *available at* https://www.nytimes.com/2017/06/16/business/wells-fargo-clawback-fair-choice-act-shareholders.html.

[48] *Id.*

[49] 17 CFR 240.14a-8(i)(12).

[50] Andrea Vittorio, Shareholder Advocacy Tool Shut Down in Republican Plan., Bloomberg BNA, Apr. 19, 2017, at 2, *available at* https://www.bna.com/shareholder-advocacy-tool-n57982086844/.

[51] *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."), *available at* 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.

[52] Ben Ashwell at 1.

[53] May Letter, *supra* note 23, at 1.

"Joint Statement on Defending Fundamental Shareholder Rights" [54] to all members of the House of Representatives.[55] The email expressed opposition to Section 844 stating that "if enacted, [it] would result in less corporate accountability and more conflict between shareowners and public companies with no clear corresponding benefits."[56]

<u>*Universal Proxies*</u>

CII opposes Section 845 of the H.R. 10 because it appears intended to bar the SEC from issuing a final rule that would allow shareowners to freely vote for those board candidates they favor in a contested election.

The problem that the SEC's October 2016 universal proxy proposal[57] would resolve that clearly articulated by the SEC's Investor Advisory Committee in 2013.[58] Namely, investors currently are disenfranchised in a proxy contest, to the extent they vote by proxy, because they have no practical ability to "split their ticket" and vote for the combination of shareowner nominees and management nominees that they believe best serve their economic interests.[59]

The comment period for the SEC's proposal ended on January 9, 2017.[60] Thirty-eight comment letters were received in response to the proposal.[61] The vast majority of commentators supported

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[54] CII, Fair Financial Rules, Joint Statement on Defending Fundamental Shareholder Rights, *available at* http://www.cii.org/files/issues_and_advocacy/financial_regulation/Joint%20Statement%20on%20Shareowner%20Rights%206_2_2017%20FINAL.pdf.
[55] Email from Jeff Mahoney, General Counsel, Council of Institutional Investors to Speaker Ryan 1 (June 6, 2017), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2017/06_05_17_email_house_members.pdf.
[56] *Id.*
[57] Universal Proxy, Exchange Act Release No. 79,164, Investment Company Act Release No. 32,339, 81 Fed. Reg. 79,122, 79,186 (proposed rule Oct. 2016), *available at* https://www.gpo.gov/fdsys/pkg/FR-2016-11-10/pdf/2016-26349.pdf.
[58] Recommendations of the Investor Advisory Committee Regarding SEC Rulemaking to Explore Universal Proxy Ballots 2 (adopted July 25, 2013) ("shareholders [currently] have no practical ability to 'split their tickets' and vote for a combination of shareholder nominees and management nominees), *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/universal-proxy-recommendation-072613.pdf.
[59] *Id.*
[60] 81 Fed. Reg. at 79,122.
[61] U.S. Securities and Exchange Commission, Comments on Proposed Rule: Universal Proxy (last viewed July 6, 2017), *available at* https://www.sec.gov/comments/s7-24-16/s72416.htm.

the proposal. In addition to CII,[62] the Investment Company Institute[63] and the CFA Institute,[64] commentators supporting the proposal included the following investors:
California State Teachers' Retirement System[65]
California Public Employees' Retirement System[66]
Colorado Public Employees' Retirement Association[67]
Fidelity Investments[68]
Florida State Board of Administration[69]
Hermes Equity Ownership Services Limited[70]
Ohio Public Employees Retirement System[71]

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[62] Letter from Ken Bertsch, Executive Director, Council of Institutional Investors 3 (Dec. 28, 2017) ("With minor enhancements, the proposed framework will provide for a constructive universal proxy regime that gives greater effect to existing shareholder rights."), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2016/12_28_16_comment_letter_SEC_universal_proxy.pdf.

[63] Letter from Dorothy M. Donohue, Deputy General Counsel, Investment Company Institute 9 (Dec. 19, 2016) ("In general, the adoption of a mandatory universal proxy for operating companies would serve the public interest in giving all shareholders the same voting options, whether they vote by proxy or in person.), *available at* https://www.sec.gov/comments/s7-24-16/s72416-1431117-129844.pdf.

[64] Letter from James Allen, CFA, Head, Capital Markets Policy, CFA Institute et al. 1 (Jan. 29, 2017) ("We commend the SEC for addressing this shortcoming of the board voting process by introducing a new Universal Proxy ballot rule that will allow shareowners to effectively split their voting ticket if they chose to do so – without having to attend a company's annual meeting in person."), *available at* https://www.sec.gov/comments/s7-24-16/s72416-1473944-130452.pdf.

[65] Letter from Anne Sheehan, Director of Corporate Governance, CalSTRS 1 (Jan. 9, 2017) ("We thank the Commission for the opportunity to support and comment on the well-researched, prudent and attentive proposed rule on Universal Proxy."), *available at* https://www.sec.gov/comments/s7-24-16/s72416-1471415-130426.pdf.

[66] Letter from Marcie Frost, Chief Executive Officer, CalPERS 2 (Jan. 9, 2017) ("We support the proposed amendments which would require proxy contestants to furnish shareowners a universal proxy card; one that includes the names of both management and dissident director nominees in an election contest in a manner that reflects, as closely as possible, the voting process available in-person."), *available at* https://www.sec.gov/comments/s7-24-16/s72416-1470820-130402.pdf.

[67] Letter from Gregory W. Smith, Executive Director, Colorado PERA 2 (Jan. 9. 2017) ("The universal proxy cards for all contested elections would guarantee that shareholders are able to choose from among all board nominees, regardless of whether they voted in person or by proxy."), *available at* https://www.sec.gov/comments/s7-24-16/s72416-1471329-130425.pdf.

[68] Letter from Marc R. Bryant, Senior Vice President, Deputy General Counsel, Fidelity Investments 2 (Jan. 9, 2017) ("Fidelity support universal proxy as a logical way to fully accommodate shareholder voting preferences."), *available at* https://www.sec.gov/comments/s7-24-16/s72416-1471250-130420.pdf.

[69] Letter from Michael P. McCauley, Senior Officer Investment Programs and Governance, FSB 1 (Jan. 11, 2017) ("The SBA staff strongly supports the Commission's effort to provide shareowners with equivalent voting opportunities, whether they vote in person or by proxy."), *available at* https://www.sec.gov/comments/s7-24-16/s72416-1481390-130533.pdf.

[70] Letter from Tim Goodman, Director, Hermes Equity Ownership Services Limited 1 (Dec. 23, 2016) ("Our experience is that we would often, possibly usually, prefer to recommend votes for candidates from both the board's and the dissident's slates [and] [t]his opportunity is currently denied in practice to our clients."), *available at* https://www.sec.gov/comments/s7-24-16/s72416-1440887-129987.pdf.

[71] Letter from Karen Carraher, Executive Director et al., Ohio Public Employees Retirement System 3 (Jan. 4, 2017) ("OPERS believes that the Universal Proxy Requirement should be mandated as proposed, since it more effectively replicates in-person attendance at a shareowners' meeting, which permits shareowners to vote for their preferred

Comptroller, State of New York[72]
Trian Fund Management[73]
Washington State Investment Board.[74]
CII's support for the SEC's proposal is derived from our membership approved policies for director elections which states:

> To facilitate the shareholder voting franchise, the opposing sides engaged in a contested election should utilize a proxy card naming all management-nominees and all shareholder-proponent nominees, providing every nominee equal prominence on the proxy card.[75]

Voting for director nominees is a fundamental right, and as long term investors, our members support the ability to choose among the best suited candidates to represent their interests inside the board room.[76] On this issue, we again agree with the former SEC Director of Corporation Finance, who recently commented:

> What I haven't heard is a good answer to this simple question: *Why shouldn't a shareholder who votes by proxy have the same voting options as a shareholder who votes in person? Unless someone comes up with a good answer to that question, I think the Commission should move forward with the proposal*. . . . Even though there are only a relatively small number of contested elections each year, *it is a glitch in the system of fair suffrage that should be fixed*.[77]

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combination of nominees from both slates"), *available at* https://www.sec.gov/comments/s7-24-16/s72416-1471224-130416.pdf.

[72] Letter from Thomas P. DiNapoli, State Comptroller, State of New York 1 (Jan. 9, 2017) ("I am writing as Trustee of the New York State Common Retirement Fund . . . and administrative head of the New York State and Local Retirement System . . . to express support for the proposed amendments to the federal proxy rules published by the Securities and Exchange Commission . . . in its Release No. 34-79164 pertaining to universal proxies . . . ."), *available at* https://www.sec.gov/comments/s7-24-16/s72416-1470796-130406.pdf.

[73] Letter from Brian L. Schorr, Chief Legal Officer and Partner, Trian Fund Management LLP 1 (Jan. 9, 2017) ("We are writing in support of the proposed amendments to the Federal proxy rules published by the U.S. Securities and Exchange Commission . . . in the Release . . . providing for the use of universal proxy cards in contested director elections."), *available at* https://www.sec.gov/comments/s7-24-16/s72416-1471095-130411.pdf.

[74] Letter from Theresa Whitmarsh, Executive Director, Washington State Investment Board 1 (Jan. 5, 2017) ("The WSIB strongly supports the U.S. Securities and Exchange Commission's proposed release regarding the use of universal proxy cards in contested elections of directors."), *available at* https://www.sec.gov/comments/s7-24-16/s72416-1463856-130298.pdf.

[75] §2.2 Director Elections.

[76] *See, e.g.*, Letter from Jack Ehnes at 2.

[77] Keith F. Higgins at 2 (emphasis added).

Not surprisingly, Section 845 of H.R. 10 is not supported by most investors[78] and many other market participants, including President Trump's Special Advisor on Regulatory Reform.[79] Some supporters of Section 845 contend that the use of universal proxies would encourage more proxy contests or favor dissidents. We, however, are unaware of any compelling empirical evidence indicating that universal proxies would favor shareowner-proponent board nominees over company-nominees (or the reverse).[80] As concluded in a recent expert analysis of the SEC proposal by attorneys with Fried Frank Harris & Jacobson LLP: "In our view, the universal proxy card mandate, if adopted, would not significantly affect the outcome of proxy contests or activist situations." [81]

<u>*Clawbacks*</u>

CII opposes Section 849 of H.R. 10 because it would narrow the scope of required clawbacks of unearned compensation from corporate executives to those we had control or authority over the company's financial reporting.

We continue to support the SEC's issuance of a final rule in response to Section 954 of Dodd-Frank entitled, "Recovery of Erroneously Awarded Compensation." The SEC's proposed rule to implement Section 954 is generally consistent with CII's membership approved corporate governance policies.[82] Those policies state:

> The compensation committee should ensure that sufficient and appropriate mechanisms and policies (for example, bonus banks and clawback policies) are in place to recover erroneous bonus and incentive awards paid in cash, stock or any other form of remuneration to current or former executive officers, and to prevent such awards from being paid out in the first instance. Awards can be erroneous due to acts or omissions resulting in fraud, financial

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[78] *See* May Letter, *supra* note 23, at 2 (opposing § 845 because it would "[r]estrict the right of shareholders to vote for directors in contested elections for board seats"); *see also* Carraher Letter, *supra* note 24, at 2-3 ("OPERS opposes Section 845 of the Act because it prevents the Securities and Exchange Commission . . . from issuing a final rule allowing shareholders to vote for their preferred board candidates in a contested election.").

[79] *See, e.g.*, Carl Icahn, Statement Regarding SEC Proposal to Require Use of Universal Proxy Cards (Oct. 27, 2016) ("the introduction of the universal proxy card will eliminate needless voter confusion in contested elections, give shareholders greater freedom of choice, and hopefully end some of the gamesmanship employed by incumbent boards to keep shareholder-nominated directors out of the boardroom"), *available at* http://carlicahn.com/statementregarding-sec-proposal-to-require-use-of-universal-proxy-cards/.

[80] *See, e.g.*, Tatyana Shumsky, SEC Weighs Universal Proxy Vote Cards, Wall St. J., Feb. 19, 2016, at 1 (quoting Michelle Anderson, associate director in the SEC's Division of Corporation Finance, that the universal proxy project is "'not about favoring the company or the dissident'"), *available at* http://blogs.wsj.com/cfo/2016/02/19/sec-weighs-universal-proxy-vote-cards/.

[81] Gail Weinstein et al., Fried Frank Harris Shriver & Jacobson LLP, Expert Analysis, A Practical Assessment of the 'Universal Proxy Card' Plan, Law360 at 5 (Dec. 14, 2016) (emphasis omitted), *available at* https://www.law360.com/articles/871184/a-practical-assessment-of-the-universal-proxy-card-plan.

[82] Listing Standards for Recovery of Erroneously Awarded Compensation, 80 Fed. Reg. 41,144 (proposed rule July 2015), *available at* https://www.federalregister.gov/articles/2015/07/14/2015-16613/listing-standards-for-recovery-of-erroneously-awarded-compensation.

> results that require restatement or some other cause that the committee believes warrants withholding or recovering incentive pay. Incentive-based compensation should be subject to recovery for a period of time of at least three years following discovery of the fraud or cause forming the basis for the recovery. The mechanisms and policies should be publicly disclosed.[83]

Consistent with our policies, we believe the final SEC rule should, as proposed,[84] apply broadly to the compensation of all current or former executive officers whether or not they had control or authority over the company's financial reporting.[85] As we explained in our comment letter to the SEC:

> In our view, establishment of a broad clawback arrangement is an essential element of a meaningful pay for performance philosophy. If executive officers are to be rewarded for "hitting their numbers"—and it turns out they failed to do so—the unearned compensation should generally be recovered notwithstanding the cause of the revision.[86]

We note that broad clawback arrangements may "keep executive officers focused on sound accounting company-wide."[87] We also note that requiring a broad clawback policy appears to be consistent with the "Commonsense Principles of Corporate Governance" recently endorsed by a number of prominent leaders of U.S. public companies, including Mary Barra, General Motors Company; Jamie Dimon, JPMorgan Chase; Jeff Immelt, GE; and Lowell McAdam, Verizon.[88] Those principles state that "companies should maintain clawback policies for both cash and equity compensation" of management.[89]

<u>*Hedging*</u>

CII opposes Section 857(a)(25) of H.R. 10 because it would repeal the requirement that public corporations disclose whether their employees and directors can hedge their company's equity compensation.

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[83] § 5.5 Pay for Performance.

[84] *See* 80 Fed. Reg. at 41,153 ("the compensation recovery provisions of Section 10D apply without regard to an executive officer's responsibility for preparing the issuer's financial statements").

[85] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to Brent J. Fields, Secretary, U.S. Securities and Exchange Commission 5 (Aug. 27, 2015), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2015/08_27_15_letter_to_SEC_clawbacks.pdf.

[86] *Id.* (footnotes omitted).

[87] Testimony of Michael S. Barr at 15.

[88] Commonsense Corporate Governance Principles VII(g) (July 2016), *available at* http://www.governanceprinciples.org/.

[89] *Id.*

We continue to support the SEC's issuance of a final rule in response to Section 955 of Dodd-Frank entitled, "Disclosure Regarding Employee and Director Hedging." The SEC's proposed rule to implement Section 955[90] has important implications for CII's long-standing membership approved corporate governance policies on hedging of compensation.[91] Those policies state:

> Compensation committees should prohibit executives and directors hedging (by buying puts and selling calls or employing other risk-minimizing techniques) equity based awards granted as long-term incentive compensation or other stock holdings in the company. And they should strongly discourage other employees from hedging their holdings in company stock.[92]

For those companies that have not yet fully adopted our policy, we believe that a final SEC rule, as proposed, would provide our members and other investors with a more complete understanding regarding the persons permitted to engage in hedging transactions and the types of hedging transactions allowed. Armed with the proposed disclosure, our members and other investors would be in a better position to make more informed investment and voting decisions, including voting decisions on proposals to adopt hedging policies, advisory votes on executive compensation and voting decisions in connection with the election of directors.

Finally, we believe the proposed disclosure also would benefit our members and other investors because the public nature of the required disclosure would result in more public companies adopting our hedging policy and enhancing long-term shareowner value. For all the above reasons, CII opposes Section 857(a)(25) of the H.R. 10 and generally supports the SEC's issuance of a final rule as proposed.[93]

Compensation Structure

CII opposes Section 857(a)(26) of H.R. 10 because it would repeal requirements to improve executive pay practices at financial institutions.

We continue to support the issuance of a final rule by the SEC and the federal financial regulators in response to Section 956 of Dodd-Frank entitled, "Enhanced Compensation Structure Reporting." As we stated in our comment letter in response to the proposed rule to implement Section 956,[94] the proposal is "largely consistent with CII's member-approved

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[90] Disclosure of Hedging by Employees, Officers, and Directors, 80 Fed. Reg. 8486 (proposed rule Feb. 2015), *available at* https://www.gpo.gov/fdsys/pkg/FR-2015-02-17/pdf/2015-02948.pdf.
[91] § 5.8d Hedging.
[92] *Id.*
[93] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to Brent Fields, Secretary, U.S. Securities and Exchange Commission 3 (Apr. 16, 2015), *available at* https://www.sec.gov/comments/s7-01-15/s70115-5.pdf.
[94] Incentive-Based Compensation Arrangements, 81 Fed. Reg. 112 (proposed rule June 10, 2016), *available at* https://www.gpo.gov/fdsys/pkg/FR-2016-06-10/pdf/2016-11788.pdf.

policies on executive compensation."[95] Those policies support reasonable, appropriately structured pay-for-performance programs that reward executives for sustainable, superior performance over the long-term, consistent with a company's investment horizon.[96] In light of those policies and the experience of the financial crisis,[97] our comment letter concludes:

> [We support] the proposed rule's over-arching requirements that incentive-based compensation arrangements at covered financial institutions 1) appropriately balance risk and reward, and 2) bar arrangements that could encourage inappropriate risks by providing excessive compensation or that could lead to material financial loss. We also support the proposed rule's recognition of the board's important role to oversee incentive-based compensation programs.[98]

We believe the issuance of a final rule, as proposed, appropriately preserves a role for incentive-based compensation at financial institutions and places a greater emphasis on risk management and long-term outcomes. The result should be greater stability for the overall market.

Proxy Access

CII opposes Section 857(a)(30) of H.R. 10 because it would repeal express authority of the SEC to issue a proxy access rule.

Section 971 of Dodd-Frank gave the SEC the express authority to develop a proxy access rule that the SEC subsequently finalized.[99] The rule, however, was struck down in 2011 on administrative procedure grounds in a controversial decision by a three judge panel of the DC Circuit.[100]

We continue to believe that proxy access—a mechanism that enables shareowners to place their nominees for director on a company's proxy card—is a fundamental right of long-term shareowners. Proxy access gives shareowners a meaningful voice in board elections. Without

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[95] Letter from Glenn Davis, Director of Research, Council of Institutional Investors, to Patrick T. Tierney, Assistant Director, Department of Treasury, Office of the Comptroller of the Currency, Legislative and Regulatory Activities Division et al. 2 (July 15, 2016), *available at* http://www.federalreserve.gov/SECRS/2016/July/20160721/R-1536/R-1536_071516_130346_394428687994_1.pdf.
[96] § 5.1 Introduction.
[97] Investors Working Group, U.S. Financial Regulatory Reform: The Investors' Perspective 22 (July 2009) (concluding that the global financial crisis resulted, in part, from "too many boards approv[ing] executive compensation plans that rewarded excessive risk-taking"), *available at* http://www.cii.org/files/issues_and_advocacy/dodd-frank_act/07_01_09_iwg_report.pdf.
[98] Letter from Glenn Davis at 3.
[99] Facilitating Shareholder Director Nominations, Securities Act Release No. 9,136, Exchange Act Release No. Investment Company Act Release No. 29,384 (Aug. 25, 2010), *available at* https://www.sec.gov/rules/final/2010/33-9136.pdf.
[100] *See, e.g.*, Jessica Holzer, Court Deals Blow to SEC, Activists, Wall St. J., July 23, 2011, at 1, *available at* https://www.wsj.com/articles/SB10001424053111903554904576461932431478332.

effective proxy access, the director election process at many companies simply offers little more than a ratification of management's slate of nominees.

Our member-approved policy on proxy access states, in part:

> Companies should provide access to management proxy materials for a long-term investor or group of long-term investors owning in aggregate at least 3% of a company's voting stock, to nominate less than a majority of the directors. Eligible investors must have owned the stock for at least two years.[101]

We generally support an approach to proxy access similar to the one that the SEC adopted in 2010 but was later vacated.[102] We note that now more than 425 U.S. public companies have voluntary adopted proxy access in a form generally consistent with our policy.[103] That includes 60% of companies in Standard & Poor's 500 index.[104] In all likelihood, the number of large and small U.S. public companies adopting proxy access will continue to grow.[105]

Relying on private ordering rather than a more uniform approach envisaged by the SEC in 2010 has led to myriad versions of proxy access, at greater legal expense than with a more uniform rule, and with the potential for various creative provisions that seem aimed at making it difficult for shareowners to use the mechanism.[106] Given the clear growing trend of public companies adopting proxy access, and the increasing complexity and related costs resulting from the current private ordering process, there may soon come a time when companies and their shareowners will favor a more uniform, less costly set of standards and requirements for proxy access. If that time should arrive, Section 971 of Dodd-Frank would facilitate the SEC's ability to respond with rulemaking in a more timely and cost-effective manner.

Chairman & CEO Structures

CII opposes Section 857(a)(31) of H.R. 10 because it would repeal required disclosures of public corporation's Chairman and CEO structures.

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[101] § 3.2 Access to Proxy.
[102] Facilitating Shareholder Director Nominations at 24 ("To use Rule 14a-11, a nominating shareholder or group will be required to satisfy an ownership threshold of at least 3% of the voting power of the company's securities entitled to be voted at the meeting.").
[103] Skadden, Arps, Slate, Meagher & Flom LLP, Proxy Access: Highlights of the 2017 Proxy Season 1 (June 20, 2017), *available at* http://www.jdsupra.com/legalnews/proxy-access-highlights-of-the-2017-28914/.
[104] *Id.*
[105] *See* CII, Proxy Access by Private Ordering 10 ("the number of companies adopting proxy access continues to grow") (Feb. 2017), *available at* *http://www.cii.org/files/publications/misc/02_02_17_proxy_access_private_ordering_final.pdf.*
[106] *See id.* ("Reliance on private ordering (rather than a more standardized approach envisaged by the SEC in 2010) has meant that this area is even more complex, with the potential for various creative ways to block or frustrate what shareowners would see as legitimate uses of the mechanism.").

We note that the SEC adopted rules in December 2009 that, in effect, implemented the disclosure requirements of Section 972 of Dodd Frank entitled, "Disclosures Regarding Chairman and CEO Structure." CII's membership approved policies generally support appointment of an independent chair. Those policies state:

> The board should be chaired by an independent director. The CEO and chair roles should only be combined in very limited circumstances; in these situations, the board should provide a written statement in the proxy materials discussing why the combined role is in the best interests of shareowners, and it should name a lead independent director who should have approval over information flow to the board, meeting agendas and meeting schedules to ensure a structure that provides an appropriate balance between the powers of the CEO and those of the independent directors.

CII members believe that the board leadership is critical to effective governance. We believe that even those who promote combination of chair and CEO roles generally share that view, and should have no objections to the existing disclosure requirement providing for clarity around the reasoning behind board leadership structure.
We note that our support for this disclosure appears to be consistent with the "Commonsense Principles of Corporate Governance" recently endorsed by a number of prominent leaders of U.S. public companies.[107] Those principles state that the "board should explain clearly . . . to shareholders why it has separated or combined the roles."[108] Our support for this disclosure is also consistent with a recent poll of institutional investors that found that "74% oppose any repeal of a separation of chair/CEO disclosure rules."[109]

<u>Governmental Accounting Standards Board (GASB)</u>

CII opposes Section 857(a)(34) of the Act because it repeals an existing market-based, independent accounting support fee for the GASB.

As we explained in a recent letter to the Committee on this topic:

> On behalf of . . . CII, we write to urge you exclude from the Financial CHOICE Act any provision that repeals section 978 of . . . Dodd-Frank . . . that provides a funding mechanism for the . . . GASB.
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> . . . .

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[107] Commonsense Corporate Governance Principles at V(a).
[108] *Id*.
[109] Ben Ashwell at 2.

> The GASB funding mechanism currently in place provides the GASB with an independent, conflict-free source of funds in order to carry out its important mission of establishing accounting and financial reporting standards for U.S. state and local governments that follow Generally Accepted Accounting Principles . . . .
>
> The independent and predictable source of funds that GASB receives benefits taxpayers and investors because it is free of the conflicts of interest, real or perceived, that were inherent in GASB's old funding source that required GASB's parent, the Financial Accounting Foundation, to solicit voluntary contributions from the very entities that would be bound by its accounting standards. We should not go back to this practice that undermines investor confidence.
>
> We support the GASB's important work and urge you to exclude any provision in your legislation that repeals GASB's current funding mechanism.[110]

Private Equity

CII opposes Sections 858-859 of H.R. 10 because it would remove transparency in private equity by requiring the SEC to exempt advisors to private equity funds from registration and reporting.

We continue to agree with the 2009 recommendation of the Investor Working Group that all investment managers of funds available to U.S. investors, including private equity funds, should be required to register with the SEC as investment advisers and be subject to oversight and disclosure requirements.[111] As has been widely reported, the existing registration and reporting requirements for advisers to private equity funds has led "firms such as KKR, Blackstone and Apollo Global Management LLC Group to [pay] . . . tens of millions in fines . . . after SEC examinations uncovered what regulators said were insufficient disclosures of some fee and expense practices to clients."[112] Those actions have expedited the elimination of certain types of

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[110] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to The Honorable Jeb Hensarling, Chairman, Committee on Financial Services, U.S. House of Representatives 1-2 (Feb. 9, 2017) (footnotes omitted), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2017/February%209,%202017%20GASB.pdf; *see* Smith Letter, supra note 20, at 2 (opposing § 857(a)(34) because "GASB funding mechanism currently in place provides the GASB with independent, conflict free source of funds in order to carry out its important mission of establishing accounting and financial reporting standards for U.S. state and local governments that follow Generally Accounting Accounting Principles").

[111] Investors Working Group at 16 ("All investment advisers and brokers offering investment advice should have to meet uniform registration requirements, regardless of the amount of assets under management, the type of product they offer or the sophistication of investors they serve[] [e]xemptions from registration should not be permitted . . . .").

[112] *See, e.g.,* Melissa Mittelman, Private Equity Eyes Tax and Financial Reform in the Trump Era, Bloomberg, Jan. 19, 2017, at 3, *available at* https://www.bloomberg.com/news/articles/2017-01-19/with-close-trump-ties-private-equity-eyes-tax-financial-reform.

fund advisor fees that many of our members regard as inappropriate, such as monitoring fees charged by certain private fund advisers.[113]

We understand that Sections 858-859 of H.R. 10 would authorize the SEC to issue rulemaking regarding certain types of records that private equity fund advisers must keep. We, however, remain concerned that Sections 858-859 would eliminate registration and certain reporting requirements for advisors to private equity funds, would inhibit the SEC's investor protection efforts in the private equity industry, would disadvantage fund managers that currently follow best practices, and would unnecessarily expose investors and all taxpayers to potentially greater systemic risks.[114]

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We commend you for holding this hearing and for your efforts to strengthen the U.S. economy and help U.S. companies raise capital. We stand ready to work with you and other interested parties in support of those efforts.

We believe the focus should be on capital market reforms that are designed to increase investor confidence. Any weakening of existing corporate governance requirements would likely be inconsistent with that goal.

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,

Jeff Mahoney

Jeffrey P. Mahoney
General Counsel

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[113] Letter from Jack Ehnes at 5 ("The information provided by these required disclosures has helped to expedite the elimination of certain types of fund adviser fees that we regard as inappropriate, such as monitoring fees charged by certain fund advisors."); *see* Carraher Letter, *supra* note 24, at 4 ("This new focus on ensuring that investors are getting the deal they bargained for has been successful in identifying how private equity advisers hide fees, shift expenses, or otherwise mislead investors.").

[114] *See, e.g.*, Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors, to The Honorable Paul D. Ryan, Speaker, United States House of Representatives et al. 1-2 (Sept. 7, 2016) (opposing proposed legislation that would roll back transparency and reporting requirements for private equity funds because it would inhibit the ability to monitor systemic risk and protect investors), *available at* www.cii.org/files/issues_and_advocacy/correspondence/2016/Sept%207%202016%20Letter%20to%20Speaker%20regarding%20H%20R%20%205424%20(003).docx%20(final).pdf.