Council of Institutional Investors
The Voice of Corporate Governance

Statement of

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for the

Corporate Governance Roundtable

hosted by

Rep. Scott Garrett

United States House of Representatives

November 16, 2015

Panel 2: Examining the U.S. Proxy System: Is it Working for Everyone?

Dear Mr. Garrett:

The Council of Institutional Investors ("CII") respectfully requests that the following statement be included in the record for the Nov. 16, 2015, roundtable on "Examining the U.S. Proxy System: Is it Working for Everyone?"

CII

Founded in 1985, CII is a nonpartisan, not-for-profit association of public, labor and corporate employee benefit funds with assets collectively exceeding $3 trillion. CII is a leading advocate for effective corporate governance standards for U.S. public companies and strong investor rights.

CII members are diverse. Voting members—members that vote on CII's corporate governance policies—include funds such the New York State Common Retirement Fund, Johnson & Johnson and the IUE-CWA Pension Fund. Non-voting members include asset managers such as BlackRock, TIAA-CREF, State Street Global Advisors and Capital Group Companies.
CII voting members are responsible for investing and safeguarding assets used to fund retirement benefits for millions of participants and beneficiaries throughout the U.S. They have a significant commitment to the U.S. capital markets. The average CII member invests nearly 60 percent of its entire portfolio in U.S. stocks and bonds.

CII voting members are also long-term, patient investors due to their far investment horizons and their heavy commitment to passive investment strategies, which involve investing in the shares making up indexes designed to represent some portion of the capital markets. Because these passive strategies restrict CII members from exercising the "Wall Street walk" and selling their shares when they are dissatisfied, corporate governance issues are of great interest to our members.

One way CII members engage in corporate governance issues is through proxy voting. Owning stock in a company gives CII members and other investors the right to vote on important matters concerning corporate strategic decisions, such as significant mergers or acquisitions, and important governance issues, such as the election of directors.

Because of the significance of the issues addressed on corporate ballots, the proxy vote is considered part of the underlying value of a stock. For CII members and others with fiduciary duties, proxy voting is also an obligation.

CII's corporate and labor fund members are subject to the 1974 Employee Retirement Income Security Act ("ERISA"), which requires fund fiduciaries to act solely in the best interests of plan participants and beneficiaries. While CII's public pension plan members are not subject to ERISA, many state and local legislatures have adopted standards closely modeled on ERISA rules. And CII member funds sponsored by private trusts and tax-exempt institutions (such as universities and churches) also tend to follow ERISA fiduciary standards.

As fiduciaries, CII members have a variety of specific duties regarding proxy voting, including:

- Fiduciaries must not vote based on their private interests, but rather to maximize the economic value of plan holdings;
- Votes must be cast on each issue that has an impact on the economic value of the stock;
- Voting decisions should be based on a careful analysis of the vote's impact on the economic value of the investment; and

- If proxy voting is delegated, plan fiduciaries have a duty to monitor proxy voting procedures and votes.

Proxy Access

CII has long believed that proxy access—the right of shareholders to place their nominees for director on a company's proxy card—is a fundamental shareholder right that gives investors a meaningful voice in corporate board elections.

CII and many investors believe proxy access would invigorate board elections and make boards more thoughtful about whom they nominate to serve as directors, more responsive to shareholders' concerns and more vigilant in their oversight of companies.

In the absence of a uniform federal proxy access rule, shareholders have filed proposals at many U.S. companies asking boards to adopt access mechanisms. Companies are adopting proxy access on their own, through "private ordering." To date, according to statistics compiled by the law firm of Covington & Burling LLP, 70 U.S. companies have adopted proxy access provisions.

While CII welcomes this trend, our organization and many members continue to believe a uniform federal proxy access rule is preferable to the slow march of private ordering. But, given the importance of this reform to members, they are not waiting and are using the tools they have to implement proxy access to the greatest extent possible.

Seventy companies is a small fraction of the 5,300 companies listed on U.S. stock exchanges. Private ordering entails significant delay, as shareholders must vote on an access proposal in one year and, if it is implemented, wait until the following year to nominate a candidate. Such delay can be problematic at a company where performance is deteriorating and prompt action would be beneficial.

Shareholder proposals are, with very few exceptions, non-binding, which means that even companies where proxy access enjoys very strong investor support need not adopt the reform if the board prefers not to do so. Adoption of access through binding bylaws faces numerous obstacles, including the 500-word limit in Rule 14a-8, which makes it difficult to draft comprehensive bylaws for submission through the shareholder proposal process; the existence of voting barriers such as supermajority vote requirements and dual-class capital structures with unequal voting rights, and even, at some companies, prohibitions on shareholder bylaw amendments; and potential state-law challenges, at least at the roughly 40 percent of companies in the Russell 3000 incorporated outside of Delaware.[1] Proxy access is a fundamental right that should be standard at all U.S. public companies and a federal rule would ensure that all companies adopt access mechanisms within a stated time period.

Secondly, a uniform federal proxy access rule would establish a standard for access mechanisms so that all companies and all investors are on the same footing. A uniform access procedure would streamline shareholders' use of the access procedure, as individualized company research and nomination materials would be unnecessary.

We also note that shareholder access to the proxy to nominate directors has long been a uniform universal right in many other major markets, from the U.K. to Australia. A study by the CFA Institute found that when shareholders elected directors in foreign markets via proxy access, 63 percent of companies experienced positive stock price returns the following year,

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[1] See Beth Young, "The Limits of Private Ordering: Restrictions on Shareholders' Ability to Initiate Governance Change and Distortions of the Shareholder Voting Process" (Nov. 2009) (available upon request from CII).

relative to the preceding year. The same study found that market-wide proxy access could increase overall U.S. market capitalization by up to $140 billion.[2]

Universal Proxy

Universal proxy or proxies refers to a proxy card on which the names of all candidates for the board appear, regardless of who nominated them. CII believes that in a contested election for board seats, the opposing sides should use proxy cards that name all management nominees and all shareholder-proponent nominees and provide each nominee equal prominence on the proxy card. On Jan. 8, 2014, CII filed a detailed rulemaking petition with the Securities and Exchange Commission ("SEC") to amend Section 14 of the Securities Exchange Act of 1934 to facilitate the use of universal proxies in contested elections of directors.

CII believes it is unclear whether adoption of a universal proxy rule would result in the election of more shareholder or company nominees to U.S. corporate boards, and we are not aware of any empirical evidence indicating either outcome. Nor do we believe that the existence of a board/shareholder communication breakdown—which CII does not believe has occurred—is a necessary prerequisite to the adoption of a universal proxy rule.

Rather, the relevant question is whether universal proxies would provide investors with the ability to more fully exercise their right to vote for the election of directors in a proxy contest. The answer to that question is a resounding "yes."

Electing directors is a fundamental right of shareholders and an effective way to ensure that directors are accountable. But existing SEC rules can impede shareholders' ability to choose their preferred candidates unless they attend the shareholder meeting in person. For many

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[2] CFA Institute, "Proxy Access in the United States: Revisiting the Proposed SEC Rule," at 8-9 (2014) (available at http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2014.n9.1)

institutional investors voting thousands of proxies, and especially for individual investors, that is a costly and impractical option.

Currently investors who vote by proxy are disenfranchised in a proxy contest because they have no practical ability to “split their ticket” and vote for the combination of shareholder nominees and management nominees that they believe best serve their economic interests.

The SEC’s “bona fide nominee” rule, adopted in 1966, requires opposing sides in a proxy contest to obtain consent before listing opposing candidates. The SEC’s 1992 “short slate” rule provides a carve-out from the consent requirement when a shareholder nominates candidates representing a minority of the board. In such cases, the dissident can list its preferred combination of shareholder and management nominees. But the short slate rule does not allow for full “mix and match” capability. Investors who want to choose among all nominees must vote in person. Universal proxies would simply level the playing field for shareholders voting by proxy: They would ensure that shareholders voting by proxy have the same rights as shareholders attending the meeting in person.

Shareholder Proposal Rules

CII does not believe that the shareholder proposal process is being abused to the detriment of the majority of shareholders. Nor does CII believe that the shareholder proposal process needs to be significantly altered. On balance, CII members believe the existing federal securities laws and proxy rules generally work quite well with respect to the shareholder proposal process.

CII has a unique perspective on shareholder proposals. Shareholder proposals afford long-term investors the opportunity to present their concerns to management and the board of directors and communicate with other shareholders, to advocate for reforms and improve performance.

Although most CII members do not file any proposals, the small percentage that does represents a substantial proportion of proposals filed by shareholders annually. According to data provided by Institutional Shareholder Services ("ISS"), CII members filed approximately 35 percent of all shareowner proposals submitted to U.S. companies this year (as of October 31).

Shareholder proposals have contributed to some significant governance reforms in recent years, including majority voting standards in uncontested elections of directors, expensing of stock options and virtual elimination of classified (staggered) boards. Most CII members prefer to discuss concerns with management and directors, rather than submit a shareholder proposal. But that is not always possible. In such cases, submitting a precatory (non-binding) shareholder proposal is a "door knocker," an invitation to a conversation with company officials.

For all of these reasons, CII and its members have a deep interest in ensuring that Rule 14a-8, the federal rule that governs shareholder proposals, is fair and workable for shareholders and companies.

CII members that file shareholder resolutions are generally comfortable with the existing federal securities laws and proxy rules, including the threshold for filing a shareholder proposal and the 13 substantive bases included in Rule 14a-8 for excluding shareholder proposals. CII members also appreciate the professionalism and dedication of the SEC staff in handling the related no-action process.

While there is debate from time to time about the scope of the 13 exclusions in Rule 14a-8, there is little debate about the wisdom of the overall regulatory model that gives shareholders notice as to matters that will come before the meeting without requiring a company to print proposals that violate state law or satisfy one of the other general categories of exclusions. This is a tradeoff that most shareholders find more than acceptable, particularly when the Rule creates a single unified set of standards for all companies.

Recently, the Staff of the Division of Corporation Finance issued guidance regarding the application of Rule 14a-8(i)(9), the "counterproposals" exclusion addressing a company's ability to omit a shareholder proposal that "directly conflicts" with a management proposal that will appear on the proxy statement. During its review of the counterproposals exclusion earlier this year, the Staff concluded that the original purpose of the exclusion was to prevent shareholders from circumventing the proxy rules governing solicitations.[3] Accordingly, the Staff announced that it would allow omission in reliance on the counterproposals exclusion only when a shareholder could not logically vote in favor of both proposals, not when the two proposals concerned the same subject, as had been Staff practice up to that time.

CII does not believe that this approach will lead to more uncertainty. In our opinion, the distinction drawn by the Staff will be straightforward to administer. The Staff's approach will allow shareholders to communicate more clearly and effectively with issuers regarding their preferences.

Proxy Advisers and SEC Staff Legal Bulletin 20 Relating to Proxy Advice

Proxy advisory firms have been in business for decades. Today, two firms—Glass Lewis & Co. and ISS—dominate the business, and several other smaller firms provide proxy advice and voting services. Many CII voting and non-voting members are clients of one or more of these firms. CII is a customer of ISS, and both ISS and Glass Lewis are non-voting members of CII.

Discussions of proxy advisory firms often assume that a proxy adviser makes a single recommendation for each ballot item, and clients follow in lockstep. That is not the case. Many

[3] See Staff Legal Bulletin 14H (Oct. 22, 2015) (available at http://www.sec.gov/interps/legal/cfslb14h.htm)

funds vote internally using their own staff, and proxy adviser research and recommendations are among the data considered in making proxy voting decisions. Even funds that delegate their voting to a proxy adviser are not "outsourcing" their voting. Funds are generally notified of proxy adviser recommendations and retain the ability to change the vote cast on their behalf. The client may perform a case-by-case review of certain highly complex proposals, such as a proposed merger, while instructing the adviser to vote in accordance with the fund's customized proxy voting guidelines for other proposals. These guidelines are fund-driven, not adviser-driven, and have the sophistication to take into account numerous factors relevant to the vote.

As well, funds that delegate are not all voting according to the advisory firms' "benchmark" recommendations, those based on the firms' own standard voting guidelines. A recent survey of CII members revealed that over three-quarters of funds delegating voting to third-party advisers had their own guidelines; thus, the advisers' recommendations reflected the funds' judgments regarding the appropriate way to analyze various types of ballot items. Each of CII's 10 largest voting members, with total assets exceeding $1.2 trillion, votes based on fund-developed proxy voting guidelines, whether they vote internally or delegate to a manager or voting agent.

CII believes that the influence of the proxy advisory firms has significantly declined in recent years, as asset managers, pension funds and others have taken greater interest in proxy voting and have developed in-house expertise to address proxy-related issues. And others share CII's view. As a May 22, 2013, *Wall Street Journal* article entitled "For Proxy Advisers, Influence Wanes" noted:

> The landscape for proxy advisers is getting rockier.
>
> Big firms that sell recommendations on how to vote in corporate elections are losing some of their relevance, as companies more aggressively court key investors ahead of big votes and those investors handle more of the voting analysis themselves.

Indeed, CII believes empirical evidence supports the *WSJ's* observation. At shareholder meetings this year (through October 31), ISS statistics show that ISS recommended against "say on pay" proposals 12.4 percent of the time yet just 2.2 percent of "say on pay" proposals received less than majority support from shareholders. Fewer than 4 percent of shareholder proposals requesting an independent board chair at 2015 shareholder meetings received majority support, even though ISS recommended in favor of these proposals 36.5 percent of the time.

It is also important to recognize that correlation between advisory firms' recommendations and institutional voting patterns—the strength of which is subject to debate—does not prove causation. The process by which advisers formulate and refine their approaches to proxy issues involves input from stakeholders and consideration of available empirical evidence; as a result, advisers' views tend to be consistent with those of many funds. Indeed, if there were a sharp divergence, we would expect to see advisers punished in the marketplace. A 2014 study showed that public opinion influences both the voting behavior of investors—as measured by mutual fund voting—and proxy advisers' recommendations.[4]

CII welcomed the SEC Staff's 2014 guidance on proxy advisers, which was largely consistent with CII's views. The Staff affirmed that registered investment advisers are not required to vote all proxies, a view that CII has long shared. CII welcomed the Staff's reminder that investment advisers have a duty to maintain sufficient oversight of third-party voting agents. CII believes many investment advisers were already doing this, but the guidance may be prompting some to be more diligent about their oversight processes.

[4] Reena Aggarwal et al., "Influence of Public Opinion on Investor Voting and Proxy Advisors" (working paper Apr. 2014) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2447012)

We believe the guidance was positive and we do not see the need for further action by the Commission.

Proxy Plumbing

In 2010, the SEC issued a concept release, generally referred to as the "proxy plumbing release," on numerous topics related to the U.S. proxy voting system. As long-term investors with a significant investment in the U.S. markets, CII members share the Commission's expressed interest in ensuring the "U.S. proxy [voting] system as a whole operates with the accuracy, reliability, transparency, accountability, and integrity that shareowners and issuers should rightfully expect."[5] CII believes that priority should be given to addressing the proxy distribution process and providing end-to-end confirmation that beneficial owners' shares have been voted in accordance with their instructions.

As you know, SEC rules require broker-dealers to distribute proxy materials to their beneficial owner customers, with issuers reimbursing for their "reasonable" expenses. A very substantial proportion of broker-dealers have contracted with Broadridge Financial Solutions to provide that service, giving Broadridge a near-monopoly. The "reasonable" fees for which broker-dealers are reimbursed are determined by the self-regulatory organizations (SRO).

The proxy plumbing release noted several problems with this process, including the appropriateness of SRO-determined distribution fees. In CII's view, those problems persist. In addition, since the proxy plumbing release was issued, Broadridge has unilaterally changed its policy on providing preliminary vote tallies in contested situations, refusing to provide them to shareholders engaged in exempt solicitations and raising serious fairness concerns. Several CII members have been adversely affected by this change. In CII's view, reform is overdue, and the

[5] Securities and Exchange Commission, Concept Release on the U.S. Proxy System, Exchange Act Release No. 62495 (July 14, 2010) (available at http://www.sec.gov/rules/concept/2010/34-62495.pdf)

focus should be on promoting competition and ensuring a level playing field for all participants in the proxy process.

The proxy plumbing release also described the difficulty beneficial owners have in determining whether their votes have been received in time and tabulated accurately. A working group made up of participants in the proxy voting process, including Broadridge, tabulators, broker-dealers and issuers, has discussed improvements to the system and piloted a “communications tool” enabling earlier reconciliation of the share position discrepancies that can lead to votes being rejected by tabulators.[6]

Broker-dealers and banks complain, however, that performing early reconciliation is too expensive, and participation in these efforts is voluntary.[7] And even this voluntary measure is only designed to prevent overvoting, which occurs when a broker-dealer or bank votes more shares than it is entitled to. There is still no mechanism by which a beneficial owner can obtain confirmation that its vote has in fact been cast as instructed. The numerous participants in the voting process, and their sometimes-conflicting interests, make SEC action on this issue necessary and appropriate.

CII does not have a policy on client-directed voting (“CDV”) or any other mechanism that might be used to increase retail shareholder participation in the voting process. CII did commission a white paper on CDV by Alan Beller, former Director of the Division of Corporation Finance, and two co-authors in August 2010.[8] The white paper noted that CDV design requires balancing the potentially conflicting policy goals of increasing retail participation and promoting shareholder decision making based on full disclosure, a core SEC concern. The paper concluded that other

[6] See http://main.governanceprofessionals.org/governanceprofessionals/orphans/ourlibrary/viewdocument?DocumentKey=d7ca885d-3e6e-49ef-abba-2ca068eec09a (video interview discussing tool and pilot program).
[7] See http://finops.co/investors/proxy-ballots-the-quest-to-confirm-a-vote/
[8] Alan L. Beller, Janet L. Fisher & Rebecca M. Tabb, “Client Directed Voting: Selected Issues and Design Perspective” (August 2010) (available upon request from CII)

reforms simplifying the voting and communication process, such as elimination of the NOBO/OBO framework[9], might help increase retail participation without implicating these tensions.

Materiality

TSC vs. Northway established that information is material and should be disclosed if a reasonable shareholder would consider it important in deciding how to vote.

CII does not have policies on sustainability reporting. But CII does not believe that the previous outcome of a shareholder proposal is the appropriate indicator of whether a particular disclosure is warranted.

Many U.S. public companies disclose information requested by shareholders even in the absence of majority support for a related shareholder proposal. For example, few proposals requesting disclosure of corporate political spending have received majority support, yet a broad and growing list of companies do disclose it.

Other information that CII and many shareholders believe to be directly relevant to the shareholder vote goes undisclosed routinely. For example, basic information about the external auditor's work, such as the name of the lead audit partner and the auditor's views with respect to management's estimates and judgments, are almost never found in proxy materials, yet shareholders are typically asked every year to ratify the board's choice of external auditor.

[9] This distinction refers to the ability of beneficial owners to object to the sharing of their names with a company under the SEC's current shareowner communication rules. Shareholders who object are referred to as OBOs, and those who do not are referred to as non-objecting beneficial owners, or NOBOs. See Beller et al., at n.22.

Investors are not monolithic. They have different investment philosophies and strategies and therefore different disclosure needs. As the U.S. Chamber of Commerce report, “Corporate Disclosure Effectiveness,” stated, “The purpose of disclosure is to provide investors with the material information they need to make informed investment and voting decisions.”[10] Many investors consider non-financial factors such as the quality of board oversight and the “tone at the top” when making investment and voting decisions; disclosures on subjects like corporate political spending can shed light on those larger factors and thereby enable more informed decision making.

[10] Center for Capital Markets Competitiveness, “Corporate Disclosure Effectiveness: Ensuring a Balanced System That Informs and Protects Investors and Facilitates Capital Formation,” at 3 (2014) (available at http://www.centerforcapitalmarkets.com/wp-content/uploads/2014/07/CCMC_Disclosure_Reform_Final_7-28-20141.pdf)