Council of Institutional Investors
The Voice of Corporate Governance

Statement of

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for the

Subcommittee on Capital Markets and Government Sponsored Enterprises

of the

Committee on Financial Services

United States House of Representatives

May 17, 2016

"Legislative Proposals to Enhance Capital Formation, Transparency, and Regulatory Accountability"

Dear Mr. Chairman Garrett and Ranking Member Maloney:

The Council of Institutional Investors ("CII") respectfully requests that the following statement be included in the record for the May 17, 2016, hearing convened by the Subcommittee on Capital Markets and Government Sponsored Enterprises on the "Proxy Advisory Firm Reform Act of 2016" introduced by Rep. Duffy[1], and the "SEC Regulatory Accountability Act" introduced by Rep. Garrett.

As discussed below, we oppose these proposals as drafted.

- The Proxy Advisory Firm Reform Act appears to us to be a solution in search of a problem, and to overreach. We do not believe there is compelling empirical evidence that institutional investors are abdicating and outsourcing their voting responsibilities, and current SEC guidance makes it clear than investment advisors have a duty to maintain sufficient oversight of third-party voting agents. We do believe that proxy advisory firms play a useful role for institutional investors, and that the bill proposes new requirements without clarity on how proxy voting works in practice today, and without sufficient analysis of costs and benefits. Moreover, we believe the proposal could put proxy advisory firms back at the center of corporate governance, after a period of substantial increase in direct engagement between companies (including boards) and their

[1] We note that the two largest U.S. proxy advisory firms, Glass Lewis & Co. ("Glass Lewis") and Institutional Shareholder Services ("ISS"), are non-voting members of CII, paying an aggregate of $24,000 in annual dues—less than 1.0 percent of CII's membership revenues. In addition, CII is a client of ISS, paying approximately $19,600 annually to ISS for its proxy research.

shareholders. We also believe the proposal would tend to pose a further barrier to entry for new proxy advisory firms.

- The SEC Regulatory Accountability Act as drafted includes provisions we believe would in practice paralyze the Securities and Exchange Commission's (SEC) regulatory activities, at least in the absence of substantially greater and assured funding. Effective SEC regulation is critical to well-functioning capital markets. We believe the proposal is unnecessary and poses significant risks to effective regulation of capital markets.

As these proposals would have significant impacts on investors, who the SEC is charged to protect, we believe it is important before moving forward that the subcommittee seek strong and current empirical evidence, and consult more thoroughly with investors, including institutional investors who dominate U.S. markets. We understand that this hearing will include direct testimony from an officer of one private equity fund, but believe the subcommittee should seek further broader participation from investors before moving forward on the specific legislation contemplated here.

CII and CII Member's Approaches to Proxy Voting

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 strong investor rights and for effective corporate governance standards for U.S. public companies.

CII members are diverse. Our voting members – who vote on CII's corporate governance policies – include a wide range of public, labor and corporate pension funds. Non-voting members include a range of asset managers with more than $20 trillion in assets under management.

CII voting members are responsible for investing and safeguarding assets used to fund retirement benefits for millions of participants and beneficiaries throughout the United States. 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 long-term, patient investors due to the long investment horizons for their pension obligations, and commitment of most to passive investment strategies, which involve investing in the shares making up indexes designed to represent some portion of the capital markets. These passive strategies restrict CII members from exercising the "Wall Street walk" and selling their shares when they are dissatisfied. This puts particular emphasis on corporate governance oversight and accountability to shareholders through the proxy vote.

Owning stock in a company gives CII members and other investors the right and responsibility 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 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:

- They 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.

The Proxy Advisory Firm Reform Act

Proxy advisory firms have been in business for decades. Today, two firms—ISS and Glass Lewis & Co.—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, which provide research on proxy voting, as well as "back office" support for complex tasks involved in voting at hundreds or thousands of companies globally.

We believe proxy advisory firm influence has been overstated, particularly now, after several years of rapidly enhanced direct engagement between companies, including board members, and institutional investors. Boards have become better at engaging shareholders directly, and the mandates in the proposed bill could potentially reverse some of that progress, putting proxy advisory firms at the center of engagement.

We note that the European Securities and Markets Authority (ESMA) found no clear evidence of market failure in relation to to proxy advisors' interaction with investors and issuers.[2] ESMA did suggest development of a code of conduct, which led a group of proxy advisors that includes ISS and Glass Lewis to establish a set of Best Practice Principles in March 2014.[3] ISS published a principles compliance statement in June 2014, and Glass Lewis did so in August 2014.[4] ESMA said in December 2015 that the principles generally meet ESMA expectations, although the principles would benefit

[2] ESMA, "Final Report: Feedback statement on the consultation regarding the role of the proxy advisory industry," February 2013, at https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-84.pdf.

[3] See http://bppgrp.info/.

[4] See http://bppgrp.info/wp-content/uploads/2014/06/BPP-ISS-ComplianceStatement-1406010.pdf and http://bppgrp.info/wp-content/uploads/2014/05/2014_22-August_Glass-Lewis-Statement.pdf

from better governance and clarity over monitoring.[5] We believe this type of initiative will be more effective than the requirements included in the proposed Proxy Advisory Firm Reform Act.

We question the rationale for the Proxy Advisory Firm Reform Act, as indicated below.

The view that ISS and Glass Lewis dictate proxy voting results is simply counter-factual.

- For example, ISS recommended against "say on pay" proposals at 12 percent of Russell 3000 companies in 2015, according to Semler Brossy (an independent compensation consulting firm).[6] But only 2.8 percent of "say on pay" proposals at Russell 3000 companies that year received less than majority support from shareholders.

- To cite another example: 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 and Glass Lewis supported most of the proposals.

[5] ESMA, "Proxy Advisors Take Steps Towards Increased Transparency,", Dec. 18, 2015; and ESMA, "Follow-up Report on the Development of the Best Practices Principles for Providers of Shareholder Voting Research and Analysis", Dec. 18, 2015. Both reports are available at https://www.esma.europa.eu/press-news/esma-news/esma-publishes-report-proxy-advisors%E2%80%99-best-practice-principles.
[6] Semler Brossy, "2015 Say on Pay Results: End of Year Report," January 26, 2016 (http://www.semlerbrossy.com/say-on-pay/entire-2015-proxy-season/).

Proxy advisory firm influence can be exaggerated by analyses that confuse correlation with causation.

- ISS and Glass Lewis tend to follow investors on governance policy, not lead them. In setting their policy frameworks, the two firms work hard to be in tune with investors (their clients), in part through extensive consultative processes, and to consider empirical evidence. Their franchises are built on credibility with investors. As a result, advisors' views tend to be consistent with those of many funds. Indeed, if there were a sharp divergence, we would expect to see advisors punished in the marketplace.

- Investors <u>and</u> proxy advisory firms that seek to take an investor perspective may tend to come to similar conclusions on some issues. They may do so based on empirical evidence, as well as broader social context. For example, a 2014 study showed that public opinion influences both the voting behavior of investors—as measured by mutual fund voting—and proxy advisors' recommendations.

- That said, as discussed further below, there is diversity of viewpoint among investors on many issues, and the proxy advisory work of ISS and Glass Lewis is dominated by custom policies geared to specific clients.

- On the large majority of votes, ISS, Glass Lewis and investors are in agreement with board recommendations, along with the large majority of shareholder opinion. Among the minority of proposals that arouse some substantial measure of debate, there are significant differences between the proxy advisory firms and their clients, and indeed between the two proxy advisory firms.

- In areas of convergence of investor views that are in tension with those that tend to be held by corporate managers, we see little evidence for the proposition that ISS and Glass Lewis "advocacy" is the driver.

    - For example, we do not believe that the frequent, overwhelming votes supporting annual election of all directors (and opposing staggered elections) has much to do with the proxy advisory firms. A substantial majority of institutional asset owners and asset managers decided some time ago that they prefer director accountability to shareholders through an annual vote.

    - There are even significant areas of relative convergence among investors in looking at executive pay, a more complex topic. Holders of a large majority of shares in most U.S. public companies have a strong preference that executive compensation structures align pay with performance, and that has tended to create sensitivity to special awards unrelated to performance, and large awards on departure to CEOs who do not have successful performance records.

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

- Many funds vote internally using their own staff, and proxy advisor research and recommendations are among the data considered in making proxy voting decisions. Even funds that delegate their voting to a proxy advisor are not "outsourcing" their voting. Funds are generally notified of proxy advisors' 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 advisor to vote in accordance with the fund's customized proxy voting guidelines for other proposals. These guidelines are fund-driven, not advisor-driven, and have the sophistication to take into account numerous factors relevant to the vote.

- Funds that delegate are not all voted according to the advisory firms' "benchmark" recommendations, those based on the firms' own standard voting guidelines. A survey of CII members revealed that more than three-quarters of funds delegating voting to third-party advisors had their own guidelines; thus, the advisors' 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. Similarly, at least 18 of the 20 largest asset management firms, with more than $26 trillion in assets under management, have their own proxy voting guidelines. There are some areas of significant agreement, and other areas of difference. Most of these investors have internal teams dedicated to governance that inform proxy voting decisions, in tandem with proxy voting committees and/or portfolio managers and analysts.

We believe that the proxy advisory firms' role is <u>less</u> central than it was 10 years ago, as direct engagement of investors and companies (increasingly including corporate board members) has stepped up substantially.

- Asset managers, pension funds and others have taken greater interest in proxy voting, and have developed much greater in-house expertise to address proxy-related issues. For example, BlackRock Chairman and CEO Larry Fink has remarked on the commitment of his firm to "consistent and sustained" engagement with portfolio companies.[7]

- Moreover, investors have become much more active in engaging their portfolio companies on governance issues. Vanguard CEO Bill McNabb said in 2015: "At Vanguard, we've been on a journey toward increased engagement over the past decade or so. Our peers in the mutual fund industry have as well."[8] And companies and boards have become much more active in seeking engagement

[7] Letter to leading global company CEOs, including the S&P 500, as reported in the BlackRock blog, April 14, 2015.
[8] F. William McNabb, "Getting to Know You: The Case for Significant Shareholder Engagement," Harvard Law School Forum on Corporate Governance and Financial Regulation, June 24, 2015.

with their shareholders on governance matters, leading to many more substantive discussions directly between companies and their shareholders, without intermediaries.

- As a May 2013 article in *The Wall Street Journal* (entitled "For Proxy Advisers, Influence Wanes") summarized:

> 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.[9]

The bill seeks to micromanage both the SEC and proxy advisory firms.

- The attempt to regulate proxy advisory firms directly by statute, and in some detail, appears to us to be unwise. The draft bill[10] would require each proxy advisory firm to provide draft recommendations to companies in advance of publication of the reports, in "a reasonable time" and with the opportunity for the company to lobby the report writer(s) on the recommendations. Aside from First Amendment issues likely raised by this provision, we note that in the context of financial analyst reports, Financial Industry Regulatory Authority (FINRA) rules specifically prohibit the same type of pre-review – precisely the opposite policy. ISS does share drafts with larger U.S. companies, and we respect ISS's decision to do so as part of its methodology. But we would urge Congress not to mandate this step. Aside from general concerns on overreach, we believe such a

[9] *The Wall Street Journal*, May 22, 2013.
[10] As published on the House Financial Services Committee web site page for this hearing (as of May 16, 2016).

mandate could significantly increase proxy advisory firm costs, posing a significant barrier to entry.

- The bill mandates a particular approach to handling concerns from management at subject companies. Each firm would be required to employ an ombudsman to receive complaints on the accuracy of voting recommendations from "the subjects of the proxy advisory firm's voting recommendations," and resolve those complaints prior to the vote date. This would appear to make the proxy advisory firms highly vulnerable to ill-founded, trivial, and even mischievous complaints from issuers. This includes issuers that may seek to disrupt the firms, particularly amidst the highly concentrated spring "proxy season," when time constraints that are dictated by corporate reporting requirements and state law rules prescribe when annual meetings must take place. It is notable that there apparently is no requirement for the ombudsman to hear complaints from investors, who pay for the service, unless and to the extent the "subjects…of the recommendations" (as the proposal frames this) is interpreted to include shareholder proponents. We have concern that this provision would substantially tilt influence in proxy voting toward management, at least in the absence of a proxy fight and direct independent solicitation by a shareholder.

The SEC has been intelligent and effective in its approach to proxy advisory firms, under existing authority.

- CII welcomed the SEC staff's 2014 guidance on proxy advisors, which was largely consistent with CII's views. The staff affirmed that registered investment advisors are not required to vote all proxies, a view that CII has long shared. CII welcomed the staff's reminder that investment advisors have a duty to maintain sufficient oversight of third-party voting agents. CII believes many investment advisors were already doing this, but the guidance may be prompting some to be more diligent about their oversight processes. We believe the guidance was positive and we do not see the need for further action by the commission.

The SEC Regulatory Accountability Act

We believe the "SEC Regulatory Accountability Act" is not necessary, and would risk significant damage to the SEC's ability to regulate U.S. capital markets.

The proposal is not necessary.

With a membership of long-term shareholders interested in maximizing share values, CII believes it is vital to avoid unnecessary regulatory costs that could hinder the capital markets and the economy. However, we also believe that at best it is not clear how the provisions of the SEC Regulatory Accountability Act 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 in this regard the proposal does not include any provision that would explicitly require the SEC to consider the costs and benefits of a proposal or rule from the perspective of long-term investors.

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.[11] Moreover, under the federal securities laws the SEC is generally required to consider whether its rulemakings are in the public interest and, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation.[12] Since the 1980s, the commission has conducted, to the extent possible, an analysis of the costs and benefits of its proposed rules.[13]

The SEC has further enhanced the SEC rulemaking process in recent years.[14] That process is, and has long been, far more extensive than that of any other federal financial regulator.

The proposal would pose substantial risk of damage to the SEC's regulatory capacity and to U.S. capital markets.

We believe the bill is based on a faulty premise that a generally accepted methodology currently exists that allows the SEC in a cost-effective manner to reliably measure and then balance the costs and benefits of its proposals or rules consistent with its mandate to protect investors. We note it is well established that while some of the costs of some

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[11] Financial Services and Bailouts of Public and Private Programs: Hearing Before the H. Comm. on Oversight and Gov't Reform, 112th Cong. 2 (2012) (testimony of Chairman Mary L. Schapiro, U.S. SEC), http://www.sec.gov/news/testimony/2012/ts041712mls.htm.
[12] *Id.*
[13] *Id* at 3.
[14] See for example guidance from the SEC Division of Risk, Strategy, and Financial Innovation (RSFI) and the Office of the General Counsel (OGC) issued in 2012.

SEC proposals or rules can be reliably estimated, the same is generally not true for the benefits.[15]

In most instances, the benefits of a commission proposal or rule relating to the financial markets, particularly a proposal or rule designed to protect investors, cannot be reliably measured. Thus, the proposal would appear to impose on the SEC a costly, one-sided, incomplete analysis in which the commission would be hard pressed to satisfy the required determination that the benefits of a proposal or rule "justify the costs of the regulation." As a result, the proposal could, for all practical purposes, prohibit the SEC from issuing 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.

Moreover, the proposal's requirement that the SEC review existing regulations within one year of passage, and at least every five years thereafter, in our view would consume the SEC's existing regulatory resources and likely require substantial additional dedicated resources. We believe this likely would paralyze SEC regulatory capacity.

We urge the subcommittee to thoroughly study the potential unintended consequences and costs from this proposal to effective financial regulation, and to capital markets.

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[15] See, e.g., U.S. Government Accountability Office, GAO-13-101, Dodd-Frank Act: Agencies' Efforts to Analyze and Coordinate Their Rules 18 (Dec. 2012), http://www.gao.gov/assets/660/650947.pdf ("As we have reported, the difficulty of reliably estimating the costs of regulations to the financial services industry and the nation has long been recognized, and the benefits of regulation generally are regarded as even more difficult to measure.").