Council of Institutional Investors
The Voice of Corporate Governance

Statement of

Ann Yerger

Executive Director

Council of Institutional Investors

to the

Subcommittee on Capital Markets and Government Sponsored Enterprises

of the

Committee on Financial Services

United States House of Representatives

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Examining the Market Power and Impact of Proxy Advisory Firms

Dear Mr. Chairman and Ranking Member Maloney:

The Council of Institutional Investors ("CII") respectfully requests that the following statement be included in the record for the June 5, 2013 hearing convened by the Subcommittee on Capital Markets and Government Sponsored Enterprises on Examining the Market Power and Impact of Proxy Advisory Firms. CII notes 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.

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 improving corporate governance standards for U.S. public companies and strengthening investor rights.

CII members are diverse. Voting members include funds such as the New Jersey Division of Investment, 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.[1]

CII 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

[1] See Attachment for a complete list of the Council's current members. For more information about the Council, please visit http://www.cii.org/members.

significant commitment to the U.S. capital markets, with the average CII member investing nearly 60 percent of its entire portfolio in U.S. stocks and bonds.[2]

They are also long-term, patient investors due to their far investment horizons and their heavy commitment to passive investment strategies. Because these passive strategies restrict Council 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 are engaged 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 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 plans 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.

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[2] Council of Institutional Investors, *Asset Allocation Survey 2009*, 4 (on file with CII) ("Domestic stocks and bonds accounted for 57.5 percent of the average portfolio of surveyed Council members.").

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 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 duty to monitor proxy voting procedures and votes.

Proxy Advisory Firms

Proxy advisory firms have been in business for decades. Today, two firms—Glass Lewis and ISS—dominate the business, and several other smaller firms provide proxy advice and voting services. Most CII voting and non-voting members are clients of one or more of those firms.

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. The Wall Street Journal's recent 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.[3]

[3] Joann Lubin & Kristen Grind, *For Proxy Advisers, Influence Wanes,* Wall St. J., May 22, 2013, http://online.wsj.com/article/SB10001424127887323336104578499554143793198.html.

Possible Steps Forward

CII believes that proxy advisory firms should:

- Register as investment advisers under the Investment Advisers Act of 1940;
- Provide substantive rationales for vote recommendations;
- Minimize conflicts of interest and disclose details of potential conflicts, including those involving companies or resolution sponsors, in the applicable meeting report;
- Correct material errors promptly and notify affected clients as soon as practicable; and
- Provide transparency into the general methodologies—without compromising proprietary models—used to make recommendations.

In addition, CII believes interpretive guidance and/or additional empirical data from the Staff of the U.S. Securities and Exchange Commission ("SEC" or "Commission") would be helpful in the following two areas: Specifically:

1. *We do not believe that the SEC's rules, or interpretations thereof, require investment advisers to vote all proxies. We, however, recognize that there may be confusion regarding this issue. We, therefore, believe SEC Staff interpretive guidance would be helpful.*

   We note that the SEC's 2003 release adopting Rule 206(4)-06 under the Investment Advisers Act requires advisers that have authority to vote proxies to adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of clients, disclose to clients information about those policies and procedures, and disclose to clients how they may obtain information on how the adviser has voted their proxies.[4] Rule 206(4)-6, however, does not contain any language requiring that all proxies be voted. One sentence in the adopting release, taken out of context, could be read to support such a mandate. It states, "The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies."[5] However, the footnote to that sentence immediately clarifies, "As we discuss later in this Release, we do not mean to suggest that an adviser that does not exercise every opportunity to vote a proxy on behalf of its clients would thereby violate its fiduciary obligations to those clients under the Act."[6] Moreover, later in the Release, the Commission explains:

> We do not suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the client's best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client.

We note that the above language is very similar to the language from a U.S. Department of Labor's 2008 interpretative bulletin addressing proxy voting obligations of ERISA fiduciaries.[7]

2. *We do not believe that, at this time, there is sufficient empirical evidence suggesting that institutional investors are abdicating and outsourcing their voting responsibilities. However, we recognize that there may be disagreement over this issue. We, therefore, believe the SEC should gather, as part of its inspection process, data on the proxy voting practices of investment advisers. This empirical data could provide a factual basis for possible future reforms.*

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[4] 17 CFR 275.206(4)-6; SEC, Final Rule: Proxy Voting by Investment Advisors, Release No. IA - 2106, 79 (Jan. 31, 2003).
[5] SEC, Final Rule: Proxy Voting by Investment Advisers, Release No. IA - 2106, 79 (Jan. 31, 2003).
[6] *Id.* n.3.
[7] 29 C.F.R. § 2509.08–2.

While CII believes some reforms of proxy advisory firms may be appropriate, we oppose regulatory involvement in methodologies used by proxy advisors to determine vote recommendations. We are also concerned about proposed reforms to require proxy advisory firms to submit advance drafts of their reports to the subject companies. We believe that such a mandate could result in at least two problems for shareowners. First, it could create an inherent conflict that may undermine the independence of the report. Second, it could cause unnecessary and costly delays in the distribution of the report.

In addition, we question the need for certain other possible reforms, including some premised on the view that the SEC lacks authority over proxy advisory firms. We believe the SEC currently has significant and sufficient authority over proxy advisory firms, regardless of whether they are registered as investment advisers. For example, we note that while proxy advisers are exempt from the requirement in the SEC's proxy rules that a proxy statement be filed in connection with a solicitation; they remain covered by Rule 14a-9, the SEC's general anti-fraud rule applicable to proxy solicitations. The SEC's 2010 proxy plumbing release discussed this exemption and confirmed that "proxy voting advice remains subject to the prohibition on false and misleading statements in Rule 14a-9."[8] As a result, proxy advisors can be liable under the securities laws for making a materially false or misleading statement in a recommendation. Complaints from issuers that advisors make recommendations based on inaccurate information could be addressed under Rule 14a-9, which both the SEC and private parties can enforce, so long as the information was material to the voting decision.

More generally, we believe that the following three additional factors should be given careful consideration before pursuing any possible proxy advisory reforms, including those generally supported by CII: (1) institutional investor proxy voting practices; (2) the voting power of proxy

[8] SEC, Concept Release on the U.S. Proxy System, Release Nos. 34-62495; IA-3052; IC-29340 (Jul. 14, 2010).

advisory firms; and (3) the market power of proxy advisory firms. The following is a summary of our views on each of those factors:

1. *Institutional Investor Proxy Voting Practices*

Today institutional investors are the dominant owners of U.S. public companies. According to the Conference Board 2010 Institutional Investor Report, institutional investors owned 50.6 percent of the U.S. equity market at the more than 70 percent of the largest U.S. companies and nearly 51 percent of all U.S. equities.[9]

In many cases, institutional ownership is concentrated with a company's largest owners. The Conference Board 2010 report found the 5 largest owners of the 25 largest U.S. companies comprised, on average, nearly 28 percent of the institutional ownership of the companies, while the 25 largest owners comprised, on average, nearly 54 percent of the institutional ownership of the companies.[10]

Institutional investors are not monolithic. They are extremely diverse and include mutual funds, state and local pension funds, and insurance companies. According to the 2010 Conference Board report, mutual funds are the dominant institutional owner, comprising more than 41 percent of all institutional shares and owning 20.9 percent of U.S. equities.[11] In contrast, state and local pension funds comprise 14.8 percent of institutional shares and own 7.5 percent of U.S. equities.[12]

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[9] The Conference Board, *The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition* 5 (Nov. 2010).
[10] *Id.* at 29-46.
[11] *Id.* at 26.
[12] *Id*.

Institutional investors are not identical when it comes to proxy voting. They may vote their shares internally using fund staff. They may delegate proxy voting to asset managers or third-party agents. They may vote based on their own internal proxy voting guidelines. They may vote based on proxy advisor recommendations. In many cases they use the services of proxy advisory firms.

It is important to note that clients of proxy advisory firms are not necessarily voting based on the firms' recommendations. They may have their own guidelines and use the proxy advisory firms' research to assist with their voting.

As indicated earlier, there is no empirical evidence demonstrating that institutional investors blindly follow the recommendations of proxy advisors. Of note, our survey of the largest public pension systems and institutional asset managers found that nearly all have their own proxy voting guidelines and use proxy advisory firms simply for the research; they do not vote based on the advisory firm's voting recommendations.

More specifically, our 10 largest voting members, with total assets aggregating $1.2 trillion, vote based on fund-developed proxy voting guidelines. They generally are clients of one or more proxy advisory firms. However, their use of the firms is generally limited to (1) using the advisory firms' research to assist with their internal proxy voting or (2) delegating the execution of voting to the advisory firms but based on their fund-developed guidelines.

Asset managers also differ in terms of how they handle their proxy voting. In recent years, we have witnessed a sea change in terms of how the largest U.S. asset managers handle their proxy voting responsibilities. Today, the largest U.S. asset managers generally have dedicated staff that specializes in proxy voting. Those firms have their own proxy voting guidelines; they do not vote based on the advisory firms' recommendations. Similar to the large public fund members of CII, they generally are clients of one or more proxy advisory firms. The advisory firms provide research or vote their proxies based on the managers' guidelines.

2. *Voting Power of Proxy Advisory Firms*

Some observers have criticized proxy advisory firms for having a disproportionate influence on voting outcomes. The estimates of the voting influence of the proxy advisory firms vary.

A study of mutual funds by Professors Stephen Choi, Jill Fisch and Marcel Kahan found that funds accounting for 25 percent of assets virtually always followed management recommendations, while funds accounting for less than 10 percent of the assets exhibited a strong tendency to follow ISS recommendations.[13] Professors Choi, Fisch and Kahan also found that a recommendation from ISS shifts the outcome of a vote by a mere 6 to 10 percent of votes cast.[14] In contrast, a study by Professors David Larcker, Allan L. McCall and Gaizka Ormazabal found that opposition by a proxy advisor results in a "20 percent increase in negative votes cast."[15]

Regardless, interpreting these statistics is difficult. Correlation between voting results and proxy advisor recommendations is not causation and should not be interpreted that votes were cast based solely on the recommendations of the advisory firms. As noted

[13] Stephen Choi et al., *Voting Through Agents: How Mutual Funds Vote on Director Elections* (Aug. 17, 2011); University of Pennsylvania, Institute for Law & Economics Research Paper No. 11-28; NYU Law and Economics Research Paper No. 11-29. Available at SSRN: http://ssrn.com/abstract=1912772 or http://dx.doi.org/10.2139/ssrn.1912772.

[14] Stephen Choi, et al., *The Power of Proxy Advisors: Myth or reality*?, 59 Emory L. J. 869 (2010).

[15] David F. Larcker et al., *Outsourcing Shareholder Voting to Proxy Advisory Firms* 7 (May 10, 2013); Stanford Graduate School of Business Research Paper No. 2105. Available at SSRN: http://ssrn.com/abstract=2101453 or http://dx.doi.org/10.2139/ssrn.2101453.

earlier, CII believes that most large institutions develop and vote based on their own set of voting guidelines. In many cases proxy advisor recommendations are simply consistent with the policies adopted by institutional investors.

This alignment is not surprising given that proxy advisor policies are not developed in a black box, removed from marketplace input. ISS policies, for example, are not developed in a vacuum. Every year ISS conducts an extensive survey on emerging governance and proxy voting issues, gathering perspectives from interested market participants. The survey is followed by in-depth roundtables and a review of relevant empirical evidence or academic literature. Before a new policy is adopted, ISS solicits comments from the public. This extensive due diligence means that ultimately ISS policies reflect the views of the marketplace—not the reverse.

Moreover, empirical evidence does not support the theory that ISS determines the fate of voting outcomes. As illustrated in the table on the following page, in 2012 ISS opposed board nominees 8.5 percent of the time, yet the incidence of a nominee failing to win majority support was less than 0.5 percent. Fewer than one in 10 shareowner proposals requesting an independent board chair receives majority support, despite the fact that ISS recommends in favor of these proposals approximately three times out of every four.

Key proposals and outcomes in 2012

Proposal type	Proposals	Average support	Received less than majority support	Opposed by ISS	Average support if opposed by ISS
Elect director (uncontested)	16,993	95.0%	0.4%	8.5%	82.0%
Advisory vote on executive compensation	2,288	90.8%	2.5%	13.2%	65.0%
Shareowner proposal requesting independent board chair	55	35.6%	92.7%	25.5%	24.1%

Source: ISS Voting Analytics database. Data covers Russell 3,000 with available vote results.

3. *Market Power of Proxy Advisory Firms*

Some observers have criticized proxy advisory firms for having a disproportionate influence on the design of corporate governance. Those observers believe that companies feel compelled to change their corporate governance practices to ensure positive recommendations from the proxy advisory firms. If true, CII believes such a strategy is misguided.

CII believes that companies should be more concerned with the views of its shareowners than the views of the proxy advisory firms. And the largest institutional investor clearly agrees. In January 2012, Blackrock sent a letter to 600 of its biggest holdings, encouraging them to engage with the firm. In the letter, it was reported that CEO Laurence D. Fink stated: “We think it is particularly important to have such discussions - with us and other investors - well in advance of the voting deadlines for your shareowner meeting and prior to any engagement you may undertake with proxy-advisory firms."[16]

CII agrees that company engagement with shareowners is the best way to gauge shareowner sentiments. In doing so, companies will likely find that on some issues—such as classified boards, poison pills and majority voting for directors—institutional investors frequently have a "one size fits all" approach that is consistent with proxy advisor recommendations. On others, such as "say on pay," they will likely find that institutional investors are comfortable giving companies the flexibility to craft compensation programs to meet unique company needs. Clearly the empirical evidence shows that companies frequently prevail despite "against" recommendations of proxy advisors.

Regardless, the decisions of directors of U.S. companies are broadly and robustly protected under the business judgment rule. As a result, assuming directors acted in good faith and as a reasonable person would have acted, shareowners cannot hold the board liable for its decisions.

And in the context of advisory votes—such as non-binding shareowner proposals and say-on-pay proposals—directors are under no obligation to act as recommended by proxy advisors or approved by shareowners. Certainly a board may face certain consequences—such as a "vote no" campaign against directors or possibly a proxy contest—depending on how shareowners evaluate the board's response. However, that potential outcome is a vital part of checks and balances in the U.S. corporate governance model.

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[16] Christopher Condon & Sree Vidya Bhaktavatsalam, *Fink Leverages BlackRock's $3.5 Trillion in Shareholder Push,* Bloomberg, Jan. 19, 2012.

CII looks forward to continuing to work cooperatively with the Subcommittee, the SEC, the proxy advisory firms and other interested parties in addressing the issues raised by this hearing. Our goal is to ensure that the issues identified are addressed in a thoughtful manner that best serves the needs of long-term investors and the U.S. capital markets.

Thank you Mr. Chairman and Ranking Member Maloney for providing CII the opportunity to submit this statement.