Testimony of

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Before the
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Committee on Banking, Housing, and Urban Affairs

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Good morning. Thank you Chairman Crapo, Ranking Member Brown, and Members of the Committee for inviting me to testify today.

My name is Dan Gallagher, and I am currently the Chief Legal Officer of Mylan N.V. From 2011 through 2015, it was my privilege to serve as a Commissioner of the SEC. I am very pleased to be here with the Committee today as you consider important matters regarding public company proxy voting issues. These are issues which I spent a lot of time considering and debating while on the Commission, and I am pleased to be here, in my personal capacity, to discuss them with you today.

In your invitation, Chairman Crapo, you asked that I address the following three issues:

(1) the role of proxy advisory firms and their involvement in the voting process, their current regulatory treatment, any views I may have, and suggestions for SEC action, if any;
(2) the shareholder proposal process, existing regulatory requirements, including current ownership and resubmission requirements, costs and benefits involved for the company and shareholders, and proposals for action, if any; and
(3) the level of retail shareholder participation, its causes, and whether the relatively low level of retail participation compared to institutional investors is cause for concern.

I note that, although not an exact overlap, your three topics correspond fairly closely with the three panels at the recent Roundtable on the Proxy Process (the 2018 Proxy Process Roundtable) which the SEC staff held at its Washington headquarters on November 15.[1] I was heartened to see that the SEC, under the strong leadership of Chairman Jay Clayton, is once again actively considering these issues.

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1 Press Release, SEC Announces Agenda, Panelists for Staff Roundtable on the Proxy Process (Nov. 8, 2018), *available at* https://www.sec.gov/news/press-release/2018-260.

I. The Role of Proxy Advisory Firms

During my time on the Commission, I spoke and wrote frequently about the need to reform the outdated regulatory regime governing the shareholder voting process and to address the outsized role of proxy advisory firms in this process.[2] Developments in investment behavior over the past 20 years have worked fundamental changes to the corporate governance landscape, and our existing regulatory regime has not caught up with these changes. The current environment creates an undue reliance on proxy advisory firms that policymakers did not anticipate as they worked to address the evolving shareholder voting landscape. Institutional ownership of shares was once negligible; now, it predominates.[3] This shift is important because individual investors are generally rationally apathetic when it comes to shareholder voting: value potentially gained through voting is outweighed by the time spent determining how to vote on numerous individual matters and actually casting those votes. In contrast, institutional investors possess economies of scale, so they regularly vote billions of shares each year on thousands of ballot items for the thousands of companies in which they invest.[4]

For example, an investor purchasing a share of an S&P 500 index mutual fund likely would have no interest in how each proxy is voted for each of the securities in each of the companies held by that fund. Indeed, reviewing individual voting items would defeat the purpose of selecting such a low-maintenance, low-cost investment alternative. Ultimately, the investor leaves the voting decision to the investment adviser to the index fund. The investor's reliance on the investment adviser inevitably results in a classic agency problem: how do we make sure that the investment adviser is voting those shares in the investor's best interest, rather than the adviser's best interest?

A. The Rise of Proxy Advisory Firms

The Commission tackled this very issue in a rulemaking in 2003, putting in place disclosure requirements to inform investors how their funds' advisers are voting, as well as outlining clear steps that advisers must undertake to ensure that they vote shares in the best

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[2] *See, e.g.,* SEC Commissioner Daniel M. Gallagher, Remarks at the 26th Annual Corporate Law Institute, Tulane University Law School: Federal Preemption of State Corporate Governance (Mar. 27, 2014) (Gallagher Tulane Remarks), *available at* https://www.sec.gov/news/speech/2014-spch032714dmg.html; SEC Commissioner Daniel M. Gallagher, Remarks at Georgetown University's Center for Financial Markets and Policy Event (Oct. 30, 2013), *available at* https://www.sec.gov/news/speech/2013-spch103013dmg. Portions of this testimony are excerpted from my article *Outsized Power and Influence: The Role of Proxy Advisors,* Washington Legal Foundation (Aug. 2014), and the Gallagher Tulane Remarks.

[3] Between 1950 and 2000, institutional ownership of total U.S. equity outstanding increased from approximately 6% to approximately 50%, where it has since remained. *See* Matteo Tonello & Stephan Rabimov, *The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition* (The Conference Board, 2010) at 22. Within the top 1,000 U.S. corporations, institutional investors are even more entrenched, holding nearly 75% of the equity. *Id*. at 27. *See also* Broadridge & PwC, *Proxy Pulse: 2018 Proxy Season Review* (2018) at 2 (Proxy Pulse) (noting that in 2018, institutional ownership of public company shares was 70%).

[4] *See* Proxy Pulse at 2 (noting that institutional shareholders voted 91% of their shares through June of 2018, while individual investors voted only 28% of their shares).

interest of their clients.[5] But, as always, regulatory intervention carries with it the risk of unintended consequences.[6] The 2003 release has since proved that to be true – to the point where the costs of the unintended consequences now arguably dwarf the benefits the Commission sought to achieve. In fact, the ultimate result of regulatory intervention has been a direct increase in the extent to which for-profit third party proxy advisers, which have no economic risk in the underlying investments, drive decision making at investment advisers and corporations.

In its 2003 release, the SEC addressed one specific and narrow manifestation of the general agency problem: that an adviser could have a conflict of interest when voting a client's securities on matters that affect the adviser's own interests (*e.g.*, if the adviser is voting shares in a company whose pension the adviser also manages). To remedy this issue, the release stated that an investment adviser's fiduciary duty to its clients requires the adviser to adopt policies and procedures reasonably designed to ensure that it votes its clients' proxies in the best interest of those clients.[7] The Commission also noted that "an adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, *based upon the recommendations of an independent third party*."[8] From these statements, two specific unintended consequences arose.

First, some investment advisers interpreted this rule as requiring them to vote every share, every time, which led to an outsourcing of voting decisions. This interpretation seemed, perhaps, to be the natural outgrowth of the Department of Labor's (DOL) 1988 "Avon Letter," which stated that "the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock."[9] As a result, investment advisers with investment authority over ERISA plan assets – and thus regulated by the DOL as well as the SEC – were already required to cast a vote on every matter. Reading the SEC's 2003 rule, some advisers understandably may have assumed that the Commission intended to codify that result for all investment advisers.

A requirement to vote every share on every vote, however, gives rise to a significant economic burden for investment advisers who may own only relatively small holdings in a large number of companies. For example, one study found that "[m]ost institutional investor holdings are relatively small portions of each firm's total securities."[10] In this study's sample, "the mean

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5 SEC Rel. No. IA-2106, *Proxy Voting by Investment Advisers* (Jan. 31, 2003), *available at* https://www.sec.gov/rules/final/ia-2106.htm. While this release requires advisers to disclose how clients can obtain information about how their securities were voted, actual disclosure requirements were set out in a companion release issued the same day. *See* SEC Rel. No. IC-25922, Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies (Jan. 31, 2003), *available at* https://www.sec.gov/rules/final/33-8188.htm.

6 This is particularly true where the intervention takes the form of a mandate, as opposed to a market-based solution (*e.g.*, disclosure and explanation of proxy votes to investors, who could then choose to remain in the fund or take their money elsewhere).

7 *See* SEC Rel. No. IA-2106, *Proxy Voting by Investment Advisers* (Jan. 31, 2003).

8 *Id.* (emphasis added).

9 *See* Letter from Allan Lebowitz, Deputy Assistant Sec'y of the Pension Welfare Benefits Admin. at the U.S. Dep't of Labor, to Helmuth Fandl, Chairman of the Ret. Bd., Avon Products, Inc. (Feb. 23, 1988), *available at* http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.

10 David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy*

(median) holding [of an individual stock by institutional investors] is 0.3% (0.03%)."[11] Given that institutional investors hold stock in hundreds or thousands of companies (for example, TIAA-CREF holds stock in 7,000 companies),[12] institutional investors – particularly the smaller ones – may not be able to invest in the costly research needed to ensure that they cast each vote in the best interest of their clients. The logical response is to outsource the research function to a third party, who could do the needed research and sell voting recommendations back to investment advisers for a fee: a proxy advisory firm. Although these firms already existed, the 2003 rule gave advisers new incentives to use them.

Second, investment advisers understandably came to view reliance on proxy advisory firms as a litigation and government enforcement insurance policy: for the price of purchasing the proxy advisory firm's recommendations, an investment adviser could ward off potential liability for its conflicts of interest.[13] Proxy advisory firms noticed the suggestion in the 2003 rule that soliciting the views of an independent third party could overcome an adviser's conflict of interest. In 2004, a proxy advisory firm requested – and received – "no-action" relief from the SEC staff that significantly expanded investment advisers' incentive to use these firms. Specifically, the staff advised advisory firm Egan-Jones that "an investment adviser that votes client proxies in accordance with a pre-determined policy based on the recommendations of an independent third party will not necessarily breach its fiduciary duty of loyalty to its clients even though the recommendations may be consistent with the adviser's own interests. In essence, the recommendations of a third party who is in fact independent of an investment adviser may cleanse the vote of the adviser's conflict."[14]

Subsequent SEC action further exacerbated these unintended consequences. In a second 2004 no-action letter to ISS,[15] the SEC staff endorsed the notion that "an investment adviser may determine that a proxy voting firm is capable of making impartial proxy voting recommendations in the best interests of the adviser's clients based on the procedures that the proxy voting firm has adopted and implemented to insulate the firm's voting recommendations from incentives to vote the proxies to further the firm's relationships with issuers" and confirmed its position from the Egan-Jones letter that a key aspect of some proxy advisory firms' business models – selling corporate governance consulting services to companies – "generally would not affect the firm's

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Advisory Firms (May 10, 2013) at 10 (Outsourcing Shareholder Voting), *available at* http://www.shareholderforum.com/access/Library/20130510_Larcker-McCall-Ormazabal.pdf.

11 *Id*.

12 *See* James K. Glassman and J. W. Verret, *How to Fix Our Broken Proxy Advisory System*, Mercatus Research (Apr. 16, 2013), *available at* http://mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf.

13 *See* Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (And Europe) Face*, 30 DEL. J. OF CORP. LAW 688 (2005) (noting that following the recommendation of a proxy advisory firm "constitutes a form of insurance against regulatory criticism").

14 *See* Letter from Douglas Schiedt, Associate Director and Chief Counsel, Division of Investment Management U.S. Securities and Exchange Commission, to Kent S. Hughes, Managing Director, Egan-Jones Proxy Services (May 27, 2004) (Egan-Jones Letter), *available at* https://perma.cc/KSJ2-JP5N.

15 *See* Letter from Douglas Schiedt, Associate Director and Chief Counsel, Division of Investment Management U.S. Securities and Exchange Commission, to Mari Anne Pisarri on behalf of Institutional Shareholder Services, Inc. (Sep. 15, 2004), *available at* https://perma.cc/Q8YH-SAXR

independence from an investment adviser."[16] This determination is somewhat incredible, as it places the proxy advisory firm in the position of telling investment advisers how to vote proxies on companies' corporate governance matters that are the subject of the proxy advisory firm's consulting services provided to those same companies—a seemingly obvious, and insurmountable, conflict of interest for the proxy adviser.[17]

Thus, in addition to selling vote recommendations to institutional investors (along with voting platforms, data aggregation, and other auxiliary services), proxy advisory firms sell consulting services to companies that want to ensure that they have structured their governance and other proxy votes so as to avoid "no" recommendations from the proxy advisory firms. The sale of voting recommendations to institutional investors makes real the risk that proxy advisory firms, in formulating their core voting recommendations, will be influenced by the proxy advisory firms' business interests. Moreover, the sale of consulting services to companies creates a risk that proxy advisory firms would be lenient in formulating voting recommendations for companies that are their clients and harsh in crafting the recommendations for those companies that have refused to retain their services. As a whole, the existing system creates incentives for proxy advisory firms to evaluate governance structures in a way that maximizes continued reliance on the services such firms provide.

The 2003 release and the 2004 no-action letters set the stage for proxy advisory firms to wield the power of the proxy through investment adviser firms that had economic, regulatory, and liability incentives to rely rotely on the proxy advisory firms' recommendations, and through the SEC staff's assurances that this arrangement was appropriate, despite the obvious conflicts of interest involved.

I am extremely pleased to note that the SEC staff withdrew the ISS and Egan-Jones letters just a few months ago,[18] and Chairman Clayton wisely reminded investors, market professionals and the securities bar that "staff statements are nonbinding and create no enforceable legal rights or obligations of the Commission or other parties."[19] As a result, I am hopeful that some of the unfettered power that was ascribed to proxy advisory firms over the past 15 years has been reined in. I also understand that the issues underlying the ISS and Egan-Jones letters are being reviewed and evaluated again by the SEC staff, including against the backdrop of feedback the Commission received from the 2018 Proxy Process Roundtable, so we may hear more from the Commission or its staff on these points in the near future.

As investment advisers consider the potential risks of reliance on proxy advisory firm analysis and corporations continue to highlight quality and conflict of interest concerns related to such analysis, all market participants should welcome this review. Because additional regulatory

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[16] *See* Egan-Jones Letter.

[17] The auditor independence rules, by contrast, flatly forbid an auditor from telling an audit client how to account for a matter, and then providing an audit opinion to investors with respect to that exact same matter. *See* SEC Rule 2-01(b) & (c)(4) of Regulation S-X. The temptation for one side of the house to rubber-stamp the advice provided by the other side of the house is simply too great.

[18] Public Statement, Statement Regarding Staff Proxy Advisory Letters (Sep. 13, 2018), *available at* https://www.sec.gov/news/public-statement/statement-regarding-staff-proxy-advisory-letters.

[19] SEC Chairman Jay Clayton, *Statement Regarding SEC Staff Views* (Sep. 13, 2018), *available at* https://www.sec.gov/news/public-statement/statement-clayton-091318.

developments since the 2003 release and the 2004 no-action letters have strengthened further proxy advisory firms' hands, the withdrawal of the 2004 letters alone is not sufficient.

B. Subsequent Developments Augmenting the Power of Proxy Advisory Firms

Since 2003, other elements of the SEC regulatory regime have acted to deepen further investment advisers' reliance on, and perhaps even need for, proxy advisory firms. First, the quantity of company disclosures has increased significantly over the past decade. For example, the SEC in 2006 adopted revisions to the proxy and periodic reporting rules to require extensive new disclosures about "executive and director compensation, related person transactions, director independence and other corporate governance matters and security ownership of officers and directors."[20] The revisions generated reams of new disclosures that were long, complex, and focused on regulatory compliance rather than telling the company's compensation story. The sheer volume of information that an investment adviser would have to review in order to make a fully-informed voting decision is difficult even to organize, much less to read and digest.

Additionally, the average number of items on which investors are asked to vote also has increased.[21] This trend is attributable at least in part to the Dodd-Frank Act and its twin advisory votes on executive compensation: a vote for how often shareholders should be asked to approve executive pay ("say-on-frequency"), and a vote to in fact approve (or disapprove) that pay on an advisory basis ("say-on-pay").[22] I will address shareholder proposals in more detail later, but we also have seen a continued increase in shareholder proposals that SEC rules generally compel companies to include as voting matters in the proxy. These additional matters continue to increase the burden placed on investors and investment advisers in deciding whether and how to vote the shares they represent.

As a result, the logistical and economic imperatives to use proxy advisory firms that the vote-every-share-every-time interpretation of the 2003 rulemaking created have only strengthened over time. According to one 2012 study, for example, over 70% of companies reported that their compensation programs were influenced by the guidance of proxy advisers.[23] And, according to a survey conducted in 2015, 63% of institutional investors reported that they rely on third-party proxy advisers to make voting decisions.[24] More recently, research from the American Council for Capital Formation (ACCF) identifies that many asset managers are

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20 SEC Rel. No. 33-8732A, *Executive Compensation and Related Person Disclosure* (Aug. 29, 2006), *available at* https://www.sec.gov/rules/final/2006/33-8732a.pdf.

21 *See, e.g.,* Larcker et al., Outsourcing Shareholder Voting at 1.

22 *See also* SEC Commissioner Michael S. Piwowar, Opening Statement at the Proxy Advisory Services Roundtable (Dec. 5, 2013) (Piwowar Proxy Adviser Remarks), https://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370542558180 ("Dodd-Frank provisions, such as mandatory say-on-pay votes, make proxy advisory firms potentially even more influential.").

23 *See* David F. Larcker, Allan L. McCall, and Brian Tayan, *The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions* (Mar. 2012) at 4, *available at* https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-survey-2012-proxy-voting_0.pdf.

24 *See* Stanford University Graduate School of Business, *2015 Investor Survey Deconstructing Proxy Statements – What Matters to Investors* (2015) at 2, *available at* https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-survyey-2015-deconstructing-proxy-statements_0.pdf.

automatically voting in alignment with proxy advisory firm recommendations, in a practice known as "robo-voting."[25] Specifically, the ACCF study found that 175 entities, representing more than $5 trillion in assets under management, follow ISS's recommendations over 95% of the time. These recommendations are provided contractually to investment advisers; as mentioned, proxy advisory firms have no fiduciary duty to shareholders, nor do they have any interest or stake in the companies that are the subject of the recommendations.

Proxy advisory firms themselves face the same difficulties institutional investors faced before the institutions determined to outsource their voting: how to formulate timely, high-quality recommendations for thousands of votes at thousands of companies based on millions of pages of data – all while competing on price with other firms. Not surprisingly, their recommendations often are just not good enough, and proxy advisory firms publish some recommendations that are based on clear, material mistakes of fact.[26] Moreover, they base some recommendations on a cookie-cutter approach to governance – *i.e.*, in favor of all proposals of a certain type, like de-staggering boards or removing poison pills, even if there is a sound basis for challenging the assumption that an otherwise beneficial governance reform might not be appropriate for a given company. As one academic article has argued:

> If the institutional investors are only using the proxy advisor voting recommendations to meet their compliance requirement with the lowest cost, these payments will not compensate proxy advisors for conducting research that is necessary to determine appropriate corporate governance structures for individual firms. Under this scenario, the resulting recommendations will tend to be based on simple, low cost approaches that ignore the complex contextual aspects that are almost certainly instrumental in selecting the corporate governance structure for individual firms.[27]

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[25] *See* "The Realities of Robo-Voting," posted by Timothy M. Doyle, American Council for Capital Formation (ACCF), to the Harvard Law School Forum on Corporate Governance and Financial Regulation, November 29, 2018, *available at* https://corpgov.law.harvard.edu/2018/11/29/the-realities-of-robo-voting/.

[26] *See, e.g.,* Center On Executive Compensation, *A Call for Change in the Proxy Advisory Industry Status Quo* (Jan. 2011) at 58-9 (describing two member surveys conducted by the Center On Executive Compensation and HR Policy Association in 2010 which found significant rates of error in proxy advisory firm research and reports on executive compensation matters), *available at* http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf. *See also* Letter from Business Roundtable on Proxy Advisory Firms, to Mary Jo White, SEC Chairman (Sept. 12, 2013), *available at* http://businessroundtable.org/resources/letter-to-chairman-white-on-proxy-advisory-firms (in its inquiry, almost all of the twenty companies that responded indicated that they historically have found one or more factual errors in the reports prepared by proxy advisory services). A 2016 decision from the Delaware Chancery Court sheds additional light on the complex plumbing currently underlying the proxy voting process, as well as the potential pitfalls surrounding reliance on proxy advisory firms. In that case, the Court concluded that certain investors had given up their appraisal rights in connection with a merger transaction based upon an error – albeit apparently inadvertent – on the part of ISS in transmitting voting instructions to Broadridge, the entity ultimately responsible for executing the proxies at issue. The Court held that by relying on ISS to transmit its voting instructions, the investment adviser "accepted the risk" that ISS might ultimately pass along voting instructions that were inconsistent with the adviser's wishes. *See In re Appraisal of Dell, Inc.*, C.A. No. 9322-VCL (Del. Ch. Ct. May 11, 2016), *available at* https://courts.delaware.gov/Opinions/Download.aspx?id=240830.

[27] See Larcker et al., Outsourcing Shareholder Voting at 3; *see also* James K. Glassman & Hester Peirce, *How*

Unfortunately, companies have little access to proxy advisory firms in order either to correct a mistake of fact, or to explain why a generic corporate governance recommendation is the wrong result in the specific instance: letting companies appeal to the advisory firm is time-consuming and expensive, neither of which is consistent with the proxy advisory firm's business model. As a result, while the companies that also hire a proxy advisory firm for the latter's corporate consulting services may have some minimal degree of access (*e.g.*, by being provided an opportunity to make limited comments on draft reports), smaller companies that are not clients generally are not afforded any such rights.

Advisers that rely wholesale on the proxy advisory firm's recommendations also tend not to afford companies an opportunity to tell their story. This is unsurprising: if the advisers felt it necessary to spend significant time and make contextualized decisions about casting each vote, they would not have outsourced their vote. But it is also supremely ironic: under the current regulatory regime, a company that may want to engage in good faith with its shareholders may find that it has no meaningful opportunity to do so.

The cookie-cutter approach to governance combined with the limited opportunities for companies to tell their story is deeply troubling to me. Without consideration of both sides of a voting item on a case-by-case basis, there is no way of knowing if a particular outcome is in the best interests of shareholders. Indeed, this discussion is about much more than arguments over whether a statement in a proxy advisory firm's analysis is an error or a difference of opinion. Regardless of whether a dispute is over the facts, the analysis or the methodology, investors deserve to hear both sides of the story. Reform should make sure that all sides are able to express their concerns to investment advisers before votes are cast.

The rise of proxy advisers and the outsized influence they wield on the shareholder voting process have real consequences for investors, the vast majority of whom are interested in maximizing the value of their shares. In conducting their analysis, proxy advisory firms routinely fail to demonstrate how (or whether) their recommendations increase shareholder value. If investment advisers are relying on proxy adviser analysis, an explanation of how a particular recommendation relates to shareholder value is essential. Recent research shows that "when public companies implement certain 'best practices' promulgated by proxy advisers — in this case with regard to stock option exchange programs — their gains in shareholder value are on average 50% to 100% less than other firms."[28] Another study analyzed the impact of say-on-pay voting requirements under the Dodd-Frank Act and found that "compensation changes desired by

Proxy Advisory Services Became So Powerful, Mercatus on Policy (June 2014), *available at* http://mercatus.org/sites/default/files/Peirce-Proxy-Advisory-Services-MOP.pdf (noting that "one-size-fits-all recommendations miss the nuances of particular corporations").

28 David F. Larcker and Allan L. McCall , "Proxy Advisers Don't Help Shareholders," WALL ST. J. (Dec. 8, 2013), *available at* http://www.wsj.com/articles/SB10001424052702303497804579241842269425358. *See also* Robert Daines, Ian Gow, and David Larker, *Rating the Ratings: How Good Are Commercial Governance Ratings,* Rock Center for Corporate Governance at Stanford University Working Paper Series No. 1 (Sept. 4, 2009) (finding that corporate governance ratings produced by certain proxy advisory firms and other corporate governance rating organizations "have either limited or no success in predicting firm performance or other outcomes of interest to shareholders").

proxy advisory firms produce a net cost to shareholders, while compensation changes not related to proxy advisors' criteria are value-neutral."[29] The study concluded that outsourcing voting decisions to proxy advisers appears to have the unintended consequence that boards of directors are induced "to make compensation decisions that *decrease* shareholder value."[30]

C. The Initial Regulatory Response

Concerns surrounding proxy advisory firms have been on the SEC's radar for some time now, most notably when they were raised in the 2010 Concept Release on the U.S. Proxy System (Proxy Plumbing release). This release outlined the conflict-of-interest and low-quality voting recommendation issues addressed above, and it requested comment on a long list of potential regulatory solutions. In December 2013, the SEC also held a roundtable (the 2013 Roundtable) to examine key questions about the influence of proxy advisory firms on institutional investors, the lack of competition in this market, the lack of transparency in the proxy advisory firms' vote recommendation process and, significantly, the obvious conflicts of interest when proxy advisory firms provide advisory services to issuers while making voting recommendations to investors. Then Commissioner Michael Piwowar correctly pointed out in his opening remarks at the 2013 Roundtable:

> By requiring advisers to vote on every single matter – irrespective of whether such vote would impact the performance of investment portfolios – our previous actions may have unintentionally turned shareholding voting into a regulatory compliance issue, rather than one focused on the benefits for investors. This is an unfortunate result, not merely because it may have served to entrench an anti-competitive duopoly, but more importantly because it is inconsistent with our investor protection mandate. For these reasons, we should rectify this situation immediately.[31]

A wide range of other parties, including members of Congress, academics, public interest groups, the media, and a national securities exchange, also have been calling for reforms.[32] There also has been substantial interest and work regarding the role of proxy advisers on the international front, including legislation introduced by the European Commission to address the accuracy and reliability of proxy advisers' analysis as well as their conflicts of interest.[33]

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[29] David F. Larcker et al., Outsourcing Shareholder Voting at 36.

[30] *Id*. at 45.

[31] Piwowar Proxy Adviser Remarks.

[32] *See* SEC Commissioner Daniel M. Gallagher, Remarks at Georgetown University's Center for Financial Markets and Policy Event (Oct. 30, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370540197480. *See also, e.g.,* Yin Wilczek, *If SEC Fails to Move on Proxy Advisors, Lawmaker Promises Congressional Action*, Bloomberg BNA (June 20, 2014), *available at* https://www.bna.com/sec-fails-move-n17179891458/ (discussing Congressman McHenry's promise of congressional action in the absence of three key reforms: repealing the no-action letters; identifying transparency, efficiency, and accountability measures for proxy advisory firms; and permitting portfolio managers to use cost-benefit analysis to determine whether to cast a vote); Comments of the Washington Legal Foundation on Issues Raised at the Proxy Advisory Firm Roundtable (Jan. 10, 2014), *available at* http://www.wlf.org/upload/litigation/misc/SECProxyAdvisorComments_Jan2014.pdf.

[33] *See* Proposal for a directive of the European Parliament and of the Council amending Directive 2007/36/EC

After the SEC's concept release and the 2013 Roundtable, which provided a wealth of information and perspectives, the SEC staff on June 30, 2014 moved toward addressing some of the serious issues involving proxy advisers. The Division of Investment Management and the Division of Corporation Finance released Staff Legal Bulletin No. 20 (SLB 20), providing much-needed guidance and clarification as to the duties and obligations of proxy advisers, and to the duties and obligations of investment advisers that make use of proxy advisers' services.[34] This guidance was a good, initial step in addressing the serious deficiencies currently plaguing the proxy advisory process.

In particular, SLB 20 did three important things worth highlighting. First, it clarified the widespread misconception discussed above that the Commission's 2003 release mandates that investment advisers cast a ballot for each and every vote. The guidance made clear that an investment adviser and its client have significant flexibility in determining how the investment adviser should vote on the client's behalf, including by agreeing that votes will be cast always, sometimes (*e.g.*, only on certain key issues), or never. SLB 20 also noted that the investment adviser and client can agree to vote consistent with management's recommendations.

Second, SLB 20 cautioned against misguided reliance on the two 2004 staff no-action letters. The guidance made clear that investment advisers have a continuing duty to monitor the activities of their proxy advisers, including whether, among other things, the proxy advisory firm has the capacity to "ensure that its proxy voting recommendations are based on current and *accurate* information."[35] This is an important issue, as I have heard from many companies that proxy advisory firms sometimes produce recommendations based on materially false or inaccurate information, but they are unable to have the proxy advisory firm even acknowledge these claims, much less review them and determine whether to revise its recommendation in light of the corrected information. The recent withdrawal of the 2004 staff no-action letters should ameliorate any misplaced reliance on old habits, but I worry that it's not enough.

Third, SLB 20 made clear that a proxy advisory firm must disclose to recipients of voting recommendations any significant relationship the proxy advisory firm has with a company or security holder proponent. This critical disclosure must clearly and adequately describe the nature and scope of the relationship, and boilerplate will not suffice.

D. The Limits of SLB 20 and The Need for Additional Reforms

While the increased attention and initial reforms described above were a step in the right direction, more work needs to be done to address the outsized role proxy advisers continue to

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as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement (Apr. 9, 2014), *available at* https://eur-lex.europa.eu/resource.html?uri=cellar:59fccf6c-c094-11e3-86f9-01aa75ed71a1.0003.01/DOC_1&format=PDF.

34 Division of Investment Management and Division of Corporation Finance, U.S. Securities and Exchange Commission, SEC Staff Legal Bulletin No. 20, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms* (June 30, 2014) (SLB 20), *available at* https://www.sec.gov/interps/legal/cfslb20.htm.

35 SLB 20 (emphasis added).

play in the shareholder voting process. I am hopeful that the 2018 Proxy Process Roundtable will lead to additional guidance or regulatory reforms from the SEC. It is long past time to have a balanced system that efficiently and effectively furthers the interests and needs of shareholders, their investment advisers, and the public companies in which they invest.

And while SLB 20 was a good first step, I remain concerned that the guidance does not fully address the fact that SEC rules have accorded to proxy advisers a special and privileged role in our securities laws – a role similar to that of nationally recognized statistical ratings organizations (NRSROs) before the financial crisis. It has become clear to me that, over the past decade, certain segments of the investment adviser industry have become too dependent on proxy advisory firms, and there is therefore a risk that these firms will not take full advantage of the SEC's guidance to reduce that reliance. Over four years after SLB 20 was released, many market participants seem to have simply taken a "business as usual" approach. This approach is manifest in the continued market dominance of the two largest proxy advisory firms, ISS and Glass, Lewis & Co. ISS alone advises more than 60% of U.S. institutional investors on how to vote on corporate ballot items.[36]

Different pieces of proposed legislation over the past five years have put forth the idea that proxy advisory firms should be registered with the SEC, just as our system requires registration of broker-dealers and investment advisers. In 2016, Congressman Sean Duffy and now former Congressman (and current Delaware Governor) John Carney introduced the Corporate Governance Reform and Transparency Act to create a new SEC registration and oversight regime for proxy advisory firms similar to that which Congress put in place for credit rating agencies in 2006. That bill was ultimately passed in the House with bipartisan support.

Most recently, the bipartisan Corporate Governance Fairness Act was introduced by Senators Reed, Perdue, Jones, Tillis, Heitkamp and Kennedy of this Committee.[37] The bill would require the SEC to regulate and inspect all major proxy advisory firms under the Investment Advisers Act. As the press release announcing the bill stated, "[The advice of proxy advisory firms] is critical for investors as they decide how to vote their shares on important corporate governance matters, such as director elections or whether to sell the company."[38]

Congressional attention to the issue of proxy advisory firm oversight is important and needed, and it is truly refreshing to see bipartisan efforts to provide an appropriate regulatory framework for these firms given the impact they have on corporate governance in the U.S. Absent such efforts, the outsized role of proxy advisory firms will only continue to grow.

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36 *See* James K. Glassman, "Regulators Are a Proxy Advisers Best Friend," WALL ST. J. (Dec. 17, 2014), *available at* https://www.wsj.com/articles/james-k-glassman-regulators-are-a-proxy-advisers-best-friend-1418863046. *See also* James Copland, David Larcker, and Brian Tayan, *Proxy Advisory Firms, Empirical Evidence And The Case For Reform* (May 2018) at 13 (finding that an against recommendation from proxy advisors "is associated with a reduction in the favorable vote count by 15%-30%"), *available at* https://www.manhattan-institute.org/sites/default/files/R-JC-0518-v2.pdf.

37 S. 3614, 115th Cong. (2018), *available at* https://www.congress.gov/115/bills/s3614/BILLS-115s3614is.pdf.

38 Press Release, Tillis Introduces Bipartisan Legislation to Protect Investors and Ensure Proper Oversight of Proxy Advisory Firms (Nov. 14, 2018), *available at* https://www.tillis.senate.gov/public/index.cfm/2018/11/tillis-introduces-bipartisan-legislation-to-protect-investors-and-ensure-proper-oversight-of-proxy-advisory-firms.

II. The Shareholder Proposal Process

It is important to discuss the role of proxy advisory firms in influencing the votes that investors and investment advisers cast, but we also must consider the matters upon which investors or their advisers are asked to cast votes, and why. While the conduct of a company's annual shareholder meeting is generally governed by state law, the process of communicating with shareholders to solicit proxies for voting at that meeting is regulated by the Commission under federal law. The Commission's rules have for decades permitted qualifying shareholders to require the company to publish certain proposals in the company's proxy statement, which are then voted upon at the annual meeting. Whether the Commission's rule on shareholder proposals (Rule 14a-8) was right or wrong when initially adopted in December 1942, the shareholder proposal process is now replete with defects and inefficiencies. I spoke about the need for reform in this area in remarks I gave at the 26th Annual Corporate Law Institute at Tulane University Law School back in 2014.[39] Unfortunately, little has changed since then.

The Commission has never adequately assessed the costs and benefits of its shareholder proposal process. Currently, a proponent can bring a shareholder proposal pursuant to Rule 14a-8 if he or she has owned $2,000, a threshold established 20 years ago, or 1% (whichever is less) of the company's stock for one year, so long as the proposal complies with a handful of substantive—but in some cases discretionary—requirements. Activist investors and corporate gadflies have used these loose rules to hijack the shareholder proposal system to advance their own environmental, social and political agendas.

The data and statistics are striking. During the 2018 proxy season, there were 788 shareholder proposals appearing in corporate proxy statements and 43% of those proposals addressed social and environmental issues, with 11% taking up lobbying activities and political contributions.[40] Of all shareholder proposals that appeared in proxy statements, only 10% received a majority vote in favor from shareholders.[41] The ESG proposals that accounted for 43% of the total number of proposals—only about 5% of those received majority shareholder support.[42]

Also, these proposals are not coming from ordinary shareholders concerned with promoting shareholder value for all investors. Last year, about 19% came from pension funds and organized labor, about 46% came from religious and social policy investors and fully 25% came from one particular individual and his associates who have made a trade in submitting 14a-

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[39] Gallagher Tulane Remarks.

[40] *See* Gibson Dunn, *Client Alert: Shareholder Proposal Developments During the 2018 Proxy Season* (July 12, 2018) at 3–4, *available at* https://www.gibsondunn.com/wp-content/uploads/2018/07/shareholder-proposal-developments-during-the-2018-proxy-season.pdf.

[41] *See id.* at 5.

[42] *See* Institutional Shareholder Services, *U.S. Environmental and Social Issues, 2018 Proxy Season Review* (Aug. 30, 2018) at 7, *available at* https://www.isscorporatesolutions.com/library/2018-es-us-proxy-season-review/.

8 proposals to multiple companies.[43]

In other words, the vast majority of proposals are brought by individuals or institutions with idiosyncratic and sometimes political agendas that are often unrelated to, or even in conflict with, the interests of other shareholders. As Commissioner Elad Roisman said in his opening remarks at the 2018 Proxy Process Roundtable last month, "We have to strike a balance [...] between proponents who seek to increase shareholder value with their proposals and those who exploit the process to further their personal agenda. Proposals brought by the latter can be a waste of shareholders' time and money, as it is the shareholders who ultimately bear the costs companies spend defending these proposals."[44] In an era when more and more Americans are relying on their individual investments to secure their retirements and send their kids to college, it seems to me they are entitled to their regulators' vigilance in staving off needless waste in those investment systems.

Given all of this, it's time we asked whether the shareholder proposal system as currently designed is a net negative for the average investor.[45] Existing shareholders who are unhappy with management have a range of well-accepted responses other than proposals. Given the depth and liquidity of today's markets, passive investors can simply sell their position—taking the so-called "Wall Street Walk." Investors can threaten to take this Walk as a means of influencing management. Investors can also vote against directors who are not sufficiently overseeing management. And, of course, where management is breaching its fiduciary duties, investors can have recourse to the courts.

In a series of speeches during my time on the Commission, I proposed a number of modest reforms to Rule 14a-8, including, among others, revising the absurdly low holding requirements needed to submit a shareholder proposal and moving to a percentage test; clarifying and bolstering requirements regarding the substance of shareholder proposals; and increasing the thresholds required to re-submit a failed shareholder proposal from one year to the next.[46] From comments made by the Commissioners, SEC staff and panel participants at the 2018 Proxy Process Roundtable, I believe some of this low-hanging fruit is easily within reach, and I am cautiously optimistic that we may see progress on this front in the near term (or at least in our lifetimes).

III. Retail Shareholder Participation

As I noted at the beginning of my remarks, individual investors are generally rationally apathetic when it comes to shareholder voting: value potentially gained through voting is outweighed by the burden of determining how to vote and actually casting that vote. This can be an optimal state and should not be conflated with a notion that retail investors have been

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[43] *See* James Copland and Margaret O'Keefe, *Proxy Monitor 2017: Season Review*, *available at* http://www.proxymonitor.org/Forms/pmr_15.aspx.

[44] SEC Commissioner Elad L. Roisman, *Statement at Proxy Process Roundtable* (Nov. 15, 2018), *available at* https://www.sec.gov/news/public-statement/statement-roisman-111518.

[45] Allan T. Ingraham & Anna Koyfman, *Analysis of the Wealth Effects of Shareholders Proposals-Vol. III* (U.S. Chamber of Commerce, May 2, 2013).

[46] *See, e.g.,* Gallagher Tulane Remarks.

disenfranchised. At the same time, I am aware of several efforts to increase retail investors' participation in the proxy process by making it easier for individuals to make and communicate their own voting decisions in a cost-effective manner. I think this is an important area that this Committee has rightly taken up today as part of its evaluation of the proxy system in the U.S.

A little historical context may be helpful in understanding the changing role played by individual investors in our markets today. Although over half (about 55%) of Americans are invested in the stock market in one way or another today[47], many of those investments are made through mutual funds and portfolio accounts rather than through direct investment in the stocks of any particular companies.[48] This reflects a consistent trend line over the past half century of declining direct stock ownership by retail (individual) investors – in 1950, individual investors held almost 94% of corporate stock; in 1980, the percentage held by individuals had slipped but still represented a sizeable majority with more than 70% of the market.[49] By 2000, institutional investors held almost half of all stock in the American market and just recently, in 2018, the percentage held by individual investors had fallen to only 30%.[50]

Thirty percent is still a pretty good chunk, though. Certainly a block of 30% could make a difference in many elections, and yet less than 30% (about 28%) of the shares held by retail investors were voted at American companies' annual meetings last year.[51] I noted earlier why that may be predictable and optimal, but there are also systemic roadblocks to retail participation that warrant a closer look. Even when they hold stock in individual companies, retail investors still must rely on a market intermediary—a brokerage firm—to facilitate the voting process. The individual who invested his or her money typically does not even show up in the corporate records as a shareholder: the brokerage firm holds those shares in "street name." The broker then needs to pass along proxy statements and solicit votes from the actual, so-called "beneficial" owners. That's a tedious system with needless costs and inefficiencies.

As a side point, I'd also note that a change to the New York Stock Exchange's rules on the heels of the Dodd-Frank Act also cast a pall over retail voting. (Regardless of which exchange a company's stock is traded on, brokers as members of the NYSE must follow its rules.) Back in 2009, the NYSE, with a newly reconstituted Commission's encouragement, amended its rule concerning the matters on which brokers can cast discretionary votes– in other words, if a broker has not received express voting instructions from its customer, can it still cast a vote for its retail customers' shares?[52] Brokers can only do that for so-called "routine" matters.

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47 *See* Gallup News Service, *Gallup Poll Social Series: Economy and Personal Finance* (Apr. 2–11, 2018), *available at* https://news.gallup.com/file/poll/233747/180504StockOwnership.pdf.

48 *See* Sarah Holden, Daniel Schrass, and Michael Bogden, *Ownership of Mutual Funds, Shareholder Sentiment, and Use of the Internet, 2017* (Oct. 2017), *available at* https://www.ici.org/pdf/per23-07.pdf.

49 *See* Matteo Tonello & Stephan Rabimov, *supra* note 3 at 22.

50 *See id.;* Proxy Pulse at 4.

51 *See* Proxy Pulse at 4.

52 SEC Release No. 34-60215, *Order Approving Proposed Rule Change, as modified by Amendment No. 4, to Amend NYSE Rule 452 and Corresponding Listed Company Manual Section 402.08 to Eliminate Broker Discretionary Voting for the Election of Directors, Except for Companies Registered under the Investment Company Act of 1940, and to Codify Two Previously Published Interpretations that Do Not Permit Broker Discretionary Voting for Material Amendments to Investment Advisory Contracts with an Investment Company* (Jul. 1, 2009), *available at* https://www.sec.gov/rules/sro/nyse/2009/34-60215.pdf.

It used to be that routine matters included uncontested director elections, but not so after the 2009 rule change (proxy contests have never been routine).[53] The say-on-pay votes to which Dodd-Frank subjected public companies are not "routine" matters either.[54] There's not much left – often only the ratification of the independent auditor. In a very real sense, it's more complicated and burdensome for a retail investor to vote on matters on a company's proxy card than it is for big, highly resourced institutional investors.

Chairman Clayton has been clear from day one of his tenure at the SEC that the interests of retail investors would be of paramount concern to the Commission.[55] This is a needed and refreshing focus for the Commission. As part of this emphasis on retail investor issues, the SEC's Investor Advisory Committee recently held a meeting focused on proxy voting issues[56] and, of course, the SEC staff recently held the 2018 Proxy Process Roundtable.[57] As part of these events, many comment letters were submitted to the SEC. Of particular import, I believe, was the letter submitted by Ken Bertsch, the Executive Director of the Council of Institutional Investors (CII), to the Investor Advisory Committee. In his letter, Mr. Bertsch strongly and rightfully advocates for the SEC to facilitate the usage of blockchain technology in the proxy voting process.[58]

I agree with Mr. Bertsch that "[i]f deployed properly, blockchain-based proxy voting could protect investor privacy while enhancing:

- **Timeliness**—The dissemination of materials, process of voting, and reporting of results occurs immediately and simultaneously when conducted on the blockchain.
- **Accessibility**— The blockchain represents a technological advancement that improves the accessibility of the proxy voting process to all shareholders, large and small, potentially improving participation rates.
- **Accuracy**— The blockchain utilizes a gatekeeper to allocate and authenticate votes, and the technology itself immutably tabulates votes as they are cast.
- **Certainty**— Shareholders can achieve end-to-end confirmation on the

[53] *Id.*

[54] *See* H.R. 4173 – Dodd-Frank Wall Street Reform and Consumer Protection Act, 111th Cong. (2010) (enacted), *available at* https://www.congress.gov/111/plaws/publ203/PLAW-111publ203.pdf.

[55] *See e.g.,* Chairman Jay Clayton, Remarks at the Economic Club of New York (Jul. 12, 2017), *available at* https://www.sec.gov/news/speech/remarks-economic-club-new-york.

[56] *See* SEC Release No. 33-10531, *Investor Advisory Committee Meeting* (Aug. 17, 2018), *available at* https://www.sec.gov/rules/other/2018/33-10531.pdf.

[57] In his statement last July announcing that the SEC staff would be holding a roundtable on proxy issues, Chairman Clayton noted that he was asking the staff to consider "the extent to which relatively low retail investor participation should be of concern and should inform analysis of existing regulation." *See* Chairman Jay Clayton, "Statement Announcing SEC Staff Roundtable on the Proxy Process,' July 30, 2018, *available at* https://www.sec.gov/news/public-statement/statement-announcing-sec-staff-roundtable-proxy-process.

[58] In full disclosure, I am a member of the Board of Directors of Symbiont, which is the market-leading smart contracts platform for institutional applications of blockchain technology, reflecting my long interest in the promise of this new technology.

blockchain since it records the executed voting instructions.

- **Cost-effectiveness**— We believe a blockchain-based system in the long run will be substantially less expensive than the current system by eliminating certain delays, frictions, and opacity."[59]

The benefits of blockchain technology will not be limited to institutional investors. As I discussed earlier, retail investors face their own unique challenges when exercising their proxy voting rights, and blockchain technology can alleviate many if not all of these challenges.

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In closing, I want to thank the Committee for holding this important hearing and inviting me to speak with you today. I firmly believe that meaningful reforms can be made to the proxy process which will have salutary effects for investors and our capital markets more broadly, and I would welcome the opportunity to contribute to those efforts if there is any additional way I can be helpful to the Committee. Thank you.

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[59] *See* Ken Bertsch, Remarks to the SEC Investor Advisory Committee (Sep. 13, 2018), *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac091318-opening-remarks-ken-bertsch.pdf.