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Committee on Financial Services
U.S. House of Representatives

Hearing on "Examining the Market Power and Impact of Proxy Advisory Firms"

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Chairman Garrett, Ranking Member Maloney, and Members of the Subcommittee, my name is Niels Holch, and I am the Executive Director of the Shareholder Communications Coalition.

The Shareholder Communications Coalition (www.shareholdercoalition.com) comprises three professional associations representing the interests of public companies: Business Roundtable, the Society of Corporate Secretaries & Governance Professionals, and the National Investor Relations Institute.

The Shareholder Communications Coalition was established in 2005, after Business Roundtable filed a Petition for Rulemaking with the Securities and Exchange Commission ("SEC") in 2004, urging the agency to conduct a comprehensive evaluation of the shareholder communications and proxy voting system.

Many of the current SEC rules governing this system were adopted in 1985, more than 25 years ago. These SEC rules were promulgated during a period when most annual meetings were routine, and few matters were contested. These rules also were developed at a time when technology and electronic communications were not nearly as sophisticated as they are today.

It was not until six (6) years after the Business Roundtable Petition for Rulemaking was filed that the SEC undertook an evaluation of the shareholder communications and proxy voting system, and, in July 2010, released for public comment a Concept Release on the U.S. Proxy System.

In its Concept Release, the SEC acknowledged that the time had come to review various aspects of the U.S. proxy system. The Concept Release outlined concerns that have been raised regarding the accuracy, reliability, transparency, accountability, and integrity of the current proxy system. The Concept Release also discussed possible regulatory solutions to the many problems that have been identified, including those related to shareholder communications, proxy distribution and voting, and proxy advisory services.

The SEC received more than 300 comment letters in response to this Concept Release, the substantial majority of which expressed the view that reforms to the existing system are necessary.

Unfortunately, another three (3) years has passed and the SEC has not initiated any rulemakings to follow-up on the Concept Release and address the many identified problems in the current shareholder communications and proxy voting system.

While we acknowledge the SEC’s heavy workload under the Dodd-Frank and JOBS Acts, the Coalition believes strongly that there should not be any further delays—it is now time for the SEC to address the concerns identified in the Concept Release.

As the SEC itself noted in its Concept Release: "[w]ith 600 billion shares voted every year at more than 13,000 shareholder meetings, shareholders should be served by a well-functioning proxy system that promotes efficient and accurate voting."[1]

The Coalition urges the members of this Subcommittee to request that the SEC turn to these issues and promptly initiate a series of rulemakings to reform its shareholder communications and proxy rules.

The Current Proxy System

In order to promote an understanding of the problems in this area, let me explain in greater detail how the current proxy system works, and why the Coalition believes reforms are necessary.

It is estimated that 75-80% of all public company shares in the United States are held in "street name," meaning in the name of a broker or a bank that holds the shares on behalf of its clients and customers, who are called the "beneficial owners." When shares are purchased in street name, the underlying beneficial owners of the shares are not registered on the books and records of a public company.

The street name system of stock ownership expanded after the Wall Street paperwork crisis in the 1970's. The primary purpose of this system was—and still is today—to enable securities transactions to be processed and cleared in an efficient manner.

Under SEC and stock exchange rules, brokers and banks are responsible for distributing annual meeting materials provided by companies (and requesting voting

[1] Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42,982, at 42,983 (July 22, 2010).

instructions) from beneficial owners who are holding their shares in street name. Since many shareholders do not attend annual meetings in person, companies need to solicit votes through a proxy system that functions in a similar fashion to the absentee balloting process used in federal and state elections.

The U.S. proxy system is complicated and multi-faceted, involving several layers of intermediaries who are not the economic owners of corporate shares. This intermediation in the proxy process increases the complexity and the cost of processing proxy materials and tabulating votes. It also makes it very difficult for companies to know who their shareholders are and to communicate with them in an effective manner.

The proxy system and the SEC's rules have also not kept pace with the development of back office systems used in the securities industry, significant advances in the use and availability of communication technologies, and the growth of the Internet.

Similarly, corporate governance practices have changed significantly since the 1980's, when many of the SEC rules governing the proxy system were put in place. There has been a substantial move away from plurality voting in favor of majority voting for uncontested director elections. Shareholder proposals are on the increase, as is voting support for them. The Dodd-Frank Act now requires companies to provide a regular "say on pay" advisory vote for their shareholders. And recent changes to New York Stock Exchange rules have limited broker discretionary voting.

These changes have accelerated the need for companies to communicate more frequently, and on a more time-sensitive basis, with their shareholders. However, this is difficult to accomplish under the current proxy system, which is controlled by brokers and banks, and which classifies beneficial owners as either Objecting Beneficial Owners

(“OBOs”) or Non-Objecting Beneficial Owners (“NOBOs”). Public companies are not permitted to communicate directly with OBOs; and communication with NOBOs is expensive and restricted with respect to the distribution of proxy materials.

As you will see from this testimony, the public companies represented by the Coalition have one overriding goal in this area: *they want to know who their shareholders are, and they want to be able to communicate directly with them*.

Public Company Concerns with the Current Proxy Communication and Voting System

Public companies are understandably frustrated by a shareholder communications system that prevents them from knowing who many of their shareholders are and effectively communicating with them. Under the current structure, companies seeking to encourage more voting participation by beneficial owners, and engage in dialogue with them, cannot do so without using a complicated, circuitous, and expensive process that is largely outside their control.

The Need for Direct Shareholder Communications

Public companies want to have direct communications with their shareholders. The NOBO/OBO system impedes communications between shareholders and the companies they are invested in. Survey research has demonstrated that individual investors are confused by this classification system. In an age of instant communications and heightened shareholder empowerment, there is no reason to have this type of barrier to open and direct communications between a public company and its beneficial owners.

For these reasons, the Coalition supports the elimination of the NOBO/OBO classification system. This reform would ensure that public companies could have access to contact information and share position for their beneficial owners and would be permitted to communicate with them directly.

This reform would also bring the U.S. system in line with the capital market practices of other countries, where companies are entitled to receive information regarding the identities of their beneficial owners. As an example, the United Kingdom requires full transparency regarding the identity of individuals and institutions holding voting rights and/or beneficial owner interests, with civil and criminal penalties for a failure to make appropriate disclosures to public companies.[2]

Once public companies have access to information about their shareholders, they could assume the responsibility of distributing proxy materials directly to their shareholders, thereby facilitating direct communications with them.

Some investors—both individual and institutional—may want to retain their anonymity, either for trading purposes or for proxy voting purposes, or both, and we anticipate that the system could provide for that. For example, those investors who wish to remain anonymous could be permitted to establish nominee accounts, or otherwise use custodial arrangements to maintain their anonymity. Nominee status and custodial arrangements are common methods for institutional investors to hold their shares anonymously, and these methods should not change under the proposed reform.

Obviously, before any change is made to the NOBO/OBO system, there should be adequate notice to all investors, so that they have sufficient time to consider their options.

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[2] See Sections 793-795 of the UK Companies Act 2006.

Other stakeholders in the proxy process have expressed similar concerns about the barriers to communicating with beneficial owners in the street name system. For example, the Council of Institutional Investors commissioned a study on the proxy processing system, which was released in February of 2010.[3] The study was critical of the NOBO/OBO system and supportive of measures to increase the potential of direct communications between companies and their shareholders.[4]

The Need for an Improved Proxy Voting System

Other concerns have been raised about the mechanics of the current proxy voting system, which needs to be improved to ensure that vote counts are accurate, verifiable, and auditable.

Reports in the news media of voting miscounts and delays in determining election results by proxy service providers have raised questions about the integrity of the proxy voting process. Additionally, there is no ability for an independent third-party to audit and verify the results of a close election.

These proxy voting issues need to be addressed, as increased investor activism will certainly cause many more close votes on shareholder proposals, director elections, and other matters.

The integrity of the proxy voting process is essential to the proper functioning of our capital markets. Proxy voting should be fully transparent and verifiable, starting with a list of beneficial owners eligible to vote at a shareholder meeting and ending with the final tabulation of votes cast at the shareholder meeting.

[3] Alan L. Beller and Janet L. Fisher, The OBO/NOBO Distinction in Beneficial Ownership: Implications for Shareowner Communications and Voting (Feb. 18, 2010).

[4] See Letter from Glenn Davis, Senior Research Associate, Council of Institutional Investors, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, SEC File No. S7-14-10 (Oct. 14, 2010).

The vote counts on matters before a shareholder meeting should be auditable and capable of third-party verification, so that a validation of the votes of all shareholders can occur.

Public Company Concerns with Proxy Advisory Firms

Public companies are also concerned about the role and activities of the private firms providing proxy advisory services to institutional investors, which operate today with very little regulation or oversight. The SEC also raised this issue in its 2010 Concept Release.

There is a lack of transparency in the way proxy advisory firms operate, with insufficient information available about their standards, procedures, and methodologies. Conflicts of interest exist in several of their business practices; and concerns exist about their use of incorrect factual information in formulating specific voting recommendations.

These firms have considerable influence in the proxy voting process, as they generate voting recommendations for their clients, and, in fact, make voting decisions for some of their clients. The clients of these firms are institutional investors, including pension plans, mutual funds, hedge funds, and endowments.

Despite their large role in proxy matters, proxy advisory firms develop their policies using a "one-size-fits-all" approach that generally applies the same standards to all public companies, instead of evaluating the specific facts and circumstances of each company they evaluate.

One of the reasons that proxy advisory firms have become so powerful is that many interpret SEC and Department of Labor rules and guidance as requiring institutional investors to vote all their proxies at shareholder meetings as a part of the fiduciary duties they owe to their clients, investors, and beneficiaries. These regulations and guidance apply to investment companies, investment advisers, and many retirement and pension plans.

Many institutional investors and their third-party investment managers—especially mid-size and smaller firms—choose to reduce costs by not having in-house staff to analyze and vote on proxy items. Instead, these institutional investors and managers typically outsource their voting decisions to proxy advisory firms.

The proxy advisory industry is subject to a regulatory framework that can best be described as a patchwork quilt. As an example, the largest proxy advisory firm, Institutional Shareholder Services ("ISS"), has chosen to register under the Investment Advisers Act of 1940. However, the SEC's rules for investment advisers do not reflect the unique role that these advisory firms perform in the proxy voting process.

The second biggest proxy advisory firm, Glass Lewis, is not registered as an investment adviser and is not currently subject to any regulatory supervision. For example, the SEC just sanctioned ISS under the Investment Advisers Act for failing to establish or enforce written policies and procedures to prevent the misuse of material, non-public information by ISS employees with third parties.[5] As a non-registered entity, Glass Lewis is not subject to a number of provisions of the Investment Advisers Act and the SEC rules implementing the Act.

[5] See Order Instituting Administrative and Cease-and-Desist Proceedings and Imposing Remedial Sanctions and a Cease-and-Desist Order, In the Matter of Institutional Shareholder Services, Inc., Administrative Proceeding File No. 3-15331, May 23, 2013, available at http://www.sec.gov/litigation/admin/2013/ia-3611.pdf.

Additionally, the SEC has created an exemption from its proxy rules for these firms, so they are not required to abide by solicitation and disclosure rules that apply to other proxy participants. Thus, their reports, in contrast to company proxy materials, are not publicly available, even after annual meetings.

This patchwork system should not be permitted to continue, and these firms should be subject to more robust oversight by the SEC and the institutional investors that rely on them. For example, the current exemption from the proxy rules that proxy advisory firms rely on could be conditioned on their meeting certain minimum requirements governing their activities and conduct. The SEC should also consider a requirement that all proxy advisory firms register under the Investment Advisers Act of 1940, under a targeted regulatory framework that reflects the unique role they perform in the proxy voting process.

As noted earlier, there is a need for greater transparency about the internal procedures, policies, standards, methodologies, and assumptions used by these firms to develop voting recommendations.

And there needs to be attention to the problem of inaccuracies in the reports provided by proxy advisory firms. One firm—ISS—provides drafts (on a very short turnaround) only to S&P 500 companies and the other major proxy advisory firm—Glass Lewis—does not even do that.

All proxy advisory firms should be required to provide each public company with a copy of their draft reports, in advance of dissemination to their clients, to permit a company to review and correct any inaccurate factual information contained in these reports. Shareholders should not be voting based on inaccurate information in the reports of proxy advisory firms.

Another problem is that Glass Lewis refuses to provide a copy of its final reports to any public company that does not pay to subscribe to its services. And for those who do pay, both firms are attempting to impose unreasonable restrictions on a company's use of the information. It does not seem right that companies should have to pay a proxy advisory firm to find out what their shareholders are being told about the matters being voted on at a shareholder meeting.

Conflicts of interest within these firms also need to be addressed. One proxy advisory firm, for example, provides corporate governance and executive compensation consulting services to public companies, in addition to providing voting recommendations to its institutional clients on proxy matters for these same companies.

Another conflict that exists is proxy advisory firms providing voting recommendations on shareholder proposals submitted to companies by their institutional investor clients.

These conflicts should be specifically disclosed to clients of proxy advisory firms so that they may evaluate this information in the context of the firms' voting recommendations.

Along with considering greater regulatory oversight of proxy advisory firms, the SEC and Department of Labor should review the existing regulatory framework applicable to the use of proxy advisory firms by institutional investors. This review should include the guidance and interpretive letters that have been issued over the years on this subject. The SEC and Department of Labor should ensure that institutional investors are exercising sufficient oversight over their use of proxy advisory services, in a manner consistent with their fiduciary duties.

Next Steps

As noted earlier, it has been more than 25 years since the SEC's proxy rules have been updated and nine (9) years since the Business Roundtable filed its Petition for Rulemaking with the SEC, urging reform to the shareholder communications and proxy voting system.

The SEC must turn its attention to reforming the proxy system, addressing the issues raised in its 2010 Concept Release. We anticipate it would do so through a series of rulemakings in which it would obtain the input of public companies and other stakeholders in the proxy process.

The Coalition urges the members of this Subcommittee to request SEC action in this area.

Thank you for the opportunity to present the Shareholder Communication Coalition's views on these important issues. At the appropriate time, I am happy to answer any questions that the members of the Subcommittee may have.