Statement of the U.S. Chamber of Commerce

ON: "Examining the Market Power and Impact of Proxy Advisory Firms"

TO: The House Subcommittee on Capital Markets and Government Sponsored Enterprises

BY: Harvey Pitt

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The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on issues are developed by Chamber members serving on committees, subcommittees, councils, and task forces. Nearly 1,900 businesspeople participate in this process.

Chairman Garrett, Ranking Member Maloney, and Members of the Capital Markets and Government Sponsored Enterprises Subcommittee:

Introduction

I am pleased to participate in this Subcommittee's important hearings, at your invitation, representing the U.S. Chamber of Commerce (Chamber), to discuss the extensive, but unfettered, influence over corporate governance currently being wielded by proxy advisory firms.

By way of background, I am the founder and Chief Executive Officer of the global business consulting firm, Kalorama Partners, LLC, and its affiliated law firm, Kalorama Legal Services, PLLC (collectively, Kalorama).[1] Prior to founding Kalorama, as the Subcommittee is aware, I was privileged to serve the SEC in two separate tours of duty—first as a member of the SEC's Staff, from 1968-1978, culminating with my service, from 1975-1978, as SEC General Counsel, and second, as the SEC's 26th Chairman, from 2001-2003. In the nearly twenty-five years between my two governmental tours of duty, I was a senior partner in, and co-chaired, an international corporate law firm.

In the past forty-five years, I have served, variously, as a government policy maker and private sector advisor on a full panoply of matters affecting our capital and financial markets, publicly-held corporations, capital and financial market professionals and participants, and entities interested in, or affected by, the operations of this country's capital and financial markets. In my current role as CEO of the Kalorama firms, I am principally engaged in matters affecting corporate governance, regulatory policies and compliance-related issues. My professional experiences have provided me with an understanding of the ternary relationship between proxy advisory firms, investment portfolio manager organizations, and public companies, as well as the problematic corporate governance issues created by current practices of proxy advisory firms.

Summary

The allocation of capital to and governance of, public companies are inexorably intertwined with and vital catalysts for, our economic growth. Yet, disconcertingly, over the past decade and a half—largely as the result of governmental policies and

[1] As the Committee has requested, I have attached (as Exhibit 1) a copy of my current resume, summarizing my education, experience and affiliations pertinent to the subject matter of this hearing.

administrative rulemaking—we have experienced a continuous and sizeable drop in the existing number of U.S. public companies.[2]

Effective and transparent corporate governance systems that encourage meaningful shareholder communications are key if public companies are to thrive. Informed and transparent proxy advice can provide constructive support for effective corporate governance, but only if transparency exists throughout the process, and the advice being provided is directly correlated to, and solely motivated by, investor needs. These two essential components of effective proxy advice are currently lacking, and have been for some time.

For a number of years, the Chamber has expressed its long-standing concerns with the lack of transparency and accountability in, as well as the actual and potential conflicts of interest permeating, the operation of proxy advisory firms.[3] And, the Chamber has not been alone in voicing concerns with the operations of proxy advisory firms, both in the U.S. and globally.[4] The Chamber's concerns with certain practices and attributes of the most dominant members of the proxy advisory

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[2] *See e.g.*, D. Weild, E. Kim and L. Newport (Grant Thornton), THE TROUBLE WITH SMALL TICK SIZES, p. 16 (Sept. 2012), available at http://www.gt.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/Trouble_Small_Ticks.pdf (drop of over 43% of the number of public companies); A. Stuart, MISSING: PUBLIC COMPANIES, CFO.com (Mar. 22, 2011), http://www.cfo.com/article.cfm/14563859 (loss of 42% of public companies listed on major U.S. exchanges).

[3] *See*, *e.g.*, Chamber, Letter to SEC Chairman Mary Schapiro (May 30, 2012), attached as Exhibit 2 (discussing inherent conflict of Glass Lewis recommending a favorable vote on activist measures undertaken by its owner, the Ontario Teachers' Pension Plan); *see also*, Chamber, Letter re SEC Concept Release on the U.S. Proxy System, SEC File No. S7-14-10 RIN 3235-AK43, attached as Exhibit 3.

[4] *See generally* J. Glassman & J. Verret, HOW TO FIX OUR BROKEN PROXY ADVISORY SYSTEM, Mercatus Center, George Mason University ("Mercatus Paper") (Apr. 16, 2013), available at http://mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf (highlighting significant concerns regarding the role of proxy advisory firms in the U.S. capital markets). The European Securities and Markets Authority ("ESMA") has focused substantial attention on proxy advisory firms in recent years. In March of 2012, ESMA published "Discussion Paper: An Overview of the Proxy Advisory Industry, Considerations on Possible Policy Options," available at http://www.esma.europa.eu/system/files/2012-212.pdf. More recently, on February 19, 2013, ESMA published its "Final Report on The Proxy Advisor Industry," available at http://www.esma.europa.eu/system/files/2013-84.pdf. These publications identify European regulatory concerns regarding the independence of proxy advisory firms, as well as the accuracy and reliability of the advice these firms provide, as problems that warrant the formation of an industry-wide EU Code of Conduct to identify, disclose and manage conflicts of interest and otherwise enhance transparency and integrity in the proxy advice industry. In addition, on June 21, 2012, the Canadian Securities Administrators ("CSA") voiced its concerns regarding the proxy advisory industry. *See* Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms, available at http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20120621_25-401_proxy-advisory-firms.htm, and called for discussion aimed at resolving a variety of concerns, including (1) potential conflicts of interest; (2) lack of transparency; (3) potential inaccuracies and limited opportunity for issuer engagement; (4) perceived corporate governance implications; and (5) extent of reliance by institutional investors.

industry[5] are based on core tenets—transparency, accountability, and adherence to the letter and spirit of fiduciary duties—that are critical for, but frequently absent from, the practices of the dominant companies comprising this industry.

The conflicts of interest that compromise the efforts of the dominant proxy advisory firms pose a glaring hazard to shareholders, because proxy advisory firms have exercised disproportionate influence over the proxies cast by some institutional investors on behalf of these institutions' investors, often at the same time these proxy advisory firms receive compensation from the same public companies about which they are recommending voting positions to their investment portfolio management organization clients.

Proxy advisory firms are unregulated; more significantly, they operate without any applicable standards—either externally-imposed or self-imposed—and do not formally subscribe to well-defined ethical precepts, while cavalierly rejecting private sector requests for transparency in the formulation of their proxy advice, as well as increased accountability for the recommendations they make. This lack of any operable framework for such a powerful presence on economic growth and corporate governance is unprecedented in our society.[6]

Moreover, regulatory bodies have observed the growing impact of proxy advisory firms on U.S. corporate governance, combined with the lack of any coherent articulation of standards to which these firms adhere, but have not spoken definitively—in any official pronouncement—about the need for standards to govern the activities of proxy advisory firms, the importance of assuring fidelity to fiduciary principles by these entities, or the troublesome and pervasive conflicts of interest that encumber the dominant proxy advisory firms and plague recommendations they make.[7]

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[5] Two proxy advisory firms—Institutional Shareholder Services Inc. ("ISS") and Glass Lewis & Co., LLC ("Glass Lewis")—together comprise about 97% of the proxy advisory business. *See* Mercatus Paper*,* supra n. 4, at p. 8 (noting that ISS and Glass Lewis possess, respectively, a 61 percent and 36 percent market share of the proxy advisory business). Moreover, it has been estimated that ISS and Glass Lewis effectively "control" 38% of the institutional shareholders' vote, *see* Ertimur, Yonca, Ferri, Fabrizio and Oesch, David, SHAREHOLDER VOTES AND PROXY ADVISORS: EVIDENCE FROM SAY ON PAY, 7th Annual Conference on Empirical Legal Studies Paper (Feb. 25, 2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2019239.

[6] Indeed, even the press, which is subject to First Amendment protections against the government's abridgement of the right of free speech, has subjected itself to both industry standards and individually imposed ethical and transparency requirements. *See*, *e.g.,* The Society of Professional Journalists Code of Ethics, available at http://www.spj.org/ethicscode.asp (instructing journalists to "avoid conflicts of interest, real or perceived; Remain free of associations and activities that may compromise integrity or damage credibility" and to "disclose unavoidable conflicts").

[7] The Securities and Exchange Commission ("SEC")—a logical agency to provide some guidance and direction for proxy advisory firms—has noted the importance of proxy advisory firms and promised to address the issues

To address this lack of articulated core principles and best practices, in March of this year, the Chamber published its *Best Practices and Core Principles for the Development, Dispensation and Receipt of Proxy Advice* (*Chamber Principles*),[8] a project on which I was privileged to participate. At a minimum, the *Chamber Principles* provide a crucial predicate for a private sector dialogue on these issues and, more broadly, provide constructive guidance for collaborative private sector efforts to repair this broken system.

Background

As the Subcommittee is well aware, investors invest capital in public companies with the expectation they will receive a positive return on their investment and be entitled, under applicable state corporation law and fundamental corporate foundational documents—charters and by-laws—to elect directors and to approve or disapprove proposals relating to the governance of the corporations in which they have invested.[9] Day-to-day management of public companies is left—as it must be—with company management, overseen by the company's board of directors.

Individual—or so-called "retail"—shareholders have the right to vote for directors and on shareholder proposals, based on the number of shares they own, but

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surrounding their activities. *See* SEC Concept Release on the U.S. Proxy System at 105-26 (July 14, 2010), available at http://www.sec.gov/rules/concept/2010/34-62495.pdf (discussing "concerns about the role of proxy advisory firms"—specifically, "conflicts of interest" and "lack of accuracy and transparency in formulating voting recommendations"). And, it has indicated that proxy advisory firms will be part of its regulatory agenda, *see* SEC Agency Financial Report for FY 2012 at 31, available at http://www.sec.gov/about/secpar/secafr2012.pdf#2012review (noting that, "in FY 2013, the SEC will develop recommendations for an interpretive release addressing issues raised in the July, 2010 'Proxy Plumbing' concept release about proxy advisory firms"); E. Chasan, SEC PLANS NEW GUIDANCE ON PROXY ADVISERS, CFO Journal (June 7, 2012) (stating that the then-Director of SEC's Division of Corporation Finance, said that, after the 2012 proxy season, "the SEC staff will look at issuing fresh 'interpretive guidance' about the fiduciary duties investors have in assessing the information they get from proxy advisers and how those services handle conflicts of interest"), http://blogs.wsj.com/cfo/2012/06/07/sec-plans-new-guidance-on-proxy-advisers/, but has not fulfilled its stated intentions. Individual SEC members have spoken out about the lack of principled and conflict-free behavior by proxy advisory firms. *See*, *e.g.*, SEC Commissioner Daniel M. Gallagher, Remarks at 12th European Corporate Governance Law Conference (May 17, 2013), available at http://www.sec.gov/news/speech/2013/spch051713dmg.htm; SEC Commissioner Troy A. Paredes, Remarks at Society of Corporate Secretaries & Governance Professionals, 66th National Conference on "The Shape of Things to Come" (July 13, 2012), available at http://www.sec.gov/news/speech/2012/spch071312tap.htm#P39_14566.

[8] A copy of the *Chamber Principles* is attached as Exhibit 4.

[9] Until 2002, and the passage of the Sarbanes-Oxley Act of 2002, Pub.L. 107–204, 116 Stat. 745, the laws of a corporation's state of incorporation governed the substantive rights of shareholders, while federal law governed the disclosures required when public companies solicit shareholder votes, and the methodology by which those votes are solicited. Sarbanes-Oxley's encroachment on states' substantive provision of shareholder rights was considerably expanded by the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub.L. 111–203, H.R. 4173 ("Dodd-Frank Act"). Many corporate governance issues are presented to public company shareholders in the form of so-called shareholder proposals, and are governed by SEC Rule 14a-8(d), 17 C.F.R. §240.14a-8(d).

are not obligated to do so. For a variety of reasons, retail shareholder participation in director elections and shareholder proposals has declined markedly over the years, in some cases constituting no more than five percent of the total votes held by retail investors.[10]

In contrast, institutional investors,[11] or those who pool funds of similarly-situated individuals and invest those funds with the expectation of producing a positive return for the investors whose funds they manage, are legally obligated to vote shares under their management in director elections and with respect to shareholder proposals. Some institutional investors—SEC-registered investment advisers—are specifically required to promulgate policies describing how they will vote the shares of public companies subject to their management and, a considerable period of time after votes have been cast, must disclose how they actually voted those shares.[12]

Institutional investors and institutional portfolio managers routinely invest in the equity securities of hundreds, if not thousands, of public companies. Institutional portfolio managers owe fiduciary duties of loyalty and care to the investors whose assets they manage, with respect to all activities undertaken on behalf of their clients, including exercising proxies for the portfolio securities they manage. The requisite due diligence to fulfill the fiduciary duties associated with proxy voting—learning and understanding the issues around director elections and shareholder proposals, and determining the voting position that will best further the interests of their investors—is complex, costly, and burdensome.

Thus, investment portfolio managers that exercise delegated authority to vote proxies involving public companies held in the investment portfolios they manage, often retain proxy advisory firms to assist them in appropriately exercising their important voting responsibilities and ascertaining how best to satisfy their fiduciary obligations. Proxy advisory firms provide that assistance in various forms, including

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[10] *See, e.g.*, F. Saccone, E-PROXY REFORM, ACTIVISM, AND THE DECLINE IN RETAIL SHAREHOLDER VOTING, The Conference Board Directors Notes No. DN-021 at 4 (Dec. 26, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1731362 (quoting a 2008 speech by then-SEC Commissioner Paul Atkins that noted the number of retail accounts voting, where e-proxy was used, was 5.7%, and citing to data from 2009 and 2010 demonstrating that those retail voting accounts that received notice of a proxy vote (instead of the full proxy materials) voted between 4 and 5 % of the time.

[11] Institutional investors include insurance companies; private pension funds; corporate, state, municipal and labor union pension funds; commercial banks, educational and other endowment funds, trust funds; collective investment funds; trust funds; hedge funds, SEC-registered investment advisers, private equity funds; state-registered investment advisers; venture capital funds; and mutual funds.

[12] *See* SEC Investment Advisers Act Rule 206(4)-6, 17 C.F.R. §80b-206(4)-6.

analyzing voting issues and/or providing specific voting recommendations; these firms frequently manage all aspects of the proxy process for their investment portfolio manager clients. Specifically, proxy advisory firms may:

- Research portfolio companies, including issues of relevance to director elections and shareholder proposals;
- Provide voting recommendations; and
- Cast actual votes for their clients.

Investment portfolio managers utilize one or all of these proxy advisory services.

<u>Proxy Advisory Firms</u>

Two firms—ISS and Glass Lewis—dominate the proxy advisory industry. Together, they control 97% of the proxy advice market.[13] More significantly, it has recently been estimated that ISS and Glass Lewis "control" 38% of the shareholder vote.[14] This means that, an identical ISS and Glass Lewis recommendation will move 38% of the shareholder vote, absent a vocal campaign against that position. This is an obvious reflection of the fact that ISS' and Glass Lewis' institutional clients frequently follow those firms' recommendations automatically. Unfortunately, advice provided by ISS and Glass Lewis is not tailored to the interests of the shareholders of each firm's investment portfolio manager clients, nor is it formulated with any consideration of the stated policies and purposes of the portfolios housing the equity securities to which the recommendations relate.

Given the huge percentage of the vote likely controlled by ISS and Glass Lewis, the failure of an issuer to comply with those firms' preferred policies saddles issuers with a large number of negative votes *before voting has even begun*. Proxy advisors, therefore, also can affect valuations and the ultimate outcomes of contests and specific transactional matters. ***As a result, ISS and Glass Lewis have become the de facto standard setters for corporate governance policies in the U.S.***

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[13] *See* n. 5, *supra*. There are other firms, such as Egan-Jones Proxy Services Inc. ("Egan Jones"), that provide a full array of proxy advisory services, as well as companies that provide research only, such as Manifest Information Services Ltd.,, although these firms have negligible market presence.

[14] ISS reportedly influences 24.7% of the votes cast, and Glass Lewis reportedly influences 12.9% of the shareholder vote. *See* n. 5, *supra*.

A recent example of the significant power wielded by these two firms is worth highlighting for the Subcommittee. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) includes a provision requiring shareholders of public companies to be given a non-binding, advisory, vote on executive compensation, otherwise known as "Say on Pay."[15] In doing so, Congress explicitly provided that shareholders should determine whether the frequency of such "Say on Pay" votes should occur at intervals of one, two or three years.

Putting to one side whether Congress should have mandated shareholder votes on executive compensation, this Dodd Frank Act provision's structure permitted shareholders to determine the frequency of such votes best fitting each public company's needs, affording them the flexibility to match the shareholders' advisory vote with the term of the company's compensation packages, normally three years. ISS and Glass Lewis announced an ironclad recommendation that, in *all instances* the frequency of "Say on Pay" votes should be yearly. The advisory firms did this without any evidence whether a particular frequency of voting cycle would provide better shareholder return than a different cycle, or whether differences among companies might warrant a frequency cycle longer than one year.

A frequency cycle of one year means that institutional investors must re-evaluate their portfolio companies' compensation practices every year, even if particular portfolio companies fix their executives' compensation on a three-year review cycle. Apart from the utter waste and meaninglessness fostered by the iron-clad ISS/Glass Lewis position on this issue, the one year cycle they vigorously recommended, by definition, means that most, if not all, of the two firms' institutional portfolio manager clients will need to retain ISS and Glass Lewis to fulfill their obligation to vote yearly on executive compensation.

Interestingly, there was no disclosure by ISS or Glass Lewis of their conflict of interest in recommending an iron-clad one-year voting cycle on executive compensation for every single public company. This lack of disclosure could have occurred for one of two reasons—either one or both firms were totally insensitive to their conflict of interest in recommending an annual vote on this issue, or one or both were aware of the conflict but decided not to disclose it. Either way, their failure to disclose the conflict inherent in their recommendation is itself damning evidence of the need for even minimal standards to govern how proxy advisory firms render their services.

[15] Dodd-Frank Act §951 (adding new §14A(a) to the Securities Exchange Act of 1934).

Of course, by recommending a one-year frequency vote, ISS and Glass Lewis have likely procured additional advisory business yearly. Moreover, in making a one-size-fits all recommendation that a "Say on Pay" vote must be held annually for all companies, ISS and Glass Lewis thwarted the public policy determination Congress made to permit shareholders to tailor the frequency of this vote to the circumstances of each company. It is not often that any industry in our society has the ability, single-handedly, to override Congressional policy. More importantly, the ISS/Glass Lewis recommendations effectively eviscerated the ability of corporate shareholders to debate and decide the issue.

This was all done without any study or empirical evidence on how the frequency of "Say on Pay" votes affects shareholder values, either in general or vis-à-vis specific companies. In fact, a recent study by the Center for Corporate Governance at Stanford University's Graduate School of Business concluded that proxy advisory firms' preferred compensation policies actually have a *negative* effect on share value.[16] Nevertheless, because of ISS' and Glass Lewis' recommendations, Dodd-Frank Act was rewritten to provide for a universal one year "Say on Pay" votes.[17]

Despite this market dominance and influence on corporate governance policies, the proxy advisory industry has been beset by problems, enmeshed in frequent conflicts of interest and generally shown great resistance to standards that might improve their performance and avoid eventual governmental oversight.[18] The lack of transparency and accountability of proxy advisory firms is a troubling trend that undermines confidence in, and stalls progress of, strong corporate governance. The role of proxy advice has become increasingly important as the number and complexity of issues on proxy ballots has grown exponentially. And yet, proxy advisors have not taken steps to ensure their voting recommendations are developed based on clear, objective, and empirically-based corporate governance standards to help management and investors evaluate and improve corporate governance as a means of increasing shareholder value.

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[16] D. Larker, A. McCall and G. Ormazabal, THE ECONOMIC CONSEQUENCES OF PROXY ADVISOR SAY-ON-PAY VOTING POLICIES, Stanford Graduate School of Business Research Paper No. 2105 (July 5, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2101453.

[17] In theory, individual public companies could have waged campaigns against the ISS/Glass Lewis position of a universal one-year frequency cycle for Say on Pay votes, but the costs of waging such a campaign would have been prohibitive, especially given the likelihood that at least 38% of the votes were initially aligned against such a campaign. While Congress does not subject its legislative efforts to a meaningful cost-benefit analysis, this is one area where the Country could have benefitted from such an analysis.

[18] *See* ISS Response to the U.S. Chamber of Commerce's Guidelines for Proxy Advisory Firms (Mar. 21, 2013), available at http://www.issgovernance.com/press/issresponsechamberofcommerce.

While ISS and Glass Lewis purport to be striving for transparency and accountability in the corporate governance ***of others***, these firms show no inclination toward applying to themselves the same standards they recommend others follow. Transparency and accountability are missing vis-à-vis the way ISS and Glass Lewis develop voting policies and recommendations. Thus, for example, although ISS is a *de facto* governance standard setter for corporate America, akin to the accounting pronouncements of the Financial Accounting Standards Board, ISS does not follow even the more mundane and ministerial general procedures or guidelines all legitimate and non-self-anointed private sector and governmental standard setters follow when ISS changes its annual voting policies, such as a providing a public comment and notice period. Without adequate procedures, it is unclear who (and what) really drive ISS' policy updates. Additionally, ISS' almost simultaneous release of voting policies with the closure of an unnaturally short comment period call into question whether letters submitted to ISS by public stakeholders are understood, considered, or even read.

Similarly troubling, ISS may afford larger companies twenty-four hours to review and respond to company-specific recommendations, but other companies are provided absolutely no opportunity to review or respond to these company-specific recommendations whatsoever.[19] There is no basis for this discriminatory practice on ISS' part. Indeed, it could be argued that most of its clients have the capacity to ferret out information about the largest public companies by themselves, whereas very few—if any—would have the ability to find out much about smaller companies that ISS totally excludes from any participation in ISS' fact-finding and formulation of recommendations.[20]

Glass Lewis, in turn, is a "black box" that does not permit any type of input or dialogue into its fact-finding and recommendation-formulation processes. Nor does Glass Lewis conduct a general public review of its policy positions and updates.

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[19] To follow-up on an active dialogue that the Chamber had fostered with corporate secretaries and ISS to correct some of these flaws, the Chamber in 2010 wrote to ISS and the SEC with a proposal to inject transparency and accountability into this system by creating Administrative Procedure Act-like processes for voting policies and recommendations. *See* memorandum from U.S. Chamber of Commerce to ISS (August 4, 2010), available at http://www.sec.gov/comments/s7-14-10/s71410-268.pdf. This would have allowed for an open dialogue in which all stakeholders could have participated, and would have better informed ISS of circumstances material to the interests of its clients. To date ISS has not acted or commented on these recommendations.

[20] One could speculate that the reason ISS denies smaller public companies any opportunity to comment is that such smaller firms are less likely than larger companies to become ISS clients. Another speculative rationale for it approach may be that ISS does not devote adequate resources to researching smaller public companies, perhaps utilizing generic policy positions to formulate its recommendations; if that were the case, permitting comment by smaller companies might consume energies and resources ISS is unwilling to expend in formulating its positions with respect to such smaller-sized companies.

Rather, for most observers, the first glimpse of Glass Lewis' annual policy updates occurs *after* Glass Lewis' policies have already been finalized. It is of enormous concern as well that Glass Lewis does not provide public companies with the chance to review and respond to recommendations.

The stakes for many public companies are quite high—director elections, major corporate transactions and significant shareholder proposals all can have an enormous impact on the companies confronting those issues and, even more importantly, can have a profound effect on the shareholders who have invested in those companies. By refusing to provide any input whatsoever into its positions, Glass Lewis appears affirmatively to embrace the notion that it would rather base its position on factual errors than take the time to ensure that its positions are based on factually correct premises. No other industry—whether its members are government regulated or merely faithful to industry best practices—could survive such a cavalier disrespect for factual accuracy, fairness and transparency.

ISS and Glass Lewis also are subject to potential conflicts of interest that impair the reliability, fairness and accuracy of their recommendations. ISS operates a consulting division that provides advice to the same public companies about which ISS opines and influences institutional votes, including selling advice on the ways these companies can achieve better ISS corporate governance ratings. In fact, ISS' ownership of this consulting arm—accepting fees from both the institutional investors who receive their voting advice as well as from the public companies that are the subject of their voting advice—has been a focal point for criticism of the conflicts of interest inherent in this business model, including criticism from the firm's former CEO.[21]

It should also be mentioned that ISS s, when making recommendations on a shareholder proposal of competing slates of directors, do not disclose if the proponent of the proposal or slate is a client.[22]

Notably, just two weeks ago, ISS settled SEC charges that ISS' failure to establish or enforce written policies and procedures enabled an ISS employee to provide information to a proxy solicitor concerning how more than 100 of ISS' institutional shareholder advisory clients were voting their proxy ballots. Without admitting or denying the allegations, the firm agreed to pay a $300,000 fine and to

[21] M. Murphy, "Nell Minow Says Governance Has a Long Way to Go," CFO Journal (June 26, 2012), available at http://blogs.wsj.com/cfo/2012/06/26/nell-minow-says-governance-has-a-long-ways-to-go/?mod=wsjpro_hps_cforeport.

[22] *See* Glass Lewis Conflict of Interest Statement, available at http://www.glasslewis.com/about-glass-lewis/disclosure-of-conflict/.

engage an independent compliance consultant to review its supervisory and compliance policies and procedures.[23] Although virtually all business enterprises have policies regarding the handling of the type of information that the ISS employee misused, ISS' failure to adopt such procedures and policies is consistent with its long-standing opposition to developing reasonable policies and procedures regarding any aspect of its proxy advisory activities.

It is also significant that Glass Lewis is owned by an activist institutional investor—the Ontario Teachers' Pension Plan—and yet Glass Lewis takes positions on the precise issues its parent company forcefully advocates for public U.S. companies. The Chamber has written the SEC on several occasions regarding the apparent conflict of interest presented by the issuance of Glass Lewis recommendations in favor of activist measures undertaken by its owner.[24] To date, however, the SEC apparently has taken no action in response to these events, and has not provided the Chamber with a substantive response. The Chamber also wrote to the Department of Labor (DOL), asking that it also look into these matters, as the advice ERISA pension funds receive must be linked to shareholder return and free of potential conflicts of interest.[25] To date, the DOL apparently has taken no action in response to these events, and also has not provided the Chamber with a substantive response.

Concerns also have been raised that certain politically-motivated clients of both ISS and Glass Lewis disproportionately influence those firms' vote recommendations, and the policies they are based on, to advance a political agenda that is not geared towards improving shareholder return.[26] This is particularly troublesome, given the recent rise in the number of shareholder proposals related to political spending disclosures. The concern here is that certain politically-motivated shareholders may be attempting to use corporate governance processes to silence corporate speech, rather than to increase shareholder returns, and ISS and Glass Lewis may be

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[23] *In the Matter of Institutional Shareholder Services Inc*., Inv. Advisers Act Rel. No. 3611 (May 23, 2013), available at http://www.sec.gov/litigation/admin/2013/ia-3611.pdf.

[24] *See* Letter from Tom Quaadman to SEC Chairman Mary Schapiro (May 30, 2012), available at http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/2012-5.30-Glass-Lewis-letter-release.pdf; Letter from Tom Quaadman to SEC Chairman Mary Schapiro (Sept. 12, 2011), available at http://www.sec.gov/comments/s7-14-10/s71410-301.pdf.

[25] *See* Letter from Tom Quaadman to Assistant Secretary of Labor Phyllis Borzi (June 25, 2012), available at http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/2012-6.25-DOL-Letter-re-Glss-Lewis-Canadian-Pacific.pdf.

[26] *See* J. Glassman & J. Verret, FIXING THE BROKEN PROXY SYSTEM, Bloomberg (Apr. 23, 2013), available at http://www.bloomberg.com/news/2013-04-23/proxy-firm-debacle-can-be-reversed.html.

affirmatively embracing those efforts, rather than focusing their efforts on improving shareholder results.

Additionally, serious questions have been raised about the quality and rigor of the research undertaken by proxy advisory firms. For instance, ISS apparently employs 180 analysts to evaluate 250,000 issues, spread over thousands of companies, within a six-month period known as proxy season.[27] As noted above, "Say on Pay" votes have become an annual event for U.S. public companies, and thus an annual recommendation for proxy advisory firms. In forming its "Say on Pay" recommendations, ISS compares companies' compensation levels against groups of companies that ISS deems to be the comparable.

But, ISS does not disclose how it develops these so-called "peer groups," or the criteria on which these "peer groups" are predicated. Not surprisingly, these "peer groups" have generated heavy criticism due to the inconsistent standards utilized to form them, and the inaccurate bases on which these so-called "peer groups" are predicated.[28] This criticism is not without legitimacy, as hotels have found their ISS-selected "peers" to include automotive-parts companies and holding companies involved in numerous business segments.[29] Indeed, during the last full proxy season, ISS's poor "peer group" formulations, combined with its unwillingness to amend poorly constructed and unrepresentative "peer groups," prompted a number of companies to take the extraordinary step of filing additional proxy materials following receipt of ISS's report to educate investors on the inappropriateness of the "peer group" chosen by ISS.[30]

These issues with proxy advisory firms have set back the cause of good corporate governance and, if unaddressed, may have the potential to reverse otherwise

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[27] *Chamber Principles* at 3, available at http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Best-Practices-and-Core-Principles-for-Proxy-Advisors.pdf.

[28] *See*, *e.g.*, P. Park, CORPORATE GOVERNANCE WATCH: COMPANIES CRITICIZE ISS OVER PEER GROUP SELECTION METHODOLOGY, Business Law Currents, Thomson Reuters Westlaw (May 17, 2013), http://currents.westlawbusiness.com/Article.aspx?id=444afa88-6898-4913-bece-8233280a2390&cid=&src=&sp=.

[29] *See* E. Chasan, WATCHDOG CHALLENGED OVER PAY BENCHMARKS, CFO Journal (May 8, 2012) available at http://blogs.wsj.com/cfo/2012/05/08/watchdog-challenged-over-pay-benchmarks/; *see also See*, *e.g.*, P. Park, CORPORATE GOVERNANCE WATCH: COMPANIES CRITICIZE ISS OVER PEER GROUP SELECTION METHODOLOGY, *supra* n. 29 (criticizing ISS' selection of "peer groups," such as a coal company and transportation company as peers for an oil and gas storage company); S. Quinlivan, ISS' PEER GROUPS BEGIN TO SPUR COMPLAINTS, Making Sense of Dodd-Frank, DODD-FRANK.COM (Mar. 23, 2012), available at http://dodd-frank.com/iss%E2%80%99-peer-groups-begin-to-spur-complaints/

[30] *See e.g.*, J. Barrall, PROXY SEASON 2012: THE ROLE OF SUPPLEMENTAL PROXY SOLICITATIONS, Los Angeles & San Francisco Daily Journal (June 18, 2012), available from http://www.lw.com/thoughtLeadership/proxy-season-2012-supplemental-proxy-solicitations.

positive advances in corporate governance, such as increased communications and the empowerment of directors and shareholders that have occurred over the past few decades.

<u>Relevant Factors</u>

Rule 206(4)-6

In 2003, while I was the Chairman of the SEC, the Commission adopted Investment Advisers Act Rule 206(4)-6, requiring registered investment portfolio management organizations to adopt and disclose policies regarding how portfolio managers would vote the securities in their various managed portfolios. The Commission specifically noted that an investment portfolio manager's fiduciary duties encompassed the voting of portfolio securities. In so doing, the SEC recognized that investment advisers, either directly or indirectly through affiliates, may have relationships with issuers that could potentially influence the decision-making of the investment adviser in exercising client proxy votes, thereby compromising the adviser's independence and violating the adviser's fiduciary duty to act in the best interests of its clients.

Notably, the SEC's only mention in its release proposing the adoption of Rule 206(4)-6 of proxy advisory firms was indirect, and was made in reference to the investment adviser policies, indicating that

> [t]he extent to which the adviser relies on the advice of third parties or delegates to committees should also ordinarily be covered by the policies.[31]

Consistent with the extremely limited attention in the Rule 206(4)-6 Proposing Release dedicated to proxy advisory firms, the Commission's release announcing the adoption of the Rule included only a single sentence referencing an investment adviser's use of a proxy advisory firm; it noted that

> [a]n adviser could demonstrate that [its] vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-

[31] Proxy Voting by Investment Advisers Proposed Rule at II.A.2. Rel. No. IA-2059; File No. S7-38-02 (Sept. 20, 2002), available at http://www.sec.gov/rules/proposed/ia-2059.htm.

> determined policy, based upon the recommendations of an independent third party.[32]

The "conflict of interest" referred to was the possible conflict between an investment adviser and a third party—to wit, the focus of Rule 206(4)-6 more generally—not to a possible conflict between the third party and the corporate issuer. Indeed, at the time, I discussed the catalyst for this rule being potential conflicts of interest that mutual fund investment advisers face in voting their shares. Specifically, I explained that,

> because the securities are held for the benefit of the investors, they deserve to know the fund's proxy voting policies and whether [those policies] were in fact followed. Many wield voting power in the face of conflicts; they may cast votes furthering their own interests rather than those for whom they vote.[33]

The Staff's "No-Action" Letters

After my tenure as Chairman ended, in 2004, the SEC Staff profoundly changed the requirements of Rule 206(4)-6 by issuing a "no-action letter" to Egan-Jones (Egan-Jones No-Action Letter) on May 27, 2004,[34] as supplemented by a subsequent "no-action letter" issued to ISS (ISS No-Action Letter) on September 15, 2004 (collectively, No-Action Letters).[35] As a practical matter, the No-Action Letters had the legal effect of permitting registered investment advisers to rely exclusively on a proxy advisory firm's ***general*** policies and procedures pertaining to conflicts of interest—as opposed to any specific conflicts a proxy advisory firm might have with respect to a particular issue or a particular company about which the proxy advisory firm might make a recommendation—to determine if the proxy advisory firm was independent and could be relied upon to cast a vote for the investment adviser, without the adviser being deemed to have violated Rule 206(4)-2 of the Investment Advisers Act or any other provision of the federal securities laws.

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[32] Proxy Voting by Investment Advisers Final Rule at II.A.2.b., 17 CFR 275, Rel. No. IA-2106, File No. S7-38-02 (Mar. 10, 2003), available at http://www.sec.gov/rules/final/ia-2106.htm.

[33] Chairman Harvey L. Pitt, SEC, "Speech by SEC Chairman: Remarks at the Commission Open Meeting," (Jan. 23, 2003), http://www.sec.gov/news/speech/spch012303hlp.htm.

[34] Egan-Jones Proxy Services, SEC No-Action Letter (May 27, 2004), *available at* http://www.sec.gov/divisions/investment/noaction/egan052704.htm.

[35] Institutional Shareholder Services, Inc., SEC No-Action Letter (Sept. 15, 2004), *available at* http://www.sec.gov/divisions/investment/noaction/iss091504.htm.

In its Egan-Jones No-Action Letter, the SEC Staff indicated that recommendations of a third party proxy advisory firm that is independent of an investment adviser "may cleanse the vote" cast by an investment adviser of any conflict the adviser otherwise might have. In addition, the Staff announced, as a general rule that, "the mere fact that the proxy advisory firm provides advice on corporate governance issues and receives compensation from the Issuer for these services generally would not affect the firm's independence from an investment adviser." The Staff noted, however, that an investment adviser "should take reasonable steps to verify that the third party is in fact independent of the adviser based on all of the relevant facts and circumstances."

Soon thereafter, ISS sought clarification of the Egan-Jones No-Action Letter by asking if an investment adviser could satisfy the independence requirement of Rule 206(4)-6 if it "determines the impartiality of a proxy voting firm based on the firm's ***overall*** policies and procedures rather than on an examination of the proxy voting firm's ***specific*** relationships with individual issuers" (emphases supplied). The Commission's staff responded to ISS by providing the requested assurances that an investment adviser may, without violating Rule 206(4)-6, rely exclusively on a proxy advisory firm's general conflict policies and procedures in determining the firm's impartiality to make recommendations. Departing from the Staff's Egan-Jones letter, the SEC Staff advised ISS that "a case-by-case evaluation of a proxy voting firm's potential conflicts" is not necessary, and that an investment adviser could determine the independence of a proxy advisory firm "based on the firm's conflict procedures," without more.[36]

The No-Action Letters effectively instruct that, if investment advisers rely on recommendations of proxy advisory firms, they need not concern themselves about conflicts of interests regarding the advisory firms' specific relationships with issuers about whom the proxy advisory firms are making recommendations. While the Chamber is reviewing these issues in relation to proxy advisory firms, in other contexts the Chamber has raised concerns regarding Staff developed policies that have not been not approved by the SEC Commissioners, nor been vetted through normal Administrative Procedure Act processes, including a cost benefit analysis.

[36] The No-Action Letters are not typical SEC no-action letters, which the SEC has generally limited to informal guidance on particular circumstances and specific addressees. The SEC describes its typical no-action letter as a document "in which an authorized staff official indicates that the staff will not recommend any enforcement action to the Commission if the proposed transaction described in the incoming correspondence is consummated." SEC Rel. No. 33-6253, SEC Docket Vol. 21, No. 5 at 320-21 n.2 (Nov. 11, 1980). These letters contain no disclaimer that the Letters' contents are limited to the specific facts and circumstances presented in the requesting letters.

Chamber Principles

Given this background, and the current state of the proxy advisory industry, the Chamber believed it prudent to develop a set of core principles and best practices to serve as a basis for a dialogue among proxy advisory firms, the public companies about which they report, and investment portfolio manager organizations to which proxy advisory firms report. I was privileged to be an active participant in the development of the core principles and best practices the Chamber sought to memorialize. The ultimate goal of this effort is the development of a universally embraced private-sector system that brings transparency and accountability to the activities of proxy advisory firms, fosters strong corporate governance and ensures that benefitting public company shareholders is the paramount consideration of all operative participants in the proxy voting process.

The Chamber recognized that the best practices aspect of its efforts necessarily would require public discussion about this important component of corporate governance, and the Chamber Principles were designed to foster that public discussion and assist all participants in the proxy voting process in formulating sensible procedure to ensure that the interests of shareholders are paramount. Two proxy advisory firms exert enormous influence vis-à-vis corporate governance standards, principles, concepts, voting and have effectively become *de facto* corporate governance standard setters. The Chamber's principles are intended to focus attention on this fact and the consequences that flow from it. In addition, a critical Chamber goal is to educate the public and foster discussions regarding the current lack of standards for, and oversight of, proxy advisory firms, and the problems engendered as a result.

More regulation is not the answer. Nor is there a need for the SEC formally to "institutionalize" the Chamber Principles—the core principles already exist, as a matter of state and federal law. Rather, the Chamber believes that Congress and the SEC should encourage public companies, investors, and proxy advisory firms to engage in the necessary dialogue to create a system that will impose transparency and accountability on proxy advisory firms. This dialogue should build on other positive trends in the proxy system, including greater communication between companies and shareholders, and enhanced due diligence by asset managers in executing shareholder votes.

The Chamber has developed these best practices and core principles to improve corporate governance by ensuring that proxy advisory firms:

- Are free from conflicts of interest that could improperly influence proxy advisory firms' recommendations;

- Ensure that reports are factually correct and establish a fair and reasonable process for correcting errors;

- Produce vote recommendations and policy standards that are supported by data driven procedures and methodologies that tie recommendations to shareholder value;

- Allow for a robust dialogue between proxy advisory firms and stakeholders when developing policy standards and vote recommendations;

- Provide vote recommendations to reflect the individual condition, status and structure of each company and not employ one-size-fits all voting advice; and

- Provide for communication with public companies to prevent factual errors and better understand the facts surrounding the financial condition and governance of a company.

Conclusion

As I noted at the outset, I appreciate this opportunity to express my views on these important issues. We hope that Congress will support the Chamber's efforts to ensure transparency, accountability, and fairness in the activities of proxy advisory firms, and encourage all stakeholders to participate in this endeavor. We look forward to working with you on this important issue.

I stand ready to try to assist the Subcommittee in any way I can, and to respond to any questions the Members of the Subcommittee might have.