PROXY SEASON 2018

Examining Developments & Looking Forward

CENTER FOR CAPITAL MARKETS COMPETITIVENESS

Nasdaq

2018 PROXY SEASON SURVEY

Presented by:

CENTER FOR CAPITAL MARKETS COMPETITIVENESS

Momentum continues to grow for reform of the proxy advisory industry in the U.S. Despite being plagued by conflicts of interest, a lack of transparency, and prone to making significant errors in voting recommendations, proxy advisory firms continue to carry a significant amount of influence over the manner in which public companies are run.

Two proxy firms—Institutional Shareholder Services (ISS) and Glass Lewis —control roughly 97% of the proxy advisory industry, constituting a duopoly that have become the de facto standard setters for corporate governance in the U.S.

In recent years, problems with the proxy advisory industry have garnered the attention of U.S. and global regulators, Republican and Democrat members of Congress, institutional investors, academics, and others. Proxy advisory firms have been criticized on a number of issues:

- Rampant conflicts of interest that can impact the objectivity of voting recommendations made to institutional investors.
- A one-size-fits-all approach to voting recommendations that ignores the unique characteristics and operations of individual companies.
- A lack of willingness to constructively engage with issuers, particularly small and midsize issuers that are disproportionately impacted by proxy advisory firms.
- A lack of transparency throughout the research and development of voting recommendations.
- Frequent and significant errors in analysis and an unwillingness to address errors.

These issues with the proxy advisory industry are often cited as a challenge to the willingness of businesses to go and stay public. The U.S. is home to roughly half the number of public companies that existed 20 years ago, and reform of this industry is essential to reversing this troublesome trend. Having fewer public companies not only jeopardizes the growth prospects of businesses, but it limits the investment opportunities for Main Street investors who depend on vibrant public markets to create and sustain wealth.

Fortunately, problems with proxy advisory firms have not been lost on policymakers. In June 2014, the staff of the Securities and Exchange Commission (SEC) published guidance[1] owing to concerns surrounding the increasingly outsize role and influence of proxy advisory firms on corporate governance matters in the U.S. and globally. The guidance addressed issues and concerns raised by stakeholders and provided clarity about the SEC's Proxy Voting Rule[2] and the availability of exemptions for proxy advisory firms from the SEC's proxy solicitation requirements.

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1. The SEC Staff Guidance can be found at https://www.sec.gov/interps/legal/cfslb20.htm

2. Investment Advisers Act Rule 206-4(6)

In December 2017, the U.S. House of Representatives passed H.R. 4015, the Corporate Governance Reform and Transparency Act of 2017. This bipartisan legislation would require proxy advisory firms to register with the SEC and become subjected to a robust oversight regime. Given the amount of influence that proxy advisory firms have and the flaws in their business model, it is striking that this remains a significant segment of our economy with very little oversight. Under H.R. 4015, proxy advisory firms would have to disclose and manage any conflicts of interest, demonstrate they have the capability to provide sound research and recommendations, and provide public companies with sufficient time to respond to errors or flaws in voting recommendations.

In September 2018, the SEC took a significant step by withdrawing two no-action letters that were issued to ISS and Egan-Jones, another proxy advisory firm, in 2004. These no-action letters have had the practical effect of allowing investment advisers to outsource their voting responsibilities to proxy advisory firms, thereby increasing the amount of influence that ISS and Glass Lewis have over corporate governance. Withdrawal of these no-action letters is a necessary first step by the SEC that will facilitate further reforms.

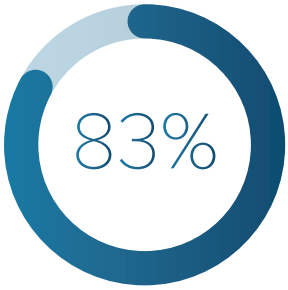
2018 PROXY SEASON SURVEY

The U.S. Chamber of Commerce's Center for Capital Markets Competitiveness (CCMC) and Nasdaq partnered again this summer for a survey of public company experiences with proxy advisory firms during the 2018 proxy season. This is the fourth annual CCMC/Nasdaq proxy season survey, and it is intended to help policymakers understand how public companies have navigated the 2018 season. One hundred sixty-five (165) companies completed this year's survey.

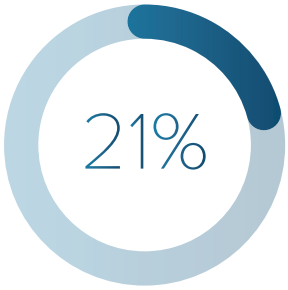
If there is a theme to the survey results this year, it is that notwithstanding the 2014 SEC guidance, few material improvements have been observed in the proxy advisory system. Companies are bringing more issues to the attention of proxy advisory firms, but they still find it difficult to engage in constructive discussions that lead to better informed voting recommendations. Conflicts of interest still pervade the industry, and many report a lack of transparency into how recommendations are developed. We believe that this survey will serve as an important tool to help inform policymakers about the next steps of reform for the proxy advisory industry.

Corporate Engagement with Proxy Advisory Firms — Requests Still Made to Engage but Little Change in Outcome

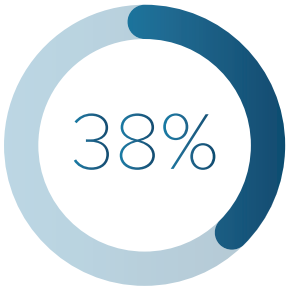
Ninety-two (92%) of companies surveyed had a proxy advisory firm make a recommendation on an issue featured in their proxy statements, nearly identical to 2017, but an 11% increase over 2016.



The vast majority (83%) of companies carefully monitor proxy advisory firm recommendations for accuracy or reliance on outdated information.



Twenty-one (21%) of the companies surveyed formally requested previews of advisor recommendations—a 9% decrease from 2017, but little changed from 2016. For companies that requested a preview, proxy advisory firms provided them only 44% of the time, a 4% drop from 2017.



Thirty-eight (38%) of the companies asked proxy advisory firms for opportunities to provide input both before and after the firms' recommendations were finalized. However, as in previous years, the amount of time companies were given to respond to recommendations varied. Companies again reported being given anywhere from 30 to 60 minutes to two weeks. In 2018, 1 to 2 days was a common response among companies.

Only thirty-nine (39%) of the companies believed that the proxy advisory firms carefully researched and took into account all relevant aspects of the particular issue on which it provided advice, up from 35% in 2017.

Twenty-nine (29%) of the companies pursued opportunities to meet with proxy advisory firms on issues subject to shareholder votes, a significant decrease from 52% in 2017. Of those companies that sought a meeting, their request was denied 57% of the time, significantly more often than in 2017. Companies reported mixed results from meetings they had.

Corporate Engagement With Investors and the SEC

- The number of companies reporting that they have some form of year-round, regulator communications program with institutional investors dropped from 91% in 2017 to 78% in 2018. However, many of these companies that have such a program find it extremely beneficial, with several having had one in place for years.

- When companies felt that they were not afforded adequate opportunities for input to a proposed proxy advisor recommendation, they notified the proxy advisory firm and portfolio managers 26% of the time, a small change from 2017.

- When companies believed that a proxy advisory firm relied on inaccurate or stale data, they alerted portfolio managers and/or the SEC 46% of the time, a 19% decrease from 2017 but nearly identical to the 2016 survey. As in previous years, for companies that alerted portfolio managers or the SEC, new reports are rarely issued.

- Companies advised proxy advisory firms and their clients if specific recommendations did not advance the economic best interests of shareholders 39% of the time, lower than 2017 but still higher than the 30% that reported doing so in 2016.

More Companies Bring Conflicts of Interest to the Attention of Proxy Advisory Firms

- Of the companies surveyed, 10% identified significant conflicts of interest at proxy advisory firms, and 21% of those that did find conflicts brought them to the attention of the firms—a 7% increase from 2017. A few companies said that ISS' business model, which includes both a research and a consulting arm, was inherently conflicted and in some cases have been approached by ISS' consulting arm soon after a negative recommendation was issued.

Continued Strong Support for the Corporate Governance Reform and Transparency Act

- An overwhelming 97% of companies support the Corporate Governance Reform and Transparency Act of 2017, which passed the House of Representatives in December 2017 and would require proxy advisory firms to register with the SEC.

Large Percentage of Shares Voted in Line With Proxy Advisory Firm Recommendations

- One perceived problem with the proxy advisory system has been a trend toward "robo-voting" where a company's outstanding shares are voted in line with an ISS or Glass Lewis recommendation in the 24-hour period after the recommendation is issued. With ISS, several companies reported that 10%-15% of their shares would vote automatically in line, while others estimated that between 25%-30% fell into that category. The problem seemed to be less apparent with Glass Lewis, with many companies reporting that less than 10% of their shares would be voted in line within 24-hours.

PROXY ADVICE **BEST PRACTICES**

The 2014 SEC Staff Guidance structures its substantive advice as responses to specific questions. The three constituency groups affected by the SEC Staff Guidance—proxy advisory firms, portfolio managers, and public companies—must focus their attention on five overarching principles:

Fiduciary duty

Fiduciary duties permeate and govern all aspects of the development, dispensation, and receipt of proxy advice. Some investors use proxy advisory reports as one data point among many in an independent process to determine how or when they should vote their shares. Unfortunately, other investors may outsource their voting to proxy advisory firms without any due diligence.

Shareholder value

Enhancing and promoting shareholder value must be the core consideration in rendering proxy voting advice as well as making proxy voting decisions.

Freedom from conflicts

The proper role of proxy advisory firms vis-à-vis proxy voting is to provide accurate and current information to assist those with voting power to further the economic best interests of those who entrust their assets to portfolio managers and are the beneficial shareholders of public companies. If proxy advisory firms exceed that role—for example, by effectively exercising or being granted a measure of discretion over how shares are voted on specific proposals, or by failing to make proper disclosure regarding specific conflicts of interest afflicting a proxy advisory firm in connection with voting recommendations it is making—the proxy advisory firms so employed, and those engaging them, incur serious legal and regulatory consequences.

Portfolio manager discretion

Clarity is provided regarding the scope of portfolio managers' obligations to exercise a vote on proxy issues, and the obligations emphasizes the broad discretion portfolio managers have—subject to appropriate procedures and safeguards—to refrain from voting on every, or even any, proposal put before shareholders for a vote.

Compliance

In light of the direction provided, proxy advisory firms and portfolio managers need to reassess their current practices and procedures and adopt appropriate changes necessitated by the SEC Staff Guidance, while public companies should be aware of the direction provided to other stakeholders and consider it when developing policies and practices.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