COMMENTS

of

THE WASHINGTON LEGAL FOUNDATION

to the

SECURITIES AND EXCHANGE COMMISSION

Concerning

ISSUES RAISED AT THE PROXY ADVISORY FIRM ROUNDTABLE (FILE NO. 4-670)

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Re: Comments on Issues Raised at the Proxy Advisory Firm Roundtable

Dear Commission:

The Washington Legal Foundation (WLF) thanks the Securities and Exchange Commission (SEC or "the Commission") for the opportunity to comment on the current state of proxy advisory firm use by investment advisers and institutional investors. Founded in 1977, WLF is a national 501(c)(3) law firm and policy center that advocates for free-market principles, limited and accountable government, individual rights, business civil liberties, and the rule of law through litigation, the dissemination of legal publications, and filing regulatory comments. WLF believes that free enterprise leads to a more prosperous and peaceful society.

WLF shares the Commission's concern for protecting the interests of shareholders and applauds the SEC's hosting of a roundtable on the important questions surrounding proxy advisory services (PAS) firms. WLF is interested in this topic precisely because of public policy concerns that the current proxy advisory services regime interferes with legitimate interests of shareholders of publicly traded companies, and we recognize that the Commission's primary

concern is the protection of these investors. WLF hopes these comments will assist the Commission in addressing these concerns, so that the true ownership rights of shareholders will not be warped by influences inconsistent with the economic interests of shareholders in maximizing share value.

I. Introduction

WLF has received complaints about the proxy-voting process and, in particular, about proxy advisory services firms several times in the past few months; concern about the current state of affairs appears to be mounting. In fact, this issue is among the top handful of items that WLF has heard about recently from the general counsel of publicly traded companies—and it is the single most frequently mentioned issue in the securities area. Complaints on this topic have been volunteered, were not solicited by WLF, and come from a wide variety of industries. We believe the increasing distress arising from this issue derives in part from a belief that PAS firms are taking positions on an array of public policy issues that are not in the best interests of the shareholders.

More and more publicly traded companies find themselves incurring costs for proxy fights over corporate governance issues, as well as scores of issues that have little or nothing to do with effective governance of these companies. Even where there is not an actual proxy fight in the classic sense, companies are incurring burgeoning costs for investor relations teams that are not focused on economic issues, but rather on social or other concerns that would not be the subject of discussion with their investors but for the stances taken by the PAS firms. Entities like Glass Lewis & Co. and Institutional Shareholder Services (ISS), which together control some

97% of the proxy advisory services market, increasingly hamper management's ability to forestall proxy controversies and focus on issues truly affecting shareholder value. WLF believes that time-consuming shareholder proposals distract attention and drain resources away from productive activities that would both add to the company's bottom line and redound to the benefit of shareholders. Because PAS firms recommend votes that tend to increase the percentage of shareholders voting against the recommendations of management, they exacerbate the proliferation of proxy-voting issues with which management has to contend.

All of this unwelcome interference might be warranted if it boosted shareholder returns—or even if it had increasing shareholder returns as its primary purpose. But it is not at all clear that this proxy-voting trend serves shareholder interests. As NASDAQ *OMX* (the public company that owns NASDAQ) General Counsel Edward Knight points out: "[T]here is evidence that the [PAS] Firms not only increase the costs of being a public company, but also create disincentives for companies to become public in the first place."[1] Furthermore, in some cases, a PAS firm will take a position running counter to the economic interest of shareholders (because the proposals would raise the cost of doing business without a commensurate return on the redirected dollars). Such adverse positions are more likely where no requirement exists for the PAS firm to be transparent about how it determines that its recommendations are in the best interests of shareholders, or even to disclose the reason for its decision, as other proxy solicitors—including the company itself—must do.

The problems with the existing proxy-voting regime fall into three broad areas. First, the current structure has not resolved the conflict of interest problems that supposedly justified the

[1] Edward Knight, Executive Vice President, General Counsel, and Chief Regulatory Officer of NASDAQ *OMX* in Oct. 8, 2013 letter to the SEC. http://www.sec.gov/rules/petitions/2013/petn4-666.pdf

creation of the regime in the first instance. Second, perhaps as an unintended consequence of the way the system was devised, PAS firms flood the marketplace with bad information and do so with impunity. Third, the process forces votes (and encourages vote recommendations by PAS firms) on subjects outside the competence of the firms to handle. The remainder of this comment will spell out these broad areas of concern in greater detail and suggest some possible remedies for the Commission's further consideration.

II. The Problems with the Existing Proxy Voting Regime

A. Conflicts of Interest Persist

Perhaps the most significant single indictment of the current proxy advisory regime is that it fails to solve the very problem it was created to address. The current problem began when, in an effort to curtail potential conflicts of interest, the Commission imposed a new rule in 2003—the "Proxy Voting by Investment Advisers" rule—that required entities such as institutional investors and investment advisers to disclose the policies and procedures that they use to determine how to vote proxies. And to satisfy this new requirement, the SEC allowed investment advisers to turn to third-party firms that offer advice on proxy voting. When a 2004 SEC no-action letter[2] clarified that relying on such firms creates a veritable safe harbor, the reliance on PAS firms grew, and their impact blossomed.

But as James Glassman and J.W. Verret wrote in a Mercatus Center analysis last April, "Instead of encouraging funds to assume more responsibility for their proxy votes, the rule

[2] *See* "Investment Advisers Act of 1940—Rule 206(4)-6: Institutional Shareholder Services, Inc." SEC letter to Mari Anne Pisarri, September 15, 2004. http://www.sec.gov/divisions/investment/noaction/iss091504.htm

pushes them to assume less."[3] How so? Inexplicably, even though the Proxy Voting by Investment Advisers rule itself requires entities to disclose their processes for determining how to vote proxies, that rule does not apply to the PAS firms. Hence, institutional investors and investment advisers who choose to rely on the (opaque) advice of PAS firms do not actually disclose how they chose to vote proxies except by relying on unexplained third-party advice. In this manner firms assume less responsibility than before for their proxy votes. Such outsourcing of fiduciary duty cannot be what the original framers of the Proxy Voting by Investment Advisers rule had in mind.

Worse yet, thanks to a second 2004 no-action letter,[4] the Commission has created a new set of potential conflicts of interest. As Glassman and Verret put it, "Instead of eliminating conflicts of interest, the rule simply shifted their source." Rather than come from conflicts generated by the institutional investors' / investment advisers' other clients, the conflicts now emanate from other clients of the PAS firms. The Commission has instructed proxy advisory firms that they can provide advice to public companies on corporate governance issues—including how to win proxy votes—at the same time that they make proxy-voting recommendations to investment advisers. The NASDAQ *OMX* petition summarizes this conflict well: "At the same time it [ISS or Glass Lewis] evaluates companies against its own non-transparent corporate governance guidelines, it profits as a consultant to help these same companies obtain higher governance ratings and/or provide to institutional investor clients voting recommendations regarding these companies' shareholder proposals."

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[3] "How to Fix Our Broken Proxy Advisory System," James K. Glassman and J.W. Verret, Mercatus Center, April 16, 2013. http://mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf

[4] *See* "Investment Advisers Act of 1940—Rule 206(4)-6: Egan-Jones Proxy Services," SEC letter to Kent S. Hughes, May 27, 2004. http://www.sec.gov/divisions/investment/noaction/egan052704.htm

A July 19, 2013 comment on the Commission's 2010 Concept Release[5] offers a troubling anecdote that starkly illustrates these transparency and conflict concerns.[6] In the comments, the general counsel of Axcelis Technologies related that company's attempt to earn ISS's recommendation on an Equity Incentive Plan for Axcelis employees. Even though Axcelis set the percentage for the cap on plan grants at a level that had met ISS's previous standard, ISS recommended a vote against approval of the proxy containing the plan just nine days before the company's annual meeting. A frantic back-and-forth between Axcelis and ISS ensued. Axcelis believed that ISS's reasoning and conclusions regarding Axcelis's cap were deeply flawed. But because ISS refused to share its methodology, Axcelis was forced to offer a lower cap on its proxy statement just three days before its annual meeting, thereby reducing the shares employees could receive. One week after the meeting, the Axcelis general counsel received a call from an ISS representative. In a voicemail, the representative referenced the Equity Incentive Plan cap debacle and suggested that "going forward … you do have the ability to work with us prior to filing a proxy" to determine what ISS might recommend to its investor clients.

Proxy advisory services firms are vulnerable to a second kind of conflict of interest as well, arising from the ideological agendas of clients. Those agendas, which can include demands that businesses, *e.g.*, cast aside their First Amendment rights or alter their environmental policies in unscientific ways, can be—indeed, often are—directly at odds with shareholders' primary interest in growing share value. And yet the PAS firms are free to follow the lead of their clients and advance those ideological agendas, if they so choose. WLF believes that one group of shareholders—be it 5% or 50% of the total—should not be able to take control of the income-

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[5] http://www.sec.gov/rules/concept/2010/34-62495.pdf

[6] Lynnette C. Fallon, Executive Vice President HR/Legal and General Counsel of Axcelis Technologies, Inc. in July 19, 2013 letter to the SEC. http://www.sec.gov/comments/s7-14-10/s71410-322.pdf

generating power of the corporate investment and usurp that power to serve purposes that were not originally contemplated by state corporate law, the corporate charter, the by-laws, or any disclosure documents that solicited the investment by the shareholders.

Proxy advisory services firm representatives at last month's SEC roundtable[7] on the proxy process said they believe enough safeguards are in place to prevent conflicts of interest. However, those representations did not reassure many companies, who understand that these private firms answer only to their own clients and equity holders. As long as PAS firms suffer no consequences for recommendations they make against public company shareholders' economic interests, there is little reason to think such recommendations will cease being made.

B. Bad Information Drives Bad Decisionmaking

The next category of concern with PAS firms stems from their giving advice based on factual errors. At least three different reasons are suggested for such unreliable or erroneous information. First, companies contend that the PAS firms are not very diligent when it comes to getting the facts right. Simply put, the reports (particularly draft reports) are sometimes rife with errors. Companies attribute this to the fact that there is no restriction on what proxy advisory reports say, virtually no consequence for being wrong, and no obligation to disclose or defend their decisions. Due to this flawed incentive structure, it appears that the PAS firms depend much too heavily on the companies—which have a strong incentive to police this—to correct whatever errors permeate the analysis. At the same time, the PAS firms have inadequate processes in place to identify and correct errors. Although at least one of the PAS firms purports to give advance copies of its reports to the company whose ballot issues it is reviewing, this

[7] See materials on the Commission website, "Proxy Advisory Services Roundtable," at http://www.sec.gov/spotlight/proxy-advisory-services.shtml.

apparently is not a uniform or mandatory practice, and even companies that receive advance reports do not necessarily receive them far enough in advance to undertake the kind of thorough vetting that is required to ensure that the reports are accurate. Also, PAS firms do not necessarily wait on the corporation before distributing their reports, so at least some investment advisers and institutional investors cast their votes before factual errors have been corrected.

Second, corporations complain that the analysts who research the recommendations lack sufficient training and experience to adequately assess the virtues and flaws of various proxy proposals. So, even if they are not proceeding based on factual errors, their recommendations carry far more weight than they should given the wont of genuine expertise and lack of depth behind them. Most analysts are simply not equipped to base their recommendations on context-specific factors that strongly influence the wisdom of certain policies for particular companies, and other analysts do not appear to invest the time necessary to consider such factors even when they have the relevant expertise to make such tailored assessments.

The third concern is a complete lack of transparency regarding the methods PAS firms employ to reach the recommendations they make. Because companies cannot know the standard against which they will be judged, the Commission has created a moving target that undermines important rule-of-law values like predictability. Indeed, because the companies do not have to divulge their methodologies, companies are in essence being governed by a regulation whose content they do not know—which undermines a host of other rule-of-law values including clarity, publicity, non-retroactivity, stability, and capability of compliance (*i.e.*, knowing what the law is in advance and that it is going to remain the same long enough to comply with it).[8]

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[8] *See generally*, Lon L. Fuller, The Morality of Law, rev. ed. (New Haven: Yale University Press) (1969).

Relatedly, companies believe that PAS firms use bad benchmarks and faulty analogies that disserve shareholders and good governance. Mercatus's analysis and NASDAQ *OMX*'s petition likewise criticize the advisory firms for using "one-size-fits-all" formulae and ratings to determine whether investors should approve a public company's governance proposals. Because ISS and Glass Lewis keep some of the models and methods they use to reach their recommendations secret, companies can neither effectively evaluate how investors might vote nor challenge a PAS firm's conclusion if they believe it is flawed.

One frustrated observer who prefers anonymity described the situation to WLF this way:

> ISS is lazy and stupid, hiding in a little crevice created by the market and regulations. They are similar to accreditors, and the US News school rankings, in that they have no incentive to ensure the information they use is correct, because the institutions they are rating have every incentive to correct their mistakes. So, they just throw some stuff up against the wall, guesstimates of what might be right, and wait for the companies to call and correct them. Their incentive is not to invest in staff to do the work. They put out their ratings and just wait for people to come back and rebut their statements—but they are so thinly staffed that it can take weeks to correct wrong information.
>
> Perhaps ISS has had threats of libel suits, but I doubt it, because everyone knows that ISS has a lot of influence, so you just need to play along. Just because a proxy advisory firm collects money doesn't mean it is creating value. It's as though someone walked onto a public highway with a cardboard tollbooth, and everyone blinked, so soon everyone started paying the toll. Because of antitrust concerns, the toll-payers are afraid to get together and tell the guy in the cardboard tollbooth to go pound sand. So is there a role for government to say 'get your damn tollbooth off the road?'

Another person who has dealt with the PAS firms as a general counsel is only slightly more forgiving in his analysis:

> ISS tries hard. But they are Procrustean—you have to fit their model. Take the issue of the 'peer group.' Directors and compensation consultants spend a lot of time defining the appropriate peers for benchmarking executive compensation. They pick companies in the same industry, of about the same size, do a regression analysis when not the same size, look for outliers, etc. Most compensation consultants like to pick companies that are already using them—that way they can make sure their information is correct and they have more accurate information for levels below the executive team. They use 20-30 companies to get a large enough sample. Every year they compare the companies, adjust for mergers, etc. It is hard work. ISS says, 'We'll ignore the work you did and use a different peer group, and we'll fit you into one of them.' Such an analysis often leads to a meat cleaver whack against the compensation committee or management. That may make the proxy advisory firm's job easier, but it interferes with the hard work of the compensation committees needed to recruit and retain executives in line with the board's view of competition for management in the real world.

At a minimum, these viewpoints shared with WLF, albeit anonymous, give some flavor to the depth of concern in the corporate community for the current proxy voting advisory situation. Taken seriously, however, they also underscore the consensus when it comes to the accuracy lacking in PAS firm analysis: all too often proxy reports contain recommendations based on erroneous information, made by analysts with too little expertise or real-world investment experience, applying standards that are not known in advance and that do not account for company-specific differences.

C. Lack of Competence Makes Mischief

Completely apart from the concerns over, say, adequate education and training for the analysts who staff PAS firms, there is a separate more fundamental question about whether these firms can or should provide voting recommendations at all when it comes to certain kinds of proxy issues. It's one thing for proxy advisers to benchmark corporate pay, which they might do

poorly or well, but one can at least imagine improvement over time as the firms become more transparent, receive more feedback from shareholders and the regulated community, and develop governance-specific expertise; it is quite another thing altogether to expect PAS firms to opine on the full range of Corporate Social Responsibility (CSR) issues that shareholder activists seek to drive onto proxy voting ballots. There is no reason whatsoever to believe that PAS firms can provide recommendations on these votes based on objective factors. The Commission should not sanction this blind-leading-the-blind style of proxy voting guidance.

The small cadre of firms that provide proxy advisory services increasingly provide advice to their institutional money manager and investment adviser clients on proxy proposal subjects that were traditionally regarded as matters affecting internal corporate affairs, basing their voting recommendations on factors that may not take into consideration the true cost of a proposal that led management to recommend voting against it. WLF believes shareholders expect that a professional management team inside the company is in the best position to ascertain the costs and benefits of corporate activity.

Moreover, the Proxy Voting by Investment Advisers rule sought to ameliorate conflicts of interest quite apart from these subjects. CSR issues are not the kind of issues for which management's conflicts of interest have been shown to exist or are likely to arise. Corporate management tends to look after the financial interest of shareholders and eschew expensive CSR ideas that would be to the competitive disadvantage of the company. Third-party guidance on these questions is not necessary, and PAS firms do not add value by making voting recommendations on proxy ballot issues that are outside the scope of core corporate governance matters—and outside the scope of the firms' governance expertise. There may well be

borderline cases and examples where reasonable minds differ as to whether an issue falls within the scope of core governance, but problems in this area—such as ideological conflicts of interest—can best be avoided by reducing the subject matters over which PAS firms offer recommendations. Permitting the subjective values of proxy advisers to dictate their recommendations on CSR votes is a solution in search of a problem. Companies do not need to be micromanaged on their CSR decisions any more than they need to be second-guessed on their corporate philanthropy decisions regarding which charities to support.

III. Potential Solutions for the Commission's Consideration

WLF does not initially prefer that the problems discussed herein be addressed primarily with additional regulation. Rather, a lighter touch may be required. The Commission should first take a look at unraveling some of the existing regulations that have created this mess to begin with. Rather than supplant one set of conflicts of interest with another set of conflicts of interest (and a whole host of other problems as well), it may well make sense to take a step back and look for solutions to concerns raised by proxy voting by investment advisers that do not involve third-party proxy advisory services at all. In other words, serious consideration should be given to removing the aforementioned "cardboard tollbooth" from the corporate governance road entirely where feasible.

However, if PAS firms are going to continue acting like regulators, then the same transparency and accountability demanded of actual regulators is needed. As an October petition filed with SEC by NASDAQ *OMX* urges,[9] it's time the Commission stopped studying and

[9] http://www.sec.gov/rules/petitions/2013/petn4-666.pdf

started acting to make the methodology behind such influential proxy voting advice more transparent. NASDAQ *OMX*'s petition, which has already garnered support from numerous public companies, deserves serious consideration. At a minimum, the Commission should revisit the 2004 policy letter that allows firms like ISS to contact companies like Axcelis with an implicit offer—hire us to help you prevent problems that we can cause—they can't refuse. Otherwise, a rule that was meant to buttress fiduciary duty may wind up undermining it instead.

The Commission should also require all PAS firms to disclose all actual conflicts, regardless of internal controls aimed at preventing improper influence. Requiring reports to be made public after proxy votes have occurred would also enhance transparency without necessarily compromising the ability of PAS firms to sell their services. Likewise, applying proxy solicitation rules against manipulation and the like—rules that apply to other actors involved in the proxy voting process—is also worth consideration. The Commission should also investigate ways of helping institutional investors to provide more oversight over the PAS firms that they employ.

In addition to preventing or minimizing conflicts of interest, transparency can also improve the factual content of proxy advisory reports. More transparency on methods and standards will enhance accuracy as well as predictability and other rule-of-law values. Better processes to correct errors, like giving companies copies of reports far enough in advance (and before they are made public) to allow them to vet the reports thoroughly, will also help.

Perhaps most importantly, the Commission can reduce conflicts of interest and errors by reducing the scope of proxy issues over which PAS firms render recommendations and/or

reducing the scope of proxy issues on which investment advisers and institutional investors are compelled to participate. Limiting the role of PAS firms to proxy ballot items offered by management—and avoiding controversial CSR issues where firms specializing in corporate governance bring no special insight—would also enhance the workability of the proxy advisory services regime. Forcing companies to spend more time and resources than they otherwise would on these proxy votes—including battles over CSR issues that sometimes linger due to the vote recommendations of PAS firms—risks a kind of mission creep for the Commission that distracts from the agency's mission of protecting the economic interests of shareholders.

In addition, as David Larcker and Allan McCall argued in the *Wall Street Journal*, the Commission should consider not requiring institutional investors to cast votes on every issue:

> Yes, investors should vote their shares if doing so is expected to increase shareholder value. But it is surely worth considering what would happen if institutional investors weren't required to vote in every election. Individual investors have no such obligation. The SEC should reconsider … the mandate that institutional investors participate in all corporate votes. Institutional investors should be free to make judgments about when it is in the interests of their shareholders to expend resources to research and vote proxies."[10]

Together, these recommendations should ameliorate much of the growing concern surrounding the outsized role of PAS firms in the proxy voting process.

IV. Conclusion

WLF thanks the Securities and Exchange Commission for the opportunity to comment on this very important public policy issue. Federal regulation has caused two relatively small PAS firms to be *de facto* appointed as corporate governance regulators. If that situation is to continue,

[10] "Proxy Advisers Don't Help Shareholders," by David F. Larcker and Allan L. McCall, *Wall Street Journal*, Dec. 8, 2013.

those quasi-regulators need greater oversight to curb conflicts of interest, improve the factual accuracy of reports, enable companies to understand the standard against which they are being judged, and allow PAS firms to better tailor their recommendations to specific companies.

By taking management's time, attention, and resources away from activities that would add to shareholder returns, proxy-voting battles reduce the return on investment in any particular stock. The role of PAS firms, which was no doubt created with good intentions, has exacerbated the problem. If the Commission wishes to regulate proxy voting by investment advisers, then merely replacing one set of conflicts of interest with another set of conflicts of interest is not a good or defensible outcome for the sake of shareholders—or others invested in strong corporate governance. Nor would the best interests of shareholders be served by permitting the error-prone current reporting process to continue unaddressed. Finally, the Commission should encourage PAS firms to focus on subjects where conflicts of interest on the part of management are a concern (perhaps even limiting them to proxy issues introduced by management itself). At a minimum, PAS firms should refrain from dabbling in CSR issues where those firms possess no unique expertise and are not well-positioned to assess the impact on share value.

WLF will continue to follow the proxy advisory situation closely, and we hope to see real improvement in this area that advances the best interests of shareholders in the United States.

Respectfully submitted,

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