SPEECH

Remarks at Georgetown University's Center for Financial Markets and Policy Event

Commissioner Daniel M. Gallagher

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Thank you Reena [Aggarwal] for your very kind introduction. I am delighted to be here and to have an opportunity to add to the discussion on timely and significant corporate governance topics. Corporate governance, is of course, a very broad subject, and it is therefore important to focus and take a deep dive on discrete issues, just as this conference does. Only by "eating the elephant bite by bite" can we affect real reform in the corporate governance space. And so, this evening I would like to talk about the need for the Commission to devote more attention to the role of proxy advisors, and share some brief thoughts about the SEC's rules regarding shareholder proposals.

In case anyone doubts the influence and power of the two largest proxy advisory firms, one need only look the numbers. ISS and Glass Lewis control close to *97%* of the market, and unsurprisingly, studies have shown that their recommendations have a measurable impact on proxy voting and the resulting outcomes.[1] One study found that opposition by a proxy advisor resulted in a 20% increase in votes cast, while another study found that a negative vote recommendation by ISS on a management proposal can result in a 13.6% to 20.6% sway in the vote.[2] Yet another publication stated that ISS and Glass Lewis reportedly affect 38% of votes cast at U.S. public company shareholder meetings.[3]

So how did this duopoly of proxy advisors gain such an outsized role? I'm afraid to say that the disproportionate power they wield is, in large part, an unintended consequence of SEC's actions. In 2003, the SEC adopted new rules and amendments requiring an investment adviser that exercises voting authority over its clients' proxies to, among other things, adopt policies and procedures reasonably designed to ensure that it votes those proxies in the best interests of its clients.[4] A key goal of the Commission in adopting this rule was to address an investment adviser's potential conflicts of interest when voting a client's securities on matters that affected its own interests. In the adopting release, the Commission noted that "an adviser *could* demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party."[5]

If the new rule was the proverbial camel's nose poking into the tent, what followed was the equivalent of a herd of camels trampling down the tent and eating it. Proxy advisors were quick to ask the SEC staff for guidance and clarity with respect to the new rule. The resulting pair of staff no-action letters effectively blessed the practice of investment advisers rotely voting the recommendations provided by proxy advisors, thereby, creating a *de facto* – but to be clear, not *de jure* - safe harbor.[6] In one letter, the SEC staff advised that "an investment adviser that votes client proxies in accordance with a pre-determined policy based on the recommendations of an independent third party will not necessarily breach its fiduciary duty of loyalty to its clients even though the recommendations may be consistent with the adviser's own interests. In essence, the recommendations of a third party that is in fact independent of an investment adviser may cleanse the vote of the adviser's conflict."[7] The same letter also addressed the question of whether a proxy voting firm would be considered independent if it received compensation from an issuer for providing advice on corporate governance issues. The staff found that the mere fact that a proxy voting firm provided advice and received compensation from an issuer for its services "generally would not affect the firm's independence from an investment adviser."[8]

Taken together, the new rule and no-action letters offered a get-out-of-jail-free card to investment advisers. All they had to do was to pay for and carry out a proxy advisor's recommendations and potential conflict of interest issues just wilted away. Rather than encouraging investment advisors to employ their own judgment to address and minimize any potential conflicts of interests in voting their clients'

proxies, which everyone should expect from a fiduciary, the letters cleared the way for investment advisers to shift the responsibility for those votes to third parties which have their own, potentially greater, conflicts of interests, without the fiduciary duties and liability risk faced by investment advisers. To anyone familiar with the Commission's role in mandating the use of credit ratings issued by NRSROs for regulatory purposes, all of this should sound very familiar.

The result of these two letters has been to unduly increase the role of proxy advisory firms in corporate governance. I have grave concerns as to whether investment advisers are indeed truly fulfilling their fiduciary duties when they rely on and follow recommendations from proxy advisory firms. Rote reliance by investment advisers on advice by proxy advisory firms in lieu of performing their own due diligence with respect to proxy votes hardly seems like an effective way of fulfilling their fiduciary duties and furthering their clients' interests. The fiduciary duty – certainly as we have heard it described in the Dodd-Frank §913 debate – must demand more than that. The last thing we should want is for investment advisers to adopt a mindset that leads to them blindly cast their clients' votes in line with a proxy advisor's recommendations, especially given that such recommendations are often not tailored to a fund's unique strategy or investment goals. One academic article, focusing on institutional investors, has argued, "If the institutional investors are only using the proxy advisor voting recommendations to meet their compliance requirement with the lowest cost, these payments will not compensate proxy advisors for conducting research that is necessary to determine appropriate corporate governance structures for individual firms. Under this scenario, the resulting recommendations will tend to be based on simple, low cost approaches that ignore the complex contextual aspects that are almost certainly instrumental in selecting the corporate governance structures for individual firms."[9]

So what can the Commission do to address this issue? As I have stated before, I believe that the Commission should withdraw the two proxy advisor staff no-action letters and, ideally, replace them with Commission-level guidance. Such guidance should be designed to ensure that investment advisers are complying with the original intent of the 2003 rule and effectively carrying out their fiduciary duties. This would go a long way toward mitigating the concerns arising from the outsized and potentially conflicted role of proxy advisory firms. But there are many ways to skin this cat, and I am interested in achieving effective reform regardless of the process we employ to get it done.

In addition, I believe that the Commission should fundamentally review the role and regulation of proxy advisory firms and explore possible reforms, including, but not limited to, requiring them to follow a universal code of conduct, ensuring that their recommendations are designed to increase shareholder value, increasing the transparency of their methods, ensuring that conflicts of interest are dealt with appropriately, and increasing their overall accountability. I am certainly not alone in raising these issues; in fact, calls for review and reform in this space has been issued by a wide spectrum of voices. On the international front, both the European Securities and Markets Authority and the Canadian Securities Administrators have recently tackled these topics and published calls for further review and recommendations.[10] Congress has also discussed the issue, in a hearing and more recently in a speech by Congressman Scott Garrett who noted that if the SEC does not act, then the situation should be address by Congress.[11] Indeed, the Commission recently received a petition from NASDAQ, requesting that the Commission revise the staff guidance provided in the two no-action letters I've discussed.[12] So, we have had a wide spectrum of voices calling for action, including international regulators, Congress, the media, and a national securities exchange. Clearly, this is a subject the Commission needs to address.

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I'll conclude with a few words on the proxy process itself, starting with the thresholds for submitting shareholder proposals. Our current rules require a shareholder submitting a proposal to have held for at least one year either a minimum of $2,000 in market value or 1% of the issuer's outstanding voting shares.[13] We need to reexamine whether these thresholds as well as the shareholder proposal resubmission thresholds[14] are high enough to justify the significant costs to companies in terms of issuer outreach, associated costs, and management time.

In addition, we need to take a hard look at the use of proxy votes as vehicles for social and political agendas. According to one study, 99% of the shareholder proposals for companies in the Fortune 250 voted on between 2006 and 2013 were

sponsored by institutional investors affiliated with organized labor or in furtherance of a social, religious or public-policy purpose.[15] We need to make sure that our rules strike an appropriate balance that preserves the vital ability of shareholders to have the opportunity to be heard while addressing the not insignificant costs of proxy votes that are, after all, passed on to all shareholders. I believe any review of the proxy voting process, especially the shareholder proposal submission and resubmission thresholds, would greatly benefit from an economic analysis done by our Division of Economic and Risk Analysis - especially given that the initial thresholds were not subject to such a review.[16]

So where do we go from here? I hope that the Commission, of course, takes a hard look at proxy advisors as well as proxy voting proposal thresholds, but I also encourage investment advisors, including institutional investors, to focus on proxy advisors and review whether the recommendations they receive from proxy advisors reflect an appreciation of, and are designed to further, their clients' interests, needs, and goals.

Thank you all for your attention. I've appreciated the opportunity to be here today and share my views on these vitally important subjects, and I look forward to answering your questions.

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[1] *See* Larcker, David F., McCall, Allan L. and Ormazabal, Gaizka, *Outsourcing Shareholder Voting to Proxy Advisory Firms,* May 10, 2013; *See* also "How to Fix Our Broken Proxy Advisory System", by James K. Glassman and J. W. Verret, April 16, 2013, http://mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf . *See also* Proxy Monitor Report Fall 2012: A Report on Corporate Governance and Shareholder Activism By James R. Copland with Yevgeniy Feyman and Margaret O'Keefe, http://www.proxymonitor.org/forms/pmr_04.aspx .

[2] *See* Larcker et al.

[3] "Boards Should Minimize the Role of Proxy Advisors," by Louis J. Bevilacqua, October 11, 2013 http://www.cadwalader.com/quorum/newsletter/whos-advising-the-proxy-advisors/ .

[4] Final Rule: Proxy Voting by Investment Advisers, 68 FR 6585, http://www.sec.gov/rules/final/ia-2106.htm.

[5] *Id*. Emphasis added.

[6] *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 and "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.

[7] "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.

[8] *Id*.

[9] *See* Larcker et al. at 3.

[10] *See* "ESMA recommends EU Code of Conduct for proxy advisor industry," February 19, 2013, http://www.esma.europa.eu/news/ESMA-recommends-EU-Code-Conduct-proxy-advisor-industry . *See* CSA Notice 25-301, Update on CSA Consultation Paper 25-401, "Potential Regulation of Proxy Advisory Firms," Sept. 19, 2013, available at http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20130919_25-301_update-25-401.htm .

[11] Capital Markets and Government Sponsored Enterprises Subcommittee Hearing entitled "*Examining the Market Power and Impact of Proxy Advisory Firms,*" June 5, 2013, http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=335917. Scott Garrett speech at U.S. Chamber of Commerce's Center for Capital Markets Competitiveness October 16, 2013 Event entitled "2014 Proxy Season: What Lies Ahead?"

[12] Petition Related to Proxy Advisory Firms, October 8, 2013, http://www.sec.gov/rules/petitions/2013/petn4-666.pdf.

[13] 17 C.F.R. § 240.14a-8.

[14] "Resubmissions*:* If the proposal deals with substantially the same subject matter as another proposal or proposals that has or have been previously included in the company's proxy materials within the preceding 5 calendar years, a company may exclude it from its proxy materials for any meeting held within 3 calendar years of the last time it was included if the proposal received: (i) Less than 3% of the vote if proposed once within the preceding 5 calendar years; (ii) Less than 6% of the vote on its last submission to shareholders if proposed twice previously within the preceding 5 calendar years; or (iii) Less than 10% of the vote on its last submission to shareholders if proposed three times or more previously within the preceding 5 calendar years;" *Id*.

[15] Proxy Monitor Report Fall 2013: Corporate Governance and Shareholder Activism By James R. Copland and Margaret O'Keefe, http://www.proxymonitor.org/forms/pmr_06.aspx .

[16] Final Rule: Amendments to Rules on Shareholder Proposals, 17 CFR 240.14a-8, http://www.sec.gov/rules/final/34-40018.htm.

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