Statement of the U.S. Chamber of Commerce

ON: Legislative Proposals to Enhance Capital Formation, Transparency, and Regulatory Accountability

TO: House Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises

BY: Tom Quaadman, Senior Vice President of the Center for Capital Markets Competitiveness

DATE: May 17, 2016

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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.

Testimony of Tom Quaadman
Senior Vice President, Center for Capital Markets Competitiveness of the U.S. Chamber of Commerce

Before the House Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprise

May 17, 2016

Chairman Garrett, Ranking Member Maloney, and members of the Capital Markets and Government Sponsored Enterprises subcommittee:

My name is Tom Quaadman, vice president of the Center for Capital Markets Competitiveness ("CCMC") at the U.S. Chamber of Commerce ("Chamber"). The Chamber is the world's largest business federation, representing the interests of more than three million businesses and organizations of every size, sector and region. I appreciate the opportunity to testify before the subcommittee today on behalf of the businesses that the Chamber represents.

Today's hearing is entitled "Legislative Proposals to Enhance Capital Formation, Transparency and Regulatory Accountability." In my view, this hearing is not about more or less regulation but about *smart* regulation. Sound regulatory policy and appropriate congressional oversight of the regulators who implement it are absolutely critical elements of capital markets that support economic growth.

Innovation often outpaces regulation; too often we have seen regulators struggle to keep up with evolving markets. The bills before the subcommittee today address three different regulatory structures that need updating.

1. Proxy Advice and Investing

The economic growth of our nation depends upon an efficient allocation of capital to productive uses and responsible corporate governance. Effective and transparent corporate governance systems that encourage shareholder communication and participation are a key ingredient for public companies to grow and for their investors and workers to prosper. Yet for 19 of the last 20 years we have seen the number of public companies decline. We now have fewer than half of the public companies than we did in 1996. The development and use of proxy advice by investors is an important part of corporate governance. Accordingly, it should regularly be examined in light of our continued struggle with a lack of initial public offerings and the continued outflow of public companies.

Shareholders provide public corporations with capital in the expectation of a return. Their ownership of equity interests connotes gives them voting rights, under the rubric of state corporate law and corporate by-laws, to elect directors and approve or disapprove proposals for the governance of the corporation. Day-to-day management of the corporation is left with the officers of the company and oversight of management is generally left with the Board of Directors.

Individual shareholders, or retail shareholders, have the right to vote, but are not obligated to vote. For a variety of reasons, retail shareholder participation in director elections and shareholder proposals has dropped precipitously and, in some cases, is as low as 5%.

Institutional investors[1], or those who pool large sums of money that is invested with the expectation of return, by law and regulation must generally[2] vote shares under management in director elections and on other material proposals included in proxy materials and some institutional investors must disclose how they vote those shares.

Institutional investors may invest in hundreds, if not thousands, of public companies. Therefore, the due diligence that is needed to fulfill the fiduciary duties associated with proxy voting—learning and understanding the issues around director elections and shareholder proposals and the best vote to meet the interests of an investor—is complex, costly, and burdensome.

As a result, the proxy advisory industry was created to help institutional investors fulfill these due diligence obligations. Some institutional investors use advisory firms to perform research as part of a robust due diligence operation, while others may outsource their entire voting function to advisory firms. As a result, proxy advisory firms:

a) research subject companies for issues of relevance to director elections and other management and shareholder proposals;

b) Provide voting recommendations for their clients; and

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[1] Institutional investors may include insurance companies, private or public pension funds, hedge funds, investment advisors, and mutual funds.

[2] As will be discussed further, Legal Bulletin Number 20, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms* clarified that institutional investors must vote when it determines a matter to be material.

c) Cast the actual votes for their clients.

Institutional investors may use one or all of these functions.

The proxy advisory industry has been dominated by two companies—Institutional Shareholder Services ("ISS") and Glass Lewis & Co. ("Glass Lewis"), which control 97%[3] of the proxy advice market. It has been estimated that ISS and Glass Lewis "control" 38% of the shareholder vote[4] because if ISS and Glass Lewis make the same proxy voting recommendation, it moves that percentage of the vote, absent a vocal campaign against that position. This occurs partly because some clients of ISS and Glass Lewis automatically follow their recommendations.

As a result, ISS and Glass Lewis have assumed the role of de facto standard setters for corporate governance policies. One recent example highlights the point.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") included a provision to allow shareholders to have a non-binding advisory vote on compensation, otherwise known as "Say on Pay." In doing so, Congress explicitly gave shareholders the right to determine the frequency of Say on Pay votes at one, two, or three years. This was done to give shareholders the power to decide on a policy that best fits the needs of a company and the flexibility to match the advisory vote with the length of a compensation package, which is normally three years. ISS and Glass Lewis came out with an iron-clad recommendation in all instances that the Say on Pay frequency vote should be one year. The advisory firms did this without any evidence that one frequency cycle provided better shareholder return than another, or if individual differences amongst companies called for a frequency vote other than one year.

Obviously, a one-year frequency vote means that institutional investors will have to evaluate their portfolio companies' compensation practices each year and, therefore, will rely on ISS and Glass Lewis to make voting recommendations. But in making one-size-fits all recommendation that Say on Pay must be held every year for all companies, ISS and Glass Lewis thwarted the public policy choice made by Congress and cut off the ability of shareholders to debate and decide the issue. All of this was done without any study of empirical evidence on how Say on Pay frequency vote impacts the bottom line for shareholders. In fact, a recent study by the Rock Center for Corporate Governance at Stanford University Stanford Graduate School

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[3] There are other firms such as Egan Jones which provides a full array of proxy advisory services and Manifest which provides only research. However, these firms are negligible in their market impact.

[4] ISS 24.7% Glass Lewis 12.9% Source: Ertimur, Yonca, Ferri, Fabrizio and Oesch, David, *Shareholder Votes and Proxy Advisors: Evidence from Say on Pay* (February 25, 2013). 7th Annual Conference on Empirical Legal Studies Paper.

of Business found that proxy advisory firms' favored compensation policies actually have a *negative* effect on share value.[5] So, in short, because of ISS and Glass Lewis, we now have nearly universal annual Say on Pay votes.

The lack of transparency and accountability of proxy advisory firms is a troubling trend that can undermine confidence in and stall progress of strong corporate governance. 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. Proxy advisors are riddled with conflicts of interest and internal processes that have not kept with other changes in the proxy system.

ISS has not delineated a clear process for seeking input and developing a clear and open process for developing policies and recommendations. The almost simultaneous release of the voting policies with the closure of the short comment period leads one to believe that the letters submitted by public stakeholders are not considered, much less read.

Similarly troubling, ISS may give some larger companies only 24 hours to review and respond to its company specific recommendations, while other companies are never given an opportunity to review or respond.

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.[6] This would allow for an open dialogue among all stakeholders and better inform ISS of circumstances material to the interests of its clients. To date, ISS hasn't acted or commented on these recommendations.

If ISS has an inadequate process for input, Glass Lewis has no clear process.

ISS and Glass Lewis have also been accused of having conflicts of interest that cast doubt on the unbiased nature of their proxy voting recommendations. ISS

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[5] See Larcker, David F., McCall, Allan L. and Ormazabal, Gaizka, The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policies (July 5, 2012). Stanford Graduate School of Business Research Paper No. 2105. Available at SSRN: http://ssrn.com/abstract=2101453 or http://dx.doi.org/10.2139/ssrn.2101453

[6] See Letter of August 4, 2010 to MSCI Chairman and CEO Henry Fernandez; Letter of August 5, 2010 to SEC Chairman Mary Schapiro, *Concept Release on the U.S. Proxy System File Number S7-14-10 RIN 3235-AK43*

operates a consulting division to provide advice to companies as to how they can achieve better ISS corporate governance ratings and secure shareholder approval of equity compensation plans, among other things. In fact, ISS' ownership of this consulting arm—accepting fees from both the institutional investors who receive their proxy 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.[7]

Although it does not sell consulting services like ISS, Glass Lewis is owned by an activist institutional investor—the Ontario Teachers' Pension Plan. The Chamber has written to the SEC on separate occasions regarding the appearance of a conflict of interest with the issuance of a Glass Lewis recommendation in favor of activist measures undertaken by its owner.[8] Furthermore, the Chamber wrote to the Department of Labor asking that they also look into these matters, as their policy at the time limited advice ERISA pension funds receive must be linked to shareholder return and free of potential conflicts of interest.[9]

Serious questions have been raised as to the quality and rigor of the research undertaken by proxy advisory firms. For instance, one of the proxy advisory firms employs 180 analysts to evaluate 250,000 issues, spread over thousands of companies, within a six-month period known as proxy season.

All of these issues with proxy advisory firms have caused obstacles to good corporate governance that, if unaddressed, have the potential to reverse the otherwise positive advances in corporate governance, such as increased communications and the empowerment of directors and shareholders that have occurred over the past generation.

2. Chamber Principles on Proxy Advice and SEC Roundtable

The Chamber, in 2013, developed and released developed ***Best Practices and Core Principles for the Development, Dispensation and Receipt of Proxy Advice*** ,("Chamber principles") a set of core principles and best practices to serve as a basis for proxy advisory firms, public companies they report on, and investment portfolio manager organizations they report to, to engage in a dialogue to create a

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[7] CFO Journal "Nell Minow Says Governance Has Long Way to Go" (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

[8] See Letter of May 30, 2012 to SEC Chairman Mary Schapiro attached as Exhibit x

[9] See June 25, 2012 letter to Assistant Secretary of Labor Phyllis Borzi

system that brings transparency and accountability to proxy advisory firms and foster strong corporate governance.

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

- **Are free of conflicts of interest that could influence vote 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 for 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.**

Following the release of the Chamber principles, this Subcommittee held a hearing on proxy advisory firms on June 5, 2013 and the SEC held a roundtable on proxy advisory firms on December 5, 2013. On June 30, 2014, the SEC's staff issued Legal Bulletin Number 20, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms* ("SEC Staff Guidance").[10] With the issuance of the SEC staff guidance the SEC for the first time exerted oversight over proxy advisors while providing institutional investors with valuable guidance on how to use proxy advice and when to vote shares and how public companies can interact with proxy advisory firms.

[10] The SEC Staff Guidance can be found at http://www.sec.gov/interps/legal/cfslb20.htm.

The SEC Staff Guidance provides proxy advisory firms, public companies and portfolio managers with five principles that should be adhered to:

- **Fiduciary duties permeate and govern all aspects of the development, dispensation, and receipt of proxy advice;**

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

- **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—proxy advisory firms so employed, and those engaging them, incur serious legal and regulatory consequences;**

- **Clarity is provided as to the scope of portfolio managers' obligations to exercise a vote on proxy issues, and it 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; and**

- **In light of the direction provided, proxy advisory firms, portfolio managers, and public companies need to reassess their current practices and procedures, and adopt appropriate changes necessitated by the SEC Staff Guidance.**

While the SEC staff guidance was an important first step in providing oversight, transparency, and fairness to the proxy advisory industry, problems still remain. This past summer, the Chamber, in conjunction with NASDAQ, conducted

a survey on how public companies were interacting with proxy advisory firms following the release of the SEC staff guidance.[11]

The survey found that only 25% of companies believed that proxy advisory firms carefully researched all relevant aspects of an issue that a firm provided recommendations on. When companies asked to provide input, the request was granted about half the time and companies were given between one hour and one month to respond, generally given 24-48 hours. While only 13% of public companies took steps to verify proxy advisory firm conflicts, those companies found conflicts 45% of the time. Nevertheless, many companies were unaware of the SEC staff guidance or the duties imposed upon advisory firms.

3. Proxy Advisory Firm Reform Act of 2016

The Proxy Advisory Firm Reform Act of 2016 would build upon the SEC staff guidance and resolve a number of problems that persist within the proxy advisory industry.

As highlighted in the example of Say on Pay frequency votes, ISS and Glass Lewis have the force of a regulator or standard setter, similar to the Financial Accounting Standards Board ("FASB") or the Public Company Accounting Oversight Board ("PCAOB"), thereby dominating the consideration of corporate governance issues. ISS will typically have a two week comment period of their voting recommendations with an understanding that their recommendations will be released 10 days thereafter. That is not indicative of a fair and open-minded process and, if a regulatory agency were to do so, it would be viewed as being arbitrary and capricious. Glass Lewis does not even have this modicum of a process. Furthermore, the proxy advisory firm recommendations sway a significant portion of shareholder votes without an understanding of methodologies. Instead we have a one size fits all approach and outsourcing of proxy voting by some portfolio managers.

This is not how a fair and informed corporate governance system should work and the rise of this flawed system coincides with the precipitous drop in the number of public companies in the United States.

Under this proposed legislation, proxy advisory firms would need to develop clear procedures and methodologies for the development of voting policies and recommendations. This would allow all for fair due process and prevent the system

[11] The full survey can be found at: http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/2015-Proxy-Season-Survey-Summary.pdf

from being rigged. All stakeholders would have a voice and proxy advisory firms would also have the certainty they need to ensure that their recommendations are based upon analysis, facts and meet the fiduciary duties and economic best interests of their clients.

The conflicts of interest that exist—one firm owning a consulting service, another being owned by an activist investor, neither disclosing if a proponent of a shareholder proposal or opposing director slate is a client—must be dealt with in a similar way as conflicts were for other industries in the past. Sunlight must be shed for all participants to know where there are conflicts and for the firms and their clients to manage those conflicts. This bill provides such a process. The appointment of a compliance officer will help resolve the issues and provide a point of entry for the SEC into the company to help deal with these matters.

An understanding of the resources available for a proxy advisory firm is also necessary for regulators and the marketplace to understand whether a firm has the ability to adequately research the items in a company's proxy materials and make recommendations to clients in a manner that allows clients to fulfill their fiduciary duties. Having 180 people researching thousands of companies worldwide and making recommendations on hundreds of thousands shareholder proposals and director elections in a compressed timeframe cannot meet those goals.

The behavior prohibited under the legislation would prevent the proxy advisory firms from being used as a tool by third parties to advance a hidden agenda. Those provisions, when coupled with the requirements on process and management of conflicts, will ensure that voting policies and recommendations are made through a thorough factual analysis.

One of the most important parts of the bill will be the ability for companies to be able to review and make commentary on proposed recommendations. Such input is important to ensure that proxy advisory firms understand all of the aspects of an issue and further prevent mistakes from being disseminated to investors. Glass Lewis does not allow such feedback. ISS allows for such feedback, normally for 24-48 hours, but not for companies who are outside of the S&P 500. This will help with accuracy and promote factual based analysis when making recommendations for all covered companies.

The reports by the SEC and Government Accountability Office will help to better inform Congress and the public if the goals of the legislation are bring met, if the implementing regulations are working and whether further action is needed.

A transparent and accountable proxy advisory industry that assists investors in meeting their fiduciary duties is critical for investor protection, capital formation, and competition. Efforts to deal with these issues by the industry itself have been partially effective at best. SEC Chair White and Corporation Finance Director Keith Higgins should be commended for taking on an oversight role and shedding the historic SEC notion of benign neglect in this area. While those steps have been helpful, this legislation deals with fundamental structural issues that must be resolved in order to make the public company structure in the United States work as effectively as possible to serve the long-term best interests of shareholders. .

4. SEC Regulatory Accountability Act

The Chamber strongly supports the passage of the "SEC Regulatory Accountability Act." This bill would institute innovative measures to improve the cost benefit analysis and rule writing by SEC.

The use of economic analysis in rulemaking is a significant issue of public policy, which is why the Chamber in 2013 issued a report, ***The Importance of Cost-Benefit Analysis in Financial Regulation*** outlining the legal requirements and historic use of cost benefit analysis by financial service regulators.

The SEC Regulatory Accountability Act codifies regulatory reform principles contained in Executive Orders 12866 and 13563, issued by Presidents Clinton and Obama. These bi-partisan principles include:

- **Regulators must identify the source of the problem and should promulgate a regulation only if the benefits outweigh the costs;**
- **Regulators must impose the least burden on society consistent with obtaining objectives;**
- **Regulators must identify and assess available alternatives to regulation;**
- **There must be public participation in the regulatory process;**
- **Regulators must evaluate if a proposed regulation is inconsistent, incompatible of duplicative of other federal regulations; and**

- **There should be a periodic review of existing regulations to identify obsolete or ineffective regulations.**

Smart regulation requires a re-thinking of the process for developing and implementing regulations. A final regulation should be the start, not the completion of this process. The current means of producing cost benefit analysis is limited and subject to potential manipulation. An economic analysis must be published during the rulemaking process to provide the public with an opportunity to review the analysis and provide commentary on it. This type of analysis is important for the public to understand a proposal and if it meets the criteria outlined above.

Accordingly, the Chamber believes that the innovative approach contained in the SEC Regulatory Accountability Act, combining a pre-adoption cost benefit analysis with a post-adoption look-back requirement, will allow the SEC to assess the real world impacts of new regulations and address unforeseen consequences quickly.

Under this approach, the SEC would collect data and re-evaluate a rule after a defined period to determine a rule's effectiveness, if it should be modified, or if it is needed at all. Such a periodic check of all rules would also help determine if rules are obsolete. Knowing that rules would be empirically examined would force the staff to develop an internal discipline to carefully weigh important factors in the drafting process. Requiring the examination staff to consider these issues at the outset would cause it to be more proproactive in its inspection program, less inclined to focus on after the fact disasters, and provide the SEC with more oversight of its function.

The SEC Regulatory Accountability Act will allow the SEC to better understand the markets and products it regulates, thereby preventing the regulatory dead-zones that were a contributory cause of the 2008 financial crisis.

Rule-writing by entities such as the PCAOB and Municipal Securities Rulemaking Board ("MSRB") are subject to the same requirements and enhancements contained in the SEC Regulatory Accountability Act. These subordinate organizations can develop standards and rules that can have the same effect as regulation. Rules of this sort also have to go through a final SEC rulemaking process and therefore should be subject to the same drafting requirements and cost benefit analysis.

5. Investment Advisors Modernization Act of 2016

An essential element of robust capital markets is the availability of professional investment advice. Unnecessary or duplicative regulatory burdens on investment

advisers that provide negligible investor protection benefits increase the cost of advice. Investment advisers pass those costs on to clients, including private equity and hedge funds, and other types of pooled investment vehicles. The math is simple: the more money a fund spends to obtain advice, the less money the fund has to invest in businesses that create jobs.[12]

The drag on investment caused by outdated regulations has increased in recent years because title IV of the Dodd-Frank Act required more investment advisers to register with the SEC. That is true even though the companies in which private funds invest and funds' investment advisers played *no* role in precipitating the 2008 financial crisis and never posed any systemic risk. The Investment Advisers Act of 1940 ("IAA") was enacted to provide a framework for the regulation of investment advisers but the law and regulations promulgated under it are badly in need of updating.

The Investment Advisers Modernization Act of 2016 would make sensible changes to the IAA to reduce unnecessary burdens on private fund investment advisers without any adverse impact on investor protection. The bill would eliminate not only the paperwork and storage burdens, but also the cybersecurity risks associated with storing troves of data and analysis collected for an adviser's due diligence on a company in which the fund ultimately decides not to invest. It would also simplify the rules relating to the assignment of investment advisory contracts. Without touching the absolute prohibition on misleading statements, which would remain completely intact, the bill would permit funds to use advertisements in their communications with investors possessing a higher degree of sophistication. And importantly, the bill would make sensible changes to the IAA's Custody Rule, which currently imposes unnecessary costs on private fund advisers with respect to privately offered or restricted securities and "friends and family" funds or special purpose vehicles that have only one portfolio company.

While the IAA's current regulatory requirements may yield some investor protection benefit for public company investors, their benefit to investors in private companies is negligible. The cost of compliance, however, is not negligible; it may even present a barrier to entry for smaller firms that specialize in investing in mid-cap companies. The Chamber encourages the Committee to report the Investment Advisers Modernization Act favorably to the House soon so that resources currently spent on compliance with unnecessary, duplicative, and outdated regulations can be redirected to more productive uses, like investments in Main Street businesses that innovate, produce goods and services, and create jobs.

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[12] According to the American Investment Council (previously the Private Equity Growth Capital Council), there was $632 billion in U.S. private equity investment in 2015.

6. Conclusion

The Chamber views these draft bills as critical steps to embrace new, innovative ideas and give our regulatory system the ability to adopt and fulfill its mission in changing times. Therefore, the items under consideration not only address specific issues that can be corrected, they also allow for experimentation and sustained efforts to modernize regulations.

The Proxy Advisory Firm Reform Act of 2016, SEC Regulatory Accountability Act, and the Investment Advisors Modernization Act of 2016 would help provide for more efficient capital markets, give investors additional and more reliable information, and provide the SEC with the capability for better oversight of the capital markets. This is a small but necessary step forward to help businesses access the capital needed to grow.

I am happy to take any questions that you may have at this time.