On behalf of the Institute for Policy Innovation (IPI), a free-market public policy research organization that focuses our efforts on factors that affect economic growth, I appreciate this opportunity to share our thoughts for the Commission’s Roundtable on the Proxy Process. We will comment on several discrete areas that we think the Roundtable should consider.

**Introduction: Voice and Exit**

While improving the process of shareholder involvement in corporate governance is important, we should never lose sight of the fact that, as long as shareholders have the right of exit, they retain their most important power.¹ There is no more powerful means of expressing an opinion about corporate governance than shareholder exit. In a functioning securities market, shareholders never have to put up with a corporation’s governance or other practices for one minute longer than they wish—they are not captive, and they are not powerless. If they don’t like anything about the company, they can leave immediately in almost all cases. In this way, the market itself passes judgment upon corporate governance practices in a much more powerful way than any rule the Commission can propound, though of course the Commission’s requirements of honest and transparent information empowers shareholders to make good decisions.

Shareholder right of exit is a fundamentally important factor that should not go unsaid, because too often shareholder activists and proxy advisory services act as if the only way to protect shareholders is through additional regulations. But this is simply not the case. Any shareholder who feels unhappy with anything about their investment in Company X can leave at a moment’s notice.
This observation, of course, reflects the important work of Albert Hirschman that there are two possible responses of a member of an organization to the perception of decreased benefit to the member: He or she can attempt to improve the situation through voice, or they can withdraw from the relationship through exit.

Of the two, while voice is important, exit is most powerful. The Commission’s emphasis on improving shareholder voice is commendable but the Commission should not lose track of the fact that shareholders always have exit. The Commission should not write rules as if shareholders don’t have exit.

Some might ask: But what if a shareholder is very happy with the economic performance of a company, but not with its corporate governance? We would suggest that under such circumstances, the shareholder’s judgment about the corporation’s governance is probably wrong. Superior market performance is proof that those governing the corporation are meeting their fiduciary obligations to the owners of the company. A shareholder’s opinion about ancillary governance issues that do not affect financial performance are the shareholder’s problem to deal with, and the shareholder may have a decision to make, but the shareholder should not be artificially empowered by regulation to foist their personal agendas upon the corporation as an extraneous burden.

And certainly the purpose of shareholder voice is not for shareholders, all too often an activist minority, to impose their political preferences upon corporate governance. We believe Commission rules have empowered shareholders who wish to do exactly that, and we urge the Commission to remove incentives for doing so, and in particular to remove devices that either intentionally or unintentionally have empowered political activists to conscript corporate governance into their particular political causes.

In summary, the Commission should not work from the assumption that shareholders’ powers of voice should be artificially amplfied through regulation, because to do so discounts the importance and power of shareholder exit. In a free-market economy, it is unnecessary and counterproductive for the Commission to disproportionately empower shareholder voice, because shareholders already possess the most important market power of exit.

**Concern: Where Have All the Public Companies Gone?**

There is no public policy principle by which we should prefer or favor public companies over private companies, but it is nonetheless indicative that there are today half as many public companies in the U.S. as there were twenty years ago.ii The last time the Wilshire 5000 index consisted of 5,000 companies was in 2005; today, it is comprised of less than 3,500 companies. While there are many factors behind this shift, regulatory burden is certainly one of them.

From the standpoint of the investor, it is better for there to be more rather than fewer public companies. More choice makes more diversification possible. And from an economic growth standpoint, it would also seem that more public companies would create more efficiency. We would not purport to know what the “right” mix of public and private companies is, but we think it’s likely that the mix is being distorted today because of the regulatory burden.

The fact that such a dramatic shift has taken place in a relatively short period of time should indicate to the Commission that one or more unusual things have happened. We would suggest
that one such development is the rise of shareholder activism that is unrelated to financial performance. Commission rules should not empower such activism.

**Concern: Blurring the Fiduciary Obligations of Corporate Governance**

What is the duty of corporate governance today? Is it maximizing shareholder value within the law? Or is it to be an agent of social change? Is it appropriate for government to insert itself between a corporate board and its fiduciary obligation, and conscript corporations to adopt and push non-financial objectives? How are corporate boards to determine between these often conflicting mandates? Would such conflicts be sufficient to drive a company private, or to convince a company to never go public?

If such were to happen through a proper legislative process, it would at least be accomplished through a legitimate, expressly democratic process. But what if government has facilitated the politicization of corporate governance not through a legislative process, but rather through a regulatory rulemaking?

What if Commission rules have empowered activist shareholders to burden companies with never-ending “zombie” corporate governance proposals that are often unrelated to a company’s financial success and in fact in conflict with the board’s fiduciary obligations? And what if Commission rules have empowered a small number of very powerful, unaccountable proxy advisors with agendas of their own?

We believe this is precisely what has happened.

The U.S. Chamber of Commerce’s recent “Zombie Proposals” study contains some rather shocking statistics, including:

- Current SEC rules can allow a proposal that received nearly 90% opposition in multiple years to be continuously resubmitted, creating annual pointless compliance headaches for both shareholders and corporate boards.
- According to the analysis, only 5% of these types of proposals passed. Zombie proposals made up to 32% of all failed proposals.

It’s important to note that, by blurring the obligations of corporate governance to include matters unrelated to maximizing shareholder value, shareholders are harmed. Particularly in the ultra-low interest environment of the last decade, shareholders on fixed incomes have depended on market returns for their retirement income. They postponed consumption and saved for their entire lives for this purpose, and for their returns to be reduced because corporations are being asked to attend to matters other than maximizing shareholder value is a betrayal of the representations made to them.

Also worth noting by allowing zombies to stick around through low resubmission thresholds, the SEC is forcing a silent majority of shareholders to divert resources to respond to the agenda of a minority of activists.
Concern: Politicizing Corporate Governance

We have a serious concern that proxy advisory firms sometimes advance agendas that are totally or almost totally unrelated to issues affecting financial performance, and thus we would characterize these as political rather than financial or fiduciary matters.

From a civic standpoint, we believe that it is harmful to American society for every aspect of life to be politicized. In the limited government society envisioned by the Founders, politics is a necessary element of life, but not the major concern of every American. But today, politics seems inescapable—not at church, not at university, and not even in a neighborhood.

Unfortunately, we believe the Commission has contributed to this trend expanding to Corporate America, where activist shareholders are pressuring businesses to adopt political positions through organized shareholder activism. Companies with business lines often wholly unrelated are being asked to take positions on rights of indigenous peoples, use of pesticides, deforestation, gender issues, clean energy and climate change. And these resolutions are often reinforced, if not originated, by a tiny number of proxy advisors who have no financial stake in the outcome and no fiduciary obligation to shareholders.

In fact, the proxy advisory services seem to go out of their way to be unresponsive and unaccountable:

- When 29% of surveyed companies tried to meet with proxy advisory firms, their requests were denied 57 percent of the time.iii

This failure to actually meet with companies and discuss the real-world impact of their advice undoubtedly is part of the reason why corporations have little confidence in proxy advisors:

- Only 39% of companies surveyed believe that proxy advisors did careful research and took into account all relevant aspects of issues related to the proxy recommendation.iv

This opinion is shared by Professor Robert J. Watkins of Ohio State University, who has asserted that “many of the governance recommendations of proxy advisors are based on thin (or no) empirical evidence.” He compared the actions of proxy advisors to those of the credit ratings services that exerted such disproportionate power right up until the financial crisis they themselves helped create revealed that the credit ratings emperors had no clothes. He also finds “evidence that advice from those entities appears to be of poor quality.”

This matters gravely, because as Professor Watkins says, “capital is allocated and crucial corporate governance decisions are often driven on the basis of these ratings and recommendations.” This means that bad corporate decisions driven by uninformed proxy advisory services can cascade throughout the economy, affecting the entire nation.

Concern: Disproportionate Powers Made Available to Proxy Advisory Services as a Result of the Law of Unintended Consequences

Proxy advisory services are out-of-control. They have no fiduciary obligations, their power is highly concentrated, they are bulging with conflicts of interest, and shareholders generally understand none of this. For all of the transparency and disclosure obligations that burden corporations, proxy advisors get a nearly free-pass from the Commission.
Above we have referenced the concept of “zombie proposals,” which continue to show up on ballots despite attracting minimal support. A good bit of the blame lies with proxy advisors:

- In 2018, proxy advisory firm ISS supported 95% of these zombie proposals, an increase from 88% in 2016.\(^v\)

And while proxy advisory firms have gained significant power, under current rules they do not have to comply with normal and standard Commission rules governing financial firms, such as disclosing conflicts of interest, and following a code of ethics. They can operate as a “black box” without disclosing methodologies, procedures and policies.

As Timothy Doyle of the American Council for Capital Formation has noted, “proxy advisors have emerged as quasi-regulators with unchecked power.”\(^vi\) This is problematic in and of itself, much less when considering their exemptions from oversight.

Concerns about conflicts of interest with proxy advisors have become commonplace. In the mid-2000s the Ohio Public Employee Retirement system dropped ISS’s services because of concerns about conflicts of interest. And a research paper by Tao Li of Warwick Business School strongly suggests that conflicts of interest exist with proxy advisors.\(^vii\)

Li finds that “conflicts of interest are a real concern in the proxy advisory industry, and increasing competition could help alleviate them.”

**Concern: The Role of the Small Shareholder**

We don’t like the idea of major shareholders imposing a political agenda upon the governance of a company, but large shareholders at least do have sufficient stake to justify the expectation of influencing corporate governance. So it’s hard for us to make an argument against such activism.

Small shareholders, however, do not expect to run companies. What small shareholders want (and we know this from polling) is maximum financial returns.

- According to a survey by the Spectrem Group, 88% of public pension plan beneficiaries want plan assets to be used for maximizing returns, not political agendas, even if they agree with the cause that is advocated.\(^viii\)

Average shareholders rely upon their investments for college savings, retirement, and leaving a legacy to their children.

Commission rules that allow a tiny number of small shareholders (or indeed, non-shareholders such as proxy advisors) to attempt a disproportionate amount of influence over corporate governance do a severe disservice to the large majority of small shareholders, who own shares as investments, rather than as leverage over corporate governance.

That’s why it seems unreasonable to most shareholders that, in a recent episode, a Tesla shareholder controlling only 12 shares of stock was able to introduce a resolution to oust Elon Musk as chairman. Most shareholders want maximum returns, not disproportionate control over corporate governance.

It seems that proxy advisors and some large institutional investors may have different priorities in this regard than typical shareholders:
According to a 2017 analysis by Broadridge and PricewaterhouseCoopers, large institutional investors supported environmental and social board resolutions 54 percent of the time, while only 10 percent of shares held by individual investors supported such resolutions. 

The Commission should not be making it easier for activist shareholders to exert a disproportionate influence over non-financial corporate governance matters at the expense of maximizing returns to the vast majority of individual shareholders.

Conclusion

IPI supports congressional action to address the concerns we have mentioned, including H.R. 4015, the Corporate Governance Reform and Transparency Act of 2017. It should probably not be a surprise that 97% of companies have indicated their support for the legislation as well, according to the U.S. Chamber of Commerce.

But in addition, we urge the Commission to be responsive to these concerns as well. Only legislation can lock in policy that spans Executive Branch administrations, but because today it seems so difficult for Congress to do its job, we urge the Commission to take action to rein in the intended and unintended consequences of its various rules that have created an environment where corporations are being distracted and hassled by often zombie resolutions utterly unrelated to shareholder value and driven by other-than-empirical factors, most often a political agenda. It’s better for everyone if corporate governance focuses on fiduciary obligations to shareholder value, and politics stays in the political arena.

Sincerely,

Tom Giovanetti
President

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i While it’s true that some investment vehicles designed to be indexes or otherwise passive mirrors of particular markets may claim to not actually be able to exit, one might well wonder under what justification do managers of indexes or passive investments seek to be activists?

ii https://www.wsj.com/articles/where-have-all-the-public-companies-gone-1510869125

iii Proxy Season 2018: Examining Developments & Looking Forward, Center for Capital Markets, U.S. Chamber of Commerce


v https://corpgov.law.harvard.edu/2018/05/22/the-conflicted-role-of-proxy-advisors/


viii 2017 Proxy Season Review, ProxyPulse (a Broadridge\PwC Initiative)