NATIONAL ASSOCIATION OF Manufacturers

Chris Netram

Vice President,
Tax and Domestic Economic Policy

October 30, 2018

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: File No. 4-725: *SEC Staff Roundtable on the Proxy Process*

Dear Mr. Fields:

The National Association of Manufacturers (NAM) appreciates the opportunity to provide comment to the Securities and Exchange Commission (SEC) in advance of its November 15, 2018, roundtable on the proxy process.

The NAM is the largest industrial trade association in the United States, representing small, medium, and large manufacturers across a wide range of economic sectors. Manufacturers employ more than 12 million Americans and contribute more than $2 trillion to the U.S. economy each year.

Manufacturing is a capital-intensive industry, requiring significant investments for equipment purchases and research and development (R&D). Manufacturers often turn to the capital markets to finance these pro-growth activities, which set the stage for economic expansion, innovation, and job creation. By offering shares to the public, manufacturers provide every American with the opportunity to participate in the industry's success, often through shares held by mutual funds, 401(k) accounts, and pension plans. Additionally, manufacturing workers depend on the public market to invest for retirement – 67 percent of manufacturing workers participate in a defined benefit or defined contribution retirement plan through their employer.[1]

Manufacturers know that the proxy ballot is central to enabling smart business growth and strong investor returns. A well-calibrated proxy process allows company management to engage in a productive dialogue with investors, who are of course the ultimate owners of any publicly-traded corporation, about key aspects of the business. Conversely, a flawed proxy process can be hijacked by unregulated third parties with little-to-no stake in company success or investor returns. These outside actors often pursue agendas divorced from shareholder value creation and divert valuable resources from job creation and R&D. Given the importance of a well-functioning proxy process, the NAM applauds the SEC for hosting the roundtable as a means to ensure that the proxy process supports investor-management dialogue, which is critical to the success of any publicly-traded business.

As the Commission considers discussion items for the roundtable and potential future regulatory actions, the NAM encourages focusing on ways in which the proxy process can be strengthened to bolster the relationship between public companies and Main Street investors and ensure that all parties in the system – investment advisers, company management, and proxy advisory firms alike –

[1] *National Compensation Survey: Employee Benefits*. Bureau of Labor Statistics, March 2018. https://www.bls.gov/ncs/ebs/benefits/2018/ownership/private/table02a.pdf.

remain focused on delivering returns for Americans investing for a child's education, a new home, or a secure retirement. Specifically, we urge the SEC to highlight the importance of effective guardrails around third parties (like proxy advisory firms and activist investors) that often detract from business growth and shareholder value creation, underscore investment advisers' fiduciary duty to the Main Street investors whose retirement accounts they manage and emphasize how that fiduciary duty extends to decisions around proxy voting, and focus on streamlining the proxy process in order to allow publicly-traded manufacturers to continue to focus on growing their businesses and driving shareholder returns.

I. Proxy Advisory Firms

The NAM was greatly encouraged by the SEC staff's recent decision to withdraw the 2004 no-action letters issued to Institutional Shareholder Services, Inc. (ISS) and Egan-Jones Proxy Services (Egan-Jones). These no-action letters have entrenched and empowered proxy advisory firms for more than a decade. The NAM believes the letters' withdrawal is an important first step toward a productive discussion about the firms' role in the marketplace at the November roundtable and, ultimately, targeted reform of the rules governing the proxy firm industry.

In the absence of the now-withdrawn no-action letters, market participants need clear guardrails around the relationship between investment advisers and proxy advisory firms. The NAM urges the SEC to take this opportunity to provide certainty to the market and implement effective guidance and/or regulation that underscores investment advisers' fiduciary duty to shareholders when utilizing the services of a proxy firm.

Impact of Proxy Advisory Firms

Proxy advisory firms have risen to prominence in the wake of increased institutional ownership of American stocks. According to one recent report, institutional investors now control nearly 80 percent of market value on U.S. exchanges.[2] Fund managers at institutions, charged with voting an ever-increasing number of proxies on their clients' behalf, have turned to proxy firms to shape, and sometimes even cast, their votes. These unregulated firms have enormous influence over the corporate governance policies of U.S. public companies – decisions that impact the direction of a business and the life savings of millions of Main Street investors.

To be clear, the NAM does not object to proxy firms playing a role in providing information to the marketplace. To the extent that their relationships with institutional investors result in more information for the market and enable these institutions to better serve their Main Street investor clients, the NAM believes that proxy firms can be constructive and provide a useful service. A neutral, fact-based process that results in helpful recommendations presented alongside management proposals can only benefit investors and issuers. However, the current situation is far from a neutral, fact-based process, and the recommendations produced are often problematic in a variety of ways. Indeed, the flaws embedded into the business model of proxy advisory firms are at this point well-documented, and manufacturers have time and again faced significant costs due to their influence:

- Proxy firms insist upon a one-size-fits-all approach to corporate governance, irrespective of the differences in companies' business models and the flexibility allowed under securities law;
- The process by which proxy firm recommendations are developed features a notable lack of transparency, and the firms' one-size-fits-all policies are likewise developed out of the public

[2] McGrath, Charles. "80% of equity market cap held by institutions." *Pensions & Investments*, 25 April 2017. http://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions.

eye (unlike the SEC rules with which public companies must comply, which are of course subject to a rigorous notice-and-comment process);

- Proxy firm reports and recommendations feature a profusion of errors and misleading statements, ranging from specific incorrect facts to disingenuous assumptions about, for instance, a company's peer group or compensation practices;[3]
- Proxy firms have been steadfastly resistant to engaging in a productive dialogue with issuers to correct these errors; indeed, one of the firms will only engage with companies in the S&P 500, while the other charges issuers a fee to review their draft recommendations;[4] and
- Proxy firms often engage in "robo-voting" on behalf of their clients, meaning that the flaws baked into their recommendations are translated immediately into voting power, completely cutting investment advisers and their clients out of the process and depriving issuers of a chance to correct the record or help investors better understand their side of the story.[5]

In addition to the flawed process described above, proxy advisory firms also have *prima facie* conflicts of interest. Of the two leading firms in the space, one is owned by an investor that sponsors proxy proposals, while the other operates a consulting business that counsels companies on the very corporate governance policies on which the advisory side of the firm makes recommendations. These significant conflicts of interest are particularly concerning given that investment advisers have been relying on proxy firms in large part to *avoid* conflicts of interest.

2004 ISS and Egan-Jones No-Action Letters

The traditional view of proxy voting holds that the proxy ballot solves the principal-agent problem intrinsic in the public company ownership model by allowing principals (shareholders, the true owners of a business) to provide direction to their agents (company management, which does not own the business but which exercises day-to-day control over it) in areas in which their incentives may not be perfectly aligned. However, most shareholders in today's marketplace do not own shares directly; rather, they access the market via passive investment vehicles like mutual funds and ETFs. The investment advisers who manage these funds step in between shareholders and company management and make proxy votes on the shareholders' behalf. These investment advisers owe a fiduciary duty to the Main Street investors whose retirement accounts they manage, and their decisions on how to vote an investor's shares in a corporate proxy contests must be guided by the investor's best interests.

SEC Rule 206(4)-6, commonly known as the Proxy Voting Rule, requires that advisers cleanse themselves of any of their own potential conflicts of interest in carrying out that fiduciary duty, and it allows them to do so by relying on the recommendations of an "independent third party." No-action letters issued to ISS and Egan-Jones in 2004 flesh out the investment adviser's duties when that third party is a proxy advisory firm. Unfortunately, however, the letters largely allow investment advisers to outsource their decision-making (and, often, their voting power) to the firms. This has, in

[3] Placenti, Frank M., *Are Proxy Advisors Really A Problem?* October 2018. http://accfcorpgov.org/wp-content/uploads/2018/10/ACCF_ProxyProblemReport_FINAL.pdf. A review of supplemental proxy filings from the 2016, 2017, and 2018 proxy seasons found 139 instances of factual errors, analytical errors, or serious disputes in proxy firm reports. These findings represent the tip of the iceberg, as many companies for a variety of reasons do not file supplemental proxy statements when they take issue with a proxy firm's recommendation.

[4] *Id.* 85 percent of companies report that they found out about adverse ISS recommendations less than 72 hours before the recommendations were made public. Glass Lewis provided even less opportunity to correct the record, with fully 84 percent of respondents reporting that they did not receive any advance notice at all.

[5] *Id.* A recent survey found that companies, on average, experienced a 19.3 percent uptick in shareholder votes against management within three days of an adverse ISS recommendation. Given the short turnaround, these quick votes are likely attributable to robo-voting, depriving companies of the opportunity to engage with investors or to file a supplemental proxy statement. Robo-voting thus compounds the problem of significant errors in proxy firm reports.

effect, corrupted the chain of principal-agent relationships that ensure shareholders' best interests guide market actors' decisions. Management owes a fiduciary duty to the investment advisers acting on shareholders' behalf; investment advisers owe a fiduciary duty to the shareholders themselves. Proxy firms have no such obligation to anyone. Yet investment advisers have been incentivized by the no-action letters to bring proxy firms into the process as insurance against potential charges of conflicts of interest – irrespective of the quality of the firms' recommendations or the flaws intrinsic to their business model – leading to the market distortion manufacturers and Main Street investors are experiencing today.

Of particular concern, the no-action letters largely ignore the fact that proxy firms themselves are remarkably conflicted, so investment advisers' reliance on the firms, intended to obviate conflicts of interest, has instead entrenched them. Indeed, the ISS no-action letter notes that investment advisers do not need to consider potential proxy firm conflicts on a case-by-case basis, while the Egan-Jones letter specifically excludes business consulting services as an intrinsic conflict. In addition to entrenching the firms' conflicts, investment advisers' reliance on proxy firms under the no-action letters has also allowed the firms' one-size-fits-all, non-transparent approach to corporate governance to flourish.

The NAM believes that the SEC staff's decision to withdraw the no-action letters is an important first step toward restoring the primacy of a fund manager's fiduciary duty to protect investors' retirement savings. It will also have the effect of reducing proxy firms' influence over manufacturers and the important decisions that guide company growth, job creation, and economic expansion in America.

Going forward, we encourage the SEC to replace the 2004 no-action letters with staff guidance or Commission rulemaking that better regulates the relationship between fund managers and proxy firms. Institutional investors are both the firms' primary clients and everyday Americans' primary investment outlet; this nexus provides a critical opportunity to ensure that investment advisers are not over-relying on proxy firms at the expense of the long-term health of Main Street investors' retirement savings.

Investment Managers' Fiduciary Duty to Shareholders

As the SEC considers how best to replace the 2004 no-action letters, we urge it to consider the standards a proxy advisory firm must meet to qualify as an "independent third party" on which an investment adviser could rely under Rule 206(4)-6. By conditioning an adviser's reliance on a proxy firm upon certain conditions, the SEC can underscore the tie between an investment adviser's proxy vote decision, including the decision on whether to utilize a proxy advisory firm, and the adviser's ultimate fiduciary duty to shareholders.

The NAM believes that an investment adviser should only be allowed to cleanse itself of conflicts of interest by relying on a proxy firm if the proxy firm meets certain standards. In particular, we believe that advisers should be required to verify, on a case-by-case basis, that any given recommendation is not poisoned by a conflict of interest like a proxy firm's business consulting relationship with an issuer or contract with a proponent or supporter of shareholder proposals – especially since a key reason for utilizing proxy firms is the avoidance of conflicts.

Furthermore, we believe that investment advisers should only be able to rely on proxy firms that have specific policies in place in the event of a contested recommendation. These recommendations are the heart of the firms' flawed business model – they often flow from one-size-fits-all policies, and the firms do not give issuers an opportunity to correct mistakes (either with the firm or with investors) when a recommendation is contested. Additional guardrails are unnecessary if a recommendation is uncontested, but certain standards should be met if an issuer believes a proxy firm has significantly misstated an issue. In all cases, proxy firms should provide issuers with a copy of the recommendation with sufficient time for review; if a recommendation is contested, the firm should (1) give the issuer an opportunity to respond to the recommendation, (2) disclose and justify the impact of any significant departures in methodology between the proxy firm and the issuer (*e.g.*, differences in determining peer group, disclosed compensation, or business metrics),[6] (3) include in the materials provided to the investment adviser a dissenting opinion from the issuer explaining the reasoning behind management's preferred course of action and/or highlighting errors in the firm's report, and (4) disable any robo-voting policies on the recommendation. Such an approach would improve the breadth and quality of information available to an investment adviser and enable it to make a proactive vote choice in the best interest of the investors whose funds it manages.[7]

The NAM believes that the upcoming proxy roundtable should include a robust discussion on how a reliance on proxy advisory firm recommendations impacts an investment manager's fiduciary duty to its clients. By centering the conversation on the investment adviser's fiduciary duty, the SEC can provide clarification on the due diligence required of advisers managing millions of Americans' retirement savings as well as the role that proxy firms play in the market.[8] Staff guidance or Commission rulemaking that builds on such a discussion so as to provide clarity to the market, now operating without the 2004 ISS and Egan-Jones no-action letters, would provide effective guardrails for the investment adviser-proxy firm relationship and foreground both parties' obligation to enhance shareholder value creation for Main Street investors.

SEC Oversight of Proxy Advisory Firms

The SEC could also consider a more direct approach to proxy advisory firm oversight. As discussed, proxy firms have become *de facto* regulators over company policies that impact millions of jobs and trillions of dollars in retirement savings, so the firms and their recommendations would certainly benefit from direct oversight and reform. The NAM has endorsed the Corporate Governance Reform and Transparency Act,[9] which would require proxy firms to register with the SEC. This bill, approved by the House of Representatives on a bipartisan basis, would ensure that the firms mitigate their own conflicts of interests and make reforms to their recommendation process to enhance transparency, reduce errors, increase issuer engagement, and move away from one-size-fits-all policies.

However, the SEC has the power to act without additional statutory authority from Congress. Proxy advisory firms currently rely on exemptions from the proxy solicitation rules under SEC Rule 14a-2(b). These exemptions allow the firms to avoid the Schedule 14A regulatory regime, and they have historically tailored their business to ensure that it fits within the confines of the proxy solicitation exemptions. By making targeted reforms to these exemptions, the SEC could ensure that investors

[6] Proxy firms make determinations about metrics like a company's peer group at the end of the year, a notable departure from the approach required of companies (which select their peer group at the beginning of the year in order to set their governance agenda). A proxy firm's analysis and recommendations will thus tend to be skewed when made with the benefit of 20/20 hindsight, whereas issuers make their judgements without knowing how the year will play out. Disclosing these differences would allow an investment adviser to fairly compare a company's decision vs. the firm's recommendation, but the problem could be mitigated entirely if proxy firms followed the same standards as companies and published peer groups and other company benchmarks at the year's outset.

[7] It is worth noting that the investment adviser would, in all cases, retain the right and ability to disagree with management and vote in line with the proxy firm's recommendation. Our proposal would simply improve the quality of information available in advance of that vote and ensure that the adviser is making a proactive decision rather than relying on a robo-vote by the proxy firm.

[8] It also may be pertinent for the SEC to reconsider the presumption that an investment adviser must vote in every proxy contest absent direction from a client and instead think through how that decision can be consistently subjected to the same shareholder value creation calculation to which voting decisions are subject.

[9] H.R. 4015, sponsored by Reps. Sean Duffy (R-WI), Gregory Meeks (D-NY), and Lamar Smith (R-TX).

are receiving accurate, conflict-free information without the complexity and cost burden that some contend a registration regime would impose on proxy firms.

Amendments to the proxy solicitation exemptions should address the key structural flaws endemic to the proxy firms' business model – namely, their one-size-fits-all policies, lack of transparency, propensity for errors, misleading assumptions about key benchmarks like peer groups, lack of dialogue with issuers, problematic robo-voting policies, and significant conflicts of interest. It would be relatively straightforward for the SEC to condition the proxy solicitation exemptions upon a proxy firm addressing these challenges. Specifically, the NAM urges the SEC to consider an exemption on which the proxy firms could rely that requires substantial mitigation of conflicts of interest as well as a robust process in the event of a contested recommendation (*e.g.*, one that allows issuers time to review the recommendation and submit a dissenting opinion and requires investment advisers to make a proactive decision rather than relying on robo-voting).

The regulatory regime under the proxy solicitation rules is well-established among the relevant stakeholders, so adoption of these reforms would be simple and straightforward. The NAM believes the SEC should consider this approach at the upcoming roundtable and, ultimately, as it considers how best to address the problems posed by proxy advisory firms.

II. Shareholder Proposals

NAM members value a constructive dialogue with shareholders. Manufacturers expend significant effort conducting outreach to investors about the direction of their businesses, and they strive to structure corporate governance policies to the benefit of long-term shareholder value creation. Yet despite these good faith efforts on the part of issuers and the vast majority of investors, the proxy process has in recent years been hijacked by activists that seek to force companies to act according to their own narrow interests rather than the good of the business or long-term investor returns. In many instances, these third parties take the form of activists pursuing political goals unrelated to business growth and the corresponding capital investments, R&D spending, and value creation that come with it. The proxy ballot was designed for the majority of investors to constructively engage with company management, but it has devolved in many ways into a shouting match focused on social and political issues.

To be clear, the NAM believes strongly in the importance of managing the risk of climate change, ensuring clean air and water, increasing workplace diversity, and addressing many of the other issues often pursued by activists. Indeed, manufacturers have taken proactive steps to implement environmental, social, and governance (ESG) policies suitable for their business and their investors. However, the NAM does not believe that it is appropriate for activists to abuse the proxy ballot to push goals that are better addressed by Congress or other policymaking institutions. Indeed, a recent academic study co-authored by Professor Joseph Kalt of Harvard University found that ESG proposals detract from shareholder value, contradicting activists' claims that such proposals are beneficial to shareholders.[10] This issue is exacerbated when investment advisers engage in political activity by leveraging the shares they manage – the retirement savings of millions of Americans who are unaware that their fund managers have a political agenda outside of shareholder value creation.

The NAM believes that the upcoming proxy roundtable should feature a robust discussion on two key questions around shareholder proposals:

- How can we return to a proxy process that reflects the original purpose of the proxy ballot, and what rules are in place to ensure that shareholder voices can be heard without being

[10] Joseph P. Kalt, L. Adel Turki et al., *Political, Social, and Environmental Shareholder Resolutions: Do They Create or Destroy Shareholder Value?* June 2018. http://www.shopfloor.org/wp-content/uploads/2018/06/nam_shareholder_resolutions_survey.pdf. (This study was commissioned by the NAM).

drowned out by third parties with little-to-no stake in a company and/or an agenda divorced from shareholder value creation?

- How can investment advisers stay true to their fiduciary duty to Main Street investors when considering how to vote on ESG resolutions, and how can the primacy of that fiduciary duty be communicated to both investment advisers and shareholders?

As the SEC considers its policymaking options during and after the roundtable, the NAM believes it can pursue parallel courses of action to address these important issues.

Resubmission Thresholds

To protect the integrity of the proxy ballot and preserve the right of investors to engage with management on important corporate governance issues while limiting the impact of activists with political agendas, the SEC should make targeted reforms to the resubmission thresholds in Exchange Act Rule 14a-8(i)(12). Under the current rule, failed shareholder proposals are guaranteed a spot on the succeeding year's proxy ballot if they garner only 3 percent of the investor vote, with the threshold increasing to 6 percent after two votes and 10 percent after three or more votes. By guaranteeing resubmission for failed proposals with overwhelming shareholder opposition, these outdated thresholds divert management time and company resources, and prioritize a small set of activist investors over the good of the company and the broader shareholder base.

In 1997, the SEC proposed targeted reforms to these thresholds, proposing increases to 6 percent after one vote, 15 percent after two votes, and 30 percent after three or more votes. At the time, the Commission noted that proposals failing to meet the increased thresholds would be "fairly tested" and would stand "no significant chance of obtaining the level of voting support required for approval."[11]

Politically-motivated activism divorced from long-term shareholder value creation has only increased since 1997, further underscoring the need for reform. Indeed, a recent analysis of shareholder proposals submitted between 2001 and 2018 found that nearly 30 percent of all proposals had been resubmitted three or more times.[12] The continued resubmission of "zombie" proposals distracts from legitimate issues on the proxy ballot and ignores the wishes of the 90 percent or more of investors who rejected them in the first place. The NAM urges the SEC to prioritize the needs of Main Street investors and implement increased resubmission thresholds based on its 1997 proposal. The SEC could also consider a cutoff or a waiting period for zombie proposals that have continually failed to receive majority support after multiple votes.

Similarly, the SEC should make targeted reforms to the initial submission threshold under Rule 14a-8(b). This threshold allows any investor that has held just $2,000 worth of company stock for at least one year to place a proposal on the proxy ballot. This incredibly low threshold has given rise to individuals who spam company proxy ballots by taking *de minimis* positions in a wide range of issuers so as to qualify their pet proposals on dozens of company proxy ballots. Indeed, in 2017 fully 25 percent of all shareholder proposals were sponsored by just three investors and their families.[13] The NAM supports increasing the existing $2,000 threshold to a level that more appropriately reflects true "skin in the game" for a shareholder sponsoring a proposal.

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[11] Release No. 34-39093*: Proposed Rule: Amendments to Rules on Shareholder Proposals.* 18 September 1997. https://www.sec.gov/rules/proposed/34-39093.htm.

[12] *2018 Proxy Season Trends*, FTI Consulting Strategic Communications. https://fticommunications.com/2018/08/2018-proxy-season-trends/.

[13] Copland, James R. and Margaret M. O'Keefe, *Proxy Monitor 2017: Season Review*. November 2017. http://www.proxymonitor.org/Forms/pmr_15.aspx.

Proxy Voting Guidance

To ensure that investment advisers that vote on behalf of Main Street investor clients remain solely focused on their fiduciary duty to enhance long-term shareholder value, SEC staff should issue guidance under the Proxy Voting Rule that clarifies a fund manager's obligations when considering how to vote on a politically-driven proposal.

Specifically, the NAM believes that investment advisers should have policies and procedures in place that require the identification of a clear link to shareholder value creation before voting in favor of any proxy proposal, including those focused on ESG topics – or have procedures that allow more direct input from retail shareholders themselves on these issues. Additionally, investment advisers should be required to have policies to insulate themselves from external pressures, including from potential clients and the institution's own shareholders, to support ESG proposals that may not be in shareholders' best interests. Advisers should disclose any and all such policies to investors so that investors can make informed decisions about whom they choose to manage their retirement savings and investment advisers can be held accountable to their fiduciary duty.

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Manufacturers believe that the upcoming proxy roundtable represents an exciting opportunity to have an important conversation about ways to improve the proxy process. In particular, reforms are needed to the regulatory regimes around proxy advisory firms and shareholder proposals, and a robust discussion of these issues can only benefit the health of America's capital markets. The NAM also encourages the SEC to take concrete action to address these issues following the roundtable in order to reinforce investment advisers' fiduciary duty to Main Street investors, institute rules that enable business growth and shareholder value creation, and ensure that America's public markets continue to support the growth of manufacturers in all 50 states.

On behalf of the NAM and the 12 million men and women that make things in America, thank you for your attention to these concerns.

Sincerely,

Chris Netram
Vice President, Tax & Domestic Economic Policy