Mr. Brent J. Fields, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
via SEC internet submission form

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

Dear Mr. Fields,

I am Associate Professor of Law at the Antonin Scalia Law School, George Mason University, and spent two years as Chief Economist and Senior Counsel for the U.S. House Committee on Financial Services.[1] In that capacity, I welcome the opportunity to contribute to the Securities and Exchange Commission's (SEC) Roundtable on the proxy process. Throughout my career, as both an academic and professional, much of my research and work has focused on corporate and securities law and financial regulation.

Among other areas, the SEC has sought public submissions on the role that the two dominant proxy advisors play in the proxy process and, specifically:

- *Whether various factors, including legal requirements, have resulted in investment advisers to funds and other clients relying on proxy advisory firms for information aggregation and voting recommendations to a greater extent than they should, and whether the extent of reliance on these firms is in the best interests of investment advisers and their clients, including funds and fund shareholders.*

- *Whether issuers are being given an appropriate opportunity to raise concerns if they disagree with a proxy advisory firm's recommendations, including, in particular, if the recommendation is based on erroneous, materially incomplete, or outdated information.*

- *Whether there is sufficient transparency about a proxy advisory firm's voting policies and procedures so that companies, investors, and other market participants can understand how the advisory firm reached its voting recommendations on a particular matter, and whether comparisons of recommendations across similarly situated companies have value.*

- *Whether there are conflicts of interest, including with respect to related consulting services provided by proxy advisory firms, and, if so, whether those conflicts are adequately disclosed and mitigated.*

- *The appropriate regulatory regime for proxy advisory firms and whether prior staff guidance about investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms should be modified, rescinded, or supplemented.*

As part of my research on corporate law and financial regulation, I have placed particular focus on these questions, including research for the Mercatus Center at George Mason University, together

[1] In the interest of disclosure, I serve on the board of directors of a firm that provides proxy advisory services, Egan-Jones. I do not speak on their behalf but only for myself in my role as an academic.

with my co-author James K. Glassman. The following are my views on the impact the two dominant proxy advisors in the industry, ISS and Glass-Lewis have had on corporate governance and capital markets.

Influence

More institutional ownership, a trend toward activism, and the Dodd-Frank legislation have all enhanced the power of the two largest proxy advisors, creating an effective duopoly. The single biggest catalyst for the rise in influence of these two proxy advisors, however, was the 2003 decision by the SEC to require that every mutual fund and its investment adviser disclose "the policies and procedures that [they use] to determine how to vote proxies"—matters put to a vote by the public companies whose stock the fund holds—and to disclose votes annually.[2] While the intention of the SEC was to spur greater engagement with the proxy voting process from mutual funds, this decision appears to have had the opposite effect. Many large institutional have actually been discouraged from carrying out their own independent evaluations of proxy votes and governance practices, outsourcing their shareholder voting policies to a two dominant firms in the proxy advisor industry that both rely on a "one size fits all" approach to assessing corporate governance. Consequently, with each effort to provide shareholders with more authority, a majority of whom may not seek or want it, influence is funnelled into the hands of these two dominant proxy advisors.

Good corporate governance is central to the long-term success of publicly traded companies and, by extension, the wider economy. As demonstrated by the 2003 decision, regulatory guidance can have unintended consequences; and, increased regulation should not be viewed as the only solution to corporate governance challenges. However, as long as these two dominant proxy advisors hold regulatory preferences and a regulatory mandate that funds purchase their services exists, more regulatory attention to the conflicts of interests at these advisors, and their impact on corporate governance, is warranted. If ISS and Glass-Lewis were conflict free, offered robust recommendations based on increasing shareholder value, and did not obtain demand for their services in part through regulatory pressure, then there would be no need for regulatory action. In my view none of those things are the case.

While there are times where active share voting can generate value for investors, it is not clear that is always the case system wide. Institutional Investors should have an option to establish a default voting process that votes with the management slate absent some clear red flag suggesting further inquiry is necessary (such as, for example, a recent restatement of firm financials). Based on the SEC's current guidance, it is not clear the institutional investors could establish such a policy. The SEC could remedy that problem with a change in its mutual fund voting guidance.

Conflicts of Interest

Conflicts of interest at the two dominant firms in the proxy advisory industry manifest themselves in two primary ways. The first–more subtle–conflict is the influence of proxy advisors' clients on the recommendations issued. Substantial income is provided by 'socially responsible' investing funds to proxy advisors, which are, in turn, incentivized to favor proposals that are backed by these clients. Such an approach deviates from a focus on shareholder value, generating private benefits to a

[2] SEC, "Securities and Exchange Commission Requires Proxy Voting Policies, Disclosure by Investment Companies and Investment Advisers," press release, January 1, 2003, http://www.sec.gov/news/press/2003-12.htm.

subset of investors at the expense of the average diversified investor. This has implications for another of the Roundtable's areas of focus, the role of shareholder proposals in the proxy process. In effect, proxy advisors have been granted the ability to wield the aggregate influence of all their clients to the benefit of a particular type of investor.

The second–more obvious–conflict that exists in the proxy advisory industry is the provision of consulting services to the same issuers about which recommendations are issued to investors. The implicit threat of receiving a negative recommendation from ISS is a cornerstone of the offering from that same company to publicly listed companies. In addressing conflicts of interest in the proxy advisor industry, the SEC's recent decision to rescind the 2004 no action letters is a welcome one. Instead of dealing with the growing threat of conflicts of interest in the proxy advisory industry, those no action letters actually allowed the conflict from providing consulting services to persist. The Egan-Jones letter shifted fiduciary responsibility for proxy decisions from mutual funds to third parties while simultaneously limiting the fiduciary exposure of those third parties. It should also be noted that though the Egan-Jones letter bears the name of another proxy advisor, it was ironically written in response to a letter from Egan-Jones asking the SEC to *address* conflicts of interest at ISS and Glass-Lewis. Unfortunately the SEC's response endorsed the conflicts that the initial inquiry from Egan-Jones was intended to address, and this withdrawal of the letter is a welcome development.

There are analogous concerns over conflicts of interest in other areas of financial services, particularly those stemming from the provision of consulting services. The investment community itself (including the Council for Institutional Investors and California Public Employees' Retirement System) has been steadfast in arguing against the provision of consulting services by a company's external auditor. A proxy advisor simultaneously providing governance advisory services and recommendations is akin to an auditor providing an issuer with guidance on how to navigate an external audit.

Quality of Advice

The objective of corporate governance is the enhancement and protection of shareholder value; however, it remains unclear what role shareholder value plays in the processes and methodologies of proxy advisors. In fact, the evidence appears to point to the contrary, with a lack of capacity and capability, conflicts of interest and ideological bias resulting in proxy advisor recommendations by ISS and Glass-Lewis depleting shareholder value. In two separate Stanford studies[3], researchers found that the recommendations of ISS negatively impact shareholder value, with investors better off if they were to ignore ISS. ISS also promulgates other corporate governance policies for which the empirical evidence is mixed, at best, including the right to nominate director candidates to the corporate proxy[4], options repricing[5], independent chairs[6] and Golden Parachutes.[7] While these

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[3] David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policy" (Rock Center for Corporate Governance at Stanford University Working Paper No. 119, Stanford, CA, 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id= 2101453.
David Larcker, "Do ISS Voting Recommendations Create Shareholder Value?" (Rock Center for Corporate Governance at Stanford University, Closer Look Series: Topics, Issues and Controversies in Corporate Governance and Leadership No. CGRP-13, Stanford, CA, April 19, 2011): 2, http://papers.ssrn .com/sol3/papers.cfm?abstract_id=1816543##.
[4] See Thomas Stratmann and J.W. Verret, "Does Shareholder Proxy Access Damage Share Value in Small Publicly Traded Companies?," Stanford Law Review 64 (2011): 1431–68.

policies are certainly favored by politically minded institutional investors – ISS's largest clients – they are not clearly linked to the enhancement of shareholder value and thus stronger returns to the ultimate beneficiaries of mutual funds.

In many ways, it would be unreasonable to expect the two dominant proxy advisors to be effective in providing accurate and nuanced corporate governance advice to investors. ISS's website states that it covers over 42,000 meetings a year for a client base in excess of 1,700, while Glass Lewis produces analysis on over 20,000 companies. With over half of US AGMs taking place in a three-month period, both advisors must by necessity put in place rigid methodologies in order to produce the volume of reports they do. The problem with rigid methodologies is that they simplify the complexities of business reality and do not allow for case-by-case appraisals of company practices and disclosure. This concern was recently referred to by the UK's Financial Reporting Council (FRC) in a letter to proxy advisors, stating that "*A 'box-ticking' approach does not serve the needs of your clients or promote high-standards of corporate governance in the UK*".[8] The inability of the two dominant proxy advisors to offer company and circumstance-specific recommendations and the limited empirical evidence supporting those recommendations calls into question whether ERISA and mutual fund fiduciaries are fulfilling their obligations in relying on the proxy advisor advice of ISS and Glass-Lewis.

Summary

As things stand, corporate directors and executives are subject to decision making on critical issues by two organizations that have no direct stake in corporate performance; have no fiduciary duty to ultimate beneficial owners; and, make poor decisions unrelated to shareholder value as a result. Conscientious and informed shareholders, who do have such a stake, also suffer because their votes are usurped or overwhelmed by these same organizations.

In addressing the apparent issues with the proxy advisory industry, it is not clear that strict regulation is the answer. Regulation itself has resulted in a proxy voting landscape unimagined by its original advocates. Nonetheless, there appears to be certain steps that may enhance the proxy voting process. Ending clear conflicts of interests – whereby the same entity is permitted to offer advisory services to an issuer and its shareholders on the same subject matter – would be a start. While this type of conflict is easily regulated for, the conflict relating to ideological bias and would remain. That bias cannot be removed by regulation or oversight, but only by competition. Knowledge about shareholder value depends on research, and this sort of research is difficult to design because proxy advisory firms lack transparency.

And so, fixing the current system also requires an acknowledgement of the inability for a single mutual fund to diligently vote on 100,000 items annually. Instead of requiring mutual funds to analyse these proposals, the SEC could allow those investors to carry out their own independent research of when analysis of proxy voting items would be in the funds best interests. In the event

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[5] The debate over whether options repricing is material to executive compensation packages is explored in Brian J. Hall and Thomas A. Knox, "Underwater Options and the Dynamics of Executive Pay-to-Performance Sensitivities," Journal of Accounting Research 42, no. 2 (May 2004): 365–412.

[6] See generally Roberta Romano, Foundations of Corporate Law, 2nd ed. (New York: Thomson Reuters/Foundation Press, 2010) 410–25

[7] See generally Richard A. Lambert and David F. Larcker, "Golden Parachutes, Executive Decision Making and Shareholder Wealth," Journal of Accounting and Economics 7 (1985).

[8] Sir Winfried Bischoff, Chairman of the Financial Reporting Council (July 2018)

mutual funds choose to adopt an automatic voting policy that votes with management in the absence of clear red flags, they should be able to do so. This alteration would have a knock-on effect, in that it would create an environment where proxy advisors compete by providing disclosure on how their analysis and recommendations enhance shareholder value for clients–rather than simply taking advantage of the requirement that investors vote their shares as is currently the case.

I would be happy to provide more information or to discuss the issue with the Commission staff in advance of the Roundtable on November 15, 2018.

J.W. Verret