Vanessa A. Countryman, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

By email to: rule-comments@sec.gov

Re: File Number S7-22-19
SEC- Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice

January 30, 2020

Dear Ms. Countryman:

I welcome the opportunity to comment on S7-22-19, Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice.

I worked in financial services from 1987 through 2007, and I rose from researcher, to broker, to trader, and finally portfolio manager. The companies for whom I worked included Citicorp, Goldman Sachs, and State Street Global Advisors. After leaving financial services, I taught graduate and undergraduate course on economics and politics for seven years. Most of this teaching was at Columbia University, and I particularly focused on how businesses interact with markets and the government. Recently, I have been managing my own taxable and retirement funds.

Introduction

The proxy voting advisory business has become an important part of shareholder governance, and I commend The Securities and Exchange Commission (SEC, or the Commission) for striving to modernize this necessary service by clarifying existing rules and developing better ones. The advice used by investors and others who vote on investors' behalf needs to be accurate, transparent, materially complete, and fair and unbiased. Not only does the present service provided to equity market participants by proxy voting advisers fail to meet this high standard, but the two main service providers, Institutional Shareholder Services and Glass Lewis, have evolved into de facto regulators influencing, among other things, public company disclosure requirements without any statutory authority. Their position in the shareholder eco-system is anomalous; other key components of the system, e.g., issuers, securities lawyers, accounts, and rating agencies are fully integrated into the regulatory structure. Proxy voting advisory services should no longer be an exception to full SEC regulatory oversight.

Proxy voting advisers have inadvertently and increasingly come to assume a sub-optimal role in the equity markets. The processes used to determine voting recommendations are opaque; material conflicts of interest are inadequately disclosed and controlled; the time allotted for issuers to review proxy advice is insufficient or absent, and; a significant and increasing number of fund managers use proxy adviser services, especially pre-populated ballots (i.e.,"robo-voting") and "specialty reports," to justify indolent or politicized votes that sidestep the fiduciary responsibility to act in the best interest of customers, the ultimate shareholder.

The current proxy voting market distortion was largely created by the massive increase in passive investing and algorithmic trading over the last two decades and by the need for investment advisers to vote their shares cost efficiently. As I think the Commission now recognizes,[1] a number of Commission rulings and letters have inadvertently contributed to this distortion. *However, the Commission now can fix this by:*

[1] See, for example, SEC. "Statement Regarding Staff Proxy Advisory Letters." September 13, 2018; SEC. "Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions From the Proxy Rules for Proxy

- *Mandating better rules for conflict of interest disclosure and prohibition*
- *Creating a statutory review period for issuers to examine proxy recommendations*
- *Outlawing proxy adviser "consulting," and*
- *Restricting the use by fund managers of pre-populated ballots and specialty reports.*

The Inordinate, Growing, and Distorting Market Power of Proxy Voting Advisory Firms

Corporate surveys, empirical studies, and press reports clearly demonstrate: 1) the substantial market power of proxy voting advisers, and 2) the continuing growth of this power.[2] The spectacular rise of this service was caused by a 2003 SEC Rule which obligated institutional shareholders to vote their shares and allowed them to fulfill this legal obligation by hiring independent firms either to help inform their voting or make this choice for them.[3] As the proportion of shares held directly by individual fell, and those held by institutions rose (especially since 2008), dependence on proxy voting advisers grew even further.

Currently, Institutional Shareholder Services (ISS) and Glass Lewis control over 90% of the proxy voting adviser market and they are a duopoly. Studies have found that the two firms can swing 20% of votes in proxy elections. A recent analysis by the Milken Institute described this power:

> While many of the major fund complexes do not cede total autonomy to their proxy advisory firms and make their own voting decisions, the empirical findings suggest that the ISS and Glass Lewis recommendations have substantial impact upon voting decisions and outcomes. Typically, the votes are finalized by the asset manager shortly after the proxy advisory firm issues its report and shortly before the relevant voting deadline. In many instances, the asset manager is placing considerable weight upon the proxy advisory firm's analysis and recommendation….The power of the proxy advisory firm reflects not only its influence on the actual voting decisions of investors…but also the potential ex-ante impact on information production…[T]hat information production by the proxy advisory firm substitutes for and crowds out information generation by individual asset managers and limits the access of these managers to other sources. This can weaken the incentives for individual managers to undertake their own due diligence, thereby resulting in poorer governance and limiting the generation of independent informational signals and its aggregation through the voting system.[4]

In theory, proxy voting advisers exist to assist investment managers with the operationally complex task of voting on matters such as the election of directors and the approval of fundamental corporate changes. In practice, however, proxy voting advisers often either 1) substitute their values and judgement for those of fund managers, or 2) produce legal cover for some fund managers who wish to impose their own values on shareholders. The proxy voting process itself can encourage investment advisers effectively to abdicate their fiduciary responsibility. It also can be manipulated by non-share owning activists to micromanage corporate managers and advance a social and environmental agenda at variance with maximizing shareholder value.

Advisory Firms." June 30, 2014, and: "Commissioner Hester M. Peirce. Statement at Open Meeting on Proposed Amendments to Improve Accuracy and Transparency of Proxy Voting Advice." November 5, 2019.

[2] For a sampling of this literature and market comments, see: Institute for Governance. "The Troubling Case of Proxy Advisors." January, 2013; Matt Levine. "Companies Push Back on Proxy Advisers." Bloomberg. Oct. 29, 2019; Editorial Board. "The Proxy Protection Racket." *The Wall Street Journal*. November 10, 2019, and; J.W. Verret. "It's time for the SEC to tackle proxy advisory firms." *Pension & Investments*. July 17, 2019.

[3] SEC. "Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies." April 14, 2003.

[4] Chester S. Spatt. "Proxy Advisory Firms, Governance, Market Failure, and Regulation." Milken Institute. 2019. Pp. 5-6.

Uneven Research and Analysis, Intransparency, Lack of Engagement

The methodology used to formulate proxy voting advice and the sources of information on which the advice is based is not adequately disclosed. As SEC Chairman Jay Clayton has said, we "…need clarity regarding the analytical and decision-making processes advisers employ, including the extent to which those analytics are company- or industry-specific."[5] One of the reasons for this limited transparency is that the proxy advisor methodologies are essentially "one-size-fits-all," and sharing more methodological details would open the duopoly up to more criticism since the lack of real granular analysis would be laid bare. The process, apparently, is heavy on machine reading and aggregate industry comparisons, and there is little sensitivity to company difference or unique corporate issues. Part of the reason for this lack of granularity is that relative to the job they are attempting to accomplish, the two firms are woefully understaffed. As a result, recommendation can distort market outcomes by providing fund managers with incomplete, misleading or incorrect information.

A recent NASDAQ / U.S. Chamber of Commerce survey of 172 major public corporations found that "…only 39% believed that proxy advisory firms carefully researched and took into account all relevant aspects of a particular issue on which the firms provided advice..."[6] The problematic quality of some of the work is almost ensured by the failure of the proxy adviser to engage meaningfully with issuers in advance of a recommendation, and even when they do engage, issuers have little time to counter misinformation or correct factual errors. This lack of time to respond, combined with a 60% meeting request declination rate by proxy advisers, has caused fewer and fewer issuers to even bother requesting meetings or seeking dialogue.[7]

There definitely would be value in enhancing engagement between proxy advisors and issuers. Increasing issuer input will improve the accuracy and completeness of the information available to those making voting determinations. Not only will those voting benefit from more direct and easily accessible issuer input, but increased and earlier interaction with the issuers will incentivize proxy advisers to improve the accuracy, transparency, and completeness of the information provide. *The proposed Rules can correct these deficiencies by mandating that:*

- *The proxy advisers disclose their methodology and sources of information. Doing so would not be a competitive threat or necessarily release proprietary information. The contrast and example of the ratings agencies is instructive; both Standard and Poor's and Moody's provide open and publically accessible information about their methodologies.[8] The results of their work may be behind the paywall, but how they arrive at their judgements are not.*
- *A 3 and 5 day feedback window for an issuer to respond to a proxy vote recommendation should be instituted.*
- *Proxy advisors place an issuer provided hyperlink with supplemental information in a proxy recommendation when the issuer and proxy advisor fail to agree on a recommendation.*

Conflicts of Interest

The uneven research and analysis, intransparency, and lack of engagement are compounded by multiple proxy adviser conflicts of interests. According to the NASDAQ / Chamber of Commerce survey, "…19% [of

[5] Jay Clayton. "SEC Rulemaking Over the Past Year, the Road Ahead and Challenges Posed by Brexit, LIBOR Transition and Cybersecurity Risks." Dec 6, 2018.
[6] NASDAQ / U.S. Chamber of Commerce. "2019 Proxy Season Survey." Nov 21, 2019. P. 10.
[7] See, for example, NASDAQ & U.S. Chamber Of Commerce. "2019 Proxy Season Survey." November 21, 2019; SEC. "Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice. November 5, 2019. Pp. 42-43.
[8] Both the S&P and Moody's websites contain a cornucopia of information about their methodologies and how they run their businesses. For some specifics, see: S&P. "A Credit Rating is an Informed Opinion." https://www.spglobal.com/ratings/en/about/understanding-ratings and Moody's "Rating Process: Issuer/Investor Requested Ratings Process Detail." https://www.moodys.com/ratings-process/How-to-Get-Rated/002001.

companies] identified significant conflicts of interest, up from 10% in 2018."[9] These conflicts can range from advocating for board candidates who represent proxy advisory clients, to making voting recommendations on proxy proposals when the sponsor is a paying proxy advisory client or even its owner. The conflicts at ISS are particularly egregious. ISS rates corporate governance, but it also tries to sell consulting services to issuers to "help" them improve this very same corporate governance score. As the NASDAQ / Chamber of Commerce survey noted, "A striking 58% of companies reported being approached by ISS Corporate Solutions during the same year in which the company received a negative vote recommendation."[10] The contrast with Glass Lewis, which does not sell consulting services, is striking. Below is Glass Lewis' explanation why:

> We believe the provision of consulting services creates a problematic conflict of interest that goes against the very governance principles that proxy advisers like ourselves advocate. By not providing consulting services to the subjects of our reports, Glass Lewis ensures we have no financial incentive to develop policies or issue recommendations that make companies feel they need to pay for consulting services in order to achieve a favorable outcome. Further, a consulting business is not only in conflict with the interests of our clients, but in conflict with the interests of the companies who are entitled to a fair, reasonable and independent assessment.[11]

The ISS consulting conflict is reminiscent of the accounting/consulting firm conflicts of the early 2000s. The SEC (and Congress) dealt with this problem by banning accounting firms from selling consulting services to companies they are auditing. Similarly today, the SEC should:

- *Prohibit proxy advisory firms from consulting with companies when they also make recommendations on voting issues for that company.*
- *Mandate conflict of interest disclosures in the proxy voting advice.*
- *Establishing a baseline disclosure standard to which all proxy voting advice businesses must adhere.*

<u>Robo-Voting (Prepopulated Ballots)</u>

One of most practical ways proxy voting advisers assist fund managers is with the mechanics of actually voting their shares. Given the enormous number of shares that must be voted each year, this is an important service. The problem with the current system, however, is that it allows many fund managers to fulfill their *legal obligation while in essence abdicating their true fiduciary responsibility to shareholders*. As the SEC noted, clients "…utilizing such services *may choose* [emphasis added] to review the proxy voting advice business's pre-populated ballots before they are submitted or to have them submitted automatically, without further client review ("automatic submission").[12] Unfortunately, some fund managers just choose to automatically submit ballets without even a cursory review, i.e., robo-vote. This is evident from the very short lapse time between when proxy advisers release their recommendations and when fund managers vote.[13]

A recent study asked companies to report the increase in shares voted within one, two and three business days of the publication of an advisers' adverse recommendation. For the 2017 proxy season, "…participating companies reported an average of 19.3% of the total vote is voted…" within this period. For the 2016 proxy season, the companies reported "…an average 15.3% of the total vote being [voted within] the same three-day period."[14] *This indicates that a substantial number of asset managers automatically follow proxy advisory recommendations blindly and that this number is increasing.*

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[9] NASDAQ / U.S. Chamber of Commerce. Op. cit. P. 10.
[10] NASDAQ / U.S. Chamber of Commerce. Op. cit. P. 12.
[11] Katherine Rabin. "Response to U.S. Senate Banking Committee." June 1, 2018. P. 2.
[12] Ibid.
[13] See Paul Rose. "Robovoting and Proxy Vote Disclosure." SSRN. November 13, 2019, and; Ike Brannon and Jared Whitley. "Corporate Governance Oversight and Proxy Advisory Firms." Cato. Fall, 2018;
[14] Frank M. Placenti. "Are Proxy Advisors Really a Problem?" ACCF. October, 2018. Pp. cit. P. 8.

A Stanford University survey of portfolio managers in 2015 found that fund managers are only "moderately involved in voting decisions."[15] In fact, at large institutional investment firms, portfolio managers are only involved in 10% of the voting decisions.[16] A 2016 academic survey found that as much as 25% of all proxy voting outcomes is determined by proxy advisory firm recommendations.[17] A 2018 study noted that an "…extensive sample of the voting record of 713 institutional investors in 2017…shows that institutional investors are significantly likely to vote in accordance with proxy advisor recommendations across a broad spectrum of governance issues.[18] A 2018 survey undertaken by four major law firms found that hundreds of investment managers rely on the voting advice of proxy advisers almost all of the time. [19] Specifically, it found that:

- "175 asset managers managing over $5.0 trillion in assets have historically voted consistently with ISS recommendations 95% of the time, whether the matter at issue was a management proposal or a shareholder proposal, and
- 82 of the asset managers with over $1.3 trillion of assets under management voted consistently with ISS' recommendations 99% of the time..."

The outsourcing of proxy research often has been coupled with the outsourcing of vote decision-making. If a fund manager does not even review a proxy voting recommendation before automatically casting the vote, it is impossible to know if the required fiduciary responsibility has been fulfilled. Robo-voting is antithetical to good governance. *In order to remedy this situation, the SEC should:*

- *Disable the automatic submission of votes, if a company contests an adviser's recommendations. In order to vote on such an issue, the fund manager should first certify that he/she has reviewed both the proxy adviser's vote explanation and any additional information of relevance provided through a company hyperlink on the proxy ballot.*
- *Mandate disclosure of investment adviser voting including the percentage of proxy advised votes that were reviewed before being cast, and how all votes cast compare (in percentage terms) to the voting recommendations received from proxy advisers.*

Specialty Reports

As part of their service, and at the request of their clients, proxy advisers also produce "specialty reports." Among ISS offerings, for example, are reports on Faith-based Policy, Socially Responsible Policy, Sustainability Policy, and Taft-Hartley Labor Policy.[20] These reports are supposed to respond to the values and agenda of different investor types. The point is to give investment managers recommendations based on their predetermined preferences while at the same time allowing them to claim fulfillment of their fiduciary responsibility.

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[15] David F. Larcker, Ronald Schneider, Brian Tayan, Aaron Boyd. "2015 Investor Survey: Deconstructing Proxy Statements — What Matters to Investors." Stanford University, RR Donnelley, and Equilar. February, 2015. P. 2
[16] Ibid.
[17] Nadya Malenko and Yao Shen. "The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity design." *Review of Financial Studies.* December 2016. Pp. 3394-3427.
[18] James R. Copland, David F. Larcker, and Brian Tayan. "Proxy Advisory Firms: Empirical Evidence and the Case for Reform." Manhattan Institute, May 2018. P. 12
[19] Frank M. Placenti. Squire Patton Boggs. "Are Proxy Advisors Really a Problem?" Harvard Law School Forum on Corporate Governance. October, 2018. P.2. The full report can be found at: Frank M. Placenti. "Are Proxy Advisors Really a Problem?" ACCF. Oct 2018.
[20] ISS. "Custom Policy and Research. Your policy. Your way." https://www.issgovernance.com/solutions/governance-advisory-services/custom-policy-research/ Accessed Jan. 26, 2020.

The problem with the specialty reports is that proxy advisors may be peddling any recommendation the fund manager wants to purchase, regardless if it is in the best interest of the investor.

Access to these reports is not widespread since they are behind the paywall and confidential, but one investigator who has reviewed them commented as follows:

> …an analysis of these reports demonstrates that ISS frequently issues different recommendations on votes at the same companies…For example, based on a sample of 10 of the largest U.S. companies, ISS's Taft-Hartley reports recommended voting against management 47 percent of the time on average in 2019…By comparison, in its benchmark reports, ISS proposed voting against management only 10 percent of the time…Depending on the report an investor chooses to use, voting guidelines vary drastically.
>
> Put another way, ISS is effectively providing "pick and choose" governance for its customers. Investors can simply select a recommendation that meets their preferred result and still cast their vote in-line with an "independent, third-party report." Rather than providing genuinely independent analysis, ISS has created guidance for hire.[21]

This recommendation variance raises troubling questions about the standards used in the reports and whether or not the proxy voting adviser is simply allowing a fund manager to place his or her values above fund shareholders. *Given these troubling characteristics, the SEC should:*

- *State that the preparation and use of specialty reports be justified only in terms of maximizing shareholder returns and not on any other grounds. Specifically, it can adopt a standard similar to that promulgated by the Department of Labor for ERISA funds when they stated that: "A fiduciary's evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on appropriate investment horizons consistent with the plan's articulated funding and investment objectives."[22]*
- *Establish minimum disclosure standards for investment managers regarding the number and types of special reports they utilize and how they align with maximizing shareholder value.*

<u>Cost Considerations</u>

The Commission requested comment on the costs the proposals, if adopted, would impose on market participants. There is little doubt that the proposals supported in this submission would raise the cost of providing third party proxy voting services. The full increased cost should be borne by the proxy advisers and recovered, as best possible, from fee increases to the asset managers. If the investment advisors find any higher fees onerous, they have the option of providing the service for themselves (by enlarging their own stewardship groups), or perhaps even forming new industry consortia that could compete with the existing duopoly. Indeed, the ability of asset managers to create or enlarge their own stewardship groups would serve as a natural cap on costs increases by proxy advisers. Higher funding also would encourage other firms to enter the proxy voting adviser business.

While acknowledging and supporting the higher costs of this submission, it should be noted that the lowest cost option often is not the best choice. If the goal was cost minimization, then the SEC could just absolve asset managers from ever voting their shares. This is one of those rare situations where the decades-long drive by investment managers to decrease fees (especially index fees) to extraordinary low levels may be working against fund shareholders. Asset managers need the financial resources to steward their shares responsibility. If fees have to be raised a half basis point or so to protect market integrity, so be it.

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[21] Timothy M. Doyle. "Proxy Firms' Independence Is Undermined by Their Own Shadow Reports." ACCF. July 16, 2019.
[22] John J. Canary. "Interpretive Bulletins 2016-01 and 2015-01." U.S. Department of Labor. April 23, 2018. P. 2.

Conclusions

Proxy voting advisers were intended to be third party researchers assisting investment advisers with their work. They were not intended to supersede an investment adviser's responsibility to its customers, the ultimate investor. However, for a significant portion of fund advisers, following proxy voting advice has become the "default option." As discussed, a number of proxy voting advisory practices produce outcomes which unfairly disadvantage issuers and damage shareholders.

Reform of the proxy voting advisory business is not an unnecessary interference in the free market; it is a corrective to a process which has increasingly lost sight of the true obligation to shareholders. The proxy voting advice used by investors and others who vote on investors' behalf needs to be accurate, transparent, materially complete, and fair and unbiased. The present service provided to equity market participants by proxy voting advisers fails to do this. Proxy voting advisory services should no longer be an exception to full SEC regulatory oversight; it should be integrated into the equity market regulatory structure just as are issuers, securities lawyers, accountants and rating agencies.

As the SEC has said: "Investment advisers owe each of their clients a duty of care and loyalty with respect to services undertaken on the clients' behalf, including proxy voting."[23] The proper policy objective for the SEC should be to incentivize company managers through the proxy voting system to maximize the economic value of the assets owned by shareholders, whether they are owned directly by retail investors or through fund companies. The personal economic or political preferences of proxy advisers or investment managers should never trump this fiduciary duty.

The present system does not safeguard and promote the ultimate client (shareholder) interest. The Commission now can fix this by: Mandating better rules for conflict of interest disclosure and prohibition; Creating a statutory review periods for issuers to examine proxy recommendations; Outlawing proxy adviser "consulting," and; Banning the use by fund managers of robo-voting and specialty reports.

Thank you for your consideration.

Sincerely,

Jonathan A. Chanis, Ph.D.

[23] SEC. "Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice." 2019. P. 9.