SPEECH

Remarks at Transatlantic Corporate Governance Dialogue Conference: The Realities of Stewardship for Institutional Owners, Activist Investors and Proxy Advisors

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Thank you Professor [Gordon] for your very kind introduction, and thank you to the organizers for inviting me to speak today. The exchange of ideas at conferences such as this is incredibly important, and today's conference is especially timely given that the Commission is holding a roundtable to discuss the role of proxy advisors two days from now. I hope that on Thursday, and in our subsequent analysis of necessary reforms, the Commission can draw upon some of the discussions that are taking place today.

Proxy advisory firms have gained an outsized role in corporate governance in the United States largely as a result of the unintended consequences of SEC action. In 2003, the SEC adopted new rules and rule amendments requiring an investment adviser that exercises voting authority over its clients' proxies to, among other things, adopt policies and procedures reasonably designed to ensure that it votes those proxies in the best interests of its clients.[1] A key goal of the Commission in adopting this rule was to address an investment adviser's potential conflicts of interest when voting a client's securities on matters that affected its own interests. In the adopting release, the Commission noted that "an adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party."[2] In response to the new rules, proxy advisors asked the SEC staff for guidance. The resulting pair of staff no-action letters effectively blessed the practice of investment advisers rotely voting the recommendations provided by proxy advisors.[3] I have spoken at length on a number of occasions about the perceived safe harbor that these letters have created and the fiduciary and other concerns they raised, and I have called for Commission action to address the harm they have done.[4]

The SEC has been concerned about the role of proxy advisors for some time. In a 2010 concept release often referred to as the "proxy plumbing release," the Commission revisited the issue of proxy advisory firms by highlighting several of its concerns, including conflicts of interest and the lack of accuracy and transparency in formulating voting recommendations.[5] Since then, increased calls for a review of the role of proxy advisors have come from a wide range of parties, including Congress, academia, the media, and a national securities exchange.[6]

Recently, a number of our regulatory colleagues from around the world have taken an increased interest in proxy advisory matters. For example, our regulatory neighbors to the north delved into some of these issues. In 2012, the Canadian Securities Administrators (CSA) published for comment a consultation paper regarding potential regulation of proxy advisory firms.[7] The purpose of the paper was to provide a forum for discussion of concerns raised about proxy advisory firm services and their potential impact on Canadian capital markets, and to determine whether, and if so how, these concerns should be addressed. After an extensive review of the comments received, the CSA recently concluded that a response was indeed warranted, stating, "In our view, a policy-based approach that would give guidance on recommended practices and disclosure for proxy advisory firms will promote transparency and understanding in the services provided and is an appropriate response under the circumstances."[8]

As I'm sure some of today's panelists and participants can attest, policymakers in Europe have expressed concerns about the role of proxy advisors as well. In 2011, for example, the French AMF published a report on proxy advisory firms that included several recommendations aimed at promoting transparency and addressing conflicts of interests.[9]

Separately, the European Securities and Markets Authority (ESMA) suggested in a report issued earlier this year that the proxy advisory industry may want to provide greater clarity to subscribers and stakeholders on what they can rightfully expect. ESMA chair Steven Maijoor noted, in connection with the issuance of that report, "There are a number of concerns regarding conflicts of interest management and the transparency of analysis and advice, which we believe would benefit from improved clarity on the part of the industry."[10] Although ESMA concluded that it currently did not favor the introduction of binding measures, it encouraged the proxy advisory industry to develop its own code of conduct. ESMA suggested that such a code should focus on certain principles, including identifying, disclosing, and managing conflicts of interest, and fostering transparency to ensure the accuracy and reliability of advice.[11] The Proxy Advisory industry responded, and recently provided for public consultation a set of best practice principles.[12] I encourage the corporate governance community to weigh in and share their thoughts.

Concerns about proxy advisors have been raised outside of Europe and North America as well. In 2012, the Australian Government Corporations and Markets Advisory Committee published a discussion paper addressing annual meetings and shareholder engagement and asked for feedback on a number of questions and topics. One of the questions raised was whether legislative or other initiatives should be adopted for proxy advisors, including with respect to their standards, and to what extent investors should "be entitled to rely on the advice of proxy advisers in making voting decisions."[13] Even in countries where proxy advisory firm services are still a relatively new business, concerns have been raised regarding their role and practices. Pratip Kar, a former executive director on the Securities and Exchange Board of India recently highlighted his major concerns about proxy advisors, including conflicts of interest, providing voting recommendations without adequate accountability, and the misalignment of voting power and economic interest.[14] I'm very heartened to see regulators from around the world focusing on this important issue, because it goes to the heart of corporate governance and the fiduciary duty.

So given the seemingly global regulatory concern regarding proxy advisors, what can policymakers learn from each other? I think a major lesson is that regulators should avoid granting these firms special privileges, intentionally or otherwise. This was a painful and costly lesson the SEC learned with respect to credit rating agencies after we created an outsized role for so-called Nationally Recognized Statistical Rating Organizations by incorporating those entities into our rules. The parallels between the regulatory privileges granted to NRSROs and proxy advisory firms are striking. The path to reform need not be the same, however.

In 2003, the IOSCO technical committee formed a Credit Rating Agency Task Force to study issues related to the activities of credit rating agencies. The Task Force produced a paper that outlined "a set of principles that regulators, Credit Rating Agencies and other market participants might follow as a way to better guard the integrity of the rating process and help ensure that investors are provided with ratings that are timely and of high quality."[15] In 2004, IOSCO built on these principals by issuing a model code of conduct for credit rating agencies, later revised in 2008,[16] which the most prominent credit rating agencies used as the basis for their own codes of conduct. To state the obvious, these codes of conduct were not sufficiently effective in furthering IOSCO's goal of "providing ratings that are timely and of high quality," as demonstrated by the failure of credit rating agencies to provide accurate ratings on subprime mortgage-related securities, which was a major factor in the recent financial crisis.

In 2006, the U.S. Congress passed the Credit Rating Agency Reform Act, which for the first time established a registration and oversight regime for NRSROs. It was not until the passage of the Dodd-Frank Act, however, that Congress addressed the issue of references to NRSRO ratings embedded in regulations. Over the course of several decades, a number of U.S. regulators had inadvertently promoted reliance on credit rating agencies by incorporating references to NRSRO ratings into their rules. Section 939A of the Act requires federal agencies to remove from their regulations all such references to credit ratings or credit rating agencies.[17] This provision may be the only one in the 2,319 pages of the Dodd-Frank Act that simply and meaningfully addresses a core issue of the financial crisis, and I hope we can finalize our work under that mandate soon.

So what should the Commission do to address concerns raised by the outsized role of proxy advisors? As I have stated before, I believe that the Commission should withdraw the two proxy advisor staff no-action letters and, ideally, replace them with Commission-level guidance. Such guidance should be designed to ensure that investment advisers are complying with the original intent of the 2003 rule and effectively carrying out their fiduciary duties. This would go a long way

toward mitigating the concerns arising from the outsized and potentially conflicted role of proxy advisory firms.

I have previously spoken about additional actions the Commission should take,[18] including measures to increase transparency in this area. Due to the privileges the SEC has bestowed upon proxy advisory firms, however, before we can see whether transparency measures would be effective, the Commission needs to remedy the problematic staff guidance. The SEC's proxy advisory firm roundtable this Thursday should be the beginning of the Commission's renewed and focused attention on proxy advisors, and I look forward to working with all of you as we pursue critically important reforms.

Thank you all for your attention. I've appreciated the opportunity to be here today and share my views on these vitally important subjects, and I would be happy to take a few questions.

[1] Final Rule: Proxy Voting by Investment Advisers, 68 FR 6585, available at http://www.sec.gov/rules/final/ia-2106.htm.

[2] *Id*. Emphasis added.

[3] *See* "Investment Advisers Act of 1940—Rule 206(4)-6: Institutional Shareholder Services, Inc." SEC letter to Mari Anne Pisarri, September 15, 2004, http://www.sec.gov/divisions/investment/noaction/iss091504.htm and "Investment Advisers Act of 1940—Rule 206(4)-6: Egan-Jones Proxy Services," SEC letter to Kent S. Hughes, May 27, 2004, http://www.sec.gov/divisions/investment/noaction/egan052704.htm.

[4] *See* Commissioner Daniel M. Gallagher, "Remarks before the Corporate Directors Forum," January 29, 2013 available at http://www.sec.gov/News/Speech/Detail/Speech/1365171492142#.UpENB3cgqSo; *See* Commissioner Daniel M. Gallagher, "Remarks at 12th European Corporate Governance & Company Law Conference," May 17, 2013 available at http://www.sec.gov/News/Speech/Detail/Speech/1365171515712#.UpEMtXcgqSo; *See* Commissioner Daniel M. Gallagher, "Remarks at Society of Corporate Secretaries & Governance Professionals," July 11, 2013 available at http://www.sec.gov/News/Speech/Detail/Speech/1370539700301#.UpEMPHcgqSo; *See* Commissioner Daniel M. Gallagher, "Remarks at Georgetown University's Center for Financial Markets and Policy Event," October 30, 2013 available at http://www.sec.gov/News/Speech/Detail/Speech/1370540197480#.UpEL9HcgqSo.

[5] *See* Concept Release on the U.S. Proxy System, July 14, 2010, available at http://www.sec.gov/rules/concept/2010/34-62495.pdf.

[6] For a discussion, *see* "Remarks at Georgetown University's Center for Financial Markets and Policy Event," Commissioner Daniel Gallagher, October 30, 2013 available at http://www.sec.gov/News/Speech/Detail/Speech/1370540197480#.Uo1dp3cgrSg.

[7] *See* Consultation Paper 25-401, "Potential Regulation of Proxy Advisory Firms," June 21, 2012, available at http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20120621_25-401_proxy-advisory-firms.htm .

[8] *See* CSA Notice 25-301, Update on CSA Consultation Paper 25-401, "Potential Regulation of Proxy Advisory Firms," Sept. 19, 2013, available at http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20130919_25-301_update-25-401.htm .

[9] *See* "AMF Recommendation No. 2011-06 on Proxy Voting Advisory Firms," Autorité des Marchés Financiers, March 18, 2011 available at http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0CDIQFjAA&url=http%3A%2F%2Fwww.amf-france.org%2Ftechnique%2Fmultimedia%3FdocId%3Dworkspace%3A%2F%2FSpacesStore%2F12e1aead-0ff9-4f26-8fd0-d0ebe29d0efe_en_1.1_rendition&ei=w0aSUo_pMY7msASF_IDwBw&usg=AFQjCNEVK8Lt3fwLG_7DcWeUpJQoVekbmg&bvm=bv.56988011,d.cWc&cad=rja

[10] *See* "ESMA recommends EU Code of Conduct for proxy advisor industry," February 19, 2013, http://www.esma.europa.eu/news/ESMA-recommends-EU-Code-Conduct-proxy-advisor-industry . *See* "Final Report: Feedback statement on the consultation regarding the role of the proxy advisory industry," European Securities and Markets Authority, February 19, 2013. http://www.esma.europa.eu/system/files/2013-84.pdf .

[11] *Id.*

[12] *See* "Best Practice Principles for Governance Research Providers," developed by the Best practice Principles for Governance Research Providers Group under the Chairmanship of Dr. Zetzsche, October 28, 2013 available at http://bppgrp.info/wp-content/uploads/2013/11/BPP-Group-Principles-Consultation.pdf .

[13] *See* Discussion Paper "The AGM and shareholder engagement," the Australian Government Corporations and Markets Advisory Committee, September 14, 2012, page 42, available at http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFDiscussion+Papers/$file/AGM.pdf .

[14] *See* "Proxy advisories - Promises and perils," Pratip Kar, Business Standard, November 9, 2013, available at http://www.business-standard.com/article/opinion/pratip-kar-proxy-advisories-promises-and-perils-113110900777_1.html .

[15] *See* "Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies-Final Report," Technical Committee of the International Organization of Securities Commissions (IOSCO), February 2011, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD346.pdf at 6.

[16] *See* "Code of Conduct Fundamentals for Credit Rating Agencies," Technical Committee of the International Organization of Securities Commissions (IOSCO), December 2004 and revised May 2008 available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD180.pdf and http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf .

[17] *See* Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[18] *See* Commissioner Daniel M. Gallagher, "Remarks at 12th European Corporate Governance & Company Law Conference," May 17, 2013 available at http://www.sec.gov/News/Speech/Detail/Speech/1365171515712#.UpEMtXcgqSo; *See* Commissioner Daniel M. Gallagher, "Remarks at Society of Corporate Secretaries & Governance Professionals," July 11, 2013 available at http://www.sec.gov/News/Speech/Detail/Speech/1370539700301#.UpEMPHcgqSo; *See* Commissioner Daniel M. Gallagher, "Remarks at Georgetown University's Center for Financial Markets and Policy Event," October 30, 2013 available at http://www.sec.gov/News/Speech/Detail/Speech/1370540197480#.UpEL9HcgqSo.

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