LEGISLATIVE PROPOSALS TO EXAMINE CORPORATE GOVERNANCE

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S. HRG. 115–406

LEGISLATIVE PROPOSALS TO EXAMINE CORPORATE GOVERNANCE

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIFTEENTH CONGRESS

SECOND SESSION

ON

EXAMINING LEGISLATIVE PROPOSALS ON CORPORATE GOVERNANCE

JUNE 28, 2018

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LEGISLATIVE PROPOSALS TO EXAMINE CORPORATE GOVERNANCE

THURSDAY, JUNE 28, 2018

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:02 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Mike Crapo, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN MIKE CRAPO

Chairman CRAPO. The Committee will come to order.

Today's hearing will focus on several legislative proposals to improve corporate governance.

As with Tuesday's hearing on capital formation proposals, I intend to work with Senator Brown and with other Senators on the Banking Committee to identify and move legislative proposals through the Senate. Although some of the bills which we have been discussing today have also been discussed and considered in the House, most have not.

Today's hearing will mark a first step for those we have not yet considered or were recently introduced.

Among other things, the bills that we will discuss today would expand the definition of accredited investor, shorten the Schedule 13D filing window and increase disclosure of short positions, require FINRA to create a relief fund to cover unpaid arbitration awards to investors, draw attention to cybersecurity experience at the board level, address concerns that a gap exists between the time a firm learns of material nonpublic information and its disclosure, and highlight the unique challenges to rural area small businesses.

Finally, several Members have expressed interest in addressing the role of proxy advisory firms, and we will discuss a bill which the House has already considered and passed.

I look forward to hearing from our witnesses on these legislative proposals, and if there are ways to modify these bills to gain bipartisan support, I encourage it.

We have received some initial feedback on these bills, which will be entered into the record, without objection.

Chairman Crapo. Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman.

Welcome, all four of you as witnesses. Thank you for joining us. We will continue our discussion of bills sponsored by Banking, Housing, and Urban Affairs Committee Members, this time focusing on corporate governance.

All too often, it seems corporate boards and executives focus more on preserving their job and maximizing and enhancing their compensation than on investing in their companies and their workers, and their communities.

Instead of investing in real businesses in real towns that create jobs and build communities, they spend billions buying back stocks and handing out CEO bonuses.

Take Wells Fargo, despite being continually mired in spin, controversy, and scandal, they boosted their CEO's pay by 36 percent last year to $17 million. That is 291 times the median worker's salary at the bank, as tellers, on the average, nationally still make less than $13 an hour.

The short-term focus is painfully obvious when you consider that last year's tax bill sparked a record level of stock buybacks, $480 billion since it passed. Think about that, almost half a trillion dollars, $480 billion.

The record level of buybacks is troubling on its own, but I am even more concerned in light of SEC Commissioner Jackson's recent findings that executives were much more likely to sell their stock right after a buyback announcement than at other times. That does not sound like building long-term value to me.

This is where shareholders play a key oversight role over public companies, and institutional investors, those with the strongest voice, can be essential in holding company management accountable. Shareholders of all sizes deserve to have every tool available to make sure executives are thinking beyond their self-interest and managing for the long-term good of the company.

But we cannot just depend on shareholders. The system needs protections to ensure corporate managers are honest and address difficult issues.

I am particularly concerned about a proposed bill, the Corporate Governance Reform and Transparency Act, which would create structural obstacles for shareholders to hold corporate management accountable. The bill would make it harder for public retirement systems, including some in my State of Ohio, to use research and analysis from proxy advisors to manage investments for hard-working Americans. Why would we want to do that if we really care about those investors and those communities and those retirement systems?

It is ironic, Mr. Chairman, that some of the same people who want to expand the definition of accredited investor, confident that somebody with a million dollars in assets can make good investment decisions on startup companies, do not think the very sophisticated managers of tens of billions of dollars of assets, pension plans, for instance, can tell whether the investment advice they are buying is worth what they are paying.

I have letters opposing that bill, Mr. Chairman. I would like to submit them for the record, the bill H.R. 4015 letters from the Ohio Public Employees Retirement System, the State Teachers Retirement System of Ohio, and others, if I——

Chairman CRAPO. Without objection.

Senator BROWN. Thank you, Mr. Chairman.

We should be pushing for more shareholder engagement and oversight, for more transparency, not less. Some of the proposals we will discuss today improve transparency.

Senator Jack Reed's bill would promote more disclosure on cybersecurity. I thank the Senator from Rhode Island for that.

Senator Van Hollen's proposal would require companies to close loopholes to prevent insider trading. I thank the Senator from Maryland for that.

These types of measures require company management to upgrade their practices and disclosures to the markets. As I said at our earlier hearing this week, if we focus on passing laws that enhance investor confidence instead of undermining it, we end up helping those businesses too. It is good for shareholders, good for workers, good for communities.

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you, Senator Brown.

And today's witnesses are Mr. Thomas Quaadman, Executive Vice President of the U.S. Chamber Center of Capital Markets Competitiveness; Ms. Darla C. Stuckey, President and CEO of the Society for Corporate Governance; Professor John C. Coates IV, John F. Cogan Jr. Professor of Law and Economics at Harvard Law School; and Mr. Damon A. Silvers, Policy Director and Special Counsel at the American Federation of Labor and Congress of Industrial Organizations.

I appreciate all of you being here with us today. Your written testimony has been entered into the record, and we encourage you each to pay close attention to the clock as the Senators will have lots of questions they want to ask you.

With that, Mr. Quaadman, you may proceed.

STATEMENT OF THOMAS QUAADMAN, EXECUTIVE VICE PRESIDENT, CENTER OF CAPITAL MARKETS COMPETITIVENESS, U.S. CHAMBER OF CONGRESS

Mr. QUAADMAN. Thank you, Chairman Crapo, Ranking Member Brown, Members of the Committee. Thank you for holding this hearing today.

We have a crisis of entrepreneurship in the United States, and indeed, we have a calcification of startups in the United States. Business creating rates have not rebounded from the Great Recession. Three counties in the United States have more businesses that go out of business than are created, and 50 percent of all startups in the United States occur in 20 counties. We are literally missing hundreds of thousands of businesses that we historically would have created had this not happened.

But we also have a precipitous decline in number of public companies that started in 1996. We have less than half the number of public companies today than we did then. We have relatively the same as we did in 1982. In other words, the gains of the Reagan and Clinton administrations have been wiped out.

More needs to—the JOBS Act has arrested the decline of the number of public companies, but more needs to be done to reverse these trends, and we need to put in place policies that will help

businesses start and grow from small to large. The hearing this week are an important step forward; however, the recent reports about the rise of Chinese venture capital show that we do not have luxury of time.

The Chamber strongly supports the Corporate Governance Reform and Transparency Act. We have two proxy advisory firms that control 97 percent of the business. They are, *de facto,* standard setters of corporate governance. Each has a unique conflict of interest. Both have black box processes and systems and a failure to fix errors. All of this combines to materially impact the ability of investors to get the essential information that they need.

Firms have even, in one case, overturned the express rule of Congress and silenced investors for their own pecuniary interests. Advice should be accurate and linked to a client's fiduciary duty and economic return. While the 2014 guidance was helpful, the SEC has not exerted oversight, and we think it is important for Congress to mandate it.

We have some concerns with the Cybersecurity Disclosure Act. Cybersecurity is a top priority for businesses; however, businesses get very conflicting messages from different Government agencies. The SEC guidance on disclosure is somewhat helpful. We think that there is more that needs to be done there. However, this bill would require board expertise in cyber. It would start to pigeonhole different types of expertise in boards. It conflates the role of management and a board of directors, and indeed, it lacks the recognition that there is a relatively small number of people with cyber experience, and we do not even know if they can perform the other fiduciary duties of a board member.

We also have some concerns with the Brokaw Act. Short selling is a necessary market function for liquidity purposes. We have raised issues before with abuses to short selling, such as naked short selling or short-and-distort campaigns.

13D filings, we understand the desire to maybe modernize those; however, modernization of 13D filings can also bleed into 13F and 13G filings, which can directly, adversely impact 401(k)s. Therefore, we believe it is important for both of these issues that maybe there should be an SEC study rather than mandated requirements.

We also understand and want to work with Senator Van Hollen on the 8–K Trading Gap Act of 2018. We also agree that there needs to be strong policies to combat insider training; however, we have some concerns on the window between when an event happens and when it is deemed to be material. We want to work with Senator Van Hollen on how to clarify that.

We strongly support the Fair Investment Opportunities for Professional Experts Act. We believe that these rules should be modernized. It is long overdue, and the SEC is not active.

We have some concerns with the Compensation for Cheated Investors Act. We understand the issue and agree that those who receive an arbitration award should be able to collect on that; however, this is a small problem related to the larger picture.

And that we believe that there should be some time elapsed to allow for the FINRA transparency rules to take hold; however, we would be willing to work with both Senators Warren and Kennedy to maybe see if SIPC would ben alternative.

We also strongly support the Expanded Access to Capital for Rural Job Creators Act, introduced by Senator Jones. We think this would be an important step forward to help bring entrepreneurship to rural areas.

Thank you, Mr. Chairman. I am happy to take any questions you may have.

Chairman CRAPO. Thank you.

Ms. Stuckey.

STATEMENT OF DARLA C. STUCKEY, PRESIDENT AND CEO, SOCIETY FOR CORPORATE GOVERNANCE

Ms. STUCKEY. Chairman Crapo, Ranking Member Brown, Members of the Committee, my name is Darla Stuckey. I am the President and CEO of the Society for Corporate Governance. We appreciate the opportunity to present our views on legislation before this Committee.

We are a professional membership association of corporate secretaries and in-house counsel, and other governance professionals, representing about a thousand public companies.

As Tom said, public company ownership is on the decline. In 1997, there were about 7,100 U.S. public companies, now fewer than 3,600.

While there are a range of factors causing this, two of the bills this Committee has before it can improve the climate for public ownership—H.R. 4015, the Corporate Governance Reform and Transparency Act, and S. 1744, the Brokaw Act.

H.R. 4015, which has passed the House, addresses the role of proxy advisory firms who serve institutional investors. They operate with very little oversight. H.R. 4015 would provide badly needed improvements to the accuracy and transparency of these firms.

The proxy advisory market is dominated by two firms—Institutional Shareholder Services, or ISS, and Glass Lewis. For the uninitiated, these firms advise investors on how they should vote their shares at annual meetings as well as in corporate contests.

While recommending how an investor should vote may sound unimportant, the reality is far different. ISS and Glass Lewis analyze and recommend, for example, on composition of the board, executive compensation, and a diverse range of shareholder proposals. In fact, our members report that as much as 20 to 30 percent of their total shareholder votes are swayed by ISS and Glass Lewis.

These firms also own and control the software platforms that investors actually use to vote. They are indispensable to the institutional proxy voters.

But summarizing proxy statements in a short period of time makes errors inevitable. You may have heard that real factual errors do not exist because companies do not complain about them to the SEC. I am here to tell you that is not the case. They do exist. ISS is the dominant provider of these services, but only S&P 500 companies see their reports before they are issued. They have typically 2 days to review and correct any mistakes. The rest of the 2,500-plus companies that exist do not see them.

Glass Lewis recommendations are not made available in advance at all. The inability to see draft reports in advance can have dire consequences. Once a firm issues its recommendation to its

investor clients, the vote is in within a matter of days, and the changing of a vote is almost impossible.

I have a story about a small-cap transportation company, it happens to have a union, that highlights many problems that H.R. 4015 would fix. In May 2016, 2 weeks before their annual meeting, this company received an ISS report with an against recommendation on its say-on-pay. It was based on a factual error in their bonus plan calculation. Because the company is a small cap, it did not see the ISS report before it went to shareholders. The company scrambled to get the error corrected and a positive recommendation. ISS acknowledged the error but refused to correct it.

Despite the company's effort to contact their actual shareholders about the recommendation, they failed. Their vote was 49.8 percent. After the vote, the company did more shareholder outreach, but no shareholder asked for changes to the bonus plan. The company then disclosed its outreach efforts in its next year's proxy.

That next season, ISS issued another report, again, incredibly recommending against the company's say-on-pay. ISS simply did not believe the disclosure in the proxy that no shareholders had asked for changes to their bonus plan when it was based on a mistake, anyway.

To add insult to injury, ISS also recommended a vote against four directors on the compensation committee, one of whom was the only female board member at the time, and another of whom was one of two racially diverse members.

Thanks to above-and-beyond shareholder outreach that spring, the company got their four directors reelected at a 60 to 70 percent rate, but for the second year in a row, they lost say-on-pay at a very low rate of 32 percent.

This year, after extensive outreach to shareholders and with ISS and Glass Lewis, their say-on-pay vote was recommended in favor, and it was approved. And their directors were overwhelmingly reelected at 97 to 99 percent, so there is the gap.

This story demonstrates the influence of proxy advisory firms and the need for crucial regulation. We support its passage. We do understand that institutional investors and the proxy advisory firms themselves oppose the bill because of cost concerns for their clients. We are willing to work with the Committee to improve the legislation in a manner that accomplishes these goals.

Let me now turn to S.R. 1744, the Brokaw Act. There is no doubt that some activists create shareholder value, and the Society is not seeking to stifle activist investing. However, we do seek to level the playing field on the disclosure rules. Activists have 10 days to file a 13D after they have accumulated 5 percent of a company's stock. This means 10 days more to accumulate as much as they want, and sometimes through derivative positions that are unknown to the company.

S.R. 1744 shortens the time to 4 days and ensures that securities positions taken by activists are transparent. This is good public policy. We support the bill and the modernization.

There are two other bills before the Committee that could discourage companies from going and remaining public, and the Society opposes them in their current form—S. 536 and the 8–K Training Gap Act.

I see I am running out of time, but I am happy to answer questions. Thank you.

Chairman CRAPO. Thank you very much.

Professor Coates.

STATEMENT OF JOHN C. COATES IV, JOHN F. COGAN, JR. PROFESSOR OF LAW AND ECONOMICS, HARVARD LAW SCHOOL

Mr. COATES. Chairman Crapo, Ranking Member Brown, and Members, thank you for the opportunity to be able to comment on, I am happy to see, a bipartisan set of fairly focused proposals on how to improve corporate governance, and I commend the overall agenda for that reason.

One word about me. Before I came to Harvard, I practiced as a partner at Wachtell Lipton Rosen & Katz in New York, where I wrote 8–K proxies, 13Ds, and I only mention that because I want to emphasize that my views here are based in part on my research and teaching, but also on personal experience. I have some familiarity directly with the law's effects in this area.

Endorsements. I endorse the cybersecurity bill. It is a real problem. It is getting worse. We are playing catchup across the board, big companies and Government alike. This is the gentlest of disclosure obligations. It is hard to think of something that could be more gentle. It simply asks boards to say, "Do you have a cyber expert or not? And if not, why not?" So, contrary to suggestions to the contrary, it does not mandate experts on the board. It simply asks boards to explain why they do not have one. The answer could be because there are none available, or it could be because we have other resources that are better.

So if it is given to be gentle why do I have favor, why is it going to have any impact, well, here is something to know about proxy statements. Proxy statements are read by boards. Among all the SEC documents that the boards nominally have oversight of, they are among the most carefully read. The reason is because the proxy statements are about the board members. So they, being human, read them carefully because it is about them.

So that slight tweak to what they have to engage in, in the disclosure process, I think will help nudge those companies that have not already begun to take cyber seriously, and unfortunately, there still are some companies out there that are not facing up to the risks that they face.

One last word on this bill, there is maybe going to be some suggestion that there is a slippery slope and there is all kinds of risks and that cyber is one of them and so on. I really do want to emphasize that cyber is unique. Other than financial risk, where we already have an obligation for boards to say do they have financial expertise on the board or not, other than financial risk, cyber risk is, I believe, the one type of risk that is almost universal among public companies. It is very hard to think of a public company in this network age that is not at least somewhat exposed to cyber risk.

Unlike environmental risks, labor risks that my friend here cares about, which do affect some sectors significantly, I think cyber affects the entirety. So that is why this is not a slippery slope to

every kind of risk being addressed in the proxy statement. So that is my endorsement.

I also endorse the 8–K bill. I can talk more about that in Q&A.

I also very much endorse adding the voice of rural small business to the SEC's advisory community. I grew up in Virginia and spent a lot of time on farms in South Central Virginia, and I think there is a distinct voice that is missing at the SEC.

I also endorse the Brokaw Act. I have the same concern about discouraging shorts. I think there is a tradeoff involving short sales, and adding disclosure obligations is going to burden the ability of some shorts to function, to unveil fraud and find real problems at companies.

On the other hand, it is a little hard to understand why if you have a fairly big net short position and you are disclosing your long people, you do not have to disclose the short position.

So I would recommend adopting this bill but adding a sunset to it and forcing the SEC to study the effects on shorts over the next couple of years, and then the bill would die at that point, unless the SEC came back to you and said it was working the way we expect it to. So that would be my recommendation there.

Last minute. I endorse the goal also of the FINRA bill. It is outrageous that investors who have proven fraud can still not get recoveries, particularly if the targets of the fraud action simply quit the brokerage industry and moved over to investment and advisory industry where FINRA has no oversight. And that is a real problem.

Again, I have a slight concern that I would suggest the Committee think about, which is FINRA alone does not have full power over this industry, and I would suggest giving it to the SEC rather than to FINRA. If you want to stick with FINRA, then at least allow the SEC a year to come up with its own solution before the FINRA solution kicks in.

I oppose H.R. 4015. I think it flunks a cost-benefit test, as written. I am happy to take questions about why in the remaining time.

Thank you.

Chairman CRAPO. Thank you.

Mr. Silvers.

STATEMENT OF DAMON A. SILVERS, DIRECTOR OF POLICY AND SPECIAL COUNSEL, AFL–CIO

Mr. SILVERS. Thank you, Chairman Crapo, and good morning, Mr. Chairman, Ranking Member Brown, and Members of the Committee. My name is Damon Silvers. I am the Policy Director and Special Counsel for the AFL–CIO, America's labor federation. We represent 55 national unions, over 12 million people, on behalf of which $7 trillion of benefit funds are invested in the world's capital markets.

Like my fellow witnesses, it is an honor to be here with you and in particular to take up such a thoughtful and carefully structured agenda.

Each of the bills under consideration in this hearing fits within the following three questions: one, how to effectively protect investors from the threat of self-dealing by the experts they hire

to help them manage their money; two, how to ensure a level playing field for all investors in capital markets where information moves instantaneously and where big data means big power and big money; three, how to prevent the recurrence of the dynamic that led to the financial crisis of 2007 and 2008 where large parts of the financial system became unregulated and/or opaque with catastrophic consequences.

With those three issues and goals in mind, the remainder of my testimony will address each of the bills under consideration in turn, briefly.

First, and most importantly on the agenda this morning, H.R. 4015, the Corporate Governance Reform and Transparency Act, effectively gives corporations, CEOs, and boards the ability to control the people who are supposed to be holding them accountable. This is a very serious threat to any possibility of addressing the dynamics that Ranking Member Brown spoke to in his opening remarks.

The way this bill would do this would be, A, by creating a set of substantive regulatory obligations of a kind that no other investment advisor has to live within, and, B, by enabling companies to delay the vote recommendations and, thus, be able to essentially engage in coercive processes with the proxy advisory firms around any recommendation that was contrary to what the executives wanted, including votes on their own executive pay packages.

The AFL–CIO does believe that proxy advisors should be regulated like other investment advisors, and we would not oppose a bill that required them to register, which is not currently the law. But we do very much oppose the notion that they should be subject to a separate and punitive set of regulations, which is exactly what this bill does. It seeks to punish them for doing their jobs and to impose upon them a regulatory scheme designed to make them disloyal to their clients, among which are our members' pension funds.

Moving on to S. 2756, the Fair Investment Opportunities for Professional Experts Act, this addresses the issue of who is an accredited investor, who is allowed to invest in substantially unregulated private offerings.

The $1 million asset threshold that is core to this, together with several income thresholds, was originally set by rule in 1982 and has not been updated since then.

The bill does have an indexing provision, which we agree with, but the current baseline of the bill is far too low to act as a starting point and essentially would add to the problems that some of the other witnesses talked about in the public markets, so we oppose this bill.

The Brokaw Act, S. 1744, shortens the window between when an investor acquires a 5 percent stake and when they have to file and requires short selling to be disclosed. This makes eminent sense, and we support this bill. It prevents manipulation.

The Compensation for Cheated Investors Act, S. 2499, requires FINRA to ensure that the damage awards made to investors are actually paid, and if necessary, to use FINRA's revenue from fines to do so.

Between 2012 and 2016, there were almost $200 million in unpaid damage awards from FINRA.

This would make sure investors defrauded by brokers are actually able to collect the full amount of the award and would increase accountability and public trust in the financial system and broker-dealers. Passing S. 2499 is in the interest of investors and in the interest of maintaining and improving the integrity of our securities laws.

The S. 536, the Cybersecurity Disclosure Act, was discussed in some detail by my colleague, Professor Coates, and we view this as, again, a commonsense thing. The commission should have addressed this. In their absence, we support the bill.

We also support adding a language encouraging the Investor Advocate to think about rural issues, particularly in light of rising natural disasters and the cost of climate change.

Finally, the 8–K Trading Gap Act of 2018 is similar to the Brokaw Act. It really addresses the ability to engage in manipulations, given modern-day data around 8–K filings. It is very much in investors' interest. We support it.

So, in conclusion, you have in front of you a group of bills that are thoughtful and protect investors, and you have two bills that are dangerous. And one in particular, the one addressing proxy firms, is essentially—would—essentially defeat the corporate governance system, and we very strongly urge the defeat of that bill.

Thank you very much.

Chairman CRAPO. Thank you very much, Mr. Silvers.

I will begin the questioning, and I would like to start with you, Mr. Quaadman. The Brokaw Act would require investors to disclose short positions, and several of you have mentioned this issue with regard to it. Many institutional investors, such as pension funds, endowments, and foundations use short selling as a tool to manage risk and reduce the overall economic exposure of an investment portfolio. Short selling also plays an important role in providing market liquidity and facilitating price discovery.

Could you comment a little further on the likely impact of such disclosures on the markets and the use of short selling as a risk management tool?

Mr. QUAADMAN. Sure. Short selling is an extremely important tool for participants in the marketplace to be able to hedge their positions, and it is also important for liquidity purposes as well.

The challenge that there is in terms of the disclosures that are outlined here is that there are proprietary trading platforms that would be exposed. There are a variety of different methods, then, that could potentially harm investors.

So that is why we think if there is abuses, that is where we need to make sure that there is a light shined there, but we think it is more important for the SEC maybe to take a closer look at this rather than to start to mandate disclosures themselves.

Chairman CRAPO. Thank you.

Professor Coates, you mentioned you had some thoughts on the short selling aspect of the Brokaw Act. Could you clarify those as well?

Mr. COATES. Yes. I agree generally, although I will note the short disclosures would principally be in the 13D component, which most institutional investors would not need to comply with because their positions are passive and not intended to influence companies.

I do agree. Still, even in the very active space, I worry that disclosure could discourage some shorts from taking aggressive short positions against companies that do have problems, and shorts have played a major role in uncovering serious frauds in the past 5 years.

But having said that, I honestly do not think the SEC currently is equipped to learn much more than we could discuss today. So I would encourage a deliberate attempt to see what happened and, again, sunset the rules so that it is not going to remain there permanently if it is causing problems, but to proceed and direct the SEC to study in fact what happens.

Cost-benefit analysis, which I told you I endorse and the Chamber is very much in favor of, is a great idea in theory, but in order to really learn about the markets, you actually have to be willing to change sometimes. And I think this is a change worth making.

Chairman CRAPO. Thank you.

Ms. Stuckey, a question on proxy advisors. In testimony before the House Financial Services Committee last week, SEC Chairman Clayton discussed shareholder engagement and the proxy process. In that context, he stated that the SEC should analyze whether the voices of long-term retail investors are being underrepresented, misrepresented, or selectively represented in corporate governance.

What is your view on whether and how long-term retail investors are being represented on corporate governance matters and the role of proxy advisory firms in that representation?

Ms. STUCKEY. Thank you, Chairman Crapo. Thank you, Chairman Crapo.

Chairman CRAPO. It will come on.

Ms. STUCKEY. Is it on?

Chairman CRAPO. Yes.

Ms. STUCKEY. Thank you. Sorry for that.

If you are talking about Mr. and Mrs. 401(k) as long-term retail shareholders, they are represented by investment managers who largely vote with ISS and Glass Lewis. So they are being swept up in everything we talked about with proxy advisory firms.

They do not particularly want their companies wasting time trying to fix mistakes after the company has already written its own regulated SEC proxy statement.

I think that long-term retail shareholders really want their companies focused on strategy, competition, and innovation and cyber.

So the only other way that sort of the whole problem with proxy advisor, if it a disincentive to companies going public, then you have got long-term retail shareholders that do not have the same investment opportunity to invest in more companies, which we think is a problem.

Public, State, and private pension beneficiaries as well have no individual voice. Does any pension fund check with their beneficial owners before they vote, how they should vote on a particular shareholder proposal, say climate-related? I do not know if they check with their teachers and their firemen and their policemen, but I can imagine that there are many individuals that would be appalled at the way their votes are being cast. Basically, they are disintermediated.

Chairman CRAPO. Thank you.

Senator Brown.

Senator BROWN. Thank you.

Professor Coates, I would like to ask you about proxy advisors. Your testimony suggests the Corporate Governance Reform and Transparency Act should be renamed the "Proxy Advisor Regulation Act." Describe, if you would, briefly the procedural barriers the bill would create for shareholders and the proxy advisors that they have hired.

Mr. COATES. Sure. I think with a high-level admirable goal of trying to address potential conflicts at the proxy advisors, the way the bill was written, however, somewhat remarkably, given its origins, it expects Government to fix this problem by creating a bureaucracy at the SEC that would have fairly significant costs that it would pass along in the form of regulation, compliance officers, required ombudsmen, need to prove the efficacy and knowledge base of the advice that is being given, which is a type of regulatory requirement that is found nowhere else in the securities markets. Broker-dealers do not have to prove that they have an adequate basis for every recommendation they have.

There is significant cost associated with—and fixed cost. Let me emphasize fixed minimum cost associated with complying with the regime that is envisioned by this bill, which would discourage competition, not enhance it. So if you do not like there only being two, this would only make things worse.

And more basically, it is surprising to me that the sponsors of the bill do not recognize that under existing law, State law, and existing SEC law, the advisors could be sued by their clients if they are committing fraud or otherwise breaching their duties to their clients. And so this is a place where I am kind of inclined with the Chamber's normal position, which is we should really find the problem with the existing legal regime before adding more regulatory burdens on the system.

Senator BROWN. Thank you.

And following, Mr. Silvers, describe how the changes in the bill, what impact it would have on a large shareholder like the Ohio Public Employees Retirement System and its ability to hold management accountable.

Mr. SILVERS. Senator, the issue that pension funds face is that they are fully diversified in generally very long-term holdings in the equities market. They hold typically hundreds of stocks, and they have a fiduciary duty under both ERISA, the tax laws, and the relevant State laws to manage their assets. And the proxy vote is an asset. They have a fiduciary duty to manage their assets with expert advice.

Proxy voting firms are like other forms of investment management, provide expert advice on corporate governance to pension funds, enabling them to fulfill their duties.

Critical to that process is that the advisors have to be loyal to the pension fund. Expertise is one part of the fiduciary duty; the other part is loyalty. This bill compromises the loyalty issue significantly by enmeshing the advisor in a process of interacting with the very people whom the corporate governance process is designed to hold accountable. It puts the proxy advisory firm on both sides of the principal-agent problem.

On the one hand, it compromises the substance of the relationship between the advisor and the client.

Second, as Professor Coates said, it adds a layer of significant cost to what is otherwise a de minimis expense and one that provides substantial value in terms of votes that could affect the overall value of the securities involved, and so there is a cost issue.

There is finally an issue that Professor Coates raised briefly but I think is really worth hammering on here, which is that our entire securities law system and our pension law system, no one is required to get it right substantively as a legal matter. This is also true in corporate law. No one is held legally responsible for not making a mistake. People are held responsible for due care, and they are held responsible for loyalty, but not for perfection. And the fact that that kind of standard is sort of weaved into this bill is really telling you that the purpose of this bill is to prevent the corporate governance system from functioning.

Senator BROWN. Thank you.

I have only a few seconds. I want to ask for very short answers from Professor Coates and Mr. Silvers on the Brokaw Act. The Act put in place 50 years ago requires shareholders to report when they own a significant stake in a company. How will this bill help with transparency?

Let's start with you, Professor Coates, and I apologize, but as briefly as you can and then Mr. Silvers.

Mr. COATES. So 10 days, which is how long you have to file a 13D, is in today's environment an eternity, and it will shorten the amount of time before a filing has to be made. Derivatives economically are equivalent to the positions that normal stockownership provides, and right now, they are left out of 13D. So those two ways are the ways that it would enhance transparency.

Senator BROWN. Mr. Silvers.

Mr. SILVERS. Senator, I agree with what John said. I just want to talk to the short-selling issue.

The whole point of this regime is to give investors who are not 5 percent holders, who are not in a potentially control position, knowledge about what is going on and what people are doing potentially to control the company that they have invested in.

There is no way to understand what is going on if you do not understand what the short position is of the potentially controlling investor.

In my view, the concerns that have been raised, to wit about in general will this provision affect the ability of short sellers to operate and the ability of short sellers to play their legitimate function, I think is misplaced.

Senator BROWN. Thank you.

Chairman CRAPO. Thank you.

Senator Toomey.

Senator TOOMEY. Thanks, Mr. Chairman.

I just since returned, but I would just point out that there are some significant differences between a short position and a long position. A short position, for instance, you are subject to unlimited price risk, whereas a long position, you cannot go below zero. But there is no limit to how high a short position can go against someone.

Also, a short needs to be able to borrow the security. A long position does not have that problem.

And then, finally, I would point out that a short position does not entitle you to voting rights. So they are qualitatively very different, and I think we should proceed pretty cautiously for those reasons and others.

Let me touch on a few of the bills, and I appreciate this hearing. I think we have got some very worthwhile legislation to consider. One of them is S. 2756. That is a bipartisan bill, and the idea here is that we would acknowledge knowledge and expertise as grounds for being an accredited investor.

Let us be clear, right? The asset test and the income test that we currently use is a proxy for understanding the risk that you are going to be taking. Well, if you are a financial industry expert because it is your job, then that certainly is relevant experience. So I support this legislation.

The Family Office Technical Corrections Act is in a similar vein. What it would simply do is ensure that family members whose savings are managed through a family office are treated as accredited investors, and I think this just makes sense. It is not one of the bills under consideration at this hearing directly, but it has passed the House with a voice vote.

And I have got a letter from Private Investor Coalition in support of this. I would ask that that be included in the record.

Chairman CRAPO. Without objection.

Senator TOOMEY. And I would ask the Chairman to consider including this really important technical change in any package we might advance.

I do want to talk a little bit about S. 2499, the Compensation for Cheated Investors Act. My understanding is this legislation would create a fund funded by broker-dealers' fines, which are currently used to fund FINRA. So if that money were no longer available for that purpose and were instead used to compensate victims of fraud, then presumably the fees would have to go up that the innocent broker-dealers would have to pay into FINRA.

So I am sympathetic to the problem. Obviously, if somebody has been cheated, they ought to be made whole, but I am a little concerned that socializing this cost means spreading it among perfectly upstanding firms that have not done anything wrong to cover that which is done by bad actors.

And I further worry that this legislation could put a target on the backs, especially of smaller broker-dealers that may not have the funds to effectively defend themselves because there would be a backstop that somebody could go after that could encourage a wave of litigation.

And so, Mr. Quaadman, I would just ask, are these—do you share any of these concerns, or do you have other concerns about this legislation?

Mr. QUAADMAN. No. We share those concerns.

First off, we also have to recognize we are talking about a relatively small number of cases, I think 44, and even if you then take out those cases that maybe had gotten compensated somewhere else, we are talking about less than 30. So we are concerned that, one, if you start to use fines in this way, you are going to start to

incentivize for more fines. It is going to take some resources away from FINRA.

We also share your concerns as well that if you are going to socialize the cost of good actors, it is going to subsidize bad actors, and that is why we think it might be more appropriate to use the SIPC as maybe a vehicle to maybe take care of this.

But we also think, too, that while it has taken a while to take care of these issues, FINRA has taken some actions here, and we need to see how those take hold.

Senator TOOMEY. Thank you.

Let me just move on quickly to the proxy advisory firms, of which really are two that dominate the marketplace. One, ISS generates considerable revenue from the consulting services it provides to companies about proxy votes, while at the same time advising institutional investors how to vote on those very same issues.

It seems like a glaring conflict of interest if in fact they are receiving revenue or seeking revenue from a business, while at the same time advising investors how to vote the shares of a proxy.

Question. Do you see it as a fundamental conflict that is problematic?

Mr. QUAADMAN. Yes, we do. And, in fact, I have an email here—I will be happy to submit it for the record—of a solicitation for a company where the consulting service basically approaches a company to say, "You are going to get a better score if you use us as your consultants."

I think, too, we also have to understand that Glass Lewis has a separate conflict of interest as well because they are actually owned by two activist pension funds as well.

So we have to understand that proxy advice at its very core is to provide data to those investors so that they can make that independent judgment. They are not going to—but it has been used by others just to totally outsource their corporate governance functions.

We have addressed issues like this before credit rating agencies and financial analysts, and we should do it here.

Senator TOOMEY. [Presiding.] Thank you.

Senator REED. I guess you are in charge.

Senator TOOMEY. Am I in charge? Are you up next?

Senator REED. I am.

Senator TOOMEY. Well, I see I have run out of town. The Senator from Rhode Island.

Senator REED. Well, thank you, the Senator from Pennsylvania by way of Rhode Island. Thank you.

I want to just take a few moments to talk about my bill. I have talked to the Chairman. He has given me a little discretion, which is basically cybersecurity is I believe the most significant and universal threat that every company and enterprise in this country faces, and it is going to get worse. And it is not just a threat to the bottom line of companies. It is a national security threat.

I serve on the Armed Services Committee as a Ranking Member. I was stunned when we had General McDew, who is commander of Transportation Command. Transportation Command is the major agency in DoD that contracts with all the aircraft, all the

ships, all the logistical to move men and material and personnel into war zones and to anyplace in the world.

And here is what General McDew said:

> Cyber is the number one threat to the U.S. Transportation Command, but I believe it is the number one threat to the Nation. In our headquarters, cyber is the commander's business, but not everywhere across our country is cyber a CEO's business. In our cyber roundtables, which is one of the things we are doing to raise our level of awareness, some of the CEOs, chief security officers, cannot even get to see the board. They cannot even see the CEO. So that is a problem.

In the essence of this legislation, which is the mildest form of disclosure, it is not mandatory. It does not require a person to be on the board with a cyber degree. It asks the company in two lines to describe what they are doing.

We have companies today that we will depend upon in an emergency that may have been fully infiltrated by a cyber threat, and they are completely unaware. And their CEOs are not aware because there is nothing to make them sit down and say, "Hey, I've got to pay attention to cyber." This is the mildest form, when they read that proxy statement and say, "Oh, yeah. Boy, we have to think about cyber," otherwise it will not happen. It is not happening.

That is why you have Equifax problems. By the way, it has just been announced today that Equifax has settled with State Attorney Generals, and one of the things they have agreed to do, boost board oversight of cybersecurity because they failed, and they are not the only company that has failed and that is failing right now. And we are simply saying tell your shareholders what you are doing. You can do anything you like. You can hire a company. You can have a director, *et cetera,* this is not mandatory. This is disclosure.

This Act is bipartisan. Senator Collins, Senator McCain, Senator Warner, this is something that is absolutely critical. And I should say Senator Warner is the Ranking Member of the Intelligence Committee, and I think he brings that expertise to this support for this bill also.

The Cybersecurity Disclosure Act is supported by not only Professor Coates and Mr. Silvers—thank you—but the Alabama Securities Director Joseph P. Borg on behalf of the National—or North American Securities Administrators Association, the National Association of State Treasurers, the California Public Employees Retirement System, the Bipartisan Policy Center, Professor Jack Coffee of Columbia, and the law firm of K&L Gates, which is a very distinguished Washington firm. And I would like, whoever is the Ranking Member, to include those letters in the record.

Senator COTTON. [Presiding.] Sure.

Senator REED. Thank you.

[Laughter.]

Senator REED. Thank you, Senator.

Senator COTTON. Watch out. I am driving the bus now.

Senator REED. Yeah, OK.

So I just think this is incredibly important. You know, I fear that months, weeks, years from now, there is going to be a cyber disaster, and we are all going to look back and say, "Gee, if only we had done something." Now is the chance to do it.

Now, Ms. Stuckey, in your written testimony you say even the Council of Institutional Investors does not subscribe to the idea that all boards need a resident cyber expert. Is that correct? Are You aware that the Council of Institutional Investors supports my legislation?

Ms. STUCKEY. I was not.

Senator REED. Well, you should be.

Ms. STUCKEY. You are right.

Senator REED. Yes, you should because your testimony seems a little illogical when you are citing someone criticizing the bill that actually supports, and in fact, yesterday they sent a letter that said the Council of Institutional Investors strongly supports the stated goal of a bill to promote transparency and the oversight of cybersecurity risk of publicly traded companies. We are optimistic that S. 536 may have the potential of being pursued in a thoughtful bipartisan manner that is responsive to views of investors.

So your source is one of my biggest boosters. Thank you.

And we make that part of the record too, Mr. Chairman?

Senator COTTON. Sure.

Senator Reed. Thank you.

Now, Mr. Quaadman, you have made the point that this effectively mandates a director. That is wrong. This does not. Professor Coates pointed out, with his experience, not as an attorney, but in fact a lawyer.

I think it is interesting to note that in February 2018, the report by the Trump Council of Economic of Advisors, they said, and I quote, "Mandatory disclosure requirements were previously shown to incentivize firms to adopt better cybersecurity measures," and that is precisely what we are going today. So I would hope you would take that back for the record.

Professor Coates, you have been listening. Can you comment any further about your views on the bill?

Mr. COATES. Just to reiterate that the boards in this country are, in my experience, reasonably firm and strong-willed, and if they do not think they need a cyber expert on their board, I do not think this bill, which only requires them to say do they or do they not, and if not, why not, will force them to take one on.

I will note that a similar type of encouragement in Sarbanes-Oxley addressed financial experts, and there are 90 or so New York Stock Exchange companies that still are happy to not have a financial expert on their board, and they will explain why in their proxy statement.

So it is not as if this really does force a one-size-fits-all solution. There are one-size-fits-all solutions, and I really do worry that if there is another Equifax or similar event, we will end up with a one-size-fits-all regulatory regime. This bill, I would like to think, would head that off.

Thank you.

Senator REED. Well, I appreciate that, and again, unfortunately, based on an experience that Senator Cotton and I share position on the Armed Services Committee and also on the Intelligence Committee, and cybersecurity is something that is not a passing fancy. And as you pointed out previously, Professor Coates, it affects every enterprise in this country. It is not like a labor issue

or environmental issue where the company has nothing to do with that. So this would be a waste of their time.

Every company—I mean, look back at some of the big intrusions, the Target intrusion of a few years ago. It was an HVAC contractor who they got in through. In fact, frankly, my sense is if they are coming after us, they will not be right through the front door of the companies that are doing all the right things. It will be the companies that need the reminder to think about cybersecurity.

So, with that, Mr. Chairman, I would yield my time. Thank you.

Senator COTTON. Thank you, Senator Reed.

I will just continue on that topic. Abstracting away from any particular legislation, though, Mr. Coates, I want to address a point you made in your testimony where you said that you think based not only on your experience as a scholar, but as a practicing lawyer and someone who still advises Government agencies that the cyber threat is nearly unique among all threats that our companies and investors face. Could you elaborate a little bit more on that?

Mr. COATES. Sure. There are a variety of other kinds of risks that some investors would like boards to take on; environment, for example. And they are real, and they are important, but they only do affect a subset of public companies. There are many companies that really do not have a meaningful exposure to climate change risk, other than the way that we all do as humans on the planet.

Cyber is different than that in the sense that it is practically impossible to function as a meaningful business without your employees using these things, these cell phones, and these cell phones expose you. Your perimeter of security around your basic information systems is exposed every time one of your employees communicates to and from outside the company, and inside the company. So it is very difficult actually to come up with examples of companies that are not exposed to cyber risk, and it is a core risk. It is the kind of risk that can produce theft. It can produce fraud. It can produce longstanding corruption of data, and all of those things are going to have direct financial impacts on the company, its investors, and its customers.

So, as I say, I am mindful that there is a worry that disclosure-based governance can start to cover more and more and more, and there is a worry that where do we stop and where do we draw lines. And really, the point I am trying to make on cyber is, this is a clear difference for this type of risk for many other kinds of governance concerns that other people might have. That is all.

Senator COTTON. Thank you for that.

I want to turn now to legislation I have introduced with Senator Jones, the Small Business Audit Correction Act. It was not on the list of bills today, but, Mr. Quaadman, your organization, the Chamber, sent a letter just in the last day or two about our legislation. So I would just like to say a few words about it and get your thoughts. The bill would correct what I think are one of the unintended consequences of the Dodd-Frank Law, namely the massive increase in audit costs for small noncustodial broker-dealers. In response to the Madoff scandal, Congress decided to extend public company accounting oversight board audit requirements to all broker-dealers. In hindsight, I think Congress pretty clearly overshot the mark when they included small noncustodial firms, that

is, firms that do not hold customer assets, and thus, could not even pull off a Madoff-like scam if they wanted to.

This requirement may seem harmless or obscure, but in fact it has increased the cost for small broker-dealers quite a bit.

One Arkansas broker has told me that his audit costs have gone from $6,000 to $30,000, and he only has five employees.

That is why our legislation would make a simple change. It would exempt these small privately held noncustodial firms in good standing from the board audit requirement and allow them to file their financial statements according to the GAAS standards they used just a few years ago. I think the current audit requirements are like trying to put a square peg into a round hole, which is to say they do not fit, and they will always be high-priced.

It is true that regulators at the SEC and FINRA could relieve some of the compliance burdens themselves, but they could also reverse that decision later on. Our small brokers deserve regulatory certainty. They can only come with a change in the law, and these regulators have acknowledged that aspects of the problem can really only be solved by changing that law. They have told us that our hands are somewhat tied by the statute.

So, as I said, Mr. Quaadman, your organization sent a letter earlier this week to our Committee to support the legislation. Could you talk about why you feel these small noncustodial firms and, more importantly, their customers would benefit from the passage of this legislation and the return of right-size auditing standards?

Mr. QUAADMAN. Thank you, Senator Cotton. Thank you for introducing the bill.

I think it is important to remember, first off, that the PCOB, the first two acronym letters are for public company. Most of the broker-dealers you are talking about are not public companies, and there has always been a problem when you try and put public company controls on to private companies.

So if your bill were to pass, those broker-dealers would still be subject to GAAS, as you mentioned, and that those standards are specifically designed for private companies.

Additionally, those that have custodial accounts are going to be treated differently.

And furthermore, I would also say, too, the easiest way to find a Ponzi scheme is to take the bank records and to take the revenue statements of a firm and to match them up, and that information is still going to be available for the regulators. So we think this is a good way to rebalance the system.

Senator COTTON. Thank you for that answer.

My time has expired. I want to thank the witnesses for their testimony. I particularly want to thank Professor John Coates, who was my teacher in law school. I hope that my performance does not reflect poorly on your teaching skills, Mr. Coates, and let the record reflect he was an outstanding professor.

Senator Jones.

Senator JONES. Thank you, Mr. Chairman, and thank you for bringing up our bill that is not part of this hearing today, but I think is a very, very important bill. And I am pleased to be working with you on that.

I would like to talk just a moment. We briefly mentioned a little bit—I think everybody is generally in support of a bill that I introduced with Senators Heller, Heitkamp, and Kennedy concerning the Expanding Access to Capital for Rural Job Creators. That is, I believe, another one of those niches that often gets overlooked.

We have so much rural businesses in my State or rural areas for businesses that are not capitalizing, and, Mr. Quaadman, I noticed that in your testimony, I was struck—I did not know the specific statistic—that since the financial crisis, half of the new business creation has occurred over 20 counties out of just literally thousands of counties in the United States.

So this bill is going to create a spot, and I would like to—you know, particularly if you could maybe just expand a little bit and talk about the unique challenges for raising capital that our rural and small businesses face today.

I think just anyone can do that. I will start with you, Mr. Quaadman, but I really want to kind of get this on the record a little bit about why this is an important bill.

Mr. QUAADMAN. Sure. I think, number one, I think it is a credit to this Committee that, first off, the passive of S. 2155, which provided regulatory relief to large community banks and regional banks, is important because those banks are very important liquidity providers in rural areas.

However, we are still seeing a dearth of business creation—when we talk about the Heartland of the country and the rural areas, I mean the coastlines are doing fine. Those 20 counties, you could sort of figure out where they are. It is not a surprise.

So we think it is important to incentivize the ability of capital to go out into the different areas of the country. We think some of the work that Steve Case and J.D. Vance are doing in this area are very important, but I think your bill will help to make sure that this gets the appropriate policy discussion within the SEC and that we could start to make sure that the policies are not going to benignly ignore business owners in rural areas.

So we think this is an important step forward, and we are happy to support it and work with you on it.

Senator JONES. Great. Thank you.

Professor Coates, do you have anything, or Ms. Stuckey, do you want to——

Mr. COATES. So I endorse your bill. I think the SEC does have a tendency, for understandable reasons, to focus on the major capital markets and the major centers of capital formation, which mostly are not rural, and yet the laws and regulations that it passes and the bodies that it oversees, like FINRA, regulate the entire country. And I do think there are probably ways in which the laws and regulations could be better tailored for businesses trying to raise capital in remote areas.

I would say the network that creates cyber risk actually does create the potential for small and relatively geographically remote companies to go global, and as a result, I do think there is the possibility of a resurgence in rural job creation, but it will take some effort and some time. And I suspect it is going to need more than the SEC, but I do think having the SEC think about it will help.

Senator JONES. Ms. Stuckey, I did not mean to skip over you. If you want to briefly mention that, anything that you need to add.

Ms. STUCKEY. I did not include this in my testimony, purely because I did not have time to raise it with my members. So we do not have a—the Society does not have an official position, but we were generally for capital formation. And I cannot really imagine why we would oppose this, so long as the SEC has the bandwidth to deal with it.

Senator JONES. Mr. Silvers, do you got any thoughts?

Mr. SILVERS. Just, well, we think this is a good idea, but in doing so, I think, Senator, we would suggest both to you and to the Advocate, whom this bill was directed toward, that it is very hard to do anything really helpful for small business and small business in rural areas without taking into account issues of market concentration, both in the markets that issuers are in and in the financial markets themselves.

There has been dramatic concentration in the financial markets, and it is our somewhat uninformed guess that that has not been a good thing for rural business.

Senator JONES. All right. Thank you.

I want to just in my remaining time just thank Senators Heller and Heitkamp for their work creating this Advocate position, but also noting that the SEC has yet to fill that. So I am hoping that we can do that.

And just one quick follow-up, Professor Coates, to what you said. We have been—especially in my office, we have been strongly, strongly trying to push for more rural broadband and internet, high-speed internet access, because to be able to get global, you are not going to be able to do that if you still have dial-up, which so many counties in this country still have. So thank you for that comment as well as in reinforcing the need of rural broadband.

So thank you all for your testimony today. It was very informative.

Thank you, Mr. Chairman.

Senator TOOMEY. [Presiding.] I think Senator Cortez Masto is up.

Senator CORTEZ MASTO. Thank you. And also, I want to thank all of you. This has been a great conversation this morning.

I also want to thank the Chair and Ranking Member for considering S. 2756, the Fair Investment Opportunities for Professional Experts Act.

I was pleased to lead this bill with Senator Tillis, and I also want to thank Senators Heitkamp, Peters, Toomey, and Heller, who cosponsored it.

The bill—and I would like to talk a little bit about it because it tries to establish a balance. Change policy to expand the overall pool of accredited investors, but also reduce the proportion, qualifying solely by virtue of income and wealth alone.

I know, Professor Coates, you have concerns about this bill, but I also know—and thank you for your service on the SEC's Investor Advisory Committee. Do you know why the SEC did not follow the IAC's recommendation to raise the threshold? Because I know that is what you and Mr. Silvers talked about. That was your concern. So can you address that? Why was it not—because it has not been

looked at since 1982, and I think you said that in your testimony as well. So I would be curious if you have any insight into that.

And then also, if you have any thoughts on what income and wealth thresholds do you think would—it should be increased to that would protect unsophisticated but wealthy people from being ripped off.

Mr. COATES. So I can only speculate about the SEC. I will say that for reasons—it may not seem like a politically fraught topic, but actually, it really is because the precise scope of who can be an accredited investor will directly affect business models. And the precise decision about what kinds of education and practice experience will count will directly affect business models. So there is a real financial interest in exactly where the lines are drawn, and I think the SEC has had a lot on its plate over the last 10 years, and that was one battle they—I am speculating—decided to defer on and let you guys who are specialists at resolving political disputes resolve.

So, on your second question—and by the way, I actually am very much in favor of moving more toward experience and education——

Senator CORTEZ MASTO. OK.

Mr. COATES.——rather than relying on, as Senator Toomey said, the crude rule of net worth and income as the basis for it because it really does not match very well in practice sophistication.

So I am all in favor of expanding the pool, but I do think we need to recognize that when the dollar thresholds were set a long time ago, we have now basically expanded by—I forget exactly the number, but something from less than 2 percent to more than 6 percent of the population.

So my suggestion would be just to go back to the percentage, which can easily be derived—actually, the SEC report gives you the numbers, and so expand on the professional side, but contract on the pure net worth side would be my suggestion and then index it. So, anyway, that is my suggestion.

Senator CORTEZ MASTO. Thank you.

Mr. Silvers, do you—because I know you had concerns similarly.

Mr. SILVERS. Yes. Well, two points about this, Senator. First, my view is very similar to John's in terms of both how you might address the thresholds and the directionality we should be going in here.

At the current threshold level, it picks up a fair number of union members that I can tell you would absolutely say "we are not experts."

Senator CORTEZ MASTO. Right.

Mr. SILVERS. Right. But there is a second point here, Senator, that I think is really worth thinking hard about, and it goes back to something that Mr. Quaadman talked about in his testimony, which is the balance between the private markets and the public markets as sources of capital for our firms.

There has been a notable shift toward the private markets, and that has consequences in terms of how much information is available to investors and to the general public and the policymakers.

And the question of whether or not investors are really getting the level of protection, transparency, and market efficiency out of

private markets that traditionally they have gotten out of public markets is a question that has not gotten enough attention.

Part of the reason why this shift has occurred is because we have made the private markets much more like the public markets in terms of the ability to access capital. Whether that is a good idea in the absence of comparable levels of investor protection and transparency, again, I think is an under-investigated question.

If you move these numbers or if you lock them in, if you lock them in by statute at levels that are pretty low or if you have measures of expertise that are not real measures—and we know that qualitative things can sometimes be easily gamed. If you do that, you are enhancing this aspect of the imbalance between public and private markets, and if our concern is that we want more companies moving into public markets, that is probably not—we are pushing in the opposite direction.

The precise answers here, they are not obvious, but it is important to understand the stakes involved and some of the considerations that this Committee might want to look at.

Senator CORTEZ MASTO. But you would agree that the wealth threshold is too low?

Mr. SILVERS. Oh, absolutely. As Professor Coates said and as in my written testimony, it has not moved since 1982.

Senator CORTEZ MASTO. Right.

Mr. SILVERS. It is a third—it is picking up three times the percentage of the population, and I would just note anecdotally, the kinds of people whom it is picking up are not experts.

Senator CORTEZ MASTO. Right, right. Thank you.

And I notice my time is up.

Let me just say this, looking at the bills that we have talked about today, as I review them and will continue to. I can tell you right now I have concerns for the conversation that we had with H.R. 4015, but do support the Cybersecurity Disclosure Act of 2017 and Expanding Access to Capital for Rural Job Creators Act.

Thank you again for the conversation.

Chairman CRAPO. [Presiding.] Senator Scott, you are up.

Senator SCOTT. Oh. Thank you, Mr. Chairman. Good timing. Thank you, Mr. Chairman.

Good morning to the panel. I hope you guys are doing well.

Management at publicly owned companies should be held accountable by their shareholders. That said, I think it is important to maintain the balance between both sides, and I question whether those scales are beginning to tip.

But two proxy advisors control up to 38 percent on average of shareholder votes in the United States. That is a massive choke hold that would seem to deserve an increased level of oversight, and that is not to mention one of the proxy advisors offering consulting services.

It seems obvious that a firm that overwhelmingly dictates how investors vote their shares should not also be pitching companies on how to improve their corporate governance results.

I will go to Ms. Stuckey first and then Mr. Quaadman. Can you expand upon the conflict of interest presented by ISS doing recommendations for one side and consulting for the other side?

Ms. STUCKEY. Thank you, Senator. Yes, I can.

You are right. The conflicts are legion with ISS. For a fee, you can have ISS help you draft your proxy if you are an issuer. If you are an investor, you buy their research and recommendations. If you are a hedge fund, you can also buy their consulting services, and then they will vote on your proxy contest.

If you are a shareholder proponent that needs to make sure they can get a proposal and that will pass muster under the SEC rules, there are even people at ISS that will help you write that, and then they also vote on those shareholder proposals.

I do not know how to say it any more clearly. It is a nice business.

Senator SCOTT. Mr. Quaadman.

Mr. QUAADMAN. Senator Scott, I would echo Ms. Stuckey's answer.

I would also say—and I mentioned this in an early answer. You know, we will submit for the record an email which many of our members get, where from the consulting side of ISS, it says, you know, if you use our service, you will get a better score.

I would also want to add as well, Glass Lewis also has a significant conflict of interest. They are owned by two activist pension funds, and I think it is important to note that neither firm issues any statements as to whether or not a client is a shareholder proponent.

And neither does Glass Lewis, you know, disclose if they have a financial interest in a firm, which they said recently in a letter back to this Committee, they would only do if it is a publicly disclosed position.

So I think there is significant conflicts of interest here. As I said earlier, this is something that we have dealt with, with credit rating agencies, with financial analysts, and it is long, long overdue for this to be addressed here as well.

Senator SCOTT. Thank you for your answers.

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you, Senator.

Senator Van Hollen.

Senator VAN HOLLEN. Thank you, Mr. Chairman. Thank all of you for being here. I had to leave, but I heard your original testimony. I have some questions on the 8–K Trading Gap bill.

Professor Coates and Mr. Silvers, thank you for your support for that bill and your testimony.

Mr. Quaadman, I appreciate you also willing to work with us. You raised an issue in your statement, which I do not think is really part of the bill. You said that you want to make sure that we clarify when an event happens and when it becomes material, and here is the thing. This bill does not get into this, into that question. Maybe we should as a Committee; maybe we should not. But this bill does not do that.

What this bill says is once the company has made the determination that something is material, that is when the 4-day clock starts ticking for the filing of the disclosure. And what this bill says is during that period of time, there should not be people trading because they have already made the decision that this is relevant information, and they should not be taking advantage of that with insider trading. Do you agree with me on that?

Mr. QUAADMAN. Yes.

The issue that we raised was that if there is an event that happens, the company has 4 business days then to make a decision as to whether an issue is material.

Now, you have some companies where you have 10b–15 automatic stock selling or purchasing. You have others that do not. So, in our view, in reading the bill, at least in the version that we received, that we think that there needs to be maybe some clarity because you could have senior executives who are a part of that decisionmaking process, where we think there might be something that needs to be addressed. There are other senior executives who are not a part of that decisionmaking process as well.

So we think there is just some—there is a little bit of a gray area that we would like to sit down and maybe talk to you about.

Senator VAN HOLLEN. Well, I am always happy to talk.

It seems to me that once the decision has been made—and as I understand the 8–K disclosure requirement, that there is a 4-day time period between the actual determination by the company that is obviously material and then they have to disclose it.

I am not sure, and I—when Mr. Clayton was before the Committee, he agreed that he did not see any reason why during that 4-day period any executives should be trading stock, unless they had sort of a prescheduled purchase agreement. And the bill addresses that issue. It specifically carves out an exemption for people who had already had a scheduled plan. Is there any problem——

Mr. QUAADMAN. No, no. And, as I said, no, we recognize that.

I think where there maybe needs to be some clarity, because it also talks about material nonpublic information as well, and every company is always in control of material nonpublic information, right? If you are Apple and you have your plans for your next phone, that is material nonpublic information. So I think that is why there is just a matter of clarity because you can have an event that happens that you do not—that there is a decision made that it is not material.

So the question is, do you then create such a limited period of time that people can sell their stocks or not? So that is why I said we perfectly agree if there is a decision made, there should not be any sort of trading going on, but I think there is just that little bit of a vague area during that 4-day period that we would just like to maybe sit down and go over.

Senator VAN HOLLEN. I am happy to do that. I mean, the intent here is once the determination has been made that it is material——

Mr. QUAADMAN. We agree with——

Senator VAN HOLLEN. You agree with that?

Mr. QUAADMAN. We agree with your intent and want to work with you on it.

Senator VAN HOLLEN. Ms. Stuckey, do you agree as well?

Ms. STUCKEY. Yes, I agree with your intent, and my only basis for not supporting it at this point is because we are of the view that the trading windows are closed. As soon as a company decides that they have material nonpublic information, like you said, there may be outlier companies. The brief time I had and the members

I spoke to, they said, "We always close our trading window, and this does not happen." However, we are happy to work with you because there may be companies where that does not happen.

Senator VAN HOLLEN. Yes. I think there may be folks who may not be your members where this is happening.

There have been a number of studies that show that there—trading does happen during this 4-day period, and that clearly is trading at a time when the company executives are privy to information that the public does not have. So I look forward to working with you on that.

The last thing I will say, Mr. Chairman, is that Senator Baldwin and I and the Ranking Member Brown and other Members are going to be asking Mr. Clayton and the SEC to look into the issue of the 10b–18 safe harbor protection that was put in place many years ago with regard to stock buybacks.

There is obviously—you know, there can be good reasons sometimes for stock buybacks. We understand that, but we have seen like a trillion dollars of stock buybacks, and there are a lot of concerns raised about the potential for a conflict of interest and again insider information with respect to stock buybacks.

And I may pose a question for the record for all of you to respond.

Thank you.

Chairman CRAPO. Thank you.

Senator Tillis.

Senator TILLIS. Thank you, Mr. Chairman.

Thank you all for being here, and I think Senator Cortez Masto asked some questions related to one area, so I will not go back to that.

One question that I had were the no-action letters that were issued, the two in question by the SEC in 2004. Ms. Stuckey or Mr. Quaadman—did I pronounce that right?

Mr. QUAADMAN. Yes.

Senator TILLIS. Can you give me your opinion on the—whether or not the withdrawal of those would be positive and why?

Ms. STUCKEY. I think they would be positive, and let me just mention that as Mr. Silvers seemed to indicate that—well, those letters are what created the proxy advisory firms as they exist today. Those letters were put out to rid companies of another kind of conflict. Instead, they have created the conflicts that we now have.

The other important part of those letters is it gave investment managers an out if they hired an independent third party, but what happens is it seems like—it seems like the view of some people that the proxy advisory firms are there solely to hold the companies to account. I thought that was the role of the SEC, and that is where the line is blurring. The proxy advisory firms have become the *de facto* regulators. So I just wanted to make that point from the earlier testimony. It is really troublesome.

Withdrawing the letters, we believe would really help the situation and force the investment advisors that do have the wherewithal to vote shares like they do, which is many of the large companies already vote. They are not actually the people that rely so

heavily on proxy advisory firms, and it would go back to the system before these proxy advisors existed.

Mr. QUAADMAN. Senator Tillis, that is a great question. Number one, we believe that proxy advice should be data-driven. It should be related to the fiduciary duty of their clients, and it should also be based on shareholder return. That means it needs to be objective.

The issue with the no-action letters is that the proxy advisory firms do not have to disclose a conflict of interest. Their clients do not have to ask about a conflict of interest. So this actually allows for the firms to operate in a way that they do.

We believe this has created very serious problems with proxy advice. I have letters I can submit for the record. One is from Abbott Labs, where they provided a 22-page letter to ISS citing material shortfalls in their reports, and they refused to want to even meet with Abbott Labs or to even issue a corrected report.

I have a list of 130 supplemental filings filed with the SEC listing shortfalls in ISS and Glass Lewis reports that were not addressed.

So we think that the withdrawal to no-action letters will put more teeth into SB20, and that that will then actually allow for efficient and appropriate SEC oversight over the advisory firms.

Senator TILLIS. Thank you.

Another piece—and I think some of the Members have expressed their concerns over—you are familiar with CFIUS, I assume?

Mr. QUAADMAN. Yep.

Senator TILLIS. Some of their concerns about this being another pathway into influencing U.S. firms through moves to affect who is the CEO, who is on the board, certain policies. Do you have any insights you can give me where you think that is a valid concern and what we should do about it?

Mr. QUAADMAN. Yes. So proxy advice—you know, proxy advisor reports are—for some firms, some of the larger firms, they have their independent due diligent systems, so it is one data piece as many.

However, the reason why we always are talking about the academic reports, it is to show that there is 38 percent control, is that there are some firms that just totally outsource.

The reason why I think—the point that you raise is a very interesting one, and I want to reflect on that some more—is that we have one of the advisory firms that is owned by two Canadian active pension funds.

Senator TILLIS. Right.

Mr. QUAADMAN. So that one is if we are talking about the total mix of information as being provided to investors and there are shortfalls or there are problems in putting that together, that then becomes a problem that we have one that is controlled by foreign entities.

Senator TILLIS. Yes. You know, the CFIUS construct does not apply directly to this.

Mr. QUAADMAN. Yes.

Senator TILLIS. But once we implement CFIUS, which will be negotiated out in the NDA conference and you close some of the gateways through the CFIUS process, then people are going to be look-

ing for other ways to actually influence U.S. businesses. That is why I think we do need to actually consider it.

The only other thing is that I know that in the written testimony, there was some comment made about how the bill that we are trying to get support for here that had support in the House affects competition. Is not it really true that right now we have a duopoly between Glass Lewis and ISS? Do we have any real concept of competition in this space?

Mr. QUAADMAN. There was an effort made 10 years ago or so where PGI tried to come in as an entrant, and they only lasted a couple years. A couple years ago, there was Proxy Mosaic also tried to enter in and failed. There are a couple of smaller firms.

That is one of the reasons why I have raised this in the hearing, that this is very similar to credit rating agencies and why we need to take a very close look at it because if they are going to be the *de facto* standard setters of corporate governance, we need to make sure there is appropriate oversight.

Senator TILLIS. Thank you, Mr. Chair.

Chairman CRAPO. Thank you.

Senator Heitkamp.

Senator HEITKAMP. Thank you, Mr. Chairman.

I want to just comment a little bit about the requirement for SEC to include someone with rural business experience.

We have not yet gotten a nominee for that position. One of the reasons is I probably have put a lot of pressure on the Chairman to look not just at the coast, but look at the Midwest. And I think they are searching to try and get not only that big-to-little experience, but also a regional experience as well. And so I know that he is working hard to make that happen.

I want to go ahead and turn now to, again, the issue of proxy advisory firms. Where I think that there may be Members here who have reservations about the House bill, I do not think that you can listen to this testimony and not think that we need to have a discussion about some of the flaws that are embedded in the current system.

And so I am just going to ask some of the kind of baseline questions to just get the facts out there, and a lot of this discussion has already taken place. But we know that right now, there is no regulatory apparatus that applies to all proxy advisory firms. They are functionally unregulated in many ways like the rating agencies before——

Mr. SILVERS. Senator, I think that is not quite right. While they are not required to register as investment advisors and, thus, are not in that frame—and as I said in my testimony, we would actually be supportive of requiring them to be in that space because that is what they do. They provide investment advice. That they are enmeshed, as Professor Coates said earlier—they are enmeshed in both a variety of State law regimes and in the—and to the extent that they are providing advice and guidance to pension funds, they are enmeshed in the regime of fiduciary duty involving pension funds.

Senator HEITKAMP. OK. So maybe looking broader beyond Federal regulation, looking to State regulation, looking at what their

roles are depending upon who they are functioning for. So that is a fair point, I think.

Let us go beyond the fiduciary relationships that you just discussed. Broadly, is it not true that proxy advisory firms do not owe a fiduciary obligation to shareholders *writ large*? Is that not—anyone want to disagree with that?

Mr. QUAADMAN. Senator Heitkamp, I would just say that the clients to the advisory firms do, and that the advice that they are providing to clients is important for that. And if those clients are going to outsource their voting functions to those firms, then there is a much larger issue at play there.

Senator HEITKAMP. OK.

Mr. Silvers?

Mr. SILVERS. Senator, I think you are raising a really critical question that has to be carefully parsed. The proxy advisory firms typically, either by contract or through operation of State law or pension law, they typically owe some kind of duty to their client.

Their clients, to the extent that they are institutions, obviously owe fiduciary duties to their underlying investors, and in their relationship with the proxy advisory firm, they have to be compliant with their fiduciary duties to their ultimate investors.

What this bill, I think, really confuses in a very dangerous way, it suggests that the investors somehow owe a duty to or are required to consult with the corporation in the course of fulfilling their fiduciary duties to their beneficial holders.

The only investors that owe a fiduciary duty to the firms they invest in are controlling investors—so, for example, Fidelity invests in Exxon. Fidelity does not owe a fiduciary duty to Exxon, and people who give advice to Fidelity do not owe a fiduciary duty to Exxon.

Senator HEITKAMP. I understand what you are saying, but I think that no one benefits when the advice is not vetted, when the advice is not accurate, when the information and dialogue that is being provided has no way of being corrected when mistakes are made. That does not benefit anyone in this system to not—I mean, I think Mr. Quaadman gave an example of Abbott Labs. I think anyone who might be on the other side of that thinks that what we ought to be talking about is how do we make sure the correct information enters the marketplace as people are making investment decisions. That is really the whole reason for this entire regulatory regime that we have created, is to give accurate information to people who are investors.

Professor Coates, I think you wanted to share a comment here.

Mr. COATES. Yes, just very briefly. Abbott has its own mouth too, and they put out a proxy statement. And the normal way in which we have disputes resolved about certain kinds of information is to have more speech.

Anyone giving advice in a public way, soliciting proxies is subject to anti-fraud rules enforced by the SEC. So if ISS were to put out a report knowingly falsely or negligently falsely, they would have liability for it. So I just want to be clear that if they deliberately misrepresent facts, they are going to be subject to liability.

Senator HEITKAMP. Yes.

Mr. COATES. Now, I do think the conflict problems are a different issue, but I think on basic factual disputes, we have an amply robust system for getting the information out there for investors, in my opinion.

Senator HEITKAMP. Do you mind, Mr. Chairman, if Mr. Quaadman responds to that?

Mr. QUAADMAN. I think—look, the issue here is you have the two firms control about 38 percent of the vote. So if you talk to CEOs or those—once the ISS or Glass Lewis recommendation comes out, 30 percent of the votes come in in 24 hours. So that means that there is a high correlation, which has been showed academically that there are a number of investment firms that are just outsourcing their votes to those firms. And this is what ISS and Glass Lewis in some of the response to the Banking Committee here were saying were custom policies.

So if you have an instance where—and I think the Abbott Labs' letter is instructive, but as I said, we have got about 130 other examples. If there are 22 pages of material misstatements and they are brought to the attention of an advisory firm and that advisory firm refuses to meet on it, refuses to issue a new report on it, then those investment advisors that are outsourcing their entire voting function to an advisory firm are actually endangering what their fiduciary duties are to their clients or to their investors.

So this is where there is a—you know, there is a tremendous shortfall in oversight of corporate governance.

Senator HEITKAMP. Yes.

Thank you, Mr. Chairman, for indulging some additional answers.

But, I mean, I guess the point that I want to make is that this is an area that I think needs to be reviewed. I do not know that we have the right solution, but I think there is an opportunity here to find that commonality of interest and at least figure out what part of this we can all agree on needs to be fixed and then what part we need to have more transparency on.

And so I look forward to an ongoing discussion about this issue into the future, but very complicated, but also an opportunity, I think, to look at some mutual reforms that we could all agree on across the spectrum.

Chairman CRAPO. Thank you.

And Senator Toomey has asked for one last opportunity to ask a few questions.

Senator TOOMEY. Second round.

Chairman CRAPO. Yes.

Senator TOOMEY. Thank you, Mr. Chairman.

Chairman CRAPO. Quick, quick, quick.

Senator TOOMEY. I will be quick. Thank you.

Though we had some brief discussion and at times we have touched on this idea that there has been a relative shift in funding to private markets and away from public markets, and it strikes me that it is entirely possible that a contributing factor to this shift could be a really substantial increase in the challenges and risks and pitfalls of being a public company now and the corporate governance that comes with that.

And so what I think might be a case in point—and I want to raise this issue—is what seems to be a movement in the direction on the part of some in this environmental, social, and corporate governance investing or known as ESG investing.

Now, let me be very clear. I have absolutely no reservations whatsoever with somebody who decides that they are going to create a fund dedicated to a particular type of investment, and if that is investment that is motivated by social or cultural goals and it is fully disclosed to investors and investors choose to participate, then knock yourself out. I have absolutely no reservations.

What concerns me is cases where maybe advisors or fund managers or minority activist investors are trying to use the corporate governance voting mechanism as a way to advance a social and cultural agenda that may be inconsistent with many investors' wishes and may be inconsistent with maximizing what is best for the investors generally.

For instance, the Manhattan Institute published a report in September of 2015, and they found that pension funds that engaged in social issues, shareholder proposal activism, that those investments are associated with lower values for the firms in which they invest.

Likewise, there was a 2017 academic study commissioned by the National Association of Manufacturers that found that activist proposals detract from shareholder value.

So I guess my question—I will start with Mr. Quaadman. First of all, as just a sort of subjective question is the proxy—is that the appropriate place to litigate what can be contentious social and cultural issues in America?

Mr. QUAADMAN. No. The duty of the board is to—they have a fiduciary duty to their investors. So the problem with—you know, you have to break down ESG into its component parts. Governance is always an issue. Environmental depends on the business or the industry can be an issue. The problem is social because if we are going to allow for broad-based social issues to be debated in directors—and there is a school of thought that is emerging that if Washington cannot handle a problem, let us go to the public companies, and then let us start to debate it—you know, let us start to push is there—that means we are going to take boards away from that fiduciary duty. They are going to become debating societies.

And if we look as split as our country is on many important issues, that is going to be thrown right into the board room, and they are not going to be focused on what they should be focused on.

Senator TOOMEY. I would just say I can imagine—and I know of issues that are in the environmental and governance space that are also really ultimately social and culturally debated issues.

But, Ms. Stuckey, I wonder if you have any thoughts on this.

Ms. STUCKEY. I agree with Tom on that.

We also see our private company members growing and our public company members shrinking, but you are absolutely right. And Tom is right. Why should a board be spending time on the social issues when they should be dealing with cybersecurity?

And, also, why—there clearly is a competitive disadvantage to be a public company these days because of all the regulation. I mean, you think of activism. You think of more and more disclosure, so I would agree.

Senator TOOMEY. So if there is documented evidence that suggests that there is a category of criteria that promoting—promoting this category results in a lower return to investors, then anybody advising that would be failing to live up to their fiduciary obligations, would not they?

Mr. QUAADMAN. Yes. And I would say if you also take a look at the issue of public pension plans, those that have the lowest—the lowest performing, the taxpayer has to make up that difference.

Senator TOOMEY. Right.

Mr. QUAADMAN. And, you know, what we are also seeing here—because I agree with your statement earlier. Look, there is a market-driven—there could be a market-driven approach here. If you want to have an ESG fund, go ahead. Go right at it. Well, I think we should also be very cognizant of the European Union is actively looking at a sustainable finance directive that will look to place ESG from a top-down approach and do it very broadly.

And the reason why I raise this in terms of concern, as we looked at with GDPR and other areas, the European Union is looking to be a global standards setter. So I think we need to be very concerned here that public companies in Europe are a much different animal than they are here in the United States, and if we start to see that migrate, ESG migrate because of the European Union, I think we are going to be in some—we are going to be in a pretty difficult—we are going to see more and more public companies become private.

Senator TOOMEY. Thank you very much.

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you, Senator Toomey. I agree with the concern you raise, and it is obviously one among many that we are trying to address here.

I also want to thank the witnesses. I thought we had a very good and thoughtful discussion, and I personally got a lot of helpful insights into the legislation we are looking at. And you definitely helped us as we try to put together a package of corporate governance reforms that will improve and strengthen circumstances in the United States.

With that, I would note for all the Senators who wish to submit additional questions—and you may get some questions from the Senators who were not here and even those who were—that they need to submit those questions by Friday, July 6th. And I encourage the witnesses to respond to those questions, if you please would, as quickly as you can.

And, again, thank you very much for giving us your time and your expertise and advice here, and with that, this hearing is adjourned.

[Whereupon, at 11:38 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN CRAPO

Today's hearing will focus on several legislative proposals to improve corporate governance.

As with Tuesday's hearing on capital formation proposals, I intend to work with Ranking Member Brown and with other Senators on the Banking Committee to identify and move legislative proposals through the Senate.

Although some of the bills which we will be discussing today have also been discussed and considered in the House, most have not.

Today's hearing will mark a first step for those we have not yet considered or were recently introduced. Among other things, the bills that we will discuss today would:

- expand the definition of accredited investor;
- shorten the Schedule 13D filing window and increase disclosure of short positions;
- require FINRA to create a relief fund to cover unpaid arbitration awards to investors;
- draw attention to cybersecurity experience at the board level;
- address concerns that a gap exists between the time a firm learns of material nonpublic information and its disclosure; and
- highlight the unique challenges to rural area small businesses.

Finally, several Members have expressed interest in addressing the role of proxy advisory firms, and we will discuss a bill which the House has already considered and passed.

I look forward to hearing from our witnesses on these legislative proposals, and whether there are ways to modify these bills to gain bipartisan support.

We have received some initial feedback on these bills, which will be entered into the record.

PREPARED STATEMENT OF THOMAS QUAADMAN

EXECUTIVE VICE PRESIDENT, CENTER FOR CAPITAL MARKETS COMPETITIVENESS, U.S. CHAMBER OF COMMERCE

JUNE 28, 2018

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than three million businesses of all sizes, sectors, and regions, as well as State and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96 percent of Chamber member companies have fewer than 100 employees, and many of the Nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—*e.g.,* manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 States.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Chairman Crapo, Ranking Member Brown, and Members of the Committee on Banking, Housing and Urban Affairs: my name is Tom Quaadman, Executive Vice President of the Center for Capital Markets Competitiveness ("CCMC") at the U.S. Chamber of Commerce ("Chamber"). Thank you for the opportunity to testify today regarding the important topic of corporate governance and to discuss the Chamber's views regarding a number of legislative proposals.

The Chamber has long been concerned that the public company regulatory model in the United States has failed to keep up with the times, as evidenced by the significant drop in the number of public companies over the last two decades. The United States is now home to roughly half the number of public companies than those that existed in the mid-1990s, and the overall number of public listings has little changed from 1983.[1] While there is no single reason behind this decline, what is clear is that the overall regulatory burden—coupled with a steady rise in special interest activism—has made an initial public offering ("IPO") increasingly unattractive. In short, we need new policies that will make it more attractive for businesses to go and stay public.

The public company model has been a key source of strength and growth, which has made the American economy the strongest and most prosperous in world history. When businesses go public, jobs are created and new centers of wealth are formed. During the 1980s and 1990s, stories of the Microsoft executive assistant or the UPS driver becoming a millionaire were not uncommon after a company went through the IPO process. A 2012 study done by the Kaufmann Foundation found that for the 2,766 companies that went through the IPO process between 1996 and 2010, employment cumulatively increased by 2.2 million jobs.[2] Other benefits also accrue to companies when they go public, such as revenue growth.

The public capital markets are also not static and help to support innovation. Only about 12 percent of the Fortune 500 companies in 1955 were still on the list in 2014, while the other 88 percent have either gone bankrupt, merged, or fallen out of the Fortune 500.[3] This system of creative destruction has forced businesses to change with the times, or be replaced by new entrants with innovative ideas and products to meet the needs of consumers and an ever changing market place.

From 1996–2016, the number of public companies dropped in 19 of 20 years. The 1 year where there was an increase is attributable to the passage of the Jumpstart our Business Startups Act of 2012 ("JOBS Act"). Title I of the JOBS Act included provisions known as the IPO "on-ramp," consisting of scaled disclosure and other requirements for emerging growth companies (EGCs). These provisions had an immediate effect on the IPO market: in 2013—the first full calendar year after the JOBS Act was passed—226 IPOs were listed in the United States (the highest number since 2004), followed by 291 in 2014.[4] Importantly, the JOBS Act has demonstrated that the rules that apply to public companies can be scaled appropriately without compromising important investor protections.

However, the JOBS Act was just a start. In recent years, the Chamber has issued a number of reports and recommendations calling upon the Securities and Exchange Commission (SEC) and Congress to do more to help companies go public. Many of these reports and recommendations involve fundamental issues of corporate governance including disclosure, proxy voting, and shareholder proposals. The Chamber's reports include:

- 2013: *Best Practices and Core Principles for the Development, Dispensation, and Receipt of Proxy Advice,* a report that helped kick-start an important debate over the broken proxy advisory system in the United States;
- 2014: *Corporate Disclosure Effectiveness: Ensuring a Balanced System that Informs and Protects Investors and Facilitates Capital Formation,* a report that included two dozen specific recommendations to modernize the SEC's disclosure regime;
- 2017: *Essential Information: Modernizing Our Corporate Disclosure System,* which emphasized the importance of the longstanding "materiality" standard for corporate disclosure;
- 2017: *Shareholder Proposal Reform: The Need to Protect Investors and Promote the Long-Term Value of Public Companies,* which outlined seven recommendations on how to fix the outdated shareholder proposal system under Rule 14a–8 of the Securities Exchange Act.

And most recently, the Chamber—along with seven other organizations—issued a report entitled *Expanding the On-Ramp: Recommendations to Help More Companies Go and Stay Public,* which included 22 recommendations that would expand upon

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[1] "America's Roster of Public Companies is Shrinking Before our Eyes." Wall Street Journal, January 6, 2017. *https://www.wsj.com/articles/americas-roster-of-public-companies-is-shrinking-before-our-eyes-1483545879.*

[2] Post-IPO Employment and Revenue Growth for U.S. IPOs June 1996–2010, *http://innovation.ucdavis.edu/people/publications/kenney-m.-patton-d.-ritter-j.-2012.-post-ipo-employment-and-revenue-growth.*

[3] Mark Perry, AEIdeas, August 18, 2014.

[4] *https://www.sec.gov/info/smallbus/acsec/giovannetti-presentation-acsec-021517.pdf.*

the success of the JOBS Act. While the Chamber is pleased that many of our recommendations have been acted upon either by Congress or the SEC, there is still much room for progress.

Sarbanes-Oxley, Dodd-Frank, and the "Federalization" of Corporate Governance

Traditionally, corporate governance was structured under the State laws where a business is incorporated, as well as the by-laws of the corporation. This system allowed directors and shareholders to create governance structures that fit the needs of individual businesses and its investors.

From the time of the New Deal up until the passage of the 2002 Sarbanes-Oxley Act, with some exception in the area of compensation, the role of securities laws was a disclosure-based regime intended for investors to have the material information needed to make informed investment decisions.

Sarbanes-Oxley started a trend toward "Federalizing" corporate governance by placing the Federal Government in a more predominant role. For example, Sarbanes-Oxley created specific requirements for the composition of a company's audit committee as well as its operation. It also created a quasi-regulatory body in the Public Company Accounting Oversight Board ("PCAOB"), an entity with expansive authority and tremendous influence over the manner in which public companies are operated.

This trend was exacerbated by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), which mandated new rules on compensation committee independence, pay versus performance, compensation disclosures, claw-back policies, incentive compensation rules for financial firms, "say-on-pay" votes, new disclosure regarding the Chairman and CEO structures, conflict minerals disclosures, resource extraction disclosures, and mine safety report disclosures. Furthermore, the Investor Advisory Committee at the SEC—created by Dodd-Frank—has produced recommendations that would further expand the use of Federal mandates, such as the mandated use of universal proxy ballots in contested director elections.

In a post-Dodd-Frank world, some groups have sought to exploit Federal securities laws to advance social or political objectives. Bills have been introduced—though not passed—to require human trafficking disclosures, political and lobbying spending disclosures, and other issues that are best left addressed outside the securities laws. Policymakers should take steps to ensure that disclosure requirements always meet the test of the Supreme Court-articulated materiality standard, otherwise investors risk becoming inundated with information that does not inform their voting and investment decisions.

The Challenges of Being Public Today

The legislative mandates of Sarbanes-Oxley and the Dodd-Frank Act have been coupled with the exponential growth of the proxy statement and corporate disclosures. Furthermore, the SEC has largely failed or been unable to provide oversight over proxy advisory firms, modernize corporate disclosures, and update information delivery systems, or reform proxy plumbing systems. The SEC has also gradually receded from its duty as a gate keeper of shareholder proposals under Rule 14a–8, which has allowed agenda-driven items to work their way into board rooms and shareholder meetings. This condition has allowed a small group of special interests to dominate the shareholder proposal process and frustrate the views of a majority of shareholders. Concurrently, businesses are facing increasing pressure to disclose and engage shareholders on environmental, social, and governance issues, many of which investors have deemed immaterial.

It is little wonder why companies that are deciding to go public are increasingly doing so in nontraditional ways. For example, many companies have recently decided to go public under a dual-share class structure that limits voting rights to only certain investors. While such corporate structures have generated criticisms, many of these companies have completed successful IPOs with heavy investor interest, and some offerings have been oversubscribed. Instead of requiring businesses to submit to a myopic view of how a corporation should be structured, companies should be free to choose their own structure, and investors should be free to choose where they want to place their money. If you don't like the corporate structure, don't buy the stock. The markets will help determine if the business got it right or not.

Under the more Federalized system, rather than a company's board determining the long-term strategy of success, boards are increasingly bogged down with mandated regulatory compliance issues. Corporations are being forced into a "one size fits all" model that is more expensive, provides less opportunity to grow, and makes it more difficult to run a business.

There have been beneficial developments that have occurred over the past several decades. Shareholders are more empowered and communications between businesses and investors have increased. Businesses are understanding that they must increase board diversity on their own rather than have a mandate imposed upon them.

Nevertheless, the U.S. public company system—which is still the global gold standard by far, has been increasingly turning into a net negative. As a result, businesses and investors are walking away from an ever shrinking public company pie. America's entrepreneurs are just as comfortable staying private, or being acquired as they are going through the IPO process.

We appreciate that the Committee has called today's hearing to gather thoughts on a number of bills related to corporate governance. Our comments on these legislative proposals are included below.

H.R. 4015, the Corporate Governance Reform and Transparency Act

Effective and transparent corporate governance systems that encourage shareholder communication and participation are a key ingredient for public companies to grow, and for their investors and workers to prosper. Institutional investors may invest in large numbers of public companies. Therefore, the due diligence associated with proxy voting—learning and understanding the issues around director elections or shareholder proposals—is costly, complex, and burdensome. The proxy advisory industry emerged to help institutional investors fulfill these obligations by researching proxy matters and providing voting recommendations to clients.

The proxy advisory industry has been dominated for some time by only two firms: Institutional Shareholder Services ("ISS") and Glass Lewis. These two firms control roughly 97 percent of the proxy advice market and by some estimates can "control" up to 38 percent of the shareholder vote,[5] because some clients of ISS and Glass Lewis automatically follow their recommendations. As a result, ISS and Glass Lewis are in many ways the *de facto* standard setters for corporate governance in the United States.

Notwithstanding their influence and market power, both ISS and Glass Lewis operate with a startling lack of transparency, rampant conflicts of interest, and have been prone to make significant errors when developing vote recommendations. The Chamber's 2013 report, *Best Practices and Core Principles for the Development, Dispensation, and Receipt of Proxy Advice,* was intended to address many of these fundamental flaws of the two firms. The Chamber developed these best practices and core principles to improve corporate governance by ensuring that proxy advisory firms:

- Are free of conflicts of interest that could influence vote recommendations;
- Ensure that reports are factually correct and establish a fair and reasonable process for correcting errors;
- Produce vote recommendations and policy standards that are supported by data driven procedures and methodologies that tie recommendations to shareholder value;
- Allow for a robust dialogue between proxy advisory firms and stakeholders when developing policy standards and vote recommendations;
- Provide vote recommendations to reflect the individual condition, status, and structure for each company and not employ "one size fits all" voting advice; and
- Provide for communication with public companies to prevent factual errors and better understand the facts surrounding the financial condition and governance of a company.

Following the release of this report, congressional hearings were held and the SEC held a roundtable on proxy advisory firms on December 5, 2013. In June 2014, the SEC's staff issued Staff Legal Bulletin 20[6] which marked the first time that the SEC exerted oversight over proxy advisory firms while providing institutional investors with valuable guidance on how to use proxy advice.

However, the Chamber has found that many of the longstanding issues with these two firms remain. For example, ISS continues to operate a consulting division to provide advice to companies as to how they can achieve better ISS corporate governance ratings. ISS's ownership of both a research division and a consulting arm—accepting fees from both the institutional investors who receive their proxy voting

[5] ISS 24.7 percent Glass Lewis 12.9 percent Source: Ertimur, Yonca, Ferri, Fabrizio and Oesch, David Shareholder Votes and Proxy Advisors: Estimates from Say-on-Pay (February 25, 2013).

[6] *https://www.sec.gov/interps/legal/cfslb20.htm.*

advice as well as from the public companies that are the subject of their voting advice—has been a focal point for criticism that conflicts of interest inherent in this business model.

While Glass Lewis does not operate a consulting division, its ownership structure presents a unique conflict of interest. Glass Lewis is owned by an activist institutional investor—the Ontario Teachers' Pension Plan and the Alberta Investment Management Corporation. The Chamber brought to the attention of the SEC examples of where this ownership structure has presented conflicts related to Glass Lewis voting recommendations.[7]

Additionally, proxy advisory firms have not taken steps to ensure that their recommendations are developed based on clear, objective, and empirically based analysis. With ISS companies often times may only be given a few hours to respond to an ISS recommendation and, for example, point out if ISS has made an error in developing the recommendation. Even more troubling, Glass Lewis appears to have no clear process or procedures for providing companies with ample time to respond to recommendations.

H.R. 4015 would address many of these problems by building upon the 2014 SEC staff guidance by requiring proxy advisory firms to register with the SEC and to become more transparent with the public about their methodologies and conflicts of interest.

Under the legislation, proxy advisory firms would need to develop clear procedures and methodologies for the development of voting recommendations, which would allow for fair due process in the system. Firms would also have to both disclose and manage any conflicts of interest they have, including whether they engage in any ancillary services (such as a consulting arm) that present a direct conflict to their research work.

Proxy advisors would also have to demonstrate that they have the capability and expertise to provide empirically based and objective vote recommendations. ISS, for example, currently has only about 1,000 total employees covering 40,000 shareholder meetings in more than 100 countries. Glass Lewis has roughly 360 employees issuing approximately 20,000 research reports annually. Both firms have been prone to making flaws in assumptions or outright factual errors in many of their recommendations. H.R. 4015 would help promote a system of fact-based proxy advice and improve the quality of information that investors receive.

Additionally, H.R. 4015 directs the SEC to withdraw two no-action letters issued in 2004 to Egan-Jones and ISS. As a practical matter, these no-action letters had the effect of allowing a registered investment advisor to rely on a proxy advisory firm's general policies and procedures regarding conflicts of interest—as opposed to any specific conflict that a proxy advisory firm may have in relation to a voting recommendation. The Egan-Jones and ISS no-action letters have therefore helped to further entrench the position of proxy advisory firms, while doing little to mitigate actual conflicts of interest as they relate to particular proxy recommendations.

H.R. 4015 is a logical next step in the wake of the 2014 SEC staff guidance. The Chamber strongly supports this legislation and urges the Committee to advance a companion Senate bill as swiftly as possible.

S. 536, the Cybersecurity Disclosure Act.

There is no question that cybersecurity has become a critical issue for both businesses and Government. Illicit activity on the part of cybercriminals and other threat actors represents a grave danger to the economy and capital markets. While we are generally supportive of efforts to enhance cybersecurity, we believe that the Cybersecurity Disclosure Act misses the mark.

Regulators have worked aggressively to deal with cyber threats. The SEC has become very aggressive in its regulatory efforts, and we generally support these activities intentioned to keep our capital markets safe. The SEC's Division of Enforcement recently formed a dedicated Cyber Unit, and has been actively pursuing cases involving cybersecurity and data security. Even before the formation of the Cyber Unit, the SEC began to bring a series of cases against broker-dealers, investment advisers, and other market intermediaries for violations of SEC rules regarding safeguarding of customer data involving hacks and other cybersecurity shortcomings.[8] To its credit, FINRA (the Financial Industry Regulatory Authority), which

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[7] See *e.g.,* Letter of May 30, 2012 to SEC Chair Mary Schapiro *http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/2012-5.30-Glass Lewis-letter-release.pdf.*

[8] A lengthy list of SEC cybersecurity enforcement cases appears at *https://www.sec.gov/spotlight/cybersecurity-enforcement-actions.*

also regulates the conduct of securities broker-dealers, has likewise been highly engaged on the issue.[9]

The SEC also recently issued Commission-level guidance (the "Guidance") that clearly lays out the disclosure expectations for public companies on this important topic.[10] Central to the Guidance is the concept that material cybersecurity risks must be disclosed to investors. The Guidance also encourages public companies to adopt comprehensive policies and procedures related to cybersecurity and to assess their compliance regularly, including the sufficiency of their disclosure controls and procedures as they relate to cybersecurity disclosure. To that end, the SEC urges companies to assess whether they have sufficient disclosure controls and procedures in place to ensure that relevant information about cybersecurity risks and incidents is processed and reported to the appropriate personnel, including up the corporate ladder, to enable senior management to make disclosure decisions and certifications. Additionally, the Guidance recommends that public companies adopt policies and procedures designed to prohibit directors, officers, and other corporate insiders from trading on the basis of material nonpublic information about cybersecurity risks and incidents.

Of particular relevance to today's hearing, existing SEC regulations already require a public company to disclose the extent of its board's role in the risk oversight of the company.[11] To the extent cybersecurity risks are material to a company's business, the Guidance makes clear that this disclosure should include the nature of the board's role in overseeing the management of that risk. Additionally, the Guidance reiterates the SEC's view that disclosures regarding a company's cybersecurity risk management program and how the board of directors engages with management on cybersecurity issues will allow investors to assess how a board of directors is discharging its risk oversight responsibility.

Investors have also begun to express concerns to public company boards and management over cybersecurity risks and disclosures. According to PricewaterhouseCooper's most recent Global Investor Survey,[12] cyber threats were the most common concern of investors when asked to rank potential business, economic, policy, social, and environmental threats to a company's growth prospects. Not surprisingly, cybersecurity preparedness has become a common topic of discussion among public companies and their investors during shareholder engagement sessions.

We believe existing SEC regulations and market practices already provide the kinds of disclosure that the Cybersecurity Disclosure Act seeks to address. We believe that policymakers must focus on strengthening public-private cooperation to proactively protect against cyberattacks as opposed to taking a "blame the victim" approach.

Moreover, companies are sometimes subjected to competing directives from different Government agencies regarding cyberattacks. For example, a company may be advised by a law enforcement or national security body to not disclose an ongoing cyber breach so that the source of the attack may be discovered. Such guidance could find itself in conflict with a company's obligation to inform its investors that it has been hacked. Agencies should coordinate with one another to ensure that a company complying with one agency's directive does not find itself out of compliance with another agency.

Companies take cybersecurity very seriously and are generally proactive in taking steps to mitigate or respond to threats. Effectively requiring companies to have a board member with cyber expertise will not make companies any more or less responsive to cyber threats.

S. 1744, the Brokaw Act

We do not believe it is wise for Congress to consider S. 1744 at this point.

In its current form, the Brokaw Act would direct the SEC to amend the Section 13(d) reporting rules in a number of notable ways. First, the Brokaw Act would reduce the 10-day filing deadline for an initial Schedule 13D filing to four business days. Second, it would require the disclosure of short positions over 5 percent on Schedule 13D. Third, it would expand the definition of beneficial ownership to include a direct or indirect pecuniary interest, in addition to voting or dispositive power. As a practical matter, in making this determination, investors would there-

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[9] See FINRA's web page describing these efforts at *http://www.finra.org/industry/cybersecurity.*

[10] The complete text of the *Commission Statement and Guidance on Public Company Cybersecurity Disclosures* is available at *https://www.federalregister.gov/documents/2018/02/26/2018-03858/commission-statement-and-guidance-on-public-company-cybersecurity-disclosures.*

[11] For example, see Item 407(h) of Regulation S–K and Item 7 of Schedule 14A.

[12] *https://www.pwc.com/gx/en/ceo-survey/2018/deep-dives/pwc-global-investor-survey-2018.pdf.*

fore have to include shares held in swaps and other cash-settled derivatives, not merely equity securities or securities convertible into equity securities. Finally, the Brokaw Act would specifically require the disclosure of activity by hedge funds and groups of hedge funds under Section 13(d). The explicit inclusion of "hedge fund" in the definition of "persons" is a clear signal that the SEC is directed to pay close attention to activist investors and to concerted activity among them.

There remains a vigorous debate among market participants about the propriety of the Brokaw Act. On one side of the issue, its supporters contend that the Act would bring an additional layer of transparency to capital markets, particularly as it concerns public disclosure of short positions.

On the other hand, we have heard from many institutional investors that the Brokaw Act's accelerated Schedule 13D reporting requirements and new short position disclosures would have a chilling effect on proprietary investment strategies.

Many investors contend that they would change their market behavior as a result, which over the longer term could impede liquidity and price discovery.

The Chamber has long called on the SEC to address abusive practices related to short sales, including our call to put an end to "naked short selling." We also have very serious concerns regarding "short-and-distort" schemes, which involve spreading false or misleading information about a company in order to drive its stock price down and return a profit for the short seller. However, we are sympathetic to concerns that adoption of a broad short sale disclosure regime could hamper a legitimate market activity that increases liquidity and price discovery.

Even if the SEC were to determine that a new short-sale disclosure regime is in the public interest, the Chamber has doubts as to whether modeling such a regime on Schedule 13D reporting would prove optimal. The current legislation makes no distinction between a short seller who has taken a net short position in a company because they believe the stock will decline in value, and a short seller who may short the company as a hedge against an existing long position. Making such a distinction would require Congress or the SEC to determine the motivation and investment strategy of market participants—a difficult, if not impossible, task that speaks to the complexities of adopting a short sale disclosure regime.

We support continued study of issues related to short selling, and urge the SEC to take the lead in assessing whether future modifications to its rules on these issues are necessary or prudent.

S.___, the 8–K Trading Gap Act of 2018

The Chamber believes it is important to root out bad actors from capital markets. However, we do not believe the 8–K Trading Gap Act will prevent future insider trading activity.

First, it is already unlawful to trade on the basis of material, nonpublic information (MNPI) in violation of a fiduciary duty. Corporate insiders may not trade or make tips on the basis of MNPI learned during the course of employment. A bad actor who has determined to violate the Federal securities laws by engaging in conduct as serious as insider trading is not likely to be deterred by a second, redundant prohibition against the same misconduct that is found in an employer's internal policies, procedures, and controls.

Second, the Act assumes that all Form 8–K events are certain on Day 1 of what is often a four-business-day reporting cycle, but decisions may take several days and consultations with counsel. In many cases, a public company will not determine to file until closer to the reporting deadline of Day 4.

If this timing problem raises several questions and the company is unsure of the reporting status on Days 1, 2, and 3, how is it going to develop policies and procedures to bar insiders from trading? And how would insiders even know they are blacked out if their employer has not provided notice to them? What if the company unintentionally misses a filing deadline and the company makes a late filing months later? What are the consequences then? How do policies, procedures, and controls address these kinds of hypotheticals in any realistic, enforceable way?

S. 2756, the Fair Investment Opportunities for Professional Experts Act

The Chamber supports the Fair Investment Opportunities for Professional Experts Act, which is an innovative way to expand accredited investor definitions in a limited manner to bring more sophisticated investors into the marketplace.

It is appropriate to put in place requirements and tests that correctly define persons who have the sophistication to invest in complex vehicles and have the ability to withstand loss. Asset and income tests are objective standards that have served well in determining who should be allowed the designation of accredited investors.

Still, one may not meet these objective tests but could still fit the criteria of a sophisticated investor. Such a person, in limited circumstances, could be considered

an accredited investor. If that issue is addressed appropriately, more investors can access markets and the potential for capital formation for businesses can be expanded.

However, other factors should be allowed to be considered.

Presumably an individual who has met the educational and licensing requirements to sell securities and investments could be deemed to be of such a level of sophistication that they should be considered to be an accredited investor. This is also an objective test that could be easily codified. Accordingly, we support the Act's provisions that would lead to this result.

We also support the idea that SEC should, through notice and comment rulemaking, consider other ways to expand the accredited investor definition.

S. 2499, Compensation for Cheated Investors Act

Arbitration is an important means for customers to resolve disputes, and it provides significant benefits to consumers, investors, and businesses. Arbitration forums can provide investors or other injured parties with accessible and fair procedures for obtaining redress for claims that cannot be vindicated in court. Current FINRA rules do not mandate that arbitration be the sole forum for investors to resolve disputes with brokerages, however FINRA does require that arbitration be used if it has been requested by an investor.

According to FINRA statistics, in 2016, 2,457 arbitration cases involved customer disputes, but only 16 percent of these cases resulted in the customer being awarded compensation. Seventy-one percent settled prior to the award, while another 9 percent were withdrawn.[13] This distribution of arbitration outcomes has remained fairly consistent over the years, and a relatively low number of cases each year end up as unpaid customer arbitration awards. For example, there were 44 such cases in 2016.[14] Furthermore, 13 of the 44 unpaid arbitration award cases in 2016 involved a pre-award settlement between the customer and a brokerage firm.[15] Other cases of unpaid arbitration awards may include situations involving brokerage firms that are inactive or no longer active or registered with FINRA, meaning that FINRA no longer has jurisdiction over the firm.

FINRA's Customer Code states that unless a brokerage firm has a *bona fide* reason for nonpayment of an arbitration award, the firm must pay the award within 30 days. Firms that do not pay within 30 days risk being penalized or suspended by FINRA. The Chamber fully supports such regulatory mechanisms that ensure customers or investors receive the full amount of arbitration awards granted to them.

However, we are concerned that S. 2499, the Compensation for Cheated Investors Act would do more harm than good for investors. The legislation creates an open-ended "FINRA Relief Fund" that is to be funded in part by "sources determined by FINRA." The Relief Fund would ostensibly be created in order to compensate customers that have not received arbitration awards they are entitled to.

The legislation could effectively allow FINRA to assess firms that have done nothing wrong in order to pay out arbitration awards that have been awarded due to the activities of bad actors. It would also establish what amounts to an insurance fund that has no actuarial basis whatsoever for the amounts that should be assessed on FINRA members in order to properly fund it, which will likely lead to the fund becoming insolvent in the future.

More troubling, the legislation would empower bad actors by ensuring them there is a backstop in place—paid for by somebody else—to compensate investors they have cheated. S. 2499 also does not contemplate or take into account the existing Securities Investor Protection Corporation (SIPC) regime that was created to compensate investors in the event of a broker liquidation. We believe that these issues make S. 2499 inherently flawed, and would urge the Committee to reject the legislation.

S. 2953, the Expanding Access to Capital for Rural Job Creators Act

The Chamber supports this legislation, which would expand the focus of the Office of the Advocate for Small Business Capital Formation at the SEC to include ways to increase capital access for rural-area small businesses.

A 2016 report from the Economic Innovation group found that half of all post-recession business creation in the United States occurred across only 20 counties, and that many rural areas missed out on economic growth following the financial

[13] Discussion Paper—FINRA Perspectives on Customer Recovery available at *http://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf.*

[14] *Id.* at 6.

[15] *Id.* at 9.

crisis.[16] S. 2953 is an incremental but important step that will help focus the SEC on the needs of businesses in rural communities.

Conclusion

The Chamber appreciates the opportunity to provide perspective on these important issues on behalf of our member companies, and we commend the Senate Banking Committee for holding this important hearing. I would be happy to answer any questions you may have.

PREPARED STATEMENT OF DARLA C. STUCKEY

PRESIDENT AND CEO, SOCIETY FOR CORPORATE GOVERNANCE

JUNE 28, 2018

Chairman Crapo, Ranking Member Brown, and Members of the Committee, my name is Darla Stuckey, and I am the President and CEO of the Society for Corporate Governance. The Society appreciates the opportunity to present its views on corporate governance legislation before the Committee.

Founded in 1946, the Society is a professional membership association of more than 3,600 corporate secretaries, in-house counsel, and other governance professionals and service providers to the industry who serve approximately 1,200 entities, including about 1,000 public companies of almost every size and industry across the United States.

Society members are responsible for supporting the work of corporate boards of directors, their committees, and the executive managements of their companies on corporate governance and disclosure. Our members generally are responsible for their companies' compliance with the securities laws and regulations, corporate law, and stock exchange listing requirements.

The Decline of Public Company Ownership

A fundamental mission of the Society is to advocate for legislative and regulatory changes that will relieve some of the burdens that discourage companies from becoming and remaining public companies. There are a wide range of forces that discourage investors and the companies they own from going and remaining public. In 1997, there were approximately 7,100 public companies in the United States. Now there are fewer than 3,600.

The decline in public ownership should concern every American. Growing wealth inequality has many drivers, but fewer public companies means fewer investment opportunities for average American investors. This is particularly troubling when one considers that a significant amount of wealth is generated by a company shortly after that company goes public. Think of the opportunities that ordinary American savers have missed out in just the last few years. In fact, companies are staying private longer. In a study published on August 8, 2017, by Jay R. Ritter, Cordell Professor of Finance at the University of Florida, a company's median age for an IPO in 1999–2000 was 5 years, while from 2001–2016 it was 11 years.[1] In 2016, 74 companies became public at a median age of 10 years.[2]

As I said, there are a range of factors discouraging public ownership of companies. But the Committee has before it two bills that can directly and concretely improve the climate for public ownership, H.R. 4015, the Corporate Governance Reform and Transparency Act; and S. 1744, the Brokaw Act. I will discuss each individually.

H.R. 4015, "Corporate Governance Reform and Transparency Act"

H.R. 4015, which has passed the U.S. House of Representatives, addresses the role and activities of the private firms providing proxy advisory services to institutional investors. These entities—called proxy advisory firms—operate with very little regulation or oversight. H.R. 4015 would provide badly needed improvements to the accuracy and processes of these firms.

Background on Proxy Advisory Firms

The proxy advisory market is dominated by two firms—Institutional Shareholder Services, or ISS, and Glass Lewis. For the uninitiated, proxy advisory firms play an important role in the capital markets by advising investors how they should vote

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[16] *https://eig.org/wp-content/uploads/2016/05/recoverygrowthreport.pdf.*

[1] Jay R. Ritter, "Initial Public Offerings: Updated Statistics," University of Florida, at 11, August 8, 2017, available at *https://site.warrington.ufl.edu/ritter/files/2017/08/IPOs2016 Statistics.pdf.*

[2] *Id.* This was the lowest number of IPOs since 2009.

their proxies. This involves preparing recommendations to institutional investors who hold shares in companies—sometimes very large amounts—whether they should (or should not) vote for a particular director, approve the CEO's compensation, and/or how the investor should vote on shareholder proposals. These shareholder proposals can range from an amendment to a company's by-laws to a new climate change policy.

While simply recommending how an investor should vote may sound somewhat unimportant, the reality is far different. ISS and Glass Lewis recommendations are the single most influential pronouncement on the composition of a public company's board, its executive compensation policies, and an increasingly diverse range of shareholder proposals. In fact, anecdotal evidence from some of our member companies consistently shows that as much as 30 percent of the total shareholder votes are cast within 24 hours of the ISS and Glass Lewis recommendations being released to their clients.

In our view, proxy advisory firms exert outsized influence in the proxy voting process. These firms own and control the software platforms that send investor votes to the tabulator for a shareholder meeting, so they can be counted. The combination of generating proxy voting recommendations and controlling the physical infrastructure through which the votes are cast (sometimes with voting decisions made by the institutional investors and sometimes by default if no client voting decisions are made) are what give proxy advisory firms their importance and give rise to the imperative that these firms "get it right."

Accuracy and Accountability Problems with Proxy Advisory Firms

Proxy advisory firms make proxy recommendations on literally every public company in the United States and thousands of public companies in Europe and Asia. This is a large and labor-intensive task. The scale and complexity of making proxy voting recommendations for thousands and thousands of companies during "proxy season" effectively requires proxy advisors to do all their analysis from February to June. With almost all of the recommendations coming out in a 6–8 week period.

Reading and accurately digesting thousands of proxy statements, annual reports, and—increasingly—corporate social responsibility statements in a condensed period makes errors inevitable. Compounding this problem is the fact that many companies are not able to see the proxy advisors' reports about themselves until after each report has been issued. For any company not in the S&P 500, the only way it can see the report is to subscribe to the proxy advisor's service.[3]

It is true that ISS and Glass Lewis will send the underlying data for their reports to some companies for their review. But the analysis and final recommendations are not known, and errors occur during this process. S&P 500 companies are given their reports in advance by ISS, but companies only have 1 or 2 days (frequently over a weekend) to review before the recommendations are released publicly. There is often not enough time for companies to review what is arguably the most important corporate governance recommendation about that company each year.

One Small Cap Company's Multi-Year Battle with Factual Errors

An inability to review draft reports from proxy advisory firms means that companies who want factual errors corrected are often unable to get a response from proxy advisory firms until it is too late, *i.e.,* after investors have voted on the basis of a recommendation relying on inaccurate information.

A very real example of this problem comes from a Society member that works for a small-cap company in the transportation industry. The company's story highlights a multitude of problems that the provisions of H.R. 4015 would fix:

> In May 2016, we received an ISS report with an 'against' recommendation regarding say-on-pay that was based on a material factual error. The ISS personnel incorrectly concluded that under our annual bonus plan, we set the financial metric goal for the 2015 fiscal year lower than the actual results we had obtained in 2014. This was simply untrue—this was not a matter of methodology or interpretation, but a clear mathematical mistake.
>
> As a small-cap company, unlike larger companies, we are not given a 'preview' of our report from ISS, so we received this report just 2 weeks prior to our May 2016 annual meeting. We quickly utilized all of the methods available to us to try to get the error corrected and the recommendation

[3] ISS permits companies in the S&P 500 to have 24–48 hours to review their reports before they are issued, with no subscription required. Smaller companies must pay to receive them. Glass Lewis uses a factual database that companies can access, but does not provide draft reports to any company of any size for review before issuance.

reversed. Although ISS acknowledged the error, they declined to issue either a correction or a revised report.

We engaged in robust shareholder outreach as we have for many years, and while the shareholders who were able to speak with us quickly understood the mistake and supported our say-on-pay [proposal], we were not able to have meetings with all the shareholders we reached out to due to the extremely busy proxy 'in-season' and a large portion of our shareholders being quantitative or passive firms who outsource their voting to proxy advisory firms. The result was that our 2016 say-on-pay [proposal] narrowly failed with a 49.8 percent favorable vote outcome.

We engaged in extensive 'offseason' shareholder outreach during the fall of 2016, reaching out to shareholders representing over 75 percent of our outstanding shares, and, while shareholders offered small governance-related suggestions such as proxy access, none expressed any wish to see specific changes in our executive pay program; some instructed us to 'fix' our ISS recommendation and then they would be sure to vote in support. We promptly added proxy access, and disclosed our outreach efforts and feedback in our April 2017 proxy statement fully and accurately.

In May 2017, ISS issued their report, *again recommending against our say-on-pay,* alleging that due to our prior year's low vote outcome, our shareholders must have demanded extensive pay program changes that our compensation committee ignored. This was simply factually untrue.

Due to ISS' programmatic rules, a second consecutive year meant ISS not only recommended against say-on-pay but against the re-election of our four-member compensation committee, including a new committee member who was not even on the board at the time compensation decisions were being made. This meant that four members of our 10-member board who had been key drivers of an extraordinary 2016 business year that saw a transformative transaction with a global e-commerce company and a 26 percent shareholder return were at risk of nonre-election due to proxy advisory errors and formulaic inflexibility. Moreover, the board members being recommended against included at the time the sole female member of our board and one of our two racially diverse board members.

Thanks to above-and-beyond shareholder outreach efforts we were able to get the compensation committee members re-elected but received only 32 percent in favor of our say-on-pay vote in May 2017.

Through a combination of extensive pro-active compensation program changes and at-length engagement with ISS and Glass Lewis in the fall of 2017, this May we received 'for' recommendations from both firms in reports which were fortunately finally absent material factual errors (ISS' report still has an error regarding our perquisite program which we are attempting to fix). This recommendation resulted in a 94 percent favorable say-on-pay vote this year, demonstrating the outsize influence of proxy advisory firms and the crucial need for regulation that ensures shareholders who rely on proxy firms' recommendations are relying on accurate data. (emphasis added).

Other Problems with Proxy Advisory Firm Practices

In addition to the problems discussed above, proxy advisory firms use a "one-size-fits-all" approach that imposes the same standards on all public companies, instead of evaluating the specific facts and circumstances of each company they evaluate. This has the effect of homogenizing corporate governance practices for the benefit of the proxy advisory firms themselves and not for other stakeholders in the proxy process. In fact, one proxy advisory firm, ISS, told a large-cap Society member its proxy access bylaw that was the subject of a shareholder proposal did not comport with "best practices" and that it would recommend against management, even though over 90 percent of such bylaws have the same provisions as the one on the ballot. When pressed about how ISS could not identify this bylaw amendment as a best practice, the ISS corporate sales team member said that "for ISS best practice is the preferred practice by ISS." In short, ISS sets the standard.

Proxy advisory firms also operate without providing adequate transparency into their internal standards, procedures, and methodologies. These firms are basically "black boxes," operating with little accountability or input into their internal processes.

Conflicts of interest within these firms also need to be addressed. One of the firms—ISS—provides corporate governance and executive compensation consulting services to public companies, in addition to providing voting recommendations to its

institutional clients on the same companies. A common practice is for a company to get a call from the ISS corporate consulting sales force with a pitch that—for a price—they can miraculously fix any problems that company has had with a previous vote. Indeed, for an even higher price, a company can get even more service, including language explaining elements of an annual bonus plan in a company's Compensation Discussion and Analysis section. And, even more recently, ISS now has an environmental scorecard it pitches to companies showing negative results, and, when asked what forms the basis of the score, companies are told they can learn about it if they pay $35,000 to ISS.

Another conflict that exists is proxy advisory firms providing voting recommendations on shareholder proposals submitted to companies by their institutional investor clients. These conflicts need to be specifically and prominently disclosed to clients of proxy advisory firms so that they may evaluate this information in the context of the firms' voting recommendations. Not only do the firms recommend on their own clients' proposals, one of the firms, ISS, has a service for investors to help them craft proposals that will pass muster under SEC rules.

The Fiduciary Responsibilities of Institutional Investors

One of the reasons that proxy advisory firms have become so powerful is the belief that every vote is an asset and that asset managers must vote every item on a ballot in order to satisfy their fiduciary duty to their clients, and their clients' beneficiaries. SEC and Department of Labor rules and guidance confirm that a proxy vote is an asset and that institutional investors owe fiduciary duties to their clients, investors, and beneficiaries with respect to the voting process.

While some have interpreted these rules and guidance to mean they must vote each and every item on a proxy card, this is not the case. Rather, institutions should weigh the cost of voting certain items against the benefits of voting on those items. Clearly, not every item on a ballot must be voted if the manager in his or her judgment believes it costs more to understand and vote on an item that the vote is worth.

Practically speaking, however, no investment manager will say to his or her clients that they didn't exercise their right to vote. So they hire proxy advisory firms at the lowest cost possible and then report that they voted each of their positions (although not the number of shares)—even if they have little interest or expertise in executive compensation or environmental issues, for example. This would be the case typically with smaller passive investors, or quantitative fund managers, or those who simply own one stock as a hedge against another position.

Again, the outsize influence of proxy advisory firms is due to the many institutional investors and their third-party managers who choose to reduce costs by not having in-house proxy staffs to analyze and vote at shareholder meetings.

This is not the group of asset managers that public companies typically engage with and it is not the group of asset managers and owners who lobby and advocate against legislative proposals like H.R. 4015. That group—consisting of large asset managers like BlackRock, Vanguard, T. Rowe Price, State Street Global Advisors, TIAA–CREF, BNY Mellon, Capital Group, and other household names—manage their voting process by using proxy advisory firms as one of many data points, typically as a screen or filter, and they conduct a deeper analysis on particular companies that fall outside parameters that they have set. These firms also have "custom guidelines" that they instruct the proxy advisory firms to use when voting their shares. In addition, these institutions engage with companies directly and make their own voting policies transparent and available to issuers.

However, there are smaller institutional investors and managers that do typically "outsource" their voting decisions to proxy advisory firms that provide automated voting services. This is a way to fulfill what they believe to be their compliance obligations with respect to proxy voting at the lowest cost. Together, these small managers add up.

A number of these small managers adopt ISS and Glass Lewis "default" voting guidelines and policies and then let the proxy firms apply these policies by generating electronic ballots that reflect these default positions for each shareholder meeting. As a technical matter, the client has the right to override a particular ISS or Glass Lewis voting recommendation. *However, most of these ballots are left untouched and submitted automatically without any client input or decision.* This "robo-voting" process results in as much as 20 percent of votes that are cast automatically within 24–48 hours of the issuance of ISS and Glass Lewis reports on a company in advance of a shareholder meeting.

In all these cases, the result is an outsourcing of voting responsibilities to a nonfiduciary.

SEC Actions to Address Proxy Advisory Firm Issues

The SEC has taken a few steps to address the role and activities of proxy advisory firms. The agency evaluated the proxy system in 2009 and issued a wide-ranging Concept Release in 2010. In December 2013, the SEC held a Roundtable on Proxy Advisory Services to discuss many of these issues. The Society testified at that Roundtable.

The SEC followed up its Roundtable by issuing Staff Legal Bulletin 20 in June 2014, which provided guidance to institutional investors about their obligations under the Investment Advisers Act and established several standards for proxy advisory firms to adhere to, under the Securities Exchange Act of 1934. Institutions can and do use proxy advisory firms, so long as they insure the voting is done in accordance with their own fiduciary duties.

While these were excellent first steps in addressing these problems, more needs to be done.

The Need for Legislation to Establish a Regulatory Framework Applicable to Proxy Advisory Firms

Proxy advisory firms exist because of well-intentioned regulatory action that nevertheless has resulted in many different unintended consequences. One consequence is that the proxy advisory industry is subject to an incomplete and harmful regulatory framework. As an example, the largest proxy firm, ISS has chosen to register under the Investment Advisers Act of 1940. However, the SEC's rules for investment advisors do not reflect the unique role that proxy advisory firms perform in the proxy voting process. Proxy advisory firms do not select securities for their clients or provide investment advice in the way a typical asset manager does. Instead, these firms recommend how to vote at shareholder meetings and, as described above, automate the voting process for their clients.

The second biggest proxy advisory firm, Glass Lewis, is not registered as an investment advisor (or under any other securities statute). As a nonregistered entity, Glass Lewis is not subject to the provisions of the Investment Advisers Act, or any other SEC regulation.

Additionally, the SEC has created an exemption from its proxy rules for proxy advisory firms, so they are not required to abide by solicitation and disclosure rules that apply to other proxy participants. Thus, their recommendation reports, in contrast to company proxy materials, are not always available to issuers unless they pay for them, and they are not subject to any outside review or oversight, even after annual meetings.

This unworkable regulatory system should not be permitted to continue, and these firms should be subject to more robust oversight by the SEC and the institutional investors that rely on them. This can be accomplished by developing a targeted regulatory framework that reflects the unique role that proxy advisory firms perform in the proxy voting process.

Along with considering greater regulatory oversight of proxy advisory firms, the SEC and Department of Labor should review the existing framework applicable to the use of proxy advisory firms by institutional investors. This review should include the Egan Jones and ISS no-action letters that were issued by the SEC staff in 2004.[4] The SEC and Department of Labor should ensure that institutional investors are exercising sufficient oversight over their use of proxy advisory services, in a manner consistent with their fiduciary duties.

H.R. 4015 addresses many of the concerns raised by public companies and other participants in the U.S. proxy system. It requires the proxy advisory firms to register with the SEC. It requires these firms to be more transparent about their internal standards, procedures, and methodologies. It provides companies with a mechanism to review draft reports before they are issued. It also provides companies with a process to correct mistakes. And, finally, the bill authorizes the SEC to regulate and/or prohibit the conflicts of interest that exist in proxy advisory firms.

For these reasons, the Society strongly supports H.R. 4015 and urges its passage through the Committee on Banking, Housing, and Urban Affairs.

We do understand that several institutional investors and the proxy advisory firms themselves have opposed H.R. 4015 because of concerns about the increased costs that the requirements of the bill may impose on these firms and their institutional clients. The Society understands the need that institutional investors and their proxy voters have for summaries and analyses of proxy materials, particularly those who hold every U.S. equity and are required to vote thousands of meetings each year. The Society is mindful of these concerns and is more than willing to work

[4] *See* Egan Jones Proxy Services, May 27, 2004; and Institutional Shareholder Services, Inc., September 15, 2004.

with the Committee to improve the legislation in a manner that accomplishes its goals, while also reducing its compliance costs.

H.R. 1744, "Brokaw Act"

Another disincentive to public ownership of companies is the burden of being subject to attacks by activist investors, a number of whom have short-term agendas.

There is no doubt that some activists create longer-term shareholder value and the Society is not seeking to stifle activist investing. The Society does not believe, however, that there is a level playing field between activists and companies. Companies are required by securities laws to publicly disclose material information within 4 days. Activist investors, on the other hand, have 10 days to file a Schedule 13D, disclosing the material fact that they have acquired 5 percent of a particular company's stock.

This 10-day window has been the subject of criticism for allowing too much time for activist investors to accumulate large positions in public companies—sometimes through undisclosed derivative positions—before being required to disclose anything publicly. As an example, former SEC Chair Mary Schapiro noted in 2011 that many feel that the 10-day reporting deadline "[r]esults in secret accumulation of securities; [r]esults in material information being reported to the marketplace in an untimely fashion; and [a]llows 13D filers to trade ahead of market-moving information and maximize profit, perhaps at the expense of uninformed security holders and derivative counterparties."[5]

S. 1744 would equalize these reporting timeframes and make other necessary modernizations.

The SEC has not updated its 13D disclosure requirements in several decades and, in fact, this year is the 50th anniversary of the enactment of the Williams Act, which established this regulatory framework. S. 1744 would update these SEC requirements by closing certain loopholes and ensuring that securities positions taken by activist investors are more transparent to companies and to the capital markets.

The Brokaw Act—named for a village in Wisconsin that went bankrupt in part due to the actions of a group of hedge funds that pressured the Wausau Paper Company in 2011—would make three changes to the SEC's 13(d) disclosure rules. First, it would direct the SEC to shorten the deadline for disclosing an ownership interest from 10 days to 4 days, which is the current deadline for companies filing an 8–K report. The original 10-day deadline was developed when snail mail was the primary form of written communication, and this deadline has been eclipsed by the rise of electronic communication and the rapid speed in which securities are currently traded.

Some have argued that the 10 days was a careful balance drawn at the time to give investors an advantage over potentially entrenched management. A lot has changed on that front in 50 years and the argument that the legislative history of the Williams Act requires the 10 days for activists to have an advantage is longer relevant. Shareholder rights and shareholder engagement have come of age. In fact, so much so that we see a decrease in the number of private companies willing to take advantage of the public markets, and we see those who do go public institute stock classes to alleviate the burdens of activism and other shareholder empowerment mechanisms.

Second, the bill would require disclosure of any short or derivative positions that cross the 5 percent threshold, something that does not occur today. This closes a significant loophole that otherwise permits investors to accumulate large short and/or derivative positions in a security without any public disclosure.

And third, the bill would expand the 13(d) reporting requirement to include hedge funds and other activist investors that are coordinating activities for the purpose of seeking control or influence over a public company.

The Society has been working with the original sponsor of the Brokaw Act, Senator Tammy Baldwin of Wisconsin. This Act is now co-sponsored by Senator Perdue of Georgia and it represents good public policy for both public companies and their investors. We urge the Committee to pass this legislation to update and modernize the 13(d) disclosure regime.

Let me now turn to two bills before the Committee that could further discourage companies from going or remaining public, and that the Society opposes in their current form, S. 536, the Cybersecurity Disclosure Act, and the 8–K Trading Gap Act.

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[5] Chairman Mary L. Schapiro, "Remarks at the Transatlantic Corporate Governance Dialogue, U.S. Securities and Exchange Commission, December 15, 2011, available at *https://www.sec.gov/news/speech/2011/spch121511mls.htm.*

S. 536, "Cybersecurity Disclosure Act"

S. 536 requires public companies to disclose if they have a board member with expertise or experience in cybersecurity and to describe in detail the nature of that expertise or experience. If there isn't a cybersecurity expert on a board, a company will have to disclose "what other cybersecurity steps taken by the reporting company were taken into account by such persons responsible for identifying and evaluating nominees" for such board positions.

The Society generally believes that having special interest directors is not a good practice. First, there are not enough cyber "experts" around to serve on every board. Even if there were, it is unlikely they would agree to serve as an expert because a board member is only an overseer and not in control of all corporate affairs. He or she can only determine if management has organized and spent the resources to protect the company from cyber breaches given the type of data it has, the costs required to be expended, and the likelihood of success.

In addition, this bill is not necessary because director qualifications in the proxy already describe a person's experience and background. Anyone reading a proxy would be able to tell if a board has someone with cyber expertise as a member. A bill like this could lead to requirements that boards appoint other special interest directors.

This bill also creates a false presumption that a cyber expert director is required to effect appropriate board oversight. Concerns expressed by a Society member about encouraging a single-issue director are illustrative:

> Of course, we want our public companies' boards to have the requisite skills to deal with all sorts of issues. However, specifying the types of skills that a company's board must have strikes me as the ultimate one-size-fits-all approach and has no logical limits.
>
> Should every public company have an expert on revenue recognition? Related-party transactions? Has anyone thought through the consequences of having a board comprised of one-issue experts who may not have any other applicable skill sets? And would a cyber-expert want to be on a board, given that he or she would likely be blamed (and possibly sued) if the company had a breach or other cyber problem?[6]

Further, in its 2016 guidance for investors to assess the adequacy of their portfolio company boards' cybersecurity oversight, even the Council of Institutional Investors doesn't subscribe to the view that all boards need a resident cyber expert:

> Cybersecurity is an integral component of a board's role in risk oversight. Directors have the authority, capacity and responsibility to make pivotal contributions in this area by ensuring adequate resources and management expertise are allocated to robust cyber risk management policies and practices, and ensuring disclosure fairly and accurately portrays material cyber risks and incidents.
>
> *To achieve these objectives, directors need not develop advanced technical expertise.* Nor do directors need to support unrestrained capital spending on any project with a 'cyber' prefix.[7] (emphasis added)

S.___, "8–K Trading Gap Act"

The 8–K Trading Gap Act requires the SEC to issue new rules prohibiting insider trading during a "covered period." The term "covered period" is defined as the period between: (1) the date when material nonpublic information is known to officers and directors of a company; and (2) the date when the information is disclosed to the public through an 8–K or other SEC filing.

The Society believes this bill is unnecessary and could lead to unintended consequences. It is already illegal to trade on material nonpublic information, and recent SEC guidance has confirmed existing law for circumstances involving cybersecurity. In addition, public companies uniformly have insider trading policies that require pre-clearance and strictly regulate trading in a company's securities by employees, including executive officers and directors of a company. These are conservative risk management policies that apply broadly, and they typically have two levels of protection: (1) a trading window that is closed (a.k.a. "blackout period") when the company is in possession of material nonpublic information; and (2) a pre-

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[6] Robert B. Lamm, "Beware when the legislature is in session," The Securities Edge, March 19, 2017, available at *https://www.thesecuritiesedge.com/2017/03/beware-when-the-legislature-is-in-session/*.

[7] Council of Institutional Investors, "Prioritizing Cybersecurity," at 1, April 2016, available at *https://www.cii.org/files/publications/misc/4-27-16%20Prioritizing%20Cybersecurity.pdf*.

clearance procedure for more senior executives whereby no trading is allowed unless cleared by the senior legal officer of the company.

In order to determine whether the company has material nonpublic information, companies have internal processes for information to be communicated up the chain of command so that appropriate decisions can be made. This reporting up the chain is a common practice in public companies and it runs through several internal mechanisms within companies, including preparation of SEC reports, financial statements, *etc.*

A practical difficulty with this bill is how best to make the judgment call about whether a particular piece of cybersecurity information (or a situation) involves material nonpublic information, especially in an evolving situation where a company is trying to determine the difference between an intrusion and a breach.

First, a company must determine if the information is nonpublic. This sounds easier than it is, as the information must be analyzed in light of the company's current public disclosures (*e.g.,* its risk factors and MD&A).

Second, a judgment must be made as to whether the information is material. This is typically the most difficult judgment to be made; in these situations, an expected value analysis needs to be conducted, *i.e.,* would the event be material if it occurred and what is the likelihood that the event will occur? This analysis is made more difficult when, as in the case of a cyber-attack, it is often not clear for some time what the event itself is. It could be a meaningless intrusion, or a significant one.

For example, is the event when an issuer's computer system detects an intrusion; is it when the first employee learns about the intrusions; is it when the company makes a determination that the intrusion could be material; or is it when the company makes a determination that the intrusion is actually material?

These difficult judgment calls also apply to other evolving circumstances, such as an internal investigation, a negotiation over the continued employment of a senior executive, or a merger and acquisition transaction.

Trying to fix the problem of trading when there is the potential for material nonpublic information within a company would be fixing the problem by killing an ant with a bazooka. Companies are in a difficult position here as there is always potential material nonpublic information inside a company. In the case of cyber intrusions, a company would have to keep the trading window closed permanently. The net effect could be, at worst, that insiders could never sell their stock, or, at best, they would be severely limited in doing so. This would be a strong disincentive for those making a decision to take a company public, or to remain public. Moreover, because many companies compensate their employees with some form of equity, to align their interests with those of all shareholders, a reduction in the ability for employees to sell their company equity would be problematic and could lead to a de-equitization of America's workforce.

For all these reasons, the Society believes that current laws and conservative risk management policies by companies are adequately preventing executive insider trading between the time that material nonpublic information is determined and the time when a public filing is made.

Conclusion

Thank you for the opportunity to present the views of the Society on these important legislative proposals affecting corporate governance. I am happy to answer any questions you may have about these proposals.

PREPARED STATEMENT OF JOHN C. COATES IV

JOHN F. COGAN, JR. PROFESSOR OF LAW AND ECONOMICS, HARVARD LAW SCHOOL

JUNE 28, 2018

Chairman Crapo, Ranking Member Brown, and Members of the Committee, I thank you for inviting me to testify. Effective corporate governance is a crucial foundation for economic growth, and by providing accountability and legitimacy to large-scale businesses, it is a core part of America's success story. I am honored to have been asked to participate. The Committee asked for comment on the role that law plays in corporate and shareholder disclosures and governance, and how they could be improved. After answering those questions, I comment on five of the seven bills that are the focus of today's hearing, although I am happy to take questions about any of the bills.

Background and Credentials

By way of background, prior to joining Harvard, I was a partner practicing securities and corporate law at one of the Nation's most prestigious law firms, Wachtell

Lipton Rosen & Katz. I drafted proxy statements, annual reports, and prospectuses, worked with SEC staff, managed shareholder meetings, and advised on most of the governance topics before the Committee. As an advisor, I had to assist boards respond to shareholder pressures in the absence of good information. In short, I have lived the experience of coping with disclosure obligations, as well as their absence.

At Harvard, I teach, research and write about corporate law and governance in both the law school and the business school, as well as in executive education sessions with directors, CEOs, and general counsels. I co-authored a foundational "core reading" on corporate governance designed for all MBAs.[1] I am on the SEC's Investor Advisory Committee, and I am also serving as a monitor for the DOJ and a compliance consultant to the SEC.

General Remarks on Corporate Governance

Law—and the subset of law known as regulation—has always played an important role in corporate governance, and it continues to do so. Corporations are creatures of law; without an act of Government, no corporation would exist. Initially, corporate charters included Government-imposed terms that some would now label regulation, including terms about who is authorized to act for a company, how disputes among corporate officials are to be resolved, and the relative powers of investors, boards, officers, and other agents, including rights of access to information. The features of limited liability, legal personality (including the right to sue), and indefinite lifespan represent, in essence, economic subsidies—they facilitate capital formation and economic activity that would not occur without corporate law.

Today, reflecting a traditional embrace of separation of powers, those terms are set out in an array of locations. They include:

- **Federal statutes** such as
  - the Foreign Corrupt Practices Act,
  - the Williams Act, and
  - the Investment Company Act of 1940,
- **SEC, DOL,** and *IRS* regulations,
- **State corporate statutes,**
- **court decisions** interpreting purposefully vague standards of conduct,
- stock exchange **listing standards** (which function as regulation),
- corporate **charters** and **bylaws,**
- corporate governance **principles** and **codes of ethics** (which, once adopted, function like regulation in many respects),
- academic **treatises** (relied up on by courts on occasion), and
- increasingly, **codes of best practices, stewardship codes, voting policies** and governance positions taken by large index funds, other mutual funds, pension funds and proxy advisors (which reflect and reinforce governance norms).

As this list suggests, law pervades corporate governance.

Most of these laws allow ample room for variation and experimentation. The United States has never imposed "one size fits all" regulation in corporate governance. The most contentious part of the Sarbanes-Oxley Act (section 404), for example, permits companies to comply or disclose.[2] Companies are not required to do what audit firms think is necessary for an effective control system, if companies are prepared to disclose the disagreement and live with the market consequences, which a substantial number of companies choose to do. Still, the law provides the basic framework within which governance is negotiated.

The core part of that framework—although not the only one—consists of disclosure obligations. Disclosure has many virtues. Disclosure enhances legitimacy. It assures the public generally that State-created and State-subsidized corporations such as Apple, AT&T, and Facebook, with their enormous power and resources, are also working in the public interest. Disclosure is necessary for accountability. It allows investors and enforcement officials to hold corporate agents responsible for theft, fraud, or violations of other laws. Disclosure provides a basis for lawmakers to evaluate whether current laws are doing what they are intended to do. These lawmakers include Congress, the SEC, and ultimately, in a democracy, the public.

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[1] John C. Coates and Suraj Srinivasan, Corporate Governance, Core Reading, Harvard Business Publishing (2018 forthcoming).

[2] John C. Coates, The Goals and Promise of the Sarbanes-Oxley Act, 21 J. Econ. Persp. 91 (Winter 2007); John C. Coates and Suraj Srinivasan, SOX After Ten Years: A Multidisciplinary Review, 28:3 Accounting Horizons 627 (2014).

Is existing law, for example, minimizing the production of "externalities"—harms on third parties not in a position to protect themselves? Disclosure provides a foundation for improving law over time.

As an economic matter, disclosure enhances the best allocation of resources for sustained growth. Basic theorems of economics that undergird our Nation's preference for free trade commonly assume among other things those trading are on the same informational playing field (no "asymmetric information"). Disclosure helps move toward that ideal. While voluntary disclosure is common and valuable, well-designed disclosure laws also add value. They create standards, ensure comparability across companies, add enforcement tools, and greatly improve the credibility and reliability of the disclosures.

Disclosure laws are also among the least intrusive and costly forms of regulation. They are not a panacea. They have costs, although those costs are often overestimated. Generally, those costs fall—often dramatically—over time.[3] But disclosure is a mild and often clearly socially efficient means to address specific problems. This is especially true when disclosure is compared to mandatory conduct rules, structural laws such as activity bans (even if coupled with exemptions), State ownership, or political governance. The public has a tendency to demand legal change in response to crises, market crashes or corporate scandals. Those responses can be prescriptive, especially if the behavior involved took place in the dark. Disclosure reduces paranoia, and moderates reactions.

Even if information disclosed is not readily understood by the public, or even by most investors, the role of sunlight in deterring misconduct is too well known to elaborate. Disclosures can be processed by analysts, who can then provide summaries and recommendations to others. For example, as I have written about with Glenn Hubbard—who served as Chairman for President George W. Bush's Council of Economic Advisors and who currently Co-Chairs the Committee on Capital Markets Regulation—the Investment Company Act is one of the most successful disclosure laws of all time.[4] It requires disclosure of much information that few investors ever learn about directly. But the disclosures are consumed, analyzed and simplified by financial advisors and intermediaries such as Morningstar. The United States has the most successful fund industry in the world, thanks in significant part to mandatory disclosure laws.

Five Specific Bills

I turn now to five of the bills before the Committee.

Cybersecurity Disclosure Act (S. 536)

I support the Cybersecurity Disclosure Act (S. 536). On the basic issue of cyber-risk, I will not detail here what I expect the Committee already knows: cyber-attacks are more frequent and consequential each year; they are producing more and more harms to the public and investors; and, as SEC Chair Jay Clayton testified, they are not well understood by American investors.[5]

What I will emphasize is that cyber-risk is, among the many kinds of risks that companies face, nearly unique. Cyber-risk is intense, ever-changing and growing. But unlike other kinds of risks, cyber-risk is general to all companies. Only basic financial risks affect more companies. In fact, while there are some sectors (retail, financial services, and telecom) where cyber-risk is most acute, it is hard to identify any major public companies that are not faced with significant cyber-risks. This is why cyber-risk warrants special public policy attention, and why a modest disclosure law aimed at cyber-risk is not a slippery slope to overly burdensome disclosures about all kinds of risks.

S. 536 is well designed. It does not attempt to second-guess SEC guidance and rules regarding disclosures generally, or even as to cyber-risk overall. The bill simply asks publicly traded companies to disclose whether a cybersecurity expert is on the board of directors, and if not, why one is not necessary. To be clear, the bill does not require every publicly traded company to have a cybersecurity expert on

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[3] See Coates and Srinivasan, *supra* note 2; see also John C. Coates, Toward Better Cost-Benefit Analysis: An Essay on Regulatory Management, 78 Law and Contemporary Problems 1 (2015); John C. Coates, Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications, 124 Yale Law Journal 882 (2014–2015).

[4] John C. Coates and R. Glenn Hubbard, Competition in the Mutual Fund Industry: Evidence and Implications for Policy, 33 J. Corp. L. 151 (2008); see also John C. Coates, Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis, 1 J. Legal Anal. 591 (Summer 2009).

[5] John McCrank, *SEC Chief Says Cyber-Crime Risks are Substantial, Systemic,* Reuters, September 5, 2017, *http://www.reuters.com/article/us-sec-enforcement/sec-chief-says-cyber-crime-risks-are-substantial-systemic-idUSKCN1BH094.*

its board. Publicly traded companies will still decide for themselves how to tailor their resources to their cybersecurity needs and disclose what they have decided. Some companies may choose to hire outside cyber consultants. Some may choose to boost cybersecurity expertise on staff. And some may decide to have a cybersecurity expert on the board of directors.

The disclosure required would typically amount to a sentence or two. The disclosure would be contained in a particular type of document—annual proxy statements—that are among the documents that I know from experience are regularly and carefully read by boards of directors. Proxy statements are how directors are re-elected each year. They describe the directors themselves, what committees they are on, and how they function as a board. Being human, directors tend to read things about themselves more carefully than other disclosures. Given this, the bill would gently remind boards to take direct responsibility for cybersecurity, by focusing them on board-level resources regarding cyber-risk, and through that reminder, on cyber-resources more generally.

In short, no board would have to change its composition in response, and it preserves flexibility for companies to respond to cyber threats in a tailored and cost-effective way. It would not require disclosure of sensitive or proprietary information, and so would not increase the risk of cyber-attacks. It would be extremely low cost—the board is already required under SEC rules and guidance to disclose its role in risk oversight, including oversight of material cyber-risks. The bill would simply flip the switch on whether the topic needs to be explicitly addressed in proxy statements, so boards could not fail to engage the issue, as, unfortunately, many still do, despite SEC guidance and numerous high-profile examples of cyber-attacks.

8–K Trading Gap Act

I also favor the 8–K Trading Gap Act, with one suggested modification. Current rules permit insiders to game disclosure rules and reap unwarranted windfalls by trading in company stock in the window between the moment a material "current event" requiring disclosure occurs, and the moment that the disclosure is actually made. Such trading may already violate SEC Rule 10b–5. But enforcement of Rule 10b–5—an intentionally broad anti-fraud standard—is restrained by available SEC resources and the magnitude of expected recoveries in private litigation. The proposed bill would enact a bright-line ban on such trading. It would have relatively modest effects on nonfraudulent trading, as the trading could occur after a company makes required disclosure, the timing of which is within the company's control. It also exempts trades under pre-committed 10b–5–1 trading plans, further allowing insiders to achieve liquidity and diversification on a fair basis that does not disadvantage other investors.

The one suggestion I would make is to lengthen the "covered period" as defined in the bill by one trading day. Information takes some time to be reflected in market prices. Forms 8–K can be filed late in a day. The market and public investors generally should have one full trading day to digest the information in a Form 8–K before having to worry that insiders are on the other side of the trade. While I would still favor the bill without this modification, this modest change would more effectively accomplish its purposes, without imposing unnecessary costs on insiders or companies.

Proxy Advisor Regulation Act (H.R. 4015)

The third bill on which I offer comment is formally titled the "Corporate Governance Reform and Transparency Act of 2017," but in the spirit of fair disclosure, it should be renamed the "Proxy Advisor Regulation Act," because that is in fact what it is—a bill to regulate proxy advisors—and its current title provides no useful information as to its contents. Proxy advisors are indeed the sole target of the bill. In general, as a background fact, no one is required by law or regulation to consult a proxy advisor. To my knowledge, there are no regulatory or legal barriers to entry for new entrants to compete with the existing advisors. Of course, there is the usual requirement in a market economy that someone offer better services at a lower cost.

As a result, on the substance of the bill, I find myself puzzled. The bill states that its goals are to "to improve the quality of proxy advisory firms," and to "foster accountability, transparency, responsiveness, and competition in the proxy advisory firm industry." Those are worthy goals.

The puzzle is why these goals are important as a target of regulation in the proxy advisory industry, and how the bill is meant to accomplish those goals. I am unaware of a clamor from investors for regulation of proxy advisors. Usually evidence of market failure is a pre-requisite for regulation—here, that would presumably consist of evidence of the inability of investor-clients of advisory firms to obtain information by directly asking for it. Alternatively, disclosure laws may be needed for

comparability or enforcement purposes. There are so few proxy advisors, and their recommendations are under such constant scrutiny, that it seems unclear at best how those goals would be advanced by new regulations enforced by the SEC.

It is also a puzzle how its provisions could possibly pass a cost/benefit test to accomplish those goals, even if one thought the bill could accomplish those goals. Some parts of the bill—*e.g.,* the requirement to have an ombudsman and a compliance officer—seem worthy in the abstract, but have the distinct characteristic of "one size fits all." That is usually not a phrase of praise in the corporate governance arena.[6] Would a new entrant in the proxy advisory services market need a full time ombudsman or compliance officer? If not, then that requirement would deter rather than enhance competition.

A ban on modifying recommendations based on whether companies buy other services from the advisor also seems like a worthy specific goal. Is it best addressed in a Federal statute? The conduct so prohibited on its face sounds like garden-variety fraud or deceptive sales practices, something the States are long used to regulating in a variety of areas. Are the pension funds and other clients of proxy advisors not capable of enlisting State attorneys general or other enforcement allies if they suspect systematic deception of that kind? They seem able to protect their own interests from fraud or quasi-fraud with existing laws in other areas of their business.

And the final puzzle is why its sponsors and supporters believe that a Federal statute and mandatory regulation would do more to accomplish these goals as applied to proxy advisory firms than they would as applied to public company boards of directors, who routinely face conflicts of interest, or index fund advisors, who routinely make voting decisions on behalf of others without publishing their methodologies.

To be clear, I am open minded about what well-designed regulation can accomplish. Indeed, as outlined above, well-designed disclosure laws can achieve a great deal, including accountability, transparency, responsiveness, and (in some contexts) competition. But this bill is not limited to disclosure, and it is not clear that the disclosures it requires are well-suited to its goals, or are the least costly means of accomplishing the same objectives. Substantially more evidence should be in hand before mandating new regulations of this kind. I am unaware of any reliable economic evidence that would suggest that the net benefits of the bill would exceed its costs, which would be substantial.

Take, for example, the requirement that a proxy advisory firm be required to register with the SEC for simply providing proxy advice. Registration requirements are not to be mandated lightly. They impose more burdens on new entrants than on incumbents. They therefore also risk reducing competition, not increasing it.

One element of the registration form that the SEC would not have authority to drop under the bill is a requirement that the proxy firm disclose "the procedures and methodologies that the applicant uses in developing proxy voting recommendations," and the SEC would be required to make that information publicly available. Since procedures and methodologies are essentially trade secrets, the bill would destroy existing or new proxy firms' ability to protect their intellectual property. New competitors will have no way to recover investments in research and development of better procedures or methods. How would such a requirement make the industry more competitive?

I would not want to reject out of hand the idea that some regulation of proxy advisors might be warranted—particularly concerning conflicts of interests. I could imagine that some light touch disclosure rules, informational barrier requirements, or back-up enforcement might help alleviate concerns that the concentrated market for proxy advice was susceptive of abuse through that channel. If the SEC believes it lacks resources or authority to hold hearings and ultimately develop such a regulatory approach, there might be a clear need for Federal legislation. Absent that, I would recommend—in the language of academic publishing—a "revise and resubmit" decision on this bill.

Fair Investment Opportunities for Professional Experts Act (S. 2756)

This bill does three things. First, it substantially removes discretion from the SEC to alter the definition of "accredited investor" based on net worth and income, by moving the current definition into a statute and out of a rule. Second, it inflation-adjusts the current definition. Third, it directs the SEC to consider education, job, or professional experience (among other things) in potentially expanding the definition.

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[6] Cf. Society for Corporate Governance, Inc., Statement on Corporate Governance ("the Society is skeptical of one-size-fits-all governance prescriptions").

On the overall topic of how to define "accredited investor" and why it matters, I commend to this Committee the advice of the SEC's Investor Advisory Committee.[7] That advice was developed before I joined that Committee, but it is good advice, it was carefully considered, and it is advice that I endorse. I also commend to this Committee the research conducted by the SEC's Division of Economic and Risk Analysis, which lays out many consequences of different policy choices available here.[8] I note, finally, that the SEC is required to review the definition of accredited investor every 4 years under the Dodd-Frank Act.[9]

Based on that information, I conclude that the second and third effects are good ideas. The first is not. The current net worth and income thresholds have been eroded by inflation for 30 years. They are, as a result, too low.[10] To lock them into the statute now would durably expose a large number of financially vulnerable Americans to the heightened fraud risk that unregistered offerings create.

While inflation-adjusting the thresholds is a good idea, doing so would be a good idea to do so in a statute only if the current levels were a reasonable proxy for financial resilience, literacy, and sophistication. It is a good idea to add the financially educated and financial professionals to the pool of potential private-placement investors. Net worth and income have always been imperfect proxies for sophistication. It is also a good idea to delegate to the SEC, as the bill does, the precise way in which education and experience should play into a broadened definition. Some consideration should be given to ways that the definition could assure that even educated or experienced investors have financial resources to absorb losses that routinely accompany investment.

Expanding Access to Capital for Rural Job Creators Act (S. 2953)

I favor having the SEC receive advice about the interests of small businesses based in rural areas. In an era of increasing distrust and distance between rural and urban parts of this country, fostering more communication and understanding across an array of policy areas is increasingly important. Small businesses in rural areas are less likely to be able to raise capital in conventional ways than other businesses. Although rural area population is declining, relative to cities and suburbs, rural areas remain home to 60 million Americans, and a greater share of rural workers have jobs in small businesses than other areas.

PREPARED STATEMENT OF DAMON A. SILVERS

DIRECTOR OF POLICY AND SPECIAL COUNSEL, AFL–CIO

JUNE 28, 2018

Good morning, Chairman Crapo, Ranking Member Brown, and Members of the Committee. My name is Damon Silvers, and I am the Policy Director and Special Counsel for the AFL–CIO, America's labor federation representing 55 national and international labor unions and more than 12 million working people.

The AFL–CIO has since its founding seen ensuring the retirement security of working people as a central mission of the labor movement—both through our advocacy for Social Security and Medicare and through collective bargaining with employers. Today collectively bargained retirement plans account for more than $7 trillion of invested capital in this country. While the ownership of stocks and bonds remains predominantly in the hands of the wealthiest Americans, working people are major investors through our benefit funds, and our retirement security is bound up with the health of the financial system. Our members are major investors and their retirement security is bound up with the health of the financial system. For these reasons the labor movement has been actively engaged for decades in promoting effective, commonsense regulation of our capital markets.

Following the financial crisis that began in 2007, it was clear that our system of financial regulation had been dangerously weakened by laws that exempted large parts of the financial system from effective regulation, and in other cases created opportunities for regulatory arbitrage. While the Dodd-Frank Act addressed many of these weaknesses, at the time of the passage of the Act investor advocates recognized there was much left to be done. Among the key issues that remained were——

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[7] See *https://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-advisor-accredited-definition.pdf.*

[8] See *https://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf.*

[9] Dodd-Frank Act, section 413(b)(2).

[10] John Coates and Robert Pozen, Bill to Help Businesses Raise Capital Goes Too Far, Wash. Post (Mar. 12, 2012).

1) How to effectively protect investors from the threat of self-dealing by the experts they hire to help them manage their money.
2) How to ensure a level playing field for all investors in capital markets where information moves instantaneously and where big data means big power and big money.
3) How to prevent the reoccurrence of the dynamic that led to the financial crisis of large parts of the financial system becoming unregulated and/or opaque?

Each of the bills under consideration in this hearing fits within these three questions. Some of these bills would productively address these challenges, others would make these challenges worse for investors.

The remainder of my testimony will address each of the bills under consideration in turn.

H.R. 4015—Corporate Governance Reform and Transparency Act of 2017

The Corporate Governance Reform and Transparency Act would create a special regulatory regime for firms that advise investors on how to exercise their voting rights as stockholders. The bill claims to foster "accountability, transparency, responsiveness, and competition in the proxy advisory firm industry," while in reality it will interfere with shareholders' access to impartial analysis and undermine shareholders' ability to hold corporate management accountable. This bill would create conflicts of interest where none now exist, and treat proxy advisory firms differently than other asset managers. Having the right to vote and exercise other corporate governance rights is at the heart of what it means to be a shareholder. Pension funds in particular have a legal duty under ERISA, the Internal Revenue Code, and State law to obtain expert, independent advice in the management of all their plan assets, including voting rights. Pension funds and other institutional investors rely on proxy advisory firms to sort through the thousands of pages of complex financial reporting that issuers send to shareholders every proxy season. Limited time and resources makes the kind of intensive analysis performed by proxy advisory firms prohibitively difficult and costly for many institutional investors to review the massive amounts of information involved in voting proxies for large, diversified investors.

The United States Department of Treasury (Treasury) 2017 report to the President on "A Financial System that Creates Economic Opportunities, Capital Markets" found that "institutional investors, who pay for proxy advice and are responsible for voting decisions, find the services valuable, especially in sorting through the lengthy and significant disclosures contained in proxy statements." After extensive review of the industry, Treasury did not recommend any legislative changes governing proxy advisory firms.

Despite these findings, H.R. 4015 effectively gives corporations' CEO's and boards the ability to control the people who are supposed to be holding them accountable. The bill would do this by enabling companies to delay vote recommendations. Corporate executives would then be able to object to any proxy voting recommendation that is contrary to their own preferences, including votes on their own executive compensation packages.

Institutional investors and associations, including the National Association of State Treasurers and the Council of Institutional Investors oppose this bill. It would increase costs for investors, compromise the quality and reliability of information, and reduce board accountability to investors.

The AFL–CIO does believe that proxy advisors should be regulated like other investment advisors, and would not oppose a requirement that they register as such. However we strongly oppose H.R. 4015 because this bill appears to punish proxy advisors for doing their job and seeks to impose upon them a regulatory scheme designed to make them disloyal to their clients, among which are our members' pension funds.

S. 2756—Fair Investment Opportunities for Professional Experts Act

This legislation would codify the current Securities and Exchange Commission (SEC) definition of "accredited investor" The bill defines accredited investors to include individuals or couples with a net worth of $1 million excluding their primary residence, individuals with an income above $200,000 in each of the last 2 years, or couples with a joint income above $300,000 in each of the last 2 years. This effectively makes many Main Street retirement savers, particularly in high income areas, "accredited investors".

This issue is a critical component of the way our securities laws defines public markets versus private markets. We are concerned generally that private markets have increasingly been defined in law and regulation in ways that make them

essentially the same as public markets in terms of the scale of the markets and in terms of who is actually exposed to risk, but without the transparency and investor protection systems that have been built up in the public markets. S. 2756 would accelerate this trend.

This is because the definition of "accredited investor" is crucial in securities laws to determine whether a transaction qualifies for the private offering exemption from investor protection requirements. The Supreme Court limits this exemption "to those who are shown to be able to fend for themselves."[1] In other words, accredited investors are those individuals who do not need the registration and disclosure protections afforded by the Securities Act of 1933, because they would be able to evaluate potentially risky and illiquid private offerings without the investor protections provided in a public offering.

The SEC's Investor Advisory Committee (IAC) has found that the current accredited investor definition based on financial thresholds is inadequate to protect mom and pop investors, and has opposed codifying this definition in law, instead advocating for a new rulemaking that would improve the definition to permit more sophisticated investors to access private offerings while better protecting less sophisticated retirees.[2] The State securities administrators (North American Securities Administrators Association, or NASAA) also oppose codifying this low net-worth threshold.[3]

The $1 million asset threshold was originally set by rule in 1982 and has not been updated since then. Even with the inflation adjustments the bill requires every 3 years, the definition would make Main Street retirement savers "accredited investors" simply because they have saved for retirement. While we support indexing the net-worth threshold, the current baseline is far too low to act as a starting point. These individuals are often dependent on their retirement savings to survive and cannot easily recoup large investment losses.

The Fair Investment Opportunities for Professional Experts Act codifies a weakness in current investor protections and would require average retirees to be able to evaluate the risk of financial instruments as well as trained, experienced investment professionals.

For the above stated reasons, we urge you to oppose this bill.

S. 1744—Brokaw Act

In 1968, Congress passed the Williams Act to require investors to publicly disclose when they accrue a large ownership stake in a public company. The purpose of the Act was to end corporate raiders' ability to make cash tender offers to shareholders without any need to disclose their identities, intentions or report anything to the SEC. The Williams Act amended the Securities Exchange Act of 1934 to require that investors file public disclosures with the SEC within 10 days of acquiring a 5 percent or more stake in a public company. In the 50 years since the Williams Act was passed, there have been substantial changes in trading activities and technology. The Brokaw Act is a necessary and timely update to the disclosures required in Section 13(d) of the Exchange Act that accounts for trading behaviors that have emerged in recent decades and market expectations related to the speed of information access.

Currently, there is a 10-day window between when an investor crosses the 5 percent ownership threshold of a company and when that beneficial ownership position must be disclosed with a 13D filing. Since the Williams Act passed in 1968, evolution in information technology has created an appropriate expectation among investors that they will have access to information much more quickly. SEC disclosure forms are now filed electronically, which makes disclosure faster and easier for issuers. As a result, we believe the shorter filing window proposed in the Brokaw Act for 13D filings is necessary and appropriate.

Empirical evidence shows an abnormally high level of trading inside of that 10-day window, which is best explained as the action of traders with knowledge of the hedge funds' positions. This trading activity is likely to be attributable to groups of sophisticated hedge fund investors, known as "wolf packs," that communicate in the period between which they begin accumulating their position and the 13D filing is made. These groups take positions in the company with the expectation that the stock price will jump once the 13D is filed. These "wolf packs" can currently exceed

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[1] See: *Securities and Exchange Commission v. Ralston-Purina Co.*

[2] See: Recommendation of the Investor Advisory Committee: Accredited Investor Definition (October 9, 2014). Available at *http://bit.ly/22HoUHw.*

[3] North American Securities Administrators Association, "Letter from NASAA President and Alabama Securities Director Joseph P. Borg to the HFSC Chair and Ranking Member regarding markup of H.R. 3758, H.R. 477, H.R. 3857, H.R. 2201, and H.R. 1585," October 11, 2017. Available at *http://bit.ly/2xK1Lag.*

the 5 percent ownership threshold collectively without triggering any disclosure requirements at all.

Finally, activist investors can manipulate the process by secretly taking net short positions. In other words, they use their long (public) position to boost the stock price in the near term while investing far more in a short (nonpublic) position. Thus their net position is actually a bet against the company but their public position looks favorable. Activist investors often engage in public campaigns to influence stock prices. Additional transparency in this area would help investors by providing insight into the incentives of the hedge funds and the messages they are promoting about a company's prospects.

The Brokaw Act addresses three major gaps in the current legal framework related to the requirements that investors disclose when they accrue large ownership positions in a public company. First, it shortens the 10-day window between crossing the 5 percent ownership threshold and the required 13D filing—the period when trading activity spikes—down to 2 days. Second, it reforms the definition of "groups" under section 13(d) so that so-called wolf packs, groups of short-term investors seeking cash payouts, can trigger the collective ownership threshold collectively. Finally, the bill extends section 13(d) to require disclosure of "net short" positions, that is, investors would have to disclose their full position, preventing them from profiting off a large hidden short position while taking a public long position to boost the stock price.

The reforms proposed in the Brokaw Act are commonsense changes to address each of these problems. They adapt the existing securities laws to cover current practices and are essential for the strength of our markets and capital formation.

S. 2499—Compensation for Cheated Investors Act

One of the central flaws in our current system of securities regulation is the weak and inconsistent nature of the regulation of individuals and firms that provide investment advice. As an economic matter, broker-dealers, insurance agents, and investment advisors all provide investment advice. There should be a single standard of fiduciary duty that blocks self-interested behavior by all three types of advisors, and this duty should be heightened when retirement assets or other ERISA assets are at stake. But in our current system, there are significant differences in how these three types of advice providers are regulated, and how the regulations are enforced.

One particularly egregious problem that has resulted from this system is that when duties to investors are enforced by regulators, defendants are able to avoid paying damage awards, and are able to move among the three types of advice provider without consequence. Consumer protections mean nothing if regulators are unable to guarantee that defrauded consumers are made whole.

In the case of broker-dealer misconduct, a disturbing number of damage awards to investors by regulators and the courts never reach the harmed investors. The Financial Industry Regulatory Authority's (FINRA) Dispute Resolution Task Force found that in 2013 more than $62 million in arbitration awards to consumers went unpaid, with a large number of unpaid awards assessed against broker-dealers who had become inactive since the complaint was issued.[4] Between 2012 and 2016 unpaid FINRA arbitration awards totaled nearly $200 million.[5]

The compensation for Cheated Investors Act would make sure investors defrauded by brokers are able to collect the full amount of the award owed them while increasing accountability and public trust in the financial system and broker-dealers.

This bill would require FINRA to establish a compensation fund for defrauded investors who have not been able to collect from brokers even after winning arbitration or court judgment. The fund would be supported by fines and penalties charged to FINRA-regulated broker-dealers. Greater transparency for consumers is also incorporated into the bill in the form of an annual report to be published by FINRA detailing the number and value of arbitrations, awards, and unpaid claims. FINRA already collects this data and shares it with other regulators. Sharing it with the public will help improve confidence in the financial system without significant costs to regulators, broker-dealers, or investors.

FINRA has acknowledged the problem of unpaid awards and a recent discussion paper from FINRA staff included such an approach in their list of potential meas-

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[4] FINRA Dispute Resolution Task Force, Final Report and Recommendations of the FINRA Dispute Resolution Task Force, 50 (2015), available at *https://www.finra.org/sites/default/files/Final-DR-task-force-report.pdf.*

[5] FINRA, Discussion Paper—FINRA Perspectives on Customer Recovery, 7 (Feb. 8, 2018), available at *file:///C:/Users/slewis/Downloads/finra_perspectives_on_customer_recovery.pdf.*

ures to address unpaid claims.[6] This bill gives FINRA substantial latitude in administering its basic mandate, and we believe FINRA should work with the bill's sponsors to ensure that if the bill passed that its implementation was maximally effective both from the perspective of seeing to it that awards were paid and from the perspective of FINRA's effectiveness as a self-regulatory body.

Ensuring that awards are actually paid is a basic test of FINRA as a self-regulatory body. This bill is the consequence of FINRA failing to pass that test. But in reality what S. 2499 really does is give FINRA another chance to get it right, while at the same time making clear that FINRA cannot continue to ignore the problem. Passing S. 2499 is in the interests of investors and in the interest of maintaining and improving the integrity of our securities laws.

S. 536—Cybersecurity Disclosure Act of 2017

The need for the board and upper management responsibility for corporate cybersecurity is, by now, an accepted part of running a business. Data breaches have cost consumers and investors millions in recent years.

This bill directs the SEC to mandate issuer disclosure of whether any board members have expertise or experience in cybersecurity and to detail that expertise/experience; if no board member has cyber expertise, the company must disclose how cybersecurity factors were taken into account in selecting board members.

At a time when cybersecurity compromises can cause significant financial and reputational damage to businesses, investors have a reasonable expectation that publicly traded companies invest in protecting employees' and consumers' data as well as proprietary business information and internal communications. But as matters stand today investors have no real way to be sure companies are actually doing any of these things. This bill requires the SEC to promulgate rules that require companies to be transparent about what they are doing, and to do so within the context of the securities laws where misrepresenting what they are doing would subject officers and directors to liability.

Again, like the issue of FINRA not ensuring awards are paid, this is an issue that the Commission should long ago have addressed through rulemaking. But in the absence of Commission action around the issue of cybersecurity at the board level, S. 536 creates a workable framework for ensuring investors are properly informed about the seriousness with which their companies are taking these risks.

S. 2953—Expanding Access to Capital for Rural Job Creators Act

S. 2953 amends the list of entities the SEC Advocate for Small Business Capital Formation considers in its duties. The first change mandates the Advocate "identify problems that small businesses have with securing access to capital, including any unique challenges to minority-owned small businesses, women-owned small businesses, and small businesses affected by hurricanes or other natural disasters." The second change requires the Advocate report annually "a summary of the most serious issues encountered by small businesses and small business investors, including any unique issues encountered by minority-owned small businesses, women-owned small businesses, and small businesses affected by hurricanes or other natural disasters and their investors, during the reporting period."

These changes are sensible ones in light of the challenges faced by minority, women-owned and rural small businesses, and the extraordinary challenges faced by small business owners in many parts of this country as a result of natural disasters and the growing costs of climate change.

We note however that for this mandate to actually be helpful to small business requires that the SEC Advocate effectively distinguish between the interests of actual small businesses and the interests of large firms, which are increasingly dominant in the U.S. economy and in the U.S. capital markets. This is an area that deserves more thoughtful and sustained oversight by this Committee.

With that important reservation we support S. 2953.

8–K Trading Gap Act of 2018 (Van Hollen)

This bill addresses another problem involving inside information. Similar to the gaps in securities laws addressed by the Brokaw Act, this bill seeks to expand the language of current legislation to cover actions clearly prohibited by the spirit and intent of the legislation.

In this case, there is a 4-day gap between when an issuer determines that it is in possession of material nonpublic information and when it must file Form 8–K

[6] FINRA, Discussion Paper—FINRA Perspectives on Customer Recovery (Feb. 8, 2018), available at *https://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf.*

making that information public. This gap provides opportunities for insiders to trade on that information—evading the clear intent of the law.

This practice was confirmed by a research report published by a group of Harvard and Columbia professors in 2015 that coined the term, the "8–K Trading Gap." It looked at a dataset of over 15,000 Form 8–Ks and tracked insiders' trading transactions within the window before the disclosure was filed. Unsurprisingly, it found that insiders could almost always anticipate the direction of any price movement following an 8–K announcement. Additionally, they found "systematic abnormal returns of 42 basis points on average, per trade, from trades by insiders during the 8–K gap." And further, if insiders engaged in an open-market purchase of their own company's stock, they earned even larger abnormal returns of 163 basis points, which is of course far higher on an annualized basis.[7]

This bill directs the SEC to issue rules to restrict officers and directors from profiting by trading on inside information during the 8–K trading gap. Again, this is a commonsense reform that merely extends the current legal framework to cover current abuses.

Conclusion

The AFL–CIO commends the Committee for holding this hearing that in every respect addresses serious issues in capital markets regulation. Investors will benefit if loopholes can be closed that encourage self-dealing and insider trading. Investors will also benefit from legislation that encourages regulatory bodies as diverse as FINRA and the Office of the Small Business Advocate at the SEC to be more effective in doing their jobs. However, we strongly oppose the two bills in front of you, H.R. 4015 and S. 2756, that propose to weaken investor protections and the ability of our corporate governance system to perform its function of encouraging the managements of public companies to act in the long-term best interest of the corporations and their shareholders that they serve.

Thank you again for the opportunity to testify today, and I welcome your questions.

[7] Cohen, Alma and Jackson, Robert J. and Mitts, Joshua, The 8–K Trading Gap (September 7, 2015). Columbia Law and Economics Working Paper No. 524. Available at SSRN: *https://ssrn.com/abstract=2657877* or *http://dx.doi.org/10.2139/ssrn.2657877*.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM THOMAS QUAADMAN

Q.1.a. Your written testimony discussing the Fair Investment Opportunities for Professional Experts Act, S. 2756, states, "[a]sset and income tests are objective standards that have served well in determining who should be allowed the designation of accredited investors." The current asset and income tests were established in the original adoption of Regulation D in 1982, with limited changes since then.

Without adjustment for the passage of time or the impact of inflation, the income and net worth thresholds now capture a greater portion of investors than in 1982.

Please estimate the percentage of investors that would have qualified as accredited investors (i) in 1982 and (ii) as of the most recent practicable year-end using each of (a) the income test (for an individual) and (b) the net worth test. Please explain any assumptions made in estimating the number of investors or determining time periods, *etc.*

A.1.a. Section 413(b)(2)(A) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") directs the SEC to review the accredited investor definition as it relates to natural persons every 4 years. The SEC determines whether it should modify or adjust the definition for the protection of investors, in the public interest and in light of the economy. Section 413(b)(2)(A) specifies that this review shall be conducted no earlier than 4 years after enactment of the Dodd-Frank Act and every 4 years after that. The SEC staff issued the first report under Section 413 on December 18, 2015, entitled *Report on the Review of the Definition of "Accredited Investor"* (the "Report").[1]

Section X of the Report considers how revising the standards for qualifying as an accredited investor would alter the size and composition of the pool of accredited investors that are natural persons. The Federal Reserve Board's ("FRB") Survey of Consumer Finances (the "SCF") for 1983 and 2013 provided the underlying household data for this analysis. FRB conducts the SCF every 3 years, and it provides insights into household income and net worth.[2] According to the Report the population in 1983 included approximately 83.9 million households and in 2013 included approximately 122.5 million households.

In 1983, an estimated 440,000 U.S. households (0.5 percent of all households) met the $200,000 individual income threshold. In 2013,

[1] *https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf.* While the Chamber does not necessarily agree with all the policy recommendations contained in the Report, it provides a wealth of qualitative and quantitative analysis concerning the accredited investor definition.

[2] *https://www.federalreserve.gov/econres/scfindex.htm.* The 2016 SCF is the most recent survey conducted; the Report relies on 2013 data.

8.07 million U.S. households (6.6 percent of all households) met the $200,000 individual income threshold.

Similarly, the SEC staff estimated in 1983 that 1.42 million U.S. households (1.7 percent of all households) met the $1,000,000 net worth threshold. In 2013, 9.22 million U.S. households (7.5 percent of all households) met the $1,000,000 net worth threshold.

As the Report notes, Section 413(a) of the Dodd-Frank Act excluded the value of a person's primary residence from the $1,000,000 net worth calculation and directed the SEC to adjust similarly any accredited investor net worth standard in its rules. In 2011, the SEC revised Rules 215 and 501 to exclude any positive equity individuals have in their primary residences. The SCF statistics described in the preceding two paragraphs do not give effect to this change in methodology for determining net worth. Because some investors reached the $1,000,000 threshold only by including the value of their primary residence, the impact of the rule change was to reduce the total pool of eligible investors who relied on the net worth test.

Q.1.b. In addition, please provide inflation-adjusted estimates of the $200,000 annual income test and $1,000,000 net worth test, beginning from 1982 to year-end 2017. Please explain the inflation measure used and any other assumptions.

A.1.b. Using the Bureau of Labor Statistics' online Consumer Price Index (CPI) Inflation Calculator,[3] we calculated the amounts as follows measuring from the month of December in each year:

Year	Value of $200,000	Value of $1,000,000
1982	$200,000.00	$1,000,000.00
1983	$207,581.97	$1,037,909.84
1984	$215,778.69	$1,078,893.44
1985	$223,975.41	$1,119,877.05
1986	$226,434.43	$1,132,172.13
1987	$236,475.41	$1,182,377.05
1988	$246,926.23	$1,234,631.15
1989	$258,401.64	$1,292,008.20
1990	$274,180.33	$1,370,901.64
1991	$282,581.97	$1,412,909.84
1992	$290,778.69	$1,453,893.44
1993	$298,770.49	$1,493,852.46
1994	$306,762.30	$1,533,811.48
1995	$314,549.18	$1,572,745.90
1996	$325,000.00	$1,625,000.00
1997	$330,532.79	$1,652,663.93
1998	$335,860.66	$1,679,303.28
1999	$344,877.05	$1,724,385.25
2000	$356,557.38	$1,782,786.89
2001	$362,090.16	$1,810,450.82
2002	$370,696.72	$1,853,483.61
2003	$377,663.93	$1,888,319.67
2004	$389,959.02	$1,949,795.08
2005	$403,278.69	$2,016,393.44
2006	$413,524.59	$2,067,622.95
2007	$430,401.64	$2,152,008.20
2008	$430,795.08	$2,153,975.41
2009	$442,518.44	$2,212,592.21
2010	$449,137.30	$2,245,686.48
2011	$462,442.62	$2,312,213.11
2012	$470,493.85	$2,352,469.26
2013	$477,559.43	$2,387,797.13
2014	$481,172.13	$2,405,860.66
2015	$484,682.38	$2,423,411.89
2016	$494,737.70	$2,473,688.52
2017	$505,172.13	$2,525,860.66

[3] *https://data.bls.gov/cgi-bin/cpicalc.pl.*

The inflation adjustments in the preceding chart do not account for the SEC's 2011 change in methodology for determining net worth (excluding positive equity in a primary residence). Amounts rely on a base number of $1,000,000 without regard to what assets constitute that amount.

The Bureau of Economic Analysis in the Department of Commerce also maintains a Personal Consumption Expenditures (PCE) Price Index that, when used for inflation adjustment, usually produces lower results than the CPI calculation.

Q.2. You were asked about the Small Business Audit Correction Act, S. 3004, which would allow certain brokers or dealers defined under the bill to use auditors that are exempt from Public Company Accounting Oversight Board registration and supervision.

How many brokers or dealers do you believe would be covered by the definition in the bill?

A.2. The Small Business Audit Correction Act (S. 3004) would narrowly exempt privately held, noncustodial broker-dealers from a requirement that a firm registered with the Public Company Accounting Oversight Board (PCAOB) audits those privately held dealers. The 2010 Dodd-Frank Act expanded the mission of the PCAOB by granting it the authority to oversee and examine the audits of SEC-registered broker-dealers. However, this provision of the Dodd-Frank Act failed to recognize the unique business models and corporate structures of certain broker-dealers different from the types of systemic threats to the financial system that Congress intended Dodd-Frank to address. Specifically, broker-dealers that are not carrying brokers, *i.e.,* do not hold client funds in custody, and which do not issue stock to the public, have a very different risk profile than large and interconnected brokers.

S. 3004 would not exempt a noncustodial, privately held broker from audits—it simply provides that such brokers need not use a PCAOB-registered firm to conduct an annual audit. Audit standards that apply to PCAOB registered firms are designed for large, publicly traded businesses and are not appropriate for small and closely held entities. Furthermore, the exemption afforded certain broker-dealers under S. 3004 is entirely optional—if the shareholders and customers of such entities continued to demand PCAOB-registered auditors, nothing in this legislation precludes from doing so. Responsiveness to the needs and concerns of market participants is preferential to top-down mandates that fail to account for the diverse makeup of regulated entities.

To the best of our knowledge, current publicly available data does not provide for a specific number of broker-dealers that would meet the definition under S. 3004. We expect that the types of entities who would be eligible for this exemption would be small broker-dealers that operate in a diverse set of communities across the country. Data from the Financial Industry Regulatory Authority (FINRA) demonstrates that the vast majority of registered broker-dealers are considered "small" (less than 150 registered representatives), and we expect that firms that would benefit from S. 3004 would fall into that category.[4] Additionally, the overall

[4] 2018 FINRA Industry Snapshot.

number of broker-dealers in the United States has steadily declined—from 3,969 in 2008 to 3,132 in 2017. Rising regulatory costs may have led to this decline and to increased industry consolidation. We believe S. 3004 would help address some of those concerns.

Q.3. Does the definition in the bill capture brokers or dealers in one or more of the following categories: active high-frequency trading or principal trading firms, sophisticated market-maker firms, private placement brokers, dealers in the to-be-announced (TBA) for mortgage-backed securities market, and alternative trading system routing brokers, in addition to retail customer-facing brokers or dealers?

A.3. The legislation provides the PCAOB need not oversee auditors of privately held, noncustodial brokers in good standing, and that those auditors do not need to abide by PCAOB standards when auditing such brokers. It does not exempt brokers that meet this definition from any or all audits. Because the definition included in S. 3004 does not contemplate certain lines of business that a broker may engage in, publicly available data does not provide a definitive answer as to specific included or excluded lines of business.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SASSE FROM THOMAS QUAADMAN

Q.1. As policymakers how should we strike the right balance between encouraging firms to go public and improving the private capital markets?

A.1. In one of the more troubling recent developments in the IPO market, not only are fewer companies willing to go public, but those that do tend to go public much later in their lifecycle. Instead of young, fast growing companies that need the public markets to grow, many IPOs in recent years have been of relatively large and established companies, and the IPO process is largely a liquidity event for company founders. This has two main effects: 1) It has become clear that the public markets are more inhospitable for small companies than in the past; 2) "Main Street" investors now invest in later stage companies after institutional or accredited investors have earned many of the early stage gains. As a result, households have fewer opportunities to create sustainable wealth over the long term.

We believe there are many actions policymakers can take to help improve the public company model, particularly for smaller companies. Earlier this year the Chamber, along with seven other organizations, released a report with 22 recommendations for how to help more companies go and stay public.[1] We believe that this is a multifaceted regulatory issue that covers overall reporting burdens and costs for public companies, market structure concerns, as well as financial reporting issues that policymakers need to be address.

In terms of private capital markets, the strength and depth of these markets has certainly increased in recent years. Many contributing factors are outside the realm of Congress or the SEC,

[1] *https://www.centerforcapitalmarkets.com/wp-content/uploads/2018/04/IPO-Report__EXPANDING-THE-ON-RAMP.pdf.*

such as low interest rates and the growth of sovereign wealth and private equity funds. These factors—low interest rates in particular—have fueled an M&A boom in the private markets that have made a buyout a more attractive option than going public for many growing companies.

However, we believe that policymakers should not always count on the private markets being this robust. While companies should not go public before they are ready, we believe that many artificial regulatory barriers make staying private a more attractive option. We believe that removing some of these barriers would give companies more financing options, which should be the ultimate goal of policymakers.

Q.2. Are the private capital markets currently high-functioning? If not, where are the biggest potential areas for improvement?

A.2. We believe that the private capital markets are very high functioning for many companies, particularly for those in the midmarket or for larger companies that seek to acquire other businesses. However, we believe policymakers can make several improvements to help small and startup businesses acquire the capital they need to grow. Several such improvements are included in the JOBS and Investor Confidence Act, which recently passed the House of Representatives.

That legislation includes provisions that would clarify some of the general solicitation rules stemming from the 2012 Jumpstart our Business Startups (JOBS) Act, and would expand the definition of an "accredited investor." We believe that these provisions and others would help young, early stage companies raise capital from a broad pool of investors and would ultimately lead to greater economic growth and job creation.

Q.3. I'm concerned about the increasingly uneven geographic distribution of growth. As the Economic Innovation Group has found, economic growth is largely clustered in the most prosperous areas, instead of evenly distributed across areas like the Great Plains and the Midwest. Would increasing access to equity and crowdfunded debt improve the geographic distribution of new firms?

A.3. We agree with your concerns. The Economic Innovation Group's 2016 study[2] found that roughly 50 percent of new business startups in the post-recession period occurred in only 20 counties in the United States. Business formation has largely occurred only in coastal areas, leaving behind broad swaths of the country. Additionally, many post-crisis rules have hindered bank lending, particularly to small businesses. The Federal Reserve's 2016 survey of small businesses found that 60 percent of applicants received less than the amount for which they applied, while 24 percent were unable to obtain any financing at all.[3] New, innovative ideas such as crowdfunding can help businesses raise capital from their communities and from investors around the country.

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[2] *https://eig.org/wp-content/uploads/2016/05/recoverygrowthreport.pdf.*

[3] Federal Reserve Banks, 2016 Small Business Credit Survey: Report on Employer Firms (Apr. 2017), available at *https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf.*

Q.4. When do new and smaller firms tend to rely upon access to equity or crowdfunded debt instead of a traditional bank loan? For example, some have suggested that technology-based firms rely more upon equity while main street companies like restaurants more rely upon bank loans. What are the biggest hurdles new and smaller firms have—regulatorily or otherwise—in accessing equity and crowdfunded debt?

A.4. Companies seeking a high level of growth but that need an infusion of capital to meet customer demands or to invest in production tend to favor equity financing, which is typically significantly more expensive than debt financing. In the securities space, regulatory hurdles make it difficult for businesses to access equity financing. One such hurdle is the limited pool of "accredited" investors who are eligible to invest in certain private offerings.

Current SEC rules deem only those that meet certain asset or net income thresholds as "accredited." Expanding that definition to include those that can demonstrate a certain level of financial sophistication would expand the pool of investors and capital available to growing businesses. Allowing special purpose vehicles (SPVs) to pool investors in a crowdfunding offering (significantly reducing recordkeeping and other costs) is another potential solution. The House-passed JOBS and Investor Confidence Act includes such a solution.

Q.5. Is there currently sufficient clarity about the conditions under which an offering by a small business issuer would qualify as a "transactions by an issuer not involving any public offering" under Section 4(a)(2) of the Securities Act? Are small businesses able to acquire such clarity without paying a meaningful amount in legal fees?

A.5. Attorneys who practice securities law believe there is sufficient clarity on these issues. The seminal case on Section 4(a)(2) is the Supreme Court's 1953 decision in *SEC v. Ralston Purina Co.*[4] In that case, the Court laid out a series of factors that regulators must balance to make the critical inquiry of whether a private offering exists. Numerous subsequent lower court opinions over the past six decades have further fleshed out these criteria.

However, the test is necessarily a subjective one and, unlike a private offering under the SEC's Regulation D, an offering conducted under the statutory exemption in Section 4(a)(2) does not receive the benefit of blue sky (State securities law) preemption under the National Securities Markets Improvements Act of 1996. An issuer relying on Section 4(a)(2) must also find an exemption from registration in each State in which it makes an offering, or qualify the offering with the applicable State securities regulator. This can be an expensive and time-consuming process. For these reasons, most securities lawyers prefer to rely on the Regulation D safe harbor instead of the statutory exemption when conducting a private offering on behalf of an early stage or smaller business.

While securities lawyers understand these parameters fairly well, the criteria are not necessarily intuitive and the average small business owner is not likely to be knowledgeable of their in-

[4] 346 US 119 (1953).

tricacies. It is a daunting task to research the criteria on one's own without the aid of an attorney, particularly as it concerns State securities law requirements. Many of the lower-cost attorneys who focus on smaller businesses are not knowledgeable about securities law, or choose not to practice it due to hefty insurance premiums that errors and omissions (E&O) insurance carriers assess against lawyers who practice securities law. Accordingly, many small business owners are not able to retain low-cost, competent securities counsel.

We understand that the SEC frequently receives inquiries from small business owners seeking to understand the securities laws as they apply to their businesses. Because the SEC cannot provide legal advice to the public, its ability to respond to these inquiries is somewhat limited. However, the SEC has informed us that these inquiries commonly involve small business owners seeking to complete a "friends and family" fundraising for seed or growth capital. Congress could provide relief by expanding the Securities Act of 1933 to exempt offerings for close friends and family members of small business owners, insofar as such offerings do not always meet the criteria of Section 4(a)(2) as the courts or the SEC's Regulation D safe harbor have laid out.

Although we are sensitive to the fact that State securities law preemption is a delicate issue, preempting the registration and qualification provisions of State securities law (but not the antifraud authority of blue sky regulators) would also simplify the offering process for small business owners.

Q.6. Representative Emmer's bill, H.R. 2201, the Micro Offering Safe Harbor Act would "exempt certain micro-offerings from: (1) State regulation of securities offerings, and (2) Federal prohibitions related to interstate solicitation."[5] Such offerings could be worth up to $500,000, have 35 participants, and involve an instance where the "purchaser has a substantive pre-existing relationship with the issuer . . . "[6] How would you evaluate this legislation? If you have concerns with this legislation, how would you ideally address them?

A.6. The Chamber strongly supports this legislation, which would provide a regulatory regime for a tailored and narrow type of securities offering. Attorney, accounting, and other costs for such small offerings can be daunting enough to small businesses that they often refrain from raising the capital they need to expand. We believe that H.R. 2201 properly balances both capital formation and investor protection concerns and we urge Congress to pass it as swiftly as possible.

Q.7.a. How viable is conducting an offering under the SEC's Regulation Crowdfunding, particularly for new and smaller businesses? What about for businesses that are not located in the top five largest cities? What about for smaller offering sizes? If smaller offering sizes tend to be less viable, how large must an offering be to be viable?

Q.7.b. Would there be merit to increasing the offering limit for Regulation Crowdfunding issuers, from $1 million? Why or why not?

[5] *https://www.congress.gov/bill/115th-congress/house-bill/2201.*
[6] *https://www.congress.gov/bill/115th-congress/house-bill/2201.*

If so, what should the limit be? For example, the 2017 SEC Government-Business Forum on Small Business Capital Formation recommended raising the limit to $5 million.

A.7.a.–b. As the SEC's Division of Economic Risk and Analysis reported, as of February 2017, 75 percent of completed crowdfunding offerings have occurred across only four States (CA, TX, MA, and DE).[7] During the period covered in this report (5/16/2016–12/31/2016), there were 163 unique crowdfunding offerings, with a median amount raised of $171,000. These statistics indicate that the total impact of Title III of the JOBS Act remains somewhat muted, given the relatively low number of crowdfunding offerings initiated and amounts raised.

We do believe that the arbitrary cap on the amount that businesses can raise during a 12-month period ($1 million) ultimately serves as a disincentive to commence a crowdfunding offering. In many cases, businesses must seek the advice of outside counsel in order to ensure compliance with all crowdfunding rules and may be required to obtain audited financial statements for an offering over $500,000. Legal and audit costs can be significant, and when compared with the relatively low amount companies are able to raise via crowdfunding, costs associated with an offering can become a disincentive to use Regulation CF.

We believe that increasing the $1 million limit could ultimately make crowdfunding a more attractive means of obtaining financing. We also support changes included in the House-passed JOBS And Investor Confidence Act that would allow special purpose vehicles (SPVs) to pool individuals together to invest in crowdfunding offerings.

We also believe that since the SEC adopted its crowdfunding rules in 2015 and that equity crowdfunding is a new capital formation concept, it will take time for market participants to learn how to use Regulation CF for their benefit. This, coupled with the changes included in the JOBS and Investor Confidence Act and a potential increase in the offering amount allowed, would ultimately help Title III of the JOBS Act reach its full potential.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORTEZ MASTO FROM THOMAS QUAADMAN

S. 2756, Fair Investment Opportunities for Professional Experts Act (Accredited Investor Bill)

Q.1. In recent months, we read about how millionaires like Rupert Murdoch, the Waltons, and the DeVos's each lost a hundred million dollars or more when they invested in Theranos. One of many red flags was the absence of an audited financial statement which one would think a sophisticated investor would demand before shelling over $125 million dollars.

The bill requires the SEC develop a test for financial sophistication for accredited investors who do not meet the income or wealth threshold.

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[7] U.S. securities-based crowdfunding under Title III of the JOBS Act, SEC Division of Economic and Risk Analysis. February 28, 2017, at 18. Covers period from May 16, 2016–December 31, 2016.

Q.1.a. Is a test a reasonable requirement to help investors better protect themselves?

A.1.a. The SEC's current rules for defining an "accredited investor" only allow the SEC to deem individuals accredited based on certain asset and income levels. An accredited individual must have at least $200,000 in annual income ($300,000 for couples), or must have a net worth of $1 million (excluding the value of an individual's primary residence). This definition may be both under- and over-inclusive: It excludes individuals that have income and assets that fall below the thresholds, but who may be financially savvy and fully capable of understanding the risks and awards associated with private placements. However, it could include individuals that may be extremely wealthy but who do not have any understanding of basic financial or investment concepts. Put simply, we do not believe that an individual's financial status presents a complete picture as to their ability to invest wisely and in a manner that will not expose them to serious financial risk.

Furthermore, as former SEC Commissioner Michael Piwowar has noted, allowing a household to invest in both private and public offerings could ultimately have the effect of reducing that household's overall portfolio risk, as long as their assets have a low correlation with one another.[1] We agree with Commissioner Piwowar's sentiments and believe that opening up the private markets to greater investment will ultimately benefit not just issuers but also households that will have more opportunities to create wealth.

We believe that some type of test or other mechanism to determine the investment understanding of an individual—as envisioned by S. 2756—is an appropriate requirement that will help protect investors and ensure that the SEC will only accredit those who are able to demonstrate investment knowledge. It should be noted that the Financial Industry Regulatory Authority (FINRA) administers several exams in order to license professionals to, for example, sell securities or oversee those who do. Individuals that take these exams must be able to demonstrate a strong understanding of financial markets and investment concepts. An exam designed to do the same for individuals looking to invest in private offerings could be an effective means of responsibly expanding the number of accredited investors in the United States.

Q.1.b. If so, what do you think should be in such a test?

A.1.b. S. 2756 envisions that potential accredited investors should be able to demonstrate a "reasonable level of relevant financial expertise" that includes an ability to understand voting rights, economic rights, and disclosure obligations of a private issuer, the basic components of a financial statement, and the investment risk associated with a private investment.

Furthermore, the courts over the years have ascribed a number of factors to help define a "reasonable investor." For example, courts have indicated that reasonable investors should be:

1. Able to complete basic mathematical calculations.

[1] Acting Chairman Michael S. Piwowar, Remarks at the "SEC Speaks" Conference 2017: Remembering the Forgotten Investor. February 24, 2017.

2. Familiar with the basic operation of a securities margin account.
3. Able to understand the time value of money and basic principles of diversification.
4. Aware of what free cash and securities may be used to earn interest
5. Able to read and understand risk factors and other disclosures plainly presented in a prospectus.
6. Able to "grasp the probabilistic significance" of merger negotiations.
7. Generally aware of macroeconomic conditions.[2]

We believe that many of these concepts—in addition to the factors already included in S. 2756—would be appropriate to consider in such a test.

Q.1.c. How should the test ensure that biases do not arise?

A.1.c. We believe that the focus should be on determining one's financial sophistication based upon objective investment topics, whatever entity will develop and administer such a test. The provisions included in S. 2756—coupled with court-articulated factors that define a "reasonable investor" would be an appropriate starting point.

Q.1.d. Do you think the SEC should permit other firms to develop, teach and administer tests? If so, what would be the benefits and concerns of a third-party testing system?

A.1.d. The SEC currently delegates certain examination authority to self-regulatory organizations. For example, FINRA develops and administers dozens of examinations for individuals employed in the securities industry.

A third-party testing system could be a cost-effective and efficient way to administer examinations. Such a third party must be independent and must be able to demonstrate that it has the ability and expertise to administer examinations in a fair and objective manner. Under such an arrangement, the SEC may choose to retain some authority. For example, the SEC could assist with the development of exam questions (and update questions and topics as necessary), then assign the third party to administer the test, record results, and furnish the results to the SEC. We believe that S. 2756 as currently written provides the SEC with sufficient flexibility to determine the best manner in which to utilize third parties.

Q.2. As you know, my State of Nevada is one of the leading States for retiree in-migration. Many of these retirees, and many working Nevada residents, are counting on their pensions from State, teacher or labor union pension funds. Several of these large pension fund managers, including the SEIU which has about 18,000 members in Nevada, have publicly opposed H.R. 4015. They have raised

[2] See, *e.g.,* In re Merck & Co., Inc. Securities Litigation, 432 F.3d 261, 270 (3d Cir. 2005); *Levitin v. PaineWebber, Inc.,* 159 F.3d 698, 702 (2d Cir. 1997); In re *Donald J. Trump Casino Securities Litigation,* 7 F.3d 357, 371–77 (3d Cir. 1993); *Dodds v. Cigna Securities,* Inc., 12 F.3d 346, 351 (2d Cir. 1993); *Flamm v. Eberstadt,* 814 F.2d 1169, 1175 (7th Cir. 1987); *Zerman v. Ball,* 735 F.2d 15, 21 (2d Cir. 1984); *Ash v. LFE Corp.,* 525 F.2d 215, 219 (3d Cir. 1975).

concerns that it will interfere with the independent advice that they rely on from proxy advisors.

Why should the Congress undermine the fiduciary responsibility and interfere with the contractual relationship of proxy advisors to their clients by requiring these proxy advisors to show their data and recommendations to the companies under review, even before their clients get to see them?

A.2. Under existing law and SEC regulation, proxy advisory firms do not owe any underlying fiduciary duty to any party. Institutional Shareholder Services (ISS) claims that its status as a registered investment advisor (RIA) requires it to act as a fiduciary to its investor clients, but not its corporate clients. However, Glass Lewis is not registered in any capacity with the SEC. Put simply, no existing law or regulation requires a proxy advisory firm to owe a fiduciary duty to anyone.

In the context of proxy advice and proxy voting, the actual fiduciary duty lies with institutional investment managers who are required to vote proxies in the best interests of their shareholders. Past SEC actions have effectively allowed investment managers to outsource this responsibility to third parties such as proxy advisory firms. Two no-action letters the SEC issued in 2004 to Egan-Jones and to ISS allowed investment managers to "cleanse" any conflict of interest related to a particular proxy issue by relying on a proxy advisor firm for a vote recommendation. The no-action letters also allowed an investment manager to rely solely on a proxy advisory firm's general policies and procedures pertaining to conflicts of interest, as opposed to any specific conflicts around a specific company or issue.

This has enabled rampant conflicts of interest in the proxy advisory firm industry. For example, ISS runs a consulting business for corporate clients in addition to its voting recommendation business, which is an inherent conflict of interest. An activist Canadian pension plan owns Glass Lewis that has taken positions on proxy issues at U.S. companies.

Since proxy advisory firms have no underlying duty or applicable regulatory regime, they face little or no consequences for poor business practices. Public companies often tell us that they are granted an insufficient amount of time to respond to a draft voting recommendation, even in cases where the recommendation includes factual errors or flaws in methodology. For example, a survey the U.S. Chamber and Nasdaq conducted in 2017 found that a majority of public companies surveyed were only given 1 or 2 days to review and respond to a proxy advisory firm recommendation.[3] Small and mid-size companies usually have no chance to respond to a recommendation from either Glass Lewis or ISS.

This opaque system—which has resulted in multiple errors and mistakes in recommendations—is ultimately harmful to investors as it leads to bad information in the marketplace. We believe that the modest requirement in H.R. 4015 to grant at least 3 days for companies to respond to a recommendation is an entirely reasonable expectation, and there is nothing in the legislation that would

[3] *http://www.centerforcapitalmarkets.com/wp-content/uploads/2017/07/FINAL-CCMC-Survey.docx.pdf?x48633.*

require a proxy advisory firm to incorporate the feedback it received from a company into its recommendation.

Proxy advisory firms also do not have the proper resources to analyze appropriately the tens of thousands of director elections and shareholder proposals they issue reports on. The combination of a lack of resources, faulty reports, failure to fix errors, and conflicts of interest adversely affects the useful information available to investors. This can lead to a faulty decisionmaking process that can generate lower returns for the retirees mentioned in the question, and the entities that help them attain a secure retirement.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM DARLA C. STUCKEY

Q.1. You stated, "[i]f you are talking about Mr. and Mrs. 401(k) as long-term retail shareholders, they are represented by investment managers who largely vote with ISS and Glass Lewis," and "[p]ublic, State, and private pension beneficiaries as well have no individual voice."

Does any pension fund check with their beneficial owners before they vote how they should vote on a particular shareholder proposal, say climate-related?

A.1. I am not aware that this happens. Please see study from Spectrem Group [attached] for further information on pensioners and their views on how their assets are managed.

Q.2. Putting aside proposals related to corporate social responsibility, do investment managers regularly consult individual 401(k) investors, or pension plan participants, on voting decisions relating to the securities held in their funds or plans for corporate actions such as mergers? Please describe any such mechanisms or voting processes and identify the funds or plans that have consulted ultimate beneficial owners on corporate actions or shareholder votes.

A.2. I am not aware that this happens.

Q.3. In what ways to do companies seek out the views of ultimate beneficial owners (*e.g.,* individual 401(k) investors or pension plan participants) on corporate actions or shareholder votes? Please provide relevant examples, if any.

A.3. Companies know their own 401(k) beneficiaries and communicate with them generally as employees or former employees. I am not aware that they seek out the views of those individuals on shareholder votes. However, they do have a fiduciary duty to vote in accordance with what they think is best for all shareholders including 401(k) plan beneficiaries. With respect to companies seeking out the views of the beneficial owners of their stock held in other company-sponsored 401(k) plans or pensions, those individuals are not known to the company because typically shares are held through indexes or mutual funds whose managers vote the shares.

EX. If I own a Mutual Fund "A" large cap growth fund in my personal Society 401(k) which owns Google stock, Google would never know me or be able to solicit my input on voting. Rather, the Mutual Fund A would vote those Google shares.

Q.4. Your testimony discussed a transportation company's interaction with ISS over a recommendation on a say-on-pay vote.

Q.4.a. Generally, what is the result of a failed say-on-pay vote? What were the consequences for the company you mentioned? Did the company benefit from its shareholder outreach?

Q.4.b. Would the representatives of that company be willing to provide the Banking Committee detailed information regarding the error and the facts of its case?

A.4.a.–b. A shareholder vote on executive compensation is required by section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which added section 14A to the Securities Exchange Act of 1934. Pursuant to section 14A(c), the shareholder vote is not binding on the issuer or the board of directors. Nonetheless, the reputational effects of a failed vote on executive compensation can be significant. As described in my testimony, the effect on this company primarily related to potential implications for shareholder approval of board members and damage to the company's shareholder relations, which required extensive outreach efforts. Although the shareholder outreach was beneficial, ISS's factual error forced the company to devote efforts to informing shareholders of ISS's error, which risked crowding out other important corporate matters.

The company provided the example to the Society for Corporate Governance on the condition that the company not be identified. My written testimony contains additional detailed information regarding the error and the facts of this case.

SpectremGroup
Voice of the Investor

TENSIONS WITH PENSIONS:

An Analysis of Public Pension Fund Members' Knowledge and Sentiment about How Their Money Is Being Invested.

ABOUT THE AUTHOR

Spectrem Group

Spectrem Group is the leading provider of market research, consulting and content in the wealth management and retirement markets. Spectrem Group strategically analyzes its ongoing primary research with investors to assist financial providers and advisors in understanding the Voice of the Investor.

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EXECUTIVE SUMMARY

The public pension systems in the United States provide retirement security for teachers, firefighters, police officers and other public servants. For decades, fund managers, working with investment professionals and actuaries, have administered these funds. The goal for the pension fund is to meet or exceed the desired investment results required to fulfill the funding obligations calculated by the actuaries. This is a complex task in which numerous boards, investment professionals, actuaries and administrators seek to work together to achieve the goals of the pension. Pensions are big in terms of dollars and important because of the number of individuals covered by these funds.

Despite record stock market results in the past few years, many U.S. public pension funds today remain underfunded.[1] Pension funds have addressed the decline in returns by increased allocation of assets into hedge funds and private equity – known as alternative investments. At the same time, pension funds have become increasingly active in allocating resources to social and/or political causes.[2]

Spectrem Group decided to explore pension fund members' awareness of the underfunded status of their pension funds and determine if they were worried about not receiving anticipated pension payments. Spectrem sought to find out if pension members were aware of the amount of political and/or social investments within the fund as well as the level of alternative investments. Two of the pension funds that have taken significant initiative in political and/or social causes are the California Public Employee's Retirement System (CalPERS)[3] and the New York City Retirement Systems (NYC Funds)[4]. The NYC Funds reflects five funds which include: New York City Employees' Retirement System (NYCERS), Teachers' Retirement System (TRS), Police Pension Fund, Fire Department Pension Fund and the Board of Education Retirement System (BERS). (See Appendix A for breakdown).

Spectrem determined that surveying members of NYC Funds and CalPERS and comparing their opinions to a nationwide sample of other public pension fund members would provide a benchmark regarding these issues for pension funds nationwide.

Our study builds a pensioner viewpoint on the critical issues facing these institutions and measures:

- Awareness of funded status and core pension fundamentals
- Amount of concern regarding ability to collect full benefits
- Preference on current investment trends
- Sentiment of pension activities (shareholder voting and disclosure)
- Goals and objectives for fund managers

Key Findings include the following:

- Pension members plan to rely upon their pension for at least 50% of their retirement income.
- Pension members are largely unaware of recent pension fund investment results and are overly confident in and satisfied with recent results. In fact, 80% of NYC Funds and 63% of CalPERS members believe their pensions are fully funded, even though both funds are underfunded.
- Once informed of the actual level of underfunding with their fund, pension members showed high levels of concern about their ability to collect future benefits.
- Fund managers should focus on returns and managing the pension back to a fully funded status. Focusing on maximizing returns and returning the fund to 100% funded status was

[1] https://www.cnbc.com/2017/10/18/state-pension-funds-continue-to-fall-behind-heres-how-much-you-owe.html
[2] https://www.forbes.com/sites/jeffreydorfman/2014/09/11/public-pensions-are-still-marching-to-their-death/#660bbb8236ab
[3] https://www.city-journal.org/html/pension-fund-ate-california-13528.html
[4] http://www.reason.com/blog/2017/06/21/new-york-city-pension-crisis-report

supported by 78% of the National pension members, 74% of CalPERS members and 66% of NYC Funds pension members. Only a small percentage supported investing in projects that supported political and/or social causes.

Other Findings include the following:

- Most pension members consider themselves to be fairly knowledgeable about investing and their pension program details, but in reality, their knowledge level falls short. Most cannot identify if their pension is fully funded, the recent returns of the fund, or the current investment direction of the fund.

- Many pension fund members are concerned that the fund may spend too much time on shareholder voting issues. Regardless of the amount of time and resources a pension fund decides to allocate to shareholder proposal voting, providing a clear rationale for the vote to members is critical. Pension members are very interested in justification for voting behavior, especially young members.

- Respondents underestimate the amount of alternative investments in their fund, and upon learning the actual amount desired less. Similarly, upon learning of recent underperformance of alternative energy assets in the fund, many pensioners expressed a desire for less investment in this sector.

SURVEY METHODOLOGY

The survey was conducted online from November 8, 2017 to November 26, 2017. As previously noted, pension members from CalPERS and NYC Funds were compared against a sample identified as the "National" segment. The National segment included individuals from the New York State Common Retirement Fund, the Florida Retirement System, Missouri State Employees' Retirement System, and the Teacher Retirement System of Texas. A small number of respondents were from other public pension plans not identified above.

In total, there were responses from 807 CalPERS members, 771 NYC Funds respondents and 1,687 National members.

ATTITUDES REGARDING PENSION FUNDS

Most pension members will be relying upon their pension income during retirement to some extent. When asked what percentage of their existing or anticipated retirement income did their pension represent, most pension members indicated that their pension income is or will represent about half of their retirement income. Not surprisingly, retired members were generally more likely to indicate that the pension represents a higher percentage of their retirement income compared to active members (see Appendix A chart C).

Retirement Income from Pension Benefits

National	CalPERS	NYC Funds
49%	50%	46%

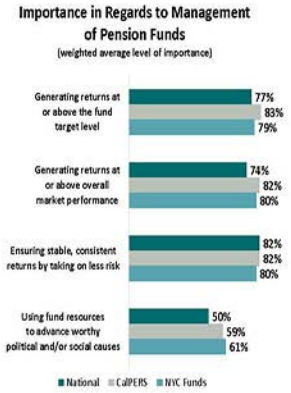
Younger pension members probably anticipate supplementing their retirement income with additional savings. And since retirement may be perceived as being too far in the future to worry about, their attitudes regarding how the pension fund is managed and for what objectives may be colored by their distance from retirement.

Pension members were generally satisfied with how their pension assets were being managed. More than three-quarters of the National group were satisfied. CalPERS members were slightly more satisfied than the National group and the NYC Funds pension members were the most satisfied with how their pension assets were being managed.

Satisfaction with Management of Pension Assets			
	National	CalPERS	NYC Funds
Extremely satisfied	39%	43%	48%
Moderately satisfied	35%	35%	35%
Slightly satisfied	10%	10%	9%
Neither satisfied nor dissatisfied	12%	10%	7%

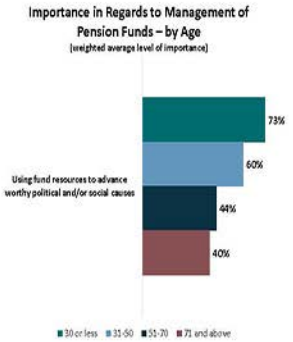
As age increased, satisfaction levels with how the assets are being managed increased as well (See Appendix A chart D). This is interesting to note because the NYC Funds members, who are generally younger, were also the most satisfied.

When asked what they felt was most important in regards to management of their pension funds, investment-related factors were identified as being most important by pension members from all of the groups. For members of the National group, stable and consistent returns generated by taking on less risk was the most important factor. CalPERS members rated generating returns at or above the fund target level as most important followed closely by generating returns at or above overall market performance. Ensuring stable and consistent returns by taking on less risk was also



valued highly by the CalPERS participants. Similarly, NYC Funds members identified stable, consistent returns at or above the overall market performance as the most important, followed immediately by returns above the fund target level. Using fund resources to advance worthy political and/or social causes, while not the most important factor, was still important to 61% of the pension members. The NYC Funds members rated this factor higher than the other two groups. CalPERS followed closely behind while the National group rated this item lower than the other two groups.

Younger pension members, however, were much more interested in using fund resources to advance worthy political and/or social causes than



older pension members.

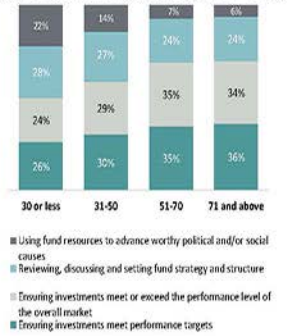
Pension members were asked how fund mangers should allocate their time and attention regarding their pension fund assets. Respondents were given a scale of 0 to 100 and asked to break up the time allocations to equal 100. As you can see, pension members felt that roughly equal amounts of time should be allocated to ensuring investments meet performance targets and ensuring investments meet or exceed the performance level of the overall market. Roughly a quarter of the pension fund managers' time should be dedicated to the overall fund strategy and structure. Pension members felt that only a small percentage of time should be dedicated to using fund resources to advance worthy political and/or social causes. This number varied by segment with the NYC Funds members being more supportive of fund managers spending time

and effort on worthy political and/or social causes than both CalPERS members and National members.

Time Fund Managers Should Allocate to the Following Objectives			
	National	CalPERS	NYC Funds
Ensuring investments meet performance targets	33%	31%	30%
Ensuring investments meet or exceed the performance level of the overall market	32%	31%	27%
Reviewing, discussing and setting fund strategy and structure	25%	26%	26%
Using fund resources to advance worthy political and/or social causes	9%	13%	16%

Similar to the findings above, younger pension members expressed greater support for fund managers dedicating more time to using the fund

Time and Attention That Should be Allocated to Each Pension Fund Manager Objective – by Age



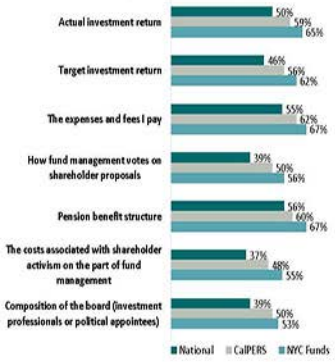
resources to advance worthy political and/or social causes.

Overall, pension fund members strongly believe that fund managers should focus on investment performance. Most expect them to generate returns that not only meet but exceed their targets. They also want them to generate stable, consistent returns and avoid risk. At the same time, however, slightly more than half are open to the pension investing in political and/or social causes. They do not want their fund managers to spend a lot of time, however, on the political and/or social causes. Younger pension members, who have a longer investment time horizon, are more supportive of political and/or social investments, but still rate investment-related factors as more important.

KNOWLEDGE AND AWARENESS

Pension members claim to be well informed about many of the details of their pension plan, especially those details that tend to be investment related. More than half of National members, 59% of CalPERS members and 65% of NYC Funds members indicate they are well informed about the actual investment return of the fund and just slightly lower percentages claim knowledge of the target investment return. An even higher percentage of pension members claim to be informed about expenses and fees they pay with 56% of National members claiming to know this information, 62% of CalPERS members being informed, and 67% of NYC Funds members indicating they are informed. Similarly, more than

Informed Level of Pension Program Details
(weighted average informed level)



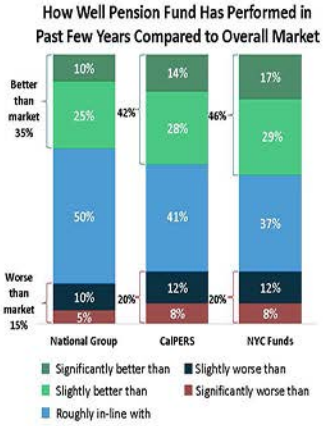
half of pension members are informed about the pension benefit structure (56% vs. 60% vs. 67%). Pension members are less informed, however, on details regarding shareholder voting, the composition of the board, and the costs of shareholder activism. Overall, more than half of the NYC Funds members indicated they were informed about the composition of the board (53%), how fund management votes on shareholder activism (55%), and the costs associated with shareholder activism on the part of fund management (55%). Roughly half of CalPERS members claim to be informed about these issues with 50% indicating they are informed about the composition of the board, 50% also feel informed about how the fund management votes on shareholder proposals and 48% indicate they are aware of the costs associated with shareholder activism. National pension members, however, were less informed about these issues. Only 39% are informed about the composition of the board, 40% are informed about how the fund management votes on shareholder proposals and only 38% believe they are informed about the costs associated with shareholder activism.

Pension members generally feel knowledgeable or very knowledgeable about investments. Fifty-eight percent of the National group claims to be very or fairly knowledgeable about investments. Sixty-one percent of CalPERS members feel similarly. Seventy-one percent of NYC Funds members indicate they are very or fairly knowledgeable about investments.

Investment Knowledge			
	National	CalPERS	NYC Funds
Very knowledgeable about financial products/ investments	16%	22%	28%
Fairly knowledgeable	41%	39%	43%
Not very knowledgeable, but do know some things	34%	30%	24%
Not at all knowledgeable	10%	8%	5%

After being asked about their overall investment knowledge and how well-informed they felt about their pension fund, pension members were specifically asked how they felt that their pension fund has performed over the past couple years compared to the overall market.

While the largest percentages of pension members felt that their fund performed roughly in-line with the market (50%, 41%, and 37%, respectively), almost half of NYC Funds members



(46%) believed their fund performed slightly better or significantly better than the market. CalPERS members also were optimistic with 42% feeling their fund had beat the market. Only 35% of the National group felt their fund had outperformed the market.

In reality, CalPERS and NYC Funds both had returns below that of the overall benchmarks, as did most of the National pensions identified (See Appendix A chart E). It is interesting to note that 43% of pension members that claimed to be most knowledgeable were more likely to indicate their fund had outperformed the overall market. Similarly, 63% of those who indicated they were well informed also believed that their fund performed better than the market.

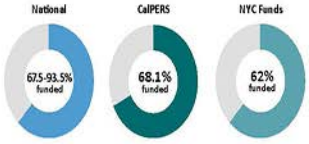
Some pension funds are fully funded, meaning they have enough money on hand today to cover future obligations. Others are underfunded, which means a gap exists between what's in their accounts today and what they'll need to pay out in the future. Pension members were asked to identify whether or not they believed their pension fund was fully funded.

Believe Pension is Fully (100%) Funded

NYC Funds pension members were the most likely to indicate that their pension is fully funded (80%) while the CalPERS members were the least likely to indicate that their pension was fully funded (63%). Sixty-six percent of National members indicated that they believe their pension fund is fully funded.

In reality, none of these pensions are fully funded. Based upon annual reports, CalPERS is funded at 68.1% and NYC Funds is funded at 62%. The other pension funds included in the National group range from funding levels of 67.5% to 93.5% (See Appendix A chart F).

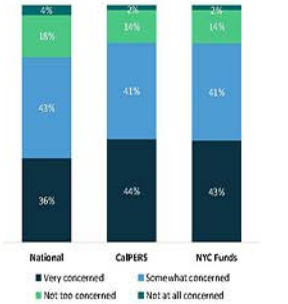
Actual Funded Level of Pensions



Pension members that indicated that they believed their government pension fund was underfunded were asked what funding level was maintained by their pension fund. The average results were fairly close to the actual funding levels.

For those who believe their pension is underfunded, their level of concern about whether it may have an impact on their ability to collect in the future is relatively high. For National pension members, their level of concern is 70% while CalPERS and NYC Funds members both expressed a higher average level of concern (76%). Previously, many pension members identified themselves as moderately well-informed about the actual investment returns and target investment returns of their fund. Upon further questioning, however, many pensioners' beliefs about fund performance were more optimistic than the actual performance of the fund. Similarly, when pension members were questioned regarding the funding levels of their pension funds, the largest numbers of pensioners indicated that their pension fund was fully funded, despite the fact that none of the funds are fully funded. For those who understood that their pension was underfunded, they expressed concern regarding their own ability to collect their pension in the future.

Concern Over the Impact an Underfunded Pension Fund Will Have on Ability to Collect From it in Future



Unlike funding and investment performance issues, pension members admitted they were not as well informed about issues such as the composition of the board, how fund management votes on shareholder proposals as well as the costs associated with shareholder activism on the part of fund management.

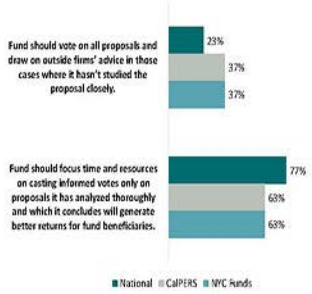
PROPOSAL VOTING

Each year, investors of all types receive shareholder proposals asking them to vote on specific issues. Pensions and other large institutional shareholders tend to cast votes on

almost every single shareholder proposal that's offered, which often number in the thousands. Some say pension funds should exercise their right to vote on all proposals, while others say they should only cast votes on proposals they have studied closely, abstaining on the rest. Spectrem asked pension members how they felt pension fund managers should handle shareholder voting.

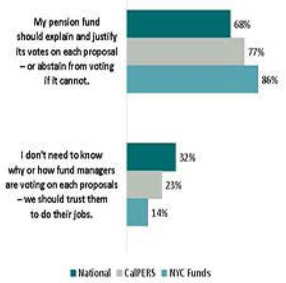
National pension members were the most likely to indicate that their pension fund should focus its time and resources on casting informed votes only on proposals it has analyzed thoroughly and which it concludes will generate better returns for fund beneficiaries. Sixty-three percent of both CalPERS and NYC Funds pension members felt similarly.

Shareholder Proposal Voting Preference



It's important to note that more than a third of both CalPERS and NYC Funds pension fund members felt that their pension fund should vote on all proposals and draw on outside firms' advice in those cases where it hasn't studied the proposal closely. Younger pension members from all three groups were more likely to feel that their pension fund should vote on all proposals. (See Appendix A chart G). Analyzing the results by age shows that pension members age 30 or less were more supportive of their fund voting on all proposals: 31% of young National members, 49% of young CalPERS members and 42% of young NYC Funds members. Overall, as age increased the support for pension funds to vote on all proposals decreased.

Stance on Pension Fund Voting Rationale



As indicated previously, pension funds and other large institutional investors cast votes on thousands of shareholder proposals each year, the vast majority of which have very little to do with improving the financial performance of the targeted company. Significant costs are incurred by the fund as part of the process of voting on all these proposals, even though few earn majority support. Pension fund members were asked if the pension fund managers should be required to explain to fund beneficiaries the rationale behind the fund's decision to vote on each individual proposal.

Pension fund members were interested in receiving an explanation and justification of votes on each shareholder proposal and indicated that the pension fund should abstain if it cannot provide the explanation. NYC Funds pension members were the most supportive of this concept (86%) followed by CalPERS pension members (77%) and then National members at 69%. Almost a third of National pension members felt that they didn't need to know why or how fund managers were voting – that they should be trusted.

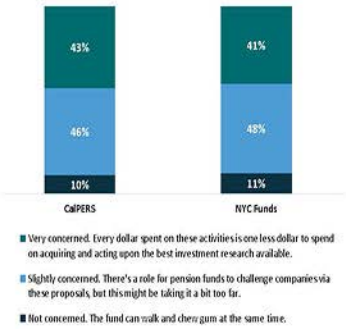
Once again, there were age-related differences of opinion regarding these results. Ninety-one percent of pension members age 30 and under want their pension fund to explain and justify its votes or to abstain from voting if it cannot. Once again, the level of support for this concept decreases with age (See Appendix A chart H).

Some say that the pensions' activities in this area divert time and resources away from more important priorities. Others say it's perfectly appropriate for the pension to vote all its shares on all matters. CalPERS and NYC Funds pension members were asked if they were concerned about the amount of time and resources spent on these activities.

The largest percentages of pension members in each group were slightly concerned that their pension funds might be taking this a bit too far. More than four in 10 members of each pension fund were very concerned that the dollars spent on these activities was a dollar less for the fund to spend on acquiring and acting on the best investment research available. One in 10 pension members felt that the fund can walk and chew gum at the same time.

Pension members generally feel that the pension fund should focus its time and resources on casting informed votes only on proposals that have been thoroughly analyzed and which will create better results for pension beneficiaries. But one in three of the pension members from CalPERS and NYC Funds funds, especially younger members, support the fund voting on all shareholder proposals while relying upon the expertise and advice of outsiders. Additionally, most pension members believe that the pension fund should explain and justify its votes on each proposal or abstain from voting. This belief increases as age decreases. Responding to these

Concern Over Possibility Pension's Focus May be on the Wrong Thing



shareholder initiatives requires a significant amount of fund managers' time and expense. The largest percentage of pension members are slightly concerned about the resources required for shareholder voting but 4 in 10 are very concerned that the dollars spent on these activities may lessen the ability for the fund to acquire and act on the best research available.

CALL TO ACTION

Pension fund members had several messages for fund managers, especially once they learned their pension was underfunded.

Focus on Returns

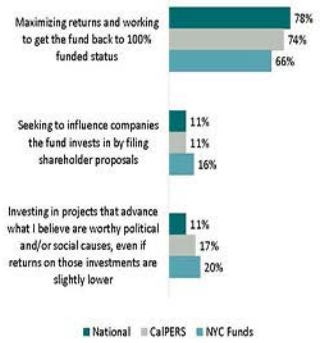
Pension fund members were asked to identify the single most important thing that investment managers should be focused on in terms of managing their pension fund. The largest percentages indicated maximizing returns is most important.

Seventy-eight percent of National pension members were focused on returns along with 74% of CalPERS pension members. NYC Funds members were less likely to choose maximizing return with only 66% indicating this was the most important. Twenty percent of NYC Funds pension members believe in investing in projects that they believe to be worthy political and/or social causes even if the returns are lower. Sixteen percent of the NYC Funds members indicated that seeking to influence companies the fund invests in by filing shareholder proposals was most important.

Once again, age has an impact on responses. Thirty percent of investors age 30 and under were more likely to choose investing in projects that advance their beliefs. Interest in investing in worthy political and/or social causes decreased as age increased. Not surprisingly, older individuals were more likely to choose maximizing return as the most important. The percentage of investors choosing returns as most important increased commiserate with age (See Appendix A chart I).

Those pension members who indicated that maximizing return was most important were

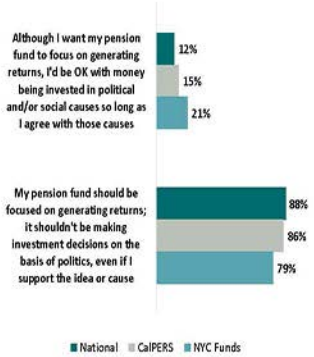
Most Important Item Investment Managers Should Focus on When Managing Pension Fund



asked if it would be OK for the fund to invest in political and/or social causes that he or she supported or if the pension fund should only be focused on generating return, even if the pension member supported the cause. The largest percentages of these return-focused individuals felt that the fund should be focused on generating returns, even if the pension member supported a specific cause. While pension members from CalPERS and the National segment responded similarly, 21% of the NYC Funds pension members were open to the concept of the fund investing in political or social causes he or she might support.

Again, there were strong responses to this question based upon age. Ninety-one percent of pension members age 51 and older believe investment managers should focus on returns and not politics, even if the pension member supports the cause. In contrast, 34% of pension members age 30 and under might support investing in political and/or social causes so long as they agree with the causes (See Appendix A chart J). Similarly, pension members who indicated that their pension fund should focus on investing in worthy political and/or social causes or seeking to influence companies the fund invests in through shareholder votes were asked how important investment returns should be for the fund (See Appendix A chart K). More than half of the 23% of National pension members who chose political and/or social issues over return indicated that return was somewhat important. Fifty-three percent of those individuals indicated that the fund shouldn't invest in things it believes will perform poorly but that performance should not be the only consideration when investing in worthy political and/or social causes. Just over a third of this sub-segment of the National group support the fund investing in political and/or social causes but only if those investments perform in-line with the market or better. CalPERS pension members who chose political and/or social causes as more important than returns (28%) were even more likely than the National members to indicate that return is very important. Similarly, almost half of the NYC Funds sub-

Statement That Best Aligns With Personal Views on Pension Fund Focus
(asked of return-focused individuals)



group that supports political and/or social causes over return (36%) believe that return is still very important.

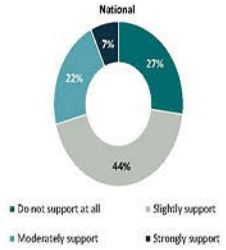
Importance of Return (Asked of Influence/Political-Focused Individuals)			
	National	CalPERS	NYC Funds
Not important. If the fund decides to invest in what I believe are worthy political/social causes, it should do so without worrying about the performance.	13%	9%	10%
Somewhat important. Fund shouldn't invest in things it knows will perform poorly, but it shouldn't allow performance to be the only consideration in investing in what I believe are worthy political/social causes.	51%	45%	47%
Very important. I support using the fund to advance what I believe are worthy political/social causes, but only if those investments perform in line with the market, or better.	36%	50%	46%

Pension members generally want their fund managers to focus on investment returns over political and/or social causes. In fact, of those focused on returns, 86% of CalPERS members and 79% within NYC Funds indicated their pension fund should be focused on generating returns and shouldn't be making investment decisions on the basis of politics even if they support the idea or cause. Many of those pension members who believe focusing on return is most important are older pension members. Pension members who support investment in political and/or social investments, or influencing corporations through shareholder votes, still feel that return is somewhat or very important. While many believe that the political and/or social investment should perform in-line with the market or better, others feel that the fund should not invest in things that they know will perform poorly, but performance should not be the only consideration. NYC Funds' pension members are more likely to be supportive of political and/or social investments than others.

Reduce Alternative Investments

National pension members were informed that, according to Reuters, returns generated by private pension funds were three times higher than public pension fund returns over the last year, and public pensions have underperformed the S&P index for several years in a row. Some of these public pension funds have sought to "catch up" on performance by pursuing "alternative investments," which can out-perform the market, but typically carry more risk and higher fees. National pension fund members were asked if they supported having alternative investments as part of their pension fund.

Level of Support Regarding Alternative Investments Within Public Pension Fund



These pension members indicated that they slightly or moderately supported having alternative investments in their fund.

Both the NYC Funds pension fund and the CalPERS fund hold alternative investments. Pension members from these funds were specifically asked about how much of their fund was invested in alternative investments as well as whether their fund had the appropriate level of investment in alternatives.

It was explained to the pension members that some pension funds have tried to offset poor investment performance by increasing their exposure to alternative investments. These investments do have the potential to outperform the market, but often carry greater risk and higher fees. When CalPERS and NYC Funds pension members were asked what percentage of the pension fund they believed was invested in

alternative investments, the average answer was approximately 6%.

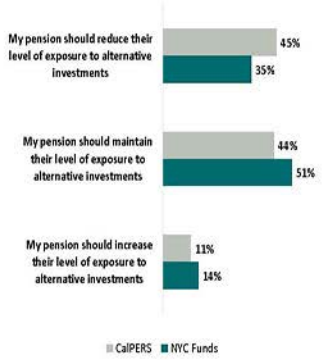
Actually, 20% of the CalPERS fund is invested in alternatives and 12% of the NYC Funds fund is invested in alternatives.

Estimated % of Fund Invested in Alternatives		
	CalPERS	NYC Funds
0%	1%	2%
0% to 2.5%	8%	8%
2.5% to 5.0%	26%	27%
5.0% to 7.5%	32%	32%
7.5% to 10%	19%	18%
More than 10%	14%	13%

Pension fund members were then informed about the amount of alternative investments in their fund and asked their opinion about maintaining, reducing or increasing the alternative investments in their fund. Pension members were told that some say these investments (alternatives) are worth the risk, especially if they can help the fund generate higher returns than those of the overall market. Others say that pension funds aren't hedge funds and because of whom their beneficiaries are, pension plans should be looking to reduce risk, not add to it.

The net difference indicates that pension members in both CalPERS and NYC Funds funds generally support reduction of the fund's exposure to alternative investments. Age also influences pension members' attitudes regarding the fund's exposure to alternative investment. The net difference for pension members age 30 or less to reduce investment in alternatives is 2% compared to 35% for pension members age 71 and above. Overall, the percentages increased in relationship to age. (See Appendix A chart L).

Position Regarding Pension's Exposure to Alternative Investments



Pension members are slightly or moderately supportive of having alternative investments in their pension fund. CalPERS and NYC Funds members were asked the level of alternative investments in their fund, and estimated the percentage to be lower than the actual amount. Overall, pension members lean towards reducing the amount of the pension funds invested in alternative investments. Younger pension members are more supportive of alternative investments than older pension members.

CALPERS	VS.	NYC Funds
95% believe generating returns at or above the fund target level is important.		95% believe generating returns at or above the fund target level is important.
59% believe political and/or social causes are important.		61% believe political and/or social causes are important.
13% of fund managers' time and resources should be allocated to worthy political and/or social causes.		28% indicated they are very knowledgeable about financial products and investments.
22% indicated they are very knowledgeable about financial products and investments.		16% of fund managers' time and resources should be allocated to worthy political and/or social causes.
42% believe their fund has performed better than or significantly better than the market.		46% believe their fund has performed better than or significantly better than the market.
63% believe their pension is fully funded.		80% believe their pension is fully funded.
44% are "very concerned" about their ability to collect benefits in the future.		43% are "very concerned" about their ability to collect benefits in the future.
63% believe pension should focus its time and resources on casting informed votes only on those proposals it has analyzed thoroughly and which it concludes will benefit the fund's beneficiaries.		63% believe pension should focus its time and resources on casting informed votes only on those proposals it has analyzed thoroughly and which it concludes will benefit the fund's beneficiaries.
77% believe fund should provide explanation and justification for shareholder votes - or fund should abstain from voting.		86% believe fund should provide explanation and justification for shareholder votes - or fund should abstain from voting.
74% believe the single most important thing is maximizing returns and working to get the fund back to 100-percent funded status.		66% believe the single most important thing is maximizing returns and working to get the fund back to 100-percent funded status.
45% pension members support reduction of alternative investments. Younger members more likely to support increasing investment in these asset classes.		35% pension members support reduction of alternative investments. Younger members more likely to support increasing investment in these asset classes.

IMPLICATIONS

- **Pension members are satisfied with how their pensions are being managed but, despite claiming they are well informed, most do not understand that their funds are underfunded and are not meeting target levels of investment performance.** Therefore, pension members need more information, communication and education.

- **Maximizing returns and achieving funding levels are the most important objectives as defined by pension members.** Members believe pension fund managers should be spending most of their time on performance related objectives and only a small amount of time using fund resources to advance political causes.

- **Using the fund resources to advance worthy political and/or social causes was only important to roughly half of pension members, especially younger members.** Yet, even those individuals who felt the fund should advance these political and/or social causes wanted investment performance to be in line with the market.

- **Pension fund managers should focus their voting efforts primarily on issues that will directly affect and benefit the fund rather than voting on every issue.** Pension members want to be informed about these votes and the justification for each vote. This may require a significant amount of resources and is in contrast to concerns members have that too much time is spent on these issues.

- **Pension members were unaware of the amount of alternative investments in their funds.** They generally want these assets reduced.

- **Overall younger pension members seek more aggressive investments.** This corresponds to their retirement time horizon.

- **Younger pension members are more supportive of political and/or social causes and therefore more supportive of their funds being involved in these issues.** This corresponds to other Spectrem research regarding social investing.

APPENDIX A (SUPPORTING RESEARCH RESPONSES)

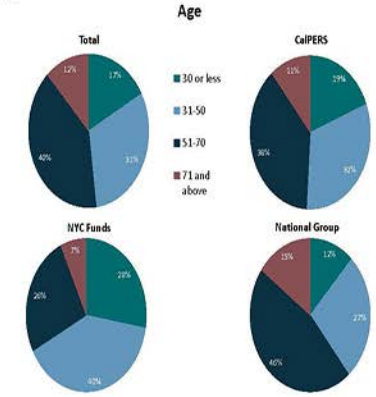
Background of CalPERS and NYC Funds

CalPERS has a total membership of over 1.9 million members: 1.257 million active and inactive, and 668,000 benefit recipients. In the most recent year for which returns are available, CalPERS had an 11.2 percent time-weighted rate of return. The 12-month returns were led by the public equity investments, which generated a 19.6 percent return. Private equity also delivered double-digit net returns at 13.9 percent, followed by real assets, with net returns of 7.4 percent.[5]

The New York City Retirement Systems has 733,109 total members. The total return for the 5 pension funds included in the Systems over the past 12 months ending on December 11, 2017 ranged from 12.9 percent to 15.2 percent.[6] The breakdown of the funds' membership is as follows:

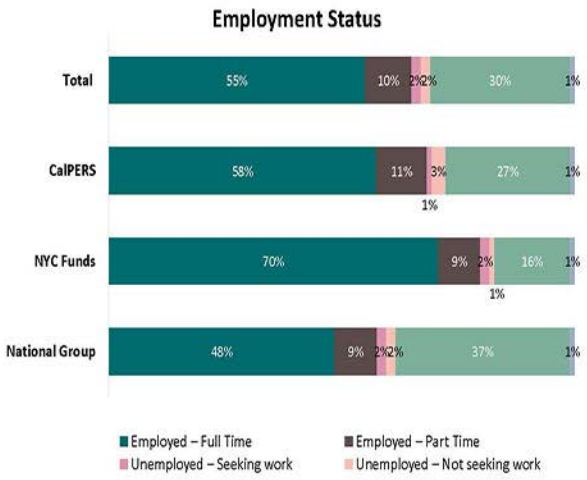
	Active Members	Pensioners, beneficiaries, others	TOTAL members
NYCERS	185,758	170,835	356,593
TRS	114,652	103,606	218,258
Police	34,435	50,733	85,168
Fire	10,780	16,760	27,540
BERS	24,903	20,647	45,550
Total	370,528	362,581	733,109

A.

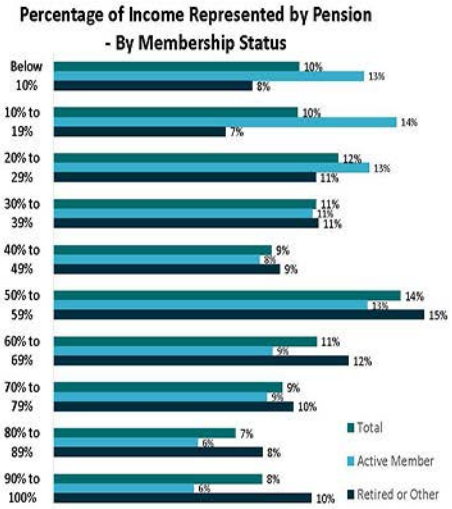


[5] CalPERS, 2016-2017 Comprehensive Annual Financial Report, (2017), https://www.calpers.ca.gov/docs/forms-publications/cafr-2017.pdf (page 98)
[6] New York City Retirement Systems Common Investment Meeting (CIM), December 11, 2017, https://comptroller.nyc.gov/wp-content/uploads/2017/12/CIM_Presentation-Slides_PUBLIC-SESSION_website_presented-on-121117.pdf (Page 12)

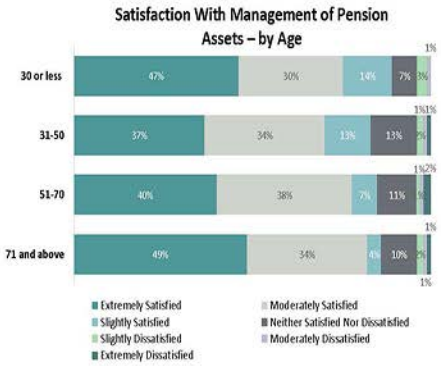
B.


Employment Status
Total
55%
10%
2%
2%
30%
1%
CalPERS
58%
11%
3%
1%
27%
1%
NYC Funds
70%
9%
2%
1%
16%
1%
National Group
48%
9%
2%
2%
37%
1%
Employed – Full Time
Employed – Part Time
Unemployed – Seeking work
Unemployed – Not seeking work

C.


Percentage of Income Represented by Pension
- By Membership Status
Below 10%
10%
13%
8%
10% to 19%
10%
14%
7%
20% to 29%
12%
13%
11%
30% to 39%
11%
11%
11%
40% to 49%
9%
8%
9%
50% to 59%
14%
13%
15%
60% to 69%
11%
9%
12%
70% to 79%
9%
9%
10%
80% to 89%
7%
6%
8%
90% to 100%
8%
6%
10%
Total
Active Member
Retired or Other

D.



E.

Investment Performance of Funds

Over the last year, the CalSTRS Investment Portfolio produced an absolute return of 1.4 percent, trailing the policy benchmark by 60 basis points. Relative outperformance by the Global Equity class aided relative performance, whereas relative underperformance by the Private Markets and Fixed Income classes detracted from relative performance.[1]

The NYC Fund's investment performance for the fiscal year ended March 31, 2017 was 11.48 percent gross of certain investment fees.[2]

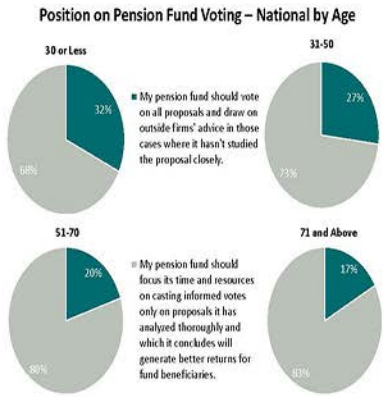
[1] CalSTRS, **2016-17 Comprehensive Annual Financial Report**, (2017), https://www.calpers.ca.gov/docs/forms-publications/cafr-2017.pdf (page 98)

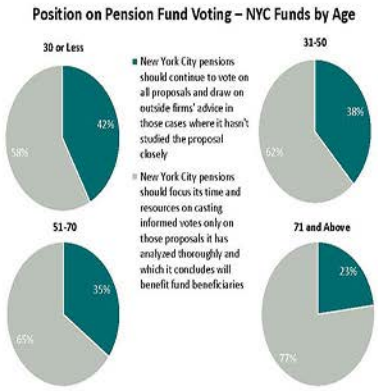
[2] New York City Retirement Systems Common Investment Meeting (CIM), December 11, 2017, https://comptroller.nyc.gov/wp-content/uploads/2017/12/CIM_Presentation-Slides_PUBLIC-SESSION_website_presented-on-121117.pdf (Page 12)

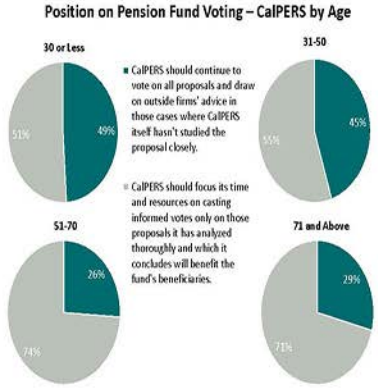
F.

National Pension Funding Levels			
Fund Name	**Level of Funding**	**Source**	**Date of Data**
The Florida Retirement System	84.9%	Florida Retirement System Pension Plan GASB 67	June 30, 2016
TRS Pension Fund (Texas)	79.7%	2016 Comprehensive Annual Financial Report	August 31, 2016
MSEP (Missouri)	67.5%	Missouri State Employees' Retirement System Comprehesive Annual Financial Report	June 30, 2017
New York State Common Retirement Fund	93.5%	2017 Comprehensive Annual Financial Report	March 31, 2017
California State Teachers' Retirement Fund	69%	2016 Comprehensive Annual Financial Report	June 30, 2016

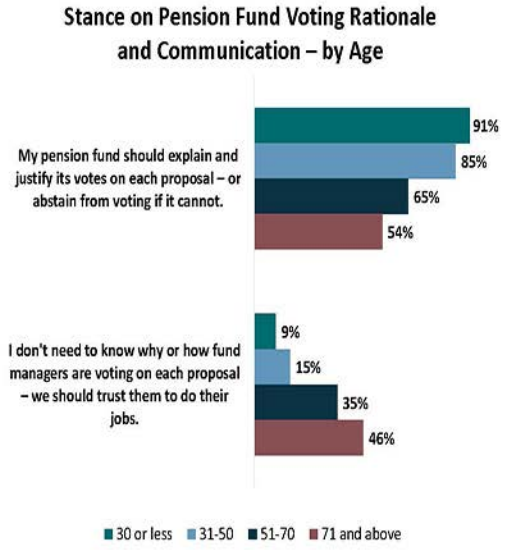
G.


Position on Pension Fund Voting – National by Age
30 or Less
32%
68%
31-50
27%
73%
My pension fund should vote on all proposals and draw on outside firms' advice in those cases where it hasn't studied the proposal closely.
51-70
20%
80%
71 and Above
17%
83%
My pension fund should focus its time and resources on casting informed votes only on proposals it has analyzed thoroughly and which it concludes will generate better returns for fund beneficiaries.

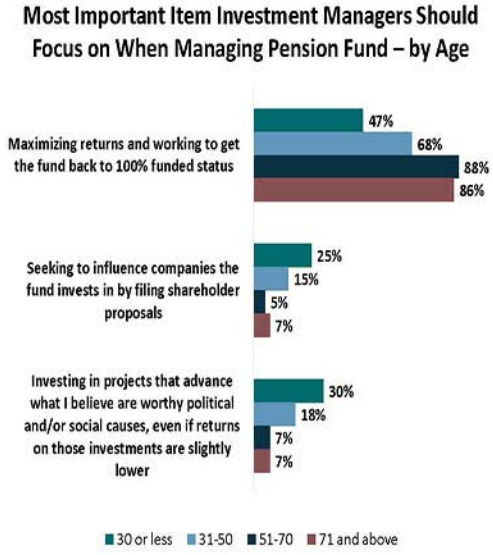

Position on Pension Fund Voting – NYC Funds by Age
30 or Less
42%
58%
31-50
38%
62%
New York City pensions should continue to vote on all proposals and draw on outside firms' advice in those cases where it hasn't studied the proposal closely
New York City pensions should focus its time and resources on casting informed votes only on those proposals it has analyzed thoroughly and which it concludes will benefit fund beneficiaries
51-70
35%
65%
71 and Above
23%
77%


Position on Pension Fund Voting – CalPERS by Age
30 or Less
49%
51%
31-50
45%
55%
CalPERS should continue to vote on all proposals and draw on outside firms' advice in those cases where CalPERS itself hasn't studied the proposal closely.
CalPERS should focus its time and resources on casting informed votes only on those proposals it has analyzed thoroughly and which it concludes will benefit the fund's beneficiaries.
51-70
26%
74%
71 and Above
29%
71%

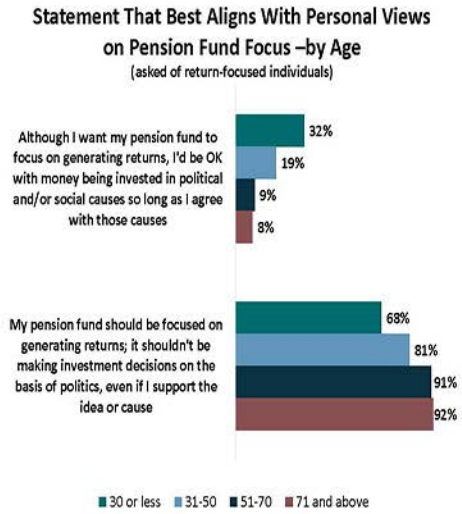
H.


Stance on Pension Fund Voting Rationale and Communication – by Age
My pension fund should explain and justify its votes on each proposal – or abstain from voting if it cannot.
91%
85%
65%
54%
I don't need to know why or how fund managers are voting on each proposal – we should trust them to do their jobs.
9%
15%
35%
46%
30 or less
31-50
51-70
71 and above

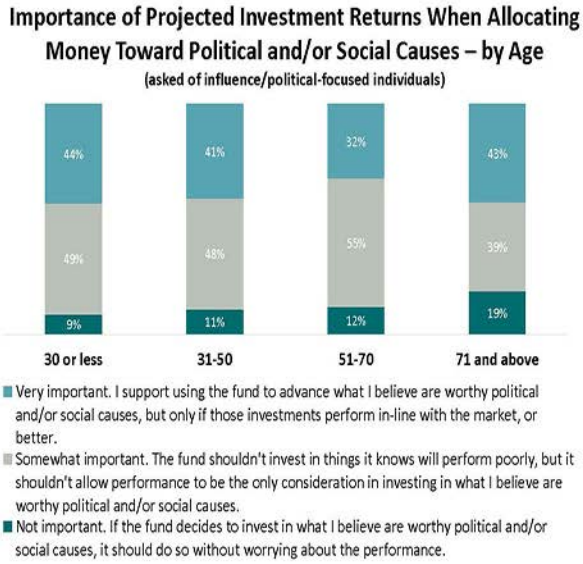
I.


Most Important Item Investment Managers Should Focus on When Managing Pension Fund – by Age
Maximizing returns and working to get the fund back to 100% funded status
47%
68%
88%
86%
Seeking to influence companies the fund invests in by filing shareholder proposals
25%
15%
5%
7%
Investing in projects that advance what I believe are worthy political and/or social causes, even if returns on those investments are slightly lower
30%
18%
7%
7%
30 or less
31-50
51-70
71 and above

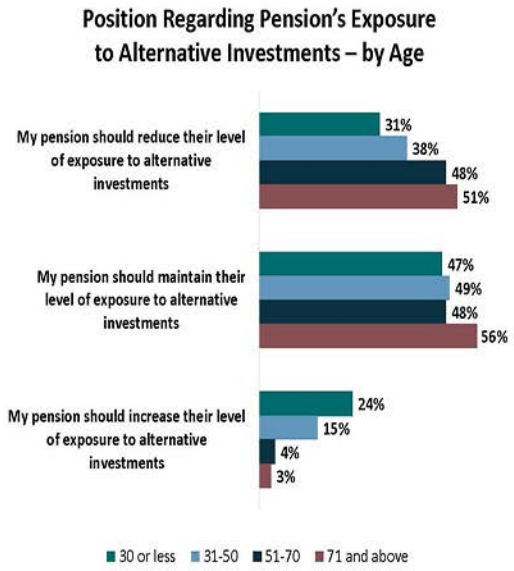
J.


Statement That Best Aligns With Personal Views on Pension Fund Focus –by Age
(asked of return-focused individuals)
Although I want my pension fund to focus on generating returns, I'd be OK with money being invested in political and/or social causes so long as I agree with those causes
32%
19%
9%
8%
My pension fund should be focused on generating returns; it shouldn't be making investment decisions on the basis of politics, even if I support the idea or cause
68%
81%
91%
92%
30 or less
31-50
51-70
71 and above

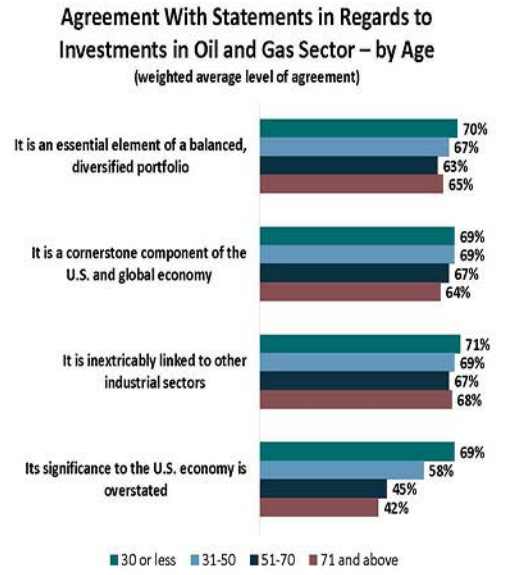
K.


Importance of Projected Investment Returns When Allocating Money Toward Political and/or Social Causes – by Age
(asked of influence/political-focused individuals)
44%
49%
9%
41%
48%
11%
32%
55%
12%
43%
39%
19%
30 or less
31-50
51-70
71 and above
Very important. I support using the fund to advance what I believe are worthy political and/or social causes, but only if those investments perform in-line with the market, or better.
Somewhat important. The fund shouldn't invest in things it knows will perform poorly, but it shouldn't allow performance to be the only consideration in investing in what I believe are worthy political and/or social causes.
Not important. If the fund decides to invest in what I believe are worthy political and/or social causes, it should do so without worrying about the performance.

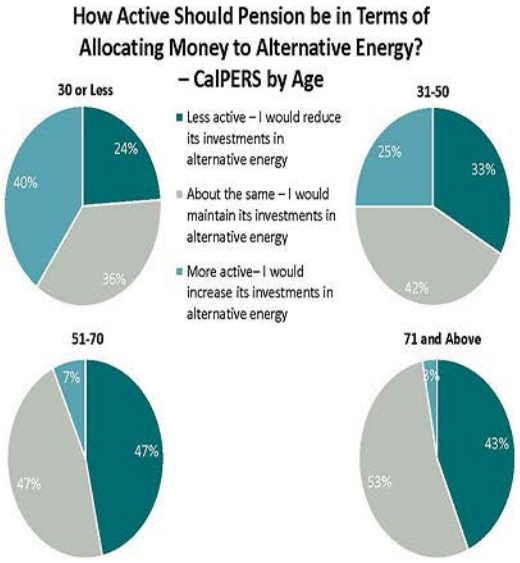
L.

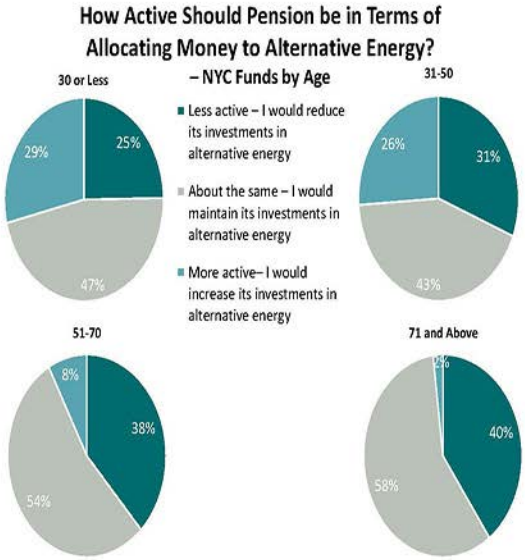

Position Regarding Pension's Exposure to Alternative Investments – by Age
My pension should reduce their level of exposure to alternative investments
31%
38%
48%
51%
My pension should maintain their level of exposure to alternative investments
47%
49%
48%
56%
My pension should increase their level of exposure to alternative investments
24%
15%
4%
3%
30 or less
31-50
51-70
71 and above

M.


Agreement With Statements in Regards to Investments in Oil and Gas Sector – by Age
(weighted average level of agreement)
It is an essential element of a balanced, diversified portfolio
70%
67%
63%
65%
It is a cornerstone component of the U.S. and global economy
69%
69%
67%
64%
It is inextricably linked to other industrial sectors
71%
69%
67%
68%
Its significance to the U.S. economy is overstated
69%
58%
45%
42%
30 or less
31-50
51-70
71 and above

N.


How Active Should Pension be in Terms of Allocating Money to Alternative Energy? – CalPERS by Age
30 or Less
24%
40%
36%
31-50
25%
33%
42%
51-70
7%
47%
47%
71 and Above
2%
43%
53%
Less active – I would reduce its investments in alternative energy
About the same – I would maintain its investments in alternative energy
More active– I would increase its investments in alternative energy


How Active Should Pension be in Terms of Allocating Money to Alternative Energy? – NYC Funds by Age
30 or Less
25%
29%
47%
31-50
26%
31%
43%
51-70
8%
38%
54%
71 and Above
2%
40%
58%
Less active – I would reduce its investments in alternative energy
About the same – I would maintain its investments in alternative energy
More active– I would increase its investments in alternative energy

APPENDIX B (ACTUAL SURVEY AND RESPONSES)

In total, there were responses from 807 CalPERS members, 771 NYC Funds respondents and 1,687 National members. It is important to note that NYC Funds respondents were generally younger than the other two segments. This becomes important as the data regarding attitudes regarding ESG/political investments is analyzed. (See Appendix chart A).

Due to the age of the respondents, more of the NYC Funds members were actively participating. CalPERS and the National segment had higher percentages of retired pension members (See Appendix B).

It should also be noted that the NYC Funds included teachers, as did the National sample. The CalPERS sample does not include teachers. This is important because previous research conducted by Spectrem Group has shown that teachers are more supportive of social issues than other occupations.

National, California, NYC

	National	CalPERS	NYC Funds
Survey Sample Size	1,687	807	771
95% Confidence Margin of Error		3.45%	3.53%

General / Profile

1. Please rate your overall level of satisfaction with how your pension assets are being managed.

	National	CalPERS	NYC Funds
Extremely satisfied	39%	43%	48%
Moderately satisfied	34%	35%	35%
Slightly satisfied	10%	10%	9%
Neither satisfied nor dissatisfied	12%	10%	7%
Slightly dissatisfied	2%	2%	1%
Moderately dissatisfied	1%	1%	1%
Extremely dissatisfied	2%	0%	0%
Weighted Average	**81%**	**85%**	**88%**

2. Please rate the level of importance of each item to you in how your pension fund is managed?

Weighted average level of importance

	National	CalPERS	NYC Funds
Generating returns at or above the fund target level	77%	83%	79%
Generating returns at or above overall market performance	74%	82%	80%
Ensuring stable, consistent returns by taking on less risk	82%	82%	80%
Using fund resources to advance worthy political and/or social causes	50%	59%	61%

3. Rate the following pension fund manager objectives in terms of how much time and attention he or she should allocate to each. Please assign values from 0 - 100 for each area; total value must sum to 100.

	National	CalPERS	NYC Funds
Ensuring investments meet performance targets	33%	31%	30%
Ensuring investments meet or exceed the performance level of the overall market	32%	31%	27%
Reviewing, discussing and setting fund strategy and structure	25%	26%	26%
Using fund resources to advance worthy political and/or social causes	9%	13%	16%

4. What percentage of your retirement income does, or will, the benefits from your pension fund represent, in terms of your total income?

	National	CalPERS	NYC Funds
Average Percent of Retirement Income	49%	50%	46%

5. To what extent do you agree with the following statements about the oil and gas sector from an investment standpoint? Please select one answer for each.

Weighted average level of agreeance

	National	CalPERS	NYC Funds
It is an essential element of a balanced, diversified portfolio	65%	67%	67%
It is a cornerstone component of the U.S. and global economy	67%	69%	68%
It is inextricably linked to other industrial sectors	68%	70%	70%
Its significance to the U.S. economy is overstated	50%	55%	59%

Awareness

6. How informed are you about the following details of your pension program: Please select one for each.

Weighted average informed level

	National	CalPERS	NYC Funds
Actual investment return	50%	59%	65%
Target investment return	46%	56%	62%
The expenses and fees I pay	55%	62%	67%
How fund management votes on shareholder proposals	39%	50%	56%
Pension benefit structure	56%	60%	67%
The costs associated with shareholder activism on the part of fund management	37%	48%	55%
Composition of the Board (Investment Professionals or Political Appointees)	39%	50%	53%
Average Informed	**46%**	**55%**	**61%**

7. Compared to the overall market, how well do you think your pension fund has performed over the past couple years? Please select one.

	National	CalPERS	NYC Funds
Significantly worse than	5%	8%	8%
Slightly worse than	10%	12%	12%
Roughly in-line with	50%	41%	37%
Slightly better than	25%	28%	29%
Significantly better than	10%	14%	17%
Total Worse	**15%**	**20%**	**19%**
Total Better	**35%**	**42%**	**46%**

8. Some pension funds are fully funded, meaning they have enough money on hand today to cover future obligations. Others are underfunded, which means a gap exists between what's in their accounts today and what they'll need to pay out in the future. Based on what you know about your own pension fund, is it: Please select one.

	National	CalPERS	NYC Funds
Fully funded	66%	63%	80%
Underfunded	34%	37%	20%

9. You indicated you believe that your government pension fund is underfunded. In percentage terms, how well-funded do you think it currently is?

	National	CalPERS	NYC Funds
The underfunded status is… (Average)	64%	66%	62%

10. How concerned are you about the idea that, if your pension fund remains underfunded, it may have an impact on what you're able to collect from it in the future? Please select one.

	National	CalPERS	NYC Funds
Very concerned	36%	44%	43%
Somewhat concerned	43%	41%	41%
Not too concerned	18%	14%	14%
Not at all concerned	4%	2%	2%
Weighted Average	**71%**	**76%**	**76%**

11. How would you rate your knowledge level as an investor? Please select one.

	National	CalPERS	NYC Funds
I am very knowledgeable about financial products and investments.	16%	22%	28%
I am fairly knowledgeable, but still have a great deal to learn.	41%	39%	43%
I am not very knowledgeable about financial products and investments, but I do understand some things.	34%	30%	24%
I am not at all knowledgeable about financial products and investments.	10%	8%	5%
Average	**55%**	**58%**	**64%**

Proposal Voting

12. Pensions and other large institutional shareholders tend to cast votes on almost every single shareholder proposal that's offered, which often number in the thousands each year. Some say pension funds should exercise their right to vote on all proposals, while others say they should only cast votes on proposals they have studied closely, abstaining on the rest. Which position below best aligns with your thinking? Please select one.

	National	CalPERS	NYC Funds
My pension fund should vote on all proposals and draw on outside firms' advice in those cases where it hasn't studied the proposal closely.	23%	37%	37%
My pension fund should focus its time and resources on casting informed votes only on proposals it has analyzed thoroughly and which it concludes will generate better returns for fund beneficiaries.	77%	63%	63%

13. Pension funds and other large institutional investors cast votes on thousands of shareholder proposals each year, the vast majority of which having very little to do with improving the financial performance of the targeted company. Significant costs are incurred by the fund as part of the process of voting on all these proposals, even though few earn majority support. Should pension fund managers be required to explain to fund beneficiaries the rationale behind the fund's decision to vote on each individual proposal? Please select one.

	National	CalPERS	NYC Funds
My pension fund should explain and justify its votes on each proposal – or abstain from voting if it cannot.	68%	77%	86%
I don't need to know why or how fund managers are voting on each proposals – we should trust them to do their jobs.	32%	23%	14%

14. *Pension specific statement about the amount of shareholder proposals* - Some say that the pensions activities in this area divert time and resources away from more important priorities. Others say it's perfectly appropriate for the pension to vote all its shares on all matters. How concerned are you that the pension's focus may be on the wrong thing? Please select one.

	CalPERS	NYC Funds
Not concerned. The fund can walk and chew gum at the same time.	10%	11%
Slightly concerned. There's a role for pension funds to challenge companies via these proposals, but this might be taking it a bit too far.	46%	48%
Very concerned. Every dollar spent on these activities is one less dollar to spend on acquiring and acting upon the best investment research available.	43%	41%

CALL TO ACTION

Focus on Returns

15. In general, the single most important thing that investment managers should be focused on in terms of managing my pension fund is:

Please select one.

	National	CalPERS	NYC Funds
Maximizing returns and working to get the fund back to 100% funded status	78%	74%	66%
Seeking to influence companies the fund invests in by filing shareholder proposals	11%	11%	16%
Investing in projects that advance what I believe are worthy political/ social causes, even if returns on those investments are slightly lower	11%	17%	20%

(Asked of return focused individuals)
16. Following up on the last question, which of the following statements best aligns with your own personal views? Please select one.

	National	CalPERS	NYC Funds
Although I want my pension fund to focus on generating returns, I'd be OK with money being invested in political and/ or social causes so long as I agree with those causes	12%	15%	21%
My pension fund should be focused on generating returns; it shouldn't be making investment decisions on the basis of politics, even if I support the idea or cause	88%	86%	79%

(Asked of influence/political focused individuals)
17. How important should projected investment returns be in determining whether to allocate money (and if so, how much) toward political and/ or social causes? Please select one.

	National	CalPERS	NYC Funds
Not important. If the fund decides to invest in what I believe are worthy political and/or social causes, it should do so without worrying about the performance.	14%	9%	10%
Somewhat important. The fund shouldn't invest in things it knows will perform poorly, but it shouldn't allow performance to be the only consideration in investing in what I believe are worthy political and/or social causes.	51%	45%	47%
Very important. I support using the fund to advance what I believe are worthy political and/or social causes, but only if those investments perform in-line with the market, or better.	36%	50%	46%

Reduce Alternative Energy Investments

18. *Pension specific statement about pension performance in alternative energy* - Of course, past performance is not necessarily indicative of future results, but if it were up to you, how active would your pension be in terms of allocating money to these sectors?

	CalPERS	NYC Funds
Less active – I would reduce its investments in alternative energy	37%	32%
About the same – I would maintain its investments in alternative energy	44%	48%
More active– I would increase its investments in alternative energy	19%	20%
Net Difference	**18% Reduce**	**12% Recycle**

Reduce Alternative Investments

19. Some pension funds have tried to offset poor investment performance by increasing their exposure to alternative investments. These investments do have the potential to outperform the market, but often carry greater risk and higher fees. What percentage of total assets do you believe alternative investments currently represents in your pension's portfolio? Please select one.

	CalPERS	NYC Funds
0%	1%	2%
0% to 2.5%	8%	8%
2.5% to 5.0%	26%	27%
5.0% to 7.5%	32%	32%
7.5% to 10%	19%	18%
More than 10%	14%	13%
Average	**6.3%**	**6.1%**
Actual (not displayed)	**20%**	**12%**

20. *Pension specific statement about the amount of alternative investments* - Some say these investments are worth the risk, especially if they can help the fund generate higher returns than those of the overall market. Others say that pension funds aren't hedge funds – because of who their beneficiaries are, they should be looking to reduce risk, not add to it. Which position below best aligns with your thinking on this matter?

	CalPERS	NYC Funds
My pension should reduce their level of exposure to alternative investments	45%	35%
My pension should maintain their level of exposure to alternative investments	44%	51%
My pension should increase their level of exposure to alternative investments	11%	14%
Net Difference	**34% Reduce**	**21% Recycle**

21. (National Only) According to Reuters, returns generated by private pension funds were three times higher than public pension fund returns over the last year, and public pensions have underperformed the S&P index for several years in a row. Some of these public pension funds have sought to "catch up" on performance by pursuing "alternative investments," which can out-perform the market, but typically carry more risk and higher fees. How much do you support additional alternative investments within your public pension fund? Please select one answer.

	National
Do not support at all	27%
Slightly support	44%
Moderately support	22%
Strongly support	7%
Weighted Average	**36%**

Age

	30 or less	31 - 50	51 - 70	71 and over
Sample Size	17%	31%	40%	12%
Average Age	25.5	39.5	61.6	74.9

General / Profile

1. Please rate your overall level of satisfaction with how your pension assets are being managed.

	30 or less	31 - 50	51 - 70	71 and over
Extremely satisfied	47%	37%	40%	49%
Moderately satisfied	30%	34%	38%	34%
Slightly satisfied	14%	13%	7%	4%
Neither satisfied nor dissatisfied	7%	13%	11%	10%
Slightly dissatisfied	3%	2%	1%	2%
Moderately dissatisfied	1%	1%	1%	1%
Extremely dissatisfied	0%	1%	2%	1%
Weighted Average	**86%**	**81%**	**82%**	**86%**

2. Please rate the level of importance of each item to you in how your pension fund is managed? *Weighted average level of importance*

	30 or less	31 - 50	51 - 70	71 and over
Generating returns at or above the fund target level	71%	78%	81%	76%
Generating returns at or above overall market performance	75%	77%	78%	73%
Ensuring stable, consistent returns by taking on less risk	79%	79%	82%	80%
Using fund resources to advance worthy political and/or social causes	73%	60%	44%	40%

3. Rate the following pension fund manager objectives in terms of how much time and attention he or she should allocate to each. Please assign values from 0 - 100 for each area; total value must sum to 100.

	30 or less	31 - 50	51 - 70	71 and over
Ensuring investments meet performance targets	26%	30%	35%	36%
Ensuring investments meet or exceed the performance level of the overall market	24%	29%	35%	34%
Reviewing, discussing and setting fund strategy and structure	28%	27%	24%	24%
Using fund resources to advance worthy political and/or social causes	22%	14%	7%	6%

4. What percentage of your retirement income does, or will, the benefits from your pension fund represent, in terms of your total income?

	30 or less	31 - 50	51 - 70	71 and over
Average Percent of Retirement Income	45.0	44.6	51.0	53.3

5. To what extent do you agree with the following statements about the oil and gas sector from an investment standpoint? Please select one answer for each.

Weighted average level of agreeance

	30 or less	31 - 50	51 - 70	71 and over
It is an essential element of a balanced, diversified portfolio	70%	67%	62%	65%
It is a cornerstone component of the U.S. and global economy	69%	69%	67%	64%
It is inextricably linked to other industrial sectors	71%	69%	67%	68%
Its significance to the U.S. economy is overstated	69%	58%	45%	42%

Awareness

6. How informed are you about the following details of your pension program: Please select one for each.

Weighted average informed level

	30 or less	31 - 50	51 - 70	71 and over
Actual investment return	65%	56%	52%	45%
Target investment return	65%	53%	46%	38%
The expenses and fees I pay	71%	60%	53%	46%
How fund management votes on shareholder proposals	64%	48%	36%	30%
Pension benefit structure	67%	59%	55%	52%
The costs associated with shareholder activism on the part of fund management	67%	47%	32%	26%
Composition of the Board (Investment Professionals or Political Appointees)	67%	46%	35%	31%
Average Informed	**67%**	**53%**	**44%**	**38%**

7. Compared to the overall market, how well do you think your pension fund has performed over the past couple years? Please select one.

	30 or less	31 - 50	51 - 70	71 and over
Significantly worse than	10%	8%	3%	4%
Slightly worse than	13%	11%	9%	12%
Roughly in-line with	33%	46%	49%	46%
Slightly better than	28%	23%	29%	28%
Significantly better than	18%	12%	10%	10%
Total Worse	**23%**	**19%**	**12%**	**16%**
Total Better	**46%**	**35%**	**39%**	**38%**

8. Some pension funds are fully funded, meaning they have enough money on hand today to cover future obligations. Others are underfunded, which means a gap exists between what's in their accounts today and what they'll need to pay out in the future. Based on what you know about your own pension fund, is it: Please select one.

	30 or less	31 - 50	51 - 70	71 and over
Fully funded	79%	71%	63%	64%
Underfunded	22%	29%	37%	36%

9. You indicated you believe that your government pension fund is underfunded. In percentage terms, how well-funded do you think it currently is?

	30 or less	31 - 50	51 - 70	71 and over
The underfunded status is… Average)	61.0	62.1	64.5	69.2

10. How concerned are you about the idea that, if your pension fund remains underfunded, it may have an impact on what you're able to collect from it in the future? Please select one.

	30 or less	31 - 50	51 - 70	71 and over
Very concerned	44%	48%	37%	24%
Somewhat concerned	43%	41%	41%	47%
Not too concerned	13%	10%	18%	25%
Not at all concerned	2%	2%	4%	4%
Weighted Average	77%	79%	70%	64%

11. How would you rate your knowledge level as an investor? Please select one.

	30 or less	31 - 50	51 - 70	71 and over
I am very knowledgeable about financial products and investments.	41%	25%	9%	8%
I am fairly knowledgeable, but still have a great deal to learn.	38%	39%	43%	44%
I am not very knowledgeable about financial products and investments, but I do understand some things.	17%	26%	39%	37%
I am not at all knowledgeable about financial products and investments.	4%	9%	10%	10%
Average	**72%**	**60%**	**51%**	**50%**

Proposal Voting

12. Pensions and other large institutional shareholders tend to cast votes on almost every single shareholder proposal that's offered, which often number in the thousands each year. Some say pension funds should exercise their right to vote on all proposals, while others say they should only cast votes on proposals they have studied closely, abstaining on the rest. Which position below best aligns with your thinking? Please select one.

National	30 or less	31 - 50	51 - 70	71 and over
My pension fund should vote on all proposals and draw on outside firms' advice in those cases where it hasn't studied the proposal closely.	32%	27%	20%	17%
My pension fund should focus its time and resources on casting informed votes only on proposals it has analyzed thoroughly and which it concludes will generate better returns for fund beneficiaries.	68%	73%	80%	83%

CalPERS	30 or less	31 - 50	51 - 70	71 and over
CalPERS should continue to vote on all proposals and draw on outside firms' advice in those cases where CalPERS itself hasn't studied the proposal closely.	49%	45%	26%	29%
CalPERS should focus its time and resources on casting informed votes only on those proposals it has analyzed thoroughly and which it concludes will benefit the fund's beneficiaries.	51%	55%	74%	71%

NYC Funds	30 or less	31 - 50	51 - 70	71 and over
New York City pensions should continue to vote on all proposals and draw on outside firms' advice in those cases where it hasn't studied the proposal closely	42%	38%	35%	23%
New York City pensions should focus its time and resources on casting informed votes only on those proposals it has analyzed thoroughly and which it concludes will benefit fund beneficiaries	58%	62%	65%	77%

13. Pension funds and other large institutional investors cast votes on thousands of shareholder proposals each year, the vast majority of which having very little to do with improving the financial performance of the targeted company. Significant costs are incurred by the fund as part of the process of voting on all these proposals, even though few earn majority support. Should pension fund managers be required to explain to fund beneficiaries the rationale behind the fund's decision to vote on each individual proposal? Please select one.

	30 or less	31 - 50	51 - 70	71 and over
My pension fund should explain and justify its votes on each proposal – or abstain from voting if it cannot.	91%	85%	65%	54%
I don't need to know why or how fund managers are voting on each proposals – we should trust them to do their jobs.	9%	15%	35%	46%

14. *Pension specific statement about the amount of shareholder proposals* - Some say that the pensions activities in this area divert time and resources away from more important priorities. Others say it's perfectly appropriate for the pension to vote all its shares on all matters. How concerned are you that the pension's focus may be on the wrong thing? Please select one.

CalPERS	30 or less	31 - 50	51 - 70	71 and over
Not concerned. CalPERS can walk and chew gum at the same time.	13%	7%	11%	10%
Slightly concerned. There's a role for big funds like CalPERS to challenge companies via these proposals, but this might be taking it too far	38%	43%	51%	52%
Very concerned. Every dollar spent on these activities is one less dollar that can be spent on acquiring and acting upon the best investment research available	48%	50%	37%	37%

	30 or less	31 - 50	51 - 70	71 and over
Not concerned. The fund can walk and chew gum at the same time.	10%	8%	10%	36%
Slightly concerned. There's a role for pension funds to challenge companies via these proposals, but this might be taking it a bit too far	51%	46%	50%	40%
Very concerned. Every dollar spent on these activities is one less dollar to spend on acquiring and acting upon the best investment research available	39%	45%	40%	25%

CALL TO ACTION

Focus on Returns

15. In general, the single most important thing that investment managers should be focused on in terms of managing my pension fund is: Please select one.

	30 or less	31 - 50	51 - 70	71 and over
Maximizing returns and working to get the fund back to 100-percent funded status	47%	68%	88%	86%
Seeking to influence companies the fund invests in by filing shareholder proposals	25%	15%	5%	7%
Investing in projects that advance what I believe are worthy political and/or social causes, even if returns on those investments are slightly lower	30%	18%	7%	7%

(Asked of return focused individuals)

16. Following up on the last question, which of the following statements best aligns with your own personal views? Please select one.

	30 or less	31 - 50	51 - 70	71 and over
Although I want my pension fund to focus on generating returns, I'd be OK with money being invested in political and/or social causes so long as I agree with those causes	32%	19%	9%	8%
My pension fund should be focused on generating returns; it shouldn't be making investment decisions on the basis of politics, even if I support the idea or cause	68%	81%	91%	92%

(Asked of influence/political focused individuals)

17. How important should projected investment returns be in determining whether to allocate money (and if so, how much) toward political and/or social causes? Please select one.

	30 or less	31 - 50	51 - 70	71 and over
Not important. If the fund decides to invest in what I believe are worthy political and/ or social causes, it should do so without worrying about the performance.	9%	11%	12%	19%
Somewhat important. The fund shouldn't invest in things it knows will perform poorly, but it shouldn't allow performance to be the only consideration in investing in what I believe are worthy political and/or social causes.	49%	48%	55%	39%
Very important. I support using the fund to advance what I believe are worthy political and/or social causes, but only if those investments perform in-line with the market, or better.	44%	41%	32%	43%

Reduce Alternative Energy Investments

18. *Pension specific statement about pension performance in alternative energy* - Of course, past performance is not necessarily indicative of future results, but if it were up to you, how active would your pension be in terms of allocating money to these sectors?

CalPERS	30 or less	31 - 50	51 - 70	71 and over
Less active – I would reduce its investments in alternative energy	24%	33%	47%	43%
About the same – I would maintain its investments in alternative energy	36%	42%	47%	53%
More active– I would increase its investments in alternative energy	40%	25%	7%	3%
Net Difference	**14% Increase**	**8% Reduce**	**40% Reduce**	**40% Reduce**

NYC Funds	30 or less	31 - 50	51 - 70	71 and over
Less active – I would reduce its investments in alternative energy	25%	31%	38%	40%
About the same – I would maintain its investments in alternative energy	47%	43%	54%	58%
More active– I would increase its investments in alternative energy	29%	26%	8%	2%
Net Difference	**4% Increase**	**5% Reduce**	**30% Reduce**	**38% Reduce**

Reduce Alternative Investments

19. Some pension funds have tried to offset poor investment performance by increasing their exposure to alternative investments. These investments do have the potential to outperform the market, but often carry greater risk and higher fees. What percentage of total assets do you believe alternative investments currently represents in your pension's portfolio? Please select one.

CalPERS	30 or less	31 - 50	51 - 70	71 and over
0%	1%	1%	1%	5%
0% to 2.5%	6%	10%	8%	7%
2.5% to 5.0%	33%	26%	23%	26%
5.0% to 7.5%	37%	34%	29%	26%
7.5% to 10%	13%	19%	20%	24%
More than 10%	10%	10%	20%	13%
Average	**5.86%**	**6.04%**	**6.71%**	**6.22%**
Actual (not displayed)	**20%**	**20%**	**20%**	**20%**

NYC Funds	30 or less	31 - 50	51 - 70	71 and over
0%	0	1%	4%	4%
0% to 2.5%	9%	7%	10%	9%
2.5% to 5.0%	31%	28%	21%	32%
5.0% to 7.5%	35%	33%	28%	25%
7.5% to 10%	19%	18%	18%	15%
More than 10%	6%	13%	19%	15%
Average	**5.80%**	**6.24%**	**6.45%**	**5.87%**
Actual (not displayed)	**12%**	**12%**	**12%**	**12%**

20. *Pension specific statement about the amount of alternative investments* - Some say these investments are worth the risk, especially if they can help the fund generate higher returns than those of the overall market. Others say that pension funds aren't hedge funds – because of who their beneficiaries are, they should be looking to reduce risk, not add to it. Which position below best aligns with your thinking on this matter?

	30 or less	31 - 50	51 - 70	71 and over
My pension should reduce their level of exposure to alternative investments	28%	35%	42%	40%
My pension should maintain their level of exposure to alternative investments	47%	51%	53%	57%
My pension should increase their level of exposure to alternative investments	26%	14%	5%	4%
Net Difference	**2% Reduce**	**21% Reduce**	**37% Reduce**	**35% Reduce**

21. (National Only) According to Reuters, returns generated by private pension funds were three times higher than public pension fund returns over the last year, and public pensions have underperformed the S&P index for several years in a row. Some of these public pension funds have sought to "catch up" on performance by pursuing "alternative investments," which can out-perform the market, but typically carry more risk and higher fees. How much do you support additional alternative investments within your public pension fund? Please select one answer.

	30 or less	31 - 50	51 - 70	71 and over
Do not support at all	8%	17%	35%	35%
Slightly support	33%	45%	44%	47%
Moderately support	32%	28%	18%	17%
Strongly support	27%	10%	3%	1%
Weighted Average	**59%**	**44%**	**30%**	**28%**

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORTEZ MASTO FROM DARLA C. STUCKEY

S. 2756, Fair Investment Opportunities for Professional Experts Act (Accredited Investor Bill)

Q.1. In recent months, we read about how millionaires like Rupert Murdoch, the Waltons, and the DeVos's each lost a hundred million dollars or more when they invested in Theranos. One of many red flags was the absence of an audited financial statement which one would think a sophisticated investor would demand before shelling over $125 million dollars.

Q.1.a. The bill requires that the SEC develop a test for financial sophistication for accredited investors who do not meet the income or wealth threshold. Is a test a reasonable requirement to help investors better protect themselves?

Q.1.b. If so, what do you think should be in such a test?

Q.1.c. How should the test ensure that biases do not arise?

Q.1.d. Do you think the SEC should permit other firms to develop, teach and administer tests? If so, what would be the benefits and concerns of a third-party testing system?

A.1.a.–d. The Society does not have a position on this bill.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM JOHN C. COATES IV

Q.1. The Small Business Audit Correction Act, S. 3004, would allow certain brokers or dealers defined under the bill to use auditors that are exempt from Public Company Accounting Oversight Board registration and supervision.

How many brokers or dealers do you believe would be covered by the definition in the bill?

A.1. The great majority of broker-dealer firms would be covered. The primary restrictions are that the firms have fewer than 150 registered representatives, are noncustody firms, and clear through another firm. Roughly 3,400 of FINRA's roughly 3,700 member firms have fewer than 150 registered reps. The vast majority of broker-dealers, and an even larger percentage of small broker-dealers, do not maintain custody of client securities and are not self-clearing. While I am not aware of a public dataset that could answer this question precisely, it would be reasonable to believe that more than 3000 broker-dealers would be covered by the definition in the bill.

Q.2. Does that definition in the bill capture brokers or dealers in one or more of the following categories: active high-frequency trading or principal trading firms, sophisticated market-maker firms, private placement brokers, dealers in the to-be-announced (TBA) for mortgage-backed securities market, and alternative trading system routing brokers, in addition to retail customer facing brokers or dealers?

A.2. Yes. Many of the kinds of firms listed in the question would be covered by the definition in the bill.

Q.3. At the hearing, proxy advisors were identified as contributing to the decline in the number of public companies.

Do you know of any evidence or studies that support this claim?

A.3. No. The best studies of the decline of the number of U.S. public companies focus on large-scale economic shifts, such as an increase in economies of scale in many industries, and the relative increase in the availability of capital in the private equity markets. The single best recent study is that Xiaohui Gao, Jay R. Ritter, and Zhongyan Zhu, entitled "Where Have all the IPOs Gone?," 48 J. Fin. Quant. Anal. 1663–1692 (2013), available at *https://tinyurl.com/yba6sw9j.* It concludes:

> Regulatory changes aimed at increasing the number of IPOs are likely to have minor effects, since the decline in IPOs is not due to a broken IPO market, but because small independent companies are not necessarily the profit-maximizing form of organization.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VAN HOLLEN FROM JOHN C. COATES IV

Q.1. In your testimony you say that H.R. 4015, Corporate Governance Reform and Transparency Act of 2017, would create conflicts of interest for firms that use proxy advisory services. Please elaborate on this. What is the problem that H.R. 4015 is trying to solve?

A.1. Proxy advisory firms face potential conflicts of interest if they have other lines of business (as with ISS) or owners (as with Glass Lewis). Basic disclosure and information-barrier regulation can address conflicts of interest, as in many other settings. Well-designed, light touch regulation of conflicts would seem to me a possibly admirable goal for a statute addressing proxy advisory firms. However, as I testified, I do not believe that H.R. 4105 as currently drafted does that. It would impose unnecessary costs without adequately demonstrated benefits.

Q.2. Some have tried to pinpoint the root causes of decreases in IPOs. Please discuss what factors have been at play with regard to the decrease in IPOs.

A.2. The best studies of the decline of the number of U.S. public companies focus on large-scale economic shifts, such as an increase in economies of scale in many industries, and the relative increase in the availability of capital in the private equity markets. The single best recent study is that Xiaohui Gao, Jay R. Ritter, and Zhongyan Zhu, entitled "Where Have all the IPOs Gone?," 48 J. Fin. Quant. Anal. 1663–1692 (2013), available at *https://tinyurl.com/yba6sw9j.* It concludes:

> Regulatory changes aimed at increasing the number of IPOs are likely to have minor effects, since the decline in IPOs is not due to a broken IPO market, but because small independent companies are not necessarily the profit-maximizing form of organization.

I am aware of no reliable research to suggest proxy advisory firms have played a meaningful role in the decline in IPOs. It is hard to see how proxy advisory firms could have done so. It should be noted that firms can elect dual-class structures at the time of an IPO, which would make the prospect of shareholder voting—whether or not informed by proxy advisory firms—unimportant.

Dual-class IPOs have been increasing in recent years, but not enough to offset the overall decline, which is driven by economic and not regulatory or governance factors.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORTEZ MASTO FROM JOHN C. COATES IV

S. 2756, Fair Investment Opportunities for Professional Experts Act (Accredited Investor Bill)

Q.1. In recent months, we read about how millionaires like Rupert Murdoch, the Waltons, and the DeVos's each lost a hundred million dollars or more when they invested in Theranos. One of many red flags was the absence of an audited financial statement which one would think a sophisticated investor would demand before shelling over $125 million dollars.

Q.1.a. The bill requires the SEC to develop a test for financial sophistication for accredited investors who do not meet the income or wealth threshold. Is a test a reasonable requirement to help investors better protect themselves?

A.1.a. I would not view such a test as a way for investors to better protect themselves. Rather, such a test would be a way to evaluate whether some investors are already able to protect themselves. If well-designed, such a test would be more likely to distinguish such investors from others than the current asset/income thresholds, which even if at a reasonable level would be a crude measure, and are out of date.

Q.1.b. If so, what do you think should be in such a test?

A.1.b. Sophisticated investors able to protect themselves are at least knowledgeable about finance, accounting, financial statement analysis, and the institutions and regulations of the financial industry. Designing a test of such topics would be a challenging and somewhat time-consuming task, as it would require balancing the need to fairly test relevant knowledge (both theoretical and as applied to typical investment decisions) against the need to not have the test be so lengthy or detailed as to deter sophisticated investors from attempting to take it. But could be done. While it would not need to be as comprehensive as existing regulatory examinations for individuals to become "registered reps" (the "Series 7" exam) or certified financial planners or analysts, it could draw on those exams and tests for material and topics.

Q.1.c. How should the test ensure that biases do not arise?

A.1.c. To some extent, cognitive biases—such as over-optimism or unjustified self-confidence, or attribution of luck in the financial markets to skill—are inevitable. Even the most sophisticated investors are subject to them. Standard tests of financial knowledge are not generally viewed as creating or worsening biases. If a concern is that third parties would "teach to the test" and through that process increase or worsen biases, then that could be addressed by varying or randomizing elements of the test—as with SATs—so that no one could design a curriculum that would both adequately prepare someone for the test and simultaneously increase or worsen biases in the process. In any event, whether a test (or

the teaching to prepare for it) worsens biases is itself capable of being tested, and the results could be used to refine the test over time.

Q.1.d. Do you think the SEC should permit other firms to develop, teach and administer tests? If so, what would be the benefits and concerns of a third-party testing system?

A.1.d. I would prefer a dedicated unit with an adequately funded SEC oversee the design, testing, and administration of any such test. While for-profit private actors may be likely to work more quickly and competition provides good incentives in many contexts, the world of education is dominated by public institutions and nonprofits for reasons that would carry over to this area. I would worry that for-profit private test designers (and trade associations and many other organizations that are formally nonprofits as well) might have conflicts of interest in designing the tests. (I would expect third parties to then provide curricula to prepare investors to take such a test, but they should not be privy to the actual contents of the test.) If the SEC chose, it could seek to rely on third parties—appropriately screened through customary RFP process that would include consideration of potential conflicts of interest. But I would leave that to the SEC to choose, rather than directing that in a statute.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

LETTER, REPORT, AND EMAIL SUBMITTED BY THOMAS QUAADMAN

Dear Shareholder,

Institutional Shareholder Services ("ISS") issued its Proxy Analysis and Voting Recommendations (the "Report") on Abbott Laboratories ("Abbott", the "Company", "we", "us" or "our") today. We write to highlight and correct the Report's substantial errors in analysis and fact. These errors lead ISS to incorrect, unreliable voting recommendations on the advisory vote on executive compensation and the shareholder proposal concerning separation of Chairman and CEO which are on the agenda for our Annual Meeting. **Abbott's Board of Directors continue to recommend that you vote "FOR" on the advisory vote on the Company's executive compensation ("Say-on-Pay") and "Against" the shareholder proposal regarding the separation of the roles of Chairman of the Board and CEO.**

ISS is aware of the flaws and inaccuracies in its Report and has disregarded our attempts to correct them. Attached as Annex A is the detailed letter sent to ISS correcting their errors, omissions and misrepresentations. [1] Additionally, we made multiple requests to ISS for a meeting to discuss the Report. Contrary to their stated policies, however, ISS refused to engage and proceeded to publish a flawed and inaccurate Report.

In 2017 the Company performed at the top of its peer group with Total Shareholder Return (TSR) growth of 52% and completed all of its financial and strategic objectives. The CEO was granted LTI in 2017 at the 23rd percentile of our peer group. Abbott improved over 35 points on ISS' Key Relative Degree of Alignment test and achieved an overall "low concern" outcome on ISS' quantitative tests. It is absurd that in the face of these facts that ISS has not recommended support for Say-On-Pay. ISS's recommendations should be objective and based on facts.

Instead, ISS's recommendation on executive pay is driven by:

- **Manipulation of our peer group**—ISS altered the Company's peer group and selected inappropriate peers which do not reflect the impact of Abbott's significant increase in size following two significant acquisitions, St. Jude and Alere, during 2017. ISS added peers which do not even meet their own criteria and omitted Company selected peers if they paid relatively high while performing relatively low, thus purposely manipulating the outcome.

- **Manipulation of GAAP and non-GAAP measures**—ISS selectively uses GAAP and non-GAAP measures during its analysis. When GAAP measures are employed, ISS ignores the one-time impact of U.S. Tax Reform and thereby understates all of Abbott's financial metrics. Although they state EBITDA is the most important measure for our GICS code, they exclude its use. Abbott outperformed all of its Company and ISS peers in EBITDA growth. Inclusion of EBITDA in the analysis would have positively impacted Abbott's scoring. After excluding EBITDA, ISS then claims ROA, ROIC and ROE results are low based on the one-time GAAP-effect of U.S. Tax Reform. With such arbitrary methods, ISS artificially inflates pay and falsely asserts operating performance is lower. Moreover, ISS makes little attempt to explain the composition of, or rationale for use of, those measures.

- **Inflation of CEO compensation**—ISS uses a non-GAAP approach to the valuation of option grants which leads to an inflated and incorrect calculation of 3-year average CEO pay. For example, the combination of a 10-year option life (Abbott's average option life is actually 6) with

[1] The letter sent to ISS contains certain non-GAAP financial measures. Please see Annex B for a reconciliation to GAAP.

a 3-year volatility assumption purposely overstates the value of the grant the Compensation Committee made, the value of the award the CEO received, the actual expense to the Company and the actual impact on shareholders.

- **A false claim that our Proxy Filing lacked adequate disclosure**—ISS incorrectly claims that our disclosure in our Proxy Filing lacks rigor and specifics. To the contrary our disclosure clearly states the reasons for compensation decisions as well as specific targets and achievement levels, the design of our compensation programs, and provides disclosure on 2018 grants which is not required or provided by most companies. Although we do not publish competitively sensitive strategic goals, the goals themselves are direct, measurable, time-bound and individually assigned to the appropriate executives. They are neither subjective or without rigor as ISS suggests.

ISS then reaches a conclusion regarding separation of Chairman and CEO based entirely on "concerns" about control of executive compensation that ISS created through its distorted analysis.

ISS's pay recommendations should not be determined by manipulating a peer group and selectively using GAAP and non-GAAP measures to artificially lessen performance while inflating CEO pay. Our CEO was awarded LTI at the 23rd percentile of our peer group in 2017, while our Company performed at the top of our peer group with a TSR of 52%. Yet ISS has chosen to manipulate performance and pay measures, and incorrectly contend that our Proxy Statement lacks robust and adequate disclosure to recommend a vote against Say-On-Pay. ISS then uses its flawed conclusion on executive pay as the basis for its conclusion on the separation of Chairman and CEO.

We have previously set forth in our proxy statement a comprehensive discussion of our pay for performance philosophy and our robust executive compensation program and governance process. The Compensation Committee takes great care to ensure that compensation decisions are based on tangible performance in accordance with our pay for performance philosophy, as evidence by the varied pay decisions related to pay that are reflected in our proxy.

Should you have any questions, please contact Scott Leinenweber, Vice President, Investor Relations, at (224) 668-0791 or Melissa Brotz, Divisional Vice President, Head of Public Affairs, at (224) 668-3456.

*We urge all shareholders to review the attached letter sent to ISS which explains the Report's errors in detail, to reject ISS flawed recommendations and to vote **"FOR"** on the Say-on-Pay proposal and **"AGAINST"** the independent chair shareholder proposal.*

Roxanne S. Austin
Chair of the Compensation Committee
Abbott Laboratories Board of Directors

Annex A

April 3, 2018

ISS US Research Team

Attention: Jolene Dugan, Liz Williams

Re: Draft Report for Abbott Laboratories ("Abbott")

We are in receipt of your preliminary draft of the ISS proxy analysis (the "Draft Report") for Abbott's proxy statement for its 2018 annual meeting of shareholders (the "Abbott Proxy").

We are submitting this letter to correct substantial errors in the Draft Report regarding your recommendation on the advisory vote on executive compensation, and your recommendation on the shareholder proposal concerning separation of the Chair and CEO role, which depends directly on your deeply flawed conclusions regarding Abbott's executive compensation levels and design practices.

We strongly object to the factual misrepresentations in your quantitative and qualitative analysis. Specifically, the quantitative analysis in the Draft Report relies upon significant misstatements and flaws which bias the results and create an incorrect conclusion regarding our compensation program:

- **Alteration and selection of an inappropriate peer group** to which to compare Abbott and failure to reflect the impact of Abbott's significant increase in size following two significant acquisitions during 2017. Correction of this error, opined on by two separate advisors/consultants, renders Abbott's RDA a "Low" concern
- **Inappropriate use of performance measures** in the Financial Performance Assessment (the "FPA"), and the omission of a key metric (EBITDA) from the FPA rendering it fatally flawed
- **Artificially inflated CEO compensation** based on an incorrect calculation of 3-year average CEO pay using a non-GAAP approach (despite using only GAAP measures in the flawed FPA). A correction of the false and improper valuation of stock options alone would have lowered Abbott's RDA to "Low Concern", obviating the need for a detailed qualitative review
- **Misrepresentation of Abbott's incentive compensation practices.** You frequently claim lack of specifics or rigor. This is, in fact, not the case at all. Where you may deem disclosure insufficient, we omit detail, particularly on strategic goals and performance due to competitive sensitivity. Your complaint about the degrees of specifics or disclosures cannot merit a recommended vote of "NO" on Say on Pay
- **Substantive reliance on our CEO's 2018 equity award as a basis for concern** which is irrelevant to 2017's Say on Pay recommendation, and is provided only as information in advance of next year.

By correcting any of these errors, there would be no need for a further qualitative review. Regardless, we will address the inaccuracies in the qualitative review as well below.

ISS's own analysis on page 14 of the Draft Report indicates that the compensation of Abbott's CEO is substantially aligned with performance, based on relative degree of alignment, absolute pay-TSR alignment and multiple of median pay, meriting a "Low Concern" level on ISS's initial quantitative analysis. In fact, the relative degree of alignment (RDA) would be well within the "Low" level of concern if ISS had used a peer group that appropriately reflects Abbott's size **and/or used the GAAP value** of the stock options granted to our CEO, which is the true basis on which he is paid. Further, although the information Abbott has provided its shareholders about its 2018 equity awards (information which few other companies provide) is not relevant to the analysis of this year's (2017) Say on Pay proposal, ISS notes it as a reason for its Say on Pay recommendation. **As a result, ISS's decision to recommend against Abbott's say-on-pay proposal appears to be principally driven by inaccurate disclosure concerns or a selective approach designed to garner a specific level of concern, rather than a truly objective analysis.** Given that the level of disclosure in Abbott's Proxy is more fulsome than in any prior year and complies with all requirements of securities laws, that Abbott has further strengthened the rigor of our program by significantly increasing the requirements for vesting performance shares, and that Abbott actually voluntarily disclosed the 2018 equity grant a year before it is required, a recommendation against Abbott's Say on Pay proposal based on flawed disclosure concerns is without foundation.

We also note that ISS alternates between GAAP and non-GAAP measures apparently whenever it best suits its analysis and without labelling which version of metrics it is using. For example, the return metrics used in the FPA are strictly based on GAAP measures. However, ISS revalues our CEO's option grant using non-GAAP metrics, significantly inflating the value and skewing the analysis. In addition, the Abbott Proxy clearly states (page 31) that our officer financial goals are based on adjusted measures that reflect the true results of our ongoing operations. This is what our Compensation Committee and our investors use to evaluate our business; therefore, that is what we manage to, focus on, and we are compensated for.

The Draft Report paints a misleading picture of Abbott's compensation program that misrepresents the facts to our shareholders. The ISS recommendation is important to us, and we request that you

correct these errors and modify your report and recommendations based on the information contained herein.

Below we provide a detailed analysis of the errors in the Draft Report. None of the information in this letter is material non-public information.

"SAY-ON-PAY" ADVISORY VOTE

1. Peer Group and Financial Performance

Impact of Significant Increase in Size of Abbott Following Acquisitions

As explained in our March 1, 2018 and December 11, 2017 letters to Mr. Bimal Patel, your Vice President, U.S. Research, Abbott completed two large strategic acquisitions during 2017 which greatly increased our size and had a substantial impact on our financial metrics. As these letters appear not to have been adequately considered, we have reiterated their contents below.

The acquisitions of St. Jude Medical (completed January 4, 2017) and Alere (completed October 3, 2017) increased Abbott's size significantly. During 2016, our total revenue was $20.9 billion. With the addition of these two acquisitions and our growth, annual revenue increased approximately 38% to $28.9 billion on a full-year pro forma basis for 2017.

Based on input from a compensation advisor and consultant, our Compensation Committee revised the peer group used for benchmarking pay and performance in 2017 to reflect the impact of these acquisitions on company size (sales and market cap) and business mix, as well as to reflect recent changes in the characteristics of our peer companies due to their own changes. However, our Compensation Committee's overall approach to identifying peers did not change. Our Compensation Committee ensured that the peer group continues to represent the unique breadth and diversity of our businesses, similar revenue size and market capitalization (fundamental ISS selection criteria), broad geographic coverage, return of cash profile and consumer-facing focus. The Abbott Proxy includes a detailed description of the factors that were considered in the determination of the peer group by our Compensation Committee. Notably the average revenues and average market capitalization of this peer group is equivalent to Abbott's, to account for and balance companies both larger and smaller than Abbott.

ISS Inappropriate Peer Selection Criteria

By developing and using a peer group, the median of which is **28% smaller** in terms of revenue than Abbott following our 2017 acquisitions, **ISS has produced a misleading view of the alignment between Abbott's relative pay and performance by comparing Abbott to peers which do not adequately reflect Abbott's increased size, scope, and complexity.** For example, Baxter, less than one-third of our size, is included as a peer even though it violates your own revenue criteria for peers. The inclusion of HCA Healthcare, a totally U.S.-based hospital management and service company, is completely inappropriate considering Abbott's global footprint and the diversity of its businesses. You also selectively excluded four Abbott proxy peers that have higher pay and lower performance, which had the effect of adversely skewing ISS's analysis. Overall the ISS peer group median revenues of $20.8B is 28% lower than Abbott's revenues of $28.9B, with similarly large differentials in market capitalization. To demonstrate this inconsistency, we asked our consultant to replicate ISS's Relative Degree of Alignment ("RDA") test using first the ISS selected peer group and then calculate the RDA using the Company's peer group recommended by the external consultants. The following table illustrates that by disregarding the Company's selected peers, ISS has reduced Abbott's RDA by an astounding 17 points, resulting in a "Cautionary Low" concern level, instead of a more appropriate "Low" concern level.

ISS US Research Team
April 3, 2018
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ISS Peer Group

ISS Selected Peer Group	3-Year TSR % as Calculated by ISS	3-Year Total Pay (avg.) as Calculated by ISS
3M CO	16.4%	18,850
BAXTER	19.3%	12,547
BECTON DICKINSON	18.3%	12,431
BRISTOL MYERS	3.9%	17,053
DANAHER	13.6%	12,753
EATON	8.1%	14,181
EMERSON	6.4%	14,309
HCA HEALTHCARE	5.8%	19,319
HONEYWELL	18.4%	24,698
JOHNSON & JOHNSON	13.0%	26,911
KIMBERLY CLARK	4.5%	15,241
MEDTRONIC	5.5%	23,493
PROCTER & GAMBLE	3.3%	17,180
THERMO FISHER	14.7%	17,670
ABBOTT	**10.75%**	**21,151***
Percent Rank	49.0	80.3
RDA Result	-31 "Cautionary Low"	
Median Revenues	**$20.8 Billion**	
Median Market Cap	**$70.4 Billion**	
Abbott Revenues	**$28.9 Billion**	
Abbott Market Cap	**$99.3 Billion**	

Abbott's Peer Group

Abbott Compensation Committee Approved Peer Group	3-Year TSR % as Calculated by ISS	3-Year Total Pay (avg.) as Calculated by ISS
3M CO	16.4%	18,850
BECTON DICKINSON	18.3%	12,431
BRISTOL MYERS	3.9%	17,053
DANAHER	13.6%	12,753
EATON	8.1%	14,181
EMERSON	6.4%	14,309
HONEYWELL	18.4%	24,698
JOHNSON CONTROLS	-3.5%	27,384
JOHNSON & JOHNSON	13.0%	26,911
KIMBERLY CLARK	4.5%	15,241
COCA COLA	6.0%	15,181
MONDELEZ	6.4%	19,013
MEDTRONIC	5.5%	23,493
PROCTER & GAMBLE	3.3%	17,180
THERMO FISHER	14.7%	17,670
UNITED TECHNOLOGIES	5.6%	14,674
ABBOTT	**10.75%**	**21,151***
Percent Rank	62.4	76.5
RDA Results	-14 "Low"	
Median Revenues	**$27.8 Billion**	
Median Market Cap	**$88.2 Billion**	
Abbott Revenues	**$28.9 Billion**	
Abbott Market Cap	**$99.3 Billion**	

*Based on ISS calculations. **In Abbott's proxy (page 44) 3-year average CEO pay is $19,552,771.**

Fatally Flawed Financial Performance Assessment

The FPA, on page 14 of the Draft Report, which is relevant for Abbott **only due to ISS's selection of an inappropriate peer group** as illustrated above, misrepresents Abbott's performance by measuring it based on metrics that are inconsistent with our ongoing operating performance and our M&A activity, which our shareholders have consistently validated and supported.

As explained in our March 1, 2018 letter and in the call with our Lead Director and Compensation Committee Chair in February 2017, while ISS's approach to measuring company performance might produce reasonable results for a company **without** significant acquisition and divestiture activity, for a company **with recent large acquisitions**, an approach focusing solely on GAAP or unadjusted measures will produce misleading results. For example, the Draft Report shows Abbott's return on equity ("ROE") metric as being in the lowest quartile. Page 35 of the Abbott Proxy illustrates the impact of the AbbVie separation on Abbott's ROE metric—Abbott **retained 90% of the equity and only 35% of net income** of the pre-separation corporation. Obviously, this has a dramatic impact on the ROE for an extended period of time if ROE is not adjusted to take into account the separation, which is why we explained the impact in the Abbott Proxy. **This impact has been totally disregarded and ignored.** Whereas Abbott's ROE was 29.8% in the year ending just prior to the separation of AbbVie, due to the board-approved capitalization of the two companies, Abbott's ROE changed to 13.1% while AbbVie's increased to 115%. Abbott's market capitalization at the time of the separation was $50.7 billion while AbbVie's was $55.5 billion. As of year-end 2017, the combined market capitalization was $253.7 billion. Abbott's market capitalization alone as of year-end 2017 was $99.3 billion, reflecting an increase of 96%, almost double since the separation.

Similarly, acquisitions impact other return metrics as the denominator (be it assets, equity, or invested capital) increases immediately while returns "catch up" over time as synergies are realized and product pipelines come to market.

While our unadjusted return metrics have been impacted as expected due to our recent acquisitions (St. Jude Medical and Alere), our adjusted EBITDA growth remains high, including an increase from $5.02 billion to $7.2 billion in 2017, a 43% increase (as noted in Annex 1 of the proxy). This increase places us at the top of our peer group **and** the peer group ISS used for its analysis of our programs in the Draft Report. It is incomprehensible that ISS did not use EBITDA in its FPA, **despite highlighting it as the most**

important metric for our GICS classification, due to our recent M&A activity. Even though that same M&A activity impacts our Return metrics, ISS is choosing to include those. Excluding EBITDA, a metric that we perform extremely well on as disclosed on page 26 of our proxy, renders the FPA fatally flawed for assessing Abbott's performance. Since EBITDA information is readily available, it is not reasonable to subject Abbott to the FPA or to use the FPA as the basis for making a recommendation to shareholders, without including it.

In addition, in the Overview section of the Pay for Performance analysis on page 17 of the Draft Report, there is a reference to the decrease in net income from $1.4 billion in 2016 to $477 million in 2017, but with no context or explanation. As noted in our most recent Form 10-K, **this is primarily due to a one-time net expense of $1.46 billion related to the estimated impact of U.S. tax reform, which was left out of your analysis. Highlighting this as evidence of Abbott's allegedly mixed performance during 2017 blatantly misrepresents Abbott's performance and reflects a lack of understanding of financial metrics and undermines the analysis**. This is a prime example of why our Compensation Committee, our investors and the investment community do not singularly focus on GAAP numbers and instead focus on results that are appropriately adjusted to reflect on-going operations.

Investors, companies, rating agencies, and governmental agencies all use adjusted metrics to measure our company and all companies. They are skilled enough, smart enough, and well trained so that they can use judgment and not simply GAAP metrics in assessing a company. But it appears that ISS makes no such efforts. This renders the analysis misleading in the extreme and out of touch with how ISS's own customers and the rest of the investing world evaluate a company. From the inappropriate conclusion that our earnings declined, to the over reliance on the FPA as an evaluation metric, and the exclusion of EBITDA where we rank first in our peer group, the Draft Report is rife with erroneous conclusions due to this blind over-reliance on GAAP metrics.

2. Misrepresentation of Abbott's Disclosure and Incentive Compensation Practices

Long-Term Incentive Awards

The Draft Report contends that "performance-conditioned equity awards are earned based on annual rather than multi-year performance, and the company does not disclose results relative to this goal to allow investors to fully determine its rigor" (pages 1 and 12). Further, the Draft Report indicates that

less than 50% of the CEO's long-term incentive awards were performance-based (page 17). Both statements are false and misleading.

Contrary to ISS's incorrect assessment, multi-year measures are used in three separate steps in the LTI Award Process -- to determine the Company LTI Award Guidelines, to adjust those guidelines based on individual officer performance, and then to ultimately vest in the awards.

First, as clearly disclosed on pages 27 and 34 of the Abbott Proxy, the grant of all equity awards (both time and performance-vesting) is conditioned on Abbott's relative TSR performance over one-year, three-year, and five-year performance periods. The Committee considered all three of these periods, and in its discretion, gave more weight to the more recent periods.

Second, as clearly disclosed on page 34 of the Abbott Proxy, the grant value of Abbott's equity awards that is determined based on its relative TSR performance is then modified based on individual goals and performance related to sales and market growth, margin contribution and strategic milestones, all of which are assessed over **three years and are specifically objective and measurable.** As a result of these first two steps, the equity awards granted to Abbott's CEO (and other NEOs) are 100% performance-based (rather than only 41.1% performance-based, as you wrongly state on page 17 of the Draft Report).

Third, as clearly disclosed on page 35 of the Abbott Proxy, once a performance-vesting equity award is granted, 1/3 of each award vests for *each* year that the ROE goal is achieved—satisfaction of the ROE goal in one year would not obviate the need to achieve that goal in two other years for the remaining 2/3 of the award. In response to shareholder feedback, and as described on page 29 of the Abbott Proxy, the vesting period for new performance-vesting restricted share awards was set at three years, meaning that holders only have one opportunity to vest in each 1/3 of the award. Accordingly, ISS's statement that multi-year performance is not considered and that the disclosure is somehow lacking is completely wrong and highly misleading.

Further, there is no basis for the statement that it is difficult to assess the rigor of the performance goals from Abbott's disclosure because actual performance is not disclosed. It is, in fact, disclosed. With respect to relative TSR, Abbott's performance over one-year, three-year, and five-year performance periods since 2013, is disclosed in detail on page 5 of the Abbott Proxy. With respect to ROE, the targets and the fact that they have been achieved is disclosed **every year**. The implication that Abbott's Compensation Committee, composed of entirely independent directors and advised by an independent

compensation consultant, intentionally set less than demanding goals and then tried to obscure this from shareholders is outrageous.

The strong correlation between long-term incentive awards and performance is manifest in our historical grant practices. In years when we have not achieved our goals or our TSR has lagged our peers, our Compensation Committee has demonstrated a clear willingness to reduce grant sizes. For example, based on 2016 performance, our 2017 LTI grant was made at the 25th percentile of our guidelines and, based on 2013 performance, our 2014 LTI grant was made at the 37th percentile grant of our guidelines. We believe (based on our independent compensation consultant's benchmarking and the experience of our directors) this approach demonstrates rigor in goal setting of performance measures, is aligned with our shareholders' experience, and is unique among large cap companies, which typically peg annual equity grant values to a specific benchmark level (e.g., market median), irrespective of recent financial and/or stock price performance.

Our approach to LTI grants is not "standard." Additionally, as stated on page 34 of the Abbott Proxy, we also believe that this approach is **far more rigorous** than the "standard" approach used by the overwhelming majority of large cap companies. In the future, we will attempt to put even more explanation and disclosure in, subject to the limitations of competitive information. Obviously, there are limitations on the degree of specificity that can be disclosed in strategic objectives due to competitive sensitivities, as they often relate to M&A, new product developments, etc. For example, the acquisitions of St. Jude Medical and Alere were part of long-term strategic goals that clearly could not be disclosed prior to completion. The absence of that disclosure does not mean goals do not exist or are not rigorous. And it does not render them "subjective". They are highly sensitive competitive information, and therefore, inappropriate to disclose.

Annual Incentive Awards

The Draft Report also suggests that the Compensation Committee does not set rigorous goals for purposes of annual incentive awards. We disagree. **Abbott sets a double-digit target for earnings growth nearly every year.** We achieved **double-digit** adjusted EPS growth in 8 of the past 11 years (achieving that level in the other three years on a constant-currency basis), and beat Street consensus in 40 of those 44 quarters. Not only do we set rigorous goals, we consistently meet or beat them. As noted on page 32 of our proxy, to receive even a partial payout for sales, **the business must grow at the**

market rate. And to achieve a full payout, the business must **exceed** the market rate of growth. **None** of our peers to our knowledge set their hurdles so high. Beating the market garners a 100% payout at Abbott, not more. And to achieve above-target payouts, one must considerably beat the market.

In order to maximize shareholder value over the long-term, and mitigate improper risk taking for a business as large and complex as Abbott's, the Compensation Committee believes it is appropriate to determine annual incentives based on a combination of financial operating goals and specific and measurable strategic objectives, the latter of which the Draft Report wrongly characterizes as "subjective." The strategic objectives, which are clearly enumerated on pages 35-37 of the Abbott Proxy, are far from subjective. Mr. White's strategic objectives, for example were related to the "successful reshaping of Abbott through the AMO divestiture and acquisitions of St. Jude Medical and Alere Inc." Mr. Yoor's strategic objectives "included M&A activity support, transformation of the finance organization and implementation of key financing and cash flow improvement initiatives which significantly overachieved their targets." **These are specific, objectively identifiable and measurable goals, the achievement of which was made clear through the public announcement of the completion of the transactions and, more importantly, the significant success of our business that followed, which is predicated on the successful integration of these two significant acquisitions.**

Each of these acquisitions has a price target and a deal model that identifies financial performance for sales, earnings, synergies, and one-time costs. When we reference "successful integration" in our proxy it is because **each of these metrics was met**. Similarly, the success of the financing and cash flow improvement initiatives was made clear through the increase in cash flow (as illustrated in our public filings and the Abbott Proxy on page 38 which shows a 113% increase in cash flow between 2017 and 2016). This increase in cash flow allowed us to retire $3.95 billion of debt in January 2018 and an additional $2.0 billion of debt in March 2018 ahead of schedule and targets. **The fact that not all of these types of goals lend themselves to a formulaic assessment or that we do not publicly disclose confidential competitive and market targets does not make them "subjective".** Our shareholders clearly agree with the Compensation Committee's assessment of the satisfaction of these goals given that we were #1 in Total Shareholder Return in our peer group for 2017 and that any Say on Pay vote outcomes for each of the past three years have been in the mid-90's.

If the goals were not rigorous, one would expect to see payouts consistently above target. On the contrary, our short-term incentive payouts are highly differentiated based on performance. In 2017,

Abbott significantly overachieved key financial and strategic goals and, as disclosed on page 31 of the Abbott Proxy, **however short-term incentive payouts ranged from 18% to 163% of target**, with an average of 105% of target. By contrast, in 2016, Abbott met its key financial goals but certain businesses did not and, as disclosed on page 33 of our 2017 proxy, short-term incentive payouts ranged from 10% to 122% of target, with an average of 92% of target. **We believe this level of market leading differentiation is relatively unique to Abbott.**

We believe this differentiation, with respect to both short- and long-term incentive compensation, reflects both rigorous goals for individual officers and a program that strongly aligns pay to performance. That ISS chooses to overlook these facts and criticize the rigor of our goals and alignment of our payouts to performance calls into question the credibility of ISS and its analysis. Abbott's proxy disclosure evolves each year and strives to be as clear, concise and easy to understand as possible.

3. Artificially Inflated Description of CEO Compensation

As illustrated throughout the Abbott Proxy, **the grant date fair value of long-term incentive award opportunities is directly based on performance**. Abbott's Compensation Committee has, since 2013, consistently granted equity awards that are allocated (based on a grant date fair value using GAAP assumptions) **50% in the form of options and 50% in the form of performance-restricted shares.**

It is unclear why (and indeed is inappropriate that) ISS chooses to value options using assumptions different from the GAAP assumption used by Abbott in its audited financial statements. ISS's methodology not only doesn't conform to GAAP and would not be allowed in Abbott's financial statements, it would violate SEC disclosure rules. ISS's valuation method adds millions of dollars of compensation which Mr. White did not receive, Abbott's Compensation Committee did not approve, and Abbott will never expense. The fact that the ISS methodology leads to such a different result than that included by Abbott in its audited financial statements should be a signal that something is wrong with the ISS methodology. The consistent overvaluation of Abbott awards is misleading and reflects a lack of judgment on the part of ISS.

The ISS assumptions which assume a 10-year life paired with inaccurate volatility, yield, and risk-free rate are misleading and demonstrate a basic lack of understanding of the process companies use to grant, investors use to evaluate, and the accounting rules for valuing stock options. For example, a 10-year life would only be appropriate if the option is freely transferable. The valuation of stock options

requires an estimate of volatility over the expected option term. Basing the volatility on three years of data, as ISS has done, is inconsistent with the ISS expected term of 10 years and seems only to be designed to maximize option value and misstate compensation. This makes a material, incorrect, and misleading difference in your calculation of CEO compensation and again in the conclusion you draw.

ISS's incorrect valuation of Abbott's options adds over $1.5 million to our 3-year average CEO pay. In fact, according to our consultants, had ISS used the actual value of our CEO's options in the analysis, the RDA would have yielded a "Low" level of concern; thereby changing the entire analysis of our compensation program.

2016 Stock Option Award Valuation		
Assumptions	ISS	Abbott
Strike Price	$38.40	$38.40
Term (years)	10	6
Volatility	20%	17%
Dividend Yield	2.50%	2.70%
Risk Free Rate	1.76%	1.40%
Fair Value Per Option	$6.73	$4.38
CEO Award Value (in 000)	$8,067	$5,246
% Difference ISS vs. Abbott	54%	
$ Difference ISS vs. Abbott	$2,821	

2017 Stock Option Award Valuation		
Assumptions	ISS	Abbott
Strike Price	$44.40	$44.40
Term (years)	10	6
Volatility	21%	18%
Dividend Yield	2.28%	2.40%
Risk Free Rate	2.42%	2.10%
Fair Value Per Option	$9.27	$6.42
CEO Award Value (in 000)	$5,920	$4,100
% Difference ISS vs. Abbott	44%	
$ Difference ISS vs. Abbott	$1,820	

ISS's election to use a non-GAAP valuation of options results in a flawed and misleading evaluation by:

- Misrepresenting the mix of options and performance-restricted awards;
- Artificially increasing the value of CEO pay beyond what was approved by our Compensation Committee;
- Creating a misleading RDA assessment score;
- Conducting a misleading FPA review and recommendation against Say on Pay; and by extension
- Incorrectly informing ISS's recommendation on the shareholder proposal concerning separation of the Chair and CEO roles

The election to use non-GAAP valuation of options is entirely inconsistent given the complete reliance upon GAAP metrics in the FPA and other quantitative tests ISS uses in its evaluation. By using a non-

GAAP measure for option valuation, ISS seems to acknowledge that there are times when a non-GAAP metric may be appropriate. But by creating your own assumptions vs. using those that companies are required to use makes any critique of a company's option value unreliable and of no utility to an investor. And basing the valuation on assumptions that bear no resemblance to reality again illustrates that ISS's methodology is arbitrary, capricious, out of touch with the investing community, and not consistent with standard accounting requirements.

4. Unfounded Disclosure Concerns

Setting aside the concerns detailed above, **ISS's own analysis on page 14 of the Draft Report indicates that the compensation of Abbott's CEO is substantially aligned with performance, based on relative degree of alignment, absolute pay-TSR alignment and multiple of median, meriting a "Low" level of concern on ISS's initial quantitative analysis.** As a result, ISS's decision to recommend against Abbott's say-on-pay proposal appears to be principally driven by disclosure sufficiency concerns regarding strategic performance goals.

The disclosure in the Abbott Proxy is similar to—and, in fact, more detailed than that included in—last year's proxy statement, where ISS supported Abbott's Say on Pay vote. As discussed above, the strategic goals for each officer are clearly enumerated on pages 35-37 of the Abbott Proxy. Further, our independent compensation consultant has advised us that the level of disclosure regarding strategic goals in Abbott's Proxy is consistent with the level of disclosure included in the proxy statements of most other public companies that use strategic goals. Finally, the Draft Report states that "the company does not disclose the level of achievement earned for each component of the formulaic incentive plan." **This too is false.** The overachievement of these goals is highlighted on page 38 of our proxy.

The Abbott Proxy reflects the carefully considered judgment of our Compensation Committee regarding the appropriate balance between providing the disclosure necessary for shareholders to assess our plans and not revealing confidential information that could be used by our competitors, which would ultimately harm our shareholders by disclosing material non-public business segment plans and performance for competitors to see. Given that the level of disclosure in Abbott's Proxy is more fulsome than in any prior year and complies with all requirements of the securities laws, that Abbott has further strengthened the rigor of our program by increasing the requirements for vesting performance shares, and that Abbott actually disclosed more than required by voluntarily disclosing the

2018 equity grant a year before it is required, a recommendation against Abbott's Say on Pay proposal based on disclosure concerns is misleading and unreasonable. We request that you correct the errors in the draft report and change your Say on Pay recommendation to "FOR", reflecting the more accurate information we have noted.

SHAREHOLDER PROPOSAL REGARDING SEPARATION OF CHAIR AND CEO POSITIONS

The Draft Report recommends a vote "FOR" the independent chair shareholder proposal based principally on an inaccurate and inappropriate recommendation regarding the say-on-pay vote, which has been clarified and corrected above. As the Draft Report notes that ISS has no significant concerns with Abbott's governance structure or responsiveness to shareholders, an "AGAINST" recommendation by ISS is warranted.

In addition, we note the following:

1. Governance of CEO Compensation

Under Abbott's existing governance arrangements, **the Chairman and CEO plays no role in the determination of his own compensation**. Instead these decisions are made by Abbott's Compensation Committee, comprised solely of independent directors and advised by an independent compensation consultant. The Chairman and CEO is not invited to participate in any discussions of his own compensation nor is he aware of the recommendation of the independent consultant or the committee's deliberations prior to being informed of his awards. Accordingly, having a separate Chairman would have no impact upon the decisions related to CEO compensation.

2. Flexibility to Act in the Best Interests of Shareholders

The Board is entrusted to act in the best interests of shareholders and should be given full flexibility to select the best person for the Chairman and/or CEO role. While the independent chair shareholder proposal does not require an immediate change to the board leadership structure, Abbott operates in a dynamic and competitive environment and the proposal, if implemented, will impede the Board's long-term ability to select candidates who are best suited to the applicable circumstances and needs of Abbott and its shareholders.

3. Demonstrated Long-Term Focus

The Board firmly believes that Abbott's existing leadership structure has served shareholders well. Under the current joint CEO and Chairman structure, Abbott has continuously transformed through several strategic actions. In just the past year, Abbott acquired St. Jude Medical, Inc., and Alere Inc., creating a medical devices and diagnostics leader, positioning the company for continued profitable growth. In 2017, Abbott's one-year total shareholder return was 52%, which was 30.2 percentage points above the Standard & Poor's 500 Index. The current Chairman and CEO has been on the Barron's Most Admired CEO list for 9 consecutive years. Nonetheless, the Board can appoint an Independent Chairman at any time should they feel it is in the best interest of the company.

4. Rigorous Independent Management Oversight

Every Board member other than the Chairman is independent under the New York Stock Exchange rules. Abbott's independent directors evaluate the CEO's performance annually and regularly review its leadership structure. Abbott's independent directors also sit on all key committees that oversee the integrity of Abbott's financial statements, executive compensation and the nomination of new directors.

5. Robust Lead Director Structure

Abbott also has a lead independent director whose role complies with the ISS definition of a robust lead director. The lead independent director serves as a liaison between the Chairman and the independent directors (which is Abbott's entire Board, minus the Chairman), and reviews matters such as meeting agendas, meeting schedules to assure that there is sufficient time for discussion of all agenda items, and, where appropriate, information sent to the board. The lead independent director also has the authority to call meetings of the independent directors and, if requested by major shareholders, ensures that he or she is available for consultation and direct communication.

6. No Proven Benefits

Even the Draft Report recognizes that many large companies combine the posts of chairman and CEO and perform well under this arrangement. Empirical studies also show that separating the Chairman and CEO roles does not result in better operating performance or improved corporate governance.

Accordingly, the Board continues to believe that providing it with the flexibility to choose the most suitable candidate for Chairman and/or CEO best serves the interest of Abbott's shareholders.

* * *

This letter clarifies our practices with which you expressed concern, and we expect that ISS will decide to change its recommendation on the "say-on-pay" advisory vote (and correct the errors in its analysis) and the independent chair shareholder proposal.

The Draft Report states that ISS's support for the independent chair proposal is primarily driven by the adverse vote recommendation on the Say on Pay proposal. Since this is based on an erroneous analysis of Abbott's compensation, and therefore a false premise, we hope that ISS will change/correct this recommendation as well. When the record has been corrected with the facts, a recommendation of "FOR" on the Say on Pay proposal and "AGAINST" on the independent chair shareholder proposal is clearly warranted.

Sincerely,

/s/ Stephen R. Fussell

SRF:sla

Annex B

GAAP Reconciliations

Abbott uses various non-GAAP financial measures to adjust for specified items that are unusual or unpredictable, such as cost reduction initiatives, restructuring programs, integration activities and other business acquisition-related costs, the estimated 2017 impact of U.S. tax reform, and the recognition of a gain and deferred taxes associated with the sale of the Medical Optics business. These non-GAAP financial measures also exclude intangible amortization expense to provide greater visibility on the results of operations excluding these costs, similar to how Abbott's management internally assesses performance.

Abbott's management believes the presentation of these non-GAAP financial measures provides useful information to investors regarding Abbott's results of operations as these non-GAAP financial measures allow investors to better evaluate ongoing business performance. Abbott's management also uses these non-GAAP financial measures internally to monitor performance. Abbott, however, cautions investors to consider these non-GAAP financial measures in addition to, and not as a substitute for, financial measures prepared in accordance with GAAP.

1. *"Whereas Abbott's ROE was 29.8% in the year ending just prior to the separation of AbbVie, due to the board-approved capitalization of the two companies, Abbott's ROE changed to 13.1% while AbbVie's increased to 115%."* (Page 6)

Return on Equity (%)	2012	2013
Adjusted Calculation	29.8%	13.1%
GAAP Calculation	23.2%	9.9%
Variance	6.6%	3.2%
Adjusted vs. GAAP - Increase / (Decrease)		
Adjusted for specified items including intangibles amortization, acquisition-related cost reduction initiatives, and other expenses.	7.1%	2.9%
Adjusted for discontinued operations	-	(0.7%)
Balance sheet adjustments	(0.5%)	1.0%
Components of Variance	6.6%	3.2%

2. "*While our unadjusted return metrics have been impacted as expected due to our recent acquisitions (St. Jude Medical and Alere), our adjusted EBITDA growth remains high, including an increase from $5.02 billion to $7.2 billion in 2017, a 43% increase (as noted in Annex 1 of the proxy).*" (Page 6)

The reconciliation of Adjusted EBITDA to Earnings from Continuing Operations is as follows:

(in millions)	2017	2016	% Change
Earnings from Continuing Operations	$ 353	$1,063	−67%
Less Tax Expense on Earnings from Continuing Operations	1,878	350	
Earnings from Continuing Operations before taxes	2,231	1,413	
Specified Items Including Intangible Amortization	3,038	2,617	
Interest Expense	879	186	
Depreciation	1,046	803	
Adjusted EBITDA	$ 7,194	$5,019	43%

Abbott Laboratories and Subsidiaries
Details of Specified Items
Year Ended December 31, 2017
(In millions)
(unaudited)

	Acquisition or Divestiture-related[a]	Restructuring and Cost Reduction Initiatives[b]	Intangible Amortization	Other[c]	Total Specifieds
Gross Margin	$ 983	$ 195	$1,975	$ —	$3,153
R&D	(72)	(105)	—	(59)	(236)
SG&A	(812)	(50)	—	1	(861)
Interest expense, net	(24)	—	—	—	(24)
Other (income) expense, net	1,285	(34)	—	(15)	1,236
Earnings from Continuing Operations before taxes	$ 606	$ 384	$1,975	$ 73	3,038

[a] Acquisition-related expenses include bankers' fees and costs for legal, accounting, tax, and other services related to business acquisitions, integration costs which represent incremental costs directly related to integrating the acquired businesses and include expenditures for consulting, retention, severance, and the integration of systems, processes and business activities, fair value adjustments to contingent consideration related to a business acquisition, and inventory step-up amortization. The specified items in interest expense include amortization expense associated with acquisition-related bridge facility fees. Divestiture-related expenses include incremental costs to separate the divested businesses as well as bankers' fees and costs for legal, accounting, tax, and other services related to the divestitures. Divestiture-related items also include any gains in the period related to the sale of Mylan N.V. ordinary shares.

[b] Restructuring and cost reduction initiative expenses include severance, outplacement, inventory write-downs, asset impairments, accelerated depreciation, and other direct costs associated with specific restructuring plans and cost reduction initiatives. Restructuring and cost reduction plans consist of distinct initiatives to streamline operations including the consolidation and rationalization of business activities and

facilities, workforce reductions, the transfer of product lines between manufacturing facilities, and the transfer of other business activities between sites. Any gains related to the divestiture of a facility as part of a restructuring program are also included in this category.

(c) Other expense primarily relates to impairments of a financial instrument and an R&D asset as well as the acquisition of an R&D asset.

Abbott Laboratories and Subsidiaries
Details of Specified Items
Year Ended December 31, 2016
(in millions)
(unaudited)

	Acquisition or Divestiture-related[a]	Restructuring and Cost Reduction Initiatives[b]	Mylan Equity Investment Adjustment[c]	Venezuela Devaluation[d]	Intangible Amortization	Other[e]	Total Specifieds
Gross Margin	$ 24	$ 72	$ —	$ 15	$550	$ —	$ 661
R&D	(9)	(6)	—	—	—	(62)	(77)
SG&A	(133)	(89)	—	(10)	—	(17)	(249)
Interest expense, net	(240)	—	—	—	—	—	(240)
Net foreign exchange (gain) loss	—	—	—	(480)	—	—	(480)
Other (income) expense, net	38	—	(947)	(1)	—	—	(910)
Earnings from Continuing Operations before taxes	$ 368	$ 167	$ 947	$ 506	$550	$ 79	2,617

(a) Acquisition-related expenses include bankers' fees and costs for legal, accounting, tax, and other services related to business acquisitions, integration costs which represent incremental costs directly related to integrating the acquired businesses and include expenditures for consulting, retention, severance, and the integration of systems, processes and business activities, fair value adjustments to contingent consideration related to a business acquisition, inventory step-up amortization, and gains on a previously held investment for which the company acquired a controlling interest. The specified items in interest expense include amortization expense associated with acquisition-related bridge facility fees and net interest expense associated with the debt issued in November 2016 in advance to fund the cash portion of the acquisition of St. Jude Medical in January 2017. Divestiture-related expenses include incremental costs to separate the divested businesses as well as bankers' fees and costs for legal, accounting, tax, and other services related to the divestitures.

(b) Restructuring and cost reduction initiative expenses include severance, outplacement, inventory write-downs, asset impairments, accelerated depreciation, and other direct costs associated with specific restructuring plans and cost reduction initiatives. Restructuring and cost reduction plans consist of distinct initiatives to streamline operations including the consolidation and rationalization of business activities and facilities, workforce reductions, the transfer of product lines between manufacturing facilities, and the transfer of other business activities between sites. Any gains related to the divestiture of a facility as part of a restructuring program are also included in this category.

(c) Mylan equity investment adjustment expense reflects the adjustment of Abbott's holding of Mylan N.V. ordinary shares due to a decline in the fair value of the securities which was considered by Abbott to be other than temporary.

(d) Venezuela devaluation expenses include the foreign exchange loss of $480 million related to the revaluation of Abbott's net monetary assets in Venezuela using the Dicom exchange rate as well as inventory and other asset impairments in Venezuela related to the move to the Dicom exchange rate. The Dicom rate is the Venezuelan government's official floating exchange rate.

(e) Other expense relates to other unusual significant costs such as a significant litigation settlement and the impairment of an R&D asset.

3. "*We achieved **double-digit** adjusted EPS growth in 8 of the past 11 years (achieving that level in the other three years on a constant-currency basis)...*" (Page 9)

   We achieved double-digit GAAP EPS growth in 4 of the past 11 years and triple-digit growth in 2 of the past 11 years (with single-digit or negative growth in the 5 other years).

4. "*Similarly, the success of the financing and cash flow improvement initiatives was made clear through the increase in cash flow (as illustrated in our public filings and the Abbott Proxy on page 38 which shows a 113% increase in cash flow between 2017 and 2016).*" (Page 10)

($ millions)	2017	2016	% Change
Operating Cash Flow	$5,570	$3,203	74%
Less Capital Expenditures	(1,135)	(1,121)	
Adjusted Free Cash Flow	$4,435	$2,082	113%

Proxy Solicitations Re Proxy Advisory Reports

Draft 5/19/2017

	Company	Form	Filed	Excerpts
1	ARCONIC INC.	DEFA14A	5/15/2017	I am writing to alert you to several significant calculation mistakes contained in the Glass Lewis report on Arconic relating to the total return we have generated for our shareholders over the 1-, 3- and 5-year periods ended January 31, 2017. Glass Lewis cited these erroneous calculations as a "reasonable basis for shareholders to question the effectiveness of the incumbent board." We note, for example, that in the one year period ended January 31, 2017, the total shareholder return actually generated for our shareholders was +64% but Glass Lewis erroneously calculates it to be -26%. There are also large calculation mistakes for the 3- and 5-year periods ended January 31, 2017. (For three years, Glass Lewis reports that the return is +36% when the correct number is +7%; for five years, Glass Lewis calculates -28% when the correct return is +21%.) (See Exhibit 1 for detailed calculations). Glass Lewis also used companies we cited as "peers" in erroneous calculations regarding our past. The fact is that the owners of Alcoa Inc. from eight years ago saw their wealth increase by approximately $8 billion through the transformation of the company and its split into two public companies. We recognize that this proxy fight is about the future, not the past. We believe we have the right strategy for maximizing value for shareholders going forward.
2	ALEXANDRIA REAL ESTATE EQUITIES INC	DEFA14A	05/02/2017	Glass Lewis has recommended voting against our Say-on-Pay Proposal because of their perceived disconnect between pay and performance. In addition to being facially inaccurate, the Glass Lewis report contains many factual errors and flawed methodology, which we detail below. While we recognize the value that proxy advisory firms provide to our stockholders, it is imperative that their reports contain accurate information. Our executive compensation is well aligned with our performance, and specifically aligned with our growth over the three-year period ending December 31, 2016, in the key metrics that are important to investors in the REIT industry - total stockholder return ("TSR") and growth in funds from operations ("FFO") per share. Moreover, the charts below demonstrate that our pay and performance are aligned relative to the pay and performance of both our peer group and the Equilar/Glass Lewis peer group, even though the latter is flawed for the reasons described below. The Glass Lewis statement that "the Company performed moderately worse than its peers" is factually inaccurate, as both our TSR and growth in FFO per share are at the top of all applicable peer and index groups (see the following charts). As a result, there is no basis for the statement by Glass Lewis that there is a "disconnect between pay and performance." We believe this statement is the result of the Glass Lewis formulaic pay-for-performance letter grading system (for which Glass Lewis does not disclose its methodology) that has produced a nonsensical result based in part on incorrect TSR data, one of the many factual errors in the Glass Lewis report noted below.
3	FMC CORP	DEFA14A	4/10/2017	Dear FMC Shareholder, I would like to address you directly regarding FMC's Advisory Vote on Executive Compensation at the 2017 shareholder meeting. Despite the significant changes we made to our programs after last year's vote, both ISS and Glass Lewis have again recommended a vote against FMC's programs. In our view, ISS and Glass Lewis have failed to account for these matters in reaching their recommendations, instead focusing on narrow measures of shareholder return and incidental aspects of the incentive programs and executive awards. .We sincerely hope you will consider these factors while considering how you vote at FMC's shareholder meeting, and particularly on the Advisory Vote on Executive Compensation.

4	WELLS FARGO & COMPANY/MN	DEFA14A	4/7/2017	The Board of Directors of Wells Fargo & Company (NYSE: WFC) issued the following statement regarding today's report on Wells Fargo by Institutional Shareholder Services ("ISS") in connection with the April 25, 2017 Annual Meeting of Stockholders: . "The extreme and unprecedented ISS voting recommendation on directors fails to recognize the active engagement of the Board and the substantial actions it has already taken to strengthen oversight and increase accountability at all levels of Wells Fargo, including important improvements to corporate governance. The ISS report was also issued without taking into account findings of the Board's independent investigation, which was launched last September and will be made public shortly. We strongly disagree with the unwarranted recommendation by ISS to vote against 12 of Wells Fargo's 15 directors—and urge our shareholders to disregard ISS's director voting recommendations and judge for themselves the findings of the investigation and the strong actions the Board has already taken." . The Board has already taken numerous actions and supported management's steps to promote accountability, strengthen oversight, and hold to account those responsible for improper sales practices, including:...
5	PRAXAIR INC	DEFA14A	4/6/2017	In particular, we request that you vote FOR Item 3, the Say-on-Pay proposal. We are providing you with this additional information regarding this proposal in order to address the critical oversights made by Institutional Shareholder Services ("ISS") in recommending against the Say-on-Pay proposal in its report of April 4, 2017 ("ISS Report"), contrary to the Board's recommendation. We believe our executive compensation program is appropriately designed, competitive with market practices, has significant pay at risk and adequately balances short-term to long- term incentive payouts to ensure shareholder alignment. It is worth noting that one of the other proxy advisory firms, Glass Lewis, recommended a FOR vote on this item in its report dated March 27, 2017. Response to Specific ISS Report Items . The ISS Report identifies a number of issues in its assessment of our executive compensation program that were used to support an "against" recommendation that we believe are inaccurate or do not fully represent the facts. . • ISS asserts "the CEO's fixed pay and cash opportunities increased … despite long-term lagging TSR." • Due to its own equity valuation methodology, ISS maintains the Compensation Committee is awarding a 60/40 mix of stock options and PSUs. • ISS highlights the lowering of performance targets without a commensurate decline in potential payouts. • ISS appears to place negligible importance on strategic, non-financial performance. • ISS asserts that Praxair had "weak operational performance."

6	WILLIAMS COMPANIES INC	DEFA14A	6/20/2016	The Williams Companies, Inc. (NYSE: WMB) ("Williams") today announced that three out of four of the leading proxy advisory firms – Institutional Shareholder Services ("ISS"), Egan-Jones Proxy Services ("Egan-Jones") and Pensions & Investment Research Consultants Limited ("PIRC"), Europe's largest independent corporate governance and shareholder advisory consultancy – recommend that Williams stockholders vote "FOR" the proposed transaction with Energy Transfer Equity, L.P. (NYSE: ETE) ("ETE") at Williams' special meeting of stockholders scheduled for Monday, June 27, 2016. Williams also today noted that it believes Glass, Lewis & Co. ("Glass Lewis") reached the wrong conclusion in recommending against the proposed transaction. While Williams appreciates that Glass Lewis expects that the "greater scale and asset diversification provided by the proposed transaction could potentially position the Company to better manage the current challenging commodity price environment, including by providing more diversified cash flows and a wide range of potential strategic opportunities," the Glass Lewis recommendation fails to reflect the potential upside in the transaction, the value certainty provided by the cash component and the risks associated with a standalone Williams. Other key observations regarding Glass Lewis' recommendation include: • In failing to assess the value of consideration being offered to Williams stockholders in the transaction, Glass Lewis ignores the significant acquisition premium being offered to those stockholders. If Williams stockholders were to reinvest the cash consideration of $8.10 per share in ETE stock at the current ETE share price (as of June 17, 2016), Williams stockholders would own 74% of the combined company, significantly in excess of Williams' proportionate value contribution. • Glass Lewis mistakenly cites a revised aggregate pre-tax annual corporate synergy total of $126 million in the base case. While the expected commercial synergies have been revised to $126 million in the base case and more than $500 million in the upside case, Glass Lewis' analysis omitted the fact that there are also additional significant material cost synergies that the companies expect to realize through the transaction. The base case of commercial synergies is consistent with the range of potential synergies considered by the Williams Board in approving the merger and by Williams' financial advisors when performing the analyses and arriving at their opinions. …

7	PIONEER NATURAL RESOURCES CO	DEFA14A	5/11/2016	Two proxy advisory firms, Institutional Shareholder Services, Inc. ("ISS") and Glass, Lewis & Co., LLC ("Glass Lewis"), have recommended that stockholders vote against our Say-on-Pay Proposal. Pioneer strongly believes its executive compensation program is in the best interests of the Company's stockholders, and asks that you support the Say-on-Pay Proposal for the reasons set forth in this Supplement. The Company believes that the 2015 compensation program was well aligned with performance, and, in substance, was administered in a manner consistent with prior years, and therefore deserves the continued support of its stockholders. The proxy advisory firms' negative recommendations were driven primarily by one component of the executive compensation program, the annual bonus, that represented less than 11% of the CEO's 2015 compensation, rather than the outcomes of the overall program, putting form over substance . ... Primarily because the Compensation Committee approved these discretionary cash bonuses, ISS and Glass Lewis have recommended that stockholders vote against Pioneer's entire executive compensation program. ISS , itself, recognizes that the total 2015 compensation for Pioneer's CEO was reasonable relative to its performance and to that of the Company's peers. Glass Lewis stated that the Company has adequately aligned executive pay and corporate performance, that it did not identify pay-for-performance issues that should be of substantial concern to stockholders, and recognized that the Company's performance was better than its peers. Pioneer believes that ISS, particularly, misunderstands the function of the baseline performance hurdle. The achievement of the baseline performance hurdle would not have established a bonus amount. Since the Company first implemented the structured cash bonus incentive plan, the baseline performance hurdle has been used solely to determine whether a payout was permitted under the program so as to permit tax deductibility for purposes of Section 162(m). The final amount of payout has always been driven by the Committee's assessment of performance in areas other than net operating cash flow. Instead, the Compensation Committee established goals for the important performance factors that drive stockholder value, including production, cost reduction, and debt levels, which were achieved at above target level for 2015.
8	OMNICOM GROUP INC.	DEFA14A	5/10/2016	We are disappointed by Institutional Shareholder Services Inc.'s ("ISS") recommendation to vote against Mr. Purcell. It is clear from its report that ISS failed to place sufficient value on the approach we took in response to the shareholder proposal. As ISS acknowledges in its proxy voting guidelines FAQ, independent board chair shareholder proposals are "more nuanced and allow for a broader range of implementation." It would be illogical to vote against Mr. Purcell, the very director who so strongly advocated that we make the governance changes desired by Omnicom shareholders.

9	ALEXANDRIA REAL ESTATE EQUITIES INC	DEFA14A	5/2/2016	Institutional Shareholder Services ("ISS") has recommended that its clients vote FOR the election of all directors and all other proposals, including the Say-on-Pay Proposal, partially in recognition of our outstanding multi-year performance. Glass Lewis & Co. ("Glass Lewis") has recommended voting against our Say-on-Pay Proposal for reasons that we refute in detail below. While we recognize that our stockholders make their voting decisions independently, and often pursuant to internal guidelines, we also understand that the advisory reports are utilized as research tools by many of our stockholders. In this regard, we believe it is imperative that such reports contain accurate information. After the significant changes made to our compensation program, coupled with outstanding TSR and growth in FFO and NAV per share in 2015 and in the three years ending on December 31, 2015, a negative recommendation from Glass Lewis defies credulity and ignores the Compensation Committee's work in designing an appropriate compensation program to align compensation with multi-year performance. As described in our 2016 proxy statement, the fundamental principle that drives the pay decisions of our independent Compensation Committee is to reward performance. The Compensation Committee believes that each named executive officer's total annual compensation should vary with the performance of the Company for the year in question, and acts accordingly. As shown in the following chart, our executive compensation is well aligned with our performance and specifically aligned with our growth over the three-year period ending December 31, 2015 in the key metrics that are important to us and investors in the real estate investment trust ("REIT") industry. Our pay and performance are aligned relative to the pay and performance of our peer group and the Equilar/Glass Lewis peer group, which is flawed for the reasons described below. We believe the Glass Lewis suggestion that there is a "disconnect" between our pay and performance is based in large part on its onesize-fits-all model that relies on certain metrics that are not relevant to the REIT industry. For example, the Glass Lewis model considers relative earnings per share, a metric that was not used in the Glass Lewis analysis for our 2015 annual meeting and a metric that is not relevant to the REIT industry because it includes the impact of depreciation expense, which results in differences from company to company depending on the timing of investment and disposition decisions and variation in useful lives. As a result, REIT investors have for many years focused on growth in FFO per share and NAV per share when evaluating the performance of a REIT. In addition, we call your attention to the following errors, omissions, and misconceptions in the Glass Lewis report:

10	PENTAIR PLC	DEFA14A	4/25/2016	Dear Pentair Shareholder: . We are writing to address the recent negative vote recommendation from Institutional Shareholder Services Inc. ("ISS") for our advisory vote on executive compensation at our 2016 Annual General Meeting of Shareholders. Specifically, ISS' conclusion that there is a disconnect between our Chief Executive Officer's ("CEO's") pay and performance is incorrect. As ISS observes, 2015 was a challenging year for our business. However, those challenges were fully reflected in declining CEO pay: Glass, Lewis & Co., a leading proxy advisory firm, has recommended that shareholders vote FOR our advisory vote on executive compensation, specifically noting Pentair's "track record of aligning pay with performance." In conclusion, we ask for your support in our advisory vote on executive compensation at our 2016 Annual General Meeting of Shareholders, which is scheduled for May 10, 2016. ISS's negative recommendation was based on a flawed analysis of our compensation programs that did not appropriately take into account the significant declines in our CEO's pay in 2015 or the performance-based nature of our annual and long-term incentive compensation programs. We hope that you will find this summary and the more complete discussion of our executive compensation programs found in our Compensation Discussion & Analysis compelling evidence of our strong CEO pay-for-performance practices. We appreciate your continued support.
11	EXPEDITORS INTERNATIONAL OF WASHINGTON INC	DEFA14A	4/19/2016	A proxy advisory firm has recommended the shareholders vote against the Say-on-Pay proposal and in favor of shareholder proposal 6. . In light of these recommendations, we are providing this supplemental information in response to the recent feedback from the proxy advisory firm. CEO Compensation vs TSR. The proxy advisor shows a high level of concern for pay for performance, with the key reason being a misalignment of the two. This advisor specifically states that our CEO pay has out ranked Company TSR performance over the last three years, relative to reasonably comparable peers. In so doing, this advisor included the $8 million 2013 retirement bonus to our former CEO in its calculations. We believe the one-time bonus payment should be excluded from these calculations because it was the only retirement bonus ever paid in Company history, and in 2014 the Board passed a resolution prohibiting the payment of any future retirement bonuses. In continuing to include the retirement bonus, this advisor both presents a skewed depiction of the actual degree of alignment between the Company's executive compensation and TSR, and fails to provide an accurate one that could be of value to those seeking this information. We are quite confident that when excluding the retirement bonus it demonstrates an exceedingly high degree of alignment of pay with performance based on this advisor's methodology. Compensation Relies on a Single Performance Metric : The proxy advisory firm further states that, while our sole performance metric, operating income, is commendable, it may overly focus executives on a single aspect of Company performance. We believe U.S. GAAP operating income is the most appropriate comprehensive measurement for our business. The formula is simple, achieving it is not.

12	ALLERGAN PLC	DEFA14A	4/19/2016	As you may be aware, one of the two major proxy-advisory firms, Institutional Shareholder Services (or "ISS"), recommends differently than the Company's Board of Directors on four items on the agenda for the 2016 annual meeting. The other, Glass Lewis, recommends differently than the Company's Board of Directors on two agenda items. We have evaluated and strongly disagree with these recommendations for the reasons stated below. We ask that all of our shareholders carefully consider and evaluate the unique circumstances surrounding certain of the actions taken by the Company and highlighted by ISS and Glass Lewis before determining how to vote this year. Though we will address several of the specific recommendations and the Company's responses in turn, we would also like to highlight several key developments which our shareholders should consider when performing their own evaluations:... Glass Lewis erroneously stated in their report that a portion of the awards issued under our Transformation Incentive Plan and that related to total shareholder return or TSR could be earned for below median performance. In fact, no portion of any awards related to TSR could be earned for below median performance. For the second year in row, Glass Lewis did not include its full pay-for-performance analysis in its report. For shareholders who rely only on Glass Lewis materials to make voting decisions, there is no discussion of the Company's industry leading performance over this time period.
13	WEC ENERGY GROUP, INC.	DEFA14A	4/18/2016	In its 2016 Proxy Paper, Glass Lewis is recommending a vote against the Proposal primarily because of a perceived disconnect between pay and performance. We strongly disagree with this recommendation and believe Glass Lewis is not properly assessing our executive compensation program. We believe these supplemental materials together with our Proxy Statement explain fully how our compensation plan is strongly tied to performance and deserves your support. Contrary to Glass Lewis, Institutional Shareholder Services ("ISS") is recommending a vote FOR the Proposal, noting that the Company's pay and performance are aligned at this time.... Glass Lewis raised several concerns about our executive compensation program. Below, we provide Glass Lewis' comments and the Company's responses.
14	PERRIGO CO PLC	DEFA14A	4/14/2016	While two of the leading proxy advisory firms (Glass Lewis and Egan-Jones) have also recommended that our shareholders vote "FOR" the say-on-pay proposal, one advisory firm, Institutional Shareholder Services ("ISS"), recommended a vote against the proposal. For this reason, we are writing not only to reiterate the Board's recommendation in favor of this proposal but also to provide additional information that explains in detail the key compensation decisions of our Remuneration Committee and Board and to clarify certain factors that we believe mitigate the concerns expressed by ISS. Response to ISS's Position . While Glass Lewis and Egan-Jones have recommended that our shareholders vote "FOR" the say-on-pay proposal, ISS has recommended a vote against the proposal. In our view, however, ISS did not properly take into account the factors discussed above relating to our compensation decisions for the 2015 Stub Period. In addition, we believe that ISS used a flawed methodology in its comparison of certain awards to those of a peer group. For example, in comparing our CEO's current compensation to that of peer firms, ISS aggregated restricted stock and option awards granted over an 18-month period , without annualizing. ISS then compared those 18 months of grants to the equity grants made by ISS's selected peer firms over a 12-month period. This method does not give shareholders a fair comparison. It is also not internally consistent, as cash compensation is annualized. We believe the proper comparison is the fully-annualized figure of $15 million, not the ISS figure of $21 million:

15	HOLOGIC INC	DEFA14A	2/11/2016	Institutional Shareholder Services Inc. ("ISS"), a proxy advisory firm, has issued a recommendation that stockholders withhold their votes for two of our directors nominated for re-election. The Company believes the ISS recommendation to withhold a vote for the Chair of our Compensation Committee is based on an erroneous reading of the proxy disclosure relating to stockholder ratification requirements. Additionally, we have provided above further disclosure relating to the positive stockholder feedback relating to the actions taken to address the stockholder proposal on executive severance arrangements. The Company's position as it relates to the acceleration of equity vesting upon a change-in-control is clearly described in the proxy statement and was supported by numerous stockholders.
16	SL GREEN REALTY CORP	DEFA14A	5/28/2015	I would like to take this opportunity to address the conclusions in the ISS report issued on May 22, 2015, regarding SL Green Realty Corp. ("us," "SLG" or the "Company"). We take strong exception to the recently issued ISS recommendation regarding the advisory vote on executive compensation, or say-on-pay proposal, at our 2015 annual meeting and ask that you reconsider your position. We believe that the qualitative analysis that appeared to lead to your recommendation (i) failed to appropriately account for our superior performance and the strong alignment between our performance and our CEO's compensation as evidenced by the results of your own quantitative analysis, (ii) utilized a "peer group" that is not truly representative of our peers in assessing our CEO's compensation and (iii) misunderstood and mischaracterized important aspects of our 2014 executive compensation. ISS's qualitative analysis, in our view, misses the big picture… . As an overall matter, we believe the strong alignment between our performance and our CEO's compensation demonstrates that our Compensation Committee has made appropriate decisions with respect to compensation that is not tied in a formulaic manner to pre- established goals. Furthermore, the vast majority of our CEO's compensation in fact is now tied in a formulaic manner to pre-established goals, including (i) all awards under our outperformance plans, (ii) all equity awards to be made pursuant to his employment agreement and (iii) 75% of his annual cash bonus opportunity. As a result, we believe ISS's qualitative analysis should be revisited. We are particularly frustrated that the primary concerns raised in ISS's qualitative analysis were not identified, nor were any other concerns identified, by ISS when we met with its research team representatives in late 2014 as part of our stockholder outreach and, in fact, these representatives were complimentary of the changes that we had made to our executive compensation programs. We believe that your analysis needs to place greater emphasis on the outstanding short-term and long-term performance of SLG. Your voting recommendation places far too much weight on a flawed, subjective analysis of a few aspects of our executive compensation. ISS badly mischaracterizes a feature of our amended employment agreements by labeling it as a "retesting." As our proxy statement makes clear, the vesting of the future equity awards to be granted each year under our CEO's employment agreement is based on the achievement of financial performance goals either during the year in question or on a cumulative basis from the first year of the award through the end of a subsequent year during the term of the agreement. The feature ISS mischaracterizes, which allows awards to be earned based on cumulative performance over the full term of the contract, we view as a highly effective method of aligning our CEO compensation with our long-term view of TRS and FFO. It is far from running counter to a "key tenet of a pay-for-performance philosophy."

17	KINDRED HEALTHCARE, INC	DEFA14A	5/18/2015	I am writing to relay additional information to both Institutional Shareholder Services, Inc. ("ISS") and our shareholders that we believe should be considered with respect to the re-election of Mr. Frederick J. Kleisner to the Board of Directors of Kindred Healthcare, Inc ("Kindred"). ISS issued a voting report on May 14, 2015 that recommended a vote "FOR" all Kindred's director nominees with the exception of Mr. Kleisner, Chair of Kindred's Executive Compensation Committee, based on its view that Kindred's response to a shareholder proposal regarding change in control severance arrangements that garnered majority approval at the 2014 annual meeting (the "Shareholder Proposal") was "insufficient." In fact, the Board of Directors amended Kindred's Corporate Governance Guidelines on July 30, 2014 to adopt the very policy that was the subject of the Shareholder Proposal (as set forth and highlighted on pages 8 and 9 of the Corporate Governance Guidelines attached hereto), as noted in the Company's Proxy Statement, which we believe makes the recommendation against Mr. Kleisner inaccurate and misleading. Moreover, ISS's statement that "long-term cash awards will vest and pay out their maximum opportunity in the event of a change in control" is erroneous, since this plan was amended (and approved by shareholders) in 2013 to pay out at target upon a change in control.
18	EXPEDITORS INTERNATIONAL OF WASHINGTON INC	DEFA14A	5/11/2015	A proxy advisory firm, Institutional Shareholder Services, Inc. (ISS), has recommended that shareholders vote against the Say-on-Pay proposal, and in favor of Shareholder Proposals 8, 9 and 10… . In light of the ISS recommendation on these four proposals, we thought it would be helpful to provide you the supplemental information set forth below. We hope you find this information, together with the information set forth in our Proxy Statement, helpful in your decision making process. ISS states in their 2015 report that "ISS has recommended against the company's plans for several years, in part as a result of the excessive retirement package to the former CEO/founder, and resulting misalignment of pay and long- term performance, as well as due to the design of the incentive program." This comment is simply incorrect, as demonstrated below. ISS also stated that "The compensation committee does not acknowledge that the say-on-pay proposal failed to pass at the 2014 annual meeting." This comment is similarly incorrect. In Proposal No. 2 Advisory Vote to Approve Named Executive Officer Compensation on page 30 of our 2015 Proxy, we clearly state "At the 2014 Annual Meeting of Shareholders, 56% of votes were cast against the non-binding vote to approve the Company's NEO compensation." The Compensation Committee Report has an entire section entitled "Shareholder Feedback Following the 2014 Say-On-Pay Vote: What We Heard & How We Responded" on page 14 and the timeline presents separate and distinct points noting the Say-on-Pay failure and the timing of the Compensation Committee's response. In our opinion, what ISS fails to take into account, is the comprehensive multivariate components of operating income that are required to be successfully managed to achieve increases in operating income and overall Company performance. There are many supporting policies that add robustness to this metric. As an example, no mention is made about how the cumulative nature of the plan requires that any operating losses must be recouped before further bonuses can be paid and the Company's strict credit accountability. By its very nature, a focus on operating income precludes what ISS labels as "a narrow focus." ISS's assertions to the contrary are further reinforcement of our opinion that they did not understand the detailed description of our historically proven compensation program contained in Compensation Discussion and Analysis.

19	DUPONT E I DE NEMOURS & CO	DEFA14A	5/4/2015	DuPont believes it is critical that shareholders have important information regarding the April 27, 2015 report from the proxy advisory services firm Institutional Shareholder Services (ISS). Much of the report reflects the misinformation and inaccuracies from Trian's materials. Specifically, the report fails to consider: • DuPont is a strong performer, having beaten the market and its peers over the last one-, three-, and five-year periods and delivered 266% total shareholder return under current management. value—Board change is not warranted. 6. Trian's Breakup Plan Is High-Risk and Value-Destructive. This Is a Fundamental Reason for Not Adding Trian Nominees to the DuPont Board and Must Be Considered in this Proxy Contest. The report does not address the value-destructive nature of the Trian breakup plan or Trian's singular focus on this agenda. What the report misses: In evaluating whether Trian's breakup plan makes sense, ISS concluded that "we don't know [the answer], and neither does anyone else outside the DuPont boardroom."11 Yet, ISS apparently failed to consider the fact that: • DuPont's and it has continued to increase. From December 31, 2008 through mid-March 2013, prior to Trian's investment, DuPont generated 135% total shareholder return compared to 90% for the S&P 500.3 Track Record of Outperformance Under Management's Tenure1 Despite DuPont's outperformance – both before and after Trian's appearance – ISS has adopted Trian's time periods to exclude any management-driven performance. To do so is to simply accept Trian's self-serving argument that DuPont's continued stock price improvement is the result of Trian's influence. In fact, the stock price has continued to increase
20	NEWFIELD EXPLORATION CO /DE/	DEFA14A	5/1/2015	ISS contends that our long-term performance awards have a "retesting feature that undermines the fact that superior performance is required for a target level payout." Their analysis is flawed. Our long-term performance awards are actually designed to incentivize top-tier performance early during the three-year performance period, prevent penalizing executives for short-term market swings and reduce potential undesirable behaviors causing market manipulation around vesting dates. . We have always believed in a pay for performance compensation philosophy, taking into consideration both Company

21	AMERICAN WATER WORKS COMPANY, INC.	DEFA14A	5/1/2015	Our Board of Directors and a leading proxy advisory firm Egan-Jones have recommended that stockholders vote in favor of the Exclusive Forum Proposal. In contrast, ISS Proxy Advisory Services, or ISS, and Glass, Lewis & Co., LLC, or Glass Lewis, have each recommended that their respective clients vote against the Exclusive Forum Proposal. We respectfully disagree with the recommendations of ISS and Glass Lewis with respect to our Exclusive Forum Proposal. In light of the ISS and Glass Lewis recommendations against the Exclusive Forum Proposal, we would like to provide additional information regarding our rationale for the Exclusive Forum Proposal and why we believe that the recommendations of ISS and Glass Lewis against the Exclusive Forum Proposal are based on the flawed reasoning that a company should suffer substantial harm from litigation brought by stockholders in the courts located in jurisdictions other than those within the State of Delaware before it is entitled to submit an exclusive jurisdiction bylaw amendment to a shareholder vote. We believe this information is critical to an understanding of the Exclusive Forum Proposal. You should consider the following additional information before determining how to vote your proxy card as to the Exclusive Forum Proposal. In its analysis, ISS appears to base its recommendation primarily on the absence of any disclosure in American Water's proxy statement that American Water has "suffered any unusually substantial harm from litigation brought by stockholders in the courts of jurisdictions other than Delaware." Thus, it appears that the position of ISS on exclusive forum proposals is that stockholders have to first suffer substantial harm in order for a board to be justified in recommending thoughtful and proactive risk management measures that in the board's view are aimed at preventing or mitigating such harm. Despite the flawed reasoning of ISS, your Board has decided that the best interests of stockholders require that it proactively manage the risks that American Water faces as the most geographically diversified and largest publicly-traded, United States water and wastewater utility company by seeking to have the Delaware Courts serve as the exclusive forum for the adjudication of certain legal disputes.
22	DUPONT EIDE NEMOURS & CO	DEFA14A	4/27/2015	DuPont (NYSE: DD) today issued the following statement in response to an April 27, 2015 report issued by Institutional Shareholder Services (ISS) relating to the election of directors to DuPont's Board of Directors at the Company's May 13, 2015 Annual Meeting of Shareholders. We strongly believe ISS reached the wrong conclusion in failing to which may not be realized. Forward-looking statements also involve risks and uncertainties, many of which are beyond the company's control. Some of the important factors that could cause the company's actual results to differ materially from those projected in any such forward-looking statements are: fluctuations in energy and raw material prices; failure to develop and market new products and optimally manage product life cycles; ability to respond to market acceptance, rules, regulations and policies affecting products based on biotechnology; significant litigation and environmental matters ; failure to appropriately manage process safety and product stewardship issues; changes in laws and regulations or political conditions; global economic and capital markets conditions, such as inflation, interest and currency exchange rates; business or supply disruptions; security threats, such as acts of sabotage, terrorism or war, weather events and natural disasters; ability to protect and enforce the company's intellectual property rights; successful integration of acquired businesses and separation of underperforming or non-strategic assets or businesses and successful completion of the

23	VERIZON COMMUNICATIONS INC	DEFA14A	4/24/2015	following a change in control promotes stability and focus during a time of potential uncertainty. In 2013, our shareholders approved Verizon's Long-Term Incentive Plan with a vote of over 88% in favor. . Also, Glass Lewis, a proxy advisory firm, recommends a vote AGAINST the proposal because its adoption "could prove burdensome for the Company and present challenges in its implementation." The firm's report also notes that any equity payments made in connection with a change in control are required to be subject to a shareholder vote. . The proposal says that your Chief Executive Officer, Lowell C awards became payable as of the last day of the calendar year. Thus, the amounts listed in our 2015 Proxy Statement are only estimates based on assumptions required by the SEC proxy disclosure rules. It is incorrect to say he would receive this amount because his performance stock unit awards are entirely at risk. Any payout will be determined after the end of the applicable award cycle. If the threshold performance criterion for a performance stock unit award is not met at the end of the award cycle, he gets nothing with respect to the award.
24	ALEXANDRIA REAL ESTATE EQUITIES INC	DEFA14A	4/24/2015	Dear Stockholders: . We are writing to you today to underscore the importance of your independent analysis regarding the agenda items submitted for your vote at our 2015 Annual Meeting of Stockholders. Our Board recommends you cast your vote FOR all proposals, and would like to draw you attention specifically to Proposal Two, the advisory vote to approve our executive compensation (the "Say-on-Pay Proposal"). The proxy advisory firms of Institutional Shareholder Services ("ISS") and Egan-Jones Rating Company ("Egan-Jones") have each recommended that their clients vote FOR the Say-on-Pay Proposal, partially in recognition of our outstanding 2014 performance. . Our total stockholder return ("TSR") in 2014 was #1 in our peer group, #1 among the 22 companies included in the FTSE NAREIT Equity Office Index, #1 among the 22 companies included in the SNL US REIT Office Index, and higher than the total return of the S&P 500 Equity Index and the Russell 2000 Index. Our 2014 TSR was even #1 among the 15 companies included in the peer group used by Glass Lewis & Co experienced management group. We are confident that the facts support a vote in favor of our compensation program. . As further described below, the Glass Lewis report contains certain factual errors and omissions, is incomplete and misleading in several respects, and we believe does not sufficiently consider our outstanding performance in 2014. Glass Lewis does not recognize the fact that the only changes made to our executive compensation program since Glass Lewis itself recommended voting FOR our say-on-pay proposal in 2014 were those clearly described in our 2015 proxy statement, every one of which
25	YUM BRANDS INC	DEFA14A	4/14/2015	Response to ISS Comments . Third, in its report ISS made several observations that are incorrect or incomplete and, therefore, deserve direct response, specifically: . · Above Median Benchmarking — Greg Creed became CEO of YUM effective January 1, 2015. With his appointment, we set his 2015 pay below the 50 th percentile compared to our peer group given that he is new in the role. This is a change from the 75 th percentile target total compensation used to set David Novak's pay as CEO, which reflected his tenure and long-term performance. We believe this change should be taken into , unlike most, does cap potential payouts at no more than target if absolute TSR is less than zero— even if the relative ranking were to otherwise indicate a higher earned award. . In summary, our PSP requires higher performance to earn the same outcomes compared to most relative TSR plans. . Furthermore, ISS recommends that full-value awards be earned only if performance exceeds the median. However, 74% of relative TSR plans result in the target being earned at the 50 th percentile or lower performance. . · Accelerated Vesting on Change in Control — We received a shareholder proposal asking the Board to

26	PRAXAIR INC	DEFA14A	4/8/2015	leadership structure based on core corporate governance considerations, and not based on the short-term factors and flawed rationale in the ISS Report. . The Board's leadership structure is a fundamental and key aspect of Praxair's corporate governance structure and should be determined primarily by the governance considerations that we discuss in the Proxy Statement on pages 5-7. As noted in the Proxy Statement, our Governance & Nominating Committee (consisting entirely of independent directors) periodically examines the Board leadership structure based on a variety of factors, and has determined that the present leadership structure of a combined Chairman and CEO is the most effective and appropriate at this time for the reasons set forth on page 5 of the Proxy Statement. . In fact, the ISS report expressly confirms that Praxair has a sound core corporate governance structure including: . • An independent Lead Director whose robust duties clearly counterbalance a combined Chairman/CEO role and conform to the very duties that ISS itself prescribes as necessary; . • No problematic governance practices; . • A Board that is substantially (90%) independent; and . • Completely independent board committees
27	CELANESE CORP	DEFA14A	4/7/2015	We are proud of our record performance for 2014 and thus we believe that the ISS data fails to fully inform stockholders of our performance. . WE RECOMMEND THAT YOU VOTE FOR OUR SAY-ON-PAY PROPOSAL (PROPOSAL 2). . We believe that the information provided in our Proxy Statement and this letter clearly demonstrates our strong commitment to pay for performance. We remain committed to aligning our executive compensation program with the interests of our stockholders. We will continue to ask for your input as we further refine our executive compensation programs to best align pay for performance and , we chose to include a "re-test" feature in our annual LTI program. If our "re-test" feature ever applied, executives would still only have the opportunity to earn 34% of their target number of PRSUs. . ISS's peer group methodology change appears to have had a significant influence on their voting recommendation, and the outcome is inconsistent with our record earnings and stockholder cash returns. . According to ISS' report, we scored a -42% on ISS' relative degree of alignment test. Because this amount is higher than -40%, ISS assigned a "Medium Concern" to ISS' initial quantitative screen of our executive compensation. By comparison, our multiple of peer group median and absolute alignment scores were well within ISS "Low Concern" levels on these other two quantitative tests. . In reviewing the peer group ISS used for this year, we noticed that ISS added two companies not in last year's ISS peer group 4 and removed two companies that were in last year's ISS peer group. 5 We think that the impact of ISS changing its peer group for Celanese from 2014 to 2015 reduced our relative degree of alignment score from approximately -33.5 (which would have been a "Low Concern") to -42%, about a 9%

28	CINTAS CORP	DEFA14A	10/3/2014	Cintas Corporation will hold its annual meeting of shareholders (Annual Meeting) on October 21, 2014. At the Annual Meeting, shareholders will be asked to approve an amendment (Amendment) to the Cintas Corporation 2005 Equity Compensation Plan (2005 Plan) to increase the number of shares of common stock available for issuance under the 2005 Plan by 7,000,000 shares. . On September 26, 2014, ISS Proxy Advisory Services (ISS) issued its recommendations on all of the proposals to be acted on at the Annual Meeting. ISS is in agreement with Cintas' Board of Director's recommendations for all items except for the Amendment. . Cintas disagrees with the ISS recommendation to vote against the approval of the Amendment due to the ISS methodology of valuing the Shareholder Value Transfer (SVT) at 12%, when historical Cintas practices would value the SVT at less than ISS's "Company-Specific Allowable Cap" of 8%. . We believe that the ISS calculation of SVT is incorrect due to the assumption that all additional shares being requested for approval (7,000,000), together with the currently available shares (2,317,172), will be issued as restricted stock at a value of $56.28 per share. . Historically, Cintas considering this SVT of 3.4% with the SVT of 3.77% for shares that have been granted but remain unexercised, the total cost of the 2005 Plan would be 7.17%, not the 11.61% that ISS calculates. . Why We Believe You Should Vote for the Amendment . The 2005 Plan authorizes the Compensation Committee of the Cintas Board of Directors to provide equity-based compensation for the purpose of fostering and promoting our long-term financial success and increasing stockholder value. Some of the key features of the 2005 Plan that reflect our commitment to effective management of equity and incentive compensation are
29	DARDEN RESTAURANTS INC	DEFA14A	9/26/2014	Warns Shareholders that Any Vote on the White Card Could Result in Giving Total Control of the . Board to Starboard and Its Nominees . ORLANDO, Fla., - September 26, 2014 - Darden Restaurants, Inc. (NYSE: DRI) today issued the following statement regarding a September 25, 2014 report by Institutional Shareholder Services ("ISS"). The report relates to the election of directors to Darden's Board of Directors at the Company's 2014 Annual Meeting of Shareholders to be held on October 10, 2014. . We believe that shareholders should be alarmed that ISS has recommended wholesale change with virtually NO initiatives, including a significant share repurchase and maintaining the Company's annual dividend at $2.20 per share. The flawed analysis upon which ISS relies results in $107 million of incorrect costs that were never incurred and undervalues the amount of the deal consideration attributable to Red Lobster's operating business and related assets by nearly half a billion dollars, as detailed in the presentation and associated press release issued by Darden on August 4, 2014. . Contrary to ISS's view, we have heard from many shareholders who do not support ceding total control of the Board to Starboard

30	WALMART STORES INC	DEFA14A	5/29/2014	Independent proxy advisory firm Glass, Lewis & Co., LLC agreed with the Board and recommended a vote "FOR" Proposal No. 3. Institutional Shareholder Services, Inc. ("ISS"), another proxy advisory firm, has recommended a vote "AGAINST" this proposal. We believe that ISS's analysis misconstrues the nature and operation of Walmart's executive compensation program. . We believe ISS's recommendations are incorrect and inconsistent with prior years' analyses. The primary difference this year appears to be the submission of a letter, dated May 19, 2014, from CtW Investment Group ("CtW"), which contains a number of misrepresentations and intentionally misconstrues our executive compensation program. CtW is a union- affiliated group that has a long and consistent track record of opposing Walmart, with its sole motive being to undermine the Company in an attempt to organize Walmart's associates. As ISS acknowledges in its report, ISS's own quantitative analysis shows that Walmart's executive pay is of "low concern," with executive pay aligned with performance, and that Walmart's CEO pay is low relative to the median of its peers. ISS itself further acknowledges that "[e]xecutive compensation has not historically been a particular concern at Wal-Mart; most features of its program meet best practice standards, and CEO pay disclosed for FY2014 raised no concerns in ISS'[s] pay-for-performance screen. . . . most features of the program, and decisions made with
31	SL GREEN REALTY CORP	DEFA14A	5/21/2014	to take this opportunity to address the conclusions in the ISS report issued on May 17, 2014 regarding SL Green Realty Corp. ("us," "SLG" or the "Company"). . We take strong exception to the recently issued ISS recommendation regarding the advisory vote on executive compensation at our 2014 annual meeting and ask that you reconsider your position. We believe that the qualitative analysis that appeared to lead to your recommendation (i) contained certain critical and material factual errors and mischaracterizations, (ii) inappropriately disregarded our superior performance and the strong alignment -term performance of SLG. Your voting recommendation placed far too much weight on a flawed, subjective analysis of a few arbitrarily selected aspects of our executive compensation. . ISS's qualitative analysis resulting in your voting recommendation is flawed. . The ISS recommendation regarding the advisory vote on executive compensation appeared to be primarily based on a flawed, subjective analysis of a few arbitrarily selected aspects of our executive compensation. The following addresses the points raised in the ISS report issued on May 17, 2014: . · We did, in fact, fully address our stockholders
32	STAPLES INC	DEFA14A	5/20/2014	framework for high independence of the Board and a strong counterbalancing structure with an independent Lead Director that has robust duties, ISS reached its conclusion based on TSR and the same flawed subjective analysis on pay and performance as discussed above. Glass Lewis believes that the vesting of Board and executive leadership in one person inhibits independent oversight. We strongly disagree and urge stockholders to vote "AGAINST" the proposal for the reasons set forth in our proxy statement and also stated below: . • Staples is undergoing a multi-year strategic reinvention to reshape our

33	REPUBLIC SERVICES, INC.	DEFA14A	4/24/2014	Compensation (the "Say on Pay Proposal") . Dear Stockholder: . We are writing to you in our capacity as the Management Development and Compensation Committee (the "Compensation Committee") of the Board of Directors of Republic Services, Inc. to ask for your continued support at our 2014 Annual Meeting of Stockholders by voting in accordance with the recommendations of our Board of Directors on all proposals. In particular, we want to provide you with information and request that you vote "FOR" Proposal 2 — the Say on Pay Proposal . . Proxy-advisory service Institutional Shareholder Services ("ISS") is recommending a vote against our Say on Pay Proposal, asserting a pay-for-performance misalignment. We believe ISS's review is flawed. . Executive summary . • Our absolute pay-for-performance alignment is better than 79% of companies, according to ISS. . • ISS's qualitative analysis and quantitative screens overlook important information. . • ISS's principal qualitative argument is its objection to Republic lowering annual bonus performance targets in 2013 without also lowering payout targets. There is no reason these two items should be correlated. When establishing performance targets, the Compensation Committee considers such factors as prior-year actual performance, the macro-economic environment, industry specific conditions, and changes in regulations and laws. . • ISS also objects to the increase in our CEO's total target compensation. The Compensation Committee intentionally set his compensation significantly below the median of his peers when he became CEO in 2011. The Compensation Committee believes Mr. Slager has done an excellent job since taking office, and we have brought his compensation more in line with, but still lagging, the median. . • ISS's quantitative screen fails to appropriately
34	AFLAC INC	DEFA14A	4/22/2014	Supplemental Information Regarding Proposal 2 - Advisory Vote on Executive Compensation . Several weeks ago we provided our shareholders with the proxy statement for Aflac Incorporated's 2014 Annual Meeting of Shareholders, which will be held on May 5, 2014. The unanimous recommendation of our Board of Directors was that shareholders vote in support of Proposal 2 in the proxy statement-the advisory vote on executive compensation ("say on pay") proposal. . One proxy advisory firm, Institutional Shareholder Services (ISS), recently recommended that shareholders vote against the proposal based on their concerns about the compensation paid to our Chief Executive Officer. Other proxy advisory firms, including Glass Lewis and Egan-Jones have recommended votes in favor of our say on pay proposal. We strongly disagree with the ISS recommendation because it relies on a methodology that fails to take into account important features of our longstanding CEO performance-based compensation program. . Our program is described in considerable detail in the proxy statement precisely because it does not conform to ISS' standardized analysis (or any other analysis that does not take important , performance-based features of our program into account). Accordingly, we encourage you to read our description of the program carefully when considering how to vote on Proposal 2. We highlight below some particular concerns with the ISS analysis that we believe will be helpful in your decision making process. . Overview of Our Compensation Approach . Aflac, the pioneer in say on pay, has always employed rigorous standards in setting executive compensation. We were, in 2008, the very first U.S. public company to give shareholders the opportunity to vote on executive compensation, long before it became a

35	RYDER SYSTEM INC	DEFA14A	4/21/2014	aware, Glass Lewis and Egan-Jones, two well-known proxy advisory firms, have recommended positive votes in line with the recommendations of the Board on all proposals. However, in contrast to Glass Lewis and Egan-Jones, ISS recommended a "withhold" vote from the Board's director nominees "for the board's failure to respond appropriately to a shareholder proposal". . Withholding votes for Ryder's director nominees is an excessive reaction and unjustifiable response from ISS given that the Board is proposing to remove 8 of the 9 current supermajority provisions in response to the shareholder proposal Statement dated March 17, 2014. In connection with Ryder's Annual Meeting of Shareholders on May 2, 2014, Ryder is communicating the information below to its shareholders commencing on April 21, 2014. . April 21, 2014 . Dear Shareholder: . By now, you should have received our Notice of 2014 Annual Meeting of Shareholders and Proxy Statement (the "proxy statement"). You can also view our proxy statement at: https://www.proxyvote.com. . We are writing to inform you that Ryder and our Board of Directors (the "Board") strongly disagree with Institutional Shareholder Services' ("ISS") recent proxy report . . Contrary to ISS's characterizations of the Board's actions as unresponsive, the Board has presented proposals (which ISS recommends) to eliminate supermajority provisions in our Articles and By-Laws regarding the following: (1) fixing the number of directors, (2) board classification provisions, (3) shareholder nomination of director candidates, (4) board vacancies, (5) the removal of directors, (6) shareholder amendments to our By-Laws (contained in our By-Laws), (7) amendments to certain provisions of our By-Laws (contained in our Articles) and (8) certain business combinations with interested
36	ENTERGY CORP /DE/	DEFA14A	4/16/2014	on Executive Compensation . Dear Shareholder: . We are writing to ask for your support at our 2014 Annual Meeting of Shareholders by voting in accordance with the recommendations of our Board of Directors on all proposals. In particular, we want to provide you with additional information and request that you vote "FOR" Proposal 3—Advisory Vote on Executive Compensation (Say-on-Pay). . Although we received the support of Glass Lewis & Co., Institutional Shareholder Services (ISS) has recommended a vote against our Say-on-Pay proposal. We believe ISS's pay-for-performance review is flawed, as we compensation actually received is taken into account, our executive compensation is well aligned with performance. This is the same conclusion reached by Glass Lewis in its report, which found that our compensation practices and incentive plans "appear successfully designed to ensure the alignment of pay with performance," employing "objective and transparent performance formulas" which "effectively track the short and long term performance of the Company." . 2013 EPS Targets and Payouts . In its qualitative review, ISS expressed concern with the fact that the earnings per share (EPS) targets set for 2013 further explain below. . Our Pay Programs and Practices Effectively Align Pay with Performance . In its pay-for-performance quantitative screen, ISS found our total CEO compensation to be below the median of our peer group and found our absolute alignment to be better than 82% of our peers. However, due to ISS's failure to account for actual payouts of performance-based awards in its analysis, it found our relative degree of alignment to fall just within the range it categorizes as "high concern." In fact, as we demonstrate on page 28 of the Proxy Statement and discuss below, when the value of all

37	ALLEGHANY CORP /DE	DEFA14A	4/15/2014	• Further, ISS's "correction" of its prior factual error continues to give the misleading impression that actual catastrophe losses at RSUI and TransRe do not have any impact on funding calculations for annual incentive pools under the MIP. In order to avoid any confusion on this point, we explain that actual catastrophe losses — whether in excess of, or less than, average catastrophe losses in a particular year — do in fact fully impact funding calculations for annual incentive pools during the four-year averaging period in which they are included. . • The maximum award amount payable to our
38	ALLEGHANY CORP /DE	DEFA14A	4/15/2014	One of the key factors identified by ISS in its initial report contained a serious factual error . "Corrected" report implies above average cat losses are excluded . Average aggregate cat losses of approximately $400 million were included in the 2013 incentive pool funding calculation . Such average losses were deducted from 2013 pre-tax earnings in place of actual 2013 cat losses . Rather than encourage short-term risk-taking, actual losses become part of the average calculation for four years, holding management
39	DARDEN RESTAURANTS INC	DEFA14A	4/14/2014	Darden Restaurants, Inc. (NYSE: DRI) issued the following statement regarding an April 11 report by Institutional Shareholder Services ("ISS"). The ISS report relates to whether Darden shareholders should submit consents to Starboard Value LP and its affiliates ("Starboard") in connection with Starboard's efforts to call is in the best interest of all Darden shareholders. . With regard to the April 11 report issued by Glass, Lewis & Co. regarding Starboard's consent solicitation, the Company stated: . The Glass Lewis report does not give appropriate consideration to the facts, including Darden's actual operating and financial performance and value creation initiatives, and the assertions regarding Darden's record of engagement are demonstrably false. Further, the conclusions reach far beyond the question of whether to call a Special Meeting, which is currently the only matter before Darden shareholders. We are disappointed that Glass Lewis issued this report without meeting any members of Darden's Board of Directors or management team. . All of us at Darden are focused on improving performance and enhancing shareholder value, and we believe the actions we are taking best position the Company to achieve these objectives. . If Darden shareholders have already submitted a white written request card to Starboard supporting the call of a Special Meeting, they can revoke such consent by submitting a BLUE revocation card to the Company today. If shareholders have not submitted a white written request card to Starboard

40	OWENS CORNING	DEFA14A	4/1/2014	Advisory Vote to Approve 2013 Named Executive Officer Compensation (the "Say on Pay" proposal). . As you may be aware, Egan-Jones, a proxy advisory firm, has recommended a positive vote on the Say on Pay proposal. Other firms, such as Institutional Shareholder Services and Glass Lewis (the "Firms"), issued negative vote recommendations. We are taking this opportunity to clear up certain oversights made by the Firms recommending against the Say on Pay proposal, as well as to provide you with additional information and context regarding our executive compensation programs and actions. . We believe our executive compensation programs are appropriately designed, competitive with market practices and aligned with stockholder value creation. Our programs target the median of similar companies, have significant pay at risk, and appropriately use equity to ensure stockholder alignment. The structure of compensation programs for our named executive officers has not changed over the last five years, and has historically enjoyed the support of all the proxy advisory firms. . In connection with your voting decision, we would like to highlight the following points. . • Our compensation is performance based. An the Company's stock price increases. . Management and the Compensation Committee believe the Firms' pay evaluation methodology is incomplete and that an alternative pay calculation, known as realizable pay provides more clarity on how compensation outcomes are linked to the Company's financial and stock price performance. This is particularly important at Owens Corning because equity-based awards account for the most significant portion of the total compensation of our CEO and other named executive officers. Because the Compensation Committee believes that long-term, equity-based compensation
41	BEST BUY CO INC	DEFA14A	6/10/2013	now in the position it is - manifestly stronger and representing one of this year's highest performing stocks on the S&P 500. . We are pleased that the proxy advisory firm, Glass Lewis, has recognized the work of the Board and the Compensation Committee by recommending that shareholders vote FOR item 3 of our Proxy Statement - our "Say on Pay" proposal. By contrast, the other leading proxy advisory firm, Institutional Shareholder Services ("ISS"), has recommended that shareholders vote against our Say on Pay proposal. Their primary concerns are the continuity payments made to retain executive management through the past year's crisis and the compensation delivered to our new CEO to replace the amounts he forfeited upon resignation from his prior employer. Notably, Glass Lewis, when addressing the same payments, recognized that "such payments, to a certain degree, are necessary to respond to the challenges of the past year and position the Company for the future." . We appreciate Glass Lewis's perspective and respectfully submit that ISS's differing opinion fails to recognize that our on-going turnaround is attributable to the efforts of our new CEO, Hubert Joly, and his leadership team and a result of many of the very same decisions ISS now challenges. We ask shareholders to consider the following in making their own assessments: . • At the time of last year's shareholder meeting, the Company was in the midst of a highly public crisis involving the exit of its CEO, the resignation from the Board of its Founder, Chairman and largest shareholder, and declining business performance. The Board's paramount duty at that time was to attract and recruit a CEO with the talent and skills necessary to stabilize the Company and transform its business performance. . • The first step in achieving this

42	CHESAPEAKE ENERGY CORP	DEFA14A	6/5/2013	our named executive officer compensation. . Institutional Shareholder Services Inc. ("ISS") and Glass Lewis & Co. ("Glass Lewis"), prominent proxy voting advisory services, have recently published their recommendations on voting with respect to matters set forth in the Chesapeake proxy statement. Both ISS and Glass Lewis recommend that shareholders vote against Thomas L. Ryan for director while ISS recommends voting against our named executive officer compensation (Glass Lewis recommends voting in favor of our named executive officer compensation). We are writing to address the concerns of ISS and Glass Lewis regarding Mr. Ryan and set forth the reasons why we believe ISS' recommendation regarding the advisory vote to approve named executive officer compensation is based on an incomplete and flawed analysis. . Thomas L. Ryan Election . The makeup of the Board has changed substantially since our 2012 Annual Meeting of Shareholders. Of the nine directors serving on the Board a year ago, only one remains. The Board has appointed an independent non-executive Chairman and six other independent directors, including appointing Thomas L. Ryan last month. In addition, following the 2013 Annual Meeting of the recommendations of ISS and Glass Lewis against Mr. Ryan is that he serves on the boards of four public companies (including his own, SCI). Mr. Ryan has informed us that he intends to resolve this issue by the end of this year. We believe this is strong evidence of his commitment to Chesapeake and hope that you show your support by casting your vote "For" Mr. Ryan. . Vote to Approve Named Executive Officer Compensation . The Compensation Committee of the Board has taken substantial steps since 2011 to ensure that Chesapeake's compensation programs appropriately tie executive pay to Company
43	SL GREEN REALTY CORP	DEFA14A	6/5/2013	Shareholder Services Inc. ("ISS"), a proxy advisory service, has recommended that stockholders vote against Proposal 2 and Proposal 3. We strongly disagree with ISS and encourage you to vote FOR our Advisory Vote on the Compensation of our Named Executive Officers and FOR the approval of our Third Amended and Restated 2005 Stock Option and Incentive Plan. . As you evaluate Proposals 2 and 3, we believe that, in addition to the information contained in our 2013 Proxy Statement, you should carefully consider the important information provided below. We have also attached written correspondence that we would appear to contradict the concern voiced in the subjective ISS commentary on the same 5-year period. I would also relate that my average CEO compensation has meaningfully decreased in the 2007-2012 time period from that of prior years. . · While the fact that I ultimately "realized" $18.97 million under the 2010 Notional Unit Plan ("NUP") is indisputable, I believe this performance reward is taken out of context and highlighted incorrectly by ISS as an indicator of poor pay for performance alignment based on incorrect facts as follows: . o This plan payout is mentioned in the same paragraph with flawed for the reasons set forth above. We believe that the approval of the Plan is critical to maintaining the strong alignment between management and stockholder interests. Should the SLG equity plan upsize be rejected, it would put the Company in the unfortunate position of being forced to utilize cash in lieu of equity in order to carry out its compensation program, which we do not believe would be in the best interests of stockholders. . * * * . We at SL Green remain committed to delivering value for our stockholders. To that end, we believe that ISS' recommendations with respect to the Advisory

44	AFFILIATED MANAGERS GROUP, INC.	DEFA14A	6/3/2013	received unfavorable recommendations on our "Say on Pay" proposal from two proxy advisory firms, ISS and Glass Lewis. Each firm recommended our shareholders vote "for" all other proposals, including the re-election of all Directors, the approval of a new Incentive Stock Award Plan and the ratification of our independent auditor, PricewaterhouseCoopers LLP. . The recommendations against our compensation programs and policies were unexpected. In their own reports and by their measures, they cite AMG's substantial outperformance versus peers and broader indices with respect to Total Stockholder Return , and even illustrate the strong alignment of pay with performance — but then recommend against approval of our compensation program, despite having recommended in favor of our program in 2012 . Our outstanding performance (both for the year and over the long term, we are at or near the top of our peer group on a rolling basis annually since our public offering) has continued since last year's review, while compensation has remained at the same level by ISS calculations. Furthermore, AMG achieved record high Economic earnings per share of $7.71 in 2012, a 16% increase over 2011, and reported additional detail on our compensation program, and how it has worked in concert with AMG's growth strategy to create tremendous stockholder value over the last year, over the last three and five years, and in every period since our public offering. In particular, within the attachment we provide additional context on the limitations of the proxy firm reports, and their failure to accurately assess our company and compensation program; on AMG's remarkable performance, both recently and in the long run; the alignment of pay for performance in our program; and the strength and shareholder-friendliness of
45	BIG LOTS INC	DEFA14A	5/20/2013	statement. However, ISS and Glass Lewis both failed to subtract a restricted stock award of $10.5 million that Mr. Fishman forfeited based on Big Lots' 2012 performance metrics. Thus his realized compensation was less than $2 million - demonstrating a strong link between pay and performance and refuting the pay-for-performance disconnect on which the proxy firms have based their analyses. 1 . In addition, a number of key changes to our executive compensation program have been implemented in 2013. 2 Our new CEO, David Campisi, has a significantly smaller compensation package than Mr. Fishman. The

46	ALEXANDRIA REAL ESTATE EQUITIES INC	DEFA14A	5/14/2013	asked to cast an advisory vote on ARE's executive compensation, as described in the Proxy Statement ("Proposal Three"). Two proxy advisory firms, Institutional Shareholder Services Inc. ("ISS") and Glass Lewis & Co. ("Glass Lewis"), have recommended that stockholders vote "against" Proposal Three. Glass Lewis also recommended withholding support as to director nominee Richard Jennings, the current Chairperson of the Compensation Committee of the Board of Directors (the "Compensation Committee"). . ISS and Glass Lewis state that the Company's executive compensation program does not align executive these results will translate into improved TSR as the effects of the Company's transformation are recognized. . 2. The ISS and Glass Lewis assertions that certain features of our compensation program contribute to a pay-for-performance disconnect are incorrect. . The ISS Report states that the base salary of Joel Marcus, our Chief Executive Officer ("CEO"), and the target level for his short term cash bonus (150% of base salary) are higher than the peer group. ISS's peer group contains a number of companies that operate in very different sectors than the Company and, thus, ISS's peer group is not useful for the purpose of comparing salaries. The Company strongly believes that our compensation program is in line with the market in which we operate and compete for executive talent, and is necessary to ensure the retention of our CEO. . ISS criticizes the Company for awarding our CEO a signing bonus in connection with his new employment agreement and a long-term equity bonus in the same year and Glass Lewis states that the signing bonus received by Mr. Marcus contributed to compensation inequality in 2012. These criticisms are unfounded. The long-term equity bonus is awarded to recognize the
47	RANGE RESOURCES CORP	DEFA14A	5/14/2013	GHG emissions in its actual operations in the field. . [Range response 5/8/13] . All that information is on the website. Check under Environment tab then air quality. . I would have thought that on this serious of a matter of the proposal that a courtesy call would have confirmed the facts before you published your report. . Also your 88% figure of directors owning stock is incorrect. Ms Lowe has owned the shares for a while. She was not elected until April 1st. So if you want to use record date for your box info, then she was not elected yet and all directors owned shares. . ISS then on May 10 th issued [Range's email request 5/6/13] . Dear ..... and ....., attached are our comments. Hopefully we can have a short discussion after you have had time to review our concerns and suggestions. . Thank you for allowing us to review prior to publication. . [ISS email response 5/6/13] . Thank you, ..., we appreciate your reviewing the draft. We will consider the comments carefully and incorporate into our analysis as warranted. We will get back to you if we feel a conversation is needed, but please note this is the absolute height of proxy season, so, as we state in our cover letter, "only truly whether FOR or AGAINST. Unfortunately, we believe that ISS's objective was to issue a report supporting the Trillium proposal regardless of ISS's policies and regardless of the steps taken by Range. ISS's response to Range's comments on the draft ISS report was: . [ISS response 5/8/13] . "We carefully considered your comments on the methane emissions proposal. Because much of the information in your response is not available publicly, we are unable to act on it. If you were to publish this information in the future, we will always consider a recommendation in light of new material facts." . All the

48	DEAN FOODS CO	DEFA14A	5/13/2013	Glass Lewis recommends voting "AGAINST" . approval of our executive . compensation . program . and . the . election . of . Tom . Davis . as . a . director . because . he . serves on the Compensation Committee . – . We . strongly . disagree . with . Glass . Lewis' . analysis, . which . criticizes . the . Company's . pay-for- . performance . – . Glass . Lewis . states . that . the . Company . "performed . worse . than . its . peers" . despite . an . approximate . 47.4% increase in the Company's stock price during 2012. The Company believes that any . "pay-for-performance" . analysis . that . criticizes an approximate 47.4% increase in stock price and . associated increase in TSR (Total Shareholder Return) is fundamentally flawed.
49	EXXON MOBIL CORP	DEFA14A	5/13/2013	ISS has issued a voting recommendation inconsistent with the Board's recommendation on ExxonMobil's say on pay proposal. As explained in the attached letter to shareholders, we believe the ISS recommendation fails to account for the particular facts and circumstances of ExxonMobil's business. . Key flaws in the ISS analysis include: . -Emphasis on short-term performance . - Does not take into account outperformance of Total Shareholder Return relative to oil/gas industry peers . - Fails to adjust for size and complexity relative to ISS selected peers . - Misrepresentation of bonus linkage to Exxon Mobil Corporation David S. Rosenthal . 5959 Las Colinas Boulevard Vice President, Investor Relations . Irving, TX 75039-2298 and Secretary . May 13, 2013 . Re: Supplemental Information Related to Item 3 – Advisory Vote to Approve Executive Compensation . Dear Investor, . As you may have noted, ISS has issued a voting recommendation inconsistent with the Board's recommendation on the say on pay proposal for ExxonMobil's upcoming annual meeting. As explained in more detail below, we believe the ISS recommendation fails to account for the particular facts and circumstances of ExxonMobil's business and urge you to vote FOR Item 3 (advisory vote to approve executive compensation) on our proxy. . Key flaws in the ISS analysis include: . — Emphasis on Short-Term Performance . The ISS model inappropriately focuses on short-term stock performance (i.e., one- and three-year relative total shareholder return, or TSR) which does not correlate well with long-term performance (see page 48 of the CD&A in the 2013 proxy). This is compounded by ISS's use of TSR data across multiple industries. Cross-industry performance comparisons do not recognize the counter-cyclical aspects of different industries

50	JPMORGAN CHASE & CO	DEFA14A	5/10/2013	President of Barnard College. She began her career as a corporate lawyer. Ms. Futter has been a director of the Federal Reserve Bank of New York, where she also served as its Chairman. She has also served as a director of a number of public companies, including currently, Consolidated Edison, Inc., as well as previously American International Group and Viacom. . The proxy advisory consultants have recommended against the re-election of these members of the Risk Policy Committee because of the losses suffered in CIO's Synthetic Credit Portfolio. We believe this opposition is misplaced and relies on condemnation of the Risk Policy Committee's work or the Company's otherwise successful approach to risk matters. It is telling, in this regard, that in the year when those losses arose, the Company still produced record earnings, grew its tangible book value per share by 15% and increased its tangible common equity by 16%. . Second , contrary to the implications of the proxy advisory consultants, for most of its history, the Synthetic Credit Portfolio was an effective offset to the Company's significant credit exposure . 3 inferences and conclusions at odds with the extensive review by the independent Review Committee of the Board on which we both served. . First , the events surrounding the CIO losses were unique and idiosyncratic. They are not representative of the quality of the Company's risk management processes or culture. Indeed, one of the principal causes of the losses in the Synthetic Credit Portfolio was the failure to apply the same processes and disciplines in CIO that the Company has in place for its client-facing businesses. We do not believe that one can fairly extrapolate from the losses in CIO a broad
51	HESS CORP	DEFA14A	5/6/2013	Hess Corporation (NYSE: HES) ("Hess" or "the Company") today released a white paper on the report issued by Institutional Shareholder Services Inc. ("ISS"). . The Board recommends that shareholders vote FOR the election of Hess' highly qualified independent nominees on the WHITE proxy card. . For information about Hess' transformation and the 2013 Annual Meeting, please visit: www.transforminghess.com. . Included below is the full text of the white paper: . WHITE PAPER ON THE ISS REPORT ON HESS CORPORATION . Hess believes that the ISS report RECOMMENDATION REFLECTS THE ORGANIZATION'S . INSTITUTIONAL BIAS TOWARD ACTIVIST SHAREHOLDERS . Institutional investors rely upon ISS or other proxy advisory firms to make objective, unbiased recommendations across a wide array of corporate voting matters. This responsibility is even more pronounced in contested situations in which companies face potentially value-threatening challenges. Given the importance of these situations, ISS owes a duty to its clients and to companies and their shareholders - a duty that mandates cogent, clear-eyed analysis of key issues. . Instead of objective analysis, however, recent Fee paid previously with preliminary materials. . Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing. . 1) Amount Previously Paid: . 2) Form, Schedule or Registration Statement No.: . 3) Filing Party: . 4) Date Filed: . Hess Issues White Paper on ISS Report . Highlights Flaws in ISS' Analysis . Recommends Voting the White Proxy Card for the Election of Hess' New, Highly Qualified

52	HESS CORP	DEFA14A	5/3/2013	Hess Corporation (NYSE: HES) today commented on the report issued by Institutional Shareholder Services Inc. ("ISS"). ISS's flawed analysis does not reflect the fact that Hess has nominated five all new independent director nominees to oversee the continued execution of a market-endorsed transformation plan and disregards the highly problematic compensation scheme put in place for Elliott Management's dissident nominees. Hess notes that Egan Jones, a competing proxy advisory firm, yesterday issued a report in support of ALL of Hess' director nominees and believes that shareholders who conduct their own thoughtful analysis will arrive at the same conclusion. Hess continues to urge shareholders to vote on the WHITE proxy card FOR all of its new, highly qualified, independent director nominees at the Company's 2013 Annual Shareholders Meeting, which will be held on May 16, 2013. . The Company said, "ISS has betrayed its own principles. We have Fee paid previously with preliminary materials. . Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing. . 1) Amount Previously Paid: . 2) Form, Schedule or Registration Statement No.: . 3) Filing Party: . 4) Date Filed: . HESS CORPORATION . News Release . HESS COMMENTS ON ISS REPORT . ISS BETRAYS OWN PRINCIPLES; FLAWED ANALYSIS IGNORES KEY FACTS AND HESS' SLATE OF ALL NEW, WORLD-CLASS
53	MORGAN STANLEY	DEFA14A	5/3/2013	Dear Fellow Morgan Stanley Shareholder: . Morgan Stanley's Board of Directors recommends that you vote in favor of the four proposals to shareholders and the election of the nominees to the Board of Directors. The proxy advisory firm Glass Lewis has recommended that shareholders vote against one of these proposals - say on pay - and against one of the director nominees, James Owens. The proxy advisory firm Institutional Shareholder Services has recommended the opposite - that shareholders vote in favor of both the say on pay proposal and in favor of all director nominees, including James Owens. We believe that the Glass Lewis recommendations fail to reflect critical facts about Morgan Stanley which were considered by Institutional Shareholder Services, and I would like to briefly summarize the reasons to support these important proposals. . A d viso r y Sa y on P a y P r o po sal . The Say on Pay proposal centers on CEO compensation in relation to company performance. According to Glass Lewis, they use a quantitative model to evaluate performance. In the case of Morgan Stanley's 2012 performance, the data used in this model on an unadjusted basis produces a distorted conclusion that does not accurately reflect our operating performance. The financial information used in the Glass Lewis model includes an accounting convention under generally accepted accounting principles (GAAP) referred to as "debt value adjustment" (DVA) which requires companies to adjust revenues for changes in the fair value of certain outstanding borrowings. . In 2012, Morgan Stanley's credit spreads (the amount that we must pay over a credit risk-free rate to borrow money in the debt markets) declined by an unusually large amount - over 250 basis points. These

54	HESS CORP	DEFA14A	5/2/2013	Fee paid previously with preliminary materials. . Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing. . 1) Amount Previously Paid: . 2) Form, Schedule or Registration Statement No.: . 3) Filing Party: . 4) Date Filed: . HESS CORPORATION . News Release . FOR IMMEDIATE RELEASE . HESS COMMENTS ON GLASS LEWIS REPORT . FLAWED, ONE-SIDED RECOMMENDATION DOES NOT REFLECT OVERWHELMING SUPPORT HESS TRANSFORMATION PLAN HAS RECEIVED FROM SHAREHOLDERS AND . INDEPENDENT WALL STREET ANALYSTS . GLASS LEWIS UNDERMINES ITS OWN ANALYSIS; FINDS ELLIOTT COMPENSATION SCHEME COMPROMISES INDEPENDENCE OF DISSIDENT SLATE, CREATES DIVIDED BOARD . HESS URGES SHAREHOLDERS ELECT ALL HESS' NEW, INDEPENDENT DIRECTOR NOMINEES . ON THE WHITE PROXY CARD . NEW YORK - May 1, 2013 - Hess Corporation (NYSE: HES) ("Hess" or the "Company") today commented on the report issued by Glass Lewis & Co. ("Glass Lewis"). Glass Lewis's flawed recommendations do not reflect the overwhelmingly positive support Hess' transformation plan has received from its shareholders and independent Wall Street analysts. Glass Lewis also undermines the integrity of its own analysis by raising serious concerns about the highly problematic compensation scheme put in place for Elliott Management's director candidates, questioning the independence of the same dissident nominees it supports. Hess disagrees with Glass Lewis' recommendation and believes that shareholders who follow its recommendation at a time when Hess is executing on a market-endorsed transformation plan will put the value of their investment at risk. Hess continues to urge shareholders to
55	HESS CORP	DEFA14A	5/2/2013	proxy advisory firms and the following statement: "The system is broken and it is time to fix it. The voting standards and advice issued by proxy advisory firms need to be grounded in fact and reflect reality. As the number and complexity of issues on the proxy has grown exponentially, proxy advisory firms have failed to develop open, clear and evidence based standard setting systems to help ensure the advice they provide strengthens corporate governance and shareholder value. They also are riddled with conflicts of interest and outdated processes that threaten the credibility and reliability of

56	VULCAN MATERIALS CO	DEFA14A	4/30/2013	Advisory Vote on Executive Compensation ("Say-on-Pay") and "AGAINST" Proposal 6, Shareholder Proposal on Independent Chair of the Board of Directors . You can view our Proxy Statement under the Investor Relations tab at www.vulcanmaterials.com . . Contrary to the Board's recommendation, and the favorable recommendation of leading proxy advisory firm Glass Lewis & Co. , ISS Proxy Advisory Services ("ISS") recently recommended that its clients vote against the Say-on-Pay proposal. We believe the ISS recommendation is based on incorrect information and a misunderstanding of our compensation practices . Further, while ISS acknowledged that we have instituted a "robust" lead independent director structure and stated that they saw "no performance concerns," ISS recommended that its clients support the shareholder proposal calling for an independent Chair of the Board of Directors, solely on account of the same, unfounded concerns about our executive compensation program. . VULCAN COMPENSATION IS ALIGNED WITH COMPANY PERFORMANCE . According to Glass Lewis, "the Company maintains a well-designed executive compensation program" that has "aligned executive compensation with performance." Even ISS' own report shows, Vulcan's CEO compensation has tracked total shareholder return over the past several years. It is not surprising, therefore, that Vulcan's Say-on-Pay proposals have been supported by more than 93% of the shares voted at each of our last two annual meetings. . ISS' OPINIONS ON VULCAN'S COMPENSATION PROGRAM ARE FACTUALLY WRONG . In its report, ISS suggests that Vulcan's Board of Directors changed the metric by which we measure management's short-term performance in our compensation program in order to influence the level of payouts. In fact, our application of the new metric that we are using to
57	PROLOGIS, INC.	DEFA14A	4/24/2013	2008 – 2012 Compensation Comparison . Contractual Amounts vs. Amounts Paid to Walt Rakowich . ISS' recommendation "against" our Say on Pay ("SOP") proposal is driven by our retired co-CEO's compensation in his final year. We believe ISS has reached the wrong conclusion and failed to account for certain key facts and circumstances when issuing their recommendation. . • ISS focused on Walt Rakowich per their "higher paid co-CEO rule" and ran the quantitative tests, which pointed to a "high concern" due to his severance. Without Walt's severance, these same tests would register a "low concern combined pre-merger expenses of the two companies. . • For the period from November 11, 2008 (when Mr. Rakowich became CEO of ProLogis Trust) to December 31, 2012 (when Mr. Rakowich retired), the company's total annualized return to stockholders was 28% and the total annualized return including dividends was 180%. . • The focus for the 2013 proxy should be on the compensation of our continuing CEO, Hamid Moghadam. Based on ISS' own report, Hamid's compensation for 2012 is below the median of the ISS selected peer group. . • Walt's employment and severance arrangement was fully disclosed in the ProLogis

58	HUMANA INC	DEFA14A	03/29/2013	This month, you received the proxy statement for the Humana Inc. 2013 Annual Meeting of Stockholders, scheduled for April 25, 2013 (the "Annual Meeting"). In the proxy statement, our Board of Directors recommends a vote "For" Proposal No. 3 - the advisory resolution approving executive compensation (often called "say on pay"). . We write to bring to your attention a significant disagreement between the Company and Institutional Shareholder Services Inc. ("ISS") with respect to ISS' Proxy Report issued on March 20, 2013. In the ISS Proxy Report, ISS has recommended a vote "Against" our Proposal No. 3, and despite a discussion with ISS about their analysis in the Proxy Report, we continue to strongly disagree with ISS' rationale and conclusions. . For the reasons set forth below, we believe ISS' recommendation is based on an incomplete and flawed analysis of the Company's compensation program, and we urge you to vote "FOR" Proposal No. 3 - the advisory resolution approving executive compensation. . McCallister Non-Compete Payment . As disclosed in our proxy statement, in . McCallister's non-compete as a departure payment. We believe this analysis to be flawed as it fails to adequately consider the following: . · any preexisting equity agreement non-compete restrictions would expire on December 31, 2013 (one-year following termination of Mr. McCallister's employment), whereas the new non-compete extends until two years following termination of his Board service, a substantially longer non-compete term; . · the enhanced non- compete term automatically extends as Mr. McCallister's Board service continues; and . · the amount paid by the Company for the enhanced two-year-plus non
59	ELECTRONIC ARTS INC.	DEFA14A	7/10/2012	• 75% of our CEO's fiscal 2012 compensation was in the form of long-term equity grants of which 50% of the number of shares granted and approximately 60% of the value of shares granted to our CEO consisted of performance- based RSUs, which are earned based on EA's TSR relative to the performance of each of the companies in the NASDAQ-100. For our performance-based equity awards, EA's TSR needs to be at the 60 th percentile of the index for the targeted number of shares to vest. . • ISS incorrectly characterizes the equity grants awarded to our CEO in fiscal 2012 as merely additive to the value of equity granted to him in fiscal 2011, and fails to consider the following factors: . • Our CEO's equity mix was changed from 100% time-based awards to a mix of time- and performance-based RSUs in fiscal 2012: 125,000 time- based RSUs were granted, along with performance-based RSUs, of which up to 125,000 shares may vest if target performance levels are achieved. . • The number of shares and value of time-based awards to our CEO has decreased significantly over the past three years: . Fiscal 2010 Fiscal 2011 Fiscal 2012 . Shares 387,000 200,000 125,000 . Value $ 7,294,950 $ 3,508,000 $ 2,802,500 . • In • In contrast, ISS uses a formulaic approach to select peer companies based on industry code, market capitalization, and revenue. Based on these criteria, ISS selected 14 peers for EA. However, we do not compete for executive talent with most of the companies

60	AUTODESK INC	DEFA14A	5/31/2012	Pay). As you may be aware, Institutional Shareholder Services ("ISS") and Glass-Lewis have recommended a vote against this proposal. We strongly disagree with ISS' and Glass Lewis' recommendations, as well as the underlying methodology used in each report, however, for the sake of brevity and because many of our objections are similar, we focus here solely on the ISS report. 1 . The reasons we disagree with ISS are summarized here and then described in more detail below: . • ISS' Pay for Performance methodology is flawed . • ISS confuses timing of equity decisions — Equity grants made in March 2011 for Performance" methodology is flawed. . • Performance/Award Timing Disconnect . • ISS in their 2012 US Compensation Policy Frequently Asked Questions 2 states . • "...pay opportunities should be reflective of the company's past performance..." . • Later in the FAQ, ISS answers a question that addresses equity grants which have been made near the beginning of one fiscal year for prior fiscal year performance. ISS states: . • "...such timing issues can be problematic for investors evaluating the relationship between . 1 We have similar and related disagreements with Glass-Lewis' methodology, degree of were based on operational performance in fiscal 2011. ISS is analyzing March 2011 pay against fiscal 2012 performance results . • ISS inflates the valuation of stock options . • Realizable pay provides a more realistic metric for measuring pay for performance by measuring actual gains from equity awards and bonus payouts as of a specific date . • ISS uses a flawed peer group . • With their 2012 recommendation, ISS creates a new peer group and contradicts their published 2011 view that Autodesk's peer group was of "Low Concern" . • Autodesk satisfies all 2012 Pay for Performance criteria when using
61	AUTODESK INC	DEFA14A	5/25/2012	Dear Stockholder: . We are writing to ask for your support at Autodesk's Annual Meeting of Stockholders with respect to Proposal 3, Non-Binding Vote to Approve Named Executive Compensation (Say on Pay). As you may be aware, Institutional Shareholder Services ("ISS") and Glass-Lewis have recommended a vote against this proposal. We strongly disagree with ISS' and Glass Lewis' recommendations, as well as the underlying methodology used in each report, however, for the sake of brevity and because many of our objections are similar, we focus here solely on the ISS report 1 . . The reasons we disagree with ISS are summarized and then described in more detail below: . • ISS' Pay for Performance methodology is flawed . • ISS over-inflates the valuation of stock-based compensation . • ISS confuses timing of equity decisions — Equity grants made in March 2011 were based on operational performance in fiscal 2011. ISS is analyzing March 2011 pay against January 31, 2012 performance results . • Realizable pay provides a more realistic metric for measuring pay for performance by measuring actual gains from equity awards and bonus payouts as of a specific date . • ISS uses a flawed peer group . • With their 2012 recommendation, ISS creates a new peer group and contradicts their published 2011 view that Autodesk's peer group was of "Low Concern" . • Autodesk satisfies all 2012 Pay for Performance criteria when using Autodesk's own defined peer group (instead of using ISS' flawed 2012 peer group) . • Autodesk maintains strong compensation governance and practices . • Autodesk made meaningful changes for fiscal year 2013 in response to Say on Pay feedback from stockholders, including performance stock units and mandatory holding requirements for the Board and executives . • Autodesk's operating performance (which ISS ignores

62	STAPLES INC	DEFA14A	5/23/2012	ISS Proxy Advisory Services (ISS) has recommended a vote "AGAINST" Item 3. Two other leading proxy advisory firms, however, have recommended that stockholders vote "FOR" Item 3. We strongly disagree with ISS' recommendation, as well as the underlying ISS analysis and methodology, and believe that the changes we implemented in 2012 are substantial and will improve our pay for performance alignment. Accordingly, we urge you to vote "FOR" approval of Item 3. . In deciding how to vote on Item 3, we encourage you to read the relevant portions of our 2012 proxy statement and consider the information objectives, especially since one of the more significant changes involved a substantial amount of pay being dependent on a cumulative 3 year goal. ISS also ignores the fact that all of the significant compensation decisions for fiscal year 2011 were made prior to our stockholder outreach program. In fact, Glass Lewis and Egan-Jones, both recommended that stockholders vote "FOR" Item 3, with Glass Lewis noting the significant changes we implemented and the need to give the changes time to take effect since the changes are focused on improving the alignment of pay and performance. Egan-Jones, in its ISS' peer group comparison is flawed . ISS' methodology for constructing its peer groups for purposes of its pay for performance analysis is fundamentally flawed. ISS applies a mechanical process that is based on the Global Industry Classification System and a company's revenues and market capitalization but neglects to adequately qualitatively assess who the best peer companies are based on competitive business and talent acquisition conditions. In the ISS 14 company peer group, there are seven companies that are also reflected in the Staples' selected peer group (Best Buy, Gap, J.C. Penney
63	CHEVRON CORP	DEFA14A	5/21/2012	We urge you to vote against all of the stockholder proposals set forth in Chevron's 2012 Proxy Statement for the reasons described in the Proxy Statement and discussed below. We are providing this additional communication because we think it is important to respond to the factual errors and poor quality of analysis contained in the report recently released by ISS Proxy Advisory Services. . ISS has recommended that its clients vote for regarding exclusive forum provisions, independent chairman, special stockholder meetings and director with environmental expertise—items 4, 5, 10 and 11 on the proxy—because those are the items with the most errors or misleading statements in the ISS report. . Item 4 on the Proxy: Stockholder Proposal Regarding Exclusive Forum Provisions . Your Board adopted the exclusive forum by-law provision to protect stockholders' economic interests and to mitigate the risks of excessive litigation costs. ISS's recommendation is premised on a deeply flawed requirement that companies incur substantial harm as a result seven of eight stockholder proposals. ISS's recommendations are entirely inconsistent with the report's positive profile of Chevron's financial condition and performance against ISS's selected peers (page 3), Governance Risk Indicators (page 4), compensation profile (pages 5-6), and support for all director-nominees (pages 8-10). ISS itself notes that "the company has no governance issues at this time." Despite this, ISS has disregarded your Board's rationale for recommending that Chevron stockholders vote AGAINST these stockholder proposals. . This letter is focused on the stockholder proposals

64	DEVON ENERGY CORP/DE	DEFA14A	5/21/2012	The standardized peer group methodology utilized by ISS Proxy Advisory Services (ISS) to make relative pay and performance comparisons results in the inclusion of companies with which Devon does not compete for investors, customers, personnel talent or production resources. Seven of the 12 companies in the ISS-generated peer group are not in the E&P industry---three are coal companies, three are pipeline companies, and one is a refiner. This defect overstates Devon's executive pay relative to peers and incorrectly implies pay is not aligned with performance. . ¡ The chart below reflects the composition of the two peer groups as well as the differences in the percentile ranks of TSR and CEO pay yielded from the two groups (0 to 100 = lowest to highest). A comparison of the two yields the following
65	RANGE RESOURCES CORP	DEFA14A	5/15/2012	value of their base salaries in Range common stock. This represents a significant commitment to shareholder alignment by our executive officers. . ISS Proxy Advisory Services allowed Range to comment on their recommendations prior to their release but did not change their recommendation. However, ISS, just as Glass Lewis, fails to distinguish between the change in control accelerated vesting event , any actual payment of any change in control payments and the fact that the award which would be forfeited in a pro rata vesting formula has already been earned . The acceleration in vesting of equity in control transaction. Importantly, while the equity awards would vest, NO change of control payments would be made unless an executive officer was terminated within 12 months of the date of the change in control event. The vesting of equity awards would incentivize executives to maximize the value of any potential change of control event for the benefit of all shareholders even if the executives were subsequently terminated. The proposed change could create a significant disincentive for executives to pursue a change in control. . We believe that the ISS conclusion that " Adoption of a pro-rata
66	AK STEEL HOLDING CORP	DEFA14A	5/14/2012	Proxy Advisory Services ("ISS") recently issued a flawed report recommending a vote against this proposal, based on concerns about the link between Company performance and the compensation of our Named Executive Officers and the Company's performance compared to an ISS-created group of purported "peer" companies. The Company strongly disagrees with ISS and its recommendation. The fundamental basis for the ISS recommendation is that the performance of the Company in terms of total shareholder return lags behind a "peer" group established by ISS for comparison purposes, while the compensation of the Company's CEO is slightly above (1.08 times) the median of that ISS-established peer group. The Company believes that there are many significant errors in the ISS analysis, but those errors start with the fact that ISS has predicated its analysis on a comparison to a completely inappropriate "peer" group. There are other errors which underlie the ISS recommendation and the Company has addressed the most significant (though not all) of them below. We encourage you to review and consider the points below, as well as the information in the "Executive Compensation" section of the Company's 2012 Proxy

67	EXXON MOBIL CORP	DEFA14A	5/11/2012	recommendation on the say on pay proposal for ExxonMobil's upcoming annual meeting. As explained in more detail below, we believe the ISS recommendation fails to take account of the particular facts and circumstances of ExxonMobil's business Key flaws in the ISS analysis include: . • Emphasis on Short-Term Performance. The ISS model inappropriately focuses on short-term stock performance (i.e., one- and three-year relative total shareholder return, or TSR) which does not correlate to long-term performance (see page 46 of CD&A). As you know, ExxonMobil's compensation program is designed to support superior and sustainable performance over the much longer time periods – 10, 20
68	NEXTERA ENERGY INC	DEFA14A	5/11/2012	However, proxy advisory firm ISS Proxy Advisory Services ("ISS") has recently issued a report recommending that its clients vote against this proposal, contrary to the recommendation of the Board of Directors. . ISS recommends a vote against the Company's say-on-pay proposal because of what ISS characterizes as a "pay-for-performance disconnect." ISS has issued this recommendation despite what it acknowledges is a "generally positive shareholder return backdrop." ISS noted in its report that it had recommended past and will support increases in long-term shareholder value in the future. The ISS analysis omits or gives insufficient attention to the following facts shareholders should be aware of in order to make an informed decision on this year's say-on-pay proposal. . ISS's peer group selection results in an analysis that distorts the Company's relative pay for performance. . The peer group selected by ISS to benchmark NextEra Energy's chief executive officer compensation is incomplete, as it includes a subset of the Company's energy services industry peers and fails to include any of its "general
69	YUM BRANDS INC	DEFA14A	5/9/2012	Institutional Shareholder Services ("ISS") has recommended that shareholders vote against the Say on Pay proposal. As discussed in detail below, the Company's Board of Directors strongly disagrees with ISS's position. Accordingly, the Board recommends that you vote "FOR" the approval of Item 3. . Fundamental Choice . In this vote, shareholders are faced with a fundamental choice: The program and, therefore, lacks balance in its approach and leads to inaccurate and erroneous conclusions as a result. . Below is a discussion of several of the defects in the ISS analysis. . Peer Group . ISS's peer group and the corresponding criticism of Yum's benchmarking group is flawed in several key areas, specifically: . • ISS group is created by a formula, has too few companies and therefore is more subject to outliers as a result; . • ISS group includes companies distinctly dissimilar from Yum and therefore have little relevance; and . • No allowance is made for the distinct complication and added scope Management Planning and Development Committee's studied approach based on a long term philosophy and design that has ensured alignment of management with shareholder interests, helped drive great Company performance and produced superior returns for shareholders over the short and long term OR, ISS's one size fits all/check the box approach to compensation. . As discussed in more detail below, ISS's recommendation is a flawed and poorly conceived approach that fails when applied to Yum's compensation program. Below we will: . • Summarize Yum's strong shareholder returns over the short and long term
70	DEAN FOODS CO	DEFA14A	5/8/2012	•Glass Lewis recommends voting "AGAINST" . (i) our executive compensation . program . because, . among . other . reasons, . they . allege . we . have . failed . to . align . pay . for performance and (ii) election of J. Wayne Mailloux to the Board because he . serves on our Compensation Committee . –We strongly disagree with Glass Lewis' . analysis, which seems to utilize a . substantially different peer

71	INVESCO LTD.	DEFA14A	5/8/2012	Failure to apply judgment is, in many instances, including for Invesco, resulting in peer groups with no meaningful alignment of business model and complexity, customer or client base, or geographical scope. . The ISS-designated peer group for Invesco is shown in the box below. Notably, of the 13 listed companies, Invesco's management and board of directors view only one of them, Franklin Resources, as a true peer. Having only one out of 13 (or 8%) of the ISS-generated peer group within our industry does not produce an appropriate peer group. . ISS-Designated Peer Group . · CME Group Inc. . · Cullen/Frost The ISS-designated peer group . We understand ISS's strong desire to apply a standard methodology in generating a peer group for the public companies that ISS reviews. For the 2012 proxy season, ISS's newly-introduced methodology generated a peer group for Invesco from companies within an industry classification utilizing two criteria (i) balance sheet asset size, and (ii) market capitalization. We believe that once ISS's methodology generates a peer group listing, ISS should use its informed judgment to ensure the peer group is appropriate , credible and relevant for the company under review Bankers, Inc. . · E*Trade Financial Corporation . · Franklin Resources, Inc. . · Hancock Holding Company . · IntercontinentalExchange, Inc. . · Jefferies Group, Inc. . · NYSE Euronext . · Raymond James Financial, Inc. . · SVB Financial Group . · TD Ameritrade Holding Corporation . · The NASDAQ OMX Group, Inc. . · Vornado Realty Trust . The ISS peer group consists mainly of community banks, financial exchanges and REITs, rather than a peer group consisting of publicly traded organizations that are in the asset management and custody bank industry. Such a misaligned peer group produces misleading executive compensation
72	VENTAS INC	DEFA14A	5/3/2012	However, ISS failed to reference this superior performance in the discussion of its recommendation with respect to our advisory vote on executive compensation. . The ISS report also failed to consider the context in which our compensation decisions were made. As support for its recommendation, ISS noted the 26% increase in Ms. Cafaro's base salary and our 2011 benchmarking of certain elements of Ms. Cafaro's compensation to the 65 th percentile of the peer group we used for 2011 compensation purposes (as disclosed in our 2012 proxy statement). However, these observations ignored the fact that our size and performance were well above the size and performance of not only our 2011 compensation peer group, but also the peer group used by ISS in its report. In 2011, we completed more than $11 billion in acquisitions, doubling our asset base and ending the year as the sixth largest REIT by equity market capitalization, the ninth largest REIT by enterprise value and the largest owner of seniors housing in the United States, and we had a pending agreement to acquire Cogdell Spencer Inc., making us the largest owner of medical office buildings in the United States. As a result, our relative consistent with a pay-for-performance philosophy. 2 . Similar conclusions are borne out by reviewing the ISS peer group, for which ISS noted that Ms. Cafaro's 2011 compensation was above the median. The disparity between Ms. Cafaro's 2011 base salary of $915,000 and the ISS peer group median of $823,000 is consistent with the difference between our December 31, 2011 equity market capitalization of $16 billion and the ISS peer group median equity market capitalization of $12.5 billion, as well as the difference between our one-year TSR of 9.68% and the ISS peer group median TSR of 1.66%. Accordingly, Ms

73	J C PENNEY CO INC	DEFA14A	5/1/2012	Institutional Shareholder Services ("ISS") has recommended that stockholders vote against each of these proposals. As discussed in further detail below, the Company's Board of Directors strongly disagrees with ISS' position. Accordingly, the Board recommends that you vote "FOR" the . Among the companies that ISS includes in its selected peer group analysis are four automobile/transportation industry companies (AutoNation, CarMax, Genuine Parts Company, and Penske Automotive Group) that do not align in any respect with jcpenney's business model. The inclusion of these companies, which comprise nearly 30% of ISS' purported peer group, simply makes no sense, and highlights the flaws in ISS' methodology. . Contrary to ISS' report, the 2011 say-on-pay vote reflected substantial support for the Company's executive compensation program. In 2011, 72% of votes were cast in favor of the opposition from non-affiliated shareholders." ISS provides no objective support, however, for this statement (despite its claim that it only considers publicly available information when preparing its analyses and making vote recommendations). ISS' characterization devalues the votes of Pershing Square and Vornado and implies that they, as major stockholders, should not have an equal say in matters that are of importance to the Company's stockholders. . ISS' negative recommendation on say-on-pay fails to consider the importance of ensuring a smooth transition as Mr. Johnson assumed the CEO position and
74	SEMPRA ENERGY	DEFA14A	4/30/2012	Glass Lewis & Co., another proxy advisory firm, has recommended a vote AGAINST both our Say-on-Pay proposal and the members of the Compensation Committee of the Board of Directors. . Our board of directors recommends a vote FOR our Say-on-Pay proposal, and in this letter we will provide key highlights of our: . — Very strong short-term and long-term financial performance. . — Performance-based compensation aligned with shareholder interests. . — Shareholder engagement and strong compensation governance practices. . We will also discuss the flaws in the Glass Lewis analysis. . Outstanding short term and long-term financial performance: . Our financial performance has been very strong over both the short-term and long-term. Glass Lewis' analysis lacks transparency, is conceptually flawed and inaccurate: . Glass Lewis' analysis lacks transparency and is fundamentally flawed. Below are a few illustrative examples: . — Glass Lewis reports our CEO's compensation at $12.5 million in the Pay for Performance section of their report. This is not the 2011 compensation of our current CEO, Ms. Reed ($6.1 million 3) and it is not the compensation of our former CEO, Mr. Felsinger ($9.9 million 3). It is also not the average or weighted average of their 2011 compensation. We cannot determine how they arrived at their numbers.

75	MORGAN STANLEY	DEFA14A	4/30/2012	While we are pleased that both advisory firms support our proposals on our advisory vote on pay and our director equity plan, we believe that ISS's recommendation regarding the amendment to our equity share plan failed to properly reflect certain critical issues regarding this proposal. Last year, the amendment to our equity share plan received a 73% vote under similar circumstances of positive Glass Lewis and negative ISS recommendations. I would compensation creates an important alignment between employees and shareholders. That is why we disagree with ISS's customary formula-based methodology used to evaluate equity incentive plans, which resulted in ISS not supporting the amendment of the EICP. In our view, the methodology used by ISS does not appropriately reflect important considerations regarding Morgan Stanley's compensation practices. In order for you to make a fully informed voting decision on this important matter, we have outlined below several key concerns with the ISS analysis. . First, the ISS methodology did not reflect that the
76	BOSTON SCIENTIFIC CORP	DEFA14A	4/27/2012	Below we outline reasons why we believe that ISS's analysis of these inducement grants is flawed and why such grants were consistent with the ISS Proxy Advisory Services (ISS) recently recommended that its clients vote "against" the Company's advisory vote on executive compensation. As indicated in its report, ISS's negative vote recommendation is primarily based on its belief
77	HESS CORP	DEFA14A	4/17/2012	Institutional Shareholder Services ("ISS") and Glass, Lewis & Co., LLC ("Glass Lewis") recommended a vote against our say on pay proposal and Glass Lewis recommended a vote against two directors on our Committee. For the reasons discussed below, we believe these recommendations are unjustified and the analyses underpinning these recommendations are misleading and flawed. . 1. The Committee approved several actions to address 2011 pay for performance. In response to 2011 performance, our Committee, at its earliest opportunity in 2012, took the following actions: . · CEO bonus reduced. The chief executive . . Value of 2011 LTI awards reduced. The 2011 LTI grants were made in February 2011 and reflect the Company's successful performance in 2010 (including TSR of 27%), not 2011 performance. However, later in 2011, well after these compensation decisions had been made, our stock price declined. ISS and Glass Lewis assess performance using grant date values. If ISS and Glass Lewis had valued the awards based on the 2011 ending stock price (as we show in the realizable pay table in our proxy statement), CEO pay and performance are clearly aligned. . Hess' Conclusion . The Committee reinforced pay for performance by reducing 2011 CEO pay, adopting a new TSR based performance share plan and eliminating stock option awards. . 2. ISS discounts and Glass Lewis ignores our new relative TSR plan. After careful consideration of alternative long-term incentive plan designs, in early 2012 the Committee approved performance shares that are earned based on relative TSR. ISS misleadingly claims that our relative TSR goals are not rigorous relative to target LTI values. . · Our Committee considered several alternative LTI designs. ISS states that investors might expect LTI designs based on business plan and strategic

78	MARRIOTT INTERNATIONAL INC /MD/	DEFA14A	4/17/2012	To our disappointment, Institutional Shareholder Services Inc. (ISS) has recommended that its clients vote against Item 3. . Marriott's 2011 compensation was appropriate when compared to other companies in Marriott's industry sector. . ISS Fails to Adequately Recognize the Favorable Impact of the Timeshare Spin-Off to Shareholder Value . ISS asserts that there is a "pay for performance" disconnect as a result of the decision by the Board's Compensation Policy Committee (the "Committee") to make several adjustments related to the spin-off of our timeshare business to the financial metric (earnings per share) used to assess Company performance under the 2011 annual incentive plan. . The timeshare spin-off was announced on February the strength of the Company's underlying business, is reflected in the Company's stock price performance since the date of the spin-off, which has substantially outperformed the market. From November 20, 2011 (pre-spin) through April 12, 2012, stock prices for the Company and VAC combined are up 34 percent, Starwood Hotels & Resorts' stock price is up 18 percent and the S&P is up 16 percent. Year to date in 2012, the Company's stock price (alone) is up 29 percent, Starwood Hotels & Resorts' stock price is up 17 percent and the S&P is up 10 percent. . Despite these results, the ISS analysis fails
79	LABORATORY CORP OF AMERICA HOLDINGS	DEFA14A	4/17/2012	We are writing to ask for your support for our upcoming Advisory Vote to Approve Executive Compensation ("Say-on- Pay"). We recently received a report from the proxy advisory firm Institutional Shareholder Services (ISS) recommending that their clients vote against this proposal. We strongly disagree with the ISS report for the reasons described below. . Our Philosophy and Approach to Executive Compensation is Unchanged From Last future equity compensation was the implementation of clawback provisions on incentive compensation, which we – and ISS – view as a positive enhancement to the robust corporate governance aspects of our program; and . • . Another proxy advisory firm, Glass Lewis, has recommended a vote for approval of our Say-on-Pay proposal this year (as they did last year). . ISS' recommendation this year is inconsistent with its approach last year, the overwhelming stockholder approval of last year's Say-On-Pay proposal, and with ISS' current observations of our "generally positive financial returns and generally salutary compensation practices." . The ISS Peer Group is Flawed . The primary basis for the ISS recommendation appears to be that our CEO compensation is not aligned with our total shareholder return, as measured against a "peer group" chosen by ISS in its sole discretion. Unfortunately, the peer group used by ISS for these purposes was chosen based on factors not relevant to LabCorp. . • . Although LabCorp has few direct business peers that are publicly traded and report compensation, our Compensation Committee, management and compensation consultant have devoted considerable time and effort to developing

80	NCR CORP	DEFA14A	4/12/2012	emphasizes pay for performance; . II. Our CEO is an outstanding leader who merits an opportunity to earn compensation at or above the 75th percentile; . III. It is in our shareholders' interest to retain our CEO; and . IV. The analysis done by ISS on company performance and Total Shareholder Return ("TSR") is misleading and flawed as it underestimates NCR's operating results. . I. NCR's compensation program emphasizes pay for performance . • In 2011, 62% of the CEO's total direct compensation was performance based, dependent on delivering stretch performance targets, and remains at risk if these targets are not on Pay Proposal") . Dear Shareholder: . We are writing to ask you to support the Board of Directors' recommendation and vote FOR NCR's Say on Pay Proposal that was included in the Company's Proxy Statement (the "Proxy") that was filed on March 12, 2012 and can also be located at www.ncr.com/investor-relations. Institutional Shareholders Services ("ISS") has recommended a vote against the Say on Pay Proposal citing what they perceive as a significant pay-for-performance disconnect. The Board of Directors strongly disagrees with ISS' recommendation and believes: . I. NCR's compensation program emphasizes pay for performance; . II. Our CEO is an outstanding leader who merits an opportunity to earn compensation at or above the 75th percentile; . III. It is in our shareholders' interest to retain our CEO; and . IV. The analysis done by ISS on company performance and Total Shareholder Return ("TSR") is misleading and flawed as it underestimates NCR's operating results. . I. NCR's compensation program emphasizes pay for performance . • In 2011, 62% of the CEO's total direct compensation was performance based, dependent on delivering stretch performance targets, and remains at risk if these targets are not
81	UNITED STATES STEEL CORP	DEFA14A	4/4/2012	ISS Proxy Advisory Services ("ISS") has recommended that its clients vote against our executive compensation proposal. For the reasons discussed below, we believe ISS's analysis is erroneous and urge you to vote FOR the executive compensation proposal: . • ISS's peer group is flawed, and is inconsistent with ISS's own stated guidelines for constructing a comparison group. ISS's peer group is a small sample of companies heavily weighted towards those with substantially lower revenues than U. S. Steel. Specifically: . o The ISS peer group includes only 12 companies, which is below ISS's stated guideline of 14 to 24 companies and includes 10 companies with lower revenues than U. S. Steel; . o Only two companies in the ISS peer group have greater revenues than U. S. Steel; . o Even though ISS's guidelines indicate that peer group companies should have revenues at least equal to 50 percent of U. S. Steel's revenues, 5 of the 12 companies in the ISS peer group have revenues that are less than 50 percent of U. S. Steel's revenues; and . o One of ISS's peer companies is an 81 percent indirectly-owned public subsidiary of a Mexican public company. . Revenue size typically is a principal factor in benchmarking the compensation of public company executives because there is a correlation between revenue size and the scope and complexity of

82	BARD C R INC /NJ/	DEFA14A	4/3/2012	Institutional Shareholder Services (ISS) has recommended against our "Say-on-Pay" proposal based on ISS's faulty assessment of Bard's short-term performance, and its resulting assertion that there is a misalignment between our CEO pay and performance. . We believe that the ISS recommendation is fundamentally flawed based on its rigid model that fails to consider facts and circumstances particular to C. R. Bard. For the reasons set forth below, we request that you vote "FOR" our Say-on-Pay proposal. . Summary of Our Position . • Bard achieved solid operating performance in 2011, which is not captured in ISS's short-term total shareholder return (TSR) analysis. In addition, using TSR as the sole performance screen
83	HUNTINGTON BANCSHARES INC/MD	DEFA14A	4/3/2012	Institutional Shareholder Services (ISS) has recommended an "AGAINST" vote on our Say on Pay proposal, citing a misalignment between CEO pay and company performance . . • While we passed most of ISS' new 2012 tests, only the five-year absolute test showed a misalignment. This assessment and conclusion is inaccurate for two primary reasons: . ¡ The ISS five-year analysis period included two years attributed to our former CEO and did not consider only our performance and progress since Mr. Steinour joined in January 2009. Importantly, Huntington passed the ISS one- and three-year tests, periods aligned with performance under our current CEO. . ¡ The ISS methodology for valuation of stock options incorporates a volatility assumption based on the last three-year period, a period of extreme bank stock price volatility due to the financial crises. As a result, ISS' volatility assumption is 3.6 times higher than the historically based long-term volatility assumption we used. ISS values our CEO's stock option grant at $5.4 million over Huntington's $2.97 million valuation, which was determined in accordance with generally accepted accounting principles in the United States (GAAP) and is consistent with SEC disclosure rules. . Based solely on the combination of these two factors, ISS inaccurately concluded a long-term CEO pay-performance misalignment. . • Although the ISS
84	ADOBE SYSTEMS INC	DEFA14A	4/2/2012	Dear Stockholder: . We are writing to ask for your support at the Annual Meeting with respect to Proposal 4, or Say on Pay. As you may be aware, Institutional Shareholder Services ("ISS") has recommended a vote against this proposal. We strongly disagree with its recommendation, as well as the underlying methodology used in the ISS report, for the reasons discussed below. . 1. The ISS analysis utilizes an inappropriate peer group . ISS' peer group selection to benchmark our executive compensation though they are of value only if and to the extent that the share price when exercised exceeds the grant date price. The ISS report further distorts our compensation programs by failing to take into account that we have eliminated stock options for all of our employees — including our executives — for 2012 in response to previous stockholder and ISS feedback. . The following chart demonstrates the relationship between ISS' valuation of our CEO stock option grants and the value of our stock options as determined in accordance with U.S. GAAP and reported in our Summary Compensation Table: . 3. ISS Committee's analysis and focus on defining a peer group of high-technology companies at which our executives' positions would be analogous in scope and complexity. The position taken by ISS ignores the fact that we must offer our senior management compensation packages that are competitive with the peer companies with which we compete for talent, which is another key factor used by the Committee in selecting our peer group. . While the ISS peer group includes some of the same companies found in the peer group used by the Committee, the ISS peer group also includes companies such as Alliance Data Systems

85	UNITED TECHNOLOGIES CORP /DE/	DEFA14A	3/22/2012	Institutional Shareholder Services ("ISS") has recommended a vote against this proposal. In its report, ISS concedes that "shareholders have benefited from investing long-term at UTX, as demonstrated by the company's three-year and five-year TSRs." ISS, nonetheless, recommends against UTC's Say-on-Pay proposal principally on the basis of: . • a limited and fundamentally misaligned comparison group that ISS has arbitrarily formulated; and . • a Total Shareowner Return ("TSR") measurement formula that fails to adjust for near-term volatility resulting from extraordinary events. . The Compensation Discussion and Analysis on page 19 of our Proxy Statement explains in detail UTC's pay for performance and shareowner alignment compensation program objectives. At last year's Annual Meeting of Shareowners, with the support of ISS, UTC's compensation program was approved with the support of 98% of the votes cast. Nothing has changed. UTC's Board of Directors remains committed to compensation that drives performance and aligns with investors' interests. UTC's benchmarks, targets and metrics, which have successfully correlated with outstanding near- and long-term performance in the past, remain in place. As explained below, the only thing that has changed is ISS' assessment methodology, which we believe to be fundamentally deficient. . ISSUE SUMMARY . • The ISS analysis is materially flawed as its peer group methodology does not present relevant comparisons . • Twelve of 15 ISS identified peers are not industrial companies
86	WALT DISNEY CO/	DEFA14A	3/1/2012	In its report, ISS has substituted its opinion for the studied analysis and judgment reached by the Board. As detailed below, the ISS approach and reasoning are both deeply flawed and out of touch with shareholder interests, given the circumstances and the performance of the Company. . The Board's decisions are in the best interests of its shareholders and thus, deserve shareholder support. . ISS RECOMMENDATION AGAINST THE MEMBERS OF THE GOVERNANCE & NOMINATING COMMITEE . • After many months of deliberation, the Company's Board of Directors made a decision about how best to structure its CEO succession process. In doing so, the Board carefully considered various leadership models, the powers of a lead independent director, Mr. Iger's performance throughout his tenure (as detailed below) and the Board's experience with Mr. Iger, as well as its assessment of his leadership abilities. Of critical
87	WALT DISNEY CO/	DEFA14A	3/1/2012	On March 1, 2012, The Walt Disney Company issued the following statement: . Disney fundamentally disagrees with certain of ISS's recommendations, which are based on both flawed premises and methodology. The Company's Board of Directors adheres to a rigorous performance test for compensation, and the Company's tremendous performance under Bob Iger is evident. Disney had record financial performance in Fiscal Year 2011 and its total shareholder return is more than four times greater than that of the S&P 500 during Mr. Iger's more than six years of leadership . After careful and considered deliberation, the Board took action to secure Mr. Iger's leadership through his expected retirement in 2016 to provide for an effective, seamless succession and management transition and continuity of the Company's proven strategy. In addition, the board will appoint an independent lead director with duties and responsibilities that, ironically, exceed in scope those recommended by ISS.

88	QUALCOMM INC/DE	DEFA14A	2/21/2012	Institutional Shareholder Services (ISS) has recommended a vote against this proposal. We strongly disagree with its recommendation. ISS based its recommendation largely on the size of our CEO's equity awards measured against a group of comparator companies determined by ISS. We take issue with the peer group selected by ISS to benchmark our CEO compensation and believe that it fails to recognize that Qualcomm is one of the largest companies in the United States by market capitalization value, and fails to recognize our unique business structure. We understand that ISS policy requires that it takes a standardized approach that identifies comparator companies based on revenues. In contrast, we determined, with input from an independent consultant, our peer group primarily based on market capitalization. This difference in comparator groups is the primary source of the difference between the recommendations of our Board and ISS on the Say on Pay proposal. If ISS had used Qualcomm's compensation peer group, rather than its policy-generated comparators, we believe we would have passed ISS' CEO compensation tests. . Our Board believes that market capitalization, rather than revenues, is appropriate as the primary criterion for selecting companies for executive compensation decision-making for the following reasons
89	CARDINAL HEALTH INC	DEFA14A	10/25/2011	Dear [name]: . In case you are using a Glass Lewis October 12, 2011 report as a guideline, we feel compelled to point out several inaccuracies in its analysis. We've communicated these points to Glass Lewis. . The Glass Lewis report recommends against the advisory vote on executive compensation due to (1) Cardinal Health's purported sole reliance on time-vesting, long-term incentive awards and (2) Cardinal Health's failure to align executive pay with performance, based upon an inaccurate assessment that Cardinal Health has "performed moderately worse than its peers ." . Turning first to long-term incentives, page 18 of the Glass Lewis report incorrectly states that Cardinal Health does not grant performance-based long-term incentive awards. Specifically, the report states that "To the best of our knowledge, the Company does not grant performance-vesting incentive awards . . . . In this case, shareholders should be concerned with the Company's failure to implement a performance-based long-term incentive plan with objective metrics and goals." To the contrary, the Compensation Disclosure and Analysis in our 2011 proxy statement includes disclosure on page 36 table as support for Cardinal Health's performance vis-à-vis the comparator groups used by Glass Lewis: . We believe that the above "Change in Book Value per Share" and "Change in Operating CF" metrics are flawed and that the metrics in the table below properly reflect the spin-off of CareFusion. Since Glass Lewis does not make their methodology publicly available, we have attempted to reverse engineer the metrics and conclude they do not include appropriate adjustments for our August 2009 spin-off of CareFusion Corporation. Below is the same Glass Lewis table with "Change in Book Value per Share

90	TWENTY-FIRST CENTURY FOX, INC.	DEFA14A	10/11/2011	The proxy advisory firms' disregard of the exceptional performance by News Corporation demonstrates a failure to recognize the value created for stockholders by News Corporation's Board of Directors, members of management and employees around the world. . 2) Our CEO's compensation is aligned with performance . • News Corporation's strategy and goal of creating long-term growth and value for stockholders drives our philosophy and how we design executive compensation programs and practices. . • Our CEO manages one of the world's leading media companies in a fast-changing, competitive environment, and , certain proxy advisory firms, including ISS, recommend that stockholders vote against our advisory executive compensation proposal. Stockholders should reject these recommendations and vote " FOR " that proposal. . 3) The Amendment to Mr. Carey's employment agreement increased the total portion of his compensation opportunity that is linked to performance and resulted in a stronger pay-for-performance model . • In August 2010 Chase Carey, News Corporation's Deputy Chairman, President and Chief Operating Officer, agreed to amend his employment agreement to adjust significantly the pay mix of his total
91	RALPH LAUREN CORP	DEFA14A	7/26/2011	Polo Ralph Lauren Corporation (the "Company") is contacting certain institutional investors regarding the recent recommendation by Institutional Shareholder Services ("ISS") for the established under the Company's incentive plans are sufficiently challenging. ISS has failed to recognize the prolonged weakness and uncertainty in global economic conditions, the other Company-specific strategic decisions and the investments made to support long-term shareholder value creation that were considered at the time the goals were set by the Compensation & Organizational Development Committee (the "Compensation Committee"). Moreover, our successful execution of these strategic considerations and our willingness to invest in the long-term have been important in driving our results over three strongly disagree that the aspects of Mr. Lauren's compensation cited by ISS give rise to poor pay practices. . Company Financial Performance: . o In its analysis of Mr. Lauren's compensation, ISS suggests that a disconnect exists between Mr. Lauren's total pay and performance despite its acknowledgment that the Company's one, three and five year total shareholder returns have "outperformed the sector and the S&P 500, and [the Company's] operational metrics have also improved." The Company's strong financial results were achieved in spite of extraordinarily weak and highly uncertain global economic

92	GAMESTOP CORP.	DEFA14A	6/3/2011	As you may be aware, ISS Proxy Advisory Services ("ISS"), in its May 31, 2011 report (the "Report"), recommended that our stockholders vote against ratification of our named executive officer compensation in the non-binding advisory vote included as Proposal 2 in the Proxy Total Stockholder Returns ("TSR") underperformed the sector median and there were significant pay increases for the Executive Chairman and the Chief Executive Officer (CEO). This analysis by ISS in our opinion is flawed for several reasons. ISS failed to note that: Daniel A. DeMatteo has been our Executive Chairman since June 2010. Mr. DeMatteo's base pay and target short-term incentive did not change from fiscal 2009 to fiscal 2010, nor did it change when he was elevated from the CEO position to Executive Chairman. The increase in overall pay for Mr. DeMatteo from fiscal 2009 to fiscal 2010 was February 2010) to a more equitable level considering his position with the Company relative to other executives, including the new chief financial officer hired in August 2009. Mr. Raines did not receive a long-term incentive award upon being named CEO in June 2010. . In its Report, ISS indicated that, while a significant portion of the pay increase is tied to improved financial performance at the Company, they believed there were some problematic pay issues. ISS failed to note that, in setting executive compensation for fiscal 2011, the Company made numerous positive changes to align the Company's pay
93	FREEPORT-MCMORAN INC	DEFA14A	6/2/2011	ISS Proxy Advisory Services (ISS) has recommended that its clients vote against Proposal No. 2. For the reasons set forth below, our Board of Directors strongly program adopted by our stockholders two years ago with over 88% voting in favor — and which ISS recommended approving; . • A flawed stock option valuation that uses inconsistent assumptions, resulting in executive compensation that is overstated; and . • A formulaic approach that fails to consider our company's facts and circumstances, all of which are disclosed in our 2011 proxy statement. . ISS's Newfound Concern Regarding Our Annual Incentive Plan Adopted by Stockholders . We note that ISS expresses concern with the design of our 2009 Annual Incentive Plan, or AIP. Importantly, ISS omits from its disagrees with ISS's analysis and resulting recommendation and urges stockholders to vote FOR the approval of Proposal No. 2. . ISS acknowledges that our company reported strong performance for 2010, that our total stockholder return significantly outperformed our industry peer group and the S&P 500 Index on a one-, three- and five-year performance period and that our stockholders have benefited from their investment in our company. Nevertheless, ISS recommends a vote against Proposal No. 2, basing its recommendation on the following: . • Newfound concern regarding the design of our annual incentive

94	CHESAPEAKE ENERGY CORP	DEFA14A	5/27/2011	As you know, our shareholders' meeting is June 10, 2011, and Institutional Shareholder Services ("ISS") has issued voting recommendations inconsistent with our Board's recommendations on the election of two of our directors, the advisory vote on executive compensation ("say on pay") and one shareholder proposal . We understand that ISS must apply a prescribed methodology when evaluating so many different companies; however, this approach by its nature fails to take into account important company-specific facts and circumstances. . Over the last 18 months, we have met with the corporate governance specialists from many of our largest shareholders and our Board has taken concrete action in response to the feedback from those meetings. Because the ISS process cannot take such actions into account, we believe ISS inappropriately recommends withhold votes against two director nominees. More fundamentally, the ISS model focuses on short-term stock performance (one and three years), rather than the longer time periods that are most relevant to Chesapeake. Such a short-term focus cannot consider performance measures that should be included to properly understand how our management has created documented long-term value for our shareholders. For example, our CEO was recently named to a list of only eight CEOs who have led U.S.-based companies to 20 years or more of annual shareholder returns of at least 20%. We address the shortcomings of the ISS approach below and request that you vote "FOR" the
95	CME GROUP INC.	DEFA14A	5/25/2011	therefore elected to forgo incentive compensation. As a result, ISS reported median pay for its CEO peer group that was less than the ISS-reported median pay provided to the other named executive officers within those same companies. Since CEO pay is generally expected to be higher than the pay for his or her direct reports, we believe ISS' market comparison for Mr. Donohue's pay is flawed. We note that this peer group differs significantly from our CEO peer group comprised of exchanges, asset managers, brokerages and transaction processors (page 42 of the Proxy Statement.) . We also question the lack We question the appropriateness of the CEO peer group set forth in the ISS report. ISS has identified the following companies as our CEO peer group: E*Trade Financial Corporation; Interactive Brokers Group, Inc.; IntercontinentalExchange, Inc.; Jeffries Group, Inc.; Nelnet, Inc.; Raymond James Financial, Inc.; The Student Loan Corporation; and MF Global Ltd. We note that of these eight companies, three experienced a change in their CEO leadership during 2010, one deferred its equity compensation grant to January 2011, and one has a CEO that is a controlling shareholder of the company and of inclusion of NASDAQ OMX Group, Inc. and NYSE Euronext in the ISS peer group – two key players in our industry and competitors with respect to our business and experienced talent. We continue to believe that our CEO peer group, established with the use of an outside compensation consultant familiar with our industry, is more appropriate to benchmark our compensation. Using this comparison, Mr. Donohue's compensation package is in line with the market median. . We believe that stock options serve the purpose of incenting the creation of long-term shareholder value. Unlike ISS, we believe that

96	ALEXANDRIA REAL ESTATE EQUITIES INC	DEFA14A	5/16/2011	Two proxy advisory firms have issued recommendations with respect to this advisory vote. Glass Lewis & Co. has recommended stockholders vote "for" Proposal Three, and Institutional Shareholder Services ("ISS") has recommended a vote "against" Proposal Three. . ARE strongly disagrees with ISS's flawed analysis. For the reasons gross-up provisions are present only in one named executive officer's legacy contract. Mr. Marcus's restricted stock- related gross-up is subject to an annual cap, and the Compensation Committee plans to reevaluate it in the coming year. . 1. Our Compensation Committee's decisions reflect compensation that is strongly linked to performance and performance has been outstanding. Specifically, Mr. Marcus's 2010 compensation was closely based on performance. . ISS's assertion that ARE has a pay-for-performance disconnect is incorrect. The Compensation Committee strongly believes in pay-for-performance. ISS . . . ISS erroneously states that ARE's TSR was below the peer median for both the one- and three-year periods. ISS uses an irrelevant peer group and an alternate method of calculating TSR. ARE has a sustained history of growth and creating shareholder value, despite the Great Recession. Assuming reinvestment of dividends, ARE has a one- year TSR of 16.5%, a three-year TSR of (20.1%) and a five-year TSR of 7.3%. Additionally, ARE's TSR since its May 1997 . 2
97	DEAN FOODS CO	DEFA14A	5/13/2011	We . strongly . believe . that . ISS' . recommendation . fails . to . give . appropriate . weight . to . our . pay . for . performance . alignment . in . 2010, . specifically . in . light . of . the . fact . that . we . received . a . favorable . stockholder . vote . with . respect . to . our . use . of . excise . tax . gross-ups . in . 2010. . For . these . reasons, . our . Board . of . Directors . recommends . a . vote . "FOR" . Proposal . Three, . approving . our . executive . compensation . as . disclosed . in . the . 2011 . proxy . statement. . 4
98	JPMORGAN CHASE & CO	DEFA14A	5/11/2011	ISS incorrectly states that JPMC has a "focus on short-term- (prior year) performance". JPMC included specific performance factors related to 2010 at page 13 of the proxy statement and in Appendix D at page 59 to evidence concrete performance factors relevant to a disciplined discipline around a fortress balance sheet and strong business and functional management teams enabled the Firm to absorb two failed institutions, Bear Stearns and Washington Mutual, helping to avoid added stress on the . Page 4 of 6 growth strategy. . Likewise for other NEOs, there is clear reference to consideration of longer-term performance, for example: Mr. Braunstein (Mr. Braunstein provided strong and effective leadership of Investment Banking for the Americas since 2008 ...He helped build our leading client franchise in the Investment Bank over the past decade ...) and Ms. Drew (responsible for measuring, monitoring and managing the Firm's liquidity, interest rate risk and foreign exchange risk, each of which were critical in managing through the past three years ....) . ISS incorrectly categorizes JPMC as a company that

99	AMGEN INC	DEFA14A	5/9/2011	Institutional Shareholder Services Proxy Advisory Services ("ISS") and Glass Lewis & Co., LLC ("Glass Lewis") have recently recommended that their clients vote "against" Amgen's advisory vote on executive compensation due to perceived pay-for-performance issues and "for" a stockholder proposal to implement shareholder action by written consent. Below we outline the reasons why we believe ISS' and Glass Lewis' analyses of Amgen's executive compensation programs are flawed and why we believe our executive compensation programs are reasonable, competitive and oriented toward rewarding long-term performance in support of stockholders' interests. We also point out inaccuracies in the rationale provided by ISS for their recommendations on the stockholder proposal to implement shareholder return ("TSR") goals were achieved over three years. . With respect to performance units, which comprise a significant portion of the equity paid to our CEO, it is appropriate to analyze the actual value of performance units earned by our CEO in 2010 based on our absolute TSR performance for the 2008-2010 period. Instead, ISS and Glass Lewis employ the grant date fair value of performance units granted to our CEO in 2010, which are earned over a period that includes future fiscal years (2010-2012), even though ISS and Glass Lewis are assessing our performance based on our TSR over the past
100	SCHW AB CHARLES CORP	DEFA14A	5/9/2011	The ISS analysis fails to discuss the performance-based nature of short-term cash incentive awards under CSC's Corporate Executive Bonus Plan ("CEBP"), all of which is subject to performance metrics established by the Compensation Committee. In addition, all long-term incentive awards are performance-based. The performance-based restricted stock units only vest if the performance goals set by the Compensation Committee are met, and the stock options, which have an exercise price based on the closing price on the grant date, only have value if CSC's stock price increases. While the ISS methodology apparently does not recognize the performance-based nature of the stock options, we believe that the ISS report should have recognized the significant number of options held by the named executive officers that were "out of the money" as of December 31, 2010, as reported in the Outstanding Equity Awards table of CSC's proxy statement. . Short-term cash incentives as a percentage of target declined in 2010, demonstrating the pay for performance link . The ISS analysis fails to discuss the decline of payouts as a percentage of the target award under the CEBP from 2009 to 2010. Payments for 2010 were made based on earnings per share ("EPS") as measured against targets established by the Compensation Committee. Target awards expressed as a percentage of base salary for each of the named executive officers were the same in 2010 as 2009. Based on performance, payouts as a percentage of target under the CEBP declined from 75% of the target award in 2009 to 70% of the target award in 2010. . Long-term compensation was forfeited in 2010 when performance objectives were not met . The ISS analysis fails to recognize that the named executive officers forfeited portions of restricted stock and

101	DR PEPPER SNAPPLE GROUP, INC.	DEFA14A	5/6/2011	compensation program. . ISS indicates in its Governance Risk Indicators that each component of its "Executive Compensation Evaluation" is a "Low" level of concern, except for "Severance/CIC Agreements". ISS' recommendation against the entire executive compensation package is based solely on our inclusion of one newly hired executive in the CIC Plan. We strongly disagree with this approach, because it fails to consider all of the elements of our executive compensation program in making their recommendation. . It is worthy of note that Glass Lewis, another leading proxy advisory firm, has recommended a vote of our website at www.drpeppersnapplegroup.com . . We write to bring to your attention a significant disagreement between DPS and ISS with respect to ISS' proxy report regarding a proposal to be voted on at DPS' annual meeting of stockholders to be held on May 19, 2011. . In its report, ISS recommends a vote "against" the Company's recommendation on the advisory vote on executive compensation. ISS makes this recommendation because the Company included one new executive in its Change-In-Control Severance Plan (the "CIC Plan"). The CIC Plan provides that payments made under the CIC Plan that are subject to excise taxes under Section 280G of the Internal Revenue Code will be grossed up (as described in our Proxy Statement under Historical Executive Compensation Information — Post Termination Compensation — Change in Control). We strongly disagree with ISS' analysis and its recommendation, which penalizes our entire compensation program because of one element of that program. . For the reasons set forth below, we urge you to vote "FOR" the approval of the advisory vote on executive compensation . . 1. ISS has based its recommendation on only one small element of a comprehensive executive
102	EXXON MOBIL CORP	DEFA14A	5/6/2011	Since you are one of ExxonMobil's key investors, I am writing to you to bring to your attention our concerns with a voting recommendation recently issued by a proxy advisory firm regarding Item 3 – advisory vote on executive compensation ("say on pay") contained in ExxonMobil's 2011 proxy. . Institutional Shareholder Services (ISS) has issued a voting recommendation inconsistent with the Board's recommendation on the say on pay proposal. We believe the ISS recommendation is fundamentally flawed as it is based on a rigid model that fails to take account of ExxonMobil's individual facts and circumstances. . In particular, ISS fails to recognize the significant performance basis of ExxonMobil's compensation program and the close link between the compensation program and our business strategy. Most fundamentally, the ISS model inappropriately focuses on short-term performance (1 and 3 years), rather than the significantly longer time periods that are most relevant for ExxonMobil's business strategy and for evaluating the performance of our executives. We outline the flaws in the ISS approach below and request that you vote "FOR" the say on pay proposal (Item 3) in the proxy. . Emphasis on Short-Term Performance . The ISS recommendation is heavily influenced by a short-term orientation, which is total shareholder return (TSR) on a 1- and 3-year basis. For the reasons explained in our proxy statement and accompanying compensation brochure, ExxonMobil's business depends on investment lead times ranging from a minimum of five to 10 years, to decades. Our

103	MORGAN STANLEY	DEFA14A	5/4/2011	May 2011 . Dear Fellow Morgan Stanley Shareholder: . Morgan Stanley's Board of Directors recommends that shareholders approve two key proposals at our upcoming annual shareholders meeting: the amendment to our equity share plan as well as our advisory vote on pay, both of which we believe are important to our continuing efforts to build our business and deliver shareholder value. . The proxy advisory firm Glass Lewis has recommended that shareholders vote FOR both the amendment to our share plan and our advisory vote on pay. The report from the proxy advisory firm ISS which recommended against shareholders in 2010, but are necessary to maintain an appropriate mix of "at risk" equity, deferred compensation and cash awards for our expanded employee base. Indeed, they are the minimum needed to maintain the appropriate compensation mix for the coming year. That's why we are disappointed that ISS, based on its customary methodology used to evaluate equity incentive plans, did not support the amendment of the Plan. As we noted above, Glass Lewis recommended support for the amendment to our Plan this year. In our view, the methodology used by ISS did not appropriately reflect , however, failed to properly reflect several critical issues regarding these proposals, which I would like to address in this letter. . In recent years, Morgan Stanley has fundamentally restructured the way it pays its employees, more closely tying compensation to the Firm's long-term financial performance. The Firm: . · Substantially increased the portion of year-end compensation that is deferred and "at risk" - with more than 80% of the Operating Committee's compensation deferred in 2010, vs. 42% in 2008. . · Included "at risk" performance stock units in senior executive compensation, which only deliver
104	PRINCIPAL FINANCIAL GROUP INC	DEFA14A	5/4/2011	The following letter was sent to certain common shareholders of Principal Financial Group, Inc. . beginning on May 4, 2011. . _, 2011 . Re: Principal Financial Group, Inc. ("PFG") 2011 Proxy Statement . To: Our Shareholders: . ISS Proxy Advisory Services and Glass Lewis & Co. each recently issued its analysis of the . proposals in PFG's proxy statement and their recommendations for voting on such proposals. . Both reports contain information we believe to be inaccurate. The following addresses those . inaccuracies. . ISS . ISS states that PFG director Gary E. Costley is a non-independent member of the Board based on . its classifications and that shareholders should therefore vote against Dr. Costley's election to the . Board. Applying NYSE Listing Standards, which the PFG Board adheres to, Dr. Costley is an . independent director. ISS has determined that Dr. Costley is not independent due to the payment . by the Company in 2010 of $28,316 in legal fees to a law firm that has 140 lawyers, 93 of whom . are partners, including Dr. Costley's son-in law. His son-in- law's affiliation with the law firm . was unknown to the Company at the time the Company engaged the firm. In addition, Dr. . Costley's son-in-law provided all the members . of the PFG Board audit, compensation and nominating committees are independent under NYSE . Listing Standards. . We thus urge you to vote FOR Dr. Costley's election to the Company's board at our annual . meeting. . ISS uses an executive compensation peer group for PFG based on the broad GICS sector, "Life . and Health Insurance." The peer group selected by the Human Resources Committee of the PFG . Board, as shown on page 26 of PFG's 2011 Proxy Statement, is a more appropriate peer group . for this purpose because it is based on companies with which PFG competes. The GICS sector . 40301020

105	ALLSTATE CORP	DEFA14A	5/4/2011	One proxy advisory firm has issued voting recommendations with which we strongly disagree that are based on incorrect or no analysis and that could put the value of your Allstate investment at risk. . The Board recommends that you vote on the proposals as follows: . · FOR election of all directors . · FOR ratification of auditors . · FOR the amendment to our certificate of incorporation to allow not less than 20% of Allstate's outstanding shares to call special meetings . · FOR the amendment to stockholder right to call special meetings using the 10% ownership threshold preferred by this proxy advisory firm. . · Allstate's directors employ first-rate governance practices that are responsive to stockholders and have been recognized as "low concern" by this same proxy advisory firm. . · A vote against the entire board, as suggested by one proxy advisory firm, is irresponsible and could interfere with continuity of good governance practices and consequently, negatively impact stock value. . · A thorough biography of each director's qualifications can be found in our proxy statement beginning on page 13 . . Vote FOR the Amendment to the Certificate of Incorporation Designating the Delaware Court of Chancery as the Forum for Certain Actions . · Designating the Delaware Court of Chancery as the sole and exclusive forum for certain actions benefits Allstate and its stockholders by avoiding the possible misapplication and inconsistent interpretations of Delaware law in other forums and the costs incurred when similar issues are litigated in multiple forums. . · In contrast, one proxy advisory firm stated that, because this is a novel issue for the firm, it has not developed a formal voting guideline
106	ANTHEM, INC.	DEFA14A	5/4/2011	In the Company proxy statement, our Board of Directors recommends a vote "against" the shareholder proposal to require an independent board chair and a vote "against" the shareholder proposal to reincorporate the Company from Indiana to Delaware. ISS has recommended a vote "for" these proposals, and we strongly disagree with ISS' rationale. For the reasons set forth below, we believe ISS' recommendations are based on inappropriate assumptions and incomplete analysis of the Rank 69% 67% 43% . If the more appropriate peer group of WellPoint's six direct competitors in managed health care is used, WellPoint's 3 and 5 year TSR is greater than the median performance of this more appropriate peer group. . Direct Peer Group . TSR as of 12/31/10 . Company 1yr 3yr 5yr TSR . YTD . (as of : 5/1/11) . UnitedHealth Group 20% -14% -10% 37% . Aetna -4% -19% -8% 36% . Humana 25% -10% 0% 39% . Cigna 4% -12% 0% 28% . Health Net 17% -17% -12% 22% . Coventry Health Care 9% -24% -14% 22% . Direct Peer Median 13% -16% -9% 32% . WellPoint -2% -13% -7% 36% . WLP %ile Rank 3% 67% 64% 59% . ISS' methodology fails to take any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing. . (1) Amount Previously Paid: . (2) Form, Schedule or Registration Statement No.: . (3) Filing Party: . (4) Date Filed: . Commencing May 4, 2011, WellPoint, Inc. sent the following communication to certain shareholders. . Dear Fellow Shareholder: . We write to bring to your attention a significant disagreement between the Company and ISS with respect

107	J C PENNEY CO INC	DEFA14A	5/3/2011	Board of Directors has recommended that you vote "FOR" the approval of Proposal 4. . ISS Proxy Advisory Services ("ISS") has recommended that its clients vote "AGAINST" Proposal 4. ISS asserts that there is a misalignment between the Company's performance and the compensation of its Chairman of the Board and Chief Executive Officer. The Board of Directors strongly disagrees with this analysis, as well as the underlying methodology, and urges you to vote "FOR" approval of Proposal 4. . Financial Performance . The Company has made significant strides in executing its long range plan and delivering value to stockholders. In fiscal 2010, comparable store sales grew 2.5 percent over 2009 and earnings per share from continuing operations of $1.59 were 48.6% higher than 2009. Further, in February 2011, the Board of Directors approved a new $900 million share repurchase program to return value to stockholders. . ISS's methodology fails to reflect the Company's strong comparative financial performance. First, ISS's recommendation is based in part on a calendar year comparison of the Company's Total Shareholder Return ("TSR") with that of a group of companies selected by ISS using the Global Industry Classification Standard ("GICS") methodology. . The appropriate timeframe to measure the Company's TSR is on a fiscal year basis, rather than a calendar year basis. Like many retail companies, the Company's fiscal year runs from February through the end of January, and includes the holiday season, when a significant portion of sales and profits are recorded. Accordingly, the Company aligns its compensation philosophy and practices with fiscal year performance. Based on fiscal year results, the Company's 2010 TSR is above the median of the GICS peer companies used by ISS. . Second, ISS's use of a GICS peer
108	OCCIDENTAL PETROLEUM CORP /DE/	DEFA14A	4/22/2011	members of the Compensation Committee, and a FOR vote on the Say-on-Pay proposal. . Unfortunately, in the same Report, ISS recommends that Occidental shareholders vote AGAINST the five Directors who sat on our Nominating Committee in 2010, and Ray Irani, the Chairman of the Board. They base this recommendation on their assertion that, "The appointment of the Executive Chair for a three-year term is not in the best interests of shareholders." . We strongly disagree with this ISS recommendation and believe that their analysis is deeply flawed. We would therefore respectfully ask you to consider the
109	FEDERAL REALTY INVESTMENT TRUST	DEFA14A	4/21/2011	"against" Proposal 3 while our Board of Trustees has unanimously recommended that shareholders vote "for" this proposal. We believe that ISS's analysis of our executive compensation programs is flawed. We outline below the reasons why we believe this and why we believe that our executive compensation programs are in line with a pay for performance philosophy. . Basis for ISS Recommendation . ISS noted the following two primary reasons for recommending a vote against our executive officer compensation: (a) the compensation of our Chief Executive Officer was increased in 2010 notwithstanding that our 1
110	CONOCOPHILLIPS	DEFA14A	4/21/2011	control, to two newly hired executive officers, pursuant to pre-existing plans applicable to similarly ranked employees, and (ii) provided additional years of credited service under Company pension plans. We strongly disagree with ISS' analysis, which utilizes a "one-size-fits-all" approach and does not give enough weight to the important criteria of pay for performance. For the reasons set forth below, we believe ISS' recommendation is based on incomplete and inaccurate analysis and we urge you to vote "FOR" in the advisory vote on executive compensation . . • ISS' analysis fails to provide

111	GENERAL ELECTRIC CO	DEFA14A	4/7/2011	ISS's analysis, which evaluates stock-price performance over a multi-year period, but evaluates CEO compensation on a year-over-year basis. For the reasons set forth below, we believe ISS's recommendations are based on incomplete and inaccurate analysis and we urge you to vote "FOR" the advisory vote on executive compensation . . • ISS's analysis fails to consider actions that aligned pay with performance during the recession . GE's Management Development and Compensation Committee looks at performance and compensation over time, and we believe that it is important for shareowners as well to look at Commencing April 7, 2011, General Electric Company sent the following . communication to certain shareowners. . We write to bring to your attention a significant disagreement between the Company and ISS with respect to ISS's Proxy Report regarding the proposals to be voted on at GE's annual meeting of shareowners to be held on April 27, 2011. . In its report, ISS recommends a vote "against" the Company's recommendation on the advisory vote on executive compensation asserting that there is a misalignment between long-term Company performance and the compensation of our CEO. We strongly disagree with our CEO's compensation over recent years and evaluate his 2010 compensation in that light. In evaluating our CEO's pay, our shareowners should consider that he has not received a salary increase since 2005, he declined a cash bonus in both 2008 and 2009 and he declined in 2009 an $11.7 million payout he earned under the Company's long-term performance plan. By focusing on year-over-year changes in compensation and failing to evaluate either overall compensation levels or past compensation actions, ISS's analysis has the effect of distorting GE's compensation programs and penalizing GE's
112	TEXTRON INC	DEFA14A	4/6/2011	Glass Lewis & Co., a proxy advisory firm, is recommending a vote "Against" the Say on Pay proposal. You should dismiss the Glass Lewis recommendation, as their model does not appropriately reflect the substantial accomplishments being made by Textron and its new management team, and because their analysis contains several quantitative flaws. . The Glass Lewis "pay for performance model" is based on an average of 3-, 2- and 1-year performance data, which misses the mark with respect to Textron, as it ignores the fact that important changes were made by the Board and Company after the decline in share price that resulted from the severe impact of the 2008/09 recession on our commercial finance and commercial aircraft businesses. . The Board installed a new CEO and CFO during the latter half are familiar with the progress we have made. Penalizing this Board and management team with a vote against our executive compensation practices would be completely inconsistent with recent actions and accomplishments and potentially harmful to the Company. . Furthermore, Glass Lewis compares Textron to an unnamed sector group of 21 "large industrial companies" and a sub-industry group of 12 "industrial conglomerates." Accordingly, the Glass Lewis model appears to be overly punitive for the natural cyclicality that exists in our commercial aircraft businesses, which may not be present in the peer

113	NORTHERN TRUST CORP	DEFA14A	4/1/2011	regulatory capital requirements of 6%, 10%, and 5%, respectively. . • The Corporation continues to invest in its businesses, including by investing $518 million in technology in 2010. . Comparative Financial Performance . We understand that ISS's recommendation is based in part on a comparison of the Corporation's total shareholder return with that of a group of companies selected by ISS using the Global Industry Classification Standard ("GICS") methodology. We believe that such methodology fails to provide an accurate comparison of the Corporation's financial results. For example, this group of companies includes several companies that are engaged in entirely different and unrelated businesses, such as payday loans, credit cards, securities exchanges, brokerage/trading, pawnshops, and venture capital, and fails to include certain companies that are generally recognized as our competitors. . When compared with the largest U.S. banks and financial institutions, which the Corporation views as its main competitors, we believe the Corporation has exhibited a record of strong financial performance. The Corporation's 5-year compound annual growth rates for Net Income and Diluted Earnings Per Share are 2.8%
114	HP INC	DEFA14A	3/11/2011	As described below, we believe ISS' recommendations are fundamentally flawed. . All of our director nominees are outstanding I am writing in connection with our upcoming annual meeting of stockholders to express our vehement disagreement with ISS Proxy Advisory Services' voting recommendations on certain director nominees and on the advisory vote on executive compensation -- and to urge you, for the reasons set forth below, to Board members. As we disclosed in the proxy materials previously provided to you, the nominees unanimously approved by the Board include five individuals who became directors in January 2011. Each of these individuals, all of whom are independent under ISS' own classification, NYSE rules and our own independence standards, is very experienced and well qualified to serve HP effectively, including several with significant industry experience. Notwithstanding the fact that we added these five highly qualified, world-class directors to enhance our Board, ISS has, without a reasonable basis to do so

115	WALT DISNEY CO/	DEFA14A	3/2/2011	tests for restricted stock unit awards, ISS made frequent reference to what it argued was the short-term nature of a one-year earnings per share component of the Company's current performance test. In point of fact, however, the EPS test is a three-year test. ISS acknowledged this mistake in the introduction to its update, but the body of the report (which relied on that error) and the rationale supporting the recommendation remained unchanged. Again, we believe that, on the basis of a corrected record, ISS's rationale does not hold. The three year EPS measure is an integral component of a long Commencing March 2, 2011, The Walt Disney Company sent the following communication to certain shareholders. . We write with respect to the ISS Proxy Report you may have seen regarding the proposals to be voted on at The Walt Disney Company annual shareholder meeting. We take serious issue with ISS's recommendations against the Company's position on the advisory vote on executive compensation and the shareholder proposal regarding performance tests for restricted stock units. We set forth below why we believe the two negative ISS recommendations are unwarranted. . 1. ISS's recommendation to vote "against" the advisory vote on executive compensation relates to a practice that no longer exists. The recommendation appears to be grounded on a concern that the Company "recently extended excise tax gross ups." But, in point of fact, the Company's Compensation Committee has adopted a policy, fully disclosed in the proxy statement, that prohibits excise tax gross ups in any future agreements with executive officers, or in any material amendments or extensions of existing agreements, unless the provision is submitted to approval by shareholders. The "recent" extension of a gross up that ISS refers to
116	JOHNSON CONTROLS INTERNATIONAL PLC	DEFA14A	2/22/2011	shareholders in understanding the proposal and to facilitate prompt voting. . Further, one of the larger proxy advisory firms, ISS Proxy Advisory Services, has recommended that its clients vote "against" Proposal 8a, while management, along with another large proxy advisory firm (Glass Lewis & Co.) has recommended that shareholders vote "for" this proposal. We believe that ISS's analysis of our executive compensation programs is flawed. We outline below the reasons why we believe this and why we believe Tyco's executive compensation programs pay for performance. . Structure of CEO Compensation. . ISS's premise) in 2010 consisted of performance share units and stock options (split 50 / 50). Including "all other compensation" (perquisites and changes in pension value), these equity awards comprised over 50% of compensation. Another 17% of targeted direct pay was in the form of a performance-based bonus opportunity. Note that the ISS report states that for 2009 and 2010, 87% and 85%, respectively, of our CEO's compensation was "at risk." . Of the long-term equity component, which again constitutes at least 50% of compensation, half is in the form of stock options and half is in the form of performance shares. . ISS takes the position that stock options are not performance-based. We disagree with this assessment because stock options, by their nature, will not provide any return to an executive unless there is appreciation in stock price. We also believe that ISS often places an inflated value on stock options, so that many companies that use
117	BARNES & NOBLE INC	DEFA14A	9/20/2010	Rights Plan should be rejected because it could enable him to form a control bloc with Aletheia without providing shareholders the premium they deserve. While ISS has a track record of supporting dissidents, we believe its analysis is flawed and not in the best interest of our shareholders."

118	TARGET CORP	DEFA14A	5/21/2009	believes that the RiskMetrics report on the Target proxy contest contains a number of statements and comparisons that are inaccurate or misleading. This White Paper highlights some of the flaws that Target sees in the RiskMetrics report. . 1. RiskMetrics wrongly criticizes Target's real estate ownership as "atypical."* . In several places in its report, RiskMetrics refers to Target's "atypical amount of real estate ownership"* versus other big box retailers implying that Target's real estate ownership is suboptimal compared with other retailers. The assertion that Target is following an "atypical nominees that the board could accept on a consensual basis."* Bill Ackman, Glass Lewis Proxy Talk, May 12, 2009.. Target believes the record reflects that Target and its Board and Nominating Committee were deliberative and thoughtful in considering Pershing Square's initial suggested candidates, while Pershing Square was hasty and last- minute in the selection of its current slate. . 7. The RiskMetrics report lacks any critical analysis of Pershing Square's nominees. . In its May 19, 2009 report recommending that Target shareholders elect all four of the Board's nominees, Glass Lewis & Co. states materials filed with the SEC concerning Target are available free of charge at http://www.sec.gov and http://investors.target.com. Shareholders should read carefully the definitive proxy statement and the accompanying WHITE proxy card before making any voting decision. . 7 . On the evening of May 20, 2009, Target Corporation posted the following text and link on a page on its web site: . 5/20/09 . Target Sees Flaws in RiskMetrics' Report on Target Corporation . Target believes that the RiskMetrics report on the Target proxy contest contains a number of statements that are inaccurate or misleading. This White
119	TARGET CORP	DEFA14A	5/20/2009	And we believe that, unfortunately, RiskMetrics' analysis includes numerous statements and comparisons that are inaccurate or misleading. In our opinion, the report is fundamentally flawed and should be viewed critically by investors. We have a long history of being open with and accessible to our shareholders. And we have been consistent and transparent in our relationship with Pershing Square from the beginning. We simply do not believe that the election of any of the Pershing Square nominees would enhance the creation of shareholder value or be in the best interest of our shareholders.
120	TARGET CORP	DEFA14A	5/19/2009	proxy card at Target's 2009 Annual Meeting of Shareholders to be held on May 28, 2009. Target is very disappointed with the RiskMetrics' flawed recommendation, which Target believes does not adhere to RiskMetrics' own previously articulated framework for analyzing proxy fights. Target urges shareholders to vote for all four of Target's nominees. . In its May 19, 2009 report recommending that Target shareholders elect all four of the Board's nominees, Glass Lewis states*: . . "First and foremost, we believe investors should be concerned regarding Mr. Ackman's change in strategy against Target. Pershing

121	OFFICE DEPOT INC	DEFA14A	4/22/2008	over the long term in a competitive market. . - . After careful review of the PROXY Governance and Glass Lewis reports, we believe the conclusions are the result of analysis that is inconsistent with compensation best practices and is flawed in several respects due to several factors: (1) the peer groups against which ODP was benchmarked in both cases was inappropriate in its composition for reasons explained in more detailed in the text below, (2) there are several factual errors made with respect components and timing of our CEOs compensation, and (3) we believe the retention and sign-on grants The following document supersedes the document in the filing made by Office Depot, Inc. on Schedule 14A on April 21, 2008 at 12:35 PM: . OFFICE DEPOT, INC. . Response to PROXY Governance, Inc. and Glass Lewis & Co Comments on Executive Compensation . This document is intended to outline the Compensation Committee's philosophy, approach and considerations in determining CEO compensation. It also provides a chronological order to the steps the Compensation Committee took over the last 3 years to assure that compensation grants were appropriately linked to business performance. . A. Overview . - . Both PROXY Governance and Glass Lewis expressed concerns with executive compensation at Office Depot as part of their review of the competing proxies. In both cases, the key issues raised were: . o Whether the Compensation Committee followed pay-for-performance policies in determining the CEO's level of compensation compared to Office Depot's performance. And . o Whether the CEO's compensation reported in the proxy published in March 2008 was too high compared to the median of their respective peer groups. . - . The Compensation Committee is committed to a pay-for-performance philosophy for our CEO and our
122	OFFICE DEPOT INC	DEFA14A	4/21/2008	Response to PROXY Governance, Inc. and Glass Lewis & Co Comments on . Executive Compensation . This document is intended to outline the Compensation Committee's philosophy, approach and considerations in determining CEO compensation. It also provides a chronological order to the steps the Compensation Committee took over the last 3 years to assure that compensation grants were appropriately linked to business performance. . A. Overview . - . Both PROXY Governance and Glass Lewis expressed concerns with executive compensation at Office Depot as part of their review of the competing performance, you see that ODP has a total commitment to "pay-for-performance," and in practice executes this philosophy. . o This means higher CEO compensation earned for superior performance and reduced compensation when performance falls short of pre-established goals. In this way, pay is directly tied to the financial results of Company and the interests of Office Depot's shareholders. . o The Compensation Committee also focuses the need to retain executive talent over the long term in a competitive market. . - . After careful review of the PROXY Governance and Glass Lewis reports, we believe the conclusions are the result of analysis that is inconsistent with compensation best practices and is flawed in several respects due to several factors: (1) the peer groups against which ODP was benchmarked in both cases was inappropriate in its composition for reasons explained in more detailed in the text below, (2) there are several factual errors made with respect components and timing of our CEOs compensation, and (3) we believe the retention and sign-on grants should be excluded from annual compensation statistical comparisons. . B. Compensation Committee Action on CEO Compensation . - The key to a proper

123	AUTODESK INC	DEFA14A	6/22/2007	these nominees, whose guidance and experience have contributed to a 630% increase in Autodesk's stock price over the past five years. . Without considering the Board's record of value creation in their analysis, two proxy advisory firms, Institutional Stockholder Services (ISS) and Glass Lewis & Co., recently recommended that stockholders vote against a majority of Autodesk directors. We urge you to disregard these firm's recommendations and carefully review the following information before voting your Autodesk shares. . ISS's and Glass Lewis's recommendations are not based on the performance of our Nasdaq, ultimately adversely affecting shareholder value. . It is important to put in perspective Autodesk's voluntary review concerning its stock options. Among other things, this review found no evidence that any officer or director backdated any stock option granted to himself or herself, nor any evidence of a measurement date error involving any stock option grant made to a person serving as a director. The review also concluded that it was unlikely that those involved in the matters intended to misstate the Company's financial statements or that they understood the associated accounting the continued repurchase of our shares. . As previously announced, we are actively seeking new Board members to further enhance the seasoned group of existing directors. Indeed, we are working with executive search firms to identify new, independent, qualified candidates and hope to announce those candidates in the coming months. ISS and Glass Lewis, however, considered neither this fact nor any of Autodesk's financial and operating achievements in their analysis prior to reaching their opinions. . We believe that a failure to reelect members of Autodesk's Board could negatively impact stockholder
124	RANGE RESOURCES CORP	DEFA14A	5/18/2007	Range is once again asking our stockholders to examine all the facts surrounding our proxy proposal for 950,000 more shares to be authorized under our 2005 Equity Based Compensation Plan. Glass Lewis & Co. has recommended FOR the proposal but ISS has recommended AGAINST the proposal. Range believes that the ISS analysis has both significant factual and analytical errors . Our rebuttal to the ISS analysis is contained in the attached memorandum. . Range believes that it is important to talk directly to our stockholders who have benefited from the 900+% increase in our common stock price over the last five years. That performance was possible due to the performance of our people. A key to the retention and attraction of top notch professionals is our equity compensation under the 2005 Plan. This Plan works for the stockholders. The SARs granted under the 2005 Plan are only as valuable as our employees increase the value of the common stock for everyone's benefit. . An adequate supply of authorized shares under the Plan is key for the Compensation Committee to continue a long term equity award program to incentivize all our employees. It is important for our stockholders to give that vote of confidence to our employees and our future performance by passing the proposal to add additional shares to the plan. The stockholders should pass the proposal because it makes business sense, it is cost effective and it accomplishes its objective. . Please consider the points covered in the memorandum. We believe the ISS analysis significantly misrepresents the cost of the plan

125	TESORO CORP /NEW /	DEFA14A	4/27/2005	We hope that ISS's recommendation, which we believe is based on an inaccurate interpretation of the intended purpose of the proposed Plan, will not affect your decision to approve this proposal, and we recommend that you vote "FOR" the 2005 Non-Employee Director Stock Plan. If you have any questions, please do not We make this recommendation because: . • We believe that the 2005 Plan will further align the interests of our non-employee directors with those of our stockholders, and is consistent with the industry's growing practice of providing less cash and more equity-based compensation to non-employee directors. The resulting cost to the Company and its stockholders for the directors' annual retainer fees would be exactly the same because the portion paid in shares would otherwise be paid in cash. ISS's objection to the 2005 Plan is based on an erroneous
126	VALERO ENERGY CORP/TX	DEFA14A	4/5/2005	Simply stated, the ISS methodology fails to consider the steps we have taken to limit dilution and focuses narrowly on a questionable estimate of the cost of our plan. . Our Recommendation . We believe our equity compensation philosophy has proven to be an excellent means for aligning our employees' interests with your interests in the long- term growth and profitability of Valero. The company's management and Board of Directors request that you vote to approve the 2005 Omnibus Stock Incentive Plan. If you or your organization seek direction from Unfortunately, ISS' model gives little consideration to the fact that nearly all of the shares that have been delivered to our employees under our equity compensation plans have been treasury shares repurchased in the open market by the company and not newly issued shares. In fact, in the last four years, the total number of newly issued shares from all of our equity compensation plans was approximately 5.5 million shares, which represents 2.2 % of our total shares outstanding. Nevertheless, ISS' practice, based solely on their limited model, is to recommend that investors vote against requests for
127	BOEING CO	DEFA14A	4/27/2004	concerns voiced on major corporate governance proposals that received significant shareholder support in 2002 and 2003. First, though, it is important to note the inaccuracies in the ISS report. These proposals did not, as ISS contends, receive a "clear mandate of the company's shareholders for two consecutive years." ISS states that "at the company's past two annual meetings a majority of the shares cast voted in favor of the shareholder proposals to declassify the board and to remove the supermajority vote provision." This is incorrect. While a majority of the "yes/no votes" were voted for the
128	WALT DISNEY CO/	DEFA14A	2/26/2004	statement was issued by The Walt Disney Company on February 25, 2004, in response to a report by Glass Lewis & Co. on Disney's annual meeting and may be deemed "soliciting materials" within the meaning of the Securities Exchange Act of 1934, as amended, and the regulations of the Securities and Exchange Commission issued thereunder: This report is a side show by Glass Lewis, an upstart company that is trying to grab publicity that diverts attention from the fact that Disney's record of building value is indisputable and that it is a well-managed company with world-class governance and a laser-focus on building shareholder value that is on track for earnings growth from continuing operations in excess of 30 percent this year and double-digit growth through 2007. This report is laced with one-sided allegations and opinions that have not been subjected to any objective test of truth, and should be viewed as such; as well as riddled with serious factual errors. For example, the report says Disney purchased the ABC television network for $19 billion and then suggests that it was a questionable deal. In fact, Disney acquired the entirety of Capital Cities/ABC for that price, which included a set of

129	WALT DISNEY CO/	DEFA14A	2/10/2004	, whether or not stated in the Guidelines, the Board has the inherent right to waive the application of this or any other provision. That said, the Board made very clear this year its determination to adhere to its retirement policy. I believe that determination will continue in the future. 6. My Service as a Director: In their recent open letter Messrs. Disney and Gold urge stockholders to vote no on the re-election of four directors. There are many inaccurate statements in their letter, only one of which I will address here. As to me, they assert that "In addition to his full-time career as a practicing lawyer, ex-Senator Mitchell serves on far too many other boards to permit him adequate time for his Disney commitments." That statement is inaccurate in three respects. First, I do not practice law full-time. When I reentered the practice of law after retiring from the Senate, it was with the explicit agreement of my colleagues that I would not devote full-time to the practice and would be free to engage in other activities of my choice, including serving on corporate boards. That arrangement remains in effect. Second, I serve on three other boards, a number which is in compliance with the
130	MORGAN STANLEY	DEFA14A	3/14/2002	ISS does not appear to us to have undertaken any analysis of the Morgan . Stanley proposal itself, the reasons set forth by our Board recommending . against the proposal or whether a staggered Board is appropriate for our . company. Rather, ISS appears simply to have adopted a uniform policy of . recommending against all staggered Boards, irrespective of a company's . particular facts and circumstances. In addition, we believe ISS' . recommendation has a number of flaws: . . o ISS asserts that the empirical evidence on staggered boards suggests that . they are not in the best interests of shareholders from a financial . perspective. Others, however, have found that the evidence on this matter . is "ambiguous." See IRRC Corporate Governance Service, February 2002 . Background Report. ISS fails to advise its clients of these differing . views. Indeed, even the untested study to be published later this year on . which ISS relies itself acknowledges that further research is required on . whether staggered boards provide benefits in terms of higher acquisition . premia and recognizes that its conclusions on staggered boards go against . the weight of much of the previous research on such boards. . . o ISS fails to advise its clients that ISS has not undertaken any analysis . of Morgan Stanley's particular circumstances (for example, the matters . described by our Board under the heading "Relationships" in our Proxy . Statement). . . o ISS does not highlight for its clients statements in the stockholder . proposal that are contrary to ISS' own statements. For example, the . proposal states: "The great majority of New York Stock Exchange listed . corporations elect all their directors each year." ISS, on the other . hand, states: "... classification remains the rule, not the

131	CITRIX SYSTEMS INC	DEFA14A	5/9/2000	approval of each of these amendments will enable us to continue . our success at adding value to our shareholder base. Notwithstanding the results . tabulated by a quantitative model instituted by Institutional Shareholder . Services (ISS), we urge you to vote in favor or "FOR" all submitted proposals. . . Citrix Systems, Inc., originally founded in 1989, worked through many trials and . tribulations during its first years of operation before taking ownership of the . company to the public markets in the form of an Initial Public Offering in . December of 1995. In our five years as a publicly traded company, our market . capitalization has grown from $150 million to over $10 billion, and our stock . has returned over 2,458%. . . The ISS recommendation to vote against Proposal No. 3 & No. 4, sacrifices our . ability to continue to add value to our loyal shareholder base and seriously . jeopardizes our ability to meet the challenges of facing a more competitive . landscape in both the technology field and in competition for recruiting, . retaining, and rewarding talented individuals. ALTHOUGH ISS INITIALLY VOTED . AGAINST PROPOSAL NO. 2, ISS HAS CONFIRMED THAT DUE TO THEIR ERROR, THEY HAVE . SINCE ISSUED A RECOMMENDATION IN by 6,773%, or by 64% when . comparing FY 1999 and 1998. . o We continue to be the premiere provider of application server software . and during 1999 we were added to the S&P 500 and reconfirmed into the . NASDAQ 100. . o As of the end of FY 1999, we have returned 2,458% as compared to 377% . for NASDAQ and 260% for the S&P 500 over the same period. . . 1995 STOCK PLAN AND 2000 DIRECTOR AND OFFICER STOCK OPTION AND INCENTIVE PLAN . . We believe that the ISS recommendation against Proposal No. 3 & 4 fails to take . the following into consideration: . . ALL EMPLOYEES PARTICIPATE: Our plan is broad based and covers
132	NORFOLK SOUTHERN CORP	DEFA14A	5/2/1995	the . executive must pay the corporation the fair market value of . the shares at the time of award. ISS assumes that no future . awards would be in the form of fair market value options, . but instead would be in other forms which would require the . corporation to bear the full cost. This incorrect . assumption makes the proposal appear almost twice as costly . as it would be under the plan's past practice. . . As additional background information, I have also included a copy . of our response to ISS. If you have any questions, please call. . . The response may not be shared with third parties, nor should

-----Original Message-----
From: [redacted] [mailto[redacted]@isscorporateservices.com]
Sent: Monday, September 08, 2014 8:54 AM
Subject: U.S. 2014 ISS Post Season Report Now Available/Equity Plans for 2015 & 2016?

Good morning:

The 2014 ISS Post Season Report is now available. Please let me know if you would like a copy. There's no charge for this.

Also, as you may know, ISS will introduce a new 'balanced scorecard' methodology in 2015 for evaluating equity compensation proposals. The scorecard will consist of a number of weighted factors (such the absolute magnitude of compensation, forward looking compensation program disclosure, equity plan features, etc). Companies could thus exceed the traditional company-specific allowable cap and still receive a positive vote recommendation. ISS corporate services will provide our client companies with full advice and consultation around the scorecard factors.

Any issuer with a pay plan coming in the next few years will benefit from having access now to the ISS Compensation Suite. If you're not a current client here, you can lock in the current/early adopter price for the Suite.

Please let me know if you have any questions here.

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ISS Corporate Services, Inc. (ICS) is a wholly owned subsidiary of Institutional Shareholder Services Inc. (ISS). ICS provides advisory services, analytical tools and information to companies to enable them to improve shareholder value and reduce risk through the adoption of improved corporate governance and executive compensation practices. The ISS Global Research Department, which is separate from ICS, will not give preferential treatment to, and is under no obligation to support, any proxy proposal of a company (whether or not that company has purchased products or services from ICS). No statement from an employee of ICS should be construed as a guarantee that ISS will recommend that its clients vote in favor of any particular proxy proposal.

LETTERS, STATEMENTS, AND REPORTS SUBMITTED BY CHAIRMAN CRAPO

The Brokaw Act would harm American shareholders

The Brokaw Act is an attempt to use federal legislation to deter shareholder engagement in the management of America's companies. The rationale for the Act, as well as the narrative about its namesake, is completely devoid of evidence. While the bill is represented as necessary to "protect Main Street" from "predatory activist hedge funds," the effect of its implementation would be to curtail a profoundly positive force in the American economy. Americans have a lot riding on the success of our public companies. Our country has largely entrusted our children's education, our retirement savings, and our legacy to the success of the stock market. Shareholder activism plays a key role in improving corporate governance and providing accountability to the companies which Americans have entrusted so much. If policymakers discourage shareholder activism, poor governance, poor management, and corporate greed will flourish.

Shareholder Engagement improves America's corporations

This attack on American activist investors is entirely unwarranted. Academic studies have clearly established that activist investors increase long-term shareholder value, which benefits educational endowments, pension funds, non-profit organizations and all individuals who own public company shares. A comprehensive study led by Harvard Prof. Lucien Bebchuck, for example, examined over 2000 activist events spanning 13 years and found that in the short run these interventions average a 6 percent rise in stock prices and maintained those gains over a five-year period. More recently, the *Economist* analyzed the 50 largest activist positions taken since 2009, and it found that 84 percent resulted in a rise in market capitalization; 80 percent show a rise in R&D spending; 72 percent had an increase in investment; and 62 percent experienced a rise in net income. Engaged shareholder activists make American companies more competitive, creating and saving American jobs.

Brokaw, Wisconsin, is misrepresented

The bill's sponsors use a false narrative about events in Brokaw, Wisconsin, to advance their investor restrictions. They wrongly claim that an activist investor (Starboard Value) forced the closure of Wausau Paper's mill in Brokaw, Wisconsin. In fact, when the Wausau board made the decision close the mill, the activist investor had no board representation and had been a minor shareholder for a mere five months. Before that, other paper mills in New Hampshire, Maine and Wisconsin had been shuttered by Wausau Paper's management. The activist had actually proposed that Wausau's color business, which included the mill, to be sold a more sustainable operator. The timeline of events is clear: Years of management mistakes preceded an activist rescue. Had the activist not invested in Wausau, the company would have likely gone bankrupt.

Shortening the 13D Window would upset a delicate balance

When investors acquire beneficial ownership of more than five percent of voting class stock in a public company, they are required to file a "Schedule 13D" form with the Securities and Exchange

Commission (SEC) within ten days. The Brokaw Act would overturn a delicate balance between shareholders and management that has evolved over decades by rewriting longstanding SEC Rule 13d-1(a), shortening the 10-day disclosure period to four days. The bill's sponsors suggest this is an innocuous "modernization." To the contrary, the current Schedule 13D procedures create shareholder value by giving investors a powerful tool to improve entrenched and ineffective management. No change should be made before conducting an analysis of the costs and benefits to shareholders.

As background, Congress originally set the 10-day window in 1968 when it passed the Williams Act (P.L. 90-439) for one overriding reason: to strike a balance between the rights of shareholders and the needs of management. In passing the Williams Act, Congress recognized that outside shareholders "should not be discouraged, since they often serve a useful purpose by providing a check on entrenched but inefficient management." Even back then, the SEC recognized that the Williams Act "was not intended either to encourage or discourage such offers or acquisitions, nor was it intended to give an advantage either to management or the outside group."

Since then, poor performing corporate managers have devised a number of ways to frustrate shareholder engagement, ranging from the use of poison pill legal strategies, to staggered board elections, to state-level legislation. Changing this aspect of the 13d rule without considering others would dramatically skew the current balance toward poor performing corporate managers who wish to entrench themselves against the company's owners—the shareholders. It would harm the pension funds, education endowments, and individual investors who benefit from shareholder activism.

More recently, Section 929R of the Dodd-Frank Act of 2010 granted the SEC explicit statutory authority to shorten the current 13d filing window. The SEC studied this issue extensively over the past several years, even issuing a "concept release" reviewing Schedule 13D in December of 2011. After extensive review, recognizing the delicate set of checks and balances that have developed as a result of the current requirements, the SEC chose not to act on the proposal.

Policymakers understand that a complex ecosystem has developed around the existing rules, and changing them could have significant unintended consequences.

Red herrings should not be used to slur American investors

The Brokaw Act aims at other alleged investor practices that are already restricted by law, rule, and common sense. For example, the sponsor claims without evidence that activists form groups to skirt the intent of disclosure rules. In fact, there is already broad and strong regulation that prohibits investors coordinating efforts without proper disclosure. The sponsor suggests that activists take "net short" positions in companies in which they are engaged. That would defy reason. The entire point of investor activism is to increase share value. Activist positions are, by definition, long. <u>These provisions, and the associated extreme language in the sponsor's press release, do nothing more than slur a large segment of the investment community that helps America become more competitive and prosperous, benefiting all American shareholders.</u>

Financial Industry Regulatory Authority

Marcia E. Asquith
Executive Vice President,
Board and External Relations

June 27, 2018

The Honorable Mike Crapo, Chairman
The Honorable Sherrod Brown, Ranking Member
U.S. Senate Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Crapo and Ranking Member Brown:

On Thursday, June 28, the Senate Banking Committee is scheduled to hold a hearing on several corporate governance bills, including S. 2499, a bill that would require FINRA to establish a new brokerage industry insurance fund to compensate investors who are unable to collect arbitration awards. Because we believe it is highly pertinent to the Committee's consideration of this bill, we respectfully request that the enclosed discussion paper entitled *FINRA Perspectives on Customer Recovery* (the "Discussion Paper"), together with this letter, be entered into the record for the hearing.

As you are aware, plaintiffs or consumers of goods and services, who are awarded damages for claims they initiate in federal or state courts, or in an arbitration forum, against individuals or businesses cannot always recover on those judgments or awards. FINRA has been working to address this important issue in the context of the securities arbitration forum that FINRA operates for the resolution of disputes between customers and FINRA members or their employees.[1] In particular, during the past year FINRA has engaged in an extensive study of this topic, and published the Discussion Paper in February to promote and inform a broader dialogue on how to further address the issue of unpaid arbitration awards, including by:

- Describing FINRA's arbitration forum, how it operates pursuant to rules approved by, and under the supervision of, the Securities and Exchange Commission (the "SEC"), and that FINRA does not require customers to arbitrate disputes with broker-dealers or prevent customers from pursuing relief in federal or state courts;[2]

- Explaining that when customer awards go unpaid, it is not because the customer's claim was brought in the FINRA forum – indeed, by confirming the

[1] Customer recovery issues also can occur in disputes settled in other forums (including courts) and may involve other segments of the financial services industry. FINRA is unaware of any U.S. arbitration or court system that has established a fund for the payment of arbitration awards or court judgments.

[2] Most broker-dealers require customers opening an account to agree in writing to arbitration disputes concerning the account. Section 921 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, authorizes the SEC to prohibit, or impose conditions or limitations on, the use of mandatory arbitration clauses in customer account agreements in the securities industry.

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award in court the customer is in the same position as if the customer had brought the claim in court – but rather because of the respondent's inability or unwillingness to pay;

- Providing data on the extent and nature of unpaid arbitration awards in FINRA's arbitration forum (which represent 2 percent of all customer arbitration cases brought during the relevant period);

- Outlining the extensive steps that FINRA has taken to date to address this issue, including by mandating payment of customer awards by its members, by suspending those who do not pay awards from the brokerage industry (although FINRA cannot restrict these persons from operating in other sectors of the financial services industry), and by expanding options available to customers with claims against respondents who are unlikely to be able to pay;[3] and

- Describing additional steps that FINRA is currently working on, within the scope of its jurisdiction, to incentivize further the payment of customer arbitration awards[4] and to expand further options for customers where respondents are unlikely to pay.[5]

In addition, to promote further consideration of this issue by policy makers, the Discussion Paper describes additional steps that have been identified by FINRA or other parties that could be taken to address the issue of unpaid customer arbitration awards. These steps, none of which were endorsed by the Discussion Paper, would require SEC rulemaking or federal legislation, or would present policy issues that should be considered by the SEC or Congress, and include:

- Rulemaking review by the SEC to require firms to raise or maintain additional capital;

---

[3] In the past few years, FINRA has also developed a number of initiatives under our high-risk broker program to identify and expel bad actors from the brokerage industry to the extent possible under federal law. These initiatives help target those firms and individuals who may leave arbitration awards unpaid. We are working actively on additional rule proposals in this area. *See* FINRA Requests Comment on FINRA Rule Amendments Relating to High-Risk Brokers and the Firms That Employ Them (2018), Regulatory Notice 18-16. FINRA also recently issued guidance that reiterates the supervisory obligations of member firms regarding associated persons with a history of past misconduct—including those with adverse arbitration decisions. *See* Guidance on Implementing Effective Heightened Supervisory Procedures for Associated Persons With a History of Past Misconduct (2018), Regulatory Notice 18-15.

[4] *See* FINRA Requests Comment on Proposed Amendments to Its Membership Application Program to Incentivize Payment of Arbitration Awards (2018), Regulatory Notice 18-06. In addition, in April 2018, FINRA began reporting on the Uniform Disciplinary Action Reporting Form ("Form U6") if a firm or associated person has had an unpaid customer arbitration award discharged in bankruptcy or if an arbitration claim has been stayed due to a bankruptcy proceeding.

[5] *See* Amendments to the Code of Arbitration Procedure for Customer Disputes to Expand the Options Available to Customers if a Firm or Associated Person Is or Becomes Inactive (2017), Regulatory Notice 17-33.

- Legislation by Congress to expand Securities Investor Protection Corporation (SIPC) coverage to include unpaid arbitration awards;
- Legislation by Congress or rulemaking by the SEC or FINRA to require firms to carry insurance to cover unpaid arbitration awards;
- legislation by Congress or rulemaking by the SEC or FINRA to create a second brokerage industry fund, separate from SIPC, to cover unpaid awards;
- amendments to the SEC's *Form BD* to require disclosure regarding unpaid awards by firms;
- legislation by Congress to amend the Securities Exchange Act of 1934 (the "Exchange Act") statutory disqualification definition to include more instances in which a firm or individual fails to pay an arbitration award; and
- legislation by Congress to amend the Bankruptcy Code so that arbitration awards cannot be discharged in bankruptcy.

Each of these proposals involves important tradeoffs and significant policy choices that require careful consideration so that all the advantages and disadvantages of the options can be weighed against each other, unintended consequences can be minimized, and any actions taken can result in higher levels of customer recovery. Moreover, the Discussion Paper describes how it would be useful to consider in a more holistic manner the various dispute resolution systems and related regulatory frameworks applicable to different but related areas of the financial services industry, to take into account the different channels through which customers receive similar financial services and to understand fully the potential implications of any particular approach for investors and industry participants.

S. 2499 would mandate the creation of a second brokerage industry insurance fund to cover arbitration awards, including awards for claims that Congress has previously determined should not be covered by SIPC. As noted above, the idea of such a fund is one of the approaches described in the Discussion Paper that raises substantial policy issues requiring consideration together with other potential solutions to minimize unintended consequences for investors and industry participants.[6] In addition, as introduced and without further development, the bill's approach to creating such an insurance fund leaves unclear how to address important questions regarding the fairness, funding and financial sustainability of any such fund, as well as a number of practical implementation challenges. Notes 49-52 and the accompanying text in the

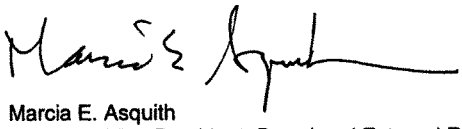
[6] When Congress established the first securities industry insurance fund, SIPC, by enacting the Securities Investor Protection Act of 1970, there was an extensive deliberative process informed by input from many sources and stakeholders. Among other things, the process included a number of Congressional hearings and legislative mark-ups which considered proposals developed by both the SEC and a specially convened Task Force. Congress also drew on the experiences of the stock exchanges that had been operating their own insolvency funds.

Discussion Paper highlight some of the relevant issues that need to be addressed when considering the creation of a second brokerage industry insurance fund.[7]

FINRA welcomes the Committee's interest in the important issue of customer recovery in connection with both the brokerage industry and the wider financial services sector. As Congress considers how to address customer recovery, FINRA stands ready to work with this Committee, the SEC and other stakeholders to develop effective, sustainable solutions to promote customer recovery and root out bad actors who harm investors. In addition, FINRA officials would welcome the opportunity to meet with the Committee to review the issues and options described in the Discussion Paper.

Please feel free to contact me or Gregory Dean, SVP, Office of Government Affairs at (202) 728-8217, if you would like to discuss any of these issues in more detail.

Sincerely,



Marcia E. Asquith
Executive Vice President, Board and External Relations

Attachment: Discussion Paper – FINRA Perspectives on Customer Recovery

[7] By way of example, some approaches to consider for addressing the financial viability of such a fund include appropriate caps on payouts (such as those used for the FDIC or SIPC funds), potential "frontline" protections such as indemnity insurance (an approach adopted in the United Kingdom), and a "backstop" funding source (such as the $2.5 billion U.S. Government-backed line of credit available to SIPC).

FINRA

Discussion Paper—
FINRA Perspectives on Customer Recovery

FEBRUARY 8, 2018

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Customers who pursue civil remedies or arbitration claims against investment professionals cannot always recover on their judgments or awards. Customers encounter this challenge across the forums in which they may pursue action—whether state or federal court, a dispute resolution forum administered by a regulator, a private arbitration venue, or otherwise—and across the range of financial services they may use. When a customer is unable to recover on a judgment or award, the customer may be left without any redress for the harm suffered, and public confidence in the financial services industry and the regulatory framework under which it operates may be diminished.

FINRA has been focused on this important issue for many years in the context of the arbitration forum that FINRA operates for the resolution of disputes between customers and FINRA members or their employees.[1] As with other dispute resolution forums, customers who receive awards in the FINRA forum are sometimes unable to collect on those awards. FINRA has taken a number of steps to address this problem, and has proposed several additional measures that would further mitigate, albeit not eliminate, the issue of unpaid awards.

In considering further steps to improve customer recovery in its own forum, FINRA believes it is important to engage in a collaborative dialogue with other regulators and policy makers, as well as the many other stakeholders in this issue, for several reasons.

First, FINRA has identified several additional steps that could be taken (described below) to address unpaid awards that would require action by, or should be pursued in consultation with, other authorities. Certain of these steps could also raise questions of their impact on, or application to, other segments of the financial services industry outside of FINRA's jurisdiction. Even actions taken solely by FINRA with respect to unpaid awards can have customer protection or other implications for other regulatory regimes that should be considered—such as when FINRA suspends an individual from the brokerage industry for failing to pay an award, and that individual continues to operate elsewhere in the financial services industry.

In addition, in light of the similarities between some of the services offered by brokers that FINRA regulates and investment advisers, different approaches to dispute resolution as between these two channels require careful consideration to ensure investor protection. Moreover, as a general matter, the issue of unpaid awards is not unique to FINRA's forum or the broker-dealer industry—customers can have unpaid

claims that arise from other forums or that are against other types of financial firms. A holistic consideration of how customer recovery is or is not addressed across related areas of financial services will better inform what steps to better protect customers would be appropriate in the context of each of these areas, and what consequences action in any one area may have for others.

FINRA is issuing this Paper in order to help inform this broader dialogue by providing FINRA's perspectives on customer recovery in the dispute resolution forum it administers. The Paper provides an overview of the FINRA arbitration forum, makes available additional data about unpaid awards in the forum, describes the steps that FINRA has taken to address those unpaid awards, and identifies additional measures that could be taken to either enhance the resources to pay such awards or provide greater incentives to pay such awards.

The Paper briefly identifies some of the potential issues that may arise for customer recovery in other forums, but it does not provide a comprehensive survey of how the process, policy tools, and results of recovery in the FINRA forum compare with other forums. This Paper is intended to help encourage a continued dialogue about those questions while directly informing the further enhancement of customer recovery in the FINRA forum itself. To that end, FINRA plans to organize discussions with other regulators and policy makers to further address this topic, identify additional data or analysis that may help inform effective decision-making in this area, and consider potential courses of action.

I. Summary – Customer Recovery in FINRA Arbitration

Arbitration is an important means of customer recovery in disputes involving investment professionals. Most broker-dealers and many investment advisers[2] require customers opening accounts to agree in writing to arbitrate disputes concerning the account. FINRA rules *do not* require customers to arbitrate disputes with broker-dealers, nor does FINRA preclude customers from pursuing relief in state or federal courts; however, FINRA rules do require arbitration if requested by the customer.

In FINRA arbitration, the majority of customer cases—approximately 69 percent—result in settlements reached by the parties;[3] typically, approximately 18 percent of cases proceed to award.[4] When the customer pursues arbitration and obtains a monetary award, the customer can have the award confirmed in court, and thus is in a similar position as a customer who obtains a judgment in court. Arbitration claimants have access to the same collection tools as in a court judgment. In either situation, the award or judgment may not be paid. Thus, a customer's recovery depends on the ability to collect from the respondents, not on whether the customer sought relief in arbitration or in court.

The issues surrounding the ability of customers to collect on awards are not unique to FINRA arbitration or the broker-dealer industry. What is unique to arbitration against broker-dealers is that FINRA suspends individuals and firms from the broker-dealer industry due to non-payment of a FINRA arbitration award. It is important that these similarities and differences be taken into account in considering the issues of customer recovery. For example, investors may obtain similar services from investment advisers who are not FINRA members. Unlike FINRA member broker-dealers, however, investment advisers registered with the Securities and Exchange Commission (SEC) are not subject to disciplinary sanctions or suspension from the investment adviser industry if they do not timely pay arbitration awards assessed against them. In addition, if an individual is suspended from the broker-dealer industry due to the individual's failure to pay a FINRA arbitration award, FINRA is not aware of any federal provisions that would prevent that individual from entering or continuing in another area of the financial services industry, including acting as an investment adviser.

Customer Recovery Across Dispute Resolution Forums			
	FINRA Arbitration	Private Arbitration (e.g., AAA, JAMS)	Court
SEC Oversight of Forum	*		
FINRA Suspension for Non-Payment of Award or Judgment	*		
Awards or Judgments Publicly Available	*		*
Enforcement of Award or Judgment Allowed in Court	*	*	*
Customer Claimant Responsible for Collecting Award or Judgment	*	*	*
Payment of Award or Judgment Ensured or Guaranteed			

FINRA collects certain data on customer recovery in the FINRA arbitration forum. Those data show that FINRA customer arbitration cases decided by award represent a small subset of all cases filed. For example, of the 2,457 arbitration cases involving customer disputes in 2016, only 389 (16 percent of all cases) closed by award; and of those awards, 44 (2 percent of all cases) went unpaid.[5] FINRA has not been able to obtain similar data regarding customer recovery against non-FINRA members, or in court or other non-FINRA forums. For example, there is no affirmative requirement for an investment adviser to report a failure to pay arbitration awards on Form ADV,[6] and FINRA is unaware of data on the volume of arbitration or court claims against advisers or the amount of awards that are unpaid.

If a customer is not able to recover monetary damages awarded in the FINRA arbitration forum, that does not always mean that a customer did not receive any monetary payment in connection with the underlying dispute. In many cases that result in unpaid awards, a customer settles with one or more parties pre-award, but proceeds to obtain an award against other parties named in the case, who then fail to pay the award. For example, of the 44 awards that went unpaid in 2016, 13 involved a settlement with one or more firms pre-award.

Although a customer can always enforce an arbitration award in court, FINRA also has taken steps to mandate payment of customer arbitration awards by its members, to restrict those who do not pay awards through suspension from the industry, and to expand options available to customers with claims against respondents who are unlikely to be able to pay. FINRA has also identified other approaches that could be taken to help customers recover monetary damages against FINRA member broker-dealers and associated persons, some of which may also be relevant for financial industry participants who are not FINRA members. These approaches generally would require SEC rulemaking or federal legislation, or present policy issues that should be considered by the SEC or Congress. FINRA recognizes that each of these approaches involves important tradeoffs and policy choices that would require further consideration and analysis by relevant regulators and policymakers before being implemented. The approaches are discussed more fully below and include, among other alternatives:

- rulemaking by the SEC to require firms to raise or maintain additional capital;
- legislation by Congress to expand Securities Investor Protection Corporation (SIPC) coverage to include unpaid customer arbitration awards;
- legislation by Congress or rulemaking by the SEC or FINRA to require firms to carry insurance to cover unpaid arbitration awards;

- legislation by Congress or rulemaking by the SEC or FINRA to create a second brokerage industry fund, separate from SIPC;
- amendments to the SEC's Form BD to require disclosure regarding unpaid awards by firms;
- legislation by Congress to amend the Securities Exchange Act of 1934 (Exchange Act) statutory disqualification definition to include more instances in which a firm or individual fails to pay an arbitration award; and
- legislation by Congress to amend the Bankruptcy Code so that arbitration awards cannot be discharged in bankruptcy.

II. Background

A. Securities Arbitration

Arbitration in the broker-dealer industry has been subject to oversight by the SEC for many years. In 1976, the SEC established an Office of Consumer Affairs, whose mandate was to explore alternative methods for the resolution of disputes between individual investors and brokers and firms, including the establishment of a single nationwide system for investor dispute resolution.[7] Ultimately, the SEC concluded that litigation is a burdensome and complex option for investors, as well as cost prohibitive for those investors with small claims.

In light of the fact that several self-regulatory organizations (SROs) maintained separate arbitration forums at the time,[8] the SEC decided not to impose rules related to investor dispute resolution as long as the SROs took affirmative measures to provide nationwide forums with uniform rules, accessibility for investors, convenient locations, fair fees, and panels that included persons not engaged in the securities business. For the last 40 years, the SEC has overseen the evolution of arbitration to resolve investor disputes against broker-dealers, including through the SRO rule filing process.[9]

B. FINRA's Arbitration Forum

FINRA operates the largest securities arbitration forum in the United States to assist in the resolution of monetary and business disputes involving investors, securities firms, and individual brokers.[10] FINRA's primary role in the arbitration process is to administer cases brought to the forum in a neutral, efficient, and fair manner. In its capacity as a neutral administrator of the forum, FINRA does not have any input into the outcome of arbitrations.

All rules related to the FINRA arbitration program have been filed with and approved by the SEC, after publication in the *Federal Register* and a finding by the SEC that such rules are in the public interest.[11] The SEC regularly examines FINRA's arbitration forum. In addition, FINRA has periodically undertaken to enhance the operation of the program, informed by input from external stakeholders.[12]

FINRA's arbitration forum has 71 hearing locations—at least one in every state. Depending on the amount of damages being sought, disputes in the arbitration forum are heard by either a panel of three arbitrators, or by a single arbitrator. Member firms pay for most costs, and FINRA waives fees for investors experiencing financial hardship. The average turnaround time across all arbitration cases is 15 months.

In all cases involving investors, parties have the option to have their case decided exclusively by public arbitrators who have no ties to the securities industry. FINRA maintains a roster of more than 7,300 arbitrators, conducts a comprehensive pre-approval background check on all arbitrator applicants, and provides training and continuing education for arbitrators. In addition, FINRA actively recruits minority and female arbitrators, and publishes data on the diversity of the arbitrator pool on the FINRA website.[13]

FINRA publishes detailed arbitration statistics on its website, including the number of cases filed and their respective outcomes.[14] All arbitration awards are made publicly available.[15] The award provides the names of the parties, the arbitrators, the allegations, the date and location of the hearing, and the arbitrators' rulings.

C. Predispute Arbitration Agreements

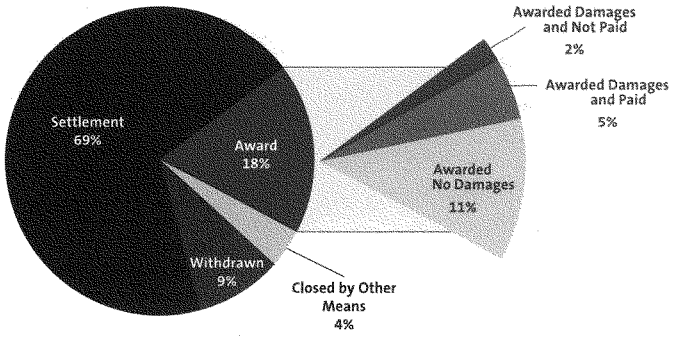
FINRA does not preclude customers from pursuing relief in state or federal courts. Most broker-dealers, however, require customers opening accounts to agree in writing to arbitrate disputes concerning the account.[16] Although FINRA does not require member firms or their customers to enter into predispute arbitration agreements or otherwise use arbitration in lieu of civil litigation, FINRA's rules do establish certain minimum disclosure and related requirements regarding the use of such agreements.[17] In addition, FINRA arbitration is required if there is a written agreement requiring FINRA arbitration or if it is requested by the customer.[18]

Even with a predispute arbitration agreement, member firms and customers may elect, by mutual consent, to resolve their disputes in a forum other than at FINRA, such as at a private arbitration forum (*e.g.*, AAA or JAMS) or by civil litigation, after a dispute has arisen between the parties. In addition, if a written agreement to arbitrate at FINRA does not exist or if the customer does not request FINRA arbitration, the parties to a dispute may agree to resolve their disputes at a private arbitration forum or in civil litigation. FINRA rules also protect a customer's rights to pursue class actions in court notwithstanding any predispute arbitration agreement.[19]

D. Customer Recovery in FINRA Arbitration

Arbitration cases decided by award represent a small subset of all cases filed.[20] For example, there were 2,457 arbitration cases involving customer disputes in 2016, but only 16 percent (389) closed by award. Another 71 percent (1,747) settled prior to award, 9 percent (212) were withdrawn, and 4 percent (109) closed by other means (*e.g.*, stipulated award, bankruptcy of critical party, uncured deficient claim, forum denied, or stayed by court action). This general distribution in how customer disputes are resolved has remained steady in recent years (*see* chart).

How Customer Arbitration Cases Closed (2012-2016)

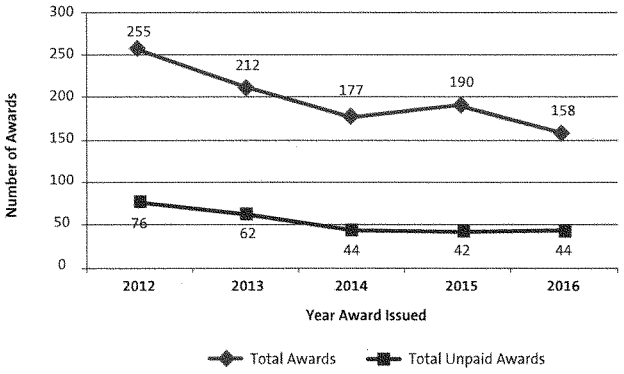


When an arbitration panel awards monetary damages to the customer claimant, the respondent may fail to pay the awarded damages.

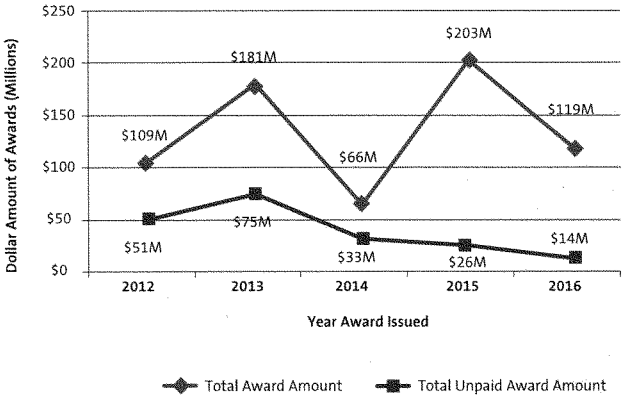
To provide additional transparency about its forum and better inform discussions regarding this topic, FINRA is making data on unpaid customer arbitration awards for the past five years available on its website. FINRA has previously included certain of these data in its annual report to the SEC regarding unpaid customer arbitration awards, including the number of monetary awards, the amount of monetary relief awarded, and the number and amount of unpaid monetary awards.[21] These data also underlie the graphics presented in this Paper.[22] To FINRA's knowledge, this is the first time that a dispute resolution forum has made publicly available this level of data on unpaid awards or judgments.

The number of unpaid awards as a share of the total number of customer arbitration awards has remained relatively stable in recent years, while the share by dollar amount has fluctuated due to variability in the size of awards (*see* graphs).[23]

Number of Unpaid Customer Arbitration Awards by Year



Dollar Amount of Unpaid Customer Arbitration Awards by Year

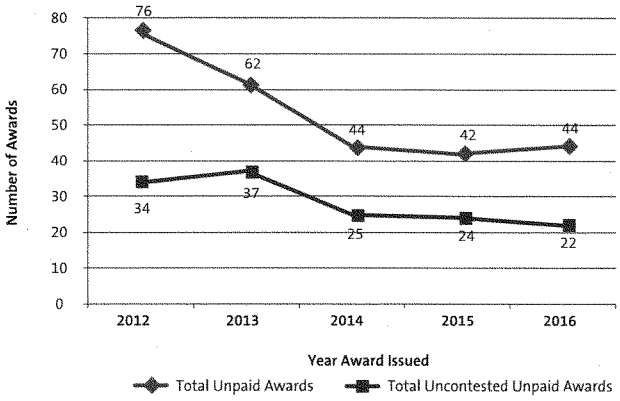


Unpaid customer arbitration awards against firms primarily involve smaller-sized firms.[24]

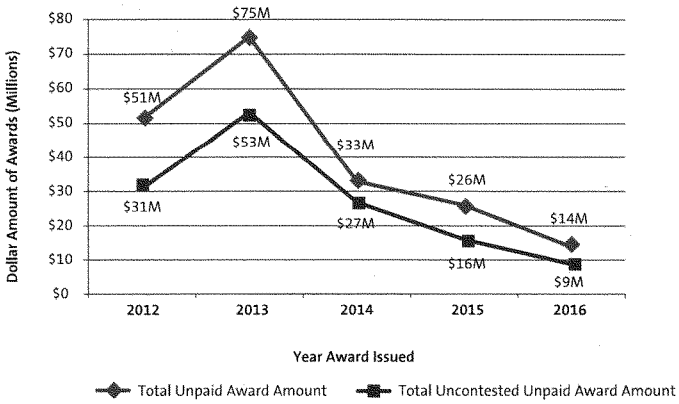
Size of Firms With Unpaid Customer Arbitration Awards by Number of Registered Brokers		
Year Award Issued	Average Firm Size	Median Firm Size
2012	34	25
2013	76	39
2014	70	41
2015	81	56
2016	55	30

Often, an arbitration claim resulting in an unpaid award is uncontested, meaning that the respondent firm or individual does not appear to oppose the customer's claims in the arbitration proceeding. If a respondent firm or individual fails to appear at a hearing, the panel may determine that the hearing may go forward, and may render an award as though all parties had been present.[25] If a respondent firm or individual is inactive (as defined below) and fails to file an answer within the required time period, at the request of the customer claimant, the arbitrator may render an award based on the pleadings and other materials submitted, as well as any additional information requested by the arbitrator from the customer claimant.[26] In recent years, a large share of unpaid arbitration awards have resulted from uncontested claims, measured by both the number and value of awards (*see* graphs).

Number of Unpaid Customer Arbitration Awards in Cases That Were Uncontested by Year

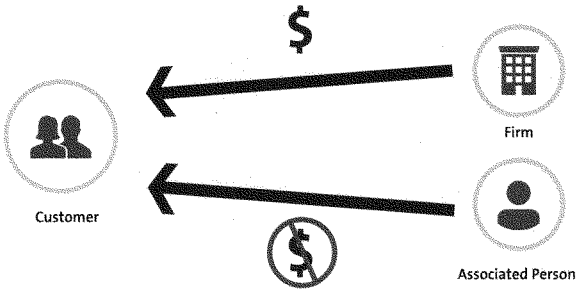


Dollar Amount of Unpaid Customer Arbitration Awards in Cases That Were Uncontested by Year



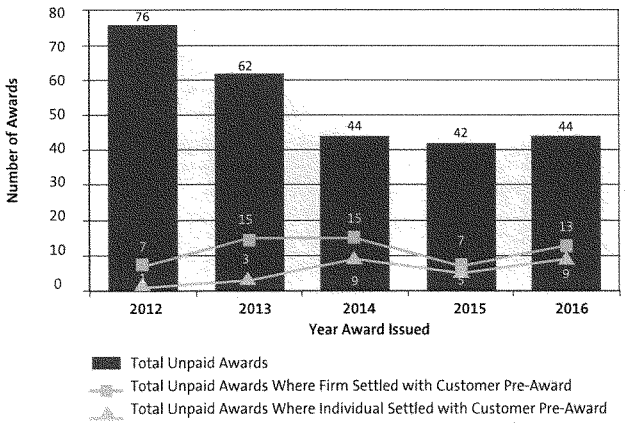
An unpaid award against one party does not always mean that a customer did not receive any monetary payment in connection with the underlying dispute (*see* graphic). In a number of cases that result in unpaid customer arbitration awards, a customer claimant settles with one or more parties pre-award, but proceeds to obtain an award against other parties named in the case, who then fail to pay the award. In recent years, a significant number of unpaid customer arbitration awards have involved a pre-award settlement with one or more firms or individuals involved in the dispute (*see* graphs).

An Unpaid Award Does NOT Always Mean the Customer Did Not Receive Any Payment



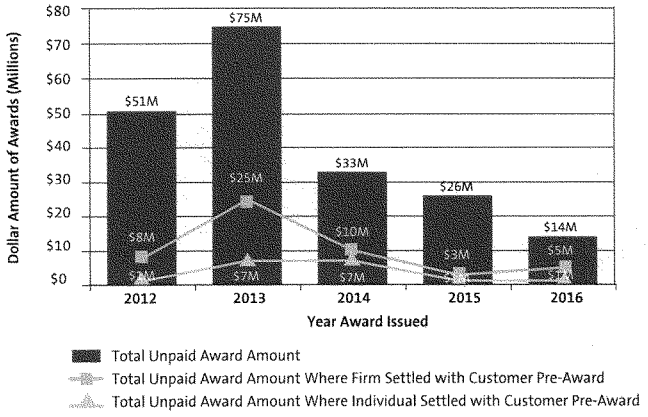
In 2016, 13 of 44 unpaid awards involved a pre-award settlement between the customer and one or more firms.

Number of Unpaid Customer Arbitration Awards With Pre-Award Settlements by Year*



* Because both a firm and an individual who was associated with the firm may have settled in the same case pre-award, figures for firms and individuals may overlap.

Dollar Amount of Unpaid Customer Arbitration Awards With Pre-Award Settlements by Year*



* Because both a firm and an individual who was associated with the firm may have settled in the same case pre-award, figures for firms and individuals may overlap.

III. FINRA Measures Related to Customer Recovery

A claimant in the FINRA arbitration forum is in a similar position as if the claimant had brought an action in court and been awarded the same amount of damages.[27] As in a court judgment, the responsibility to collect on an arbitration award lies with the claiming party. Similarly, as is the case with federal and state court systems and other arbitration forums, FINRA's arbitration forum does not ensure payment of damages awarded. Arbitration claimants have access to the same collection tools as in a court judgment: if a respondent fails to pay an arbitration award, the claimant may take the award to court and have it converted to a judgment. The claimant may then attempt to collect on the judgment using the court's collection procedures.

Although a customer claimant can always enforce an arbitration award in court, FINRA also has taken steps to mandate payment of customer arbitration awards by its members, to restrict—through suspension from the brokerage industry—those who do not pay awards, and to expand options available to customers with claims against respondents who are unlikely to be able to pay.

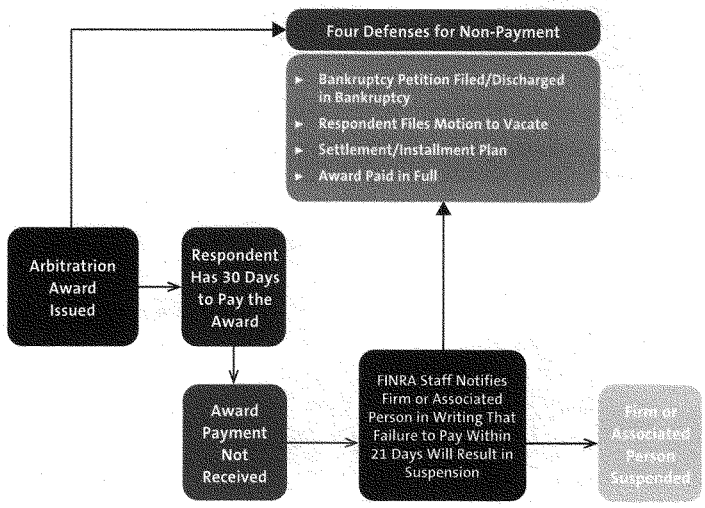
It is important to note that most unpaid customer arbitration awards are rendered against firms or individuals whose FINRA registration has been terminated, suspended, canceled, or revoked, or who have been expelled from FINRA. These firms and individuals are generally referred to as "inactive," and are no longer FINRA members or associated with a FINRA member, although they may continue to operate in another area of the financial services industry where FINRA registration is not required. Firms and individuals can become inactive prior to an arbitration claim being filed, during an arbitration proceeding, or subsequent to an arbitration award, and this status can be caused by FINRA's action—for example, as described below, when a firm or individual fails to pay an award—or the firm's or individual's own voluntary action. As described below, FINRA is constrained in its ability to help enforce collection of an unpaid award against an inactive firm or individual. Some firms or individuals may remain active notwithstanding an unpaid award because they have a defense to non-payment, such as bankruptcy.[28]

A. Requirement to Pay and Restrictions for Failure to Pay

Under FINRA's Customer Code, unless a respondent has a defense to non-payment, a respondent must pay a monetary award within 30 days of receipt.[29] In order to incentivize member firms or associated persons to pay customer awards, and restrict those who do not, FINRA suspends from the brokerage industry any member firm or associated person who fails to pay an arbitration award. If a member firm or associated person fails to comply with an arbitration award or a settlement agreement related to an arbitration, FINRA staff notifies such firm or associated person in writing that the failure to comply within 21 days of service of the notice will result in a suspension of membership or a suspension from associating with any member.[30]

Unless a firm or associated person has a valid defense to non-payment,[31] the threat of suspension directed at active firms and associated persons can be an effective tool to compel payment of an award or settlement.[32]

FINRA Suspension for Non-Payment of Customer Arbitration Awards



In 2016, FINRA instituted expedited suspension proceedings against 20 active firms or associated persons in connection with 15 customer awards; 15 firms and associated persons paid the award or reached a post-award settlement.[33]

In each suspension action, FINRA creates a record that the firm or associated person failed to demonstrate payment of an arbitration award, and prevents the firm and associated person from being an active FINRA member or associating with a FINRA member until the award has been satisfied. Firms with unpaid awards cannot re-register without satisfying the award.[34] Individuals cannot register as representatives of any brokerage firm without paying or discharging the outstanding award.

In considering potential approaches to enhance customer recovery, it is important to note that the restrictions described above are limited to FINRA member broker-dealers and associated persons. For example, unlike FINRA member broker-dealers and associated persons, SEC-registered investment advisers are not subject to similar disciplinary sanctions or suspension from the investment adviser industry if they do not timely pay arbitration awards assessed against them.[35] If an associated person of a FINRA member is suspended due to the failure to pay a FINRA arbitration award, FINRA is not aware of any federal provisions that would prevent that individual from entering or continuing in another area of the financial services industry, including acting as an investment adviser.[36]

B. Expanded Options Where Respondents Are Unlikely to be Able to Pay

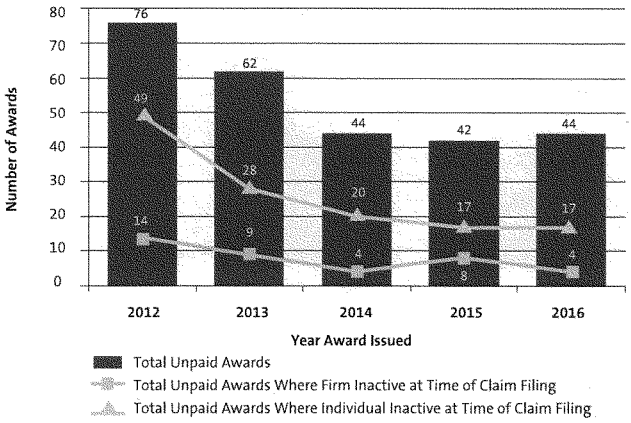
As noted above, most unpaid customer arbitration awards are rendered against member firms or associated persons who are inactive. Inactive respondents are less likely to be able to pay an award, and FINRA is constrained in its ability to help enforce collection. FINRA therefore has adopted other rules and procedures that expand the options available to a customer when dealing with such respondents.

When a customer claimant first files an arbitration claim, FINRA staff alerts the customer if the respondent firm or broker is inactive. FINRA also informs the customer that awards against such firms or brokers have a much higher incidence of non-payment and that FINRA has limited disciplinary authority over inactive firms or associated persons that fail to pay arbitration awards. Thus, the customer knows before pursuing the claim in arbitration that collection of an award may be more difficult. In addition, upon learning that the respondent firm or associated person is inactive, a customer may determine to amend his or her claim to add other respondents from whom the customer may be able to collect should the claim go to award.

A customer is not required to use an arbitration forum when bringing a claim against a firm that is inactive.[37] In these circumstances, the customer is able to evaluate the likelihood of collecting on an award and make an informed decision whether to proceed in arbitration, to file the claim in court, or to amend his or her claim, regardless of whether the customer signed a predispute arbitration agreement.[38] Accordingly, claims against inactive firms proceed in arbitration only at the customer's option.

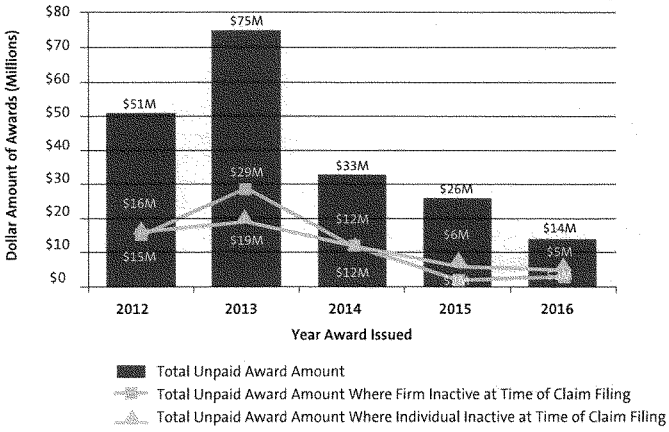
In FINRA's experience, however, customer claimants who have been notified that the respondent is inactive almost always decide to pursue arbitration claims, which can result in unpaid awards.[39] For example, in 2016, four of the 44 unpaid customer arbitration awards were in cases where the firm was inactive at the time the claim was filed (comprising $3 million of $14 million unpaid that year); 17 of the 44 unpaid customer arbitration awards involved individuals who were no longer associated with a FINRA member at the time the claim was filed (comprising $5 million of the $14 million unpaid that year).[40] Similar shares of unpaid awards have been attributable to inactive firms and individuals in recent years (*see* graphs). As discussed above, it is important to note that respondent firms and individuals can also become inactive during an arbitration proceeding as well as post-award.

Number of Unpaid Customer Arbitration Awards with Inactive Respondents at Time of Claim Filing by Year*



* Because both a firm and an individual who was associated with the firm may be inactive at the time a claim is brought, figures for firms and individuals may overlap.

Dollar Amount of Unpaid Customer Arbitration Awards with Inactive Respondents at Time of Claim Filing by Year*



* Because both a firm and an individual who was associated with the firm may be inactive at the time a claim is brought, figures for firms and individuals may overlap.

FINRA rules provide streamlined default proceedings for customers where an inactive firm or associated person does not answer or appear.[41] These proceedings are designed to make it easier, faster, and less expensive for customers to obtain an award against an inactive firm or associated person that can be enforced in court. This step is particularly important because inactive firms and associated persons are not necessarily insolvent, and an award is an important precondition for the customer to obtain redress even where FINRA no longer has jurisdiction.

Firms and associated persons may also be less likely—or simply unable—to pay an award because they have entered bankruptcy.[42] Such firms and individuals may still be active and remain registered with FINRA. However, federal law generally prohibits FINRA from using any measures to help enforce collection of the award against a firm or individual that has entered bankruptcy.[43]

C. Additional Proposals Under Consideration

The measures described above have helped customers obtain more timely judgments against firms and associated persons, but do not always enable customers to collect awards. Ultimately, it can be difficult for customers to collect from firms or associated persons that are inactive or insolvent, or both, whether the customer has an arbitration award or a court judgment.

Accordingly, FINRA has considered other approaches it can take to further incentivize the payment of customer arbitration awards and expand options for customers where respondents are unlikely to be able to pay. Currently pending proposals include:

- **Giving investors additional options where respondents are unlikely to pay.** In October 2017, FINRA issued a *Regulatory Notice* seeking comment on proposed amendments to the Customer Code that would permit a customer to withdraw an arbitration claim against an inactive associated person, and file in court, despite the existence of a predispute arbitration agreement.[44] The proposed amendments would treat claims against inactive associated persons the same in this respect as claims against inactive firms, as described above. The comment period expired on December 18, 2017. FINRA is currently in the process of reviewing the comment letters.
- **Giving investors more information about unpaid awards.** In May 2017, the FINRA Board approved proposed amendments to Form U4 to elicit information from registered representatives that do not pay arbitration awards, settlements, and judgments in full and in accordance with their terms. The proposed amendments to Form U4 would alert investors to associated persons who have failed to pay customer arbitration awards, settlements, and judgments and, therefore, help them make more informed decisions regarding where to invest.[45] The development of the uniform registration forms is conducted jointly between FINRA and the North American Securities Administrators Association (NASAA). FINRA is currently in discussions with NASAA regarding the proposed amendments to Form U4.
- **Enhancing the safeguards to prevent evasion of a payment obligation.** Today, FINRA also issued a *Regulatory Notice* seeking comment on proposed amendments to create further incentives for the timely payment of awards by preventing an individual from switching firms, or a firm from using asset transfers or similar transactions, to avoid payment of arbitration awards while staying in business. The amendments would address situations where: (1) a FINRA member firm hires individuals with pending arbitration claims, where there are concerns about the payment of those claims should they go to award or result in a settlement, and the supervision of those individuals; and (2) a member firm with substantial arbitration claims seeks to avoid payment of the claims should they go to award or result in a settlement by shifting its assets, which are typically customer accounts, or its managers and owners, to another firm and closing down. The comment period expires on April 9, 2018.

IV. Other Approaches to Further Address Customer Recovery

In pursuing these measures, FINRA has identified other approaches that could be taken to further address the issue of unpaid customer arbitration awards, but that would require SEC rulemaking or federal legislation, or present policy issues that should be considered by the SEC or Congress. FINRA recognizes that each of these approaches involves important tradeoffs and policy choices that would require further consideration and analysis by relevant regulators and policymakers before being implemented.

Other Approaches to Further Address Customer Recovery of Unpaid Arbitration Awards			
	Requires Federal Legislation	Requires SEC Rulemaking	Requires SEC Approval of FINRA Rulemaking
Require Firms to Raise or Preserve Additional Capital		*	
Expanding SIPC Coverage	*		
Creation of Second Brokerage Industry Fund *	*	*	*
Other Insurance Options *	*	*	*
Greater Disclosure of Relevant Information on Form BD		*	
Changes to the Statutory Disqualification Definition	*		
Bankruptcy Code Changes	*		

* Implementation of these approaches may require federal legislation, SEC rulemaking, SEC approval of a FINRA-proposed rule change, or some combination of the foregoing.

The primary approaches FINRA has considered can be divided into two categories: (1) those that would enhance resources available to pay awards; and (2) those that would create further incentives to pay awards. The approaches are summarized below.

A. Approaches That Would Enhance Resources to Pay Awards

1. Require Firms to Raise or Preserve Additional Capital

One potential approach that would help ensure that firms have the resources to pay arbitration awards is to raise firms' net capital requirements when they are facing arbitration claims. Among the alternatives for accomplishing this goal are: (1) requiring earlier recognition of potential awards in determining net worth for purposes of net capital calculations; (2) changing the net capital requirements to limit withdrawal of capital when open arbitrations are material; and (3) otherwise changing net capital requirements to reflect arbitration claims. Another alternative is to raise firms' net capital requirements in general, regardless of whether a firm is facing arbitration claims.

Most introducing brokers have a relatively small minimum net capital requirement ($5,000) because they do not maintain custody of client assets. Although these firms are generally required to also keep capital to cover six and two thirds percent of their aggregate indebtedness (including contingent liabilities like litigation and arbitration claims),[46] the firms are not required to have assets that fully cover litigation or arbitration claims until they are included on the balance sheet. Under the current rules, these items generally are not included on the balance sheet until the matter is resolved and the actual liability is required to be recorded, often in much greater amount than the firm can absorb through the capital it has available at that time.

Broker-dealer capital requirements have long been set by the SEC, and any of these changes would require amendments to or interpretations of the SEC's net capital rules and would present important implementation issues that would need to be considered. In particular, raising net capital requirements would require careful consideration of the potential impact on smaller firms.

2. Expanded SIPC Coverage/Second Brokerage Industry Fund/Insurance

Other approaches to enhancing the resources available to pay awards would provide customers with some level of compensation for unpaid arbitration awards. Implementation of these approaches may require federal legislation, SEC rulemaking, SEC approval of a FINRA proposed rule change, or some combination of the foregoing.

- **Expanding SIPC Coverage.** One such approach that has been suggested would be to expand the existing SIPC coverage to include unpaid customer arbitration awards. Congress created SIPC to protect customers' claims for securities entrusted to failed broker-dealers (or for cash entrusted to them in connection with transactions in securities). SIPC has a $2.5 billion fund raised through assessments on its members,[47] which it uses to provide each customer of a SIPC member with $500,000 of protection[48] against the possibility that the SIPC member will fail and be unable to return its customers' cash and securities. SIPC does not protect customers against losses relating to poor investment recommendations, misrepresentations in the sale of securities, market manipulation, or many other types of fraud, nor does it guarantee payment of arbitration awards relating to such losses; SIPC only protects claims for the return of securities or cash entrusted to a failed broker-dealer (*e.g.*, claims for theft of such securities or funds or conversion of them through unauthorized trading). Expanding SIPC coverage to unpaid arbitration awards would require federal legislation and would raise a number of policy issues to consider.[49]
- **Creation of Second Brokerage Industry Fund.** Another approach would be to create a second brokerage industry fund, separate from SIPC, to cover unpaid customer arbitration awards. This second fund could be established by Congress through legislation, by SEC or FINRA rulemaking (where any FINRA rules would require SEC approval), or a combination of the foregoing. It could be funded by assessments of brokerage industry participants directly, indirectly through a FINRA funding mechanism, or in some other manner.[50] The creation of such a fund would raise many of the same questions as an expansion of the SIPC regime, as well as some additional issues.[51] FINRA believes that Congress or the SEC should be involved in any decision to create a second brokerage industry fund for unpaid arbitration awards, especially to the extent it would cover claims that Congress has determined should not be covered by SIPC.[52]
- **Other Insurance Options.** Another approach would involve requiring firms to carry insurance to cover unpaid customer arbitration awards. An insurance solution could be in the form of commercial insurance products or a captive insurance program. This approach raises many of the same questions as expanding SIPC coverage or creating a second brokerage industry fund.

B. Approaches That Would Create Further Incentives to Pay Awards

1. Greater Disclosure of Relevant Information on Form BD

Similar to the proposed individual disclosures on Form U4 discussed in Section III.C. above, the SEC could amend its Form BD to elicit information from member firms that do not pay arbitration awards, settlements, and judgments in full and in accordance with their terms. This approach would provide customers with additional information about member firms with unpaid customer arbitration awards, settlements, and judgments.[53]

2. Changes to the "Statutory Disqualification" Definition

A potential approach to incentivize firms and associated persons to pay arbitration awards would be to expand the "statutory disqualification" definition under Exchange Act Section 3(a)(39) to include more instances in which a member firm[54] or associated person fails to pay an arbitration award.[55] Such an amendment to the definition of a "statutory disqualification" could include: (1) firms and individuals that fail to pay an arbitration award, whether or not it is dischargeable or has been discharged in bankruptcy; and (2) a control person that previously controlled a firm whose membership was suspended for failure to comply with an arbitration award. This amendment would better enable FINRA to use one of its strongest tools—denial of registration or membership—to further incentivize payment of awards by a broader group of parties.[56] Such an amendment might also further incentivize payment because of the potential consequences of a statutory disqualification for the firm or individual in other areas of the securities industry. Amending the statutory disqualification definition would require federal legislation to implement, including potentially changes to the Bankruptcy Code, as discussed below.

3. Bankruptcy Code Changes

Another potential approach to incentivize member firms and associated persons to pay arbitration awards would be to change the Bankruptcy Code such that, among other things, arbitration awards cannot be discharged in bankruptcy. Currently, member firms and associated persons can avoid payment of arbitration awards by filing for bankruptcy protection. Under the Bankruptcy Code, arbitration awards are generally treated as unsecured civil debts that are subject to discharge.[57] Such amendments would help prevent individuals and firms from filing for bankruptcy to avoid arbitration, confirmation of an award, or liability for a confirmed award. In addition, similar to statutory disqualification, they would allow FINRA to use the prospect of revoking registration or preventing an individual from re-registering with a firm to incentivize payment. These measures would not guarantee that a customer will be paid, only that the customer's rights to enforce a judgment cannot be extinguished by a bankruptcy. In addition, any consideration of such amendments would need to take into account important potential policy implications of not allowing insolvent individuals to discharge awards against them.

IV. Conclusion

FINRA operates a fair and efficient arbitration program under the supervision of the SEC and in accordance with rules approved by the SEC. FINRA has long been concerned, however, about circumstances in which a customer receives an arbitration award against a firm or individual but is not paid. This result happens not because the customer's claim was brought in the FINRA forum—indeed, by confirming the award in court the customer is in the same position as if the customer had brought the claim in court—but rather because of the respondent's inability or unwillingness to pay. FINRA has taken a number of steps to address the issue of unpaid awards to date, including by suspending member firms or individuals who do not pay their awards from the industry, and FINRA is continuing to pursue a number of proposals to further address this issue within the scope of its jurisdiction.

FINRA also believes, however, that it is important to engage in a broader discussion with other regulators and policy makers, as well as other stakeholders in the issue, about customer recovery more generally. For example, a number of additional steps to address unpaid awards that are identified above would require action by, or raise issues that should be considered by, the SEC or Congress. Many of these steps could also raise questions of their impact on, or application to, other segments of the financial services industry outside of FINRA's jurisdiction. In addition, as noted above, the treatment of unpaid arbitration awards in the FINRA forum can have customer protection implications for other regulatory regimes—such as when FINRA suspends an individual for failing to pay an award, and that individual continues to operate as an investment adviser or in another area of the financial services industry.

Moreover, the problem of customers not being able to collect on an arbitration award or judgment is not unique to the brokerage industry, and it would be useful to consider in a more holistic manner the different dispute resolution systems and related regulatory frameworks applicable to different areas of the financial services industry. Fully addressing the issue of customer recovery requires an approach that takes into account the different channels through which customers receive financial services and prevents regulatory arbitrage between them.

By issuing this Paper and releasing additional data on unpaid awards in the FINRA forum, FINRA hopes to advance the broader dialogue on customer recovery as well as inform the continued enhancement of its own forum. As a next step, FINRA plans to organize discussions with other regulators and policy makers to further address this topic, identify additional data or analysis that may help inform effective decision-making in this area, and consider potential courses of action.

Endnotes

1. While FINRA's arbitration forum is used for both intra-industry and customer disputes, this Paper focuses on customer disputes.

2. *See* Comments of Comm'r Luis A. Aguilar, *Outmanned and Outgunned: Fighting on Behalf of Investors Despite Efforts to Weaken Investor Protections*, Annual NASAA/SEC 19(d) Conference, Washington, D.C., April 16, 2013, *available at https://www.sec.gov/News/Speech/Detail/Speech/1365171515400* (noting that mandatory predispute arbitration provisions are "now popping-up in the investment advisory industry"); *see also* Mass. Sec. Div. Staff, *Report on Massachusetts Investment Advisers' Use of Mandatory Pre-Dispute Arbitration Clauses in Investment Advisory Contracts*, at 2, February 11, 2013 (indicating prevalence in use of mandatory predispute arbitration clauses among investment advisers registered in that state), *available at http://www.sec.state.ma.us/sct/sctarbitration/Report%20on%20MA%20iAs'%20Use%20of%20MPDACs.pdf.* There are no specific regulatory requirements governing the use of predispute arbitration agreements by investment advisers.

3. In FINRA's experience, the vast majority of settlements result in monetary relief for the customer claimant.

4. These percentages are based on customer cases closed between 2012-2016. All data provided in this Paper are current as of its publication date, and may change due to subsequent developments.

5. If the parties agree to a post-award settlement, FINRA does not track if the award has not been paid unless a party informs FINRA. Accordingly, FINRA treats such awards as paid in full, unless a party to the award notifies FINRA that a payment has been missed or an award has not been paid in full. If FINRA is later notified that the parties have not complied with a payment plan or post-award settlement, FINRA commences expedited suspension proceedings under FINRA Rule 9554 and will update the unpaid awards data to reflect the full amount of the award as an unpaid award.

6. There is no explicit requirement on Form ADV for SEC-registered advisers to disclose arbitration awards. The SEC has stated, however, that disclosure regarding arbitration awards may be required if the investment adviser considers it to be material information. Form ADV requires disclosure of all material facts by a state-registered adviser if the adviser, a management person or a supervised person has been involved in an award or otherwise found liable in an arbitration claim alleging damages in excess of $2,500 involving any of the following: (a) an investment or an investment-related business or activity; (b) fraud, false statement(s), or omissions; (c) theft, embezzlement, or other wrongful taking of property; (d) bribery, forgery, counterfeiting, or extortion; or (e) dishonest, unfair, or unethical practices. *See* Form ADV, Part 2A, Item 19 and Part 2B, Item 7, *available at https://www.sec.gov/about/forms/formadv-part2.pdf. See also* Form ADV Part 1B, Item 2E (requiring disclosure by state-registered advisers if the adviser, an advisory affiliate, or a management person is currently or has been the subject of an arbitration claim alleging damages in excess of $2,500, involving any of the following: (a) any investment or an investment-related business or activity; (b) fraud, false statement(s), or omissions; (c) theft, embezzlement, or other wrongful taking of property; (d) bribery, forgery, counterfeiting, or extortion; or (e) dishonest, unfair, or unethical practices), *available at http://www.nasaa.org/wp-content/uploads/2012/10/Form-ADV-Part-1B.pdf.*

   FINRA member firms use the Uniform Application for Securities Industry Registration or Transfer (Form U4) to register their representatives with the appropriate SROs and jurisdictions by filing the form in the Central Registration Depository (CRD®) system. Most of the information that is reported to the CRD system via Form U4 is made publicly available through BrokerCheck®. Among other things, Form U4 elicits information from a registered representative about any investment-related, consumer-initiated arbitration or civil litigation in which he or she was named as a respondent and which alleged that the representative was involved in one or more sales practice violations, and which: (a) is still pending; (b) resulted in an arbitration award or civil judgment, regardless of amount; (c) was settled, prior to 05/18/2009, for an amount of $10,000 or more; or (d) was settled, on or after 05/18/2009, for an amount of $15,000 or more. *See* Question 14I(1) of Form U4 available at *https://www.finra.org/file/form-u4*. In addition, Form U4 elicits information from registered representatives that have been the subject of an investment-related, consumer initiated arbitration claim or civil litigation which alleged that the representative was involved in one or more sales practice violations, and which: (a) was settled for $15,000 or more; or (b) resulted in an arbitration award or civil judgment against any named respondents regardless of the amount. *See* Question 14I(4) of Form U4. Finally, Form U4 elicits information from registered representatives who within the past 24 months have been the subject of an investment-related, consumer-initiated arbitration claim or civil litigation not otherwise reported on Form U4, which: (a) alleged that the representative was involved in one or more sales practice violations and contained a claim for compensatory damages of $5,000 or more; or (b) alleged that the representative was involved in forgery, theft, misappropriation or conversion of funds or securities. In addition, Form U4 requires the reporting of the total amount of the settlement, award or monetary judgment, and the amount for which the registered representative is responsible. As discussed below, in May 2017, the FINRA Board of Governors (Board) approved proposed amendments to Form U4 to elicit information from registered representatives that do not pay arbitration awards, settlements, and judgments in full and in accordance with their terms.

7. *See* Exchange Act Release No. 13470 (April 26, 1977), 42 FR 23892 (May 11, 1977).

8. Today, FINRA provides dispute resolution services for several exchanges pursuant to Regulatory Services Agreements. *See http://www.finra.org/arbitration-and-mediation/other-exchanges-using-finras-forum.*

9. The SEC has not directed the establishment of an arbitration forum for customers of investment advisers, and customers of investment advisers do not have the right to require their advisers to resolve disputes in an SEC-regulated forum. *See also infra* note 21.

10. During the past 10 years alone, FINRA's arbitration forum has helped resolve over 46,000 intra-industry and customer disputes through arbitration. Of these, approximately 14,000 involved intra-industry disputes and 32,000 involved customer disputes. Information regarding FINRA's arbitration program is *available at http://www.finra.org/arbitration-and-mediation.*

11. Prior to filing a proposed rule change with the SEC, FINRA typically seeks public comment on the rule proposal through issuance of the proposal and a request for comment in a *Regulatory Notice*. Thus, there is an opportunity for public comment on a FINRA rule proposal prior to filing of the proposal with the SEC and another opportunity for comment once the SEC publishes the proposal in the *Federal Register*. Certain limited types of proposed rule changes take effect upon filing with the SEC.

12. Most recently, FINRA formed a Dispute Resolution Task Force in 2014 to suggest strategies to enhance the transparency, impartiality, and efficiency of FINRA's securities dispute resolution forum for all participants. *See Final Report and Recommendations of the FINRA Dispute Resolution Task Force*, December 2015, *available at http://www.finra.org/sites/default/files/Final-DR-task-force-report.pdf*. The Task Force brought together a diverse group of leading investor advocates, academics, regulators, and industry representatives to help ensure that FINRA arbitration and mediation processes continue to serve the needs of the investing public. The Task Force worked independently, setting its own agendas and topics for consideration, and proactively solicited input from a wide range of interested persons and organizations. Among other things, the Task Force reviewed FINRA's actions against broker-dealers or associated persons who do not pay awards, and discussed whether to recommend that FINRA reconsider an insurance requirement for payment of awards, but reached no consensus. FINRA has taken action on 45 of the 51 recommendations that were ultimately made in the Task Force's report; six are pending. FINRA periodically provides public updates on its progress in addressing the Task Force recommendations. *See Status Report on FINRA Dispute Resolution Task Force Recommendations*, February 2017, *available at http://www.finra.org/sites/default/files/DR_task_report_status_020817.pdf*.

    For other examples of periodic reviews of the arbitration forum, *see, e.g., NASD Dispute Resolution, The Arbitration Policy Task Force Report – A Report Card*, July 27, 2007, *available at http://www.finra.org/sites/default/files/Industry/p036466.pdf*; and *Securities Arbitration Reform: Report of the Arbitration Policy Task Force to the Board of Governors National Association of Securities Dealers, Inc.*, 1996.

13. *See http://www.finra.org/arbitration-and-mediation/diversity-and-finra-arbitrator-recruitment*.

14. *See http://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics*.

15. *See http://www.finra.org/arbitration-and-mediation/arbitration-awards*.

16. From 1953 to 1987, the arbitration of federal securities law claims was strictly voluntary, and the courts would not enforce predispute arbitration agreements relating to such claims. In addition, Rule 15c2-2(a) under the Exchange Act provided that: "It shall be a fraudulent, manipulative or deceptive act or practice for a broker or dealer to enter into an agreement with any public customer which purports to bind the customer to the arbitration of future disputes between them arising under the federal securities laws, or to have in effect such an agreement, pursuant to which it effects transactions with or for a customer." The SEC noted that it adopted Rule 15c2-2 "[b]ecause years of informal discussions have failed to correct" the practice of agreements to arbitrate future disputes between broker-dealers and their public customers arising under the federal securities laws. *See* Exchange Act Release No. 20397 (November 18, 1983), 48 FR 53404 (November 28, 1983).

    In 1987, the Supreme Court held that predispute arbitration agreements are enforceable as to claims brought under the Exchange Act, and Rule 15c2-2(a) was rescinded. *Wilko v. Swan*, 346 U.S. 427 (1953), overruled by *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987); Exchange Act Release No. 25034 (October 15, 1987), 52 FR 39216 (October 21, 1987) (Rescission of Rule Governing Use of Predispute Arbitration Clauses in Broker-Dealer Customer Agreements). As a result, firms can today compel arbitration of customer claims through inclusion of predispute arbitration provisions in their agreements with customers.

    The SEC is authorized by Section 921 of the Dodd-Frank Consumer Reform and Wall Street Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), to limit or prohibit the use of agreements to arbitrate future disputes if it finds that such limitation or prohibition is in the public interest and for the protection of investors.

17. To help ensure that customers understand these predispute arbitration agreements, FINRA Rule 2268 sets forth requirements that apply when firms use them. These requirements include that any predispute arbitration clause must be highlighted in the agreement and immediately preceded by disclosures that the agreement contains such a clause and that describe the consequences of agreeing to arbitration.

18. *See* FINRA Rule 12200 of the Code of Arbitration Procedure for Customer Disputes ("Customer Code").

19. *See* FINRA Rules 2268 and 12204.

20. The top controversy types in customer arbitrations include breach of fiduciary duty, negligence, misrepresentation, failure to supervise, suitability, omission of facts, and fraud. *See https://www.finra.org/arbitration-and-mediation/dispute-resolution-statistics#top15controversycustomers*. A single arbitration case may include multiple controversy types.

21. In June 2000, the United States Government Accountability Office (GAO) issued a report expressing concern about unpaid arbitration awards. *See* GAO Report to Congressional Requesters, *Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards*, June 2000, *available at https://www.gao.gov/assets/160/156962.pdf*. The GAO recommended that the Chairman of the SEC: (1) require FINRA to adopt procedures for monitoring the payment of arbitration awards, including requesting the parties in an arbitration to notify FINRA by the end of the 30-day payment period about the payment status of any monetary award, so that FINRA can begin timely suspension proceedings against non-paying broker-dealers; (2) require FINRA to develop procedures to address the problem of unpaid awards caused by failed broker-dealers to help reduce costs and increase options for investors; (3) work with SROs to develop and publicize information to focus investor attention on the possibility of unpaid awards and encourage investors to more thoroughly evaluate the backgrounds of broker-dealers and individual brokers with whom they intend to do business; and (4) examine periodically the extent of non-payment of SRO arbitration awards to determine the effectiveness of action taken to improve the payment of awards. In addition, the GAO recommended that to the extent unpaid awards remain a problem, the Chairman should establish a process to assess the feasibility of alternative approaches to addressing the problem. *See id.*, p. 9.

In September 2000, in response to the recommendations in the GAO report, the SEC requested that FINRA provide it with periodic information concerning unpaid arbitration awards. Since then, FINRA has tracked unpaid arbitration awards at the FINRA forum and submitted annual reports to the SEC.

22. The data on the website will be updated periodically and, therefore, over time may differ from the data presented in this Paper. For example, the 2016 data will be updated to reflect the outcome of two currently pending judicial motions to vacate awards totaling $1.4 million. *See infra* note 23.

23. Under FINRA's Customer Code, FINRA arbitration awards are considered final and not subject to review or appeal through FINRA. However, parties have the right under federal and state law to challenge the award by filing a motion to vacate the arbitration award in a court of competent jurisdiction. The grounds for vacating an arbitration award are extremely limited, and motions to vacate are rarely successful. If a motion to vacate is successful, the underlying award is invalidated and there is no payment obligation. If a motion to vacate is denied, the award stands and the payment obligation is revived. While a motion to vacate is pending, the award payment obligation is stayed and the award is therefore not classified as unpaid. The figures provided for 2016 do not include awards in two customer cases totaling $1.4 million because there are pending judicial motions to vacate those awards.

24. During 2012 – 2016, there were five "mid-size" firms (as defined by FINRA By-Laws) with unpaid customer arbitration awards. *See* Article I of the FINRA By-Laws (defining a "mid-size" firm to mean any member firm with at least 151 and no more than 499 registered persons).

25. *See* FINRA Rule 12603.

26. *See* FINRA Rule 12801. The arbitrator may not issue an award based solely on the nonappearance of a party. Claimants must present a sufficient basis to support the making of an award. The arbitrator may not award damages in an amount greater than the damages requested in the statement of claim, and may not award any other relief that was not requested in the statement of claim. *See id.*

27. FINRA has not been able to obtain data about court awards to determine how the payment levels for awards at the FINRA arbitration forum compare to the payment levels for awards received in court proceedings in general.

28. *See infra* note 29.

29. *See* FINRA Rule 12904(j). An associated person or firm has four available defenses to FINRA disciplinary measures for non-payment in customer cases: (1) the firm or associated person paid the award in full; (2) the parties have agreed to installment payments or have otherwise settled the matter; (3) the firm or associated person has filed a timely motion to vacate or modify the award and such motion has not been denied; and (4) the firm or associated person has filed a petition in bankruptcy and the bankruptcy proceeding is pending or the award has been discharged by the bankruptcy court. *See Notice to Members 00-55* (August 2000).

    In July 2010, FINRA eliminated the "bona fide inability to pay" defense in the expedited suspension proceedings it initiates when a firm or associated person fails to pay an arbitration award to a customer. *See Regulatory Notice 10-31* (June 2010). Until this change became effective, if a respondent demonstrated a financial inability to pay the award—regardless of the reason—FINRA was limited in its ability to use a potential suspension of membership to incentivize payment. When FINRA's efforts to suspend a respondent who had not paid an award were not successful, a claimant was much less likely to be paid.

30. *See* FINRA Rule 9554(a).

31. *See supra* note 29.

32. FINRA can also institute expedited suspension proceedings against formerly associated persons for failing to pay an award or settlement for a period of two years after the award was rendered or the settlement agreement was entered into. *See* Article V, Section 4(b) of the FINRA By-Laws; *Notice to Members 04-57* (August 2004). During 2016, FINRA instituted expedited suspension proceedings against 46 formerly associated persons in connection with 32 customer awards. As a result, five individuals paid the award or reached a post-award settlement with the customer, and 37 individuals were suspended for non-payment. FINRA was unable to locate four individuals. Some awards cases involved several formerly associated persons, resulting in more suspensions than number of awards.

33. As a result of the expedited suspension proceedings, eight firms paid the award or reached a post-award settlement with the customer and seven individuals paid the award or reached a post-award settlement with the customer. One firm was suspended and four individuals filed for bankruptcy.

34. With respect to new member firms, in accordance with the standards for admission under the rules governing FINRA's Membership Application Program, FINRA can presumptively deny a new membership application if the applicant or its associated persons are subject to an unpaid arbitration award. *See* NASD Rule 1014(a).

35. *See* SEC, Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, at 134, January 2011, *available at https://www.sec.gov/news/studies/2011/913studyfinal.pdf* ("FINRA may suspend or cancel the membership of any member, or suspend any associated or formerly associated person from association with any member, for failure to comply with an arbitration award or with a written and executed settlement agreement obtained in connection with an arbitration or mediation. Investment advisers are not subject to such sanctions, and legislation might be required for the Commission to impose them.")

36. Some associated persons who failed to pay arbitration awards in 2015 and 2016, for example, were suspended from being associated with a FINRA member, but continue to be registered as investment advisers.

37. *See* FINRA Rule 12202. Typically, the inactive firm will not appear, resulting in the arbitrators basing their ruling on the customer's presentation of the conduct and harm.

38. If the customer notifies FINRA in writing that he or she does not want to proceed against the inactive firm in FINRA's forum, the staff deems the customer's agreement to submit to arbitration rescinded and sends the customer a full refund of any filing fee remitted.

39. Claimants' counsel has indicated to FINRA staff that they continue to pursue claims against inactive firms and associated persons due to the possibility of collection from various parties, sources, and entities not named in the arbitration case, including: (1) bankruptcy trustees; (2) commercial insurance policies; (3) successor firms; (4) fidelity bonds; and (5) control persons.

40. Because both a firm and an individual who was associated with the firm may be inactive at the time a claim is brought, figures for firms and individuals may overlap.

41. *See* FINRA Rule 12801.

42. If a firm or individual files for bankruptcy after a claim is filed, but before an award is rendered, the arbitration proceeding will be stayed as to that firm or individual. If a firm or individual files for bankruptcy prior to a claim being filed, there would not be an arbitration proceeding involving that firm or individual.

43. The "automatic stay" under the Bankruptcy Code generally stays any action to collect a debt owed by a person that has filed a bankruptcy petition (or become the subject of a liquidation under the Securities Investor Protection Act (SIPA)). However, in the unusual circumstance where a bankruptcy court determines an arbitration award not to be dischargeable in the bankruptcy (or SIPA liquidation), and the customer claimant notifies FINRA of this fact, FINRA will commence expedited suspension proceedings against the firm or individual under FINRA Rule 9554.

    Creditors with claims allowed by the bankruptcy court generally are entitled to receive distributions or payments on their claims from the liquidation of the bankrupt person's assets (or under a plan approved by the court in the case of a bankruptcy under Chapter 11 or 13 of the Bankruptcy Code). Although these payments may be considerably less than the amount of the claim (and may even be zero), they nevertheless generally discharge the claim. Customers with arbitration awards against a firm or associated person that has entered bankruptcy therefore may receive only a fraction of their award, or even nothing, when that award is discharged in bankruptcy.

    While SIPC protects customers' claims for funds and securities entrusted to their broker even if the broker is in bankruptcy, SIPC does not protect customers' unpaid arbitration awards unless they are for the return of such funds or securities (*e.g.*, claims for theft of such funds or securities or claims arising out of unauthorized trading).

44. *See Regulatory Notice 17-33* (October 2017).

45. As discussed above, FINRA suspends individuals for non-payment of a customer arbitration award. Among other things, the proposed amendments could provide disclosure where an individual has a defense to non-payment, such as bankruptcy, or where an individual does not have a defense to non-payment, but has not yet been suspended by FINRA. In addition, making this information publicly available could lead to a decrease in unpaid customer arbitration awards as customers may determine not to invest with firms whose associated persons have these disclosures.

46. An introducing firm may also opt out of the requirement to hold capital equal to six and two thirds percent of its aggregate indebtedness by increasing its minimum net capital to $250,000.

47. SIPC also has a $2.5 billion line of credit with the U.S. Treasury that SIPC may access if its fund is insufficient.

48. Claims with respect to cash in a customers' account are only protected up to $250,000.

49. These issues include, for example, the incentives created by, and implications of, such a regime on the behavior of customers, firms and individual brokers; whether increases in SIPC assessments payable by firms would be required; whether the existing caps on SIPC protection would be appropriate; and whether it is appropriate for certain firms (*e.g.*, those that are larger, better capitalized, or have stronger compliance programs) to effectively subsidize other firms that do not pay their arbitration awards.

50. If operated by FINRA, steps would also need to be taken to ensure that such a fund does not compromise FINRA's tax-exempt status.

51. These issues include, for example, the scope of claims covered by the second fund (*e.g.*, whether it would cover only awards from the FINRA forum, or also unpaid awards from non-FINRA forums, or court awards); how the claims process for such a fund would interact with the established SIPC claims process and liquidation proceedings in the case of a firm that is the subject of a SIPC liquidation (*e.g.*, would a claim first be filed in the SIPC liquidation and, only after it is allowed but deemed ineligible for SIPC protection, filed in the forum for the second fund); whether the creation of such a fund would be consistent with Congress' rationale for limiting the scope of claims eligible for SIPC protection; the appropriate caps on payouts by the second fund; whether, like SIPC, the second fund would have access to federal funding as a backstop; how to handle awards arising from uncontested arbitration claims; who would determine the validity of claims made against the fund and otherwise administer the fund; and the distribution of funding costs across the financial industry.

52. Any establishment or operation of such a fund by FINRA could also raise questions regarding FINRA's continued impartiality in operating the arbitration forum.

53. As discussed above, FINRA suspends member firms for non-payment of a customer arbitration award. Among other things, proposed amendments to Form BD could include providing disclosure where a firm has a defense to non-payment, such as bankruptcy, or where a firm does not have a defense to non-payment, but has not yet been suspended by FINRA.

54. Changes to the "statutory disqualification" definition and Bankruptcy Code (as discussed below) could also affect other financial industry professionals providing advice to customers, such as investment advisers.

55. The FINRA By-Laws provide that no person shall be admitted to or continued in membership if it becomes subject to a disqualification; and that no person shall be associated with a member, continue to be associated with a member, or transfer association to another member if such person is or becomes subject to disqualification. FINRA's authority to deny registration or membership of disqualified persons or members is set forth in Exchange Act Section 15A(g)(2). Article III, Section 4 of the FINRA By-Laws states that a person is subject to a "disqualification" with respect to membership, or association with a member, if such person is subject to any "statutory disqualification" as such term is defined in Exchange Act Section 3(a)(39).

56. As discussed in Section III.A. above, FINRA can suspend a firm's membership or suspend an individual from associating with a member if the firm or individual fails to comply with an arbitration award or a settlement agreement related to arbitration. However, bankruptcy is a defense to such non-payment. *See supra* note 29.

57. There are some limited exceptions to discharge, but most arbitration awards do not fall into these exceptions, and even if they do, the process to obtain an exception is cumbersome and expensive for a customer.

Investor protection. Market integrity.

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MANAGED FUNDS
ASSOCIATION

Written Statement of Richard H. Baker
President & Chief Executive Officer
Managed Funds Association

Before the Senate Committee on
Banking, Housing, and Urban Affairs

Legislative Proposals to Examine Corporate Governance

JUNE 28, 2018

Chairman Crapo, Ranking Member Brown, and Members of the Committee, I am Richard H. Baker, President & Chief Executive Officer of the Managed Funds Association ("**MFA**"). I am pleased to provide this statement on behalf of MFA to present our members' views on S. 1744, the "Brokaw Act," one of the legislative proposals that are the focus of today's hearing. MFA represents the majority of the world's largest hedge funds and is the primary advocate for sound business practices for hedge funds, funds of funds, managed futures funds, and service providers. MFA's members manage a substantial portion of the approximately $3 trillion invested in hedge funds around the world. Our members serve pensions, university endowments, and other institutions.

MFA's members are among the most sophisticated investors and play an important role in our financial system. They provide liquidity and price discovery to capital markets, capital to companies seeking to grow or improve their businesses, and important investment options to investors seeking to increase portfolio returns with less risk, such as pension funds trying to meet their future obligations to plan beneficiaries. As investors, MFA members help dampen market volatility by providing liquidity and pricing efficiency across many markets. Hedge fund managers are fiduciaries that invest funds on behalf of accredited and institutional investors. Our members' skills help institutions and their stakeholders plan for retirement, honor pension obligations, and fund scholarships, among other important goals.

Short selling is an important strategy used by many MFA members and other investors. Many institutional investors – such as pension funds, endowments, and foundations – use short selling as a tool to manage risk and reduce the overall economic exposure of an investment portfolio. By using short selling in a manner that hedges risk, investors are able to reduce their overall market exposure and achieve higher risk-adjusted returns.

Short selling helps markets function efficiently by increasing price efficiency, providing market liquidity, promoting capital formation, and potentially reducing economy-damaging price bubbles. Markets function best when they represent the broadest possible set of views. Short selling allows investors to say when they believe an asset is overvalued. The more efficient a market is at determining prices, the better it will function for investors. If investors think markets can only go up, the price of that stock would continue to increase, creating a bubble that eventually has to pop – putting practically every investor, and if the bubble is large enough even the overall economy, at risk. This is what happened following the speculation of the dot-com bubble during the late 1990s. When long buyers and short sellers counterbalance each other, prices are more likely to reflect the actual value of the assets.

Short selling is subject to a robust regulatory framework, primarily encapsulated in Regulation SHO, that has been effective in preventing potentially abusive short sale activity. In addition to Regulation SHO, those engaged in short selling are subject to the broad anti-fraud provisions of the federal securities laws, which provide the SEC with extensive authority to investigate and punish fraudulent conduct. MFA strongly supports punishment of those who commit fraud, which is essential to ensuring integrity, fairness,

and public confidence in our capital markets.

As part of this regulatory framework, there is also a substantial amount of aggregate information about short sales that is publicly available, and more information is readily available to regulators. This information gives regulators quick, easy access to aggregate, market-wide short sale information.

S. 1744 would require for the first time the public disclosure of individual investor short positions. We strongly believe the existing system of regulation and reporting of short selling is effective, and that public disclosure of individual investor short positions would be inconsistent with the long-standing, effective approach taken by Congress and the SEC.

Short sales are fundamentally different from long investments and accordingly are disclosed to the public on an aggregate basis, and not on an individual investor basis. A holder of a long position in a company has the right to vote in shareholder elections that influence the direction of the company. A holder of a short position in that company, however, has no voting rights. This vital distinction leads to different public reporting requirements for long positions and short positions, *i.e.*, individual investor disclosure for long positions, and aggregate disclosure for short positions, that should be maintained.

Public disclosure of individual investor short positions would harm markets by discouraging investors from utilizing short selling and consequently reducing price efficiency and market liquidity, which would make it more difficult for issuers – whether banks, corporates, or sovereigns – to raise capital. Public disclosure of individual investor short positions also would likely be misinterpreted by investors and lead to increased volatility and herding behavior to the detriment of investors and companies.

The following discussion provides a comprehensive overview of short selling and its regulatory framework, and explains in detail these likely harmful effects that would result from public disclosure of individual investor short positions. Short selling helps keep our markets liquid and efficient, which leads to healthier markets for investors and companies and in turn promotes the allocation of capital to our economy.

I appreciate the opportunity to present this statement on behalf of MFA as the Committee considers legislative proposals relating to corporate governance. MFA is committed to working with Members and staff of Congress, the Committee, and regulators to ensure the continued vibrancy of our financial markets and to strengthen our Nation's economy. MFA would be happy to answer any questions that you may have.

I. Introduction

Short selling is an important strategy used by investors, including fiduciaries managing others' assets. Market participants engage in short selling for different reasons, including to manage risk, hedge portfolios, and reflect a view that the current market price of a security is above its fair value.

The goal of this paper is to demystify short selling and explain how, through appropriate regulation, it leads to healthier markets for investors and companies.

Key Takeaways

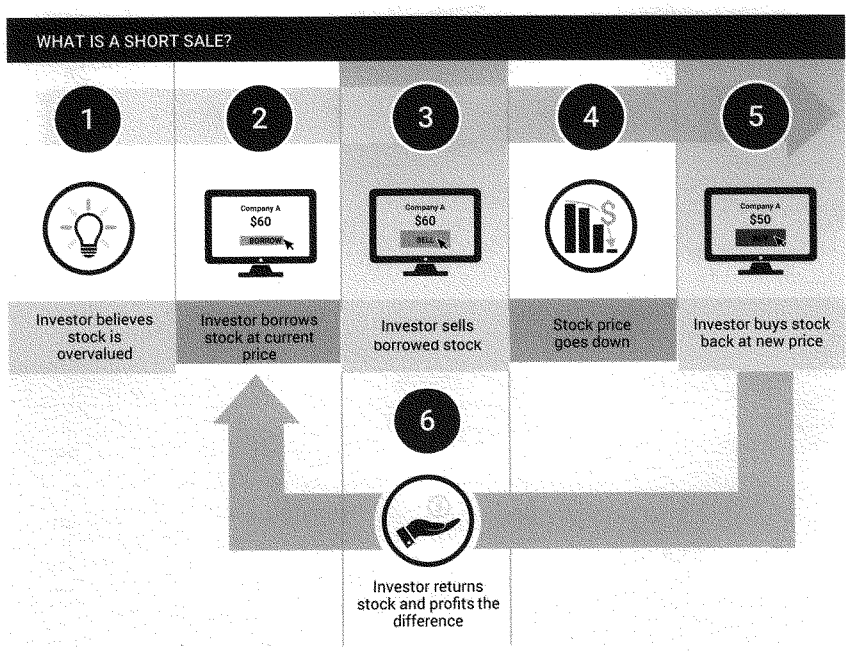
- Investors use short sales for many purposes, including to express a view that a stock is overvalued based on fundamental analysis, to hedge different types of risk in their portfolio and to reduce volatility. Market makers use short sales to facilitate investors' buying and selling stocks.
- Short sales of all types lead to significant benefits for investors, companies, and markets. They can have a stabilizing effect on the market and are not the cause of rapid price declines of stocks. Similarly, short selling does not increase volatility during periods of market stress.
- Short selling activities are federally regulated. The SEC has adopted a comprehensive set of regulations and reporting requirements designed to prevent abusive practices.
- Short sales are distinct from long investments and accordingly are disclosed to the public on an aggregate basis. Disclosure of individual investor short positions would likely lead to negative consequences for investors and companies.

II. What is a Short Sale?

In a short sale, an investor borrows a security and sells it, then later buys back the security and returns it. Typically, the short seller borrows the security from a broker-dealer or an institutional investor, such as a mutual fund, pension fund, or insurance company. The short seller ultimately closes out the short position by purchasing the security on the open market (or by using an equivalent security it already owns), and returns the security to the lender.

For example, an investor may believe that the stock price of Company A is overvalued. Company A is trading at $60 per share, so the investor borrows shares of Company A stock at $60 per share and immediately sells them in a short sale. Later, Company A's stock price declines to $50 a share, and the investor buys shares back in order to return the borrowed shares. Since the price is lower, the investor profits on the difference – $10 per share (minus transaction costs and interest paid to the lender). However, if the price of Company A's stock goes up, the investor must buy back shares at a higher price and will lose money.[1]

Short sales play an important role in our markets and are quite common. In fact, the SEC has found that short sales account for approximately 49 percent of listed equity share volume.[2]



1 See Key Points About Regulation SHO, Securities and Exchange Commission, available at: http://www.sec.gov/investor/pubs/regsho.htm.

2 See Study on Short Sale Position and Transaction Reporting, SEC Division of Economic and Risk Analysis (June 2014) ("SEC Staff Study"), available at: https://www.sec.gov/files/short-sale-position-and-transaction-reporting%2C0.pdf.

Why Are Short Sales Used?

Short sales are used to:

- **Express a view about the value of a company.** Investors engaging in fundamental research typically analyze and interpret public information to determine if they believe a stock is under or overvalued. If they believe a stock is undervalued, investors purchase the stock, while if they believe it is overvalued, they sell the stock. If investors do not own the stock they determine is overvalued, they can sell it by means of a short sale.
- **Balance investments.** An investor with a short position in a company may later take a long position in the company. An investor engaged in fundamental and extensive research is often able to determine when he/she believes a company has become undervalued and change from a short position to a long position.
- **Hedge different types of market exposures.** For example, an investor with a long position in the stock of Beverage Company A may also take a short position in the stock of Beverage Company B. The short position is designed to eliminate the risk in the long position of Beverage Company A that the beverage industry underperforms the market. It is not an indication that the investor believes Beverage Company B is overvalued.
- **Manage portfolio risk.** In the alternative, an investor could take a short position in the stock of Consumer Goods Company A (or multiple consumer goods companies) to reduce the risk in the long position of Beverage Company A that the consumer goods sector underperforms. Again, the short position does not indicate that the investor believes the companies are overvalued; rather the short position is an insurance policy against market downturn in that sector.
- **Reduce the total exposure of a long portfolio to the broader market.** By taking short positions in a basket of stocks, an index, or an ETF, short sales allow investors to minimize the general risk that markets will go up or down.
- **Reduce risk in positions in the same company.** In a convertible bond arbitrage strategy, an investor purchases convertible bonds of a company and also sells short the company's stock. A convertible bond can be converted into stock at a pre-determined time and price. In this strategy, the investor uses short sales to reduce some of the risk of holding the convertible bonds.
- **Facilitate market making.** In addition to investors, market makers also use short selling. Market makers are broker-dealers that stand ready to buy and sell stocks on a regular basis at a quoted price. Market makers sell short when filling customer orders for stocks that they do not already hold in their inventory. Market makers also use short selling to facilitate customer orders in other types of securities, such as equity-based options. Market makers have been found to account for about 35 percent of short sales.[3]

3 Id.

III. How Do Investors Borrow Securities for Short Sales?

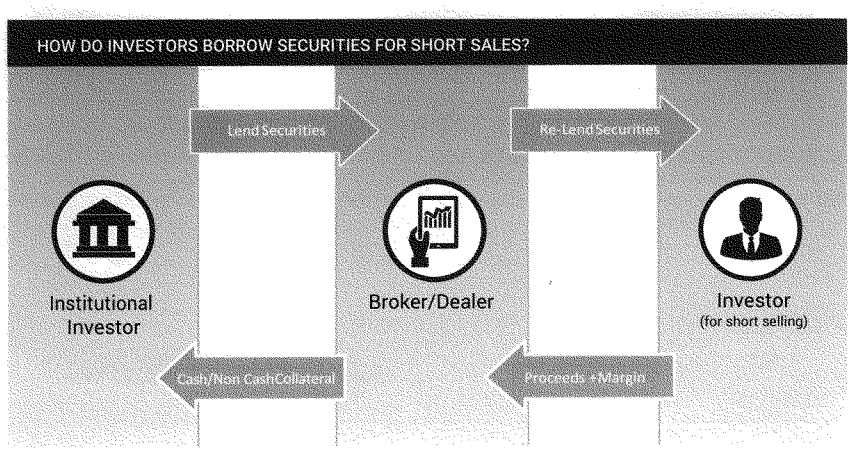
Securities lending is an important part of the short selling process. If an investor sells short and does not arrange to borrow the security, the buyer of the security would not receive the security. This is called "naked shorting" and results in a "failure to deliver" (i.e., the seller fails to deliver the security to the buyer). As explained in more detail below, SEC rules generally prohibit naked shorting.

Broker-dealers and institutional investors often lend securities in connection with short sale transactions. Typically, an institutional investor will lend securities to a broker-dealer, which will relend the securities to an investor for short selling. An institutional investor can generate significant income by lending its securities.

The short selling customer will secure its obligation to return the borrowed security to its broker-dealer lender by posting the short sale proceeds and an additional amount (called margin) with the broker-dealer. The broker-dealer borrower, in turn, secures its obligation to return the borrowed security to the institutional lender by pledging cash or non-cash collateral. Institutional lenders receiving cash collateral typically reinvest it to generate interest income.

Market conditions determine what the borrower will pay. If the security is generally available to be borrowed in the securities lending market, the institutional lender will rebate to the broker-dealer borrower a small amount based on an interest rate. If the security has limited availability to be borrowed, the broker-dealer borrower may have to pay the institutional lender a small amount (called a negative rebate). In either case, if the collateral is non-cash, the borrower will also pay the lender a loan fee.[4] When the short seller closes out the short sale, he/she purchases the security and delivers it to the lender.

The securities lending process is an effective method for investors to engage in short selling and for institutional investors to act as lenders and generate additional income for their investors. The broad range of institutional investors lending their shares for short selling is also a clear indication that these investors do not view short selling as detrimental to the price of the shares.



4 See SEC Staff Study at page 5-6.

IV. How Does Short Selling Affect Investors, Companies, & Markets?

Investors use short selling as a tool to manage risk and reduce the overall economic exposure of an investment portfolio. Many institutional investors – such as pension funds, endowments, and foundations – invest in investment vehicles that engage in short selling as a means to mitigate overall risk to their portfolios. By using short selling in a manner that hedges risk, investors are able to reduce their overall market exposure and achieve higher risk-adjusted returns.

How Short Selling Helps Investors & Promotes Healthier Markets:

- Increases Price Efficiency
- Provides Market Liquidity
- Promotes Capital Formation
- Reduces Price Bubbles

Short selling helps markets function efficiently by increasing price efficiency,[5] providing market liquidity,[6] promoting capital formation, and potentially reducing economy-damaging price bubbles. The SEC and the academic community regularly affirm these important benefits to investors, companies, and markets.[7] Below is a short description of how these benefits help investors and lead to healthier markets.

Stock Prices are More Accurate

Price efficiency is a measure of how accurately market prices reflect available information. A security's price is deemed to be efficient if it accurately reflects market participants' collective opinion of its fundamental value. An efficient price would reflect both optimistic and pessimistic investor opinions.

Transaction prices best reflect information when investors who make investment decisions on the basis of estimates of fundamental value can invest without restrictions or costs. If fundamental investors do not own the stock they determine is overvalued, they can sell it by means of a short sale. In this way, fundamental investors, such as hedge funds, some mutual funds, and others, contribute to price efficiency through the use of short selling.[8]

Markets are More Liquid & Less Volatile for Investors

Market liquidity is the ability of trades to occur in reasonably large amounts at or near the market price. A liquid security is one in which buyers and sellers can transact in reasonably large sizes with only a minimal impact on the price of the security.

Short selling promotes market liquidity through different methods. One method is through market makers who fill customer orders for securities. Short selling by market makers helps offset imbalances in the flow of buy and sell orders, when demand would otherwise exceed supply.

It is a widely held misconception that short selling increases market volatility during times of extreme market stress, leading to accelerated declines in prices. In fact, evidence shows that during a price decline, short sellers will often sell less, or close out their short positions by purchasing shares of the security, which offsets sales by long position holders.

Perhaps even more importantly, short selling supplies liquidity and reduces volatility when short sellers trade in the opposite direction of price movements. It is a widely held misconception that short selling increases

5 See, e.g., Ekkehart Boehmer & Julie Wu, Short Selling and the Informational Efficiency of Prices, (Working Paper, Aug. 16, 2010), available at: http://ssrn.com/abstract=972620.

6 See SEC Staff Study at Appendix E ("The academic literature provides ample theoretical support for, and empirical evidence of, the importance of short selling for liquidity.").

7 Id. ("Theoretical studies support the notion that short sellers promote price efficiency, finding that restrictions on short selling should lead to less accurate prices, higher volatility, and should hinder price discovery.").

8 See SEC Staff Study at page 11.

market volatility during times of extreme market stress, leading to accelerated declines in prices. In fact, evidence shows that during a price decline, short sellers will often sell less, or close out their short positions by purchasing shares of the security, which offsets sales by long position holders.[9]

During the financial crisis, for example, there were claims that short selling was responsible for significant declines in shares of financial companies. In response, the SEC in September 2008 adopted a temporary ban on short sales of financial companies. The "protected" class also included many companies beyond financials. During the temporary ban, however, the shares of these companies continued to decline and did not appear to be affected by the ban.[10]

Following the ban, SEC staff analyzed data on short selling activity during the volatile period in early September 2008 that prompted the SEC to adopt the ban. SEC staff found that the results were not consistent with the claim that episodes of extreme negative returns were caused by short selling activity. In fact, the analysis concluded that short sale volume is higher for periods of positive returns than for periods of negative returns.[11]

After the ban, then-SEC Chairman Christopher Cox indicated that the costs of the ban appeared to outweigh the benefits, and that he would have been unlikely to adopt the ban based on this information.[12]

Then-SEC Chairman Christopher Cox indicated that the costs [associated with a short selling ban] appeared to outweigh the benefits.

Capital is More Efficiently Allocated to Companies

In promoting price efficiency, short selling also improves the allocation of capital to its most productive uses, which facilitates capital formation.

When a stock is overvalued, the expected return implied by its price is too low, which leads to an artificially low cost of capital. For example, if some stocks are overvalued, too much capital is likely to be allocated to these companies. The result is that overvalued companies may fund less profitable or unprofitable projects, while profitable projects could go unfunded by companies whose stock is undervalued.

Short selling also facilitates capital formation by contributing to more liquid markets. Liquid markets promote capital formation because investors prefer to invest capital in markets with low transaction costs and in which they can quickly establish and liquidate positions.

Reduces the Risk of Market Bubbles

From a long-term perspective, stocks that are overvalued present a problem for the economy. The market will eventually correct the mispricing, but in the meantime, real resources may flow to the overvalued stock or industry. Perhaps the best example was the housing bubble that popped in 2008. Investments in mispriced real estate led to long-term disruptions in the real economy long after the bubble was corrected. Another example was the dot-com bubble, where markets corrected overvalued stocks in a relatively short period of time but firms and employees took much longer to recover.[13]

The absence of short selling in those cases could have made the situation worse. Short selling also helps reduce the risk of future market bubbles.

9 See, e.g., Daniel Aromi and Cecilia Caglio, Memorandum from SEC Office of Economic Analysis to SEC Chairman Christopher Cox on Short Selling Activity During the First Weeks of September 2008 (Dec. 16, 2008), ("SEC Memorandum") available at: http://www.sec.gov/comments/s7-08-09/s70809-369.pdf.

10 See, e.g., Robert Battalio, Hamid Mehran, and Paul Schultz, Market Declines: What Is Accomplished by Banning Short-Selling?, Federal Reserve Bank of New York, Current Issues in Economics and Finance, vol. 18, no. 5 (2012) ("The preponderance of evidence suggests that the bans did little to slow the decline in the prices of financial stocks.") ("Federal Reserve Short Selling Paper"), available at: https://www.newyorkfed.org/medialibrary/media/research/current_issues/ci18-5.pdf.

11 See SEC Memorandum ("We find that for all but one subgroup, short selling is higher during periods of extremely positive returns than in periods of extreme negative returns . . . These findings indicate that, on average, short seller's intraday activity is contrarian. On average, short sales seem to decrease intraday volatility by selling relatively more during periods of positive returns.").

12 Rachelle Younglai, Reuters, SEC Chief Has Regrets Over Short-selling Ban (Dec. 31, 2008).

13 See Federal Reserve Short Selling Paper at page 2.

V. How are Short Sales Regulated?

The SEC regulates short sales primarily through Regulation SHO, which became effective in 2005. Regulation SHO modernized short selling regulation by addressing concerns regarding persistent failures to deliver and potentially abusive naked short selling.

As noted above, in a naked short sale, the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard three-day settlement period. As a result, the seller fails to deliver securities to the buyer when delivery is due (a failure to deliver).

Failures to deliver can also occur for legitimate reasons. For example, human or mechanical errors or processing delays from transferring securities in physical certificate rather than book-entry form could cause a failure to deliver on a long sale. For short sales, market makers that sell short a thinly traded, illiquid stock in response to customer demand may have difficulty obtaining securities in time for delivery.

The SEC designed Regulation SHO to address concerns associated with failures to deliver and it has further amended Regulation SHO to strengthen its requirements and eliminate certain exceptions.

As amended, Regulation SHO imposes the following requirements on short selling:

- **Rule 200 – Marking Requirements:** Rule 200 requires that orders placed with a broker-dealer must be marked "long," "short," or "short exempt."
- **Rule 201 – Short Sale Price Test Circuit Breaker :** Rule 201 is designed to prevent short selling from driving down further the price of a security that has already experienced a significant price decline and to facilitate the ability of long sellers to sell first upon such a decline. The rule restricts the price at which short sales may be effected when a stock has triggered a circuit breaker by experiencing a price decline of at least 10 percent in one day. When the circuit breaker is in effect, a person may not execute a short sale at a price that is less than or equal to the current price. Once the circuit breaker has been triggered, the price test restriction will apply to short sale orders in that security for the remainder of the day and the following day.
- **Rule 203(b)(1) and (2) – Locate Requirement:** Rule 203 requires a broker-dealer to have reasonable grounds to believe that a security can be borrowed so that it can be delivered on the delivery date before effecting a short sale order in any equity security (known as a locate). This locate must be made and documented prior to effecting the short sale.
- **Rule 204 – Close-out Requirement:** Rule 204 requires broker-dealers to close out failure to deliver positions by purchasing or borrowing securities of like kind and quantity. The broker-dealer generally must close out a failure to deliver for a short sale transaction by no later than the beginning of regular trading hours on the settlement day following the settlement date.

In October 2008, the SEC supplemented the Regulation SHO framework to prevent failures to deliver by adopting Rule 10b-21, an antifraud rule under the Securities Exchange Act of 1934 (Exchange Act). This rule prohibits a customer from deceiving a broker about its intention or ability to deliver a security before the settlement date. Rule 10b-21 reinforces Regulation SHO by imposing additional liability on a person that fails to deliver a security on or before the delivery date.

The Regulation SHO framework for short selling has worked exceedingly well in reducing failures to deliver. In 2011, for example, the SEC's Division of Risk, Strategy and Financial Innovation, found that since 2008, failures to deliver had declined by 65.7 percent across all securities, and failures to deliver had declined by 85.1percent for threshold stocks (shares with persistent failures to deliver).[14]

14 See Memorandum from SEC Division of Risk, Strategy and Financial Innovation, Impact of Recent SHO Rule Changes on Fails to Deliver (Apr. 25, 2011), available at: http://www.sec.gov/spotlight/shortsales/failsmemo042511.pdf.

Overall, Regulation SHO has been effective in preventing potentially abusive short sale activity. In fact, the SEC has noted that short selling abuse is less common than other types of market abuse.[15]

Overall, Regulation SHO has been effective in preventing potentially abusive short sale activity. In fact, the SEC recently noted that short selling abuse is less common than other types of market abuse.

In addition to Regulation SHO, those engaged in short selling are subject to the broad anti-fraud provisions of the federal securities law, such as Rule 10b-5 under the Exchange Act, which prohibits any manipulative conduct, including intentional dissemination of false information. The SEC has extensive authority to investigate and punish fraudulent conduct.

How Are Short Sales Reported?

In addition to Regulation SHO, the SEC oversees short sales through an extensive system of reporting. There is a substantial amount of information about short sales that is publicly available, and more information is readily available to regulators

Taken together, this information gives regulators quick, easy access to aggregate, market-wide short sale information.

The Financial Industry Regulatory Authority (FINRA), which is the self-regulatory organization (SRO) that regulates and oversees broker-dealers pursuant to SEC oversight, plays an important role in short sale reporting. As the SRO for broker-dealers, FINRA collects short interest information in individual securities from broker-dealers and aggregates the information. FINRA requires that broker-dealers report short positions in all equity securities twice monthly through its online filing.

Information Reported on Short Selling Activity:

- Twice-monthly publicly available short interest information for individual stocks.
- Publicly available daily aggregate short sale volume for individual stocks.
- Institutional investor short sale trading information maintained by broker-dealers and available to the SEC upon request.
- Short selling and other trading data upon implementation of the SEC Consolidated Audit Trail that will be accessible by the SEC and other regulators.

In a process that takes approximately 11 days after the settlement date, or two weeks after the last trading date for the short positions, FINRA validates and aggregates the information and, along with the NYSE and NASDAQ, publishes it.[16]

In addition to the short interest reports, FINRA also publishes two other short selling reports in conjunction with stock exchanges. One report is comprised of the daily aggregated short sale volume in individual securities.

A second report provides individual short sale transactions in all exchange-listed equity securities. These data sets are published by FINRA and/or the stock exchanges on no more than a one-month delay and can be found on their websites.[17]

15 See SEC Staff Study at page 74 ("There were 273 Commission enforcement actions from 2004 through 2010 than involved market manipulation. Of these, only 14% involved short-side manipulation while 86% did not involve short selling.")

16 This information is available at: http://www.nyxdata.com/Data-Products/NYSE-Group-Short-Interest and https://www.nasdaq.com/quotes/short-interest.aspx.

17 Links to the short selling data sets can be found at http://www.sec.gov/answers/shortsalevolume.htm.

In 2011, the SEC adopted a rule that requires broker-dealers to maintain additional information about the trading activities of large traders.[18] Under the rule, broker-dealers for large traders are required to maintain records of transactions effected through accounts of such large traders and electronically report these transactions to the SEC upon request through the Electronic Blue Sheets systems that are used for reporting trade information.[19] This reporting system has enhanced the SEC's ability to quickly access trading data from such large traders.

The SEC also has broad authority to request short selling information from its registrants, including mutual fund and hedge fund managers, which must maintain the information pursuant to the Investment Advisers Act.[20] The SEC uses its authority to detect and investigate any potentially abusive practices.

In addition to these reports, the SEC in the future will have access to additional short sale information. The SEC has adopted a rule to create a Consolidated Audit Trail that would allow regulators to track all activity throughout the U.S. markets in National Market System (NMS) securities.[21] The rule requires national securities exchanges to submit a plan to create, implement and maintain the Consolidated Audit Trail. In 2016, the SEC approved the plan and soon the Consolidated Audit Trail will allow the SEC and the exchanges to have access to extensive information on all orders to trade NMS securities. Later this year, securities exchanges must begin submitting data to a central repository.

The audit trail data will include information on short sale order marks, the identity of the customer and an open/close indicator. Significantly, the SEC staff has indicated that, with access to this information, the SEC may be able to run processes to track short selling and buy-to-cover activity and to identify the activity of large short sellers.[22]

These short sale reports provide the SEC with detailed information it can use to better ensure that the benefits of short selling flow to investors, companies, and markets while protecting investors.

The Dodd-Frank Act and Short Sale Reporting

The short sale reports that the SEC has established match up well with the section of the Dodd-Frank Act related to short sale reporting. Section 929X(a) of the Dodd-Frank Act instructs the SEC to provide for the public disclosure of aggregate short sale information.[23] In addition to the text of Section 929X(a), the legislative history of the Section confirms that disclosure should be of aggregate, rather than individual, short positions.[24] Aggregate information is consistent with the type of short selling information that is currently reported by FINRA and the stock exchanges.

European Short Sale Reporting

In response to the financial crisis, European policymakers established a framework for investors to report and publicly disclose significant short positions in shares of European companies. Since November 2012, the European Regulation on Short Selling and Certain Aspects of Credit Default Swaps (EU SSR) has been in effect. Under the EU SSR, investors must report short positions of 0.2 percent of share capital and above to regulators and disclose short positions of 0.5 percent and above of share capital to the public.

18 Rule 13h-1 under the Exchange Act. A "large trader" includes a person whose securities transactions equal or exceed 2 million shares or $20 million during any calendar day, or 20 million shares or $200 million during any calendar month.

19 "Bluesheeting" refers to the system by which the SEC asks a broker-dealer to identify the investor who made a trade that the broker-dealer executed.

20 Rule 204-2.

21 Rule 613 under the Exchange Act. Additional information on the Consolidated Audit Trail Rule is available at: https://www.sec.gov/divisions/marketreg/rule613-info.htm and https://www.catnmsplan.com/home/about-cat/planning/.

22 See SEC Staff Study at page 24.

23 Section 929X(a) provides that the SEC shall prescribe rules providing for the public disclosure, on at least a monthly basis, of the name of the issuer and the title, class, CUSIP number, aggregate amount of the number of short sales of each security, and any failures to deliver the security following the end of the reporting period. The SEC has not adopted rules under this provision.

24 Section 929X(a) followed from the combination of the House and Senate bills that formed the basis for the Dodd-Frank Act. A review of these bills makes clear that Congress intended for public, aggregate short position disclosure. See letter from Richard H. Baker, President and CEO, Managed funds Association, to James A. Brigagliano, Deputy Director, Division of Trading & Markets, Securities and Exchange Commission, dated Feb. 7, 2011, available at: http://www.managedfunds.org/wp-content/uploads/2011/06/2.7.11-MFA.Letter.on_.Short_.Sale_.Disclosures.under_.Section.929X.of_.Dodd_.Frank_.pdf.

In 2017, ESMA published a report on the EU SSR noting that while public disclosure brings increased transparency, it may also lead to pricing inefficiency and could reinforce herding behavior.[25]

In 2018, in the first comprehensive study[26] using data collected between 2013-2016, ESMA analyzed the impacts of the EU's short sale disclosure requirements on European markets (see adjacent box). ESMA found that disclosure thresholds influence the behavior of investors, who avoid crossing reporting thresholds in order to maintain the secrecy of their positions. This suggests that a disclosure regime suppresses market efficiency and the associated price discovery process. Moreover, ESMA found evidence of herding behavior caused by disclosure, observing that the data "strongly suggest that investors react to public disclosure by increasing the size of their [short] position, thereby reinforcing herd behaviour."

The lasting impact of public short position disclosure is likely to be reduced price efficiency and market liquidity, which would make it more difficult for issuers – whether banks, corporates, or sovereigns – to raise capital.

Results of 2018 ESMA Short Sale Disclosure Analysis:

- In 2018, ESMA analyzed the impact of the EU's short sale disclosure requirements on investor behavior. Using data collected between 2013-2016, ESMA found that the EU's disclosure rules influence market outcomes.
- First, ESMA found that market participants seek to avoid public disclosure by avoiding crossing the 0.5 percent threshold, suggesting that the threshold suppresses market efficiency by discouraging further increases in net short positions.
- Second, ESMA found that the public reporting threshold reinforces herding behavior in markets, with disclosure of a net short position above 0.5 percent by one investor leading to subsequent disclosures by other investors.

25 See ESMA's Technical Advice on the evaluation of certain elements of the Short Selling Regulation (Dec. 21, 2017), available at: https://www.esma.europa.eu/sites/default/files/library/technical_advice_on_the_evaluation_of_certain_aspects_of_the_ssr.pdf.

26 See "The Public Disclosure of Net Short Positions," in ESMA Report on Trends, Risks, and Vulnerabilities (April 13, 2018), available at: https://www.esma.europa.eu/sites/default/files/library/esma50-165-538_report_on_trends_risks_and_vulnerabilities_no.1_2018.pdf#page=60.

VI. Short Sale Reporting Requirements and Long Position Reporting Requirements

Many investors are more familiar with the public reporting requirements for holders of long positions. As a result, the reporting requirements for holders of short positions are sometimes compared with the reporting requirements for holders of long positions.

Before examining the different reporting requirements for short and long positions, as well as the reasons for the SEC's determination, here are the SEC's main rules for public disclosure of long positions:

- Investors that own more than five percent of a company's outstanding securities report their long positions publicly either on SEC Schedule 13D or SEC Schedule 13G.
- Institutional investment managers that exercise investment discretion of $100 million or more in certain U.S. publicly-traded equity securities report their long positions on SEC Form 13F within 45 days of the end of each calendar quarter.[27]

The remainder of this section explains the different approaches to reporting of long positions and short positions, and the reasons for the SEC's long-standing determination not to require public disclosure of individual investors' short positions.

Reasons Why Short Sales are Reported Differently than Long Positions:

- Disclosure of Individual Long Positions is Based on Voting Rights in Shares
- Public Disclosure Could Lead to Herding and Increased Volatility
- Public Disclosure of Individual Short Positions is Likely to be Misinterpreted by Investors
- Public Disclosure Would Reduce Price Efficiency, Market Liquidity and Capital Formation, and Increase Market Volatility
- Public Disclosure May Cause Companies to React Adversely to Investors
- Adverse Publicity from Public Disclosure May Deter Investors from Benefiting from Alternative Investment Classes

Disclosure of Individual Long Positions is Based on Voting Rights in Shares

As a holder of a long position in a company, an investor has the right to vote in shareholder elections that influence the direction of the company. A holder of a short position in that company, however, has no voting rights. This fundamental difference leads to different public reporting requirements.

Appropriate public disclosure of long equity positions by large beneficial owners is justified because investors have a legitimate interest in knowing who controls the voting rights that could influence a company. There is no corresponding need for investors or others to know the identity of holders of short positions,[28] because short sellers have no ownership and, therefore, no ability to vote as shareholders to influence the company. Accordingly, public disclosure of large long positions on SEC Schedules 13D and 13G is designed to provide investors and companies with information about owners that may have the potential to influence control of the company.[29]

Likewise, SEC Form 13F also requires public disclosure

27 A position that is fewer than 10,000 shares of a given issuer and less than $200,000 of aggregate fair market value does not have to be reported on Form 13F.

28 See SEC Staff Study at page 75 ("The objectives of reporting long positions under Section 13 of the Exchange Act are related more to corporate control and investment manager position disclosure than to abusive trading. Therefore, the Division does not believe that short position reporting should necessarily be symmetric with long position reporting.").

29 See Exchange Act Release No. 37403 (July 5, 1996) ("The beneficial ownership reporting requirements embodied in Sections 13(d) and 13(g) of the Securities Exchange Act of 1934 . . . and the regulations adopted thereunder are intended to provide investors and the subject issuer with information about accumulations of securities that may have the potential to change or influence control of the issuer.").

only of long positions. Form 13F reflects a balance between the interests of knowing the owners of a company with the legitimate interests that institutional investors have in safeguarding information about their investments.

Public Disclosure Could Lead to Herding & Increased Volatility

Additional public disclosure of individual short positions may lead to an increase in shorting of stocks (or long sales) if other market participants take positions that follow investors' publicized short positions. This herding behavior could also lead to increased market volatility if potential buyers were then less likely to purchase shares with large short positions.

There are many real-world examples where the behavior of a high-profile investor is likely to have influenced the actions of other market participants and affected a company's share price. Short position reports could exacerbate this herding behavior to the detriment of companies and investors. As noted on page 12, ESMA recently analyzed the EU's short sale disclosure regime and determined that public reporting reinforces herding behavior in markets.

Public Disclosure of Individual Short Positions is Likely to be Misinterpreted by Investors

Investors often take short positions in shares of a company for portfolio risk management purposes rather than because they have taken a negative fundamental view on the particular company. If other investors believe the short position reflects a negative view on the company, the company and other investors who are holding long positions in the company would be adversely impacted.

For example, an investor that is primarily long shares in a particular industry sector may consider that one company's shares are likely to outperform another and may express that view by taking a long position in the first company and a short position in the second company. The investing public is likely to mistakenly interpret disclosure of the short position as an absolute negative view on the company. Misinterpretation of this information is likely to have a greater impact in those industry sectors which are vulnerable to negative public sentiment.

Public Disclosure Would Reduce Price Efficiency, Market Liquidity, Capital Formation, and Increase Market Volatility

Short investors and long investors face a different set of risks. Long investors cannot lose more than they paid for the security, while short sellers can lose as much as the price of the security can rise. Holders of short positions are therefore exposed to unlimited loss in the event of stock prices increasing before they can exit their position.

Public disclosure of short positions may subject market participants to the risk of a short squeeze. A short squeeze is when the price of a security is pushed upward to force short sellers out of their positions. Short sellers are generally required by brokers to maintain margin above a certain level. As prices rise, short sellers must add cash to their margin accounts or close out their short positions. Investors with short positions that are publicly disclosed would be more vulnerable to a short squeeze because other market participants would know the extent of their short positions.

As a result of these unique risks, public disclosure of individual short positions would reduce short selling to a greater extent than public disclosure of long positions. The harm to price efficiency, market liquidity, capital formation and market volatility would flow through to all market participants, not only to short sellers. Institutional and retail investors alike would experience increased transaction costs (i.e., wider bid-ask spreads) and longer times to fill orders. Public companies would face higher costs of capital as a result of less efficient prices and impaired capital formation. And all investors and companies would be subject to the increased risk of price bubbles and higher market volatility.

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Public Disclosure May Cause Companies to React Adversely to Investors

Public disclosure of individual short positions would harm investors if companies cease or limit communications with those investors and exclude them from information sessions. Some firms have in fact indicated they would limit communications with investors they identify to have short positions in their shares. Such a result would have a negative impact on capital markets by limiting the free flow of information essential for informed investments and effective price discovery.

Some firms have in fact indicated they would limit communications with investors they identify to have short positions in their shares. Such a result would have a negative impact on capital markets by limiting the free flow of information essential for informed investments and effective price discovery.

More broadly, public disclosure of individual short positions could have a long lasting negative impact on markets by having a chilling effect on information and disclosure provided by companies, as well as harming the relationship between investors and companies.

Adverse Publicity from Public Disclosure May Deter Investors from Benefiting from Alternative Investment Classes

Public disclosure of individual short positions could cause institutional investors – such as pension funds, endowments, and foundations – to modify their investments in investment vehicles that engage in short selling due to the risk of adverse publicity that could arise from inaccurate perceptions of short selling. In the long-term, such investors may forego diversification and risk management benefits provided by alternative investment vehicles, which could ultimately erode returns to these investors.

Public Disclosure Would Reduce Returns for Investors Seeking to Mitigate the Risk Profile of their Portfolio

Public disclosure of individual short positions could provide other market participants with information that they could use to reverse engineer the trading strategies of the short position holder. By carefully analyzing publicly available short positions and long positions of an investor, a sophisticated competitor could understand the investor's investment strategy and use the information in a manner that could be harmful to the investor. As a result, public disclosure would likely cause harm to the investment strategies of investment vehicles and the returns of their investors.

VII. Conclusion

The SEC regulates short selling in a comprehensive manner through Regulation SHO, which has been effective in deterring abusive practices. The SEC has also established a reporting and disclosure framework that provides regulators and investors with information about short selling. In light of this regulatory structure, public disclosure of individual positions would not provide a meaningful enhancement to oversight of short selling activities.

The SEC has previously assessed the value of the short selling information it receives and considered whether additional information would be helpful.

In 2014, the SEC's Division of Economic and Risk Analysis published a study of the feasibility, benefits, and costs of requiring reporting of short sale positions in real time, either publicly or to the SEC and FINRA.[30] In the study, SEC staff compared the potential benefits of receiving real-time short position information with the short sale information it currently has access to and that would become available following implementation of the Consolidated Audit Trail.

> *"The benefits from making real-time short position reporting information available to the public and regulators are likely to be modest. In particular,* **the Division believes that real- time short position reporting and transaction marking would provide regulators with little additional information than would already be available from the Consolidated Audit Trail.** *" - SEC Staff Study (emphasis added)*

In the study, SEC staff declined to indicate that this type of additional short sale information would be useful. SEC staff instead concluded that "the benefits from making real-time short position reporting information available to the public and regulators are likely to be modest. In particular, the Division believes that real-time short position reporting and transaction marking would provide regulators with little additional information than would already be available from the Consolidated Audit Trail."[31]

In 2009, the SEC had the opportunity to assess the value of additional short sale information reported by investors. During the financial crisis in 2008, the SEC used its emergency powers to require institutional investment managers to submit to the SEC on a weekly basis non-public reports of their short positions on new Form SH.[32] The SEC received the short position reports from investment managers for a ten-month period. In July 2009, the SEC allowed the reporting requirement to expire. At that time, the SEC explained that instead of continuing to require managers to report short sale information, it would instead increase the public availability of short sale information through reporting by SROs.

The experience of Form SH appears to illustrate that individual short sale reporting by investors did not materially enhance the SEC's oversight capabilities.

In closing, it is worth recalling that the issue of short selling is not new. In 1934, the Senate Banking and Currency Committee noted that few subjects have been characterized by greater differences of opinion than that of short selling.[33] Congress, however, at that time chose not to prohibit short selling, but instead to grant the SEC power to regulate short sales to prevent any misconduct.

Congress has subsequently reaffirmed that judgment numerous times, including in the Securities Act Amendments of 1975, which created the framework for today's National Market System.

The Dodd-Frank Act likewise reaffirmed that judgment and did not ban short selling or require the SEC to adopt individualized short sale disclosure along the same lines as long position disclosure.

The SEC has used its authority to effectively regulate short selling, and has monitored and revised its rules over time to keep pace with an evolving market. As a result, regulators and academics have recognized short selling as an integral part of well-functioning, efficient equity markets and as a way to help lower transaction costs and promote the responsible allocation of capital.

30 See SEC Staff Study.

31 See SEC Staff Study at page vii.

32 For each security, Form SH identified the issuer and CUSIP number, the start of day short position, the number and value of securities sold short during the day, the end of day short position, the largest intraday short position, and the time of the largest intraday short position. Short positions of less than 0.25% of the class of shares with a fair market value of less than $1 million were not reported. The reporting requirement was implemented by emergency orders followed by an interim final temporary rule, Rule 10a3-T under the Exchange Act; see Securities Exchange Act Release No. 58591 (Sept.18, 2008).

33 See Stock Exchange Practices, Report of Senate Committee on Banking and Currency, S. Rep. No. 1455, 73rd Cong. (1934).

Chris Netram
Vice President
Tax and Domestic Economic Policy

June 28, 2018

The Honorable Mike Crapo
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Dear Chairman Crapo and Ranking Member Brown:

On behalf of the National Association of Manufacturers (NAM) and the 12 million men and women who make things in America, I write to thank you for holding today's hearing on corporate governance issues.

As the nation's largest industrial trade association, the NAM represents small, medium, and large manufacturers across a wide range of economic sectors who collectively 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. These activities set the stage for economic growth, innovation, and increased employment. Manufacturers have looked to the capital markets to finance these pro-growth activities. By offering shares to the public, manufacturers provide everyday Americans the opportunity to participate in the industry's success, often through shares held by 401(k) and pension plans. This unique relationship between issuers and their investors underscores the importance of smart corporate governance, and of Congressional and SEC oversight of the players in the space.

Manufacturers believe that effective corporate governance policies protect investors, and the industry takes seriously its obligation to disclose material information, implement effective policies, and continually engage with shareholders. However, unregulated third parties with little-to-no stake in a company or its success all too often play an outsized role in this important process. These actors – namely, proxy advisory firms and activist investors – have agendas divorced from shareholder value creation, and thus can have a deleterious effect on the annual proxy process, a company's corporate governance policies, and, ultimately, investor returns. The NAM is encouraged that you are holding today's hearing to examine these important issues, and to consider Congress's role in ensuring that America's public markets continue to support both capital formation for growing businesses and investor returns for hard-working Americans saving for the future.

Proxy Advisory Firm Oversight

The NAM applauds the Banking Committee for considering at today's hearing proposed oversight of the proxy advisory firm industry, and appreciates the efforts of Senators Thom Tillis (R-NC), Dean Heller (R-NV), and David Perdue (R-GA) for taking the lead on this important issue in the Senate. Moreover, we strongly support the House-passed Corporate Governance Reform and Transparency Act (H.R. 4015) and urge the Committee to consider the bill's approach to regulating proxy advisory firms.

Proxy advisory firms have risen to prominence in the wake of increased institutional ownership of American stocks. 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 investments in millions of workers' retirement accounts. Yet they are not subject to regulatory oversight and offer little in the way of transparency or dialogue with the issuers impacted by their recommendations. Their activities effectively constitute a black box quasi-regulatory regime that imposes a one-size-fits-all approach to corporate governance on America's public companies. In addition, proxy advisory firms 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.

As *de facto* regulators over company policies that impact millions of jobs and trillions of dollars in retirement savings, the NAM strongly believes that proxy advisory firms and their recommendation process are in desperate need of oversight and reform. Increased transparency, improved dialogue with issuers, and disclosure and mitigation of conflicts of interest would benefit investors and issuers alike. The bipartisan Corporate Governance Reform and Transparency Act would allow investors to make informed proxy voting decisions and ultimately lead to better corporate governance policies at America's public companies.

Politically-Motivated Shareholder Proposals

In recent years, manufacturers have experienced a rise in politically-motivated shareholder activism that seeks to force companies to act on issues unrelated to their core business or investor returns. The proxy ballot, which was designed for the majority of investors to constructively engage with company management, is now being abused by a vocal minority of activists. Going forward, the NAM encourages the Banking Committee to consider reforms to the shareholder proposal process in order to preserve the right of investors to engage with management on important corporate governance issues while limiting the impact of activists with political agendas.

A recent academic study co-authored by Professor Joseph Kalt of Harvard University found that activist proposals detract from shareholder value, contradicting activists' claims that such proposals are beneficial to shareholders.[1] These negative returns are in addition to the time and resources that a company must expend to engage on activist proposals. The NAM supports efforts to prevent a vocal minority of activist investors from hijacking a company's annual proxy ballot, such as H.R. 5756, which was recently approved by the House Financial Services Committee.

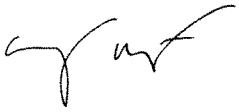
* * * *

Unregulated actors pursing their own agendas at the expense of company growth and shareholder value creation divert management's time and attention and ultimately harm everyday investors. They

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

also present barriers to the public market for small and medium-size companies, limiting capital formation and depriving investors of the upside potential of a small business's growth on the market. The NAM encourages the Banking Committee to continue to work through these important corporate governance issues following today's hearing, and we look forward to partnering with you to ensure that America's public markets continue to support the growth of manufacturers in all 50 states.

Sincerely,



Chris Netram
Vice President, Tax & Domestic Economic Policy

June 26, 2018

The Honorable Mike Crapo, Chairman
The Honorable Sherrod Brown, Ranking Member
U.S. Senate Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

Via email: Jonathan_Gould@banking.senate.gov

Re: Objection to the Compensation for Cheated Investors Act (S.2499)

Dear Chairman Crapo and Ranking Member Brown:

My name is Wendy Lanton and I am the Chair of the Small Firm Advisory Committee ("SFAC") for the Financial Industry Regulatory Authority ("FINRA"). Our committee is made up of 10 senior executives of small firms (firms with 1-150 registered representatives), half of whom are elected by their peers. Our committee represents the interests of the 3,337 FINRA small firm members and ensures that issues of interest and concern to small firms are effectively communicated to and considered by FINRA. It should be noted that the views and opinions expressed herein are those of the SFAC members and may not be shared by FINRA.

I am writing to express the Small Firm Advisory Committee's opposition to The Compensation for Cheated Investors Act (S.2499) which was introduced on March 6, 2018. This bill, if passed, would establish a relief fund that would pay unpaid final arbitration awards. The proposed relief fund would be funded first from penalties paid by brokers (fine money) and second, from sources determined by FINRA (not from investors).

While we are very much in support of having customers with legitimate claims having their awards paid, creating a fund to cover unpaid arbitration awards will actually create more problems and harm small firms. We believe it will incentivize unscrupulous claimant's counsel to initiate arbitration claims against small firms because they know of the existence of an available fund. It is noteworthy that small firms have limited resources to fight against unfounded claims, such that we often elect to settle matters, not because we committed the offense, but because we cannot afford the cost of arbitration proceedings. Moreover, 50% of unpaid arbitration awards are never adjudicated. Cases are brought against broker-dealers that are no longer in business and while they are brought to an arbitration forum, these cases are won by default. The claim necessarily goes unpaid because the firm is no longer in the industry.

The passage of S.2499 would result in creating a bottomless pit for hungry, dishonest claimant's counsel. As drafted, if an award is granted, even though the claim was uncontested and perhaps unfounded, FINRA would be forced to ensure the claim is paid, no matter the dollar amount of the claim. If FINRA fine revenue is not sufficient to meet the unpaid arbitration awards FINRA will be forced to tax its membership on an unlimited basis to ensure the award monies are paid. This will put a tremendous burden on small firms which make up over 90% of FINRAs membership. Small firms will not have the money to meet such an unexpected expense and as a result may be forced to close their doors. Small firms are already leaving the industry at approximately 2 firms per week. That number will continue to

grow. Small firms serve an incredibly underrepresented part of the investing public and we want to continue to service our customers.

It is worth noting that if an arbitration is awarded and goes unpaid, claimants do have another option. They can have their decision converted to a judgment which can be enforced by a court of law. This puts the claim in the same position as if it was originally brought in court. We believe claimants should explore all available options that are not being exhausted today. Our committee has offered to establish an advisory working group to help find a solution to the unpaid arbitration awards issue. One area we would like to explore is how to help claimants perfect their judgments in state court at a minimal expense to the claimant.

This proposed legislation casts a wide net with broad reaching unintended consequences. This bill, if enacted, is particularly harsh to small firms and we urge you not to support this bill.

Sincerely,

The FINRA Small Firm Advisory Committee

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Submitted Testimony

of the Securities Industry and Financial Markets Association

before the U.S. Senate

Committee on Banking, Housing, and Urban Affairs

Hearing entitled "Legislative Proposals to Examine Corporate Governance"

June 28, 2018

While the Securities Industry and Financial Markets Association (SIFMA)[1] and its member firms have a perspective to offer on many of the legislative proposals that the Committee is evaluating this week, we are writing today specifically to highlight our opposition to S. 2499, legislation recently introduced by Senators Warren (D-MA) and Kennedy (R-LA). If enacted into law, this harmful legislation would force the Financial Industry Regulatory Authority (FINRA) to create a pool of money of infinite size to pay-off unpaid FINRA arbitration awards.

As SIFMA comments on the legislation, it is important to recognize that the problem of unpaid arbitration awards is a challenging one to solve for and our disagreement with the sponsors of the legislation may be more about the best method or methods with which to solve the problem, not that there is a problem. With thousands of brokers operating in the United States today, there are bound to be bad apples, just as you have in any industry. Additionally, it is important to understand that the issue of unpaid awards is not unique to FINRA arbitration or to the securities industry -- the issue is common to all dispute resolution systems and all industries. Investors who recover judgments in court-based proceedings face the same exact issue. FINRA arbitration awards, however, are significantly easier to collect upon than court-based judgments, and in fact, can be converted into court judgments and then enforced using the judicial system.[2] Under the Federal Arbitration Act, the investor may sue in court to enforce the award and the court must confirm the award unless it finds there was corruption, fraud, evident partiality, misconduct, or the arbitrators exceeded their powers (all of which are rare). A court confirmation of a FINRA arbitration award has the same effect as a judgment recovered following a civil trial. Upon a court's confirmation, the investor can use all means available to a successful litigant in a judicial proceeding, including levying against the defendant's assets.

Generally speaking, SIFMA strongly supports exploring reforms to reduce the number of unpaid arbitration awards. An industry-financed pool, however, is a poor public policy choice to achieve that end because it is unfair to the broker-dealers who honor their arbitration award obligations, is essentially a tax on investors, and introduces numerous moral hazards. Specifically, we oppose S. 2499 for the following reasons:

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[1] SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $18.5 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] FINRA rules facilitate the payment of arbitration awards. Within 30 days of receipt of an award, firms must notify FINRA in writing that they have either paid or otherwise complied with the award. FINRA suspends any firm or associated person that fails to comply with an arbitration award. FINRA then records in the Central Registration Depository (CRD) that the firm or associated person failed to pay the award. The CRD reference prevents the firm and associated person from reentering the securities industry until the award has been paid. According to FINRA, suspension or the threat of suspension often forces payment of the award or payment to the satisfaction of investors.

1. Using Enforcement Penalties to Pay Unpaid Arbitration Awards Creates Inappropriate Conflicts of Interest.

The legislation currently requires that the recovery pool be funded first from enforcement penalties paid by brokers. By doing so, the bill would create a perverse incentive for FINRA to increase both the number of enforcement actions that it brings, and the dollar amount of penalties that it imposes, in order to ensure that the recovery pool is adequately stocked. The bill would thus introduce a new and significant conflict of interest into enforcement actions brought by FINRA. Our members would be left to wonder whether FINRA's enforcement actions and penalties were based on legitimate regulatory concerns or whether the recovery pool was simply running low.

2. It is Fundamentally Unfair to Require Good Actors (Who Pay Their Arbitration Awards) to Pay for Bad Actors (Who Do Not).

If enforcement fines are insufficient to cover unpaid awards, the bill requires FINRA to make-up any shortfall from its other funding sources. Notably, FINRA's other funding sources derive in substantial part from its members (thousands of brokers). Thus, this provision of the bill is fundamentally unfair because it would require the many firms that pay their arbitration awards to pay for the few firms that do not.

3. An Unbounded Money Pool Will Attract Abuse and Gamesmanship and Will Serve Plaintiffs' Lawyers Over Investors.

By forcing FINRA to create and maintain a perpetual pool of money to pay unpaid awards, the bill would spur the growth of a cottage industry of plaintiffs' lawyers who would collect, aggregate, and pursue, prior unpaid awards solely for purposes of cashing-in on the free money pool. Plaintiffs' lawyers could pay pennies on the dollar to collect unpaid awards or pursue them only for hefty contingency fees. Ultimately, the recover pool for prior unpaid awards would primarily serve plaintiffs lawyers and their fees, not investors.

Likewise, plaintiffs' lawyers would likely aggressively pursue new arbitration claims – even ones with questionable merits – against smaller or under-capitalized broker-dealers, knowing that the likely result will be a default judgment for the full claimed amount, which will then be paid out of the proposed fund. One would reasonably expect to see the number of arbitration claims, the claim amounts, and the default rate to grow year over year, putting strain on the system and rewarding legal gamesmanship.

4. FINRA Has Already Taken Numerous Steps to Resolve the Issue Under its Existing Authority and Policymakers Should Give Those Efforts a Chance.

Finally, and perhaps most importantly, legislation in this area is premature given that FINRA has engaged in a process to address the issue of unpaid arbitration awards. Recently FINRA examined several alternative approaches to address the issue and concluded that the best approach would be to propose several amendments to FINRA rules:

- In February 2018, FINRA requested comment on proposed amendments to its Membership Application Program (MAP) rules to create further incentives for the timely payment of arbitration awards by preventing an individual from switching firms, or a firm from using asset transfers or similar transactions, to avoid payment of arbitration awards while staying in business.[3] In April 2018, SIFMA filed a comment letter in support of FINRA's proposal, stating:

  > "[w]e have long held that the issue of unpaid awards originates with the integrity and quality control standards that FINRA establishes for membership. That is the most appropriate juncture and means to address the issue, rather than viewing the issue as requiring some form of post-award collection pool, insurance, or guaranty."[4]

  In other words, to the extent that less reputable firms do not have sufficient funds to pay their arbitration awards, the issue is not with the FINRA arbitration system, but with the manner in which firms manage their capital and risk, which can and should be addressed outside the context of FINRA arbitration awards.

- FINRA's proposal would amend the new member application (NMA) and continuing member application (CMA) to impose new restrictions on firms with pending arbitration claims, unpaid arbitration awards, or unpaid settlements relating to an arbitration. The proposal would:

  - presumptively deny an NMA or CMA if the firm or its associated persons are subject to unpaid arbitration awards. The presumption could be overcome by demonstrating the ability to satisfy the claims, whether through an escrow agreement, a clearing deposit, a guarantee, a reserve fund, or otherwise;
  - make unavailable the safe harbor for business expansion if the member has unpaid arbitration awards; and

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[3] FINRA Regulatory Notice 18-06 (February 8, 2018), *FINRA Requests Comment on Proposed Amendments to its Membership Application Program to Incentivize Payment of Arbitration Awards*, available at http://www.finra.org/industry/notices/18-06.

[4] SIFMA Comment re: FINRA Regulatory Notice 18-06 (April 9, 2018), available at http://www.finra.org/sites/default/files/notice_comment_file_ref/18-06_sifma_comment.pdf.

- require firms engaged in asset acquisitions or transfers that have unpaid arbitration awards to file a Form CMA.

- FINRA is reviewing comment letters submitted in response to its proposal and remains engaged in the process of finalizing its proposed changes to the MAP rules.

- When respondents are no longer in business, recovery of arbitration awards against them often is unavailing. For that reason, FINRA has also proposed amendments to its Code of Arbitration Procedure for Customer Disputes (Code) to expand a customer's options to withdraw an arbitration claim if a firm or an associated person becomes inactive before a claim is filed or during a pending arbitration.[5] In addition, the proposed amendments would allow customers to amend pleadings, postpone hearings and receive a refund of filing fees under these situations.[6] As with the MAP proposal, FINRA is also reviewing comment letters submitted in response to this proposal and remains engaged in the process of finalizing its proposed changes.

- Finally, FINRA is considering changes to its Form U4 registration statement for financial advisors in order to add new disclosures about arbitration awards, settlements and judgments that are not paid in full.[7] FINRA's Board of Governors approved such changes in May 2017, but FINRA has not yet issued its rule proposal.[8]

Conclusion

S. 2499 is fundamentally unfair and inappropriately places the burden of unpaid arbitration awards upon the backs of those firms who do pay their awards, and ultimately, their customers. FINRA has all the authority it currently needs to reduce the number of unpaid awards and Congress is better served by fulfilling its oversight function at this time. These proposals should be allowed to run their course -- with policymakers being given a chance to evaluate their efficacy -- before considering more drastic alternatives.

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[5] FINRA Regulatory Notice 17-33 (October 18, 2017), Amendments to the Code of Arbitration Procedure for Customer Disputes to Expand the Options Available to Customers if a Firm or Associated Person Is or Becomes Inactive, available at http://www.finra.org/industry/notices/17-33.

[6] Id.

[7] See FINRA Form U4, available at http://www.finra.org/sites/default/files/form-u4.pdf.

[8] See Update: FINRA Board of Governors Meeting (May 11, 2017), available at http://www.finra.org/industry/update-finra-board-governors-meeting-051017.

LETTERS, STATEMENTS, AND REPORTS SUBMITTED BY SENATOR BROWN

December 18, 2017

Dear Representative:

On behalf of Americans for Financial Reform (AFR), we are writing to urge you to vote against HR 4015, the "Corporate Governance Reform and Transparency Act of 2017", which will be considered on the House floor this week.[1] By placing an excessive and unnecessary regulatory burden on proxy advisory firms, this bill would unfairly disadvantage shareholders as compared to firm management, and raise serious First Amendment concerns as well. AFR joins major representatives of shareholders such as the Council of Institutional Investors (CII) and the California Public Employee Retirement System (CALPERS) in opposing this bill.

HR 4015 would establish a new Federal regulatory scheme for proxy advisory firms. These firms provide institutional investors, including pension funds, with the research and information they need in order to exercise their voting rights as shareholders. The regulations proposed in HR 4015 would require proxy advisory firms to provide the management of public companies with detailed voting recommendations relevant to their firms before these recommendations were shown to shareholders who paid for proxy advisory services. Advisory firms would also be required to resolve any complaints from firm management, and employ an ombudsman to ensure that such complaints were addressed. If complaints were not resolved to the satisfaction of firm management, then the full text of complaints from companies would be included next to voting recommendations in proxy advisory reports. Regulations would also mandate extensive disclosure requirements for the details of proxy advisory methodologies, reducing incentives to invest in developing such methodologies. The costs of this regulatory regime would be passed on to investors and pension funds that use proxy advisory services.

The regulatory scheme is a transparent attempt to weaken if not eliminate the independence of proxy advisory firms from firm management by placing sharp restrictions on their expression of opinions which differ from those of firm management. Besides raising First Amendment issues, this improperly restricts the ability of shareholders to obtain independent views on how they should exercise their voting rights.

This legislation cannot be justified, as some have attempted to do, by any analogy to the regulation of credit rating agencies. Proxy advisory services do not face a fundamental conflict of interest in their business model because they are not paid by securities issuers while providing certification of securities quality to securities investors. They also have not been implicated in massive fraudulent behavior that contributed directly to a global financial crisis. Further, proxy

[1] Americans for Financial Reform is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of coalition members is available at http://ourfinancialsecurity.org/about/our-coalition/.

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advisory services are clearly recognized as providing opinions regarding voting decisions, in a context where many other such opinions are available, rather than being entities that certify the quality of securities.

Any concerns about the independence of proxy advisory services can be addressed by simply requiring such services to register as investment advisors under the Investment Advisors Act. The radical regulatory scheme laid out in HR 4015 goes far beyond anything even mentioned in the recent Treasury Department report on capital markets, which examined the issue of proxy advisory firms and recommended only that regulators engage in "further study and evaluation of proxy advisory firms, including regulatory responses to promote free market principles if appropriate."[2] The regulatory scheme in HR 4015, besides being misguided in other ways, certainly does not promote free market principles.

The effort in HR 4015 to eliminate the independent voice of proxy advisory services should be rejected. We urge you to vote against it.

For more information please contact AFR's Policy Director, Marcus Stanley, at marcus@ourfinancialsecurity.org or 202-466-3672.

Sincerely,

Americans for Financial Reform

[2] https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf

SHAREHOLDER RIGHTS

How Powerful is ISS? Less—and in Different Ways—than Most People Think

By Stephen Choi, Jill Fisch and Marcel Kahan

Institutional Shareholder Services (ISS) is commonly regarded as the most powerful of all proxy advisors. Virtually every major institutional investor subscribes to its proxy research services. Its voting recommendations, according to some estimates, swing 20 percent to 30 percent of the shareholder votes. Delaware's Chancellor Leo Strine colorfully explains that "[P]owerful CEOs come on bended knee to Rockville, Maryland, where ISS resides ... because the CEOs recognize that some institutional investors will simply follow ISS's advice rather than do any thinking of their own."[1]

ISS might be expected to exert its greatest influence in director elections. Director elections present a potential problem for institutional investors. They are very common; apart from the (very rare) case of a contested election, they are hardly ever significant enough to merit substantial resources to figure out how to vote; and because each director election is different, they do not easily lend themselves to simple "rules of thumb" policies that institutions use for shareholder proposals (such as "always vote for proposals to dismantle a staggered board"). What could be simpler, therefore, than subscribe to ISS and head its advice?

A straightforward comparison of the votes in favor of directors who received a "for" recommendation by ISS to the votes received by directors who received a "withhold" recommendations seems to make the case that ISS is very powerful. This difference amounts to 20 percent of the votes cast. These rudimentary statistics suggest that ISS determines the voting by shareholders holding 20 percent of the shares.

Stephen Choi is the Murray and Kathleen Bring Professor of Law at New York University School of Law, Jill Fisch is the Perry Golkin Professor of Law at University of Pennsylvania Law School and Marcel Kahan is the George T. Lowy Professor of Law at New York University School of Law.

If correct, this conclusion would be troubling. ISS, which owns no shares on its own, would control the voting of by far the largest block of shares. It would be an extraordinarily powerful institution, with unclear incentives and few if any checks on how it exercises its power.

In a series of empirical studies, we have investigated the influence of ISS. Our conclusion is that the power of ISS has been greatly overstated. We estimate that an ISS recommendation shifts six percent to 10 percent of the shareholder vote. Our research further suggests that even this influence is to a large extent due to the substantive information provided by ISS and to the fact that ISS recommendations reflect the pre-existing voting preferences of its subscriber base, rather than to investors blindly following ISS.

Let us start with the statistics cited above. In our study, directors who received a "for" vote recommendation from ISS did receive about 20 percent more "for" votes than directors who received an ISS "withhold" vote recommendation. The respective percentages were 96.4 percent and 76.1 percent. But that does not mean that ISS controls 20.3 percent of the votes. In fact, much of the difference is likely explained by other factors.

First, ISS voting recommendations are not random. ISS bases its "withhold" recommendations on certain factors, many of which are consistent with widely held views about corporate governance. Thus, for example, we found that the likelihood of receiving a "withhold" recommendation increased by 39.4 percent for directors who failed to attend at least 75 percent of the board and committee meetings; by 42.2 percent for directors who failed to implement a shareholder proposal that received majority support at the preceding annual meeting; and by 16.7 percent for outside directors who had certain business relationships with the company.

These factors not only affected the ISS recommendation. They also reduced the overall shareholder vote *whether or not ISS issued a "withhold" recommendation for the director.* Thus, one reason for the 20 percent difference in votes is that shareholders and ISS may have independently, but based on the same reasons, arrived at the same conclusion as to how to vote. In fact, shareholders can and do vote in a manner consistent with ISS recommendations without even being aware of the recommendations, as long as the shareholders have access to the information that forms the basis of the recommendations and hold similar views about its significance.

In our studies, we use regression estimates to differentiate between the effects of an ISS recommendation itself and the effects of the factors underlying the ISS recommendation. Our ability to make this differentiation is limited: we know only some of the factors relevant to ISS recommendations and, given the large size of our data set (over 12,000 director votes) we are constrained in our ability to include all relevant factors due to the difficulty of gathering the requisite data. Our inability to control for all the relevant factors has the effect of overstating the impact of the ISS recommendations. With this caveat in mind, we estimate that an ISS recommendation shifts 13.1 percent of the votes for the median company. Because we could not include all relevant factors, this figure should be regarded as the upper bound of the true influence of ISS, rather than an estimate of its actual influence.

We refined this estimate to measure the overall influence by ISS using a different technique. The subscriber base of ISS includes most institutional investors, but few if any individual investors. The influence of ISS can thus be measured by estimating the differential in voting between individual and institutional investors. To do so, we collected for each firm, information about the percentage of shares held by institutional shareholders and the percentage held by (non-insider) individual shareholders. We then estimated the effect of an ISS withhold recommendation on each subgroup. As expected, an ISS withhold recommendation reduced the "for" vote cast by institutional shareholders by more (17.7 percent) than it did for individual shareholders (7.0 percent). Taking the 10.7 percent difference in the effect as a measure of the influence of ISS, and given the fact that institutional investors held on average 60 percent of the stock of the companies in our sample, we calculated that ISS swings on average 6.4 percent of the total votes. Considering both of these techniques, our best estimate is that an ISS recommendation shifts 6 percent to 10 percent of the votes.

Even this six percent to 10 percent figure, however, must be qualified in two respects. When ISS issues a "withhold" recommendation, it provides its subscribers with the principal reason for the recommendation. Rather than consistently voting with ISS, shareholders may do so selectively, depending on the reason for the recommendation. The converse, however, is not true. When ISS issues a "for" recommendation, it rarely provides further information that would lead its subscribers to vote "withhold." And it is not the case that all directors who receive "for" recommendations have unblemished records. For example, of 81 directors in our sample who missed at least 25 percent of the board meetings, 45 received a "for" recommendation from ISS.

This suggests that ISS "for" recommendations may be more influential than its "withhold" recommendations (in the sense that investors are less able to second-guess "for" recommendations). It also implies that ISS "withhold" recommendations may represent an informational focal point for large withhold votes. To be sure, some investors can and do gather their own information to supplement information provided by ISS and may decide to vote "withhold" even if ISS issues a "for" recommendation. But other investors may not be aware of that information. In contrast, if ISS issues a "withhold" recommendation, virtually every major institutional investor will be alerted to the problem that generated the adverse recommendation.

In our most recent study, we found substantial evidence that this "agenda-setting" dynamic is important.[2] For that study, we collected

information on the votes by funds in a sample of 56 mutual fund families which, in the aggregate, accounted for approximately 50 percent of the domestic equities held by mutual funds. In our sample, only funds representing three percent of the sample assets followed 90 percent or more of the withhold recommendations issued by ISS, perhaps without any thinking on their own. But a much larger portion, accounting for 34 percent of the sample assets, followed 30 percent to 60 percent of the ISS "withhold" recommendations (and funds accounting for 10 percent of the sample followed 60 percent to 90 percent of the withhold recommendations). While some of these funds may have arrived at the same conclusion as ISS did completely independently, we believe that it is likely that many of these funds based their decision to vote "withhold" at least in part on information supplied by ISS. But the fact that these funds regularly fail to follow ISS "withhold" recommendations indicates that they apply their own analysis to the information provided by ISS.

We also found that, for a large number of funds, ISS withhold recommendations do not explain most of the fund's withhold votes. This is particularly true for the largest fund families, which exercise the greatest voting power. Thus, for funds accounting for 73 percent of the sample assets, less than 30 percent of the funds' withhold votes were cast in accordance with an ISS "withhold" recommendation. The remaining 70 percent of the withhold votes were cast on directors for whom ISS recommended a "for" vote. However, because these withhold votes were spread over a large number of different nominees, they tended not to result in very high withhold percentages for many nominees.

Consider, for example, the voting record of Putnam and Vanguard, two of the largest mutual fund families. Neither Putnam nor Vanguard follows ISS consistently, or even generally. Thus, Putnam withheld its vote for 671 director candidates in our sample, but ISS recommended a "withhold" vote for only 115 (or 17 percent) of those 671 directors. Similarly, Vanguard withheld its vote for 1435 director candidates in our sample although ISS recommended a "withhold" vote for only 345 (or 24 percent) of those 1435 directors. Yet it is true that in 45 of the 96 cases (or 47 percent) where *both* Putnam *and* Vanguard decided to cast withhold votes, these votes corresponded to an ISS "withhold" recommendation. ISS "withhold" recommendations appear to lead to a higher likelihood of multiple fund families withholding.

Even for funds that seem to adhere to ISS recommendations consistently, the power of ISS may be less than it appears. ISS regularly consults with its subscriber base in devising the policies it employs in making voting recommendations. Rather than imposing its own preferences, ISS pursues a strategy of conforming its policies to those of its subscribers. To be sure, some funds may follow ISS blindly, similar to readers of the New York Times who base their votes for city council members or local judges on a New York Times endorsement, without performing any independent analysis. But these votes may be preceded by a determination that, by and large, ISS recommendations, or the endorsements by the New York Times correspond to one's own view. And although ISS is the largest proxy advisor, it has competitors. Thus, a fund that is looking to follow someone blindly has a choice between following ISS, Glass Lewis, Egan Jones, Macro Consulting, or CtW Investment Group.

We do not want to understate the power of ISS. In particular, in uncontested director elections, a director who receives a "for" vote recommendation from ISS is virtually assured of receiving a respectable percentage of affirmative votes. But a director who receives a "withhold" vote recommendation is not doomed. Rather, whether such a director receives an embarrassingly high percentage of "withhold" votes hinges on additional factors.

In our studies, we were able to identify four such factors: whether the director missed more than 25 percent of the board meetings; whether Fidelity cast a withhold vote; whether a shareholder resolution was adopted at the prior

year's annual meeting of the company and the company ignored the resolution; and whether the director was an outside director with certain business ties to the company *and* received a withhold vote from Vanguard. If ISS recommended "withhold" and at least one of these factors was present, the likelihood that the director received 30 percent or more withhold votes was 48 percent and the likelihood that he or she received a majority withhold vote was five percent. If ISS recommended "withhold" but none of these factors was present, the respective likelihoods were much lower, 18 percent and 0.5 percent.

Is ISS influential? The answer is clearly yes. But it is less influential than commonly asserted, and one needs to understand the reasons for this influence and the manner in which it is exerted. Only a small group of investors follow ISS without performing any independent analysis, and even these investors may do so because they have concluded that they generally agree with ISS. A much larger group of investors follows ISS selectively. The main source of ISS's influence derives from ISS providing, or failing to provide, relevant information to its subscriber base.

This power to choose the information that investors can easily access in deciding how to vote is important. But it is a far cry from the power to control the ultimate votes. This also means that ISS can be held to account, by its subscribers as well as by the portfolio companies it covers, for the accuracy of its information. Thus, while ISS is powerful, there are significant checks and balances that constrain its discretion. On the whole, because ISS dramatically reduces the cost to investors of obtaining the information that it supplies, the system of shareholder voting works better with an institution like ISS than it would without it.

Notes

1. Leo E. Strine, Jr., The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face, 30 Del. J. Corp. L. 673, 688 (2005).

2. The study is available in full at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1912772.

Via Hand Delivery

June 27, 2018

The Honorable Michael Crapo
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Re: June 28, 2018 hearing entitled "Legislative Proposals to Examine Corporate Governance"[1]

Dear Mr. Chairman and Ranking Member Brown:

I am writing on behalf of the Council of Institutional Investors (CII), a nonpartisan, nonprofit association of public, corporate, and union employee benefit funds, other employee benefit plans, foundations, and endowments with combined assets under management exceeding $3.5 trillion. Our member funds include major long-term shareholders with a duty to protect the retirement savings of millions of workers and their families.

Our associate members include a range of asset managers with more than $25 trillion in assets under management, most also with long-term investment horizons. CII members share a commitment to healthy public capital markets and strong corporate governance.[2]

The purpose of this letter is to thank you for holding the above referenced hearing and to share with you a summary of our views on corporate governance and two of the legislative proposals that we understand are likely to be discussed at the hearing and are of particular interest to our members. We would respectfully request that this letter be included in the hearing record.

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[1] United States Senate Committee on Banking, Housing, and Urban Affairs, Hearings, https://www.banking.senate.gov/hearings.

[2] For more information about the Council of Institutional Investors (CII) and our members, please visit CII's website at http://www.cii.org/about_us. We note that the two largest U.S. proxy advisory firms, Glass Lewis & Co. and Institutional Shareholder Services Inc. (ISS), are non-voting associate members of CII, paying an aggregate of $24,000 in annual dues—less than 1.0 percent of CII's membership revenues. In addition, CII is a client of ISS, paying approximately $19,600 annually to ISS for its proxy research.

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Corporate Governance

CII has long held that good corporate governance—defined to include market transparency, integrity and accountability of management to boards and shareowners—is in the best long-term interests of shareowners and the U.S. capital markets.[3]

We believe that shareowners, other investors and other stakeholders benefit when rules and regulations provide adequate protections to owners and ensure that important information is promptly and transparently provided to the marketplace.[4]

The value of good governance structures and practices within public companies—such as substantially independent boards, [5] all-independent key committees, [6] and measures to promote board accountability[7]—is backed by common sense and experience. We believe such structures and practices ensure that directors have the necessary independence from management to, among other things, monitor and assess corporate performance; select, monitor, evaluate and, when necessary, replace the chief executive and other senior managers; oversee management succession; and structure, monitor and approve compensation paid to the chief executive and other senior managers. They also ensure that directors are accountable to shareowners.

We are unaware of any evidence of a causal connection between federally imposed improvements to corporate governance and the decline in the number initial public offerings or public businesses in the United States.[8]

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[3] CII, Policies on Other Issues, Value of Corporate Governance, http://www.cii.org/policies_other_issues#value_corp_gov.

[4] *Id.*

[5] *See* Council of Institutional Investors, Corporate Governance Policies § 2.3 Independent Board (Updated September 15, 2017), https://www.cii.org/files/policies/09_15_17_corp_gov_policies.pdf.

[6] *See* Corporate Governance Policies § 2.5 All-independent Board Committees.

[7] *See,* Corporate Governance Policies § 2.1 Annual Election of Directors; § 2.6 Board Accountability to Shareholders (stating that boards should seek shareholder views on important governance, management, and performance matters and take actions recommended by shareholder proposals that receive a majority of votes cast for and against).

[8] *See* Michael J. Mauboussin et al., Credit Suisse, "The Incredible Shrinking Universe of Stocks, The Causes and Consequences of Fewer U.S. Equities" 20 (Mar. 22, 2017) ("the shrinkage in the population of listed companies started well before . . . [Sarbanes-Oxley Act] was implemented"), https://www.cmgwealth.com/wp-content/uploads/2017/03/document_1072753661.pdf; Office of Investor Advocate, U.S. Securities and Exchange Commission, Report on Objectives 6 (2018) ("recent academic studies demonstrate that it is difficult to establish any causal connection between disclosure mandates and IPO activity"), https://www.sec.gov/files/sec-office-investor-advocate-report-on-objectives-fy2018.pdf; "Legislative Proposals to Help Fuel Capital and Growth on Main Street:" Hearing before the H. Subcomm. Cap. Markets, Sec., & Investment, 115th Cong. (May 23, 2018) (Statement of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School at 2) ("the decline of IPO's . . . cannot be blamed on an over-regulating national regulator"), https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-jcoffee-20180523.pdf; Elisabeth de Fontenay, "The Deregulation of Private Capital and the Decline of the Public Company," 68 Hastings L.J. 445, 448 (Mar. 29, 2017) ("even if public company disclosure requirements had remained constant over the last three decades, there would likely still be a dearth of public companies today, due to the increasing ease of raising capital privately") *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/elisabeth-de-fontenay-deregulation-private-capital.pdf.

Proxy Advisory Firms

Many CII members and other institutional investors voluntarily contract with proxy advisory firms to obtain cost-effective independent research to help inform their proxy voting and engagement decisions, and to execute votes based on funds' own proxy voting guidelines. Proxy voting is a critical means by which shareowners hold corporate executives and boards to account and is a hallmark of shareholder ownership and accountability. The system of corporate governance in the United States relies on the accountability of Chief Executive Officers and boards of directors alike to shareowners, and ensuring unencumbered shareholder access to independent research is a crucial underpinning of effective corporate governance.

H.R. 4015[9]

H.R. 4015 would require, as a matter of federal law, that proxy advisory firms share their research reports and proxy voting recommendations with the companies about whom they are writing before they are shared with the institutional investors who are their paying clients.[10] While the stated goal of the proposed legislation is the "protection of investors,"[11] we believe the legislation would bias proxy advisory firms in favor of corporate management on matters about which there are significant differences of view. We also believe that the new requirements it would impose are unnecessary, overly burdensome and counter-productive. Many investors and investor organizations outside of CII's membership share our concerns.[12]

Further, the proposed legislation appears to be based on several false premises, including the erroneous conclusions that: (1) proxy advisory firms initiate many of the so-called "activist" hedge fund agendas; (2) proxy advisory firms dictate proxy voting results; and (3) institutional investors do not drive or form their own voting decisions. Indeed, while many pension funds and other institutional investors contract with proxy advisory firms to review their research, most large holders have adopted their own policies and may employ the proxy advisory firms to help administer the voting of proxies during challenging proxy seasons.

In short, most large institutional investors do not "rubber stamp" the proxy advisory firms' recommendations. Rather, they vote their proxies according to their own guidelines. While many large institutional investors rely on proxy advisors to help them manage the analysis of issues presented in the proxy statements accompanying thousands of shareholder meetings annually, and to help administer proxy voting, this does not mean that they abdicate their responsibility for their own voting decisions.

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[9] H.R. 4015, 115th Cong. (Dec. 21, 2017), https://www.congress.gov/115/bills/hr4015/BILLS-115hr4015rfs.pdf.
[10] H.R. 4015 § 3(a).
[11] *Id.* at Preamble.
[12] *See* Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to The Honorable Michael Crapo, Chairman, Committee on Banking, Housing, and Urban Affairs et al. (Feb. 27, 2018) (signed by 48 investors and investor organizations including many investors and investor organizations that are not currently members of CII), https://www.cii.org/files/issues_and_advocacy/correspondence/2018/Feb%2027-18%20Final%20Letter%20CII%20on%20proxy%20advisor%20legislation.pdf; *see also* Letter from Thomas P. DiNapoli, NYS Comptroller et al. to The Honorable Charles E. Schumer, Minority Leader, United States Senate (May 29, 2018) ("On behalf of the more than two million state, city, and local government employees, teachers, retirees, and beneficiaries, we urge your strenuous opposition to . . . H.R. 4015 in the Senate.") (on file with CII).

The independence that shareowners exercise when voting their proxies is evident in the statistics related to "say on pay" proposals and director elections. Although Institutional Shareholder Services Inc. (ISS), the largest proxy advisory firm, recommended voting against say-on-pay proposals at 11.8% of Russell 3000 companies in 2017, only 1.4% of those proposals received less than majority support from shareowners.[13] Similarly, although ISS recommended voting against or withholding votes from the election of 10.8% of uncontested director-nominees, just 0.2% failed to obtain majority support.[14]

We are particularly concerned that if enacted, H.R. 4015, while providing no clear benefits to institutional investors, would:

- Grant companies the right to review the proxy advisory firms' research reports before the paying customers – investors – receive the reports;[15]
- Mandate that proxy advisory firms hire an ombudsman to receive and resolve corporations' complaints;[16]
- Require proxy advisory firms to publish a company's statement "detailing its complaints" in the proxy advisory firms' final reports to their clients, if the ombudsman is unable to resolve these complaints and if the company makes the request in writing; and[17]
- Increase barriers to new entrants and potentially lead some current proxy advisory firms to exit the industry altogether.

Giving corporate issuers the "right to review" the proxy advisors' work product before the reports go to the paying customers is unprecedented. It would give corporate management substantial undue influence over proxy advisory firms' reports. The approach would create a dynamic that would encourage proxy advisory firms to view management as their research clients, rather than the investors who contract for this research.

Another concern is that such forced pre-publication review may not be consistent with First Amendment rights to freedom of speech. Regardless, the attempt by government fiat to interpose corporate management between investors and those whom investors voluntarily hire to provide them with independent research is highly questionable as a matter of public policy and inconsistent with free-market principles.

Practically, the additional regulatory hurdles imposed would: (1) increase the complexity of the challenges faced by the proxy advisory firms; (2) impose even more severe time constraints on the production of reports; and, without doubt, (3) add significant resource burdens that would increase the cost of their services. The higher costs would likely be passed along to their institutional investor clients.

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[13] ISS Voting Analytics Database (June 21, 2018) (on file with CII).
[14] *Id.*
[15] H.R. 4015 § 3(a).
[16] *Id.*
[17] *Id.*

Under H.R. 4015, pension funds and other institutional investors would have less time to analyze the advisor's reports and recommendations in the context of their own adopted proxy voting guidelines to arrive at informed voting decisions. Time is already tight, particularly in the highly concentrated spring "proxy season," due to the limited period between a company's publication of the annual meeting proxy materials and annual meeting dates. Simply put, the proposed legislation is not constructive regulatory "reform," and is not supported by institutional investors.

Moreover, H.R. 4015 does not appear to contemplate a parallel requirement that dissidents in a proxy fight or proponents of shareowner proposals also receive the recommendations and research in advance. This would violate an underlying tenet of U.S. corporate governance that where matters are contested in corporate elections, management and shareowner advocates should operate on a level playing field.

H.R. 4015 would also require the Securities and Exchange Commission (SEC) to assess the ability of proxy advisory firms to perform their duties and to assess the adequacy of proxy advisory firms' "financial and managerial resources."[18]

The entities that are in the best position to make assessments about whether a service provider – including proxy advisory firms – are adhering to contractual terms negotiated with clients are the clients themselves, not the government. Pension funds and other institutional investors that choose to purchase these services are sophisticated consumers who are fully capable of making prudent choices based on free-market principles.

In 2014, the SEC staff issued guidance reaffirming that investment advisors have a duty to maintain sufficient oversight of proxy advisory firms and other third-party voting agents.[19] CII and many institutional investors publicly supported that guidance.[20] We are unaware of any compelling empirical evidence indicating that the guidance is not being followed or that the burdensome federal regulatory scheme contemplated by the proposed legislation is needed. If the Committee is concerned about proxy advisory firms, we would respectfully suggest that the Committee request that the SEC brief the Committee on whether the 2014 guidance is being adequately followed and enforced.

If enacted, the proposed legislation would increase costs for pension plans and other institutional investors with no clear benefits. The costs could rise substantially if investors seek to maintain current levels of scrutiny and due diligence around proxy voting amid the exit of some or all proxy advisory firms from the business. These increased costs would also likely impair the ability of institutional investors to promote good corporate governance and accountability at the companies in which they own stock. Proxy advisory firms, while imperfect, play an important and useful role in enabling effective and cost-efficient independent research, analysis and

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[18] *Id.*

[19] SEC Staff Legal Bulletin No. 20 (June 30, 2014), https://www.sec.gov/interps/legal/cfslb20.htm.

[20] *See* Letter from Jeff Mahoney, General Counsel, CII, to The Honorable Scott Garrett, Chairman, Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services et al. 5 (July 23, 2014) ("Consistent with our recommendation, the Guidance clarifies that investment advisers are not required to vote every proxy."), https://www.cii.org/files/issues_and_advocacy/correspondence/2014/07_23_14_letter_Subcommittee_Capital_Markets.pdf.

informed proxy voting advice for large institutional shareholders, particularly since many funds hold shares of thousands of companies in their investment portfolios.

We believe that the cost estimate provided by the Congressional Budget Office (CBO) to the House Financial Services Committee in December 2017 underestimates the costs that this bill would impose through private-sector mandates.[21] The CBO should analyze the probable effects of the proposal on competition, and the costs to investors if: (1) competition is reduced and the pricing power of a surviving proxy advisory firm is enhanced, and (2) if all present firms exit the market and the services they provided are no longer available, forcing individual investors to use internal resources not subject to the new regulatory mandate.

Finally, we note that in October 2017, the United States Department of Treasury (Treasury) performed outreach to identify views on proxy advisory firms in connection with its report to the President on "A Financial System that Creates Economic Opportunities, Capital Markets."[22] In that report, the Treasury found that "institutional investors, who pay for proxy advice and are responsible for voting decisions, find the services valuable, especially in sorting through the lengthy and significant disclosures contained in proxy statements."[23] More importantly, the Treasury did not recommend any legislative changes governing the proxy advisory firm industry.[24] Contrary to H.R. 4015's focus on government intervention, the Treasury recommended that any regulatory response *should promote free market principles*.[25]

Cybersecurity

CII believes that cybersecurity is an integral component of a board's role in risk oversight.[26] Directors have the authority, capacity and responsibility to make pivotal contributions in this area by ensuring adequate resources and management expertise are allocated to robust cyber risk management policies and practices, and ensuring disclosure fairly and accurately portrays material cyber risks and incidents.[27] To achieve these objectives, directors need to:

- Understand management's cybersecurity strategy;
- Learn where cybersecurity weaknesses lie, and;
- Support informed, reasonable investment in the protection of critical data and assets.[28]

Consistent with our view, we generally agree with SEC Chairman Jay Clayton that "in today's world, companies must have adequate policies and procedures in place to ensure that they

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[21] Congressional Budget Office, H.R. 4015, Corporate Governance Reform and Transparency Act, https://www.cbo.gov/publication/53377.
[22] U.S. Department of the Treasury, A Financial System That Creates Economic Opportunities, Capital Markets 31 (Oct. 2017), https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf
[23] *Id.*
[24] *See id.* ("Treasury recommends further study and evaluation of proxy advisory firms, including regulatory responses to promote free market principles if appropriate.").
[25] *See id.* (emphasis added).
[26] CII, Prioritizing Cybersecurity, Five Investor Questions for Portfolio Company Boards 2 (Apr. 2016), https://www.cii.org/files/publications/misc/4-27-16%20Prioritizing%20Cybersecurity.pdf.
[27] *Id.*
[28] *Id.*

respond appropriately to—and, where necessary, adequately disclosure—material cyber risks and incidents."[29]

On February 2018, the SEC issued a statement and interpretative guidance to assist public companies in preparing disclosures about cybersecurity.[30] Some investors believe the guidance is insufficient.[31]

S. 536[32]

S. 536 directs the SEC to issue final rules requiring a registered issuer to:

- Disclose in its mandatory annual report or annual proxy statement whether any member of its governing body has expertise or experience in cybersecurity, including details necessary to describe fully the nature of that expertise or experience; and
- If no member has such expertise or experience, describe what other company cybersecurity steps were taken into account by the persons responsible for identifying and evaluating nominees for the governing body.[33]

CII strongly supports the stated goal of the bill to "promote transparency in the oversight of cybersecurity risks at publicly traded companies."[34] We are optimistic that, unlike H.R. 4015, S. 536 may have the potential of being pursued in a thoughtful and bi-partisan manner that is responsive to the views of investors.[35]

Thank you for considering these views. CII would be very happy to discuss its perspective in more detail. I can be can be reached at jeff@cii.org or by telephone at (202) 822-0800.

Sincerely,

Jeff Mahoney
General Counsel

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[29] Oversight of the U.S. Securities and Exchange Commission, Before the H. Comm. on Fin. Servs., 115th Cong. (June 21, 2018) (Testimony of Jay Clayton, Chairman, SEC at 8), http://www.mondovisione.com/media-and-resources/news/testimony-on-oversight-of-the-us-securities-and-exchange-commission-sec-cha-1/.
[30] Press Release 2018-22, SEC Adopts Statement and Interpretative Guidance on Public Company Cybersecurity Disclosures (Feb. 21, 2018), https://www.sec.gov/news/press-release/2018-22.
[31] *See, e.g.*, Hazel Bradford, Investors Pushing Harder for Cybersecurity Solution, P&I, Mar. 5, 2018 ("Mr. DiNapoli, the sole trustee of the $209.1 billion New York State Common Retirement Fund, Albany, agrees that the latest SEC action fell short."), http://www.pionline.com/article/20180305/PRINT/180309912/investors-pushing-harder-for-cybersecurity-solution.
[32] S. 536, 115th Cong. (Mar. 7, 2017), https://www.congress.gov/115/bills/s536/BILLS-115s536is.pdf.
[33] *See id.*at § 2.
[34] *Id;* Letter from Ken Bertsch, Executive Director, Council of Institutional Investors to The Honorable Jack Reed, United States Senate (July 7, 2017), https://www.cii.org/files/07_07_17%20letter%20to%20Senator%20Reed.pdf.
[35] *See* H.R. 4015, Final Vote Results for Roll Call 702 (more than 90% of House Democrats voted nay on H.R. 4015), http://clerk.house.gov/evs/2017/roll702.xml.

CC: The Honorable Dean Heller, Chairman, Subcommittee on Securities, Insurance, and Investment, Committee on Banking, Housing, and Urban Affairs
The Honorable Mark Warner, Ranking Member, Subcommittee on Securities, Insurance and Investment, Committee on Banking, Housing, and Urban Affairs
The Honorable Richard Shelby, Committee on Banking, Housing, and Urban Affairs
The Honorable Bob Corker, Committee on Banking, Housing, and Urban Affairs
The Honorable Patrick J. Toomey, Committee on Banking, Housing, and Urban Affairs
The Honorable Tim Scott, Committee on Banking, Housing, and Urban Affairs
The Honorable Ben Sasse, Committee on Banking, Housing, and Urban Affairs
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The Honorable Elizabeth Warren, Committee on Banking, Housing, and Urban Affairs
The Honorable Heidi Heitkamp, Committee on Banking, Housing, and Urban Affairs
The Honorable Joe Donnelly, Committee on Banking, Housing, and Urban Affairs
The Honorable Brian Schatz, Committee on Banking, Housing, and Urban Affairs
The Honorable Chris Van Hollen, Committee on Banking, Housing, and Urban Affairs
The Honorable Catherine Cortez Masto, Committee on Banking, Housing, and Urban Affairs
The Honorable Doug Jones, Committee on Banking, Housing, and Urban Affairs

United States Government Accountability Office

Report to Congressional Committees

July 2013

INTERNAL CONTROLS

SEC Should Consider Requiring Companies to Disclose Whether They Obtained an Auditor Attestation

GAO-13-582

GAO Highlights

Highlights of GAO-13-582, a report to congressional committees

July 2013

INTERNAL CONTROLS

SEC Should Consider Requiring Companies to Disclose Whether They Obtained an Auditor Attestation

Why GAO Did This Study

Section 404(b) of the Sarbanes-Oxley Act requires a public company to have its independent auditor attest to and report on management's internal control over financial reporting; this is known as the auditor attestation requirement. In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act exempted companies with less than $75 million in public float from the auditor attestation requirement. The act mandated that GAO examine the impact of the permanent exemption on the quality of financial reporting by small public companies and on investors. This report discusses (1) how the number of financial statement restatements compares between exempt and nonexempt companies (i.e., those with $75 million or more in public float), (2) the costs and benefits of complying with the attestation requirement, and (3) what is known about the extent to which investor confidence is affected by compliance with the auditor attestation requirement. GAO analyzed financial restatements and audit fees data; surveyed 746 public companies with a response rate of 25 percent; interviewed regulatory officials and others; and reviewed laws, surveys, and studies.

What GAO Recommends

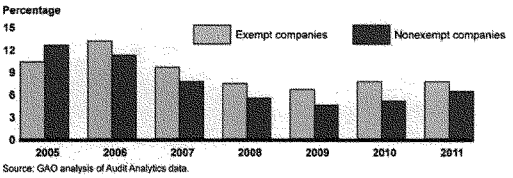
GAO recommends that SEC consider requiring public companies, where applicable, to explicitly disclose whether they obtained an auditor attestation of their internal controls. SEC responded that investors could determine attestation status from available information. But without clear disclosure, investors may misinterpret a company's status; therefore, this warrants SEC's further consideration.

View GAO-13-582. For more information, contact A. Nicole Clowers at (202) 512-8678 or clowersa@gao.gov.

What GAO Found

Since the implementation of the auditor attestation requirement of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act), companies exempt from the requirement have had more financial restatements (a company's revision of publicly reported financial information) than nonexempt companies, and the percentage of exempt companies restating generally has exceeded that of nonexempt companies. Exempt and nonexempt companies restated their financial statements for similar reasons (e.g., revenue recognition and expenses), and the majority of these restatements produced a negative effect on the companies' financial statements.

Percentage of Exempt and Nonexempt Companies That Restated Their Financial Statements, 2005 to 2011



Source: GAO analysis of Audit Analytics data.

Note: Nonexempt companies first complied with the Section 404(b) requirement for their first fiscal year ending on or after November 15, 2004. Exempt companies never had to comply with the requirement.

Views on the costs and benefits of auditor attestation vary among companies and others. Although companies and others reported that the costs associated with compliance can be significant, especially for smaller companies, GAO's and others' analyses show that these costs have declined for companies of all sizes since 2004. Companies and others reported benefits of compliance, such as improved internal controls and reliability of financial reports. However, measuring whether auditor attestation compliance costs outweigh the benefits is difficult and views among companies and others were mixed as to whether the costs exceeded the benefits of compliance.

A majority of empirical studies GAO reviewed suggest that compliance with the auditor attestation requirement has a positive impact on investor confidence in the quality of financial reports. Some interviewees said the independent scrutiny of a company's internal controls is an important investor protection safeguard. The Securities and Exchange Commission (SEC) does not require exempt companies to disclose in their annual report whether they voluntarily obtained an auditor attestation. SEC officials said it is not common for SEC to require a company to disclose voluntary compliance with requirements from which it is exempt. However, federal securities laws require companies to disclose relevant information to investors to aid in their investment decisions. Although information on auditor attestation status is available to investors, requiring a company to explicitly state whether it has obtained an auditor attestation on internal controls could increase transparency and investor protection.

United States Government Accountability Office

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GAO U.S. GOVERNMENT ACCOUNTABILITY OFFICE
441 G St. N.W.
Washington, DC 20548

July 3, 2013

The Honorable Tim Johnson
Chairman
The Honorable Mike Crapo
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Jeb Hensarling
Chairman
The Honorable Maxine Waters
Ranking Member
Committee on Financial Services
House of Representatives

Public and investor confidence in the accuracy, reliability, and transparency of companies' financial reporting is critical to the effective functioning of U.S. capital markets. In response to a series of high-profile corporate accounting scandals that resulted in substantial losses to investors at the start of the last decade, Congress passed the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act).[1] The act introduced major reforms to public company financial reporting and auditing that were intended to, among other things, improve the reliability of financial reporting and enhance audit quality. Effective internal controls are a key focus of these reforms. In particular, Section 404(b) of the act—the auditor attestation requirement—requires that each public company's independent auditor annually attest to and report on management's assessment of the effectiveness of the company's internal control over financial reporting.[2] The auditor determines whether any material weaknesses exist as of year-end.

[1]Pub. L. No. 107-204, 116 Stat. 745 (2002).

[2]Section 404(b) applies to companies required to file reports with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934. *Id* at § 404(a). Registered investment companies and asset-backed issuers generally are exempt from Section 404(b). *See* Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Reports, 68 Fed. Reg. 36,636 (June 18, 2003).

The auditor attestation requirement has been subject to much debate since its inception. Congress, business groups, regulators, consumer, investor and auditing groups, and academics have debated the need for small public companies (generally considered to be public companies with a publicly available stock value of less than $75 million) to comply with the auditor attestation requirement. Opponents of the requirement argue that compliance is too costly, especially for small public companies. In contrast, proponents of the requirement argue that, generally, small public companies lack adequate internal controls and restate their financial statements—that is, revise their financial statements to correct accounting errors—more often than large companies. Therefore, they argue, the requirement provides an important investor protection safeguard by ensuring independent scrutiny of a company's financial reporting process.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) Section 989G, amended the Sarbanes-Oxley Act so that Section 404(b) does not apply with respect to "any audit report prepared for an issuer that is neither a 'large accelerated filer' nor an 'accelerated filer' as those terms are defined" by the Securities and Exchange Commission (SEC).[3] By adding Section 404(c) to the Sarbanes-Oxley Act, Section 989G permanently exempted smaller issuers from the requirement to obtain an auditor's attestation on management's assessment of the company's effectiveness of internal control over financial reporting.[4] At the time of enactment in 2010, Section 989G affected about 5,500 small public companies, representing about 61

[3]Pub. L. No. 111-203, § 989G(a), 124 Stat. 1376, 1948 (2010). SEC refers to small public companies and large public companies as nonaccelerated filers and accelerated filers, respectively, and uses a public float measurement to determine the category of filer. Although the term "nonaccelerated filer" is not defined in SEC rules, it refers to a reporting company that does not meet the definition of either an "accelerated filer" or a "large accelerated filer" under the Securities Exchange Act of 1934 Rule 12b-2. 17 C.F.R. § 240.12b-2. An accelerated filer generally is a company that has been public for at least 12 months and, among other things, had at least $75 million but less than $700 million in public float as of the last business day of its most recently completed second fiscal quarter and filed at least one annual report with SEC. A large accelerated filer generally is a company that has been public for at least 12 months and, among other things, had a public float of $700 million or more as of the last business day of its most recently completed second fiscal quarter and filed at least one annual report with SEC. SEC defines public float as the worldwide aggregate market value of voting and nonvoting common equity held by nonaffiliates of the filer.

[4]§ 989G(a).

percent of all public companies, by exempting them from the requirement.[5]

Section 989I of the Dodd-Frank Act mandated us to study and report on the impact of the permanent exemption on the quality of financial reporting by smaller public companies and on investors.[6] This report discusses: (1) how the number of financial statement restatements compares between exempt and nonexempt companies; (2) the costs and benefits for nonexempt companies and exempt companies that voluntarily comply with the auditor attestation requirement; and (3) what is known about the extent to which investor confidence in the integrity of financial statements is affected by whether or not companies comply with the auditor attestation requirement. For the purposes of this report, we define exempt companies as those with less than $75 million in public float (nonaccelerated filers) and nonexempt companies as those with $75 million or more in public float (accelerated filers).

To identify the number of financial statement restatements (referred to as financial restatements) and trends, we analyzed data from Audit Analytics' Restatement database, which contains company information (such as assets, revenues, restatements, market capitalization, location, and industry classification code) for 2005 through 2011.[7] We identified 6,436 financial restatements by 4,536 public companies, 2,834 of which were exempt companies.[8] We used Audit Analytics' 69 classifications to classify the type of financial restatements into six categories: core expenses (i.e., ongoing operating expenses), noncore expenses (i.e., nonoperating or nonrecurring expenses), revenue recognition, reclassifications and disclosures, underlying events (i.e., accounting for mergers or acquisitions), and other (e.g., restatements related to

[5]See Securities and Exchange Commission, *Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers with Public Float Between $75 and $250 Million* (Washington, D.C.: April 2011).

[6]§ 989I(a)-(b).

[7]Audit Analytics is an online market intelligence service that provides information on SEC registrants. Audit Analytics maintains a proprietary database containing information from the filings public companies submit to SEC, such as audit fees, audit opinions, and financial restatements.

[8]The number of financial restatements exceeds the number of public companies issuing financial restatements because some of these companies restated their financial statements more than once.

pensions and any other issues identified in the restatement).[9] To identify audit costs of compliance, we analyzed data from Audit Analytics' Auditor Opinion database, which contains auditors' report information, including audit fees, nonaudit fees, auditor name, audit opinions, revenues, and company size, for 2005 through 2011. Our analyses of audit costs do not include 2012 data because some of the data for small companies were incomplete as we concluded our analysis. According to Audit Analytics, the incomplete data was often due to the fact that the small companies had not yet filed the relevant information with SEC. In addition, although 2012 restatement data are available, we were unable to conduct some of our analyses of restatements for 2012 because of incomplete 2012 small-company data in the Auditor Opinion database. We tested samples of the Audit Analytics database information and found it to be reliable for our purposes.

To obtain information on large and small public companies' experiences with the costs and benefits of complying with the auditor attestation requirement and the extent to which investor confidence in the integrity of financial statements is affected by companies' compliance with the requirement (referred to as auditor attestation status), we identified a population of 4,053 companies that fit within the scope of our review. To define the population, we obtained a list of all publicly traded companies for calendar years 2004 through 2011 from Audit Analytics. We stratified the population into three strata by first identifying the nonaccelerated filers that voluntarily complied with the integrated audit requirement in any year from 2004 through 2011. We excluded from our population any exempt company that did not obtain an auditor attestation of its internal controls and then stratified the remaining companies into accelerated filers and large accelerated filers.[10] We surveyed all nonaccelerated filers that

[9]Susan Scholz, *The Changing Nature and Consequences of Public Company Financial Restatements: 1997-2006*, a special report prepared at the request of the Department of the Treasury, April 2008. Five of the six categories are based on the classification scheme developed by academics Zoe-Vonna Palmrose and Susan Scholz. The remaining category ("other") was developed by GAO and comprises financial restatements that were not included in one of the other categories.

[10]To identify accelerated filers and large accelerated filers, we relied upon the companies' SEC filing status, which is based on public float. In instances in which companies did not disclose their filing status, we relied upon the companies' market capitalization, as reported in the Audit Analytics database, to make an independent determination of likely filing status. Market capitalization is defined as the total dollar market value of all of a firm's outstanding shares and is calculated by multiplying a firm's outstanding shares by the current market price of one share.

voluntarily complied as well as a random sample of both strata of accelerated filers for a total survey population of 746 companies. We received valid responses from 195 companies. The weighted response rate for this survey, which accounts for the differential sampling fractions within each strata, was 25 percent. All percentage estimates presented in this report have a margin of error of plus or minus 15 percentage points or fewer, and all estimates of averages have a relative margin of error of plus or minus 20 percent or less, unless otherwise noted.

For all three objectives, we interviewed representatives of small public companies, regulatory bodies (SEC and Public Company Accounting Oversight Board (PCAOB)), trade associations (representing individual and institutional investors, accounting firms, financial analysts and investment professionals, and financial executives), industry experts, a large pension fund, a credit rating agency, and academics knowledgeable about accounting issues. We also reviewed relevant academic, industry, and SEC research studies and surveys.[11] Appendix I contains a more detailed description of our scope and methodology.

We conducted this performance audit from May 2012 to July 2013 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Internal control generally serves as a first line of defense for public companies in safeguarding assets and preventing and detecting errors and fraud. Internal control is defined as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of the following objectives: (1) effectiveness and efficiency of operations; (2) reliability of financial reporting; and (3) compliance with laws and regulations.[12]

[11]See the bibliography for a detailed list of sources reviewed.

[12]COSO, Internal Control – Integrated Framework, 1992, 1994, and 2013. The "reliability of financial reporting" objective is the objective that is relevant for purposes of Section 404 and the SEC's implementing rules.

Internal control over financial reporting is further defined in the SEC regulations implementing Section 404 of the Sarbanes-Oxley Act.[13] These regulations define internal control over financial reporting as a means of providing reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements, including those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.[14]

Regulators regard an effective internal control system as a foundation for high-quality financial reporting by companies. Title IV, Section 404 of the Sarbanes-Oxley Act, aims to help protect investors by, among other things, improving the accuracy, reliability, and transparency of corporate financial reporting and disclosures. Section 404 has the following two key sections:

- Section 404(a) requires company management to state its responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting and assess the effectiveness of its internal control over financial reporting in each annual report filed with SEC.[15] In 2007, SEC issued guidance for

[13]Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Reports, 68 Fed. Reg. 36636 (June 18, 2003) (amending 17 C.F.R. §§ 210, 228, 229, 240, 249, 270, and 274).

[14]*Id.*

[15]Pub. L. No. 107-204, § 404(a), 116 Stat. 745, 789 (2010) (codified as amended at 15 U.S.C. § 7262).

management regarding its report on internal control over financial reporting.[16]

- Section 404(b) requires the firms that serve as external auditors for public companies to provide an opinion on the internal control assessment made by the companies' management regarding the effectiveness of the company's internal control over financial reporting as of year-end.[17] In 2007, PCAOB issued Auditing Standard No. 5, which contains the requirements that apply when an auditor is engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting.[18]

While management is responsible for the implementation of an effective internal control process, the external auditor obtains reasonable assurance to provide an opinion on the effectiveness of a company's internal control over financial reporting through an independent audit. Investors need to know that the financial statements on which they make investment decisions are reliable. The auditor attestation process involves the external auditor's testing and evaluation of the company's internal control over financial reporting and relevant documentation in order to provide an opinion on the effectiveness of the company's internal control over financial reporting as of year-end; a company's internal control over financial reporting cannot be considered effective if one or more material weaknesses exist.[19]

Auditor attestation of the effectiveness of internal control over financial reporting has been required for public companies with a public float of

[16]*Commission Guidance Regarding Management's Report on Internal Control over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934*, Interpretation, SEC Release No. 33-8810 (June 20, 2007).

[17]§ 404(b).

[18]Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements* (PCAOB 2007).

[19]SEC and PCAOB define a material weakness as a deficiency, or combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the firm's annual or interim financial statements will not be prevented or detected on a timely basis. *See* SEC Regulation S-X, 17 C.F.R. § 210.1-02(a)(4); Auditing Standard No. 5.

$75 million or more (accelerated filers) since 2004.[20] However, SEC delayed implementing the auditor attestation for public companies with less than $75 million in public float (nonaccelerated filers) several times from the original compliance date of April 15, 2005, to June 15, 2010, in response to concerns about compliance costs and management and auditor preparedness.[21] On July 21, 2010, the Dodd-Frank Act permanently exempted nonaccelerated filers from the auditor attestation requirement.[22] The Dodd-Frank Act did not exempt nonaccelerated filers from Section 404(a) of the Sarbanes-Oxley Act (management's assessment of internal controls). See table 1 for final compliance dates for internal control over financial reporting by issuer filer status.

[20]Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Reports, 68 Fed. Reg. at 36,647.

[21]GAO, *Community Banks and Credit Unions: Impact of the Dodd-Frank Act Depends Largely on Future Rule Makings*, GAO-12-881 (Washington, D.C.: Sep. 13, 2012).

[22]Pub. L. No. 111-203, § 989G(a), 124 Stat. 1376, 1948 (2010) (codified at 15 U.S.C.§7262) (amending Sarbanes-Oxley Act). SEC amended its rules and forms to conform to Section 404(c) of the Sarbanes-Oxley Act, as added by Section 989G of the Dodd-Frank Act. *See* Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers, 75 Fed. Reg. 57,385 (Sept. 21, 2010). Section 404(c) provides that Section 404(b) of the Sarbanes-Oxley Act shall not apply with respect to any audit report prepared for an issuer that is neither an accelerated filer nor a large accelerated filer as defined in Rule 12b–2 under the Securities Exchange Act of 1934. Pub. L. No. 107-204, § 404(c), 116 Stat. 745, 789 (2010) (codified as amended at 15 U.S.C. § 7262). Additionally, the Jumpstart Our Business Startups Act ("JOBS Act") also exempted emerging growth companies, defined generally as issuers with less than $1 billion in annual gross revenue, from the auditor attestation requirement of Section 404(b) as long as the issuer retains emerging growth company status, which is subject to four conditions. Among other conditions, an issuer will ordinarily no longer retain emerging growth company status at the end of the fiscal year in which the fifth anniversary of its initial public offering of common equity securities occurs. Pub. L. No. 112-106, § 103, 126 Stat. 306, 310 (2012). In addition, our study did not specifically address the impact of this JOBS Act exemption on the number of exempt companies, the number of restatements by exempt companies, the auditor attestation practices of newly public companies or investor perception of the reliability of financial statements of emerging growth companies.

Table 1: Sarbanes-Oxley Act Section 404 Requirements Compliance Dates by Filer Status Set by SEC

		Compliance dates for internal control over financial reporting requirements	
	Issuer filer status	**Management's report on internal controls and effectiveness**	**External auditor's attestation report on internal controls and effectiveness**
U.S. issuer	Large accelerated filer or accelerated filer ($75 million or more in public float)	Annual reports filed with SEC for fiscal years ending on or after November 15, 2004	Annual reports filed with SEC for fiscal years ending on or after November 15, 2004
	Nonaccelerated filer (less than $75 million in public float)	Annual reports filed with SEC for fiscal years ending on or after December 15, 2007	Permanently exempted by Dodd-Frank Act on July 21, 2010
Foreign private issuer	Large accelerated filer ($700 million or more in public float)	Annual reports filed with SEC for fiscal years ending on or after July 15, 2006	Annual reports filed with SEC for fiscal years ending on or after July 15, 2006
	Accelerated filer ($75 million or more and less than $700 million in public float)	Annual reports filed with SEC for fiscal years ending on or after July 15, 2006	Annual reports filed with SEC for fiscal years ending on or after July 15, 2007
	Nonaccelerated filer (less than $75 million in public float)	Annual reports filed with SEC for fiscal years ending on or after December 15, 2007	Permanently exempted by Dodd-Frank Act on July 21, 2010
Newly public company (U.S. or foreign private issuer)	Large accelerated filer or accelerated filer ($75 million or more in public float)	Second annual report filed with SEC following company's initial public offering	Second annual report filed with SEC following company's initial public offering
	Nonaccelerated filer (less than $75 million in public float)	Second annual report filed with SEC following company's initial public offering	Permanently exempted by Dodd-Frank Act on July 21, 2010

Sources: GAO and SEC.

Note: Foreign private issuers are generally foreign companies that have a relatively lesser degree of U.S. share ownership or U.S. business contacts. SEC has adopted special rules applicable to foreign private issuers that are designed to recognize international and home jurisdiction. 17 C.F.R. § 240.3b-4; 17 C.F.R. § 230.405.

The number of exempt companies exceeded the number of nonexempt companies in each year from 2005 through 2011 (see table 2). According to our analysis of Audit Analytics data, the number of exempt companies fluctuated and ultimately declined from 6,333 in 2005 to 5,459 in 2011 (13.8 percent during that period). The number of nonexempt companies also fluctuated and ultimately declined from 4,256 in 2005 to 3,671 in 2011(13.7 percent).

Table 2: Number of Exempt and Nonexempt Companies, 2005-2011

Year	Number of exempt companies	Number of nonexempt companies
2005	6,333	4,256
2006	5,858	4,455
2007	5,530	4,437
2008	5,915	4,166
2009	6,285	3,697
2010	6,166	3,586
2011	5,459	3,671

Source: GAO analysis of Audit Analytics data.

Note: The number of exempt companies includes companies that voluntarily complied with the auditor attestation requirement. Company estimates in the table do not include subsidiaries of a public company, registered investment companies, or asset-backed securities issuers. Exempt companies are nonaccelerated filers, including smaller reporting companies. For our purposes, we grouped companies that did not disclose their filing status but whose market capitalization was less than $75 million with exempt companies. For example, companies that did not disclose their filing status include Canadian Form 40-F filers. We used market capitalization as a proxy for public float in these instances because the Audit Analytics database did not contain information on companies' public float. Nonexempt companies are accelerated filers and large accelerated filers. For our purposes, we grouped companies that did not disclose their filing status but whose market capitalization was equal to or greater than $75 million with nonexempt companies. We excluded companies that did not disclose their filing status and that did not have a reported market capitalization.

SEC and PCAOB have issued regulations, standards, and guidance to implement the Sarbanes-Oxley Act. In 2007, in response to companies' concerns about implementation costs, SEC provided implementation guidance to company management, and PCAOB issued a new auditing standard to external auditors to make the internal controls audit process more efficient and more cost-effective.[23] SEC's guidance for management in implementing Section 404(a) of Sarbanes-Oxley Act and PCAOB's Auditing Standard No. 5 for external auditors in implementing Section 404(b) of Sarbanes-Oxley Act endorsed a "top-down, risk-based approach" that emphasizes preventing or detecting material misstatements in financial statements by focusing on those risks that are more likely to contribute to such misstatements. These changes were provided to create a more flexible environment where company management and external auditors can scale their internal controls

[23] *Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934*, Interpretation, 72 Fed. Reg. 35,324 (June 27, 2007); and Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements* (PCAOB 2007).

evaluation based on the particular characteristics of a company to reduce costs and to align SEC and PCAOB requirements for evaluating the effectiveness of internal controls.

Both SEC regulations and PCAOB Auditing Standard No. 5 state that management is required to base its assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework established by a body of experts that followed due process procedures. Both the SEC guidance and PCAOB's auditing standard cite the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework as an example of a suitable framework for purposes of Section 404 compliance.[24] In 1992, COSO issued its "Internal Control—Integrated Framework" (the COSO framework) to help businesses and other entities assess and enhance their internal controls. Since that time, the COSO framework has been recognized by regulatory standard setters and others as a comprehensive framework for evaluating internal control, including internal control over financial reporting.[25] The framework consists of five interrelated components: control environment, risk assessment, control activities, information and communication, and monitoring.[26] However, SEC and PCAOB do not mandate the use of any particular framework.

[24]COSO was originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, an independent private-sector initiative that studied the causal factors that can lead to fraudulent financial reporting and developed recommendations for public companies and their independent auditors, SEC and other regulators, and educational institutions.

[25]COSO, *Internal Control – Integrated Framework*, 1992, 1994, and 2013.

[26]On May 14, 2013, COSO issued an update to its 1992 Internal Control-Integrated Framework to: (1) reflect a business environment that is more complex than it was when the original framework was developed; (2) broaden the application of internal control in addressing operations and reporting objectives; and (3) clarify what constitutes effective internal control.

The Percentage of Exempt Companies with Financial Restatements Was Generally Greater Than the Percentage of Nonexempt Companies from 2005 through 2011

Since the implementation of the Sarbanes-Oxley Act, the number and percentage of exempt companies restating their financial statements has generally exceeded the number and percentage of nonexempt companies restating. However, from 2005 through 2011, restatements by exempt companies were generally proportionate to their percentage of our total population. Specifically, on average, almost 64 percent of companies restating were exempt companies and exempt companies made up, on average, 60 percent of our total population. Exempt and nonexempt companies restated their financial statements for similar reasons, and the majority of these restatements produced a negative effect on the companies' financial statements.

Exempt Companies Generally Have Had More Financial Restatements Than Nonexempt Companies

The number of financial statement restatements by exempt and nonexempt companies has generally declined since 2005. As illustrated in figure 1, the number of financial restatements peaked in 2006 for exempt companies and declined gradually until 2011, despite a slight uptick in 2010. The number of restatements peaked in 2005 for nonexempt companies, declined gradually until 2009, and then trended upward for the remaining 2 years of the review period. As we have previously reported, some industry observers noted the financial reporting requirements of the Sarbanes-Oxley Act and PCAOB inspections may have led to a higher than average number of restatements in 2005 and 2006.[27] A 2010 Audit Analytics report noted that some observers attributed the subsequent decline in restatements to a belief that SEC relaxed standards in 2008 relating to materiality of errors and the need to file restatements.[28] The number of financial restatements by exempt companies exceeded the number of financial restatements by nonexempt companies each year from 2005 through 2011. However, although the overall number of financial restatements from 2009 through 2011 remained lower than the prior period, the number of financial restatements by nonexempt companies increased about 23 percent from

[27]GAO, *Financial Restatements: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Activities*, GAO-06-678 (Washington, D.C.: Mar. 5, 2007).

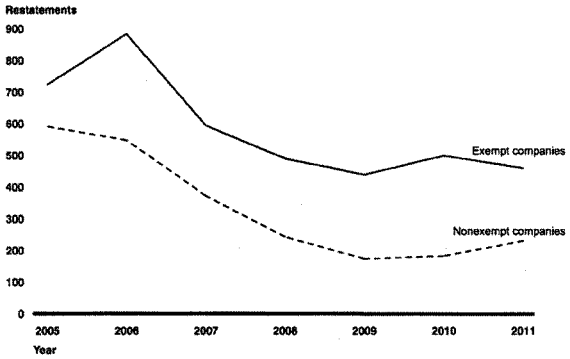
[28]Audit Analytics, *2009 Financial Restatements: A Nine Year Comparison* (Sutton, Mass.: February 2010).

2010 through 2011. The number of financial restatements by exempt companies declined almost 8 percent during the same period.

SEC officials and one market expert with whom we spoke indicated that there is no clear explanation for these restatement trends. They also said that a review of each individual financial restatement would be necessary to determine the reasons for the restatement trends, but they offered a few factors to consider when assessing the trends. In particular, a recent Audit Analytics report found that approximately 57 percent of restatements disclosed in 2011 were defined as revision restatements, the highest level since 2005 (the first full year of the disclosure requirement).[29] According to the report, revision restatements generally do not undermine reliance on past financials and are less disruptive to the market. SEC officials noted that although restatements by nonexempt companies have increased, as illustrated in the Audit Analytics report, they may be less severe as a result of higher numbers of revision restatements, fewer issues per restatement, and a lower cumulative impact on the company's net income. According to our analysis of Audit Analytics data, in 2011, the percentage of restatements that were revision restatements was approximately 62 percent for exempt companies compared to approximately 70 percent for nonexempt companies. SEC officials also suggested that the detection rate of financial restatements could affect restatement trends, especially when looking only at a one or two year period. The officials said that the lag time on detection and the likelihood of detection could be different between exempt and nonexempt companies. Finally, SEC officials said that it is important to consider the nature and severity of restatements.

[29]Audit Analytics, *2011 Financial Restatements: An Eleven Year Comparison* (Sutton, Mass.: April 2012). A revision restatement is defined as a restatement contained in a periodic report without prior disclosure in Form 8-K, Item 4.02. SEC requires public companies to disclose a determination that any previously issued financial statements should no longer be relied upon. Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, 69 Fed. Reg. 15,594 (Mar. 25, 2004).This set of disclosure requirements became effective August 23, 2004. *Id.*

Figure 1: Number of Restatements by Exempt Companies and Nonexempt Companies, 2005-2011



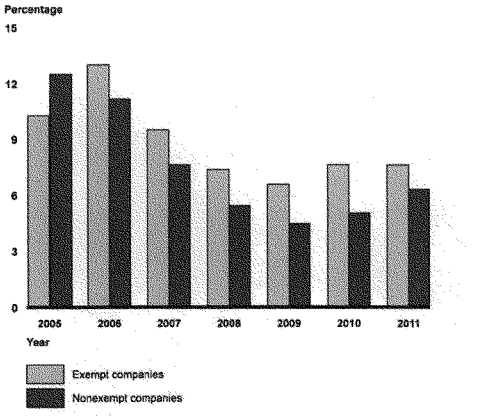
Source: GAO analysis of Audit Analytics data.

Note: The data for this table include the number of restatements disclosed in each calendar year from 2005 through 2011.

Except for 2005, the percentage of exempt companies restating their financial statements exceeded the percentage of nonexempt companies restating. From 2006 through 2009, there was a decline in the percentage of restatements for both exempt companies and nonexempt companies. The percentage of exempt companies restating their financial statements rose in 2010 to 7.6 percent and remained constant in 2011 (see fig. 2).[30] At the same time, starting in 2010, the percentage of nonexempt companies restating has been on the increase. In addition, from 2005 to 2011, on average, almost 64 percent of companies restating were exempt companies, which made up 60 percent of our total population.

[30]The data reflect the unique number of exempt and nonexempt companies restating in each calendar year, independent of the period or periods being restated. The percentage is calculated by dividing the number of unique restating exempt companies in a given year by the total population of unique exempt companies for that year.

Figure 2: Percentage of Exempt and Nonexempt Companies That Restated Their Financial Statements, 2005-2011



Source: GAO analysis of Audit Analytics data.

Note: The data for this table are based on the proportion of the unique number of exempt and nonexempt companies disclosing a restatement each calendar year divided by the respective populations for fiscal years 2005 through 2011.

Our analysis is generally consistent with a number of studies that have found that exempt companies restate their financial statements at a higher rate than nonexempt companies.[31] These studies suggest that having an auditor attest to the effectiveness of a company's internal control over financial reporting generally reduces the likelihood of financial restatements. For example, in 2009, Audit Analytics found that for companies that did not obtain an auditor attestation and stated that

[31]Securities and Exchange Commission, *Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers with Public Float Between $75 and $250 Million* (Washington, D.C.: April 2011); Audit Analytics, *Restatements Disclosed by the Two Types of SOX 404 Issuers: (1) Auditor Attestation Filers and (2) Management-Only Report Filers* (Sutton, Mass., November 2009); and A. Nagy, "Section 404 Compliance and Financial Reporting Quality," *Accounting Horizons*, vol. 24, no. 3 (2010).

they had effective internal controls, their financial restatement rate was 46 percent higher than the restatement rate for companies that had obtained an auditor attestation and stated that they had effective internal controls.[32]

Exempt Companies That Voluntarily Complied with Auditor Attestation Issued Fewer Restatements Than Exempt Companies That Did Not

Exempt companies that voluntarily complied with the auditor attestation requirement constitute a small percentage of exempt companies (see table 3). Prior to the passage of the Dodd-Frank Act in July 2010, the number of exempt companies voluntarily complying with the auditor attestation requirement grew 70 percent from 2008 through 2009. Although SEC deferred the requirement for nonaccelerated filers to comply until June 15, 2010, some exempt companies likely voluntarily complied in anticipation of SEC's implementation of the requirement.[33] Nonetheless, in 2009 during the peak compliance period for exempt companies that voluntarily complied, 6.9 percent (435) of a total population of 6,285 exempt companies voluntarily complied with the auditor attestation requirement. According to one academic study, exempt companies that voluntarily comply with the auditor's attestation requirement are more likely than companies that do not comply to have evidence of the superior quality of their internal control over financial reporting and fewer restatements, among other factors.[34]

[32]Audit Analytics, *Restatements Disclosed by the Two Types of SOX 404 Issuers: (1) Auditor Attestation Filers and (2) Management-Only Report Filers* (Sutton, Mass., November 2009). Audit Analytics uses SEC data for its analysis, and SEC and PCAOB define internal control over financial reporting as effective if a material weakness does not exist. *See* SEC Regulation S-K, 17 C.F.R § 229.308(a)(3); Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting that Is Integrated with an Audit of Financial Statements (PCAOB 2007).

[33]Prior to issuing several temporary exemptions from the auditor attestation requirement, SEC issued guidance stating that nonaccelerated (exempt) companies were not required to obtain an auditor's report on internal control over financial reporting until the company filed an annual report for its fiscal year ending on or after April 15, 2005. See Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Reports, 68 Fed. Reg. at 36,651.

[34]See K. Brown, P. Pacham, J. Li, E. Mohammad, F. A. Elayan, and F. Chu, "The Valuation Effect and Motivations of Voluntary Compliance with Auditor's Attestation Under Sarbanes-Oxley Act Section 404 (B)," Working paper, (Jan. 15, 2012).

Table 3: Number of Exempt Companies That Did and Did Not Voluntarily Comply with the Auditor Attestation Requirement and the Percentage of Companies That Filed Restatements, 2005-2011

	Exempt companies that did not voluntarily comply			Exempt companies that voluntarily complied			Total exempt companies		
Year	Total number	Total number restating	Percent restating	Total number	Total number restating	Percent restating	Total number	Total number restating	Percent restating
2005	6,253	643	10.28%	80	7	8.75%	6,333	650	10.26%
2006	5,755	750	13.03	103	12	11.65	5,858	762	13.01
2007	5,370	513	9.55	160	12	7.50	5,530	525	9.49
2008	5,659	418	7.39	256	17	6.64	5,915	435	7.35
2009	5,850	387	6.62	435	24	5.52	6,285	411	6.54
2010	5,816	453	7.79	350	16	4.57	6,166	469	7.61
2011	5,160	392	7.60	299	23	7.69	5,459	415	7.60

Source: GAO analysis of Audit Analytics data.

As table 3 also shows, the percentage of financial restatements by exempt companies that voluntarily complied with the requirement is generally lower than that of exempt companies that did not voluntarily comply. From 2005 through 2011, on average, 7.5 percent of exempt companies that voluntarily complied restated their financial statements compared to 8.9 percent of restating exempt companies that did not voluntarily comply.

Reasons for Financial Restatement and Industry Trends Are Generally Consistent for Both Exempt and Nonexempt Companies

From 2005 through 2011, based on our analysis of Audit Analytics data, the majority of exempt and nonexempt companies that restated their financial statements did so as the result of an accounting rule misapplication.[35] That is, a company revised previously issued public financial information that contained an accounting inaccuracy. To analyze the reasons for financial restatements, we used Audit Analytics' 69 classifications to classify the type of financial restatements into six categories (see table 4): revenue recognition, core expenses, noncore

[35]An "accounting rule misapplication" refers to the misapplication of Generally Accepted Accounting Principles.

expenses, reclassifications and disclosures, underlying events, and other.[36]

Table 4: Financial Restatement Category Descriptions

Category	Description
Revenue recognition	Restatements due to improper revenue accounting. This category includes restatements originating from a failure to properly interpret sales contracts for hidden rebate, return, barter, or resale clauses. They may also relate to the treatment of sales returns, credits, and other allowances.
Core expenses	Restatements of companies' ongoing operating expenses. This category includes cost of sales, compensation expenses, lease and depreciation costs, selling, general and administrative expenses, and research and development costs.
Noncore expenses	Restatements that affect net income but do not arise from ongoing operating expenses. This category includes accounting for interest, taxes, and derivatives. It also includes misstatements arising from accounting for nonrecurring events.
Reclassifications and disclosures	Restatements due to improperly classified financial statement items (e.g., current liabilities classified as long-term debt on the balance sheet, or cash flows from operating activities classified as cash flows from financing activities on the statement of cash flows). This category includes restatements that generally revise footnote information.
Underlying events	Restatements due to improper accounting for acquisitions or mergers and issues from problems with foreign affiliates and their related accounting or financial reporting.
Other	Any restatement not covered by the listed categories. This category includes restatements related to pensions and any other issues identified in the restatement

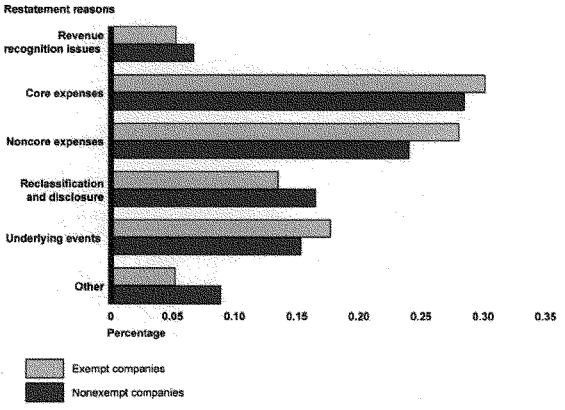
Sources: Zoe-Vonna Palmrose and Susan Scholz and GAO

Based on our classification, core expenses (i.e., ongoing operating expenses) were the most frequently identified category of restatement for both exempt and nonexempt companies. Specifically, core expenses accounted for 30.2 percent of disclosures by exempt companies and 28.5

[36]Five of the six categories are based on the classification scheme developed by academics Zoe-Vonna Palmrose and Susan Scholz. The sixth category ("other") was developed by GAO and comprises financial restatements that were not included in one of the other categories.

percent of disclosures by nonexempt companies from 2005 through 2011 (see fig. 3). Core expenses include cost of sales, compensation expenses, lease and depreciation costs, selling, general and administrative expenses, and research and development costs. Noncore expenses (i.e., nonoperating expenses) were the second most frequently identified reason for restatement across exempt and nonexempt companies during this period. Each of the other reasons for restatements represented less than 20 percent of all restatements by exempt and nonexempt companies during the period.

Figure 3: Reasons for Financial Restatements by Exempt Companies and Nonexempt Companies, 2005-2011



Source: GAO analysis of Audit Analytics data.

From 2005 through 2011, the majority of financial restatements by exempt and nonexempt companies negatively impacted the company's financial statements.[37] Specifically, 87.6 percent of financial restatements by exempt companies resulted in a negative net effect on the financial

[37]Audit Analytics' Restatement database includes an assessment of whether the effect on the financial statement is positive or negative.

statements—the income statement, the balance sheet, the statement of cash flows, or the statement of shareholder's equity—of these companies. Similarly, 80.6 percent of financial restatements by nonexempt companies resulted in a negative net effect on the company's financial statements.

The characteristics of exempt and nonexempt companies with financial restatements varied from 2005 through 2011. For example, in terms of industry characteristics, on average, most exempt companies restating were in the manufacturing sector (29.4 percent), followed by agriculture, construction, and mining (14.6 percent). On average, most of the nonexempt companies restating were in the manufacturing sector (29.3 percent), followed by the financial sector (16.6 percent). Further, in 2011, 91.4 percent of nonexempt companies restating compared to 35.3 percent of exempt companies were listed on an exchange.[38] In addition, nonexempt companies had an average financial restatement period that was longer than that of exempt companies.[39] Specifically, from 2005 through 2011, nonexempt companies had an average financial restatement period of 9 quarters compared to an average financial restatement period of almost 6 quarters for exempt companies.

Views on the Costs and Benefits of Auditor Attestation Vary among Companies and Others

Companies and others identified various costs of the auditor attestation requirement. A number of studies and surveys show that since the passage of the Sarbanes-Oxley Act, and especially since the 2007 reforms by SEC and PCAOB, audit costs have declined for companies of all sizes. These studies and surveys also show that these costs, as a percentage of revenues, affect smaller companies disproportionately compared to their larger counterparts. Companies and others also identified benefits of compliance, including stronger internal controls and more transparent and reliable financial reports. However, determining whether auditor attestation compliance costs outweigh the benefits is difficult because many costs and benefits cannot be readily quantified.

[38]Companies were listed on the New York Stock Exchange, Nasdaq National Market, Nasdaq Smallcap Market, American Stock Exchange, or were traded in the over-the-counter market.

[39]The financial restatement period is the accounting period (e.g., last 4 quarters) of the previously issued financial statements that contained a material inaccuracy that had to be corrected by filing revised financial statements with SEC.

Auditor Attestation Costs Can Be Significant, Especially for Small Companies, but Costs Are Declining

A number of studies and surveys show that the estimated costs of obtaining an external auditor attestation on internal control over financial reporting are significant for companies of all sizes. Obtaining an auditor attestation incurs both direct and indirect costs, according to one study.[40] Direct costs are expenses incurred to fulfill the auditor attestation requirement, such as the audit fees, external fees paid to outside contractors and vendors that help companies comply with the requirement, salaries of internal staff for hours spent preparing for auditor attestation compliance, and nonlabor expenses (e.g., technology, software, travel, and computers related to compliance). Indirect costs are those costs not directly linked to obtaining the auditor attestation. Two examples of indirect costs cited by one interviewee and one study are the time spent by management in preparing for and addressing auditors' inquiries, which diverts their attention from strategic planning, and the diversion of funds from capital investments to auditor attestation-related expenses.[41]

Audit fees are a significant direct cost of the auditor attestation requirement. Sarbanes-Oxley Act and PCAOB standards require that the financial statement audit and the auditor attestation audit be conducted on an integrated basis.[42] As a result, the auditor attestation is included in the total audit fees—that is, the total amount companies pay to their external auditors to conduct the integrated audit. Audit fees are based on several factors, including but not limited to the scope of an audit, which is a function of a company's complexity and risk; the total effort required by the external auditor to complete the audit; and the risk associated with performing the audit.[43] However, according to SEC's 2011 study and one

[40]C. R. Alexander, S. W. Bauguess, G. Bernile, Y. A. Lee, and J. Marietta-Westberg, "The Economic Effects of SOX Section 404 Compliance: A Corporate Insider Perspective," Working paper, (March 2010).

[41]Y. Jahmani and W. A. Dowling, "The Impact of Sarbanes-Oxley Act," *Journal of Business & Economics Research*, vol. 6, no. 10 (2008).

[42]Pub. L. No. 107-204, § 404(b), 116 Stat. 745, 789 (2010) (codified as amended at 15 U.S.C. § 7262); Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements* (PCAOB 2007).

[43]According to PCAOB Auditing Standard No. 8, in an audit of financial statements, audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, i.e., the financial statements are not presented fairly in conformity with the applicable financial reporting framework. Auditing Standard No. 8, *Audit Risk* (PCAOB 2010).

interviewee, the costs incurred by a company to comply with the auditor attestation requirement generally decline after the initial year.

We analyzed total audit fees as a percentage of revenues from 2005 through 2011 for exempt and nonexempt companies.[44] We found that exempt companies, which tend to be smaller, had higher average total audit costs, measured as a percentage of revenues, compared to nonexempt companies (see table 5). Among exempt companies, the data indicate that exempt companies that do not voluntarily comply with the auditor attestation requirement have (except for 2006) higher average total audit fees as a percentage of revenues than the exempt companies that voluntarily comply. While two academics we contacted about this trend could not provide a definitive explanation, there are many factors beside company size that can affect audit fees.

Table 5: Average Total Audit Fees as a Percentage of Revenues, 2005-2011

	Exempt companies that did not voluntarily comply		Exempt companies that voluntarily complied		Nonexempt companies	
Year	Number of companies	Percentage	Number of companies	Percentage	Number of companies	Percentage
2005	3729	2.93%	50	1.44%	4151	1.40%
2006	2927	2.65	77	3.07	4206	1.41
2007	2370	3.14	111	1.95	4060	1.07
2008	2306	3.19	215	1.16	3967	1.11
2009	2449	3.27	393	2.98	3560	1.33
2010	2546	3.14	322	1.57	3476	0.91
2011	2227	3.41	265	1.22	3556	1.15

Source: GAO analysis of Audit Analytics data.

Note: In calculating the average audit fees as a percentage of revenues, companies in all three categories with less than $150,000 in revenue are excluded.

Our data analysis results are consistent with our previous work on audit fees. Specifically, in 2006, we reported that smaller public companies paid disproportionately higher audit fees compared to larger public

[44]SEC defines audit fees as those fees for financial statement audit and review services performed by the auditor to fulfill its responsibility under generally accepted accounting standards or to render an opinion or review report on the financial statements.

companies.[45] Smaller public companies noted that they incur higher audit fees and other costs, such as hiring more staff or paying outside consultants to comply with the internal control provisions of the Sarbanes-Oxley Act. One study noted that historically, these higher audit fees and other costs increased regulatory costs for smaller public companies because regulatory compliance, in general, involves a significant number of fixed costs regardless of the size of a company. Thus, smaller companies with lower revenues are forced to bear these fixed costs over a smaller revenue base compared to larger companies.[46]

However, the auditor attestation is one element of the total audit fees. To gauge the amount spent on the auditor attestation, we asked respondents to our survey to provide us with the amount of total audit fees and the approximate amount attributable to complying with the auditor attestation requirement. Based on our survey results, we estimate that all companies with a market capitalization of less than $10 billion that obtained an auditor attestation in 2012 spent, on average, about $350,000 for auditor attestation fees, representing about 29 percent of their average total audit fees.[47]

Although these costs remain significant for many companies, the cost of implementing the auditor attestation provision has been declining and varies by company size. For example, SEC's 2009 study on internal control over financial reporting found that, among other things, the mean auditor attestation costs declined from about $821,000 to about $584,000 (approximately 29 percent) pre- and –post 2007 reforms for all companies that obtained an auditor attestation. Median costs declined from about $358,000 to $275,000 (approximately 23 percent) pre- and –post 2007

[45]GAO, *Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies*, GAO-06-361 (Washington, D.C.: Apr. 13, 2006).

[46]J. L. Orcutt, "The Case Against Exempting Smaller Reporting Companies from Sarbanes-Oxley Section 404: Why Market-Based Solutions are Not Likely to Harm Ordinary Investors," *Fordham Journal of Corporate & Financial Law*, vol. 14, no. 2 (2009).

[47]The weighted estimates have margins of error of about plus or minus $71,000 and plus or minus 6 percentage points, respectively. In addition to sampling error, the weighted estimates are subject to nonsampling error in that respondents were asked to provide the approximate amount attributable to the auditor attestation requirement. See appendix I for more details.

reforms.[48] According to the study and an academic we interviewed, costs have been declining for a variety of reasons, including companies and auditors gaining experience in the auditor attestation environment and the 2007 SEC and PCAOB guidance. The academic further stated that in the early years of implementation of Section 404(b), initial costs were high for all companies, in part, because they had not previously implemented effective internal controls.[49]

Companies and Others Also Identified Perceived Benefits of Compliance

There are two types of potential benefits or positive impacts—direct and indirect—that companies can receive from complying with the auditor attestation requirement according to one study.[50] Direct benefits are those directly related to improvements in the company's financial reporting process, such as the quality of the internal control structure, the audit committee's confidence in the internal control structure, the quality of financial reporting, and the company's ability to prevent and detect fraud. Indirect benefits are other dimensions that may be affected by changes in the quality of the financial reporting process, such as a company's ability to raise capital, the liquidity of the common stock, and the confidence investors and other users of financial statements may have in the company.

[48]Securities and Exchange Commission, *Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements* (Washington, D.C.: September 2009).

[49]Internal control is not a new requirement for public companies. In December 1977, as a result of corporate falsification of records and improper accounting, Congress enacted the Foreign Corrupt Practices Act (FCPA). Pub. L. No. 95-213, 91 Stat. 1494 (1977) (codified at 15 U.S.C. §§ 78dd-1-78dd-3). The FCPA's internal accounting control requirements were intended to prevent fraudulent financial reporting, among other things. The FCPA amended the Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78pp (2012), to require public companies to (1) make and keep books, records, and accounts that in reasonable detail accurately and fairly reflect the transactions and dispositions of assets and (2) develop and maintain a system of internal accounting controls sufficient to provide reasonable assurance that transactions are executed with management authorization and that transactions are recorded in a manner to (a) allow the preparation of financial statements in accordance with generally accepted accounting principles or other applicable criteria and (b) maintain accountability for assets. *Id.* (amending Sec. 13(b) of the Securities Exchange Act of 1934; codified at 15 U.S.C. § 78q(b)).

[50]C. R. Alexander, S. W. Bauguess, G. Bernile, Y. A. Lee, and J. Marietta-Westberg, "The Economic Effects of SOX Section 404 Compliance: A Corporate Insider Perspective," Working paper, (March 2010).

Respondents to our survey identified a number of benefits or positive impacts stemming from compliance with the auditor attestation requirement, although fewer of them perceived indirect benefits compared to direct benefits. Many survey respondents noted that they experienced a number of direct benefits. For example, we estimate that:

- 80 percent of all companies view the quality of their company's internal control structure as benefiting from the auditor attestation;
- 73 percent view their audit committee's confidence in internal control over financial reporting as benefiting from the auditor attestation;
- 53 percent view their financial reporting as benefiting from the requirement; and
- 46 percent view their ability to prevent and detect fraud as benefiting from the auditor attestation (see table 6).

Our findings are consistent with other surveys. In particular, Protiviti's 2013 survey found that, among other things, 80 percent of respondents reported that their company's internal control over financial reporting structure had improved since they began complying with the auditor attestation requirement.[51] However, we also found that, except for improved confidence in the financial reports of other Section 404(b) compliant companies, fewer companies' perceived indirect benefits of the requirement. Specifically, based on our survey results, no more than 30 percent of all companies with less than $10 billion in market capitalization perceived any of the identified indirect benefits (see table 6) as stemming from the auditor attestation requirement.

[51]Protiviti, *2013 Sarbanes-Oxley Compliance Survey: Building Value in Your SOX Compliance Program*. 2013.

Table 6: Estimated Percentage of Companies with Market Capitalization Less Than $10 Billion That Perceive Benefits from the Auditor Attestation, by Type of Benefit

Type of benefit	Percentage
Direct benefits:	
Quality of company's internal control structure	80%
Audit committee's confidence in company's internal control over financial reporting	73
Quality of company's financial reporting	53
Ability to prevent and detect fraud	46
Indirect benefits:	
Company's ability to raise capital	16
Investor confidence in company	30
Efficiency of company's operation	19
Efficiency of company's financial reporting process	19
Liquidity of company's common stock	7
Timeliness of company's financial statement audit	11
Company's overall value	16
Confidence in the financial reports of other 404(b) compliant companies	52

Source: GAO survey.

Note: The percentage estimates have a margin of error of plus or minus 15 percentage points or fewer.

A 2013 study conducted by one academic we interviewed examined the earnings quality—how well earnings reflect actual firm performance—of exempt companies and nonexempt companies.[52] The study found a significant deterioration in the quality of earnings for exempt companies, but not for nonexempt companies.[53] In addition, SEC in its 2009 study on

[52]A. D. Holder, K. E. Karim, and A. Robin, "Was Dodd-Frank Justified in Exempting Small Firms from Section 404b Compliance?" *Accounting Horizons*, vol. 27 no. 1 (March 2013). There is no single definition of the term "earnings quality."

[53]Two other studies looking at the effect of auditor attestation on exempt and small nonexempt companies had similar findings: one found that compliance with auditor attestation had improved the quality of financial reporting as measured by materially misstated financial statements (see Nagy, "Section 404 Compliance and Financial Reporting Quality," *Accounting Horizons*, vol. 24, no. 3 (2010), while the other found that auditor attestation benefits small companies via higher revenue quality as measured by discretionary (abnormal) revenues (see G. V. Krishnan and W. Yu, "Do Small Firms Benefit from Auditor Attestation of Internal Control Effectiveness?" *Auditing: A Journal of Practice and Theory*, vol. 31 no. 4 (2012)).

auditors' involvement in internal control over financial reporting noted the following benefits: (1) the independent auditor's assessment of the effectiveness of a company's internal controls results in a more disciplined management assessment process; (2) the independent auditor's expertise can provide management with an additional perspective on the quality of the company's internal controls; and (3) the independent audit of a company's internal controls improves the reliability of a company's internal control disclosures and financial reports. According to some academic researchers, obtaining an auditor attestation can also have a positive impact on a company's cost of capital. One academic we interviewed noted that by complying with the auditor attestation requirement small companies incur lower borrowing costs and therefore a lower cost of capital because investors have greater trust in the accuracy of the companies' financial reporting. Another academic we interviewed noted that companies that do not comply with Section 404(b) of the Sarbanes-Oxley Act reduce investors' confidence in the companies and reduce the transparency and reliability of companies' financial filings. As a result, he would expect their cost of capital to increase. In addition, as discussed later in the report, a 2013 study empirically supports the view that companies that voluntarily comply with the auditor attestation have lower cost of capital.[54]

Measuring the Costs and Benefits of the Auditor Attestation Requirement Is Difficult, and Views Differ on Whether Benefits Exceed Costs

Measuring both the costs and benefits of the auditor attestation requirement is difficult. According several studies, direct costs, such as audit fees, are tangible and immediate and therefore are more readily measured. Indirect costs, such as opportunity costs, are more difficult to measure because they are less tangible. In comparison, however, benefits are more difficult to identify, measure, and quantify than costs because they are intangible and may occur over a longer period.[55] Because measuring the costs and benefits of auditor attestation is difficult, comparing costs and benefits is also challenging.

[54]C. A. Cassell, L.A. Myers, and J. Zhou, "The Effects of Voluntary Internal Control Audits on the Cost of Capital," Working paper, (Feb. 13, 2013).

[55]Y. Jahmani and W. A. Dowling, "The Impact of Sarbanes-Oxley Act," *Journal of Business & Economics Research*, vol. 6, no. 10 (2008); Coates IV, John C. "The Goals and Promise of the Sarbanes-Oxley Act," *Journal of Economic Perspectives*, vol. 21, no. 1 (2007); and Chief Financial Officers' Council and the President's Council on Integrity and Efficiency, "Estimating the Costs and Benefits of Rendering an Opinion on Internal Control over Financial Reporting."

Our survey results indicate that the views on whether the benefits associated with auditor attestation compliance outweigh the costs are mixed. According to our survey results, we estimate that about 57 percent of all companies with less than $10 billion in market capitalization view the costs as somewhat or greatly outweighing the benefits; 16 percent of the companies view the benefits as somewhat or greatly outweighing costs; 21 percent of the companies view costs and benefits as being about equal; and 6 percent are not sure. Generally, the perceptions were consistent across companies of different sizes.[56] Some of the reasons companies gave for their views include that the costs are particularly onerous for smaller companies, the time and effort devoted to 404 divert resources away from more value-added activities, and that the attestation overemphasizes testing and the number of controls that are necessary. Some of the reasons companies gave to support the view that the benefits outweigh the costs include that the attestation leads to improved internal control over financial reporting process, increases investor confidence in company's financial reports, and makes it easier to detect fraud.

Companies, trade associations, industry experts, and academics we interviewed expressed various views on the cost-benefit ratio of the auditor attestation. Companies generally assess the costs and benefits of auditor attestation as it relates to themselves and not the marketplace. For example, chief financial officers of two exempt companies that previously had obtained auditor attestations stated that the costs of compliance outweighed the benefits because of the money and time that they (and companies in general) spent on obtaining auditor attestation and the lack of benefits gained from such attestation. In addition, a 2010 empirical study looking at companies of comparable size with public float between $50 million and $100 million found that the net effect of auditor attestation (as measured by stock returns) was negative.[57] The reduction in the market value of nonexempt companies suggests that the costs of

[56]For exempt companies that voluntarily complied with the auditor attestation requirement, 63 percent view the costs as somewhat or greatly outweighing the benefits; 19 percent view the benefits as somewhat or greatly outweighing costs; 15 percent view costs and benefits as being about equal; and 3 percent are not sure. For nonexempt companies, 57 percent view the costs as somewhat or greatly outweighing the benefits; 15 percent view the benefits as somewhat or greatly outweighing costs; 21 percent view costs and benefits as being about equal; and 7 percent are not sure.

[57]P. Iliev, "The Effect of SOX Section 404: Costs, Earnings Quality, and Stock Prices," *Journal of Finance*, vol. 65, no. 3 (2010).

compliance may outweigh the benefits for small companies. In contrast, trade associations, industry experts, and some academics we interviewed generally view the benefits as outweighing the costs. They stated generally that even though the auditor attestation is costly to obtain, it has led to more reliable financial reporting, greater transparency and investor protections, or improved internal control systems. SEC and PCAOB officials noted that their agencies have not taken an official position regarding whether the benefits of a company obtaining an auditor attestation outweigh the costs.

Other survey results also show mixed views on whether the benefits associated with auditor attestation compliance outweigh the costs. A 2012 survey of financial, compliance, internal audit, and other executives examined issues companies must address related to the Sarbanes-Oxley Act. The survey results show that even though initial costs and efforts to comply with Section 404 were burdensome, many companies (31 percent of respondents) viewed the benefits as outweighing the costs, in part due to improvement in internal controls.[58] Fifty percent of all responding companies viewed the costs as outweighing the benefits to some degree, and 19 percent viewed the costs and benefits as equal. Large companies held a slightly more positive view of the benefits than small companies. Another 2012 annual survey that looked at audit fees found that 51 percent of the companies that complied with the auditor attestation requirement thought that they had better internal controls as a result and that the attestation was worth the expense.[59] Thirty-seven percent of respondents thought they had better internal controls but that this benefit was not worth the expense, and 7 percent thought that the cost of compliance far exceeded any additional improvement to internal controls. In comparison, the 2005 annual survey showed that during the early implementation of Section 404(b) of Sarbanes-Oxley Act, over 90 percent of survey respondents said that the costs outweighed the benefits.[60]

[58]Protiviti, *2012 Sarbanes-Oxley Compliance Survey: Where U.S.-Listed Companies Stand – Reviewing Cost, Time, Effort and Process*. 2012.

[59]Financial Executives International and Financial Executives Research Foundation, *2012 Audit Fee Survey* (Morristown, N.J.: 2012). Financial Executives International is a trade group for financial executives.

[60]Financial Executives International and Financial Executives Research Foundation, *Special Survey on Sarbanes-Oxley Section 404 Implementation* (Morristown, N.J.: 2005).

Auditor Attestations Appear to Positively Affect Investor Confidence, and Disclosure of Compliance Status Could Enhance Investor Protection

Research suggests that auditor attestation generally has a positive effect on investor confidence. Although exempt companies are currently not required to disclose whether they voluntarily complied with the auditor attestation requirement in their annual reports, doing so would provide investors with important information that may influence their investment decisions.

Most Empirical Studies We Reviewed Suggest That Auditor Attestation Has a Positive Impact on Investor Confidence

Recent empirical studies we reviewed found that auditor attestation of internal controls generally has a positive impact on investor confidence. Investor confidence is considered an indirect benefit to companies that comply with the auditor attestation requirement. Specifically, an auditor attestation of internal controls helps to reduce information asymmetries between a company's management and investors.[61] With increased transparency and better financial reporting due to reliable third-party attestation, investors face a lower risk of losses from fraud. This lowered risk has a number of positive consequences for companies, such as enabling them to pay less for the capital as more confident investors require a lower rate of return on their money.

Because investor confidence is difficult to measure directly, empirical research has examined the impact of auditor attestation on other variables that are considered proxies for investor confidence, including the cost of equity and debt capital, stock performance, and liquidity.[62] As

[61]Information asymmetry refers to the fact that managers of a company typically know more than outsiders about the conditions of the company and its future prospects. They can exploit this information asymmetry to help the company or themselves by, for example, releasing limited or biased information. These actions would affect the ability of investors to make good investment decisions and in turn lead to inefficiencies, such as misallocation of capital.

[62]Our focus in this section is on recent empirical research about the impact on investor confidence of auditor attestations required by the Sarbanes-Oxley Act's Section 404(b). There is a large body of empirical research that has investigated different aspects of the implementation of the Sarbanes-Oxley Act's Sections 302, 404(a), and 404(b) since the passage of the act. See A. Schneider, A. Gramling, D. R. Hermanson and Z. Ye, "A Review of Academic Literature on Internal Control Reporting Under SOX," *Journal of Accounting Literature,* vol. 28 (2009).

described below, such research has found that the auditor attestation increases investor confidence.

- A 2012 study examined exempt and nonexempt companies with market capitalization between $25 million and $125 million. This study found that the market value of equity—as measured by the common stock price—is positively associated with the book value of equity—which is an element in financial statements—but that this relationship is stronger for nonexempt companies.[63] In other words, investors appear to put greater trust on the book value of equity of companies that are subject to auditor attestation compared to those companies that are not. As a result, book value is more likely to have a positive effect on market value if the auditor attestation is present. These results are consistent with the notion that the auditor attestation provides useful and relevant information to investors.

- A 2013 study found that exempt companies that voluntarily comply with the auditor attestation enjoy a lower cost of capital. Specifically, both the cost of equity and the cost of debt are significantly lower for companies that voluntarily comply with the requirement compared to those exempt companies that do not.[64] These results are consistent with the view that auditor attestation leads to higher investor confidence and that voluntary compliance with the requirement reduces the risk companies present to investors. This lowered risk, in turn, reduces the risk premium that investors demand to hold these companies' stocks or bonds.

- A 2012 study examined the equity market response to the 2009 proposed permanent exemption from the auditor attestation requirement for public companies with a public float of less than

[63]G. V. Krishnan and W. Yu, "Do Small Firms Benefit from Auditor Attestation of Internal Control Effectiveness?" *Auditing: A Journal of Practice and Theory*, vol. 34, no.1 (2012).

[64]C. A. Cassell, L.A. Myers, and J. Zhou, "The Effects of Voluntary Internal Control Audits on the Cost of Capital," Working paper, (Feb. 13, 2013).

75 million.[65] The study found a negative market response to the exemption but less so for those companies that voluntarily complied before 2009. It also found that to reduce information asymmetry, companies that voluntarily comply use their compliance as a signal to the marketplace of the superior quality of their financial reporting—a signal that is credible because it is costly and difficult to imitate by companies with weak internal controls.[66] Also, companies that voluntarily complied with auditor attestation had significant increases in liquidity.[67]

Other research supports the view that auditor attestation of internal control effectiveness matters for investors and other market participants insofar as adverse auditor reports have negative consequences for companies. Such consequences include higher cost of debt (and possibly

[65]More specifically, the study undertakes an empirical investigation of the response to the November 2009 Garrett-Adler amendment approved by the House Financial Services Committee, which proposed to exempt smaller public companies from the auditor attestation requirement. (*see* Investor Protection Act of 2009, H.R. 3817, 111th Cong. § 606). K. Brown, P. Pacharn, J. Li, E. Mohammad, F. A. Elayan, and F. Chu, "The Valuation Effect and Motivations of Voluntary Compliance with Auditor's Attestation under Sarbanes-Oxley Act Section 404 (B)," Working paper, (Jan. 15, 2012).

[66]Signaling may provide a benefit especially to small, high-growth companies that need capital to expand. Exempt companies have to balance the potential benefits and cost of voluntary compliance, as auditors' involvement increases the likelihood that internal control deficiencies will be discovered and disclosed, with negative consequences.

[67]This increase suggests that auditor attestation enhances public confidence in financial reports leading to a flight to quality by investors and an increase in liquidity, in which investors move their capital away from assets perceived as risky in favor of those viewed as safer.

higher cost of equity), lower probability that lenders will extend lines of credit, stricter loan terms, and unfavorable stock recommendations.[68]

While most research findings we reviewed suggest auditor attestation provides valuable information to investors and has a positive effect on confidence, a 2011 study questions the value of the auditor attestation for small companies.[69] Looking at exempt and small nonexempt companies with market capitalization of $300 million or less, the study finds that small companies that became nonexempt, and therefore subject to the auditor attestation requirement, in 2004 experienced a statistically significant increase in their material weakness disclosure rate, but companies that remained exempt saw similar increases through their management reports under Section 404(a) of the Sarbanes-Oxley Act. The results suggest that auditor attestation provides little additional information to investors in terms of detecting material weaknesses because there is no statistically significant difference in the rate of disclosure of material weakness between the two types of companies.

Anecdotal Information Also Suggests Auditor Attestation Can Positively Impact Investor Confidence

The majority of academics and market participants we interviewed suggest that having auditor attestation positively impacts investor confidence. Specifically, they told us that the involvement of auditors in attesting to the effectiveness of internal controls improves the reliability of the financial reporting and serves to protect investors. As a result, they said, the exemption granted to small companies is likely to reduce investor confidence because these companies already have greater

[68]See for example, A. Crabtree and J. J. Maher, "Credit Ratings, Cost of Debt, and Internal Control Disclosures: A Comparison of SOC 302 and SOX 404," *The Journal of Applied Business Research*, vol. 28, no. 5, (2012); J.B. Kim, B.Y. Song, L. Zhang, "Internal Control Weakness and Bank Loan Contracting: Evidence from SOX Section 404 Disclosures," *The Accounting Review*, vol. 86, no. 4 (2011); D. Dhaliwal, C. Hogan, R. Trezevant, and M. Wilkins, "Internal Control Disclosures, Monitoring, and the Cost of Debt," *The Accounting Review*, vol. 86, no. 4 (2011); H. Ashbaugh-Skaife, D. Collins, W. Kinney, and R. LaFond, "The Effect of SOX Internal Control Deficiencies on Firm Risk and Cost of Equity," *Journal of Accounting Research*, vol. 47, no. 1 (2009); A. Schneider and B.K. Church, "The Effect of Auditors' Internal Control Opinions on Loan Decisions," *Journal of Accounting and Public Policy*, vol. 27, no.1 (2008); S. K. Asare and A. Wright, "The Effect of Type of Internal Control Report on Users' Confidence in the Accompanying Financial Statement Audit Report," *Contemporary Accounting Research*, vol. 29, no. 1 (2012).

[69]W. R. Kinney and M. L. Shepardson, "Do Control Effectiveness Disclosures Require SOX 404(b) Internal Control Audits? A Natural Experiment with Small U.S. Public Companies," *Journal of Accounting Research*, vol. 49, no. 2. (2011).

informational asymmetry. They said that according to academic and other studies, small companies are also more likely than large ones to have serious internal control problems. Furthermore, they commented that management's report on internal controls alone is often uninformative because management often fails to detect internal control deficiencies or classifies them as less severe than they are. Some market participants also told us that any company accessing capital markets, regardless of size, should be required to comply with the auditor attestation requirement as investors in any company, large or small, are entitled to the same investor protection.

Our survey results also indicate that some companies view auditor attestation as contributing to investor confidence, which is similar to findings from others' studies and surveys. Our survey results show that the majority of respondents are more confident in the financial reports of companies that comply with the auditor attestation requirement than companies that do not. In addition, we estimate that 30 percent of responding nonexempt and exempt companies that voluntarily comply thought that the requirement increased investor confidence in their own company, while 20 percent were not sure and the remaining 50 percent reported no impact. This perspective is consistent with the results from an in-depth 2009 telephone survey SEC conducted of a small group of financial statement users—such as lenders, securities analysts, credit rating agencies, and other investors—regarding their views on the benefits of auditor attestation. These SEC survey respondents indicated that the auditor's attestation report provides additional benefits to users and other investors beyond the management's report under Section 404(a) and that the requirement generally has a positive impact on their confidence in companies' financial reports. Moreover, in response to a 2010 Center for Audit Quality (CAQ) survey of individual investors, almost two-thirds of investors said they were concerned about exempting companies with annual revenues of under $75 million from the independent auditor attestation requirement, suggesting that the requirement has a positive effect on individual investors' confidence in the financial information generated by smaller companies.[70] Similarly, in a

[70]Center for Audit Quality, *The CAQ's Fourth Annual Individual Investor Survey*, September 2010. The Center for Audit Quality is a nonprofit group whose board includes leaders from the public company auditing firms, the American Institute of CPAs, and three members from outside the public company auditing profession. The organization is affiliated with the American Institute of CPAs and seeks to enhance investor confidence and public trust in the global capital markets.

2012 survey of investors conducted by the PCAOB Investor Advisory Group on the role, relevance, and value of the audit, over 60 percent of respondents said that the auditor's opinion on the effectiveness of internal controls is critical in making investment decisions.[71] Further, in a 2012 survey of individual investors by CAQ, 70 percent of the respondents identified independent audits in general as the most effective means of protecting their interests.[72]

Disclosure of Auditor Attestation Status Could Enhance Transparency

Explicit disclosure of auditor attestation status in exempt companies' annual reports could quickly provide investors useful information that may influence their investment decisions. Currently, exempt companies are not required to disclose in their annual reports whether they have voluntarily obtained an auditor attestation on their internal controls. From 2005 through 2010, SEC granted small public companies multiple extensions from having to comply with the auditor attestation requirement. During this time of forbearance, SEC required exempt companies to include a general statement in their annual report that the company was not required to comply with the auditor attestation requirement because of SEC's grant of temporary exemption status. According to SEC officials, the statement served to provide investors who may have been looking for the attestation an explanation of its absence. SEC granted its final temporary exemption to take effect on June 15, 2010, prior to the passage of the Dodd-Frank Act. SEC did not require exempt companies to include the disclosure statement when implementing the provision of the Dodd-Frank Act that created the permanent exemption.

SEC officials said that it is not common for the agency to require a company to disclose compliance status for requirements that are not applicable to the company—which, according to SEC officials, could potentially influence a company's behavior. Further, SEC officials noted that information on the company's filing status—and, therefore exemption status—can be found in the company's annual reports and other

[71]In addition, about 47 percent of respondents reported using the auditor's report "always" or "often" when making investment decisions, with about 27 percent reporting using it "sometimes." PCAOB Investor Advisory Group, March 28, 2012, presentation on the Role, Relevance, and Value of the Audit.

[72]Center for Audit Quality, *The CAQ's Sixth Annual Main Street Investor Survey*, September 2012.

documents, which are available to all investors.[73] Therefore, SEC officials stated that such information allows investors to determine whether an attestation has been obtained. However, while this information is available, a company's attestation status is not readily apparent without some knowledge or interpretation of the current reporting requirements. As noted earlier, SEC has previously required companies to provide additional clarity on their compliance with the auditor attestation requirement. Thus, requiring companies to explicitly disclose their auditor attestation status would be consistent with its past action.

Further, federal securities laws require public companies to disclose relevant information to investors to aid them in their investment decisions.[74] Many market participants we interviewed consider the external auditor's assessment of the effectiveness of a company's internal control over financial reporting to be important information for investors. Thus, many market participants we interviewed and companies we surveyed noted that exempt companies should be required to explicitly disclose whether or not they obtained an auditor attestation to make the information more transparent for investors. In particular, according to the results of our survey, we estimate that 57 percent of all companies with less than $10 billion in market capitalization are in favor of requiring exempt companies to disclose whether they have voluntarily obtained an auditor attestation. A representative from one company said "I believe there is an assumption that SEC-listed companies are in compliance with 404. If companies are not, they should disclose such." A representative from another company said that "If investors value the independent audit, then they should be made aware of situations where such audit has not been performed. Investors should not have to interpret the regulations to know if the audit is required." Some companies we surveyed that were not in favor of such disclosure generally believed that investors can get the information from the audit opinion in the annual report. As of year-end 2011, approximately 300 exempt companies had voluntarily complied with the auditor attestation requirement. Although information on voluntary compliance with the auditor attestation requirement is determinable, having the information explicitly disclosed could benefit investors. Such

[73]See for example, Items 8 and 9A in the annual reports filed with SEC and Item 308(a)(4) of Regulation S-K, as amended in 2010.

[74]See *generally* Securities Act of 1933, §§ 7, 8, 11, 12, and 17; Securities Exchange Act of 1934, §§ 10, 13, and 14.

disclosure would increase transparency and investor protection by making investors more aware of this important investment information.

Conclusions

Investors need accurate financial information with which to make informed investment decisions, and effective internal controls are necessary for accurate and reliable financial reporting. The attestation requirement is part of legislation aimed at helping to protect investors by, among other things, improving the quality of corporate financial reporting and disclosures. Perceptions of the costs and benefits of auditor attestation continue to vary among companies and others, but among other benefits, obtaining auditor attestation appears to have a positive impact on investor confidence. In addition, our analysis found that companies (both exempt and nonexempt) that obtained an auditor attestation generally had fewer financial restatements than those that did not, which suggests that knowing whether a company has obtained the auditor attestation may be useful for investors in gauging the reliability of a company's financial reporting. However, because SEC regulations currently do not require explicit statements regarding the voluntary attainment of auditor attestation, investors may have to interpret reporting requirements and filings to determine whether exempt companies have obtained an auditor attestation. Previously, when certain companies were temporarily exempt from the auditor attestation requirement, SEC required explicit disclosure of exemption status in companies' annual reports. However, SEC eliminated this requirement in 2010 when companies of certain sizes were permanently exempted. Federal securities laws require public companies to disclose relevant information to investors to aid them in their investment decisions. Although information on a company's exempt status is available to investors, explicit disclosure would increase transparency and investor protection by making investors readily aware of whether a company has obtained an auditor attestation on internal controls. The disclosure could serve as an important indicator of the reliability of a company's financial reporting, which may influence investors' decisions.

Recommendation for Executive Action

To enhance transparency and investor protection, we recommend that SEC consider requiring public companies, where applicable, to explicitly disclose whether they obtained an auditor attestation of their internal controls.

Agency and Third-Party Comments and Our Evaluation

We provided a draft of the report to the SEC Chairman for her review and comment. SEC provided written comments that are summarized below and reprinted in appendix II. We also provided a draft of the report to PCAOB and relevant excerpts of the draft report to Audit Analytics for technical review. We received technical comments from SEC, PCAOB, and Audit Analytics that were incorporated as appropriate.

In its written comments, SEC did not comment on our recommendation that it consider requiring public companies to explicitly disclose whether they have obtained an internal control attestation. Rather, SEC confirmed, as described in the draft report, that a nonaccelerated filer (referred to as an exempt company in our report) does not have to explicitly disclose whether it obtained an auditor attestation report on its internal controls in its annual report. However, SEC stated that this fact can be easily determined by investors from information that is already disclosed in the annual report. In addition, SEC stated that investors can also find information regarding the existence of an opinion on internal controls by looking at the audit report in the company's filing. SEC also noted that PCAOB standards permit an auditor that is not engaged to opine on internal controls to include a statement in its report on the financial statements indicating that it is not opining on the internal controls. In our report, we acknowledge that information needed to determine a company's auditor attestation status is available. However, because an explicit statement on the company's status is not required, investors must deduce the company's status from the available information. Explicit disclosure could significantly decrease the potential for investors to misinterpret the information regarding a company's audit attestation status. Such disclosure would increase transparency and investor protection by making investors readily aware of this important investment information. We therefore maintain that the disclosure warrants further consideration by SEC.

We are sending copies of this report to appropriate congressional committees, SEC, PCAOB, Audit Analytics and other interested parties. In addition, the report is available at no charge on the GAO website at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (202) 512-8678 or clowersa@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix IV.

A. Nicole Clowers
Director
Financial Markets and
Community Investment

Appendix I: Objectives, Scope, and Methodology

This report discusses: (1) how the number of financial statement restatements compares between exempt and nonexempt companies; (2) the costs and benefits for nonexempt companies as well as exempt companies that voluntarily comply with the auditor attestation requirement; and (3) what is known about the extent to which investor confidence in the integrity of financial statements is affected by whether or not companies comply with the auditor attestation requirement. We define exempt companies as those with less than $75 million in public float (nonaccelerated filers) and nonexempt companies as those with $75 million or more in public float (accelerated filers). For the purposes of this report, we define exempt companies as those with less than $75 million in public float (nonaccelerated filers) and nonexempt companies as those with $75 million or more in public float (accelerated filers).

To address all three objectives, we reviewed and analyzed information from a variety of sources, including the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act), the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), relevant regulatory press releases and related public comment letters, and available research studies.[1] We also interviewed officials from the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB), and we interviewed chief financial officers of small public companies, representatives of relevant trade associations (representing individual and institutional investors, accounting companies, financial analysts and investment professionals, and financial executives), a large pension fund, a credit rating agency, academics knowledgeable about accounting issues, and industry experts.

Comparison of Exempt and Nonexempt Financial Restatements

To determine the number of financial statement restatements (referred to as financial restatements) and trends, we analyzed data from the Audit Analytics database from 2005 through 2011.[2] We used the Audit Analytics' Auditor Opinion database to generate the population of exempt

[1]Pub. L. No. 107-204, 116 Stat. 745 (2002); Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2]Audit Analytics is an online market intelligence service that provides information on SEC registrants. Audit Analytics maintains a proprietary database containing information from the filings public companies submit to SEC, such as audit fees, audit opinions, and financial restatements.

and nonexempt companies in each year from 2005 through 2011.[3] Our analysis does not include 2012 data because 2012 small-company data was incomplete. According to Audit Analytics, the incomplete data was often due to the fact that small companies had not yet filed the relevant information with SEC. The sample we used to produce the population of exempt and nonexempt companies does not include subsidiaries of a public company, registered investment companies, or asset-backed securities issuers. Once we excluded these companies from the entire population, we grouped the remaining companies based on their filing status (i.e., nonaccelerated filer, smaller reporting company, accelerated filer, large accelerated filer, and filers that did not disclose their filing status).[4] Exempt companies are nonaccelerated filers, including smaller reporting companies. For our purposes, we grouped companies that did not disclose their filing status but whose market capitalization was less than $75 million with exempt companies.[5] We also identified for each year from 2005 through 2011 exempt companies that voluntarily complied with the integrated audit requirement as indicated in the data. Nonexempt companies are accelerated filers and large accelerated filers. For our purposes, we grouped companies that did not disclose their filing status but whose market capitalization was equal to or greater than $75 million with nonexempt companies. We excluded companies that did not disclose their filing status and did not have a reported market capitalization.

We then used Audit Analytics' Restatement database, which contains company information (e.g., assets, revenues, restatements, market capitalization, location, and industry classification code) to identify the

[3]The Audit Opinion data set covers all SEC registrants who have disclosed their auditor's report on the audit of the financial statements in electronic filings and represents the data concerning the auditor's opinion.

[4]The designation of "Large Accelerated Filer" was not approved by SEC until December 2005, and the designation of "Smaller Reporting Company" was not approved by SEC until January 2008. See Revisions to Accelerated Filer Definition and Accelerated Deadlines for Filing Periodic Reports, 70 Fed. Reg. 76626 (Dec. 27, 2005); Smaller Reporting Company Regulatory Relief and Simplification, 73 Fed. Reg. 934 (Jan. 4, 2008).

[5]Companies that did not disclose their filing status include Canadian Form 40-F filers and others. We used market capitalization because Audit Analytics database does not capture companies' public float. Market capitalization is defined as the total dollar market value of all of a company's outstanding shares and is calculated by multiplying the number of a company's outstanding shares by the current market price of one share. Public float is a subset of market capitalization. SEC defines public float as the worldwide aggregate market value of voting and nonvoting common equity held by nonaffiliates of the filer. *See* 12 C.F.R. § 240.12b-2.

number of financial restatements from 2005 through 2011 based on our population of exempt companies, exempt companies that voluntarily complied, and nonexempt companies. Using this database, we identified 6,436 financial restatements by 4,536 public companies, 2,834 of which were exempt companies. We used Audit Analytics' 69 classifications to classify the type of financial restatements into six categories: core expenses (i.e., ongoing operating expenses), noncore expenses (i.e., nonoperating or nonrecurring expenses), revenue recognition (i.e., improperly record revenues), reclassifications and disclosures, underlying events (i.e., accounting for mergers and acquisitions), and other.[6] The majority of restatements we classified were the result of an accounting rule misapplication.[7] To identify audit costs of compliance, we analyzed data from Audit Analytics' Auditor Opinion database, which contains auditors' report information such as audit fees, nonaudit fees, auditor name, audit opinions, revenues, and company size, among other information from 2005 through 2011. Our analyses of audit costs do not include 2012 data because 2012 small-company data was incomplete. The incomplete data was often due to the fact that small companies had not yet filed the relevant information with SEC. We tested a sample of the Audit Analytics database information and found it to be reliable for our purposes. For example, we cross-checked random samples from each of Audit Analytics' databases with information on financial restatements, filing status, and internal controls from SEC's Electronic Data Gathering, Analysis, and Retrieval system. We also spoke with other users of Audit Analytics data as well as Audit Analytics officials. In addition, we reviewed relevant research studies and papers on the impact of compliance with the internal control audits on financial restatements. We consider the information to be reliable for our purpose of determining financial statement restatement trends and audit fee calculations.

[6]Five of the six categories are based on the classification scheme developed by academics Zoe-Vonna Palmrose and Susan Scholz. The "other" category was developed by GAO and comprises financial restatements that were not included in one of the other categories.

[7]The Audit Analytics Restatement database uses a taxonomy to group restatements into three categories (1) restatements based on accounting rule misapplication failure (i.e., generally accepted accounting principles); (2) restatements based on financial fraud, irregularities, and misrepresentations; and (3) restatements based on accounting and clerical errors. The database includes a fourth category to identify significant additional issues in the restatement (i.e., material weakness or loan covenant violation).

Costs and Benefits of Auditor Attestation Compliance

To examine the characteristics of publicly traded companies that complied, either voluntarily or because required, with the requirement to obtain an independent auditor attestation of their internal controls, we conducted a web-based survey of companies that had either voluntarily complied or were required to comply with the integrated audit requirement in any year between 2004 and 2011. Based on a list of publicly traded companies obtained from Audit Analytics, we identified 4,053 companies that had either voluntarily complied with the integrated audit requirement in any year from 2004 through 2011 or that were required to comply in 2011 as determined by their filing status.[8] We stratified the population into three strata by first identifying the nonaccelerated voluntary filers. These are companies that voluntarily complied with the integrated audit requirement in any year from 2004 through 2011. Since our primary focus was on the nonaccelerated voluntary filers, we selected all 392 of these companies.[9] From the remaining companies in the population, we created two additional strata based on 2011 filing status, and we took a random sample of companies from the remaining strata. The sample sizes for the remaining strata were determined to produce a proportion estimate within each stratum that would achieve a precision of plus or minus 10 percentage points or less, at the 95 percent confidence level. Finally, we increased the sample size based on the expected response rate of 40 percent. We submitted our survey to a total of 850 companies from the original population of 4,053.

We identified 104 companies in our sample that were closed, merged with another company, or improperly included in the sampling frame. We received valid responses from 195 out of the remaining 746 sampled companies (see table 7). The weighted response rate, which accounts for the differential sampling fractions within strata, is 25 percent.

[8]In this report, we use Audit Analytics data, which are based on public filings made with SEC, to develop the population for our survey. SEC uses public float to determine companies' filing status as of the companies' most recently completed second fiscal quarter. To account for changes that could occur with regard to the companies' filing status as of their recently completed second fiscal quarter and the end of the year, we filtered the populations by market capitalization because public float data were not available in the Audit Analytics database.

[9]This figure was based on the unique number of exempt firms who voluntarily complied with the requirement from 2004 through 2011 based on their filing status and market capitalization rate greater than zero and less than $75 million.

Table 7: Survey Sample Disposition

Stratum	Population size	Sample size	Out of scope	Respondents
1. Nonaccelerated voluntary filers	392	392	92	93
2. Accelerated filers	1,620	228	9	56
3. Large accelerated filers	2,041	230	3	46
Total	**4,053**	**850**	**104**	**195**

Source: GAO.

We conducted this survey in a web-based format. The questionnaire was designed by a GAO survey specialist in collaboration with GAO staff with subject-matter expertise. The questionnaire was also reviewed by experts at SEC. We pretested drafts of our questionnaire with three public companies of different sizes to ensure that the questions and response categories were clear, that terminology was used correctly, and that the questions did not place an undue burden on the respondents. The pretests were conducted by telephone with company financial executives in Iowa, Virginia, and Washington, D.C. Pretests included GAO methodologists and GAO subject-matter experts. Based on the feedback received from the pretests, we made changes to the content and format of some survey questions. We directed our survey to the chief executive officer, chief financial officer, or chief accounting officer, whose names and email addresses we obtained from Nexis. We activated our web-based survey on December 17, 2012, and closed the survey on February 19, 2013. We sent follow-up emails on three occasions to remind respondents to complete the survey and conducted telephone follow-ups to increase the response rate.

Because our survey was based on a random sample of the population, it is subject to sampling errors. In addition, the practical difficulties of conducting any survey may introduce nonsampling errors. For example, difference in how a particular question is interpreted or the sources of information available to respondents may introduce errors. We took steps, such as those described above, to minimize such nonsampling errors in the development of the questionnaire and the data collection and data analysis stages as well. For example, because this was a web-based survey, respondents entered their responses directly into the database, reducing the possibility of data-entry error. Finally, when the data were analyzed, a second independent analyst reviewed all computer programs. We conducted an analysis of our survey results to identify potential sources of nonresponse bias using two methods. First, we examined the

response propensity of the sampled companies by several demographic characteristics. These characteristics included market capitalization size categories, region, and sector. Our second method consisted of comparing weighted estimates from respondents and nonrespondents to known population values for total market capitalization. We conducted statistical tests of differences, at the 95 percent confidence level, between estimates and known population values, and between respondents and nonrespondents. We determined that there was significant bias induced by the largest companies (measured by market capitalization) not responding to the survey. In other words, we found that companies with market capitalization over $10 billion were underrepresented in our sample. However, we found no evidence of substantial nonresponse bias based on these characteristics when generalizing to the population of companies with market capitalization less than or equal to $10 billion. Therefore, we adjusted the scope of our survey to include only those companies with market capitalization of less than or equal to $10 billion (see table 8).

Table 8: Sample Disposition for Adjusted Target Population

Stratum	Population size	Sample size	Out of scope	Respondents
1. Nonaccelerated voluntary filers	392	392	92	93
2. Accelerated filers	1,620	228	9	56
3. Large accelerated filers	1,585	176	1	43
Total	**3,597**	**796**	**102**	**192**

Source: GAO.

Because we found no evidence of substantial nonresponse bias when generalizing to the adjusted target population and the weighted response rate of 25 percent, we determined that weighted estimates generated from these survey results are generalizable to the population of in-scope companies.[10] We generated weighted estimates and generalized the

[10]In-scope population refers to the population to which we are generalizing that includes all publically traded companies with a public float value of less than $75 million that voluntarily complied with the integrated audit requirement in any year from 2004 through 2011 as well as those public companies with a market capitalization under $10 billion that were required to comply in 2011 and that remained in business at the time of the survey.

results to the estimated in-scope population of 3,432 companies (plus or minus 42 companies).[11]

Because we followed a probability procedure based on random selections, our sample is only one of a large number of samples that we might have drawn. Since each sample could have provided different estimates, we express our confidence in the precision of our particular sample's results as a 95 percent confidence interval. This is the interval that would contain the actual population value for 95 percent of the samples we could have drawn. As a result, we are 95 percent confident that each of the confidence intervals in this report includes the true values in the study population. All percentage estimates presented in this report have a margin of error of plus or minus 15 percentage points or fewer, and all estimates of averages have a relative margin of error of plus or minus 20 percent or less, unless otherwise noted.

To obtain information on the impact of obtaining an auditor attestation on a company's cost of capital, we included questions in our web-based survey to large and small public companies of various industries about this matter, interviewed trade associations, industry experts, a large pension fund, and academics; and reviewed relevant academic and SEC research studies.

Investor Confidence and Integrity of Financial Statements

To examine the extent to which investor confidence in the integrity of financial statements is affected by companies' compliance with the auditor attestation requirement, we reviewed relevant empirical literature written by academic researchers, as well as recent surveys, studies, reports, and articles by others. To identify these studies, we asked for recommendations from academics, SEC, PCAOB, and representatives of organizations that address issues related to the auditor attestation requirement. We reviewed bibliographies of papers we obtained to identify additional material. In addition, we conducted searches of online databases such as ProQuest and Nexis using keywords to link Section 404(b) of the Sarbanes-Oxley Act with investor confidence. We also conducted interviews with agencies and organizations, as well as

[11]Since we were able to identify 104 out of scope companies in our sample, we can logically expect that there are out of scope companies in the population that were not sampled. The 3,423 represents an estimated number of in-scope companies and because it is based on a random sample, we can compute a margin of error of plus or minus 42 companies around that estimate.

academics and other knowledgeable individuals who focus on issues related to investor confidence and the auditor attestation requirement. Moreover, we interviewed small public companies exempt from auditor attestation but who nonetheless complied with the requirement. In addition, we reviewed surveys undertaken by various government agencies and organizations to gauge the impact of the auditor attestation on investor confidence. We conducted a focused review of the research related to Section 404(b) of the Sarbanes-Oxley Act and summarized the recent studies most relevant to our objective. The empirical research discussed may have limitations, such as accuracy of measures and proxies used. We reviewed published works by academic researchers, government agencies, and organizations with expertise in the field. We performed our searches from September 2012 through May 2013. We assessed the reliability of these studies for use as corroborating evidence and found them to be reliable for our purposes. We also included questions in our web-based survey to large and small public companies of various industries about this matter. Lastly, we reviewed relevant federal securities laws, the Securities Act of 1933 and the Securities Exchange Act of 1934.[12]

We conducted this performance audit from May 2012 to July 2013 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[12]Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (2012)); Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78pp (2012)).

Appendix II: Comments from the Securities and Exchange Commission

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

June 20, 2013

A. Nicole Clowers
Director
Financial Markets and Community Investment
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Ms. Clowers:

Thank you for the opportunity to review the draft report required by Section 989I of the Dodd-Frank Wall Street Reform and Consumer Protection Act. We greatly appreciate the valuable insight that the Government Accountability Office ("GAO") has provided regarding the importance of reliable financial reporting, including the importance of internal control over financial reporting ("ICFR") and the independent audit function.

The draft report correctly identifies that a non-accelerated filer that does not voluntarily include in its annual report an attestation report from its auditor on ICFR is not required to disclose this fact explicitly. We believe that this fact can be easily determined by investors from information that is already disclosed in the annual report. An issuer is required to indicate its filing status on the cover page of its annual report, clearly disclosing whether the issuer is a non-accelerated filer and, therefore, exempt from the auditor attestation requirement. Further, SEC rules require any issuer that includes an auditor's attestation report on ICFR in its annual report, whether the attestation report is voluntary or required, to include a statement that the attestation report is included in the annual report.[1] As a result, non-accelerated filers that voluntarily provide an attestation report are readily identified.

In addition, investors can also find information regarding the existence of an opinion on ICFR by looking at the audit report in the issuer's filing. For example, when the auditor is engaged to opine on ICFR, Public Company Accounting Oversight Board ("PCAOB") standards permit the auditor to issue a combined report, which would contain both an opinion on the financial statements and an opinion on ICFR.[2] If the auditor chooses to issue a separate attestation report on ICFR, PCAOB standards require an explicit statement that the issuer's ICFR

[1] *See* Item 308(a)(4) of Regulation S-K.

[2] *See* PCAOB Auditing Standard ("AS") No. 5, paragraph 86.

A. Nicole Clowers
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has been audited.[3] In the case of either combined or separate reports, the fact that the auditor opined on ICFR is clearly disclosed in the auditor's report on the financial statements.

When the auditor is not engaged to opine on ICFR, PCAOB standards permit the auditor to also include in its report on the financial statements an explicit statement of this fact and that the auditor does not express an opinion on ICFR.[4] The PCAOB has announced that, as part of its standard-setting agenda, it plans to propose changes to the auditor's reporting model later in 2013. As part of this project, we understand that the PCAOB staff intends to recommend that the PCAOB seek specific feedback on requiring, as opposed to permitting, these explicit statements.

We remain dedicated to continuously evaluating and improving our disclosure requirements and to making sure that investors have the information they need to make informed investment decisions. We appreciate GAO's attention to these important issues, and we would like to thank you and your staff for your work.

Sincerely,

Paul Beswick
Chief Accountant
Office of the Chief Accountant

Lona Nallengara
Acting Director
Division of Corporation Finance

[3] See PCAOB AS No. 5, paragraph 88.

[4] See PCAOB AU Section 9550.10.

Appendix III: GAO Survey of Accelerated Filers and Nonaccelerated Filers

Survey of Accelerated and Non-accelerated Filers Regarding Section 404(b) of the Sarbanes-Oxley Act

United States Government Accountability Office

Introduction

The U.S. Government Accountability Office (GAO) is the independent evaluation and investigative agency of the Congress. As statutorily mandated by Section 989I of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), GAO is currently conducting a study with respect to the auditor attestation requirement under Section 404(b) of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act) for securities issuers whose market capitalization is less than $75 million (referred to as non-accelerated filers). Section 989G(a) of the Dodd-Frank Act amended the Sarbanes-Oxley Act to permanently exempt non-accelerated filers from having to comply with the auditor attestation requirement under Section 404(b) of the Sarbanes-Oxley Act.

Your participation in the survey will help us provide a comprehensive report to the Congress. In reporting the results of the survey, we will not be individual responses to you or your company by name. GAO generally reports the results of surveys in aggregate. While GAO may incorporate individual responses in the report, we will do so in a manner designed to ensure that individual respondents cannot be identified. Further, GAO will not otherwise release individually identifiable versions of responses unless required by law or requested by a member of Congress.

To learn more about completing the survey, printing your responses, and whom to contact if you have questions, click here for help.

Thank you in advance for your cooperation.

Section 1 - Background Information

1. Please provide contact information for the primary person completing this questionnaire in the event we need to contact you to clarify a survey response.

Name:

Company:

E-mail address:

Office telephone:

Title: [none]

Specify other title:

Please note: In this questionnaire, the fiscal year is defined by how **your company** defines its fiscal year.

2. In what year did your company **first file** an annual report, such as a Form 10-K or Form 20-F, with the Securities and Exchange Commission (SEC)?

- Before fiscal year 2007
- During fiscal year 2007
- During fiscal year 2008
- During fiscal year 2009
- During fiscal year 2010
- During fiscal year 2011
- During fiscal year 2012
- No response

3. Which best describes your company?

- A U.S. issuer
- A foreign private issuer
- No response

Please note: For question 4, total market capitalization is the dollar amount of the total number of shares outstanding (non-affiliates and affiliates) multiplied by the share price.

4. What is your company's total market capitalization as of the most recently ended fiscal year?

$

Section 2 - Fiscal Year and Filing Status

5. What is the end date of the fiscal year for which you last filed a Form 10-K or 20-F or 40-F?
(Please enter month, day, and year. For example, if your company's fiscal year ended on December 31, 2011, and it filed its Form 10-K in February 2012, you would enter December 31, 2011.)

Month	Day	Year
[none]	[none]	[none]

6. On Form 10-K or 20-F, which box for SEC registrant filing status did your company check for each of the following fiscal years? *(Select one answer in each row.)*

	Large accelerated filer	Accelerated filer	Non-accelerated filer	Small reporting company	Not sure	Not applicable
FY 2004	○	○	○	○	○	○
FY 2005	○	○	○	○	○	○
FY 2006	○	○	○	○	○	○
FY 2007	○	○	○	○	○	○
FY 2008	○	○	○	○	○	○
FY 2009	○	○	○	○	○	○
FY 2010	○	○	○	○	○	○
FY 2011	○	○	○	○	○	○
FY 2012	○	○	○	○	○	○

Please note: Throughout this questionnaire, ICFR will refer to "internal control over financial reporting."

7. In which of the following fiscal years did your company have an independent audit of the effectiveness of its ICFR? *(Select one answer in each row.)*

	Yes	No	Not sure	Not applicable
FY 2004	○	○	○	○
FY 2005	○	○	○	○
FY 2006	○	○	○	○
FY 2007	○	○	○	○
FY 2008	○	○	○	○
FY 2009	○	○	○	○
FY 2010	○	○	○	○
FY 2011	○	○	○	○
FY 2012	○	○	○	○

8. Which one of the following statements best describes your company?

- ○ We have always been a non-accelerated filer or a smaller reporting company
- ○ We were once a non-accelerated filer or a smaller reporting company, but are no longer a non-accelerated filer or small reporting company

- We were once a large accelerated filer or accelerated filer, but are no longer a large accelerated filer or accelerated filer
- We have always been a large accelerated filer or accelerated filer *(Click here to go to Section 3 - Total Audit Fees)*
- Not sure *(Click here to go to Section 3 - Total Audit Fees)*

8a. Did your company ever **voluntarily** have an independent audit of the effectiveness of its ICFR?

- Yes - *Continue with question 8b.*
- No *(Click here to skip to question 8e)*
- Not sure *(Click here to skip to question 8e)*

8b. For which of the following reason(s) did your company choose to voluntarily have an independent audit of the effectiveness of its ICFR? ***(Select all that apply.)***

- To evaluate the effectiveness of the company's internal controls
- To instill audit committee confidence in the company's ICFR
- To ensure the quality of the company's financial reporting
- To improve company's ability to raise capital
- To instill investor confidence in the company
- To detect or prevent potential fraud
- For other reason(s) - *If selected, specify other reason(s) below.*

Please specify other reason(s):

8c. Since fiscal year 2004 has your company ever **stopped having a voluntary audit** of the effectiveness of its ICFR?

- Yes - *Continue with 8d.*
- No *(Click here to skip to question 8e)*
- Not sure *(Click here to skip to question 8e)*

8d. *(If yes)* For what reason(s) did your company choose to stop having a voluntary audit of the effectiveness of its ICFR? ***(Select all that apply.)***

- We no longer qualified for an exemption from an audit of the ICFR
- They are too costly
- They are too time-consuming
- We believe it was useful to do once but not on an annual basis
- We believe that non-accelerated filers and smaller reporting companies should be exempt from this requirement
- For other reason(s) - *If selected, specify other reason(s) below.*

Please specify other reason(s):

8e. For the next fiscal year, does your company plan to voluntarily have an independent audit of the effectiveness its ICFR?

- Yes *(Click here to go to Section 3 - Total Audit Fees)*
- No - *Continue with question 8f.*
- Not sure *(Click here to go to Section 3 - Total Audit Fees)*

8f. *(If no)* For what reason(s) does your company **not** plan to have a voluntary audit of the effectiveness of its ICFR for the next fiscal year? ***(Select all that apply.)***

- We no longer qualified for an exemption from an audit of the ICFR
- They are too costly
- They are too time-consuming

- ☐ We believe it was useful to do once but not on an annual basis
- ☐ We believe that non-accelerated filers and smaller reporting companies should be exempt from this requirement
- ☐ For other reason(s) - *If selected, specify other reason(s) below.*

Please specify other reason(s):

Section 3 - Total Audit Fees

This next section of the survey is about the total fees your company paid its independent auditor for both the audit of the financial statements and the audit of ICFR, as well as factors that may have caused those fees to change from year to year.

You should **exclude** from your total audit fees any fees paid for non-audit services (such as tax compliance services or audit services that are not related to filings of your company's financial statements with the SEC, such as fees to audit an employee benefit plan).

9. What is the **total amount of audit fees paid** to your independent auditor and the **approximate amount of fees paid for the audit of ICFR** for fiscal years 2009, 2010, 2011, and 2012? *(Enter whole dollar amounts. If unknown, check box.)*

	Total audit fees	Approximate fees for audit of the ICFR	
FY 2009	$	$	☐ Unknown
FY 2010	$	$	☐ Unknown
FY 2011	$	$	☐ Unknown
FY 2012	$	$	☐ Unknown

10. **For fiscal year 2011**, if the following events or factors occurred, what impact did they have on your company's total audit fees (relative to what these fees would have been had these events or factors not occurred)? *(Select one answer in each row.)*

Event or factor

	Not applicable, event did not occur	Caused higher fees	Had little or no impact	Caused lower fees	Not sure
a. Material acquisition or divestiture	○	○	○	○	○
b. Restatement of company's prior financial statements	○	○	○	○	○
c. Change in use by your independent auditor or the work of others (e.g., management, internal audit)	○	○	○	○	○
d. Adoption of new accounting and auditing pronouncements (separate from Auditing Standard No. 5)	○	○	○	○	○
e. Change of auditor	○	○	○	○	○
f. Change in the number of hours the auditor needed to conduct the audit due to changes other than those listed above	○	○	○	○	○
g. Other event or factor - *If applicable, specify other event/factor below.*	○	○	○	○	○
h. Other event or factor - *If applicable, specify other event/factor below.*	○	○	○	○	○

Please specify other event or factor for row g:

Please specify other event or factor for row h:

Section 4 - Fees Related to the ICFR Audit

In this section, we will ask questions about the costs of compliance that are associated with the independent audit of ICFR, which can be measured as dollar fees or time spent. In answering these questions, you should exclude from consideration the costs of the traditional financial statement audit.

Audit background and perception

11. **Between the fiscal year 2011 and fiscal year 2012 independent audits of your company's ICFR**, how much of an impact, if any, did the following factors have on the **amount of time spent by the independent auditor to conduct the audits**? *(Select one answer in each row.)*

	Not applicable	Caused a decrease in time spent	Had little or no impact on time spent	Caused an increase in time spent	Not sure
a. Change in the number of accounts and processes selected for audit	○	○	○	○	○
b. Change in the number of areas for which the independent auditor conducted walk-throughs	○	○	○	○	○
c. Change in the number of controls selected and/or the nature, timing, and extent of control testing by the auditor	○	○	○	○	○
d. Change in the number of company locations selected for audit	○	○	○	○	○
e. Change in the degree of the auditor's use of the work of others (e.g., management, internal audit)	○	○	○	○	○
f. Change in the number of hours the auditor needed to conduct the audit due to changes other than those listed above	○	○	○	○	○
g. Other change - *If applicable, specify other change(s) below.*	○	○	○	○	○

Please specify other change(s) for row g:

Use of COSO or other frameworks

The Committee of Sponsoring Organizations of the Treadway Commission's (COSO) Internal Control-Integrated Framework is a framework for designing and evaluating systems of internal control.

12. What internal control framework does your company primarily use to comply with Section 404(a) and 404(b) of the Sarbanes-Oxley Act?

○ COSO
○ Another framework - *If selected, identify the other framework below.*
○ Not sure

Please identify the other framework:

COSO's update to its 1992 Internal Control-Integrated Framework - This update is designed to describe how to evaluate internal controls in an operating and regulatory environment that is more complex than it was when the original framework was developed (Note: The updated internal control framework will not take effect until the first quarter of calendar year 2013.)

13. What impact, if any, do you expect the COSO updated internal control framework to have on the amount of time it will take to complete the independent audit of the ICFR **in fiscal year 2013**?

The COSO update will:

- ○ decrease the time greatly
- ○ decrease the time somewhat
- ○ have no effect
- ○ increase the time somewhat
- ○ increase the time greatly
- ○ Not sure

Non-labor costs

14. Approximately how much money did your company spend on software, hardware, travel, and any other **non-labor expenditure** to help you comply with Section 404(b) for fiscal years 2009, 2010, 2011, and 2012? *(Enter whole dollar amounts. If unknown or if not applicable, check the appropriate box.)*

	Approximate amount spent on software, hardware, travel, and other non-labor expenditures		
FY 2009	$	☐ Unknown	☐ Not applicable
FY 2010	$	☐ Unknown	☐ Not applicable
FY 2011	$	☐ Unknown	☐ Not applicable
FY 2012	$	☐ Unknown	☐ Not applicable

Section 5 - Use of Outside Vendors and/or Consultants

Many companies hire outside vendors and/or consultants to assist management in its evaluation of ICFR. These may include Sarbanes-Oxley Act 404 consultants or IT consultants or any other providers of goods and services that were obtained specifically to support the company's 404(a) - management's assessment of ICFR - and 404(b) - independent audit of ICFR - compliance process.

In this survey, **"outside vendors and/or consultants" do not include your company's independent auditor.**

15. For **any** of the following fiscal years - 2009, 2010, 2011, or 2012 did your company **hire an outside vendor and/or consultant** to assist management in its evaluation of ICFR?

- ○ Yes
- ○ No *(Click here to go to Section 5 - Internal Staff Costs)*
- ○ Not sure *(Click here to go to Section 6 - Internal Staff Costs)*

15a. Approximately how much money did your company spend on **fees paid to outside vendors and/or consultants** specifically to help you comply with Section 404(a) and 404(b) for fiscal years 2009, 2010, 2011, and 2012? *(Enter whole dollar amounts. If unknown or if not applicable, check the appropriate box.)*

Section 404(a)	Approximate amount of fees paid to outside vendors and/or consultants to comply with Section 404(a)		
FY 2009	$	☐ Unknown	☐ Not applicable
FY 2010	$	☐ Unknown	☐ Not applicable
FY 2011	$	☐ Unknown	☐ Not applicable
FY 2012	$	☐ Unknown	☐ Not applicable

Section 404(b)	Approximate amount of fees paid to outside vendors and/or consultants to comply with Section 404(b)		
FY 2009	$	☐ Unknown	☐ Not applicable
FY 2010	$	☐ Unknown	☐ Not applicable
FY 2011	$	☐ Unknown	☐ Not applicable
FY 2012	$	☐ Unknown	☐ Not applicable

15b. **For fiscal year 2011**, for each of the services identified below, to what extent, if at all, did your

company rely on the services of outside vendors and/or consultants to help it comply with **Section 404(b)** of the independent audit of ICFR? *(Select one answer in each row.)*

	Great extent	Moderate extent	Some extent	No extent	Not sure
a. To identify risks to your company's financial reporting	○	○	○	○	○
b. To identify controls that address identified risks	○	○	○	○	○
c. To document controls identified to address risks	○	○	○	○	○
d. To gather evidence related to testing the operational effectiveness of controls	○	○	○	○	○
e. To test and evaluate the effectiveness of controls	○	○	○	○	○
f. To evaluate deficiencies identified to determine if they were significant deficiencies or material weaknesses	○	○	○	○	○
g. To develop disclosures on SEC filings related to management's assessment	○	○	○	○	○
h. To help you prepare for an independent audit of ICFR	○	○	○	○	○
i. Other services - *If applicable, specify other service(s) below.*	○	○	○	○	○

Please specify other services for row i:

Section 6 - Internal Staff Costs

The next series of questions will focus on your company's internal staff effort required to comply with Section 404(a) and 404(b).

16. For **any** of the following fiscal years - 2009, 2010, 2011, or 2012 did your company **use internal staff** to comply with Section 404(a) and 404(b)?

- ○ Yes
- ○ No *(Click here to go to Section 7 - Other Effects of Section 404(b))*
- ○ Not sure *(Click here to go to Section 7 - Other Effects of Section 404(b))*

16a. What was the approximate **total number of internal staff hours** your company spent on the 404(a) and 404(b) compliance process for fiscal years 2009, 2010, 2011, and 2012?
(Enter numbers. If unknown or if not applicable, check the appropriate box.)

Section 404(a)	Approximate total internal staff hours spent on the 404(a) compliance process		
FY 2009	____ hours	☐ Unknown	☐ Not applicable
FY 2010	____ hours	☐ Unknown	☐ Not applicable
FY 2011	____ hours	☐ Unknown	☐ Not applicable
FY 2012	____ hours	☐ Unknown	☐ Not applicable

Section 404(b)	Approximate total internal staff hours spent on the 404(b) compliance process		
FY 2009	____ hours	☐ Unknown	☐ Not applicable
FY 2010	____ hours	☐ Unknown	☐ Not applicable
FY 2011	____ hours	☐ Unknown	☐ Not applicable
FY 2012	____ hours	☐ Unknown	☐ Not applicable

16b. **What was the approximate cost for the work done by your company's internal staff** on the 404(a) and 404(b) compliance process for fiscal years 2009, 2010, 2011, and 2012?
(Enter whole dollar amounts. If unknown or if not applicable, check the appropriate box.)

Section 404(a)	Approximate cost for the work done by your company's internal staff on the 404(a) compliance process		
FY 2009	$	☐ Unknown	☐ Not applicable
FY 2010	$	☐ Unknown	☐ Not applicable
FY 2011	$	☐ Unknown	☐ Not applicable
FY 2012	$	☐ Unknown	☐ Not applicable

Section 404(b)	Approximate cost for the work done by your company's internal staff on the 404(b) compliance process		
FY 2009	$	☐ Unknown	☐ Not applicable
FY 2010	$	☐ Unknown	☐ Not applicable
FY 2011	$	☐ Unknown	☐ Not applicable
FY 2012	$	☐ Unknown	☐ Not applicable

Section 7 - Other Effects of Section 404(b)

We are interested in understanding the general impact that complying with Section 404(b) has had on your company and its participation in the capital markets.

17. **Whether or not your company is currently subject to complying with Section 404(b) of the Sarbanes-Oxley Act**, to the best of your knowledge, has complying with Section 404(b) had a positive impact, no impact, or a negative impact on each of the following? *(Select one answer in each row.)*

	Very positive impact	Somewhat positive impact	No impact	Somewhat negative impact	Very negative impact	Not sure
a. The quality of your company's internal control structure	○	○	○	○	○	○
b. The audit committee's confidence in the company's ICFR	○	○	○	○	○	○
c. The quality of your company's financial reporting	○	○	○	○	○	○
d. Your company's ability to prevent and detect fraud	○	○	○	○	○	○
e. Your company's ability to raise capital	○	○	○	○	○	○
f. Investor confidence in your company	○	○	○	○	○	○
g. Efficiency of your company's operation	○	○	○	○	○	○
h. The efficiency of your company's financial reporting process	○	○	○	○	○	○
i. The liquidity of your company's common stock	○	○	○	○	○	○
j. The timeliness of your company financial statement audit	○	○	○	○	○	○
k. Your company's overall firm value	○	○	○	○	○	○
l. Your confidence in the financial reports of other 404(b) compliant companies	○	○	○	○	○	○
m. Other aspect- *If applicable, specify other aspectsat below.*	○	○	○	○	○	○

Please specify other aspects for row m:

Section 8 - Opinion on Costs and Benefits of Section 404(b)

18. Based on your experience complying with Section 404(b) of the Sarbanes-Oxley Act, do you think the benefits of complying with Section 404(b) outweigh the costs or do the costs outweigh the benefits?

- ○ The benefits greatly outweigh costs
- ○ The benefits somewhat outweigh the costs
- ○ The benefits and costs are about equal
- ○ The costs somewhat outweigh the benefits
- ○ The costs greatly outweigh the benefits
- ○ Not sure *(Click here to skip to question 20)*

19. What reason(s) led you to the way you answered question 18?

Section 8 - Opinion on Disclosure

20. In your opinion, should issuers that are **exempted** from the 404(b) requirement - to have an independent audit of their ICFR - be **required** to disclose the lack of such an audit to investors such as through a check box disclosure on the front of the Form 10-K?

- ○ Definitely yes
- ○ Probably yes
- ○ No opinion
- ○ Probably no
- ○ Definitely no

21. What reason(s) led you to the way you answered question 20?

Section 10 - Comments and Final Response Submission

22. If you have any additional comments regarding any previous question or any topic covered in this questionnaire, please enter them in the space below.

23. **Are you ready to submit your final completed survey to GAO?**
(This is equivalent to mailing a completed paper survey to us. It tells us that your answers are official and final.)

- Yes, my survey is complete - *To submit your final responses, please click on "Exit" below.*
- No, my survey is not yet complete - *To save your responses for later, please click on "Exit" below.*

You may view and print your completed survey by clicking on the Summary link in the menu to the left.

Thank you very much for your assistance.

Print

Exit

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

A. Nicole Clowers, (202) 512-8678 or clowersa@gao.gov

Staff Acknowledgments

In addition to the contact named above, Karen Tremba, (Assistant Director), James Ashley, Bethany Benitez, William Chatlos, Janet Eackloff, Joe Hunter, Cathy Hurley, Stuart Kaufman, Marc Molino, Lauren Nunnally, Jennifer Schwartz, and Seyda Wentworth made key contributions to this report.

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GLASS LEWIS

June 1, 2018

The Honorable Dean Heller
Chairman
Subcommittee on Securities, Insurance & Investment
Senate Committee on Banking
324 Hart Senate Office Building
Washington, DC 20510

Dear Chairman Heller,

We received the letter dated May 9, 2018 regarding your review of the proxy advisory industry and the business practices of proxy advisory firms. We appreciate the opportunity to provide answers to your questions, as well as additional information about Glass Lewis.

We also wish to take this opportunity to respond to certain misleading, inaccurate and conflicted reports published by groups such as the American Council for Capital Formation (ACCF), the Manhattan Institute, Nasdaq and the U.S. Chamber of Commerce. To begin with, we would like to note the following facts:

- Unlike Institutional Shareholder Services ("ISS"), Glass Lewis does not provide consulting services to issuers. We believe the provision of consulting services creates a problematic conflict of interest that goes against the very governance principles that proxy advisors 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.
- Glass Lewis transparently discloses all potential conflicts of interest in every report published, including those relating to our owners, the Ontario Teachers' Pension Plan ("OTPP") and Alberta Investment Management Company ("AIMCo"). Glass Lewis is owned – not operated – by OTPP and AIMCo.
- Glass Lewis' voting policy guidelines are publicly available, open year-round to public comment and informed by feedback from all market participants. In 2017, more than 1,300 investors and 2,300 companies (of the more than 13,000 companies we contacted in 2017) provided feedback on Glass Lewis' policy guidelines.
- Glass Lewis' guidelines and views on core principles and best practices are reviewed and updated to incorporate feedback from our independent research advisory council, which is chaired by David Nierenberg of the D3 Family Funds and includes Charles A. Bowsher (chair emeritus), who served for 15 years as the Comptroller General of the United States and head of the U.S. Government Accountability Office ("GAO"), appointed by President Ronald Reagan in 1981.

- Glass Lewis does not exert undue influence on investors. This is clearly evidenced by the fact that during the 2017 proxy season Glass Lewis recommended voting FOR 92% of the proposals it analyzed from the U.S. issuer meetings it covers (the board and management of these companies recommended voting FOR 98% of the same) and yet, as noted by ACCF sponsor Ernst & Young[1], directors received majority FOR votes 99.9% of the time and say-on-pay proposals received majority FOR votes 99.1% of the time. As further noted by Ernst & Young, directors received average support of 96% and say on pay proposals received average support of 93% compared to Glass Lewis' FOR recommendations of 89% and 84%, respectively. The market is clearly working as shareholders are voting independently of both Glass Lewis and company management.

VOTING SYSTEM

We request that you provide detailed information on how the Viewpoint voting service works and why you think your company is in compliance with SEC Staff Legal Bulletin 20, especially in circumstances where each client does not have to formally approve or submit the pre-populated electronic ballot that you are producing for each shareholder meeting.

In SEC Staff Legal Bulletin No. 20 ("SLB 20"), the SEC provided its interpretation of the requirements of Rule 14a-2(b)(1) under the Securities Exchange Act of 1934, which, among other things, explains how proxy advisory firms may or may not rely on the exemption from the federal proxy rules. SLB 20 provides in relevant part as follows:

> "**Question 6.** When is a proxy advisory firm subject to the federal proxy rules?
>
> **Answer.** A proxy advisory firm would be subject to the federal proxy rules when it engages in a "solicitation," which is defined under Exchange Act Rule 14a-1(l) to include "the furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy." As a general matter, the Commission has stated that the furnishing of proxy voting advice constitutes a "solicitation" subject to the information and filing requirements of the federal proxy rules. Providing recommendations that are reasonably calculated to result in the procurement, withholding, or revocation of a proxy would subject a proxy advisory firm to the proxy rules. Exchange Act Rule 14a-2(b) provides exemptions from the information and filing requirements of the federal proxy rules that a proxy advisory firm may rely upon if it meets the requirements of the exemptions.
>
> **Question 7.** Where a shareholder (such as an institutional investor) retains a proxy advisory firm to assist in the establishment of general proxy voting guidelines and policies and authorizes the proxy advisory firm to execute a proxy or submit voting instructions on its behalf, and permits the proxy advisory firm to use its discretion to apply the guidelines to

[1] EY Center for Board Matters; 2017 Proxy Season Review; June 2017; http://www.ey.com/Publication/vwLUAssets/ey-2017-proxy-season-review/$File/ey-2017-proxy-season-review.pdf

determine how to vote on particular proposals, may the proxy advisory firm providing such services rely on the exemption from the proxy rules in Exchange Act Rule 14a-2(b)(1)?

Answer. No. Rule 14a-2(b)(1) provides an exemption from most provisions of the federal proxy rules for "any solicitation by or on behalf of any person who does not, at any time during such solicitation, seek directly or indirectly, either on its own or another's behalf, the power to act as a proxy for a security holder and does not furnish or otherwise request, or act on behalf of a person who furnishes or requests, a form of revocation, abstention, consent or authorization." The exemption would not be available for a proxy advisory firm offering a service that allows the client to establish, in advance of receiving proxy materials for a particular shareholder meeting, general guidelines or policies that the proxy advisory firm will apply to vote on behalf of the client."

Glass Lewis complies with the interpretation given by the SEC with respect to what does and does not constitute a solicitation of proxies. As we do not seek, directly or indirectly, the power to act as a proxy for security holders nor do we have the authority to deviate from clients' specific voting instructions, we are eligible for the exemption from the federal proxy rules.

As required by the Rule 14a-2(b)(1) exemption, Glass Lewis does not furnish or otherwise request, or act on behalf of a person who furnishes or requests, a form of revocation, abstention, consent or authorization. These powers all remain with Glass Lewis' institutional investor clients. Most importantly, Glass Lewis, as a proxy advisory firm, is not executing a "vote on behalf of the client," as described in the answer to Question 7. Glass Lewis' Viewpoint platform delivers the client's votes based on the client's specific voting instructions.

When an institutional investor engages Glass Lewis as its proxy advisory firm, the onus is on the institutional investor to develop its own voting policy and determine how such policy is applied to each voting issue.

While Glass Lewis works with each client to implement the client's respective proxy voting policy on the Viewpoint platform, the formulation of the actual policy is at the sole discretion of the client. For instance, if a client already has a detailed policy, Glass Lewis works with such client to set up its preexisting policy on the Viewpoint platform. However, if a client does not yet have its own policy or is interested in redeveloping its existing policy, Glass Lewis provides the client with (i) a comprehensive list of various voting issues that arise across all markets; (ii) detailed information regarding Glass Lewis' proxy voting policies, issue-by-issue approaches, and models used in the development of Glass Lewis' proprietary Proxy Paper research reports; (iii) data and analytics to help the client analyze its voting history relative to policy, vote results, publicly-available peer voting data, company performance, etc.; and (iv) up-to-date information regarding global regulatory, legislative and industry policies and developments that may be relevant to the client's governance activities.

Once the client determines how it would like to address each voting issue, Glass Lewis works with the client to develop a new or updated policy and implements the new or updated policy on the Viewpoint platform to address each voting issue in accordance with the client's instructions.

Each client's voting policy is specific and detailed, and covers several issues based largely on laws, regulations and listing rules applicable in each relevant market and, in some cases, specific to an issuer's sector.

By way of example, Glass Lewis identifies 250 separate voting issues that regularly appear on meeting agendas, for U.S. companies alone, and works with clients to craft voting policies for each of them. This is proof that institutional investor clients' voting policies are not merely "general guidelines or policies," as referenced in the answer to Question 7 of SLB 20.

Glass Lewis does not have the discretion to deviate from a client's instructions or to determine a vote that is not consistent with the policy specified by the client.

In cases where a client has not provided a specific voting instruction, voting is done manually by the client through the Viewpoint platform. Clients regularly audit the voting to ensure that Glass Lewis is executing in accordance with client instructions. Auditing procedures are typically determined by the client's compliance committee, governance team and/or portfolio management team.

You assert in your letter that because the Viewpoint platform pre-populates an electronic ballot for a client with the votes that reflect the client's voting policies and because a client may elect to have its completed ballot submitted automatically by a specified date in order to avoid missing voting deadlines, the service falls outside the SEC's guidance and the exemption provided in Rule 14a-2(b)(1).

This simply is not the case.

There is nothing in the SEC's guidance, or the rule, that suggests an investment adviser must manually vote all of the many thousands of proxies it receives every year, or that it must reiterate its voting policies after each of the many proxy statements it receives.

Such a requirement also would conflict with the SEC Staff's response to Question 1 in SLB 20. In that question, the SEC was asked what steps an investment adviser could take to demonstrate that its proxies were being cast in accordance with the adviser's proxy voting policies and in the best interests of the adviser's clients. The SEC answered by suggesting that the adviser periodically review a sample of the proxies voted to see whether they complied with the adviser's policies. This supports the common practice among institutional investors of casting ballots in accordance with a predetermined client-specific voting policy. There is little difference in principle between an institutional investor's practice of voting based on pre-set voting instructions in accordance with the investor's voting policies and an investor buying or selling a security in accordance with the investor's investment policy by providing specific standing instructions to their broker to buy or sell a specified amount of the security at specific times (e.g., monthly or quarterly) based on client-defined criteria.

The pre-population of voting instructions on a ballot by Glass Lewis' Viewpoint platform is merely an administrative, ministerial task that strictly adheres to each client's specific voting instructions and involves no discretion on the part of Glass Lewis.

The platform alerts each client when its preliminary ballot is ready for review, and clients have all the disclosures and other information they need at their fingertips to review and evaluate the matters up for a vote. Clients can choose to restrict the submission of a ballot until after specified client personnel have reviewed and approved the votes. Clients can, and do, make changes to the preliminary ballot before signing off, and can even change their vote and resubmit it, assuming the voting deadline has not passed. Clients audit Glass Lewis' compliance with their voting policies on a regular basis.

In addition, while it was not covered in your letter, we note that there is another exemption from the federal proxy rules that proxy advisory firms can rely on, and which was discussed by the SEC in SLB 20.

Rule 14a-2(b)(3) of the Securities Exchange Act of 1934 contains an exemption that extends to the provision of proxy voting advice by any person to another person with whom it has a business relationship provided certain conditions are met. In order for the exemption to apply, the person giving the proxy voting advice must: (i) give financial advice in the ordinary course of business; (ii) disclose to the recipient of its advice any significant relationship with the issuer, its affiliates, or a security-holder proponent of the matter on which advice is given, as well as any material interest it may have in the matter to be voted on; (iii) not receive any special commission or remuneration for furnishing the advice from any person other than the recipient of the advice and others who receive similar advice; and (iv) not furnish the advice on behalf of any person soliciting proxies or on behalf of a participant in a contested election.

Glass Lewis meets all the above criteria and thereby relies on this exemption as well.

Specifically, as described in further detail below, Glass Lewis provides sufficient disclosure on the face of its Proxy Paper reports to enable its clients to: (i) understand the nature and scope of any potential conflict it may have with the issuer, its affiliates, or a security-holder proponent of a matter on which advice is given, as well as any material interest it may have in such matter; and (ii) make an assessment about the reliability or objectivity of the recommendation.

REPORT ACCURACY

Why doesn't Glass Lewis initiate a draft review process for companies, in order to improve the quality of your reports?

In 2015, Glass Lewis launched the *Issuer Data Report* ("IDR") service to provide issuers with free access to a data-only version of their Proxy Paper research report. This review process enables issuers to notify Glass Lewis of any factual mistakes in the publicly-available data we have collected from issuers and third-party sources, prior to our completing and publishing the analysis for our investor clients (http://www.glasslewis.com/issuer-data-report/). The IDR service is available to all issuers that sign up for the IDR prior to releasing their proxy materials for the relevant meeting. (See "2017 IDR Participants" attachment for a list of companies that participated in the Issuer Data Report program in 2017.)

In our view, if Glass Lewis were to initiate a draft review process of the complete Proxy Paper report (i.e. with Glass Lewis' analysis and recommendations): (i) investors would be denied access to independent research; (ii) significant constraints would be placed on the time investors have to properly consider the analysis in order to develop informed proxy voting decisions; and (iii) issuers could potentially determine an investor's vote selections (even before the investor itself knew) given that investors publicly disclose their policies, which may be based on Glass Lewis' analysis.

We note that FINRA has adopted rules addressing analogous conflicts of interest arising from the publication of research reports by research analysts associated with broker-dealer firms. FINRA Rule 2241 requires broker-dealer firms to adopt written policies and procedures "reasonably designed to promote objective and reliable research that reflects the truly held opinions of research analysts and to prevent the use of research reports or research analysts to manipulate or condition the market or favor the interests of the member or a current or prospective customer or class of customers."

Among other things, these procedures are required to insulate the research analysts and their reports from influence by the firm's investment banking interests, including by prohibiting prepublication review, clearance or approval by any persons not directly responsible for the preparation, content and distribution of the research reports (other than legal and compliance personnel). Like Glass Lewis and our IDR service, FINRA permits the prepublication review of a research report by an issuer that is the subject of a report solely for the purpose of fact verification, subject to several conditions.

Most importantly, we believe this type of dialogue would exacerbate the lingering misconception that issuers should be primarily concerned with the views of proxy advisory firms rather than with those of their shareholders. It would also create the false perception that proxy advisory firms are standard setters, or even quasi-regulators, empowered by their clients to negotiate changes to companies' governance or compensation strategies. Indeed, Glass Lewis has actively avoided providing consulting services to issuers, despite the temptation of a lucrative issuer consulting business, because we believe it may encourage both the use and perpetuation of this false perception to extract sales. Investors take their fiduciary responsibility to vote shares, engage with issuers and operate as good stewards very seriously; placing proxy advisory firms in between issuers and investors in this regard would inhibit direct engagement. In our view, issuers and investors are both better served by preserving the independence of proxy advisory firms through the avoidance of undue influences.

Glass Lewis strongly believes that the IDR program not only works as an effective tool to improve the quality of our Proxy Paper research reports but also allows issuers to participate in the process without compromising Glass Lewis' independence as a proxy advisory firm nor limiting the time investors have to make fully informed voting decisions.

Why do you charge companies for a courtesy copy of the report once it is issued?

Glass Lewis' proxy analysis and voting recommendations are valuable intellectual property. As a result, any institution interested in obtaining a copy of a report, whether it be an institutional

investor, an issuer or an advisor to issuers, must purchase the report. Since launching the free IDR service, we have continued to expand the free services we offer issuers, most notably our issuer engagement program. However, like the companies we cover, Glass Lewis has a duty to its shareholders to achieve an appropriate return on the investments we make in our products and services. Further, considering that we have decided to avoid the problematic conflicts of interests that may result from providing consulting services to companies, we do not operate a business model that treats its proxy research reports as a loss leader for more lucrative consulting fees. Most importantly, in a free market our clients should not be compelled to subsidize the free distribution of our intellectual property to other consumers.

If an issuer identifies an error in a draft report, what corrective measures do you take?

Glass Lewis has an online, auditable process for receiving, tracking and responding to alleged errors or omissions in reports that are brought to Glass Lewis' attention (http://www.glasslewis.com/report-error/). When Glass Lewis is notified of a purported factual error or omission, we immediately review the report and, if there is a reasonable likelihood the report will require revision, we remove the report from its published status so no additional clients can access it. If a report is updated to reflect any new publicly-available disclosures by the issuer or the correction of a factual error, Glass Lewis notifies all clients that accessed the report or have corresponding ballots, regardless of whether the update affected any recommendations. There is no deadline for notification of a purported factual error or omission. Additionally, the exact nature of the report's updates and revisions are clearly described in the republished report. If an issuer notifies Glass Lewis of a relevant factual error or omission in a report, Glass Lewis' research team will respond and address the issuer's comments and/or questions. Glass Lewis is committed to ensuring its Proxy Paper reports contain accurate information. Accuracy is reported independently of research teams on a companywide basis, is a key determinant in the performance assessment of analysts and is strongly aligned with our competitive interests of retaining and winning clients.

Do you publicly disclose your guidelines and methodologies for preparing draft reports? If not, why not?

Yes. We publish unabridged guidelines for the analysis of U.S. issuers, as well as the voting guidelines for other major countries on our company website (http://www.glasslewis.com/guidelines/).

Moreover, Glass Lewis is fully transparent about the policies and procedures we employ for developing the methodologies used in the analysis of each issuer covered, which include, but are not limited to: (i) tailoring our approach to each country's relevant regulations, practices and corporate governance codes; (ii) tailoring our approach to each issuer's size, industry, operations and maturity; and (iii) consulting with Glass Lewis' Research Advisory Council, an independent external group of prominent industry experts, to ensure Glass Lewis' proxy voting policies are comprehensive, well-reasoned and reflective of current global governance and regulatory practices and developments (http://www.glasslewis.com/leadership-2/); (iv) revising and enhancing our methodologies, at least annually, in response to regulatory developments, market practices and issuer trends, which are closely monitored and assessed throughout the year; and (v) engaging and

maintaining an ongoing dialogue with a wide range of market participants, the largest group being the companies we engage with, as well as actively participating in panels, working groups and industry conferences.

As you are aware, ISS is a registered investment adviser with the SEC. Why has your company chosen not to register with the SEC as an investment adviser?

We are aware that ISS is a registered investment adviser with the SEC. In fact, Glass Lewis was previously registered under the Investment Advisers Act of 1940 but our registration was withdrawn in 2005 on the advice of legal counsel. Wilmer Hale, our law firm at the time, determined that Glass Lewis should not be deemed an investment adviser on the basis that Glass Lewis' Proxy Paper research reports and accompanying voting recommendations do not meet the elements of "investment advice" spelled out in Section 202(a)(11) of the Advisers Act, i.e., advice as to "the value of securities," "the advisability of investing in, purchasing or selling securities" or "analyses or reports concerning securities." (Please find attached a memo prepared by Wilmer Hale on this topic.)[2]

For its Proxy Paper research reports, Glass Lewis analyzes the issues presented for shareholder vote based on the Glass Lewis house policy without commenting on the investment merits of the securities issued by the subject companies. Specifically, Glass Lewis does not: (i) recommend that clients invest or trade in, purchase, sell, or hold securities; (ii) exercise investment discretion over client assets; or (iii) have any responsibility for selecting which securities are to be purchased or sold by clients or how to allocate investments among different types of securities or other assets.

Since the legal advice we received from Wilmer Hale in 2005, we have revisited the issue of our registration under the RIA framework numerous times and, in all such instances, our counsel, now Willkie Farr & Gallagher, has continued to advise us that registration as an investment advisor with the SEC would be inappropriate given the nature of our activities as a proxy advisory firm.

CONFLICTS OF INTEREST

While ISS has a consulting service that charges public companies a fee to learn how best to comply with its benchmark voting policies and obtain favorable recommendations in the future, my understanding is that Glass Lewis does not have any type of affiliated consulting service that provides advice to the same companies that it is making voting recommendations on to its clients. Is this correct?

This is correct. Glass Lewis does not provide consulting services to the issuers it covers in its Proxy Paper reports. This helps ensure that our voting recommendations and analysis are disinterested.

In our view, offering consulting services to public companies for a fee may infringe upon a proxy

[2] Please note that this attachment is only available to Glass Lewis' institutional investor clients upon request via compliance@glasslewis.com.

advisory firm's ability to independently analyze the issues up for vote and to make unbiased voting recommendations to clients.

Notwithstanding the foregoing, Glass Lewis recognizes that dialogue, at the appropriate time, with all issuers that wish to engage can foster mutual understanding, transparency and feedback with respect to Glass Lewis' policies, methodologies and analysis, as well as the unique circumstances that each issuer faces based on a multitude of factors (e.g., their size, industry, operations and maturity). Therefore, Glass Lewis is open to engaging with any issuer that wants to engage with us outside of the solicitation period.

As a result, Glass Lewis has an ongoing practice of proactively contacting companies globally. By way of example, in 2017 alone we contacted more than 13,000 companies (one-third of which are based in the United States and Canada), to provide them with free and comprehensive information on topics relating to Glass Lewis, including: (i) policy and guideline information; (ii) directions for how to sign up for the free IDR service; (iii) directions for how to request an engagement with Glass Lewis (always at no cost); and (iv) directions for how to provide feedback on Glass Lewis reports and policies.

In addition, Glass Lewis engaged with more than 2,300 issuers in 2017, nearly half of which independently requested a meeting with Glass Lewis analysts. As a result, Glass Lewis conducted nearly 1,400 formal meetings with almost 1,100 issuers in person or by phone in 2017, many of which were with issuers that engage with Glass Lewis at least once annually. Typically, these meetings focus on Glass Lewis' research policies and methodologies and participants' respective views on governance practices given the unique context of their companies and last an hour or more. Glass Lewis declined only 6% of meeting requests, as they breached our policy of not engaging with issuers during the solicitation period preceding issuer's shareholder meeting (see below). Additionally, issuers withdrew 7% of meeting requests, as a meeting was no longer required following our response to their initial inquiry. (See "2017 Glass Lewis Meetings With Public Companies" for a list of the public companies that conducted meetings with Glass Lewis research analysts in 2017.)[3]

We believe that allowing an issuer to engage with us during the solicitation period may lead to discussions about the issuer's proxy, thereby providing issuers with an opportunity to lobby Glass Lewis for a change in policy or a specific recommendation against management. To ensure our research is always objective, Glass Lewis takes this added precaution and postpones any engagements until after the solicitation period has ended, with the below exception.

In the case of a dissident campaign, transaction or shareholder proposal, Glass Lewis may meet with the shareholder proponent or dissident during the solicitation period only if we afford the issuer the same opportunity. These meetings may provide our analysts with useful context given the unusual volume and timing of disclosures made during the solicitation period of these extraordinary shareholder meetings. As is always the case, however, it is important to reiterate that our analysis

[3] Please note that this attachment is only available to Glass Lewis' institutional investor clients upon request via compliance@glasslewis.com.

and recommendations are based solely on publicly-available information. In the event Glass Lewis does agree to hold such meetings, it makes full disclosure of this decision in the relevant Proxy Paper reports we publish.

During the solicitation period, issuers and clients can still contact Glass Lewis to provide additional information and clarifications, or to allege an error or omission in any of our reports, via our online, auditable process for receiving, tracking and responding to such queries and notifications. Any issuer or client that contacts us regarding these matters will receive a timely response from our operations team and, if appropriate, from the analyst(s) responsible for the relevant report. Glass Lewis' analysts may also use the same process to seek clarification from an issuer in the rare circumstance that its public disclosure is unclear. However, in furtherance of Glass Lewis' commitment to avoid any conflicts of interest, as well as to refrain from using non-public information, analysts are strictly prohibited from meeting privately with issuers during the solicitation period.

Is it correct that GL discloses any potential or actual conflict of interest on the front page of each company report? And, please provide us with an explanation about the types of conflicts that you identify and disclose?

Yes. Glass Lewis adds a disclosure note to the front cover of the relevant Proxy Paper report when Glass Lewis determines that there is a potential or actual conflict of interest.

Moreover, Glass Lewis has robust policies and procedures in place to help manage and address such conflicts. These conflict management policies and procedures were developed to address investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms, as detailed in SLB 20 discussed above. (Please see attached copy of the "Glass Lewis Conflict of Interest Statement," which is publicly available on Glass Lewis' website at http://www.glasslewis.com/conflict-of-interest/. Also attached is a copy of the "Glass Lewis Conflict Management Procedures," which are available from Glass Lewis upon request.)[4]

The Glass Lewis Compliance Committee – comprising Glass Lewis' Chief Executive Officer; Chief Operating Officer; Senior Vice President of Research and Engagement; Senior Vice President and General Counsel; and Director of Compliance – meets quarterly to discuss, among other things, any new potential conflicts of interest that have arisen and need to be addressed and communicated to clients.

Currently, Glass Lewis identifies and discloses the following types of potential conflicts:

Owners

- ***Significant Ownership Stake***. One or both of Glass Lewis' owners holds a stake significant enough to be publicly disclosed in accordance with a local market's

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regulatory requirements or Glass Lewis becomes aware through public disclosure of OTPP's or AIMCo's ownership stake in an issuer Glass Lewis is covering.

- Example: "Please be advised that Ontario Teachers' Pension Plan Board, one of Glass Lewis' owners, holds a stake in this company significant enough to be publicly announced in accordance with such company's local market regulatory requirements. For a complete copy of the Glass Lewis Conflict of Interest Statement, please visit www.glasslewis.com/conflict-of-interest/."

- ***Dissident Shareholder or Shareholder Proposal Proponent.*** One or both of Glass Lewis' owners is a dissident shareholder in a proxy contest or a shareholder proposal proponent. Please note: This particular conflict has never occurred.

  - Example: "The shareholder proponent of Proposal X is the Ontario Teachers' Pension Plan Board, one of Glass Lewis' owners."

Corporate Issuers, Directors, Dissident Shareholders and Shareholder Proposal Proponents

- ***Engagement***. Glass Lewis Research Analyst(s) had a meeting with the issuer.

  - Example: "Please be advised that Glass Lewis' research analysts engaged with the Company prior to the release of its meeting materials. The purpose of the engagement was to discuss the Company's unique corporate governance practices and provide an opportunity for the Company to seek clarification and understanding of Glass Lewis' general approach to key governance issues. Glass Lewis does not provide consulting services to corporate issuers or to any of its directors or advisors. Glass Lewis' analysis and recommendations are based solely on publicly-available information. Under no circumstance does Glass Lewis develop its research or make vote recommendations based on non-public information. For further information regarding our engagement policy, please visit www.glasslewis.com/engagement-policy/. For a complete copy of the Glass Lewis Conflict of Interest Statement, please visit www.glasslewis.com/conflict-of-interest/."

- ***Report Purchase***. An issuer, director, dissident shareholder or shareholder proposal proponent purchases a research report directly from Glass Lewis.

  - Example: "Micron Technology purchased a copy of this Proxy Paper from Glass Lewis for receipt after publication to institutional investor clients."

- ***Investor Client Ownership***. A Glass Lewis institutional investor client is an issuer, or is related to or owned by an issuer.

- Example: "J.P. Morgan Investment Management subscribes to Glass Lewis' products and services and is affiliated to JPMorgan Asian Investment Trust plc."

- ***Investor Client Activism***. A Glass Lewis institutional investor client submits a shareholder proposal at a company, is a dissident shareholder in a proxy contest, or is otherwise publicly soliciting shareholder support for or against a director or proposal.

  - Example: "The shareholder proponent of Proposal 5, New York State Common Retirement Fund, is a client of Glass Lewis."

Employees, Agents and Related Parties

- ***Direct Affiliation***. An employee of Glass Lewis or any of the company's subsidiaries, a member of the Research Advisory Council, or a member of Glass Lewis' Strategic Committee[5] serves as an executive or director of a corporate issuer.

  - Example: "Mr. (Robert) Bertram, a director of Alaris Royalty, is a member of Glass Lewis' Strategic Committee."

- ***Indirect Affiliation***. A relative of an employee of Glass Lewis or any of Glass Lewis' subsidiaries serves as an executive or director of an issuer.

  - Example: "The CFO of LEAF is the sister-in-law of a Proxy Research Analyst of Glass Lewis. The Proxy Research Analyst was not involved in any manner in the voting recommendations provided in this Proxy Paper."

Vendors and Business Partners

- ***Partnerships***. Glass Lewis has a material business partnership with an issuer.

  - Example: "Glass Lewis has a commercial relationship with Broadridge for the provision and processing of ballots for Glass Lewis' voting clients. In addition, Glass Lewis and Broadridge offer an integrated recommendation service whereby Glass Lewis' recommendations are available through Broadridge's ProxyEdge platform."

[5] Under Delaware law, LLC's are not required to have a Board of Directors. Therefore, Glass Lewis does not have a Board of Directors. Instead, Glass Lewis has a Strategic Committee, chaired by Robert Bertram, the former chief investment officer of OTPP and composed of one representative of each of Glass Lewis' owners (OTPP and AIMCo). The Glass Lewis Strategic Committee has no decision making or managerial authority. It simply acts as a liaison between Glass Lewis' management and owners.

- ***Significant Economic Relationships***. Glass Lewis has a commercial relationship with an issuer that is material to the provision of Glass Lewis' products and services or the contract value exceeds $50,000 a year.

  - Example: "Glass Lewis has a commercial relationship with Salesforce for CRM services."

We are also interested in learning about whether you disclose, in monetary terms, the size of the client relationship involved and whether you disclose conflicts involving more than one proponent or active supporter of a particular shareholder proposal.

No. Where a conflict note is about a client of Glass Lewis, we do not disclose, in monetary terms, the size of the client relationship involved. Because we do not consult with issuers, our largest revenue generating clients are typically large institutional investors that often have confidentiality provisions in their agreements with Glass Lewis. As it relates to issuer clients, the only revenue we receive from public companies originates from the one-time fee a company pays us when it purchases a copy of its own Proxy Paper report.

In terms of conflict disclosures related to shareholder proposals, as described above, Glass Lewis adds relevant disclosure when there is one or more than one proponent or active supporter of a particular shareholder proposal. Glass Lewis makes a conflict disclosure for any proponent or active supporter that is (i) a client of Glass Lewis; (ii) an issuer that purchased the relevant report directly from Glass Lewis; (iii) had a meeting with Glass Lewis analyst(s); (iv) are the owners or parent company of an investor client of Glass Lewis; (v) have a commercial relationship with Glass Lewis; (vi) have a personal relationship with Glass Lewis; and/or (vii) is an owner of Glass Lewis.

Please provide a record of each instance of proxy voting advice that your company or any regulatory body has determined constituted or may have constituted a conflict of interest over the last 10 years, and all related documents and communication. If no such record is maintained, please explain why.

Upon request, Glass Lewis makes available to clients a comprehensive list of all reports published where a potential or perceived conflict of interest is identified by Glass Lewis. This record goes back more than 10 years and is maintained for our own purposes, the benefit of our clients and any other parties with the appropriate authority to receive it. In 2017, Glass Lewis published 23,210 reports, including 5,660 reports on U.S. issuers and 17,550 reports on non-U.S. issuers. The reports for 2017 contained 1,993 conflicts notes, including 754 conflict notes in U.S. issuer reports and 1,239 conflict notes in non-U.S. issuer reports.

The breakdown of the 2017 conflict notes by type was as follows:

28	OTPP and/or AIMCo has a reportable position in the issuer.
9	Glass Lewis employee, relative of an employee, independent Research Advisory Council Member or member of the Glass Lewis Strategic Committee, comprising owner representatives, is an executive or director at the issuer.

387	Investor client is a division of the issuer.
95	Investor client is a shareholder-proposal proponent or a dissident in a proxy fight.
15	Glass Lewis has a business relationship with the issuer.
1,459	Glass Lewis met with the issuer or the issuer purchased its Glass Lewis Proxy Paper report.

Please provide a list of all outside entities from whom you obtain information referring or relating to your proxy voting advice, and descriptions of any evaluations that are performed to ensure such information is accurate and that the information provider does not have a conflict of interest with the company with respect to which the information is being provided.

As discussed throughout this letter, Glass Lewis strongly believes that our research and recommendations should be based exclusively on publicly-available information. As a result, we do not include information in our Proxy Paper research reports that is not available to all other market participants. Issuers holding a meeting of shareholders have the opportunity, under the proxy rules, to provide all the information necessary for shareholders to make an informed voting decision and to make statements in support of management's recommendations and against initiatives that management opposes. Glass Lewis encourages issuers to provide comprehensive and clear disclosure about the relevant matters for consideration by shareholders. Below are examples of the sources of information we use in developing our proxy analysis and vote recommendations.

Issuer Filings. The vast majority of information used in our analysis comes directly from each issuer's public filings and press releases. We only provide recommendations on proposals where information from said filings is sufficient to make a judgment. In the case of a shareholder proposal or proxy contest, we source information directly from filings made available by the shareholder proponent or dissident. We use an automated process to ingest 8-K and DEF14A filings from the public SEC API.

Issuer Engagements. In addition to the information made publicly available by issuers, Glass Lewis meets regularly with issuers outside the solicitation period to foster mutual understanding and to enhance our understanding of the context specific to each company. In the case of a dissident campaign or shareholder proposal, Glass Lewis may meet with the shareholder proponent or dissident during the solicitation period only if we afford the company the same opportunity. All meetings may provide useful context for our analysts; however, our analysis and recommendations rely solely on publicly-available information. We disclose the details of all meetings in the relevant Proxy Paper reports for the companies we analyze.

Issuer Data Report. As outlined above, issuers can — free of charge — review the key underlying data used by Glass Lewis to develop our analysis prior to publication of the final research report to our clients. By utilizing this service, issuers provide the Glass Lewis research team with input on the data that is directly relevant to our Proxy Paper; however, our analysis and recommendations rely

solely on publicly-available information. (See the attached "2017 IDR Participants" for a list of companies that participated in the IDR program.)[6]

Third-Party Data Suppliers. Glass Lewis sources data from the following third-party suppliers:

Equilar. Glass Lewis sources data on executive compensation from Equilar for our pay-for-performance (P4P) analysis, which we include in our reports. Prior to finalizing the P4P analysis, Glass Lewis' Quantitative Analysis Team verifies Equilar's data against the publicly-available information disclosed by each issuer. The verification process accounts for unusual situations that may affect our P4P analysis, including multiple CEOs in the past year, severances or forfeitures in the past year and significant M&A activity that may affect performance results. Any issuer with a P4P grade of D or F is verified twice. In addition, Glass Lewis sources peer-group data from Equilar for use in determining an issuer's performance relative to that of its peers. Equilar uses publicly-available issuer data, in conjunction with its own methodology, to deliver the executive compensation and issuer peer group data to Glass Lewis.

S&P Capital IQ. Glass Lewis sources information regarding share ownership, market valuation and financial data displayed on the "Peer Comparison" page of our Proxy Paper reports from S&P Capital IQ. Glass Lewis conducts spot-checking of the S&P Capital IQ data on a daily basis and works closely with S&P Capital IQ to address and correct any inconsistency or irregularity that may arise from these checks. S&P Capital IQ uses publicly-available issuer data, in conjunction with its own methodology, to deliver the data to Glass Lewis.

Sustainalytics. Glass Lewis sources ESG data featured on the "ESG Profile" page of our Proxy Paper reports from Sustainalytics. The data delivered to Glass Lewis is updated by Sustainalytics monthly, at which time Glass Lewis conducts a review of the data. Sustainalytics uses publicly-available issuer data, in conjunction with its own methodology, to deliver the ESG data to Glass Lewis. The analytics and ratings featured on the Sustainalytics page of Glass Lewis' reports are not factors in Glass Lewis' proprietary recommendations.

Proxy Insight. Glass Lewis procures proxy vote results data from Proxy Insight, which collects its data from publicly-available sources. Data is received from Proxy Insight on an ad-hoc basis (daily or weekly) through an API. Glass Lewis analysts review the Proxy Insight data used in each Proxy Paper report prior to publication. Random samplings are also pulled to ensure data integrity.

Director Insight. Glass Lewis sources executive compensation and peer group data for European issuers from Director Insight. Data is received from Director Insight on an ad-hoc, per-report basis. The data is compiled and reviewed by Glass Lewis' analysts manually for

[6] Please note that this attachment is only available to Glass Lewis' institutional investor clients upon request via compliance@glasslewis.com.

each Proxy Paper report. Director Insight uses publicly-available issuer data to deliver the executive compensation and peer group data to Glass Lewis.

Are you disclosing cross-ownership, where owners or executives of your firm may have a significant ownership interest in, or serve on the board of directors of, entities that have proposals on which the firm is offering vote recommendations?

Yes. Glass Lewis maintains a Code of Ethics, managed by Glass Lewis' Senior Vice President and General Counsel, whereby employees and contractors are required to disclose any outside activities, ownership interests or personal relationships which may be deemed a conflict of interest for Glass Lewis and its clients. In addition, as part of our personal trading policy, employees and contractors are required to: (i) disclose all personal accounts in which any securities are held, regardless of whether the employee or contractor has direct or indirect influence or control (i.e. investment discretion) over the management of the account; (ii) ensure that duplicate account statements and duplicate transaction confirmations for these accounts are being forwarded to Glass Lewis; and (iii) obtain pre-authorization from Glass Lewis for any trading activity.

If an employee of Glass Lewis or any of its subsidiaries, a member of the Glass Lewis Research Advisory Council, or a member of the Glass Lewis Strategic Committee serves as an executive or director of a public company, Glass Lewis will add a conflict disclosure note on the face of the relevant Proxy Paper report. Similarly, if a relative of an employee of Glass Lewis or any of its subsidiaries serves as an executive or director of a public company, Glass Lewis also adds a disclosure note.

As it relates to significant ownership interests, there have been no incidents in the history of Glass Lewis where an employee or consultant has owned a significant ownership interest in a company that was the subject of a Glass Lewis Proxy Paper report. If this situation were to arise, Glass Lewis would add a disclosure note to address the potential conflict. Additionally, if the employee who engendered these potential conflicts is also a member of the Glass Lewis research organization, that individual will recuse himself or herself from participating in any aspect of the research process for the company in question. Failure to do so is cause for termination.

Are you disclosing financial interests by your owners, the Ontario Teachers' Pension Plan Board and the Alberta Investment Management Corporation?

Glass Lewis has no direct insight into the financial interests of OTPP or AIMCo, other than what is made publicly available through their published annual reports or any other publicly-available information as disclosed by OTPP and AIMCo. Based on this, Glass Lewis will add a conflict disclosure note on the face of the relevant Proxy Paper report, where: (i) either OTPP, AIMCo or both institutions hold a stake significant enough to be publicly disclosed in accordance with a local market's regulatory requirements; or (ii) Glass Lewis becomes aware through public disclosure of OTPP's or AIMCo's ownership stake in an issuer Glass Lewis is covering.

Are you disclosing these financial or business relationships when they involve or include a proponent or an active supporter of matters in which you are making voting recommendations?

Yes. As discussed earlier, we identify and disclose all potential conflicts of interest on matters where we make voting recommendations. Of the 1,993 conflict notes in 2017, the vast majority of these potential conflicts of interest related to the issuer that was the subject of our recommendations – and not to our ownership, a shareholder proponent or an activist.

Almost all potential conflicts disclosed by Glass Lewis in 2017, 93.8% to be exact, related to issuers that either (i) met with a Glass Lewis research analyst(s); (ii) purchased a copy of their own report, to be delivered after publication of the report to our investor clients; (iii) are the owners or parent company of an investor client of Glass Lewis; (iv) have a commercial relationship with Glass Lewis; or (v) have a personal relationship with Glass Lewis. This compares with just 4.8% of cases where we identified and disclosed a potential conflict of interest with a shareholder proponent or active supporter that was a client and 1.4% of cases where our owners had a reportable position in the issuer.

We appreciate the opportunity to respond to your May 9, 2018 letter and hope that our answers address your concerns regarding business practices within the proxy advisory industry. If you have any additional questions regarding Glass Lewis, or the proxy advisory industry in general, we would be happy to address them.

Sincerely,

Katherine H. Rabin
Chief Executive Officer

cc: The Honorable Tim Scott
The Honorable David Perdue
The Honorable Thom Tillis
The Honorable Tom Cotton
The Honorable Mike Rounds

Enclosures

Glass Lewis' Conflict of Interest Statement
Glass Lewis' Conflict Management Procedures
Wilmer Hale Memo Re: Glass Lewis Status Under the Investment Advisors Act of 1940
2017 Glass Lewis Meetings With Public Companies
2017 IDR Participants

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July 6, 2018

The Honorable Michael Crapo
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Crapo and Ranking Member Brown:

Thank you for holding the hearing on June 28, 2018 on "Legislative Proposals to Examine Corporate Governance." Institutional Shareholder Services Inc. (ISS) thanks the Committee for its commitment to ensuring that corporate governance in the United States is robust and works to support our nation's capital markets and economy. To this end, ISS respectfully submits this statement, as well as the enclosed document, for inclusion in the hearing record in order to help clarify misconceptions and to correct misinformation about ISS and the proxy advisory industry that were raised during last week's hearing.

FACT: ISS is a Registered Investment Adviser (RIA) and is subject to strict SEC oversight
Contrary to the suggestions oft made in the hearing, ISS is a Registered Investment Adviser ("RIA") and is therefore subject to the Investment Advisers Act of 1940 ("Advisers Act") and the rules and regulations that the U.S. Securities and Exchange Commission ("SEC") has promulgated thereunder. The Advisers Act and related SEC rules provide a mature and comprehensive regulatory regime that covers virtually every aspect of our business and that subjects ISS to the SEC's continuing oversight and examination authority.

As an RIA, ISS is required to implement and maintain a comprehensive compliance program, including a mandatory requirement for a Code of Ethics, which is publicly available on our website.[1] The RIA regime also dictates that we provide clients with transparency about our internal operations, including how potential conflicts of interest are addressed. Indeed, ISS is already subject to and complying with rigorous federal legal requirements.

FACT: Proxy advisory firms, including ISS, have a fiduciary obligation to their clients
As an RIA, ISS has a fiduciary obligation to our investor clients, which means ISS and our employees must carry out our duties solely in the best interest of clients and free from any compromising influences and loyalties.

Further, we note that in 2010, the SEC confirmed that proxy advice is a form of investment advice subject to the Advisers Act and the rules and regulations thereunder.[2] The SEC restated this view just last month in a proposed interpretive release on investment adviser standards of conduct.[3]

FACT: Proxy advisory firms *do not* set or regulate corporate governance disclosure standards, *do not* set shareholder meeting agendas, *do not* put forward shareholder proposals, and *do not* advocate for shareholder proponents, and *do not* vote proxies.
ISS' *only* job is to analyze proxy statements and provide informed research and vote recommendations based on the policies and guidelines that our institutional investor clients have selected, and in many cases developed, themselves. We are an independent provider of data, analytics and voting recommendations to support our clients in their own decision-making.

[1] Available at: https://www.issgovernance.com/file/duediligence/iss-regulatory-code-and-exhibits-june-2017.pdf

[2] Concept Release on the U.S. Proxy System, IA Release No. 3052 (July 14, 2010) ("Proxy Concept Release") at 110.

[3] Proposed SEC Interpretation Regarding Standard of Conduct for Investment Advisers, IA Release No. 4889 (April 18, 2018) ("IA Interpretive Release")

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Indeed, it is proxy advisory firms' clients who control both their voting policies and their vote decisions.

Federal statutes and state law dictate most of the items that appear on proxy statements to be voted upon by shareholders. The remaining agenda items, including the selection of nominees for election to the Board, are overwhelmingly put forward by corporate management, or sometimes by a company's shareholders.

Further, as a disinterested fiduciary, ISS has no financial stake in the outcome of a particular vote. ISS does not choose the ballots or agenda items on which we render advice. Rather, at a client's direction, we are asked by our clients to analyze and provide a voting recommendation for each agenda item related to every equity security held in our clients' portfolios. In fact, we are agnostic as to whether clients support a proposal, reject the proposal or abstain from voting altogether. Indeed, ISS will recommend contradictory votes on the same issue if individual clients' policies conflict. We are similarly indifferent as to whether clients choose to follow an ISS vote recommendation or not.

FACT: ISS' report error rate is minor, and what's often classified by the issuer as an error is in fact a fundamental disagreement in corporate governance philosophy.
ISS is committed to ensuring the accuracy and quality of our reports. As an RIA and a fiduciary, we have adopted a number of policies and procedures designed to ensure the integrity of our data collection and research process, upon which our reports are founded. We have robust systems and controls designed to ensure that research reports and vote recommendations include high-quality, relevant information; are accurate; are correctly based on policies selected or developed by the client; and are reviewed by appropriate personnel prior to publication. ISS commissions regular SSAE 16 audits, conducted by a third-party auditor, to ensure compliance with our internal control processes, including our research process.

ISS' research team does, infrequently, identify or receive notice of material factual errors in research reports that have already been published to our clients. ISS tracks such occurrences, which are rare. In 2017, for example, ISS covered over 6,400 meetings in the United States and the error rate was approximately 0.76% as measured by post-publication "Proxy Alerts" to clients notifying them of a material error within our benchmark proxy research that resulted in a change of a vote recommendation.

It is therefore particularly disconcerting that during the hearing Mr. Tom Quaadman, Executive Vice President at the U.S. Chamber Center of Capital Markets Competitiveness, mischaracterized our engagement with Abbott Laboratories ("Abbott"). In fact, it is false that ISS "refused to meet with Abbott Labs or... correct the report." We are enclosing with this submission a letter which ISS sent to Abbott in response to their filing. As the letter explains, after sharing a draft report with Abbott, receiving Abbott's written comments and prior to publishing our final report, ISS, in fact, modified its report and corrected two minor factual inaccuracies: the date Abbott entered into an agreement to acquire Alere and the start year of Abbott's audit firm.

Further, even before Abbott published its proxy statement, ISS considered arguments made by Abbott that ISS should change its selection of "comparable corporations" (or peers) for purposes of evaluating Abbott's executive compensation program. After consideration of the merits of Abbott's comments and consistent with ISS' policy approach, ISS subsequently removed an ISS selected peer to instead include a company suggested by Abbott. This resulted in even greater overlap – 12 out of 16 corporations - between the final peer group used by ISS and Abbott's self-selected peers. In presenting the information to our clients in our report and consistent with our normal approach, we outlined in *side-by-side* fashion the peers selected by Abbott Labs and the ISS-selected peers.

Following this engagement, Abbott requested a meeting, a request which ISS acknowledged and to which it responded. Consistent with our stated engagement policies, and considering the proxy season had already begun, ISS responded the same day to let Abbott know that the company's comments were being reviewed, that we would reach out to Abbott if we had any questions, and asked Abbott to let us know if it had any additional comments. Our records show no other requests for engagement were received from Abbott in 2018 prior to the delivery of the draft ISS Report to Abbott for factual review.

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This process and the change made based on Abbott's feedback clearly demonstrate the extent to which ISS does engage with, and take into account, the input of the companies that it covers. While differences in approach and opinion may still exist, that is a far cry from the suggestion that the underlying analysis or vote recommendation results from a mistake or error.

Finally, we reiterate the findings of a 2007 GAO Report, which concluded that our clients trust us to provide "reliable, efficient services."[4] The GAO's follow-up report in 2016 addressed this further, stating "Both corporate issuers and institutional investors [the GAO] interviewed said that the data errors they found in the proxy reports were mostly minor..."[5]

FACT: Proxy advisory firms do not "control" shareholder votes.

Proxy advisory firms' clients control both their voting policies and their vote decisions. As noted by the Council of Institutional Investors (CII), a leading nonpartisan and nonprofit association of public, corporate and union employee benefit funds and state and local entities with combined assets exceeding $3.5 trillion: "Proxy advisory firm influence is exaggerated by analyses that confuse correlation with causation. ISS and Glass Lewis tend to follow investors on governance policy, not lead them....Their franchises are built on credibility with investors. As a result, advisors' views reflect those of many funds."[6] Indeed, as Ms. Darla Stuckey, President and CEO of the Society for Corporate Governance, acknowledged during the hearing, "proxy advisory firms...serve institutional investors."

We note that this is consistent with the results of a 2012 survey of asset managers by Tapestry Networks that found proxy advisory firms' "role as data aggregators" has become increasingly important to asset managers, and that even if smaller managers are more reliant on such advisory firms, they still acknowledge that responsibility for voting outcomes lies with investors.[7]

We also point you to the myriad of opposition letters to H.R.4015, "The Corporate Governance Reform and Transparency Act," in which institutional investors, pension funds, state retirement systems, as well as state treasurers and comptrollers reiterate their opposition to the assertion that they are uninformed buy-side investors who outsource their investment and proxy voting decisions.

FACT: ISS discloses all perceived and real conflicts of interest, and transparently complies with relevant SEC requirements. ISS is not aware of any instance in which a proxy research report or a vote recommendation was compromised by a conflict of interest.

As an RIA, ISS takes its fiduciary duty of loyalty very seriously. We place primary importance on conducting our business in a transparent and responsible manner, and have developed a comprehensive program to manage potential conflicts of

[4] Jones, Y. D. (2007). *Issues Relating to Firms that Advise Institutional Investors on Proxy Voting.* (GAO-07-765). Washington, DC: Government Accountability Office (hereafter, "2007 GAO Report"), note 1 at 13.

[5] Clements, M. (2016). *Proxy Advisory Firms' Role in Voting and Corporate Governance Practices.* (GAO-17-47). Washington, DC: Government Accountability Office at 29.

[6] June 13, 2016 letter from the Council of Institutional Investors to Rep. Hensarling, Chair of House Committee on Financial Services.

[7] Bew, Robyn and Fields, Richard, Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers (June 2012) at 2. Available at SSRN: http://ssrn.com/abstract=2084231. ("Across the board, participants in our research said they value proxy firms' ability to collect, organize, and present vast amounts of data, and they believe smaller asset managers are more reliant on those services. Nonetheless, participants emphasized that responsibility for voting outcomes lies with investors").

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interest as required by the Advisers Act and related SEC rules. Moreover, ISS has adopted a significant relationship disclosure policy and took robust steps to enhance transparency following the promulgation of SLB 20.

As required by the Advisers Act's compliance program rule,[8] ISS has implemented, maintains and periodically updates a program designed to eliminate, or manage and disclose, conflicts of interest. This program includes appointing a chief compliance officer, establishing comprehensive compliance policies and procedures, and testing the adequacy of those policies and procedures and the effectiveness of their implementation on an ongoing basis, ISS has also adopted, as mentioned earlier, a comprehensive Code of Ethics as the Advisers Act regulatory regime also requires.[9]

Separate and apart from our compliance protocols, ISS addresses conflicts, in part, by being a transparent, policy-based organization, with research and voting recommendations based on publicly-disclosed information available to all shareholders. Contrary to Mr. Quaadman's claim, ISS provides our clients (and other stakeholders) with an extensive array of information to ensure that they are fully informed of our policies to manage conflicts of interests, and of any potential conflicts and the steps ISS has taken to address them. Among other things, ISS supplies a comprehensive due diligence compliance package, publicly available on our website, so that our clients (and other stakeholders) can confidently and fully assess the reliability and objectivity of our voting recommendations.

One measure that ISS has historically taken to ensure transparency is the disclosure of instances where a relationship between ISS and a party exists that may present a conflict of interest. This includes potential conflicts with ISS Corporate Solutions, Inc. ("ICS"), which is the subsidiary of ISS that provides governance tools and services to corporate issuer clients. ISS' standard institutional client contract contains specific disclosure regarding the work of ICS, ensuring our clients have full visibility into any significant relationships that may exist between ISS and the subjects of our proxy research reports.

ISS' institutional clients can readily identify any potential conflict of interest through ISS' primary client delivery platform, ProxyExchange (PX), which provides information about the identity of ICS clients, as well as the types of services provided to those issuers and the revenue received from them. Similarly, each proxy analysis and research report issued by ISS contains a legend indicating that the subject of the analysis or report may be a client of ICS. This legend also advises institutional clients about the way in which they can receive additional, specific details about any issuer's use of products and services from ICS, which can be as simple as emailing our Legal/Compliance department via disclosure@issgovernance.com.

One of the most important components of the ISS compliance program is the firewall maintained between the core institutional business and the ICS business. This firewall includes the physical and functional separation between ICS and ISS, with a particular focus on the separation of ICS from the ISS Global Research team. A key goal of the firewall is to keep the ISS Global Research team from learning even the identity of ICS' clients, thereby ensuring the objectivity and independence of ISS' research process and vote recommendations. The firewall mitigates potential conflicts via several layers of separation:

- ICS is a separate legal entity from ISS.
- ICS is physically separated from ISS, and its day-to-day operations are separately managed.
- The ISS Global Research team works independently from ICS.
- ICS and ISS staff are forbidden to discuss the identity of ICS clients.
- ISS' institutional analysts' salaries, bonuses and other forms of compensation are not linked to any specific ICS activity or sale.

[8] *See* Advisers Act Rule 206(4)-7.

[9] *See*. Advisers Act Rule 204A-1.

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Yet another element of the conflict mitigation procedures is the "blackout period," pursuant to which ICS staff may only have limited interactions with issuers or their representatives when a "live" voting issue is pending for review by ISS. The "blackout period" runs from immediately after definitive proxy materials are filed with the appropriate regulatory body through the date of the issuer's shareholders' meeting. During this period, interactions between ICS and its corporate clients are limited. During the blackout period, ICS is precluded from providing advisory services to, or otherwise interacting with, issuers with respect to matters that are "live" or pending on the issuer's proxy statement. In addition, during the blackout period, ICS does not engage in marketing or selling efforts to issuers (whether they are existing ICS clients or prospects).

Moreover, ICS explicitly tells its corporate clients, and also indicates in their contracts that ISS will not give preferential treatment to, and is under no obligation to support, any proxy proposal of an ICS client. Contrary to Ms. Stuckey's statement, neither ISS nor ICS "help you to draft your proxy if you're an issuer." ICS further informs its clients that ISS' Global Research team prepares its analyses and vote recommendations independently of, and with no involvement from, ICS.

Finally, ISS is not aware of any instance in which a proxy research report or a vote recommendation was compromised by a conflict of interest, nor any instance where a regulatory body has reached that conclusion. We are heartened by the fact that the most vocal critics of ISS on this point are those who speak on behalf of corporate management, and not the investors who rely on ISS' research and vote recommendations. We see this as a strong indication that we are managing this potential conflict extremely well.

Furthermore, provisions of HR4015 would be in fact undermine the firewall between these two firms.

FACT: Proxy advisory industry is competitive and there are no artificial barriers to entry
There are no artificial barriers to entry into the proxy advisory industry in the United States. We operate in a competitive market and, as Mr. Quaadman himself stated during the hearing, we have seen entrants come and go within the industry. Moreover, institutional investors are not required to purchase our services. In the free market, institutional investors purchase our services because they choose to do so, and find value in the products we provide.

ISS is indeed an industry leader and has earned its market share by virtue of the quality of its work and the level of service it has provided for more than a quarter century. The GAO report entitled "Issues Relating to Firms that Advise Institutional Investors on Proxy Voting" concluded as much when it wrote that ISS has "gained a reputation with institutional investors for providing reliable, comprehensive proxy research and recommendations."[10] While we have seen the widely circulated conjecture that two firms "control" 97% of the proxy advisory industry, this is not a statistic we have verified or can confirm.

Ultimately, as noted at the hearing by Harvard Law Professor John Coates, no one is required by law or regulation to consult a proxy advisor. Similarly, there is no requirement to follow our vote recommendations. The ultimate voting decision for each resolution at a company meeting remains the responsibility of our clients, the owners of the corporation, as we believe it should. Our clients are sophisticated institutional investors who owe a fiduciary duty to their plan beneficiaries.

With regard to H.R.4015 and any similar legislation, we agree with many of the concerns about the negative impacts of this legislation that were raised during the hearing. We believe the litmus test for any federal intrusion into the free market is whether it targets a proven problem and seeks to address it cost-effectively. The proposed bill does not pass either test. Further, we have not heard from any institutional investor who supports H.R.4015 or the underlying arguments upon which the legislation is founded.

The investors who use proxy advisory services do not see the "problem" the proposed legislation purports to address. In

[10] Jones, Y. D. (2007). *Issues Relating to Firms that Advise Institutional Investors on Proxy Voting.* (GAO-07-765). Washington, DC: Government Accountability Office (hereafter, "2007 GAO Report") at 13.

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fact, as Mr. Silvers stated, institutional investors are concerned that the legislation, as written, seeks to "impose a new regulatory scheme designed to make [proxy advisory firms] disloyal to their clients" and would "essentially defeat the corporate governance system."

In conclusion, ISS appreciates this opportunity to set the record straight and underscore the rigorous regulatory system and internal compliance program under which we operate. If there is any additional information I can provide or if you have any follow-up questions, please do not hesitate to contact me.

Sincerely,

Gary Retelny, President and Chief Executive Officer

CC: Members, Committee on Banking, Housing and Urban Affairs, U.S. Senate

INTERNATIONAL BROTHERHOOD OF TEAMSTERS

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General President

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KEN HALL
General Secretary-Treasurer

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June 27, 2018

The Honorable Michael Crapo
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510

RE: Proposed legislation regarding institutional investors and regulation of proxy advisory firms

Dear Chairman Crapo and Ranking Member Brown:

On behalf of the International Brotherhood of Teamsters, I am writing to reiterate our vigorous opposition to H.R.4015, yet another iteration of legislation that would set a dangerous precedent by undermining the system of corporate governance upon which our nation's capital markets are based.

The International Brotherhood of Teamsters represents 1.4 million hardworking men and women who are the very backbone of America's robust economic growth. We are known as the champion of workers in myriad occupations, including freight drivers and warehouse, vegetable, sanitation, healthcare, and bakery workers across United States.

The International Brotherhood of Teamsters and affiliated pension and benefit funds oversee roughly $100 billion in assets under management. We are long-term shareowners with a duty to promote and protect retirement assets of Teamster members, retirees and their families. Our union has been at the forefront of investors advocating for common sense corporate governance reforms that improve corporate accountability to shareholders and transparency in corporate reporting.

We believe H.R.4015 and similar provisions in the Financial CHOICE Act (FCA) would

i. Undermine our pension funds', and therefore our members', ability to participate fully in the governance of publicly held corporations;
ii. Severely undercut proxy advisory firms' ability to uphold their fiduciary obligation to provide us, their investor clients, with independent analysis;
iii. Discourage industry competition by introducing barriers to entry for new proxy advisory firms, potentially leading smaller existing firms to exit the industry altogether;
iv. Re-orient any surviving proxy advisory firms to serve companies rather than investors;
v. Delay our pension funds' receipt of reports and recommendations which we have commissioned and paid for; and
vi. Increase costs to pension funds and our members, reducing the pensions to our over 1.4 million members, with no discernable benefits.

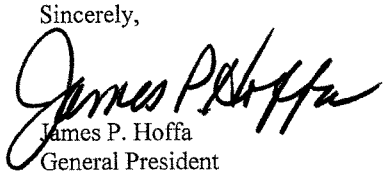
We are especially troubled by the provision of H.R.4015 and FCA that require proxy advisory firms to submit their data, research, and recommendations for pre-review of corporations that are the subject of these very reports – before we, the paying customer, sees the report. The legislation goes so far as to allow corporations to include their dissenting comments in our reports. This right to pre-review and edit is a form of corporate censorship and would clearly undermine the value and independence of the proxy advisory firms' recommendations. By giving companies substantial influence over, if not an absolute veto of, proxy advisory firms' reports, the legislation would also compromise the fiduciary duty that proxy advisory firms owe to us.

The independence of the research provided by proxy advisors is a critical element of our right, as shareholders, to hold the board of directors accountable and to cast informed proxy votes on corporate governance and proxy voting policies. It underpins the basis of effective accountability of board of directors by shareowners, upon which our nation's system of corporate governance relies. We believe the legislation, if enacted, would set a very dangerous precedent in financial services, where independence is a hallmark of honest investment advice, buy-sell recommendations and auditing.

Finally, it is disconcerting to us that some organizations – in fact, driven and funded by the corporate voice – have recently positioned themselves to be the champion of the American workers who invest in our capital markets in support of such objectionable legislation.

We join our fellow labor unions, pension funds, and institutional investors, including many state pension funds, in steadfast opposition to H.R. 4015 and any similar legislation, and look to you, members of the Senate Banking Committee, to stand behind shareholders and oppose this dangerous legislation.

Sincerely,



James P. Hoffa
General President

cc: Members, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

NASAA

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June 28, 2018

The Honorable Mike Crapo
Chairman
Senate Committee on Banking, Housing
& Urban Affairs
538 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member
Senate Committee on Banking, Housing
& Urban Affairs
538 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Legislation Considered by the Committee on June 26, 2018 and June 28, 2018

Dear Chairman Crapo and Ranking Member Brown:

On behalf of the North American Securities Administrators Association (NASAA),[1] I am writing to provide NASAA's perspective on certain legislative proposals that have been the subject of hearings by the Committee on Banking, Housing and Urban Affairs during the week of June 25, 2018.

1. The "Cybersecurity Disclosure Act" (S. 536)

The "Cybersecurity Disclosure Act" would amend the Securities Exchange Act of 1934 to require that publicly traded companies disclose in their annual filings with the U.S. Securities and Exchange Commission (SEC) whether any member of their governing body, such as their board of directors or general partner, possesses expertise or experience in cybersecurity. The bill does not impose any requirements on issuers beyond disclosure of the specified information.

Incentivizing publicly traded companies to consider whether they have adequate cybersecurity expertise in their governing body is an appropriate step given that cyberattacks on U.S. companies continue to increase in both frequency and sophistication. Cybersecurity risk and preparedness can have major implications for businesses and their investors.[2] Further, investors, issuers, and consumers stand to be well-served by policies that encourage companies to consider cybersecurity risks proactively, as opposed to after a data breach or other intrusion has occurred, when the harm may be

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

[2] In 2017, I authored an op-ed highlighting the growing concern over the number of cyberattacks perpetrated against companies and the efforts state securities regulators are taking to assist mid-sized investment advisers to improve their cybersecurity practices. (See: Borg, Joseph P. "Everyone has a Role in Protecting against Cyberattacks". September 5, 2017. Available at www.americanbar.org/content/dam/aba/administrative/business_law/newsletters/CL680000/full-issue-201709.authcheckdam.pdf).

President: Joseph Borg (Alabama)
President-Elect: Michael Pieciak (Vermont)
Executive Director: Joseph Brady

Secretary: Shonita Bossier (Kentucky)
Treasurer: Tom Cotter (Alberta)

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Bryan Lantagne (Massachusetts)
Melanie Senter Lubin (Maryland)
Tanya Solov (Illinois)
Gerald Rome (Colorado)

irreversible. In fact, we note that since the bill's introduction in 2017, the SEC has issued guidance that compliments and supports the legislation's premise.[3]

NASAA is pleased to support S. 536.

2. The "Fair Investment Opportunities for Professional Experts Act" (S. 2756)

S. 2756, the "Fair Investment Opportunities for Professional Experts Act", would amend the Securities Act of 1933 to add specified, inflation-adjusted income and net-worth standards to the "accredited investor" definition. In addition, the bill extends "accredited investor" status to new categories of natural persons who would qualify as "accredited" irrespective of income or net-worth.

NASAA is not wholly opposed to efforts to modernize the accredited investor standard, including in a manner that would increase the size of this marketplace, as is envisioned by S. 2756. Further, NASAA appreciates the steps that the sponsors of S. 2756 have taken to improve the legislation relative to similarly entitled legislation previously passed by the House of Representatives, including in consultation with NASAA.[4] Nevertheless, state regulators have a very large stake in any legislative changes that would affect the private securities markets.[5] We strongly believe that any legislation that effects a further expansion of private securities markets must also take steps to improve the oversight of these markets by providing regulators with better tools to address fraud and misconduct in these markets.[6]

Further, NASAA respectfully reminds the Committee that policies that implicate private securities markets cannot be judged in isolation. Over the past two decades, there has been a dramatic shift in how companies raise capital. Private securities once comprised just a fraction of the overall marketplace, but today they serve as a major source of capital for certain businesses, exceeding the public markets.[7] The unprecedented growth in private markets, and the decline in initial public

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[3] "U.S. SEC Calls for 'Clearer' Cyber Risk Disclosure from Companies". *Reuters*. February 21, 2018. *See:* https://www.reuters.com/article/us-usa-sec-cyber/u-s-sec-calls-for-clearer-cyber-risk-disclosure-from-companies-idUSKCN1G52FK.

[4] Section 2(b) of S. 2756 imposes guidelines that the SEC must follow in issuing a rule to determine whether a natural person may qualify as an accredited investor by virtue of education, job, or professional experience. No similar requirements are included in H.R.1585, the "Fair Investment Opportunities for Professional Experts Act". We also note that, whereas H.R. 1585 would adjust the income and net-worth standards to account for inflation every five years, S. 2756 would adjust them every three years.

[5] State securities regulators, pursuant to their antifraud authority, are the de-facto primary regulators of offerings conducted under Regulation D, Rule 506. State regulators frequently receive complaints from those who are victimized in offerings conducted under Rule 506, and expend considerable resources policing this marketplace.

[6] Specifically, S. 2756 should be improved by incorporating modest changes to Rule 506 and Form D that will enhance the ability of the SEC and NASAA members to protect investors while minimizing the burdens to the small businesses who utilize the rule to raise capital. Such changes were proposed by the SEC in 2013, but have not yet been adopted. (*For additional information, see: https://www.sec.gov/comments/4-692/4692-34.pdf*). NASAA has also offered suggestions for how to revise the current accredited investor definition to more accurately measure investor sophistication, and to limit the exposure of less sophisticated investors to the risks of the private marketplace. (*For additional information, see: http://www.nasaa.org/wp-content/uploads/2013/10/NASAA-Letter-to-House-Leadership-Re-HR-1585-11-1-17.pdf*).

[7] See: SEC Division of Economic and Risk Analysis, Access to Capital and Market Liquidity (Aug. 8, 2017), available at https://www.sec.gov/files/access-to-capital-and-market-liquidity-study-dera-2017.pdf. See also: Scott W. Bauguess, Deputy Director, SEC Division of Economic Risk and Analysis, Private Securities Offerings post-JOBS Act. Presentation to

offerings (IPOs), can be attributed in part to Congress. Congress has made it easier for companies to raise capital in private markets and that is one of the main reasons that more companies are staying private for longer instead of pursuing IPOs.[8] Given Congress's ongoing, bipartisan interest in increasing the number of IPOs – efforts which were discussed by the Committee at a hearing earlier this week[9] – Congress should be thoughtful in taking any steps that would further expand the private markets to the potential detriment of public markets.

3. The "Helping Angels Lead Our Startups Act" (S. 588)

The "Helping Angels Lead Our Startups Act", or "HALOS Act," would direct the SEC to amend Rule 506 of Regulation D to specify that prohibitions on general solicitation and general advertising in Rule 506 offerings do not apply to sales events (also called "demo days", "venture fairs", or "pitch days") that are sponsored by a governmental entity, a college or university, a nonprofit organization, an angel investor group, a trade association, a venture forum, or a venture capital association. The bill would also limit the amount and type of information that can be communicated prior to, and at, such events.

Given that Congress has already acted to repeal the prohibition on general solicitation in certain private securities offerings under SEC Rule 506(c), it is not clear why Congress would now require the SEC to relax rules governing the use of solicitation to non-accredited investors under Rule 506(b).[10] However, in the event that Congress determines such action is appropriate, there are steps the Senate can and should take to improve the legislation prior to its becoming law.

As presently constituted, the types of entities that would be eligible to sponsor an event under S. 588 is exceptionally broad. Congress should consider whether these criteria should be made more tailored thereby narrowing the number of entities eligible to sponsor such events.[11] Further, Congress

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Accounting Standards Executive Committee (Feb. 25, 2016), available at https://www.sec.gov/info/smallbus/acsec/private-_securities-offerings-post-jobs-act-bauguess-022516.pdf.

[8] As Healthy Markets Association Executive Director Tyler Gellasch recently testified to a subcommittee of the House Financial Services Committee, "It's not a great mystery why in the last few years the trend has developed whereby there are more private offerings in the U.S. today than public ones. In the past, the law and SEC rules simply didn't permit all these private offerings. Over the past two decades, however, Congress and the SEC have spent years constructing ad hoc exemptions and exceptions designed to allow firms, their executives, and their early investors to sell securities without incurring the costs or burdens typically associated with public offerings. While some of these exemptions and exceptions may have been well-intended, the undeniable result has been that they have grown so dramatically that they have undermined the public markets." (See: Testimony of Tyler Gellasch before the House Financial Services Committee, Subcommittee on Capital Markets, Securities and Investment (May 23, 2018).

[9] *See: Legislative Proposals to Increase Access to Capital*, Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs, 115th Cong. (Jun. 26, 2018).

[10] In Title II of the JOBS Act of 2012, Congress expanded companies' ability to attract buyers to their private offerings by permitting general solicitation and advertising. This exemption, codified under SEC Rule 506(c), can be claimed provided that issuers only sell to accredited investors and that they take "reasonable steps" to verify that the investors are accredited. The HALOS Act would go further and exempt demo days from the prohibition on general solicitation and advertising, thereby allowing companies to generally solicit and advertise and still be able to use 506(b), which unlike Rule 506 (c), does not require issuers to take reasonable steps to determine whether investors are accredited.

[11] As University of University of Mississippi Law School Professor Mercer Bullard testified to the Committee this week, S. 588 "will allow virtually any type of public entity to advertise and host an event that can be attended by any person for the purpose of any issuer pitching a securities offering." *See:* https://www.banking.senate.gov/imo/media/doc/Bullard%20Testimony%206-26-18.pdf

should require the filing of Form D with the SEC and the relevant state regulator prior to the event.[12] The information included in Form D would be particularly valuable to state regulators who will be tasked with ensuring that "demo days" and similar events sponsored in their jurisdictions are legitimate and compliant with the law. Finally, Congress should clarify that attendance at an event does not in itself establish a pre-existing relationship for purposes of Rule 506(b).

4. The "Compensation for Cheated Investors Act" (S. 2499)

S. 2499, the "Compensation for Cheated Investors Act", would direct the Financial Industry Regulatory Authority (FINRA) to establish a fund to provide investors with the full value of unpaid arbitration awards issued against brokerage firms or brokers regulated by FINRA. The bill would also require FINRA to provide enhanced public disclosure of information pertaining to the total number of arbitration awards issued in favor of investors against brokerage firms or brokers regulated by FINRA.

NASAA welcomes the introduction of S. 2499, and wholeheartedly supports the intent behind the legislation, which is to ensure that wronged investors are not literally left holding the bag when it comes to the payment of arbitration awards issued against broker-dealer firms and their representatives. Unpaid arbitration awards remain an unresolved and well-documented investor protection concern. In failing to pay arbitration awards, broker-dealers fail to comply with their legal, regulatory and ethical obligations. NASAA has been a longstanding proponent of measures to address this problem.[13] We look forward to working with Congress and other stakeholders to finding a solution so that no investor awards or settlements go unpaid.

5. The "Expanding Access to Capital for Rural Job Creators Act" (S. 2953)

S. 2953, the "Expanding Access to Capital for Rural Job Creators Act", would amend the Securities Exchange Act of 1934 to add "rural-area small businesses" to the scope of small businesses with unique challenges and issues from which the SEC Advocate for Small Business Capital Formation is required to (1) identify problems with securing access to capital; and (2) issue an annual report containing a summary of the most serious issues encountered by such businesses and their investors.

As the closest regulators to the investing public, NASAA's members regularly work with and assist local businesses seeking investment capital. On the basis of this experience, we strongly agree with legislation's premise – which is that rural communities and the small businesses located in these communities can face unique barriers to accessing capital.

NASAA is pleased to support S. 2953.

Thank you for your consideration of NASAA's views. If I may be of further assistance, please don't hesitate to contact me or Michael Canning, NASAA's Director of Policy and Government Affairs, at (202) 737-0900.

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[12] NASAA has repeatedly urged Congress to require the filing of Form D prior to sale or general solicitation of securities offerings exempt from registration under Regulation D. Under the current rules, Form D need not be filed until 15 days after the first sale, so an issuer can advertise for investors without filing the form. The lack of any pre-solicitation filing makes it impossible for state enforcement personnel to easily determine whether an offering is being conducted in accordance with the securities laws.

[13] *See, e.g.*, Letter from NASAA President Joseph Borg to March E. Asquith regarding FINRA Regulatory Notice 17-33 (Dec. 20, 2017).

Sincerely,

Joseph P. Borg
NASAA President and Alabama Securities Commission Director

THOMAS P. DiNAPOLI
STATE COMPTROLLER

110 STATE STREET
ALBANY, NEW YORK 12236

STATE OF NEW YORK
OFFICE OF THE STATE COMPTROLLER

June 27, 2018

Honorable Michael Crapo
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Re: June 28, 2018, Hearing entitled, "Legislative Proposals to Examine Corporate Governance."

Dear Mr. Chairman and Ranking Member Brown:

As Comptroller of the State of New York, I am Trustee of the New York State Common Retirement Fund (Fund), the third largest public pension fund in the United States, with an estimated $206.9 billion in assets under management as of March 31, 2018. The Fund holds and invests the assets of the New York State and Local Retirement System on behalf of more than one million state and local government employees and retirees and their beneficiaries.

In that regard, I respectfully share with you a summary of my views on two matters of great significance to investors that I understand will be addressed at a hearing of the Committee on Banking, Housing, and Urban Affairs on June 28, 2018.

H.R. 4015 - Corporate Governance Reform and Transparency Act of 2017

I strongly oppose H.R. 4015. As Trustee of the Fund, it is part of my fiduciary responsibility to cast proxy votes at over 3,000 portfolio companies annually. The ability to fulfill this fundamental responsibility requires timely, independent research to make informed proxy voting decisions and hold boards to account for their oversight of the companies in which the Fund is invested.

H.R. 4015, which was passed by the House of Representatives on a near party-line vote, would weaken corporate accountability to shareowners, undercut the invaluable independence of the proxy advisory firms that investors retain, and dramatically increase costs to our Fund and other institutional investors. While the Fund independently votes its company proxies based on its own proxy voting guidelines, we review the research provided by proxy advisors to inform our analysis of important voting matters, such as corporate transactions, the election of directors, and executive compensation. This bill would make it harder for the Fund to get the information we need and is not the type of "Corporate Governance Reform" investors have requested, want, or need.

Among several troubling provisions, H.R. 4015 would require that proxy advisory firms consider company complaints and employ an ombudsman to attempt to resolve them. If the complaint cannot be resolved to the company's satisfaction, the firm would be required to publish the company's dissenting opinion in its advice to its clients. This would give companies outsized influence and place a barrier between independent researchers and their paying customers. It would increase the cost of this service, impose severe time constraints on the production of reports, and effectively commandeer the proxy advisory firms to provide yet another platform for the company's views—which are already communicated from companies to shareowners in several other ways.

The Fund, like other institutional investors, retains proxy advisory firms in order to obtain cost-efficient, informed and independent research, analysis and advice. The independence of that advice is absolutely essential, and if proxy advisors are required to obtain corporate review and include objections in their reports before releasing their research to investors, that independence would be compromised, depriving investors of a vital resource.

S.536 – Cybersecurity Disclosure Act of 2017

I am deeply concerned about the lack of transparency and disclosure regarding cyber risk at public companies. Cyber risk has been identified as an area of urgent concern for public companies by members of Congress on both sides of the aisle, Commissioners and staff of the Securities Exchange Commission (SEC), corporate management and directors, and investor groups.

I recognize the Committee's work on this issue and support the disclosures proposed by S.536, "Cybersecurity Disclosure Act of 2017." However, I believe the legislation does not go far enough in providing investors the comprehensive disclosures needed to determine whether a company has identified its vulnerability to cyber incidents and taken adequate steps to mitigate that risk. Given what is perceived by many investors as a lack of adequate guidance from the SEC on corporate cybersecurity disclosures, I urge the Committee to consider the need for more robust rulemaking than is required in S.536.

As an example of the type of disclosure I believe companies should provide, I am enclosing a copy of a shareholder resolution I filed on behalf of the Fund for consideration by shareholders at Express Scripts Holding Company's annual meeting.

The resolution requested Express Scripts' Board to prepare a report that will allow investors to assess cyber risk practices, including:

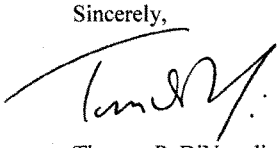
- identifying the source of cybersecurity risk (including from outsourced functions);
- explaining how the company addresses those risks;
- describing past cyber incidents experienced by the company;
- outlining risks related to cyber incidents that remain undetected for an extended period;
- describing relevant insurance coverage; providing information on compliance, regulatory or contractual obligations related to cyber risk; and
- explaining how cybersecurity risks are reflected in financial statements.

We also requested that the report address various issues relating to the scope and frequency of the Board's oversight of cyber risks. The resolution received support from over 30 percent of Express Scripts' shareholders, which is substantial support for a new shareholder proposal.

I believe this type of comprehensive disclosure would provide useful information, allowing investors to better understand how companies are managing potential risks and assist them in investment decisions.

Thank you for your consideration of my comments on these legislative proposals, both of which relate to matters of great importance to investors.

Sincerely,



Thomas P. DiNapoli
State Comptroller

cc: Members, Senate Committee on Banking, Housing and Urban Affairs

Enc. NYS Common Retirement Fund Cyber Risk Report Resolution

New York State Common Retirement Fund Cyber Risk Report Resolution

Prior to becoming the Chairman of the SEC, Jay Clayton wrote, "cyber-threats are among the most urgent risk to America's economic and national security and the personal safety of its citizens." As recently as October 2017, the Co-Director of SEC Division of Enforcement identified cybersecurity disclosure as a priority and subject of potential enforcement "where there may be a cyber-related disclosure failure by a public company."

In 2017, the Healthcare Industry Cybersecurity Task Force noted the industry experienced more cyber incidents resulting in data breaches than any of the other 15 critical infrastructure sectors. According to a 2016 report by the Ponemon Institute, data breaches in healthcare are increasingly costly and frequent, and continue to put patient data at risk. The report estimates that data breaches could be costing the healthcare industry $6.2 billion.

In 2008, the Express Scripts Holding Company (Company) disclosed a data breach affecting personal and medical information of over 700,000 customers.

The Company recognized in its 2017 10-K that:

[The Company's] ability to conduct operations depends on the security and stability of our technology infrastructure as well as the effectiveness of, and our ability to execute, business continuity plans across our operations. A failure in the security of our technology infrastructure or a significant disruption in service within our operations could materially adversely affect our business and results of operations.

However, the Company has not provided shareholders with a full report regarding this risk and its policies, procedures or other information concerning how it mitigates this risk.

RESOLVED: The Company's shareholders ask the Board to review and publicly report (at reasonable cost, in a reasonable timeframe, and omitting proprietary and confidential information) on its cyber risk and actions taken to mitigate that risk. A report adequate for investors to assess practices should include:

- aspects of business or operations that give rise to material cyber risk;
- the extent to which the Company outsources functions that have material cyber risks, descriptions of those functions and how the Company addresses those risks;
- descriptions of cyber incidents experienced by the Company that individually or in the aggregate are material, including a description of costs and consequences;
- risks related to cyber incidents that remain undetected for an extended period;
- description of relevant insurance coverage;
- compliance, regulatory or contractual obligations related to cyber risk;
- certification to widely recognized standards; and
- how cyber risks and cyber incidents are reflected in financial statements.

The report should also discuss the scope and frequency of the Board's oversight of cyber risks which may include review of relevant systems, policies, and procedures, related to:

- determining critical assets (e.g., customer information);
- employee training on data security and privacy-related risks;
- due diligence for third party vendors and potential acquisitions;
- data breach and incident response plans;
- minimization of data collection and retention; and
- security policies and audit frequency.

SCHOOL EMPLOYEES RETIREMENT SYSTEM OF OHIO
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RICHARD STENSRUD
Executive Director

HELEN M. NINOS
Deputy Executive Director

July 2, 2018

The Honorable Mike Crapo
Chairman, Senate Banking, Housing and Urban Affairs Committee
239 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member, Senate Banking, Housing and Urban Affairs Committee
713 Hart Senate Office Building
Washington, DC 20510

Re: Proposed Legislation Relating to Proxy Advisory Firms, HR 4015

Dear Chairman Crapo and Ranking Member Brown:

On behalf of the School Employees Retirement System of Ohio (SERS), I am writing to express SERS' opposition to HR 4015, the Corporate Governance Reform and Transparency Act of 2017. We are deeply concerned that if this bill becomes law SERS' ability to effectively vote shareholder proposals will be negatively impacted.

If passed in its current form, HR 4015 would impose burdensome regulations on proxy advisory firms to the detriment of institutional investors, making it difficult and more costly for shareholders like SERS to work with a proxy advisory firm to implement our custom proxy voting policy. We are very concerned that passage of this bill would mean that SERS could not fulfill its fiduciary duty to vote proxies in a way that enhances the long-term value of our fund's investment in public companies. If proxy advisory firms are subject to additional federal regulations we anticipate seeing higher costs for the services they provide, less competition in the marketplace, and a shortened window of time to review proxy issues before they are brought to a vote at companies' annual meetings.

Proxy advisory firm research plays a vital role in SERS' ability to vote proxies. In calendar year 2017, SERS voted on a total of 27,614 proxies at 2,228 public companies. We utilize a proxy advisory firm to perform proxy voting research, provide a proxy voting platform, and vote proxies on behalf of SERS in accordance with our custom policy. This custom policy is not a "rubber stamp" of the proxy voting advisory firm's recommendations, but is instead a policy developed by SERS staff that reflects specific Corporate Governance Principles adopted by our Retirement Board.

Additionally, HR 4015 would require proxy advisory firms to give corporations the right to review reports prior to them being shared with their clients. This could give corporate management undue influence over the proxy advisory firms' reports. As the client of a proxy advisory firm, SERS has voluntarily hired and paid for independent proxy research, not research that has been influenced by corporate management.

SERS takes its fiduciary duty to vote proxies very seriously, and we do not have the staff or resources to commit to the high level of due diligence that is required to vote proxies without the assistance of a proxy advisory firm. We rely on the independent information provided by these types of firms in order to fulfill our obligations as shareholders and as fiduciaries.

Thank you for considering our views. We urge you and your fellow members of the Senate Banking, Housing and Urban Affairs Committee to reject HR 4015.

Sincerely,

Richard Stensrud

Richard Stensrud
Executive Director

RETIREMENT BOARD

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Employee-Member

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BEVERLY A. WOOLRIDGE
Retiree-Member

DANIEL L. WILSON
Appointed Member

Ohio Public Employees Retirement System

June 28, 2018

The Honorable Michael Crapo
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 20515

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 20515

Re: June 28, 2018, hearing entitled "Legislative Proposals to Examine Corporate Governance"

Dear Chairman Crapo and Ranking Member Brown:

We are writing on behalf of the Ohio Public Employees Retirement System (OPERS) to oppose H.R. 4015, the Corporate Governance Reform and Transparency Act of 2017 (Act), a bill that could significantly and negatively impact OPERS' ability to effectively and efficiently vote its proxies and fulfill its fiduciary obligations. We would also respectfully request that this letter be included in the hearing record.

OPERS is the 12th largest public retirement system in the country, with more than one million active, inactive, and retired members, which means that almost one out of every 12 Ohioans has some connection to our System. In order to provide secure retirement benefits for our members, OPERS has invested more than $100 billion in capital markets around the world, including holdings in more than 9,300 public companies. As a fiduciary, OPERS is required to act in the best interest of its members, and this responsibility extends to the prudent management of the investments we make with our members' retirement contributions. As a result, we regularly engage with public companies in order to establish an on-going dialogue with boards of directors. Through this relationship-building, we hope to better understand the viewpoints of the companies in which we are invested, and to more effectively convey our thoughts and concerns regarding the maximization of shareholder value.

However, with limited staff and resources, it is extremely difficult to fully research the thousands of proxies we receive each proxy season. Without timely access to the reports provided by our proxy advisory firms, it would be all but impossible to meet our obligations to our members.

We are aware of the criticisms that have been leveled at proxy advisory firms, namely that they wield undue influence over the proxy voting decisions of their clients, but OPERS has taken steps to ensure that this is not the case. Our Board of Trustees has adopted proxy voting guidelines to govern our voting decisions as shareholders. All of OPERS' proxy votes are cast in alignment with the guidelines, and implemented via a custom vote policy with our proxy

OPERS

advisory firm. Additionally, OPERS' Corporate Governance staff has controls in place to mitigate proxy advisory firm errors, including a comprehensive annual review of our custom vote policy and manual review of ballots containing manual vote items.

Given the absolute necessity of proxy advisory firms and the services they provide, we were concerned when the House of Representatives passed H.R. 4015 last December. The House-passed version of the Act included many changes that would erode investor confidence in the impartiality and independence of proxy advisory firm reports, and reduce the likelihood that institutional investors receive the research and analysis they need in a timely manner. As the Committee on Banking, Housing, and Urban Affairs considers whether regulation of proxy advisory firms is necessary, please remember that H.R. 4015, if enacted, would make it harder – perhaps impossible – for OPERS to effectively vote each of the thousands of proxies it receives during any given proxy season. In our view, this constitutes a violation of our duty to our members and the people of Ohio, and is therefore unacceptable.

We urge you to oppose the Corporate Governance and Transparency Act of 2017.

Thank you for your continued support of Ohio's public retirement systems. If you have questions regarding OPERS' comments or proxy voting guidelines, please do not hesitate to contact OPERS' Corporate Governance Officer, Patti Brammer, at 614.225.0942.

Sincerely,

Karen E Carraher

Karen Carraher
Executive Director

Patti Brammer

Patti Brammer
Corporate Governance Officer

STATE TEACHERS RETIREMENT SYSTEM OF OHIO

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RETIREMENT BOARD CHAIR
MARK HILL

RETIREMENT BOARD VICE CHAIR
ROBERT STEIN

EXECUTIVE DIRECTOR
MICHAEL J. NEHF

June 26, 2018

The Honorable Mike Crapo
Chairman, Senate Banking, Housing and Urban Affairs Committee
239 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member, Senate Banking, Housing and Urban Affairs Committee
713 Hart Senate Office Building
Washington, DC 20510

Dear Chairman Crapo and Ranking Member Brown:

On behalf of the State Teachers Retirement System (STRS) of Ohio active members, retirees, board and staff, I write in opposition to HR 4015, the Corporate Governance Reform and Transparency Act of 2017, a bill that, if allowed to become law, could negatively impact STRS Ohio's ability to effectively vote its shareholder proxies.

As a large institutional investor, STRS Ohio values the services provided by the proxy advisory firm with which we are contracted. Their services are absolutely necessary as it is impossible for our staff to fully research every proxy, as evidenced by the 42,932 proxies on which the system voted in calendar year 2017. Further, the impartial voting recommendations provided by our advisor are considered in conjunction with our proxy voting guidelines. As such, we are not simply taking their advice and acting in a manner consistent with their recommendations. Rather, we are conducting our own internal checks and balances. They are advising, but ultimately it is STRS Ohio board and staff that are deciding how to vote on all proxies.

It is our considered belief that the provisions of HR 4015 would dilute and hinder the process currently in place by requiring the proxy advisory firms to give corporations the right to review reports prior to them being shared with the client. Further, it would require the proxy advisory firms to hire an ombudsman to resolve any differences and then mandate that the firm include a dissenting statement from the company, if requested, to accompany the report to the client if the ombudsman is unable to resolve differences. It would seem that this new bureaucracy being created via HR 4015 would also be adding to the costs STRS Ohio has as institutional investors, funds that we believe are better used to provide benefits for our active and retired members.

In closing, I appreciate your time and consideration of the views of STRS Ohio. We urge you and your fellow members of the Senate Banking, Housing and Urban Affairs Committee to reject HR 4015.

Sincerely,

Michael J. Nehf
Executive Director

LETTER SUBMITTED BY SENATOR TOOMEY

June 27, 2017

The Honorable Patrick Toomey
United States Senator
SR-248 Russell Senate Office Bldg.
Washington, DC 20510

Dear Senator Toomey,

On October 12, 2017 the House Financial Services Committee by unanimous recorded vote of 60-0 ordered to be reported H.R. 3972 the Family Office Technical Correction Act. On October 24, 2017 the House of Representatives passed by voice vote H.R. 3972 and on October 25, 2017 it was received in the Senate and referred to the Committee on Banking.

As background a family office is a private entity formed and controlled by the family it serves. A family office does not offer investment advice or services to the public. Rule 202(a)(11)(G)-1 (the "Family Office Rule") under the Investment Advisers Act of 1940 the "Advisers Act" exempts family offices from registration as an investment adviser under the Advisers Act.

In keeping with the scope and intent of the Family Office Rule and prior SEC actions, family offices are requesting the following three technical corrections.

1. Definition of Accredited Investor: Amend the definition of Accredited Investor in Regulation D under the Securities Act of 1933 to include any "family client" of a family office as defined in the Family Office Rule an Accredited Investor.

2. Definition of Qualified Purchaser: Amend the definition of Qualified Purchaser under the Investment Company Act of 1940 (the "ICA") to include any "family client" of a family office as a Qualified Purchaser.

3. Family Office exemption under Investment Company Act: Amend the ICA to include a new exemption for family offices and family clients from registration as an investment company under the ICA.

We believe H.R. 3972 to be the ideal legislative vehicle to include the amendments outlined above and respectfully request Senate approval of the language proposed.

Sincerely,

Tim Terry, Secretary
Private Investor Coalition

For your reference.

* Copy of H.R. 3972 Family Office Technical Correction Act
* H.R. 3972 House Committee Report
* Proposed Amendment Language of Definition of "Qualified Purchaser"
* Proposed Amendment Language for New Section 3(c)(15)
* Overview of Technical Corrections for Family Offices/Family Clients

LETTERS SUBMITTED BY SENATOR SCOTT

203 East Main Street, Spartanburg, SC 29319
864-597-8000

October 6, 2017

The Honorable Senator Tim Scott
U.S. Senate
717 Hart Senate Office Building
Washington, DC 20510

Subject: Introduction of the Brokaw Act (by Senator Baldwin)

Dear Senator Scott:

The purpose in writing this letter is to encourage you to lend your name and support to the re-introduction of the Brokaw Act by Senator Tammy Baldwin (D-WI). This legislation would modernize the Securities and Exchange Commission's Rule 13(d) disclosure regime for institutional investors. I am writing on behalf of Denny's Corporation, whose home offices are located in the Upstate of South Carolina, in Spartanburg.

Under current SEC rules, an investor accumulating more than 5% of a registered equity security is required to publicly disclose such interest by filing a beneficial ownership report with the SEC on Schedule 13D. This report is to be filed within 10 days after the investor crosses the 5% threshold.

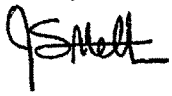
The SEC has not updated these disclosure requirements in several decades and Senator Baldwin's bill—which was introduced last year as S. 2720—would update the rules to close certain loopholes and make positions taken by activists more transparent to companies and to the capital markets.

Brokaw is the name of a village in Wisconsin that was harmed by activist hedge funds that seized control of the Wausau Paper Company in 2011. These activist funds delayed filing a Schedule 13D by using derivative securities to accumulate more than 5% of the Company's equity shares. Once they obtained effective control of the company, they shut down the Brokaw mill and bankrupted the village, in order to make a short-term profit on their activities.

The 2017 version of Senator Baldwin's bill would make three changes to the 13(d) disclosure rules. First, it would shorten the deadline for disclosing an ownership interest from 10 days to 4 days, which is the current deadline for filing an 8-K report. Second, the bill would require disclosure of any short or derivative positions that cross the 5% threshold, something that does not occur today. And finally, the bill would expand the 13(d) reporting requirement to include hedge funds and other activist investors that are coordinating activities for the purpose of seeking control or influence over a public company.

The Brokaw Act is good policy for both public companies and their investors. Attached is a summary of the bill's provisions. On behalf of the Denny's Corporation, we hope you will help us introduce and pass this legislation to update and modernize the 13(d) disclosure regime.

Sincerely,



J. Scott Melton
Assistant General Counsel,
Corporate Governance Officer and Secretary

Summary of S. 1744, the "Brokaw Act"
(introduced by Senators Tammy Baldwin (D-WI) and David Perdue (R-GA))

Brokaw is the name of a village in Wisconsin that was harmed by a group of hedge funds that seized control of the Wausau Paper Company in 2011.

Shortens the Schedule 13D Reporting Window. Current Securities and Exchange Commission (SEC) rules require beneficial owners (i.e., street name shareholders) of more than 5% of a registered class of equity security to disclose such ownership interest by filing a beneficial ownership report on Schedule 13D.

A Schedule 13D is required to be filed with the SEC within 10 days after the beneficial owner crosses the 5% threshold. This 10-day window has been the subject of criticism for allowing too much time for activist investors to accumulate large positions in U.S. public companies before being required to disclose anything publicly. To address this problem, the Brokaw Act directs the SEC to shorten this disclosure window to 4 business days, which is the current deadline for filing an 8-K report.

Requires Disclosure of Large Short Positions. Schedule 13D filings only require disclosure of large ownership positions and not large short positions. The Brokaw Act expands SEC disclosure and reporting requirements for investors acquiring a direct or indirect short interest position that represents more than 5% of a registered class of equity security. An investor that crosses the 5% threshold would be required to file the equivalent of a Schedule 13D disclosing such short interest position within 4 business days after crossing the 5% threshold.

Under the Brokaw Act, a beneficial owner holding both long and short positions in a security would not be permitted to calculate beneficial ownership using a net calculation. Instead, the beneficial owner would be required to use the greater percentage of its long or short position to calculate beneficial ownership for these purposes.

Expands the Definition of Beneficial Ownership. Under current SEC rules, investors are considered to be a beneficial owner of a security if they have voting and/or investment power over such security. The definition of beneficial ownership does not include anyone with a purely economic interest in the security.

To address this problem, the Brokaw Act would expand the definition of beneficial ownership to include any person who has a "pecuniary or indirect pecuniary interest in such security." This would require investors to include in their beneficial ownership calculation certain derivative instruments, such as cash-settled equity swaps, that do not provide an investor with any voting or investment power over the underlying equity security, but do provide the investor with economic exposure to the underlying equity security.

Expands the Definition of "Person" for Reporting Purposes. The Brokaw Act restricts the activities of certain hedge funds by defining "person" for purposes of beneficial ownership reporting to include hedge funds as well as the coordination of certain activities by two or more persons. Specifically, the Brokaw Act defines "person" to include:

> 2 or more persons acting as a partnership, limited partnership, syndicate, or other group, or otherwise coordinating the actions of the persons, for the purpose of (i) acquiring, holding, or disposing of securities of an issuer; (ii) seeking to control or influence the board, management, or policies of an issuer; or (iii) evading, or assisting others in evading, designation as a 'person' ....

The definition of "person" in the bill incorporates the definition of a hedge fund contained in the Bank Holding Company Act of 1956 (12 US.C. 1851(h)). The definition also includes a group of hedge funds or persons working together to evade the disclosure requirements in Section 13 of the Securities Exchange Act of 1934.

1155 F Street, NW • Suite 400 • Washington, DC 20004
(202) 393-4400 • Fax: (202) 393-4414

July 27, 2017

The Honorable Tim Scott
U.S. Senate
717 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Scott:

On behalf of more than 4,400 Home Depot employees in South Carolina, we are writing to encourage you to support to the re-introduction of the Brokaw Act by Senator Tammy Baldwin (D-WI). This legislation would modernize the Securities and Exchange Commission's Rule 13(d) disclosure regime for institutional investors.

Under current SEC rules, an investor accumulating more than 5 percent of a registered equity security is required to publicly disclose such interest by filing a beneficial ownership report with the SEC on Schedule 13D. This report is to be filed within 10 days after the investor crosses the 5 pecent threshold.

The SEC has not updated these disclosure requirements in several decades and Senator Baldwin's bill—which was introduced last year as S. 2720—would update the rules to close certain loopholes and make positions taken by activists more transparent to companies and other investors.

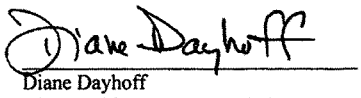
The Brokaw Act is named for a small town in Wisconsin that went bankrupt after the closure of its paper mill by an activist hedge fund. The activist fund abused outdated securities rules to buy up the Wausau Paper Company, force out its executives, and demand short-term profits at the expense of the company's long-term future. The activists generated significant returns for themselves at the expense of the workers in Brokaw.

The 2017 version of Senator Baldwin's bill would make three changes to the 13(d) disclosure rules. First, it would shorten the deadline for disclosing an ownership interest from 10 days to four days, which is the current deadline for companies to file 8-K reports to disclose material developments.

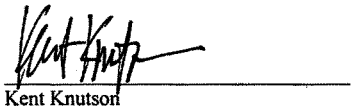
Second, the bill would require disclosure of any short or derivative positions that cross the 5 percent threshold, something that does not occur today. And finally, the bill would expand the 13(d) reporting requirement to include hedge funds and other activist investors that are coordinating activities for the purpose of seeking control or influence over a public company.

The Brokaw Act is good policy for public companies, their investors, and employees, and it should receive bipartisan support. Attached is a summary of the bill's provisions. On behalf of The Home Depot and our 25 stores in South Carolina, we hope you will help us introduce and pass this legislation to update and modernize the 13(d) disclosure regime.

Sincerely,



Diane Dayhoff
Vice President Investor Relations



Kent Knutson
Vice President Government Relations

FLUOR.

Fluor Corporation
6700 Las Colinas Blvd.
Irving, TX 75039
USA

469-398-7672 tel
469-398-7713 fax

David T. Seaton
Chairman and Chief Executive Officer

October 10, 2017

The Honorable Tim Scott
U.S. Senate
717 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Scott:

On behalf of 8,000 Fluor employees in South Carolina, I am writing to encourage you to lend your name and support for S. 1744 (the "Brokaw Act"), which has been introduced by Senator Tammy Baldwin (D-WI) and Senator David Perdue (R-GA). This bipartisan legislation would modernize the Securities and Exchange Commission's Rule 13(d) disclosure regime for institutional investors.

Under current SEC rules, an investor accumulating more than 5% of a registered equity security is required to publicly disclose such interest by filing a beneficial ownership report with the SEC on Schedule 13D. This report is to be filed within 10 days after the investor crosses the 5% threshold.

The SEC has not updated these disclosure requirements in several decades and Senator Baldwin's bill—which was introduced last year as S. 2720—would update the rules to close certain loopholes and make positions taken by activists more transparent to companies and other investors.

The Brokaw Act is named for a small town in Wisconsin that went bankrupt after the closure of its paper mill by an activist hedge fund. The activist fund abused outdated securities rules to buy up the Wausau Paper Company, force out its executives, and demand short-term profits at the expense of the company's long-term future. The activists generated significant returns for themselves at the expense of the workers in Brokaw.

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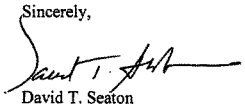
four days, which is the current deadline for companies to file 8-K reports to disclose material developments. Second, the bill would require disclosure of any short or derivative positions that cross the 5% threshold, something that does not occur today. And finally, the bill would expand the 13(d) reporting requirement to include hedge funds and other activist investors that are coordinating activities for the purpose of seeking control or influence over a public company.

The Brokaw Act is good policy for public companies, their investors, and employees, and it should receive bipartisan support. Attached is a summary of the bill's provisions. On behalf of Fluor and our employees in South Carolina, we hope that you will support this legislation to update and modernize the 13(d) disclosure regime.

Sincerely,



David T. Seaton

ARTICLE, LETTERS, AND STATEMENTS SUBMITTED BY SENATOR REED

Submission for the Record from Senator Reed

- The White House Council of Economic Advisors noted in a February 2018 report that "certain mandatory disclosure requirements were previously shown to incentivi ze firms to adopt better cybersecurity measures (see, e.g., Gordon et al. 2015, who conduct an analysis of externalities resulting from weak cybersecurity)."
    - Here's a link to the report: https://www.whitehouse.gov/wp-content/uploads/2018/02/The-Cost-of-Malicious-Cyber-Activity-to-the-U.S.-Economy.pdf

- In his oral testimony to the Senate Banking Committee on April 19th, 2018, Federal Reserve Vice Chairman for Supervision **Randy K. Quarles**, stated: "*The idea of having a board member with cyber expertise, when I have been on boards that have had a board member with that kind of expertise that has been extremely useful. That has not just been a nice thing to have. It has been extremely useful.*"

June 6, 2017

The Honorable Jack Reed
728 Hart Senate Office Building
Washington, DC 20510

The Honorable Susan Collins
413 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Mark Warner
474 Russell Senate Office Building
Washington, DC 20510

Dear Senators Reed, Collins, and Warner,

The Bipartisan Policy Center (BPC) supports your efforts to ensure publicly traded companies are taking cyber threats and data privacy seriously. The relentless cyberattacks on our most sensitive public and private electronic networks is one of the biggest challenges facing the United States today.

The Cybersecurity Disclosure Act of 2017, which would require publicly traded companies to disclose whether any of the company's Board of Directors is a cyber security expert in their Security and Exchange Commission filings, encourages companies to continue to prioritize cyber threats by requiring transparency with the public on their level of cyber focus.

Publicly traded companies rightly take the cyber threat seriously, and have devoted significant time and resources to protecting consumers and the U.S. economy against attacks. With our adversaries' cyber capabilities growing stronger every day, however, it is important that this private sector leadership continue and that companies continue to be vigilant in shoring up their cyber defenses. The Cybersecurity Disclosure Act of 2017 helps in this effort. We thank you for your leadership on this important issue.

Sincerely,

Jason Grumet

President
Bipartisan Policy Center

California Public Employees' Retirement System
Executive Office
P.O. Box 942701
Sacramento, CA 94229-2701
TTY: (877) 249-7442
(916) 795-3829 phone • (916) 795-3410 fax
www.calpers.ca.gov

July 26, 2017

The Honorable Jack Reed
United States Senate
728 Hart Senate Office Building
Washington, DC 20510

Dear Senator Reed:

Subject: S. 536, THE "CYBERSECURITY DISCLOSURE ACT OF 2017"

On behalf of the California Public Employees' Retirement System (CalPERS), I write to express support for S. 536, the "Cybersecurity Disclosure Act of 2017", legislation that would increase transparency for investors and help to ensure that public companies are appropriately prioritizing cybersecurity and data privacy matters.

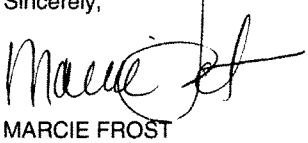
CalPERS is the largest public, defined benefit pension fund in the United States, with approximately $330.51 billion in global assets, as of market close July 19, 2017. CalPERS manages investment assets on behalf of more than 1.8 million public employees, retirees, and beneficiaries. As a global, institutional investor with a long-term investment horizon, we believe that all investors, whether large institutions or private individuals, should have access to disclosures that allow them to make informed voting and investment decisions.

S. 536 represents a reasonable and timely response to the increasing prominence of cybersecurity threats in our financial markets and the broader economy. By requiring the disclosure of cybersecurity expertise - or lack thereof - on corporate boards, the bill would ensure that investors have access to decision-useful information to better assess the ability of corporate management to adequately address cybersecurity risks. Moreover, S. 536 would help to promote capital market efficiency by providing greater insight into the extent to which companies are focused on data security and the protection of consumer information.

I applaud you for your leadership on cybersecurity issues and for your bipartisan approach to generating corporate financial reporting that seek to provide transparent and relevant information to investors about the efforts of publicly-traded companies in this area.

Please do not hesitate to contact Mary Anne Ashley, Chief of our Legislative Affairs Division, at (916) 795-2565, if we can be of any assistance as this measure proceeds.

Sincerely,



MARCIE FROST
Chief Executive Officer

cc: The Honorable Mark Warner
The Honorable Susan Collins

Via Hand Delivery

June 27, 2018

The Honorable Michael Crapo
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Re: June 28, 2018 hearing entitled "Legislative Proposals to Examine Corporate Governance"[1]

Dear Mr. Chairman and Ranking Member Brown:

I am writing on behalf of the Council of Institutional Investors (CII), a nonpartisan, nonprofit association of public, corporate, and union employee benefit funds, other employee benefit plans, foundations, and endowments with combined assets under management exceeding $3.5 trillion. Our member funds include major long-term shareholders with a duty to protect the retirement savings of millions of workers and their families.

Our associate members include a range of asset managers with more than $25 trillion in assets under management, most also with long-term investment horizons. CII members share a commitment to healthy public capital markets and strong corporate governance.[2]

The purpose of this letter is to thank you for holding the above referenced hearing and to share with you a summary of our views on corporate governance and two of the legislative proposals that we understand are likely to be discussed at the hearing and are of particular interest to our members. We would respectfully request that this letter be included in the hearing record.

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[1] United States Senate Committee on Banking, Housing, and Urban Affairs, Hearings, https://www.banking.senate.gov/hearings.

[2] For more information about the Council of Institutional Investors (CII) and our members, please visit CII's website at http://www.cii.org/about_us. We note that the two largest U.S. proxy advisory firms, Glass Lewis & Co. and Institutional Shareholder Services Inc. (ISS), are non-voting associate members of CII, paying an aggregate of $24,000 in annual dues—less than 1.0 percent of CII's membership revenues. In addition, CII is a client of ISS, paying approximately $19,600 annually to ISS for its proxy research.

1717 Pennsylvania Avenue, NW | Suite 350 | Washington, DC 20006 | Main 202.822.0800 | Fax 202.822.0801 | www.cii.org

Corporate Governance

CII has long held that good corporate governance—defined to include market transparency, integrity and accountability of management to boards and shareowners—is in the best long-term interests of shareowners and the U.S. capital markets.[3]

We believe that shareowners, other investors and other stakeholders benefit when rules and regulations provide adequate protections to owners and ensure that important information is promptly and transparently provided to the marketplace.[4]

The value of good governance structures and practices within public companies—such as substantially independent boards, [5] all-independent key committees, [6] and measures to promote board accountability[7]—is backed by common sense and experience. We believe such structures and practices ensure that directors have the necessary independence from management to, among other things, monitor and assess corporate performance; select, monitor, evaluate and, when necessary, replace the chief executive and other senior managers; oversee management succession; and structure, monitor and approve compensation paid to the chief executive and other senior managers. They also ensure that directors are accountable to shareowners.

We are unaware of any evidence of a causal connection between federally imposed improvements to corporate governance and the decline in the number initial public offerings or public businesses in the United States.[8]

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[3] CII, Policies on Other Issues, Value of Corporate Governance, http://www.cii.org/policies_other_issues#value_corp_gov.

[4] *Id.*

[5] *See* Council of Institutional Investors, Corporate Governance Policies § 2.3 Independent Board (Updated September 15, 2017), https://www.cii.org/files/policies/09_15_17_corp_gov_policies.pdf.

[6] *See* Corporate Governance Policies § 2.5 All-independent Board Committees.

[7] *See.* Corporate Governance Policies § 2.1 Annual Election of Directors; § 2.6 Board Accountability to Shareholders (stating that boards should seek shareholder views on important governance, management, and performance matters and take actions recommended by shareholder proposals that receive a majority of votes cast for and against).

[8] *See* Michael J. Mauboussin et al., Credit Suisse, "The Incredible Shrinking Universe of Stocks, The Causes and Consequences of Fewer U.S. Equities" 20 (Mar. 22, 2017) ("the shrinkage in the population of listed companies started well before . . . [Sarbanes-Oxley Act] was implemented"), https://www.cmgwealth.com/wp-content/uploads/2017/03/document_1072753661.pdf; Office of Investor Advocate, U.S. Securities and Exchange Commission, Report on Objectives 6 (2018) ("recent academic studies demonstrate that it is difficult to establish any causal connection between disclosure mandates and IPO activity"), https://www.sec.gov/files/sec-office-investor-advocate-report-on-objectives-fy2018.pdf; "Legislative Proposals to Help Fuel Capital and Growth on Main Street:" Hearing before the H. Subcomm. Cap. Markets, Sec., & Investment, 115th Cong. (May 23, 2018) (Statement of Professor John C. Coffee, Jr., Adolf A. Berle Professor of Law, Columbia University Law School at 2) ("the decline of IPO's . . . cannot be blamed on an over-regulating national regulator"), https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-jcoffee-20180523.pdf; Elisabeth de Fontenay, "The Deregulation of Private Capital and the Decline of the Public Company," 68 Hastings L.J. 445, 448 (Mar. 29, 2017) ("even if public company disclosure requirements had remained constant over the last three decades, there would likely still be a dearth of public companies today, due to the increasing ease of raising capital privately") *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/elisabeth-de-fontenay-deregulation-private-capital.pdf.

Proxy Advisory Firms

Many CII members and other institutional investors voluntarily contract with proxy advisory firms to obtain cost-effective independent research to help inform their proxy voting and engagement decisions, and to execute votes based on funds' own proxy voting guidelines. Proxy voting is a critical means by which shareowners hold corporate executives and boards to account and is a hallmark of shareholder ownership and accountability. The system of corporate governance in the United States relies on the accountability of Chief Executive Officers and boards of directors alike to shareowners, and ensuring unencumbered shareholder access to independent research is a crucial underpinning of effective corporate governance.

H.R. 4015[9]

H.R. 4015 would require, as a matter of federal law, that proxy advisory firms share their research reports and proxy voting recommendations with the companies about whom they are writing before they are shared with the institutional investors who are their paying clients.[10] While the stated goal of the proposed legislation is the "protection of investors,"[11] we believe the legislation would bias proxy advisory firms in favor of corporate management on matters about which there are significant differences of view. We also believe that the new requirements it would impose are unnecessary, overly burdensome and counter-productive. Many investors and investor organizations outside of CII's membership share our concerns.[12]

Further, the proposed legislation appears to be based on several false premises, including the erroneous conclusions that: (1) proxy advisory firms initiate many of the so-called "activist" hedge fund agendas; (2) proxy advisory firms dictate proxy voting results; and (3) institutional investors do not drive or form their own voting decisions. Indeed, while many pension funds and other institutional investors contract with proxy advisory firms to review their research, most large holders have adopted their own policies and may employ the proxy advisory firms to help administer the voting of proxies during challenging proxy seasons.

In short, most large institutional investors do not "rubber stamp" the proxy advisory firms' recommendations. Rather, they vote their proxies according to their own guidelines. While many large institutional investors rely on proxy advisors to help them manage the analysis of issues presented in the proxy statements accompanying thousands of shareholder meetings annually, and to help administer proxy voting, this does not mean that they abdicate their responsibility for their own voting decisions.

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[9] H.R. 4015, 115th Cong. (Dec. 21, 2017), https://www.congress.gov/115/bills/hr4015/BILLS-115hr4015rfs.pdf.
[10] H.R. 4015 § 3(a).
[11] *Id.* at Preamble.
[12] *See* Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to The Honorable Michael Crapo, Chairman, Committee on Banking, Housing, and Urban Affairs et al. (Feb. 27, 2018) (signed by 48 investors and investor organizations including many investors and investor organizations that are not currently members of CII), https://www.cii.org/files/issues_and_advocacy/correspondence/2018/Feb%2027-18%20Final%20Letter%20CII%20on%20proxy%20advisor%20legislation.pdf; *see also* Letter from Thomas P. DiNapoli, NYS Comptroller et al. to The Honorable Charles E. Schumer, Minority Leader, United States Senate (May 29, 2018) ("On behalf of the more than two million state, city, and local government employees, teachers, retirees, and beneficiaries, we urge your strenuous opposition to . . . H.R. 4015 in the Senate.") (on file with CII).

The independence that shareowners exercise when voting their proxies is evident in the statistics related to "say on pay" proposals and director elections. Although Institutional Shareholder Services Inc. (ISS), the largest proxy advisory firm, recommended voting against say-on-pay proposals at 11.8% of Russell 3000 companies in 2017, only 1.4% of those proposals received less than majority support from shareowners.[13] Similarly, although ISS recommended voting against or withholding votes from the election of 10.8% of uncontested director-nominees, just 0.2% failed to obtain majority support.[14]

We are particularly concerned that if enacted, H.R. 4015, while providing no clear benefits to institutional investors, would:

- Grant companies the right to review the proxy advisory firms' research reports before the paying customers – investors – receive the reports;[15]
- Mandate that proxy advisory firms hire an ombudsman to receive and resolve corporations' complaints;[16]
- Require proxy advisory firms to publish a company's statement "detailing its complaints" in the proxy advisory firms' final reports to their clients, if the ombudsman is unable to resolve these complaints and if the company makes the request in writing; and[17]
- Increase barriers to new entrants and potentially lead some current proxy advisory firms to exit the industry altogether.

Giving corporate issuers the "right to review" the proxy advisors' work product before the reports go to the paying customers is unprecedented. It would give corporate management substantial undue influence over proxy advisory firms' reports. The approach would create a dynamic that would encourage proxy advisory firms to view management as their research clients, rather than the investors who contract for this research.

Another concern is that such forced pre-publication review may not be consistent with First Amendment rights to freedom of speech. Regardless, the attempt by government fiat to interpose corporate management between investors and those whom investors voluntarily hire to provide them with independent research is highly questionable as a matter of public policy and inconsistent with free-market principles.

Practically, the additional regulatory hurdles imposed would: (1) increase the complexity of the challenges faced by the proxy advisory firms; (2) impose even more severe time constraints on the production of reports; and, without doubt, (3) add significant resource burdens that would increase the cost of their services. The higher costs would likely be passed along to their institutional investor clients.

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[13] ISS Voting Analytics Database (June 21, 2018) (on file with CII).
[14] *Id.*
[15] H.R. 4015 § 3(a).
[16] *Id.*
[17] *Id.*

Under H.R. 4015, pension funds and other institutional investors would have less time to analyze the advisor's reports and recommendations in the context of their own adopted proxy voting guidelines to arrive at informed voting decisions. Time is already tight, particularly in the highly concentrated spring "proxy season," due to the limited period between a company's publication of the annual meeting proxy materials and annual meeting dates. Simply put, the proposed legislation is not constructive regulatory "reform," and is not supported by institutional investors.

Moreover, H.R. 4015 does not appear to contemplate a parallel requirement that dissidents in a proxy fight or proponents of shareowner proposals also receive the recommendations and research in advance. This would violate an underlying tenet of U.S. corporate governance that where matters are contested in corporate elections, management and shareowner advocates should operate on a level playing field.

H.R. 4015 would also require the Securities and Exchange Commission (SEC) to assess the ability of proxy advisory firms to perform their duties and to assess the adequacy of proxy advisory firms' "financial and managerial resources."[18]

The entities that are in the best position to make assessments about whether a service provider – including proxy advisory firms – are adhering to contractual terms negotiated with clients are the clients themselves, not the government. Pension funds and other institutional investors that choose to purchase these services are sophisticated consumers who are fully capable of making prudent choices based on free-market principles.

In 2014, the SEC staff issued guidance reaffirming that investment advisors have a duty to maintain sufficient oversight of proxy advisory firms and other third-party voting agents.[19] CII and many institutional investors publicly supported that guidance.[20] We are unaware of any compelling empirical evidence indicating that the guidance is not being followed or that the burdensome federal regulatory scheme contemplated by the proposed legislation is needed. If the Committee is concerned about proxy advisory firms, we would respectfully suggest that the Committee request that the SEC brief the Committee on whether the 2014 guidance is being adequately followed and enforced.

If enacted, the proposed legislation would increase costs for pension plans and other institutional investors with no clear benefits. The costs could rise substantially if investors seek to maintain current levels of scrutiny and due diligence around proxy voting amid the exit of some or all proxy advisory firms from the business. These increased costs would also likely impair the ability of institutional investors to promote good corporate governance and accountability at the companies in which they own stock. Proxy advisory firms, while imperfect, play an important and useful role in enabling effective and cost-efficient independent research, analysis and

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[18] *Id.*

[19] SEC Staff Legal Bulletin No. 20 (June 30, 2014), https://www.sec.gov/interps/legal/cfslb20.htm.

[20] *See* Letter from Jeff Mahoney, General Counsel, CII, to The Honorable Scott Garrett, Chairman, Subcommittee on Capital Markets and Government Sponsored Enterprises, Committee on Financial Services et al. 5 (July 23, 2014) ("Consistent with our recommendation, the Guidance clarifies that investment advisers are not required to vote every proxy."), https://www.cii.org/files/issues_and_advocacy/correspondence/2014/07_23_14_letter_Subcommittee_Capital_Markets.pdf.

informed proxy voting advice for large institutional shareholders, particularly since many funds hold shares of thousands of companies in their investment portfolios.

We believe that the cost estimate provided by the Congressional Budget Office (CBO) to the House Financial Services Committee in December 2017 underestimates the costs that this bill would impose through private-sector mandates.[21] The CBO should analyze the probable effects of the proposal on competition, and the costs to investors if: (1) competition is reduced and the pricing power of a surviving proxy advisory firm is enhanced, and (2) if all present firms exit the market and the services they provided are no longer available, forcing individual investors to use internal resources not subject to the new regulatory mandate.

Finally, we note that in October 2017, the United States Department of Treasury (Treasury) performed outreach to identify views on proxy advisory firms in connection with its report to the President on "A Financial System that Creates Economic Opportunities, Capital Markets."[22] In that report, the Treasury found that "institutional investors, who pay for proxy advice and are responsible for voting decisions, find the services valuable, especially in sorting through the lengthy and significant disclosures contained in proxy statements."[23] More importantly, the Treasury did not recommend any legislative changes governing the proxy advisory firm industry.[24] Contrary to H.R. 4015's focus on government intervention, the Treasury recommended that any regulatory response *should promote free market principles*.[25]

Cybersecurity

CII believes that cybersecurity is an integral component of a board's role in risk oversight.[26] Directors have the authority, capacity and responsibility to make pivotal contributions in this area by ensuring adequate resources and management expertise are allocated to robust cyber risk management policies and practices, and ensuring disclosure fairly and accurately portrays material cyber risks and incidents.[27] To achieve these objectives, directors need to:

- Understand management's cybersecurity strategy;
- Learn where cybersecurity weaknesses lie, and;
- Support informed, reasonable investment in the protection of critical data and assets.[28]

Consistent with our view, we generally agree with SEC Chairman Jay Clayton that "in today's world, companies must have adequate policies and procedures in place to ensure that they

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[21] Congressional Budget Office, H.R. 4015, Corporate Governance Reform and Transparency Act, https://www.cbo.gov/publication/53377.
[22] U.S. Department of the Treasury, A Financial System That Creates Economic Opportunities, Capital Markets 31 (Oct. 2017), https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf
[23] *Id.*
[24] *See id.* ("Treasury recommends further study and evaluation of proxy advisory firms, including regulatory responses to promote free market principles if appropriate.").
[25] *See id.* (emphasis added).
[26] CII, Prioritizing Cybersecurity, Five Investor Questions for Portfolio Company Boards 2 (Apr. 2016), https://www.cii.org/files/publications/misc/4-27-16%20Prioritizing%20Cybersecurity.pdf.
[27] *Id.*
[28] *Id.*

respond appropriately to—and, where necessary, adequately disclosure—material cyber risks and incidents."[29]

On February 2018, the SEC issued a statement and interpretative guidance to assist public companies in preparing disclosures about cybersecurity.[30] Some investors believe the guidance is insufficient.[31]

S. 536[32]

S. 536 directs the SEC to issue final rules requiring a registered issuer to:

- Disclose in its mandatory annual report or annual proxy statement whether any member of its governing body has expertise or experience in cybersecurity, including details necessary to describe fully the nature of that expertise or experience; and
- If no member has such expertise or experience, describe what other company cybersecurity steps were taken into account by the persons responsible for identifying and evaluating nominees for the governing body.[33]

CII strongly supports the stated goal of the bill to "promote transparency in the oversight of cybersecurity risks at publicly traded companies."[34] We are optimistic that, unlike H.R. 4015, S. 536 may have the potential of being pursued in a thoughtful and bi-partisan manner that is responsive to the views of investors.[35]

Thank you for considering these views. CII would be very happy to discuss its perspective in more detail. I can be can be reached at jeff@cii.org or by telephone at (202) 822-0800.

Sincerely,

Jeff Mahoney
General Counsel

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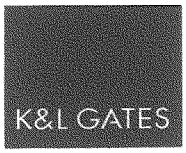
[29] Oversight of the U.S. Securities and Exchange Commission, Before the H. Comm. on Fin. Servs., 115th Cong. (June 21, 2018) (Testimony of Jay Clayton, Chairman, SEC at 8), http://www.mondovisione.com/media-and-resources/news/testimony-on-oversight-of-the-us-securities-and-exchange-commission-sec-cha-1/.
[30] Press Release 2018-22, SEC Adopts Statement and Interpretative Guidance on Public Company Cybersecurity Disclosures (Feb. 21, 2018), https://www.sec.gov/news/press-release/2018-22.
[31] *See, e.g.*, Hazel Bradford, Investors Pushing Harder for Cybersecurity Solution, P&I, Mar. 5, 2018 ("Mr. DiNapoli, the sole trustee of the $209.1 billion New York State Common Retirement Fund, Albany, agrees that the latest SEC action fell short."), http://www.pionline.com/article/20180305/PRINT/180309912/investors-pushing-harder-for-cybersecurity-solution.
[32] S. 536, 115th Cong. (Mar. 7, 2017), https://www.congress.gov/115/bills/s536/BILLS-115s536is.pdf.
[33] *See id.*at § 2.
[34] *Id;* Letter from Ken Bertsch, Executive Director, Council of Institutional Investors to The Honorable Jack Reed, United States Senate (July 7, 2017), https://www.cii.org/files/07_07_17%20letter%20to%20Senator%20Reed.pdf.
[35] *See* H.R. 4015, Final Vote Results for Roll Call 702 (more than 90% of House Democrats voted nay on H.R. 4015), http://clerk.house.gov/evs/2017/roll702.xml.

CC: The Honorable Dean Heller, Chairman, Subcommittee on Securities, Insurance, and Investment, Committee on Banking, Housing, and Urban Affairs
The Honorable Mark Warner, Ranking Member, Subcommittee on Securities, Insurance and Investment, Committee on Banking, Housing, and Urban Affairs
The Honorable Richard Shelby, Committee on Banking, Housing, and Urban Affairs
The Honorable Bob Corker, Committee on Banking, Housing, and Urban Affairs
The Honorable Patrick J. Toomey, Committee on Banking, Housing, and Urban Affairs
The Honorable Tim Scott, Committee on Banking, Housing, and Urban Affairs
The Honorable Ben Sasse, Committee on Banking, Housing, and Urban Affairs
The Honorable Tom Cotton, Committee on Banking, Housing, and Urban Affairs
The Honorable Michael Rounds, Committee on Banking, Housing, and Urban Affairs
The Honorable David Perdue, Committee on Banking, Housing, and Urban Affairs
The Honorable Thom Tillis, Committee on Banking, Housing, and Urban Affairs
The Honorable John Kennedy, Committee on Banking, Housing, and Urban Affairs
The Honorable Jerry Moran, Committee on Banking, Housing, and Urban Affairs
The Honorable Jack Reed, Committee on Banking, Housing, and Urban Affairs
The Honorable Robert Menendez, Committee on Banking, Housing, and Urban Affairs
The Honorable John Tester, Committee on Banking, Housing, and Urban Affairs
The Honorable Elizabeth Warren, Committee on Banking, Housing, and Urban Affairs
The Honorable Heidi Heitkamp, Committee on Banking, Housing, and Urban Affairs
The Honorable Joe Donnelly, Committee on Banking, Housing, and Urban Affairs
The Honorable Brian Schatz, Committee on Banking, Housing, and Urban Affairs
The Honorable Chris Van Hollen, Committee on Banking, Housing, and Urban Affairs
The Honorable Catherine Cortez Masto, Committee on Banking, Housing, and Urban Affairs
The Honorable Doug Jones, Committee on Banking, Housing, and Urban Affairs



June 27, 2018

The Honorable Jack Reed
United States Senate
Washington, DC 20510

Dear Senator Reed:

We join the Bipartisan Policy Center, North American Securities Administrators Association, Inc., Council of Institutional Investors, National Association of State Treasurers, CalPERS, Columbia Law Professor Jack Coffee, Harvard Law Professor John Coates and former International Monetary Fund Chief Economist and Massachusetts Institute of Technology Professor Simon Johnson (among others) in support of S.536, the Cybersecurity Disclosure Act of 2017. As its title implies, S. 536 seeks to supplement existing corporate governance practices with disclosure requirements about "in house" cybersecurity expertise.

From data breaches to ransomware to nation-state cyber attacks, everyone can agree that cyber threats — whether on the public or private sector — are a serious threat to the United States. The increasingly sophisticated nature of these threats makes addressing them a continual, and escalating, challenge. We all benefit from any step that helps prioritize responding to and preventing these threats.

S. 536 is one such step that is critical but not overly burdensome. If enacted, S. 536 will direct the Securities and Exchange Commission to issue rules requiring a publicly traded company to disclose whether any board member has expertise in cybersecurity and, if not, what actions the board has implemented to prioritize cybersecurity. S. 536 does not tell publicly traded companies how to "do cybersecurity." Rather, consistent with a multitude of other cybersecurity-related laws and industry standards, you and the other bill sponsors recognize that cybersecurity requirements must be adaptable to the sensitivity of information and systems. By requiring disclosure but not prescribing specific cybersecurity expertise or measures, S. 536 promotes prioritization of cybersecurity oversight among public companies and enhances transparency for investors to enable them to make informed investment decisions.

Please do not hesitate to contact us if we can assist in any way with your efforts.

Sincerely,

Mark L. Johnson

Julia B. Jacobson

K&L GATES LLP
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T +1 617 261 3100 F +1 617 261 3175 klgates.com

Via Hand Delivery

July 7, 2017

The Honorable Jack Reed
United States Senate
Washington, DC 20510

Dear Senator Reed:

We are writing in support of S.536, the Cybersecurity Disclosure Act of 2017.[1]

The Council of Institutional Investors (CII) is a nonpartisan, nonprofit association of employee benefit plans, foundations and endowments with combined assets under management exceeding $3 trillion. Our voting member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families. Our associate (non-voting) members include a range of asset managers with more than $20 trillion in assets under management.[2]

Investors are looking to company boards for leadership in addressing the risks and mitigating the damage associated with cyber incidents.[3] CII believes that "[e]ffective cybersecurity risk management starts with the board."[4] We, therefore, applaud you for pursuing S.536 and for doing so in a bi-partisan manner. CII strongly supports the stated goal of the bill to "promote transparency in the oversight of cybersecurity risks at publicly traded companies."[5]

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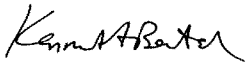
[1] S.536, 115th Cong. (Mar. 7, 2017), *available at* https://www.congress.gov/bill/115th-congress/senate-bill/536/text?q=%7B%22search%22%3A%5B%22S.+536%22%5D%7D&r=1.
[2] For more information about the Council of Institutional Investor (Council or CII) and our members, please visit the Council's website at http://www.cii.org/members.
[3] Council of Institutional Investors, "Prioritizing Cybersecurity, Five Investor Questions for Portfolio Company Boards" 2 (Apr. 2016), *available at* http://www.cii.org/files/publications/misc/4-27-16%20Prioritizing%20Cybersecurity.pdf.
[4] *Id.*
[5] S.536.

1717 Pennsylvania Avenue NW • Suite 350 • Washington, DC 20006 Main 202.822.0800 • Fax 202.822.0801 www.cii.org

We thank you for your leadership on this important issue. Please feel free to let me know if I can be of any help as this measure makes its way forward. I can be contacted at 202.822.0800.

Sincerely,



Ken Bertsch
Executive Director

CC: The Honorable Mark Warner, United States Senate
The Honorable Susan Collins, United States Senate

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
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www.nasaa.org

June 28, 2018

The Honorable Mike Crapo
Chairman
Senate Committee on Banking, Housing
& Urban Affairs
538 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member
Senate Committee on Banking, Housing
& Urban Affairs
538 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Legislation Considered by the Committee on June 26, 2018 and June 28, 2018

Dear Chairman Crapo and Ranking Member Brown:

On behalf of the North American Securities Administrators Association (NASAA),[1] I am writing to provide NASAA's perspective on certain legislative proposals that have been the subject of hearings by the Committee on Banking, Housing and Urban Affairs during the week of June 25, 2018.

1. The "Cybersecurity Disclosure Act" (S. 536)

The "Cybersecurity Disclosure Act" would amend the Securities Exchange Act of 1934 to require that publicly traded companies disclose in their annual filings with the U.S. Securities and Exchange Commission (SEC) whether any member of their governing body, such as their board of directors or general partner, possesses expertise or experience in cybersecurity. The bill does not impose any requirements on issuers beyond disclosure of the specified information.

Incentivizing publicly traded companies to consider whether they have adequate cybersecurity expertise in their governing body is an appropriate step given that cyberattacks on U.S. companies continue to increase in both frequency and sophistication. Cybersecurity risk and preparedness can have major implications for businesses and their investors.[2] Further, investors, issuers, and consumers stand to be well-served by policies that encourage companies to consider cybersecurity risks proactively, as opposed to after a data breach or other intrusion has occurred, when the harm may be

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

[2] In 2017, I authored an op-ed highlighting the growing concern over the number of cyberattacks perpetrated against companies and the efforts state securities regulators are taking to assist mid-sized investment advisers to improve their cybersecurity practices. (See: Borg, Joseph P. "Everyone has a Role in Protecting against Cyberattacks". September 5, 2017. Available at www.americanbar.org/content/dam/aba/administrative/business_law/newsletters/CL680000/full-issue-201709.authcheckdam.pdf).

President: Joseph Borg (Alabama)
President-Elect: Michael Pieciak (Vermont)
Executive Director: Joseph Brady
Secretary: Shonita Bossier (Kentucky)
Treasurer: Tom Cotter (Alberta)
Directors: Pamela Epting (Florida)
Bryan Lantagne (Massachusetts)
Melanie Senter Lubin (Maryland)
Tanya Solov (Illinois)
Gerald Rome (Colorado)

irreversible. In fact, we note that since the bill's introduction in 2017, the SEC has issued guidance that compliments and supports the legislation's premise.[3]

NASAA is pleased to support S. 536.

2. The "Fair Investment Opportunities for Professional Experts Act" (S. 2756)

S. 2756, the "Fair Investment Opportunities for Professional Experts Act", would amend the Securities Act of 1933 to add specified, inflation-adjusted income and net-worth standards to the "accredited investor" definition. In addition, the bill extends "accredited investor" status to new categories of natural persons who would qualify as "accredited" irrespective of income or net-worth.

NASAA is not wholly opposed to efforts to modernize the accredited investor standard, including in a manner that would increase the size of this marketplace, as is envisioned by S. 2756. Further, NASAA appreciates the steps that the sponsors of S. 2756 have taken to improve the legislation relative to similarly entitled legislation previously passed by the House of Representatives, including in consultation with NASAA.[4] Nevertheless, state regulators have a very large stake in any legislative changes that would affect the private securities markets.[5] We strongly believe that any legislation that effects a further expansion of private securities markets must also take steps to improve the oversight of these markets by providing regulators with better tools to address fraud and misconduct in these markets.[6]

Further, NASAA respectfully reminds the Committee that policies that implicate private securities markets cannot be judged in isolation. Over the past two decades, there has been a dramatic shift in how companies raise capital. Private securities once comprised just a fraction of the overall marketplace, but today they serve as a major source of capital for certain businesses, exceeding the public markets.[7] The unprecedented growth in private markets, and the decline in initial public

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[3] "U.S. SEC Calls for 'Clearer' Cyber Risk Disclosure from Companies". *Reuters*. February 21, 2018. *See:* https://www.reuters.com/article/us-usa-sec-cyber/u-s-sec-calls-for-clearer-cyber-risk-disclosure-from-companies-idUSKCN1G52FK.

[4] Section 2(b) of S. 2756 imposes guidelines that the SEC must follow in issuing a rule to determine whether a natural person may qualify as an accredited investor by virtue of education, job, or professional experience. No similar requirements are included in H.R.1585, the "Fair Investment Opportunities for Professional Experts Act". We also note that, whereas H.R. 1585 would adjust the income and net-worth standards to account for inflation every five years, S. 2756 would adjust them every three years.

[5] State securities regulators, pursuant to their antifraud authority, are the de-facto primary regulators of offerings conducted under Regulation D, Rule 506. State regulators frequently receive complaints from those who are victimized in offerings conducted under Rule 506, and expend considerable resources policing this marketplace.

[6] Specifically, S. 2756 should be improved by incorporating modest changes to Rule 506 and Form D that will enhance the ability of the SEC and NASAA members to protect investors while minimizing the burdens to the small businesses who utilize the rule to raise capital. Such changes were proposed by the SEC in 2013, but have not yet been adopted. (*For additional information, see: https://www.sec.gov/comments/4-692/4692-34.pdf*). NASAA has also offered suggestions for how to revise the current accredited investor definition to more accurately measure investor sophistication, and to limit the exposure of less sophisticated investors to the risks of the private marketplace. (*For additional information, see: http://www.nasaa.org/wp-content/uploads/2013/10/NASAA-Letter-to-House-Leadership-Re-HR-1585-11-1-17.pdf*).

[7] See: SEC Division of Economic and Risk Analysis, Access to Capital and Market Liquidity (Aug. 8, 2017), available at https://www.sec.gov/files/access-to-capital-and-market-liquidity-study-dera-2017.pdf. See also: Scott W. Bauguess, Deputy Director, SEC Division of Economic Risk and Analysis, Private Securities Offerings post-JOBS Act. Presentation to

offerings (IPOs), can be attributed in part to Congress. Congress has made it easier for companies to raise capital in private markets and that is one of the main reasons that more companies are staying private for longer instead of pursuing IPOs.[8] Given Congress's ongoing, bipartisan interest in increasing the number of IPOs – efforts which were discussed by the Committee at a hearing earlier this week[9] – Congress should be thoughtful in taking any steps that would further expand the private markets to the potential detriment of public markets.

3. The "Helping Angels Lead Our Startups Act" (S. 588)

The "Helping Angels Lead Our Startups Act", or "HALOS Act," would direct the SEC to amend Rule 506 of Regulation D to specify that prohibitions on general solicitation and general advertising in Rule 506 offerings do not apply to sales events (also called "demo days", "venture fairs", or "pitch days") that are sponsored by a governmental entity, a college or university, a nonprofit organization, an angel investor group, a trade association, a venture forum, or a venture capital association. The bill would also limit the amount and type of information that can be communicated prior to, and at, such events.

Given that Congress has already acted to repeal the prohibition on general solicitation in certain private securities offerings under SEC Rule 506(c), it is not clear why Congress would now require the SEC to relax rules governing the use of solicitation to non-accredited investors under Rule 506(b).[10] However, in the event that Congress determines such action is appropriate, there are steps the Senate can and should take to improve the legislation prior to its becoming law.

As presently constituted, the types of entities that would be eligible to sponsor an event under S. 588 is exceptionally broad. Congress should consider whether these criteria should be made more tailored thereby narrowing the number of entities eligible to sponsor such events.[11] Further, Congress

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Accounting Standards Executive Committee (Feb. 25, 2016), available at https://www.sec.gov/info/smallbus/acsec/private- securities-offerings-post-jobs-act-bauguess-022516.pdf.

[8] As Healthy Markets Association Executive Director Tyler Gellasch recently testified to a subcommittee of the House Financial Services Committee, "It's not a great mystery why in the last few years the trend has developed whereby there are more private offerings in the U.S. today than public ones. In the past, the law and SEC rules simply didn't permit all these private offerings. Over the past two decades, however, Congress and the SEC have spent years constructing ad hoc exemptions and exceptions designed to allow firms, their executives, and their early investors to sell securities without incurring the costs or burdens typically associated with public offerings. While some of these exemptions and exceptions may have been well-intended, the undeniable result has been that they have grown so dramatically that they have undermined the public markets." (See: Testimony of Tyler Gellasch before the House Financial Services Committee, Subcommittee on Capital Markets, Securities and Investment (May 23, 2018).

[9] *See: Legislative Proposals to Increase Access to Capital*, Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs, 115th Cong. (Jun. 26, 2018).

[10] In Title II of the JOBS Act of 2012, Congress expanded companies' ability to attract buyers to their private offerings by permitting general solicitation and advertising. This exemption, codified under SEC Rule 506(c), can be claimed provided that issuers only sell to accredited investors and that they take "reasonable steps" to verify that the investors are accredited. The HALOS Act would go further and exempt demo days from the prohibition on general solicitation and advertising, thereby allowing companies to generally solicit and advertise and still be able to use 506(b), which unlike Rule 506 (c), does not require issuers to take reasonable steps to determine whether investors are accredited.

[11] As University of University of Mississippi Law School Professor Mercer Bullard testified to the Committee this week, S. 588 "will allow virtually any type of public entity to advertise and host an event that can be attended by any person for the purpose of any issuer pitching a securities offering." *See:* https://www.banking.senate.gov/imo/media/doc/Bullard%20Testimony%206-26-18.pdf

should require the filing of Form D with the SEC and the relevant state regulator prior to the event.[12] The information included in Form D would be particularly valuable to state regulators who will be tasked with ensuring that "demo days" and similar events sponsored in their jurisdictions are legitimate and compliant with the law. Finally, Congress should clarify that attendance at an event does not in itself establish a pre-existing relationship for purposes of Rule 506(b).

4. The "Compensation for Cheated Investors Act" (S. 2499)

S. 2499, the "Compensation for Cheated Investors Act", would direct the Financial Industry Regulatory Authority (FINRA) to establish a fund to provide investors with the full value of unpaid arbitration awards issued against brokerage firms or brokers regulated by FINRA. The bill would also require FINRA to provide enhanced public disclosure of information pertaining to the total number of arbitration awards issued in favor of investors against brokerage firms or brokers regulated by FINRA.

NASAA welcomes the introduction of S. 2499, and wholeheartedly supports the intent behind the legislation, which is to ensure that wronged investors are not literally left holding the bag when it comes to the payment of arbitration awards issued against broker-dealer firms and their representatives. Unpaid arbitration awards remain an unresolved and well-documented investor protection concern. In failing to pay arbitration awards, broker-dealers fail to comply with their legal, regulatory and ethical obligations. NASAA has been a longstanding proponent of measures to address this problem.[13] We look forward to working with Congress and other stakeholders to finding a solution so that no investor awards or settlements go unpaid.

5. The "Expanding Access to Capital for Rural Job Creators Act" (S. 2953)

S. 2953, the "Expanding Access to Capital for Rural Job Creators Act", would amend the Securities Exchange Act of 1934 to add "rural-area small businesses" to the scope of small businesses with unique challenges and issues from which the SEC Advocate for Small Business Capital Formation is required to (1) identify problems with securing access to capital; and (2) issue an annual report containing a summary of the most serious issues encountered by such businesses and their investors.

As the closest regulators to the investing public, NASAA's members regularly work with and assist local businesses seeking investment capital. On the basis of this experience, we strongly agree with legislation's premise – which is that rural communities and the small businesses located in these communities can face unique barriers to accessing capital.

NASAA is pleased to support S. 2953.

Thank you for your consideration of NASAA's views. If I may be of further assistance, please don't hesitate to contact me or Michael Canning, NASAA's Director of Policy and Government Affairs, at (202) 737-0900.

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[12] NASAA has repeatedly urged Congress to require the filing of Form D prior to sale or general solicitation of securities offerings exempt from registration under Regulation D. Under the current rules, Form D need not be filed until 15 days after the first sale, so an issuer can advertise for investors without filing the form. The lack of any pre-solicitation filing makes it impossible for state enforcement personnel to easily determine whether an offering is being conducted in accordance with the securities laws.

[13] *See, e.g.*, Letter from NASAA President Joseph Borg to March E. Asquith regarding FINRA Regulatory Notice 17-33 (Dec. 20, 2017).

Sincerely,

Joseph P. Borg
NASAA President and Alabama Securities Commission Director

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
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Washington, D.C. 20002
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www.nasaa.org

January 31, 2018

The Honorable Jack Reed
Unites States Senator
728 Hart Senate Office Building
Washington, DC 20510

Re: Cybersecurity Disclosure Act of 2017 (S.536)

Dear Senator Reed:

On behalf of the North American Securities Administrators Association (NASAA),[1] I am writing to express support for S. 536, the "Cybersecurity Disclosure Act of 2017," which would require that publicly traded companies disclose in annual filings with the U.S. Securities and Exchange Commission (SEC) whether any member of their governing body, such as their board of directors or general partner, possess expertise or experience in cybersecurity.

Incentivizing publicly traded companies to consider whether or not they have appropriate cybersecurity expertise on their governing body is a common-sense way to promote greater attention to cybersecurity risk by public corporations. Investors and customers are well-served by policies that encourage companies to consider such risks proactively, as opposed to after a data breach has already occurred, when such investors and customers have already been harmed. Importantly, S. 536 would not require companies to do anything beyond disclosing information; the bill merely nudges companies to act in their own best interests by creating an incentive for them to treat cybersecurity expertise as a priority at the senior leadership level. This is good news for companies and investors.

Cyberattacks on U.S. companies and businesses continue to increase in both frequency and sophistication. As you know, 2016 was another record-breaking year for data breaches, which increased 40% from the prior year to 1,091 total breaches according to the Identity Theft Resource Center.[2] In 2017, I authored an op-ed highlighting the growing concern over the number of cyberattacks perpetrated against companies and the efforts state securities regulators are taking to assist small and mid-sized investment advisers to improve their cybersecurity practices.[3]

Again, NASAA strongly supports your legislation as a measured way of incentivizing and rewarding enhanced cybersecurity expertise at the leadership level, and looks forward to working with you and the bill's other Senate sponsors to facilitate its enactment. Please do not hesitate to contact

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

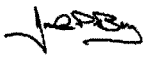
[2] Identify Theft Resource Center. "Data Breaches Increase 40 Percent in 2016, Finds New Report from Identify Theft Resource Center and CyberScout". January 19, 2017. Available at idtheftcenter.org/2016databreaches.html.

[3] Borg, Joseph P. "Everyone has a Role in Protecting against Cyberattacks". September 5, 2017. Available at americanbar.org/content/dam/aba/administrative/business_law/newsletters/CL680000/full-issue-201709.authcheckdam.pdf.

President: Joseph Borg (Alabama)
President-Elect: Michael Pieciak (Vermont)
Past President: Mike Rothman (Minnesota)
Executive Director: Joseph Brady
Secretary: Shonita Bossier (Kentucky)
Treasurer: Tom Cotter (Alberta)
Directors: Pamela Epting (Florida)
Bryan Lantagne (Massachusetts)
Melanie Senter Lubin (Maryland)
Tanya Solov (Illinois)

me or Michael Canning, NASAA's Director of Policy & Government Affairs, at (202) 797-0900, if NASAA may be of any additional assistance.

Sincerely,



Joseph P. Borg
NASAA President & Alabama Securities Director

CC: The Honorable Susan Collins
CC: The Honorable Mark Warner
CC: The Honorable John McCain

April 3, 2018

The Honorable Paul Ryan
United States House of Representatives
U.S. Capitol Building, H-232
Washington, DC 20515

The Honorable Mitch McConnell
United States Senate
U.S. Capitol Building, S-226
Washington, DC 20510

The Honorable Nancy Pelosi
United States House of Representatives
U.S. Capitol Building, H-204
Washington, DC 20515

The Honorable Chuck Schumer
United States Senate
U.S. Capitol Building, S-221
Washington, DC 20510

President
Beth Pearce, VT

Executive Committee
David Damschen, UT
Duane Davidson, WA
Manju Ganeriwala, VA
Deborah Goldberg, MA
Curtis Loftis, SC
Seth Magaziner, RI
Ken Miller, OK
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Kentucky Office:
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Lexington, KY 40507
P (859) 721-2190
F (859) 721-2194

www.NAST.org

Dear Speaker Ryan, Leader Pelosi, Majority Leader McConnell, and Leader Schumer:

On behalf of the National Association of State Treasurers (NAST), we write to express our organization's support of S. 536, the Cybersecurity Disclosure Act of 2017. We have enclosed NAST's resolution that was recently approved on this topic. This bipartisan legislation, by directing the U.S. Securities and Exchange Commission (SEC) to require registered issuers to make important disclosures related to cybersecurity, represents concrete action to protect consumers from data breaches and improve response to cyber threats.

One of the primary roles of state treasurers is the prudent management of public funds, including the overseeing of long-term institutional investments in many states. This legislation will provide critical information to shareholders in assessing their investment risks. We applaud Senators Reed, Collins, Warner, and McCain for supporting this important legislation that will result in a heightened focus on cybersecurity.

NAST is proud to join a number of other organizations supporting this letter including the Council of Institutional Investors, the Bipartisan Policy Center, and the California Public Employees' Retirement System.

We thank you for your consideration of our perspective and look forward to answering any questions you may have.

Sincerely,

Beth Pearce
Vermont State Treasurer
NAST President

David Damschen
Utah State Treasurer
NAST Senior Vice President

RESOLUTION

as approved by the Pension & Trust Investment Committee on February 11, 2018

Expressing NAST Support for Legislation, such as, S.536, the "Cybersecurity Disclosure Act of 2017", Related to Corporate Cybersecurity

WHEREAS, One of the primary roles of state treasurers is the prudent management of public funds, including, in most states, overseeing long-term institutional investments; and

WHEREAS, As institutional investors with a long-term investment horizon, shareholders have a duty to be concerned with risks to their portfolios, and therefore should have access to information that helps them assess investment risks; and

WHEREAS, A growing corporate governance concern among publicly traded companies are cybersecurity breaches. In 2016 alone, there were 60 disclosed breaches at publicly traded companies affecting thousands of clients and consumers. As of the end of June 2017 there had already been 36 disclosed breaches this year. According to an IBM 2017 Cost of Data Breach Study, the average data breach can cost as much as $3.6 million and disclose thousands of pages of sensitive corporate records; and

WHEREAS, Research by the Harvard Business Review indicates that companies are failing to institute practices that adequately address the long-term risk exposure to cyber threats, largely due to a lack of expertise with cybersecurity issues; and

WHEREAS, S.536, "Cybersecurity Disclosure Act of 2017" was introduced in the U.S. Senate in March 2017 by bi-partisan sponsors, and, if passed into law, would direct the U.S. Securities and Exchange Commission (SEC) to require registered issuers to disclose, in regular SEC reporting, whether any corporate board member has expertise or experience in cybersecurity. If no member has such experience, companies would be required to disclose what other cybersecurity steps were taken by the company when considering, identifying and evaluating possible board candidates; and

WHEREAS, Since its introduction in the Senate, multiple organizations have expressed support for S.536, including the Council of Institutional Investors, the Bipartisan Policy Center, and the California Public Employees' Retirement System; and

WHEREAS, By enacting legislation that would direct the SEC to improve transparency around cybersecurity expertise on corporate governing bodies, institutional investors will have access to information that will allow them to make informed voting and investment decisions that reflect long-term risks to shareholder value.

NOW, THEREFORE BE IT RESOLVED, that the National Association of State Treasurers supports the "Cybersecurity Disclosure Act of 2017" (S.536) (or substantially similar bills in subsequent Congresses) that will help provide institutional investors access to information about corporate cybersecurity competencies and risks.

Approved this 15 Day of March 2018, by the
National Association of State Treasurers

Hon. Elizabeth Pearce
NAST President &
Vermont State Treasurer

Harvard University
SCHOOL OF LAW
Cambridge, MA 02138

Stephen Davis, Ph.D.
Associate Director and Senior Fellow
Harvard Law School Programs on
Corporate Governance and Institutional Investors
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stdavis@law.harvard.edu

U.S. Senator Jack Reed
728 Hart Senate Office Building
Washington, DC 20510
202-224-4642

June 27 2017

Dear Senator Reed:

I write in support of S.536, the Cybersecurity Disclosure bill, which seeks to address a dangerous national threat by applying prudent, disclosure-based measures common to US corporate governance practice.

US jobs, innovation, and prosperity hinges today on the ability of corporations to protect against cyber intrusion by hackers bent on theft of critical information. Indeed, cybercrime now poses a menace that goes way above a company's technical defenses--it demands sustained attention at the top. That's why S. 536, sponsored by your good self together with Senators Susan Collins and Mark Warner, is a vital solution that uses the tools of corporate governance to strengthen American business. Under the legislation, the US Securities and Exchange Commission would require a corporation to disclose to shareholders that the board includes someone with expertise in cybersecurity—or explain, if it does not, how the board ensures highest-level attention to the matter. Since every company is different, the proposed statute assumes one size does not fit all; language in the bill would give boards flexibility to select the right oversight of cyber defenses for each. But S. 536 would assure shareholders, and Americans in general, that corporations, from the top down, meet their fiduciary duties by having eyes on cybersecurity.

The disclosure technique envisaged in the bill is one that is consistent with long-standing US law and regulation in respect of corporate governance. It avoids imposing any operational mandate, opting instead for an approach enabling corporate directors to act in ways they consider best for the companies they oversee.

Feel free to let me know if I can be of any help as this important measure makes its way forward.

Kind regards,

Stephen Davis

NEWS ARTICLE SUBMITTED BY SENATOR TILLIS

OPINION

Proxy Advisers' Influence Is Harming Retail Investors

BY **CHRISTOPHER A. IACOVELLA**
June 28, 2018

Later today, the U.S. Senate Committee on Banking, Housing and Urban Affairs will hold a hearing to discuss legislation related to corporate governance. The discussion is particularly timely given the unchecked influence that proxy advisory firms have in today's marketplace.

The dynamic between investment advisers and proxy advisory firms is a complicated one. Proxy firms are supposed to provide unbiased, expert advice to these investors on how they should vote on shareholder resolutions that would govern the companies they hold stock in. As the number of proposals has grown in recent years, so too has the influence of two dominant advisory firms, Glass Lewis and ISS. Research shows that investment advisers follow proxy advisory firms' recommendations 80 percent of the time.

But here's the rub: All too often, proxy firms have undisclosed conflicts of interest that cloud their ability to provide impartial advice and adequately represent the interests of long-term retail investors. One particularly blatant example lies in the fact that ISS provides consulting services to institutional investors, while simultaneously rating the voting performance of those companies on politically motivated proposals. Unfortunately, it has become industry practice for fund managers and institutions to rely on the conflicted recommendations of proxy advisors, rather than

conducting the necessary due diligence that their fiduciary duty requires. This results in retail investors being underrepresented, misrepresented, or selectively represented in favor politically motived shareholders.

Even Glass Lewis has acknowledged the problem with this state of affairs:

> *"We believe the provision of consulting services creates a problematic conflict of interest that goes against the very governance principles that proxy advisors like ourselves advocate ... 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."*

Enough said.

Thankfully a provision of H.R. 4105, the Corporate Governance Reform and Transparency Act of 2017, addresses this problem head-on, by directing the SEC to withdraw the 2004 no-action letters. The legislation has already passed the House of Representatives and will be featured at the Banking Committee's hearing this week. While legislation would clarify government policy on proxy advisors, the SEC can and should act on its own.

The commission should move to immediately withdraw the 2004 no-action letters referenced above. By acting quickly to ensure that proxy advisory firms are working in the best interests of small businesses and retail investors, this will serve to enhance the public's trust in America's capital markets. It is past time that a solution to the problems proxy firms present is not just talked about, but acted upon.

The American Securities Association prioritizes safe guarding the interests of retail investors by promoting public trust and confidence in the US capital markets.