CONSEQUENCES OF PROXY ADVISORS ON SENIOR INVESTMENTS

60 PLUS
AMERICAN ASSOCIATION OF SENIOR CITIZENS

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ABOUT 60 Plus

Founded in 1992 by Jim Martin, we are a nonpartisan seniors advocacy group with a free enterprise, less government, and fewer taxes view towards issues important to seniors.

Our top priorities are to end the federal estate tax and to save Social Security for future generations.

We are often viewed as the conservative alternative to the American Association of Retired Persons (AARP).

CONSEQUENCES OF PROXY ADVISORS ON SENIOR INVESTMENTS

The Securities and Exchange Commission (SEC) is hosting a roundtable on a critical issue facing American investors – the proxy process and the role proxy advisors play in it. The growing influence of proxy advisory firms is of significant concern for 60 Plus and our 7 million supporters as evidence shows the harm their practices can have on the investments of our members, senior citizens, and others saving for retirement mounts.

WHO ARE ISS AND GLASS LEWIS?

The proxy advisor industry is essentially a duopoly, with Institutional Shareholder Services (ISS) and Glass Lewis exerting control over approximately 97 percent of the market.[1] Both work by providing recommendations to shareholders on whether to vote "for" or "against" proposals based on certain criteria, and both advisors provide low-cost proxy advice to thousands of investors on a huge number of company meetings annually. ISS boasts it covers 42,000 meetings in 115 countries per year,[2] with each meeting containing multiple proposals while, yearly, Glass Lewis produces analysis on 20,000 companies on behalf of more than 1,300 institutional clients.[3] ISS's research team "consists of more than 370 data collection experts and research analysts"[4] while Glass Lewis employs over 180 staff dedicated to research.[5] While these figures are used by both advisors to promote the breadth of their services, the numbers raise clear concerns about the capacity of each advisor to effectively carry out its mission of diligence over the inherent complexity in assessing individual company practices.

In theory, proxy advisors are supposed to act as a canary in the mine for poor governance practices. ISS positions itself as enabling "the financial community to manage governance risk for the benefit of shareholders"[6] while Glass Lewis' self-anointed role is "helping institutional investors understand and connect with the companies they invest in."[7] However, in practice, evaluating thousands of proxy votes annually has engendered a 'one-size-fits-all' approach to corporate governance while also resulting in erroneous recommendations being issued to institutional investors, both of which have the potential to harm returns for all investors, particularly seniors.

1. The Case for Proxy Advisor Reform, National Investor Relations Institute. (Nov. 8, 2017), https://www.niri.org/NIRI/media/NIRI-Resources/NIRI-Case-Proxy-Advisor-Reform.pdf
2. https://www.issgovernance.com/about/about-iss/
3. http://www.glasslewis.com/company-overview/
4. https://www.issgovernance.com/file/duediligence/best-practices-principles-iss-compliance-statement-april-2017-update.pdf
5. http://www.glasslewis.com/company-overview/
6. https://www.issgovernance.com/about/about-iss/
7. http://www.glasslewis.com/

This rigid 'box-ticking' approach to corporate governance has come under fire from regulators in other jurisdictions, most recently the United Kingdom.[8] Moreover, one recent report from Frank Placenti, lead of the U.S. governance practice at Squire Patton Boggs, assessed nearly 140 supplemental proxy filings, which serve as a company's main recourse to respond to a faulty recommendation.[9] Based on a review of these filings from 94 companies from 2016 through Sept. 30, 2018, Placenti's research found 139 significant problems in recommendations, ranging from analytical and factual errors to serious disputes.

Unfortunately, this scenario doesn't stop institutions and managers from relying on these recommendations when voting their proxies on behalf of investors. In fact, all too often, fund managers vote entirely on the basis of the proxy advisors' recommendations, in a process called 'robo-voting' where they automatically vote with ISS or Glass Lewis recommendations. The favorable regulatory framework under which the SEC has allowed proxy advisors to operate[10] has not only led to a situation where investors blindly follow poor recommendations; it has the ancillary impact of disincentivizing institutional shareholders from carrying out their own independent research.

In addition, the lack of transparency with which these firms operate continues to garner significant scrutiny. For instance, ISS has come under the microscope for setting its voting policy through a closed-door process and providing consulting services to the same public companies it analyzes for voting recommendations.[11] According to the American Council for Capital Formation:

> "According to [ISS], its policies are formulated by collecting feedback from a variety of market participants through multiple channels, including 'an annual Policy Survey of institutional investors and corporate issuers, roundtables with industry groups, and ongoing feedback during proxy season.' The ISS Policy Board then uses this input to draft its policy updates on emerging governance issues. This practice lacks transparency – ISS does not disclose which institutions, pension funds, NGOs, or corporations comment in the survey, nor does it release the substance of those comments. So while investors are using the recommendations derived from the policy, they have no visibility into who is influencing it (and in what direction)."

Proxy advisory firms seem to have escaped scrutiny and criticism despite providing, without disclosing their processes or requirements, misleading analysis or inaccurate recommendations[12] that have negatively impacted companies with consequences for their shareholders.

The breadth of corporations analyzed by ISS and Glass Lewis, coupled with the number of institutions that 'robo-vote' without conducting their own review means that inadequate methodologies and initial errors in

8. Letter from Sir Winfried Bischoff Chairman, Chairman of the UK Financial Reporting Council, to proxy advisors. (Available at https://www.frc.org.uk/getattachment/179a7bd1-9fef-4f6c-94b0-3ecb882c2d05/Open-letter-from-Sir-Win-to-proxy-advisors-about-2018-Code-July-2018.pdf)
9. Are Proxy Advisors Really a Problem? Recent Data Analysis and Survey Results Demonstrate the Validity of Common Concerns. (Oct. 2018), http://accfcorpgov.org/wp-content/uploads/2018/10/ACCF_ProxyProblemReport_FINAL.pdf
10. Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms Staff Legal Bulletin No. 20 (IM/CF)
11. The Conflicted Role of Proxy Advisors, American Council for Capital Formation. (May 2018), http://accfcorpgov.org/wp-content/uploads/2018/05/ACCF_The-Conflicted-Role-of-Proxy-Advisors.pdf
12. Supra. note 9.

recommendations can multiply and compound in a way that impacts investors. As detailed by Paul Rose of Ohio State University, poor quality recommendations from proxy advisors "have serious consequences not just for the investors who purchase deficient ratings and advice, but also for the economy as a whole. Capital is allocated and crucial corporate governance decisions are often driven on the basis of these ratings and advice."[13]

WHEN HAVE PROXY ADVISORS GONE WRONG?

A review of ISS and Glass Lewis voting recommendations on proposals at several companies shows numerous failures to identify emerging corporate governance issues, which resulted in consequential destruction of shareholder value. If these advisors were doing their job and meeting their goals of managing governance risk, they should have alerted investors to what was coming, and protected the value of investments for all investors. Instead, their cursory analysis and rigid recommendations have demonstrated a lack of attentiveness and resulted in poor recommendations which have destroyed value and impacted the value of holdings for all investors – both institutional and individual.

In order to demonstrate proxy advisors' inability to analyze governance risk for shareholders, we present case studies to depict examples of how governance failings have destroyed shareholder value. We analyzed the recommendations of proxy advisors regarding the election of board members at five companies at the four annual general meetings (AGMs), prior to the governance issues becoming public. While the following table presents just a small number of examples, the rigidity of proxy advisors' approach, and their failure to adequately resource their business models, indicates that such failings are likely widespread in their governance evaluations.

TABLE 1. EXAMPLES OF PROXY ADVISORS' INABILITY TO ALERT INVESTORS TO GOVERNANCE RISK

Company	Background	Impact	ISS Approach[14]	Glass Lewis Approach[15]
Equifax	In September 2017, a data breach that had taken place at Equifax was made public. Several failures of governance, both before and after the breach, contributed to a loss in shareholder value.	In the space of a week, the company's share price fell approximately 35%.	From 2014 to 2017, ISS recommended shareholders support the re-election of each director at all four AGMs. At the 2018 AGM, when the breach had become publicized and share price had fallen, ISS recommended against the re-election of five directors.	From 2014 to 2017, Glass Lewis recommended withholding support from an individual director at the 2014 AGM. Save for that recommendation, Glass Lewis issued favorable recommendations for every director. At the 2018 AGM, subsequent to the loss in shareholder value, Glass Lewis recommended against the re-election of three directors.

13. Rose, Paul, On the Role and Regulation of Proxy Advisors (January 31, 2011). Michigan Law Review First Impressions, Vol. 109, p. 62, 2010; Ohio-State Public Law Working Paper No. 142. Available at SSRN: https://ssrn.com/abstract=1752165
14. Proxy Insight Data
15. Proxy Insight Data

Company	Background	Impact	ISS Approach[14]	Glass Lewis Approach[15]
Wells Fargo	In 2016, regulators discovered that, over a seven-year period, Wells Fargo had opened more than 2 million fake accounts.	When the opening of fake accounts was made public, the company's share price fell 11%.	From 2013 to 2016, ISS recommended shareholders support the re-election of each director at all four AGMs. At the 2017 AGM, following the announcement by regulators of the fake account scandal, ISS recommended against 12 of the 15 directors on the board.	At the 2013 and 2014 AGMs, Glass Lewis recommended shareholders oppose two directors; however, at the 2015 AGM, there was only one negative recommendation; and by the 2016 AGM (four months prior to the regulator's announcement), Glass Lewis had issued supportive recommendations for all directors. At the 2017 AGM, following the announcement by regulators of the fake account scandal, Glass Lewis recommended against six of the 15 directors on the board.
Valeant (now Bausch Health Companies)	Bausch Health Companies has been questioned and criticized consistently since 2015, when restatements, compliance issues and a weak board were initially exposed.	Since the middle of 2015, Bausch Health Companies' share price has fallen by approximately 90%, costing shareholders around $75 billion.	From 2012 to 2015, ISS recommended shareholders support the re-election of each director at all four General Meetings.	From 2012 to 2015, Glass Lewis recommended shareholders withhold support on a single director, with all other recommendations in favor.
Tesco	In September 2014, UK regulators commenced accounting fraud investigations into Tesco.	In the immediate aftermath, Tesco lost £2 billion in market cap; two senior executives at the company were forced to resign; and three senior executives have since stood trial.	From 2011 to 2014, ISS recommended shareholders support the re-election of each director at all four General Meetings.	From 2011 to 2014, Glass Lewis recommended shareholders support the re-election of each director at all four General Meetings.

14. Proxy Insight Data
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Company	Background	Impact	ISS Approach[14]	Glass Lewis Approach[15]
Carillion	In January 2018, Carillion – a construction services company – went into liquidation.	The entire value of the company – approximately £2 billion was lost.	In each of the four AGMs leading up to the collapse of the company, ISS recommended that shareholders support the re-election of all directors.	In each of the four AGMs leading up to the collapse of the company, Glass Lewis recommended that shareholders support the re-election of all directors.

The corporate governance failings at Equifax[16], Wells Fargo[17], Tesco[18] and Carillion[19] have been well documented since they occurred. Ineffective corporate governance, the absence of strong oversight, and weak corporate cultures were among the primary reasons cited for the significant loss of value at each company, despite proxy advisor recommendations failing to alert clients to those issues. ISS and Glass Lewis have time and again failed to recognize governance risk – risk that has eventually culminated in scandal, financial loss, and destruction of shareholder value. In the situations outlined, ISS did not issue a single negative or even a non-favorable recommendation against any board member.

Looking back even further, in the years leading up to the financial collapse of 2008, the two proxy advisors recommended shareholders support the re-election of all board members at a number of financial institutions, including at the 2008 AGMs of Lehmann Brothers and Royal Bank of Scotland – despite the former collapsing six months later and the latter being bailed out by the UK government within a year of the AGM.

Were these issues really unforeseeable? Or are ISS and Glass Lewis simply trying to do too much? <u>And what is it costing those pensioners and retail investors whose shares are voted by large institutions?</u>

Corporate governance is central to protecting and enhancing the value of individual's investments. However, corporate governance is about more than a simple 'box-ticking' approach based on the general and vague voting policies of proxy advisors. It varies at each company and encompasses a range of other factors, including strong and experienced boards, clear flows of information, and corporate culture. Based on the examples outlined, it is apparent that proxy advisors' approaches do not take a holistic view of corporate governance, which can lead to recommendations based on erroneous data or which that fail to address clear governance concerns ahead of time. Following regulator and media scrutiny of governance failings, there is evidence that proxy advisors begin to issue recommendations against management's proposals; however, by that stage, it is too late, and the value destruction has taken place. While this may not be of concern to proxy advisors, who have no financial stake in the share price performance of companies that they analyze, the holdings of institutional and individual investors are subject to significant damage.

14. Proxy Insight Data
15. Proxy Insight Data
16. Reuters, Equifax CEO departs, forgoes bonus after massive data breach (available at https://www.reuters.com/article/us-equifax-cyber-ceo/equifax-ceo-departs-forgoes-bonus-after-massive-data-breach-idUSKCN1C11Q9);
17. The Street, Wells Fargo Directors Exiting After Federal Reserve Slams Governance (available at: https://www.thestreet.com/story/14508322/1/wells-fargo-directors-retire-after-federal-reserve-slams-governance.html;
18. Financial Times, Tesco's board is seriously lacking in retail experience (available at: https://www.ft.com/content/2c0f73a2-4245-11e4-9818-00144feabdc0)
19. The Telegraph, Carillion chiefs face investor wrath after evidence emerges of finance 'cover up' (available at: https://www.telegraph.co.uk/business/2018/03/04/carillion-chiefs-face-investor-wrath-gross-failings-finances/)

If proxy advisors cannot provide early warning signs at companies where the most serious governance failings occur, what role do they play for the investment community and retirees? Increasingly, backed up by examples of 'robo-voting', whereby institutional investors blindly follow the recommendations of proxy advisors, it appears that shareholders are using proxy advisors to satisfy a compliance function rather than as a tool to assess governance and protect the value of investments for their clients. All investors, including seniors, need the investment community to conduct robust assessment of the governance practices of all investee companies.

If shareholders themselves did not blindly rely on the analysis and recommendations of proxy advisors, they might be in a better position to critically evaluate the governance practices of the companies in which they invest and protect the retirement funds of investors. Instead, many rely on the surface-level recommendations provided by proxy advisors which, as outlined, can lead to significant destruction in shareholder value.

POLITICAL, SOCIAL, AND ENVIRONMENTAL SHAREHOLDER RESOLUTIONS

One area where proxy advisors have taken a clear stand is in the area of political, social and environmental shareholder resolutions. In recent years, the public companies in which retirees and other average Americans invest their savings have faced numerous[20] shareholder proposals that seek – and, in many cases, effectively require – changes on issues ranging from new disclosures to changes in corporate governance policies. The cumulative growth in proxy votes, particularly on issues that might have little to do with the company's bottom line, has led investment fund and pension managers to rely on proxy advisory firms for recommendations on how to vote.

As explored in previous research, for instance, despite a lack of regulatory requirement, ISS and Glass Lewis have both altered voting policies on political and environmental issues in favor of more prescriptive, disclosure-based considerations.[21] According to its own guidance, ISS, for instance, will "generally vote for resolutions requesting that a company disclose information on the financial, physical, or regulatory risks it faces related to climate change on its operations and investments or on how the company identifies, measures, and manages such risks."[22] Moreover, so far in 2018, ISS has supported approximately 92.7 percent[23] of shareholder resolutions requesting the creation of political or lobbying reports, without any evidence that these shareholder proposals are linked to the creation or protection of shareholder value. By extension, shareholders that automatically vote in alignment with these proxy advisors are being unduly influenced by advisors' policy, unrelated to value enhancement but of their own opinion and closed-door decision making. Shareholders and their advisers should be required to vote in a way that is demonstrably tied to shareholder returns to protect the future retirement funds of individual investors; not to supplant the role of elected officials in formulating public policy.

A growing segment of the investor and business communities, along with academics[24] and elected leaders have raised significant concerns about the advisory firms' lack of transparency and their prioritization of social causes that aren't directly related to boosting shareholder value. Much of the criticism[25] has rightly centered on the advisory firms providing guidance without any material detail on the internal methodologies that informed it, or any justification for the final recommendations issued.

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20. Political, Social, and Environmental Shareholder Resolutions: Do They Create or Destroy Shareholder Value? Joseph P. Kalt, PhD and L. Adel Turki, PhD With Kenneth W. Grant, Todd D. Kendall, PhD and David Molin, PhD. Compass Lexecon. (May 2018), https://mainstreetinvestors.org/wp-content/uploads/2018/06/ESG-Paper-FINAL.pdf
21. The Conflicted Role of Proxy Advisors, American Council for Capital Formation. (May 2018), http://accfcorpgov.org/wp-content/uploads/2018/05/ACCF_The-Conflicted-Role-of-Proxy-Advisors.pdf
22. New Considerations and Action Items for the 2018 Reporting Season, White & Case. (Jan. 18, 2018), https://www.whitecase.com/publications/alert/reminders-us-public-companies-2018-annual-reporting-and-proxy-season
23. Proxy Insight Data
24. Research from Tao Li, Outsourcing Corporate Governance: Conflicts of Interest Within the Proxy Advisory Industry (July 2018) found that ISS is more likely to support shareholder resolutions proposed by labor unions
25. James K. Glassman & J.W. Verret, How to Fix Our Broken Proxy Advisory System, Mercatus Center Research. (2013), https://www.mercatus.org/publication/how-fix-our-broken-proxy-advisory-system

WHAT DOES THIS MEAN FOR SENIORS?

As explored here, proxy advisory firms are either unable to alert shareholders to impending governance risk, or are increasingly disregarding the interests of retirees by recommending in favor of shareholder proposals that have no demonstrable link to increasing shareholder returns. Both approaches have the potential to negatively impact seniors' retirement security needs by reducing shareholder returns. The role of proxy advisors and consequences of blindly following their advice present critical concerns for seniors, who are active members of the investment community as shareholders in private companies, mutual and exchange traded funds, pension funds, and other institutional investments.

When poor governance – which, as outlined above, may occur contrary to ISS and Glass Lewis' recommendations – destroys shareholder value, everyone is affected. But as many of 60Plus's members are keenly aware, the shockwaves are felt most acutely by those on fixed incomes. The negative repercussions of erroneous recommendations of proxy advisors apply to seniors in the form of damage and lost value not only in institutional investments, but also in potential loss of value in pension funds.

In part, this is because Glass Lewis and ISS have been found to be considerably susceptible to politically driven activist influence, most frequently having to do with environmental and social issues in a way that essentially eliminates these firms' theoretically neutral approach to value creation. However, even when faced with issues they should be fully capable of assessing, such as the loss of shareholder value in light of weak governance, proxy advisors have also been found wanting.

These issues especially apply to shareholders who focus on the value of their equity interests. When those investments are externally managed, it is natural to assume that they will be managed from a neutral, value creation position. However, when those investments are managed by those who align without question to the recommendations put forth by ISS and Glass Lewis, they are being managed in a way that weighs conformity to certain environmental, social, and political reporting standards above value enhancement, while failing to provide governance evaluations that protect shareholder returns and the value of investments.

WHAT NOW?

As long as ISS and Glass Lewis continue to eschew their responsibility of helping to manage governance risk and issue recommendations that are not linked to shareholder value creation, the investments of seniors and other investors remain vulnerable. It is imperative that value creation and protection take precedence. ISS and Glass Lewis need to focus on what they've set out to do – foreseeing governance maladies like those that occurred at Equifax or Wells Fargo could have preserved significant value for individual shareholders.

We need clear, common-sense regulations that establish meaningful transparency standards on proxy advisory firms. The new standards should enable more practical, balanced, and useful information to be disclosed. This will allow all investors to see where proxy advisor' recommendations come from and provide insight on any existing and future failures by Glass Lewis and ISS to make recommendations that protect shareholder value. Only then will investors be able to make more intelligent and well-informed money management decisions. Such rules would benefit all investors and further enable trust in capital markets and the underpinning financial system among all seniors, including the 7 million seniors that 60 Plus' American Association of Senior Citizens count among our supporters.

We applaud the SEC for exploring this complex issue at its roundtable and look forward to the actions the Commission will take in favor of individual investors nationwide.

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