

Congressional Hearing Summary

COMMITTEE: Senate Banking Committee

SUBJECT: Corporate Governance

DATE: June 28, 2018

Members Present

Chairman Crapo (R-ID)
Senator Toomey (R-PA)
Senator Cotton (R-AR)
Senator Scott (R-SC)
Senator Tillis (R-NC)

Ranking Member Brown (D-OH)
Senator Reed (D-RI)
Senator Jones (D-AL)
Senator Cortez-Masto (D-NV)
Senator Van Hollen (D-MD)
Senator Heitkamp (D-ND)

Witness Panel

Mr. Damon Silvers, *Policy Director and Special Counsel, American Federation of Labor and Congress of Industrial Organizations*

Professor John C. Coates, Jr., *Professor of Law and Economics, Harvard Law School*

Ms. Darla C. Stuckey, *President and CEO, Society for Corporate Governance*

Mr. Thomas Quaadman, *Executive Vice President, U.S. Chamber Center of Capital Markets Competitiveness*

Overview

On June 13, the Senate Committee on Banking, Housing, and Urban Affairs conducted a hearing on corporate governance. The committee heard from witnesses that represented a range of businesses interests regarding recent legislation proposed by the committee.

The hearing examined the issues that proxy advisory firms pose to corporate governance—specifically, the lack of transparency and conflicts of interest. The witnesses were also questioned on increasing disclosure of short positions and creating a FINRA relief fund for cheated investors.

The witnesses also discussed legislation on disclosing decisions relating to cybersecurity on their proxies and the gap of time a firm learns of non-public information. The witnesses were also questioned on increasing capital for rural job creators. The witnesses mostly disagreed on the scope of regulation necessary for various aspects of corporate governance.

Opening Remarks

Chairman Crapo

- Sen. Crapo stated today's proposed legislation would expand the definition of an "accredited investor," shorten the schedule of the 13-D filing window, increase disclosure of short positions, and require FINRA to create a relief fund to cover unpaid arbitration awards to investors.
- Sen. Crapo also stated the legislation would draw attention to cybersecurity; address concerns on the gap of time a firm learns of material non-public information and its disclosure; highlight challenges to rural areas and small businesses, as well as address proxy advisory firms.

Ranking Member Brown

- Sen. Brown highlighted the record number of stock buybacks that are occurring and the SEC's findings showing that investors were more likely to sell their stock directly after a buyback announcement than at other times—this shows a short-term not a long-term focus.
- Sen. Brown emphasized that shareholders of all sizes deserve to have every tool available to make sure executives are thinking beyond their self-interest.
- Sen. Brown brought up his concern with the [Corporate Governance Reform and Transparency Act](#) (H.R. 4015), as it would create more structural obstacles for shareholders to hold management accountable. Brown emphasized we should be pushing more shareholder engagement and oversight and more transparency.
- Sen. Brown expressed his support of Sen. Reed's bill on cybersecurity and Sen. Van Hollen's proposal on closing loopholes for insider trading.

Thomas Quadman

- Quadman emphasized the crisis of entrepreneurship the nation is in with the lack of business creation and decline of public companies.
- Quadman supports H.R. 4015, because of his concern that two proxy firms control over 90% of the business. They operate with no transparency, fail to fix errors, and operate with conflicts of interests.
- Quadman expressed his concern that *the [Cybersecurity Disclosure Act](#)* (S. 536) would require a cyber expert to be on the board. There is a small number of cyber experts and furthermore it is unknown if they could perform other fiduciary roles.
- Quadman also expressed concerns with the *[Brokaw Act](#)* (S.1744). Short selling is a necessary market function for liquidity but the chamber has acknowledged there are abuses. Quadman agreed he understands the desire to modernize 13D filings but doing that could bleed into 13F and G filings which could adversely affect 401k's. Therefore, these issues could be better addressed by an SEC study rather than mandated requirements.
- Quadman agreed with the intent of the *8K Trading Act of 2018* (on combating insider trading). But he believes there is a need to clarify the window between when an event happens and when it's deemed to be material.
- Quadman strongly supports *the [Fair Investment Opportunities for Professional Experts Act](#)* (S. 2756), and the need to modernize those rules.
- In terms of the *[Compensation for Cheated Investors Act](#)* (S. 2499), Quadman agrees that those who receive an arbitration award should be able to collect on that. However, there should be time for FINRA transparency rules to take hold, and they would support the idea of SIPC as an alternative payment method.
- Quadman also supports *[Expanding Access to Capital for Rural Job Creators](#)* (S. 2953).

Darla Stuckey

- Stuckey emphasized the concern of the decline of public company ownership, and stated that *Corporate Governance Reform and Transparency Act* (H.R. 4015) and *the Brokaw Act* (S.1744) would improve the environment for public ownership.
- Stuckey argued that H.R. 4015 would provide badly needed oversight over two companies that control 20-30% of shareholder votes—and who also own the software for voting. Also many companies are unable to review proxy reports in advance, resulting in investors voting on the basis of a recommendation relying on inaccurate information.

- Stuckey also supports S. 1744, which would seek a level playing field on disclosure rules.
- Stuckey opposes *the Cybersecurity Disclosure Act* (S. 536) and the *8K Trading Gap* as they could discourage companies from going public.

John C. Coates

- Coates is in support of *the Cybersecurity Disclosure Act* (S. 536), because cybersecurity is one of the greatest threats to all companies. This law is a gentle disclosure obligation that does not mandate having any experts on the board. While gentle, it will have an impact because all board members read proxy statements (because the statements are about the board members). So, drawing attention to cyber-experts and having to explain why you chose not to have one is important.
- Coates also stated his support of the *8K Trading Act of 2018* and *Expanding Access to Capital for Rural Job Creators Act*.
- Coates supports *the Brokaw Act*, but there is a tradeoff in short sales and adding disclosure obligations. So, Coates suggests adding a sunset provision to force the SEC to study the bills effects on shorts, and the bill would die unless the SEC can determine that it is working.
- Coates also stated his opposition to *the Corporate Governance Reform and Transparency Act*.

Damon Silvers

- Silvers opposes *the Corporate Governance Reform and Transparency Act*, as it gives corporations, CEOs, and boards the ability to control the people that are supposed to hold them accountable. It also creates a set of regulatory obligations that no other investment advisors have to deal with. Silvers is not opposed to a bill that would require proxy advisory firms to register, but they should not be subject to a set of punitive regulations.
- Silvers opposes the *Fair Investment Opportunities for Professional Experts Act*. Silvers stated that the \$1 million dollar threshold was set in 1982 and has not been updated. While Silvers agree with the indexing provision, the current baseline is too low to act as a starting point.
- Silvers supports *the Brokaw Act*. Silver believes that by shortening the window in which an investor acquires a 5% stake to when they have to file and requiring short selling's to be disclosed would prevent manipulation.
- Silvers also supports the *Compensation for Cheated Investors Act*, as it would ensure damages are actually paid. This would ultimately increase accountability and public trust in the financial system.

- Silvers also supports the *Cybersecurity Disclosure Act*, *Expanding Access to Capital for Rural Job Creators Act*, and the *8K Trading Gap*.

Highlights from Q&A

H.R. 4015

- Sen. Cortez-Masto stated her concern on *the Corporate Governance Reform and Transparency Act* but supports *the Expanding Access to Capital for Rural Job Creators Act* and *the Cybersecurity Disclosure Act*.
- Sen. Brown questioned Coates on the procedural barriers that the *Corporate Governance Reform and Transparency Act* would create for shareholders and proxy advisors. Coates replied the bill expects the government to fix the proxy advisor problems by creating a bureaucracy at the SEC, which would incur significant costs that would be passed along in terms of regulation. Coates also noted that under existing law (state and SEC) proxy advisors can already be sued by clients if they are committing fraud, so we should addressing the problem with the existing laws rather than add more burdens.
- Sen. Brown questioned how the changes in the *Corporate Governance Reform and Transparency Act*, would impact a large shareholder—how it would affect a public employees retirement system and its ability to hold management accountable. Silver explained that proxy firms provide expert advice to pension funds to enable them to fulfill their corporate governance duties. In addition to their expertise, advisors have to be loyal to the pension fund—loyalty and expertise are both part of fiduciary duty. This bill compromises the loyalty issue by enmeshing the advisor in the process of interacting with the people that the proxy access is supposed to hold accountable.

Proxy Advisory Firms

- Sen. Tillis asked if there was any concept of competition in the proxy advisory market. Quaadman replied ISS and Glass and Lewis own most of it. Quaadman noted several smaller companies that tried to come in the market but failed.
- Sen. Heitkamp questioned whether there is any regulatory apparatus for proxy advisory firms. Silvers replied there is some regulation in the form of state law regimes and regime of fiduciary duty in pension funds.
- Heitkamp then questioned if it was true that proxy firms don't owe fiduciary duty to shareholders. Silvers replied that proxy firms (either by contract or state/pension law) owe some kind of duty to their client. Their clients owe fiduciary duty to shareholders. This bill dangerously suggests that investors somehow owe a duty to (or are required to consult with) corporations in the course of fulfilling fiduciary duties to their beneficial holders.
- Sen. Heitkamp questioned how we can make sure the correct information enters the market place. Coates noted that anyone giving advice in a public way—soliciting

proxies—is subject to anti-fraud rules enforced by the SEC. Quaadman noted the issue is when an advisory firm refuses to acknowledge or meet regarding issues with their reports—there is a shortfall in oversight of corporate governance.

- Sen. Toomey and Sen. Scott brought up the conflict of interest with ISS generating money from consulting services it provides to companies about proxy votes while at the same time advising institutional investors on how to vote on the same issues. Quaadman and Stuckey agreed it is a conflict of issue, and Quaadman actually has letters from ISS claiming a company could get a better rating if you use them for consulting as well.
- Sen. Crapo asked Stuckey her view on whether long-term retail investors are being represented on corporate governance matters and the role of proxy firms in that. Stuckey replied that long term retail investors are represented by investment managers who largely vote with ISS and Glass Lewis—so they are being swept up in the problems that come with proxy advisory firms.

No Action Letters

- Sen. Tillis questioned whether withdrawing the “No Action Letters” by the SEC (2004) would be a positive action. Stuckey and Quaadman confirmed this would be positive. Quaadman noted that these letters relieve proxy firms from disclosing conflicts of interest--which is part of the problem. Quaadman and Stuckey both agreed that oversight was supposed to be the role of the SEC and withdrawing these letters will allow for more efficient and appropriate SEC oversight.

Shareholder Activism

- Sen. Toomey brought up the issue of advisors, fund managers, or minority activist investors trying to use the corporate governance voting mechanism as a way to advance a social or cultural agenda that may be inconsistent with many investor's wishes and inconsistent in investor's best interests. Quaadman agreed that a proxy is not the appropriate place to litigate contentious social issues. Debating these issues will take boards away from their fiduciary duties that they should be focused on. Stuckey agreed there are other issues they should be focused on.

Cybersecurity

- Sen. Cotton questioned Coates on how the cyber threat is a unique threat to companies. Coates replied that cyber threats are different because they affect all companies—rather than a subset of companies. Cyber threats are a core risk that can lead to theft, fraud, and long standing corruption of data.
- Sen. Reed discussed the importance of cyber security and why his bill (*Cybersecurity Disclosure Act*) is so important. Reed emphasized the bill does not mandate anything but disclosure. Reed noted that disclosure in the proxy statement will make board members pay attention. Reed noted that in Stuckey's testimony she cited a group that opposes the bill, but they are actually one of its biggest

supporters. Coates agreed that cyber security is a big threat to every enterprise, and this bill is not a one size fits all solution. If the board doesn't believe they need a cyber expertise they simply have to address the reasoning behind their decision.

Short Selling

- Sen. Crapo questioned Quaadman on what impact disclosing short positions would have on the markets and the use of short selling as a risk management tool.
 - Quaadman replied that short selling is a useful tool for participants in the marketplace to hedge their position and is also important for liquidity purposes as well. Quaadman noted the challenge in disclosure would be that proprietary platforms would be exposed and a variety of different methods could harm investors. So, the SEC should take a closer look rather mandate regulations.
 - Coates noted that short selling would be in the 13D component which most institutional investors would not need to comply with because their positions are passive. Coates is concerned that in the active space, 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 fraud).

CFIUS

- Sen. Tillis brought up CFIUS and questioned whether proxy advisory firms are a pathway into influencing U.S. firms. Quaadman noted that one of the advisory firms is owned by two Canadian active pension firms, so if we are talking about a mix of information being given to investors and there are short falls, then that is a problem being controlled by foreign companies.

Other Legislation

- Sen. Brown stated the *Brokaw Act* requires stakeholders to report when they own significant stakes in a company, and questioned how the bill would increase transparency. Coates replied that shortening the amount of time before a filing has to be made will increase transparency. Silver noted that the point is to give investors (who are not 5% holders) knowledge about what's going on and what people are doing.
- Sen. Toomey brought up his bill *the Family Technical Corrections Act* that he hopes could be passed in whatever package this committee advances.
- Sen. Toomey raised his concern with the *Compensation for Cheated Investors Act*, and the fund that would be created by broker dealer's fines—which currently fund FINRA. This would result in increased fees that innocent brokers pay to fund FINRA. Toomey argued that he is concerned that socializing this cost means spreading it

among good firms to cover bad actors .Quaadman replied he shares the same concern and it could be appropriate to use SIPC instead of FINRA.

- Sen. Cotton brought up his legislation the *Small Business Audit Correction Act*, which is not one of today's bills but works to correct one of the unintended consequences of the Dodd Frank—the massive audit costs to small non-custodial broker dealers. Quaadman supports this legislation and emphasized that we shouldn't have public company regulations on private companies.
- Sen. Jones brought up his bill on *Expanding Access to Capital for Rural Job Creators Act*. Quaadman, Coates, and Silver all endorsed the bill and the need to expand business creation out of from the 20 counties it is currently confined to.
- In reference to her bill (*Fair Investment Opportunities for Professional Experts Act*), Sen. Cortez-Masto questioned why the SEC did not follow the AIC's suggestion to raise the threshold. Coates replied he speculates the decision was probably political because the decision would have financial affects. Coates is in favor of moving more towards experience and education rather than relying on net worth and income. Silver agreed the threshold is too low, picking union workers now that wouldn't consider themselves experts.
- Sen. Van Hollen brought up the *8K Trading Gap Bill*. Van Hollen addressed Quaadman' s request to clarify when an event happens and when it becomes material. However, Van Hollen stated his bill does not address that; but rather says once the company has made the determination that something is material that's when the four day clock starts ticking (for the disclosure) and there should be no trading during that period. Quaadman agrees with the intent on prohibiting trading during the 4-day period but noted there needs to be more clarity on material non-public information. Stuckey agreed with the intent, but noted it doesn't happen with her members because they are of the view that trading windows are closed as soon as company decides they have material non-public information.

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