

Before the United States Securities and Exchange Commission
Washington, DC

IN THE MATTER OF:

Release No. 34-87457, File No. S7-22-19

Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice

Comments of the United States Department of Justice

I. Introduction

The United States Securities and Exchange Commission (“SEC”) has requested public comment on its proposed rule, *Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice* (“Proposal”), as described in its Federal Register Notice.¹ The SEC published its Request for Comment in the Federal Register on December 4, 2019.

As the U.S. Government executive branch agency primarily responsible for promoting and protecting competition, the Department of Justice (“Department”), welcomes the opportunity to share its views on the Proposal. The Department is entrusted with enforcing the federal antitrust laws, which prohibit certain business practices and transactions that harm competition and consumers. It also engages in competition advocacy, promoting competition and consumer welfare via comments on rulemakings, legislation, and court filings, among other means.

Competition is the core organizing principle of America’s economy.² Vigorous competition gives consumers the benefits of lower prices, higher quality goods and services, greater access to goods and services, and innovation.³ Like all consumers, consumers of proxy advisory services benefit from competition. According to the SEC, the Proposal would “help ensure that investors who use proxy voting advice receive more accurate, transparent, and complete information on which to make their voting decisions.”⁴ Access to accurate, transparent, and complete information is critical to fostering competitive markets, as such information tends to arm consumers with important insights they can use to make trade-offs between rival services, and thus to place greater competitive pressures on those rivals.

¹ Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice, 84 Fed. Reg. 66518 (Dec. 4, 2019) (to be codified at 17 C.F.R. pt. 240) [hereinafter Proposal].

² See, e.g., *N.C. State Bd. of Dental Exam’rs v. FTC*, 574 U.S. 494, 495 (2015) (“Federal antitrust law is a central safeguard for the Nation’s free market structures.”); *Standard Oil Co. v. FTC*, 340 U.S. 231, 248 (1951) (“The heart of our national economic policy long has been faith in the value of competition.”).

³ See, e.g., *Nat’l Soc’y of Prof’l Eng’rs v. United States*, 435 U.S. 679, 695 (1978) (noting that the antitrust laws reflect “a legislative judgment that ultimately competition will produce not only lower prices, but also better goods and services. . . . The assumption that competition is the best method of allocating resources in a free market recognizes that all elements of a bargain—quality, service, safety, and durability—and not just the immediate cost, are favorably affected by the free opportunity to select among alternative offers.”).

⁴ Proposal, *supra* note 1.

II. Proxy Advisory Industry

The Department is aware of concerns that the proxy advisory industry operates as a duopoly, with two firms who face very little regulation accounting for an estimated 97% of such services.⁵ In addition, the Department is aware of concerns that economies of scale may serve as a barrier to new entry or to clients performing these functions in-house.⁶ Critics of the leading advisory firms claim they often provide biased and/or erroneous advice,⁷ disproportionately influence voting,⁸ and, in effect, allow institutional investors to outsource their fiduciary obligations.⁹ Critics also claim that proxy advisory firms' failure to disclose their "black box" methodologies for determining vote recommendations leads to inaccurate or one-size-fits-all advice.

The Department applauds the SEC's exploration of ways to address these concerns, including through the Proposal. Individual investors count on investment managers to vote in accordance with maximizing the value of their portfolios, yet is not clear the advice of the proxy advisory firms is always aligned with this goal today.

⁵ JAMES K. GLASSMAN & J. W. VERRET, HOW TO FIX OUR BROKEN PROXY SYSTEM, GEO. MASON MERCATUS CENTER RESEARCH 8 (Apr. 16, 2013),

https://www.mercatus.org/system/files/Glassman_ProxyAdvisorySystem_04152013.pdf.

⁶ Proposal, *supra* note 1, at 66555. (further noting that a 2007 GAO Report addresses several issues related to the proxy voting advice industry, including a lack of competition within the industry); *see also* U.S. GOV'T ACCOUNTABILITY OFF., GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 13-14 (2007) ("[P]roxy advisory firms must offer comprehensive coverage of corporate proxies and implement sophisticated technology to attract clients and compete. For instance, institutional investors often hold shares in thousands of different corporations and may not be interested in subscribing to proxy advisory firms that provide research and voting recommendations on a limited portion of these holdings. As a result, proxy advisory firms need to provide thorough coverage of institutional holdings, and unless they offer comprehensive services from the beginning of their operations, they may have difficulty attracting clients. . . . The initial investment required to develop and implement such technology can be a significant expense for firms."); *see also* Chester Spatt, *Proxy Advisory Firms, Governance, Failure, and Regulation*, HARV. L. SCH. F. CORP. GOV. AND FIN. REG. (June 25, 2019), <https://corpgov.law.harvard.edu/2019/06/25/proxy-advisory-firms-governance-failure-and-regulation/> (explaining economies of scale in the industry and the observed oligopoly market structure).

⁷ *See e.g.*, U.S. CHAMBER OF COMMERCE, 2019 PROXY SEASON SURVEY 5 (Nov. 21, 2019), https://www.uschamber.com/sites/default/files/ccmc_proxyseasonsurvey2019_v1.pdf. (claiming that proxy advisory firms have "a track record of making errors and misjudgments in analysis."); *see also* INST. FOR PENSION FUND INTEGRITY, REFORMING THE PROXY ADVISORY FIRM DUOPOLY: AN ANALYSIS OF RECENT SEC GUIDANCE AND ITS IMPLICATIONS FOR PUBLIC PENSION RETIREES (Sept. 2019), http://ipfiusa.org/wp-content/uploads/2019/09/REFORMING-THE-PROXY-ADVISORY-FIRM-DUOPOLY_An-Analysis-of-Recent-SEC-Guidance-and-Its-Implications-for-Public-Pension-Retirees.pdf.

⁸ David F. Larcker, Brian Tayan, & James R. Copland, *The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry*, HARV. L. SCH. F. CORP. GOV. AND FIN. REG. (June 14, 2018), <https://corpgov.law.harvard.edu/2018/06/14/the-big-thumb-on-the-scale-an-overview-of-the-proxy-advisory-industry/> (detailing the extent of proxy advisory firms' influence on specific ballot measures).

⁹ INST. FOR PENSION FUND INTEGRITY, *supra* note 7, at 5; *see also* GLASSMAN & VERRET, *supra* note 5, at 12 ("[T]he incentive has been to outsource decision marking to firms that, for understandable business reasons, make their recommendations using one-size-fits-all standards."); *see also* Spatt, *supra* note 6.

III. The Proposal

The Proposal is aimed at improving transparency, accuracy, and completeness in the proxy voting advice process.¹⁰ Under the Proposal, registrants and certain other soliciting persons of proxy voting advice would have the opportunity to review and provide feedback on proxy materials before the advisory firms send them to their client shareholders. This provision would also provide a mechanism for clients to be informed of differing views of the underlying facts or analysis in certain circumstances. This engagement would tend to identify, and potentially to clarify, any factual or analytical disputes for clients. In addition, the Proposal would amend the definition of “solicitation” to specifically cover proxy advisory firm reports, and thus to subject them to the anti-fraud provision of the federal proxy rules. This amendment would tend to enhance the importance of accuracy and completeness of proxy materials. The Proposal would further require enhanced disclosure of information such as the proxy voting advice firm’s methodology, sources of information, material conflicts of interest, or the use of standards that materially differ from relevant standards or requirements that the SEC sets or approves. Overall then, the Proposal would tend to improve the transparency of proxy advisory firms’ practices and the accuracy of the information in their proxy voting advice materials.

IV. Competitive Issues Raised by the Proposal

The Request for Comment section of the Proposal asks a number of questions directed at the Proposal’s likely effects on competition in the proxy advisory industry, including whether it would enhance the quality of proxy voting advice or raise barriers to entry.¹¹ It notes that by promoting accuracy and transparency in proxy voting advice, the Proposal could increase demand for these services, which could lead to greater competition. Greater competition could, in turn, have a positive effect on the quality of advice in the final materials. With access to higher quality proxy voting advice, clients’ other compliance might costs decrease.

At the same time, the Proposal would impose additional costs on proxy voting advice businesses themselves. The SEC rightly focuses on the likely effects of increasing regulatory costs in this industry, which, as noted above, some observers argue is already subject to significant entry barriers. There are important goals driving the Proposal, and the Proposal explains how the SEC attempts to achieve those goals while minimizing such costs. The SEC clearly recognizes there is a balancing to be done: “To the extent these costs are greater than the related benefits (or vice versa) it could lead to decreased (or increased) demand for proxy voting advice business services, and there would be fewer (or more) efficiencies in the proxy voting process.”¹² Indeed, if the cost increases are large enough to cause some firms to exit (or to deter entry), the rules could decrease competition. Moreover, costs associated with the Proposal could potentially affect smaller or certain other proxy voting advice businesses more significantly than the larger firms. The Proposal correctly notes that larger, wealthier firms are generally better-positioned to

¹⁰ Proposal, *supra* note 1, at 66539-666540; *see also* David Oleman, Lawrence Elbaum, and Sarah Fortt, *SEC Proposals Could be Game Changing for Proxy Process*, LAW360 (Nov. 21, 2019), <https://www.law360.com/securities/articles/1219943/sec-proposals-could-be-game-changing-for-proxy-process>.

¹¹ Proposal, *supra* note 1, at 66551.

¹² Proposal, *supra* note 1, at 66550.

absorb cost increases than smaller or less wealthy rivals or new entrants. The Department would further emphasize that efforts which increase regulatory costs, in particular, should be undertaken with care, because such costs tend to be stable or to increase over time.

The Department applauds the SEC's effort to increase transparency and accountability for proxy advisory firms, and recognizes the importance of fostering competition in this space. As noted, the current competitive landscape causes some concerns and the SEC is right to consider the impact of the Proposal on competition. The Department supports efforts to inject more competition into this industry and hopes that the Proposal will do just that. At the same time, the Department would be concerned if the effect of the Proposal were to further entrench the industry leaders by raising barriers to entry. If the SEC concludes the rules risk a deleterious effect on competition, we are optimistic that it will consider and implement ways to minimize compliance burdens while making proxy advisory services more transparent and accountable.

V. Conclusion

The Department supports the SEC's efforts to foster greater transparency by proxy advisory firms. In addition, we appreciate the SEC's desire to understand the impact the Proposal may have on competition. In finalizing the Proposal, the SEC should continue to maximize the opportunities to increase competition in proxy advisory services.

Respectfully submitted,

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