

Testimony of
Michael McCauley
Senior Officer – Investment Programs & Governance
Florida State Board of Administration (SBA)
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Examining the Market Power and Impact of Proxy Advisory Firms

Chairman Garrett, Ranking Member Maloney, and Members of the Subcommittee:

Good morning. I am Michael McCauley, Senior Officer – Investment Programs and Governance, for the Florida State Board of Administration, or “SBA.” I am pleased to appear before you today on behalf of the SBA.

My testimony includes a brief overview of the Florida State Board of Administration and its investment approach, followed by a discussion of our proxy voting process and procedures and our use of proxy advisers to assist the SBA in fulfilling its proxy voting obligations. I will also discuss some proposed reforms that the SBA believes will make proxy advisers more transparent to the market and more accountable to their clients.

Florida State Board of Administration

The Florida State Board of Administration manages more than thirty separate investment mandates and trust funds, some established as direct requirements of Florida law and others developed as client-initiated trust arrangements. In total, the SBA manages approximately \$170 billion in assets, providing retirement benefits for more than 1 million current and former employees of Florida state government, public schools, universities and colleges, and many cities and local government districts. One of these funds, the Florida Retirement System Pension Plan (“FRS pension plan”), accounts for approximately 80 percent of the total assets under management. The FRS pension plan provides more than \$7.3 billion in annual benefit payments to more than 1

million individuals.¹ The SBA has a long history of successful fund management.² Under Florida law the SBA manages the funds under its care according to fiduciary standards similar to those of other public and private pension and retirement plans: The SBA must act in the best interests of the fund beneficiaries. This standard encompasses all activities of the SBA, including the voting of all proxies held in funds under SBA management.

Proxy Voting

Proxy voting is an integral part of managing assets in the best interests of fund clients and beneficiaries. In fiscal year 2012, the Florida State Board of Administration executed votes on thousands of public companies.³ During the most recent trailing twelve months ended March 31, 2013, the SBA executed votes at 9,534 public companies on 85,408 individual voting items, including director elections, audit firm ratification, executive compensation, and merger approval. Of the 85,408 voting items over the last twelve months ending March 31, 2013, the SBA cast 80 percent “for,” 16 percent “against” and 3 percent “withhold.” On less than 1 percent of ballot items, the SBA abstained or did not vote.

¹ “Annual Report, The Florida Retirement System and Other State Administered Systems,” July 1, 2010-June 30, 2011, at 41, https://www.rol.frs.state.fl.us/forms/2011-12_Annual_Report.pdf.

² “Overview of the State Board of Administration of Florida as of December 31, 2012,” <http://www.sbafla.com/fsb/LinkClick.aspx?fileticket=gXE1No0N3yI%3d&tabid=997&mid=2293>.

³ “Proxy Voting: Summary Report Fiscal year 2012,” State Board of Administration of Florida, at 12, http://www.sbafla.com/fsb/portals/Internet/CorpGov/ReportsPublications/20121031_SBAProxyVotingSummary.pdf.

The SBA makes all proxy voting decisions independently. To ensure that the SBA meets its fiduciary obligations, it established the Corporate Governance & Proxy Voting Oversight Group ("Proxy Committee") as one element in an overall enterprise risk management program. The Proxy Committee is comprised of several SBA staff members including myself, the Deputy Executive Director, the Chief Risk & Compliance Officer, the Co-Senior Investment Officers over Global Equity, and the Director of Investment Risk Management. The Proxy Committee, which met five times in 2012, oversees the SBA's proxy voting process and reviews and approves significant and contested matters regarding corporate governance and voting.

The SBA votes based on written corporate governance principles and proxy voting guidelines it develops internally for common issues expected to be presented for shareowner ratification. The SBA's proxy voting guidelines reflect its belief that good corporate governance practices will best serve and protect the funds' long-term investments, and are reviewed and approved by the SBA's Investment Advisory Council and Board of Trustees on an annual basis.

The SBA's voting policies are developed using empirical research, industry studies, investment surveys, and other general corporate finance literature. SBA voting policies are based both on market experience and balanced academic and industry studies, which aid in the application of specific policy criteria, quantitative thresholds, and other qualitative metrics. For 2012, the SBA issued guidelines for more than 350 typical voting issues and voted at least 80 percent of these issues on a case-by-case basis, following a company-specific assessment. The SBA discloses all proxy voting decisions

once they have been made, normally seven to ten days prior to annual shareowner meetings. Historical proxy votes are also archived for a period of five years and are available electronically on the SBA's website.

To supplement its own proxy voting research, the SBA purchases research and voting advice from several outside firms, principally three leading proxy advisory and corporate governance firms: Glass, Lewis & Co. ("Glass Lewis"), Manifest Information Services LLC ("Manifest"), and MSCI Institutional Shareholder Services ("ISS"). The SBA uses additional external research providers for more narrow and specialized analyses covering executive compensation. Glass Lewis's research covers the entire U.S. stock universe of Russell 3000 companies and virtually all non-U.S. equities. Manifest provides analysis of proxy issues and meeting agendas on a non-advisory basis, with a primary emphasis on European and large capitalization global companies. ISS provides specific analysis of proxy issues and meeting agendas on all publicly traded U.S. and non-U.S. equity securities. Additionally, the SBA executes its global equity votes on ISS's voting platform, ProxyExchange.⁴

When making voting decisions, the SBA considers the research and recommendations provided by Glass Lewis, Manifest and ISS, along with other relevant facts and research, and the SBA's own proxy voting guidelines.⁵ But the SBA makes voting decisions independently and in what it considers to be the best interests of the beneficiaries of the funds it manages. Proxy advisor and governance research firm

⁴ *Ibid.* at 11.

⁵ "Corporate Governance Principles & Proxy Voting Guidelines," State Board of Administration of Florida (2012), <http://www.sbafla.com/fsb/LinkClick.aspx?fileticket=KY96Es7W718%3d&tabid=1439&mid=3907>.

recommendations inform but do not determine how the State Board of Administration votes. And they do not have a disproportionate effect on SBA voting decisions. In fiscal year 2012, the votes that SBA executed correlated with the recommendations of one firm 67 percent of the time.⁶ Other historical reviews of SBA voting correlation have shown both lower and higher correlations with individual external proxy adviser recommendations, depending on both the time period studied and specific voting categories in question. Over the last few years, the SBA has voted with management (the “management-recommended-vote”) more than 80 percent of the time across all voted portfolios.

On advisory votes on executive compensation (“say on pay”), perhaps the most closely tracked proxy adviser recommendations, the SBA clearly charted its own path. In 2011, ISS recommended votes against 12.2 percent of management say-on-pay proposals. The SBA tracked ISS’s recommendations less than half the time, voting against 25.4 percent of management say-on-pay proposals. Among all SBA ‘against’ voting decisions in 2011, the SBA vote deviated 51.9 percent of the time when compared to the ISS recommended vote. SBA voting patterns on say-on-pay ballot items, both during fiscal-year 2012 and fiscal-year-to-date 2013, have not been dissimilar.

Recommendations for Reform

While the Florida State Board of Administration acknowledges the valuable role that proxy advisers play in providing pension funds with informative, accurate research on

⁶ *Ibid.* at 21

matters that are put before shareowners for a vote, we believe proxy advisory firms should provide clients with substantive rationales for vote recommendations, minimize conflicts of interest and have appropriate oversight. Toward that end, the SBA believes that proxy advisers should register as investment advisers under the Investment Advisers Act of 1940.

Registration would establish important duties and standards of care that proxy advisers must uphold when advising institutional investors. Additionally, the mandatory disclosures would expose conflicts of interest and how they are managed, and establish liability for firms that withhold information about such conflicts. Mandatory disclosures should also include material information regarding the process and methodology by which the firms make their recommendations, aimed at allowing all stakeholders to fully understand how an individual proxy adviser develops voting recommendations. This would make adviser recommendations more valuable to institutional investor clients and more transparent to other market participants. In this way registration would complement the aims of existing securities regulation, which seeks to establish full disclosure of all material information.

Thank you, Mr. Chairman for inviting me to participate at this hearing. I look forward to the opportunity to respond to any questions.