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United States House of Representatives Committee on Financial Services Subcommittee on Oversight and Investigations

Re: Testimony related to regulation of proxy advisers

Thank you to Subcommittee Chair Huizenga, Ranking Member Green, as well as the other members of the Subcommittee for the opportunity to testify before you today on a topic of utmost importance – the state of US corporate governance and the role that proxy advisers play in that debate.

It is an honor to be here. My name is Shiva Rajgopal, and I am the Kester and Byrnes Professor of Accounting and Auditing at Columbia Business School.

Virtually every testimony I have seen and read from the opponents of proxy advisers appears to be assume (i) management always works to maximize shareholder value; (ii) management's decision horizons are perfectly aligned with the shareholder's investment horizon; (iii) management knows who its shareholders are and what they actually want; and (iv) managerial accountability to its capital providers is as good as it can ever be, and all is well with the world.

I have substantial doubt about each of these premises. The state of US corporate governance is not as perfect as assumed for several reasons:

- In any company that is in a stock index of note (S&P 500 or Russell 1000), a large proportion of the equity is held by passive asset managers, who may not have the time or incentives to understand the idiosyncratic governance related problems of each company they vote on.

- CEO pay, on average, still does not track performance, despite vigorous assertions to the contrary by management. I will cite three examples. First, most CEO pay in the US follows the so-called "competitive pay policy" model that gives CEOs more shares when stock price is low and vice versa. That policy severs the link between CEO and performance.[1] Second, CEO pay over their tenures is barely different for under-performing firms relative to others.[2] Finally, in around a third of companies we looked at, managers got equity at discounted prices when they destroyed shareholder value.[3]

[1] https://www.forbes.com/sites/shivaramrajgopal/2022/10/23/most-us-companies-pay-ceos-under-a-competitive-pay-policy-but-dont-confuse-it-for-pay-with-performance/

[2] https://drive.google.com/drive/u/0/folders/1qZaHP0a58b-jTsZ9Jr6DWY6egzs3TzU0

[3] https://drive.google.com/file/d/1qZF4cf5aGw3eObYqOheNAuFXM8b4cXFE/view?pli=1

- Observable characteristics of boards of directors increasingly look similar on account of regulations, proxy advisory guidelines and social norms. What boards actually do in the boardroom is unobservable to outsiders and the consequences of their poor decision making may not be obvious for years.[4]

So, what is to be done with the topic at hand - proxy advisers. Proxy advisers are not perfect, by any means. Let me start with my concerns. We currently have an effective duopoly of two agencies in the business and we need to find ways to encourage entry of other providers. It is unclear whether they have adequate staff to monitor governance issues of 4000 stocks trading in the US and many more overseas. Whether their consulting business subsidizes the advice business is also unclear. For my taste, proxy advisers are still more deferential to management than warranted.[5]

Hence, I support some initial regulation such as asking them to register with the Securities and Exchange Commission.[6] Recent SEC rulemaking already requires more detailed and standardized conflict of interest disclosures for ISS and Glass Lewis. ISS is registered with the SEC as an investment adviser, but Glass Lewis is not.

I suggest caution beyond that point. If we hobble proxy advisers too much, the feeble health of shareholder democracy would suffer a body blow. Some institutions will simply opt out of voting on proxy proposals making management even less accountable. This could further exacerbate highly concerning trends in executive compensation -- which proxy advisers, to their credit, have helped to address by curbing egregious pay packages and highly compromised board structures.

Hence, I oppose provisions that simply add more costs to institutional investors monitoring management, including those asking for the appointment of an ombudsman, or management suing a proxy adviser, singling out ESG funds or proposals for special punitive treatment, or provisions that make it harder to table repeat proposals or require advisors to seek management input on advisor recommendations.

We must remember that proxy advisers are paid for by the customers they serve—institutional investors—and the paying customers are not asking for more regulation of proxy advisers. Enabling and facilitating efficient shareholder engagement is a market-based solution to a market derived demand for enforcing managerial accountability.

In closing, I would reiterate that any bill that makes proxy voting more onerous is a step backward in seeking accountability from corporate managers, which ultimately helps protect retail investors. A reasonable compromise is to take a few regulatory steps in terms of registration and support oversight

[4] https://www.forbes.com/sites/shivaramrajgopal/2023/06/30/meet-the-index-laggards/

[5] ISS' own data states, "the percentage of companies with failed say-on-pay votes increased to 3.2 percent, up from 2.6 percent in 2021, representing the highest failure rate since say-on-pay votes began in the US." Surely more than 3.2% of pay packages in corporate America do not reflect pay for performance, as suggested by several papers (see https://drive.google.com/file/d/1qZF4cf5aGw3eObYqOheNAuFXM8b4cXFE/view?pli=1 and https://drive.google.com/drive/u/0/folders/1qZaHP0a58b-jTsZ9Jr6DWY6egzs3TzU0 and https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4407139

[6] https://www.forbes.com/sites/shivaramrajgopal/2023/07/05/a-few-thoughts-on-the-putting-investors-first-act-of-2023part-1/ and https://www.forbes.com/sites/shivaramrajgopal/2023/07/05/a-few-thoughts-on-the-putting-investors-first-act-of-2023part-2/

by the SEC and institutional investors to encourage continued improvement in the quality and accountability of proxy advisers.

The state of US corporate governance is not as rosy as often projected. Anything that interferes with shareholder democracy obstructs the ability of institutional investors to seek corporate accountability, which, in turn, hurts the pocketbooks of retail investors and retirees' investments.

Thanks again for listening to my testimony. I look forward to answering your questions.

Yours sincerely

Shiva Rajgopal