NATIONAL ASSOCIATION OF Manufacturers

Testimony of

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Hearing on

"The Fall of ESG: Scrutinizing the Failed Use of Environmental, Social, and Governance Standards and the Influence of Proxy Advisors"

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Good afternoon Chairman Huizenga, Ranking Member Green, and members of the Subcommittee on Oversight and Investigations. My name is Charles Crain, and I am the Vice President of Domestic Policy at the National Association of Manufacturers. On behalf of the NAM's 14,000 members and the 13 million people who make things in America, I appreciate the opportunity to testify before you today on the need for urgent congressional action to rein in the outsized influence of so-called "proxy advisory firms" and to ensure that the Securities and Exchange Commission holds these powerful actors to account.

Proxy firms set corporate governance standards for publicly traded companies, and they provide voting recommendations based on those standards to institutional investors who vote in corporate proxy contests. Proxy firms have substantive beliefs and normative agendas about how public companies should be run. In other words, they are not disinterested third parties, but rather seek to guide corporate behavior to align with their own interests. Further, proxy firms do not have a fiduciary duty to the underlying investors in America's public companies—teachers, firefighters, and manufacturing workers saving for a secure retirement—so they are free to exert their outsized influence as they see fit. They do so by recommending that institutional investors vote in accordance with their pre-set, one-size-fits-all voting guidelines.

Proxy firm "recommendations" are no mere suggestions, however. Rather, institutional investors—who *do* have a fiduciary duty to the Main Street investors whose assets they manage—generally vote in lockstep with the proxy firms' recommendations, and in many cases the proxy firms actually cast votes on institutions' behalf via their robo-voting services. This degree of influence over companies' proxy contests means that ISS and Glass Lewis—the two major proxy firms, which together control over 97% of the proxy advice market—effectively set corporate governance standards for America's capital markets.

This is because proxy firms directly control a significant percentage of the shareholder vote. ISS, for instance, can affect support for a dissident slate of board nominees by 73% and support for an

uncontested director by 18%.[1] A study conducted during the SEC's consideration of proxy reforms found that 175 institutions, with more than $5 trillion in assets under management, vote in lock step with proxy firms more than 95% of the time.[2] Companies are thus forced to treat proxy firms as quasi-regulators, adjusting company policies and making disclosures to satisfy the firms in order to avoid negative recommendations on critical corporate matters—and, increasingly, on environmental and social topics outside the realm of traditional corporate governance.

Indeed, proxy firms have policies and provide recommendations on a wide range of ESG topics, which may or may not be relevant to an individual company's growth and the value it creates for shareholders. Studies have shown that proxy firms are overwhelmingly supportive of activists' ESG proposals; for example, ISS recommended in favor of nearly 80% of environmental and social proposals during the 2023 proxy season.[3] A recent NAM survey found that that nearly 78% of publicly traded manufacturers are concerned that this increased pressure on ESG topics from proxy firms and other third parties will "increase costs for public companies, divert management and board time and resources, and endanger long-term value creation."[4] The SEC's recent ESG actions only serve to further empower the proxy firms. The flood of increasingly prescriptive ESG proposals raising ever more issues with "broad societal impact" following the SEC's issuance of Staff Legal Bulletin 14L, enhanced ESG disclosures required of public companies, and the SEC's proposed amendments to Rule 14a-8 making it more difficult to exclude activist proposals all give proxy firms more leverage over public companies—and more opportunities to advance their own ESG agendas, often at the expense of shareholder value creation.

Powerful market actors with this degree of influence should clearly be subject to appropriate government oversight. But in the case of proxy firms, the case for regulatory guardrails is even stronger. Their consulting services—through which they offer guidance to companies on the very topics that will be the subject of their voting recommendations—present an obvious conflict of interest. Their inflexible policies do not account for the individual circumstances of disparate companies and their investors, and they are developed with minimal transparency or stakeholder input. And proxy firms have been unwilling to engage with companies to correct errors, reconsider misleading assumptions, or re-examine how their recommendations might impact the business in question. Yet, despite years of effort by both Congress and the SEC, proxy firms remain stubbornly unregulated.

Today's hearing comes at a crucial time. After decades of bipartisan deliberation about the appropriate policy response to proxy firms' outsized influence, the SEC's authority to provide *any oversight at all* of the proxy advice industry is under threat. In recent weeks, the SEC has abandoned its defense of the landmark 2020 proxy firm rule,[5] leaving the NAM alone before the U.S. Court of Appeals for the D.C. Circuit as the sole defender of the rule's commonsense, critical reforms. Now is the time for Congress to act urgently, and to speak definitively: the SEC has the statutory authority—and, indeed, the congressional *mandate*—to regulate proxy advisory firms. The

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[1] Larcker, David F., Brian Tayan and James R. Copland, *The Big Thumb on the Scale: An Overview of the Proxy Advisory Industry* (14 June 2018). Harvard Law School Forum on Corporate Governance. *Available at* https://corpgov.law.harvard.edu/2018/06/14/the-big-thumb-on-the-scale-an-overview-of-the-proxy-advisory-industry/.

[2] Doyle, Timothy M., *The Realities of Robo-Voting* (9 November 2018). American Council for Capital Formation. *Available at* https://accfcorpgov.org/wp-content/uploads/ACCF-RoboVoting-Report_11_8_FINAL.pdf.

[3] *Voting Matters 2023* (11 January 2024). ShareAction. *Available at* https://cdn2.assets-servd.host/shareaction-api/production/resources/reports/ShareAction_Voting-Matters_2023_2024-06-25-145106_jwpq.pdf.

[4] NAM Manufacturers' Outlook Survey, Fourth Quarter 2022 (4 January 2023). *Available at* https://www.nam.org/wp-content/uploads/2023/01/Manufacturers_Fourth_Quarter_Outlook_Survey_December_2022.pdf.

[5] *See Exemptions From the Proxy Rules for Proxy Voting Advice*, 85 Fed. Reg. 55082 (3 September 2020). Release No. 34-89372; *available at* https://www.govinfo.gov/content/pkg/FR-2020-09-03/pdf/2020-16337.pdf.

success of thousands of public companies and the life savings of millions of manufacturing workers depend on policymakers rising to this challenge.

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The SEC's authority to regulate proxy advisory firms hinges on whether providing proxy voting advice constitutes a "solicitation" under the Securities Exchange Act of 1934.[6] Undoubtedly, it does. ISS has admitted as much, going as far back as a 1991 letter to the SEC explaining how the firm's recommendations were subject to the Commission's proxy solicitation rules, and seeking amendments to and exemptions from those rules to better fit its business model.[7] Dictionaries from the time of Congress's consideration and passage of the Exchange Act bolster this interpretation, defining "solicit" to mean "to endeavor to obtain,"[8] "to awake or excite to action,"[9] "to move to action,"[10] and "to serve as an urge or incentive to; to incite"[11]—each of which clearly encompasses the impact of the influential proxy voting advice that proxy firms provide to institutional investors.

Not only does this language give the SEC the *authority* to regulate proxy firms, it provides a congressional *mandate* that the agency do so. As the Commission put it in its proposed proxy firm rule in 2019, "an overarching purpose of Section 14(a) [of the Exchange Act] is to ensure that communications to shareholders about their proxy voting decisions contain materially complete and accurate information. It would be inconsistent with that goal if persons whose business is to offer and sell voting advice broadly to large numbers of shareholders, with the expectation that their advice will factor into shareholders' voting decisions, were beyond the reach of Section 14(a)."[12] Indeed, it has long been clear that "the federal proxy rules apply to any person seeking to influence the voting of proxies by shareholders"—including proxy advisory firms.[13]

This foundational truth underpins the SEC's work in recent decades to establish an appropriate regulatory regime for proxy voting advice.[14] Given that proxy firms solicit investors' proxies, they are subject to the proxy solicitation rules—but those rules were not specifically tailored to the impacts that the firms have on the market. Proxy firms have relied on exemptions to otherwise applicable information and filing requirements within the solicitation rules—but, again, these exemptions were not designed with the firms' business models in mind. So the SEC has in recent years considered a

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[6] *See* 15 U.S.C. Sec. 78n(a)(1) ("It shall be unlawful for any person…in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy…").

[7] Letter from Nell Minnow, President, ISS to Jonathan G. Katz, Secretary, SEC (1 August 1991). *Available at* https://documents.nam.org/TAX/Letter-from-ISS-to-SEC-re-Exchange-Act-Release-No.-29315.pdf.

[8] *Black's Law Dictionary 1639* (3d ed. 1933).

[9] *Ibid.*

[10] *Webster's New International Dictionary 2394* (2d ed. 1939).

[11] *Ibid.*

[12] *Amendments to Exemptions From the Proxy Rules for Proxy Voting Advice*, 84 Fed. Reg. 66518 (4 December 2019). Release No. 34-87457; *available at* https://www.govinfo.gov/content/pkg/FR-2019-12-04/pdf/2019-24475.pdf.

[13] *Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice*, 84 Fed. Reg. 47416 (10 September 2019). Release No. 34-86721; *available at* https://www.govinfo.gov/content/pkg/FR-2019-09-10/pdf/2019-18355.pdf.

[14] *See, e.g., Concept Release on the U.S. Proxy System*, 75 Fed. Reg. 42982 (22 July 2010). Release Nos. 34-62495, IA-3052, IC-29340; *available at* https://www.govinfo.gov/content/pkg/FR-2010-07-22/pdf/2010-17615.pdf ("As a general matter, the furnishing of proxy voting advice constitutes a 'solicitation' subject to the information and filing requirements in the proxy rules."); *see also* 2019 Proxy Advice Guidance, *supra* note 13 ("[P]roxy voting advice provided by a proxy advisory firm [generally] constitute[s] a solicitation under the federal proxy rules.").

range of policy solutions more tailored to the proxy firms, each predicated on the clear definition of "solicitation" found in the Exchange Act.

The proxy firm rule adopted by the SEC in 2020 reiterates and codifies the Commission's long-standing view that the provision of proxy voting advice constitutes a solicitation. It then grants proxy firms tailored exemptions from certain requirements within the proxy solicitation rules, conditioned on the firms disclosing their conflicts of interest, sharing their final voting recommendations with impacted companies, and allowing investors to see company responses to those recommendations. The firms are under no obligation to fulfill these conditions; they are free to comply with the proxy rules' information and filing requirements like other soliciting entities if they so choose. But the 2020 rule's exemption conditions are narrowly tailored, reflect the specific risks proxy firms pose to the market without imposing broad or inapplicable mandates on them, and were developed following feedback from companies, investors, and the firms themselves.

Additionally, the 2020 rule was significantly narrowed in response to proxy firm complaints about the SEC's 2019 proposal. Specifically, the 2020 rule eased the 2019 proposal's provisions on company access to, review of, and responses to proxy firm recommendations. The 2019 rule would have required proxy firms to A.) provide companies with an opportunity to review *draft* recommendations *before* their dissemination to investors and B.) *include with the final recommendations* a hyperlink to any company responses; by contrast, the 2020 rule requires the firms to A.) provide companies with the *final* version of their recommendations *at the same time* they are disseminated to investors and B.) *have a mechanism* by which investors can become aware of any company responses to those recommendations.

The proxy firms were not satisfied with this compromise. They continue to oppose the 2020 rule despite the modifications the SEC made to its 2019 proposal to placate them, and they no longer seek the regulatory certainty that exemptions from the proxy solicitation regime would provide. Instead, proxy firms now claim that their business of influencing shareholder votes and often casting those votes on shareholders' behalf no longer qualifies as a solicitation.

Indeed, shortly after the promulgation of the SEC's 2019 guidance clarifying that proxy voting advice was indeed a solicitation and thus that the firms were subject to existing anti-fraud standards under the proxy solicitation rules, ISS filed suit against the SEC. ISS expanded its lawsuit after the 2020 rule was finalized, seeking not just to nullify the individual requirements of the rule but also to undermine the SEC's ability to regulate proxy voting advice at all. The SEC defended its authority before the U.S. District Court for the District of Columbia—and the NAM joined the Commission in that fight as an intervenor-defendant. Unfortunately, the district court judge ruled in ISS's favor earlier this year.

That brings us to today's hearing. **The NAM has appealed the district court's decision—*but the SEC has not*.** Earlier this month, the SEC filed a motion with the D.C. Circuit dismissing its appeal.[15] In other words, the SEC is abandoning its defense of the 2020 rule and effectively forswearing any future attempt to regulate proxy advisory firms. This abdication of the agency's duty to uphold congressional intent, faithfully implement lawfully promulgated regulations, and protect America's world-leading capital markets from the undue influence of proxy advisory firms is both shocking and disappointing.

Unfortunately, the SEC's actions in this case are part of a larger pattern. When Chairman Gensler took office in 2021, the SEC unlawfully suspended enforcement of the 2020 proxy firm rule, a decision vacated in a lawsuit brought by the NAM before the U.S. District Court for the Western

[15] *Institutional S'holder Servs. inc. v. SEC*, No. 24-5105 (consolidated with 24-5112) (D.C. Cir.), Mot. to Voluntarily Dismiss Appeal.

District of Texas.[16] In 2022, the Gensler SEC finalized a rule unlawfully rescinding critical portions of the 2020 rule—and, again, the SEC's actions were vacated in a lawsuit brought by the NAM, this time before the U.S. Court of Appeals for the Fifth Circuit, which held that the SEC's actions were "facially irrational" and not "reasonable or reasonably explained."[17] Now, the SEC is folding in the face of ISS's challenge, leaving the NAM alone on the battlements defending the rule of law.

Congress must clarify that the proxy firms' provision of proxy voting advice *is* solicitation under Exchange Act Section 14(a), putting to rest any doubts about the SEC's authority to regulate proxy firms. Such a clarification should not be necessary: as the NAM will argue before the D.C. Circuit, the text of the Exchange Act, contemporaneous dictionary definitions of the word "solicitation," the congressional intent of the 73rd Congress, and decades of practice by the SEC and other market actors (including proxy firms) should be sufficient to put the question to rest. But ISS's self-serving reinterpretation of unambiguous statutory text and the SEC's decision to kowtow to the proxy firms have left the 2020 rule in a precarious position. Congress can and should clarify the SEC's existing authority under the Exchange Act and, in so doing, help preserve the 2020 rule and clear a path for a future SEC to work productively to rein in these unregulated actors.

Additionally, the Oversight Subcommittee has the opportunity to investigate the SEC's choice to cast aside the 2020 rule. Why did the SEC never allow the rule to take effect and be fairly evaluated? Why did the SEC fight the NAM's attempts to preserve the rule, but fold when challenged by ISS? Why did the SEC maintain—both in the 2022 rescission rule and in the early stages of the ISS lawsuit—that proxy voting advice constituted a solicitation, only to abandon that position as the case advanced? Why does the SEC seem committed to empowering proxy advisory firms at the expense of public companies and Main Street investors?

Congress also should consider substantive reforms to bolster the requirements of the 2020 rule. Just last year, the House Financial Services Committee approved the Protecting Americans' Retirement Savings from Politics Act (H.R. 4767), sponsored by Rep. Bryan Steil (R-WI). Rep. Steil's bill would require proxy firms to register with the SEC; as a condition of registration, proxy firms would be required to:

- Provide companies with the data and information underpinning their recommendations, and grant companies an opportunity to share feedback to correct errors and misrepresentations;
- Employ an ombudsman charged with engaging with companies and resolving issues identified by impacted businesses;
- Include any company statements responding to the firm's recommendations in its final report to clients;
- Certify that the firm has sufficient staff and resources to provide voting advice based on accurate information and in the economic best interests of shareholders;
- Provide disclosures on the firm's procedures, methodologies, organizational structure, professional qualifications, and code of ethics;
- Adopt policies to identify, disclose, and manage any conflicts of interest; and
- Cease any advisory or consulting services that present a conflict of interest with respect to their recommendations.

These reforms would improve the quality, accuracy, and reliability of proxy voting advice. Notably, many of the provisions of H.R. 4767 are similar to the requirements of the SEC's proposed proxy firm rule from 2019. Congress can act now to clarify the SEC's authority and thus help preserve the 2020 rule, but additional policies such as those included in the 2019 proposal (particularly those related to companies' ability to review draft proxy firm recommendations) and the Protecting

[16] *Nat'l Ass'n of Mfrs. v. SEC*, 631 F.Supp.3d 423 (W.D. Tex. 2022).

[17] *Nat'l Ass'n of Mfrs. v. SEC*, 105 F.4th 802 (2024).

Americans' Retirement Savings from Politics Act are essential to continuing to counter the threat that proxy firms' outsized influence poses to everyday Americans' retirement savings.

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Amidst the political back-and-forth undermining the 2020 rule, the flaws endemic to proxy firms' business models persist. In fact, the firms' resistance to engagement with companies has only gotten worse: in response to the 2020 rule, ISS withdrew its program that had allowed some companies a limited opportunity to review its recommendations.[18] Publicly traded manufacturers are committed to growing their businesses, creating value for shareholders, and giving back to their communities—but manufacturers still must contend with proxy advisory firms that have divergent agendas and little interest in their success. This remains the case despite the fact that the SEC finalized its landmark proxy firm rule more than four years ago—a rule that has never been allowed to take effect.

Congress should do what the SEC will not: take steps to preserve the 2020 proxy firm rule in full, including by affirming the SEC's authority to regulate proxy voting advice. Then, Congress can build on the SEC's proxy solicitation regime by pursing policies that further increase transparency, ensure accuracy, reduce conflicts of interest, limit robo-voting, and rein in proxy firms' control over public company governance and the performance of millions of Main Street investors' life savings.

The NAM stands ready to work with Congress to ensure that manufacturers can escape the outsized influence of proxy firms and instead focus on creating jobs, contributing to their communities, powering the American economy, and investing for the future.

[18] *Company Letter Ending U.S. Draft Reviews* (2 November 2020). Institutional Shareholder Services. *Available at* https://www.issgovernance.com/file/publications/202011102_Company_Letter_Ending_US_Draft_Reviews_CA_companies.pdf.