

## WILLIAMS & JENSEN, PLLC

**Fr:** Alex Barcham

**Re:** SEC Investor Advisory Committee

**Dt:** September 13, 2018

### Summary

On September 13, the Securities and Exchange Commission (SEC) convened a [meeting](#) of the Investor Advisory Committee (Advisory Committee or IAC) to: (1) U.S. Proxy Voting Infrastructure; (2) the Commission's Proposed Transaction Fee Pilot in NMS Stocks; and (3) the Implications of Passive Investing. The Advisory Committee approved a [recommendation](#) from the Market Structure Subcommittee regarding the SEC's proposed transaction fee pilot program.

The Investor Advisory Committee was created by section 911 of the Dodd-Frank Act (DFA). It is authorized to provide recommendations to the SEC on issues relating to the regulation of securities products, trading strategies, fee structures, disclosures and other investor protection matters. The SEC is not required to adopt any recommendations of the Advisory Committee, but the Commission must provide a public response that discusses "the action, if any, the Commission intends to take."

### Commissioners/Opening Remarks:

**Chairman Jay Clayton**, in a [statement](#), noted that the Senate confirmed Commissioner Elad Roisman last week. He said the SEC will hold a roundtable on the proxy process this fall, stressing the importance of proxy votes to the shareholder governance process. He noted that the SEC issued a concept release on proxy voting in 2010, stating that a lot has changed since then and commending the IAC for examining this issue. **Clayton** said the IAC would be examining the Commission's proposal to conduct a transaction fee pilot in NMS stocks, which he suggested would help the SEC to make better informed policy decisions. He said the IAC would also be examining passive investing. He said analysts have suggested that concentration in passive funds may be increasing risk, while others have emphasized that passive investing provides a low-cost, low-maintenance way to obtain diversified investment exposure. He noted that earlier in the day he had issued a [statement](#) reiterating that SEC staff views are non-binding and create no enforceable legal rights or obligations. He noted that the Division of Investment Management issued a [statement](#) withdrawing two 2004 letters related to Egan-Jones Proxy Services and Institutional Shareholder Services (ISS).

**Commissioner Hester Peirce** and **Commissioner Elad Roisman** thanked the IAC members for their service.

**Commissioner Kara Stein** expressed particular interest in the panels on the proxy process. She said proxy votes allow shareholders to represent their interests. She suggested that the proxy process is "far from ideal," stating that shareholders who attend in person should not have greater rights than those who vote by proxy. She said proxy cards often do not list all of the people running for the board, suggesting that this should not be the case given technological developments. She said two years ago the SEC proposed the use of universal proxy cards, asserting that they should move

forward on this proposal. She urged Clayton to move forward with this vote. **Stein** said blockchain offers new opportunities to maximize shareholder engagement. She stressed the need to examine the “plumbing” of the proxy system as it is inefficient and can lead to erroneous results. She argued that the SEC should embrace technology to improve the accuracy and efficiency of the proxy system. **Stein** said there has been a rapid movement of funds from active to passive management in both equities and bonds. She stated that market participants and regulators are still grappling with the impacts of this shift. She stressed the need to examine the dynamics affecting the marketplace.

**Anne Sheehan, Vice Chairman, Director of Corporate Governance, California State Teachers' Retirement System**, said there is a great deal of interest in the proxy advisory issue. She said proxy votes are key to allowing shareholders to provide input to companies. She said the process should be transparent, accountable, efficient, and understandable. She stated that issuers should be able to easily communicate with their shareholders. She said the Committee would be examining the role of intermediaries in the proxy voting process. She stated that the Committee will also be examining the universal proxy, suggesting that in this day and age shareholders should not need to attend meetings in person to fully exercise their rights. She said blockchain could offer an opportunity to improve the proxy process. She stated that the Advisory Committee will have great interest in the SEC's proxy voting roundtable later in the fall.

**Sheehan** offered a motion to accept the minutes from the Advisory Committee's previous meeting, which was adopted.

**Commissioner Robert Jackson** stressed the importance of proxy voting to holding management accountable. He raised concerns with the SEC staff's recent statements on proxy advisory firms. He stated that the Commission has long recognized that proxy advisors play a key role in the shareholder process. He stated that less than one in three investors today has their vote counted in corporate elections. He said he is troubled that rather than focusing on fixing the voting system the announcements on the roundtables focus on the regulation of proxy advisors. He stated that “investors getting too much advice” is not a major problem facing corporations. He said corporate lobbyists' priorities should not sidetrack efforts to repair the proxy voting system. He commended the IAC for focusing their meeting on the voting system and ensuring that shareholders' votes are counted.

### **Discussion Regarding the U.S. Proxy Voting Infrastructure (Subpanel 1)**

#### *Panelists:*

Ken Bertsch, Executive Director, Council of Institutional Investors

Arthur Crozier, Chairman, Innisfree M&A Incorporated

David A. Katz, Partner, Wachtell, Lipton, Rosen & Katz

Deborah P. Majoras, Chief Legal Officer & Secretary, The Procter & Gamble Company

Brian L. Schorr, Partner and Chief Legal Officer, Triun Fund Management, L.P.

#### ***Presentations***

**Ken Bertsch (Council of Institutional Investors)**, in a [statement](#), said shareholder voting is an essential element of corporate governance, stressing that the system must be transparent and cost effective. He said the Council of Institutional Investors' (CII) members put out a statement on the need to embrace technology, such as distributed ledger technology (DLT). He said members lack confidence that their shares are voted fully and accurately. He stated that institutional investors often

vote on electronic platforms and want to be able to obtain vote confirmation. He said systemic change, such as adoption of DLT, would require significant investment of resources, but would be worthwhile. **Bertsch** described the universal proxy proposal as “low hanging fruit,” urging its adoption. He stated that shareholders should not be required to attend a meeting in person to be able to split their vote. He said CII does have concerns with the minimum solicitation requirement in the proposal, suggesting that it should be raised to more than ten. He asserted that it is time to move ahead with the universal proxy proposal. **Bertsch** said blockchain could be used to disseminate universal proxy materials and allocate votes. He said shareholders or their proxies would relay their votes along the blockchain, which would provide immediate and accurate end-to-end vote confirmation. He stated that votes cannot be removed or altered once they are entered into the blockchain. He emphasized the importance of end-to-end vote confirmation.

**David A. Katz (Wachtell, Lipton, Rosen & Katz)** said U.S. proxy voting infrastructure is outdated and has not kept up with market developments. He said the current infrastructure was created for a different era and has not been updated to account for technological changes. He said changes must address the interests of both issuers and investors and provide a level playing field for all participants. He stated that there has been a massive concentration of voting power in institutional investors, which has lowered the cost of communication with shareholders. **Katz** raised concerns with the undue influence of ISS and Glass-Lewis. He noted that many institutions have taken their proxy advisory functions back in house. He said technology has lowered the cost of communicating with shareholders, suggesting that all shareholders should receive the same information. He suggested that the system should give voice to those who are ultimately impacted. **Katz** said the system should promote participation and achieve accuracy and transparency. He stated that the current system does not provide all shareholders with the same information in a timely manner. He said there is no way for an individual shareholder to confirm that their vote has been accurately counted. He suggested that the practice of “empty voting” needs to be regulated. He suggested that the universal proxy card would resolve some issues, but could create other issues which would need to be addressed. He said the current system is confusing to investors who receive multiple voting cards and do not understand that only the last vote received is counted. He said technology can help to achieve accurate and timely results. **Chairman Jay Clayton** responded that there is room for improvement and the SEC should take action.

**Brian L. Schorr (Triam Fund Management)**, in a [statement](#), said Triam has gained 14 board seats at 12 portfolio companies since being founded. He said shareholders’ ability to participate in director elections is a principle of shareholder democracy. He said the current infrastructure makes accurate and verifiable voting tabulation nearly impossible. He noted that the 2017 Procter & Gamble (P&G) proxy contest showed the problems with the current system. He said the 2017 P&G contest included more than 2 billion votes cast and a less than 0.25 percent voting margin. **Schorr** stated that over-voting can occur when intermediaries lend shares. He said in the P&G case over-voting reconciliation did not occur until after a certified result was announced. He stated that there is no way for a beneficial owner to confirm that their vote was accurately counted. He suggested that breaks in the chain of custody can lead to votes not being counted. He said another issue is empty voting related to employee stock ownership plans (ESOPs). **Schorr** said the universal proxy card could have some utility. He said in 2017 Triam submitted a comment letter to the SEC supporting adoption of a universal proxy card. He suggested that the universal card could eliminate the problem of determining the last card received. He stressed the need to ensure shareholder votes are counted accurately.

**Deborah P. Majoras (The Procter & Gamble Company)** said the proxy system must ensure transparency and accuracy, suggesting that it is falling short. She said P&G had not faced a proxy contest until last summer, noting that they have more than 2.5 billion outstanding shares. She said half of their three million shareholders hold less than 100 shares. She stressed the need for issuers to be able to accurately communicate with investors. She said in the 2017 contest some shareholders received more than a dozen mailings, which increased turnout, but displeased many shareholders. She stressed the need to find an efficient but secure way for shareholders to vote. She said over-voting and under-voting are both common. She said voting inspectors still rely on manual processes which rely on subjective judgments. She said P&G believes it is time for proxy plumbing reform.

**Arthur Crozier (Innisfree M&A Incorporated)** said Innisfree is a proxy solicitation firm. He said changes are necessary, but expressed concern that they will lead to other issues which will need to be addressed. He said many proxy contests are decided by extremely small margins, but participation by individual shareholders has declined to 27 percent. He suggested that the best way to increase participation is through regular contact through proxy cards and calls through which shareholders can vote. He said currently issuers can only reach out to non-objecting beneficial owners (NOBOs), who currently make up less than 50 percent of shareholders in most cases. He suggested modifying the rules to allow NOBOs to directly vote. **Crozier** said another issue is breaks in the chain of custody, which result in votes not being counted and shareholders being disenfranchised. He said breaks in the custodial chain are often recurring problems. **Crozier** said Innisfree believes universal proxy cards are appropriate, as the current system can result in distorted voting results. He stated that currently shareholders can only vote for candidates on both slates by attending meetings in person. He contended that a universal proxy card would generally favor management, in spite of claims to the contrary. He suggested that there should be a process for intermediaries to alert shareholders of over-voting, and allow them to correct their vote.

### *Discussion*

**J.W. Verret (Antonin Scalia Law School, George Mason University)** said the SEC has the power to certify questions of state law to the Delaware State Supreme Court, urging them to do so more frequently. He suggested that the opt-in/opt-out issue should be part of the discussion. **Katz** said the Delaware process works well where appropriate, but does not apply to most proxy situations. He said the opt-in/opt-out issue is worth looking at. He said the focus should be on getting an accurate vote without giving either side an advantage. **Bertsch** said CII members perceive the process as broken at times and feel that their votes are not being accurately counted.

**Heidi Stam (former General Counsel at Vanguard)** said there was consensus amongst the panelists on the need for improvement. She asked what the Commission could consider doing without the time and energy required for a systemic overhaul. She asked what could be done quickly to make the process better for issuers and investors. **Katz** suggested that they should promote the use of technology. **Majoras** said she is very interested in the blockchain proposals, but she does not know how long they will take to implement. She suggested that email communication with retail investors could be low hanging fruit, to which **Stam** responded that this makes sense. **Schorr** said the current system of mailing materials is problematic for shareholders. He stated that the reconciliation of under- and over-voting is a problem, stressing that it should be completed before certified results are released. **Bertsch** said there should be a focus on larger systemic solutions, as the whole system is severely outdated.

**Commissioner Kara Stein** asked, on Chairman Clayton's behalf, for a definition of naked voting. She asked what low hanging fruit the Commission could vote on. **Crozier** said naked voting is a process through which someone holds shares, but through a derivative or other arrangement, actually holds no economic interest in the company. He recommended rethinking the NOBO situation and allowing issuers to contact them directly. He said the problem of share lending is in the hands of institutional investors themselves. **Majoras** stressed the benefit of allowing electronic delivery. She emphasized the need to bring all of the participants and intermediaries together to examine the process end-to-end. **Schorr** stressed the need to address under/over-voting reconciliation. **Katz** said the Commission should examine the benefits of blockchain. **Bertsch** expressed support for the universal proxy card. He recommended earlier notification of the record date.

**Damon Silvers (AFL-CIO)** said several of the panelists discussed the problem of getting individual investors to vote. He suggested that many investors are shareholders through a fund like Vanguard or Fidelity, stating that in that case Vanguard or Fidelity has the actual voting rights. He asserted there is consensus that there is a way to do universal proxy that everyone could live with. He suggested that there is also agreement on the need to orient the system towards long-term investors. He suggested that the big money in long-term investing is in index mutual funds and pension funds like CalSTRS. He said he is worried about "collusion" between investors and managers. He raised concerns with the impact of the recent tax reform bill. He asked what steps would most effectively empower long-term investors and get them to behave like long-term investors. **Katz** said it would require a major change in the system. He suggested changing quarterly reporting, suggesting that it promotes a focus on the short term. He stated that he does not believe that there is "collusion," but shareholders can place enormous pressure on the board. He suggested that tax laws do not promote long-term investment like they used to.

**Lisa Fairfax (George Washington University Law School)** disagreed with Silvers' claim that there is consensus support for adopting universal proxy cards. She said she is heartened that there is agreement on the need to improve the system. She asked if there is agreement on the need to improve the proxy voting system or if there will be significant pushback. She said her research shows that most people do not understand the NOBO system. **Majoras** said the devil is in the details on universal proxy. She said the 2016 proposal would only require the dissident to communicate with 50 percent of shareholders. She stressed the need to more carefully examine the NOBO issuer. **Katz** stressed the need to fix the whole system, rather than just addressing particular issues. **Crozier** said on the NOBO issue, the Commission and the Advisory Committee should recognize that some shareholders do not care and will not vote regardless.

**Allison Bennington (ValueAct Capital)** said the primary goal of corporate governance is accountability. She stated that the people who actually own shares should be the ones electing directors. She asked what percentage of corporate business communications occurs through U.S. mail. **Majoras** responded that it is very little.

**John Coates (Harvard Law School)** said e-communication is banned by Broadridge and not by SEC rules. He suggested that the issuers should work together to get Broadridge to change this policy. He asserted that Broadridge has a monopoly, suggesting that the SEC should examine whether their rules prevent competition. **Bertsch** suggested that there may be a core function of Broadridge which should be regulated like a monopoly.

**Lydia Mashburn (CATO Institute)** asked to what extent the rules could be moved to a more principles-based approach. **Katz** said there is a way to open up the process. He said if the SEC mandated blockchain tracking there could be competition on which system works best, but there could be problems if issuers choose one system and activists choose another. He expressed concern that a principles-based system without specificity in the rules will not work. **Majoras** said she agrees that some specific rules are needed, but it is bad business for the government to mandate specific technology.

### **Discussion Regarding the U.S. Proxy Voting Infrastructure (Subpanel 2)**

#### *Panelists:*

Lyell Dampeer, President, Investor Communication Solutions U.S., Broadridge Financial Solutions, Inc.

Alexander Lebow, Co-Founder, SAY

Edward Rock, Martin Lipton Professor of Law; Director, Institute for Corporate Governance & Finance, New York University School of Law

#### *Presentations*

**Lyell Dampeer (Broadridge Financial Solutions)** said U.S. equity markets are incredibly robust, powerful and complex. He said Broadridge has willingly subjected itself to third party oversight and has annual independent audits on regulatory compliance. He emphasized that Broadridge has no economic interest in any of the contests they are involved in. He noted that they are investing heavily in technology and in cybersecurity. He said they recently eliminated the requirements for the sending of physical materials to more than 75 percent of street investors, which resulted in significant savings. He stated that they have moved to support electronic voting. He said Broadridge supports universal ballots and processes them. He said they are beta-testing text voting and have allowed the use of social media for solicitations. He noted that they are also working on using DLT. **Dampeer** stressed the importance of reconciliation of voting entitlement prior to the voting date. He emphasized that the information needed for reconciliation is available, noting that they led an industry pilot in this area. He suggested that this information is available today, but it is not being used today, except after the fact to raise disingenuous complaints about over-voting. **Dampeer** said Broadridge has been providing vote confirmation for more than ten years, but can only do so when they are the tabulator. He said tabulation can be done, but it requires everyone to agree to participate. He suggested that the SEC could encourage or require participants to engage in reconciliation or book confirmation. He said technology can be used to create customized communication experiences which can drive voting, but currently most voters do not consent to receive electronic communication. **Dampeer** said the annual meeting process could be an ideal use case for DLT. He suggested that DLT can create an immutable record of voting, but this value can only be realized when all participants agree to participate on the ledger.

**Edward Rock (New York University Law School)** pointed to a case of over-voting where 80 million shares were voted and only 60 million shares existed. He said the SEC should not mandate particular technology, but should focus on what they want from a voting system. He said a voting system should have a preliminary voter list a week before the vote. He said shareholders should receive a unique voting code which they could use to vote online and receive an immediate notification of acceptance or rejection. He suggested that this should not be hard to achieve. He said Broadridge could provide this service, but many concerns have been raised that they have abused their monopoly position. He stressed the need to examine how to address this monopoly problem.

**Alexander Lebow (SAY)** said the proxy voting system is long overdue for reform, as it lacks transparency and accountability. He suggested that there is a lot of low hanging fruit in terms of technological improvements and regulatory reforms. He said SAY has seen promising early returns in improving communication to encourage shareholder engagement. He said the current processing fee schedule creates bad incentives, suggested that they should be realigned to encourage voting. He suggested that mutual funds should have a portion of their fee held back if they do not obtain voter participation. **Lebow** suggested that blockchain holds great promise, but it is not a silver bullet. He raised concerns with blockchain governance. He said decentralized public blockchains do not make sense for proxy voting, as they require some sort of centralized entity to manage permission protocols. He suggested that there is no clear argument of the superiority of blockchain to current databases for proxy voting. He suggested that there are much simpler reforms which could be implemented beside blockchain.

### *Discussion*

**Matthew Furman (Willis Group)** asked where the SEC should put proxy voting reform in its prioritization. **Dampeier** said reconciliation and confirmation do not require rule changes, though the SEC may need to require or encourage participation. He suggested that reconciliation and confirmation can already be done today. **Bertsch** emphasized the importance of reforming proxy voting, stressing the need for broader reform. He suggested that proxy reform should be prioritized over eliminating quarterly reporting. **Lebow** said proxy voting reform is important, as new investors are entering the market and may not have trust in the capital markets. **Rock** said there is an urgent need to fix the proxy voting system.

**Silvers** said there has been discussion of direct access to beneficial owners. He stated that institutional investors view Broadridge as a “benevolent monopoly” as they are a neutral arbiter of communication. He suggested that blockchain could substitute a neutral technology for a neutral firm. He asked how advocates of direct access would ensure that shareholders receive equal access. **Crozier** suggested that there is a level playing field today under Delaware statutes. **Schorr** suggested that the SEC should have strict limitation on what the information could be used for, as well as penalties for misuse.

**Mina Nguyen (AQR Capital Management)** asked about the differing statements on the availability of vote confirmation. **Katz** said the technology may be available, but it is not being used. **Bertsch** said CII members do not feel they have vote confirmation in most cases. He said there is only vote confirmation if Broadridge is the tabulator. **Dampeier** said vote confirmation is available, but not in all cases. He suggested that adoption of vote confirmation should be mandated or encouraged. He said Broadridge tabulates roughly 50 percent of U.S. meetings.

**Verret** said blockchain has promise for tabulation, reconciliation and recordkeeping, but it also has broader promise for improving corporate governance. He suggested that securities laws may impede adoption of beneficial technologies. He urged the SEC to put out a concept release on the future of corporate governance and blockchain.

**Jennifer Marietta-Westberg (New York Presbyterian Hospitals)** asked how the direct economic costs and benefits from changes to the proxy voting system could be calculated. She asked how this

data could be obtained. **Dampeier** said Broadridge could provide voter response data for different voting channels. He said they also have data on costs from postage for physical mail.

**Stam** asked Lebow if there are barriers to new firms looking to cause change in the proxy environment. **Lebow** said there is not a healthy competitive market, suggesting that there is an artificial price ceiling. **Dampeier** said the fee rate is set by NYSE. **Stam** said this area needs to be addressed and NYSE may not be the appropriate entity to set the fees.

**Jerome Solomon (Capital Group)** said Lebow commented that if mutual funds cannot get votes part of their fee should be held back. He asked why this should only be applied to mutual funds. **Lebow** said this would incent the people producing voter instruction forms to encourage voting. He said there should be an incentive fee to encourage voting.

**Sheehan** suggested that a look a proxy voting infrastructure is long overdue. She suggested that the Committee may consider a recommendation in this area.

### **Discussion Regarding the Commission's Proposed Transaction Fee Pilot in NMS Stocks**

**Sheehan** said the Market Structure Subcommittee had drafted a recommendation on the SEC's proposed transaction fee pilot program for NMS stocks.

**Paul Mahoney (University of Virginia School of Law)** said for a long time exchanges imposed fees on each transaction, but more they recently moved to maker-taker pricing. He said brokers can have a great deal of discretion about which venue they send orders to. He stated that the pilot is meant to examine how the pricing structure distorts broker incentives. He said maker-taker can hypothetically create conflicts between the interests of brokers and customers, stating that the pilot should examine if and how often this actually occurs. He said the data from this study would inform whether the Commission should rethink its regulation of access fees.

**Verret** said he supports the recommendation and commended the SEC for its approach to the pilot. He said exchanges have implicitly threatened to sue the Commission if they move forward with the pilot, suggesting that they would lose. He contended that the recommendation would be relevant to subsequent litigation.

**Mashburn** said the goals of the pilot are laudable, but a pilot is not the best way to obtain the desired data. She suggested that the data already exists, but is hard to get to. She said the SEC should look at where data already exists before making an experiment of 3,000 companies. She suggested that the rebate issue is a symptom of larger problems with Regulation NMS. She said there are problems with the rebate structure, but a pilot is not the best way to address it. **Stivers** asked Mashburn to elaborate on her statement about the larger problems with Regulation NMS. **Mashburn** said Regulation NMS has imposed a number of restrictions around order routing and best execution, which create perverse incentives for how orders are executed. She said the pilot would only examine one small part of a much larger system. **Silvers** said there are fundamental issues with the fairness of the market under Regulation NMS. He suggested that the pilot is a good start, but there should be a more comprehensive approach. He contended that the pilot is better than doing nothing. He said his "hedged support" for the proposal is not an attack on the order protection rule.

**Sheehan** said there is a need to view the pilot as part of a large system. She emphasized that the perfect should not be the enemy of the good. She said the Advisory Committee has urged the SEC to move forward with a review of Regulation NMS.

**Coates** said the recommendation has been viewed as an attack on the order protection rule, which it is not meant to be. He suggested that the recommendation be amended to include a statement that the SEC should pursue a broader review of Regulation NMS. **Mahoney** said he was fine with such a change and would add it to the recommendation.

**Marietta-Westberg** said there has been some recent press on the potential costs of the pilot. She said she would urge the SEC to pursue the most parsimonious model that would still obtain the desired data.

**Verret** said there is concentration in the market which is not due to market forces, but rather to government regulation. He said the pilot would examine the market concentration caused by the relationship between the large exchanges and the Commission. He said there are a range of directions the SEC could go after the pilot, one of which includes rescission of the order protection rule. He noted that next he would be hosting an event with Commissioner Robert Jackson and Tyler Gellasch of Healthy Markets. He said there is not a lot of data on the impact of rebates on best execution.

**Market Structure Subcommittee Chairman Matthew Furman** asked Mahoney to explain why issuers should not be concerned about whether they are in a test group or the control group. **Mahoney** said some people have argued that companies in buckets with lower fee caps could have less liquid stocks. He asserted that he does not agree with the view that the pilot will cause a major change in realized liquidity.

**A motion to approve the recommendation, as amended, was approved by voice vote.**

### **Discussion Regarding the Implications of Passive Investing**

#### *Panelists:*

Rodney Comegys, Principal and Head of the Risk Management Group, Vanguard  
Jeb B. Doggett, Managing Director, Casey Quirk by Deloitte  
Marcel Kahan, George T. Lowy Professor of Law, New York University School of Law  
Robert C. Pozen, Senior Lecturer, MIT Sloan School of Management  
Robert W. Sharps, Group Chief Investment Officer, T. Rowe Price Group, Inc.

#### *Presentations*

**Coates** said the rise of passive investing is one of the two or three most important trends in the market. He asserted that the panel was not geared at any particular policy outcome.

**Jeb B. Doggett (Casey Quirk by Deloitte)** said passive investment is one of the most important trends in asset management, suggesting that significant growth is likely to continue. He said global passively managed assets have grown to about \$15.6 trillion, which is 22 percent of global professionally managed assets. He said 50 percent of organic growth over the past three years went into passively managed funds. He said the rise of passive investment first began in the pension market and the defined contribution (DC) system. He stated that a major development in the rise of

passive investing was the development of exchange-traded funds (ETFs), suggesting that they are popular because they have tax benefits and offer access to new asset classes. **Doggett** said individuals have invested \$7 trillion in passive strategies. He said there are three main drivers of this growth: (1) performance; (2) fees; and (3) solutions. He stated that fees have risen in importance to intermediaries, noting that fees are declining rapidly in passive funds. He suggested that regulations like MiFID II will lead to a rise in passive investing in Europe.

**Rodney Comegys (Vanguard)** said passive investing has provided benefits to retail investors. He said indexing has brought extraordinary benefits to ordinary investors, including diversifying and globalizing portfolios, and democratizing professional investing. He pointed to the savings from transitioning from overpriced active investing to passive investing. He said passive funds provide an above average return with lower risk. He suggested that passive investing has pushed down the price of active management. He stated that passive investing has not created a market bubble or a momentum strategy. **Comegys** explained that index funds are price takers and not price makers. He contended that index funds have not caused market volatility. He suggested that certain products are inappropriate for retail investors, such as leveraged and inverted funds.

**Robert W. Sharps (T. Rowe Price Group)** said the rise of passive and rules-based investing has been one of the most important developments of the last decade. He said T. Rowe Price actively manages 95 percent of its assets. He said the rise of passive management is most acute in U.S. equities, but it is happening across asset classes. He stated that any such change is bound to have impacts, but they have mostly been minor thus far, though they could become larger later. He suggested that the largest impacts from the transition to passive trading will be felt during the next bear market. **Sharps** said portfolio managers have noted several concerns from the move to indexed investments. He suggested that indexed investment has led to correlation risk amongst constituent securities. He pointed to the impacts of the Health Care Spider ETF on underlying securities. He said they have observed a continued concentration of trading volume late in the day, which limits intra-day liquidity and heightens intra-day volatility. He suggested that active management drives price discovery and provides liquidity. He contended that the rise of passive management made it harder to transact on small and mid-cap stocks. He suggested that broadly passive sponsors vote their proxies responsibly, but said it is frustrating that they are often the swing votes in contested elections. He stated that Vanguard tends to vote more frequently with management than active managers or even their passive counterparts. He said the SEC should avoid any policy which promotes one strategy over the other.

**Marcel Kahan (New York University School of Law)** said passive index investors do not make stock market decisions, so the shift does not affect stock market efficiency. He suggested that the SEC should not require additional expenditures to promote research and analysis. He disputed claims that index funds are bad corporate citizens.

**Robert C. Pozen (MIT Sloan School of Management)** urged the Committee and the Commission to be neutral between active and passive. He said index funds are price takers, so active managers are needed to set the price. He suggested that there is a class of index funds with a labelling problem, such as leveraged and short funds, which are high cost and involve conflicts of interest. He suggested that they should not be labelled as ETF indexes, because they are so different from what is expected of an ETF. **Pozen** said index funds do not currently buy initial public offerings (IPOs), but they could do so with proper disclosures. He suggested that this could bring a huge pool of capital to the IPO market. He said the SEC should not add or take away corporate

governance votes from index funds, suggesting that they should be neutral. He said index funds are “fast followers” for activists. He suggested that funds like Vanguard, State Street and Fidelity do a pretty good job in handling shareholder proposals. He said index fund managers must be diligent and company-specific in regards to activist votes. He stated that the evidence is mixed on whether index funds promote better corporate governance and performance. He said to the extent index funds get into environmental, social and governance (ESG) investing they should either: (1) clarify how these efforts promote long-term value; or (2) make clear that they are trying to achieve a social goal rather than simply enhancing long-term value.

### *Discussion*

**Silvers** pointed to a professor who urged him to buy Vanguard funds, suggesting that this is still good advice. He stated that he personally invests in index funds. He said index funds have saved people lots of money in fees, suggesting that he is skeptical that there is any problem with passive management. He stated that during the financial crisis there were problems with money market funds, lifecycle funds, and hedge funds. He stated that there were disintermediation problems with money market funds. He asked if there are significant differences between ETFs and mutual funds in raising disintermediation under stress. **Pozen** said there are much greater problems for ETFs than index funds during periods of stress. He said there is now a Country Music ETF which only invests in companies near Nashville, questioning how it would function during a time of stress. **Sharps** said there are problems with less liquid assets during times of stress. He said the vast majority of passive funds are going into ETFs, which often doing a poor job of replicating the underlying securities. He suggested that ETFs will lead to dislocations which are greater or last for a longer period of time. He said there are benefits from passive investment, but at a certain point there can be too much of a good thing. **Comegys** said the ETF structure adds liquidity to the market. He said Vanguard urges investors to only buy funds which they can withstand the volatility of. He suggested that ETFs performed appropriately during the 2008 crisis.

**Verret** said the SEC should remain neutral between active and passive strategies, suggesting that they have struggled to do so in other areas. He suggested that the Committee should look at the portfolio restrictions around smaller companies. He asked if these restrictions still make sense. He asked the fiduciary implications of ESG investing by passive funds. **Sharps** said he was not familiar with the restrictions on investments in small cap companies. **Pozen** said disclosure is key for ESG investing. He said index funds could have social voting agendas, so long as they are disclosed. **Doggett** said fund managers can invest based on ESG goals, so long as they are disclosed to investors.

**Stam** said the panelists suggested that there is not much which needs to be done, but there is a need for greater understanding in this area. She suggested that the term passive is used too broadly. She asserted that some index funds invest in IPOs. She stressed the need to examine where any issues could emerge in the future. **Pozen** said there is a distinction between index mutual funds and index ETFs.

**Fairfax** asked if the corporate governance strategies are different for passive funds than actively managed funds. She asked if and where there should be concerns with ETFs and corporate governance. **Sharps** said most large passive investment sponsors have invested heavily in their governance teams. He suggested that passive funds have different processes than active managers. **Pozen** said activists present a difficult situation for index funds which do not follow individual

companies. He stated that activist proposals are very company specific and detailed. **Comegys** said Vanguard is a passive investor, but an active owner. He stated that they put a lot of resources into fulfilling their fiduciary duty. He said they take activist votes very seriously. He noted that Vanguard has more than \$1 trillion in actively managed funds, stating that they take input from their active managers.

**Marietta-Westberg** asked if there is a market friction driving the move towards passive investing. **Sharps** said he does not think so. He suggested that the arguments for passive investing have been reinforced by “recency bias.” He said it is inaccurate to argue that passive management is always better than active management. He stated that there are some passive funds where the index replication is poor and the costs are high. **Pozen** suggested that the market will reach an equilibrium point between active and passive management, but he does not know where it is. **Comegys** said active funds have much higher fees than passive funds.

**Silvers** said there is tension between the time horizons for active and passive. He asked how this tension affects corporate governance votes for firms with active and passive funds. **Pozen** said firms can vote differently in their active and passive funds.

**Coates** said the trends driving passive investment will not change any time soon. He suggested that soon 50 percent of votes for many S&P 500 companies will be held by the big five passive fund managers. He stressed the need to keep an eye on this issue.

### **Subcommittee Reports**

**Market Structure Subcommittee Chairman Matthew Furman** said the Subcommittee has voted on recommendations on retail protection in corporate and municipal bond markets, some of which the SEC has since adopted. He said they are also looking at liquidity for small cap stocks.

**Investor as Owner Subcommittee Chairman John Coates** said the Subcommittee is looking at additions to Regulation S-K related to human capital. He stated that they are also examining cyber risk.

**Sheehan** said the Advisory Committee’s December meeting would include panels on ESG reporting and the Financial Industry Regulatory Authority (FINRA) arbitration award issue.

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Jennifer Marietta-Westberg, Senior Economist, Cornerstone Research

Lydia Mashburn, Managing Director, Center for Monetary and Financial Alternatives, Cato Institute

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Damon Silvers, Director of Policy and Special Counsel, AFL-CIO

Anne Simpson, Investment Director, Sustainability, California Public Employees' Retirement System

Jerome Solomon, Fixed-income Portfolio Manager, Capital Group

Heidi Stam, Former Managing Director and General Counsel (Retired), Vanguard

J.W. Verret, Associate Professor of Law (with tenure), Antonin Scalia Law School, George Mason University and, Senior Scholar, Mercatus Center

Susan Ferris Wyderko, President and CEO, Mutual Fund Directors Forum