Legislation Targeting Proxy Advisory Firm Conflicts of Interest, Transparency Passed by House Financial Services Committee

Proxy Advisory Firm Regulatory Regime Approved on Bipartisan Vote

Over the past several years, there has been a significant focus on the influence, conflicts of interest and lack regulatory oversight of proxy advisory firms, leading to a debate over whether a more sophisticated approach is needed, and if so, how such oversight should be accomplished. Proponents of a regulatory regime have pointed to the outsized influence proxy advisors have over corporate governance and executive pay standards. Opponents to a regulatory regime have countered that regulation would inhibit competition and that the services proxy advisors provide are simply the ones requested by their clients. The debate led to the SEC issuing guidance on proxy advisory firm practices in mid-2014. However, shortcomings with that guidance, including the lack of public disclosures, have led to continued frustration, culminating with the introduction in 2016 and the subsequent re-introduction of the "Corporate Governance Reform and Transparency Act of 2017" (H.R. 4015) by Representative Sean Duffy (R-WI). The bill was passed on November 15, 2017 by the House Financial Services Committee on a bipartisan vote of 40-20 with six Democrats voting in favor, and would impose a SEC-based oversight regime on proxy advisors that would require the firms to address conflicts of interest and greater public disclosure of methodologies. The bill also had been included in the Financial Choice Act, which passed the House in June 2017. The following Policy Brief explains how there is a lack of a comprehensive proxy advisory firm oversight regime and how the Financial Choice Act would address that void.

Proxy Advisory Firms Exert Disproportionate Influence Over Corporate Governance and Executive Pay Practices Particularly since the beginning of mandatory say on pay, proxy advisory firms have played a significant and controversial role by providing proxy voting recommendations to investors (as well as determining votes for certain investors) on the ever-increasing number of proposals voted on at company annual meetings, including proposals to elect directors, and those to approve mergers, shareholder proposals, and say on pay votes. Most investors lack the resources in-house to analyze and make proxy voting decisions on every single vote they must cast for the hundreds or even thousands of companies in their portfolios. As a result, many investors rely heavily on the research and analysis proxy advisory firms provide. Because of this reliance, proxy advisory firms enjoy remarkable influence over corporate governance and executive pay standards.

At the same time, these firms are virtually unregulated. The lack of oversight has facilitated proxy advisory firm business practices which include significant conflicts of interest. Under these practices, the largest proxy advisory firm provides consulting services to issuers while also providing investors with voting recommendations on those same issuers; it also advises investors who are offering shareholder proponents on how to structure shareholder proposals on which the proxy advisory firm later will provide recommendations. Also highly problematic is the lack of transparency with regard to how proxy advisory firms determine their methodologies and the types of governance practices they support. Finally, the significant workload and low margins of the proxy advisory firm business can lead to frequent errors and inaccuracies in making recommendations which may have a material impact on issuer votes.

Shortcomings in SEC Oversight Yield Need for Congressional Action The lack of an existing regulatory framework for proxy advisory firms has led to the status quo where two firms hold 97 percent of the U.S. market and exert disproportionate influence over corporate governance and executive pay practices. Proxy advisory firms are virtually unregulated, however, they have been the topic of SEC oversight and Staff interpretive actions on multiple occasions. The most influential SEC Staff actions on proxy advisory firms came in the form of two SEC Staff No-Action letters issued in 2004. First, in May 2004, a No-Action letter to Egan-Jones articulated a duty for investment advisors, the primary client of proxy advisory firms, to verify that a proxy advisor was independent and free from influence. The letter, however, allowed investment advisors to do such verification themselves by evaluating "all the relevant facts and circumstances" surrounding the proxy advisor's services to the investor. A follow-up letter issued to Institutional Shareholder Services in September 2004 significantly limited the duties of investment advisors by holding that they could fulfill their duty to evaluate a proxy advisory firm by simply reviewing the proxy advisor's conflict of interest policies. As a result, proxy advisory firms utilize blanket, boilerplate conflict of interest policy disclosures and are deemed independent. Given proxy advisory firms' influence, the use of these boilerplate disclosures runs in direct conflict with the spirit, if not the letter, of the federal securities laws.

In 2014, following an SEC Roundtable discussion involving 20 witnesses, the SEC, in recognition that further clarity regarding investor and proxy advisory firm duties, issued Staff Guidance intended to increase the monitoring of proxy advisory firms by their investor-clients and requiring them to engage in enhanced monitoring of proxy advisory conduct. The Proxy Advisory Firm Guidance – known as Staff Legal Bulletin SLB 20 or SLB 20 – began by reviewing the responsibilities of investors with regard to proxy voting and the use of proxy advisory firms. The second part of SLB 20 requires proxy advisors to disclose to their clients when the proxy advisor has a material interest in the matter of a voting recommendation or has as "significant relationship" with either an issuer or a shareholder proponent of the matter—typically when the proxy advisory firm is determining proxy votes on behalf of the investor. However, SLB 20 made it clear that the disclosure of a potential conflict does not have to be public. Without the disclosure being public, SLB 20 has been ineffective at effectively addressing proxy advisory firm conflicts of interest and improving transparency.

Proxy Advisor Registration With the SEC to Include Significant Public Disclosure The Corporate Governance and Transparency Act makes it illegal to provide "proxy voting research, analysis, and recommendations to any client" unless a proxy advisory firm has registered with the Securities and Exchange Commission. To apply for registration, a proxy advisory firm would be required to furnish:

a) A certification that the proxy advisory firm has "adequate financial and managerial resources to consistently provide proxy advice based on accurate information";

b) The procedures and methodologies used in advising clients, including how the proxy advisor considers the size of a company when making proxy voting recommendations;

c) The organizational structure of the proxy advisor;

d) Whether or not the proxy advisor has a code of ethics;

e) A disclosure with respect to any "potential or actual conflict of interest" relating to the ownership structure of the proxy advisory firm including whether the proxy

advisor provides ancillary services, such as consulting, to corporate issuers, and if so the revenue derived from those services;

f) Conflict of interest management policies; and

g) Any other information prescribed by the SEC.

The SEC must either approve the application for registration or provide notice and the opportunity for a hearing on the grounds for denial. Upon SEC approval of the application, the SEC would be required to make all the information furnished in the registration application available for public inspection. A primary criticism of the 2014 SEC Guidance was that where proxy advisory firms were required to disclose conflicts to institutional investors, the disclosures were not required to be made public. The SEC has the power to pursue enforcement actions against an application which provides false or misleading data.

Bill Includes Major Conflict of Interest Management Requirements, Other Prohibited Conduct The bill aims to address some of the most common criticisms of proxy advisory firms which focus on conflicts of interest, concerns with inaccurate proxy advisor recommendations, and a lack of transparency surrounding the formulation of proxy voting policies. Under the terms of the bill, the SEC would pursue an enforcement action against a proxy advisory firm which fails to comply with the conflict of interest and other prohibitions. Regarding the formulation of proxy voting policies, under the bill, proxy advisors would be required to file with the SEC a public disclosure which details the formulation of its proxy voting policies and voting recommendations. The additional requirements concerning conflicts of interest and inaccuracies concerns are detailed below.

Bill Requires Significant Disclosures Concerning Conflicts of Interest. Under the bill, proxy advisory firms must maintain and enforce written conflict of interest policies and the SEC must engage in rulemaking which would either prohibit or require the management and disclosure of the following potential conflicts of interest:

a) How proxy advisory firms are paid by their clients;

b) The provision of consulting services by the firm or an affiliated entity. ISS currently provides consulting services through ISS Corporate Solutions, which is separated from the research side by a "firewall;"

c) Business relationships, ownership interests, or any other financial or personal interests between a proxy advisor an any other person, entity, or client. This is intended to address the conflicts concerning Glass Lewis, which is owned by the Ontario Teachers' Pension Plan – a major fund investor. Previously, ISS had been owned by a public company, MSCI;

d) Transparency around the formulation of proxy voting policies;

e) The execution of proxy votes if votes are based upon recommendations made by the proxy advisor in which the shareholder is a proponent;

f) Issuing recommendations where a proxy advisor provides consulting services to a client; and

g) Any other potential conflicts deemed by the SEC.

These listed conflicts of interest are directly aimed at addressing the bevy of complaints which have been aimed at proxy advisory firms. The bill also expressly prohibits proxy advisors from conditioning a voting recommendation on the purchasing of additional services, such as consulting services, from the proxy advisory firm. Likewise, it prohibits proxy advisors from departing from their methodologies if an issuer subscribes to additional services provided by the proxy advisor.

Bill Includes Provision Intended to Allow Companies to Discuss Draft Report, Address Inaccurate Proxy Voting Recommendations. The bill also addresses complaints which have focused on proxy advisory firms providing recommendations based on inaccurate data or processes. To address this, the bill would mandate that proxy advisors have sufficient staffing to produce accurate and reliable recommendations. Furthermore, proxy advisors would be required to have written and detailed procedures that would allow *all* companies to receive a draft report and be provided sufficient time to provide meaningful comment including the opportunity to present details directly to the drafters of the report. Currently only Fortune 500 companies have the opportunity to review draft reports and only from ISS. However, under the bill, the draft reports would not be the full draft reports companies currently receive from ISS. Instead it would only include the recommendations on proxy ballot issues, any public data cited in the report and any company information or substantive analysis affecting the recommendation. However, proxy advisors would be required to employ an ombudsman to receive and address complaints and must resolve the complaints in a timely fashion. The only notable difference between the 2017 version of the bill and the original version is that the 2017 version of the bill removes a provision which would require a proxy advisory firm to include a statement in the final report from the company detailing its complaints if the appointed ombudsman is unable to resolve a conflict.

Proxy advisory firms will also be required to designate a compliance officer who will be in charge of overseeing the conflict of interest and accuracy policies at the proxy advisor firm to ensure compliance with the securities laws.

Private Right of Action to Sue Proxy Advisors Over Reliability of Proxy Advisory Firm Services Removed. In the original version of the bill, companies were given the ability to sue proxy advisory firms in federal court if a proxy advisory firm fails to issue a reliable recommendation. However, the private right of action proved to be a significant deterrent to the bill's ability to receive bipartisan support so the provision was removed and replaced with a provision which states that nothing under the bill should be construed as providing a private right of action provided that the proxy advisory firm is in compliance with the rest of the requirements of the bill. A private right of action was not added back in the 2017 edition of the bill.

Proxy Advisors Required to Submit Methodology Formulations, Statement of Financial Condition, Annual Report. Another feature of the bill is an annual reporting requirement for proxy advisory firms which includes both an annual report and a statement of financial condition. The statement of financial condition requires the filing of financial statements certified by an independent public accounting. The annual reporting requirement will require proxy advisors to disclose the:

- Number of shareholder proposals reviewed by the proxy advisory firm;
- Number of recommendations made in the prior fiscal year;

- Number of staff members who reviewed and made recommendations on such proposals during the prior fiscal year; and
- Number of recommendations made in the prior fiscal year where the proponent of such recommendation was the client of or received services from the proxy advisor.

Additionally, proxy advisory firms must file with the SEC and make publicly available its methodology for the formulation of proxy voting policies and voting requirements.

SEC Required to Publish Annual Report on Proxy Advisory Industry, Instructed to Repeal Eagan-Jones, ISS No-Action Letters The bill also repeals two significant no-action letters, the Egan-Jones and ISS No-Action letters, which encourage institutional investors to use proxy advisory firms to mitigate their fiduciary liability and have helped proxy advisors to grow in influence. By repealing the No-Action letters, the SEC would be required to formally codify the No-Action letters by conducting a formal Commission rulemaking, which provides an opportunity for public comment or determining a different approach.

Additionally, under the bill the SEC will be required to publish a public report which identifies how many proxy advisors have applied for registration and gives the SEC's views on the state of the proxy advisory firm industry, including competition, transparency, methodologies and conflicts of interest. Further, the SEC will be required to comment on the quality of proxy advisory firm services, competition, any incidents of undisclosed conflicts of interest, as well as the process for registering as a proxy advisory firm.

Conclusion The Corporate Governance Reform and Transparency Act is an important recognition that the proxy advisory firm industry needs to be accountable for its research and recommendations. By creating a formal registration and oversight process, the bill creates considerable oversight for an industry that has significant influence yet has been largely unregulated.