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Will the New Year Bring Regulatory Oversight of the Proxy Advisory Firms?

The Senate and the SEC are operating on parallel paths toward the potential regulation of proxy advisory firms. However, the outcome remains uncertain.

We have seen many false starts on the road to regulate proxy advisory firms. Several recent Congressional attempts to pass legislation to regulate the proxy advisory firms have failed. In 2017, the U.S. House of Representatives passed two bills (the Financial CHOICE Act and the Corporate Governance Reform and Transparency Act) that would have imposed prescriptive requirements on the proxy advisory firms. Both of these bills died in the Senate. For its part, the Securities and Exchange Commission (SEC) has taken some recent action with regard to proxy advisory firms, but none that has fundamentally changed these firms' operating models or addressed many of the concerns of public companies. Despite past failures, there is now a renewed push to regulate proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass Lewis.

Currently, the U.S. Senate and the SEC are separately examining the possibility of imposing regulations on the proxy advisory firms. In this regard, on November 13, 2018, a bipartisan group of Senators introduced the Corporate Governance Fairness Act ("Fairness Act"), which would subject large proxy advisory firms to the Investment Advisers Act of 1940 ("Advisers Act"). Two days later, on November 15, 2018, the SEC staff held a roundtable discussion on the proxy process, which included a review of the role of the proxy advisory firms. On December 6, 2018, the Senate Finance Committee held hearings on the Fairness Act and on that same date, SEC Chair Clayton remarked in a speech that he has directed the SEC staff to recommend proposed regulation of the proxy advisory firms.

As discussed below, the Fairness Act, if enacted, would not likely result in meaningful changes in the business model or operation of the major proxy advisory firms. However, based on SEC Chair Clayton's recent remarks, the SEC appears poised to subject proxy advisory firms to potentially prescriptive rules that could directly affect their operations.

Corporate Governance Fairness Act

If enacted, the Fairness Act would require proxy advisory firms to:

- Register with the SEC as an investment adviser under the Advisers Act,
- Meet the fiduciary duty of care when providing advice to their clients (i.e., institutional shareholders),
- Allow regular SEC inspection of their books and records,
- Maintain policies and procedures to address conflicts of interest,
- Maintain and preserve certain books and records, and
- Comply with anti-fraud requirements.

Notably, the Fairness Act would not impose disclosure requirements on proxy advisory firms or require proxy advisory firms to give companies an opportunity to preview and comment on preliminary vote recommendations.

The Fairness Act would also require that within two years of its enactment, the SEC submit a report to select Congressional committees that: (i) evaluates registered proxy advisory firms' policies and programs regarding conflicts of interest, (ii) evaluates registered proxy advisory firms' policies and procedures that are designed to avoid knowingly making any false statement, or omitting to state a material fact, that would be necessary to make a statement to a client not misleading, and (iii) examines whether any additional protection to investors would be desirable. The SEC report could possibly lead to additional rulemaking or legislation.

Meridian Comments. Currently, the Fairness Act sits in the Senate Banking Committee, which held a hearing on the bill on December 6, 2018. Those called to testify[1] before the Committee had differing views of whether or how proxy advisory firms should be subject to regulatory oversight. However, each witness confirmed support for the Fairness Act and its imposition of fiduciary responsibility on proxy advisory firms. The Senate Banking Committee has not scheduled a vote on the Fairness Act or future hearings on the bill. Perhaps the Committee will defer action on the Fairness Act until it becomes clear whether the SEC will propose rules regulating the proxy advisory firms.

If history is any guide, the enactment of the Fairness Act would not likely significantly alter the business models or operations of the proxy advisory firms. For nearly 20 years, ISS has been a registered investment adviser under the Advisers Act. Nonetheless, the Advisers Act has had no major impact on ISS's business model, service offerings or operating procedures. Nor has it slowed ISS's aggressive expansion and marketing of consulting services to public companies for which it issues proxy vote recommendations. Additionally, the Advisers Act has not caused ISS to increase the transparency of its decision-making methodologies (in fact, it has arguably become less transparent). Lastly, the Advisers Act has not caused ISS to allow all public companies to review ISS's proxy vote recommendations.[2]

The Fairness Act would require the SEC to conduct periodic inspections of proxy advisory firms in accordance with a scheduled timetable. Frequent inspections could potentially result in proxy advisory firms making more company-friendly operational changes to their business models. However, that is far from certain.

SEC Staff Roundtable on Proxy Process

On November 15, 2018, the SEC staff held a roundtable discussion on the proxy process. As noted in our Client Update dated November 13, 2018, the roundtable was comprised of three distinct panel discussions, one of which focused on the proxy advisory firms. That diverse panel included representatives from two public companies (General Motors and Atlas Air Worldwide), a business-leaning think tank (American Enterprise Institute), four institutional investors and a professor at NYU Law School. In addition, the CEOs of the two major proxy advisory firms and a co-founder of Egan-Jones, a less prominent proxy advisory firm, sat on the panel.

Unsurprisingly, ISS and Glass Lewis voiced support for maintaining the status quo. During the roundtable, these proxy advisory firms contended that regulatory oversight of their industry is not required because their current business models: (i) deliver to investors highly valued services at a reasonable price, (ii) are responsive to public companies' concerns, (iii) adequately disclose and address conflicts of interest, and

[1] Testifying before the Committee were Mr. Daniel Gallagher, former SEC Commissioner, Mr. Michael Garland, Assistant Comptroller, New York City and Mr. Thomas Quaadman, Executive Vice President, U.S. Chamber of Commerce Center of Capital Markets Competitiveness.

[2] ISS voluntarily previews its vote recommendations solely with S&P 500 companies.

(iv) deliver company proxy reports that are subject to an extremely low error rate. To further bolster their position, the proxy advisory firms take the somewhat ironic position that their influence on proxy voting outcomes has been overstated.

Consistent with the ISS and Glass Lewis views, the four investor panelists were not in favor of regulatory oversight, fearing that any enacted legislation or regulation would increase their costs to access the services of the proxy advisory firms.

Lastly, the two public companies expressed concern about the accuracy of company proxy reports issued by the proxy advisors, as well as the inability to preview draft reports or meaningfully engage with proxy advisors during the proxy solicitation period. However, the companies stopped short of calling for new rules or regulations to govern the proxy advisory firms.

Meridian Comments*.* The SEC staff roundtable discussion ended inconclusively. The SEC staff could arguably interpret the discussion as generally supporting the status quo, especially given that the two public companies seemed reluctant to expressly and publicly support regulatory oversight of the proxy advisory firms. Institutional shareholder panelists were clearly opposed to intrusive regulation of the proxy advisory firms.

Contrary to the mixed outcome of the roundtable discussion, the majority of comment letters submitted in advance of the roundtable discussion were supportive of some form of regulatory oversight of the proxy advisory firms. Of the 76 parties who submitted comment letters that covered the role of proxy advisory firms in the proxy process, two-thirds favored such regulatory oversight. Notably, no public company submitted a comment letter to the SEC, other than Nasdaq.

SEC Chair Clayton's Speech on Potential Rulemaking

Perhaps motivated by these comment letters, SEC Chair Clayton in a December 6, 2018 speech noted that "there is growing agreement that some changes are warranted" with respect to proxy advisory firms. In particular, Chair Clayton noted that future rulemaking may address the following items:

- Clarity regarding the division of labor, responsibility and authority between proxy advisors and the investment advisors they serve,
- Framework for addressing conflicts of interests at proxy advisory firms,
- Transparency regarding investment advisors' analytical and decision-making processes, including the extent to which those analytics are company- or industry-specific, and
- Investor access to issuer responses to information included in proxy advisory firms' company reports.

Meridian Comments*.* The last two items are particularly notable. Potential rules relating to enhanced transparency could require proxy advisory firms to fully disclose "black box" and proprietary analytics underlying their decision-making processes. This transparency could allow companies to replicate a proxy advisory firm's analytics and determine the firm's likely vote recommendations across a number of proxy voting policies, which are currently subject to confidential proprietary analytics. More significantly, potential rules relating to the last item could require proxy advisory firms to allow all or some prescribed portion of public companies (e.g., Russell 3000 companies) the opportunity to preview and comment on proxy vote recommendations and to require the proxy advisory firms to include such comments in their final reports.

Chair Clayton has directed the SEC staff to formulate recommendations for the Commission's consideration that cover the above items and other issues. On the timing of any rulemaking, Chair Clayton made the following observation: "it is clear to me that the these issues will not improve on their own with time, and I intend to move forward with the staff recommendations, prioritizing those initiatives that are most likely to improve our markets for our long-term Main Street investors."

Chair Clayton's remarks are the clearest signal yet that the SEC is ready to move forward on an accelerated basis to adopt rules that could directly impact proxy advisory firms' operations and business models.

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