

Congressional Committee Debates Proxy Advisor Reform Bill

On May 17th of this year, the House Financial Services Committee held a hearing to review three legislative proposals intended to improve the U.S. economy. Chief among these proposals was a draft bill to regulate proxy advisory firms (the “Proxy Advisory Firm Reform Act of 2016”). The two sponsors of the bill, Representative Sean Duffy (R-Wisconsin) and Representative John Carney (D-Delaware), who are both members of the House Financial Services Committee, hail the bill as a strong step forward in promoting greater accountability, transparency, responsiveness, and competition in the proxy advisory firm industry.

A copy of the draft bill is available at financialservices.house.gov/uploadedfiles/bills-114-pafra-pih.pdf.

Significance of Bill

For several years now, the corporate community, as well as other observers, have expressed concern about the growing influence of the firms that are often retained by institutional shareholders to advise them and, in some instances, even cast votes of the matters being submitted for action at each year’s Annual Meetings of Shareholders. (According to various sources, Institutional Shareholder Services, Inc. (“ISS”) and Glass Lewis & Co. LLC., the two largest firms, control approximately 97% of the proxy advisory services market.) Further concerns have arisen about the business practices of these firms which are often cited for offering their consulting services to companies that receive an unfavorable vote recommendation. Although these concerns have existed for some time, until now there has been little action to increase transparency and accountability in this industry.

In 2014, the Securities and Exchange Commission held a roundtable to better understand the perspectives of both corporate issuers and the proxy advisory firms, which resulted in some interpretive guidance on potential conflict of interest issues (see SEC Staff Legal Bulletin No. 20). However, since the introduction of the mandatory shareholder advisory vote on executive compensation (the so-

called “Say-on-Pay” vote) and with the recent increase in shareholder activism, the influence of the proxy advisory firms continues to grow. This development has been exacerbated by the firms themselves, which continue to introduce new services and products that are derived from their primary analytical functions.

Summary of Bill

The bill, which would create a new regulatory framework under the Securities Exchange Act of 1934, includes the following requirements:

- **Registration requirement** – Every proxy advisory firm would be required to register with the SEC, with the information in its registration application becoming publicly available.
- **Registration statement disclosure** – The registration process would require each firm to describe, among other things:
 - ▶ its procedures and methodologies for advising its clients (including how company size influences voting recommendations);
 - ▶ its code of ethics (if any);
 - ▶ any actual or potential conflict of interest arising from its business model and its largest client relationships; and
 - ▶ its policies and procedures for managing conflicts of interest.
- **SEC must affirmatively approve registration** – The SEC would be required to take affirmative action to grant an application for registration, which may be denied if it finds that a firm “does not have adequate management or financial resources to consistently produce proxy advisory services with accuracy and integrity and to materially comply with [its own] procedures and methodologies...”

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- **Conflicts of Interest** – The SEC would be required to promulgate rules addressing the management and disclosure of any conflicts of interest by a registered firm, including potential conflicts relating to how the firm is compensated and the provision of consulting or advisory services.
- **Voting recommendation reliability** – Each registered firm would be required to:
 - ▶ Employ sufficient staff to produce accurate and reliable voting recommendations;
 - ▶ Implement procedures allowing companies sufficient time to receive and respond to voting recommendations before they are finalized and transmitted to clients; and
 - ▶ Employ an ombudsman to handle complaints about the accuracy of voting recommendations in a timely manner.
- **Prohibited conduct** – The SEC would be required to promulgate rules prohibiting unfair, coercive, or abusive acts or practices relating to the offering of services by a registered firm, including conditioning voting recommendations on the purchase of other services or products from the firm or any person associated with the firm.
- **Financial condition** – Each registered proxy advisory firm would be required to furnish the SEC certified financial statements and other information on its financial condition at intervals determined by the SEC.
- **Annual report** – Each registered firm would be required to annually report to the SEC, among other things, the number of shareholder proposals reviewed in the prior year, the number of recommendations made in the prior year, and the number of recommendations made in the prior year where the proponent was a client of or received services from the firm.

Next Steps

While the bill has yet to be formally introduced on the floor of the House of Representatives, this is largely viewed as a formality. And with its bipartisan support, it appears to have a good chance of being approved by the full House sometime later this year. No comparable legislation has been introduced in the Senate, however, and, in view of the presidential election later this year, it may be difficult

for the bill to be passed in what is certain to be a crowded legislative calendar.

Nonetheless, the bill has received support from several major organizations, including the U.S. Chamber of Commerce, Nasdaq, the Business Roundtable, and the Center on Executive Compensation. Consequently, it bears watching in the months ahead.

If you or your company are interested in supporting the bill, or would like to get involved in pursuing its objectives, you should contact your Congressional representatives. For additional information, you can contact the U.S. Chamber of Commerce or The Center on Executive Compensation.

Need Assistance?

Compensia has significant experience in helping companies understand and address the corporate governance and executive compensation policies of the major proxy advisory firms. If you have any questions on the topics covered in this Thoughtful Pay Alert or would like assistance in assessing how these policies are likely to affect your executive compensation program, please feel free to contact us. ■

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