NATIONAL INVESTOR RELATIONS INSTITUTE

The Case for Proxy Advisor Reform

The National Investor Relations Institute (NIRI), whose members include 3,300 investor relations professionals who represent over 1,600 public companies and $9 trillion in stock market capitalization, is pleased to support the Corporate Governance Reform and Transparency Act (H.R. 4015), which would provide greater oversight over proxy advisory firms.

H.R. 4015, sponsored by U.S. Reps. Sean Duffy (R-WI) and Gregory Meeks (D-NY), was approved by the U.S. House of Representatives in December 2017 by a vote of 238-182. This bipartisan bill has broad support from a variety of organizations, such as the Society for Corporate Governance, NYSE, Nasdaq, the Biotechnology Innovation Organization, and the U.S. Chamber of Commerce.

Proxy advisor reform is needed because Institutional Shareholder Services (ISS) and Glass Lewis & Co., which collectively control 97 percent of the U.S. market for proxy advisory services, exercise substantial influence over the annual meetings and corporate governance practices of public companies.

Collectively, ISS and Glass Lewis clients may own between 20 and 50 percent of a company's shares. While not all institutional investors follow the advice of the proxy advisors in all cases, many of them do so, particularly small and medium-size institutions that don't have their own corporate governance staffs. Although the proxy firms' influence varies by company and subject matter, governance experts have found that a negative proxy advisor recommendation can lead to a 15 to 30 percentage point differential in support for management. The influence of the proxy advisors has further increased since the arrival of Say on Pay votes on executive compensation in 2011.

Despite their significant influence, proxy advisors remain largely unregulated, while substantial concerns have been raised by companies and academics about: (1) a lack of transparency concerning their standards and methodologies; (2) the risk that their voting recommendations may be based on incorrect information; and (3) the conflicts of interest posed by several of their business practices, such as the ISS' consulting unit, which advises companies on how to comply with the opaque ISS guidelines for equity incentive plans.

Unlike investors and public companies whose proxy filings are subject to review by the Securities and Exchange Commission, proxy advisors generally are exempt from regulation. Although ISS has registered as an investment advisor, the SEC does not provide systematic oversight over the proxy firms' research processes, how the firms interact with companies, and how they communicate with investors.

To handle its proxy season workload, ISS hires temporary employees and outsources work to employees in Manila. Given the large number of companies that the proxy advisors opine on each year, the inexperience of their staffs, and the complexity of executive pay practices, it's inevitable that proxy reports will have some errors. Unfortunately, most companies don't have an opportunity to review draft reports for accuracy before investors start voting. ISS provides draft reports only to S&P 500 firms, while Glass Lewis does not allow any companies to see drafts. Glass Lewis also charges companies to see their final reports.

The need for greater SEC oversight has increased in recent years as many ISS and Glass Lewis clients have started using automated proxy voting systems whereby votes are cast based on preset voting policies without the institutional investor having to take any further action. The use of these automated systems appears to be growing among small and mid-size investment managers, as public companies have reported that a significant (up to 20 percent) percentage of their shares are voted within 24 to 48 hours of the issuance of the ISS proxy report.

The SEC issued a Staff Legal Bulletin in June 2014 that placed a greater onus on institutional investment managers to oversee the work of the proxy advisors they hire. While that staff guidance was a helpful first step, it did not adequately address how proxy advisors interact with issuers. In an August 2018 survey of NIRI's IR practitioner members, only 4 percent of respondents said they had received improved treatment (e.g., fewer errors in proxy reports, more responsiveness to concerns) from the proxy advisors. In addition, 66 percent of respondents said they had noticed factual errors or misunderstandings in their company's (or client's) proxy reports since June 2014.

The Duffy-Meeks bill includes a draft review requirement, which would help ensure that all companies are treated fairly and that investors receive more accurate proxy reports. In NIRI's 2018 survey, more than 95 percent of respondents agreed that the SEC should mandate a draft review process. H.R. 4015 also would provide greater transparency around the proxy firms' research practices and conflicts of interest.

The U.S. Senate Committee on Banking, Housing, and Urban Affairs heard testimony on this bill in June 2018. NIRI is hopeful that the Senate will act on proxy advisor reform this year and help improve the accuracy of proxy research while also increasing transparency around conflicts of interest.

Section-by-Section Summary of H.R. 4015 (Proxy Advisor Reform)

Section 1. Short Title

This Act is entitled the "Corporate Governance Reform and Transparency Act."

Section 2. Definitions

The term proxy advisory firm is defined as: "any person who is primarily engaged in the business of providing proxy voting research, analysis, ratings, or recommendations to clients, which conduct constitutes a solicitation within the meaning of section 14 and the Commission's rules and regulations thereunder, except to the extent that the person is exempted by such rules and regulations from requirements otherwise applicable to persons engaged in a solicitation."

Section 3. Registration of Proxy Advisory Firms

The bill provides for the registration of proxy advisory firms under the Securities Exchange Act of 1934.

Registration Procedures. A proxy advisory firm must file an application for registration with the SEC. The application must include the following information:

(1) a certification that the applicant is able to consistently provide proxy advice based on accurate information;
(2) the procedures and methodologies that the applicant uses in developing proxy voting recommendations, including whether and how the applicant considers the size of a company when making proxy voting recommendations;
(3) the organizational structure of the applicant;
(4) whether or not the applicant has in effect a code of ethics, and if not, the reasons therefor;
(5) any potential or actual conflict of interest relating to the ownership structure of the applicant or the provision of proxy advisory services by the applicant, including consulting or other ancillary services and the revenues derived therefrom;
(6) the policies and procedures in place to manage conflicts of interest; and
(7) Any other information the SEC deems to be necessary or appropriate.

The SEC has a 90-day period to decide whether it will grant or deny an application for registration. A proxy advisory firm has an opportunity for a hearing if the SEC intends to deny its application. This section also describes the grounds for a denial. The application for registration and all of the information submitted to the SEC by a proxy advisory firm shall be made available publicly, except for confidential disclosures and information exempt from FOIA disclosures.

Update of Registration. Each proxy advisory firm is required to update its application for registration on an annual basis, within 90-days after the end of each calendar year.

Censure, Denial, or Suspension of Registration. The SEC may censure, suspend, place limitations on, or revoke the registration of a proxy advisory firm if such action is "necessary for the protection of investors and in the public interest." Specific grounds for these disciplinary actions are listed in the bill.

Termination of Registration. The SEC may either accept the voluntary withdrawal of a proxy advisory firm from registration, or the Commission may cancel a registration.

Management of Conflicts of Interest. Each proxy advisory firm is required to establish, maintain, and enforce written policies and procedures reasonably designed to "address and manage any conflicts of interest that can arise from such business." The SEC is granted broad authority to prohibit, or otherwise regulate specific conflicts of interest, including the offering of consulting services to an issuer.

Reliability of Proxy Advisory Firm Services. Each proxy advisory firm is required to have "staff sufficient to produce proxy voting recommendations that are based on accurate and current information." Each firm is also required to develop procedures "sufficient to permit companies receiving proxy advisory firm recommendations access in a reasonable time to the draft recommendations, with an opportunity to provide meaningful comment thereon, including the opportunity to present details to the person responsible for developing the recommendation in person or telephonically."

The term "reasonable time" is defined as not less than three (3) business days.

Each proxy advisory firm is required to employ an ombudsman to receive complaints about the accuracy of voting information used in making recommendations from the subjects of the proxy firm's voting recommendations. The ombudsman is required to attempt to resolve complaints in a timely fashion and "in any event prior to the voting on the matter to which the recommendation relates."

If the ombudsman is unable to resolve such complaints prior to voting on the matter, the proxy advisory firm shall include in its final report to its clients a statement from the company detailing its complaints, if requested in writing by the company.

The bill defines the term "draft recommendations" as "the overall conclusions of proxy voting recommendations prepared for the clients of a proxy advisory firm, including any public data

therein, any company information or substantive analysis impacting the recommendation, and the specific voting recommendations on individual ballot issues." The definition also states that providing "draft recommendations" for review does not "include the entirety of the proxy firm's final report to its clients."[1]

Designation of Compliance Officer. Each proxy advisory firm is required to designate a person to be responsible for administering its compliance program.

Prohibited Conduct. The SEC is provided authority to prohibit any act or practice that is "unfair, coercive, or abusive," including (1) conditioning a voting recommendation on the purchase of other services or products, or (2) modifying a voting recommendation based on the purchase of other services or products.

Statements of Financial Condition. Each proxy advisory firm is required to file regular financial statements with the SEC, on a confidential basis and at intervals determined by the Commission.

Annual Report. Each proxy advisory firm is required to file an annual report with the SEC summarizing the "number of shareholder proposals its staff reviewed in the prior fiscal year, the number of recommendations made in the prior fiscal year, the number of staff who reviewed and made recommendations on such proposals in the prior fiscal year, and the number of recommendations made in the prior fiscal year where the proponent of such recommendation was a client of or received services from the proxy advisory firm."

Transparent Policies. Each proxy advisory firm is required to file with the SEC and make public its "methodology for the formulation of proxy voting policies and voting recommendations."

Rules of Construction. This section clarifies that the bill does not authorize a private right of action against a proxy advisory firm for either its conduct or its reports.

Regulations. The SEC is authorized to promulgate implementing regulations no later than 180 days after the enactment of the bill. The regulations are to be become effective within 1 year after the enactment of the bill.

The SEC is also required to review and, as necessary, amend its current rules and regulations that "affect the operations of proxy advisory firms." The SEC is required to direct its staff to withdraw the 2004 no-action letters (Egan-Jones and ISS).

[1] NIRI would like to amend this language so that the entire draft report is provided and not just excerpts. The bill also does not require public dissemination of all proxy advisory firm reports 90 days after a shareholder meeting, as the NIRI has recommended.

Applicability. The registration section of this bill will be in effect after regulations are issued in final form by the SEC.

Section 4. Commission Annual Report

The SEC is required to develop and publish an annual report on the Commission's website. The report is required to:

(1) identify proxy advisory firms that have applied for registration;
(2) specify the number of and actions taken on the applications;
(3) specify the views of the SEC on the "state of competition, transparency, policies and methodologies, and conflicts of interest among proxy advisory firms";
(4) include the determination of the SEC regarding the quality of proxy advisory services, the financial markets, competition among proxy advisory firms, the incidence of undisclosed conflicts of interest by proxy firms, the process for registering proxy advisory firms, and other matters relevant to this Act;
(5) identify problems, if any, resulting from the implementation of this Act; and
(6) Recommend solutions, including any legislative or regulatory solutions, to any problems identified.

Updated: September 10, 2018