Securities Regulation Daily Wrap Up, CORPORATE GOVERNANCE—Senate hearing focused on proxy advisers and board cyber expertise, (Jun. 28, 2018)

Securities Regulation Daily Wrap Up

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The Senate Banking Committee mulled bills on proxy advisers and cybersecurity as part of its ongoing review of legislation passed by the House and recently introduced in the Senate. The proxy adviser bill would require these firms to register with the Commission while the cybersecurity bill would require companies to disclose if any of their board members have cybersecurity expertise. The committee previously met to discuss numerous capital formation bills.

Proxy advisers. Perhaps the most controversial of the bills considered is one that would impose new requirements on proxy advisory firms. Thomas Quaadman, executive vice president of the Center for Capital Markets at the U.S. Chamber of Commerce, testified that there is a "crisis of entrepreneurship" in the U.S. In prepared remarks, he pointed to the increasing federalization of corporate governance generally and the lack of accountability of proxy advisers. During questioning from senators, Quaadman elaborated that proxy advisers do not have to disclose their conflicts of interests and he worried that one of the large proxy advisers is controlled by Canadian entities. He also said that the SEC's Staff Legal Bulletin No. 20 did not go far enough regarding proxy voting and that House legislation could resolve many of the issues left open by the SEC's guidance.

According to Darla Stuckey, president and CEO, Society for Corporate Governance, proxy advisory firms are prone to errors and adhere to a single framework for creating standards for evaluating companies. Stuckey also said in her written testimony that the SEC should withdraw two no-action letters on proxy advisory firms. In reply to a question, Stuckey likened proxy advisory firms to de facto regulators.

By contrast, Harvard law professor John Coates observed that legislation might be needed if the SEC lacked resources or authorities, but that H.R. 4015 was aimed primarily at regulating proxy advisory firms and that it was not clear how the bill's purposes would be achieved when proxy advisors already incur public scrutiny of their recommendations.

Damon Silvers, director of policy and special counsel for the AFL-CIO, noted that the bill could create more problems than it seeks to resolve. "Despite these findings, H.R. 4015 effectively gives corporations' CEO's and boards the ability to control the people who are supposed to be holding them accountable," said Silvers. He also explained in reply to questions from senators that the bill appears to require "perfection" by proxy advisers, a standard that is at odds with existing laws that focus on loyalty and care but do not punish mere mistakes.

Representative Sean Duffy (R-Wis) re-introduced the Corporate Governance Reform and Transparency Act of 2017 (H.R. 4015) to regulate proxy advisory firms. Similar language was included in the Financial CHOICE Act (H.R. 10; See Subtitle Q, Section 481, et seq.). The bill also is similar to one Rep. Duffy sponsored in the 114th Congress (H.R. 5311) and which was reported by the House Financial Services Committee 41-18 (by comparison, the current House FSC reported H.R. 4015 by a vote of 40-20 and it passed the House by a vote of 238-182). Moreover, the Treasury Department's report on capital markets cited a GAO study and the SEC's proxy concept release on the growing concerns about proxy advisers' influence, but the report did not take a position on proxy advisory firm regulation and instead recommended further study.

The Duffy bill would require proxy advisory firms to register with the Commission. Currently, most proxy advisers are not SEC-registered, but those that are do so under an exemption from the prohibition on registration as an

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investment adviser under Investment Advisers Act Rule 203A-2. Specifically, a proxy adviser may register as a pension consultant if it meets certain criteria, including that it advises plans with assets of at least $200 million.

The Duffy bill also would require a proxy advisory firm to base its voting recommendations on accurate and current information. A firm would have to develop procedures to afford a company access to draft recommendations within a reasonable time and to allow the company to offer meaningful comments. A proxy advisory firm would have to employ an ombudsman to handle complaints from companies and send a final report to clients that includes a statement by a company of its complaints about the accuracy of voting information; a firm would also have to appoint a compliance officer. Moreover, a proxy advisory firm would have to establish written policies and procedures that are reasonably designed to manage conflicts of interest.

Cybersecurity and other bills. A bill introduced by Sen. Jack Reed (D-RI) (S. 536) would direct the SEC to issue rules that require company boards to disclose if they have members with cybersecurity expertise or, if the board lacks such expertise, to otherwise disclose what other steps were taken in identifying and evaluating prospective board members regarding cybersecurity expertise.

Professor Coates said the bill is "well designed" and would require only brief disclosure; he added in his live testimony that boards are "strong-willed" and will choose whether to disclose or not, much as they do with respect to the presence or absence of financial experts on board audit committees under Sarbanes-Oxley Act Section 407. Both Quaadman and Stuckey expressed reservations about S. 536. Quaadman observed that the SEC's recently updated cybersecurity guidance (the SEC last issued guidance in 2011) and other regulations tell firms how to make disclosures about board oversight of risk.

Other bills that could receive additional consideration include the following:

- The Brokaw Act (S. 1744)—The bill would require any person who acquires certain beneficial or short interests to file a statement that contains the information required by Schedule 13D within four days.
- 8-K Trading Gap Act—Senator Chris Van Hollen (D-Md) explained that the bill would provide that, once a company decides that information is material, the four-day clock for disclosure on Form 8-K would begin to run and that executives should not be trading during this period.
- Fair Investment Opportunities for Professional Experts Act (S. 2756)—The bill would extend accredited investor status to licensed or registered broker-dealers and to persons with demonstrable education, job, or professional experience.
- S. 2499—Under the bill, FINRA would be required to create a relief fund to pay the full value of certain unpaid arbitration awards.
- Expanding Access to Capital for Rural Job Creators Act (S. 2953)—The bill would amend Exchange Act Section 4(j) to require the Advocate for Small Business Capital Formation to consider the interests of rural-area small businesses.
- Small Business Audit Correction Act (S. 3004)—Senator Tom Cotton (R-Ark) mentioned legislation he introduced to address the costs to small, noncustodial broker-dealers who would be exempt from certain SOX audit requirements. The bill was not on the list of bills to be formally considered by the committee.

Companies: U.S. Chamber of Commerce; Society for Corporate Governance

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