Securities Regulation Daily Wrap Up, TOP STORY—Senator Reed introduces proxy adviser regulation bill ahead of SEC roundtable, (Nov. 14, 2018)

Securities Regulation Daily Wrap Up

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The Senate has joined the debate over whether and how to regulate proxy advisory firms now that Sen. Jack Reed (D-RI) has introduced a bill to require the largest proxy advisory firms to register with the SEC under the Investment Advisers Act. The Corporate Governance Fairness Act (S. 3614), appears to stand in contrast to the Corporate Governance Reform and Transparency Act (H.R. 4015), which the House passed last year as a stand-alone bill mostly along party lines (about 12 Democrats voting in favor) and also passed as a component of the CHOICE Act (H.R. 10, Sections 481-483).

The Senate bill emphasizes investor confidence in the proxy advisory regime. "In short, the Congressional intent of this legislation is to preserve the critical role played by proxy advisory firms and to hold them accountable to investors," Sen. Reed said on the Senate floor.

The timing of Sen. Reed's bill was intended to coincide with tomorrow's scheduled SEC roundtable on the proxy process, at which the day's final panel will address proxy advisory firms. The question of proxy adviser regulation has been contested for many years. For example, the Treasury Department's October 2017 Capital Markets report cited a GAO study on growing concerns about proxy advisers but did not take a set position and instead recommended further study. The SEC previously issued its 2010 proxy plumbing concept release, held a November 2013 roundtable on proxy advisory services, and issued Staff Legal Bulletin 20 on the related topic of investment advisers' duties. The Senate Banking Committee mulled the House proxy adviser bill at a hearing in June 2018.

A quick comparison. Although the text of the Senate bill was not immediately available, it is possible, based on Sen. Reed's floor remarks and his press release, to puzzle out some of the apparent differences between the Senate and House proxy adviser bills. Perhaps the biggest difference is which proxy advisory firms would be required to register with the SEC.

Currently, proxy advisers are not required to register with the SEC, although a small number of firms do register with the SEC under an exemption from the prohibition on registration applicable to pension consultants that is contained in Advisers Act Rule 203A-2. The Senate bill would require "major" proxy advisers to register with the SEC as investment advisers, while smaller proxy advisers would have the option to register. In his floor remarks, Sen. Reed explained that the two-speed registration requirement was designed "…to not discourage new entrants into the proxy advisory business." Presumably, the bill text would define the characteristics that make a firm a "major" proxy adviser. Registration would be accomplished under the Investment Advisers Act such that proxy advisory firms would have fiduciary duties to their clients.

By contrast, the House bill would require all proxy advisers to register under proposed Exchange Act Section 15H. The House bill defines "proxy advisory firm" as any person primarily engaged in, among other things, the business of providing proxy voting recommendations and whose conduct falls within the meaning of "solicitation" as defined in Exchange Act Section 14 and the applicable SEC rules, unless otherwise exempted.

The Senate bill also would have the SEC conduct periodic examinations with two goals. First, the SEC must conduct a "serious review" of proxy advisers' conflicts of interest policies. Second, the SEC must review whether any proxy advisory firms "knowingly made false statements to any…clients."

The House bill, pending review of the text of the Senate bill, appears to contain more detailed, additional requirements. For one, proxy advisers would have to adopt written policies and procedures reasonably designed to address and manage conflicts of interest. The SEC would be required to issue rules to prohibit (or to manage and disclose) proxy advisers' conflicts of interest. Proxy advisers also would need to have sufficient staff to ensure the accuracy and currency of voting recommendations, while companies subject to recommendations could obtain reasonable access to, and comment on, draft recommendations; proxy advisers would have to employ ombudsmen to resolve disputes over voting information used in making recommendations. Moreover, proxy advisers would need to have compliance officers, refrain from engaging in prohibited conduct, confidentially file their financial statements with the SEC, file annual reports with the SEC, and file their methodologies with the SEC and make those methodologies publicly available.

The SEC would have annual reporting obligations under both the Senate and House bills. The Senate bill would require the SEC to consult with "all relevant stakeholders" and periodically report its recommendations for proxy adviser regulation to the Senate Banking Committee and the House Financial Services Committee. Under the House bill, the SEC would have to issue an annual report on proxy advisers that includes items to be brought to the attention of Congress.

Lastly, the House bill would require the SEC to withdraw two no-action letters regarding investment advisers' use of independent third-party recommendations in voting client proxies (*See*, Egan-Jones Proxy Services, May 27, 2004 and Institutional Shareholder Services, Inc., September 15, 2004). In September 2018, the SEC's Division of Investment Management, partly in preparation for the November 2018 proxy roundtable, issued a statement in which it withdrew these letters.

Prospects for enactment. The bipartisan Senate bill has five co-sponsors: Republican Senators David Perdue (R-Ga), Thom Tillis (R-NC), and John Kennedy (R-La), and Democratic Senators Heidi Heitkamp (D-ND) and Doug Jones (D-Ala). The prospects for enactment of proxy adviser reforms as the current session of Congress winds up may focus on whether some version of the House and Senate bills could be attached to other must-pass legislation.

The next Congress, however, will have a different composition and may produce different legislative goals for proxy advisers. Democrats will control the House while Republicans, with a somewhat larger majority, will remain in control of the Senate. Among the Senate bill's co-sponsors, Sen. Heitkamp, who lost her reelection bid, will be replaced by Republican Kevin Cramer, who currently holds North Dakota's at large congressional seat.

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