ALERT MEMORANDUM

The SEC Backs Off on Proxy Advisory Firms

November 23, 2021

Last week saw a new twist in the SEC's nearly 20-year struggle to develop a stable regulatory approach to the activities of the proxy advisory firms — principally ISS and Glass Lewis — that have come to play such an important role in shareholder voting at U.S. public companies.

Proxy advisory firms are principally in the business of advising institutional investors about upcoming shareholder votes. In July 2020, the SEC under Chair Jay Clayton amended the federal proxy rules to regulate proxy advisory firms, but that did not end the triangular controversy among the proxy advisory firms, their critics among public companies and their supporters among institutional investors.

The SEC under Chair Gary Gensler has now moved closer to the camp of the supporters, and on November 17, the SEC proposed new rule amendments that would eliminate the core elements of the new requirements imposed on proxy advisory firms in July 2020.[1] There will be a comment period on the proposal, and skirmishing in the courts, but the proposal seems destined to be adopted.

When that happens – and as a practical matter even before that – proxy advisory firms will not be legally required to provide the subject company with the guidance they provide to clients or to make the subject company's response available to their clients. Other aspects of the 2020 rules will survive, but, going forward, the process between proxy advisory firms and subject companies will be primarily a matter for private ordering, much as it was before the 2020 rules.

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[1] SEC Release No. 34-93595 (the "Proposing Release"), available here.

Background — the Road to the SEC's July 2020 Measures

The SEC's attention to proxy advisory firms dates back almost two decades. In 2004, the SEC staff issued two no-action letters indicating that relying on a proxy advisory firm could be a way for an investment adviser to avoid conflicts of interest in the exercise of its voting responsibilities. In 2010, the increasing role of proxy advisory firms was one focus of a broader concept release on the proxy voting process generally. The SEC staff issued a Staff Legal Bulletin in 2014, cautioning investment advisers against over-relying on delegation to proxy advisory firms in carrying out their fiduciary duties with respect to their proxy voting responsibilities.

Under SEC Chair Clayton, the focus intensified. In 2018 the staff withdrew the two no-action letters[2] ahead of a 2018 Roundtable on the Proxy Process,[3] at which the SEC gathered opinions from all sides. In August 2019, the SEC issued interpretation and guidance,[4] which elaborated the SEC's position on the duties of investment advisers that rely on proxy advisory firms and confirmed the SEC's view on the applicability of the federal proxy solicitation rules to proxy voting advice by proxy advisory firms.

The SEC has relied on two grounds in regulating proxy voting advice.[5]

— First, the SEC has taken the position since 2010 that proxy voting advice may be "solicitation" subject to regulation under Section 14 of the Securities Exchange Act of 1934. Proxy advisory firms have, however, proceeded on the assumption that they are not subject to the information and filing requirements that apply to proxy solicitation under the federal proxy rules.

— Second, many of the clients of the proxy advisory firms are themselves investment advisers, registered with the SEC under the Investment Advisers Act of 1940. If an investment adviser exercises voting authority, Rule 206(4)-6 under the Advisers Act requires it to adopt and implement written policies and procedures that are reasonably designed to ensure that it votes in the best interest of its clients. Since 2014, the SEC has emphasized to registered investment advisers that they should take these duties to clients into account when they rely on proxy advisory firms.

The SEC's July 2020 Rules

The Clayton SEC's focus on proxy advisors culminated with rules and guidance adopted in July 2020. The July 2020 rules had two main parts.[6]

— The SEC amended its definition of proxy solicitation so it explicitly includes proxy voting advice. It also amended its antifraud rule for proxy solicitations to include, as an example of a false or misleading statement, failure to disclose material information regarding proxy voting advice.

— The SEC adopted new conditions that a proxy advisory firm must meet in order to be exempt from the information and filing requirements that otherwise apply to proxy solicitations. These conditions include (1) conflict disclosures the proxy advisory firm must provide to its clients, (2) procedures to make proxy voting advice available to the company, at the latest when the advice goes to clients, and (3) a mechanism by which, if the company provides a written response to the voting advice, clients can reasonably be expected to become aware of the company's response in a timely manner. They do not apply to M&A transactions and contested elections,[7] or to proxy

[2] SEC Division of Investment Management, "Statement Regarding Staff Proxy Advisory Letters," available here.
[3] See our alert memo about the 2018 Roundtable here.
[4] See our blog post about the August 2019 guidance here.
[5] The SEC has not relied on the argument that the proxy advisory firms themselves are subject to regulation under the Advisers Act. The proxy advisory firms have different analyses of their own regulatory status, and only ISS is registered as an investment adviser under the Advisers Act.
[6] See our alert memo about the July 2020 rules here.
[7] Rule 14a-2(b)(9)(vi).

voting advice provided pursuant to custom policies.[8]

The new rules became effective in late 2020, but they had an extended compliance date of December 1, 2021 for the new conditions applicable to the proxy advisory firms. As a result, the new process and disclosure requirements would have applied for the 2022 annual proxy season.

This regulatory activity in 2019-2020 was accompanied by a party-line split in the Commission itself, with each new action opposed by the two Democratic commissioners. It also gave rise to voluminous and sharply divided commentary, which has not abated subsequently.

In June 2021, the SEC – now under Chair Gary Gensler – announced that it would reconsider the July 2020 rules,[9] and the SEC's Division of Corporation Finance announced that it would not take enforcement action for violation of the process requirements in the July 2020 rules.[10]

The party-line split at the Commission persists, with the two Republican commissioners dissenting at length from the decision last week to issue the Proposing Release. Political party lines have increasingly colored SEC rulemaking in recent years, and this trend seems likely to continue.

The New Proposal (1): Delete the Process Requirements for Proxy Advisory Firms

On November 17, 2021, the SEC voted to propose amendments to the rules adopted in July 2020. These amendments would leave in place the rules establishing that proxy voting advice is generally solicitation, and that proxy voting advice is exempt from the content and filing requirements of the proxy rules if the proxy advisory firm meets certain conditions.[11]

However, the amendments would eliminate the two process requirements that the July 2020 rules imposed as conditions to this exemption – making proxy voting advice available to the company and making the company's response available to clients.

The proposed amendments leave only one condition to the exemption intact: a proxy voting advisor must provide specified disclosures about conflicts of interest.[12]

To justify such a rapid change in its regulatory approach – proposing to amend rules adopted only 16 months ago after several years of analysis – the Proposing Release provides a "reassessment" of the policy judgments underlying the July 2020 rules. In particular, the Proposing Release:

— describes the continuing opposition from institutional investors and their trade groups, and expresses agreement with their concern that the July 2020 rules will have "potential adverse effects on the independence, cost and timeliness of proxy voting advice";[13]

— refers to the work of the Best Practice Principles Group (BPPG), a group of proxy advisory firms established under the auspices of the European Securities and Markets Authority that promotes a voluntary code of conduct for proxy advice;[14] and

— provides a detailed analysis of the current practices of the proxy advisory firms, which appears to rely heavily on a report published by the Independent Oversight Committee of the BPPG.[15]

[8] Rule 14a-2(b)(9)(v).
[9] SEC, "Statement on the application of the proxy rules to proxy voting advice," available here.
[10] SEC Division of Corporation Finance, "Statement on Compliance with the Commission's 2019 Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice and Amended Rules 14a-1(1), 14a-2(b), 14a-9," available here.
[11] The exemptions are set forth in paragraphs (b)(1) and (b)(3) of Rule 14a-2. The conditions are set forth in paragraph (b)(9) of Rule 14a-2.
[12] Rule 14a-2(b)(9)(i).
[13] Proposing Release at 22.
[14] Proposing Release at 14. The BPPG and its Oversight Committee have not attracted as much attention as they might, but we expect their prominence to increase in the wake of the discussion in the Proposing Release.
[15] Proposing Release at 15-19.

The most striking feature of this analysis is how differently ISS and Glass Lewis approach providing subject companies with access and an opportunity to comment on voting recommendations. In particular, Glass Lewis comes far closer than ISS to the kind of responsive process with subject companies that the July 2020 rules sought to promote.

The Proposing Release argues that there are "market-based incentives" for the firms to improve their issuer outreach practices, and that rescinding the process requirements of the July 2020 rules will provide them with "flexibility to select mechanisms" for that purpose. It also states without further explanation that "our continued observance of these mechanisms in practice, including during the 2021 proxy season, has given us additional confidence in their efficacy."

The New Proposal (2): Adjust the Exposure of Proxy Advisory Firms to Antifraud Litigation

The July 2020 rules amended the definition of "solicitation"[16] under the SEC's proxy rules to cover the existing proxy advisory firms as expressly as possible. Since proxy voting advice is solicitation, it is subject to Rule 14a-9, which prohibits the making of false or misleading statements in a proxy solicitation. Rule 14a-9 includes a note giving examples of statements that may be false or misleading, and the July 2020 rules added an example specifically for proxy advisory firms: failure to disclose material information regarding proxy voting advice, such as the firm's methodology, sources of information, or conflicts of interest.

The proposed amendments leave in place the amended definition and confirms the possibility that Rule 14a-9 liability would apply to proxy voting advice. However, it would delete the examples from the note to Rule 14a-9. The Proposing Release explains that the change is meant to reduce uncertainty about the liability risks proxy advisory firms may run, and to confirm that they are not liable for statements of opinion. The Proposing Release provides a brief interpretive discussion of the SEC's basis for that view, citing among other things the Supreme Court's decision in the *Omnicare* case.[17]

While it is true that commentators have expressed concern about liability exposure for proxy advisory firms, the SEC has not historically brought enforcement actions against them, and neither have companies covered by their voting advice. There is case law finding that an investor has a private right of action against a company under Rule 14a-9, but a claim by a company against a proxy advisory firm would be a step further. It seems unlikely that companies will assert such claims in connection with ordinary course proxy voting advice, for practical and reputational reasons, although perhaps in an especially contentious proxy battle or merger a party might have a sufficient incentive for bringing such a claim.

Related Litigation

As mentioned above, the proposed amendments would not alter the language adopted in July 2020 under which proxy voting advice is viewed as a solicitation. That view had already been expressed in the 2010 Concept Release and then echoed in the 2014 Staff Legal Bulletin and in the August 2019 guidance.

ISS has challenged this view in federal court, in an action against the SEC, arguing that the interpretation that proxy voting advice constituted a solicitation under the federal proxy rules "exceeds the SEC's statutory authority under Section 14(a) of the Exchange Act and is contrary to the plain language of the statute."[18] The action was first brought in 2019, stayed until the conclusion of the 2020 rulemaking and then resumed, but in June 2021 it was stayed again

[16] Paragraph (l) of Rule 14a-1.

[17] *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, 575 U.S. 175 (2015) (for purposes of liability under Section 11 of the Securities Act, a sincere statement of pure opinion is not an 'untrue statement of material fact' even if the belief is wrong unless it contains embedded facts that are false or omits the basis of the opinion, if that basis differs from what a reasonable observer would expect).

[18] *Institutional Shareholder Services Inc. v. Securities and Exchange Commission* (U.S. District Court for the District of Columbia). The complaint is available here.

when the SEC announced that it would reconsider the July 2020 rules.[19]

Following the June 2021 announcement, however, the National Association of Manufacturers and Natural Gas Services Group, Inc. filed a separate lawsuit against the SEC in federal court, arguing that "[t]he SEC's suspension of the Proxy Advice Rule is flatly unlawful" under the Administrative Procedure Act because it was not done following a notice-and-comment procedure.[20] The parties are currently briefing summary judgment motions in this action.

Takeaways

— *Interaction between a proxy advisor and a subject company does not depend on SEC rules*. The proposed amendments will probably be adopted essentially as proposed, the process requirements in the July 2020 rules will be swept away, and in the meantime they are effectively a dead letter anyway. The Proposing Release says that Glass Lewis and ISS are already interacting with subject companies much as the July 2020 rules would require. With the stimulus removed, nothing will require them to do so.

— *Investment advisers are still subject to the same SEC rules and guidance as before*. The SEC has not proposed to rescind the various measures it took in 2019-2020, which already became effective, to require investment advisers to exercise caution in relying on proxy advice and to consider issuer responses that are made available. The Proposing Release does raise the question whether they should be modified, but it does not enter into any detail.

— *Company reaction to proxy advice*. Many companies already consider putting out additional soliciting material in response to proxy voting advice, and some do so. Even without SEC rules on the matter, developing market practices may give companies better and more timely opportunities to respond, and their responses may get increasing attention from investors. But there are still reasons not to respond, and not to be confrontational — including reluctance to highlight the voting advice and reluctance to pick a fight with a proxy advisory firm.

— *The SEC has changed camps*. Regulation of proxy voting advice is just one example: the SEC under Chair Gensler is more open to the arguments of institutional investors, and less open to the arguments of registrants, than under Chair Clayton. The forthcoming proposals on ESG disclosure will presumably also reflect this change.

— *The BPPG has moved into the spotlight*. Corporations that hope to develop a better process with proxy advisory firms should take a close interest in the work of the BPPG and especially its Independent Oversight Committee. With the momentum of the Proposing Release, that group could have an important positive impact on the process.

— *The big picture*. From the issuer point of view, the dissatisfaction with proxy advisory firms has largely to do with the power of a duopoly of advisors to develop and promote a substantive corporate governance agenda. The SEC was never going to change that, and the BPPG probably won't do so either. The dynamics of the proxy advisory firms' influence could still change, though, as a result of evolving relationships among stakeholders, including increasingly assertive stewardship agendas on the part of investment managers themselves.

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[19] The June 2021 announcement came only days before scheduled oral arguments on motions for summary judgment, and promptly after the announcement the case was suspended.

[20] *National Association of Manufacturers. v. Securities and Exchange Commission* (U.S. District Court for the Western District of Texas). The complaint is available here.