SEC Regulation of Proxy Advisory Firms – Recent Developments

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Background on Proxy Advisory Firms

• Proxy advisory firm – *a working definition*:
  • An independent third party hired by institutional investors (and investment advisers with authority to vote shares on behalf of their clients) to provide advice and recommendations about how to vote their shares on proposals included in public company proxy statements.

• Examples of proxy advisory firms: Institutional Shareholder Services (“ISS”) and Glass Lewis.

• Proxy advisory firms have developed a prominent role in the executive compensation area, particularly since the advent of “say-on-pay” advisory voting under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.
The SEC and Proxy Advisory Firms – Recent History (prior to 2019)

• For several years, the Securities and Exchange Commission (“SEC”) has been gathering information regarding proxy advisory firms, in light of the significance of institutional investors to U.S. capital markets and concerns raised by some about proxy advisory firm business practices.

• For example:
  • 2010 Concept Release on the U.S. Proxy System (Release No. 34-62495) (seeking comment about, among other things, the role and legal status of proxy advisory firms),
  • 2013 Roundtable on Proxy Advisory Services,
  • 2014 SEC Staff Legal Bulletin No. 20, Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms, and
  • 2018 Roundtable on the Proxy Process (including a panel on the role of proxy advisory firms)
August 2019 SEC Interpretive Guidance

- On August 21, 2019, by a 3-2 vote, the SEC issued two pieces of interpretive guidance related to proxy advisory firms:
  - Securities Exchange Act Release No. 34-86721, Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice (the “Proxy Adviser Release”):
    - The Proxy Adviser Release sets forth the SEC’s interpretation that the voting recommendation of a proxy advisory firm generally constitutes “solicitation” of a proxy for federal securities law purposes, regardless of whether the person providing the advice itself is seeking authorization to act as a proxy.
    - This interpretation would subject proxy advisory firm recommendations to the anti-fraud provisions of the proxy rules.
    - Investment advisers that are subject to regulation under the Investment Advisers Act of 1940 (such as asset managers hired by institutional investors) owe their clients a duty of care and loyalty with respect to their investment advisory services, including, where applicable, the voting of proxies.
    - The Investment Adviser release discusses how that fiduciary duty should apply to proxy voting on behalf of clients, particularly when the investment adviser hires a proxy advisory firm to assist with proxy voting recommendations.
ISS v. SEC

• On October 31, 2019, ISS sued the SEC in the U.S. District Court for the District of Columbia, asking the court to declare that the Proxy Adviser Release is invalid and to enjoin the SEC from taking any enforcement action against ISS based on the interpretation of the proxy rules set out in the Proxy Adviser Release.

• ISS claims include:
  • That the Proxy Adviser Release is contrary to the plain language of the Exchange Act and exceeds the SEC’s statutory authority under the Exchange Act (because proxy advisory firm voting recommendations are not given “in order to achieve a specific outcome” in a shareholder vote and because proxy advisory firms should be regulated by the SEC only under the Investment Advisers Act of 1940).
  • That the Proxy Adviser Release violates the Administrative Procedure Act, because it was not promulgated through notice-and-comment procedures.
  • That the Proxy Adviser Release is arbitrary and capricious.
SEC Proposed Rules Regarding Proxy Advisory Firms

• On November 5, 2019, by a 3-2 vote, the SEC proposed rules that, if finalized, would significantly impact the role of proxy advisory firms (Exchange Act Release No. 34-87457).

• Consistent with the August 2019 interpretive guidance, voting recommendations made by proxy advisory firms to their clients would constitute the “solicitation” of a proxy, causing the anti-fraud provisions of Exchange Act Rule 14a-9 to apply.
  • Specifically, solicitation of a proxy would include “[a]ny proxy voting advice that makes a recommendation to a security holder as to its vote, consent or authorization on a specific matter for which security holder approval is solicited, and that is furnished by a person that markets its expertise as a provider of such proxy voting advice, separately from other forms of investment advice, and sells such proxy voting advice for a fee.”

• Proxy advisory firms would be required to include in their voting recommendation reports prominent disclosures regarding conflicts of interest.

• An entirely new “notice and comment” process would be created:
  • A company that files its proxy statement at least 45 days before the shareholder meeting would be entitled to a 5 day notice and comment period in which to review and provide feedback on the proxy advisory firm’s draft report, and a company that that files its proxy statement at least 25 days before the shareholder meeting would be entitled to a notice & comment period of at least 3 days; the proxy advisory firm must provide the company with a copy of the final report at least 2 days before it is distributed.
  • In either case, by timely request, the company could require the proxy advisory firm to include in its voting recommendations report a hyperlink to a written response prepared by the company.
Where do We Go from Here? A Few Things to Watch

• Near term considerations:
  • The volume and nature of comments received by the SEC (the comment period expires February 3, 2020, unless extended).
  • The progress (or lack thereof) of ISS’s lawsuit against the SEC.
  • Will the SEC proposal, even though not yet effective, have any impact on proxy advisory firm approaches in the 2020 proxy season (e.g., any changes to the “boilerplate” disclosures in ISS and Glass Lewis research reports)?
  • Will the SEC proposal, even though not yet effective, have any impact on how issuers respond in the event of a negative recommendation from ISS or Glass Lewis during the 2020 proxy season?
  • Will the SEC proposal be finalized?

• Longer term considerations:
  • If the proposed rules go into effect, how will issuers use the notice and comment process?
  • Will the proposed rules have the effect of amplifying or reducing the relative power of any particular market participants (e.g., activist investors versus other institutional investors, issuers versus proxy advisory firms, relative competitive positions of different proxy advisory firms)?
  • How will investment advisers and institutional investors react to the proposed rules?
  • Will the proposed rules result in any changes in proxy advisory firm business models (e.g., regarding potential conflicts of interest)?