CLEARY GOTTLIEB

ALERT MEMORANDUM

Proxy Advisory Firms — The SEC Drops the Other Shoe

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On November 5, a divided Securities and Exchange Commission ("SEC") proposed new rules about proxy advisory firms.

The proposed rules would, if adopted, have three principal effects:

— Before a proxy advisory firm distributes its recommendations for a particular shareholder vote to its clients, it would be required to give a company an opportunity to comment on the recommendations. The proposed rules provide specific choreography for this interaction between the firm and the company.

— In the proxy voting advice that a proxy advisory firm distributes to its clients, the firm would be required, if the company so requests, to include a hyperlink to a company statement responding to the firm's recommendations.

— The proxy voting advice would also be required to include disclosures on conflicts of interest, including between the proxy advisory firm and the company. The firm would also have a strong incentive, under revised antifraud provisions, to include disclosure on its methodology and sources.

The proposed rules would also codify the view that proxy voting advice, as it is currently provided by ISS and Glass Lewis, constitutes a proxy solicitation. This view underpins the SEC's attempt to regulate the proxy advisory firms, and it is hotly contested, including in a lawsuit filed by ISS in late October.

The SEC has been signaling for some time that the amendments in this proposal were coming, most recently in guidance it issued in August 2019. Now they are here, and they probably represent the outer limit of what the current Commission will do on the topic of proxy advice. The proposal generally reflects requests that many companies have made, addressing their perception that the proxy advisory process has not been as careful, reasonable and fair as it should be in light of the substantial influence of the proxy advisory firms.

However, the proposal will attract opposition not only from the firms themselves but also from various shareholder groups, including large institutional investors that use their services.[1] The proposal may also attract opposition from smaller asset managers that rely on the proxy advisory firms to help them fulfill fiduciary responsibilities in respect of the voting of shares. The issuance of the proposal was opposed by the two Democratic Commissioners.

Given this expected opposition, there is some doubt whether the proposed amendments will advance to become rules, and the prospects for final adoption could be impacted by the political calendar. If they do advance, companies would probably find them to be valuable improvements in the proxy process, but these rules should not fundamentally change the relationships among companies, their institutional shareholders, and the proxy advisory firms. Nevertheless, it seems reasonable to wonder whether large institutional investors will change their approach to the regular shareholder engagement process if they believe the SEC's regulation of proxy advisory firms is too "management friendly."[2] For the proxy advisory firms, increased compliance costs and regulatory risk could impact pricing and competitive dynamics in a market that is dominated by only two firms, ISS and Glass Lewis.

Background — The SEC's Agenda on Shareholder Voting

Under Chair Jay Clayton, the SEC has pursued an ambitious review of the regulatory framework for shareholder voting at public companies. These topics are as controversial as ever, and the SEC has now taken a series of 3-2 votes on them.

Just three months ago, in August 2019, the SEC (also by a 3-2 vote) issued two separate releases providing "guidance" relating to proxy advisory firms.[3] The August guidance was styled as interpretive guidance under existing rules, rather than new rulemaking. One release described the proxy voting responsibilities of investment advisers and the steps they should take in connection with relying on proxy advisory firms. The other confirmed the SEC's previous guidance on the applicability of the proxy solicitation rules to proxy voting advice.

At the end of October — less than a week before the new rule proposal — ISS filed an action in federal court seeking declaratory and injunctive relief against the SEC's second piece of August guidance. ISS's principal contention is that its voting recommendations should not be regulated as proxy solicitations, but should instead be treated as investment advice and regulated under the framework for investment advisers. (ISS is registered as an investment adviser, but Glass Lewis is not.) That position, if it prevails, would sweep away the conceptual basis for this new proposal.[4]

1 See the statement released by the Council of Institutional Investors on the day the proposed rules were released: Leading Investor Group Rebukes SEC for Proposed Rules That Undercut Critical Shareholder Rights at https://www.cii.org/nov052019_shareholder_rights ("'CEOs do not like public challenges to how and how much they are paid, or to be second-guessed by shareholders on a range of environmental, social and governance matters,' said Ken Bertsch, CII's executive director. 'That is what is driving the concerted effort by lobbyists for CEOs to prod the SEC to shackle proxy advisory firms.'").

2 See *Id*. ("The Council of Institutional Investors (CII) today criticized the Securities and Exchange Commission (SEC) for proposing rules that undercut important shareholder rights and appear intended to limit shareholders' voice at public companies in which they invest.").

3 See our blog post about the August guidance HERE.

4 The ISS complaint gives a preliminary idea of the arguments ISS expects to make. It seeks to distinguish proxy advisory firms, which have no business interest in the shareholder vote other than to earn fee income from their advice, from others involved in the solicitation of proxies incident to another business interest that is not limited to providing advice; and it argues that only the second category should be regulated as proxy solicitation while the first should be

The SEC Proposal (Part 1) — Mandatory Interaction Between Proxy Advisory Firms and Companies

When proxy advisory firms issue voting advice, they do not follow the SEC rules that apply to proxy solicitations: their advice does not conform to the information requirements for proxy solicitations, and it is not filed with the SEC as proxy solicitations must be. This approach is permitted by two exemptions from the proxy rules, which have been in place for more than 25 years – paragraphs (b)(1) and (b)(3) of Rule 14a-2.[5]

The SEC's proposal would add new conditions to those exemptions, requiring a proxy advisory firm to interact with the company before distributing its voting recommendation to its clients. The basic structure of the dialogue would be as follows:

Review and feedback period

— The proxy advisory firm must provide the company with a copy of its proposed proxy voting advice for a "review and feedback period."

— The duration of the period depends on when the company files its definitive proxy statement: three business days if the filing occurs at least 25 calendar days before the shareholder meeting and an extra two business days if the filing occurs at least 45 calendar days before the meeting. No review and feedback period is required if the filing occurs less than 25 calendar days before the meeting, which would be very unusual for a typical shareholder meeting.

— The proxy advisory firm is not required to incorporate or reflect any of the feedback it receives in its recommendations.

Final notice of voting advice

— The proxy advisory firm must provide the company with a copy of its proxy voting advice, including any revisions made after the review and feedback period, two business days before distributing the advice to its clients.

Company statement

— If the company wishes to make a statement regarding the proxy voting advice, and it makes a timely request to the proxy advisory firm, the firm is required to include a hyperlink to the statement in its proxy voting advice. The company would have to file its statement as additional solicitation material.

Confidentiality agreement

— The proxy advisory firm can require the company to enter into a confidentiality agreement regarding its voting advice, which terminates upon its distribution to its clients. If the company does not agree, the firm is apparently excused from otherwise required company interaction.

This process would be a significant change to existing practices. Currently, ISS provides only S&P 500 companies the opportunity, very briefly (often 48 hours or less), to review materials, while Glass Lewis charges a fee for a preview of its report.[6] Where a plain factual error is brought to their attention, they have become more cooperative in correcting it, though

regulated as investment advice. Whether that distinction limits the SEC's authority to regulate the proxy advisory firms will now be for the federal courts to determine.

5 Paragraph (b)(3), adopted in 1979, provides an exemption for proxy voting advice given to someone with whom an advisor has a business relationship that meets specified conditions. See *Shareholder Communications, Shareholder Participation in Corporate Electoral Process and Corporate Governance Generally*, Release No. 34-16356 (Nov. 21, 1979). Paragraph (b)(1), adopted in 1992, provides an exemption for a solicitation that does not seek a proxy and meets certain other conditions. See *Regulation of Communications Among Shareholders*, Release No. 34-31326 (Oct. 16, 1992).

6 In 2019 Glass Lewis launched a pilot program which permits a limited number of companies to review its voting advice and to provide a "report feedback statement" to be delivered with the voting advice to Glass Lewis's clients for a fee. The proposed rules would require essentially the same process without charge.

the process can be inefficient. Where the company disagrees with the proxy advisory firm's analysis or wants to present counterarguments, its options are unsatisfactory, particularly if it has not reviewed the report in advance. Many votes are submitted by investors within three days after receiving the report, which inhibits the practical ability of a company to ensure that actual votes are not tainted by errors or to engage in dialogue with shareholders regarding disagreements prior to the submission of votes.

Under the proposal, assuming the required confidentiality agreement does not become an obstacle, almost every company would have a chance to review and provide feedback on proxy voting advice. Outright factual errors could be caught and corrected before the voting advice is distributed, with the antifraud provisions of Rule 14a-9 providing a strong incentive to do so.

The hyperlink option might become attractive as a vehicle to present the company's perspective on a contentious point, although its practical impact could be limited: many investment advisers and shareholders follow the recommendations of ISS or Glass Lewis precisely because they do not have the time or resources to evaluate complex competing arguments.

The SEC Proposal (Part 2) – Disclosures in Proxy Voting Advice

The SEC's proposal would also affect the content of the voting recommendations that proxy advisory firms distribute to their clients. First, it would require that the firms include specific disclosures on conflicts of interest, as an additional condition to the exemptions from the content and filing rules on which the firms rely. The rules would also require disclosure of any material transactions or relationships between the firm (and its affiliates) and the company in respect of the matter covered by the voting advice.

Second, the proposal would provide an "example" of omissions from proxy voting advice that "may be misleading." The example reads this way:

> *failure to disclose material information regarding proxy voting advice … such as the [firm's] methodology, sources of information, conflicts of interest or use of standards that materially differ from relevant standards or requirements that the Commission sets or approves.*

This example would be added to an existing note that accompanies Rule 14a-9, which is the antifraud rule that applies specifically to proxy solicitations, and it would provide the proxy advisory firms with a strong incentive to provide disclosures on the identified topics.

These disclosures would presumably quickly become boilerplate in practice, but they would serve to further focus the attention of the proxy advisory firms on developing processes to identify and address conflicts. Also, although the market is aware that ISS has both a proxy advisory business and a corporate advisory business, the disclosure would presumably be required to state whether or not the specific company in question hired the latter in regard to shareholder votes on which the former is rendering voting advice.

Antifraud Liability of Proxy Advisory Firms?

The SEC's position that the distribution of proxy voting advice is a "solicitation" under its rules — which it reiterated in the August guidance and now proposes to establish expressly by rule — led it to emphasize the applicability of Rule 14a-9, which prohibits the making of false or misleading statements in a proxy solicitation. The SEC could presumably rely on Rule 14a-9 in an enforcement action against a proxy advisory firm, which it has not done in the past. But in a private action, while there is case law finding that an *investor* has a private right of action against a company under Rule 14a-9, a claim by a company against a proxy advisory firm would be a step further — one it seems unlikely that companies will take for practical and reputational reasons in the ordinary course, although perhaps in a particularly contentious proxy battle or merger a party might have a sufficient incentive for bringing such a claim.

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The proposing release can be found HERE. The comment period will close 60 days after the release is published in the Federal Register, likely in mid-January 2020.

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