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ISS and Glass Lewis: SEC Adopts Proxy Advisor Reform – Initial Perspectives and Implications

Today, the U.S. Securities and Exchange Commission adopted amendments to the proxy rules governing proxy advisors (e.g., Institutional Shareholder Services ("ISS") and Glass-Lewis), which SEC Chairman Jay Clayton noted are part of the SEC's on-going efforts to "modernize and enhance the accuracy, transparency and effectiveness of [the] proxy voting system." He added that the new rules reflect the importance of ensuring that institutional investors act "in a manner consistent with their fiduciary obligations" and, especially when using third parties like proxy advisors, "have access to transparent, accurate and materially complete information on which to make their voting decisions."

As we previously discussed, the SEC's initial proposed rules met with a mix of supportive and dissenting views from investors, stiff resistance from the proxy advisory firms and the Council of Institutional Investors, and clear support from public companies and other market participants who share the concern that proxy advisory firms wield undue power and influence in the proxy voting process. Importantly, the SEC's adopting release also includes several warning shots that may restrain, at least in part, a few of the more controversial and abusive tactics that enable activist hedge funds and other market participants to unduly influence proxy advisory firm recommendations or evade Schedule 13(d)/(g) reporting requirements.

Summary of New Rules. The rules amend Rule 14a-1(l) to codify the interpretation and guidance released by the SEC in August 2019 (discussed here) that proxy voting advice constitutes "solicitation" under the securities laws and is subject to anti-fraud rules. With respect to proxy advisory firm policies and practices, revised Rule 14a-2(b) (and new sub-section Rule 14a-2(b)(9)) will require that proxy advisors comply with certain conditions to be able to rely on exemptions from the information and filing requirements of the proxy rules:

1. Increased Disclosure Regarding Conflicts of Interest. Proxy advisors must disclose material conflicts of interest in their proxy voting advice, which will assist investors to gauge the objectivity and reliability of the proxy advice.

2. Proxy Advisors Must Provide Reports to Issuers At Least Simultaneously With Distribution to Clients and Notify Investors of Issuer Responses Prior to Voting. Proxy advisors must adopt and disclose policies and procedures reasonably designed to ensure that their reports are given to issuers and that investors have access to issuer responses before voting. The new rules include two non-exclusive safe-harbors for proxy advisors to ensure compliance with these principles. First, reports must be shared with issuers prior to or at the same time as dissemination to investors, thus providing companies some opportunity to identify factual errors or methodological weaknesses in proxy advisor reports (many S&P 500, but not smaller-cap, companies already receive pre-publication draft reports from ISS). Second, proxy advisors must notify their clients that the issuer has filed or intends to file a response to the report if the company provides that notification to them (which will become a new practice pointer for companies).

Proxy advisors will also be required to include a hyperlink that allows investors to access the written views of the issuer as to the proxy advice. The rules leave it to the proxy advisor to determine how best to ensure that investors have an opportunity to review issuer responses before voting, including whether to disable automatic submission features that pre-populate clients' electronic ballots with voting recommendations and automatically submit them for counting.

<u>Anti-Fraud 14a-9 Rules and Proxy Voting Advice</u>. Because proxy voting advice is a "solicitation" under the securities laws, it is subject to Rule 14a-9, which prohibits material omissions and materially false or misleading statements. The amendments modify Rule 14a-9 to include new examples of when the failure to disclose certain material information (such as methodology, sources of information, and conflicts of interests, etc.) in proxy voting advice could be considered misleading under Rule 14a-9.

<u>Treatment of Proxy Contests, Other Contested Situations and M&A Transactions</u>. The rules also include certain exemptions from the safe harbor requirements to provide advance or contemporaneous disclosures to companies and issuer response alerts to investors that would apply to most director election contests as traditionally waged and certain M&A transactions where such matters "are subject to the Federal proxy rules' information and filing requirements, including the requirement to file and furnish a definitive proxy statement." Notably, this accommodation does not reach "exempt solicitations (including solicitations as to M&A transactions or contested matters)." Where these exemptions apply, proxy advisory firms will, for example, have the option to redact from early or contemporaneous distribution to issuers only the applicable portions of their proxy voting advice. How these exemptions will be applied in practice remains to be seen, including as to shareholder meetings involving multiple and related proposals, and proxy advisory firms will retain their outsized influence on some of the most sensitive and critical situations facing a company.

Activist Investors, Arbs, and Proxy Advisory Firms Behaving Badly. Tucked into the footnotes of a lengthy release and accordingly not yet receiving the attention they deserve are several other important statements. For example, the SEC has wisely addressed head-on the following practices that public companies and investors often have to contend with in activism situations.

<u>First</u>, companies and investors have experienced situations where activist investors, event-driven hedge funds, pension funds invested in the attacking activist investor and arbitrageurs seek to aggressively lobby proxy advisory firms against deals and other important matters with private calls and sessions without filing their own full proxy materials or disclosing their activity and views. The release makes clear that necessary disclosures by proxy advisory firms "may include disclosure about certain business practices in which the proxy voting advice business engages that might reasonably be expected to call into question its objectivity and the independence of its advice" such as where the advisory firm has a practice of "selectively consulting with certain clients before issuing its benchmark voting recommendation on a specific matter (e.g., a contested director election or merger)" given the risk that "consulted clients' voting preferences [may] influence recommendations given to other clients that were not consulted and importantly, without the knowledge of those clients not consulted."

Second, with respect to activist wolfpacks and other forms of potentially coordinated activity that is implemented to avoid triggering Schedule 13(d) requirements, the adopting release states that "use of a proxy voting advice business by investors as a vehicle for the purpose of coordinating their voting decisions regarding an issuer's securities without complying with the filing obligations of Section 13(d) or 13(g) would raise compliance concerns under the beneficial ownership reporting requirements."

Differences from the Proposed Rules. The amendments deviate from the SEC's initial proposal in certain important respects, potentially weakening the effort to dampen the outsized influence of proxy advisory firms. Notably, the SEC abandoned a key element of its proposal that would have required all proxy advisors to submit their reports to all companies before distributing them to investors. Advance submission would have given companies the opportunity to identify factual errors or methodological weaknesses in proxy advisor reports and make appropriate preparations to ensure investors have accurate and complete information when making voting decisions. Instead, the SEC adopted a much softer alternative that leaves it to the discretion of the proxy advisor as to whether to distribute the report to the issuer prior to or simultaneously with the distribution to investors.

The amendments also carve-out "custom policies" – that is, voting advice reflecting the particular preferences of the proxy advisor's client – from the notice and response requirements of the rules. This creates uncertainty as to whether notice and response requirements will apply in cases where institutional investors implement the same policies as their proxy advisor and/or have policies that are based in large part on their proxy advisor's benchmarks and policies, which are circumstances that should not be considered "custom" policies and that seem to us to be contemplated within the spirit of the notice and response rules.

Transition Periods, Effective Dates, and the ISS Lawsuit. Proxy advisory firms are not required to comply with the amendments concerning Rule 14a-2(b)(9) until December 1, 2021; full compliance would be expected for the 2022 proxy season. ISS previously filed a lawsuit against the SEC in federal district court in Washington, D.C. regarding the proposed rules, which lawsuit was stayed. In light of the changes made in the final rules and the significant differences from what was originally proposed, it remains to be seen whether ISS will withdraw the lawsuit or file an amended complaint.

Supplemental Guidance to Investment Advisers. Separately, the SEC Division of Investment Management supplemented its August 2019 guidance (discussed here) with respect to the fiduciary responsibilities of investment advisers (e.g., fund managers) as applied to proxy voting and their use of proxy advisory firms such as ISS and Glass Lewis. The updated guidance provides that investment advisers would likely need to consider an issuer response to a proxy advisory recommendation that is provided with sufficient advance notice and would reasonably be expected to affect the investment adviser's voting determination.

The guidance also calls for investment advisers to consider disclosing the extent of their use of automated voting and how their policies and procedures related to automated voting take into account additional information disclosed by an issuer. This guidance should temper investment advisors' use of "robo-voting" and wholesale reliance on proxy advisors' advice. It should also increase the likelihood of investor review of a company's supplemental proxy filings and/or responses, which companies may make more frequently as a result of these changes.

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The rules adopted today are not uncontroversial. Commissioner Allison Herren Lee dissented from the approval, channeling the views of some that the proxy voting system is "not broken" and that the new rules will increase cost and complexity and could impact management accountability to investors. The majority view of the Commission, however, was focused on the need to protect the ultimate beneficiaries, "Main Street" investors, and promote accurate and complete information in the marketplace, especially taking into account the outsized power and influence of proxy advisory firms and the substantial reliance still placed upon them by institutional investors and investment advisers.

Although the amendments adopted are not as robust as the SEC had initially proposed, we believe that the heightened disclosures and more balanced information resulting from the rules adopted today will ultimately improve the voting and engagement process and benefit long-term shareholders and other corporate stakeholders. Today's approval is an important step towards promoting accountability in voting, encouraging increased transparency into proxy advisors' methodologies and analyses, and reducing rote application of one-size-fits-all voting policies. These changes may also facilitate and encourage independent, informed voting decisions by institutional investors, more open dialogue between companies and proxy advisors, and direct engagement between companies and their investors.

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