The attached article, Corporate Governance Update: Regulatory Instability for Proxy Advisory Firms, was published in the New York Law Journal on July 27, 2022

July 28, 2022

Corporate Governance Update: Regulatory Instability for Proxy Advisory Firms

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The latest developments in the SEC regulation of proxy advisory firms are good news for ISS and Glass Lewis, but they are a disappointment for proponents of conscientious and consistent rulemaking. The 2020 updates to proxy advisory rules were the result of a thorough process that was conducted by Commission staff across ten years and two politically distinct administrations, yet the framework implemented by the 2020 rules has been substantially gutted in the span of just a few months — without ever having taken effect. This unwelcome instability in the regulatory environment casts unfortunate doubt on the SEC's commitment to being a nonpartisan, market-oriented regulator. It is likely to create uncertainty regarding future rulemaking, as to proxy advisory services specifically and as to potentially controversial areas in general.

The 2020 Rules

As we have previously observed, the SEC's 2020 proxy advisory rulemaking effort met with a predictable mix of responses. There was opposition from the proxy advisory firms and the Council of Institutional Investors, and there was approval and support from public companies and other market participants who share the concern that proxy advisory firms wield disproportionate power and influence in the proxy voting process.

From the standpoint of regulatory stability, the important feature of the 2020 rule amendments was that they were a decade in the making. The outsized role of proxy advisory firms was first addressed in a 2010 SEC concept release on the proxy voting process, and a 2014 Staff Legal Bulletin warned investment advisors that their fiduciary duties precluded over-reliance on proxy advisory firms. In 2018, the SEC held a roundtable on the proxy process and in 2019 issued interpretation and guidance that confirmed the applicability of the federal proxy solicitation rules to proxy voting advice by proxy advisory firms and elaborated the SEC's position regarding the responsibilities of investment advisers that chose to rely on proxy advisory firms. Continued work by Commission staff under the leadership of Chair Jay Clayton led to the adoption of rules and guidance in 2020 that represented the most significant steps the SEC had taken to date in regulating the provision of proxy voting services by proxy advisory firms. The prevailing view among market participants — other than proxy advisors and some of their clients — was that the 2020 rule amendments made meaningful improvements to

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the proxy voting process that would promote accountability and increase transparency regarding the advice of proxy advisory firms.

The 2021 Undoing

Revisiting the 2020 proxy advisory rulemaking was near the top of SEC Chair Gary Gensler's agenda. He announced in June 2021, two months after assuming office, that the SEC would be reviewing and reconsidering the 2020 rule amendments. The SEC stated that it therefore would not be enforcing the 2020 rules, which had been scheduled to take effect in December 2021. In late 2021, the SEC proposed amendments to the 2020 rules that substantially revoked the new conditions under which proxy advisory firms could provide advice through an exemption to the content and filing requirements of the federal proxy rules. These new amendments were approved as expected earlier this month. The 2022 amendments entirely eliminated the process requirements imposed by the 2020 rules, both of which were carefully targeted at improving transparency and accuracy in the provision of proxy voting advice. The rescinded requirements had been that proxy advisory firms make their advice available in advance to the subject company and that they make any company response available to their clients; the only 2020-imposed condition for exemption now remaining is that proxy advisory firms make certain disclosures as to conflicts of interest. Despite this victory, proxy advisory firms still chafe at the 2019 guidance that set the stage for the 2020 rulemaking by confirming the SEC's regulation of proxy voting advice as a proxy solicitation, and the 2022 amendments have prompted ISS to renew its legal challenge to this position.

The SEC's abrupt turnabout, taken without the benefit of seeing the 2020 rules in practice, has left market participants and observers wondering what changed between 2020 and 2022. The 2020 rulemaking effort had been a thorough one, years in the making, and the 2022 amendments seemed, by contrast, to have been undertaken hastily and with the goal of simply undoing what had been done. The 2022 reversal is a clear sign that the SEC is now prioritizing the interests of institutional investors. The press release announcing the adoption of the 2022 rules, albeit brief, highlighted the need of institutional investors for "independent and timely advice" from proxy advisors — while at the same time noting the rescission of the 2020-imposed condition that subject companies be made aware of that very same advice "in a timely manner" — as well as the "express[ed] concerns" of "institutional investors and other clients of proxy voting advice businesses."

In support of the 2022 amendments, the adopting release states: "We believe this new policy balance better alleviates the costs and risks to PVABs, as compared to the 2020 Final Rules, and better addresses PVAB clients' and other investors' concerns about receiving timely and independent advice from PVABs." These concerns were not new, having been on the record prior to the 2020 rule amendments, and the release asserts that the policy reassessment analysis "is supported by the continued, strong opposition" of institutional investors to the 2020 amendments as well

as "certain voluntary practices" of proxy advisory firms. The release notes that these firms have "market-based incentives" to follow some of the requirements of the 2020 amendments and that voluntary actions are generally more cost-effective. In essence, the SEC's explanations for its 2022 action seem to rest heavily on the view that proxy advisory firms should be given broad latitude and the benefit of any doubt. As evidenced by statements at the 2018 SEC roundtable and in comment letters submitted both in 2019-2020 and 2021-2022, there are many market participants that do not share the current SEC's accommodating view that self-regulation of proxy advisory firms is the optimal approach for the market.

Looking Ahead

The 2022 amendments cannot be seen as a necessary course correction — as they are not based on issues with implementation of the 2020 rules — but instead amount simply to a policy shift. Administrative policy changes are certainly appropriate from time to time; however, in order to maintain credibility and stability, they are properly the product of thoughtful, data-driven, and transparent processes. The SEC's precipitous reversal raises the question for market participants as to what they can expect going forward. Chair Gensler has an ambitious rulemaking agenda, and it remains to be seen what his legacy ultimately will be. If Commission rulemaking comes to be understood as politically driven rather than independently generated in response to market needs, then rules adopted near the end of a presidential term may be viewed, in effect, as provisional or at least up for negotiation. It would significantly undermine the SEC's effectiveness and authority if regulated market participants consider it an open question as to whether SEC directives will be enforced from one administration to the next. With its recent actions regarding the regulation of proxy advisory services, the SEC may have eviscerated more than the 2020 rules.