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SEC Signals New Direction On Proxy Advice Regulations

By **Tom Zanki**

Law360 (June 4, 2021, 8:30 PM EDT) -- The U.S. Securities and Exchange Commission's decision to reconsider new rules governing proxy advisory firms signals a policy shift that could alter or undo what is seen as a corporate-friendly regulatory regime installed at the tail end of the Trump administration.

SEC Chairman Gary Gensler directed staff on Tuesday to **reconsider recently issued interpretations and rules** governing proxy advisory firms, which sell voting advice to institutional shareholders of public companies. In turn, the SEC's Division of Corporation Finance said it won't recommend enforcement actions against proxy firms while the review is ongoing.

Gensler's statement didn't commit to any specific outcome. But his instructions that staff should consider recommending further regulatory action, combined with the SEC's political shift to Democratic control since the election of President Joe Biden, indicate that revisions are possible.

"It's likely there will be change," said Mayer Brown LLP counsel Laura Richman, who counsels SEC-reporting companies.

Whether existing rules will be repealed or altered isn't yet clear. A June 1 court motion by the SEC seeking to suspend litigation while the agency revisits its rules — the SEC is **being sued** by proxy firm Institutional Shareholder Services Inc. over its new policies — notes that further regulatory action could "substantially narrow or eliminate" issues under dispute.

U.S. District Judge Amit Mehta of the District of Columbia granted the SEC's motion to hold the case in abeyance Wednesday, several days before a hearing was scheduled.

The SEC's review involves two actions that would have increased oversight of proxy advisory firms and were passed by a divided SEC that disagreed on whether the rules were needed.

The first matter involves a **2019 SEC interpretation** stating that voting advice provided by proxy firms is considered a solicitation under federal proxy rules — meaning that such firms could be held liable for materially misleading or false statements. The agency also issued related guidance that year describing how anti-fraud rules apply to such advice.

The SEC followed up last summer, **enacting rules that codified** the 2019 interpretation. The rules also required that proxy firms abide by certain conditions to remain exempt from securities filing requirements that apply to corporations and activist investors under proxy rules. The conditions require that proxy firms disclose conflicts of interests and that such firms allow companies to review and respond to their voting recommendations before shareholders vote.

The interpretation and rules package followed a **contentious debate** on the role of proxy advisory firms, with Republicans supporting the measures on grounds that such firms have become influential in shaping corporate governance without much oversight. Democrats opposed both measures, which passed by 3-2 votes, concerned that the rules would harm investors' ability to obtain unbiased advice and hold corporate executives accountable.

Proxy firms advise institutional investors who own stakes in public companies on how to vote on board of directors elections, plus they provide advice on hot-button topics like merger proposals, CEO pay, and climate and diversity policies. Business groups allege that proxy advice is often conflicted and error-prone, criticism that **proxy firms dispute**. The proxy market is dominated by ISS and Glass Lewis & Co., both of which lauded the SEC for launching its new review.

A group representing institutional investors also voiced support for the review, saying larger shareholders never clamored for the rules. Council of Institutional Investors Executive Director Amy Borrus said "it's Christmas in June for investors" after the SEC statements came out.

"Last year's controversial proxy advice rule was a solution in search of a problem," Borrus said in a statement. "Institutional investors, who are the paying clients of proxy advisory firms, did not seek it, nor did they support it. Chair Gensler's action on proxy advice ... shows he is prepared to go big and bold, regardless of the almost certain pushback from the business community."

Business groups, which saw last year's SEC rules as reasonable efforts to hold proxy firms accountable and keep shareholders accurately informed, are pushing back. The U.S. Chamber of Commerce's Center for Capital Market Competitiveness and the National Association of Manufacturers argued that there was no need for a review.

"This rule was developed after years of debate and multiple rounds of public comment, and there is no justification for repealing it less than a year after finalization without any chance for its vital investor protections to take effect and be fairly evaluated," said Aric Newhouse, the NAM's senior vice president of policy and government relations, in a statement Thursday.

The SEC's Republican commissioners who supported last year's rules are also questioning why a review is necessary, saying the rules were extensively debated and duly enacted.

"We find it difficult ... to imagine what has changed in the roughly 10 months since the commission last considered this issue that would call into question such recently adopted requirements," SEC Commissioners Hester Peirce and Elad Roisman said in a joint statement.

Peirce and Roisman added that proxy firms are not required to comply with the new rules — which took effect in November — until Dec. 1, 2021, which they said "makes it challenging, if not impossible, for us to know how these requirements will work in practice."

In its statement Tuesday, the Division of Corporation Finance said that if the full SEC takes new regulatory action that leaves exemption conditions of the 2020 rules in place along with the Dec. 1 compliance date, then the division will not recommend any enforcement action "for a reasonable period of time" after resumption of ISS' litigation challenging the rules.

Eversheds Sutherland partner Cynthia Krus said that given the long history of the proxy feud — the SEC issued a concept release in 2010 seeking comment on whether it should intervene to improve the proxy system, though it took no action then — it's unfortunate that market participants don't have more clarity about how to prepare for the 2022 proxy season.

"What concerns me is the uncertainty," said Krus, who counsels companies and investment funds. "The market doesn't operate very well when you don't know what you have to do to comply. This leaves both the issuers and proxy solicitors in an uncertain environment."

Mayer Brown's Richman said that if the SEC does move forward with revisions, that likely won't happen at "lighting speed" given the time it takes regulators to issue notice on new rules and seek public comment. The agency is also grappling with other priorities.

Market participants should thus follow matters closely, Richman said.

"All parties involved in the proxy process should be monitoring what is going on," she said.

--Editing by Aaron Pelc and Kelly Duncan.