

Legal Update

SEC Investor Advisory Committee Calls for Revamp of SEC Proxy Voting Rules and Interpretations

In a 10-to-5 decision on January 24, the Securities and Exchange Commission Investor Advisory Committee ("Committee") voted to recommend to the US Securities and Exchange Commission ("SEC") that the SEC "revise and republish" two of its recently proposed rule amendments and two recent SEC interpretations regarding proxy voting matters (the "Proxy Actions"), namely:

- Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice, Release No. 34-87457 (Nov. 5, 2019) (the "Proposed Proxy Advice Rule Amendments");
- Procedural Requirements and Resubmission Thresholds under Exchange Act Rule 14a-8, Release No. 34-87458 (Nov. 5, 2019) (with the Proposed Proxy Advice Rule Amendments, the "Proposed Rule Amendments");
- Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Release No. IA-5325 (Aug. 21, 2019) (the "Investment Adviser Policy Statement"); and
- Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice, Release No. 34-86721 (Aug. 21, 2019)¹ (the "Proxy Advice Interpretation" and, with the

Investment Adviser Policy Statement, the "SEC Guidance").²

The Committee's [recommendations](#) are summarized below.

The Committee's Purpose The Committee was established pursuant to [Section 911 of the Dodd-Frank Act](#) to advise the SEC on matters related to, among other things, the protection of investor interests, the promotion of investor confidence and the integrity of the securities markets.³ The Committee is authorized to submit findings and recommendations to the SEC for its review and consideration, and on January 24, 2020, it voted to do so with respect to the Proxy Actions.

What were the Committee's concerns about the Proxy Actions?

The Committee voiced concern that the Proxy Actions:

- may collectively and on balance not serve investor interests; and
- will not reliably achieve their stated goals.

In the Committee's view:

- the US proxy system is in need of more basic reform;
- a link needs to be established between the Proxy Actions and clearly identified problems; and
- reasonable alternatives should be considered.

What did the Committee ask the SEC to do?

The Committee asked the SEC to consider the following as the SEC assesses its next steps regarding proxy voting:

Cumulative Impact – The Committee asked the SEC to consider the cumulative impact of the Proxy Actions on investors, and the potential for unintended consequences, particularly as they relate to small and mid-sized market participants. The Committee wants the SEC to ensure that the Proxy Actions will not result in “unjustified additional burdens and costs on small and mid-sized asset managers that will impair their ability to perform their responsibilities to clients.”

Practical Machinery – The Committee asked the SEC to consider whether the Proxy Actions will “preserve the critical role that proxy advisory firms play in the dissemination of information and in providing the practical machinery of proxy voting for the vast majority of shareholders (through their representatives).” The Committee believes that these services are “essential to the smooth functioning of shareholder engagement in governance and are not dependent on recommendations or advice on how to vote on specific matters.” The Committee recommended that the SEC evaluate the impact of the Proxy Actions on the proxy advisory service market, as the Committee believes the Proxy Actions could “impair the ability of proxy advisors to sustain their businesses, and deter new competitors to

enter the business, which could result in increased monopoly power and more—not fewer—one-size-fits-all voting outcomes.”

Identified Problems and Better Alternatives

– The Committee queried whether the Proxy Actions are “tightly linked to clearly identified problems” and further whether there are better alternatives. In this regard, the Committee called for a focus on economic analysis⁴ and a connection between the specific proposals and stated objectives. The Committee believes that this would help the SEC cultivate alternatives “that may be more likely to achieve the stated goals of the proposals at a lower net social cost.”

Draft Proxy Advisor Reports An example of an alternative that the SEC did not analyze and that the Committee believes would have a lower risk of proxy advice bias would be to “require proxy advisors to disclose a draft of their reports or recommendations to company managers simultaneously with or somewhat after they disclose them to proxy advisor clients, and to impose a waiting period before clients subject to the SEC’s jurisdiction could act on the advice or recommendations.” The Committee noted that at the SEC’s Proxy Roundtable, the SEC heard that “many asset manager clients of proxy advisors would prefer to see drafts before the company managers see the drafts.”⁵

What were the Committee’s overall recommendations to the SEC?

Revisit Priorities – The Committee reiterated its view that the Proxy Actions “simply do not address the most serious issues in the current proxy system—such as counting votes correctly.” The Committee strongly voiced its

belief that it is “critical that the SEC take up end-to-end vote confirmations, reconciliations, and universal proxies.” The Committee then admonished the SEC for not taking action to date on proxy plumbing matters:

Despite inclusion in the SEC’s overall proxy system agenda, despite our previous recommendations, no formal guidance or rulemaking regarding proxy plumbing yet have been published by the SEC, and the SEC has not moved to finalize its good 2016 proposal on universal proxies.

“**Proxy Plumbing**” Last September, the Committee submitted [recommendations](#) to the SEC regarding the US proxy system, i.e., “proxy plumbing.”

Revise and Republish the Proposed Rule Amendments

– The Committee recommended that the SEC revise and reissue the two Proposed Rule Amendments for the following six purposes:

- To present a “balanced assessment” of proxy advisors and shareholder proposals.
- To comply with SEC guidance on economic analyses for rule proposals.
- To present evidence that supports the need for the proposals, instead of “stating simply that problems ‘may’ exist.”
- To address alternatives to the proposals and further address why those alternatives are not “more likely to achieve the stated goals of the proposals at a lower net social cost.”
- To address more completely how the Proxy Actions impact small and mid-sized investment managers and retail investors.

Impact on Small and Mid-Sized Asset Managers

The SEC has noted the extreme concentration of the proxy advice market (there are two leading proxy advisory firms). Further, the SEC has acknowledged that “large institutions [rely] less than small institutions on the research and recommendations offered by proxy voting advice businesses.”⁶ The Committee believes that, given this, the proxy advisory firms may simply pass on all or a portion of any increased compliance costs resulting from the Proxy Actions to their clients. The Committee observed that the larger asset managers have “increasingly internalized voting analysis, are less in need of advisory services, and have more effective choice to cut reliance if not cost-justified” and that small and medium firms “do not have this choice. They will face heightened compliance costs, which may render their businesses unsustainable. Independent small and mid-sized asset managers are under severe pressures from substantial consolidation in the asset management industry and ongoing shifts towards index-fund sponsors.”

- To discuss the risk that the rules as proposed could “impair the ability of proxy advisors to sustain their businesses, or new competitors to enter the business, which could result in increased monopoly power and more—not fewer—one-size-fits-all voting outcomes.”

The Demise of the Proxy Voting Advisor?

The Committee believes that the Proposed Proxy Advice Rule Amendments⁷ create “the likelihood that smaller firms that the SEC seems to characterize as proxy advisors will exit the business (to the extent such firms are covered by the proposal), and potential new entrants will decide against doing business as proxy advisors; and there is a risk that one or both of the major proxy advisors may be unable to sustain its business model with the increased net costs caused by the rule.”

Reconsider the SEC Guidance – The Committee noted that the SEC Guidance did not go through a notice-and-comment process, and thus they did not “reflect the input that the rule proposals are now eliciting from knowledgeable stakeholders.” The Committee believes that this has created confusion for investors, and further that the SEC Guidance should be “reconsidered in the context of revised rule proposals that respond to the above recommendations.” The Committee stated that:

On the one hand, the SEC purported to not be changing anything material in its rules regarding shareholder voting or reliance on proxy advisors. On the other hand, there are widespread impressions, reinforced by some statements in and about the guidance by SEC Commissioners and staff, that the guidance was intended to “update” the way the SEC approached investment advisors’ fiduciary duties relating to proxy voting. From the perspective of a regulated investment advisor, any alteration that may increase the scrutiny of the SEC in its evaluation of compliance with a fiduciary duty is material.

More on the Administrative Process

The Committee noted a pending lawsuit in which one of the two major proxy advisors apparently suggested that it does not view the Proxy Advice Interpretation as reflecting no change. The Committee believes that this view “does corroborate some of the confusion that we believe the guidance actions created. The lack of clarity may reflect the fact that the guidance did not go through a public notice-and-comment process in which asset managers could have been asked whether the proposed guidance documents actually did add clarity. A motion by the SEC (which was unopposed by the plaintiff proxy advisor) to hold this litigation in abeyance pending the conclusion of the SEC’s proxy advice rulemaking has been granted.

Concluding Thoughts

As the SEC is not obligated to follow the Committee’s recommendations (which are advisory only), it is unclear whether and to what extent the SEC will consider and incorporate them going forward. The comment period on the Proposed Proxy Voting Amendments ended on February 3, 2020, and numerous comment letters have been submitted. Also, as mentioned above, the litigation involving the Proxy Advice Interpretation is currently on hold. In a related court filing, the SEC stated that it will not invoke that guidance as an independent source of binding law in any enforcement or regulatory action while the case is being held in abeyance. However, the SEC added that it may continue to maintain its interpretation of the underlying statutes and regulations.

Investment advisers of all sizes would be wise to closely follow the rulemaking process as well as related litigation and, if they have not yet done so, submit

comments to the SEC on the Proposed Proxy Advice Rule Amendments, which they may do even though the comment period has ended. Further, investment advisers that have not yet done so should carefully review the SEC Guidance and evaluate their own proxy voting practices and procedures.

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Endnotes

- ¹ Notably, the guidance in the Proxy Advice Interpretation was later incorporated into the Proposed Proxy Advice Rule Amendments (see below re: administrative process).
- ² For more information about these developments, please see the following Mayer Brown Legal Updates:
<https://www.mayerbrown.com/en/perspectives-events/publications/2019/11/sec-proposes-proxy-voting-advice-rule-amendments>,
<https://www.mayerbrown.com/en/perspectives-events/publications/2019/09/sec-publishes-guidance-on-the-proxy-voting-responsibilities-of-investment-advisers>
and <https://www.mayerbrown.com/en/perspectives-events/publications/2019/08/sec-issues-guidance-on-the-application-of-the-proxy-rules-to-voting-advice>.
- ³ A list of the Committee's officers and members can be found at <https://www.sec.gov/spotlight/investor-advisory-committee.shtml>.
- ⁴ See Current Guidance on Economic Analysis in SEC Rulemakings, Memo dated March 6, 2012, available at https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.
- ⁵ In the spirit of full disclosure, the Committee did note that this statement was made by a representative of one of the two leading proxy advisors and that the SEC might test the accuracy of this statement by surveying proxy advisor clients.
- ⁶ Rel. No. 34-87457 at 80.
- ⁷ Rel. No. 34-87457.

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