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The SEC's Proxy Advisory Firm Disclosure Reforms

The boards of directors of public companies provide strategic planning and oversight. The boards, in turn respond to the views of shareholders and may vote on proposed corporate changes if the proposals gain a majority of affirmative shareholder votes at annual and special shareholder meetings. Proposals may include issues involving prospective mergers, executive compensation, environmental policy, corporate diversity, political contributions, and executive management. Due to the large number and diverse array of issues in such proposals, proxy advisory firms have emerged to provide proposal voting recommendations to institutional investors, who are large shareholders in most public companies.

In July 2020, the Securities and Exchange Commission (SEC) adopted controversial amendments to its proxy rules implemented pursuant to the Securities Exchange Act of 1934 (1934 Act; P.L. 73-291) that require proxy advisory firms to disclose more information about themselves, including potential conflicts of interests. In July 2022, the SEC reversed key parts of the 2020 rulemaking.

The Proxy Advisory Industry

State-based business incorporation laws give the states substantial authority over companies that are incorporated within a given state, including various aspects of shareholder voting. Under such laws, at annual and special shareholder meetings, shareholders have the right to vote their shares to elect directors, approve or reject a company's generally binding management proposals, and submit and vote on generally non-binding shareholder proposals.

Within the parameters of the state incorporation laws, under Rule 14a-8 of the 1934 Act, the SEC oversees the types of information shareholder proposals contain, who is eligible to submit proposals for a vote, and how that information is disseminated to voters via a proxy statement. The proxy statement is an SEC-required document containing information that companies provide to shareholders to enable them to make informed decisions about proposals being considered at shareholder meetings.

Approximately 70% of the outstanding shares in publicly owned domestic corporations are owned by institutional investors such as mutual funds, index funds, pension funds, and hedge funds. Institutional investors' individual portfolios may contain the securities of hundreds of different public companies. As a consequence, for many of them, understanding the issues associated with multiple public company board member elections and thousands of shareholder proposals at corporate shareholder meetings can be both complicated and costly. Many medium and smaller-sized institutional investors often lack the necessary size to cost-effectively conduct such research and outsource such work to advisory firms. While they tend to conduct in-house research, some larger investors such as BlackRock also supplement their research through the use of advisory firms.

The advisory business is dominated by two firms, Glass Lewis and Institutional Shareholder Services (ISS), jointly estimated to have about 97% of the advisory market share. In 2004, two SEC no-action letters indicated that institutional investment managers could show that their proxies voted in the best interest of their clients through the use of voting policies formulated by independent third parties, such as proxy advisory firms. The development is widely credited with helping to "institutionalize" demand for the advisory firms' services.

Views on the Advisory Firms

Through the years, various academics and business interests—including the U.S. Chamber of Commerce, the American Council for Capital Formation, the Society for Corporate Governance, the Business Roundtable, the NASDAQ Stock Exchange, and the National Association of Manufacturers (NAM)—have argued that, among other things, advisory firms require additional regulation because:

- There tends to be an overreliance on them, said to be problematic because it diminishes the likelihood that investors will engage with portfolio firms. An extreme reliance is found in something called robo-voting wherein investor clients vote immediately after receiving advisory firm recommendations. A potential downside of this is that it leaves portfolio firms with little opportunity to assess the advice and respond.

- Their voting recommendations can push a social and political agenda that some contend have little connection to shareholder value. Chief among them are the pervasive so-called environmental, social, and political proposals whose contributions to shareholder value is a debate that has garnered mixed research findings.

- They have potential conflicts of interests that may bias their recommendations and are not adequately disclosed. For example, an ISS subsidiary earns fees from public companies for advising them on corporate governance and compensation policies.

- Their research protocols are not transparent, and the research may be subject to problematic omissions and methods and analytical flaws. These are said to be reinforced by the allegedly non-competitive nature of the industry's essentially duopolistic structure.

Countering such criticisms, advisory firms and investor interests—including union-based pension plans, the Council of Institutional Investors (CII), the Consumer Federation of America, and the SEC's Investor Advisory Committee—have argued the following:

- While investors are guided by the advisor's recommendations, they make their own voting decisions, and the advisory firms wield little actual influence over client voting behavior.
- The firms have established conflict of interest disclosure protocols and firewalls separating their proxy advisory work from their other services.
- The firms make an insignificant number of material errors in their work, and client concerns over inaccuracies are negligible.
- Robo-voting merely reflects investors' needs for informational efficiencies as they navigate the plethora of proposals that confront them.
- The ongoing demand for the firm's services is a reflection of generally positive client assessments of the value and the integrity of their work.

An array of academic research has lent some credence to both critical and supportive views.

The Regulation of Advisory Firms and the 2020 Rules

Rule 14a-1(l) of the 1934 Act regulates shareholder proxy solicitations—a shareholder's request to authorize another entity to cast his or her vote at shareholder meetings. Historically, advisory firms resisted the notion that their actions were subject to the SEC's broad definition of *proxy solicitation*. However, critically, they typically relied upon exemptions from the extensive information and filing requirements conventionally required of those who solicit proxies. The exemptions derived from SEC determinations that investors did not require the protections provided by such information with respect to advisory firm involvement in the proxy voting process.

In August 2019, the SEC issued interpretive guidance further clarifying its long-standing view that advisory firms are indeed subject to the federal proxy solicitation rules.

On July 22, 2020, referencing the aforementioned concerns over transparency, overreliance, inaccuracies, and conflicts of interest, the SEC adopted controversial final rules that amend various rules within the 1934 Act that require advisory firms to provide expanded disclosures. The rules went into effect on September 3, 2020, and are meant to ensure that advisory firm clients "have reasonable and timely access to more transparent, accurate and complete information on which to make voting decisions." Major components of the final rules were as follows:

- The SEC amended its definition of *proxy solicitation* under Rule 14a-1(l) to include advisory services involving proxy voting.
- The SEC amended Rule 14a-2(b) to adopt new conditions that a proxy advisory firm must meet in order to be exempt from the information and filing requirements otherwise applicable to proxy solicitations, including (1) conflict of interest disclosures advisory firms must provide their clients, (2) procedures to make advisory voting recommendations available to the target firm either at or right before it is given to clients, and (3) a mechanism through which portfolio firm responses to advisory firm voting recommendations are readily available to their clients before a corporate meeting; and
- The SEC amended Rule 14a-9 to include examples of when the failure to disclose certain material information on key elements involved in formulating proxy voting advice could be misleading and violate anti-fraud laws.

The final rules generally duplicate the rules as proposed by the SEC in November 2019—except they do not contain a requirement that advisory firms must give portfolio firms a chance to preview and respond to their voting recommendations prior to submission to their clients. Institutional investors were highly critical of that measure.

The U.S. Chamber of Commerce's response to the final rules typified reactions from the business community. It said that the rules would "protect investors, promote transparency, end conflicts of interest and boost U.S. competitiveness through oversight of … advisory firms." The CII's response typified that in the institutional investor community: The rules "could result in delays in distribution of proxy advice, driving up costs for investors, impairing the independence of proxy advice and causing uncertainty for institutional investors…. The SEC has not established a compelling case to tighten [their] regulation."

The 2022 Rule Reversal

In June 2021, the newly established SEC chair, Gary Gensler, said that the SEC would review and reconsider the 2020 rule amendments, which were to take effect in December 2021. That same month, the SEC's Division of Corporate Finance stated that it would not recommend enforcement of the 2020 proxy advisory firm rules while they were under agency reconsideration.

In November 2021, the SEC commissioners proposed new rules that reversed key parts of the 2020 rules. The rules were finalized in July 2022 and took effect in September 2022. In doing so, the SEC noted that advisory firm clients had complained that under the 2020 rules, their compliance costs had risen and "the independence and timeliness" of the advice on proxy voting had been undermined.

Under the 2022 rules, proxy voting advice would still be considered a "solicitation" under the proxy rules, and advisory firms would still have to disclose conflicts of interest. However, the new rules rescinded the 2020 rules requiring proxy advisory firms to (1) make their advice available in advance to the subject companies, (2) make any subject company response available to their clients; and (3) provide examples of situations in which the failure to disclose certain information in proxy voting advice might be misleading.

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