The Global CEO Advisory Firm

U.S. Regulatory Update: Are We One Step Closer to Proxy Advisor Reform?

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The Changing Dynamics

In a move that could have a far-reaching impact on companies, the U.S. Securities and Exchange Commission recently announced that it has withdrawn two guidance letters relating to how investors use proxy advisors. These withdrawals by the SEC, along with its stated rationale for the withdrawals and the two pieces of pending Congressional legislation (H.R. 4015 and H.R. 10, see Appendix) related to proxy advisors, collectively increase the likelihood for proxy advisor reform in the future. While some investors have already taken certain steps to lessen their reliance on proxy advisors, any proxy advisory reform would change the dynamics between companies, investors, and proxy advisors.

Key Proxy Voting Regulatory Background

In 2003, the SEC required investors to have proxy voting policies that ensure all proxy votes were cast in the best interest of their clients. The rule also required investors to manage potential conflicts of interest (e.g. conflicts that could arise if an investor were voting at the shareholder meeting of one of its clients), noting that reliance on proxy advisor recommendations can resolve such conflicts if the proxy advisor was "independent."

In 2004, the SEC issued two separate guidance letters confirming: (i) a proxy advisor that also provides advice to companies can still be deemed "independent"; and (ii) an investor could deem a proxy advisor "independent" based on a review of its conflict of interest policies. It has been argued that these letters also provided a safe harbor for investors to fulfill their legal proxy voting obligations by following proxy advisor recommendations in all instances and not just votes where there was a potential conflict for the investor.

In 2014, the SEC issued a bulletin outlining investors' responsibility regarding proxy voting and the use of proxy advisors. The bulletin was largely issued in response to arguments from the business community that the two major proxy advisors were not "independent" because of their governance consulting business (in the case of ISS) and ownership structure (in the case of Glass Lewis, which is owned by public pension funds). The bulletin also described the exemption available to proxy advisors from the disclosure requirements under the proxy solicitation rules, and the steps needed to qualify for that exemption.

In September 2018, the SEC withdrew the 2004 guidance letters to "facilitate discussion" at an upcoming proxy voting roundtable, and because of "other policy considerations in mind." The SEC also noted that upcoming roundtable discussions will help inform the 2014 bulletin (described above) and future proxy advisor regulation.

How Could Proxy Advisors Be Impacted by Proxy Advisor Reform?

Proxy advisors have been under scrutiny for many years regarding their perceived conflicts of interest and the accuracy of their research reports. Because of this scrutiny and concern about the quality of their reports, proxy advisors have been increasing their engagement with companies in recent years. However, proposed legislation would require proxy advisors to allow all companies to review the company's own research and recommendations prior to publication. This would likely increase proxy advisory firms' cost of doing business and would constrain their ability to engage with companies prior to formulation of the research. Proxy advisors may also feel pressure to be more collaborative and open to engagement with companies from a proxy policy perspective, at least in the short-term.

How Could Investors Be Impacted by Proxy Advisor Reform?

In response to both clients and the potential for regulatory reform, many large investors have been gradually decreasing their reliance on a proxy advisor's vote recommendations – developing their own proxy policies, increasing their governance staff, and expanding their engagement capabilities. Yet many investors still follow a proxy advisor's recommendation on some or all items, as a matter of policy. Regardless, all investors may seek to further reduce their reliance on proxy advisors given the looming probability of proxy advisor regulation.

Investors with significant corporate governance staff may expand even more to enhance their engagement and voting activities. Those investors with limited corporate governance staff may also expand to develop their own proxy voting policies, and perhaps even begin to engage with companies on proxy voting issues. And with an increased focus on responsible investing more generally, the evolution of investor proxy voting and engagement is by no means over.

How Could Companies Be Impacted by Proxy Advisor Reform?

If current legislation were approved in its current form, all companies would have the ability to review proxy advisors' draft research and recommendations and provide input prior to publication. Large companies that currently have a draft review available to them would be treated the same as all companies in the draft review process. Companies that disagree with a recommendation would have the ability to respond to the company and have their rebuttal included in the research report, although changing a recommendation requires a thorough understanding of proxy advisory firms' voting policies and procedures.

Given both the regulatory developments and the investor trends described above, companies should begin to prepare for the 2019 proxy season by:

- Reviewing the applicable regulatory developments;
- Designing an investor engagement plan (including investors that may never have engaged before);
- Developing an engagement strategy with the proxy advisors;
- Preparing a proxy statement with clear and compelling messaging;
- Keeping its board members appraised of the potential impact of proxy advisor regulatory reform; and
- Ensuring strong governance messaging is consistent across all channels (e.g., including website).

What Happens Next?

The SEC plans to hold a roundtable in November on a variety of proxy voting issues, including: (i) the voting process; (ii) shareholder proposals; (iii) retail shareholder voting; (iv) technology/innovation; (v) proxy advisors; (vi) staff guidance on investment advisor responsibility as to proxy voting and use of proxy advisors; and (vii) universal proxy cards. The SEC stated that it plans to utilize what it learns at the roundtable for future considerations, including proxy advisor regulation.

Conclusion

The SEC's recent decision to withdraw two guidance letters, its rationale for such withdrawal, and the pending legislation on proxy advisor reform described in the Appendix seem to establish a significant likelihood and clear path for proxy advisory reform. Any proxy advisory reform will impact not only proxy advisors, but will also impact investors and companies, putting companies in a necessary position to be increasingly regulatory-savvy, engagement-focused, and investor-targeted in their governance strategy.

We will keep you informed on these important and evolving issues as they continue to develop.

Appendix

The Corporate Governance Reform and Transparency Act (H.R. 4015)

The U.S. House of Representatives passed H.R. 4015 on December 20, 2017. The Senate Committee on Banking, Housing and Urban Affairs held a hearing on this bill on June 28, 2018, but there has been no further action to date. The bill aims to further regulate proxy advisors and would instruct the SEC to withdraw the two guidance letters related to proxy advisors described herein (which the SEC has already done). Under the bill, proxy advisors would be required to:

- Register as an investment advisor with the SEC;
- Disclose potential conflicts of interest and policies;
- Disclose their methodologies for policies and recommendations;
- Provide public companies with at least three days to review and comment on its report;
- Appoint an ombudsman to resolve disputes with companies;
- Have any such unresolved disputes disclosed in the research report; and
- Be subject to SEC oversight and potential suspension, censure or revocation.

The Financial Choice Act of 2017 (H.R. 10)

The U.S. House of Representatives passed H.R. 10 on June 9, 2017. It remains unclear if the U.S. Senate will take up the bill. While the bill primarily aims to amend bank regulations established under Dodd-Frank, it also contains material corporate governance reform, including:

- Increasing the eligibility requirements for shareholder proposals to 1% held for 3 years;
- Doubling the resubmission thresholds for shareholder proposals;
- Prohibiting shareholder proposals submitted by a person via proxy;
- Requiring similar regulation of proxy advisors (as described in H.R. 4015 herein);
- Prohibiting the SEC from issuing rules on universal ballots and Proxy Access;
- Requiring companies to hold “Say on Pay” votes only when material pay changes are made;
- Limiting the claw-back requirement for erroneously awarded compensation; and
- Repealing pay ratio, hedging policy, and board leadership structure disclosure requirements.

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