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THE LATEST IN THE SAGA OF THE SEC'S REGULATION OF PROXY ADVISORY FIRMS:

THE FIFTH CIRCUIT INVALIDATES THE SEC'S RESCISSION OF NOTICE-AND-AWARENESS PROVISIONS

On June 26, 2024, the Fifth Circuit Court of Appeals vacated a significant part of a 2022 Securities and Exchange Commission (SEC) rulemaking, which itself was a reversal of the agency's 2020 amendments to the rules relating to proxy voting advice produced and disseminated by proxy advisory firms. This is the latest chapter in the long, and as yet unfinished, story of SEC regulation of proxy advisory firms.

BACKGROUND

Public companies hold annual and special meetings at which shareholders vote on various corporate governance matters. Shareholders do not typically attend these meetings in person and instead cast their votes using proxies.

Proxy advisory firms, such as Institutional Shareholder Services Inc. (ISS) and Glass, Lewis & Co., provide advice to investment advisers and institutional investors on how to vote on matters at public company shareholder meetings through generally applicable benchmark recommendations, specialty policies such as a voting policy relating to sustainability, or recommendations tailored to a particular client's request. This advice is valuable to the proxy advisory firms' clients, given that many asset managers invest in hundreds, if not thousands, of companies, many of which hold their annual shareholders' meetings during the same time frame each year. However, the corporate community has long raised concerns about the extent of proxy advisory firms' influence over matters that public companies put to shareholder vote, including elections of directors, say-on-pay votes, and votes on shareholder proposals. Critics of proxy advisory firms have also argued that the firms face significant conflicts of interest, and that their vote recommendations are often incorrect.

The SEC has been examining issues surrounding proxy advisors and the proxy voting process over the course of many years. During the last administration, under Chairman Jay Clayton, the SEC tackled the

controversial issue of proxy advisory firm influence over proxy voting, first through the issuance of guidance and then revisions to the proxy solicitation rules. Those changes, and the SEC's subsequent reversal of certain aspects of those rules under Chair Gary Gensler, are the topic of a variety of lawsuits that leave the state of regulation of proxy advisory firms uncertain.

2019 GUIDANCE AND 2020 AMENDMENTS

The Securities Exchange Act of 1934 prohibits the solicitation of proxies with respect to registered securities in contravention of SEC rules, but the Act does not define "solicitation." Under the SEC's proxy rules, solicitations are subject to certain information and filing requirements unless an exemption applies. The SEC's longstanding position has been that proxy voting advice by a proxy voting advisor is a solicitation under the proxy rules. In 2019, the SEC published guidance and an interpretation confirming this position and that the failure to disclose material information regarding proxy voting advice could cause such advice to be misleading in violation of the proxy rules. ISS sued the SEC in the U.S. District Court for the District of Columbia in October 2019, asserting that the guidance was unlawful and seeking declaratory and injunctive relief. Because the SEC indicated that it was considering proxy voting advice amendments to the proxy solicitation rules, ISS and the SEC agreed that the litigation would be held in abeyance until the SEC promulgated its final rules.

In July 2020, the SEC adopted amendments to its proxy solicitation rules that:

- amended Rule 14a-1(l) to codify the SEC's position that voting advice provided by proxy advisory firms generally constitutes a solicitation under the proxy rules;
- added to the examples of misleading information in Rule 14a-9 to make clear that the failure to disclose material information regarding proxy voting advice, such as a proxy advisory firm's methodology, sources of information or conflicts of interest, could cause such advice to be misleading in violation of the proxy rules; and
- amended Rule 14a-2(b) to add the following principles-based conditions to the exemptions to the information and filing requirements of the proxy rules that advisory firms have historically relied on:
 - proxy advisory firms must disclose conflicts of interest to their clients in their proxy voting advice or in the electronic medium used to deliver that advice; and
 - proxy advisory firms must adhere to "notice-and-awareness provisions," namely by: (i) establishing procedures designed to allow all companies that are the subject of their voting advice to have access to that advice in a timely manner, and (ii) providing a mechanism for their clients to become aware of any written company response to their voting advice on a timely basis before they vote.

Following adoption of the 2020 amendments, ISS reactivated its litigation, challenging the adopted rules and the related SEC guidance.

CHANGE OF POSITION

The amendments to Rules 14a-1(l) and 14a-9 became effective on November 2, 2020, although those revisions did not create any new obligations. Compliance with the notice-and-awareness conditions in Rule 14a-2(b) was not required until December 1, 2021. Shortly after taking office, SEC Chair Gensler directed the SEC Staff to consider whether to recommend revising the newly adopted rules and as a result of this mandate, the SEC Staff published a statement announcing that it would not enforce the rules or related guidance.

In November 2021, the SEC issued a proposal to rescind certain aspects of the 2020 rules with an unusually short comment period of just 30 days. According to the rulemaking release, a reconsideration of the 2020 rules was necessary in part because in the 16 months following the adoption of the 2020 amendments, proxy voting advisors developed “industry-wide best practices” to address the concerns that caused the SEC to issue the 2020 amendments.¹

Subsequently, in 2022 the SEC adopted revisions to the proxy advisory firm rules that rescinded certain aspects of the 2020 rulemaking, including the notice-and-awareness conditions of the rule. In addition, the SEC removed the example from Rule 14a-9. The press release announcing the action explained the current SEC view that the 2020 rules “may impede and impair the timeliness and independence of proxy voting advice and subject proxy voting advice businesses to undue litigation risks and compliance costs.”

Notably, the SEC did not propose to rescind the amendment that codified the definitions of the terms “solicit” and “solicitation” as including proxy voting advice. As a result, the amended rule did not eliminate the requirement for proxy advisory firms, depending upon particular facts and circumstances, to disclose conflicts of interest.

The 2020 staff announcement and the 2022 rulemaking gave rise to a somewhat confusing array of litigation, including the recent Fifth Circuit decision.

FIFTH CIRCUIT - NATIONAL ASSOCIATION OF MANUFACTURERS V. SEC

In July 2022, the National Association of Manufacturers, along with the Natural Gas Services Group, filed suit against the SEC in the U.S. District Court for the Western District of Texas, asking that the 2022 amendments be declared invalid due to violations of the Administrative Procedure Act and for failing to adequately justify its change in position. They also argued that the comment period the SEC provided for the proposed rule changes did not provide interested parties a meaningful opportunity to comment on the proposal. In December 2022, the district court issued an order granting summary judgment to the SEC, which the National Association of Manufacturers then appealed to the Fifth Circuit Court of Appeals.

On June 26, 2024, a unanimous Fifth Circuit panel reversed the lower court's decision, vacated the 2022 rulemaking to the extent it rescinded the 2020 rule's notice and-awareness conditions, and remanded the matter back to the SEC.

The Fifth Circuit's decision makes clear that when a new administration comes into office, the SEC may change policies, "but if the new policy is based on facts different from those underlying the prior policy, a more detailed explanation is required. Failure to explain its decision to rely on different facts can be arbitrary and capricious." As the opinion explains, the SEC's explanation of its decision to rescind the 2020 amendments was arbitrary and capricious in two ways:

"First, the agency failed adequately to explain its decision to disregard its prior factual finding that the notice-and-awareness conditions posed little or no risk to the timeliness and independence of proxy voting advice. Second, the agency failed to provide a reasonable explanation why these risks were so significant under the 2020 Rule as to justify its rescission. These shortcomings require vacatur of the 2022 Rescission, but only to the extent it rescinded the notice-and-awareness conditions."

The Fifth Circuit further characterized that the SEC's concerns that the notice-and-awareness conditions threaten timeliness and independence of proxy voting advice as "facially irrational" and "wholly implausible."

The Circuit Court found that an appropriate remedy for a violation of the Administrative Procedure Act is to vacate the agency action. However, in recognition of the severability clause contained in the 2022 adopting release, the Court determined to vacate and remand to the SEC only those portions of the rescission related to the notice-and-awareness conditions.

In light of its conclusion that the SEC's action was arbitrary and capricious, the Court found no need to address appellants' arguments regarding the brief comment period.

SIXTH CIRCUIT - US CHAMBER OF COMMERCE V. SEC

In July 2022, a parallel challenge to the 2022 rescission was brought by the US Chamber of Commerce, Business Roundtable, and Tennessee Chamber of Commerce and Industry in the U.S. District Court for the Middle District of Tennessee. The parties sought to overturn the 2022 rulemaking on the same grounds advanced by NAM. The district court upheld the 2022 rules, but the Chamber and other parties have appealed to the Sixth Circuit Court of Appeals. Oral arguments took place in October 2023, but the decision has not yet been issued. The parties recently urged the Sixth Circuit to hold that the comment period was inadequate "which would provide the full relief that appellants seek—namely, vacatur of the entire rule[.]"

D.C. CIRCUIT - ISS LITIGATION

The ISS case in the D.C. District Court, which had again been held in abeyance while the SEC considered the 2022 rule amendments, was reactivated, challenging the SEC's interpretation of the term "solicitation," arguing that the SEC failed to comply with the Administrative Procedure Act, and that the views expressed in the 2020 adopting release were arbitrary and capricious. The National Association of Manufacturers intervened on the side of the SEC in support of the 2020 rule changes.

In February 2024, the D.C. District Court held that the proxy advisory firm rules were invalid, and that the "SEC acted contrary to law and in excess of statutory authority when it amended the proxy rules' definition of 'solicit' and 'solicitation' to include proxy voting advice for a fee." The SEC and the National Association of Manufacturers have appealed the decision to the D.C. Circuit Court of Appeals.

PRACTICAL CONSIDERATIONS

- The SEC has not yet indicated its next steps in light of the Fifth Circuit's remand, which is made even more complicated by the pending cases in the D.C. Circuit and Sixth Circuit Courts of Appeals. The various cases have created a potential divide among the Circuits as to whether, and to what extent, the SEC may regulate proxy advisory firms, which hopefully will be resolved prior to the next proxy season.
- In the meantime, public companies and their board should continue to engage with the proxy advisory firms in a constructive manner, including preparing for the potential reenactment of the notice-and-awareness provisions. In addition, public companies should expect further scrutiny and litigation involving proxy voting advice and voting practices of institutional investors more broadly.
- On a broader note, if in the future, SEC leadership attempts to reverse course on prior rulemakings, the Fifth Circuit's decision provides useful guidance to both the SEC and potential litigants on the need for the agency to adequately explain any departure from its prior factual findings.

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ENDNOTES

¹ There are three proxy advisory firms – ISS, Glass Lewis, and Egan-Jones – with ISS and Glass Lewis holding an estimated 97% market share.