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Leading Investor Group Blasts SEC's Proposed Rules for Proxy Advice and Shareholder Proposals

SEC Should Consider Narrower Mandated Review for Proxy Advice

Washington, D.C., January 31, 2020 — The Council of Institutional Investors today submitted comment letters to the Securities and Exchange Commission (SEC) that oppose the agency's proposed rules that would undercut important shareholder rights, hamper the ability of investors to cast informed votes at public company annual meetings and restrict the collective voice of shareholders on issues of concern at companies in which they invest.

The two proposals are the most significant attempt by the SEC to limit the voice of shareholders since the Commission was created in 1934. They would tighten regulation of proxy advisory firms and shareholder proposals in ways that CII believes are fundamentally flawed and unnecessary. If adopted, both proposals would introduce complexity and micromanagement in proxy voting and in shareholder-company engagement processes that have worked well for decades. CII urges the SEC to withdraw both proposals and focus instead on festering problems in the proxy voting system. View the letters here and here.

"The SEC has failed to make the case for the drastic regulatory scheme it would impose on proxy advisory firms, or for rolling back shareholder proposal rights," said CII Executive Director Ken Bertsch. "The rule proposals are solutions in search of a problem."

CII believes the SEC should be tackling urgent obstacles in the proxy voting infrastructure. **"The SEC has put the cart before the horse," Bertsch said. "The SEC's first priority should be to fix the creaky proxy plumbing—the nuts and bolts of the ways that proxy cards are solicited and votes are counted."** He noted that at the SEC's November 2018 roundtable on the proxy process, there was striking unanimity among participants that modernizing the proxy infrastructure was the most urgent reform**. "Putting roadblocks in the way of shareholder voting in a system that does not deliver accurate vote counts does not make sense."**

CII and many institutional investors are especially alarmed by the heavy-handed regulatory structure the SEC proposed for proxy advisory firms that provide institutional investors with independent research on the fairness of CEO compensation and other matters on company ballots at annual shareholder meetings. The SEC would require the firms to give companies two separate reviews of research, delaying delivery of reports to investor clients by more than a week.

"Giving companies a week or more to review and comment on proxy advisory firm reports before the reports go to paying investor clients is both unworkable and unwarranted

interference in the market" Bertsch said. It would constrict the time the firms have to collect, verify and analyze company data, complete reports and get them to paying clients. That, in turn, would severely squeeze the time investors have to scrutinize proxy advice, do their own analysis and vote their shares. It would also drive up costs to investors. Inevitably, the review process will increase management influence over proxy advice, jeopardizing the independence of proxy advisors.

CII believes the SEC's economic analysis fails to support the costly new regulatory framework the Commission would impose on proxy advisor firms. CII's own detailed review of alleged errors by proxy advisory firms found a factual error rate on a report basis of just 0.57% to 0.123%.

CII also questions whether the SEC has the authority to regulate proxy advisors in the manner proposed. The Commission's interpretation that proxy advice is "solicitation" under federal securities rules faces a legal challenge. We believe this issue ultimately will be decided in court.

However, if the SEC insists the proxy advisory firms provide advance notice to companies, CII believes that any mandated corporate review and response period should be for a maximum of two business days, that companies should get facts and data only (not analysis and recommendations) and only if they file definitive proxy statements at least 50 days before the shareholder meeting. CII also believes the SEC should require companies to reimburse proxy advisors for reasonable expenses associated with the required review and response, and provide proxy advisors with a safe harbor from liability under Rule 14a-9 (lawsuits alleging false and misleading information) if they comply with all of the requirements.

"Letting companies review facts and data—but not the analysis or conclusions—that proxy advisors gather generally parallels the process that FINRA requires for stock analysts," Bertsch explained. Under FINRA rules, *which the SEC approved*, stock analysts may not share their reports and buy/sell/hold recommendations with management at all.

Please see the detailed fact sheets below summarizing the SEC's proposed rules and CII's comment letters.

FACT SHEET
Proposal to Regulate Proxy Advisory Firms

A. What the SEC has Proposed

The SEC proposal contains two main categories of amendments to federal securities laws governing regulation of proxy advisory firms. The proposal would:

1. **Codify that a person furnishing proxy voting recommendations, research and analysis is considered to be engaging in a proxy solicitation.**
    a. Proposed amendment would codify an "Interpretation and Guidance" that the SEC issued in August 2019.[1]
    b. Legal conclusion that services of proxy advisors are proxy solicitations is significant because:
        - It would essentially prevent a proxy advisor from providing services unless it qualifies for an exemption from proxy solicitation rules that require substantial information and filing requirements.
        - It would subject proxy advisors to Rule 14a-9 liability for materially misleading misstatements or omissions.

2. **Revise rules that proxy advisory firms must meet to remain exempt from proxy solicitation rules. The new conditions or hurdles for proxy advisors include:**
    a. Proxy advisors must disclose in a specified manner material conflicts of interest in the proxy voting "advice" (or report) and in any electronic medium used to deliver advice.
    b. Proxy advisors must provide an opportunity for companies and "other soliciting persons" (which means dissidents in proxy fights) to review and give feedback on a draft proxy advisor report on annual and special meetings before sending it to institutional investor clients. The required feedback period would be:
        - 5 business days if the company files its definitive proxy statement 45 calendar days before a meeting
        - 3 business days if the company files between 45 and 25 calendar days prior to a meeting
    c. Proxy advisors must provide an additional opportunity for companies to review a "final" proxy advisor report no later than 2 business days before distribution to proxy advisor clients.

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[1] The August Interpretation and Guidance was issued with no cost/benefit analysis and no public comment period.

d. If a proxy is filed 25 calendar days or less before the annual meeting, there would be no obligation for the proxy advisor to allow an opportunity for feedback.[2]
e. Proxy advisors must allow companies to provide a written response that would be included via hyperlink in final proxy advisor report.

B. CII's Response—Key Points

1. **The SEC fails to make the case for such a drastic regulatory scheme.**
    a. The SEC references claims by management and lobbyists that proxy advisory firms' reports are strewn with errors, but provides no analysis of that contention.
    b. CII's own review of the claims found they are not supported by facts.
    c. Nor does the proposal provide any basis for business lobbyist charges that proxy advisory firms exert undue influence over how institutional investors vote.
        - To the contrary, while ISS recommended voting against say-on-pay (SOP) proposals at 12.3% of Russell 3000 companies in 2018, just 2.4% of those companies received less than majority shareholder support on SOP proposals. In 2019, Glass Lewis recommended in favor of 89% of directors and 84% of SOP proposals, while directors received average support of 96% and SOP proposals garnered average support of 93%.
2. Investors and their advisors value the independence of research and recommendations that they receive from proxy advisory firms that they choose to retain.
    a. That came through loud and clear at the November 2018 SEC roundtable on the proxy system. When an SEC staffer asked the panel on proxy advisors if they thought more regulation was needed, none of the panelists—investors and corporate representatives, too—said yes.

3. **Requiring proxy advisory firms to give companies two separate reviews of research before they can send the research to institutional investor clients is unworkable and will not improve the research.**
    a. It will constrict the time proxy advisory firms have to collect, verify and analyze company data, complete reports and get them to paying clients. The increased costs and time crunch will inevitably be passed on to investors and asset managers.

[2] CII analysis of Broadridge data for 2019 finds that 97.1% of companies filed annual meeting materials at least 25 days before the annual meeting, and therefore would have qualified for the right of company management to review proxy advisor reports.

b. It will severely squeeze the time shareholders have to scrutinize the proxy advice, do their own analysis and vote their shares.
c. It will increase management influence over proxy advice, jeopardizing the independence of proxy advisory firms that institutional investors retain to meet their fiduciary responsibilities.

4. **The added costs and legal liabilities for proxy advisory firms will limit competition, block new entrants and potentially crush smaller firms. Ultimately, the proxy advice business could become a monopoly.**
   a. Competition already is too limited. The SEC's "one-size-fits-all" governmental mandates will serve not only to limit investor choice and the potential for differing models for proxy advisory firms, but also will reduce market pressures for accuracy and quality of analysis. That is the opposite of what the Commission says it seeks.

5. **The proposed amendments are "arbitrary and capricious" rulemaking.**
   a. SEC has not provided a cost-benefit analysis that comes even close to justifying such a momentous change.[3]
   b. The mandate to let companies review proxy advisory firm reports before clients see them is the opposite of rules governing stock analyst reports.[4]

6. **If the SEC is determined to go this route, the mandated review should be narrower in scope:**
   a. To be able to review and respond to draft proxy voting advice, companies must:
      - File definitive proxy statement at least 50 calendar days before their shareholder meeting
      - Reimburse the proxy advisor for reasonable expenses associated with required review and response

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[3] For example, the SEC analysis inexplicably assumes that on average one-third of U.S. companies would be subject to proxy advisory reports each year, or 1,897 registrants, with one report per registrant. This suggests the SEC analyst was unaware either that (1) proxy advisor business models generally require them to cover all companies their clients are invested in, and many institutional investors have widely diversified portfolios; or (2) state law public company annual meeting requirements. Glass Lewis alone issued 5,565 proxy research reports on U.S. companies in 2018. The SEC estimate that proxy advisory firms on average would have to expend a total of 250 hours per year on all additional requirements imposed under the new regulation is absurd. Glass Lewis, for example, noted that the SEC analysis works out to an assumption that all the new requirements would require it to spend less than three additional minutes per report. Glass Lewis rough preliminary estimate is that the burden under the rule is 240 times the Commission's estimate.
[4] FINRA Rule 2241, which the SEC approved, explicitly prohibits stock analysts from sharing draft research reports with target companies (other than to check facts after approval from the firm's legal or compliance department), to guard against company influence that could impair analysts' independence.

b. The government mandate for management review and response period should be limited to a maximum of two business days (a proxy advisory firm could provide more time if it chooses).
c. The government mandate should be limited to factual information and data only (a proxy advisory firm could provide more if it chooses, notwithstanding that doing so would be contrary to the FINRA rules for analysts)
d. A proxy advisor could (if it chooses) provide its draft data reports to clients at the same time it provides reports to companies, as long as reports are labeled as draft and the proxy advisor does not execute votes during the draft review period.
e. Proxy advisors that comply with all of the review requirements would be eligible for a safe harbor to shield them from liability under Rule 14a-9.

We believe a rule based on the stipulations above would not worsen the very substantial time crunch challenges that institutional investors face in voting and would set a baseline for corporate reviews while leaving but room for market-based competition to go further.

FACT SHEET
Proposal to Limit Shareholder Proposals (Amend Rule 14a-8)

A. What the SEC has Proposed

The SEC rule changes would limit Rule 14a-8, the shareholder proposal rule, by:

1. **Raising stock ownership requirements if shares have been held less than three year**
    a. Currently, a shareholder must have held shares valued at a minimum of $2,000 for at least one year.
    b. Under the proposed change, required ownership would be $25,000 if held for less than two years, $15,000 if held for between two and three years, and $2,000 if held for more than three years. The changes also would no longer permit aggregation of shares. The stipulated amounts must be held by the single individual or entity. This is intended to limit use of shareholder proposals by individual investors, given purported costs to issuers (although the SEC does not consider benefits).

2. **Raising resubmission thresholds substantially**
    a. Currently, a proposal may not be submitted if a proposal on the same subject matter received support of less than 3% of shares if voted on once in the preceding five years; 6% if voted on twice in the preceding five years; and 10% if voted on three times or more in the previous five years.
    b. Under the proposed changes, the resubmission thresholds would be raised to 5% the first year; 15% the second; and 25% the third. The operation of this rule would be the same – that is, it applies if a proposal "addresses substantially the same subject matter" as an earlier proposal that failed to meet the threshold requirement.
    c. The SEC also would put in place a new rule that if a proposal receives between 25% and 50% support, but that vote decreased by 10% or more from the immediately preceding vote, e.g., from 40% to 36%, it would be excludable (4=10% x 40). This so-called "lack of momentum" rule may have limited effect, but will impact topics on which votes are substantial but volatile, particularly those influenced by company performance (notably proposals for an independent chair[5]).

[5] For example, a 2019 proposal to Boeing requesting an independent board chair would have been excludable, based on a substantial but reduced vote in 2018 when the Boeing share price was very high. By the time of the vote, impacts on the airplane manufacturer from crashes of its 737 MAX airliners had begun to depress the share price, and the 2019 proposal that was eligible under existing rules again received more

3. Making a series of **changes to make it more challenging to file proposals** (aimed in particular at hindering prolific individual proponents but with potential for collateral damage to many other proponents) including:
    a. Unnecessary tightening of the "one-proposal" rule, inhibiting shareholders' use of skilled representatives to assist in filing and engagement
    b. Requirement for the proponent to be available to discuss the proposal with the company within a short (20-day) government-specified window after filing
    c. Requirement to provide "documentation attesting that the shareholder supports the proposal and authorizes the representative to submit" it

B. CII's Response—KeyPpoints

1. **The SEC proposal is a solution in search of a problem**
    a. Most shareholder proposals are mere recommendations; they are not binding. They provide a moderate tool for shareholders collectively to consider focused change and communicate that collective view to company boards. It is true that in theory shareholders can fire boards who are on a wrong path, but the shareholder proposal is a much more nuanced, light-touch tool.
    b. Shareholder proposals foster collective communication not only between shareholders and management, but also between shareholders in a market with many regulatory restrictions on such communication.

2. **The shareholder proposal rule is working well, and there is no good reason for the SEC's revamp now.**
    a. The number of shareholder proposals submitted has declined. A 2019 report by Sullivan & Cromwell found that the number of proposals submitted has been on a downward trend since 2015. Voting support on average has increased.
    b. The number of shareholder proposals is modest, accounting for less than 2% of voting items at U.S. shareholder meetings. On average only 13% of Russell 3000 companies receive a shareholder proposal in a given year.
    c. Shareholder proposals have played a major role in valuable changes in corporate governance practices and corporate reporting and practice on environmental and social matters. These include board and committee independence; independent board leadership; shareholder rights including a majority vote standard in election of directors; board diversity;

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support. After the Boeing crisis deepened, the board finally agreed to name an independent chair later in 2019.

accounting for stock options; paying outside board members significantly in stock and ending pension benefits for directors; strengthened equal employment and nondiscrimination practices; and sustainability reporting.

d. It is true that corporate CEOs have not always welcomed pressure for these changes – thus the intense corporate lobbying to limit the rule.
e. Often, it has taken time for an idea to gather support. For example, proposals on climate impact reporting and board diversity in the 1990s initially received support from about 6% of shareholders and took years to build the widespread support they have today.
f. There is no evidence or merit for the argument that companies do not IPO because at some point (on average, once every seven years) they may receive a non-binding shareholder proposal.

3. **The SEC's analysis of the costs and benefits of the proposed rule is weak at best.**
    a. CII finds significant deficiencies in the analysis that the SEC has done on the purported costs and benefits of the proposed rulemaking. The proposal is wholly lacking in hard data and fails to take into account benefits that are difficult to quantify.
    b. The cost to companies of responding to shareholder proposals is mostly a self-imposed burden and one that too many inflate by taking a "kitchen sink" approach to resisting proposals.
    c. The proposal's wildly divergent – and unexplained – estimates of the costs of shareholder proposals make it difficult to see that there is a strong case for reforming the current rule.

4. **The SEC proposes "nanny-state" procedural requirements that are not necessary.**
    a. The proposal has new, highly prescriptive and intrusive process requirements, including restrictions on: a shareholder using a representative to draft and file a proposal; aggregating shares to file; how many proposals an individual may submit; and a shareholder proponent's availability to dialogue with a company. These appear mainly intended to hinder individual proponents, but would have collateral damage on institutional proponents.
    b. The focus should be on an idea's merit, not who proposes it. Smaller investors have used shareholder proposals to press for changes that eventually were widely accepted among larger investors and corporate governance standard-setters.
    c. We believe the more stringent ownership requirements to file a proposal are unwarranted, except to adjust the $2,000 baseline, which was set in 1998, for inflation. Nor do we believe that current thresholds to resubmit a proposal need to be raised.

d. The SEC provides no empirical evidence to support its assumption that short-term investors may only be interested in a “general cause,” not shareholder value.
e. The higher limits will have the greatest impact on diversified “Main Street” investors with smaller portfolios who may be interested in submitting a proposal.
f. The SEC should fix problems with the proxy plumbing that prevent accurate vote-counting before experimenting with higher vote thresholds for resubmitting proposals.
g. The perceived need to raise the thresholds rests on a flawed assumption that proposals that fail to achieve the proposed thresholds are not “on a path to meaningful shareholder support” and should be omitted.
h. The true value of a shareholder proposal is not its ability to garner a majority vote from shareholders. Even if a shareholder proposal falls short of majority support, there is value to a company in learning that a significant percentage of its shareholders have a certain view of what should be done to enhance the value of their investment.
i. Well-established governance norms (such as clawbacks of unearned by, independent board majorities and fully independent board compensation and nominating committees, board diversity) rarely received majority support in their early years.

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About CII: *The Council of Institutional Investors (CII) is a nonprofit, nonpartisan association of U.S. asset owners, primarily pension funds, state and local entities charged with investing public assets, endowments and foundations, with combined global assets that exceed $4 trillion. CII's associate members include non-U.S. asset owners with more than $4 trillion in global assets, and a range of asset managers with more than $35 trillion in global assets under management. CII is a leading voice for effective corporate governance, strong shareowner rights and sensible financial rules that foster fair, transparent and vibrant capital markets.*