"STOP, LOOK AND LISTEN"—BORROWING A FAMILIAR CONCEPT TO IMPROVE THE SEC'S PROPOSED RULES REGARDING PROXY ADVISORS

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Executive Summary:

The publication of a "Stop, Look and Listen" communication is explicitly embraced in the SEC's tender offer rules as a method for alerting shareholders that more information will soon be available that could influence their decision to tender or retain their shares.(SEC Rule 14d-9(f). Such communications ask investors to pause until the target of the tender offer publishes its side of the story before making their tender decision.

An analogous mechanism should be employed in the SEC's proposed rules relating to the proxy advisory firms in those instances where the registrant provides a written response to the voting recommendation of a proxy advisor. ("Proposed Rules") (https://www.sec.gov/rules/proposed/2019/34-87457.pdf)

The current draft of the Proposed Rules takes a step in that direction by mandating that registrants receive a proxy advisor's final recommendation two days before its publication. This two-day period is intended to allow the registrant time to prepare a response to be included by hyperlink in the proxy advisor's report when it is delivered to institutional investors.

In theory, the inclusion of the registrant's response would provide investors with the opportunity to consider both sides of the story before voting. In practice, this is not likely to be generally effective due to the practice of electronic default voting used by some proxy advisors, including the nation's largest.

When default voting is employed, each investor's electronic proxy ballot is pre-populated and then submitted with voting positions based upon the proxy advisor's analysis of the proposal using the advisor's benchmark policies or the client's pre-existing proxy voting policies. Electronic default voting, called by some "robo-voting," is prevalent. (*Are Proxy Advisors Really a Problem*, Frank M. Placenti, November 7, 2018. https://www.sec.gov/rules/proposed/2019/34-87457.pdf)

Evidence also shows that many of these electronic votes are cast by default vote shortly after the advisor's report is published, providing no time to analyze the advisor's recommendation, let alone a registrant's response. This is not an isolated occurrence. Voting data demonstrates that default voting may influence the outcome on a given proxy proposal by as much as 20% (or more in certain cases), thus undermining the goals of informed shareholder participation in governance.

Accordingly, unless the Proposed Rules are modified to provide for some interruption or alteration of the default electronic voting process, the SEC will have effected a "look and listen" period, without having first "stopped" default voting. The reform sought by the SEC will be far less effective than it would have hoped.

In its Adopting Release for the Proposed Rules, (https://www.sec.gov/rules/proposed/2019/34-87457.pdf) the Commission sought comment regarding the need to address default electronic voting in order to effectuate meaningful reform to the proxy voting process.(Adopting Release, page 66.) This article will propose an approach the Commission might employ to bring about a "Stop, Look and Listen" solution without unduly delaying or burdening the proxy process.

The Proposed Rules

On November 5, 2019, the SEC issued proposed rules that would tighten regulation of proxy advisors and modernize the process through which shareholder proposals are submitted. A summary of the proposed rules appears here. https://corpgov.law.harvard.edu/2019/11/23/the-secs-evolving-views-regarding-proxy-advisors/

The Proposed Rules would revise the exemptions to the information and filing requirements under SEC Rule 14a-2(b). To obtain the benefits of the revised exemptions, proxy advisory firms would be required to (a) disclose material conflicts of interest in their proxy voting advice; (b) give registrants and certain other soliciting persons an opportunity to review and provide feedback on proxy voting advice before it is issued; (c) require proxy advisors to give final notice to registrants before proxy voting advice is issued by providing them with a copy of the advisor's final report two days before it is issued to their clients; and (d) on request, include in that final report a hyperlink or analogous electronic medium directing the recipient to a written statement that sets forth all of the registrant's views on the proxy voting advice.

The Proposed Rules have been met with a flurry of over 600 comment letters[1], reflecting both enthusiastic support and vituperative opposition.[2] As might be expected, the two largest proxy advisory firms, Institutional Shareholder Services ("ISS") and Glass Lewis ("GL")

[1] https://www.law360.com/articles/1250398/sec-s-m-a-chief-says-proxy-firm-rules-will-be-ready-in-2020

[2] The comment letters submitted to the SEC are too numerous to cite here, but can be viewed in SEC File No. S7-22.29.

have lodged extensive opposition to virtually every aspect of the Proposed Rules.[3]

One of the central features of the Proposed Rules is the requirement that registrants be given an opportunity to review and comment upon the proxy advisor's report on two separate occasions. First, they would be able to review a draft of the report and comment upon it. Presumably, registrant's will include corrections of factual or analytical errors in their comments. The Proposed Rules provide that the proxy advisors have no duty to accept any of the registrant's comments on their drafts. However, under the Proposed Rules as well as guidance issued by the SEC in August 2019 (SEC Release Nos. IA-5325; IC-33605) the proxy advisor would be operating subject to the constraints of SEC Rule 14a-9. The Commission's position is that, in most cases, proxy recommendations are proxy solicitations. SEC Rule 14d-9 prohibits false and misleading proxy solicitations. Presumably, if a registrant were to provide information objectively demonstrating errors or misinformation in the proxy advisor's draft report, an advisor who fails to make appropriate modifications to that report before publishing it risks violating Rule 14d-9. The comment letters submitted by ISS and GL cited in Note 11 make reference to the specter of this liability. Proxy advisors should, therefore, be motivated to consider corrective information provided by a registrant rather than reject it out of hand.

The proposed rules contemplate an opportunity for the registrant to review the advisor's report in final form at least two days before it is publically issued. (Adopting Release, page 48.)

Following this second review, the registrant would then have the opportunity to request that the proxy advisor include within its the report a hyperlink or another analogous medium providing access to a

[3] Letter of ISS to Vanessa A. Countryman dated January 31, 2020, filed electronically in SEC File No. S7-22-19; Letter of Glass Lewis to Vanessa A. Countryman dated February 3, 2020, Filed electronically in SEC File No. S7-22-19.

statement by the registrant, presumably stating its opposition to the advisor's recommendation, correcting misstatements in it, providing additional matters for consideration by the investor before they cast their vote. (Adopting Release, page 48.)

As presently written, the Proposed Rules require the advisor to permit this second review of its report regardless of whether the recommendation of the proxy advisor aligns with or opposes the position being taken by the registrant. In other words, the second review period would apply to 100 percent of all proxy proposals, even though, in practice, proxy advisors make recommendations that are contrary to the positions taken by the registrant only infrequently. The ISS website states that "ninety-five percent of the time, proxy advisers recommend vote outcomes that are in line with corporate leadership . . .[and] in 2017, ISS voting recommendations for shareholder meetings of the largest 500 U.S. companies were aligned with those of management roughly 92 percent of the time." [https://www.issgovernance.com/compliance/due-diligence-materials/industry-resources/.

While the Proposed Rules address a number of the concerns of the registrant community with respect to the current proxy advisory system, they do not address a practice commonly called "robo-voting" and more formally known as electronic default voting. When electronic default voting is employed, proxy advisors pre-populate their clients' ballots with the advisor's recommendations. In some cases, the voting recommendations reflect the advisor's benchmark guidelines, while in others they are based on pre-existing policies or instructions of the investor. The pre-population of ballots enables investors to vote on all matters with a single electronic input.

In many cases, these votes are cast in very close proximity to the issuance of the proxy advisor's report and in a manner that reflects

virtual lock step adherence to the advisor's recommendations. Indeed, certain institutional investors have traditionally followed the recommendations of proxy advisory firms in nearly 100 percent of all cases.(Proxy Insight Report, American Council for Capital Formation, October 2018. http://accf.org/2018/11/09/new-report-robo-voting-confirmed/

The combination of these factors indicates that, when default voting is in place, there is no meaningful opportunity for registrants to tell their story through either supplemental proxy filings or a shareholder outreach program. There is no reason to believe that the inclusion of the registrant's response in the advisor's report would be dramatically more effective in assuring that the registrant's position is considered before default electronic votes are cast.

The Commission's Request for Comment on Robo-Voting

In the Adopting Release, the Commission sought comments on 51 numbered questions (many of which have multiple subparts). In question number 44,[4] the Commission asked for comment as follows:

> In instances where proxy voting advice business provide voting execution services (pre-population and automatic submission) to clients, are clients likely to review a registrant's response to voting advice? *Should we amend Rules 14a-2(b)(1) and 14a-2(b)(2) so that the availability of the exemptions is conditioned upon a proxy voting advice business structuring its electronic voting platform to disable the automatic submission of votes in instances where a registrant has submitted a response to the voting advice; should we require proxy voting advice businesses to disable the automatic submission of votes unless a client clicks on the*

[4] Adopting Release, page 66.

> *hyperlink and/or accesses the registrant's…response, or otherwise confirms in a pre-populated voting choice before the proxy advisor submits the votes to be counted.* What would be the impact and cost to clients if proxy voting advice businesses are disabling pre-population or automatic submissions to vote? Could there be an effect on registrants? For example, if a proxy voting advice business were to disable the automatic submission of clients' votes, could that deter some clients from submitting votes at all, thereby affecting the registrant's ability to achieve a quorum for an annual meeting? If we were to adopt such a condition, what transitional challenges or logistical issues would disabling pre-population of automatic submission for votes present for proxy voting advice businesses, and could those challenges or issues be mitigated? [*Emphasis Supplied*.]

Question 44 signals the Commission's interest in determining whether measures beyond the two day review period and the opportunity to include a response to the advisor's report are needed to ensure that investors have an opportunity to consider the response provided by the registrant before they cast their vote. Seemingly embodied within that question is a recognition that, if current electronic default voting mechanisms are left in place, many investors will have their votes cast electronically and by default without ever having reviewed (or having an opportunity to review) the registrant's response to the advisor's recommendation.

The Commission Staff may be concerned about mandate to completely disable electronic default voting would increase costs for investors and proxy advisors. As expressed in Question 44, the Commission may also be concerned about how suspension of automatic voting may impair the ability of registrants to obtain a quorum.

Borrowing the Concept of "Stop, Look and Listen"

Just a few years before the crash of 1929, Harvard Economics Professor, William Z. Ripley warned that corporations were not providing accurate financial information to their investors and argued that a disclosure framework was needed.[5] The Securities Act of 1933 and the creation of the Securities and Exchange Commission in 1934 has been in part attributed to Ripley's writings. At the heart of that legislation was the view that investors should have adequate information before making decisions affecting their investments. The federal securities laws are replete with regulations that are consistent with this view.

Among them is Rule 14d-9 (f), which operates in the tender offer context. (https://www.govinfo.gov/content/pkg/CFR-2010-title17-vol3/pdf/CFR-2010-title17-vol3-sec240-14d-9.pdf) This rule recognizes that companies can be subject to an unsolicited tender offer on a surprise basis and then be unable to fully reply to the tender offer instantaneously and in the extensive manner required by the federal securities laws. Rule 14d 9(f) permits a "Stop, Look and Listen" communication that allows a company to communicate to its shareholders the need to pause before tendering while the company prepares and communicates a more fulsome response to the offer.

Registrants seeking some type of suspension to robo-voting are essentially asking for a "Stop, Look and Listen" mechanism with respect to the small subset of proxy proposals where the registrant's position is contrary to that being recommended by a proxy advisor. This request is based on a recognition that, unless robo-voting mechanisms are suspended or altered, the opportunity for investors to "look and listen"

[5] William Z. Ripley, Main Street and Wall Street (1927).

to a registrant's response before they vote will not be meaningful without a temporary "stop" to default voting.

Admittedly, the analogy to Rule 14d-9(f) is not perfect. Some would argue that the decision to tender shares has far more import than casting a vote at a routine shareholders meeting. However, not all matters presented at shareholders meetings are routine. Moreover, the securities laws do not generally distinguish between "really important" investment decisions and "less important" investment decisions, and instead seek to assure that investors receive all information that it relevant to each such decision.

It must also be conceded that the "stop" embodied in a Rule 14d-9(f) communication is a request from the registrant, not a structural regulatory mandate. While that is accurate, it is also true that, in the tender offer context, there is no default electronic tender mechanism creating a risk of an automatic tender before the registrant can communicate its position on the offer.

A Proposed Solution

Giving registrants a two day "heads up" concerning the contents of a proxy advisor's recommendation is a good start, and the Commission is to be lauded for its good intentions. However, that two day response period will prove to be a feeble reform in the absence of some mechanism to deal with electronic default voting. The author believes that a possible solution to this problem involves the following:

- Distinguish between the situations in which the registrant is submitting a response and those in which it is not, and use this to define the universe of "contested "situations in which electronic default voting needs to be altered.

- In cases in which a registrant is not submitting a response, electronic default voting can proceed as it has in the past.

- In those contested situations in which the registrant is requesting the inclusion of a response, the proxy advisory firm would have the option to either: (i) disable electronic default voting, or (ii) pre-populate the investor's ballot on contested items with an "abstain" or "no vote" selection.

- Investors could then either choose to not vote with respect to these contested matters (through the pre-populated abstention or no vote). Or, the investor could record a different vote after taking the affirmative step to replace the pre-populated no vote or abstention after considering the information provided by the proxy advisor and the registrant.

While this simple mechanism would not guarantee that investors studiously analyze the advisor's report or the registrant's response, the design of this system would be consistent with the fiduciary duty of institutional investors to be fully informed at the time they cast their vote and would allow differing levels of review and analysis by investors based upon the goals and contractual obligations of the funds. It would also allow investors to refrain from voting on certain matters. This is consistent with the guidance provided by the SEC in its Staff Legal Bulletin 20 (June 30, 2014) that funds have no duty to vote on all matters and that they can shape their voting obligations by agreement with their investors. https://www.sec.gov/interps/legal/cfslb20.htm

Investors who determine that the nature of a particular contested issue does not require them to cast a vote would have the option to refrain from voting by retaining the pre-populated abstention or no vote. This would not impose any burden on them, nor would it affect the registrant's ability to secure a quorum. Nor would it "unduly" delay the

voting process—unless one considers the time required for an institutional investor to study both sides of a contested issue before making a fiduciary decision an "undue" delay.

Further, a fund that has an announced policy of voting in a particular pre-determined manner on defined issue categories would be free to do so. The proposed modification to the default voting mechanism would not mandate how an investor votes, it would simply help to create an environment in which they "Stop, Look and Listen" before voting on contested issues, rather than effectively delegating the voting decision on those matter to the proxy advisor.

Conclusion

The SEC's Proposed Rules seek to provide investors who employ proxy advisors an opportunity to "look and listen" to both the proxy advisor's report and the registrant's response before casting their vote. However, that measure will not achieve its regulatory goals unless current electronic default voting practices are "stopped" or otherwise altered. Without changes to default voting, the registrant's response to an advisor's recommendation will likely be unread, untimely and futile.

Suspension of robo-voting (or requiring the pre-population of ballots on contested matters with a neutral "abstain" or "no-vote" position) would serve as a real time reminder to fiduciaries of the need to inform themselves about a contested proposal by requiring them to undertake the volitional act of changing a pre-populated neutral vote to an affirmative or negative vote. On the other hand, if the investor does not view the matter in question as one that merits the time and effort to do so, it could elect to have its neutral vote remain in place. This system is consistent with SEC's view that funds can determine to "focus

resources on only particular types of proposals based on the client's preferences."(Staff Legal Bulletin 20, Question 2.)

Although proxy advisors and those who support them are likely to object to the foregoing modest proposal, it should be remembered that all parties in the proxy process have a shared interest in assuring that investors cast their votes on a fully informed basis. Those who complain about *any* burden imposed upon proxy advisors by *any* additional regulation should be asked why they consistently voice strong objection to measures intended to ensure that their clients have the full benefit of both sides of the story before they cast their vote.