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What's New for the 2019 Proxy Season: Momentum Grows for Proxy Voting Reform and Sustainability Disclosure

By Cathy Dixon and Aabha Sharma

The past few weeks have been particularly eventful for those who follow the turbulent, complex world of proxy voting and shareholder activism. The drama began on September 12, 2018, with an announcement by proxy advisory firm Glass Lewis, Inc. (Glass Lewis) that, in response to increasing investor demand for quality ESG information to guide proxy voting and investment decisions, the firm would integrate sustainability disclosure guidance developed by the U.S.-based Sustainability Accounting Standards Board (SASB) into Glass Lewis's proxy voting recommendations for the 2019 proxy season. One day later, the SEC's Division of Investment Management published a statement withdrawing staff letters issued to Egan-Jones Proxy Services (Egan-Jones) and Institutional Shareholder Services, Inc. (ISS), respectively, in 2004 that have been criticized widely by members of Congress and others as unduly expanding the influence of proxy advisory firms in the proxy voting process. SEC Chair Jay Clayton also released two public statements on September 13, 2018: the first emphasizing in general terms the "Commission's longstanding position that all staff statements are nonbinding and create no enforceable rights or obligations of the Commission or other parties"; and the second linking withdrawal of the *Egan-Jones* and *ISS* letters to the upcoming SEC Staff Roundtable on the Proxy Process unveiled by the Chair in late July of this year. On Friday September 21, 2018, the SEC announced that the Proxy Roundtable will be held on November 15 "to hear investor, issuer, and other market participant views about the proxy process and rules."

To provide context for the SEC's unfolding "proxy plumbing" initiative, we begin in Part I with a brief history of the SEC's traditionally "hands-off" approach to the regulation of proxy advisory firms and the accompanying public debate on whether the SEC has struck the appropriate regulatory balance. In Part II we look at developments in anticipation of the November 15 Proxy Roundtable. Part III discusses another recent and still-evolving story – Glass Lewis's announcement of its intent to integrate SASB's materiality-focused sustainability disclosure standards in the firm's proxy voting products, and what this development might signal regarding the growing interest of investors and companies alike in voluntary corporate reporting on key ESG issues.

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I. SEC and Staff Historical Approach to Regulation of Proxy Advisory Firms

Issued in the wake of the SEC's adoption in 2003 of Rule 206(4)-6 under the Investment Advisers Act of 1940, as amended (Advisers Act), the *Egan-Jones* and *ISS* letters offered specific staff guidance regarding the circumstances in which a registered investment adviser (RIA) could rely on proxy voting recommendations and related services provided by an "independent" proxy advisory firm consistent with the RIA's fiduciary duty to its own clients "to adopt written policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interest of its clients, including procedures to address any material conflict that may arise between the interest of the adviser and the clients."[1] In these letters, the staff emphasized the obligation of investment advisers to assess carefully whether a particular proxy advisory firm has the capacity and competency to analyze proxy issues adequately and formulate decision-useful voting recommendations in an impartial manner. In this connection, the staff underscored the need for RIAs to review a proxy advisory firm's own conflict of interest procedures in deciding whether to engage that firm's services.

Several years later, the SEC itself took a tentative step into the fray. In 2010, the SEC issued a concept release soliciting comments on a broad array of "proxy plumbing" issues, including but not limited to the proper role of proxy advisory firms in the proxy voting process. More specifically, the SEC invited public comment on the extent to which the voting recommendations of proxy advisory firms serve the interests of investors in informed proxy voting, and whether, and if so, how, the SEC should take steps to improve the utility of such recommendations to investors. In particular, the SEC requested feedback on whether it should clarify existing regulations or propose additional regulations to address concerns about the existence and disclosure of conflicts of interest on the part of proxy advisory firms, and about the accuracy and transparency of the formulation of their voting recommendations. Many comment letters were submitted to the SEC, but no further action was taken at the Commission level until this year (as discussed in Part II, below).

In the meantime, the SEC staff updated its guidance regarding the appropriate role and regulation of proxy advisory firms. In June 2014, the Division of Investment Management and the Division of Corporation Finance published guidance in the form of Staff Legal Bulletin No. 20 (SLB 20). SLB 20 updated the Division of Investment Management's guidance about the scope of RIA's duties in voting client proxies and retaining proxy advisory firms. More specifically, the bulletin outlines the considerations that a RIA may wish to take into account if it retains a proxy advisory firm to assist it in exercising its proxy voting duties, including the proxy advisory firm's capacity and competency to adequately analyze proxy issues; the investment adviser's ongoing duties to oversee any proxy advisory firms it retains, including by adopting and implementing policies and procedures reasonably designed to provide sufficient ongoing oversight. The Division of Corporation Finance also expressed its views on the application of the federal proxy rules to the activities of proxy advisory firms.[2]

Although SLB 20 cited the now-defunct *Egan-Jones* and *ISS* letters in a footnote, the proposition stated in the accompanying text of this SLB remains intact after the staff's withdrawal of these letters on September 13, 2018:

> When considering whether to retain or continue retaining any particular proxy advisory firm to provide proxy voting recommendations, the staff believes that an investment adviser should ascertain, among other things, whether the proxy advisory firm has the capacity and competency to adequately analyze proxy issues.

Critics apparently have not been persuaded that the SEC and its staff have addressed concerns regarding the dominant role of proxy advisory firms in the corporate voting process, pointing to such firms' mounting influence over the outcome of proxy contests.[3] Among these critics are members of Congress, some of whom have figured prominently in the ongoing debate.[4] For example, a majority of the House of Representatives voted late last year to pass the Corporate Governance Reform and Transparency Act of 2017 (H.R. 4015), which is now pending in the Senate.[5] H.R. 4015 aims to "improve the quality of proxy advisory firms for the protection of investors and the U.S. economy, and in the public interest, by fostering accountability, transparency, responsiveness, and competition in the proxy advisory firm industry." In addition to directing the SEC to withdraw the 2004 *Egan-Jones* and *ISS* letters[6] (which, as discussed, the SEC staff has done), the legislation would require a proxy advisory firm to file an application for registration with the SEC – not as an investment adviser under the Advisers Act, but rather under a new Section 15H of the Securities Exchange Act of 1934, as amended (Exchange Act). This application would contain, among other things, a certification that the proxy advisor is able consistently to provide proxy advice based on accurate information; a description of the procedures and methodologies that the applicant firm uses in developing proxy voting recommendations; and disclosure of any potential or actual conflicts of interest the proxy advisor may have and the policies in place to manage such conflicts.

II. Are We Poised on the Threshold of SEC "Proxy Plumbing" Reform?

According to the Division of Investment Management's September 13, 2018 statement, possible topics for discussion by participants at the November 15 Proxy Roundtable (as previously outlined by Chair Clayton) include the mechanics of the proxy voting process, declining retail shareholder participation in this process, shareholder proposals, the role and regulation of proxy advisory firms, the use of technology to facilitate proxy communications and voting and, last but not least, the still-pending 2016 SEC proposal to amend the proxy rules to mandate universal proxy cards in certain contested situations. The Division of Investment Management explained that, in working on the agenda for the upcoming roundtable, it "has been considering (among other topics) whether prior staff guidance about investment adviser responsibilities in voting client proxies and retaining proxy advisory firms should be modified, rescinded or supplemented." In the staff's view, withdrawal of the two 2004 letters – while leaving intact the joint guidance of the Divisions of Investment Management and Corporation Finance contained in Staff Legal Bulletin No. 20 -- would "facilitate discussion" at the roundtable and inform "any future [staff] recommendations to the Commission with respect to proxy advisory firms."

That same day, the SEC's Investor Advisory Committee (IAC) convened a public meeting at SEC headquarters in Washington, D.C. to discuss the U.S. proxy voting infrastructure and the implications of passive vs. active investing. There were panel discussions regarding transparency in the voting process, how best to avoid or correct errors in the tabulation of proxy votes, the viability of blockchain-based voting and the possible revival of a prior administration's universal proxy card rulemaking proposal. Perhaps in deference to the impending proxy roundtable, participants in the IAC meeting largely avoided the contentious subject of proxy advisory firms. Still, this topic looms large on the relatively near horizon.

Thus, it seems appropriate to conclude with SEC Commissioner Jackson's September 14, 2018 statement expressing reservations regarding the current spotlight on proxy advisory firms. Commissioner Jackson emphasized that "the law governing investor use of proxy advisors is no different today than it was yesterday," observing that despite the demise of the *Egan-Jones* and *ISS* letters, the SEC "has long recognized that proxy advisors . . . serve an important role in the shareholder-voting process, and today's statements do nothing to change that." Commissioner Jackson urged his colleagues "not to allow corporate lobbyists' priorities to sidetrack our important work in fixing the American system for corporate voting."

Echoing Commissioner Jackson's statement, Glass Lewis on September 14 released a response letter to the Division of Investment Management's statement announcing the withdrawal of the *Egan-Jones* and *ISS* letters. In this letter, Glass Lewis asserted that, "the law in this area has not changed. Indeed, it has always been the law that an investment adviser, as a fiduciary to its clients, is required to take steps to avoid having a conflict of interest influence its decisions on behalf of clients." Glass Lewis also provided a summary of its processes and procedures for voting client proxies.

III. Glass Lewis Jumps into the Sustainability Disclosure Realm, and What This Might Mean

Glass Lewis announced plans on September 12 to integrate guidance on ESG-related disclosure topics developed by SASB into the proxy advisory firm's proxy voting reports and other products. While few details have been provided thus far, Glass Lewis indicates that further information will be made available in advance of the 2019 proxy season, once SASB finalizes its materiality-centered standards. Glass Lewis, which has been a SASB Alliance Organizational Member since 2017, licensed SASB standards for use as a tool to enable investors to "easily identify whether items are aligned with the SASB standards, [thereby] helping inform . . . proxy voting and engagement activities."[7]

This development appears responsive to increasing investor interest in using sustainability performance metrics to facilitate proxy voting and investment decision-making. For example, in a recent interview, State Street Global Advisors' Head of ESG Investments and Asset Stewardship, Rakhi Kumar, observed that:

> As the long-term research continues to show that ESG helps from a risk/return perspective, we are going to see more growth in the demand for integrated ESG solutions. This is where . . . SASB comes in. They provide a materiality map, which is something companies need to learn about . . . We think SASB is a significant part of the solution – it was developed by investors and has an investor perspective of ESG risks.

SASB is just one of several independent, non-governmental organizations that have devised voluntary guidelines for identification and disclosure of sustainability information to various corporate stakeholders. Unlike other organizations, however, SASB has taken an investor-oriented approach, focusing on sector-specific known trends and uncertainties that are reasonably likely to have a material impact on the financial condition and/or operating performance of a company and, as such, would be considered "material" for purposes of the federal securities laws. SASB currently maintains provisional standards for 77 industries across 11 sectors, and is reportedly close to finalizing these standards.

The SEC takes the position that companies have obligations under existing rules to provide certain disclosures in periodic reports and other filings relating to climate change and other environmental risks, as most recently emphasized in an interpretive release clarifying requirements for public companies to disclose in the Management's Discussion and Analysis and risk factor sections (among others) of their annual and quarterly reports the "material impacts" of climate change on their business, financial condition, and/or results of operations.[8] In April 2016, the SEC issued a concept release seeking input on the specific sustainability issues important to investors; who the "reasonable investor" is in today's securities markets; what a disclosure framework for ESG matters might look like, including which, if any of the existing sustainability reporting frameworks should be considered by the SEC if it were to develop additional disclosure requirements; and what costs and challenges would investors and issuers face related to providing additional disclosure. To date, there has been no indication that the SEC intends to take further action in this area, although a rulemaking petition filed on October 1, 2018 shows that CalPERS and other institutional investors will continue to press the SEC to establish an enhanced mandatory disclosure regime.

ESG disclosure issues are attracting some (if limited) Congressional attention. Most recently, on September 17, 2018, Massachusetts Senator Elizabeth Warren introduced a bill entitled the Climate Risk Disclosure Act of 2018,[9] that recognizes "long-term financial and economic risks and opportunities relating to climate change . . . constitute information that issuers . . . may reasonably expect to affect shareholder decisionmaking; and . . . should regularly identify, evaluate, and disclose". The bill directs the SEC to issue, not later than one year after the date of enactment, final rules establishing disclosure requirements for public companies with respect to their climate-related risks. Such rules would have to require, among other things, that companies disclose the potential financial impact of risks posed by climate change and "allow for intra- and cross-industry comparison, to the extent practicable, of climate-related risk exposure through the inclusion of standardized industry-specific and sector-specific disclosure metrics, as identified by the Commission . . . ."

As discussed in our Alert available here, one state has acted to promote corporate innovation in the sustainability disclosure realm. Delaware recently enacted the Certification of Adoption of Transparency and Sustainability Standards Act in an effort to establish a "voluntary disclosure regime to foster dialogue around sustainability and responsibility among participating Delaware business entities their various stakeholders." While compliance is entirely volitional, the implications may be significant given that Delaware is the home of more than 50% of U.S. publicly traded corporations.

Even as some have voiced concern regarding the proliferation of voluntary disclosure frameworks (while at the same time opposing more governmentally-mandated disclosure requirements), an increasing number of large public companies – including multinationals based in the United States – have shown more interest in experimenting with ESG disclosures outside the confines of SEC-filed documents. These companies are becoming more comfortable with posting "sustainability" reports on their websites that do not necessarily follow any single disclosure framework.[10] To illustrate, NRG Energy, Inc. headquartered in Princeton, New Jersey, voluntarily publishes a sustainability report that reflects its adherence to sustainability and transparency objectives formulated by the United Nations,[11] Global Reporting Initiative (GRI), SASB and the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD).[12] Similarly, JetBlue's 2017 ESG Report has separate sections containing SASB- and TCFD-"compliant" disclosures.[13]

We expect such creative "private ordering" efforts to continue, as U.S. companies adapt to market and regulatory demands around the world.

IV. Concluding Thoughts

We are following developments at the SEC and elsewhere regarding the potential for heightened regulation of proxy advisory firms and all other aspects of the "proxy plumbing" initiative, including the November 15, 2018 Proxy Roundtable, and will update our clients and friends as events unfold. While the extent to which SASB standards will influence Glass Lewis proxy voting reports and recommendations remains to be seen, one thing is now clear -- directors and senior management must be prepared to respond to the various non-governmental forces now at work seeking greater corporate transparency with respect to the identification and management of key sustainability risks. As we have suggested before (e.g., in our alert available here), companies should take steps to ensure that the board's agenda both informs and facilitates directors' oversight of the company's sustainability risk management practices and any related public disclosures – whether made voluntarily or in accordance with existing SEC rules -- and engage regularly with investors and other major stakeholders to understand their sustainability performance-related concerns.

ENDNOTES

[1] *See* Egan-Jones Proxy Services, SEC Staff Letter (May 27, 2004) and Institutional Shareholder Services, Inc., SEC Staff Letter (Sept. 15, 2004). These letters are no longer available on the SEC website.

[2] The Division of Corporation Finance explained in SLB 20 that a proxy advisory firm is subject to the federal proxy rules when it engages in a "solicitation," pointing to the SEC's long-held view that the furnishing of proxy advice constitutes a "solicitation" subject to the information and filing requirements of the federal proxy rules. An exemption from these requirements is available for "any solicitation by or on behalf of any person who does not, at any time during such solicitation, seek directly or indirectly, either on its own or another's behalf, the power to act as a proxy for a security holder and does not furnish or otherwise request, or act on behalf of a person who furnishes or requests, a form of revocation, abstention, consent or authorization." However, the solicitation exemption is not available for a proxy advisory firm offering a service that allows the client to establish, in advance of receiving proxy materials for a particular shareholder meeting, general guidelines or policies that the proxy advisory firm will apply to vote on behalf of the client.

[3] *See*, e.g., James R. Copland, David F. Larcker and Brian Tayan, *The Big Thumb on the Scale*, The Rock Center for Corporate Governance at Stanford University (May 2018); Timothy M. Doyle, *The Conflicted Role of Proxy Advisors*, American Council for Capital Formation (May 2018).

[4] *See, e.g.,* Statement of House Financial Services Committee Chair Jeb Hensarling (R-TX), Regarding SEC Staff Proxy Advisory Letter Withdrawals (Wash., D.C., Sept. 13, 2018), available here.

[5] The Senate Committee on Banking, Housing, and Urban Affairs held a hearing on June 28, 2018 entitled "Legislative Proposals to Examine Corporate Governance". The hearing agenda included, among other topics, the provisions of H.R. 4015.

[6] It is worth noting in this regard that five Republican Senators (Messrs. Tillis, Rounds, Perdue, Crapo, Heller and Scott) sent a letter dated August 2, 2018, to the Comptroller General of the U.S. Government Accountability Office seeking a determination of whether the SEC staff guidance set forth in the *Egan-Jones* and *ISS* letters constitute a "rule" under the Congressional Review Act. It is unclear what impact, if any, the Division of Investment Management's withdrawal of the two letters on September 13, 2018, will have on the Senators' request.

[7] Glass Lewis is not the only proxy advisory firm focusing on corporate sustainability disclosure in response to investor demands. As discussed in our Alert available here, ISS earlier in the year introduced its Environmental & Social (E&S) QualityScore Disclosure and Transparency Signal. According to ISS, QualityScore will measure the quality of corporate disclosures on E&S issues relative to a company's peers.

[8] This builds on interpretive guidance issued by the SEC in 2003, available here.

[9] The bill has seven Democratic co-sponsors, Senators Whitehouse (RI), Schatz (HA), Markey (MA), Booker (NJ), Merkley (OR), Harris (CA) and Gillibrand (NY).

[10] Regardless of whether these disclosures appear within or outside the four corners of an SEC filing, they are subject (as is any public corporate communication) to the antifraud provisions of the federal securities laws.

[11] The United Nations Global Compact and the GRI, in August 2018, released a report entitled "Integrating the SDGs into Corporate Reporting: A Practical Guide", available here.

[12] *See* NRG's 2017 Sustainability Report, accompanied by indexed references to GRI and SASB standards, which can be accessed through a sustainability webpage on the company's website, available here.

[13] *See* JetBlue 2017 SASB and TCFD Report, available here.

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