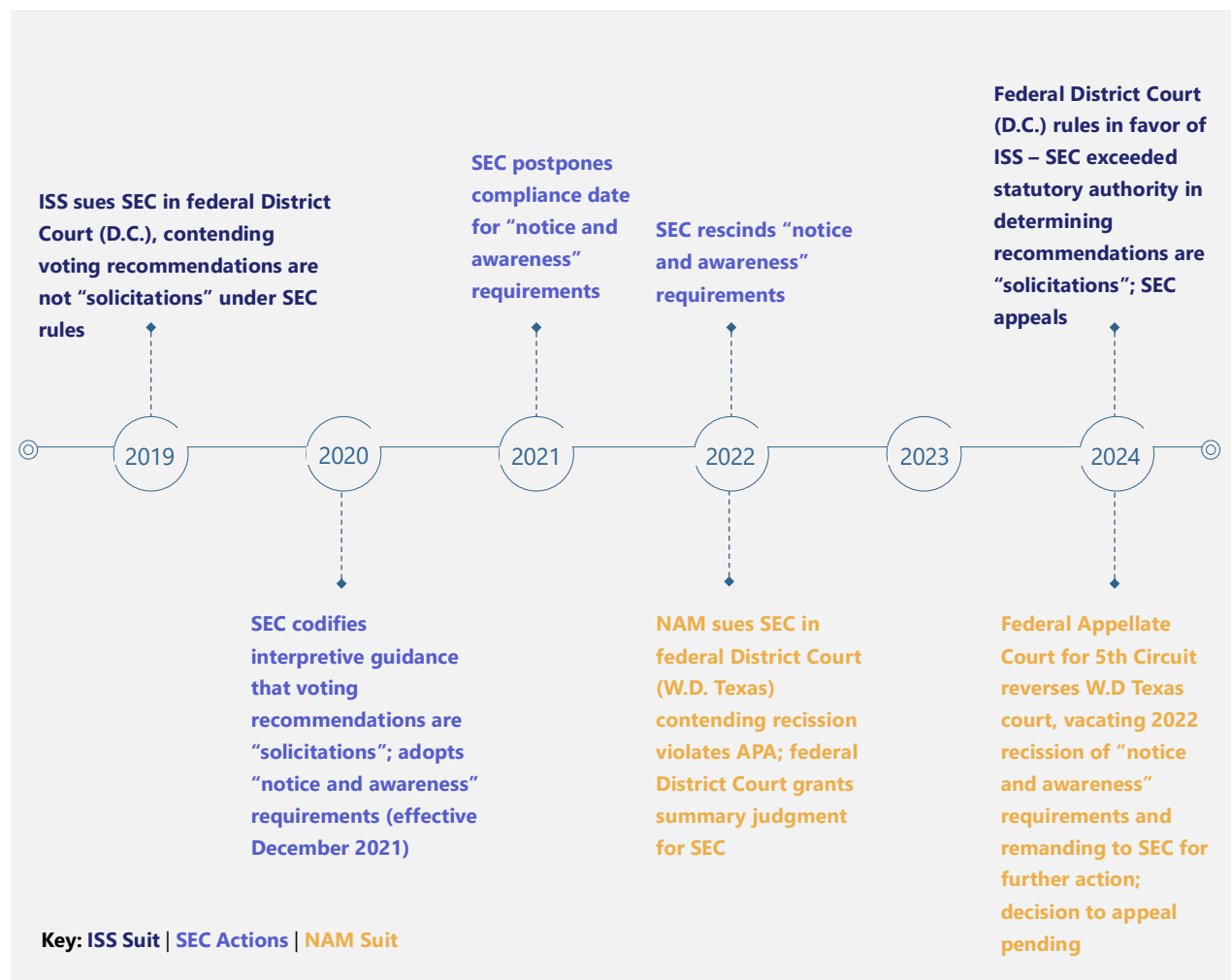


Federal Court Decisions Spur Revisiting of SEC Regulation of Proxy Advisory Firms

Recently, the U.S. Court of Appeals for the Fifth Circuit held that the SEC acted “arbitrarily and capriciously” in 2022 when it rescinded its 2020 rules requiring proxy advisory firms to make their proxy voting advice available to covered companies and make their clients aware of any company response to the advice. This follows a federal district court decision earlier this year questioning the SEC’s authority to regulate proxy advisory firms under its proxy solicitation rules. These decisions have created considerable uncertainty as to what, if anything, proxy advisory firms are required to provide to the companies covered by their research and voting recommendations.



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While the initial reaction of the corporate community was that, in view of the lawsuit filed by the National Association of Manufacturers and National Gas Services Group (the “NAM Suit”) as described below, the SEC could be forced to consider reinstating the “notice and awareness” conditions enabling proxy advisory firms to satisfy an exemption from the proxy solicitation rules (perhaps even in time for the 2025 proxy season) or take some other action, the reverberations of the decision in the lawsuit challenging the SEC’s authority to regulate proxy advisory firms (the “ISS Suit”) (as described below) and the subsequent appeals have made this uncertain. The interplay between the two decisions, first the holding in the ISS Suit vacating the SEC’s 2020 codification of its interpretation of a “solicitation” followed by the more recent decision by the 5th Circuit is problematic. If the decision in the ISS Suit is upheld on appeal, it appears that, in the absence of further guidance from the federal courts, the “notice and awareness” conditions likely will no longer apply since they are conditions to an exemption to a regulatory amendment that no longer exists.

Given the lengthy history of the debate between the corporate and investor communities over the role of the proxy advisory firms in the corporate governance arena, it is probable that the proxy advisory firms will continue to face pushback from reporting companies subject to their scrutiny and the SEC may continue to face legal challenges in attempting to regulate these firms. Thus, companies and investors will need to continue to closely monitor this area and consult their legal counsel to understand the current and – potentially – future status of the SEC’s efforts to regulate proxy advisory firms. We do not foresee any clarity emerging on the near-term horizon as to how to navigate these apparently conflicting decisions.

HISTORY OF SEC REGULATORY ACTIONS

In July 2020, the SEC, under the Trump Administration, codified its prior interpretive guidance that its proxy solicitation rules applied to proxy advisory firms providing advice for a fee (such as Institutional Shareholder Services, Inc. (“ISS”) and Glass Lewis & Co. Inc.) and, at the same time, exempted them from the disclosure and filing requirements of such rules if specified conditions were satisfied. Among these conditions were requirements that a proxy advisory firm:

- provide its proxy voting advice to a subject company either before or concurrently with the transmission of such advice to its clients; and
- implement a process for notifying its clients when a company issued a response to the voting advice *before* they cast their vote on the matter under consideration (the “notice and awareness” conditions).

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To enable proxy advisory firms to develop appropriate procedures for implementing the “notice and awareness” conditions, the SEC delayed compliance until December 1, 2021.

The SEC’s actions were highly controversial (including its determination that the proxy solicitation rules applied to proxy advisory firms). In fact, even before the SEC’s 2020 actions, ISS had sued the SEC about its interpretive guidance that proxy advisory firms’ vote recommendations were “solicitations” under the federal proxy rules.

In June 2021, the SEC, under the Biden Administration, announced that it was revisiting its regulation of proxy voting advice and postponed the compliance date with the “notice and awareness” conditions while it considered further action.¹ Subsequently, in July 2022, the SEC rescinded the “notice and awareness” conditions. Thereafter, the National Association of Manufacturers (“NAM”) and Natural Gas Services Group brought suit (the “NAM Suit”) against the SEC alleging a failure to follow proper procedures under the Administrative Procedures Act or provide an adequate justification for the rescission.²

THE NAM SUIT

Initially, the U.S. Federal District Court for the Western District of Texas rejected the arguments set forth in the NAM Suit and granted summary judgment in favor of the SEC in late 2022. However, upon appeal, in June 2024 the 5th Circuit Court of Appeals reversed the district court’s decision indicating that, among other things, the SEC had failed to adequately explain why it had previously found that the “notice and awareness” conditions did not affect the issuance of independent proxy voting advice and also failed to adequately explain why rescission was justified. The 5th Circuit vacated the 2022 rescission and remanded the matter to the SEC for further action consistent with its decision. As of the date of this Thoughtful Pay Alert, the SEC has not announced whether it intends to appeal this decision.

¹ The NAM challenged this suspension in the U.S. Federal District Court for the Western District of Texas, which ultimately held that the suspension was unlawful because it was done without notice and comment. However, this decision has limited consequence because the SEC formally rescinded the “notice and awareness” conditions before the District Court issued its decision in September 2022.

² A similar case filed by the U.S. Chamber of Commerce, the Business Roundtable, and the Tennessee Chamber of Commerce & Industry is currently pending before the U.S. Court of Appeals for the Sixth Circuit. As of the date of this Thoughtful Pay Alert, the 6th Circuit has not yet issued its decision. If the 6th Circuit rules in favor of the SEC, it would create a conflict between the appellate courts that may require Supreme Court intervention.

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THE ISS SUIT

While the parties were waiting for a decision in the NAM Suit, in February 2024 the U.S. Federal District Court for the District of Columbia held that the SEC had acted contrary to law and in excess of its statutory authority when it amended the proxy solicitation rules to include proxy voting advice for a fee. Subsequently, in May 2024 both the SEC and the NAM³ filed notices of appeal with the D.C. District Court. These appeals are currently pending.

³ It is worth noting that, while NAM is the defendant in the ISS Suit, it is also the plaintiff in the NAM Suit. Apparently, NAM does not question the SEC's authority to regulate the proxy advisory firms, but objects to the way it has chosen to do so.

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