

District Courts Side with the SEC Regarding Proxy Advice Reform, but Fifth Circuit Review May Present Challenges

By: Eric Belfi, Christine Fox and David Saldamando

Background

On July 13, 2022, the Securities and Exchange Commission (SEC) voted to adopt amendments to its rules governing proxy voting advice,¹ voting to partially rescind a set of rules enacted during the Trump administration that “made it somewhat more difficult for investors to influence public companies via shareholder voting.”² The prior rules enacted in 2020 increased restrictions on proxy voting advice businesses (PVAB), which advise institutional investors on how to vote their shares in a proxy contest.³

According to the SEC, “[o]ne of the defining characteristics of today’s market is the significant role played by institutional investors, which today own, by some estimates, between 70 and 80 percent of the market value of U.S. public companies. Investment advisers voting

on behalf of clients and other institutional investors, by virtue of their significant holdings (often on behalf of others, including retail investors) in many public companies, must manage the logistics of voting in potentially hundreds, if not thousands, of shareholder meetings and on thousands of proposals that are presented at these meetings each year, with the significant portion of those voting decisions concentrated in a period of a few months.”⁴ To that end, “[i]nvestment advisers and other institutional investors often retain proxy advisory firms to assist them in making

their voting determinations on behalf of clients and to handle other aspects of the voting process.”⁵ Such proxy advisory firms “typically provide institutional investors and other clients a variety of services that relate to the substance of voting, such as:

- 1) providing research and analysis regarding the matters subject to a vote;
- 2) promulgating general voting guidelines that their clients can adopt; and

3) making voting recommendations to their clients on specific matters subject to a shareholder vote, either based on the [proxy advisory firm’s] own voting guidelines or on custom voting guidelines that the client has created.”⁶

The two largest proxy advisory firms in the country (i.e., Institutional Shareholder Services and Glass Lewis) together serve more than 3,300 institutional

clients, including the majority of the world’s largest pension plans, mutual funds, and asset managers, who themselves collectively manage trillions of dollars in assets.⁷

The 2020 Rules

On July 13, 2022, the SEC rescinded and eliminated two rules which were passed in 2020:

- requiring proxy advisory firms to make their vote recommendations available to the public compa-



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ny no later than when the advice is disseminated to the proxy advisor’s clients; and

- requiring proxy advisory firms to provide their clients with a “mechanism” for becoming aware of the public company’s written response to the proxy advisory firm’s recommendation, essentially requiring a proxy advisory firm to provide the institutional investors with the company’s response to their advice (together, the 2020 Rules).

These former rules on the books served to enhance corporate management’s influence in a proxy battle by granting the company “advance access”⁸ to the proxy advisory firm’s recommendation, and by requiring that the proxy advisory firms separately notify their clients of the company’s response to their recommendations. Institutional investors and PVABs thus expressed concerns that the independence of the investor’s vote was jeopardized by the 2020 Rules since functionally, “proxy advisory firms may feel **pressure to tilt voting recommendations in favor of management** more often, to avoid critical comments from companies that could draw out the voting process and expose the firms to costly threats of litigation.”⁹

In addition, there were concerns of the increased compliance costs for PVABs and investors, and the timeliness of the recommendations that the PVABs give to the investors.

Current Landscape of the Case Law

Multiple entities, including the Chamber of Commerce and the Business Roundtable, have filed suits against the SEC challenging the rescission and elimination of the business friendly 2020 Rules. Two actions, *Chamber of Commerce of the United States of America et al. v. SEC*, No. 22-cv-00561, 2023 WL 3063819 (M.D. Tenn.

Apr. 24, 2023) and *National Association of Manufacturers et al. v. SEC*, No. 22-cv-00163, 2022 WL 17420760 (W.D. Tex. Dec. 4, 2022), reached the summary judgment stage of the litigation.

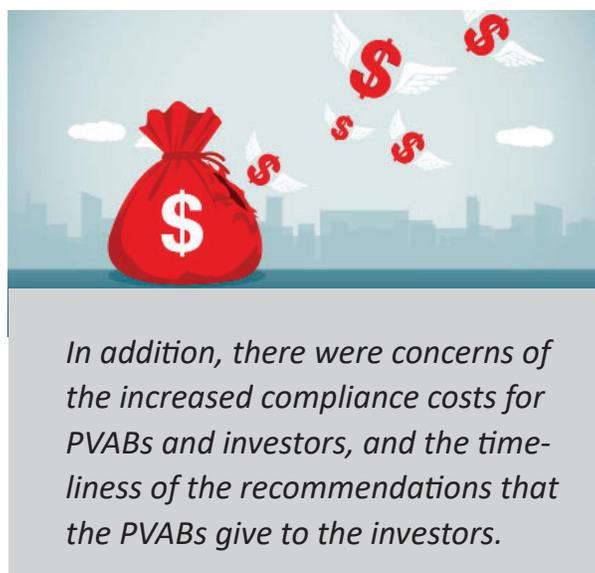
Notably, both courts denied the plaintiffs’ motion for summary judgment against the SEC, and granted defendant SEC’s motion for summary judgment, ruling in favor of the SEC’s rescission of the 2020 Rules. The outcome of the decisions is discussed in greater detail below.

Chamber of Commerce et al. v. SEC (M.D. Tenn. Apr. 24, 2023)

The plaintiffs asked the court to set aside the 2022 amendments on the grounds that they were adopted in violation of the Administrative Procedure Act (APA). The Court found the SEC acted appropriately in carrying out the 2022 reversal of the 2020 Rules, rejecting the plaintiffs’ arguments that the agency should have “asserted more aggressively that its prior analysis [regarding the 2020 Rules] was unacceptably flawed,” finding that this would have been an exercise in “empty theater that would, if anything, obfuscate matters.”¹⁰

Among other things, the most notable takeaway from the court’s decision in this regard is below:

The question of which way any “political winds” were blowing at any given time is beyond this court’s knowledge. The Western District’s statement, however, correctly identifies what this case actually is about: a change in the SEC’s policy preference, plain and simple. The SEC did not provide a record show-



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ing that its 2020 reasoning had been definitively debunked, because that is neither what happened nor **what was required to happen for the SEC to act. Rather, the SEC re-considered a matter and came down on a different side of a debatable question, which it was permitted to do**, and then it explained that decision clearly and thoroughly, as was required. Because the SEC explained in sufficient scope and detail why it concluded that the 2022 policy was preferable, it satisfied the general APA obligations at the heart of Counts III and IV. The court accordingly will grant the defendants summary judgment on those counts.¹¹



The Court also found that the SEC “fully identified and explained the concerns on both sides of the issue and set forth its conclusion regarding which was more persuasive.”¹²

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National Association of Manufacturers et al. v. SEC (W.D. Tex. Dec. 4, 2022)

Likewise, the Court in *National Association of Manufacturers* analyzed whether the SEC’s decision to rescind the proxy voting advice conditions was “reasonable and reasonably explained” as required under the APA.¹³ The Court held that the SEC’s 2022 rescission of the 2020 Rules was within “the bounds of reasoned decision making.”¹⁴

The Court concluded that the SEC met the applicable relevant legal standard, *i.e.*, that “the Commission

must have (1) examined ‘the relevant data’ and (2) articulated a ‘satisfactory explanation’ possessing a ‘rational connection between the facts found and the choice made.’”¹⁵ More specifically, the Court found

that, as required under the relevant standard, the SEC provided “good reasons” for the rescission of the 2020 Rules, and that “the agency believes [the reversal] to be better.”¹⁶ According to the SEC, the rescission of the 2020 Rules was a better policy because: “First, the 2022 Rescission would ‘alleviate[] costs ... to PVABs’ imposed by the 2020 Amendments. Second, reversing the 2020 Amendments would better ‘address PVAB clients’ and other investors’ concerns about receiving timely and

independent advice from PVABs.”¹⁷ The Court granted the SEC’s motion for summary judgment.

Fifth Circuit Hears Appeal of District Court Decision in National Association of Manufacturers et al. v. SEC (Oral argument on August 7, 2023; Decision Sub Judice)

On August 7, 2023, the Fifth Circuit Court of Appeals heard oral argument on the appeal in *National Association of Manufacturers*. The SEC argued that “reasonable people can and do disagree about the notice and awareness conditions at issue in this case. That division stems from different reasonable judgments about how to weigh the conditions’ uncertain and unquantifiable benefits and risks. In rescinding the conditions in 2022, the Commission met its obligation ... to acknowledge and give good reasons for weighing the competing interest different than it did in 2020.” The SEC in turn faced critical questioning from Judge Edith Jones concerning the SEC’s decision to rescind the 2020 Rules. Judge Jones seemed to focus more

on the factual underpinnings of the case, asserting that it appeared that the timeliness concern that was asserted by the SEC was not in existence from the beginning, because when the PVABs were required to notify the company of their advice, “functionally they just press a send button on the computer, right?” To that end, Judge Jones called the concern about timeliness “irrational,” “because all they have to do is push a button when they send out their advice to the registrants.” Judge Jones also questioned the appropriateness of the fact that the SEC’s rescission rule change occurred with only 30 days’ notice over the holiday season.

The Fifth Circuit had not ruled on the appeal as of the date this article was written.

Significance of the Amendments and Current Takeaways

One of the main concerns of the 2020 Rules was that it could “result in delays in distribution of proxy advice, driving up costs for investors, impairing the independence of proxy advice and causing uncertainty for institutional investors.”¹⁸

Particularly, under the old 2020 Rules, companies could disagree with the PVABs’ methodology or recommendation which would drive increased exposure to litigation and increased costs or delay.

The District Courts’ upholding of the SEC’s 2022 rescission of the 2020 Rules, under direct challenges from different business-industry groups, solidifies the following benefits to institutional investors who wish to use PVABs in any proxy dispute:

- Increased independence in voting decisions
- Less exposure to litigation by the company
- More certainty
- Less delay and less threat of drawing out the voting process
- Lower costs to PVABs and thus lower costs to institutional investors

However, given that the Western District of Texas decision in *National Association of Manufacturers* is now under review before the Fifth Circuit Court

of Appeals, with the SEC facing some hard questions from the bench during oral argument on the appeal, institutional investors should continue to monitor this developing area. Should the Fifth Circuit reverse the District Court’s decision in *National Association of Manufacturers*, the potential benefits highlighted herein may not materialize after all.

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Endnotes

¹ Press Release, Securities and Exchange Commission, *SEC Adopts Amendments to Proxy Rules Governing Proxy Voting Advice* (July 13, 2022), <https://www.sec.gov/news/press-release/2022-120>.

² Paul Kiernan and Michelle Chan, *SEC’s Gensler Casts Doubt on Prospects for China Audit Deal* (July 13, 2022), <https://www.wsj.com/articles/sec-mulls-changes-to-proxy-voting-advice-shareholder-proposals-11657720813>.

³ *Id.*

⁴ *Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice* (proposed Dec. 4, 2019), <https://www.sec.gov/files/rules/proposed/2019/34-87457.pdf>.

⁵ *Id.*

⁶ *Id.*

⁷ See *Proxy Voting Advice* (proposed Nov. 26, 2021) (available at <https://www.sec.gov/files/rules/proposed/2021/34-93595.pdf>); *Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice* (proposed Dec. 4, 2019) (footnote 18) (available at <https://www.sec.gov/files/rules/proposed/2019/34-87457.pdf>).

⁸ Commissioner Allison Herren Lee, Protecting the Independence of the Proxy Voting Process: *Statement on Amendments Governing Proxy Voting Advice* (July 13, 2022), <https://www.sec.gov/news/statement/lee-statement-amendments-governing-proxy-voting-advice-071322>.

⁹ Press Release, Council of Institutional Investors, *Leading Investor Group Dismayed by SEC Proxy Advice Rules* (July 22, 2020), https://www.cii.org/july22_sec_proxy_advice_rules (emphasis added).

¹⁰ *Chamber of Commerce*, 2023 WL 3063819, at *16.

¹¹ *Id.* at *17 (emphasis added).

¹² *Id.* at *15.

¹³ *National Association of Manufacturers*, 2022 WL 17420760, at *1.

¹⁴ *Id.* at *8.

¹⁵ *Id.* at *4.

¹⁶ *Id.* at *5.

¹⁷ *Id.*

¹⁸ Press Release, Council of Institutional Investors, *Leading Investor Group Dismayed by SEC Proxy Advice Rules* (July 22, 2020), https://www.cii.org/july22_sec_proxy_advice_rules.