SEC PASSES INDEPENDENT PROXY ADVISORY FIRM REGULATIONS

By Michael Verrechia and Paul Schulman

Michael Verrechia and Paul Schulman are co-heads of Morrow Sodali's M&A and Activism Advisory Group. This was adapted and edited from Morrow Sodali's July 2020 Proxy Update, and reprinted with permission.
Contact: m.verrechia@morrowsodali.com or p.schulman@morrowsodali.com.

On July 22, 2020 the Securities and Exchange Commission passed a set of rules regulating the independent proxy advisory firms, a space currently dominated by ISS and Glass Lewis. This article will not rehash the lengthy (10 year-plus) and hotly-debated process, including ISS filing a lawsuit against the SEC in the fall of 2019, that led to the adoption of these new regulations. We will focus instead on the key provisions of the rules that affect our clients and the practical impact they will have on proxy solicitation campaigns going forward.

In the current proxy voting landscape, a vast majority of institutional investors make their own voting decisions and use the proxy advisors' recommendations solely as a resource; however there are a number of major shareholders, including large quantitative hedge funds, passive investors and private wealth managers that have no internal proxy voting resource and rely on an automatic vote. This process, commonly referred to as the "robo-vote," allows an institution to automatically follow a proxy advisor's recommendation, which nullifies the need to engage with an issuer or spend any time weighing the pros and cons of a particular vote. The SEC expressed its opinion that these firms are improperly outsourcing their fiduciary responsibilities to a third-party.

For companies with significant institutional share ownership, this block of robo-voted shares can be outcome determinative and often puts the proxy advisor in the position of being the de facto largest shareholder.

No Preview

Unfortunately for issuers, the SEC did not mandate that the proxy advisory firms provide all companies with a draft of the report prior to its publication. The ability to preview the reports was clearly the most desired outcome for issuers, allowing them to provide additional information and perspectives to the proxy advisors or correct any material errors, all in order to flip adverse vote recommendations. A number of S&P 500 clients, who have long had the benefit of receiving draft ISS reports, have been successful in either getting ISS to change its recommendation prior to publication or given a second opportunity to provide disclosure, or perspective, into the report's narrative. Smaller companies are still left having to wait until after the ISS report is released to be able to react to the analyses and recommendations.

The disadvantage to smaller companies is two-fold. First, the bar for ISS to issue a revised report, either with a vote recommendation change or clarifying language is seemingly higher than it is when attempting to affect such changes during the preview period; and second, there are always a number of firms that utilize robo-voting but then do not flip when a revised recommendation is released.

A New Pathway For Company Response

The new rules provide a more direct path for companies to furnish institutions with a counter to an ISS or Glass Lewis recommendation.

Issuers have always had the ability to file additional solicitation material to counter a proxy advisor's recommendation and to take their case directly to shareholders through engagement. However, the effectiveness of this effort can be adversely impacted by the fact that many institutions robo-vote as soon as ISS publishes its report and are unlikely to read or be

© 2020 Thomson Reuters

swayed by these supplemental filings or to engage with the company.

What the new rules provide to address this are the following:

i.) the proxy advisors must allow issuers the ability to provide a response to dispute a recommendation;

ii.) the proxy advisors must notify their clients of any such company response; and

iii.) discourage shareholders from robo-voting, and instead consider both the proxy advisor recommendation and company response.

Impact of the Rules From a Proxy Solicitor's Perspective

As most companies know from experience, proxy returns trickle in at the beginning of the solicitation period, mostly from retail shareholders, and it's only after the proxy advisor recommendation (usually two to three weeks ahead of the meeting) that initial institutional voting comes in. The first wave usually occurs within 24 hours of the ISS report and is made up not only of the robo-votes, but other clients of ISS that have given ISS the authority to vote on their behalf using a customized voting policy that is often fairly consistent with the ISS policy.

Understanding which holders are typically included in this block of votes, a proxy solicitor can identify these firms and determine the appropriate course of action for company's engagement efforts. If the proxy advisors maintain the standard timing of releasing their reports, and institutions delay their voting instructions by a week or more, the timeframe that companies have in which to engage with shareholders is significantly shortened.

Institutions that contract Glass Lewis to vote on their behalf come in much closer to the meeting, typically two to three days prior.

Many of the firms that outsource their voting to one of the proxy advisors do not have the internal resources, capability or desire to make an independent decision. Requiring them to now do so results in additional costs of compliance, research and staffing. For a quantitative-driven hedge fund who may have hundreds, if not thousands, of positions, the result may be a decision that the cost of voting outweighs the benefit and we may see less vote participation. The proxy disclosure of one of these firms reads as follows:

> "The Firm has established a two-tiered policy for voting proxies. . . . the firm will generally rely on the recommendations of its proxy adviser, Institutional Shareholder Services, Inc. ("ISS"). (If ISS does not have a recommendation, the Firm generally will abstain from voting.) For the . . . Funds, which are traded pursuant to a high turnover strategy, the Firm will abstain from voting proxies, as it has concluded that under ordinary circumstances the voting of proxies for these Funds would not be in the best interests of its clients because (a) it would divert resources away from the implementation of its trading strategy and (b) given the Funds' high rate of turnover, it is unlikely that securities held on a particular record date would remain in the portfolio on the date of the vote."

What impact, if any, these new regulations have on advisory firm recommendations and policies remains to be seen.

Proxy Solicitation Rules

The SEC has also redefined the terms "solicit" and "solicitation" of Rule 14a-1 to include the proxy voting advice given by the advisory firms will generally be considered a solicitation and subject to the proxy rules. Importantly the amended rule will include exemptions if certain conditions are met. In short the exemptions that must be satisfied include: disclosure of conflicts of interest, advisory reports are to be made available before or at the same time reports are made available to advisory firm clients, and the institutional clients of the advisory firms can expect to be aware of written statements from the advisory firms, re: issuers, in a timely manner before a shareholder meeting.

© 2020 Thomson Reuters

The disclosure of conflicts of interest is a drastic departure from the current standards as advisory firms offer consulting services to issuers regarding proposals that the advisory firms will be making future voting recommendations on.

Proposed Increase of 13F Threshold

Separately on July 10, 2020, the SEC proposed increasing the reporting threshold for a Form 13F from $100 million AUM to $3.5 billion AUM. The reporting threshold of Form 13Fs has not been changed since 1975 when Congress adopted the requirements.

Per the SEC, the intended purpose of the increase is to lessen the reporting burden on smaller investment managers. The change in the threshold is a response to the growth of the equity markets as the requirements were initially put in place to monitor large institutional investors. This new threshold, according to the SEC, would cover disclosure for greater than 90% of the dollar value of holdings currently reported but relieving almost 90% of current filers that are smaller managers.

The SEC has opened a 60-day comment period and SEC Commissioner Allison Herren Lee is an early dissenter and voted against the proposal. The effects of this, if enacted, would be wide reaching as companies would have significantly decreased transparency in their own shareholders. The ability of issuers to proactively engage with their shareholder base would be impacted greatly. Smaller investment managers would have an advantage over larger firms, who would continue to file Form 13Fs, in discreetly acquiring an equity stake in an issuer. It would also allow activist shareholders, most of whom fall below the $3.5 billion AUM threshold, to accumulate significant positions up to 4.9% with absolutely no notice to the company or other shareholders.

ESCAPE TO THE PHILIPPINES

By Paul Marrinan

Paul Marrinan has worked in International Law Enforcement for 16 years, is a member of the ACFCS, and is the founder of Túath Consulting, specializing in cybercrime, anti-money laundering, and counter-terrorist financing capacity building. He has been focused on blockchain and digital assets in recent years and holds an MSc in Forensic Computing & Cybercrime Investigation.
Contact: paul@marrinan.com.

On July13, 2020, the SEC[1]and CFTC[2] charged a little-known but surprisingly well-funded company known as Abra, legal name Plutus Financial Inc., and a related Philippines firm, for offering unregistered security-based swaps. Something that is probably not surprising when you learn that Abra's core business is digital assets or cryptocurrency. What may be surprising is how the company has offshored many of its operations to the Philippines to avoid strict regulations in the U.S.

For anyone unfamiliar with the Philippines, it is important to know that overseas remittances formed 10.2% of the country's GDP in 2018[3] and that over 65% of the domestic population, of 109 million people, is unbanked.[4] The SEC/CFTC charge shines a light on this app and similar crypto-based offerings that are well resourced but under the radar for many reasons, costing the Mountain View, CA-based company $300,000 in fines. Abra is an interesting case study based on the structure of its offering. The Californian team has outsourced many risk-related activities to other service providers, while also avoiding strict regulation by accessing an off-shore environment via Plutus Technologies Philippines Corporation. They cannot be accused of being unregulated. However, they do raise the questions about whether they are being regulated appropriately in the Philippines,