ESG Viewpoint

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US Responsible Investment regulatory update

Over the past decade, responsible investment has seen extraordinary growth and acceptance into the mainstream, with that set to continue into the next decade. Whilst Europe continues to have the highest amount of ESG-aligned assets, a significant driver of global growth can be attributed to increased interest in the US, with year-on-year increases now far out-pacing those in Europe.

Against this backdrop, in November 2019 the US Securities and Exchange Commission (SEC) raised investor fears that it plans to rein in the growth of responsible investment by releasing two proposed sets of rule amendments. These amendments were presented by the SEC as addressing concerns over the accuracy and transparency of proxy voting advice, and modernising the shareholder proposal process. However, if adopted, they would have the effect of increasing the regulatory burden on proxy advisers, and further restricting the ability for investors to file shareholder proposals.

More broadly, these proposals have been interpreted by many investors as being motivated by a pro-corporate bias at the SEC, removing what it deems to be unnecessary burdens for companies or market-based hindrances for companies, often irrespective of the consequences for investors. Of particular concern is that the SEC appears to believe that investors looking to address ESG issues at companies are not necessarily doing so in the best interest of their clients, but rather are driven by social or political considerations, directed by proxy advisers.

In January 2020, we submitted a formal response to the SEC's consultation on these proposals, with a summary of our main concerns provided below.

How is the SEC proposing to regulate proxy advisers?

Proxy advisers, such as Institutional Shareholder Services (ISS) or Glass Lewis, provide services to shareholders to help them vote their shares at company shareholder meetings. As well as assisting with the execution of their client's vote instructions, they also provide proxy research that gives recommendations on how to vote on different agenda items, based on either their own voting guidelines or on the specific policies of their clients.

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In August 2019[1], the SEC reversed a long-held position, and declared that those who publish proxy voting research and/or issue recommendations would now be considered to be partaking in "proxy solicitation". SEC rules define a 'solicitation' as a communication sent to other investors to get them to vote in a certain way. Previously a narrower definition had been applied, whereby only those who sent communications to all shareholders publicly to persuade them to vote in a certain direction were soliciting. By contrast, they will now apply a much broader definition of proxy solicitation, whereby anyone issuing advice on how to vote, including those only advising specific clients, is soliciting.

The consequence of this is that, under existing securities laws, those who conduct proxy solicitation are required to, amongst other things, publicly file all communications with the SEC. This would be inconceivable for a proxy adviser to do, as it would undermine their business model by requiring them to publicly disclose their proprietary research. In addition, they would face liability for publishing anything that could be interpreted as either materially misleading or a misstatement from omission.

In order to be exempt from these requirements, there are a new set of requirements that proxy advisers must meet, including providing an opportunity for companies to review and give feedback on draft reports for a period of up to 13 days before sending it to clients, and allowing companies to provide a written response that would be linked to within the final published report.

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The SEC has declared that those who are publishing proxy voting research and/or issuing recommendations are partaking in proxy solicitation.

[1] https://www.sec.gov/news/press-release/2019-158

What is our view on the proposals?

As we seek to best serve our clients through the effective execution of our stewardship activities, we are concerned that the new regulatory regime will introduce overly burdensome requirements, in response to issues that have been misunderstood or exaggerated. More specifically:

1. **The proposal for company review is impractical, and will reduce direct engagement between companies and investors** – Our view is that the proposed company review regime is not possible to implement when the actual time taken to do so is properly accounted for , particularly considering the concentration of most company meetings into a short period of time in Spring. Allowing companies such a lengthy review window prior to publication (up to 13 calendar days in total) will condense the time that investors have to review the research and directly engage with companies.

2. **The mandatory company review could compromise the independence of proxy research** – Under existing rules in the US, stock analysts are restricted from sharing their buy/sell recommendations with companies prior to publication, in order to protect their independence. Therefore, it seems counterintuitive to established practice that proxy advisers should be obliged to share their complete reports, including their conclusions and recommendations, as opposed to just those parts containing factual information. By allowing companies to review and comment on draft reports in their entirety, it is feared that they may have undue influence on the final vote recommendations.

3. **These proposals would increase barriers to entry and could ultimately lead to a monopoly** – By significantly increasing the regulatory burden on proxy advisers through increasing litigation risk and making their production cycle less efficient, we think that the SEC is increasing barriers to entry in an industry that is already a duopoly.

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How is the SEC proposing to change how shareholder proposals work?

Under the second set of proposed regulations, the SEC intends to revise the terms by which investors can file shareholder proposals, specifically:

- Raising stock ownership thresholds from the current requirement of by more than a factor of ten, and no longer allowing a group of investors to aggregate their shares together to meet the threshold
- Significantly raising the thresholds that allow the same proposal to re-submitted the next year, even if it does not pass in previous years
- Introducing a new momentum rule that blocks proposals where support decreases by 10% or more (e.g. from 40% to 36%)
- Various changes to administrative rules, such as tightening of the 'one-proposal' rule, meaning that more people must physically attend the AGM to present proposals, as well as a mandatory 'engagement' period between the proponent and the company

What is our view on the proposals?

We think that the shareholder proposal process has made a positive impact on improving the ESG and specifically corporate governance practices at US companies, which in turn has led to us being invested in higher quality assets on behalf of our clients. Our overall concern is that the proposed changes to the process will make it more difficult to submit and sustain proposals and therefore discourage this pattern in the future.

The current regime does not impose an inappropriate burden on companies – The actual number of shareholder proposals that are voted on each year is relatively small, generally representing less than 2% of voting items at US shareholder meetings, with only 13% of Russell 3000 companies receiving a shareholder proposal on average. Even if a shareholder proposal is passed by majority support, in most instances it is non-binding in nature, with the discretion on how and whether to act on the proposal remaining entirely with the company itself.

Shareholder proposals address more than just niche issues by special interest groups – The assumption underlying the SEC's proposed rule change appears to be that shareholder proposals are filed by special interest groups motivated by social advocacy, rather than mainstream investors motivated by improving the financial success of companies. By contrast, we consider there to be growing acceptance in the investment community that proposals should be judged on the merit of their content, irrespective of who it is that presents or files them. This is reflected by that fact that support for shareholder proposals on either environmental or social issues has never been higher.[2]

What next?

With the comment period closed, our original expectation was that the SEC would make a final decision on these proposals in Q2 this year. Then again, the SEC is not immune to the operational disruption of the Coronavirus epidemic and therefore progress is most likely paused for now. Either way, with a significant strong level of opposition having been expressed by the investor community, it does seem that there could be the potential for the final proposals to be somewhat amended, but it is unlikely that they will be scrapped outright.

Neither will these proposals be the last from the SEC, with the potential to rein in responsible investment activities. Recently, they launched a comment period on a proposed rule regarding the naming of funds[3], following concerns over the rise in ESG strategies with labels such as "Clean", "Impact", "Responsible" and "Sustainable". Although we would agree that rigour needs to be applied to ESG investment funds to avoid "green-washing", we are concerned that if regulations are impractical or inflexible then it could stifle product innovation to meet client needs.

Finally, there is an area where we think that the SEC should be focusing its attention at this time in order to improve market mechanics in the US: **proxy plumbing**. This is the term used to describe the processes and systems by which investors' vote instructions are transmitted, recorded and implemented at company shareholder meetings. There is broad agreement that the current system of proxy plumbing is inefficient, opaque and, all too often, inaccurate. Although the SEC's Investor Advisory Committee issued a series of recommendations[4] last year on how things could be improved, such as introducing end-to-end vote confirmation, and SEC Chairman Jay Clayton has acknowledged the importance of the issue[5], we have still not seen firm action or rule-making in this area.

[2] As discussed in our Voting Season Review for U.S. & Canada (https://www.bmogam.com/us-en/advisors/news-and-insights/2019-voting-season-review-us-and-canada/)
[3] https://www.sec.gov/rules/other/2020/ic-33809.pdf
[4] https://www.sec.gov/spotlight/investor-advisory-committee-2012/iac-recommendation-proxy-plumbing.pdf
[5] https://www.sec.gov/news/press-release/2019-158

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Key risks

The value of investments and any income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

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