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September 1, 2020

SEC Adopts Rule Amendments for Proxy Advisory Firms

By Bill McDonald

For many years, the Securities and Exchange Commission ("SEC") has considered how to regulate proxy advisory firms such as Institutional Shareholder Services ("ISS") and Glass, Lewis & Co ("Glass Lewis").[1] On July 22, 2020, the SEC adopted amendments to the proxy rules to address proxy voting advice services provided by proxy advisory firms.[2] The SEC also issued supplemental interpretative guidance addressing the responsibilities of an investment adviser if it uses the services of a proxy advisory firm in response to the adoption of the Final Rules.[3]

The Final Rules differ in several respects from the proposed rules issued in November 2019.[4] In the adopting release, the SEC emphasized several times that the Final Rules are based on "a more principles-based approach" rather than the prescriptive disclosure approach set forth in the Proposed Rules. The SEC states the Final Rules are intended to be more flexible to encompass a wide variety of circumstances.

The Final Rules in Summary

The Final Rules include two primary actions.

- The SEC codified its longstanding view that proxy voting advice constitutes a "solicitation" under Section 14A of the Securities Exchange Act of 1934 (the "Exchange Act"); and
- The SEC adopted new express conditions that a proxy advisory firm must satisfy in order to be exempt from the information and filing requirements applicable to proxy solicitations.

In connection with the Final Rules, the SEC also provided the Supplemental Guidance to investment advisers regarding their proxy voting requirements and duties in light of the adoption of the Final Rules.

Proxy advisory firms[5] will not be required to comply with the additional disclosure and procedural requirements until December 1, 2021. The other portions of the Final Rules will become effective 60 days after publication of

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[1] Release No. 34-62495, *Concept Release on the U.S. Proxy System* (Jul. 14, 2010), available here (the "Concept Release")

[2] Release No. 34-89372, *Exemptions from the Proxy Rules for Proxy Voting Advice* (Jul. 22, 2020), available here (the "Final Rules").

[3] Release No. IA-5547, *Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers* (Jul. 22, 2020), available here (the "Supplemental Guidance").

[4] Release No. 34-87457, *Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice* (Nov. 5, 2019), available here (the "Proposed Rules").

[5] In the adopting release, the SEC refers to firms that advise investment advisers and institutional investors on their voting determinations, and any person who markets and sells such advice, as "proxy

the adopting release in the Federal Register. The Supplemental Guidance is effective upon publication in the Federal Register.

Codification of the SEC's Interpretation of "Solicitation"

The SEC notes that the Exchange Act does not define "solicitation" as it relates to Section 14(a) of the Exchange Act and that the SEC has exercised its rulemaking authority to define "solicitation" and to prescribe rules and regulations as appropriate. The SEC confirms that it has been the SEC's longstanding position that proxy voting advice constitutes "solicitation" governed by the federal proxy rules. Despite this position, proxy advisory firms have historically relied upon Rule 14a-2(b)(1) and Rule 14a-2(b)(3) to provide proxy voting advice without complying with the information and filing requirements of the proxy solicitation rules. However, these two rules were adopted before proxy advisory firms started playing such a significant role in the proxy solicitation process as they now do.

The Final Rules codify the SECs interpretation by amending the definition of "solicitation" in Rule 14a-1(l)(1)(iii) by adding paragraph (A) as follows:

> "(A) Any proxy voting advice that makes a recommendation to a security holder as to its vote, consent, or authorization on a specific matter for which security holder approval is solicited, and that is furnished by a person that markets its expertise as a provider of such proxy voting advice, separately from other forms of investment advice, and sells such proxy voting advice for a fee."[6]

The SEC recognized that a proxy advisory firm may use more than one set of guidelines or policies in making its recommendation. The adopting release provides that each voting recommendation based upon a benchmark policy or specialty policy would be considered a distinct solicitation under the revised rules. The SEC also confirmed that while a voting recommendation based upon a client's own custom policies would constitute a "solicitation," the notice and response conditions addressed below are not applicable to proxy advice based on custom voting policies that are proprietary to the proxy advisory firm's client.[7]

The Final Rules also amended Rule 14a-1(l)(2) to add paragraph (v) to make it clear that "solicitation" does not include any proxy voting advice provided by a person who furnishes such advice only in response to an unprompted request.[8]

Additional Conditions to Exemptions Under Rule 14a-2(b)

As noted above, proxy advisory firms have typically relied upon Rules 14a-2(b)(1) and (3) to be exempt from the information and filing requirements of the proxy solicitation rules. The Final Rules impose new conditions under

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voting advice businesses." We will refer to such entities as "proxy advisor firms" consistent with the Supplemental Guidance.

6 New Rule 14a-1(l)(1)(iii)(A).

7 New Rule 14a-2(b)(9)(v).

8 New Rule 14a-1(l)(2)(v).

Rule 14a-2(b)(9) that must be satisfied in order for a proxy advisory firm to continue to rely upon these exemptions.

Conflicts of Interest Disclosure

The SEC provided examples of where the business interests of a proxy advisory firm could diverge from the interests of its clients. For example, providing proxy voting advice on a proposal in which the proxy advisory firm has an interest or providing ratings to institutional investors regarding a registrant's corporate governance practices while also providing consulting services to the registrant. Due to the risk that the proxy voting advice could be influenced by the business interests of the proxy advisory firm, the Final Rules require the proxy advisory firm to make certain disclosures.[9]

Pursuant to the Final Rules, it is a condition to the exemption from the information and filing requirements of the proxy solicitation rules that a proxy advisory firm include, either in its proxy voting advice or in any electronic medium used to deliver the advice, such as a client voting platform, prominent disclosure of the following:

> "(A) Any information regarding an interest, transaction, or relationship of the proxy voting advice business (or its affiliates) that is material to assessing the objectively of the proxy voting advice in light of the circumstances of the particular interest, transaction, or relationship; and
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> (B) Any policies and procedures used to identify, as well as the steps taken to address, any such material conflicts of interest arising from such interest, transaction, or relationship; and" [10]

The Final Rules are principles-based and intended to provide the proxy advisory firm flexibility to determine the level of detail or whether a relationship or interest should be disclosed.

Notice of Proxy Voting Advice

The Final Rules require, as a condition to the availability of the exemptions to the proxy solicitation rules, that the proxy advisory firm must adopt and publicly disclose written policies and procedures reasonably designed to ensure that:

> "(A) Registrants that are the subject of the proxy voting advice have such advice made available to them at or prior to the time when such advice is disseminated to the proxy voting advice business's clients; and
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> (B) The proxy voting advice business provides its clients with a mechanism by which they can reasonably be expected to become aware of any written statement regarding its proxy voting advice by registrants who are the subject of such advice, in a

[9] New Rule 14a-9(i).

[10] New Rule 14a-9(i)(A) and (B).

> timely manner before the security holder meeting (or, if no meeting, before the votes, consents, or authorizations may be used to effect the proposed action)."[11]

The Final Rules leave it to the discretion of the proxy advisory firm to choose the best way to implement the principles in the rule. In light of this flexibility, Rule 14a-2(b)(9)(iii) provides a non-exclusive safe harbor provision that gives assurance to the proxy advisory firm that it has satisfied the requirements of Rule 14a-2(b)(9)(ii)(A) if the proxy advisory firm has written policies and procedures that are reasonably designed to provide the registrant with a copy of the proxy voting advice, at no charge, no later than the time the advice is provided to the proxy advisory firm's clients.

The safe harbor policies and procedures may include conditions requiring that:

> "(A) The registrant has filed its definitive proxy statement at least 40 calendar days before the security holder meeting date (or if no meeting is held, at least 40 calendar days before the date the votes, consents, or authorizations may be used to effect the proposed action); and
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> (B) The registrant has acknowledged that it will only use the copy of the proxy voting advice for its internal purposes and/or in connection with the solicitation and such copy will not be published or otherwise shared except with the registrant's employees or advisers." [12]

The Final Rules include a note to Rule 14a-2(b)(9)(ii)(A) that if the proxy voting advice is subsequently revised, the proxy advisory firm is not required to provide the revised version to the registrant.

Access to Registrant's Response

The Final Rules also require the proxy advisory firm to provide its clients a mechanism by which they can reasonably be expected to become aware of any written statement in response to the proxy voting advice in a timely manner before the shareholder meeting (or before the vote or consent, if there is no meeting).[13]

Due to the principle-based nature of the rule, the SEC provided a non-exclusive safe harbor provision in Rule 14a-2(b)(9)(iv) that, if followed, will result in the proxy advisory firm being deemed to have satisfied this requirement of the new rules. The safe harbor requires the proxy advisory firm to adopt written policies and procedures that are reasonably designed to inform clients when a registrant notifies the proxy advisory firm that it intends to file, or has filed, additional soliciting material with the SEC setting forth the registrant's response to the proxy voting advice. The safe harbor can be satisfied by:

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[11] New Rule 14a-9(ii)(A) and (B).

[12] New Rule 14a-2(b)(9)(iii)(A) and (B).

[13] New Rule 14a-2(b)(9)(ii)(B).

> "(A) The proxy voting advice business providing notice to its clients on its electronic platform that the registrant intends to file or has filed such additional soliciting materials and including an active hyperlink to those materials on EDGAR when available; or
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> (B) The proxy voting advice business providing notice to its clients through email or other electronic means that the registrant intends to file or has filed such additional soliciting materials and including an active hyperlink to those materials on EDGAR when available."

The rule itself refers to making the clients aware of the registrant's response. However, the safe harbor provision also refers to making clients aware of a registrant's intent to file additional soliciting materials. The SEC notes that depending on the facts and circumstances, a proxy advisory firm may be required to provide two notices to its clients. The first notice may need to inform the clients of the registrant's intent to provide supplemental proxy materials, since such supplemental proxy materials may be relevant and material to their voting decisions. The second notice could provide the clients a hyperlink to the registrant's supplemental proxy materials once filed with the SEC.

The SEC stated that whether a proxy advisory firm had complied with the new rules would be determined by the particular facts and circumstances of the proxy advisory firm's written policies and procedures and whether such policies and procedures are reasonably designed to ensure that the conditions of Rule 14a-2(b)(9)(ii)(A) and (B) are met. The adopting release includes a list of factors that may be relevant in determining whether the proxy advisory firm has complied with the new rules.

As noted above, proxy advisory firms do not need to comply with Rule 14a-2(b)(9)(ii) in order to rely upon the exemptions to the extent the proxy voting advice is based on a custom policy. In addition, Rule 14a-2(b)(9)(ii) is not applicable to proxy voting advice as to solicitations regarding certain mergers and acquisitions and contested matters.[14]

Amendments to Rule 14a-9

Rule 14a-9 prohibits any proxy solicitation from containing false or misleading statements with respect to any material fact at the time and in light of the circumstances under which the statements are made. In addition, such solicitation must not omit to state a material fact necessary in order to make the statements therein not false or misleading.[15] In the adopting release, the SEC refers to its recent guidance addressing the applicability of Rule 14a-9 to proxy voting advice.[16] In the Final Rules, the SEC adds a note to Rule 14a-9 to include

[14] New Rule 14a-2(b)(9)(vi).

[15] Rule 14a-9.

[16] Question and Response 2 of *Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice*, Release No. 34-86721 (Aug. 21, 2019), available *here*.

examples of the types of information that a proxy advisory firm should consider disclosing to avoid a potential violation of Rule 14a-9.[17]

Supplemental Guidance for Investment Advisors

In addition to the new rules and amendments discussed above, the SEC provided supplemental guidance to investment advisers regarding their proxy voting responsibilities in light of the new and amended proxy solicitation rules.[18] The Supplemental Guidance is in addition to previous guidance provided in 2019[19] and is intended to assist investment advisers in the exercise of proxy voting authority on behalf of its clients.

The Supplemental Guidance focuses on two situations where the proxy advisory firm assists the investment adviser with voting execution. These services include "pre-population," where the proxy advisory firm populates the client's votes based on the firm's recommendations and client's existing voting instructions, and "automated voting," where the proxy advisory firm submits the client's votes.

When an investment adviser utilizes either of these types of services, the Supplemental Guidance includes steps and recommendations to ensure that the investment adviser exercises voting authority in its client's best interest.

- The investment adviser should consider whether its policies and procedures address a situation where the investment adviser becomes aware of a registrant's intent to file, or the filing of, supplemental proxy information in response to the proxy advisory firm's vote recommendation after the investment adviser has received the proxy advisory firm's recommendations but before the vote submission deadline.

- The investment adviser should consider reviewing its agreements with any proxy advisory firms to determine whether the firm may use material nonpublic information regarding the investment adviser's pre-populated or automated voting in any manner that is not in the best interests of the investment adviser's clients.

- The SEC notes that an investment adviser has a duty to make full and fair disclosure to its clients of all material facts relating to the advisory relationship. The Supplemental Guidance states these facts include voting authority with respect to client's securities and states that the investment adviser should consider disclosing the extent to which it uses automated voting and how its policies and procedures address the use of automated voting when additional soliciting materials from the registrant become available.

Practice Points

While the Final Rules did not go as far as the Proposed Rules, the resulting amendments and new rules do establish additional obligations for proxy advisory firms with respect to proxy voting advice services.

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[17] New Note e to Rule 14a-9.

[18] See Note 3.

[19] Release No. IA-5325, *Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers* (Aug. 21, 2019), available *here*.

Nonetheless, it is uncertain whether the Final Rules will have a significant impact on the power and influence of the principal proxy advisory firms.

Registrants should seek to take advantage of the Final Rules as they become effective, with the notice of proxy voting advice and access to response requirements to become effective before the 2022 proxy season. Registrants should ensure that they file their proxy statement no later than 40 calendar days before the date of its shareholder meeting (or consent or other authorization, if no meeting is held). This will be a change for many registrants that have not been using Notice and Access and have been filing less than 40 calendar days prior to the meeting date. A registrant should also be prepared to respond quickly in the event the registrant wants to file supplemental proxy materials in response to the proxy voting advice. A registrant should also consider providing prompt notice of its intent to file such supplemental proxy materials to put the proxy advisory firm on notice.

To the extent an investment adviser engages a proxy advisory firm to assist with voting execution, the investment adviser should revisit (i) its policies and procedures to ensure they address any supplemental proxy filings, (ii) its offering materials to ensure they fully disclose any such relationship with a proxy advisory firm, and (iii) its agreement with such proxy advisory firms regarding the potential use of information by the investment adviser regarding any such pre-populated or automated voting.

For further information, please contact a member of the Haynes and Boone Capital Markets and Securities practice group.