

Legal Update

SEC Adopts Proxy Voting Advice Rule Amendments

On July 22, 2020, the US Securities and Exchange Commission (SEC) adopted amendments (Final Rules) to its proxy solicitation rules that are designed to enhance the transparency, accuracy and completeness of the information that proxy voting advice businesses (proxy advisors), such as Institutional Shareholder Services Inc. (ISS) and Glass, Lewis & Co., provide to investors and others who vote on behalf of investors.¹

The Final Rules codify the SEC's position that voting advice produced by proxy advisors generally constitutes a solicitation under the proxy rules. The Final Rules add new conditions to the exemptions to the information and filing requirements of the proxy rules that proxy advisors have historically relied on. As a result, proxy advisors will have to:

- prominently disclose conflicts of interest to their clients in their proxy voting advice or in the electronic medium used to deliver that advice;
- establish procedures designed to allow all companies that are subject to their voting advice to be able to access that advice prior to or simultaneously with the release of that advice to clients; and
- provide a mechanism for their clients to be able to access any written company response to their voting advice on a timely basis before they vote.

The Final Rules also make clear that the failure to disclose material information regarding proxy voting advice could cause such advice to be misleading, in violation of the proxy rules.

Background

The Final Rules were adopted as part of the SEC's ongoing focus on improving the proxy process and infrastructure. The impetus for the proxy voting advice rules arose from a recognition that institutional investor ownership of US public companies has grown to tremendous levels, with proxy advisors influencing, and in many cases directly executing, institutional investor voting decisions impacting a large percentage of voting shares of those companies.

The SEC has been examining issues surrounding proxy advisors and the proxy voting process over the course of many years, during which time the SEC had the opportunity to consider viewpoints representing various constituencies. For example, the SEC issued a concept release in 2010 on the US proxy system, often referred to as the "proxy plumbing" release, which, among other topics, addressed the role and legal status of proxy advisors and potential regulatory responses.² Then in 2013, the SEC staff held a roundtable on the use of proxy advisors, which was followed by Staff Legal Bulletin No. 20 in 2014

providing guidance with respect to the availability and requirements of two federal proxy rule exemptions that proxy advisors may seek to rely on.

In November 2018, the SEC staff hosted another roundtable on the proxy process, with one of the three panels devoted to a discussion of proxy advisors. To facilitate discussion at that roundtable, the staff of the Division of Investment Management withdrew two no-action letters addressing investment advisers' use of recommendations of independent third parties to vote client proxies that were previously issued to Egan-Jones Proxy Services (May 27, 2004) and ISS (September 15, 2004).³

On August 21, 2019, the SEC issued an interpretive release providing guidance on how the current proxy rules apply to proxy voting advice.⁴ For more information on the Proxy Voting Advice Guidance, see our Legal Update "SEC Issues Guidance on the Application of the Proxy Rules to Voting Advice," dated August 27, 2019.⁵ On November 5, 2019, the SEC proposed amendments to its proxy solicitation rules relating to the provision of proxy voting advice by proxy advisors.⁶ For more information on that original proposal, see our Legal Update "SEC Proposes Proxy Voting Rule Amendments," dated November 12, 2019.⁷

Amendments to Proxy Solicitation Rules

Rule 14a-2(b) under the Securities Exchange Act of 1934 provides exemptions from the information and filing requirements of the SEC's proxy solicitation rules. (These exemptions do not exempt proxy solicitations from the antifraud requirements of Rule 14a-9, as discussed below.)

Proxy advisors typically rely on one or both of the following two exemptions:

- Rule 14a-2(b)(1), which generally exempts solicitations by persons who do not seek the power to act as proxy and do not have a substantial interest in the subject matter of the communication beyond their interest as shareholders.
- Rule 14a-2(b)(3), which generally exempts proxy voting advice furnished by an advisor to any other person with whom the advisor has a business relationship.

The Final Rules add conditions to these exemptions applicable to persons furnishing proxy voting advice that constitutes a solicitation, which are contained in new Rule 14a-2(b)(9).

Conflict of Interest Disclosure Conditions. New Rule 14a-2(b)(9)(i) adds conflict of interest disclosure conditions to the availability of the Rule 14a-2(b)(1) and Rule 14a-2(b)(3) exemptions for proxy advisors. This amendment requires proxy advisors to include in their proxy voting advice or in an electronic medium used to deliver that advice prominent disclosure of:

- Any information regarding an interest, transaction or relationship of the proxy advisor (or its affiliates) that is material to assessing the objectivity of the proxy voting advice in light of the circumstances of the particular interest, transaction or relationship; and
- 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.

Procedural Conditions. The Final Rules did not adopt the controversial provision of the proposed amendments that would have established a prescribed advance review and comment period for companies that are the subject of proxy voting advice. Instead, new Rule 14a-2(b)(9)(ii) requires proxy advisors to adopt and publicly disclose written policies and procedures reasonably designed to ensure that:

- Companies 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 advisor's clients; and

- The proxy advisor provides its clients with a mechanism by which they can reasonably be expected to become aware of any written statements regarding its proxy voting advice by companies that are the subject of such advice in a timely manner before the security holder meeting (or, if no meeting is held, before the votes, consents or authorizations may be used to effect the proposed action).

Proxy advisors are not required to give companies revised or updated versions of their proxy voting advice with respect to the same meeting, vote, consent or authorization.

Exceptions to Procedural Conditions. There are some exceptions to the procedural requirements described in Rule 14a-2(b)(9)(ii). For example, the new provisions do not apply to proxy voting advice to the extent such advice is based on custom voting policies that are proprietary to a proxy advisor's client. In addition, they do not apply to any portion of the proxy voting advice that makes a recommendation to a security holder as to its vote, consent or authorization in a solicitation subject to Rule 14a-3(a) (as opposed to exempt solicitations):

- To approve any transaction specified in Rule 145(a) (which covers merger and acquisition transactions such as reclassifications, mergers, consolidations and transfers of assets); or
- By any person or group of persons for the purpose of opposing a solicitation subject to this regulation by any other person or group of persons.

Safe Harbors for Procedural Conditions. To facilitate compliance with these principles-based procedural requirements, the Final Rules provide two non-exclusive safe harbors that proxy advisors may rely on for assurance that they are complying with the new Rule 14a-2(b)(9)(ii). First, proxy advisors will be deemed to satisfy the requirement of making their reports available to companies if they have written policies and procedures that are reasonably designed to provide a company with a copy of its proxy voting advice, at no charge, no later than the time the proxy advisor disseminates that advice to its clients. These policies and procedures may include conditions requiring that:

- The company 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
- The company 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 that such copy will not be published or otherwise shared except with the company's employees or advisers.

The other safe harbor addresses the requirement for proxy advisors to make their clients aware of company responses to their proxy voting advice. Under this provision, a proxy advisor will be deemed to satisfy that requirement if it has written policies and procedures that are reasonably designed to inform clients receiving proxy voting advice when a subject company notifies the proxy advisor that it intends to file, or has filed, additional soliciting materials with the SEC setting forth the company's statement regarding the advice. This safe harbor permits the proxy advisor to notify its clients:

- On its electronic platform that the company intends to file, or has filed, such additional soliciting materials, including an active hyperlink to those materials on EDGAR when available; or
- Through email or other electronic means that the company intends to file, or has filed, such additional soliciting materials, including an active hyperlink to those materials on EDGAR when available.

Amendment to Definition of Solicitation

The Final Rules codify the SEC's guidance on proxy voting advice constituting a solicitation for purposes of the proxy solicitation rules. Specifically, the Final Rules expand the definition of solicitation contained in Rule 14a-1(l)(iii) to provide that the terms "solicit" and "solicitation" include:

The furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy, including:

(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.

The Final Rules expressly carve out from the definition of solicitation "the furnishing of any proxy voting advice by a person who furnishes such advice only in response to an unprompted request."

Amendment to Antifraud Provision

Rule 14a-9 prohibits materially false or misleading statements or omissions in proxy solicitations, regardless of whether the solicitations are exempt from the information and filing requirements of the federal proxy rules. Therefore, Rule 14a-9 applies to proxy voting advice that is a solicitation. Rule 14a-9 provides some examples of what, depending on facts and circumstances, may be misleading for this purpose. The Final Rules add the following example to this list:

Failure to disclose material information regarding proxy voting advice covered by §240.14a-1(l)(1)(iii)(A), such as the proxy voting advice business's methodology, sources of information or conflicts of interest.

Compliance and Effective Dates

Proxy advisors subject to the Final Rules will not be required to comply with Rule 14a-2(b)(9) until December 1, 2021, although the SEC welcomes early compliance with that provision. This transition period only applies to Rule 14a-2(b)(9) and does not extend to the amendments to the definition of solicitation contained in Rule 14a-1(l) or the antifraud provisions contained in Rule 14a-9, which will be effective 60 days after the Final Rules are published in the *Federal Register*.

Supplemental Guidance

At the same time that the SEC adopted the Final Rules, it issued supplemental guidance regarding proxy voting responsibilities of investment advisors focusing on use of automated voting platforms, which is sometimes called "robo-voting." The supplemental guidance suggests that investment advisors consider whether they have policies and procedures to address circumstances where they become aware that a company intends to file, or has filed, additional soliciting materials with the SEC after receiving a voting recommendation but before the voting deadline. This guidance also discusses disclosure and consent requirements relating to electronic voting. For more information on this supplemental guidance, see our Legal Update "US SEC Issues Supplementary Proxy Voting Guidance for Investment Advisers," dated July 27, 2020.⁸

Practical Considerations

Because proxy advisors are being given until December 21, 2021, to comply with the conditions contained in Rule 14a-2(b)(9), a substantial portion of the new requirements do not have to be implemented until the 2022 proxy season. Accordingly, there will be time for the market to adapt to the new proxy rule requirements governing the provision of proxy voting advice.

Once the conditions of the new rule become effective, all companies will be entitled to receive copies of the proxy voting advice reports regarding their shareholder meetings and consent solicitations no later than when they are released to the proxy advisor's clients. Although some companies have been able to obtain copies of the proxy voting advice, that has not been the case for all companies. Receiving full copies of such reports, including the recommendation and the underlying analysis, will enable companies to prepare and file with the SEC their specific responses, identifying factual errors, suggesting different methodologies or peer groups they feel are more appropriate and explaining why they disagree with a proxy advisor's recommendations. This benefits the entire proxy voting process by making more information available to investors before voting decisions are finalized.

Many, but not all, companies already file additional soliciting materials to respond to a proxy advisor's voting recommendation with which they disagree. Once the new procedural conditions for the exemptions to the information and filing provisions of the proxy rules go into effect, there may be greater incentive for companies to promptly prepare responses to proxy voting advice for filing with the SEC. Currently, once companies file such additional soliciting materials with the SEC, they can directly send copies of such materials to shareholders. In addition, shareholders that follow the company's EDGAR filings will be notified once such a filing is made. But the reach of the company's position will be amplified once the new procedural conditions become effective because the employees of institutional investors with the responsibility for voting proxies—who may be different individuals than the company's primary contacts at such investors—will be promptly notified of the company's response to the proxy voting advice. While filing additional soliciting materials following an unfavorable proxy voting recommendation may not change a proxy advisor's recommendation, under the Final Rules such company filings may have a greater likelihood of reaching the institutional investors holding a large percentage of their shares and therefore may have greater potential to affect voting results.

To be impactful, a company's additional solicitation materials filed with the SEC will need to be made as soon as possible after a voting recommendation comes out to be included in the mix of information available to institutional investors before they vote. Therefore, companies that are concerned about proxy voting recommendations may want to consider in advance what types of additional soliciting materials are likely to be most effective if proxy voting advice goes against a management recommendation on a proxy proposal. It may even be productive to draft and design a template for additional soliciting material ahead of time that can be quickly finalized as needed to respond to specific proxy voting advice.

While the Final Rules do not require proxy advisors to give companies advance copies of their voting advice, the adopting release notes that offering companies the opportunity to review their proxy voting advice in advance would satisfy the principles-based rule and encourages that approach to the extent feasible, adding in a footnote that the SEC encourages proxy advisors "that are currently providing registrants with this opportunity to continue doing so as it furthers the objectives of this rule."

There is no transition period for the Rule 14a-1 amendment that expressly includes the provision of proxy voting advice by proxy advisors as part of the definition of solicitation or for the Rule 14a-9 amendment that specifies that failure to provide material information regarding proxy voting advice may be misleading under

the proxy rules. Therefore, proxy advisors may need to evaluate some aspects of their business models, such as their existing approaches to conflicts of interest and related disclosure, to assess whether there are any facts and circumstances that could give rise to potential liability under the proxy rules.

The Final Rules reflect the SEC's balancing of divergent, and often competing, views coming from various perspectives as it updated the impacted aspects of the proxy system in light of changes to the proxy voting market structure. As a result, there may continue to be criticisms of certain aspects of the rules or guidance from some market participants.

ISS sued the SEC in the US District Court for the District of Columbia in October 2019, asserting that the Proxy Voting Advice Guidance was unlawful and seeking declaratory and injunctive relief. Following the SEC's proposal of proxy voting advice amendments to the proxy solicitation rules, ISS and the SEC agreed that this litigation would be held in abeyance until the SEC promulgated its final rules, and the court entered an order to that effect. Now that the Final Rules have been adopted, it is possible this litigation may resume.

For more information about the topics raised in this Legal Update, please contact the author Laura D. Richman, any of the following lawyers or any other member of our Corporate & Securities practice.

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Endnotes

¹ <https://www.sec.gov/rules/final/2020/34-89372.pdf>

² <https://www.sec.gov/rules/concept/2010/34-62495.pdf>

³ <https://www.sec.gov/news/public-statement/statement-regarding-staff-proxy-advisory-letters>

⁴ <https://www.sec.gov/rules/interp/2019/34-86721.pdf>

⁵ <https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/08/secissuesguidanceontheapplication.pdf>

⁶ <https://www.sec.gov/rules/proposed/2019/34-87457.pdf>

⁷ <https://www.mayerbrown.com/en/perspectives-events/publications/2019/11/sec-proposes-proxy-voting-advice-rule-amendments>

⁸ <https://www.mayerbrown.com/en/perspectives-events/publications/2020/07/us-sec-issues-supplementary-proxy-voting-guidance-for-investment-advisers>

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