Client Alert

July 2020

SEC Amends Rules for Proxy Advisory Firms

On July 22, 2020, the Securities and Exchange Commission (SEC) adopted final rules and supplemental interpretive guidance that modify the proxy rules as applied to proxy advisory firms and clarify the fiduciary duties of investment advisers when voting proxies. Compared to the proposed version of the rules issued in November 2019, the final rules take, according to the SEC, "a less prescriptive, more principles-based approach" to regulation of the proxy advisory industry. The final rules become effective 60 days after publication in the Federal Register; however, businesses will not be required to comply with the additional disclosure requirements under Rule 14a-2(b)(9) until December 1, 2021. The supplemental guidance for investment advisers is immediately effective upon publication in the Federal Register.

Proxy Voting Advice Generally Constitutes "Solicitation" under the Exchange Act

The amendments codify prior SEC interpretive guidance that proxy voting advice constitutes a "solicitation" under Section 14(a) of the Exchange Act. The SEC rejected commenters' objections to the SEC's authority and interpretation with respect to the new rule, and explained that the amendments represent the "longstanding view" of the Commission.

The amendments modify Rule 14a-1(*l*)(1)(iii) to make clear that the terms "solicitation" or "solicit" include any proxy voting advice that: (a) makes a recommendation to a shareholder as to its vote, consent, or authorization on a specific matter for which shareholder approval is sought, and (b) is furnished by a person who markets its expertise as a provider of such advice, separately from other types of investment advice, and sells such advice for a fee. Whether a communication will ultimately be deemed a solicitation pursuant to Section 14(a); however, will depend upon the specific nature, content, and timing of the communication as well as the circumstances surrounding the transmission of the communication.

The SEC has cited certain factors about a proxy voting advice business that indicate its advice may constitute a solicitation under Section 14(a), which include that the proxy voting advice business:

- provides proxy voting advice that generally describes the specific proposals and presents a vote recommendation for each proposal indicating how the client should vote;
- markets its expertise in researching and analyzing matters that are subject to a proxy vote for the purposes of assisting its clients in making voting decisions;
- charges a fee for its advisory services, including for advice on how a client should vote; and
- provides its recommendation shortly before a shareholder meeting or authorization vote.

To constitute a solicitation under Section 14(a), the business must provide voting recommendations in connection with its services, rather than exercising delegated voting authority on behalf of its clients. To the extent proxy voting advice is deemed a solicitation, advice formulated pursuant to each separate policy or set of guidelines will be considered a distinct solicitation under Section 14(a). Likewise, the

amendments require that proxy voting advice provided pursuant to a custom policy constitutes a distinct solicitation as well.

Unless an exemption is satisfied, a person providing proxy voting advice that constitutes a solicitation under Rule 14a-1(*l*)(1)(iii)(A) must comply with certain information and filing requirements, including the obligation to file and furnish a definitive proxy statement. Exemptions under Rule 14a-2(b)(1) and Rule 14a-2(b)(3) are available for any proxy voting advice business that can satisfy the new conditions set forth in Rule 14a-2(b)(9). The amendments expand the conditions that must be satisfied by increasing the disclosure requirements for conflicts of interests and establishing a new disclosure requirement with respect to policies and procedures designed to increase an issuer's engagement opportunities and provide more accurate and complete information to clients.

New Condition to Exemption #1: Conflicts of Interest Disclosure

As noted above, a proxy voting advice business must satisfy the conditions under Rule 14a-2(b)(9) to rely on the exemptions set forth in Rule 14a-2(b)(1) and Rule 14a-2(b)(3). Under the new Rule 14a-2(b)(9)(i), proxy voting advice businesses that rely on either exemption must include with their voting advice certain information about their conflicts of interest and policies to identify such conflicts. Specifically, the amendments require businesses to include with their voting advice disclosure of:

- any information regarding an interest, transaction, or relationship of the proxy voting advice business (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.

According to the SEC, the principle-based rule described above presents sufficient flexibility to encompass a broad variety of circumstances or relationships that may not fall within specific parameters, but nevertheless may be material to a client's assessment of the proxy voting advice businesses' objectivity. This disclosure requirement applies to all proxy voting advice that is provided in reliance on the exemptions in Rule 14a-(b)(1) and Rule 14a-(b)(3). Under the amendments, proxy voting advice businesses may include the required disclosure either in the proxy voting advice furnished to clients or in an electronic medium used to deliver the proxy voting advice, such as a client voting platform.

New Condition to Exemption #2: Enhanced Client Disclosure

Under the new Rule 14a-2(b)(9)(ii), a proxy voting advice business that seeks to rely on the exemptions under Rule 14a-(2)(b)(1) and Rule 14a-(2)(b)(3) to avoid furnishing a proxy statement must adopt and publicly disclose written policies and procedures that are reasonably designed to ensure that clients receive complete and timely disclosure. In particular, Rule 14a-2(b)(9)(ii) requires:

- Pursuant to paragraph (A), registrants that are the subject of the proxy voting advice must have such advice made available to them at or prior to the time the advice is disseminated to clients of the proxy voting advice business.

- Under paragraph (B), the proxy voting advice business must provide its clients with a mechanism by which they can reasonably expect to become aware of written statements regarding its proxy voting advice by registrants that are the subject of such advice, in a timely manner before the shareholder meeting (or, if no meeting, before the votes, consents, or authorizations may be used to effect the proposed action).

Timely Notice of Advice to Registrants

Under the amendments, proxy voting advice businesses must adopt and publicly disclose policies and procedures reasonably designed to ensure that proxy voting advice is made available to registrants "at or prior to the time when such advice is disseminated to the proxy voting advice business clients." In a shift from the proposed version of the rules, which gave registrants the right to review advice prior to its dissemination, the final rules, as adopted, do not require registrants to have the opportunity to review voting advice prior to its dissemination to clients. The SEC noted, however, that, to the extent feasible, providing registrants a review period prior to dissemination is encouraged by the Commission and would satisfy the principles under Rule 14a-2(b)(9)(ii)(A).

Recognizing the need for clarity with respect to compliance, the amendments adopted a non-exclusive safe harbor that, if satisfied, will be deemed to comply with the new rule. Under the safe harbor, a proxy voting advice business must establish written policies and procedures governing the process for providing registrants with a copy of its proxy voting advice, at no cost, no later than the time such advice is disseminated to clients.

A proxy voting advice business may include conditions to furnishing its advice to issuers concurrently with its dissemination to clients by requiring that issuers:

- file their definitive proxy statement at least 40 calendar days before the shareholder meeting; and
- expressly acknowledge that they will use the proxy voting advice only for their internal purposes and/or in connection with the solicitation and it will not be published or otherwise shared except with the issuer's employees or advisers.

Timely Notice of Rebuttal to Clients

Under Rule 14a-2(b)(9)(ii)(B), proxy voting advice businesses must adopt and publicly disclose policies and procedures that are reasonably designed to ensure that their business clients will be made aware of a registrant's rebuttal about proxy voting advice in a timely manner before the shareholder meeting, or relevant consent or vote.

As noted above, the SEC cited an understanding for the need for greater legal certainty in satisfying the principle-based rule and established another non-exclusive safe harbor that, if followed, will be deemed to satisfy the new rule. The safe harbor requires proxy voting advice businesses that avail themselves of the exemptions under Rule 14a-(b)(1) and Rule 14a-(b)(3) to establish written policies and procedures reasonably designed to inform clients that a registrant has notified the proxy voting advice business of its intention to file additional soliciting materials setting forth its views regarding such advice.

A proxy voting advice business can satisfy the safe harbor by one of two methods:

- provide notice of the registrant's filing, or intention to file, additional materials on the proxy voting advice business's electronic client platform (and include an active hyperlink to those materials on EDGAR when available); or
- provide notice through email or other electronic means that the registrant has filed, or has informed the proxy voting advice business that it intends to file, additional soliciting materials.

Pursuant to the amendments, immaterial or unintentional failures will prevent compliance with the conditions of Rule 14a-2(b)(9)(ii). The SEC stressed the importance of its principle-based approach, which is meant to be flexible to encompass a variety of circumstances and businesses. A proxy voting advice business may satisfy the principles under Rule 14a-2(b)(9) beyond the safe harbor requirements, and whether it does will depend on the particular facts and circumstances of the policies and procedures established by the business.

Although the analysis is fact-based, and therefore, no single factor will control the determination, the SEC has provided a few factors it considers relevant when deciding whether a policy or procedure satisfies the principles of the rule, including:

- the degree to which a registrant has time to respond and whether the policy ensures prompt conveyance of information to the registrant;

- the extent to which the mechanism provided to clients is an efficient means by which they can reasonably be expected to become aware of the registrant's written response, once it is filed, such that the client has sufficient time to consider such response in connection with a vote; and

- the reasonableness, based on facts and circumstances, of any fees charged by a proxy voting advice business to a registrant as a condition to receiving a copy of its proxy voting advice and the extent to which such fees may dissuade a registrant from seeking to review and provide a response to such proxy voting advice.

The amendments identify certain circumstances in which a business need not comply with Rule 14a-2(b)(9)(ii) in order to rely on either the Rule 14a-2(b)(1) or (b)(3) exemption. Under the amendments, proxy voting advice businesses are not required to comply with Rule 14a-2(b)(9)(ii) in order to rely on either exemption if (1) their proxy voting advice is based on a custom policy that is proprietary to a proxy voting advice business's client, or (2) they provide proxy voting advice as to non-exempt solicitations regarding certain mergers and acquisitions or contested matters, such as contested director elections.

Amendments to Antifraud Rule

The final rules also amend Rule 14a-9, the SEC's antifraud rule applicable to proxy solicitations. The amendments modify Rule 14a-9 to include examples of when the failure to disclose certain material information in proxy voting advice could, depending upon the particular facts and circumstances, be considered misleading within the meaning of the rule. Specifically, the new examples include the failure to disclose material information regarding proxy voting advice covered by Rule 14a-1(*l*)(1)(iii)(A), such as the proxy voting advice business's methodology, sources of information, or conflicts of interest.

Interpretive Guidance

On the same day the SEC adopted the final rules, it also published supplemental interpretive guidance for investment advisers regarding their proxy voting responsibilities under the Investment Advisers Act of 1940. In particular, the guidance addresses certain concerns about investment advisers that provide pre-populated voting instructions to proxy advisory firms, given the likelihood that under the rule they will be informed if an issuer contests a particular matter. The supplemental guidance also addresses disclosure obligations and client consent when investment advisers use automated services for voting.

The supplemental guidance states that an investment adviser should consider whether its policies and procedures address circumstances where the investment adviser has become aware that an issuer intends to file or has filed additional soliciting materials with the SEC after the investment adviser has received the proxy advisory firm's voting recommendation but before the submission deadline. Specifically, the guidance states that if an issuer files such additional information sufficiently in advance of the submission deadline and such information would reasonably be expected to affect the investment adviser's voting determination, the investment adviser would likely need to consider such information prior to exercising voting authority in order to demonstrate that it is voting in its client's best interest.

Practical Takeaways

Public companies that were hoping the SEC would provide more substantive oversight of the proxy advisory industry may be disappointed by the final rules and related interpretive guidance. Rather than the tight operational controls the SEC imposes on other securities intermediaries such as transfer agents,

broker-dealers, credit-rating agencies, and securities exchanges, here the SEC instead chose a lighter-touch approach. In this respect, proxy advisors remain something of an anomaly in the proxy solicitation process; all other participants in the chain from the issuer to the ultimate beneficial owner are closely regulated, and not subject to a loose, principles-based regime. In a presidential election year, the unusually long transition period for Rule 14a-2(b)(9) also provides ample time for a future SEC or Congress to further revise or completely undo the SEC's most recent actions. Also of note, the new rules were approved by a 3-1 vote of the commissioners.

Still, public companies should begin planning for the effectiveness of the new rules and taking steps to operationalize their slightly-changed role in the proxy solicitation process. For example, issuers should begin implementing processes and procedures that ensure their definitive proxy statement can be filed at least 40 calendar days before the shareholder meeting. Issuers should recognize that although proxy advisory firms must now establish a mechanism to ensure a client is reasonably aware of an issuer's rebuttal, because the rule allows proxy advisory firms to provide its voting advice to clients simultaneous to providing such advice to issuers, issuers may have little time to engage with the proxy advisory firm or prepare a persuasive rebuttal in a timely manner. While proxy advisory firms will probably remain open to correcting factual errors in their reports to clients, they are not likely to change their current policies against revising content that leads to a difference of opinion with an issuer. In this respect, public companies should continue to be ready to challenge individual proxy advisory recommendations through direct outreach to investors.

Contacts

Anthony J. Eppert
anthonyeppert@HuntonAK.com

Steven M. Haas
shaas@HuntonAK.com

Chelsea Lomprey
clomprey@HuntonAK.com

Susan S. Failla
sfailla@HuntonAK.com

Scott H. Kimpel
skimpel@HuntonAK.com