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SEC Adopts Rules for Proxy Voting Advisory Firms, Issues Supplemental Guidance for Investment Advisors

WRITTEN BY

Eugene W. McDermott, Jr. | Rob Evans | Stanley Keller | Michael K. Renetzky | Tom Bohac

On July 22, 2020, the SEC adopted final rules on the application of its proxy solicitation rules to proxy voting advisors. (See our November 2019 blog post on the proposed rules here.) Among other things, the new rules will, for practical purposes, require these proxy advisory firms – most notably Institutional Shareholder Services (ISS) and Glass Lewis – to make their voting recommendations for any public company's annual meeting of shareholders available to that company at or before the time the recommendations become available to the proxy advisory firm's institutional investor clients, so long as the public company files its proxy statement at least 40 days before the meeting. Proxy advisory firms will also need to give their clients a means to become aware of any written statements made by the public company about their voting advice prior to the shareholder meeting. The new rules also address concerns over proxy advisory firms' conflicts of interest.

At the same time, the SEC also issued supplementary guidance to registered investment advisors regarding their proxy voting responsibilities in view of the new rules, building upon guidance released in August 2019. (See our blog post and our FUNDamentals QuickStudy discussing the earlier guidance here and here.)

Proxy rules applied to proxy voting advisory firms

Institutional investors hold the vast majority of shares in the public equity markets today. Since 2003, proxy advisory firms have come to play a critical role by providing voting recommendations for use in shareholder meetings for the thousands of public companies within the portfolios of their investment adviser and institutional investor clients. Because many investment advisers and institutional investors have essentially outsourced their voting decisions to these proxy advisory firms, the voting guidelines adopted by these firms have become an important standard – some would say *de facto* regulations – in executive compensation decisions and the design of equity compensation plans, the adoption of anti-takeover measures, and other governance matters. Because these firms will often recommend that investors vote against, or withhold a vote from, a company's director nominees where the company's governance policies, anti-takeover protections, board independence, compensation policies or other practices fall outside of the advisory firm's guidelines, the influence of these voting guidelines extends well beyond matters put directly to a shareholder vote.

These voting guidelines are often stricter than SEC, NYSE or Nasdaq requirements and are adopted and revised without formal public input and with varying degrees of transparency. Public companies have minimal opportunity to review and respond to these recommendations before they are published: ISS permits only S&P 500 companies to review reports 24-48 hours before publication, but only for factual inaccuracies and not for comment on the

recommendations themselves, while Glass Lewis permits companies to review only certain underlying data points 24-48 hours in advance for factual inaccuracies, but not the report itself. The result is often a voting recommendation that, from the proxy advisor's perspective, distills the general voting preferences of an institutional shareholder base and applies it to thousands of public company shareholder proposals on a compressed timeframe during the annual proxy season, but from a public company's perspective, often applies a one-size-fits-all approach to a company's individual circumstance, without an effective means for the company to tell its story in a way that may influence the recommendation or outcome.

Against this backdrop, the new SEC rules will codify the staff's prior position that proxy advisors' voting advice constitutes a "solicitation" subject to the SEC's proxy rules, including the anti-fraud provisions of Rule 14a-9 that prohibit materially false or misleading statements. Importantly, the existing exemptions from the information and filing requirements under Rule 14a-2(b)(1) and (3), upon which proxy advisors currently rely, will no longer be available unless:

- The proxy advisor includes in its advice or on its electronic platform prominent disclosure of certain conflicts of interests, transactions or relationships that may bear on its objectivity, and its policies used to identity and address such conflicts; and
- The proxy advisor has adopted and publicly disclosed written policies reasonably designed to ensure that (a) registrants that are the subject of proxy voting advice have that advice made available to them at or prior to the time the advice is disseminated to the proxy advisor's clients, and (b) the proxy advisor's clients have a mechanism by which they can reasonably be expected to become aware of any written statements regarding the voting advice made by a public company who is the subject of that advice.

The policies adopted by the proxy advisor may include conditions requiring that, to receive the proxy voting advice, a public company must file its definitive proxy statement at least 40 days prior to the shareholder meeting, and also may require the public company to acknowledge that it will use its copy of the voting advice only for limited purposes in connection with the solicitation, and will not otherwise publish or share it. The policies may also require that, in order for the proxy advisory firm to make its clients aware of a public company's written statements in response, the company must notify the proxy advisory firm that it intends to file or has filed additional soliciting materials with the SEC.

The requirement that a proxy advisor ensure registrant access to recommendations will not apply to advice based on customized voting policies that are proprietary to a proxy voting advisor's client, nor to recommendations relating to merger transactions or contested matters.

Finally, the new rules amend the anti-fraud provisions of Rule 14a-9 to add examples of how proxy voting advice may be misleading within the meaning of that rule. A proxy advisory firm may run afoul of the anti-fraud rules if it fails to disclose material information about such items as the advisory firm's methodology, sources of information or conflicts of interest.

Guidance for investment advisers

In August 2019, the SEC provided guidance to investment advisers, such as fund managers, regarding their proxy voting responsibilities and related fiduciary duties, particularly where an investment adviser is relying on a proxy advisory firm for voting decisions. The SEC has supplemented that guidance to reflect the new rules.

The supplemental guidance addresses the use of services provided by proxy advisory firms that will either populate each client's votes shown on the proxy advisory firm's electronic voting platform with the proxy advisory firm's own recommendations, or automatically submit the client's votes based on those recommendations (sometimes called robo-voting). The guidance suggests that in order to demonstrate that it is making voting determinations in its clients' best interests, an investment advisor should consider whether its own policies and procedures address circumstances where it becomes aware that a public company intends to file or has filed additional soliciting material relevant to the vote before the submission deadline. Where it becomes aware of such additional material with sufficient advance notice, the investment adviser would likely need to consider the additional information prior to exercising voting authority.

The guidance also suggests that an investment adviser who uses automated voting services should consider disclosing to its own clients the extent to which it uses those services, and how its policies and procedures address circumstances when it becomes aware that an issuer has filed additional information relating to a matter to be voted upon. This disclosure could be made on the adviser's Form ADV under Rule 206(4)-6 of the Investment Advisers Act. Without this information, the SEC suggests that clients might not have enough information to provide informed consent for purposes of agreeing to the scope of its relationship with the investment adviser, or for purposes of the investment adviser's obligation under its duty of loyalty to provide full and fair disclosure relating to the advisory relationship. In order to be "full and fair," the SEC reiterated that the disclosure should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision on whether to provide its consent.

Key takeaways

It remains unclear what effect these new rules will have over time on the broad powers wielded by proxy advisory firms over corporate policies and shareholder voting results. However, they will no doubt offer some relief to public companies who have struggled to reconcile their board's views on how to act in the best interests of shareholders under their individual circumstances with the sometimes monolithic prescriptions in the proxy advisory firms' voting guidelines. Taken together with the guidance for investment advisers, the new rules should provide public companies of all sizes reliable access to the voting recommendations, facilitate communication of a company's position to the recipients of those recommendations, encourage institutional investors to take company responses into account when exercising their voting discretion, and give investment advisers second thoughts about using proxy advisory firms' services to fulfill their proxy voting responsibilities to their clients.

Proxy advisory firms will not be required to comply with the new rules until December 1, 2021, so that the 2022 proxy season will be the first experience for most companies with the new rules. This timing is also subject to actions in the pending lawsuit brought by ISS challenging the SEC's authority to regulate it, which was stayed until the SEC adopted final rules. The changes to the definition of "solicitation" and to the anti-fraud provisions of Rule 14a-9 will be effective 60 days after publication in the Federal Register, since they represent codification of existing staff provisions.

Finally, we note that this is one step in a larger effort by the SEC to revisit the complex system through which proxy statements are distributed by public companies and shares are voted. In Chairman Clayton's public statement accompanying the adoption of the new rules and guidance, he noted that efforts to address "proxy plumbing" and "universal proxy" are on the Commission's short-term agenda.

If you have questions about the new rules or guidance, your regular Locke Lord contact and any of the authors can discuss these matters with you.

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