SEC Proposes Rules to Regulate Proxy Advisory Firms

The Securities and Exchange Commission has proposed amendments to the federal proxy rules that would impose significant new disclosure and engagement requirements on proxy advisory firms such as Institutional Shareholder Services, Inc. ("ISS") and Glass Lewis & Co. Intended to improve the accuracy and transparency of the proxy voting advice provided to the institutional investor community, the proposed amendments are part of the SEC's ongoing initiative to modernize and improve the proxy voting process.

In addition to codifying the SEC's current interpretive position that generally proxy advisory firms engage in solicitations subject to the federal proxy rules when they distribute their proxy voting advice to clients, the proposed amendments go on to exempt such firms from the filing and information delivery requirements of the proxy rules if they satisfy three conditions, including giving companies the opportunity to review and comment on proxy voting advice before it is distributed to clients.

This Thoughtful Pay Alert summarizes the key aspects of the proposed amendments.

Background

The federal proxy rules govern the solicitation of proxies[1] in connection with an annual or special meeting of shareholders. Generally, these rules require the soliciting party to satisfy certain filing and information delivery requirements when conducting a proxy solicitation.

In August 2019, the SEC issued interpretive guidance confirming its position that the dissemination of proxy voting advice by a proxy advisory firm generally constitutes a "solicitation" subject to the federal proxy rules. As such, these solicitations are subject to the applicable filing and information delivery requirements of the proxy rules unless the conditions of an available exemption are satisfied. Further, the guidance clarified that proxy voting advice is subject to the antifraud provisions of the proxy rules and thus prohibited from containing any materially false or misleading statement.

Subsequently, in October ISS filed a lawsuit in federal court against the SEC seeking to invalidate the August guidance, asserting that the provision of proxy voting advice does not involve a solicitation subject to the federal proxy rules and that, among other things, the Commission exceeded its statutory authority in issuing the guidance and failed to comply with the Administrative Procedures Act in promulgating what is essentially a substantive rule.

Proposed Amendments

Against this backdrop, in November the SEC proposed amendments to the federal proxy rules that would affect proxy advisory firms in the following respects.

Definition of "Solicitation"

The SEC is proposing to codify its August 2019 interpretive position that proxy advisory firms generally engage in solicitations when they provide proxy voting advice to their clients. As proposed, the amendments would make clear that the terms "solicit" and "solicitation" include any proxy voting advice that makes a recommendation to a shareholder as to its vote, consent, or authorization on a specific matter for which shareholder approval is solicited, and that is furnished by a person who markets its expertise as a provider of such advice, separately from other forms of investment advice, and sells such advice for a fee.

New Conditions for Reliance on "Solicitation" Exemptions

The SEC is proposing to amend the exemptions used to provide proxy voting advice without complying with the filing and information delivery requirements of the proxy rules to impose three conditions on proxy advisory firms seeking to rely on such exemptions:

Disclosure of Conflicts of Interest

Proxy advisory firms would be required to include in their proxy voting advice prominent disclosure of any material conflicts of interest in the matter or parties concerning which they are providing the advice. This disclosure would need to be sufficiently detailed so that clients could understand the nature and scope of the interest, transaction, or relationship to appropriately assess the objectivity and reliability of the related proxy voting advice. Further, proxy advisory firms would be required to disclose any policies and procedures used to identify, as well as steps taken to

[1] Generally, a "proxy" is the delegation of voting authority to a representative on behalf of the actual vote holder.

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address, any such material conflicts of interest arising from such interest, transaction, or relationship.

Review of Proxy Voting Advice

Review and Feedback Period - Proxy advisory firms would be required to provide companies with a standardized opportunity to review and give feedback on proxy voting advice before the advice was distributed to clients[2]. The length of time for this review would vary between three and five business days depending on how far in advance of its annual meeting of shareholders the company has filed its definitive proxy statement. Specifically:

- If a company files its definitive proxy statement 45 calendar days or more before the date of its shareholders' meeting, it would be provided at least five business days to review the proxy voting advice and provide feedback.
- If a company files its definitive proxy statement less than 45 but at least 25 calendar days before the date of its shareholders' meeting, it would be provided at least three business days to review the proxy voting advice and provide feedback.
- If a company files its definitive proxy statement less than 25 calendar days before its shareholders' meeting, a proxy advisory firm would have no obligation to provide the proxy voting advice to the company.

The proposals make clear that proxy advisory firms are not obligated to accept any of the company's suggested revisions to the proxy voting advice that are submitted as part of the feedback.

Final Notice of Proxy Voting Advice - In addition to this review and feedback period, proxy advisory firms would be required to provide companies that met the advance filing requirements with a final notice and copy of their proxy voting advice no later than two business days prior to delivery of the proxy voting advice to clients. This "final review" would give companies the opportunity to determine the extent to which the proxy voting advice had changed, including whether the proxy advisory firm had made any revisions as a result of feedback from the company. Companies would be entitled to this two-business day final notice period whether or not they provided comments on the version of proxy voting advice they received in connection with the review and feedback period.

Response to Proxy Voting Advice

If requested prior to the expiration of the two business day final notice period, proxy advisory firms would be required to include an active hyperlink in their proxy voting advice directing the recipient of the advice to a written statement setting forth the company's views on the proxy voting advice. Because this statement would be considered a solicitation under the proxy rules, it would need to be filed with the SEC as supplemental proxy materials and would be subject to the antifraud provisions of the rules. Once the final notice period had expired, a proxy advisory firm would be under no further obligation to provide a company with additional opportunities to review its proxy voting advice with respect to the same meeting.

Amendment of Antifraud Provisions

In its August interpretive guidance, the SEC confirmed that solicitations conducted by proxy advisory firms, even if exempt from the filing and information delivery requirements of the federal proxy rules, are subject to Exchange Act Rule 14a-9, the antifraud provision of the rules. This rule prohibits any solicitation of proxies from containing any statement of material fact that is false or misleading or from omitting to state any material fact that would cause the solicitation to be false or misleading.

To better understand the scope of this prohibition, the SEC is proposing to amend Rule 14a-9 to add the following examples of what may be misleading within the meaning of the rule to highlight the types of information that a proxy advisory firm may, depending upon the particular facts and circumstances, need to disclose: the methodology used to formulate the proxy voting advice, the sources of information on which the advice is based, material conflicts of interest that arise in connection with providing the advice, and the use of standards or requirements that materially differ from relevant standards or requirements that the SEC sets or approves.

Transition Period

The SEC is proposing a one-year transition period after the publication of a final rule in the Federal Register to give proxy advisory firms sufficient time to develop processes and systems to comply with the proposed new requirements for proxy voting advice.

Next Steps

The public comment period on the proposed rules runs for 60 days after publication of the proposals in the Federal Register. The proposed rules were published in the Federal Register on December 4, 2019. Consequently, comments should be received by February 3, 2020.

Observations

As expected, the proposed amendments are proving to be very

[2]Currently, ISS provides companies in the S&P 500 index with a copy of their draft research report for fact-checking if they have provided their contact details.

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SEC Proposes Rules to Regulate Proxy Advisory Firms (continued)

controversial and have already generated a high volume of public comment. Supporters view them as a welcome response to the growing influence of proxy advisory firms that will address several long-standing criticisms of such firms, including the lack of disclosure of material conflicts of interest, the absence of a mechanism for correcting factual errors or outdated information in their research reports, and the inability to engage with a firm over a problematic voting recommendation or methodological issue. Opponents counter that these criticisms (particularly of systemic factual errors) are overstated and that the amendments would reduce corporate accountability and do not truly serve the interests of shareholders, particularly those of medium and small cap companies. Given the vigorous debate on the role – and the need for regulation – of proxy advisory firms, it is expected that both corporate and investor viewpoints will be well-represented through the comment process.

What is certain to be a contentious rulemaking process is further clouded by ISS' legal challenge to the SEC's August 2019 interpretive guidance. In its lawsuit, ISS contends that its voting recommendations do not constitute proxy solicitations and, therefore, are not subject to regulation under the federal proxy rules. (Instead, ISS takes the position these recommendations should be treated as investment advice subject to the Investment Advisers Act.) While the federal courts will ultimately decide this issue, should ISS prevail it could not only affect the application of the interpretive guidance, but the underlying basis for the proposed amendments themselves and/or the scope of any new rules that are adopted.

As proposed, the amendments have the potential to fundamentally reshape the cadence of the annual meeting cycle and the interactions between companies, institutional shareholders, and proxy advisory firms. For example, all public companies subject to proxy advisory firm research, not just S&P 500 companies, would be able to review and provide feedback on proxy voting advice before it is published, as well as include in a firm's report a hyperlink to a company statement responding to the proxy voting advice (something S&P 500 companies are not presently able to do). This would enable companies that currently do not have that access to be better equipped to flag and correct material errors and to contact key shareholders in response to a potentially adverse voting recommendation in advance of their annual meeting. Given the speed with which many institutional shareholders submit their votes once they have received the relevant proxy voting advice, there often isn't sufficient time under the current system for companies to engage with such shareholders. (Even under the proposed amendments, however, this engagement window would continue to be very short.)

Further, these new engagement obligations could make it more costly and difficult for proxy advisory firms to deliver their reports to clients on a timely basis. (This possibility may have influenced ISS' recent decision to relax the scoring standards for aspects of its quantitative pay-for-performance methodology, thereby reducing the number of companies likely to receive a medium or high quantitative level of concern on their executive compensation program.) Thus, as some have speculated, it may cause them to re-examine the sustainability of their current business models. Finally, it is not clear how institutional shareholders will respond to the changed environment and whether they will re-evaluate the role that proxy advisory firms currently play in supporting them and/or their current shareholder engagement policies. Today, numerous institutional shareholders rely on proxy advisory firms to assist them in discharging their fiduciary responsibilities and any change to these arrangements could have implications for how these shareholders vote their shares. These arrangements, and many others, are likely to be reassessed if proxy advisory firms become subject to greater regulation.■

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