Pearl Meyer

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SEC Adopts Rule Amendments and Provides Supplemental Guidance for Proxy Advisor Voting



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Principles-Based Directives Intended to Improve Transparency, Accuracy, and Completeness of Information

On July 22, the Securities and Exchange Commission (SEC) voted 3-1 to adopt final securities rule changes[1] and related supplemental guidance[2] on the proxy voting advice process. The news was the culmination of a long-standing controversy over whether proxy advisory services, such as Institutional Shareholder Services (ISS) and Glass Lewis, had garnered too much control over the proxy voting process in providing assistance to institutional investors and advisors (IAs) in recent years[3]. The final rules, which are intended to be principles-based, were welcomed by companies, but strongly opposed by the proxy advisors (PAs), with a lawsuit from ISS potentially still pending[4]. While companies will not need to take any immediate action, they should be aware that the proxy voting process has likely shifted in their favor with easier access to PA reports that contain voting recommendations, as well as a better chance for their reaction to the PA advice to be heard directly by institutional investors and other voting shareholders.

Key Takeaways

Securities Rule Changes That Are Applicable to Proxy Advisors:

- *PAs are Engaged in Soliciting:* The final rules confirm that the services provided by PAs qualify as “solicitations” and are therefore subject to a host of onerous filing and information requirements unless they meet certain exemptions.
- *Conflict of Interest Disclosure:* PAs will need to provide their clients with a statement describing their conflicts policy, including their methodology and sources of information.
- *Companies will have Access to PA Reports and a Meaningful Rebuttal Opportunity:* Companies must have access to free PA reports at the same time they are made available to IAs, and IAs should ensure they are able to review any company responses to the PA report prior to the vote. A safe harbor methodology is suggested to accomplish this requirement, which is likely to become the norm. *Armed with no-*

cost timely reports in advance of shareholder votes, companies should be prepared to review PA reports, as well as provide comment to the extent that they disagree with the methodology or facts underlying the recommendation.

Supplemental Advice Given to Investment Advisors:

- *Review of Company Rebuttals:* IAs should have a procedure in place to review supplemental filings made by a company following the IA's receipt of the PA voting recommendation report.
- *Robovoting Disclosure:* If IAs chose to use a PA for robovoting (pre-populating ballots using PA voting methodologies), the IA should let its clients know that voting is done in this manner.

Amendment to Proxy Solicitation Rules

The amended rules codify the SEC's August 2019 interpretation that PA voting advice constitutes a "solicitation" for purposes of Rule 14a-1(l) of the Securities Exchange Act of 1934. PAs may, however, qualify for exemptions from the more onerous requirements of the proxy rules by which they are now covered if they comply with the following requirements:

- *PAs must disclose material conflicts and related policies and procedures:* They must provide disclosure of material conflicts of interest to their clients with sufficient detail to understand the nature and scope of the interest, transaction, or relationship, as well as any policies and procedures used to identify, and steps taken to address, any such material conflicts. Examples of potential conflicts cited by the SEC include making recommendations on annual meeting proposals or providing governance ratings while also (i) advising on corporate governance or compensation policies for companies, or helping increase governance scores; (ii) having a material interest in a proposal through an affiliate or through one or more client relationships; or (iii) advising on how to structure or present the company's proposal or business terms. The required disclosure may be included either in the proxy voting advice or in an electronic medium used to deliver the advice, such as the IA voting platform.
- *Companies must have concurrent access to PA recommendations:* PAs must establish policies and procedures reasonably designed to allow companies to be able to access PA advice prior to or at the same time as the advice is received by the IAs. A safe harbor is available if the PA's policies and procedures require them to provide companies with a copy of such proxy voting advice, at no charge, no later than the time it is disseminated to the IA (while many S&P 500 already receive pre-publication draft reports from ISS, smaller companies to this point have not). The safe harbor also specifies that such policies and procedures may include conditions requiring companies to (i) file their proxy at least 40 calendar days before the shareholder meeting; and (ii) expressly agree that they will only use the PA report for their internal purposes and/or in connection with the solicitation and will not publish or otherwise share the PA report except with the company's employees or advisers.
- *PAs must ensure IAs have access to company responses or rebuttals*: If a company provides the PA notice that it has filed or intends to file a response to the PA report,

the PA must make the IA aware of such response. This notification must be done in a timely manner before the shareholder meeting or other action (although this requirement is not necessary where the PA advice is based on a "custom policy" that is proprietary to a particular IA). A safe harbor is available if the PA's policies and procedures provide for notice to its clients (the IAs) on its electronic client platform or through email or other electronic means that a company has filed, or informed the PA of its intention to file additional solicitation materials setting forth the company's response to the advice (and hyperlink to these materials if filed on EDGAR).

- *Antifraud provisions could be triggered:* The rules were amended to make it clear that failure to disclose material information regarding PA advice, such as the PA's methodology, sources of information, or conflicts of interest could be misleading within the meaning of the rule.

The proposed amendments had called for far more onerous conditions for a PA to meet the exemption, and would have required PAs to provide companies with a copy of their advice in order to permit them to identify errors or other problems with the analysis *in advance* of their release to IAs, and would have also have required PAs to provide the company with a final report no later than two business days prior to its dissemination to the IAs. Nonetheless, the final safe harbor should provide some level of comfort that companies will have the opportunity to provide meaningful input *concurrent with and during the process.* Currently, companies have to pay for their Glass Lewis reports or proactively sign up to access their ISS reports in some instances (with only S&P 500 companies able to review their ISS reports in draft form). The new safe harbor provisions appear to require all reports be disseminated for free.

The amended rules will become effective 60 days after publication in the Federal Register. However, PAs will not be required to comply with the new rule until December 1, 2021.

Supplemental Guidance

In conjunction with issuance of the new and final rules on proxy voting advice, the SEC issued further guidance which supplements the guidance issued in August of 2019[5] as to how IAs should responsibly use PAs in their voting decisions. This supplemental guidance focuses on the practice of some IAs reliance on PAs to pre-populate ballots based on their voting policies and automatically vote their shares (also known as "robovoting"). Some of the Commissioners were skeptical that this type of automated voting is consistent with an IA's fiduciary duties to vote on an "informed basis." To address this issue, the guidance reiterates that IAs owe a fiduciary duty to disclose all material facts of the investment advisory relationship between the IAs and their clients, and should consider whether the use of automated voting features is a material fact that should be disclosed to their clients.

To supplement the process suggested in the final new rule above, the guidance states that an IA should consider whether its policies and procedures address circumstances where it becomes aware that a company intends to file or has filed additional soliciting materials with the SEC after the IA has received the PA firm's voting recommendation but before the

submission deadline for proxies to be voted at a shareholder meeting.

Like the initial SEC guidance issued last August, this supplemental guidance is not subject to review and comment and is effective upon publication in the Federal Register.

Conclusions

While the rule change is not as onerous on PAs as those proposed last year, companies have won a small victory in the ability to have some say or control in the information-flow process before their institutional advisors cast votes. With voting reports being widely available in a timely fashion, as well as assurance that shareholders will have easy access to company responses to PA recommendations, companies should be prepared to review reports and quickly react during proxy season. Pearl Meyer regularly assists clients with these reviews and is available to consult with your company to prepare for this new process.

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[1] See https://www.sec.gov/rules/final/2020/34-89372.pdf

[2] See https://www.sec.gov/rules/policy/2020/ia-5547.pdf

[3] For further background details, see our prior alert at https://www.pearlmeyer.com/insights-and-research/client-alert/sec-issues-interpretive-guidance-for-investment-advisors-and-proxy-advisors

[4] ISS filed a lawsuit against the SEC challenging its August 2019 guidance suggesting that ISS services were “solicitations.” The parties agreed to stay the lawsuit until the SEC adopted final rules. It is now uncertain whether ISS will proceed in light of the final rules being approved.

[5] For details with respect to prior guidance, see https://www.pearlmeyer.com/insights-and-research/client-alert/sec-issues-interpretive-guidance-for-investment-advisors-and-proxy-advisors

About the Author

Deb advises on executive compensation from a legal and regulatory perspective, including securities disclosure, tax and governance matters, contract negotiation, and reasonableness opinion letters.

About Pearl Meyer

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