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How Companies Can Prepare for SEC Proxy Advisor Reform

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The SEC's long-awaited final rules governing voting advice provided by proxy advisory firms such as Institutional Shareholders Service (ISS) and Glass Lewis (the "final rules") became effective on November 2, 2020. The final rules confirm that proxy advice constitutes a solicitation under the federal proxy rules, and provide proxy advisory firms with a conditioned exemption from the filing and information requirements that would normally apply to such solicitations. To secure the exemption, proxy advisory firms must (i) provide disclosure of conflicts of interest and (ii) adopt policies and procedures to inform public companies of the firm's proxy voting advice and notify the firm's clients of public company responses to this advice. The final rules provide two safe harbors to satisfy these conditions as well as additional guidance on the applicability of the proxy rules' anti-fraud provisions to proxy voting advice. The final rules fall short of the changes outlined in the related proposed rules issued in November 2019 (which we discussed here) principally by (i) failing to mandate an opportunity for companies that are the subject of this advice to review and provide direct feedback on voting advice before its delivery to an advisor's clients and (ii) adopting a principles-based rather than a prescriptive approach.

The final rules make the following amendments to the federal proxy rules:

Definition of "solicitation" amended to include proxy voting advice (Rule 14a-1(l)).

The SEC codified its long-communicated interpretation that proxy advice generally constitutes a solicitation under the federal proxy rules by revising the definition of "solicitation" in Exchange Act Rule 14a-1(l)(iii) to include furnishing a "proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy," and clarifying that provision of voting advice for a fee by an advisor who markets its expertise in such advice, with the expectation that such advice will be used by shareholders to make voting decisions, constitutes solicitation. Rule 14a-1(l)(2) was also amended as proposed to clarify that "solicitation" does not include proxy voting advice provided only in response to an unprompted request.

Exemptions from information and filing requirements made conditional.

Rules 14a-2(b)(1) and 14a-2(b)(3), which provide exemptions from the information and filing

requirements of the proxy rules, have been revised to allow proxy advisory firms to avail themselves of these exemptions by complying with new Rule 14a-2(b)(9), which requires:

- **Enhanced disclosure of material conflicts of interest**. New Rule 14a-2(b)(9)(i) requires proxy advisors to disclose information that is material to assessing the objectivity of their advice, as well as any policies or procedures they use to identify and address material conflicts, either in their voting advice or in the electronic means of its delivery, such as a client voting platform. The SEC release describing the final rules provides some examples of possible conflicts in the proxy advisory business role, including when (i) the consulting arm of the proxy advisor works with a company on its corporate governance and compensation policies and then provides voting advice on these measures and policies when they are up for a shareholder vote and (ii) a proxy advisor consults with some but not all of its institutional clients before issuing benchmark voting recommendations, without informing other clients of the consultation and possible influence. The new rule is principles-based, leaving the determination of both which matters are material in assessing the objectivity of voting advice and how any policies and procedures should be presented to the proxy advisors.

- **Adoption and disclosure of policies and procedures to facilitate informed decision-making by clients**. New principles-based Rules 14a-2(b)(9)(ii)(A) and (B) require the adoption and disclosure of policies and procedures designed to improve the information used by shareholders and their proxies in the proxy voting process. Non-exclusive safe harbors for satisfaction of these conditions are also provided.

- **Provision of proxy voting advice to registrants.** New Rule 14a-2(b)(9)(ii)(A) requires that proxy advisors adopt and publicly disclose policies and procedures reasonably designed to ensure that their voting advice is made available to companies who are the subject of the advice no later than when the advice is disseminated to the proxy advisor’s clients. If a company wishes to provide its views on the advice, it must do so by filing supplementary proxy materials with the SEC.

Rule 14a-2(b)(9)(ii)(A) includes a non-exclusive safe harbor: proxy advisors who publicly disclose policies and procedures reasonably designed to provide companies with a copy of their proxy voting advice at no charge a least concurrently with delivery to clients will satisfy the condition. Under this safe harbor, a proxy advisor may condition a company’s right to receive a copy of the voting advice on the company (i) filing a definitive proxy statement at least 40 days before the annual meeting and (ii) acknowledging that the disclosed information will only be used internally and will not be published or otherwise shared except with employees and advisers.

- **Mechanism to alert clients of company response.** NewRule 14a-2(b)(9)(ii)(B) requires that proxy advisors adopt written policies and procedures designed to provide a mechanism by which their clients can reasonably be expected to become aware of any written statements by a subject company regarding its proxy voting advice before the shareholders meeting or whenever the relevant voting will take place.

The final rules provide a second non-exclusive safe harbor to address this requirement: proxy advisors who publicly disclose policies and procedures reasonably designed to provide notice to

clients that a subject company has filed or intends to file supplementary proxy materials on the advice, either by posting notice on an electronic client platform, or through email or other electronic transmission, with a hyperlink on EDGAR when available, will satisfy this condition. This safe harbor gives proxy advisors discretion in developing this mechanism, including the ability to set standards for a subject company's notice of filing or intention to file supplementary proxy materials that must be met before the materials are publicized via the proxy advisor's mechanism. Notably, the final rules do not condition the availability of the Rules 14a-2(b)(1) and 14a2(b)(3) exemptions on disabling or suspending automatic voting on a proxy advisor's electronic voting platform after a company has notified the proxy advisor that it intends to file or has filed a response, even though the pre-population and automatic submission functions on automatic proxy voting platforms might allow some clients to vote their proxies before companies can file supplemental proxy materials.

Although the amendments do not give companies that are the subject of proxy advice an opportunity for prior review and comment or the right to have a link to their responses included with the advice, they give a broader range of companies the ability to communicate their positions to investors in a timely manner. Prior to the amendments, companies were able to receive reports *after* publication from ISS *gratis* and from Glass Lewis for a fee. In addition, some companies have been able to engage with proxy advisors during the solicitation period. ISS has a formal engagement policy that enables companies to provide notice of important data points in its proxy and ISS may at its discretion enter into a dialogue with a company on matters relevant to its research and recommendations. Glass Lewis allows Nasdaq and NYSE listed US companies who are registered in their Issuer Data Report program to receive and confirm the accuracy of key data points (but not the actual voting recommendations) before the advice is issued to clients if they disclose their meeting documents at least 30 days before their annual meeting. Companies that purchase Glass Lewis's research and who disclose their meeting materials at least 21 days in advance of the relevant meeting date can participate in Glass Lewis's Report Feedback Statement service that enables companies to have their unedited statements on a difference of opinion with the Glass Lewis position included with Glass Lewis's report to institutional investors.

Subjecting proxy voting advice to anti-fraud provisions.

The final rules also expand the list of examples of misleading statements and omissions in Rule 14a-9 (which applies even to exempt solicitations) to include misleading statements and omissions related to information about the proxy advisor's proprietary methodologies, sources of information, and conflicts of interest.

Going forward.

The final rules still face a final obstacle: ISS filed a lawsuit in October 2019 in the Federal District Court for the District of Columbia challenging the SEC's regulation of proxy voting advice as contrary to law and outside of the SEC's statutory authority under the Exchange Act. The case was stayed until the earlier of January 1, 2021 or the issuance of final proxy advisor rules, but was reopened following the promulgation of the final rules. The court has not yet set a date for the hearing. Until this lawsuit is finally decided, the fate of the SEC's proxy reform remains in question. Assuming the amendments are not nullified by the court, proxy advisors will not be required to implement new policies and procedures until December 1, 2021, which will give all stakeholders time to prepare. Note, however, that this transition period does not apply to the definitional amendments to Rule 14a-1(l) and the anti-fraud provisions of Rule 14a-9.

Next Steps for Companies.

The amendments provide management with an opportunity to provide some targeted response to objections underlying voting recommendations that run counter to the company's recommendations. In particular, the new rules provide smaller public companies, which may not have experience engaging with proxy advisors, with new opportunities to understand and respond to proxy voting advice. These smaller public companies should monitor the outcome of the ISS lawsuit and, if necessary, use the transition period to position themselves to benefit from the new rules by considering the following measures:

- **Step up engagement with proxy advisory firms.** A public company that is listed on the Nasdaq and NYSE exchanges can already register to receive key data points (but not actual voting recommendations) from proxy advisory firm Glass Lewis to confirm their accuracy before recommendations are sent to clients. This service is available free of charge to companies that disclose their meeting documents at least 30 days before their annual meeting. Delivery of the data points is via email and companies receive 48 hours to review and provide feedback. A company may also contact ISS to provide its analysts with contacts for questions as well as highlight any important changes in its proxy statement.

- **Appoint facilitators.** Members of management typically responsible for proxy statement review and annual meeting matters should be charged with tracking and understanding the development of relevant proxy advisor policies and procedures for obtaining voting advice and notification to proxy advisor clients of any company response, including any related deadlines and conditions. In particular, management should understand any requirements to acknowledge that the company will limit its usage of the voting advice, as well as other possible conditions not specified in the safe harbor that a proxy advisor might adopt. Even though the SEC's release provides that a full-blown confidentiality agreement may not be necessary, management should be prepared to negotiate one if requested by a proxy advisor.

- **Anti-fraud rules.** While the release suggests that company responses will be made through filing supplementary proxy materials, it is possible that a proxy advisor might allow direct written feedback, which it would then need to make available to its clients. These written responses would be subject to the anti-fraud provisions of the proxy rules and would need to be carefully reviewed by company counsel for accuracy.

Provided the final rules survive the ISS lawsuit, the new regime under these rules should enable companies to contribute to a more accurate and balanced picture of the issues on which shareholders will vote.

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