

The SEC Takes Action on Proxy Advisory Firms

July 31, 2020

For more than a decade, the SEC has been wrestling with whether and how to regulate the activities of the proxy advisory firms — principally ISS and Glass Lewis — that have come to play such an important role in shareholder voting at U.S. public companies. On July 22, 2020, the SEC adopted rules and interpretive guidance that, together, are probably as far as it will go.

Very generally, the main impact of last week's actions is that, beginning in the 2022 proxy season:

- When a proxy advisory firm gives its clients voting advice about a typical shareholders' meeting, it will have to provide the advice simultaneously to the company.
- In case the company decides to respond to the proxy voting advice, the proxy advisory firm will need to develop procedures to alert its clients to the company's response before the vote is cast.
- If the client is a registered investment adviser, it will need to have procedures to consider any company response.

This represents a step back from the SEC's November 2019 proposal, which would have prescribed a more complex interaction between the proxy advisory firm and the company.

Critics of the proxy advisory firms — already disappointed by the November 2019 proposal — will not be satisfied. On the other hand, the firms themselves and institutional investors, who generally opposed the proposal, were hoping it would be cut back further, or perhaps that it would expire unadopted in the peculiar circumstances of 2020. But now the current SEC has given the topic its best shot, and in the complicated eco-system that connects a public company with its shareholders — where asset managers play a decisive role and rely heavily on proxy advisory firms — this will provoke some adjustments but not fundamental change.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

NEW YORK

Nicolas Grabar
+1 212 225 2414
ngrabar@cgsh.com

David C. Lopez
+1 212 225 2632
dlopez@cgsh.com

Sandra L. Flow
+1 212 225 2494
sflow@cgsh.com

James E. Langston
+1 212 225 2784
jangston@cgsh.com

Mary E. Alcock
+1 212 225 2998
malcock@cgsh.com

Helena K. Grannis
+1 212 225 2376
hgrannis@cgsh.com

Shuangjun Wang
+1 212 225 2451
shwang@cgsh.com

Jasmine Johnson
+1 212 225 2458
jasjohnson@cgsh.com



The SEC's July 2020 Action in Summary:¹

The SEC has relied on two grounds in regulating proxy voting advice.²

- First, the SEC has taken the position since 2010 that proxy voting advice may be “solicitation” subject to regulation under Section 14 of the Securities Exchange Act of 1934. Proxy advisory firms have, however, proceeded on the assumption that they are not subject to the information and filing requirements that apply to proxy solicitation under the federal proxy rules.
- Second, many of the customers of the proxy advisory firms are themselves investment advisers, registered with the SEC under the Investment Advisers Act of 1940. If an investment adviser exercises voting authority, Rule 206(4)-6 under the Advisers Act requires it to adopt and implement written policies and procedures that are reasonably designed to ensure that it votes in the best interest of its clients. Since 2014, the SEC has emphasized to registered investment advisers that they should take these duties to clients into account when they rely on proxy advisory firms.

Building on this foundation, last week's SEC action included three main steps.

- The SEC amended its definition of proxy solicitation to clearly include proxy voting advice. It also amended its antifraud rule for proxy solicitations to include, as an example of a false or misleading statement, failure to disclose material information regarding proxy voting advice.
- The SEC adopted new conditions that a proxy advisory firm³ must meet in order to be exempt from the information and filing requirements that

otherwise apply to proxy solicitations. These conditions include (1) conflict disclosures the proxy advisory firm must provide to its clients, (2) procedures to make proxy voting advice available to the company, at the latest when the advice goes to clients, and (3) a mechanism by which, if the company provides a written response to the voting advice, clients can reasonably be expected to become aware of the company's response in a timely manner.

- The SEC adopted Guidance to registered investment advisers that rely on proxy advisory firms. The Guidance addresses how an investment adviser should take account of the company's response to proxy voting advice, specifically where the investment adviser automatically follows the proxy advisory firm's recommendation — a practice sometimes referred to as “robo-voting.”

The new rules will become effective 60 days after publication in the Federal Register, but there is an extended compliance date of December 1, 2021 for the new conditions applicable to the proxy advisory firms. As a result, the 2022 annual proxy season will be the first for which the new process and disclosure requirements are mandatory.

Background — the Road to the July 2020 Measures

The SEC's attention to proxy advisory firms has been building up for almost two decades. In 2004, the SEC staff issued two no-action letters that indicated that relying on a proxy advisory firm could be a way for an investment adviser to avoid conflicts of interest in the exercise of its voting responsibilities. In 2010, the increasing role of proxy advisory firms was one focus

¹ The SEC release adopting the final rules, “Exemptions from the Proxy Rules for Proxy Voting Advice” (the “[Adopting Release](#)”) is available [here](#). The SEC Guidance, “Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers” (the “[Guidance](#)”) is available at [here](#).

² The SEC has not relied on the argument that the proxy advisory firms themselves are subject to regulation under

the Advisers Act. The proxy advisory firms have different analyses of their own regulatory status, with only ISS being registered as an investment adviser under the Advisers Act. ³ The SEC's new rules use the term “proxy voting advice business” to capture a person furnishing proxy voting advice as defined under the new rules. The Guidance uses the expression “proxy advisory firm,” which we also use in this memorandum.

of a broader concept release on the proxy voting process generally. The SEC staff issued a Staff Legal Bulletin in 2014, cautioning investment advisers against over-relying on delegation to proxy advisory firms in carrying out their fiduciary duties with respect to their proxy voting responsibilities.

Under Chair Clayton, the focus has intensified. In 2018 the staff withdrew the two no-action letters⁴ ahead of the SEC's 2018 Roundtable on the Proxy Process,⁵ at which the SEC gathered opinions from all sides. Barely a year later came the SEC's interpretation and guidance in August 2019,⁶ which elaborated the SEC's position on the duties of investment advisers that rely on proxy advisory firms and confirmed the SEC's view on the applicability of the federal proxy solicitation rules to proxy voting advice by proxy advisory firms.

This process led to the November 2019 proposal (the "Proposal"),⁷ which like the August Guidance was opposed by the two Democratic commissioners at the time. Comment on the Proposal was voluminous and sharply divided, with many companies and their advocates supporting the Proposal and the proxy advisory firms strongly opposing it. Numerous investors also objected that the Proposal could result in delays in the proxy voting process, drive up costs for investors and undermine the independence of proxy advisory firms.⁸

The centerpieces of the Proposal were (1) an advance review and feedback process, in which a proxy advisory firm would give the registrant a draft of its advice and a chance to provide feedback before the advice is delivered to clients and (2) an issuer response process, in which if the company provides a written

response to the voting advice, the proxy advisory firm must include a hyperlink to the company's response in its voting advice.

The final rules adopted last week back off of both these ideas in favor of what the SEC describes as a more "principles-based" approach, as described below. Opponents of the Proposal contended that it would create a "speed bump" in the voting process, with an undue administrative burden.⁹

Commission Chair Jay Clayton described last week's actions as a "shining example" of the SEC's ongoing commitment to "enhanc[ing] the accuracy, transparency and effectiveness of our proxy voting system" and ensuring that proxy voting decisions will be better informed and more in line with the interests of Main Street investors.¹⁰ On the other hand, Commissioner Allison Herren Lee, who is currently the only Democratic commissioner, dissented from both the adoption of the final rules and the issuance of the Guidance, pithily describing the actions as "unwarranted, unwanted and unworkable."¹¹ Her dissent made this the latest in a long string of regulatory changes adopted by a vote divided along party lines.

Proxy Voting Advice as "Solicitation"

The SEC amended the definition of "solicitation"¹² under its proxy rules to cover the existing proxy advisory firms as expressly as possible. The definition already covered "the furnishing of a ... communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy," and the amendment adds this language:

⁴ SEC Division of Investment Management, "Statement Regarding Staff Proxy Advisory Letters," available [here](#).

⁵ See our alert memo about the 2018 Roundtable [here](#).

⁶ See our blog post about the August 2019 guidance [here](#).

⁷ See our blog post about the Proposal [here](#).

⁸ See, e.g., the statement released by the Council of Institutional Investors on the day the Proposal was released: *Leading Investor Group Rebukes SEC for Proposed Rules That Undercut Critical Shareholder Rights*, available [here](#).

⁹ See, e.g., the statement released by the Council of Institutional Investors on the day the final rule and supplemental guidance were released: *Leading Investor Group Dismayed by SEC Proxy Advice Rules*, available [here](#).

¹⁰ See Commissioner Chair Clayton's prepared remarks, available [here](#). The remarks of Commissioners Roisman and Peirce are available [here](#) and [here](#).

¹¹ Commissioner Lee's statement is available [here](#).

¹² Paragraph (l) of Rule 14a-1.

including [a]ny proxy voting advice that makes a recommendation to a security holder as to its vote, consent, or authorization on a specific matter for which security holder approval is solicited, and that is furnished by a person that markets its expertise as a provider of such proxy voting advice, separately from other forms of investment advice, and sells such proxy voting advice for a fee.

The view that proxy voting advice constitutes a solicitation under the federal proxy rules was expressed in the 2010 Concept Release and then echoed in the 2014 Staff Legal Bulletin and in the August 2019 guidance.

ISS filed a lawsuit against the SEC last October, arguing that the interpretation that proxy voting advice constituted a solicitation under the federal proxy rules “exceeds the SEC’s statutory authority under Section 14(a) of the Exchange Act and is contrary to the plain language of the statute.”¹³ The action was stayed pending action on the Proposal, and ISS will now need to decide whether to pursue it.

Now that proxy voting advice is clearly a solicitation, it is subject to Rule 14a-9, which prohibits the making of false or misleading statements in a proxy solicitation. Rule 14a-9 includes a note giving examples of statements that may be false or misleading, and the SEC added an example specifically for proxy advisory firms: failure to disclose material information regarding proxy voting advice, such as the firm’s methodology, sources of information, or conflicts of interest.

The SEC has not historically brought enforcement actions against proxy advisory firms. There is case law finding that an investor has a private right of action against a company under Rule 14a-9, but a claim by a

company against a proxy advisory firm would be a step further — one it seems unlikely that companies will take for practical and reputational reasons in the ordinary course, although perhaps in a particularly contentious proxy battle or merger a party might have a sufficient incentive for bringing such a claim.

Process Requirements for Proxy Advisory Firms

Two of the new conditions a proxy advisory firm must meet, in order to rely on the exemptions from information and filing requirements for proxy solicitations,¹⁴ address the process a proxy advisory firm must follow — making proxy voting advice available to the company, and making the company’s response available to clients. These provisions are complemented by the Guidance for investment advisers, which addresses an investment adviser’s consideration of the company’s response.

The new rules do not apply to M&A transactions and contested elections.¹⁵ This exemption was not in the Proposal, but was added in response to comments about the tighter deadlines and the special risks of those situations. The new rules also do not apply to proxy voting advice provided pursuant to custom policies.¹⁶

Company Access to Proxy Voting Advice

The new rules require a proxy advisory firm to have publicly disclosed policies and procedures reasonably designed to ensure that a company that is the subject of proxy voting advice has the advice made available to it at or prior to the time when the advice is disseminated to clients.¹⁷

The final rule includes a note providing that if the advice is subsequently revised, the firm is not required to make subsequent versions available to the company.

¹³ *Institutional Shareholder Services Inc. v. Securities and Exchange Commission* (U.S. District Court for the District of Columbia). The complaint is available [here](#).

¹⁴ The exemptions are set forth in paragraphs (b)(1) and (b)(3) of Rule 14a-2. The conditions are set forth in new paragraph (b)(9) of Rule 14a-2.

¹⁵ New Rule 14a-2(b)(9)(vi).

¹⁶ New Rule 14a-2(b)(9)(v).

¹⁷ New Rule 14a-2(b)(9)(ii)(A).

It also includes a note providing what the Adopting Release calls a safe harbor, which largely repeats the requirement but adds that the policies and procedures may impose these conditions:

- The company has filed its definitive proxy statement at least 40 days before its annual meeting (or before the vote is to be cast).
- The company has acknowledged that it will limit the use of the advice to internal purposes “and/or in connection with the solicitation” and will not publish it or share it except with its employees or advisers.

Client Access to the Company’s Response

The new rules in the Adopting Release also require a proxy advisory firm to provide its clients with a mechanism by which they can reasonably be expected to become aware of any written statements by the company regarding its proxy voting advice, in a “timely manner” before the meeting (or before the vote, if there is no meeting).¹⁸

A note in the final rule provides a safe harbor identifying two alternative mechanisms that will be deemed to meet this requirement: an electronic platform or an email. Both reflect the assumption that the company’s response would have to be filed with the SEC as additional soliciting material. In either case, the proxy advisory firm must provide notice that the company intends to file or has filed a response and provide an active hyperlink to the company’s EDGAR filing of the response when it becomes available.

The principal rule refers to clients becoming aware of the company’s response, but the safe harbor also refers to notice of an intent to respond. This suggests that proxy advisory firms should plan to provide notice of both, and that a company looking to increase the impact of its response would do well to inform the proxy advisory firm of its intent if the actual response will come later.

Investment Advisers That Rely on Proxy Advisory Firms

The SEC’s new Guidance for investment advisers addresses the duties of an investment adviser if it uses a proxy advisory firm to assist with voting execution. It describes two services in particular: “pre-population” (the firm has a platform on which it populates the client’s votes with the firm’s recommendations, based on the client’s standing instructions) and “automated voting” (the firm submits the votes for the client). If the investment adviser uses a service of this kind, the Guidance sets out steps it should take in order to demonstrate that it is making voting determinations in its client’s best interest.

- It “would likely need to” ensure that it has a process for assessing any votes that may be pre-populated in light of company responses that may become available prior to their submitting their votes.
- It should consider its agreements with proxy advisory firms to determine the treatment of material nonpublic information regarding how its shares are voted.
- It should provide full and fair disclosure to its clients about material facts relating the exercise of voting authority. The Guidance discusses in some detail what this might include.

This Guidance supplements the August Guidance, which highlighted that investment advisers (a) owe their clients a fiduciary duty with respect to exercising their proxy voting authority that cannot be delegated or outsourced to proxy advisory firms and (b) should regularly review and monitor their contracted proxy advisory firms to ensure that they are receiving comprehensive, accurate and clear information and advice from these firms, free of any conflicts of interest or other concerns.

¹⁸ New Rule 14a-2(b)(9)(ii)(B).

Conflicts of Interest Disclosures by Proxy Advisory Firms

The new rules also require a proxy advisory firm to provide its clients with certain disclosures relating to material conflicts of interest, as a condition to the exemption from the proxy solicitation rules.¹⁹ It must provide information regarding any interest, transaction or relationship that is material in assessing the objectivity of the firm's advice, and any policies and procedures to identify and address conflicts.

While such disclosure may be helpful to help a client assess the objectivity of the voting advice, in practice it may well become boilerplate. One focus of concern has been the consulting services provided to companies by the proxy advisory firms, and a firm will need to decide whether to provide generic disclosures or information that is specific to the company, the services it uses and the fees it pays.

Takeaways

- *What's new.* The new rules and guidance will prompt a subtle adjustment of the process between companies, proxy advisory firms and their clients — a change that might well have occurred to some degree anyway. (The impact will not extend to voting on M&A transactions or in contested elections.) After the new rules are fully effective in December 2021, a company will be assured of a prompt look (at no cost) at the voting advice that the proxy advisory firms provide. If the company decides to respond, the response might be more likely to be taken into account by shareholders. To accommodate this process, investors that rely on automatic voting may plan to vote later in the season.
- *What won't change.* From the issuer point of view, the dissatisfaction with proxy advisory firms has largely to do with the power of a duopoly of

advisors to develop and promote a substantive corporate governance agenda.²⁰ The new rules will not change that. It remains to be seen whether the power of the proxy advisory firms will decline as a result of a more assertive stewardship agenda on the part of investment managers themselves.

- *Company reactions.* Many companies already consider putting out additional soliciting material in response to proxy voting advice, and some do so. The new framework will create an earlier opportunity and may make the proxy advisory firms more open to adjusting their advice. It may also provide a reward for speed in responding, in the form of heightened attention from investment advisers. A company may want to gear up in advance, so that it is ready for a quick review and a prompt response; and if it does plan to respond, it will want to alert the proxy advisory firm quickly of its intention. But there are still reasons not to respond, or to do so without confrontation — including reluctance to highlight the voting advice and reluctance to pick a fight with a proxy advisory firm.
- *Impact on the proxy process.* According to the Adopting Release, the new rules reflect “the principle that more complete and robust information and discussion leads to more informed investor decision-making, and therefore results in choices more closely aligned with investors’ interests.”²¹ Whether they have this effect will depend in part on whether companies respond to voting advice, which they may do more often than before. And it will depend in part on how institutional investors react — but this may be hard to assess, amid the broader trend towards more conscientious and thoughtful stewardship in the investment management industry.

¹⁹ New Rule 14a-2(b)(9)(i).

²⁰ See Neil Whoriskey, *The New Civil Code: Obey*, available [here](#).

²¹ Adopting Release, page 86. The Adopting Release specifically says that the new rules are appropriate

regardless of the incidence of errors in proxy voting advice, whether clients are dissatisfied with it, or whether the advice is adverse to the company's recommendation.

- *Impact on foreign private issuers.* The proxy advisory firms have a growing impact on shareholders' meetings of U.S.-listed FPIs. But FPIs are not subject to the proxy rules, so the firms do not need an exemption, and the new rules will not apply to voting advice about an FPI. It would make sense for the firms to apply the same procedures, however, particularly since the Guidance to investment advisers presumably does extend to how they vote shares of FPIs.
- *Challenges to the rules?* It is possible there will be litigation challenging the new rules. In addition to the ISS challenge on whether proxy voting advice is solicitation, there have been suggestions that the final rules should have been re-proposed or that the cost-benefit analysis is insufficient to support them. For that matter, the 117th Congress, which will convene in January 2021, will have an opportunity to rescind the rules under the Congressional Review Act — a fate that befell one SEC rulemaking in January 2017. However, the practical impact of the new rules seems sufficiently limited that there may not be a strong enough incentive to challenge them.

...

CLEARY GOTTlieb