



U.S. CHAMBER OF COMMERCE ALERT:

THE SEC'S FINAL RULE &
GUIDANCE REGARDING
**PROXY
ADVISORY
FIRMS**



CENTER FOR CAPITAL MARKETS
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U.S. CHAMBER OF COMMERCE ALERT: THE SEC'S FINAL RULE AND GUIDANCE REGARDING PROXY ADVISORY FIRMS

SUMMARY

In July 2020, the U.S. Securities and Exchange Commission (SEC) finalized a rulemaking intended to promote transparency within the proxy advisory industry and increase the quality of vote recommendations received by institutional investors (Proxy Advisor Rule). The SEC also issued Commission-level guidance clarifying the fiduciary duties of SEC-registered investment advisers when voting proxies on behalf of fund shareholders (Commission Guidance).

Proxy advisory firms play an important role in the corporate governance ecosystem. Proxy advisors analyze and develop voting recommendations related to critical governance matters at public companies. Given the thousands of proxy issues that institutional investors may have to consider in any given year, proxy advisors can assist investment advisers in fulfilling their fiduciary duty and ensuring that votes are always cast in the best interests of shareholders.

However, the proxy advisory industry has come under extensive criticism for operating with a startling lack of transparency, rampant conflicts of interest, and a tendency to make factual errors and analytical mistakes when providing voting advice. These deficiencies can lead to misinformed voting decisions, introduce biases into the voting process, and ultimately harm Main Street investors.

The proxy advisory industry also continues to be dominated by only two firms—Institutional Shareholder Services (ISS) and Glass Lewis—which comprise over 95% of the market and whose recommendations can sway a significant portion of the vote at any given public company. Prior to issuance of the Proxy Advisor Rule, these two firms were largely unregulated for years and had in a sense become the de facto standard-setters for corporate governance in the U.S.

Over the last decade, the U.S. Chamber's Center for Capital Markets Competitiveness (CCMC) has educated members of Congress and the SEC on the problems within the proxy advisory industry and put forward a number of specific ideas for reform. During that same period, congressional hearings were held to examine the practices of proxy advisors, the SEC held round-tables and solicited public feedback on several occasions, and public companies of all sizes became activated on the issue.

The SEC's recent actions are responsive to many of the concerns raised by market participants and policymakers over the years. The Proxy Advisor Rule will facilitate a "review and feedback" mechanism so that all public companies can correct errors in draft vote recom-

mendations and ensure that shareholders receive the total mix of information prior to casting votes. The final rule will also help investment advisers better understand proxy advisory firm conflicts of interest that could taint the independence of vote recommendations. Additionally, the Commission Guidance will enhance the due diligence conducted by investment advisers and prohibit fund managers from automatically relying on recommendations from proxy advisers.

This report includes a timeline of events that have informed the SEC's actions, as well as a brief overview of the Proxy Advisor Rule and Commission Guidance, to help public companies understand how the proxy process and their relationship with proxy advisors will likely change in the coming years.

OVERVIEW OF THE PROXY ADVISOR RULE

The Proxy Advisor Rule codifies the SEC's long-standing position that providing voting advice to investors constitutes a "solicitation" under SEC rules. Proxy advisors would be eligible to obtain an exemption from certain information and filing requirements under the federal proxy rules if they meet specified conditions, including disclosing conflicts of interest and providing issuers with the ability to review and respond to draft recommendations.

In contrast to the November 2019 rule proposal, which took a more prescriptive approach toward meeting these requirements, the final rule adopts more principles-based standards for how proxy advisory firms can meet the conditions laid out in the rule. The final rule also reaffirms that proxy advisory firms remain subject to the antifraud provisions of the Exchange Act for materially false or misleading statements.

KEY TAKEAWAYS

1. The Proxy Advisor Rule codifies that providing proxy advice is a "solicitation" under the federal proxy rules.
2. The Proxy Advisor Rule should result in better disclosure regarding conflicts of interest from proxy advisory firms.
3. Any public company regardless of size that is the subject of proxy voting advice would be afforded the opportunity to correct errors and provide feedback on voting recommendations.
4. Clients of proxy advisory firms will have to be notified if an issuer has provided a written statement in response to a voting recommendation.
5. Proxy advisory firms will be held accountable by the antifraud standards under Rule 14a-9 regarding false or misleading statements.

CONFLICTS OF INTEREST

To rely on exemptions contained in Rule 14a-2(b)(1) and Rule 14a-2(b)(3) of the Exchange Act, proxy advisors would have to provide their clients with information about their conflicts of interest and the policies and procedures they have to identify conflicts of interest. Proxy advisors would have to contain the following as part of their voting advice:

- ◆ Any information regarding an interest, transaction, or relationship of the proxy voting advice business (or its affiliates) that is material to assessing the objectivity of the proxy voting advice in light of the circumstances of the particular interest, transaction, or relationship.
- ◆ Any policies and procedures used to identify, as well as the steps taken to address, any such material conflicts of interest arising from such interest, transaction, or relationship.

This is a marked improvement over previous policy enshrined in the ISS and Egan-Jones no-action letters which required that proxy advisory firms only disclose their general policies and procedures surrounding the identification of conflicts. The Proxy Advisor Rule should lead to greater disclosure of any company-specific conflicts so that investment adviser clients of proxy advisory firms can be fully informed about any potential biases present in vote recommendations.

ISSUER REVIEW AND FEEDBACK/CLIENT NOTIFICATION

To rely on the aforementioned exemptions from Exchange Act rules, proxy advisors would also be required to adopt written policies and procedures reasonably designed to ensure that any issuer that is the subject of proxy voting advice has an opportunity to provide written feedback on vote recommendations. Additionally, proxy advisors must have policies in place reasonably designed to ensure that their clients are notified—in a “timely manner”—of any written statements provided by an issuer regarding a vote recommendation. The specific requirements needed to meet the exemption are below:

- ◆ Registrants that are the subject of the proxy voting advice must have such advice made available to them at or prior to the time the advice is disseminated to clients of the proxy voting advice business.
- ◆ The proxy voting advice business must provide its clients with a mechanism by which they can reasonably expect to become aware of written statements regarding its proxy voting advice by registrants that are the subject of such advice, in a timely manner before the shareholder meeting (or, if no meeting, before the votes, consents, or authorizations may be used to effect the proposed action).

The Proxy Advisor Rule also contains a nonexclusive safe harbor that proxy advisors can rely on to satisfy the requirements necessary to obtain the exemption from certain of the SEC's proxy rules. The terms of the safe harbor include the following:

- 1.** Providing issuers that are the subject of a vote recommendation with a copy of the recommendation no later than the time the recommendation is shared with clients of the proxy advisory firm (subject to certain terms the proxy advisory firm may impose, including that the issuers file their definitive proxy statements 40 days prior to their annual general meeting, and that the recommendation be used only for the issuers' internal purposes and/or in connection with the solicitation).
- 2.** Providing notice to a proxy advisor firm's clients of an issuer's filing, or intent to file, written comments regarding a vote recommendation on the proxy advisor's electronic client platform, or providing clients with a notice through email or other electronic means that an issuer has filed or intends to file written comments.

ANTIFRAUD PROVISIONS

The Proxy Advisor Rule explicitly states that "even solicitations that are exempt from the federal proxy rules' information and filing requirements are subject to" Rule 14a-9 prohibitions against making false or misleading statements with respect to any material fact. As adopted, the Proxy Advisor Rule says that failure to disclose material information regarding proxy voting advice, "such as the proxy voting advice businesses' methodology, sources of information, or conflicts of interest" could (depending on particular facts and circumstances) be construed as misleading under Rule 14a-9. Given the history of criticisms that proxy advisors have received regarding their lack of transparency and errors contained in vote recommendations, the affirmation of Rule 14a-9 applicability is an important protection that will hold proxy advisors accountable.

OVERVIEW OF COMMISSION GUIDANCE

The Commission-level Guidance issued concurrent with the Proxy Advisor Rule clarifies the duties of investment advisers when voting proxies, taking into account that investment advisers will likely be provided with additional information in the voting process once the Proxy Advisor Rule takes effect. The Commission Guidance lays out a number of steps that investment advisers can take to demonstrate that they are casting votes in accordance with their clients' best interests, and it notes that the changes included in the Proxy Advisor Rule will "result in improvements in the mix of information that is available to investors and material to a voting decision."

Notably, the Commission Guidance addresses situations where investment advisers have pre-populated voting instructions with proxy advisor firms and, in addition to receiving voting advice, have hired proxy advisors to actually execute votes on the investment adviser's behalf. The Commission Guidance says that if under the Proxy Advisor Rule an issuer files written comments in response to a vote recommendation and such comments "would reasonably be expected to affect the investment adviser's voting determination," then the investment adviser would likely have to examine such information before voting.

Given concerns that have been raised over "robo" or "automated" voting, whereby an investment adviser automatically follows the recommendations of a proxy advisor firm and then has that same proxy advisor execute votes on its behalf, the Commission Guidance can be viewed as a disapproval of that practice. The Commission Guidance states that an investment adviser that uses automated voting should also consider disclosing the following:

- ◆ The extent of that use and under what circumstances it uses automated voting.
- ◆ How its policies and procedures address the use of automated voting in cases where it becomes aware before the submission deadline for proxies to be voted at the shareholder meeting that an issuer intends to file or has filed additional soliciting materials with the Commission regarding a matter to be voted upon.

CONCLUSION

The Proxy Advisor Rule establishes the first uniform regulatory regime for the development and dispensation of proxy advice, while the Commission Guidance helps clarify the duties of investment advisers in light of these new rules going into effect.

While the principles-based regime outlined in the Proxy Advisor Rule may lead some proxy advisors to take a different approach to compliance than others, public companies can expect greater participation in the development of vote recommendations, and investment advisers should be prepared to weigh additional information before casting votes. Given that the conflict of interest and review-and-feedback mechanism of the Proxy Advisor Rule do not go into effect until the 2022 proxy season, proxy advisors, investment advisers, and public companies have significant time to prepare and update their relative policies and procedures.

PROXY ADVISORY FIRM REFORM TIMELINE

- ◆ **2003: SEC Adopts Proxy Voting Rule.** The Proxy Voting Rule was issued to ensure that investment advisers that have the authority to vote proxies do so in the best interests of their clients.
- ◆ **2004: SEC Staff Issues No-Action Letters to ISS and Egan-Jones.** These two no-action letters had the effect of allowing investment advisers to “cleanse” a conflict of interest they may have with a particular proxy issue by relying on the recommendations of a third party, i.e., a proxy advisory firm. Further, the ISS no-action letter stated that investment advisers could determine the independence of a third-party proxy advisor by relying on the general policies and procedures that the proxy advisor maintains relating to conflicts of interests, rather than examining any type of specific relationship that could give rise to a conflict. These two no-action letters (rescinded in 2018) contribute to a greater reliance and outsourcing of voting responsibilities to proxy advisory firms, thus furthering their influence on public companies.
- ◆ **2010: SEC Issues “Proxy Plumbing” Concept Release.** The SEC’s proxy plumbing concept release provided for a holistic examination of the U.S. proxy system and acknowledged that serious concerns had been raised regarding the role of proxy advisory firms, including conflicts of interest and a lack of transparency. The Commission received several comments regarding proxy advisory firms, including concerns that large blocks of company shares were being voted automatically in line with proxy advisory firms within 48 hours of a recommendation being issued.
- ◆ **2013: U.S. Chamber Issues Report on Proxy Advisor Best Practices.** The report, Best Practices and Core Principles for the Development, Dispensation, and Receipt of Proxy Advice brought further attention to problems within the industry and called for a number of changes to improve the transparency and accuracy of voting recommendations.
- ◆ **2013: Congressional Hearing on Proxy Advisory Firms.** In June 2013, the House Capital Markets Subcommittee held a hearing titled “Examining the Market Power and Impact of Proxy Advisory Firms.” It was the first congressional hearing held on the industry and was a major milestone in terms of informing policymakers on the subject.
- ◆ **2013: SEC Staff Roundtable on Proxy Advisors.** In response to concerns over the industry, SEC staff convened a roundtable on proxy advisors that included perspectives from a wide spectrum of market participants.
- ◆ **2014: SEC Staff Issues Staff Legal Bulletin 20 (SLB 20).** SLB 20 restated the SEC’s position that proxy advice generally constitutes a “solicitation” under the SEC’s proxy rules and reaffirmed that investment advisers’ fiduciary duty requires them to conduct sufficient due diligence and oversight regarding their use of proxy advisory firms.

- ◆ **2016: Bipartisan Legislation Requiring Registration of Proxy Advisory Firms Introduced in the House of Representatives.** The Corporate Governance Reform and Transparency Act passed the House Financial Services Committee on a bipartisan vote in September 2016 and represented the first significant effort by Congress to establish a regulatory framework for proxy advisors.
- ◆ **2017: Corporate Governance Reform and Transparency Act Is Reintroduced in the New Congress.** The act passed the House in December 2017 with bipartisan support.
- ◆ **2018: SEC Withdraws 2004 ISS and Egan-Jones No-Action Letters.** The withdrawal of these letters—which had contributed to an overreliance on proxy advisors—was a critical first step to further reforms.
- ◆ **2018: SEC Holds Roundtable on the U.S. Proxy System.** In November 2018, the SEC held a public roundtable that included a robust discussion about the state of the proxy advisory industry. It also received hundreds of comments on the subject, many of which supported greater SEC oversight of the industry.
- ◆ **2019: SEC Proposes Rules for Proxy Advisory Firms.** In November 2019, the SEC proposed rules that would codify the treatment of proxy advice as a “solicitation” and require that proxy advisory firms meet certain conditions to obtain an exemption from certain information and filing requirements under the federal proxy rules.
- ◆ **2020: SEC Finalizes Proxy Advisor Rule and Issues Commission Guidance.**