OSLER

SEC finalizes amendments to proxy rules applying to proxy advisory firms

AUGUST 20, 2020 13 MIN READ

Related Expertise

- Capital Markets
- Corporate Governance
- Mergers and Acquisitions

Authors: Jason Comerford, Andrew MacDougall

Last month, the U.S. Securities and Exchange Commission (the SEC) issued final amendments to its proxy rules to regulate certain activities of proxy voting advice businesses. The final rules follow proposed amendments issued by the SEC in December 2019, which were described in our Osler Update "SEC proposes amendments to proxy rules applying to proxy advisory firms." Generally, the final rules are less prescriptive and more principles-based than those proposed in December 2019 (the 2019 Proposed Rules).

Highlights of the final amendments include the following:

- The new provisions clarify that proxy voting recommendations by proxy voting advice businesses are "solicitations" that are subject to the SEC's proxy rules (including the prohibition on false or misleading statements).
- They clarify that exemption from the SEC's proxy information and filing requirements is available only if proxy voting advice businesses
  - include in their voting advice to clients specified disclosure relating to conflicts of interest; and
  - adopt publicly disclosed policies designed
    - to ensure that issuers that are the subject of proxy voting advice have that advice made available to them at or prior to the time when the advice is disseminated to the proxy voting advice business's clients; and
    - to provide clients with a mechanism by which they can become aware, in a timely manner before the shareholder meeting, of any written statements by issuers that are the subject of the proxy voting advice.
- There is no requirement to provide issuers with an advance draft of the proposed proxy voting advice for review and comment.
- The requirements to provide notice to an issuer of the proxy voting advice and to provide a mechanism to clients regarding written statements from the issuer do not apply to contested matters, most mergers and certain asset transactions.
- Proxy advice businesses must be in compliance with the new rules relating to conflicts and notice of advice by December 1, 2021.
- The rules do not apply with respect to Canadian issuers that are foreign private issuers under U.S. securities laws. However, the Ontario Capital Markets Modernization Taskforce

Consultation Report issued in July 2020 contemplates adoption of a regulatory framework aligned with the 2019 Proposed Rules.

The SEC emphasized in its release the important and prominent role of proxy voting advice businesses as intermediaries in the proxy voting process on behalf of institutional investors, which own a majority of the outstanding shares in today's market and retain such businesses to assist them in making their voting determinations and voting their shares. The SEC noted that in recent years, issuers, investors and others have expressed concerns about the role of proxy voting advice businesses. These concerns include the accuracy of information and the transparency of the methodologies used to formulate proxy voting advice businesses' recommendations. In addition, questions have been raised about whether issuers have an adequate opportunity to review and respond before shareholder votes informed by the advice of the proxy voting advice business are cast and whether shareholders have an adequate opportunity to review the proxy voting advice, including any response from the issuer or others, before casting their votes.

The SEC determined that proxy voting advice businesses need not comply with the information and filing requirements of federal proxy rules applicable to the solicitation of proxies so long as they satisfy certain rules tailored to their role in the proxy process. Those rules are focused on helping ensure their clients have reasonable and timely access to transparent, accurate and complete information material to investors on matters presented for a vote.

Proxy voting advisory business recommendations are solicitations

Consistent with the 2019 Proposed Rules (and the SEC's historical interpretation), the SEC amended the definitions of "solicit" and "solicitation" to expressly include any proxy voting advice that makes a recommendation to a holder of a class of shares subject to the SEC's proxy rules (such as shares of U.S. companies listed on U.S. stock exchanges) as to its vote, consent or authorization on a specific matter for which shareholder approval is solicited, and that is provided by a person that markets its expertise as a provider of proxy voting advice, separately from other forms of investment advice, and sells that proxy voting advice for a fee. However, the terms "solicit" and "solicitation" expressly exclude any proxy voting advice that is provided by a person only in response to an unprompted request. With these changes, those proxy voting recommendations become formally subject to liability under the SEC's prohibitions on false and misleading statements in proxy solicitations pursuant to Rule 14a-9 of the proxy rules.

Conflicts of interest

In its release, the SEC noted that some circumstances could create a risk that a proxy voting advice business's voting advice could be influenced by its own interests, which may call into question the objectivity and independence of its advice. Examples of potential conflicts of interest cited by the SEC include a proxy voting advice business providing

- voting advice to clients on proposals to be considered at the annual shareholders' meeting of the issuer while the proxy voting advice business also earns fees (or is seeking to earn fees) from that issuer for providing consulting advice to the company;
- voting advice on a matter in which its affiliates or one or more of its clients have a material interest, such as a business transaction or a shareholder proposal proposed or actively supported by one or more of its client(s);
- ratings to institutional investors of issuers' corporate governance practices while at the

same time, for a fee, consulting for, or asking to consult with, issuers that are the subject of the ratings on how to increase their rating level;

- voting advice with respect to a shareholder meeting of an issuer in which affiliates of the proxy voting advice business hold a significant ownership interest, sit on the issuer's board of directors or have relationships with a shareholder presenting a proposal covered by the proxy voting advice; and
- voting advice on a matter on which it or its affiliates have provided advice to an issuer, a proponent or other party regarding how to structure or present the matter or the business terms to be offered in such matter.

The SEC determined that clients of proxy voting advice businesses need to be informed of such relationships in order to be able to reasonably assess the materiality of any actual or potential conflicts of interest with respect to the proxy voting advice they receive. Accordingly, as a condition to being exempt from the SEC's proxy information and filing requirements, a proxy voting advice business must include in its voting advice (or in any electronic medium used to deliver that advice, such as a client voting platform) prominent disclosure of

- 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; and
- any policies used to identify, as well as steps taken to address, any such material conflicts of interest arising from such interest, transaction or relationship.

The final rule gives proxy voting advice businesses flexibility to determine the precise level of detail needed to address any identified conflicts of interest or whether a relationship or interest that has been terminated should nevertheless be disclosed. The SEC indicated that the key determinant will be whether the information is material to an evaluation of the proxy voting advice business's objectivity.

Notice to issuers of proxy voting advice

The SEC determined that in order to increase the confidence of participants in the proxy system that clients of proxy voting advice businesses have timely access to transparent, accurate and complete information material to their voting decisions, all issuers should have timely notice of proxy voting advice relating to their company and proxy voting businesses should provide their clients with a mechanism by which they can reasonably be expected to become aware of any written response by issuers to that advice in a timely manner. Accordingly, as a further condition to being exempt from the information and filing requirements of the SEC's proxy rules, under new Rule 14a-2(b)(9)(ii), a proxy voting advice business must adopt and publicly disclose written policies and procedures reasonably designed to ensure that

- issuers that are the subject of proxy voting advice have the advice made available to them at or prior to the time when the advice is disseminated to the proxy voting advice business's clients; and
- the proxy voting advice business provides its clients with a mechanism by which they can reasonably be expected to become aware of any written statements regarding its proxy voting advice by issuers that are the subject of such advice in a timely manner before the

shareholder meeting.

Although the 2019 Proposed Rules had contemplated a mechanism in which proxy voting advice businesses would be required to provide issuers or other proxy soliciting persons with an advance draft of their proposed advice for review and comment with prescribed minimum timeframes for such review, the SEC decided not to require a process for advance review and comment on proxy voting advice.[1]

To provide certainty, the new rule includes a non-exclusive "safe harbor." Under the safe harbor, a proxy voting advice business will be deemed to satisfy the new rule if it has written policies and procedures that are reasonably designed to provide issuers with a copy of its proxy voting advice, at no charge, no later than the time it is disseminated to the business's clients. These policies and procedures may include conditions requiring that the issuer

- file its definitive proxy statement at least 40 calendar days before the shareholder meeting (although proxy voting advice businesses are free to contemplate a shorter period prior to filing); and
- acknowledge in some manner that they will only use the proxy voting advice for their internal purposes and/or in connection with the solicitation and it will not be published or otherwise shared except with the issuer's employees or advisers.

Under the safe harbor, the proxy voting advice businesses are not required to inform the issuer if, after a copy of the advice has been provided to the issuer, it is later revised or updated in light of subsequent events. Also, the proxy voting advice business is not required to engage in a dialogue with the issuer or revise its voting advice in response to any feedback received (although in the 2019 Proposed Rules, the SEC noted that a proxy voting advice business may need to consider whether revisions based on feedback are necessary in order to ensure its advice does not contain any material misstatements or omissions).

Notice to clients of the issuer's responses

The exemption from the SEC's proxy information and filing requirements in new Rule 14a-2(b)(9)(ii) also requires a proxy voting advice business to adopt and publicly disclose written policies and procedures reasonably designed to ensure that it provides its clients with a mechanism by which they can reasonably be expected to become aware of an issuer's written statements about the proxy voting advice (regardless of whether or not the proxy voting advice business's voting recommendation is contrary to the company's recommendation) in a timely manner before the shareholder meeting.

A non-exclusive safe harbor will also be available to satisfy this requirement. Under the safe harbor, the proxy voting advice business may either

- provide notice on its electronic client platform that the issuer has informed the proxy voting advice business that it intends to file or has filed additional soliciting material (and include an active hyperlink to those materials on the SEC's EDGAR website when available); or
- provide notice through email or other electronic means that the issuer has informed the proxy voting advice business that it intends to file or has filed additional soliciting material (and include an active hyperlink to those materials on EDGAR when available).

Proxy voting advice businesses may use other means to satisfy the principles-based requirements under new Rule 14a-2(b)(9)(ii) instead of relying on the protection of the safe harbors. The SEC indicated that whether a proxy voting advice business has complied with

the principles-based requirements will be a fact-specific determination.

Circumstances where the issuer and client notice conditions do not apply

The issuer and client notice requirements under new Rule 14a-2(b)(9)(ii) apply to all benchmark and specialty policies of the proxy voting advice business, but do not apply to any based on custom voting policies that are proprietary to a proxy voting advice business's clients. In addition, the requirements will not apply to proxy voting advice (or the portion of such advice) relating to

- reclassifications, mergers or consolidations, and certain transfers of assets; or
- contested matters (such as contested director elections) where proxies are being solicited in compliance with federal proxy rules' information and filing requirements;

since these tend to be fast-moving and can be subject to frequent changes and short time windows. However, the requirements relating to conflicts of interest described above and the antifraud rules described below will apply.

Application of SEC's antifraud rules

Finally, to help ensure that the proxy voting advice business's clients are provided with the material information they need to make fully informed decisions, the SEC's new rules clarify that the SEC's prohibitions on false and misleading statements under Rule 14a-9 apply to proxy voting advice. The notes to Rule 14a-9 include a new paragraph stating that the failure to disclose material information regarding proxy voting advice, such as the proxy voting advice business's methodology, sources of information or conflicts of interest could, depending on the particular facts and circumstances, be misleading within the meaning of the rule.

Compliance dates

Proxy voting advice businesses will not be required to comply with the conflicts of interest disclosure and issuer and client notice provisions under new Rule 14a-2(b)(9) until December 1, 2021. The amendments relating to the definition of solicitation and the application of the antifraud provisions in the SEC's proxy rules to proxy voting advice business's recommendations codify existing SEC interpretations and guidance and so are not subject to a phase-in period.

Canadian implications

The SEC's proxy rules do not apply to securities of most Canadian companies that are registered with the SEC (such as Canadian companies that are cross-listed to a U.S. stock exchange) because most Canadian companies are eligible for an exemption available for foreign private issuers. However, the SEC's amendments will apply to proxy voting advice covering shares of Canadian companies that are registered with the SEC and that must comply with the SEC's proxy rules because they do not qualify as foreign private issuers. The SEC's new rules may also influence practices used by proxy voting advice businesses in Canada generally.

In April 2015, the Canadian Securities Administrators (the CSA) issued National Policy 25-201

Guidance for Proxy Advisory Firms, providing guidance for proxy advisory firms operating in Canada with respect to the identification, management, mitigation and disclosure to their clients of potential conflicts of interest, the devotion of resources to prepare rigorous and credible vote recommendations and transparency regarding the development of proxy voting guidelines. More recently, the Ontario Capital Markets Modernization Taskforce issued its Consultation Report in July 2020 in which it proposes to introduce a securities regulatory framework for proxy advisory firms to provide issuers with a right to "rebut" proxy advisory firm reports and restrict proxy advisory firms from providing consulting services to issuers in respect of which the firm also provides clients with voting recommendations. Considering the SEC's amendments, and the Taskforce proposal, Canadian securities regulators may revisit their approach and consider adopting measures similar to those reflected in the SEC's final rules.

---

[1] In not requiring advance review by issuers, the SEC noted that many commenters were concerned that advance review could have undermined the ability of proxy voting advice businesses to issue impartial advice, increased the risk of insider trading based on material nonpublic information and impinged on the free speech rights of proxy voting advice businesses.