INSIGHTS

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Editor-in-Chief
AMY L. GOODMAN
(phone) 301-908-0938
agoodman16@verizon.net

EDITORIAL ADVISORY BOARD

EDITORIAL OFFICE
28 Liberty Street,
New York, NY 10005
212-771-0600

Wolters Kluwer
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SECURITIES REGULATION

SEC Makes it Official — Proxy Advisory Firms are Subject to Proxy Solicitation Rules

The SEC's proxy rule amendments will not only impact proxy advisory firms but also issuers' actions in preparing for upcoming proxy seasons. In addition, the supplemental guidance for investment advisers will require them to consider carefully their proxy voting responsibilities.

By David Martin, Reid Hooper, and Sebastian Marotta

On July 22, 2020, the Securities and Exchange Commission (SEC) adopted proxy rule amendments dealing with proxy advisory firms as part of its ongoing effort to modernize the proxy voting system.[1] The proxy rule amendments, which were proposed in November 2019, codify the SEC's view that proxy voting advice generally constitutes a solicitation under the proxy rules.[2] At the same time, proxy advisory firms may still rely, subject to newly adopted conditions, on certain exemptions from the most burdensome provisions of those proxy rules. In addition, the proxy rule amendments make clear that failure to disclose material information about proxy voting advice may be considered misleading under the anti-fraud provision of the proxy rules.

Certain proposed amendments were not included in the final rules. Notably absent is the requirement for a proxy advisory firm to provide an issuer with its proxy voting advice for the issuer's review and comment *prior to* the distribution of the proxy voting advice to the proxy advisory firm's clients.

In conjunction with the proxy rule amendments, the SEC also voted to publish supplemental guidance to investment advisers related to how proxy voting advice should be used when making their voting decisions.[3] In particular, the guidance addresses the proxy advisory firm's electronic vote management system that pre-populates a proxy for the investment adviser with suggested votes—so-called robo-voting. The supplemental guidance suggests that an investment adviser should take additional steps, such as assessing the pre-populated votes, considering additional information that may become available before the relevant votes are cast, and reviewing whether its policies and procedures are reasonably designed to ensure that the adviser exercises its voting authority in its client's best interest.

David Martin, Reid Hooper, *and* **Sebastian Marotta** *are attorneys with Covington & Burling LLP.*

Proxy Rule Amendments

Amendments to the Definition of "Solicit" and "Solicitation"

Section 14(a) of the Securities Exchange Act of 1934 (Exchange Act) creates a federal regulatory regime around the "solicitation" of proxies. A communication that constitutes a "solicitation" of a proxy will be subject to the SEC's proxy rules, whereas an act that falls outside the definition of a "solicitation" will not be regulated by the SEC. Rule 14a-1(l)(iii) of the SEC's proxy rules under the Exchange Act defines a "solicitation" as including a

> communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy.

The SEC has interpreted the term broadly and, in guidance published in August 2019, stated its view that "solicitation" encompasses the furnishing of proxy voting advice by proxy advisory firms.[4] In

that guidance, the SEC stated that this long-held interpretation dates to an interpretive release issued in 1964 which recognized that proxy voting advice, though potentially beneficial to shareholders, likely falls within the definition of a solicitation.[5] Many institutional investors and other stakeholders have questioned whether the SEC has the authority to regulate proxy advisory firms under Section 14(a) of the Exchange Act.[6] Some have argued that the SEC's definition is overbroad and has the potential to extend regulations to actors that are not engaging in solicitations according to the common-sense interpretation of the term.[7]

By adopting the proxy rule amendments, the SEC rejected these comments and codified the view it announced in its 2019 guidance. In this regard, the proxy rule amendments clarify that the terms "solicit" and "solicitation" include any proxy voting advice which (a) makes a recommendation to a shareholder as to a vote, consent, or authorization on a matter for which shareholder approval is solicited, and (b) is furnished by a person who markets its expertise as a provider of such advice and sells such advice for a fee.[8] This is true regardless of whether such proxy voting advice is based on custom policies that are proprietary to a client of the proxy advisory firm.

The proxy rule amendments also provide, however, that proxy voting advice given by a person who furnishes such advice only in response to an unprompted request shall *not* be deemed to be a solicitation.[9] The SEC said that this codifies its historical view with respect to this kind of advice.[10]

Exempt Solicitations

Irrespective of whether voting recommendations of proxy advisory firms may be considered solicitations, they generally have been considered exempt from the filing and disclosure requirements of the proxy rules by virtue of two existing exemptions—Rules 14a-2(b)(1) and (3). The first of those two exemptions is available for a solicitation by someone who does not seek the power to act as a proxy for a shareholder and does not have substantial interest in the subject matter of the communication beyond an interest as a shareholder.[11] The other exemption is available for proxy voting advice furnished by a proxy advisory firm to any other person with whom the firm has a business relationship.[12] The proxy rule amendments provide that proxy advisory firms may no longer rely on these exemptions unless they comply with new Rule 14a-2(b)(9), which requires disclosure of conflicts of interests and appropriate policies and procedures, as follows.

Proxy advisory firms must now provide specified conflict of interest disclosure in their proxy voting advice.

In order to continue relying on these existing exemptions, proxy advisory firms must now provide specified conflict of interest disclosure in their proxy voting advice or in an electronic medium used to deliver the proxy voting advice to their clients.[13] That disclosure must cover any interest, transaction, or relationship involving the proxy advisory firm and the subject of its advice, to the extent that the information is material to assessing the objectivity of the firm's advice in light of the particular facts and circumstances. The proxy advisory firm also must disclose any policies and procedures used to identify such material conflicts of interests, in addition to the steps taken to address the applicable conflicts of interest.[14]

Under Rule 14a-2(b)(9), proxy advisory firms also must adopt and publicly disclose written policies and procedures reasonably designed to ensure two things. First, that the proxy advisory firm makes its proxy voting advice regarding a particular issuer available to that issuer at or prior to the time such advice is given the firm's clients.[15] Second, that the proxy advisory firm provides its clients with a mechanism by which those clients may reasonably be expected to become aware of any written statements by issuers regarding the firm's proxy voting advice about those issuers, in

a timely manner before the applicable shareholder meeting.[16] Proxy voting advice based on custom policies that are proprietary to a client of the proxy advisory firm, however, is excluded from the requirements of the amended rule.[17]

To provide assurance to a proxy advisory firm that its written policies and procedures satisfy the above requirements, the proxy rule amendments include two non-exclusive safe harbors. A proxy advisory firm will be deemed to satisfy the written policies and procedures requirement if those policies and procedures are reasonably designed to provide an issuer with a copy of the firm's proxy voting advice, at no charge, no later than when the advice is provided to the firm's clients. In that regard, however, the safe harbor also provides that such policies may include conditions requiring an issuer to: (1) file its definitive proxy statement at least 40 calendar days before the shareholder meeting; and (2) expressly acknowledge that the issuer will only use the proxy voting advice for its own internal purposes and will not publish or share the proxy voting advice except with the issuer's own employees or advisers. However, if desired, proxy advisory firms may structure their policies to accommodate issuers that may file definitive proxy statements less than 40 calendar days before the shareholder meeting and remain within the safe harbor.

Automated voting has been particularly controversial.

A proxy advisory firm will be deemed to satisfy the requirement to make clients aware of issuers' statements regarding proxy voting advice if its policies and procedures are reasonably designed to provide notice. This may be given on the proxy advisory firm's electronic client platform or through email or other electronic means. The notice must indicate that the issuer has filed, or has informed the proxy advisory firm that it intends to file, additional soliciting materials setting forth the issuer's statement regarding the advice (and include an active hyperlink to those materials on EDGAR when available).

A proxy advisory firm will not need to comply with Rule 14a-2(b)(9)(ii) in order to rely on either the Rule 14a-2(b)(1) or (b)(3) exemption, however, to the extent that its proxy voting advice relates to a non-exempt solicitation regarding certain mergers and acquisitions or contested matters, regardless of who is making such solicitation.[18] Additionally, to the extent that a proxy advisory firm amends its previously issued proxy voting advice, the proxy advisory firm is not required to make available to issuers such amended advice.[19]

Modifications to Rule 14a-9

Rule 14a-9 prohibits materially false or misleading statements made in the solicitation of a proxy. Previously, the rule contained four examples of what may constitute a false or misleading statement depending on the particular facts and circumstances. The proxy rule amendments modify Rule 14a-9 by adding a new example that illustrates when the failure to disclose certain material information along with proxy voting advice could, depending on the facts and circumstances, be considered misleading within the meaning of the rule. This could include the failure to disclose material information about the proxy advisory firm's methodology, sources of information, or conflicts of interest.

Investment Adviser Supplemental Guidance

The SEC also supplemented prior guidance to assist investment advisers in fulfilling their proxy voting responsibilities and complying with their fiduciary duties in light of the proxy rule amendments. The supplemental guidance addresses the situation when an investment adviser uses a proxy advisory firm's electronic vote management system for population of the adviser's proxies with suggested voting recommendations (pre-population) or for voting execution services (automated voting).[20] Known colloquially as "robo-voting," automated voting has

been particularly controversial and was criticized in comment letters submitted to the SEC by issuers and industry groups.[21]

In order to comply with its fiduciary duties to its clients, the supplemental guidance encourages investment advisers to consider material information that becomes available after the delivery of the prepared proxies but before the submission deadline for proxies to be voted at the shareholder meeting. The supplemental guidance suggests that an investment adviser take additional steps, such as assessing the pre-populated or automated proxies rather than accepting them without review, considering additional information that may become available before the relevant votes are cast but after the pre-populated proxies are provided to the investment adviser by the proxy advisory firm, and reviewing its policies and procedures to ensure that the adviser exercises its voting authority in its client's best interest.[22] The SEC states that these steps are important as they relate to the investment adviser's obligation, under its duty of loyalty to the client, to provide full and fair disclosure that underpin the client's consent to the use of automated voting.

What's Next and Takeaways

Proxy advisory firms will not be required to comply with Rule 14a-2(b)(9), the new conditions for reliance on exempt solicitations under Rules 14a-2(b)(1) and (3), until December 1, 2021. That transition period, however, does not extend to the amendments to Rules 14a-1(l) and Rule 14a-9, which will be effective 60 days after publication of the final rules in the Federal Register. Eventual compliance with the rules may depend on whether the SEC receives additional challenges to the rulemaking.[23]

In dealing with the proxy rule amendments, issuers will want to think about several aspects when preparing for upcoming proxy seasons. For example, the proxy rule amendments reflect the SEC's judgment that more effective engagement between issuers and proxy advisory firms will produce more informed advice by proxy advisory firms thereby contributing to more informed decision-making by their investment adviser clients. The requirement under the new rules for proxy advisory firms to provide proxy voting advice to issuers, without charge, should provide issuers that do not currently purchase, or otherwise have an opportunity to obtain, such reports more access and time to respond to such advice. Additionally, the requirement for the proxy advisory firms to disclose conflicts of interest and appropriate policies and procedures will provide more transparency regarding the proxy advisors' services offered to issuers, investors, and other market stakeholders.

The increased access to proxy voting advice is likely to result in more use by issuers of additional soliciting materials.

In order to assure seamless access to proxy voting advice, issuers will need to be able to meet the conditions for such access that proxy advisory firms are likely to require in order to avail themselves of the safe harbors in new Rule 14a-2(b)(9)—that is, filing their definitive proxy statements at least 40 calendar days before shareholder meetings and acknowledging that they only will use the proxy voting advice for its own internal purposes and will not publish or share the proxy voting advice except with their employees or advisers. The terms of these conditions are yet to be worked out by the proxy advisory firms, and it remains to be seen whether issuers will be willing to enter into such limited use arrangements with the advisory firms if the issuers are able to obtain copies of the reports and recommendations through other means. Issuers will want to pay particular attention to the firms' policies and procedures when they are finalized.

The increased access to proxy voting advice also is likely to result in more use by issuers of additional soliciting materials in responding to negative or critical proxy voting recommendations by proxy advisory firms. And, in this process, issuers may now

pursue more pointed arguments that identify perceived factual errors in the advice and failures in that advice to disclose material information about the proxy advisory firm's methodology, sources of information, and conflicts of interest. Issuers also may consider highlighting the duties of investment advisers to take steps to ensure that the voting recommendations they receive are not based on errors made by the proxy advisory firms in making those recommendations. Effective use of the new notice procedure and hyperlink requirement as a vehicle for communicating those views and concerns directly to the investment advisers could be advantageous for issuers.

In mergers and acquisitions transactions and contested matters, issuers also may consider how the new proxy rule amendments could come into play. The amendments to Rule 14a-9 and the SEC's reaffirmed position that the anti-fraud rules apply to proxy advisory firms' recommendations, for instance, may create heightened scrutiny of those recommendations and liability risks for the proxy advisory firms, potentially resulting in greater opportunities for engagement with such firms. Issuers and other participants should be even more prepared to review and quickly develop responses to negative recommendations along with their teams of legal and financial advisors, proxy solicitors, and investor and public relations specialists.

New disclosures regarding conflicts of interest will facilitate deeper and more focused due diligence.

Lastly, investment advisers will find that new disclosures regarding conflicts of interest will facilitate deeper and more focused due diligence. This could weigh on an adviser's assessment of both the objectivity and reliability of the advice it is being given. On the other hand, advisers themselves will need to reassess their reliance on voting management systems. The stern warning of one of the SEC's commissioners that the new guidance is to the effect that fiduciary duty cannot be outsourced will cause reassessment of internal resources and overall voting policies, including, potentially, the increased use of abstentions.

Notes

1. *See Exemptions from the Proxy Rules for Proxy Voting Advice*, Release No. 34-89372 (July 22, 2020), available at *https://www.sec.gov/rules/final/2020/34-89372.pdf*. The SEC's focus dates back to a 2010 Concept Release and, more recently, a staff roundtable in 2018. *See Concept Release on the U.S. Proxy System*, Release Nos. 34-62495; IA-3052; IC-29340 (July 14, 2010), available at *https://www.sec.gov/rules/concept/2010/34-62495.pdf*; *Roundtable on the Proxy Process, Securities and Exchange Commission* (Nov. 15, 2018), available at *https://www.sec.gov/proxy-roundtable-2018*.
2. *See Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice*, Release No. 34-87457 (Nov. 5, 2019), available at *https://www.sec.gov/rules/proposed/2019/34-87457.pdf*.
3. *See Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers*, Release No. IA-5547 (July 22, 2020), available at *https://www.sec.gov/rules/policy/2020/ia-5547.pdf*. The supplemental guidance follows the SEC's recent interpretive guidance clarifying the applicability of the proxy rules to proxy voting advice and the proxy voting responsibilities of investment advisers. *See Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice*, Release No. 34-86721 (Aug. 21, 2019), available at *https://www.sec.gov/rules/interp/2019/34-86721.pdf*; *Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers*, Release Nos. IA-5325; IC-33605 (Aug. 21, 2019), available at *https://www.sec.gov/rules/interp/2019/ia-5325.pdf*.
4. Release No. 34-86721, *supra* n.3, at 9.
5. *Id.* (citing internally to *Broker-Dealer Participation in Proxy Solicitations*, Release No. 7208 (Jan. 7, 1964).
6. *See, e.g.*, Council of Institutional Investors, Comment Letter to the Securities and Exchange Commission Re:

File No. S7–22–19 (Jan. 30, 2020), available at *https://www.cii.org/files/issues_and_advocacy/correspondence/2020/20200130%20PAF%20comment%20letter%20FINAL.pdf*.

7. *See* CFA Institute, Comment Letter to the Securities and Exchange Commission Re: Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice (Feb. 3, 2020), available at *https://www.sec.gov/comments/s7-22-19/s72219-6738832-207643.pdf*.
8. 17 C.F.R. § 240.14a-1(l)(1)(iii)(A).
9. § 240.14a-1(l)(2)(v).
10. *See* Release No. 34-89372, *supra* n.1, n. 84.
11. 17 C.F.R. § 240.14a-2(b)(1).
12. § 240.14a-2(b)(3).
13. § 240.14a-2(b)(9)(i).
14. *Id.*
15. 17 C.F.R. § 240.14a-2(b)(9)(ii)(A).
16. § 240.14a-2(b)(9)(ii)(B).
17. § 240.14a-2(b)(9)(v).
18. § 240.14a-2(b)(9)(vi).
19. § 240.14a-2(b)(9)(ii)(A).
20. Release No. IA-5547, *supra* n.3, at 5.
21. *See, e.g.*, National Association of Manufacturers, Comment Letter to the Securities and Exchange Commission Re: File No. 4-725: SEC Roundtable on the Proxy Process (Oct. 30, 2018), available at *https://www.sec.gov/comments/4-725/4725-4581799-176285.pdf*.
22. Release No. IA-5547, *supra* n.3, at 5.
23. On October 31, 2019, Institutional Shareholder Services filed a lawsuit challenging the SEC's guidance issued in August 2019 on both procedural and substantive grounds. *See* ISS v. SEC, No. 19-cv-03275 (D.D.C., filed Oct. 31. 2019). On January 17, 2020, the SEC filed an Unopposed Motion to Hold Case in Abeyance, which the Federal District Court in Washington, D.C. granted and resulted in a stay in the litigation until the earlier of January 1, 2021 or the promulgation of final rules in the SEC's proxy advisor rulemaking. In light of the changes made in the final proxy rule amendments and the differences from what was originally proposed, it remains to be seen whether ISS will withdraw the lawsuit or file an amended complaint.