SEC Proposed Rules to Regulate Proxy Advisory Firms and Shareholder Proposals

November 12, 2019

On November 5, 2019, at an open meeting the SEC voted (3 to 2) to propose amendments to the proxy rules. The proposed **amendments** relate to regulating proxy advisory firms. The Commission also voted to propose **amendments** with regard to shareholder proposals, including eligibility standards for submission and resubmission. Chairman Jay Clayton observed that the proposals were "rooted in two essential aspects of effective regulation: modernization and retrospective review."

The SEC is soliciting public comment, through numerous questions in both proposals covering a range of topics and alternatives, for 60 days after their publication in the *Federal Register*.

I. Application of the Proxy Solicitation Rules to Proxy Voting Advice Businesses

The proposed amendments would codify the SEC's current interpretation that an entity that markets, offers and sells proxy voting advice is engaged in solicitation. The proposal would modify the current definition of "solicitation" from a "communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy" to include "[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 . . . . " A proxy voting advice business (which we refer to herein as a "proxy advisory firm") would be one that "markets its expertise as a provider of . . . proxy voting advice, separately from other forms of investment advice, and sells such proxy voting advice for a fee." Any proxy voting advice furnished by a person only in response to an unprompted request would not constitute a solicitation.

A proxy advisory firm would be exempt from the filing and information requirements under the proxy solicitation rules if the firm meets three conditions: (1) it discloses material conflicts of interest; (2) it provides companies an opportunity to preview and respond to the proxy voting advice before the firm sends the advice to its clients; and (3) it provides companies an opportunity to share a written statement for clients' consideration along with its proxy voting advice.

The SEC seeks comment on whether the proposed amendments would inadvertently include other types of communications and whether distinctions such as conditioning the advice on being "marketed and sold separately" are sufficient.

Disclosure of conflicts of interest

A proxy advisory firm would have to provide disclosures about material conflicts of interest with respect to (1) any material interests the proxy advisory firm (or its affiliates) has in the matter or the parties concerning which the firm is providing the advice; (2) any material transaction or relationship between the proxy advisory firm (or its affiliates) and the company, another soliciting person, or a shareholder-proponent, in connection with the matter covered by the proxy voting advice; and (3) any other information regarding the interest, transaction, or relationship of the proxy advisory firm (or its affiliates) that is material to assessing the objectivity of the proxy voting advice. In addition, the proposal would require a description of the policies and procedures the proxy advisory firm uses for identifying and addressing material conflicts of interest.

This disclosure may capture the retention by a company of the corporate services offered by the proxy advisory firm. The release proposing these amendments questions whether these disclosures should also be made public.

Opportunity to preview proxy voting advice and respond

A proxy advisory firm must provide a company an opportunity to preview the proxy voting advice and offer feedback before the firm furnishes the advice to its clients. ISS currently provides this service to S&P 500 companies. The ability under the proposed rule to review and respond, which is optional for a company, would not depend on whether the proxy voting advice is adverse to the voting recommendation of the company.

The proposed rules would also extend the opportunity to review and respond to persons who are conducting nonexempt solicitations through the use of a proxy statement and a proxy card, such as dissident shareholders in contested elections, but not proponents who file shareholder proposals or other shareholders that campaign about ballot items through exempt filings.

Under the proposed rules, so long as a company files its definitive proxy statement 25 calendar days in advance of the shareholder meeting, the company would be able to receive the proxy voting advice in advance of its release, review the content of the report and provide a response to the proxy advisory firm. The duration of the review and response period would depend on the time period between filing the definitive proxy statement and the shareholder meeting date as follows:

Number of Calendar Days the Definitive Proxy Statement Is Filed Before the Shareholder Meeting	Length of Review and Response Period
at least 45	at least 5 business days
fewer than 45, but at least 25	at least 3 business days
fewer than 25	none

Note that the proxy advisory firm would not be required to engage with the company about its response, nor would it be required to modify its advice in any form after receiving the company's response.

A proxy advisory firm could ask a company to enter into a confidentiality agreement and not publicly comment on information relating to the proxy voting advice until the proxy advisory firm has disseminated the advice to its clients. Among other questions, the release requests comment on whether companies should bear some of the associated costs.

Opportunity to provide a company's perspective in the proxy advisory firm voting recommendations

A company could have its own written statement accompany the corresponding proxy voting advice that a proxy advisory firm delivers to its clients. The proposed mechanism would require that a proxy advisory firm provide the company with a copy of the notice that the proxy advisory firm intends to furnish to its clients ("final notice of voting advice") no earlier than the expiration of the review and response period and at least two business days prior to the proxy advisory firm's delivery of the advice to its clients.

The company would then have the option to request that a hyperlink (or other analogous electronic medium) to a response statement be included in the proxy advisory firm's voting recommendation report. Certain other soliciting persons, such as shareholders engaged in a proxy contest, would also be permitted to provide response statements.

All company and shareholder statements would have to be filed with the SEC as additional soliciting materials no later than the date that the proxy voting advice is first published, sent, or given to shareholders.

Once the two-day final notice period has expired, a proxy advisory firm would not be required to offer the company any additional opportunities to include a hyperlink in the notice or to review the notice before it is sent to the firm's clients. Companies would be able to continue to file additional soliciting materials at any time.

The exemption of a proxy advisory firm in the case of an immaterial or unintentional failure to comply with the updated rules would be protected as long as (a) the proxy advisory firm made "a good faith and reasonable effort" to comply and (b) the proxy advisory firm used reasonable efforts to remedy the noncompliance as soon as practicable. Failure to comply with the conditions for exemption under the proxy solicitation rules would not create a new private right of action for registrants against proxy advisory firms.

Proxy anti-fraud rules

In addition, as with the recent August 2019 **guidance**, the SEC indicates that proxy advisory firms are subject to the anti-fraud provisions under Exchange Act Rule 14a-9. Currently, Rule 14a-9 provides four examples of what may be considered misleading within the meaning of the rule. The amended rules would add four more examples related to the failure to disclose: (1) material information regarding the proxy advisory firm's methodology, (2) sources of information, (3) conflicts of interest, and (4) the use of standards that materially differ from relevant standards or requirements that the SEC sets or approves.

The last example addresses company concerns that there may be confusion when a negative recommendation is not based on applicable SEC requirements, but rather on standards selected by the proxy advisory firm. As a result, the proxy advisory firm would need to specify when its recommendation reflects its own policies rather than noncompliance with SEC rules. The SEC emphasizes that a proxy advisory firm would be allowed to establish its own criteria for making recommendations.

One-year transition period

The SEC has proposed that a one-year transition period be instituted after the publication of the final rule in the *Federal Register* to permit market participants sufficient time to comply.

II. Rule 14a-8 Shareholder Proposals

The proposed amendments to the shareholder proposal rules would: (i) institute a tiered approach for submission eligibility based on the value and duration of equity ownership; (ii) require the shareholder to state its availability to discuss in person or by telephone the proposal with the company; (iii) raise the current resubmission thresholds; (iv) mandate additional information when a shareholder authorizes a representative to submit the proposal on its behalf; and (v) refine the rule limiting shareholders to one proposal submission per meeting.

Eligibility thresholds

Under the current eligibility requirements, a shareholder must hold at least $2,000 or 1 percent of a company's securities for at least one year. The proposed rule would eliminate the 1 percent criterion, establishing a tiered eligibility structure as follows:

- Continuous ownership of at least $2,000 for at least three years;
- Continuous ownership of at least $15,000 for at least two years; and
- Continuous ownership of at least $25,000 for at least one year.

A shareholder-proponent would have to satisfy these requirements individually and would not be permitted to aggregate holdings with other shareholders. Shareholders would continue to be permitted to co-file or
co-sponsor shareholder proposals as a group. While the SEC views co-filers' designation of a lead filer as a best practice, the proposed rules do not mandate the practice and instead the SEC seeks comment.

Eligibility thresholds for resubmission of substantially similar shareholder proposal

Under proposed Rule 14a-8(i)(12), a shareholder proposal may be excluded from a company's proxy materials if it deals with substantially the same subject matter as a prior proposal that failed to receive majority shareholder support within the preceding five years, if the most recent vote occurred within the preceding three calendar years and that vote was:

- Less than 5 percent (currently 3 percent) of the votes cast if previously voted on once;
- Less than 15 percent (currently 6 percent) of the votes cast if previously voted on twice; or
- Less than 25 percent (currently 10 percent) of the votes cast if previously voted on three times or more.

The proposed rule also adds a restriction, which the SEC release refers to as the "Momentum Requirement," for when a proposal failed to gain majority support three or more times in the last five years and experienced a 10 percent or more decline in shareholder support.

Information and documentation requirements, including when using a representative

The shareholder would be required to specify contact information as well as the dates and times between 10 to 30 calendar days of the proposal's submission that the shareholder would be available to discuss the proposal with the company. When a shareholder utilizes a representative, satisfying this requirement would be based on the shareholder's availability, not the representative's, although the representative would be permitted to participate in the engagement.

As proposed, when a representative of a shareholder submits a proposal, the representative would be required to provide documentation signed and dated by the shareholder:

- Identifying the company to which the proposal is directed;
- Identifying the meeting for which the proposal is submitted;
- Identifying the shareholder-proponent and the designated representative;
- Including the shareholder's authorization of the representative to submit the proposal and/or otherwise act on the shareholder's behalf;
- Identifying the specific proposal to be submitted; and
- Including the shareholder's statement supporting the proposal.

This proposed documentation requirement would largely codify current SEC Staff Legal Bulletin No. 14I.

Limitation of one proposal submission per shareholder meeting

While Rule 14a-8(c) provides that "[e]ach shareholder may submit no more than one proposal to a company for a particular shareholders' meeting", a shareholder can currently submit a proposal on his or her own behalf while simultaneously submitting another proposal as the representative of another shareholder. As proposed, the amended rules would limit the number of proposals that each "person," rather than each "shareholder," could submit at each meeting to one proposal. A shareholder-proponent would no longer be able to submit a proposal as a shareholder while concurrently submitting another proposal as a representative of another shareholder. Similarly, a person would be prohibited from acting as a representative for more than one shareholder.

SEC's role in shareholder proposals

The SEC Staff stated in a recent **announcement** that, starting in the 2019-2020 proxy season, it may no longer provide a written response letter to all Rule 14a-8 no-action requests. The SEC requests public comment in this proposing release on how market participants view the SEC's role.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Maurice Blanco	+55 11 4871 8402	**maurice.blanco@davispolk.com**
Joseph A. Hall	+1 212 450 4565	**joseph.hall@davispolk.com**
Michael Kaplan	+1 212 450 4111	**michael.kaplan@davispolk.com**
Sarah K. Solum	+1 650 752 2011	**sarah.solum@davispolk.com**
Richard D. Truesdell, Jr.	+1 212 450 4674	**richard.truesdell@davispolk.com**
Ning Chiu	+1 212 450 4908	**ning.chiu@davispolk.com**
Betty Moy Huber	+1 212 450 4764	**betty.huber@davispolk.com**
Paula H. Simpkins	+1 212 450 4055	**paula.simpkins@davispolk.com**