

# Meridian Client Update

## SEC Issues Proposed Rules Regulating Proxy Advisory Firms

On November 5, 2019, the Securities and Exchange Commission (“SEC”) issued proposed rules that would impose a new regulatory regime on proxy advisory firms (“PAFs”).

- PAFs, for the first time, would be required by law to preview their proxy voting advice with covered registrants before publishing their voting reports and disclose conflicts of interest.
- A registrant generally would be given either three or five days to review and provide feedback on a PAF’s proxy voting advice prior to its publication based on when the registrant filed its annual meeting proxy with the SEC.
- A PAF would not be required to modify its proxy voting advice based on the registrant’s feedback.
- A registrant could require its feedback to be included in a PAF’s proxy voting advice by hyperlink.
- A PAF would be required to provide a registrant its final proxy voting advice *prior to* its delivery to its institutional shareholder clients.
- A PAF that fails to comply with the proposed rules on previewing proxy voting advice and disclosing conflicts of interest would be subject to the information and filing requirements under the proxy rules.
- A PAF’s proxy voting advice that fails to include certain information (e.g., methodology used to determine vote recommendations) could be found to be misleading and, thereby, subject the PAF to legal sanctions and penalties.

Since the SEC held its roundtable discussion on the proxy voting process in November 2018, the SEC has indicated that it was poised to issue proposed rules regulating PAFs. The issuance of the proposed rule represents the culmination of a years long effort to impose a new regulatory regime on the PAFs. The proposed rules would:

- Codify the SEC’s interpretation that proxy voting advice generally constitutes a solicitation within the meaning of the Securities Exchange Act of 1934.
- Amend the proxy rules to clarify when the failure to disclose certain information in proxy voting advice may be considered misleading within the meaning of the rule.
- Condition the availability of certain existing exemptions from the information and filing requirements of the federal proxy rules for PAFs upon compliance with additional disclosure and procedural requirements.

## Proxy Voting Advice Constitutes a Solicitation under Federal Securities Law

On August 21, 2019, the SEC issued *interpretive guidance* clarifying that PAFs' proxy voting advice generally constitutes a solicitation within the meaning of the Securities and Exchange Act of 1934. The proposed rule would codify this interpretative guidance on PAFs' proxy voting advice. As a form of proxy solicitation, proxy voting advice would be required to satisfy Rule 14a-9 ("Anti-Fraud Requirements"), which requires solicitations to be free from false or misleading statements or omissions of material facts. A PAF's failure to comply with the Anti-Fraud Requirements could subject it to legal sanctions and penalties.

## Failure to Disclose Certain Information in Proxy Voting Advice May be Considered Misleading

The proposed rule would amend the proxy rules to provide illustrative examples of when a PAF's failure to disclose certain information in proxy voting advice may cause such advice to be false or misleading within the meaning of Rule 14a-9. Specifically, the examples provide that a PAF's proxy voting advice may be considered misleading due to the PAF's failure to disclose:

- The methodology used to develop its proxy voting advice,
- The sources of information used to develop its proxy voting advice,
- Conflicts of interest, or
- Use of standards that materially differ from relevant standards or requirements that the SEC sets or approves.

## PAFs' Exemption from Proxy Rules Conditioned on Compliance with Certain Disclosure and Procedural Requirements

Historically, the SEC has exempted certain kinds of solicitations from the proxy rules (i.e., information and filing requirements). For example, the SEC has exempted from the information and filing requirements communications by persons not seeking proxy authority and proxy voting advice given by advisors to their clients under certain circumstances. PAFs typically rely on these exemptions to provide proxy voting advice, without the necessity of complying with the filing and information requirements of the proxy rules. The proposed rule would make the availability of these exemptions conditioned upon a PAF's compliance with the following requirements: (i) registrant's review of and commentary on the PAF's proxy voting advice and (ii) conflicts procedures and disclosures, each of which is described below.<sup>1</sup>

- Registrant Review and Commentary on PAFs' Proxy Voting Advice. A PAF would be required to implement the following procedures to obtain feedback from registrants on the PAF's proxy voting advice.
  - Review and Feedback Period. A PAF would be required to provide a registrant an opportunity to review and provide feedback on the PAF's proxy voting advice covering the registrant. However, a PAF would be under no obligation to modify its proxy voting advice based on the registrant's feedback. The length of the required review and feedback period varies based on the time between the date a registrant files its annual meeting proxy and the date of the annual meeting, in accordance with the following table:

Number of Days Proxy is Filed Prior to the Annual Meeting	Registrant's Review and Feedback Period
At least 45 calendar days	No less than 5 business days
At least 25 calendar days but less than 45 calendar days	No less than 3 business days
Less than 25 calendar days	No obligation to provide review and feedback period

<sup>1</sup> The proposed rule would also impose these requirements on PAFs with respect to certain other soliciting persons (such as dissident shareholders engaged in a proxy contest).

- Final Notice of Proxy Voting Advice. A PAF would be required to provide a registrant a final notice (“Notice”) of the PAF’s proxy voting advice (i) no earlier than the end of the applicable review and feedback period and (ii) no later than two business days prior to delivery of the proxy voting advice to the PAF’s clients. The Notice would be required to include a copy of the proxy voting advice, including any revisions to such advice made by the PAF after the review and feedback period. Once the two business day period has elapsed, the PAF would be under no further obligation to provide the registrant with additional opportunities to review its proxy voting advice with respect to the same meeting.
- Hyperlink to Registrant’s Feedback on Proxy Voting Advice. At the request of a registrant prior to expiration of the applicable review and feedback period, the PAF would be required to include in its proxy voting advice and in any electronic medium used to deliver the proxy voting advice an active hyperlink or any other analogous electronic medium that leads to the registrant’s statement regarding the PAF’s proxy voting advice.
- Conflicts Procedures and Disclosures. A PAF would be required to prominently disclose in proxy voting advice materials the following items:
  - Any material interest in the matter or parties covered by the PAF’s proxy voting advice;
  - Any material transaction or relationship between the PAF and the registrant;
  - Any other information regarding the interest, transaction, or relationship of the PAF that is material to assessing the objectivity of the proxy voting advice; and
  - 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.

### **Comment Period and Transition Period If SEC Adopts Final Rule**

Comments on the proposed rule must be submitted to the SEC no later than sixty days after the rule is published in the Federal Register (as of the date of this Client Update, the SEC has yet to post the proposed rule in the Federal Register).

The SEC has proposed a one-year transition period after the publication of a final rule, if adopted, to give affected parties sufficient time to comply with the proposed new requirements.

***Meridian Comments.* The SEC is under no obligation to adopt a final rule within a specified period following the conclusion of the comment period. However, given SEC Chair Clayton’s previously stated interest in this area, the SEC is not likely to drag its feet on the proposed rule. We anticipate that the SEC is likely to adopt a final rule during the second or third quarter of 2020. If that is the case, then the final rule would not go into effect until 2021.**

However, the SEC’s attempt to impose a new regulatory regime on PAFs faces a rocky road ahead. The SEC is already receiving strong pushback from investor associations, certain large institutional investors and governance groups who believe the SEC proposal is unnecessary and counterproductive to maintaining good corporate governance. We anticipate that investors and investor groups will file a significant number of comment letters that are strongly critical of the SEC proposal. The SEC’s response to such criticism will be interesting to observe, given that the SEC is charged with protecting the interests of these very parties.

However, the real battle over the SEC’s proposed rule will likely be played out in the federal courts. Institutional Shareholder Services (ISS) is already suing the SEC in federal district court over the agency’s

previously issued guidance that proxy voting advice from a PAF constitutes a “solicitation” under federal securities laws.<sup>2</sup> ISS contends that the SEC lacks authority to regulate proxy voting advice as though it were a solicitation. ISS is seeking (i) a declaratory judgment holding that proxy voting advice does not constitute a solicitation and (ii) an injunction prohibiting the SEC from taking enforcement action against ISS based on the agency’s interpretation of proxy solicitation rules. If the district court rules in ISS’s favor, the court would likely issue an order that would prevent the SEC from moving forward on the proposed rule absent a successful legal appeal.

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The *Client Update* is prepared by Meridian Compensation Partners’ Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or [dkalfen@meridiancp.com](mailto:dkalfen@meridiancp.com).

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<sup>2</sup> On August 21, 2019, the SEC released interpretation and related guidance regarding the applicability of certain federal proxy rules to proxy voting advice rendered by PAFs. In this release, the SEC stated that such advice constitutes a solicitation under the Securities and Exchange Act of 1934.