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SEC Adopts Guidance on Proxy Advisory Firms and Proxy Rules



On Aug. 21, 2019, the Securities and Exchange Commission (the Commission) voted 3-2 to approve two interpretive guidance proposals related to proxy voting and proxy advisory firms.¹ The first guidance discusses, among other matters, the ability of investment advisers to establish a variety of voting arrangements with their clients, as well as matters they should consider when they use the services of a proxy advisory firm. In addition, the Commission issued guidance that proxy voting advice provided by proxy advisory firms generally constitutes a “solicitation” under the federal proxy rules and provided related guidance about the application of the proxy antifraud rule to proxy voting advice.

Overall, the guidance reiterates positions taken by the Commission staff in 2014.² However, certain aspects of the guidance are new, and we offer practical suggestions to investment advisers and funds as they review proxy voting policies and procedures and disclosure and consider whether amendments are appropriate.

Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers³

The Commission issued guidance designed to assist investment advisers in fulfilling their proxy voting responsibilities, particularly where they use the services of a proxy advisory firm. Rule 206(4)-6 under the Investment Advisers Act of 1940 (Advisers Act) requires an investment adviser who exercises voting authority with respect to client securities to adopt and implement written policies and procedures that are reasonably designed to ensure that the investment adviser votes proxies in the best interest of its clients.

The guidance clarifies how an investment adviser's fiduciary duty and Rule 206(4)-6 under the Advisers Act relate to an adviser's proxy voting on behalf of clients, particularly if the investment adviser retains a proxy advisory firm. The guidance discusses, among other things:

- How an investment adviser and its client, in establishing their relationship, may agree upon the scope of the investment adviser's authority and responsibilities to vote proxies on behalf of that client.
- What steps an investment adviser who has assumed voting authority on behalf of clients could take to demonstrate it is making voting determinations in a client's best interest and in accordance with the investment adviser's proxy voting policies and procedures.
- Considerations for an investment adviser if it retains a proxy advisory firm to assist it in discharging its proxy voting duties.
- Steps for an investment adviser to consider if it becomes aware of potential factual errors, incompleteness or methodological weaknesses in the proxy advisory firm's analysis that may materially affect one or more of the investment adviser's voting determinations.
- How an investment adviser could evaluate the services of a proxy advisory firm that it retains, along with any material changes in services or operations by the proxy advisory firm.
- Whether an investment adviser who has assumed voting authority on behalf of a client is required to exercise every opportunity to vote a proxy for that client.

The guidance is presented in a question-and-answer format and states that the examples it provides are not the only way for investment advisers to comply with the fiduciary duty imposed on them. Nonetheless, given the ongoing review of issues around proxy voting, advisers should expect the Commission's Office of Compliance Inspections and Examinations to review compliance with the guidance.

Many investment advisers, including fund advisers, reviewed and updated their proxy voting policies and procedures and client disclosure following the issuance of SLB 20 in 2014. Advisers should consider whether such policies and procedures and disclosure adequately address, among others, the following issues raised in the Commission guidance:

- **Retaining or continuing to use a proxy advisory firm for research or voting recommendations.** The Commission guidance includes considerations beyond those identified in SLB 20. In particular, advisers should consider how a proxy advisory firm seeks and utilizes issuer input with regard to the proxy advisory firm's proxy voting policies, methodologies and peer group constructions. In addition, advisers should conduct a "reasonable investigation" of "potential factual errors, potential incompleteness, or potential methodological weaknesses" that may materially affect a voting determination. In this context, the Commission guidance indicates that an investment adviser should consider the proxy advisory firm's "engagement with issuers," including the process for the adviser to access the issuer's views about the firm's voting recommendations "in a timely and efficient manner."⁴
- **At least annual review of policies and procedures.** The Commission guidance indicates advisers should review votes cast to ensure consistency with voting policies and procedures. Advisers should consider whether the annual review of its policies and procedures adequately addresses sampling or testing of votes cast. Advisers, particularly fund advisers, should consider whether to identify in policies or procedures factors to consider as to whether to conduct a more

detailed analysis with regard to an issuer or voting matter (e.g., with regard to corporate events or contested director elections).

- **Fund disclosure.** The Commission guidance indicates that investment advisers to multiple funds or other clients should consider whether voting policies should be different depending on the investment strategies and objectives of each client. Registered funds should ensure that any such different voting policies are appropriately reflected in relevant disclosures.
- **Refraining from voting.** The Commission guidance reiterates that investment advisers are not required to accept the authority to vote client securities. If an investment adviser accepts voting authority:
 - The investment adviser and client can agree on the scope of voting arrangements, including voting on only certain types of matters or always voting in favor of certain types of proposals.⁵ Such agreements should be subject to full disclosure and informed consent and should thus be clearly documented with the client.⁶
 - Absent specific agreement with a client, the investment adviser may determine that it is in the client's best interest to refrain from voting if, for instance, the cost to the client of voting the proxy exceeds the expected benefit to the client. However, an investment adviser "may not ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies and cannot fulfill its fiduciary responsibilities to its clients by merely refraining from voting the proxies." Thus, an adviser should consider whether its procedures should identify factors that would be relevant to a determination to refrain from voting.

Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules⁷

The Commission also issued an interpretation of Rule 14a-1(l) under the Securities Exchange Act of 1934 (Exchange Act) that proxy voting advice generally constitutes a solicitation under the federal proxy rules and related guidance regarding the application of the antifraud provisions in Exchange Act Rule 14a-9 to proxy voting advice.⁸

The Commission's interpretation that proxy voting advice generally constitutes a solicitation does not affect the ability of proxy advisory firms to continue to rely on the exemptions from the federal proxy rules' filing requirements.⁹

While much of this guidance reiterates staff positions in SLB 20, the Commission guidance also explains what a person providing proxy voting advice should consider with respect to the information it may need to disclose in order to avoid a potential violation of Rule 14a-9 where the failure to disclose such information would render the advice materially false or misleading.

In particular, the guidance highlights that a proxy advisory firm should consider whether it may need to disclose "an explanation of the methodology used to formulate its voting advice on a particular matter (including any material deviations from the provider's publicly-announced

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guidelines, policies, or standard methodologies for analyzing such matters).” If the voting advice is materially based on a methodology using a peer group comparison, the proxy advisory firm may need to include the identities of the peer group members and the reasons for selecting them. In addition, the proxy advisory firm may need to disclose third-party sources of information included in its reports and underlying its recommendations, particularly if the information deviates from the issuer’s publicly provided information.

The guidance appears to be designed to address issuer concerns that proxy advisory firms have relied on peer group comparisons that are poorly constructed (e.g., include peers from unrelated industries or differ from peers used for an issuer’s direct competitor) or on performance data or other issuer assessments that deviate from the issuer’s publicly released information. It is not clear yet what the impact of this guidance will be on proxy advisory firms and their relationships with asset management clients.

What’s Next?

The guidance and interpretation will be effective upon publication in the Federal Register, as there is no associated notice and comment period. As indicated in the Regulatory Flexibility Agenda, the Commission in the near future expects to engage in rulemaking with regard to submission and resubmission thresholds for shareholder proposals under Exchange Act Rule 14a-8 as well as proxy advisory firms’ reliance on the proxy solicitation exemptions in Exchange Act Rule 14a-2(b).

¹ Commissioners Robert Jackson and Allison Lee dissented.

² Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms, Staff Legal Bulletin No. 20 (IM/CF) (June 30, 2014) (SLB 20), available at <https://www.sec.gov/interps/legal/cfslb20.htm>.

³ Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Securities and Exchange Commission, Investment Advisers Act Rel. No. 5325 (Aug. 21, 2019), available at <https://www.sec.gov/rules/interp/2019/ia-5325.pdf>.

⁴ Two proxy advisory firms, ISS and Glass-Lewis, dominate the market for services. Both currently offer certain fact-checking and error correction processes. The Commission guidance does not clarify whether those processes are sufficient to address an investment adviser’s fiduciary duty.

⁵ In this regard, the Commission guidance helpfully notes that a client and its investment adviser could agree not to restrict the use of securities for lending to preserve the right to vote in circumstances where such voting would impose opportunity costs on the client.

⁶ Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Securities and Exchange Commission, Investment Advisers Act Rel. No. 5248 (June 5, 2019), available at <https://www.sec.gov/rules/interp/2019/ia-5248.pdf> (“Whether the disclosure is full and fair will depend upon, among other things, the nature of the client, the scope of the services, and the material fact or conflict. Full and fair disclosure for an institutional client (including the specificity, level of detail, and explanation of terminology) can differ, in some cases significantly, from full and fair disclosure for a retail client because institutional clients generally have a greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications.” (internal citations omitted)).

⁷ Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice, Securities and Exchange Commission, Exchange Act Rel. No. 34-86721 (Aug. 21, 2019), available at <https://www.sec.gov/rules/interp/2019/34-86721.pdf>.

⁸ The federal proxy rules apply to any solicitation for a proxy with respect to any security registered under Exchange Act Section 12. Under Exchange Act Rule 14a-1(l), a solicitation includes, among other things, a “communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy,” and includes communications by a person seeking to influence the voting of proxies by shareholders, regardless of whether the person itself is seeking authorization to act as a proxy.

⁹ These exemptions, found in Rule 14a-2(b), among other things, provide relief from the obligation to file a proxy statement, as long as the advisory firm complies with the exemption’s conditions.