August 28, 2019

SEC Issues Guidance on Proxy Voting Responsibilities of Investment Advisers and the Applicability of Proxy Rules to Proxy Voting Advice

On August 21, 2019, the Securities and Exchange Commission ("SEC") approved much anticipated guidance regarding the applicability of proxy rules to proxy voting advice and related guidance regarding proxy voting responsibilities of investment advisers. Over the past few years, the SEC has engaged with the public on the proxy voting process multiple times, starting with a 2010 concept release seeking input on the U.S. proxy system and more recently a 2018 roundtable on the same topics. The SEC has relied on the information gathered through these engagement efforts to issue this guidance, which takes a middle-of-the-road approach between the more stringent regulation that registrants had sought and maintaining the status quo as proxy advisory firms and some investors had urged.

While Chairman Clayton has stated that the guidance does not create "new law," Commissioners Jackson and Lee dissented, stating that additional study was needed to protect against possible unintended consequences, including, variously, potential negative impact on competition in the proxy advisory industry, decreased voting on behalf of institutional clients and increased compliance costs for all stakeholders. Further changes may still be coming, as the staff continues to consider, among other things, rule amendments to address proxy advisory firm reliance on proxy solicitation exemptions in Exchange Act Rule 14a-2(b) – which exempts such firms from complying with SEC proxy information and filing requirements – and other proxy voting issues.

Guidance Regarding the Applicability of Rules Promulgated under Section 14 of the Exchange Act to Proxy Voting Advice

The SEC issued two Q&A's on this topic.

Answer to Question 1 – Proxy voting advice generally constitutes a solicitation under the U.S. proxy rules. Question 1 reiterates that "solicitation," as defined under Exchange Act Rule 14a-1(l), is "broad and includes, among other things, a 'communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy'." 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, constitutes a solicitation. Whether a particular communication has the purpose of influencing shareholder voting decisions is fact-specific, but the SEC finds that, as a general matter, the current method by which proxy advisory firms make recommendations to its clients constitutes a solicitation. Among other things, the SEC noted that proxy advisory firms market their expertise in

researching and analyzing proxy issues to help clients make voting determinations and time their recommendations and use technology in a manner to increase the likelihood that an investment adviser will rely on the recommendation. Further, even if the client does not follow the proxy advisory firm's recommendations or if the proxy advisory firm makes recommendations based on its application of the client's voting criteria (unless the firm's services are purely administrative or ministerial), such recommendations are still part of a package of commercial services designed to influence the client's voting decisions.

Notwithstanding this conclusion, proxy advisory firms may still take advantage of exemptions to the SEC's information and filing requirements under the federal proxy rules for any solicitation that does not seek directly or indirectly the power to act as a proxy for a security holder and does not furnish or otherwise request, or act on behalf of a person who furnishes or requests, a form of revocation, abstention, consent or authorization. Also, any advice given in response to unsolicited inquiries from clients (*e.g.*, by a broker or a financial adviser to client in response to an inquiry) is still not considered a solicitation.

Answer to Question 2 – Rule 14a-9's antifraud provisions apply to proxy voting advice. Rule 14a-9 prohibits any solicitation from containing any statement that, at the time and in light of the circumstances under which it is made, is false or misleading with respect to any material fact and any omissions of material facts necessary to make the statements not false or misleading. This prohibition extends to opinions, reasons, recommendations or beliefs that are disclosed as part of the solicitation which may be statements of material facts for purposes of the rule. Therefore, a proxy advisory firm that is engaged in a solicitation through the giving of proxy voting advice must not make materially false or misleading statements or omit material facts that would be required to make the advice not misleading, such as information underlying the basis of its advice or that would affect its analysis and judgments.

A proxy advisory firm should also consider the need to disclose the following information if the omission of such information would render the advice materially false or misleading (and thus violate Rule 14a-9):

- an explanation of the methodology used to form its voting advice on a specific matter;
- if the advice is based on information other than the registrant's public disclosures, the sources of the information relied upon and the differences between this information and the publicly available information, if material; and
- any material conflicts of interest that arise in connection with the proxy voting advice in reasonably sufficient detail so the client can assess the relevance of the conflicts.

Guidance Regarding Proxy Voting Responsibilities of Investment Advisers

The SEC issued six Q&A's on proxy voting responsibilities of investment advisers.

Answer to Question 1 – The investment adviser and client may agree on the scope of the adviser's authority and responsibilities to vote proxies on behalf of the client, subject to full and fair disclosure and informed consent. Investment advisers have fiduciary duties of care and loyalty to their clients under Rule 206(4)-6 of the Investment Advisers Act of 1940. However, the specific obligations that flow from such duties with respect to proxy voting depend on the scope of voting authority given by the client to the adviser.

The guidance reiterates that the investment adviser and its client may agree on a variety of voting arrangements, subject to full and fair disclosure and informed consent, including where the adviser would:

- vote pursuant to specific parameters, *e.g.*, the adviser should vote with company management's recommendations or in favor of all proposals made by a particular shareholder;
- not vote if doing so would impose costs on the client, *e.g.,* opportunity costs incurred to restrict share lending to preserve the right to vote;
- focus voting resources on particular types of proposals based on the client's preferences, *e.g.*, proposals relating to significant corporate transactions or contested director elections; or
- not vote on certain matters where the cost of voting would be high or the benefit would be low, *e.g.*, not voting non-U.S. securities where there might be translation or travel costs to vote or where the vote would not reasonably be expected to have a material effect on the value of the client's investment.

Answer to Question 2 – An investment adviser that has assumed voting authority should take steps to conduct a reasonable investigation to determine that its voting decisions are in a client's best interests and in compliance with its policies and procedures. For example, an investment adviser that represents multiple clients should consider whether voting all of its clients' shares in accordance with a uniform voting policy would be in the best interest of each client or whether it should have different voting policies for some or all of its clients, tailored to the clients' investment strategies and objectives. An investment adviser should also consider whether certain types of matters warrant more detailed analysis beyond application of its general voting guidelines, such as the application of factors particular to the subject company or the matter under consideration, and considering the impact of the vote on the value of the client's investments.

An investment adviser should also consider reasonable measures to determine that it is casting votes consistent with its voting policies and procedures, for example, by sampling its proxy votes as part of annual compliance procedures. An adviser that uses a proxy advisory firm for voting recommendations or execution services should also consider steps to evaluate the proxy advisory firm's compliance with the adviser's voting policies and procedures, including:

- sampling pre-populated votes on the proxy advisory firm's electronic voting platform before such votes are cast;

- adoption of policies and procedures for the consideration of additional information provided by a registrant in the voting decision; and

- higher degrees of analysis for certain matters, *e.g.*, matters where the investment adviser's voting policies and procedures do not address how it should vote or that are highly contested or controversial.

The investment adviser should also review and document at least annually the adequacy of its voting policies and procedures to ensure that they have been formulated reasonably and implemented effectively, including whether the applicable policies and procedures continue to be reasonably designed to ensure that the adviser casts votes on behalf of its clients in the best interest of such clients.

Answer to Question 3 – In retaining a proxy advisory firm, an investment adviser should consider whether the firm has the capacity and competency to adequately analyze the matters for which the investment adviser is responsible for voting. Possible considerations for the investment adviser include the below:

- the adequacy and quality of the proxy advisory firm's staffing, personnel and technology;

- whether there is an effective process for seeking input from companies and from the proxy advisory firm's clients, for example, on the firm's proxy voting policies, methodologies and peer groups (*e.g.,* for say-on-pay votes);

- whether the proxy advisory firm has adequately disclosed its methodologies for formulating voting recommendations (so that the investment adviser can understand the factors underlying the proxy advisory firm's recommendations); and

- the nature of any third-party information sources used by the proxy advisory firm as a basis for its recommendations and how the firm engages with companies and third parties.

The investment adviser should also conduct a reasonable review of the proxy advisory firm's policies and procedures for identifying and addressing actual and potential conflicts of interest. This should include, among other things, assessing the adequacy of the firm's disclosures with respect to such conflicts, *e.g.,* whether such disclosures are context-specific and not-boilerplate, include details on whether the firm has provided consulting services to the registrant, the amount of compensation paid for such services and whether a shareholder proponent or affiliate is or was a client of the proxy advisory firm and whether such disclosure is readily accessible.

Answer to Question 4 – The investment adviser's policies and procedures should be reasonably designed to ensure that its voting determinations are not based on materially inaccurate or incomplete information. An investment adviser should conduct a reasonable investigation into the matter to be voted

on, which could include a periodic review of its use of proxy voting research or recommendations. Such review could include an assessment of the extent to which potential factual errors, incompleteness or methodological weaknesses materially affect the proxy advisory firm's research or recommendations analysis. The review should also consider the effectiveness of the proxy advisory firm's policies and procedures for obtaining current and accurate information, including the firm's engagement with registrants, efforts to correct any identified material deficiencies and other factors.

Answer to Question 5 – An investment adviser should adopt policies and procedures to evaluate the proxy advisory firm's services and to update such evaluations on a periodic basis. The SEC recommends that an investment adviser should adopt and implement policies and procedures that are reasonably designed to sufficiently evaluate the proxy advisory firm to ensure that proxy voting is occurring in the best interest of the client. In conducting such evaluation, the adviser should consider updating procedures, such as requiring the proxy advisory firm to update the investment adviser regarding relevant business changes and conflicts of interest, and also consider whether the proxy advisory firm appropriately updates its methodologies, guidelines and voting recommendations.

Answer to Question 6 – An investment adviser is not required to exercise every opportunity to vote a proxy for a client. The adviser may refrain from voting, if the adviser and its client have agreed in advance to limit the conditions under which the investment adviser would vote or the adviser determines that such action would be in the best interest of the client after considering whether it is fulfilling its duty of care in light of the scope of services to which it and the client have agreed, *e.g.*, after making a cost/benefit analysis.

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Despite Chairman Clayton's statements that this guidance is not new, these clarifications will likely impact the policies and procedures, as well as practices, of investment advisers and proxy advisory firms, in particular if there is a greater likelihood of registrants challenging practices under Rule 14a-9. SEC guidance, unlike rulemaking, is not subject to a comment process and, therefore, has immediate effect following publication in the *Federal Register*, although the real impact is unlikely to be evident before the 2020 proxy season, at the earliest.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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