To Our Clients and Friends

Memorandum

New Guidance and Best Practices for Investment Advisers on Proxy Voting and Use of Proxy Advisory Firms

On August 21, 2019, the Securities and Exchange Commission, in a 3-to-2 vote (along party lines), approved new guidance for investment advisers (such as fund managers) relating to their responsibilities in voting their clients' shares by proxy and relying on proxy advisory firms (such as ISS and Glass Lewis) for voting recommendations. The new guidance comes against a backdrop of increasing debate in recent years within the corporate community about the expanded use, influence and power of proxy advisory firms. Many issuers have taken the position that the proxy advisory firms have implicit conflicts of interest, generally take a one-size-fits-all approach to their voting policies, do not obtain sufficient input from the issuer when making voting recommendations, and do not have effective processes for identifying or correcting errors in the data they use to make their determinations. However, many investment advisers, who are the actual customers of the proxy advisory firms, have believed that the proxy advisory firms perform their services reasonably well. Because the new guidance was published without a notice and comment period, it becomes effective immediately upon its publication in the Federal Register.

Key Points

- **The guidance is prescriptive and in effect establishes the SEC's view of best practices that investment advisers and proxy advisory firms should utilize.** As a practical matter, the guidance will increase the pressure on proxy advisory firms to adopt these practices to the extent that they have not.
- **The new guidance largely reiterates previous SEC guidance but indicates some potential expansion of obligations for both investment advisers and proxy advisory firms.** In addressing the ongoing debate between issuers and proxy advisory firms with respect to proxy advisory firms' accountability and transparency, the new guidance tilts favorably toward issuers. A notable example is the guidance prescribing more engagement by proxy advisory firms with issuers when formulating voting recommendations (as discussed below).
- **The new guidance could potentially lead to significant changes in the way that investment advisers utilize the recommendations of proxy advisory firms.** Investment advisers may expand their in-house function for making proxy voting assessments or may increase the frequency with which they vote automatically based on the issuer's recommendation or abstain from voting.

- **The SEC urges investment advisers and proxy advisory firms to review their policies and practices in light of the new guidelines in advance of the 2020 proxy season.**

Background

Significant structural and procedural changes in share ownership and voting in recent years have necessarily affected and increased the importance of proxy voting. These changes have included a concentration of share ownership in U.S. corporations, the elimination of the broker discretionary vote in director elections, the widespread adoption of majority voting in the election of directors, and the rise of shareholder activism. At the same time, concern has grown about the expanded use, influence and power of proxy advisory firms over the voting of securities of companies in which they have no direct economic interest and as to which they may have potential conflicts of interest.

In 2010, the SEC adopted a concept release seeking public comment on a list of issues relating to the duties of care and loyalty that investment advisers, as fiduciaries, owe to their clients, including with respect to proxy voting services undertaken on a client's behalf. In 2014, the SEC released a 7-page Staff Legal Bulletin summarizing the results of a "comprehensive review" of the proxy system. The 2014 Bulletin imposed no obligations directly on the proxy advisory firms, but indicated that, for an investment adviser to fulfill its fiduciary obligations to its clients, if the investment adviser relies on a proxy advisory firm's voting recommendations, it must provide active and ongoing oversight of that function. That oversight includes due diligence with respect to the proxy advisory firm's "capacity and competency," the accuracy of the information on which the proxy advisory firm's voting recommendations are based, and the nature of the proxy advisory firm's conflicts of interest.

Now, five years later, the SEC has issued its new guidance in the form of two releases presented in Q&A format, one issued under the Investment Advisers Act of 1940 (the "Advisers Act") and one under the Securities Exchange Act of 1934 (the "Exchange Act"). The new guidance is significant in that it has been approved at the Commission level, in contrast to the 2014 Bulletin, which reflected SEC Staff interpretations. The new guidance is also more expansive than the guidance in the 2014 Bulletin, with detailed examples prescribing the actions an investment adviser should take to fulfill its fiduciary duties in ensuring that a proxy advisory firm's recommendations will be in the clients' best interest. The new guidance also applies to SEC-registered investment advisers in their compliance with Rule 206(4)-6 under the Advisers Act (the "Proxy Voting Rule"). The Proxy Voting Rule requires, among other things, that investment advisers adopt and implement written policies and procedures that are reasonably designed to ensure that they vote client securities in the best interest of clients and that include how they address material conflicts that may arise between their interests and those of their clients.

Commissioners Jackson and Lee voted against the new guidance. The concerns they expressed included the effects of the additional costs of compliance; the additional "time pressure" associated with the promotion of greater involvement by issuers in the proxy advisory firms' recommendations and the potential for such involvement to reduce the reliability and independence of the voting recommendations; and the issuance of the new guidance without economic analysis or a public comment period.

The New Guidance

The key features of the new guidance are as follows:

Scope of authority to vote or refrain from voting. Drawing on principles outlined in the SEC's interpretive guidance on investment adviser fiduciary duty issued earlier this year, the new guidance reiterates that an investment adviser's fiduciary duty follows the contours of the adviser's relationship with its client, and that the adviser may shape its relationship with the client by agreement, provided that there is full and fair disclosure and informed consent. Accordingly, the new guidance again makes clear that an investment adviser is not necessarily obligated to cast a vote on behalf of its clients on all issues, or at all. One Q&A prescribes that investment advisers ensure that the scope of their authority to vote proxies on a client's behalf is clearly defined, and provides examples of different types of voting arrangements that clearly set forth the adviser's scope of authority to vote and to decide to refrain from voting.

Tailoring of voting policies. The guidance focuses on an investment adviser's obligation to make voting determinations based on its clients' best interests and in accordance with the adviser's own proxy voting policies, rather than relying on a proxy advisory firm's policies. The guidance prescribes that an adviser should "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."

Due diligence when engaging and monitoring a proxy advisory firm--engagement with issuers. As established by previous guidance, an investment adviser has a fiduciary duty to its clients to conduct appropriate due diligence when engaging a proxy advisory firm and thereafter to monitor its work for the investment adviser. The due diligence should include an assessment of the proxy advisory firm's capacity (that is, the adequacy and quality of the firm's staffing, personnel and technology) and of the proxy advisory firm's policies and procedures to identify and address its potential conflicts of interest. Of particular note, the new guidance indicates that an investment adviser may want to consider whether the proxy advisory firm has a sufficient process for engaging with issuers to ensure that the proxy advisory firm has accurate and complete information. We observe that proxy advisory firms typically limit their engagement with issuers on the basis that expanded engagement would impede the firm's objectivity and interfere with its being able to make voting decisions on the tight timeline that investment advisers' clients require. For example, while both ISS and Glass Lewis permit issuers in some cases to review draft reports for errors, they limit issuers' ability to review or comment on the firms' methodologies or analyses, and the time allotted is typically limited to a 24-48 hour window. The new guidance suggests that proxy advisory firms should expand their current practices to allow for greater issuer involvement.

Voting advice as a "solicitation." The new guidance confirms previous Staff guidance that a proxy advisory firm's voting advice and recommendations generally constitute "solicitations" under the proxy rules (because they are intended to influence investors' voting decisions, even though the person providing the advice or recommendation is not seeking a proxy to vote the shares. While the guidance notes that a proxy advisory firm's voting advice and recommendations nonetheless continue to be exempt from proxy statement filing requirements (if the appropriate conditions therefor are met), it suggests that the SEC is considering eliminating this exemption--a change that would impose significant new costs and burdens on proxy advisory firms.

Applicability of the anti-fraud rules to voting advice. The new guidance confirms that, as proxy advisory firms' voting advice and recommendations are "solicitations" under the proxy rules, they are subject to the anti-fraud provisions of Rule 14a-9. Thus, they cannot include statements that are, at the time and under the circumstances in which they are made, "false or misleading as to any material fact" and may not "omit to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any earlier communication with respect to the solicitation of a proxy…which has become false or misleading." The guidance goes further to explain what a person providing proxy voting advice may need to disclose to ensure that the advice is not false or materially misleading.

Practice Points Based on the New Guidance

An investment adviser should review its client agreements and:

- Consider tailoring client agreements to provide for different voting policies for different clients or classes of clients in accordance with clients' specific investment strategies and objectives;

- If necessary, define or re-define (with the client's consent) the scope of the investment adviser's authority and responsibilities to vote, or ability to refrain from voting, proxies on the client's behalf;

- Consider accepting authority to vote on only certain types of matters or to always vote in favor of certain types of proposals;

- Consider adopting procedures that identify the factors on which the investment adviser would base a decision to refrain from voting proxies on behalf of a specific client or class of clients or with respect to certain types of matters (for example, a determination that the cost to the client of voting would exceed the expected benefit to the client); and

- Keep in mind that agreements with clients should be fully documented and that their enforceability is subject to full disclosure and informed consent.

An investment adviser should review its voting policies at least annually to confirm that they have been "formulated reasonably and implemented effectively" and:

- Review votes cast to ensure consistency with the investment adviser's voting policies and procedures;

- Consider whether the annual review adequately addresses sampling or testing of votes cast; and

- Consider (particularly in the case of a fund manager) whether to identify in its policies or procedures factors to consider as to whether to conduct a more detailed analysis relating to a specific issuer or voting matter, such as particular types of corporate events or contested director elections.

An investment adviser should conduct due diligence when engaging a proxy advisory firm and then should monitor the firm's work for the adviser and:

- Consider how the proxy advisory firm seeks and utilizes issuer input with regard to the proxy firm's voting policies and methodologies, including for purposes of benchmarking peer group constructions with respect to the analysis of CEO compensation;

- Consider whether the proxy advisory firm has procedures that seek to ensure "timely and efficient" engagement with issuers such that the proxy advisory firm can access an issuer's views on the firm's voting recommendations and correct errors or deficiencies that are identified; and

- Consider whether the proxy advisory firm has policies and procedures pursuant to which it identifies the source of the information included in the reports underlying its recommendations and any material variances from information that issuers have publicly disclosed.

To avoid potential violations of (and liability under) the anti-fraud proxy rules with respect to its proxy advice and voting recommendations, a proxy advisory firm should:

- Disclose its material conflicts of interest, if any;
- 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 [its] publicly-announced guidelines, policies or standard methodologies for analyzing such matters)";
- If the advice is materially based on a methodology that uses a peer group comparison, consider whether it may need to disclose which entities comprise the peer group and the reasons they were selected; and
- If a recommendation is based on information obtained from third parties, particularly where the information deviates from information publicly provided by the issuer, consider whether it should disclose the identity of the third-party sources of the information (although this may raise issues relating to the disclosure of proprietary-type or other sensitive information from sources that may not wish to be identified).

Other potential future changes. While the new guidance has been viewed as relatively modest in terms of its likely impact, potential future changes may be more significant. The SEC's release states that the Staff is "considering recommending that the Commission propose rule amendments to address proxy advisory firms' reliance on the proxy solicitation exemptions in Exchange Act Rule 14a-2(b)." As noted above, the elimination of these exemptions would significantly increase the costs and administrative burdens on proxy advisory firms. In addition, the new guidance notes that the SEC is considering possible amendment of the thresholds for submitting and resubmitting shareholder proposals under Exchange Act Rule 14a-8, as well as possible "proxy plumbing" initiatives (relating to the mechanics of and infrastructure for proxy voting). Finally, the guidance notes that Congress continues to be interested in considering the role of proxy advisory firms and possibly adopting related legislation.

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