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SEC Guidance for Proxy Advisors and Investment Advisers: Phase One of a Broader SEC Proxy Reform Initiative

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On August 21, 2019, a divided Securities and Exchange Commission voted[1] to approve the issuance of two releases that provide: (1) an interpretation and related guidance under existing federal proxy rules, adopted by the SEC under Section 14 of the Securities Exchange Act of 1934, as amended ("Exchange Act"), regarding the applicability of these rules to the provision of proxy voting advice by proxy advisory firms to their shareholder client base ("Proxy Advisors Release"); and (2) guidance to investment advisers on the nature and scope of their proxy voting responsibilities as fiduciaries under the Investment Company Act of 1940, as amended ("Advisers Act"), in situations where proxy advisory firms are retained to furnish voting-related services ("Investment Advisers Release"). The SEC interpretive positions and guidance set forth in the two releases will become effective immediately upon publication of each release in the Federal Register (which has not yet occurred).

Although it is too soon to tell precisely how the SEC's latest pronouncements might impact the rapidly approaching 2020 proxy season, we anticipate that proxy advisory firms and investment advisers alike will re-examine their respective policies and procedures this fall in light of the relevant guidance. An important takeaway for proxy advisory firms is that the SEC expects them to furnish shareholder clients with specific disclosures to avoid violating proxy antifraud provisions, which disclosures at a minimum should cover the methodology applied in formulating voting advice (in particular, the identification of peer companies for purposes of recommending so-called "say-on-pay" votes); sources of third-party information and the reasons for using such information; and material conflicts of interest. As to investment advisers, once a particular adviser agrees with its individual, fund or other institutional client to assume proxy voting authority, the adviser owes the client a fiduciary duty to cast proxy votes in the client's best interest. The Investment Advisers Release goes on to spell out in some detail the types of information an adviser should demand from a proxy advisory firm regarding conflicts of interest and various other matters, and gives several non-exclusive examples of how an adviser should conduct the required degree of diligence.

Commissioner Elad Roisman, who has been tasked by Chair Jay Clayton with leading the SEC's broader proxy reform initiative, observed during the August 21 open meeting that the SEC's two-pronged interpretation and guidance represents the first in a series of proxy-related reforms on the SEC's rulemaking agenda. More specifically, Commissioner Roisman stated that the SEC expects to consider, in the relatively near future, whether to propose amendments to: (1) Exchange Act Rule 14a-8 that would raise the submission and re-submission thresholds for the inclusion of shareholder proposals in

company proxy statements; and (2) Exchange Act Rule 14a-2(b), which contains the two key exemptions from SEC proxy information and filing requirements upon which proxy advisory firms typically rely in the ordinary course of business. Chair Clayton further indicated that he has asked the Division of Corporation Finance, which administers and interprets the federal proxy rules at the Staff level, to consider whether to recommend to the SEC that "the current rule definition of the term 'solicitation' under the federal proxy rules [Rule 14a-1(l)] … be amended to codify today's interpretation." In the longer term, according to Commissioner Roisman, the SEC plans to grapple with longstanding "proxy process" issues initially described in some detail in a 2010 SEC Concept Release on the U.S. Proxy System.[2]

The Long and Winding Road to Proxy Regulatory Reform

To provide context for the recently issued interpretation and guidance regarding voting-related services of proxy advisory firms and investment adviser proxy voting responsibilities, we begin with a brief history of proxy regulatory reform. As discussed in our previous Alert available here, until recently, there had been little movement toward reform of an already unwieldy proxy process in the aftermath of the SEC's sweeping 1992 amendments to the federal proxy rules. It was not until the SEC's adoption in 2003 of Rule 206(4)-6 under the Advisers Act that the agency began to consider in earnest the fiduciary responsibilities of investment advisers to cast proxy votes in the best interest of their clients. Among other things, Rule 206(4)-6 requires an investment adviser that exercises voting authority over client portfolio securities to adopt policies and procedures reasonably designed to ensure that the adviser votes proxies on a fully informed basis and in the best interests of clients.

In June 2014, SEC's Division of Investment Management and the Division of Corporation Finance published guidance in the form of Staff Legal Bulletin No. 20 (SLB 20). SLB 20 updated the Division of Investment Management's guidance about the scope of investment adviser's duties in voting client proxies and retaining proxy advisory firms. More specifically, the SLB outlined the considerations that an investment adviser may wish to take into account if it retains a proxy advisory firm to assist in the adviser's exercise of proxy voting duties, including the proxy advisory firm's capacity and competency to adequately analyze proxy issues; and the investment adviser's ongoing duties to oversee any proxy advisory firms it retains, including by adopting and implementing policies and procedures reasonably designed to provide sufficient ongoing oversight. As to proxy advisory firms, the Division of Corporation Finance discussed the applicability of the federal proxy rules to the activities of proxy advisory firms, along with the availability of certain of the Rule 14a-2(b) exemptions for communications the SEC deems to constitute a "solicitation."

Guidance Regarding the Applicability of Proxy Rules to Proxy Voting Advice

With the publication of interpretive guidance in the Proxy Advisors Release, in the form of two Q&A's, the SEC reaffirmed its earlier statement (in the 2010 Concept Release) that the communication of proxy voting advice by a proxy advisory firm to its shareholder clients generally falls within the broad definition of the term "solicitation" set forth in Rule 14a-1(l) of the federal proxy rules.[3] This is the case even in situations where "the proxy advisory firm is providing recommendations based on the firm's application of the client's own tailored guidelines," because the SEC believes such recommendations involve substantial analysis and ultimately are "designed to influence the client's voting decision." A client's decision to disregard the proxy advisory firm's voting recommendation does not alter the SEC's conclusion in this regard.

While reassuring proxy advisory firms that their continued ability to rely on the Rule 14a-2(b) exemptions is not in doubt (unless and until the SEC modifies these exemptions, as previously discussed), the SEC used the Proxy Advisors Release as a vehicle for highlighting an important condition to reliance on these exemptions – compliance with Rule 14a-9, the core proxy antifraud provision. In a nutshell, Rule 14a-9 "prohibits any solicitation from containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact," or which omits "any material fact necessary" to make any such statement "not false or misleading."

Citing the U.S. Supreme Court's ruling in *Virginia Bankshares, Inc. v. Sandburg*,[4] the SEC observed that "Rule 14a-9 also extends to opinions, reasons, recommendations, or beliefs that are disclosed as part of a solicitation, which may be statements of material facts for purposes of the Rule." To avoid raising antifraud concerns, a proxy advisory firm's advice, opinions and/or recommendations therefore should be accompanied by "full and fair" disclosure of "the underlying facts, assumptions, limitations" and any other information required to render such advice, opinions and/or recommendations not materially misleading.

The SEC urged providers of proxy voting advice to consider whether, depending on the particular statement made, they should disclose to clients the following types of information to minimize the risk of violating Rule 14a-9:

- an explanation of the methodology used by the proxy advisory firm to formulate voting advice on a particular matter – including any material deviations from the firm's publicly-announced guidelines, policies or standard methodologies for analyzing such matters – where the omission of such information would render the firm's voting advice materially false or misleading.

  Note: To illustrate this point, the SEC focused in footnote 34 of the Proxy Advisors Release on a proxy advisory firm's selection of peer groups as a predicate for making a voting recommendation with respect to a registrant's advisory vote on executive compensation. "To the extent that the proxy voting advice is materially based on a methodology using a group of peer companies selected by the proxy advisory firm, the disclosure may need to include the identities of the peer group members used as part of its recommendation and the reasons for selecting these peer group members as well as, if material, why its peer group members differ from those selected by the registrant."

- if a firm's proxy voting advice is based on sources of information other than a registrant's own public disclosures, such as third-party research or publications, commercial or financial information databases, or ratings or rankings, the firm should disclose these sources and the extent to which such third-party information differs from the registrant's disclosures, if these differences are material and failure to disclose the differences would render the voting advice false or misleading.

- disclosure regarding material conflicts of interest that arise in connection with the provision of proxy voting advice, in reasonably sufficient detail to enable the client to assess the relevance of those conflicts.

Guidance Regarding Proxy Voting Responsibilities of Investment Advisers

In the Investment Advisers Release, the SEC largely reaffirmed the Staff's articulation in SLB 20 of investment advisers' fiduciary responsibilities in the area of proxy voting, underscoring that, "[t]o satisfy its fiduciary duty in making any voting determination, the investment adviser must make the determination in the best interest of the client and must not place the investment adviser's own interests ahead of the interests of the client." The SEC went on to emphasize that, "for an investment adviser to form a reasonable belief that its voting determinations are in the best interest of the client, it should conduct an investigation reasonably designed to ensure that the voting determination is not based on materially inaccurate or incomplete information." The release suggests measures an investment adviser could consider in deciding how best to fulfill its due diligence obligation.

Recognizing that many investment advisers retain the services of proxy advisory firms in connection with proxy voting determinations, the SEC's guidance offers six non-exclusive examples, presented in a Q&A format, of how investment advisers may comply with their proxy voting responsibilities when utilizing proxy advisory firms' research and voting recommendations.[5] It is important to emphasize that the SEC "encourages" investment advisers to review their policies and practices in light of the new guidance in advance of next year's proxy season. An unstated, but no less potent, incentive for undertaking such a review is the possibility that the SEC's Office of Compliance Inspections and Examinations ("OCIE") might target these policies and procedures during the 2020 examination cycle.

The SEC's guidance for investment advisers is presented in the form of six Q&A's, which we summarized below:

1. *Establishing the scope of investment adviser's authority and responsibility to vote proxies*

An investment adviser ordinarily is not required to vote client securities absent an agreement with a fund or other client to assume this obligation. Where an investment adviser does accept such voting authority, it may agree with its client to a variety of voting arrangements so long as the adviser has made full and fair disclosure and obtained the client's informed consent. The SEC's guidance provides examples of possible voting arrangements to which an investment adviser and its client may agree, such as casting proxy votes in accordance with the voting recommendations of management of the issuer; voting in favor of all proposals made by certain shareholder proponents; committing to forgo exercising voting authority in circumstances under which voting would impose undue costs on the client; devoting all voting resources to a particular type of proposal; or committing not to exercise voting authority on certain types of matters.

2. *Demonstrating that the investment adviser with multiple clients is making voting determinations in a particular client's best interest, and in accordance with its proxy voting policies and procedures*

An investment adviser with multiple clients should weigh carefully, consistent with its fiduciary duty, whether voting all client shares in accordance with a uniform voting policy would be in the best interest of each client. Or, as the SEC put it, "where an investment adviser undertakes proxy voting responsibilities on behalf of multiple funds, pooled investment vehicles, or other clients, it should consider whether it should have different voting policies for some or all of these different funds, vehicles, or other clients, depending on the investment strategy and objectives of each." Moreover, "certain types of matters may necessitate that the adviser conduct a more detailed analysis than what may be entailed by application of its general voting guidelines," thus requiring the adviser to consider factors specific to the company and/or matter subject to a shareholder vote (e.g., a merger, or other major corporate event or transaction, or an election contest). The SEC recommended that an investment adviser identify in its voting policy or policies those factors that it will consider in determining which matters require company-specific evaluation, and explain how it will evaluate voting decisions on such matters.

The guidance also suggests several measures to help an investment adviser assess whether its voting determinations are consistent with its voting policies and procedures and in the client's best interest. One suggested approach involves the adviser's periodic sampling of the pre-populated proxy votes shown on the proxy advisory firm's electronic voting platform before such votes are cast. Another suggestion is to develop and implement policies and procedures for consideration of additional information regarding a specific proposal that might become available, presumably before a voting decision is made (or before the opportunity to change a previously cast vote has passed). Such information might be found in additional definitive proxy materials filed with the SEC, or other communications by the issuer or a shareholder proponent with the investment adviser "that would reasonably be expected to affect the … adviser's voting determination." Third, in situations where the adviser engages a proxy advisory firm for either voting recommendations or voting execution (or both), and the adviser's own policies and procedures do not address how the adviser should vote or a particular matter is highly contested or controversial, a "higher degree of analysis" by the adviser may be necessary or appropriate.

Last but not least, an adviser's ongoing compliance program should include at least an annual review and documentation of the adequacy of the adviser's voting policies and procedures, "to ensure that they have been formulated reasonably and implemented effectively." The touchstone for this process is 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."

3. Considerations when retaining a proxy advisory firm to assist in the investment adviser's discharge of proxy voting duties

When retaining a proxy advisory firm, "an investment adviser should consider, among other things, whether the proxy advisory firm has the capacity and competency to adequately analyze the matters for which the investment adviser is responsible for voting." Among the relevant factors the investment adviser should take into account are the adequacy and quality of the proxy advisory firm's staffing, personnel, and/or technology. Another factor the adviser should consider is whether the proxy advisory firm has an effective process for seeking timely input from issuers and firm clients with respect to the formulation and application of that firm's proxy voting guidelines or policies, methodologies, and peer group construction (e.g., for "say-on-pay" voting recommendation purposes). According to the SEC, the investment adviser must understand how the proxy advisory firm formulates its voting recommendations, and must assess whether the firm has adequately disclosed the underlying methodologies and information sources.

The SEC further recommends that an investment adviser's decision whether to hire, or continue to engage, a particular proxy advisory firm rest on that adviser's "reasonable review" of the firm's policies and procedures for identifying and addressing actual and potential conflicts of interest. Detailed examples of what the SEC deems reasonable in conducting such a review are set forth in the Investment Adviser's Release (in the SEC's response to Question No. 3).

4. Steps an investment adviser should take when it becomes aware of potential factual errors, incompleteness or methodological weaknesses in the proxy advisory firm's analysis that may materially affect the adviser's voting determinations

In the SEC's view, an investment adviser's policies and procedures relating to the exercise of proxy voting responsibilities to its clients should be reasonably designed to ensure that the adviser's voting decisions are not based on materially inaccurate or incomplete information. To cover situations where an investment adviser retains a proxy advisory firm for research or voting recommendations as an input to the adviser's voting decisions, the adviser's policies and procedures should provide for a periodic review of the proxy advisory firm's services. Such a review should evaluate the extent to which potential factual errors, incompleteness or methodological weaknesses in the proxy advisory firm's analysis materially affected the proxy advisory firm's research or recommendations utilized by the adviser. As part of this review, the investment adviser also should assess the effectiveness of the proxy advisory firm's policies and procedures for obtaining current and accurate information that is relevant to matters included in the firm's research and underpins the firm's voting recommendations. Factors to consider in this regard, include: (a) the degree of the firm's engagement with the issuer and its process, if any, for seeking the issuer's views on the firm's voting recommendations in a timely and efficient manner; (b) the firm's efforts to correct any identified material deficiencies in its analysis; (c) disclosure by the firm to its investment adviser client of information sources and methodologies used in formulating voting recommendations or executing voting instructions; and (d) the firm's consideration of factors unique to a specific issuer or proposal subject to a vote.

5. Evaluating proxy advisory firm services, including the impact of any material changes in services or operations of that firm

As discussed above, an investment adviser that has retained a proxy advisory firm to assist with its proxy voting responsibilities should adopt and implement policies and procedures that are reasonably designed to evaluate the proxy advisory firm, in order to ensure that the investment adviser casts votes on an informed basis and in the best interest of its clients. To illustrate this point, the guidance suggests that investment advisers consider adopting policies to identify and evaluate a proxy advisory firm's conflicts of interest, along with the firm's capacity and competency to provide voting recommendations or to execute votes in accordance with an investment adviser's voting instructions. An investment adviser also should consider whether a proxy advisory firm appropriately updates its methodologies, guidelines, and voting recommendations to adapt to changes in the relevant facts and circumstances, which most notably could include feedback from issuers and their shareholders.

6. Determining when to vote proxies

An investment adviser is not required to cast a proxy vote for a client, as previously noted. Rather, investment advisers and clients may agree either that the particular adviser will not exercise proxy voting authority, or, if such authority is conferred, that it will be subject to certain limitations. Even if no such limitations have been imposed by agreement, an adviser "may refrain from voting on behalf of a client if it has determined that refraining is in the best interest of that client." In reaching this conclusion, however, the adviser "may not ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies and cannot fulfill its fiduciary responsibilities by merely refraining from voting the proxies." Before deciding not to vote where authority is not otherwise withheld or circumscribed by agreement, the investment adviser thus should be very careful "to consider whether it is fulfilling its duty of care to its client in light of the scope of services to which it and the client have agreed."

Concluding Thoughts

Although more evolutionary than revolutionary in nature, the interpretations and guidance set forth in the Proxy Advisors and Investment Advisers Releases together signal the willingness of at least a majority of the SEC to construe existing rules broadly in an effort to influence the behavior of proxy advisory firms and the investment advisers that use their voting advisory services. We expect both proxy advisory firms and investment advisers to re-visit their respective policies and procedures with a view toward making any modifications needed to assure compliance with the latest SEC proxy voting pronouncements. At the end of the day, however, significant change in the current proxy voting system may not occur until the SEC proceeds with formal rulemaking – for example, by proposing to amend the Rule 14a-2(b) exemptions on which proxy advisory firms rely in providing proxy voting recommendations, raising the bar on Rule 14a-8 eligibility standards and, last but by no means least, taking specific steps to address the longstanding systemic deficiencies that were identified in the SEC's 2010 Concept Release.

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ENDNOTES

[1] Commissioners Robert J. Jackson, Jr. and Allison Herren Lee objected to the issuance of both the Proxy Advisors Release and the Investment Advisers Release, and explained their concerns during the August 21 open meeting. Commissioner Jackson noted, in his dissenting statement, that the already concentrated proxy advisory sector may become even less competitive if increased regulatory costs and other burdens further raise barriers to entry. He also noted that smaller investment advisers may lack the resources to conduct the level of diligence described in the SEC's guidance, and therefore may choose to vote less – which in turn might "give more influence to large institutions." Commissioner Lee, in her dissent, criticized the lack of a public notice-and-comment process and accompanying cost-benefit analysis, echoed Commissioner Jackson's concerns regarding the potentially negative impact of the SEC's interpretation and guidance on competition in the "highly concentrated" market for proxy advisory services, and observed that greater issuer involvement in the formulation of proxy voting advice could "undermine the reliability and independence of [proxy advisory firms'] voting recommendations."

[2] In the Concept Release, the SEC asked the following questions (among many others): "whether we should take steps to enhance the accuracy, transparency, and efficiency of the voting process; whether our rules should be revised to improve shareholder communications and encourage greater shareholder participation; and whether voting power is aligned with economic interest and whether our disclosure requirements provide investors with sufficient information about this issue." Some of these were discussed during SEC roundtables held in 2013, and again in the fall of 2018.

[3] The SEC largely focused in the Proxy Advisors Release on the fourth prong of the Rule 14a-1(l) definition of "solicitation": "The furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy." Over the years, the SEC has clarified that a "solicitation" is not just a communication transmitted with a form of proxy, but also includes either direct or indirect requests to furnish, withhold or revoke a proxy. For a more detailed discussion of the relevant regulatory history, see footnote 12 of the Proxy Advisors Release. Footnote 13 of this Release briefly describes the holdings of cases mirroring the SEC's broad construction of the term "solicitation."

[4] 501 U.S. 1083, 1092 (1991).

[5] The degree of investment advisers' reliance on the services of proxy advisory firms varies. Some investment advisers use proxy advisory firms only for "administrative" or "ministerial" services, such as use of a proxy advisory firm's electronic platform to manage voting mechanics in an efficient manner. The examples in the Investment Advisers Release do not focus on such administrative or ministerial services, but instead relate to an investment adviser's retention of a proxy advisory firm for services that underpin the "substance" of the adviser's voting determinations, such as: providing research and analysis regarding the matters subject to a vote; promulgating general voting guidelines that investment advisers can adopt; and making voting recommendations to investment advisers on specific matters subject to a vote.

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