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SEC Identifies Policies, Procedures and Disclosures Related to Registered Investment Advisers' Proxy Voting Responsibilities and Proxy Voting Advice

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On August 21, 2019, the Securities and Exchange Commission issued two interpretive releases involving proxy voting and proxy voting advice. In the first release, the SEC provided guidance regarding the responsibilities of registered investment advisers in fulfilling their fiduciary duties when they employ proxy advisory firms.[1] In the second release, the SEC interpreted the activities of proxy advisory firms as involving "solicitations" subject to the anti-fraud provisions of the SEC's proxy rules.[2] Together, the two releases provide detailed guidance on the types of policies, procedures and disclosures that investment advisers and proxy advisory firms should consider in connection with the use and provision of voting advice.

These releases appear to advance the goals of critics of proxy advisory firms by suggesting deeper regulation of the manner in which proxy advisory firms formulate voting recommendations and lay the foundation for greater Commission involvement in the relationship between proxy advisory firms and investment advisers. While the guidance is consistent with certain principles addressed through previous SEC Staff and Commission statements, including Staff Legal Bulletin 20,[3] each release identifies certain specific policies, procedures and disclosures not previously articulated by either the Staff or the Commission. Two SEC Commissioners expressed strong dissenting views on the substance of the new guidance and the lack of a formal public comment process to study its potential impact.[4] Nevertheless, this appears to be just a first step in the Commission's focus on proxy process, with the Chairman signaling that new rulemaking is likely in the near future.[5]

Context of the Commission's Action

The degree to which investment advisers rely on the recommendations of proxy advisory firms varies widely. Some rely on the administrative services provided by the proxy advisory firms and use recommendations from proxy advisory firms as one input into the investment advisers' proxy voting decisions. The voting decisions of many large investment advisers are typically made by committees and are often informed by internal policies designed to maximize the value of their clients' returns on which their own profits depend.

In 2003, the Commission adopted Rule 206(4)-6 under the Investment Advisers Act of 1940,[6] which was designed to require investment advisers to address conflicts they may have in voting client proxies. Investment advisers, for example, may manage the pension assets of a company whose proxy they are asked to vote or have an executive who serves on the board of directors of such a company.[7]

Corporate managers and their trade associations have denounced the proxy voting firms as an unregulated duopoly that has an outsized influence on proxy voting by investment advisers who excessively defer to the firms' recommendations.[8] These corporate managers and trade associations criticize the lack of transparency of proxy advisory firm decision-making, their conflicts of interest and the adequacy of their research and analysis. Some assert that the proxy advisory firms make errors in formulating recommendations, and some companies whose voting resolutions are passed upon by proxy advisory firms argue that they should be able to review the proxy advisory firms' recommendations before they are finalized to prevent errors or misinterpretations.[9] Others have criticized the extent to which institutional investors, influenced by the proxy voting advisers, vote in favor of environmental and social governance proposals.[10]

Institutional investors assert that the research and recommendations provided by proxy advisory firms[11] provide a critical service in helping to inform their own independent decisions on voting proxies.[12] They dispute the influence of proxy advisory firms, noting that institutional investors vote overwhelmingly for management proposals and may vote in significantly different percentages on the same proposal.[13] Moreover, they contend that agreement with a recommendation of a proxy voting adviser does not equate to irresponsible deference. With respect to asserted errors in formulating recommendations and the call for issuer pre-review of voting advice, proxy advisory firms argue that supposed errors are often simply differences of opinion, and some clients for whom the reports are prepared do not want the reports pre-screened by the subject companies because they believe pre-review may compromise the independence of the advice.[14]

Additionally, a number of institutional investors have expressed the view that they are satisfied with the services they receive from proxy advisory firms and oppose efforts to regulate them.[15] During his remarks at the SEC's open meeting to adopt the recent guidance, Commissioner Roisman countered this perspective stating that, in this context, he does not consider investment advisers to be the investors that the SEC is charged with protecting, but rather, the Commission's guidance on proxy voting is designed to protect the "ultimate retail investors."[16]

In context, the releases appear to be a modest effort to address some of the concerns raised by companies by encouraging greater transparency and emphasizing accountability of both the proxy advisory firms and the investment advisers that engage them. To the extent proxy advisory firms respond to the guidance by adopting new policies and procedures that include more company involvement, investment advisers may continue to have concerns about the process.

Procedural Posture

Both of the Commission's releases were presented as interpretations of existing rules. As a result, neither action was subject to public comment or the requirement to conduct a cost/benefit analysis, which was noted by the two dissenting Commissioners. While Commissioner Lee expressed concern that the guidance amounts to a substantive policy choice without the benefit of a formal public comment process,[17] Chairman Clayton stated that the potential actions discussed in the guidance are not new and should be familiar to investment advisers and other market participants.[18] Because the Commission did not request public comment on its interpretations, they are effective immediately and will apply to the 2020 proxy season.

Proxy Voting Responsibilities of Investment Advisers

Under the Advisers Act, an investment adviser has a fiduciary duty to serve the best interests of its clients at all times, including in the exercise of proxy voting authority.[19] The Proxy Voting Rule requires an investment adviser to adopt and implement written policies and procedures reasonably designed to ensure that it votes client securities in the best interests of its clients. These procedures must address the resolution of material conflicts that may arise between the interests of the investment adviser and its clients.[20] Within this framework, the Investment Adviser Guidance sets forth how an investment adviser may, and in some instances should, exercise voting authority on behalf of clients in order to meet the requirements of the Proxy Voting Rule, particularly if the investment adviser retains a proxy advisory firm.

The Investment Adviser Guidance addresses a number of specific topics, including:

1. How an investment adviser and its client may agree upon the scope of the investment adviser's authority and responsibilities to vote proxies on behalf of that client. Where an investment adviser accepts voting authority, it may agree with the client as to the scope of such authority. The Investment Adviser Guidance provides a non-exhaustive list of possible voting arrangements, including voting based on specific parameters such as the proposing party, the costs to the client of voting and the type of proposal. The fiduciary duty of the investment adviser in the context of voting will vary depending on the scope of the voting authority, but all voting determinations by an investment adviser on behalf of its clients must be made consistent with its fiduciary duty and in compliance with the Proxy Voting Rule.

2. The steps an investment adviser 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. An investment adviser with multiple clients should consider (i) whether it should have different voting policies for particular clients based on each client's best interest or objectives, (ii) whether certain types of voting matters, such as corporate events or contested elections, necessitate more detailed analysis than what may be prescribed by the investment adviser's general voting guidelines, and (iii) reasonable measures to determine that the investment adviser is acting in compliance with its voting policies and procedures. Where the investment adviser retains a proxy advisory firm, the investment adviser should consider additional steps[21] to ensure that votes are cast in accordance with both the investment adviser's voting policies and procedures and the best interests of its clients.

3. Considerations that an investment adviser should take into account when considering whether to retain or continue to retain a proxy advisory firm to assist it in exercising voting authority. The Investment Adviser Guidance states that an investment adviser should consider specific information when considering whether to retain or continue to retain a proxy advisory firm, specifically:

- whether the proxy advisory firm has the capacity and competency to adequately analyze the matters for which the investment adviser is responsible for voting, including consideration of the proxy advisory firm's staffing, personnel and/or technology;
- whether the proxy advisory firm has an effective process for timely seeking input from issuers and its clients on the proxy advisory firm's voting policies, methodologies and peer group constructions; and
- whether the proxy advisory firm has disclosed its methodologies and third-party information sources such that the investment adviser understands the factors underlying the proxy advisory firm's voting recommendations and the steps that the investment adviser should take to develop a reasonable understanding of the proxy advisory firm's interactions with issuers and third parties.

The Investment Adviser Guidance further indicates that an investment adviser should conduct a reasonable review of the proxy advisory firm's policies and procedures regarding conflicts of interest, listing a number of detailed aspects that the investment adviser should assess.[22]

4. 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 the investment adviser's voting determinations. In evaluating its ongoing use of a proxy advisory firm, an investment adviser should consider the effectiveness of the proxy advisory firm's policies and procedures in obtaining accurate and up-to-date information, including consideration of the proxy advisory firm's (i) engagement of issuers during the proxy advisory firm's process, (ii) efforts to correct identified material deficiencies in its analysis, (iii) disclosure of information sources and methodologies to the investment adviser and (iv) consideration of issuer- or proposal-specific factors for a particular vote.

5. How an investment adviser can evaluate the services of a proxy advisory firm that it retains. Under the Investment Adviser Guidance, an investment adviser that retains a proxy advisory firm should implement policies and procedures reasonably designed to sufficiently evaluate the proxy advisory firm in order to ensure that the investment adviser votes in accordance with its clients' best interests. The release notes that an investment adviser should consider requiring the proxy advisory firm to update the investment adviser regarding relevant changes to the proxy advisory firm's capacity and competency to provide voting recommendations or carry out voting instructions and changes to the proxy advisory firm's policies and procedures regarding conflict of interest. An investment adviser should also consider whether the proxy advisory firm appropriately updates its methodologies, guidelines and voting recommendations over time.

6. Whether an investment adviser that has assumed voting authority on behalf of a client is required to exercise every opportunity to vote a proxy for that client. An investment adviser may elect not to vote where doing so is in the best interest of a client and is consistent with the investment adviser's fiduciary duties owed to such client.

The Investment Adviser Guidance is largely consistent with an investment adviser's fiduciary obligations when delegating its responsibilities to another person. However, some of the specific suggestions set forth in the Investment Adviser Guidance raise questions about the cost and challenges of compliance relative to the corresponding benefit to investors. A particular vote might, for example, be controversial but of no economic significance to the investment adviser's clients. Smaller investment advisers could cease accepting voting authority from clients due to the incremental administrative burden suggested by the Investment Adviser Guidance. Moreover, the suggestion to consider a proxy advisory firm's interaction with a subject issuer appears to exceed what the Commission has previously expected of investment advisers, and it is unclear how investment advisers will respond. The Investment Adviser Guidance does not address whether an investment adviser that chooses not to engage the services of a proxy adviser would have its own fiduciary obligation to consult with corporate managers before voting shares for its clients.

Applicability of Federal Proxy Rules to Proxy Voting Advice

In the Proxy Rules Guidance, the Commission provided interpretation and guidance on the applicability of certain proxy rules to voting advice provided by proxy advisory firms. Specifically, the Proxy Rules Guidance addressed the following questions:

1. Whether proxy voting advice provided by a proxy advisory firm constitutes a solicitation under the federal proxy rules. The Commission confirmed in the Proxy Rules Guidance that proxy advice provided by a proxy advisory firm generally constitutes a "solicitation" for purposes of the federal proxy rules. Rule 14a-1 under the Securities Exchange Act of 1934 defines the term solicitation, for purposes of the federal proxy rules, to include a "communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy."[23] The Proxy Rules Guidance notes past Commission statements and relevant court decisions clarifying that the federal proxy rules apply to any person seeking to influence the voting of proxies by shareholders, regardless of whether the person itself is seeking authorization to act as a proxy or is indifferent as to the outcome of such vote.

The Commission has determined that, except where such work is merely administrative or ministerial, a proxy advisory firm's voting recommendations fall within the broad definition of solicitation for purposes of the federal proxy rules. The Commission's view is unchanged where a proxy advisory firm makes its recommendations based on its application of the investment adviser's voting guidelines. Moreover, the Commission rejected the view that a proxy advisory firm's voting recommendations are unsolicited voting advice as the communication is invited by the proxy advisory firms themselves, who generally market their expertise for the purpose of assisting voting decisions.

Importantly, the Commission stated that its interpretation and guidance do not affect the ability of proxy advisory firms to rely on the exemptions from the federal proxy rules' information and filing requirements provided by Rule 14a-2(b) under the Exchange Act.[24] That reliance, however, may be short-lived. Chairman Clayton and Commissioner Roisman both signaled in their remarks that, in the near future, the Commission expects to consider proposed rule amendments to address proxy advisory firms' reliance on the exemptions.[25] Chairman Clayton also noted that he has asked the Staff to consider whether Rule 14a-1 should be amended to codify the interpretation of the term "solicitation" contained in the Proxy Rules Guidance.[26]

2. Whether Exchange Act Rule 14a-9 applies to proxy voting advice. The Proxy Rules Guidance clarified the Commission's view that the anti-fraud provision in Rule 14a-9 under the Exchange Act applies to proxy voting advice. Rule 14a-9 prohibits any solicitation from containing any statement that is materially false or misleading or omitting to state any material fact necessary to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.[27]

In order to avoid a potential violation of Rule 14a-9, the Proxy Rules Guidance suggested that proxy advisory firms should consider disclosing certain types of information in connection with their voting recommendations. This information should be disclosed where the omission would render the proxy advisory firm's recommendations materially false or misleading, namely: (i) the methodology underlying the voting advice on a particular matter, (ii) sources of information other than the registrant's public disclosures and the degree to which the information from such sources differs from the registrant's public disclosures and (iii) material conflicts of interest. This aspect of the Proxy Rules Guidance corresponds to the information investment advisers should consider in evaluating a proxy advisory firm, according to the Investment Adviser Guidance.

The Proxy Rules Guidance is notable in laying the foundation for greater transparency about how proxy advisory firms should formulate their recommendations in order to guard against potential violations of the anti-fraud provision provided by Rule 14a-9. The Commission made clear that providing voting advice without the appropriate context, including disclosure about material conflicts of interest, could render the advice materially false and misleading. While the underlying principles may not be new, the additional detailed guidance may affect the type of information that proxy advisory firms provide to their clients.

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[1] Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Release No. IA-5325 (August 21, 2019) ("Investment Adviser Guidance").

[2] Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice, Release No. 34-86721 (August 21, 2019) ("Proxy Rules Guidance").

[3] Staff Legal Bulletin No. 20, Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms (June 30, 2014).

[4] *See* Commissioner Allison Herren Lee, "Statement of Commissioner Allison Herren Lee On Proxy Voting and Proxy Solicitation Releases" (August 21, 2019), https://www.sec.gov/news/public-statement/statement-lee-082119 ("Statement of Commissioner Lee"); Commissioner Robert J. Jackson, Jr., "Statement on Proxy-Advisor Guidance" (August 21, 2019), https://www.sec.gov/news/public-statement/statement-jackson-082119.

[5] Chairman Jay Clayton, "Statement at Open Meeting on Commission Guidance and Interpretation Regarding Proxy Voting and Proxy Voting Advice" (August 21, 2019), https://www.sec.gov/news/public-statement/statement-clayton-082119 ("Statement of Chairman Clayton").

[6] 17 CFR 275.206(4)-6 (the "Proxy Voting Rule").

[7] *Proxy Voting by Investment Advisers*, Investment Advisers Act Rel. No. 2106 (January 31, 2003).

[8] Letter from Business Roundtable (November 9, 2018) ("The market for proxy advisory services is dominated by two companies. Institutional Shareholder Services Inc. ('ISS') and Glass Lewis & Co. ('Glass Lewis') effectively operate as a duopoly, enjoying a 97 percent combined market share."); Letter from Business Roundtable (June 3, 2019) ("Further, proxy advisory firms are subject to little regulatory oversight, and there are questions as to whether some institutional investors are complying with their fiduciary duties related to the voting of the shares they control, as well as duties to oversee the proxy advisory firms they retain.").

[9] *See, e.g.*, Letter from ExxonMobil Corporation, at 6 (July 26, 2019) ("We note . . . that we do not receive a draft of any of the five specialty policy reports that ISS produces and sells as ISS recommendations. We believe this lack of review, and the apparent use of a different factual standard in these reports that accepts unsourced allegations and accusations as facts, leads to significantly inferior disclosure than exists in the benchmark reports.").

[10] *See*, *e.g.*, Letter from Nan Baurother, Member of Main Street Investors Coalition (January 25, 2019).

[11] Proxy advisory firms are investment advisers subject to the Advisers Act, although not all are registered under the Advisers Act. *Concept release on the U.S. Proxy System*, Exchange Act Rel. No. 34-62495 (July 14, 2010) ("[P]roxy advisory firms meet the definition of investment adviser because they, for compensation, engage in the business of issuing reports or analyses concerning securities and providing advice to others as to the value of securities.").

[12] Letter from Gail C. Bernstein, General Counsel, Investment Adviser Association (December 31, 2019).

[13] *ICI Research Perspective* (July 2019) ("[Mutual] funds decided how to vote in a nuanced manner based on a wide variety of factors.").

[14] Letter from T. Rowe Price Associates, Inc., at 2 (December 13, 2018) ("We are significantly more concerned, frankly, with the potential for issuers to inappropriately influence the research provided by proxy advisors to their clients.").

[15] *See, e.g.*, *Important Issues for Investors in 2019*, speech by Rick Fleming, SEC Investor Advocate (April 8, 2019) ("Indeed, at the Roundtable on the Proxy Process that the Commission held last November, I think the investors made it pretty clear that they are happy with the services they receive from proxy advisers.").

[16] *See* Commissioner Elad L. Roisman, "Statement at the Open Meeting on Commission Guidance and Interpretation Regarding Proxy Voting and Proxy Voting Advice" (August 21, 2019), https://www.sec.gov/news/public-statement/statement-roisman-082119 ("Statement of Commissioner Roisman").

[17] *See* Statement of Commissioner Lee.

[18] *See* Statement of Chairman Clayton.

[19] *See Commission Interpretation Regarding Standard of Conduct for Investment Advisers*, Release No. IA-5248, at 6-8 (June 5, 2019).

[20] 17 CFR 275.206(4)-6.

[21] Additional steps could include sampling pre-populated votes, considering policies and procedures that provide for evaluation of subsequent additional information about a particular proposal, and considering a higher degree of analysis for proposals where the investment adviser's policies and procedures do not address how to vote or where the proposal is highly contested or controversial.

[22] The Investment Adviser Guidance suggests assessing the adequacy of the proxy advisory firm's (i) policies and procedures to identify, disclose and address actual and potential conflicts of interest, including conflicts arising from proxy advisory services and affiliations, (ii) policies and procedures to disclose conflicts of interest and (iii) technological capability to deliver readily accessible conflict-of-interest disclosures.

[23] 17 CFR 240.14a-1(l).

[24] *See, e.g.*, 17 CFR 240.14a-2(b)(1) (providing an exemption, subject to certain conditions, for any solicitation by or on behalf of any person who does not, at any time during such solicitation, seek directly or indirectly, either on its own or another's behalf, 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) and 17 CFR 240.14a-2(b)(3) (providing an exemption, subject to certain conditions, for the furnishing of proxy voting advice by any person to another person with whom a business relationship exists).

[25] *See* Statement of Chairman Clayton; Statement of Commissioner Roisman.

[26] *See* Statement of Chairman Clayton.

[27] *See* 17 CFR 240.14a-9.

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