August 22, 2019

SEC Provides New Guidance on Institutional Investors' Proxy Voting Responsibilities and Use of Proxy Advisory Firms

Yesterday, the Securities and Exchange Commission approved new guidance in two releases from the Division of Corporation Finance and the Division of Investment Management concerning the fiduciary responsibilities of investment advisers (like fund managers) with respect to proxy voting, the use of proxy advisory firms (like ISS and Glass Lewis), assessing such advisory firms' "care and competency" with respect to potential factual errors, incompleteness, or methodological weaknesses that may materially affect voting recommendations, and addressing the applicability of proxy solicitation and anti-fraud rules to proxy advisory firms and their vote recommendations.

Consistent with past statements by SEC Chair Jay Clayton and Commissioner Elad Roisman, today's guidance goes beyond the 2014 staff-level interpretations regarding proxy voting and, importantly, reflects Commission-level approval. As noted by the Commission, the guidance and articulated policies (provided in question and answer formats) do not create new obligations or require rulemaking. These pronouncements increase pressure on investment advisers and proxy advisory firms in terms of what is expected of them, and should alter the behavior of those that are not already following this guidance. The SEC is encouraging investment advisers and proxy advisory firms to review their policies and practices in light of the new guidance in advance of next year's proxy season.

Division of Investment Management Guidance. As SEC Chair Clayton emphasized, "investment advisers are fiduciaries that owe each of their clients duties of care and loyalty with respect to services undertaken on their client's behalf, including voting." The guidance from the Division of Investment Management focuses on the proxy voting responsibilities of investment advisers and their fiduciary duties, especially when relying upon proxy advisory firms. One Q&A focuses on how investment advisers can ensure that the scope of their authority to vote proxies on behalf of their client is clearly defined (and offers a number of examples of possible voting arrangements). In this regard, the 2019 guidance clearly states that an adviser is not always required to cast a vote on behalf of its clients on all issues and provides relevant examples of scoping the authority to vote and deciding to refrain from voting.

A second Q&A addresses steps an investment adviser can take to demonstrate that it is making voting determinations in its client's best interests and in accordance with its own (rather than a proxy advisory firm's) proxy voting policies and procedures. In particular, the guidance questions whether an investment advisor's use of "a uniform voting policy would be in the best interest of each of its clients," and states that, as part of its ongoing compliance program, the adviser must "review and document, no less frequently than annually, the adequacy of its voting policies and procedures to ensure that they have been formulated reasonably and implemented effectively."

Another Q&A details considerations an investment adviser should take into account if it retains a proxy advisory firm, including whether the proxy advisor has an effective process for seeking timely input from issuers and others, whether it has adequately disclosed to the invest-

ment adviser its methodologies in formulating voting recommendations, and whether it provides adequate "context-specific, non-boilerplate" disclosure of actual and potential conflicts. Reflecting a similar wariness about a "one-size-fits-all" approach to complex issues, the guidance states that investment advisers should consider how proxy advisory firms consider "factors unique to a specific issuer or proposal when evaluating a matter subject to a shareholder vote" and suggests that even as to peer group determinations, proxy advisory firms should take into account "the unique characteristics regarding the issuer, to the extent available, such as: the issuer's size; its governance structure; its industry and any particular practices unique to that industry; its history; and its financial performance."

Addressing a topic that has been particularly sensitive for issuers and shareholders, the SEC provides guidance on how investment advisers should address potential errors, incompleteness or methodological weaknesses in a proxy advisory firm's analysis, including considering whether the proxy adviser has a process for engaging with issuers to ensure that it has complete and accurate information, the proxy adviser's efforts to correct any identified material deficiencies in its analysis and its process, if any, for investment advisers to access an issuer's views about the proxy advisory firm's recommendations in a timely and efficient manner. As highlighted by Commissioner Roisman, this guidance underscores that even when relying on a proxy advisory firm, "the [investment adviser] remains on the hook for its fiduciary obligations."

Fund managers should pay particular attention to their exercise of these duties in the context of M&A votes, contested elections, and other high-profile and non-ordinary-course matters, and to take steps to ensure that they and their proxy advisors have systems in place to ensure that votes are cast in compliance with the fiduciary duties owed by fund managers to their clients.

Division of Corporation Finance. The guidance from the Division of Corporation Finance re-emphasizes that proxy advisory firm recommendations and voting advice, as attempts to influence investors' voting decisions, will generally constitute "solicitations" under the proxy rules, even where the advisory firm is applying custom-tailored guidelines, whether or not the advice was solicited, and whether or not the client follows the advice. In addition, while the exemptions from certain information and proxy statement filing requirements will continue to apply to such firms if the conditions are met, the guidance confirms that Rule 14a-9's anti-fraud rules and prohibition on false and misleading solicitations apply to proxy advisory firms. Several SEC Commissioners underscored this point in their public remarks regarding the guidance.

As such, proxy advisory firm recommendations, including the associated reports, may not include statements which are, at the time and under the circumstances in which they are made, "false or misleading as to any material fact" or "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 recommends that, in order to avoid potential violations of Rule 14a-9, proxy advisors should consider providing appropriate disclosure of material conflicts of interest, third-party or other non-public information underlying their voting advice, and the methodology used to formulate their voting advice (including any material deviations from publicly announced guidelines or policies) and related analyses.

Similarly, the guidance makes clear that proxy advisory firms should disclose where they are getting the information included in their reports and the sources underlying their recommendations and identify material differences between the information they are relying upon and an issuer's public disclosures. This is significant because some companies find that advisory firms issue reports referring to performance data or other company assessments that deviate from the company's publicly-provided information.

Notably, in rejecting the arguments that the Commission should not take action because "…the investors themselves…the ones paying for proxy advice…are not asking for protection" (even though some institutional investors have in fact called for increased transparency and improvements at proxy advisory firms), Commissioner Roisman emphasized that:

> "To be clear, in this context, I do not consider asset managers to be the "investors" that the SEC is charged to protect. Rather, the investors that I believe today's recommendations aim to protect are the ultimate retail investors, who may have their life savings invested in our stock markets. These Main Street investors who invest their money in funds are the ones who will benefit from (or bear the cost of) these advisers' voting decisions. In essence, I believe it is our job as regulators to help ensure that such advisers vote proxies in a manner consistent with their fiduciary obligations and that the proxy voting advice upon which they rely is complete and based on accurate information."

The Commissioners noted that areas of potential future rulemaking include (1) proposed rules to amend the submission and resubmission thresholds for shareholder proposals under Rule 14a-8 under the Exchange Act and (2) proposed rule amendments to address proxy advisory firms' reliance on the proxy solicitation exemptions in Exchange Act Rule 14a-2(b). The SEC will also continue to consider "proxy plumbing" initiatives, and, as previously discussed, Congress remains interested in evaluating the role of proxy advisory firms and considering legislative action.

While broader reform proposals remain under consideration, we believe this new Commission-approved guidance is an important step in promoting accountability in voting, encouraging proxy advisory firms to provide expanded transparency into their methodologies and analyses and reducing rote application of one-size-fits-all policies. The guidance also holds the hope of further empowering institutional investors to reach their own independent, informed judgments on voting matters regardless of the influence of proxy advisory firms, facilitating respectful dialogue between companies and proxy advisory firms and, most importantly, encouraging regular constructive and direct engagement between companies and their investors.

Andrew R. Brownstein
Adam O. Emmerich
David A. Katz
Trevor S. Norwitz
Sabastian V. Niles
Elina Tetelbaum