SEC ISSUES NEW GUIDANCE FOR INVESTMENT ADVISERS ON PROXY VOTING

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U.S. Investment Management Alert

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OPEN MEETING OUTCOME

At an Open Meeting on August 21, 2019, the Securities and Exchange Commission (the “Commission” or “SEC”) voted three to two in favor of publishing guidance (the “Guidance”) [1] addressing the Commission's views regarding proxy voting responsibilities of investment advisers pursuant to Rule 206(4)-6 under the Investment Advisers Act of 1940, as amended (the “Advisers Act”), and Form N-1A, Form N-2, Form N-3, and Form N-CSR under the Advisers Act. The Commission also voted three to two in favor of publishing an interpretation (the “Interpretation”) regarding the applicability of Rules 14a-1 and 14a-9 under the Securities and Exchange Act of 1934, as amended (the “Exchange Act”), to proxy voting advice.

In particular, the Guidance addresses six key areas for investment advisers, including:

- how investment advisers and their clients may clearly detail the investment advisers' authority to vote proxies on their client's behalf;
- how an investment adviser can demonstrate that it is making voting determinations in the client's best interest and in accordance with the investment adviser's proxy voting policies and procedures;
- what factors an investment adviser should assess when engaging the services of a proxy advisory firm;
- steps an investment adviser should consider taking when it becomes aware of potential factual errors, potential incompleteness, or potential weaknesses in methodologies in a proxy advisory firm's analysis that may materially affect one or more of the investment adviser's voting determinations;
- how an investment adviser should evaluate the services of a proxy advisory firm that it retains, including evaluating any material changes in services or operations by the proxy advisory firm; and
- whether an investment adviser is required to exercise every opportunity to vote a proxy for a client where it has assumed proxy voting authority on behalf of the client.

In addition, the Interpretation offers some additional clarity as to what constitutes a “solicitation” under the federal proxy rules.

While the Guidance and Interpretation were issued without a notice and comment period, it did follow other opportunities for public input, including the “Roundtable on the Proxy Process” held on November 15, 2018.

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The Guidance and Interpretation adopted by the Commission is intended to provide clarity as to how investment advisers could satisfy their proxy voting obligations, but the Guidance and Interpretation are still in keeping with the principles established in Rule 206(4)-6 under the Advisers Act and Staff Legal Bulletin 20 ("SLB 20"), which was issued by the Commission 10 years after Rule 206(4)-6 was adopted. [2] SLB 20 discusses the manner in which advisers can comply with Rule 206(4)-6, including through the use of proxy advisory firms, where the adviser also adopted measures to supervise investment advisory firms and conduct diligence.

PROXY VOTING RESPONSIBILITIES OF INVESTMENT ADVISERS

Rule 206(4)-6 under the Advisers Act requires an investment adviser who exercises voting authority with respect to client securities to adopt and implement written policies and procedures that are reasonably designed to ensure that the investment adviser votes proxies in the best interest of its clients. Pursuant to Rule 206(4)-6, if an investment adviser voted client proxies in accordance with a pre-determined policy based on the recommendation of an "independent" proxy advisory firm, it could demonstrate that the votes were not subject to a conflict of interest. Prior to 2018, the Commission's views regarding the circumstances under which an investment adviser could rely on proxy voting recommendations and related services provided by proxy advisory firms to satisfy their fiduciary duties were generally found in two no-action letters, *Egan-Jones Proxy Services* ("Egan-Jones") (May 27, 2004) and *Institutional Shareholder Services, Inc.* ("ISS") (September 15, 2004), and SLB 20. [3] However, on September 13, 2018, the Division of Investment Management issued an Information Update through which it announced the withdrawal of the two no-action letters (but not SLB 20) to facilitate the discussion at the Roundtable on the Proxy Process.

The Guidance discusses how an investment adviser's fiduciary duty of care and loyalty and the requirements of Rule 206(4)-6 apply in the context of proxy voting on behalf of the adviser's clients (including pooled investment vehicles), particularly if a third-party proxy advisory firm has been engaged to assist with the adviser's proxy voting responsibilities. **Specifically, the Commission makes six key points in the Guidance**:

1. While an investment adviser is in a position to agree to a wide variety of voting arrangements with its clients, the investment adviser must ensure that it will make voting determinations under that same arrangement consistent with its fiduciary duties and proxy voting policies and procedures. Some of these voting arrangements include: (i) voting based on specific parameters designed to serve the best interests of an individual client; (ii) refraining from voting in situations that could lead to increased costs for clients; and (iii) focusing voting responsibilities only on specific kinds of proposals.
2. An investment adviser should consider ways to go about demonstrating that it is making voting determinations in the client's best interest and in accordance with the investment adviser's proxy voting policies and procedures. Some ways to go about doing this include applying client-specific voting policies for clients with different investment goals, conducting a company-specific analysis, rather than using general voting guidelines, for certain types of proposals, and taking into consideration whether a proxy advisory firm's proposals are consistent with the investment adviser's proxy voting guidelines.
3. Investment advisers should take into account the following considerations when retaining a proxy advisory firm to exercise its proxy voting duties, including, but not limited to: (i) whether the proxy advisory firm has the necessary resources to effectively advise an adviser's clients; (ii) whether the proxy advisory firm has an effective process for seeking input from issuers and its client regarding, for example, proxy

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voting policies, (iii) whether the proxy advisory firm has disclosed to the investment adviser how it arrives at its voting recommendations; and (iv) that the investment adviser understands the proxy advisory firm's methodology.

4. An investment adviser should implement policies and procedures that are "reasonably designed" to ensure that voting recommendations are not based on materially inaccurate or incomplete information. For example, an investment adviser could conduct a periodic review of a proxy advisory firm's research or voting determinations, which might include an assessment of the extent to which a proxy advisory firm's methodological shortcomings materially affected its final recommendations.
5. Investment advisers should review a proxy advisory firm's services on an ongoing basis by identifying a proxy advisory firm's potential conflicts of interest that arise and requiring the proxy advisory firm to notify the investment adviser of any material business changes.
6. Finally, an investment adviser need not exercise its voting authority every time it has an opportunity to do so. For example, if an investment adviser determines that foregoing its right to vote could be in its client's best interest, the Guidance suggests that the investment adviser should avoid voting.

APPLICABILITY OF THE FEDERAL PROXY RULES TO PROXY VOTING ADVICE

The Commission also issued an interpretation of the definition of "solicitation" and how that applies to proxy voting advice. The Interpretation states that proxy voting advice provided by a proxy advisory firm generally constitutes a solicitation under Exchange Act Rule 14a-1(l). The Interpretation also expressly states that it does not affect the availability of the two most common exemptions relied upon by proxy advisory firms to exempt their proxy voting advice from full Commission filing obligations under the proxy rules, which are found in Exchange Act Rule 14a-2(b).

Notably, the Interpretation offers further clarity on how to interpret Exchange Act Rule 14-9, which prohibits materially false or misleading statements or omissions in proxy solicitations. The Interpretation provides several examples of the types of disclosures proxy advisory firms should consider providing to ensure that their proxy voting advice is not misleading. **Some examples of information that providers of proxy voting advice may need to disclose to avoid a violation of Exchange Act Rule 14a-9 include**:

- an explanation of the methodology used to formulate voting advice on a particular matter where omission of such information could render the voting advice materially false or misleading;
- information about third-party information sources to the extent that the proxy voting advice is based on information other than the registrant's public disclosures and differences between the third party's information and the registrant's provided information are material; and
- information regarding material conflicts of interest that arise in connection with providing the proxy voting advice in reasonably sufficient detail so that clients can assess the relevance of those clients.

PRACTICAL SIGNIFICANCE

As mentioned, above, the Guidance and Interpretation are intended to assist investment advisers in complying with their proxy voting responsibilities. While the methods recommended by the Commission can be instructive in this regard, investment advisers should assess what it required of them on a client-by-client basis.

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Based on the Guidance and Interpretation, investment advisers will need to revisit their proxy voting policies and procedures and consider amendments to ensure consistency with the Guidance and Interpretation. For example, investment advisers of funds, which frequently have one set of procedures for a fund complex, should consider whether all funds can rely on the same policies and, if not, whether changes to the funds' proxy voting policies and procedures disclosure in statements of additional information or Forms N-CSR filings, as applicable, are warranted. Proxy advisory firms will need to be prepared to provide additional information to investment advisers to assist them with gaining a better understanding of the services that the proxy advisory firms provide as well as confirming that these services align with their own fiduciary duties. Investment advisers should consider strengthening their policies and procedures for both reviewing a proxy advisory firm's methodology used in forming its voting recommendations as well remediating the effects that can result from a proxy advisory firm's factual errors, incompleteness, or methodological weaknesses in providing its services.

Finally, investment advisers may also want to begin examining particular situations in which they should either refrain from or limit exercising their voting authority. These situations should be carefully documented in the investment adviser's policies and procedures.

EFFECTIVE DATE

The Guidance and Interpretation were effective upon publication in the Federal Register on September 10, 2019. The Commission also noted that there may be additional rulemaking in areas such as proxy solicitation exemptions under Exchange Act Rule 14a-2(b), on which proxy advisory firms rely, and the submission and resubmission thresholds for shareholder proposals under Exchange Act Rule 14a-8. We will continue to monitor any future developments regarding proxy related matters. In the meantime, please feel free to contact us if you should have any additional questions.

NOTES

[1] *See* Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Release Nos. IA-5325; IC-33605 (Aug. 21, 2019) https://www.sec.gov/rules/interp/2019/ia-5325.pdf; Commission Interpretation and Guidance Regarding Applicability of the Proxy Rules to Proxy Voting Advice, Release No. 34-86721 (Aug. 21, 2019) https://www.sec.gov/rules/interp/2019/34-86721.pdf.

[2] *See* SEC 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).

[3] *See Egan-Jones Proxy Services*, SEC Staff Letter (May 27, 2004) and *Institutional Shareholder Services, Inc.*, SEC Staff Letter (Sept. 15, 2004). In *Egan-Jones*, the Commission staff confirmed that a third-party proxy advisory firm could be considered independent third party if the proxy advisory firm receives compensation from an issuer for providing advice on corporate governance issues. In *ISS*, the Commission staff agreed that a case-by-case evaluation of a proxy advisory firm's potential conflicts of interest was not the only manner by which an investment adviser may fulfill its obligations under Rule 206(4)-6 and fiduciary duty of care to clients.

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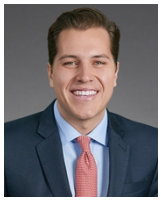

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