

August 29, 2019

SEC Issues Guidance to Clarify Investment Advisers' Proxy Voting Responsibilities and the Treatment of Proxy Advice Under the Proxy Rules

On August 21, 2019, the SEC published two releases: [Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers](#) (the “IA Release”) and [Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules](#) (the “Proxy Release”). The releases were adopted in separate 3-2 votes, with Chairman Clayton and Republican Commissioners Peirce and Roisman forming the majority in both instances and Democratic Commissioners Jackson and Lee (at her first open meeting) dissenting.

After years of debate, the IA Release and the Proxy Release represent a step towards greater SEC oversight of proxy advisory firms (each, a “Proxy Adviser”) and investment advisers’ reliance on Proxy Advisers. The oversight comes not by increased regulation of the Proxy Advisers themselves, but by providing detailed guidance to (and, thereby, possibly increasing the burdens on) investment advisers on how to monitor the advice they receive. In addition, the IA Release applies principles set forth in June’s SEC interpretive release regarding the standard of conduct of investment advisers (the “Fiduciary Interpretation”)¹ in the context of proxy voting responsibilities. The IA Release and the Proxy Release are discussed in detail below. Each release will become effective upon its publication in the *Federal Register*.

THE IA RELEASE

Overview. The IA Release contains the SEC’s guidance regarding investment advisers’ proxy voting responsibilities under fiduciary principles and Rule 206(4)-6 under the Advisers Act, and various disclosure obligations under the 1940 Act.

In particular, much of the IA Release is devoted to providing guidance to investment advisers that rely on the assistance of a Proxy Adviser to fulfill some part of their proxy voting responsibilities. The guidance is generally provided in the form of detailed examples of matters that an investment adviser “should consider” when relying on a Proxy Adviser. The IA Release states that the examples are provided “to help facilitate investment advisers’ compliance with their proxy voting responsibilities; however, these examples are not the only way by which investment advisers could comply with their principles-based fiduciary duty imposed on them by the Advisers Act.” It is not clear how investment advisers will respond to the examples and suggestions offered in the IA Release, although these types of examples and suggestions have a way of finding themselves enshrined in compliance manuals and the examination checklists of OCIE staff. As Commissioner Lee noted in her dissenting remarks, such purportedly non-binding statements in official SEC releases are the type of direction that a “regulated entity ignores . . . at its peril.”

Substantive Guidance. The IA Release follows the Q&A format of 2014’s Staff Legal Bulletin No. 20, in which the SEC staff provided its views on certain of the topics covered in the IA Release and the Proxy Release (“SLB 20”).² Accordingly, this portion of the Alert tracks that format for each of the six Questions and SEC responses in the IA Release.

¹ Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Rel. No. IA-5248 (June 5, 2019) (available [here](#)). The Fiduciary Interpretation is discussed in a separate Ropes & Gray [Alert](#).

² The official title of Staff Legal Bulletin No. 20 is “Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms” (June 30, 2014) (available [here](#)).

Question 1: How may an investment adviser and its client, in establishing their relationship, agree upon the scope of the investment adviser’s authority and responsibilities to vote proxies on behalf of that client?

The IA Release’s response to this question expressly relies upon guidance provided in the Fiduciary Interpretation. Specifically, the IA Release says that “[a]s we recently stated, ‘[t]he fiduciary duty follows the contours of the relationship between the adviser and its client, and the adviser and its client may shape that relationship by agreement, provided that there is full and fair disclosure and informed consent.’” Therefore, according to the IA Release, an adviser and its client (subject to the persistent conditions of full and fair disclosure and informed consent) are free to define the scope of the proxy voting arrangements, including the types of matters for which the adviser will exercise voting authority. The response also emphasizes the following:

- If an adviser agrees to assume proxy voting authority, the adviser must exercise that authority in a manner consistent with its fiduciary duty (which includes the adviser having a reasonable understanding of the client’s objectives and making voting decisions that are in the client’s best interest) and in compliance with Rule 206(4)-6.
- While the adviser’s fiduciary duty *with respect to proxy voting* may vary depending upon the adviser’s arrangement with a client, the relationship always remains that of a fiduciary to a client. On this point, the IA Release cites the SEC’s statement in the Fiduciary Interpretation that “an adviser’s federal fiduciary duty may not be waived, though it will apply in a manner that reflects the agreed-upon scope of the relationship.”

Note: On the second point, we believe there may be a tension between an unwaivable federal fiduciary duty and the ability of the adviser and its client to apply the duty in an agreed-upon manner. In some instances, this may lead to disputes regarding the specificity of an adviser’s arrangement with a client, as well as the reasonableness of an adviser’s action/inaction in the face of ambiguous and/or incomplete instructions or changed facts.

For example, the response states that an adviser and client can agree that the adviser will not vote proxies on the client’s behalf “at all.” A client can thus relieve an adviser of any obligation to assess whether proxies are voted in the client’s best interests. Thus, unless the adviser needs to conclude that a decision prospectively to forego voting on all matters is in the client’s best interest, this means (i) the unwaivable federal fiduciary duty to vote proxies in a client’s best interests is, in fact, waivable and (ii) an adviser should be especially careful with respect to any language in an agreement that narrows the scope of the adviser’s proxy voting responsibilities because any ambiguity in that language is likely to be construed against the adviser as the party that starts with an unwaivable fiduciary duty. Furthermore, the SEC asserts in a footnote that the responsibility for making voting determinations “is implied” absent “full and fair disclosure and informed consent,” thereby placing the burden squarely on the adviser to achieve absolute written clarity with each client as to the extent and shape of any and all limitations on its voting duties.

The remainder of the IA Release’s response to Question 1 consists of examples of voting arrangements to which an adviser and a client may agree. Interestingly, the examples do not include a situation in which an adviser has agreed to vote proxies on behalf of a client “not at all.”

Question 2: What steps could an investment adviser that has assumed the authority to vote proxies on behalf of a client take to demonstrate that it is making voting determinations in a client’s best interest and in accordance with the investment adviser’s proxy voting policies and procedures?

The IA Release’s response to this question elaborates upon requirements that are part of an adviser’s fiduciary duty when it exercises proxy voting authority. These requirements include undertaking a reasonable investigation into matters upon which the adviser votes and voting in a client’s best interest. The response includes the following points:

- When considering whether its proxy voting policies and procedures are reasonably designed to meet its fiduciary duty to its clients and to comply with Rule 206(4)-6, an adviser should consider whether voting all of its clients’ shares consistent with a uniform proxy voting policy is in each client’s best interest. By raising the question, the IA Release suggests that it might not be.
- An investment adviser should undertake reasonable measures to confirm that it is voting in a manner consistent with its voting policies and procedures. For example, as part of its annual review of its compliance policies and procedures, an adviser could sample its proxy votes to evaluate its compliance with Rule 206(4)-6.

The response also states that an investment adviser that relies upon a Proxy Adviser for voting recommendations or execution services should consider how to evaluate whether the adviser’s voting determinations are consistent with its voting policies and procedures and in the client’s best interest before the votes are cast. The response states that the fiduciary duty extends to “the need for an investment adviser to conduct a reasonable investigation into matters on which the adviser votes.” The response provides examples of approaches that an adviser could use, including periodic sampling by the investment adviser of the “pre-populated” votes shown on the Proxy Adviser’s electronic voting platform before such votes are cast, and policies and procedures “that provide for consideration of additional information that may become available regarding a particular proposal.”

Note: While the response states that the best interest determination should occur “before the votes are cast,” it may not be practicable for an adviser to make a pre-vote determination of best interest with respect to every proposal. Indeed, the prohibitive cost of undertaking a pre-vote determination with respect to every proposal is why many advisers choose to rely, in whole or in part, on a Proxy Adviser.

Question 3: What are some of the considerations that an investment adviser should take into account if it retains a proxy advisory firm to assist it in discharging its proxy voting duties?

The IA Release’s response is that an adviser should consider the following non-exhaustive list of factors:

- Whether the Proxy Adviser has the “capacity and competency” to analyze the matters for which the investment adviser is responsible for voting.
- Whether the Proxy Adviser has an effective process for seeking timely input from issuers and its clients regarding, for example, its proxy voting policies, processes and peer group constructs, including for “say-on-pay” votes.
- Whether a Proxy Adviser has disclosed to the investment adviser how it arrives at voting recommendations such that the adviser understands the factors underlying the Proxy Adviser’s recommendations.

The response also underscores that an adviser’s analysis of whether to hire a Proxy Adviser should incorporate a reasonable review of the adequacy of the Proxy Adviser’s policies and procedures concerning identifying, disclosing and addressing conflicts of interest, including (i) conflicts that generally arise from providing proxy voting recommendations and proxy voting services, (ii) conflicts that arise from activities other than providing proxy voting recommendations and proxy voting services and (iii) conflicts that arise from certain affiliations. The response suggests that steps to increase the Proxy Adviser’s transparency and input from issuers is an appropriate area for the adviser’s investigation, but

acknowledges that the adviser's review may vary, depending upon the breadth of the adviser's voting authority and the particular services that the Proxy Adviser has been hired to perform.

Question 4: When retaining a proxy advisory firm for research or voting recommendations as an input to its voting determinations, what steps should an investment adviser consider taking when it becomes aware of potential factual errors, potential incompleteness, or potential methodological weaknesses in the proxy advisory firm's analysis that may materially affect one or more of the investment adviser's voting determinations?

The IA Release's response reminds advisers that, to form a reasonable belief that voting determinations are in a client's best interest, an adviser should conduct a reasonable investigation into potential factual errors, incompleteness or methodological weaknesses (collectively, "Errors"). Therefore, the response states, an adviser's policies and procedures should be reasonably designed to ensure that its voting determinations are not based on Errors. The adviser's policies and procedures could include a regular review of the adviser's use of the Proxy Adviser's recommendations to assess the extent to which Errors materially affected the Proxy Adviser's recommendations.

The response also states that, in reviewing its use of a Proxy Adviser, an adviser should consider the effectiveness of the Proxy Adviser's policies and procedures intended to assure that the firm obtains current, accurate information. In this assessment, the response states that an adviser should consider, among other things:

- Efforts by the Proxy Adviser to rectify identified material deficiencies in its analyses.
- The Proxy Adviser's disclosure of its information sources and methods used to develop its voting recommendations to the adviser.
- Consideration by the Proxy Adviser of facts unique to a specific issuer or proposal when evaluating a matter that is subject to a shareholder vote.

Note: While the response includes, at several points, some comfort to investment advisers that their assessment may be limited in certain circumstances to Errors "that the investment adviser becomes aware of and deems credible and relevant to its voting determinations," the overall treatment of Errors will likely be viewed by many industry participants as imposing higher standards of review and oversight than had previously been understood to be the applicable standards. Of particular concern may be that the IA Release appears to extend an investment adviser's duties with respect to Errors beyond actual breakdowns to potential Errors. The IA Release does not provide much practical guidance on how an investment adviser should seek to identify potential Errors among the hundreds of proxies its clients vote, but the concern is that the reasonable diligence bar will be set with the benefit of hindsight, only after potential Errors become actual Errors.

Question 5: How can an investment adviser 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?

The IA Release's response is that an investment adviser that relies on a Proxy Adviser to help the adviser satisfy its proxy voting responsibilities should adopt and implement policies and procedures that are reasonably designed to evaluate the Proxy Adviser. The response states that such an adviser should consider policies and procedures to detect and assess the Proxy Adviser's conflicts of interest that arise in the normal course, in addition to obtaining updated information concerning the Proxy Adviser's ability to provide its services consistent with the adviser's voting instructions. Therefore, the response states, an adviser should consider requiring the Proxy Adviser to update the adviser of business changes that the adviser is likely to consider relevant to an assessment of the Proxy Adviser's ability to provide its services. An investment adviser also should consider how well the Proxy Adviser updates its rules and

methodologies to make voting recommendations on an ongoing basis, including how well the Proxy Adviser responds to feedback.

Question 6: If an investment adviser has assumed voting authority on behalf of a client, is it required to exercise every opportunity to vote a proxy for that client?

The IA Release's response is "[n]o, if either of two situations applies." The first situation is when an adviser and its client have arranged in advance to limit the circumstances in which the adviser would exercise voting authority. The second situation is when the adviser determines that refraining from voting is in the best interest of the client (e.g., the cost to the client of voting the proxy exceeds the expected benefit to the client).

Note: This response skips lightly over an area of considerable complexity in the practical interactions between investment advisers and their clients. There are myriad instances, particularly with voting proxies of non-US issuers, where the process for submitting votes can be cumbersome and costly (potentially to the client but also possibly to the investment adviser), with relatively little clear benefit to the client, such that investment advisers would strongly prefer to forego voting. But without following a rigorous process, and without taking quite seriously the SEC's admonition to achieve both full and fair disclosure and informed consent, investment advisers may struggle to satisfy the conditions outlined in the response for opting not to vote individual proxies.

THE PROXY RELEASE

Overview. The Proxy Release contains the SEC's guidance on the applicability of the federal proxy rules to proxy voting advice. The Proxy Release confirms that proxy voting advice provided by Proxy Advisers generally constitutes a solicitation subject to the federal proxy rules. In addition, while such proxy voting advice may be exempt from the federal proxy rules' filing requirements, the Proxy Release makes clear that proxy voting advice remains subject to the rules' anti-fraud provisions.

Substantive Guidance. Similar to the IA Release, the Proxy Release follows a Q&A format, but the SEC responses in the Proxy Release are less detailed than in the IA Release.

Question 1: Does proxy voting advice provided by a proxy advisory firm constitute a solicitation under the federal proxy rules?

The Proxy Release's response confirms that proxy voting advice provided by Proxy Advisers generally constitutes a "solicitation" subject to the federal proxy rules.

The Proxy Release's response begins by observing the breadth of the definition of a "solicitation" under the federal proxy rules. Under Exchange Act Rule 14a-1(l), a "solicitation" includes, among other things, a "communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy," and includes communications by a 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 to the ultimate voting outcome. Since Proxy Advisers provide recommendations that are reasonably calculated to result in the procurement, withholding, or revocation of a proxy, the SEC has stated that, as a general matter, the furnishing of proxy voting advice constitutes a "solicitation" within the meaning of Exchange Act Rule 14a-1.

In its written comment letter to the SEC,³ ISS requested that the SEC confirm that a registered investment adviser that is contractually obligated to furnish voting recommendations based on client-selected guidelines does not provide "unsolicited" proxy voting advice and, therefore, does not engage in a "solicitation" subject to the federal proxy rules.

³ Letter from Institutional Shareholder Services Inc. ("ISS") (Nov. 7, 2018) (available [here](#)).

The Proxy Release includes the SEC’s response, stating that Proxy Advisers’ proxy voting advice is distinguishable from “advice prompted by unsolicited inquiries from clients to their financial advisors or brokers on how they should vote their proxies, which remains outside the definition of a solicitation.” Thus, even when a Proxy Adviser is providing recommendations based on its application of a particular client’s own tailored voting guidelines, the Proxy Adviser does engage in a “solicitation” subject to the federal proxy rules.

The SEC’s interpretation does not affect the ability of Proxy Advisers to continue to rely on the exemptions from the federal proxy rules’ filing requirements. These exemptions, found in Rule 14a-2(b), provide relief from the obligation to file a proxy statement, as long as the Proxy Adviser complies with the exemption’s conditions.

Question 2: Does Exchange Act Rule 14a-9 apply to proxy voting advice?

The Proxy Release’s response confirms that a Proxy Adviser’s proxy voting advice is subject to Exchange Act Rule 14a-9, which 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. In addition, such solicitation must not omit to state any material fact necessary in order to make the statements therein not false or misleading.

The Proxy Release’s response makes the point that “opinions” can be considered “facts” for purposes of the antifraud rules. In addition, the response identifies additional disclosures that a Proxy Adviser may need to include with its proxy voting advice, depending on the particular statement, in order to avoid a potential violation of Rule 14a-9:

- an explanation of the methodology used to formulate its voting advice on a particular matter (including any material deviations from the Proxy Adviser’s guidelines, policies, or standard methodologies for analyzing such matters);
- to the extent that the proxy voting advice is based on information other than an issuer’s public disclosures, disclosure about such third-party information sources and the extent to which the information from these sources differs from the issuer’s public disclosures, if such differences are material; and
- disclosure about material conflicts of interest, where such disclosure is provided in reasonably sufficient detail to permit a client to assess the relevance of any conflicts.

OBSERVATIONS

In the IA Release, the SEC reminds investment advisers that, if they rely upon Proxy Advisers for anything other than purely administrative functions, the investment adviser must take steps to ensure the information and advice received results in proxy voting that is in the best interest of the adviser’s clients. Although the IA Release states that an investment adviser and its client (subject to full and fair disclosure and informed consent) are free to define the scope of the proxy voting arrangements (including not voting at all), if an adviser relies on a Proxy Adviser, it is obligated to conduct robust diligence and oversight to ensure that the Proxy Adviser produces advice that is in the best interest of the adviser’s clients.

The IA Release appears to set a high bar. Although the IA Release is generally consistent with the substance of the 2014 staff guidance in SLB 20, the IA Release goes into far more detail in providing examples of steps an investment adviser “should consider” as part of its diligence and oversight of a Proxy Adviser. Arguably, by providing these detailed examples, the IA Release seems to be attempting to elicit from advisers and Proxy Advisers a standard of conduct that, in the past, many believed was a possible topic for formal SEC rulemaking.

By noting in the Proxy Release that proxy voting advice is subject to the antifraud provisions of the federal proxy rules, the SEC’s guidance may be an attempt to warn Proxy Advisers that they face potential enforcement action for making

materially false or misleading statements or omitting material facts when providing such proxy voting advice. Separately, although the Proxy Release paves the way for public companies to bring challenges against the Proxy Advisers for providing proxy voting advice to their investment adviser clients that is materially false or misleading, we believe that the bar for those challenges – including a finding of scienter – remains quite high.

Commissioner Lee, who cast a dissenting vote with Commissioner Jackson, stated in her remarks that the two releases imposed new legal requirements but were being adopted “without notice and comment” under the federal Administrative Procedure Act. The majority was ready for this issue because Michael Conley, Solicitor for the SEC’s Office of General Counsel, was present at the SEC meeting and was asked to offer his views. He responded that, because the IA Release and Proxy Release provided only interpretive guidance regarding the SEC’s views of existing law, the releases did not constitute substantive new rulemaking and, therefore, were not subject to the Administrative Procedure Act’s notice and comment requirements.

The IA Release may place smaller investment advisers in a quandary. Knowing the SEC’s Office of Inspection and Examinations will be following up on the IA Release in periodic examinations, these advisers may rethink whether voting – in all but the most important matters – is economically feasible in view of what would appear to be their enhanced diligence and oversight obligations. Separately, the IA Release and the Proxy Release may increase Proxy Advisers’ costs, thereby ensuring (as Commissioner Jackson pointed out) that there will be fewer new entrants into the market for proxy voting advice.

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For further information about how the issues described in this Alert may impact your interests, please contact your regular Ropes & Gray attorney.