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Legal Update

SEC Publishes Guidance on the Proxy Voting Responsibilities of Investment Advisers

On August 21, 2019, the US Securities and Exchange Commission (SEC) published guidance on the proxy voting responsibilities of investment advisers under the Investment Advisers Act of 1940 (Advisers Act) and Rule 206(4)-6 thereunder (Investment Adviser Guidance).[1] On the same date, the SEC also published an interpretive release regarding the applicability of certain rules under Section 14 of the Securities Exchange Act of 1934 (Exchange Act) to proxy voting advice (Exchange Act Guidance),[2] which is the subject of a separate Mayer Brown Legal Update.[3] This Legal Update, however, focuses on the Investment Adviser Guidance.

Preliminary Matters

Before turning to the substance of the Investment Adviser Guidance, there are two preliminary matters to address. First, it is worth noting that although Rule 206(4)-6 (Proxy Voting Rule) applies only to investment advisers who are registered or are required to be registered under the Advisers Act, the guidance as drafted was not so limited. The Investment Adviser Guidance mentioned registered investment advisers only once, and that was in the context of describing the Proxy Voting Rule. The broad scope of the guidance raised concerns that it was intended to also apply to exempt advisers, such as exempt reporting advisers that are not subject to the Proxy Voting Rule. However, based on a conversation with the SEC staff, we have confirmed that the SEC intended that the Investment Adviser Guidance apply only to investment advisers that are registered or required to be registered under the Advisers Act and thus are subject to the Proxy Voting Rule.

Second, the SEC initially posted the Investment Adviser Guidance on its website under "Interpretive Releases." However, a few days later, it moved the release to the "Policy Statements" section. Based on our conversation with SEC staff, we understand that the guidance should have been posted under policy statements originally, and was later corrected. The staff also explained that the difference between interpretive guidance and a policy statement is that the SEC views a policy statement as communicating one or more non-exclusive methods for compliance, e.g., examples of how one can comply. As a practical matter, however, in our view, this guidance does not appear to differ from interpretative releases, which also often provide non-exclusive methods for compliance, as well as suggestions and examples.[4]

Background

The SEC has been considering issues surrounding proxy responsibilities of investment advisers, proxy advisory firms and the proxy voting process for years. In 2003, it adopted the Proxy Voting Rule for registered investment advisers, followed by an enforcement action related to proxy voting under Section 206(2), and the adoption of Rule 206(4)-7[5] later in the same year (mentioning proxy voting as one of the subjects to be covered by the annual review). After another enforcement action (this one in 2009, based on the Proxy Voting Rule), the SEC issued a concept release in 2010 on the US Proxy System, often referred to as the "proxy plumbing" release, which, among other topics, addressed the role and legal status of proxy advisory firms and potential regulatory responses.[6] Then, in 2013, the SEC staff held a roundtable on the use of proxy advisory firms and, in 2014, issued Staff Legal Bulletin No. 20 providing guidance with respect to the availability and requirements of two federal proxy rule exemptions that proxy advisory firms rely on. In November 2018, the SEC staff hosted a roundtable on the proxy process, with one of the three panels devoted to a discussion of proxy advisory firms. Before the roundtable, in September 2018, to the surprise of many industry participants, the staff of the Division of Investment Management withdrew two no-action letters addressing conflicts of interest related to proxy advisory firms under the Proxy Voting Rule: *Egan-Jones Proxy Services*, SEC Staff No-Action Letter (publicly available May 27, 2004) and *Institutional Shareholder Services, Inc.*, SEC Staff No-Action Letter (publicly available Sept. 15, 2004).[7] Most recently, the SEC published interpretive guidance on the standard of conduct for investment advisers (Fiduciary Interpretation),[8] to which the SEC frequently cited in the Investment Adviser Guidance.

Investment Adviser Guidance

Citing to the Fiduciary Interpretation,[9] the Investment Adviser Guidance began with the following basic principles:

- Investment advisers are fiduciaries that owe each of their clients duties of care and loyalty with respect to services undertaken on the client's behalf, including proxy voting.
- In the context of voting, the specific obligations that flow from the investment adviser's fiduciary duty depend on the scope of voting authority assumed by the adviser.
- To 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.
- Where an investment adviser has assumed the authority to vote on behalf of its client, the investment adviser, among other things, must have a reasonable understanding of the client's objectives and must make voting determinations that are in the best interest of the client.

Furthermore, the SEC stated, 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* (more on this topic below). After encouraging investment advisers to review their proxy voting policies and practices in light of the Investment Adviser Guidance in advance of next year's proxy season and to contact the staff of the SEC's Division of Investment Management with any questions about the guidance, the release then proceeded in a Q&A format, covering the topics discussed below.

DEFINING THE SCOPE OF THE ADVISER'S PROXY VOTING RESPONSIBILITIES

The SEC stated that an investment adviser is not required to accept the authority to vote client securities, regardless of whether the client undertakes to vote the proxies itself. If an investment adviser does accept voting authority, it may agree with its client, subject to full and fair disclosure and informed consent (see the Fiduciary Interpretation's discussion on this subject), on the scope of voting arrangements, including the types of matters for which it will exercise proxy voting authority. The parties could agree that all proxy voting is the adviser's responsibility or that the adviser would vote on the client's behalf only in limited circumstances or not at all. The SEC provided the following examples:

Specific Parameters – The adviser and its client could agree that the investment adviser will exercise voting authority pursuant to specific parameters. For example, the parties could agree that—absent receipt of a contrary instruction from the client or a determination by the investment adviser that voting a particular proposal in a different way would be in the client's best interest (e.g., if voting differently would further the investment strategy being pursued by the investment adviser on behalf of the client)—the adviser will vote in accordance with the recommendations of management or will vote in favor of all proposals made by certain shareholder advocates. In each case, the SEC advised that the arrangement could be subject to conditions (e.g., requiring additional analysis by the investment adviser where the voting recommendation concerns a matter that may present heightened management conflicts of interest or involves a type of matter of particular interest to the investment adviser's client or requiring that the shareholder advocate have particular expertise or an investment strategy that will further the interests of the investment adviser's client).

In light of this guidance, investment advisers should review the proxy voting provisions (or note their absence of the same) in their investment management agreements for any needed modifications. In a footnote, the SEC stated that it believes that if an investment adviser has discretionary authority to manage the client's portfolio and has not agreed with the client to a narrower scope of voting authority through full and fair disclosure and informed consent, the adviser's responsibility for making voting determinations is implied. In other words, for a discretionary adviser, in the absence of specific agreement on the matter, the "default" is that the adviser has full proxy voting responsibility. Revisiting external communications and disclosures regarding the adviser's proxy voting responsibilities and practices, including Item 17 of Form ADV Part 2A, among others, also is advisable.

Limitations Based on Opportunity Costs – The adviser and its client could agree that the adviser will not exercise voting authority in circumstances under which voting would impose costs on the client (e.g., opportunity costs for the client resulting from restricting the use of securities for lending in order to preserve the right to vote).

Limitations Based on the Type of Proposals – The parties could agree that the investment adviser will vote only on particular types of proposals based on the client's preferences, such as proposals relating to corporate events (mergers and acquisition transactions, dissolutions, conversions or consolidations) or contested elections for directors.

Limitations Based on Cost/Benefit Considerations – The parties could agree that the investment adviser will not exercise voting authority on certain types of matters where the cost of voting would be high or the benefit to the client would be low, such as circumstances where the cost of voting the proxy exceeds the expected benefit to the client (e.g., casting a

vote on a foreign security that could involve the additional costs of hiring a translator or traveling to a foreign country to vote the security in person) or circumstances under which casting a vote would not reasonably be expected to have a material effect on the value of the client's investment.

The SEC concluded by reminding advisers that, while an investment adviser and its client may scope voting responsibility through full and fair disclosure and informed consent, an investment adviser that assumes proxy voting authority must make voting determinations consistent with its fiduciary duty and in compliance with the Proxy Voting Rule.

DEMONSTRATING COMPLIANCE WITH THE BEST INTEREST STANDARD

The SEC then stated that it was going to discuss the steps that an investment adviser that has assumed the authority to vote proxies on behalf of a client could take to demonstrate that it is making voting determinations in a client's best interest, although the guidance addresses only two discrete applications of this standard, as discussed below.[10]

According to the SEC, there is a need for the adviser to conduct a reasonable investigation into matters on which the adviser votes, referring to the first section of the release. However, that section of the release did not provide detail on this concept, and referred to the reasonable investigation concept as a "should" not a need.

Multiple Clients – The SEC advised that an investment adviser should consider how its fiduciary duty and its obligations under the Proxy Voting Rule apply when it has multiple clients. Specifically, an investment adviser should consider whether voting the same way for all clients in accordance with a uniform voting policy would be in each client's best interest or whether it should have different voting policies for some or all of these clients, depending on the investment strategy and objectives of each. As an example, the SEC stated that a growth fund that targets companies with high growth prospects may have a different perspective on certain proxy matters as compared to an income or dividend fund.[11]

Matters Needing a More Detailed Analysis – According to the Investment Adviser Guidance, an investment adviser should consider whether certain matters, such as corporate events or contested director elections, may necessitate that the adviser conduct a more detailed analysis than what may be entailed by application of its general voting guidelines in order to consider factors particular to the issuer or the voting matter. In the SEC's view, whether to conduct such an analysis should be informed by the potential effect of the vote on the value of a client's investments. Further, the SEC stated that advisers should consider reflecting the above in their proxy voting policies.

In light of the foregoing, advisers should consider what documentation they might already maintain, or could start to maintain, to demonstrate compliance with the best interest standard in this context and modify their procedures accordingly. In addition, advisers should consider whether modifications to their proxy voting policies and procedures are warranted in light of the above guidance regarding multiple clients and matters needing more detailed analysis (with such consideration being appropriately documented).

DEMONSTRATING PROXY VOTING POLICY COMPLIANCE

According to the SEC, an adviser should consider reasonable measures to determine that it is conducting its proxy voting activities in accordance with its voting policies. The SEC suggested that the adviser could sample its proxy votes (particularly those that may require a more detailed analysis as noted above) as part of its annual compliance review. Regarding

proxy advisory firms, the SEC believes that an investment adviser that retains a proxy advisory firm to provide voting recommendations or voting execution services should consider additional steps to evaluate whether the adviser's votes were cast in a manner consistent with its voting policies and in the best interest of the adviser's client. The SEC suggested the following:

- The investment adviser could periodically sample the proxy advisory firm's "pre-populated" votes.
- Where the investment adviser utilizes the proxy advisory firm for voting recommendations, it could consider policies and procedures that provide for consideration of additional information that may become available regarding a particular proposal (e.g., subsequently filed additional definitive proxy materials or other information conveyed by an issuer or shareholder proponent to the investment adviser).
- With respect to matters that the investment adviser's voting policies do not address, or where the matter is highly contested or controversial, the adviser could consider whether a higher degree of analysis may be necessary or appropriate to assess whether votes were cast in the best interest of the adviser's client.

Lastly, the SEC stated that, as part of an investment adviser's ongoing compliance program, the adviser must review *and document*, no less frequently than annually, the adequacy of its voting policies (including whether the policies and procedures continue to be reasonably designed to ensure that the adviser casts votes in the best interest of clients).[12]

Although most advisers do include proxy voting as part of their annual compliance reviews, advisers who have engaged proxy advisory firms should also consider implementing appropriate reviews and testing of the firms' performance, in light of and consistent with the above guidance.

PROXY ADVISORY FIRM DUE DILIGENCE

According to the SEC, when an investment adviser is considering hiring or continuing a relationship with a proxy advisory firm for research or voting recommendations, the adviser should consider (among other things): the proxy advisory firm's capacity and competency to provide the requested services, including the adequacy and quality of staffing, personnel and technology; the firm's process for seeking timely input from issuers, proxy advisory firm clients and third parties regarding the firm's proxy voting policies; the firm's proxy voting methodologies (such that the investment adviser can understand the factors underlying the proxy advisory firm's voting recommendations); and the firm's peer group construction (e.g., how the firm takes into account unique characteristics of the issuer), including for "say-on-pay" votes.

In addition, the SEC believes that the adviser's due diligence should include a reasonable review of the proxy advisory firm's policies regarding conflicts of interest. In this regard, the SEC suggested that the adviser could assess, among other things:

- Whether the proxy advisory firm has adequate policies and procedures to identify, disclose, and address actual and potential conflicts of interest, including (1) conflicts relating to the provision of proxy voting recommendations and proxy voting services generally (e.g., arising from the provision of recommendations and services to issuers as well as proponents of shareholder proposals regarding matters that may be the subject of a vote), (2) conflicts relating to activities other

than providing proxy voting recommendations and proxy voting services, and (3) conflicts presented by certain affiliations (such as whether a third party with significant influence over the proxy advisory firm (e.g., as a shareholder, lender, or significant source of business) has taken a position on a particular voting issue or voting issues more generally); and

- Whether the proxy advisory firm's policies and procedures provide for adequate (meaning context-specific, non-boilerplate) disclosure of the firm's conflicts (which could include details on whether the issuer has received consulting services from the firm, and if so, the amount of any compensation paid, and whether a proponent of a shareholder proposal or an affiliate of the proponent is or has been a client of the firm).

According to the SEC, the above due diligence steps should be informed by the facts and circumstances at hand, e.g., the scope of the investment adviser's voting responsibility and the scope of services that the adviser retains from the firm (and in particular the type/amount of the proxy advisory firm's voting discretion).

Advisers should review their procedures regarding oversight and engagement of proxy advisory firms and modify their procedures as appropriate.

PROXY ADVISORY FIRM ERRORS AND DEFICIENCIES

In the Investment Adviser Guidance, the SEC stated that an adviser's policies and procedures should be reasonably designed to ensure that its voting determinations are not based on *materially* inaccurate or incomplete information. To that end, the SEC believes that an adviser that has retained a proxy advisory firm for research or voting recommendations should consider including in its policies and procedures a periodic review of the adviser's ongoing use of the proxy advisory firm. According to the SEC, this review could include a materiality assessment of the potential factual errors, potential incompleteness, or potential methodological weaknesses in the proxy advisory firm's analysis of which the adviser is aware and deems credible and relevant to its voting determinations.

As discussed more fully in the Exchange Act Guidance, Rule 14a-9 under the Exchange Act applies to proxy voting advice and such advice may not contain materially false or misleading statements or omit material facts that would be required to make the advice not misleading. The Exchange Act Guidance provided three examples of types of information that proxy advisory firms may need to disclose to avoid a potential violation of Rule 14a-9: an explanation of the methodology used to formulate its voting advice on a particular matter; disclosure about certain information sources (and the extent to which the information from these sources differs from the registrant's public disclosures); and disclosure about material conflicts of interest. This guidance dovetails well with the Investment Adviser Guidance in many respects.

The SEC recommended that advisers also consider the effectiveness of the proxy advisory firm's policies and procedures for obtaining current and accurate information, including:

- The proxy advisory firm's engagement with issuers, including the firm's process for ensuring that it has complete and accurate information about the issuer and the voting matter;
- The process, if any, for advisers to access the issuer's views about the firm's voting recommendations in a timely and efficient manner;
- The proxy advisory firm's efforts to correct any identified material deficiencies in its firm's analysis;

- The proxy advisory firm's disclosures to the investment adviser regarding the sources of information and methodologies used in formulating voting recommendations and/or executing voting instructions (as applicable); and
- The proxy advisory firm's consideration of factors unique to a specific issuer or proposal when evaluating a voting matter.

In addition to considering and implementing as appropriate the SEC's guidance, advisers should carefully evaluate continued reliance on a proxy advisory firm that has experienced significant problems and explore alternatives (whether that might be engaging another firm, enhancing "in house" capabilities or a combination of the foregoing or other alternatives). Further, although the SEC did not provide guidance on materiality in this context, advisers should consider applying a materiality assessment based on not only individual instances but also patterns or repetitive deficiencies that together might be viewed as material.

ONGOING EVALUATIONS OF PROXY ADVISORY FIRMS

According to the SEC, an investment adviser that has retained a proxy advisory firm to assist *substantively* with its proxy voting responsibilities should adopt and implement policies and procedures that are reasonably designed to sufficiently evaluate the firm, in order to ensure that the investment adviser casts votes in the best interest of its clients.

The SEC believes that, as a result, the investment adviser should consider requiring the proxy advisory firm to update the investment adviser about business changes that the adviser considers relevant (i.e., with respect to the proxy advisory firm's capacity and competency to provide independent proxy voting advice or carry out voting instructions). The SEC also said that an investment adviser should consider whether the proxy advisory firm appropriately updates its methodologies, guidelines, and voting recommendations on an ongoing basis, including in response to feedback from issuers and their shareholders.

Although the SEC's guidance was limited to proxy advisory firm services that are substantive in nature, advisers also should consider implementing or enhancing their ongoing oversight and evaluation of firms that provide administrative proxy voting services.

EXERCISING VOTING OPPORTUNITIES

The SEC stated that an adviser need not exercise every voting opportunity on behalf of a client in two situations. First, if the adviser and its client have agreed in advance to limit the conditions under which the adviser would exercise voting authority, as discussed above, the investment adviser need not cast a vote on behalf of the client where contemplated by their agreement.

Second, there may be times when an investment adviser that has voting authority may refrain from voting a proxy on behalf of a client, e.g., where the adviser determines that the cost *to the client* (i.e., not the cost to the adviser) of voting the proxy exceeds the expected benefit to the client. The SEC cautioned, however, that in making such a determination, 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 to its clients by merely refraining from voting the proxies. Accordingly, before refraining from voting under these circumstances, the SEC believes that the adviser should 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.

Advisers might want to consider whether and how to document their cost/benefit analysis, or otherwise show that they did not simply "ignore," and were not negligent in fulfilling, their voting responsibilities for clients.

Conclusion

In addition to considering the steps suggested above, overall, registered investment advisers should review the guidance carefully and modify their practices, procedures and disclosures as appropriate, and should do so in advance of the upcoming proxy season. In addition, although this guidance was intended solely for registered investment advisers, advisers that are exempt from registration also might want to consider the guidance carefully, particularly given the numerous references to fiduciary duty, to which all investment advisers are subject.

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Endnotes

[1] https://www.sec.gov/rules/interp/2019/ia-5325.pdf.

[2] https://www.sec.gov/rules/interp/2019/34-86721.pdf.

[3] https://www.mayerbrown.com/en/perspectives-events/publications/2019/08/sec-issues-guidance-on-the-application-of-the-proxy-rules-to-voting-advice.

[4] Furthermore, at the end of the Investment Adviser Guidance, Code of Federal Regulations (CFR) notations are included, and they refer to interpretative releases under the Advisers Act, among others. The Exchange Act Guidance (which remains on the SEC website under "Interpretive Releases") similarly refers to interpretative releases for CFR purposes. The policy statements posted on the SEC's website that we sampled do not have similar CFR notations. Also, unlike the Fiduciary Interpretation and other interpretive releases, neither the Investment Adviser Guidance nor the Exchange Act Guidance includes a discussion regarding economic considerations, which is consistent with the policy statements that we sampled.

[5] This rule requires investment advisers that are registered or required to be registered under the Advisers Act to, among other things, adopt and implement written compliance policies and procedures.

[6] https://www.sec.gov/rules/concept/2010/34-62495.pdf.

[7] https://www.sec.gov/news/public-statement/statement-regarding-staff-proxy-advisory-letters.

[8] Release No. IA-5248 (June 5, 2019).

[9] *Id.*

[10] In this section of the release, the SEC noted that an adviser uses various means to address conflicts of interest in the proxy voting context, in addition to looking to the voting recommendations of a proxy advisory firm. As an example, the SEC mentioned disclosing the conflict to clients and obtaining their consent before voting.

[11] In this regard, the SEC mentioned that funds that invest in voting securities are required to disclose their proxy voting policies and procedures in their statements of additional information or on Form N-CSR and that differences in voting policies and procedures among funds (if any) should be reflected.

[12] The SEC cited to the release adopting the Proxy Voting Rule (Release No. IA-2106 (Jan. 31, 2003)), as well as Rule 204-2(a)(17)(ii) and Rule 206(4)-7. Notably, these sources do not require documentation of the annual compliance review, although most advisers do so.

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