Updates
August 29, 2019

SEC Issues Guidance and Interpretation Aimed at Proxy Voting

The U.S. Securities and Exchange Commission (SEC) held an open meeting on August 21, 2019, (the Open Meeting) and approved two items: (1) guidance regarding the proxy voting responsibilities of investment advisers under the Investment Advisers Act of 1940 (the Advisers Act) and related proxy voting disclosures required under the Investment Company Act of 1940 (the Investment Company Act) (the Adviser Guidance); and (2) interpretation and guidance on the applicability of rules on proxy voting advice under the Securities Exchange Act of 1934 (the Exchange Act) (the Solicitation Interpretation and Guidance). The SEC and its staff have been increasingly focused on issues related to the use of proxy advisors in proxy voting over the last year, and the Open Meeting is just the latest instance of the SEC leaning on investment advisers' use of proxy advisory firms.

Background on the Proxy Voting System and Proxy Advisory Firms

The proxy voting system in the United States is complex and sits on top of a share ownership structure sometimes referred to as "proxy plumbing." Determining the record and beneficial retail shareholders entitled to vote on proxy proposals is not a straightforward process. It becomes more complex when mutual funds must vote proxies from portfolio companies on behalf of the fund's shareholders. Advisers, on behalf of their mutual fund and other clients, must determine how to vote both mechanically and substantively. In practice and following previous guidance from the SEC staff, advisers, on behalf of their mutual fund and other clients, have often relied on proxy advisory firms to assist them in voting client portfolio company proxies. This reliance has in part been designed to ensure compliance with regulatory obligations such as the requirement that advisers avoid conflicts of interest with clients when voting proxies under Rule 206(4)-6 of the Advisers Act.[1]

With the support of several other commissioners, Chairman Jay Clayton has re-energized efforts to untangle proxy plumbing and ultimately put more regulatory pressure on investment advisers' use of proxy advisory firms. First, in July 2018, Chairman Clayton issued a statement in which he called for an SEC staff roundtable to discuss a number of issues with the proxy voting system (including whether and how innovative technologies such as blockchain might be able to improve the proxy voting process). Soon after and in preparation for the roundtable, the SEC staff repealed previous no-action relief allowing the use of proxy advisory firms as a means of addressing potential conflicts of interest. The SEC staff roundtable occurred in November 2018, and in February 2019, Commissioner Elad Roisman assumed the lead role in the SEC's proxy initiative. In a speech at an Investment Company Institute event in March 2019, Commissioner Roisman identified a number of proxy-related issues that need improvement, including investment adviser fiduciary issues and proxy plumbing.

The SEC Open Meeting on August 21, 2019

In the Open Meeting on August 21, 2019, the SEC commissioners met to discuss and vote on the Adviser Guidance and the Solicitation Interpretation and Guidance. After engaging with the SEC staff, the commissioners approved both measures by a three-to-two vote, along party lines. Both the Adviser Guidance and the Solicitation Interpretation and Guidance were adopted without opportunity for notice and comment, which brings to the surface the political tension between corporate interests and those of proxy advisory firms,

which have generally embraced environmental, social and corporate governance (ESG) factors in their voting and recommendation activities.

SEC Guidance Regarding Proxy Voting Responsibilities of Investment Advisers

The SEC approved publication of the Adviser Guidance regarding the proxy voting responsibilities of investment advisers under Rule 206(4)-6 under the Advisers Act, and the related disclosures required under Form N-1A, Form N-2, Form N-3 and Form N-CSR under the Investment Company Act. According to Commissioner Roisman, the Adviser Guidance builds around the construct, which was recently elaborated upon in other SEC guidance, that an investment adviser is a fiduciary that owes a duty of care and loyalty to its clients in all respects, including in proxy voting.

As explained by Commissioner Roisman, the Adviser Guidance addresses two key issues for investment advisers:

1. The ability of an adviser and client to shape the adviser's authority to vote proxies on the client's behalf, including whether and when the adviser must vote; and
2. The responsibilities of advisers when utilizing the services of proxy advisory firms to assist with voting.

In a Q&A approach, the Adviser Guidance presents various considerations relating to the use of third-party proxy advisory firms that advisers should consider as part of compliance with their fiduciary duties. These factors include the following:

- The scope of an adviser's authority and responsibilities to vote proxies on behalf of mutual fund and other clients can be negotiated to address a variety of situations, including when and how an adviser votes proxies, circumstances where voting proxies could impose costs that outweigh the benefits and whether the adviser should only focus on certain types of proxies (e.g., those involving corporate events like mergers and acquisitions or ESG issues).
- An adviser can take a variety of steps to demonstrate how it makes voting determinations in the best interests of its mutual fund and other clients and in accordance with proxy voting policies and procedures (e.g., sampling pre-populated votes, considering additional information and providing a higher degree of analysis in certain situations).
- Whether a third-party proxy advisory potentially or already engaged by an adviser to assist with research and proxy voting recommendations has policies and procedures in place to identify and address conflicts of interests as well as to provide for adequate disclosure.
- If an adviser becomes aware of potential factual errors, potential incompleteness or potential methodological weaknesses in a proxy advisory firm's analysis, the adviser should look into the proxy advisory firm's information accumulation sources and deciphering efforts to identify any material deficiencies in the information it receives and provides to inform the adviser's proxy voting on behalf of its clients.
- The ways in which an adviser evaluates the ongoing services of a proxy advisory firm should include inquiries about any material business changes and/or updates to the proxy advisory firm's methodologies, guidelines and voting recommendations.
- There are two instances where an adviser with authority to vote proxies for a client may not vote: (1) the adviser and the mutual fund or other client have agreed to limit the conditions under which the adviser may use its voting authority; and (2) the adviser concludes that it is in the best interests of the fund or other client for it to not vote the proxy.

During the Open Meeting, Chairman Clayton and Commissioner Roisman emphasized their belief that the Adviser Guidance is aligned with the principles-based approach to adviser proxy voting responsibilities set out in Rule 206(4)-6 under the Advisers Act. In particular, and as noted by Commissioner Hester M. Peirce in her

comments, an adviser retains its fiduciary obligations to its clients throughout the proxy voting process, whether or not it hires third-party proxy advisory firms. On the other side, Commissioner Robert J. Jackson Jr. voted against the measures, arguing that the Adviser Guidance could raise the cost of operating proxy advisory firms, which could in turn restrict the proxy voting information available for investors, particularly smaller ones.

SEC Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice

The SEC also approved the publication of the Solicitation Interpretation and Guidance on August 21, 2019. Specifically, the release provides guidance on the applicability of Rules 14a-1 and 14a-9 under the Exchange Act and the meaning of "solicitation" in the context of proxy voting advice.

The Solicitation Interpretation and Guidance explains that the furnishing of proxy voting advice by proxy advisory firms constitutes a proxy "solicitation" within the meaning of Rule 14a-1 under the Exchange Act. This in turn subjects proxy advisory firms to the proxy rules under the Exchange Act relating to information and filing requirements. The SEC's interpretation does not affect the ability of proxy advisory firms to continue to rely on the exemptions from the federal proxy rules' filing requirements established under Rule 14a-2(b) of the Exchange Act.

With regard to Rule 14a-9 under the Exchange Act and the antifraud provisions of the Exchange Act generally, the Solicitation Interpretation and Guidance explains that a firm providing proxy voting advice should consider certain disclosing information related to a proxy solicitation in a manner that is not materially false or misleading. For instance, proxy advisory firms should consider providing, in detail, the following:

- An explanation of the methodology used to formulate its voting advice, especially when the advice varied from previous advice on a particular matter;
- Disclosure about any third-party sources of information used to formulate voting advice; and
- Any conflicts of interest encountered by the firm in providing proxy voting advice.

Conclusion

Chairman Clayton stated during the Open Meeting that the new guidances and interpretation relating to proxy voting were not intended to create any new regulatory obligations or to change the law. Prior to the party line vote, the two commissioners who voted against the proposals, Commissioner Allison Herren Lee and Commissioner Jackson, expressed concern that the substantive requirements included in the Adviser Guidance and the Solicitation Interpretation and Guidance, while not necessarily new from a legal or regulatory perspective, will create additional compliance costs for asset managers and proxy advisory firms. Provisions relating to the application of Rule 14a-9 to proxy advisory firm reports and recommendations may similarly have a chilling effect on the operations of proxy advisory firms due to liability concerns that reports prepared by the proxy firms could be considered materially false or misleading.

A Few Final Words on Technology and Additional Reform

At the Open Meeting and in other remarks, Chairman Clayton and Commissioner Roisman have suggested that there may as well be, in Commissioner Roisman's words, a goal of developing "comprehensive solutions [to the proxy 'plumbing' problem] based on modern technology." The SEC has raised the issue and prospect of wholesale reform of proxy plumbing. In its 2010 Proxy Concept Release, the SEC provided a depiction of how the proxy voting system works, including how proxy advisory firms fit in. A few years later in 2015, the SEC demonstrated in its 2015 Transfer Agent Concept Release the complex proxy system infrastructure that has to be navigated in the United States. Chairman Clayton and Commissioner Roisman, among others, have asked

whether blockchain technology could be a possible comprehensive solution. It could provide potential solutions to recreating new types of share ledgers, voting mechanisms or both.

Please contact experienced securities regulatory counsel with questions about this development and how it might apply to you or your business.

Endnotes

[1] In recent months, particularly through the June 2019 adoption of its fiduciary interpretation for investment advisers, the SEC has focused heavily on advisers' fiduciary duties around disclosing, obtaining consent for and mitigating/eliminating conflicts of interest. *See*, e.g., Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33,669 (July 12, 2019), https://www.govinfo.gov/content/pkg/FR-2019-07-12/pdf/2019-12208.pdf.

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