Client Alert

SEC Issues Guidance to Proxy and Investment Advisers

EXEQUITY

Independent Board and Management Advisors

On August 21, 2019, the Securities and Exchange Commission (SEC) issued guidance to proxy advisors regarding the applicability of the proxy rules to proxy voting advice.[1] The SEC also issued separate guidance to investment advisers regarding their proxy voting responsibilities. Combined, this guidance likely will impact both proxy advisors and how investment advisers handle proxy voting, which, in turn, could significantly change the proxy voting landscape for public companies.

Potential Impacts

These SEC releases' guidance potentially brings significant changes for proxy advisors, institutional shareholders, and public companies. The key points we see from these releases are:

- Proxy advisors offering proxy voting recommendations are subject to the proxy voting rules and will be treated as investment advisers. This likely will lead to all proxy advisors registering with the SEC as investment advisers, giving the SEC a larger oversight role in their activities.

- Proxy advisors will be required to comply with the proxy voting rules and provide additional disclosures (e.g., rationale for including particular companies in the peer groups they construct in order to develop a voting recommendation), if the disclosure is material in order for their proxy voting reports not to be false or misleading. This could have a significant impact on the information and details included in proxy advisors' proxy voting reports and may impact the ability of proxy advisors to require payment by public companies to receive a copy of their company's proxy voting report.

- Institutional investors do not have to vote shares that they hold if they agree to that arrangement with clients. Even if they do take on voting responsibilities, those can be

[1] *SEC Clarifies Investment Advisers' Proxy Voting Responsibilities and Application of Proxy Voting Rules to Voting Advice*, SEC Press Release 2019-158 (August 21, 2019), https://www.sec.gov/news/press-release/2019-158; SEC Release No. 34-86721, *Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice,* 17 CFR Part 241 (August 21, 2019), available at: https://www.sec.gov/rules/interp/2019/34-86721.pdf; SEC Release Nos. IA-5325; IC-33605, *Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers*, 17 CFR Parts 271 and 276 (August 21, 2019), available at: https://www.sec.gov/rules/interp/2019/ia-5325.pdf.

limited to significant events (e.g., mergers and acquisitions, dissolutions, etc.), and they apparently do not have to vote on every proposal.

- Ultimately, if fewer institutional investors vote, the influence of those who do vote will grow (likely significantly). This, in turn, will cause companies to be more cognizant of and compliant with the proxy voting guidelines of their voting institutional shareholders to ensure their voting support.

Application of Proxy Voting Rules to Voting Advice

The SEC guidance makes clear that proxy voting advice provided by proxy advisory firms generally constitutes a solicitation subject to the federal proxy rules. The guidance goes on to say that proxy advisory firms can still rely on exemptions from the federal proxy rules' filing requirements, including not having to file a proxy statement themselves.

The guidance does indicate that even if the proxy solicitation is exempt from the proxy rules' filing requirements, it remains 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 it is made, is false or misleading with respect to any material fact.

The guidance provides several considerations for proxy advisors who provide proxy voting advice in order to avoid a potential violation of Rule 14a-9:

- Disclosure of an explanation of the methodology used to formulate its voting advice on a particular matter, including any material deviations from the provider's publicly announced guidelines, policies, or standard methodologies for analyzing such matters, where omission of such information would render the voting advice materially false or misleading. To the extent the proxy voting advice is based on information other than the registrant's public disclosures, such as third-party information sources, disclosure about these information sources and the extent to which the information from these sources differs from the public disclosures provided by the registrant if such differences are material and the failure to disclose the differences would render the voting advice false or misleading; and

- Disclosure about material conflicts of interest that arise in connection with providing the proxy voting advice in reasonably sufficient detail so that the client can assess the relevance of those conflicts. It is not clear whether this would require disclosure of fees paid by a public company to ISS for consulting services.

The guidance provides in footnotes the following tidbits that should help guide proxy advisory firms in complying with the proxy voting rules:

- If a proxy advisory firm bases its advice on the use of a peer group it constructs for the subject company, the disclosure may need to include the identities of the peer group companies used and the rationale for selecting these companies, as well as, if material, why the proxy advisor's peer group differs from those used by the subject company.

- The third-party information that might trigger additional disclosure as indicated above could include third-party research or publications, commercial or financial information databases, or ratings or rankings published by third parties.

***Exequity Comments**: The above requirements appear to require proxy advisors to provide additional disclosures in their proxy voting reports, if such disclosures would be material. It will depend on how the SEC interprets the requirement to detail peer group methodology and rationale for peer company selection to determine how significant a change will be required from proxy advisors. If proxy advisors can simply provide a general statement about their peer group methodology and not have to go into the nitty-gritty details on why a particular company was selected as part of its peer group, it likely will be business as usual for proxy advisors. However, if the SEC requires a specific rationale for each company, then this would likely herald a change in proxy advisors' proxy voting reports.*

The same issue will exist with respect to third-party information. For example, if a proxy advisor utilizes financial information from Standard & Poor's (S&P), which has been adjusted and is not the information public companies have filed with the SEC, the SEC will need to indicate whether a general statement that the proxy advisor utilizes S&P's data is sufficient or a full explanation of the differences between the S&P data and the company's/companies' public disclosure(s) would be necessary. Another issue with such third-party information is if the proxy advisor uses it to construct another metric that is then used in the proxy advisor's voting recommendations (e.g., ISS has proposed placing a greater emphasis on the use of EVA metrics, whose formulation often are difficult to replicate unless the precise formula and methodology used are disclosed). Again, this could have a significant impact on proxy advisors' proxy voting reports depending on where the SEC comes out on this issue.

But more than anything else, this guidance ensures that proxy voting recommendations will be subject to the federal proxy voting rules and their exemptions. At least one proxy advisor (ISS) is already registered with the SEC as an investment adviser. But it is now more likely that all proxy advisors will register as such given this guidance, will subject them to new oversight by the SEC.

Guidance Regarding Proxy Voting Responsibilities of Investment Advisers

The SEC guidance to investment advisers on their proxy voting responsibilities reminds investment advisers that they owe clients a duty of care and loyalty. Further, if investment advisers exercise voting authority on behalf of a client, they must adopt and implement written policies and procedures that are reasonably designed to ensure that the investment adviser votes proxies in the best interests of clients.

The guidance clarifies how an investment adviser's fiduciary duty and Rule 206(4)-6 under the Advisers Act relate to an adviser's proxy voting on behalf of clients, particularly if they retain a proxy advisory firm.

The guidance is in a question and answer format and discusses:

- How an investment adviser and its client, in establishing their relationship, may agree upon the scope of the investment adviser's authority and responsibilities to vote proxies on behalf of the client;
- What steps an investment adviser, who has assumed voting authority on behalf of clients, could take to demonstrate it is making voting determinations in a client's best interest and in accordance with the investment adviser's proxy voting policies and procedures;
- 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;

- Steps for an investment adviser to consider if 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;

- How an investment adviser could 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 who has assumed voting authority on behalf of a client is required to exercise every opportunity to vote a proxy for that client.

In particular, the SEC release provides guidance with respect to voting authority of an investment adviser:

- The guidance clearly sets forth that an investment adviser does not have to accept the authority to vote client securities, regardless of whether the client undertakes to vote proxies itself.

- Even in cases where an investment adviser accepts voting responsibility, it may agree with the client on the scope of voting arrangements, including the types of matters for which it will exercise such proxy voting authority.

  Examples of this type of agreement on voting included voting in accordance with management of the issuer or voting in favor of all proposals made by particular shareholder proponents.

- The guidance makes clear that the agreement on voting authority could specify that the investment advisor would only exercise such voting authority on particular types of proposals (mergers and acquisitions, dissolutions, conversions, or consolidations) or contested director elections and could refrain from voting if doing so enables the client to economically benefit through the lending of shares.

- The guidance also provides that an investment adviser and its client may 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.

  Examples where this might be the case include: circumstances where the cost of voting the proxy exceeds the expected benefit to the client, including casting a vote on a foreign security that could involve additional costs of hiring a translator or traveling to a foreign country to vote in person, and circumstances under which casting a vote would not reasonably be expected to have a material effect on the value of the client's investment.

Exequity Comments*: The big take away here is that investment advisers apparently do not have to vote the proxies of the securities held by their clients so long as they have agreed with their clients to that arrangement. Further, investment advisers and clients can define the voting authority to the extent they would like within the examples provided in the guidance. This could have a significant impact on public company proxy votes going forward if proxy voting authority will not be delegated to the investment adviser (e.g., an index mutual fund and its clients decide no proxy voting authority will be delegated to the fund). In such case, it is unlikely that retail investors in such mutual funds would (or even could) vote the proxies of the securities underlying their mutual fund ownership interest. If that were to happen, then some large institutional investors would no longer participate in proxy voting or in "routine" proxy votes.*

This would have at least two direct impacts. First, it would increase the influence of those institutional shareholders (and their proxy voting policies) that actually vote (likely activist shareholder and/or active funds). Second, public companies may find their vote outcomes a bit more volatile, may need to make revisions to their compensation plans and programs to ensure compliance with the proxy voting guidelines of their voting shareholders, and may need to engage in more shareholder outreach in order to secure approval of proposals from those shareholders that will vote.

Finally, investment advisers will be required to consider any potential conflicts of interests of proxy advisors when using their proxy voting recommendations to determine or inform their proxy voting actions. Proxy advisors will likely have to beef up their disclosures regarding real and potential conflicts of interests in their proxy voting reports to provide their clients with enough information to make an informed voting decision.

Effective Date

The SEC guidance is effective when published in the Federal Register.

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