SEC Issues Staff Guidance on Rules Applicable to Investment Advisers and Proxy Advisory Firms

On June 30, the Divisions of Investment Management and Corporation Finance of the SEC issued staff guidance, in the form of a Staff Legal Bulletin, addressing investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms. The guidance also addresses the requirements of the exemptions from the federal proxy rules that proxy advisory firms may seek to satisfy. The guidance follows the SEC's collection of extensive public input, including the comment process on the SEC's 2010 concept release on the proxy system and the discussion at the 2013 SEC roundtable convened to discuss proxy advisory firms, a NASDAQ *OMX* petition for rulemaking regarding proxy advisory firms, and discussion and action by the European Securities and Markets Authority and the Canadian Securities Administration regarding proxy advisory firms in their respective markets.

Some investment advisers or proxy advisory firms might believe (incorrectly, in our view) that the guidance does not require changes from the current situation. The staff, however, states that investment advisers and proxy advisory firms may want or need to modify their current practices in light of the guidance and that it expects that any necessary changes will be made prior to next year's proxy season.

We do not believe that the guidance will significantly alter the current practice of investment advisers relying, in some cases to a very large degree, on the voting recommendations and related services of the small number of proxy advisory firms. We do believe, however, that certain aspects of the interactions between issuers, investors, investment advisers and proxy advisory firms will change. Over time, some of those changes could become meaningful, particularly with regard to investment advisers' attention to and oversight of their proxy voting duties and procedures, attention to and disclosure of proxy advisory firms' conflicts, and the accuracy of information on which voting recommendations and decisions are based.

We expect the guidance will result in changes that modestly mitigate two of the most controversial aspects of the current proxy voting model:

- ***Conflicts of Interest.*** **In order to preserve their exemption from the public disclosure and filing requirements otherwise applicable to the solicitation of proxies, proxy advisory firms that also provide consulting services to issuers or that have other conflicts with respect to the outcome of proxy votes will be required to disclose material conflicts to their investment adviser clients. For practical reasons, such disclosure will likely also be publicly available. It is not clear whether the disclosure will include the amount paid by issuers for consulting and other services. The disclosure will likely enable future studies about the correlation between voting recommendations and consulting and other services.**

- ***Accuracy of Information.*** **While the guidance does not impose a direct obligation on proxy advisory firms to ensure the accuracy of the information on which they base their recommendations, it incentivizes investment advisers to ensure that voting recommendations by the proxy advisory firms they retain are based on reasonably extensive analysis and careful data collection. This may lead to greater opportunity for issuers to comment on proxy advisory firms' analyses and data. Issuers may be incentivized to highlight, through additional proxy soliciting materials or otherwise, perceived lapses by the proxy advisory firms; this, in turn, may lead investment advisers to pressure proxy advisory firms to be more thorough and thoughtful in their recommendations.**

The guidance focuses on several major issues within the proxy advisory firm debate. Specifically, the guidance:

- **clarifies that the fiduciary duties of investment advisers do not require that they vote every proxy, but rather points out there is flexibility as to how investors and investment advisers address proxy voting authority and emphasizes the importance of establishing an understanding between the investment adviser and the investor regarding how proxy voting authority will be exercised.**

- **notes that investment advisers have existing, ongoing obligations to monitor that their voting of proxies is consistent with their fiduciary duties to their investors (and, if they are registered, their required voting policies and procedures), and clarifies that when an investment adviser retains a proxy advisory firm, it must satisfy its fiduciary obligations both in making its retention decision and in carrying out ongoing oversight and monitoring of the proxy advisory firm.**

- **establishes that proxy advisory firms are subject to federal proxy rules and, if they seek to submit proxies on behalf of their clients, that they must meet the conditions of the applicable exemption to the rules, in particular regarding disclosure of conflicts (as described below) to avoid the public disclosure and filing obligations that would otherwise be required.**

<u>Fiduciary Duties of an Investment Adviser in Voting its Client's Proxies</u>

Background: In 2003, the SEC adopted Rule 206(4)-6 under the Investment Advisers Act of 1940, which was responsive, in part, to concerns regarding potential conflicts of interest when an investment adviser had discretion to vote a client's proxies on issues that affected the investment adviser's own interests. The rule required that the investment advisers adopt policies and procedures reasonably designed to ensure that they vote their clients' proxies in the best interest of their clients.

In the Adopting Release for Rule 206(4)-6, the SEC identified the investment advisers' responsibilities regarding proxy voting as part of its fiduciary duties of loyalty and care to their clients.[1] Although the Adopting Release explicitly stated that a decision *not to vote* could be consistent with an investment adviser's fiduciary duties, Rule 206(4)-6 and the Adopting Release were interpreted by many to require that the investment adviser exercise each opportunity to vote.

The Guidance. **The guidance clarifies that the fiduciary duties of investment advisers do not require that they vote every proxy, but rather points out there is flexibility as to how investors and investment advisers address proxy voting authority and emphasizes the importance of establishing an understanding between the investment adviser and the investor regarding how proxy voting authority will be exercised.** The Guidance emphasizes the importance of "agreement" between an investment adviser and the investor. The agreement may be with respect to the types of proposals or issues on which the investment adviser will focus its voting resources, whether it will align itself with management or a particular shareholder proponent, or whether it will abstain from voting proxies altogether. "An investment adviser and its client have flexibility in determining the scope of the investment adviser's obligation to exercise proxy voting authority."

<u>Fiduciary Duties of an Investment Adviser to Provide Ongoing Oversight</u>

Background: Also in the Rule 206(4)-6 Adopting Release, the SEC suggested that voting client proxies in accordance with a pre-determined policy, "based on the recommendations of an independent third party" could demonstrate that an investment adviser's vote was not conflicted. One year later, the SEC staff issued two no-action letters containing guidance that was viewed by many as establishing a "safe harbor" against charges of a conflict of interest if the investment adviser relied on an independent proxy advisory firm's recommendations in voting its clients' proxies. In a 2013 speech, Commissioner Gallagher recommended replacing the staff no-action letters with Commission-level guidance "clarifying to institutional investors that they need to take responsibility for their voting decisions rather than engaging in rote reliance on proxy advisory firm recommendations . . .."

The Guidance. **The guidance notes that investment advisers have existing, ongoing obligations to monitor that their voting of proxies is consistent with their fiduciary duties to their investors (and, if they are registered, their required voting policies and procedures), and clarifies that when an investment adviser retains a proxy advisory firm, it must satisfy its fiduciary obligations both in making its retention decision and in carrying out ongoing oversight and monitoring of the proxy advisory firm.** This includes:

- evaluating a proxy advisory firm's capacity and competency to adequately analyze proxy issues, including by considering the proxy advisory firm's staffing and personnel, the accuracy of its information, potential conflicts of interest and any other considerations

[1] The issue of a fiduciary duty to vote equity securities was raised in 1988 with respect to managers of Employee Retirement Income Security Act (ERISA) plan assets. In an advisory opinion, the U.S. Department of Labor concluded that a manager's fiduciary duties included an obligation to vote shares owned by benefit plans unless the manager could show that a failure to vote was in the best interest of plan participants and beneficiaries: "[t]he fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the economic value of the plan's investment."

that the investment adviser believes are relevant to the nature and quality of the services provided by the proxy advisory firm;

- implementing policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the proxy advisory firm, for example, by requiring the proxy advisory firm to provide updates about the issues that the investment adviser considers relevant; and

- following up, when an investment adviser has determined that a recommendation is based on a material factual error, by taking reasonable steps to investigate the error, and seeking to determine whether the proxy advisory firm is taking reasonable steps to reduce similar errors in the future. (As described above, this aspect of the guidance could also increase the opportunities for and the impact of issuers that seek to have proxy advisory firms correct what issuers believe are errors of fact or interpretation on which recommendations are based).

Proxy Advisory Firms and Federal Proxy Rules

Background: Concerns about institutional investor reliance on proxy advisory firms has been matched by critiques of the practices and policies of proxy advisory firms themselves. In particular, critics have asserted (i) a lack of transparency regarding how proxy advisory firms establish their voting recommendations and (ii) conflicts of interest that may improperly influence their voting recommendations, particularly with respect to the simultaneous provision of consulting services to issuers and shareholder proponents, on the one hand, and voting recommendations to shareholders regarding the same issuers and the proposals put forth on a proxy, on the other.

Critics of proxy advisory firms have suggested a number of ways for the SEC to address their concerns, including by issuing a new rule or providing guidance that would include proxy advisory firms within the purview of the federal proxy rules, subjecting the proxy advisory firms to disclosure and filing requirements that would shine light on their practices and methodologies.

The Guidance. **The guidance establishes that furnishing proxy voting advice constitutes a "solicitation" under Rule 14a-1(*l*) of the Securities Exchange Act of 1934, subject to the public disclosure and filing requirements of the federal proxy rules.**

The guidance also states that a proxy advisory firm may qualify for an exemption from the Exchange Act requirements (i) under Rule 14a-2(b)(1), if it limits its activities only to distributing reports containing recommendations (and not acting as a proxy for the client receiving recommendations), or (ii) under Rule 14a-2(b)(3), if it provides proxy voting advice to a person with whom it has a business relationship, subject to certain conditions. One condition of the Rule 14a-2(b)(3) exemption is that the proxy advisory firm disclose to the recipient of its advice any "significant" relationship with a company or shareholder proponent that is the focus of its advice, as well as any "material interests" of the proxy advisory firm in the matter. The guidance states that "boilerplate language" would be insufficient to comply with the disclosure requirement. Instead, the disclosure should "enable the recipient to understand the nature and scope of the relationship or interest, including the steps taken, if any, to mitigate the conflict, and . . . to make an assessment about the reliability or objectivity of the recommendation." In addition, proxy advisory firms have an "affirmative duty" to provide the required information: "We do not believe that providing the information upon request would satisfy the requirement in the rule."

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Please feel free to call any of your regular contacts at the firm or any of our partners and counsel listed under "Corporate Governance" in the Practices Section of the website if you have any questions.

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