SULLIVAN & CROMWELL LLP

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SEC Takes First Step on Proxy Reform

SEC Issues Proxy Voting Guidance and Interpretation (1) Confirming Proxy Voting Responsibilities of Investment Advisers, Including That Advisers Are not Required to Vote all Client Securities and That Voting Must Place Client Interests Ahead of the Adviser's Own Interests and (2) Clarifying That Federal Proxy Rules Apply to Proxy Voting Advice; SEC Staff Continues to Consider Further Rulemaking

SUMMARY

On August 21, 2019, the SEC took the first step in implementing its agenda for proxy reform, issuing guidance and interpretive advice in two separate releases that will be effective upon publication in the Federal Register. The first release confirms that the existing rules accommodate a variety of voting arrangements agreed by an investment adviser and its client (including not voting all client securities) but that in all cases any voting by an investment adviser must be in its client's best interest (and the adviser must not place its own interests ahead of the interests of the client). In a second release, the SEC clarifies that proxy voting advice issued by proxy advisory firms generally constitutes a "solicitation" under Exchange Act Rule 14a-1(l) and that the antifraud provisions in Exchange Act Rule 14a-9 apply to proxy voting advice. Both releases were approved by a 3-to-2 vote, with Commissioners Jackson and Lee dissenting. As next steps, the SEC staff is considering potential recommendations to amend Rule 14a-2(b), which provides exemptions from the information and filing requirements of the federal proxy rules and other amendments to the federal proxy rules.

PROXY VOTING RESPONSIBILITIES OF INVESTMENT ADVISERS

The proxy voting responsibility guidance, which was developed by the SEC's Division of Investment Management, addresses two primary areas: (1) the ability of an investment adviser and its client to shape the investment adviser's authority to vote proxies on the client's behalf; and (2) the responsibilities

of an investment adviser when retaining a proxy advisory firm to assist with proxy voting, consistent with the investment adviser's fiduciary duty.[1] The guidance also reiterates that investment advisers owe their clients a duty of care and a duty of loyalty with respect to any services undertaken on clients' behalf, including proxy voting. Accordingly, in all cases, any voting determinations by an investment adviser must be made in the best interest of the client, and the adviser may not place its own interests ahead of the interests of the client.

With respect to the first primary area covered by the proxy voting responsibility guidance, the SEC discusses, among other things: how an investment adviser and its client may agree on the scope of the investment adviser's authority and responsibilities to vote proxies on behalf of the client; whether an investment adviser that has assumed voting authority on behalf of a client is required to exercise every opportunity to vote a proxy for the client; and steps an investment adviser that has assumed proxy voting authority may take to demonstrate that its voting determinations are in its client's best interest and in accordance with the investment adviser's proxy voting policies and procedures, including:

- ***Scope of authority.*** An investment adviser may agree with its client on the scope of the investment adviser's voting authority, subject to full and fair disclosure and informed consent. The application of the investment adviser's fiduciary duty, and the specific obligations that flow from its fiduciary duty, depend on the agreed-upon scope of the investment adviser's voting authority. The proxy voting responsibility guidance provides examples of different voting arrangements to which an investment adviser and its client may agree.
- ***Exercising voting authority.*** An investment adviser does not need to exercise every opportunity to vote a proxy for a client if (1) as contemplated by a prior agreement with the client, the scope of the investment adviser's voting authority is so limited, or (2) the investment adviser has determined that refraining from voting a proxy on behalf of a client is in the best interest of that client, such as when the cost to the client of voting the proxy exceeds the expected benefit to the client. The SEC clarified that in making the latter determination, the investment 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."
- ***Steps to demonstrate that the investment adviser's voting determinations are in the client's best interest and in accordance with the investment adviser's proxy voting policies and procedures.*** An investment adviser should consider whether a uniform voting policy is in the best interest of each of its clients or whether it should have different voting policies for some or all of its clients, depending on the objectives and strategies of each, and disclose on relevant disclosure forms any different voting policies and procedures. Certain matters, such as mergers and acquisitions transactions, dissolutions, conversions, consolidations and contested elections for directors, may require a more detailed analysis from the investment adviser than an application of its general voting guidelines (the SEC states that these types of matters may require an investment adviser "to consider

[1] In his statement at the Open Meeting, Commissioner Roisman stated: "To be clear, in this context, I do not consider asset managers to be the "investors" that the SEC is charged to protect. Rather, the investors that I believe today's recommendations aim to protect are the ultimate retail investors, who may have their life savings invested in our stock markets. These Main Street investors who invest their money in funds are the ones who will benefit from (or bear the cost of) these advisers' voting decisions. In essence, I believe it is our job as regulators to help ensure that such advisers vote proxies in a manner consistent with their fiduciary obligations and that the proxy voting advice upon which they rely is complete and based on accurate information." We note that the SEC's guidance relates to investment advisers' duties to all clients, and not only to clients that are retail investors or that are vehicles, such as mutual funds and certain other collective vehicles, that predominantly serve retail investors, and that an investment adviser's fiduciary duty runs to its client (such as a mutual fund) and not to the shareholders of a client.

factors particular to the issuer or the voting matter under consideration"). An investment adviser also should consider reasonable measures to ensure that its proxy voting is in accordance with its voting policies and procedures, such as sampling the proxy votes cast on behalf of clients as part of the investment adviser's mandatory annual review of its own compliance policies and procedures (including voting policies and procedures). The SEC suggests taking additional steps to evaluate whether its voting determinations are consistent with its voting policies and procedures when utilizing a proxy advisory firm to provide voting recommendations or voting execution services.

With respect to the second primary area covered by the proxy voting responsibility guidance, the SEC discusses, among other things: considerations when retaining a proxy advisory firm to assist an investment adviser in discharging its proxy voting duties; steps for an investment adviser to consider when becoming aware of potential factual errors, incompleteness or methodological weaknesses in a proxy advisory firm's analysis for its research or voting recommendations that may materially affect the investment adviser's voting determinations; and considerations for an investment adviser in evaluating the services of a retained proxy advisory firm (including evaluating any material changes in services or operations by the proxy advisory firm), including:

- ***Considerations when retaining a proxy advisory firm.*** An investment adviser should consider, among other factors, whether the proxy advisory firm has: "the capacity and competency to adequately analyze the matters for which the investment adviser is responsible for voting"; an effective process for seeking input from issuers and its clients with respect to its voting policies, methodologies and construction of issuer peer groups; and adequate policies and procedures for identifying and addressing conflicts of interest. Investment advisers should also understand the methodologies that the proxy advisory firm uses to make its voting recommendations. The SEC notes that the steps an investment adviser should take in considering whether to retain a proxy advisory firm could depend on, among other things, the scope of the investment adviser's voting authority and the types of services the proxy advisory firm has been retained to perform, meaning that an investment adviser may take only some or all of the steps outlined in the guidance depending on such factors.
- ***Considerations when an investment adviser becomes aware of potential errors, incompleteness or weaknesses in the proxy advisory firm's analysis.*** To be able to form a reasonable belief that its proxy voting is in the client's best interest, an investment adviser should investigate such potential factual errors, incompleteness or methodological weaknesses in a proxy advisory firm's analysis. To do so, the investment adviser should have policies and procedures that are reasonably designed to ensure that its voting determinations are not based on materially inaccurate or incomplete information. For example, the investment adviser's policies and procedures could include a review of the investment adviser's use of the proxy advisory firm's research or voting recommendations, including an assessment of the extent to which potential factual errors, incompleteness or methodological weaknesses in the proxy advisory firm's analysis materially affected such research or recommendations and the effectiveness of the proxy advisory firm's policies and procedures for obtaining current and accurate information.
- ***Considerations when evaluating services of a retained proxy advisory firm.*** To satisfy Rule 206(4)-6 under the Investment Advisers Act of 1940, an investment adviser should adopt and implement policies and procedures that are "reasonably designed to sufficiently evaluate the third party in order to ensure that the investment adviser casts votes in the best interest of its clients." Investment advisers that retain a proxy advisory firm to provide research or voting recommendations, therefore, should consider policies and procedures "to identify and evaluate a proxy advisory firm's conflicts of interest that can arise on an ongoing basis" and should also consider requiring the proxy advisory firm to provide updates regarding business changes the investment adviser considers relevant. The proxy voting responsibility guidance states that an investment adviser "should also 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."

APPLICABILITY OF FEDERAL PROXY RULES TO PROXY VOTING ADVICE

The proxy rule guidance, which was developed by the SEC's Division of Corporation Finance, interprets Exchange Act Rule 14a-1(l) to generally include proxy voting advice provided by a proxy advisory firm as a "solicitation" subject to the federal proxy rules. Rule 14a-1(l) defines "solicitation" to include, among other communications, the furnishing of communication to shareholders "under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy."

The interpretation reiterates the SEC's previously stated view that a communication 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, constitutes a "solicitation" and concludes that proxy advisory firms' voting advice generally seeks to effect such influence given that proxy advisory firms market their expertise for research and analytics in relation to voting decisions and present recommendations for proposals indicating how clients should vote. The SEC distinguishes such services provided by proxy advisory firms 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."

The SEC's interpretation does not restrict the ability of proxy advisory firms to rely on any applicable exemptions from the information and filing requirements of the federal proxy rules set forth in Exchange Act Rule 14a-2(b). The exemptions include relief for certain communications, such as "any solicitation by or on behalf of any person who does not, at any time during such solicitation, seek directly or indirectly, either on its own or another's behalf, the power to act as a proxy for a security holder and does not furnish or otherwise request, or act on behalf of a person who furnishes or requests, a form of revocation, abstention, consent or authorization."

However, regardless of whether a proxy advisory firm's proxy voting advice is exempt from the information and filing requirements of the federal proxy rules, a "solicitation" by that firm 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 under which it is made, is "false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation." The proxy rule guidance clarifies that opinions, reasons, recommendations and beliefs that are disclosed as part of a solicitation may constitute "material facts" under Exchange Act Rule 14a-9, and their underlying facts, assumptions, limitations and other information may need to be disclosed.

The SEC provides examples of information that providers of proxy voting advice, such as proxy advisory firms, should consider disclosing in order to comply with Exchange Act Rule 14a-9, including the following: an explanation of the methodology (or material deviations from previously announced methodologies) used to formulate its voting advice where the omission of such information would render the voting advice materially false or misleading; to the extent the advice is based on information other than the registrant's public disclosure, disclosure about the sources for such information, the extent to which such information materially differs from public disclosures by the registrant and the extent to which the failure to disclose such differences would render the advice false or misleading; and material conflicts of interest arising in connection with providing proxy voting advice, in reasonably sufficient detail so that the client can assess the relevance of those conflicts.

IMPLICATIONS

Proxy reform continues to be an area of focus for the SEC, and we anticipate that the SEC will issue additional guidance or rulemaking in this area. With respect to the guidance adopted last Wednesday in particular, the proxy voting responsibility guidance notes that, based on feedback received, the SEC may supplement the guidance, and the proxy rule guidance notes that its issuance is part of the SEC's review of the overall proxy process, and that the SEC staff is considering recommending that the SEC propose rule amendments to address proxy advisory firms' reliance on the proxy solicitation exemptions under Exchange Act Rule 14a-2(b).

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