

August 23, 2019

SEC ISSUES NEW GUIDANCE FOR PROXY ADVISORS AND INVESTMENT ADVISERS ENGAGED IN THE PROXY VOTING PROCESS

To Our Clients and Friends:

On August 21, 2019, the Securities and Exchange Commission (the “Commission”) issued new guidance regarding two elements of the proxy voting process^[1] that are influenced by proxy advisory firms: proxy voting advice issued by proxy advisors and proxy voting by investment advisers who use that proxy voting advice. The guidance, in the words of Commissioner Elad L. Roisman, “reiterate[s] longstanding Commission rules and positions that remain applicable and very relevant in today’s marketplace.” Notably, the two releases issued by the Commission are not subject to notice and comment and will instead become effective upon publication in the Federal Register.

Specifically, the Commission approved issuing both:

- a Commission interpretation that the provision of proxy voting advice by proxy advisory firms generally constitutes a “solicitation” under federal proxy rules and new Commission guidance about the availability of exemptions from the federal proxy rules and the applicability of the proxy anti-fraud rule to proxy voting advice (the “Proxy Voting Advice Release”);^[2] and
- new Commission guidance intended to facilitate investment advisers’ compliance with the fiduciary duties owed to each client in connection with the exercise of investment advisers’ proxy voting responsibilities, including in connection with their use of proxy advisory firms (the “Proxy Voting Responsibilities Release”^[3] and together, the “Releases”).

The Commission approved both Releases by a vote of 3-2, with Commissioners Robert J. Jackson, Jr. and Allison Herren Lee dissenting from each Release. In their statements explaining their opposition, Commissioners Jackson and Lee expressed concern that neither was subject to a notice and comment period, which prevented the Commission from fully considering the consequences of the new guidance.^[4] Both Commissioners also questioned whether the Releases will increase costs associated with the provision and use of proxy voting advice, and Commissioner Lee expressed concern that greater issuer involvement in the proxy voting recommendation process could “undermine the reliability and independence of voting recommendations.”

Background

Over the past several years, the Commission and its staff (the “Staff”) have issued statements and held public forums to discuss issues related to voting advice issued by proxy advisory firms and investment advisers’ reliance on that advice. For example, in July 2010, the Commission issued a concept release^[5]

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that sought public comment on, among other topics, the legal status and role of proxy advisory firms.[6] And in June 2014, the staff of the Divisions of Investment Management and Corporation Finance issued Staff Legal Bulletin No. 20 (“SLB 20”),[7] which provided guidance on investment advisers’ responsibilities in voting client proxies and retaining proxy advisory firms and the availability and requirements of two exemptions to the federal proxy rules often relied upon by proxy advisory firms.[8]

Subsequently the Staff held a roundtable in November 2018 to provide an opportunity for market participants to engage with the Staff on various aspects of the proxy process (the “2018 Roundtable”).[9] The 2018 Roundtable included panels addressing each of the regulation of proxy advisory firms, proxy voting mechanics and technology, and shareholder proposals. Participants on the proxy advisory firms panel discussed investor advisers’ reliance on voting advice provided by proxy advisory firms, how proxy advisory firms address conflicts of interest and challenges issuers face in correcting factual errors in voting recommendations published by proxy advisory firms.[10]

Following the 2018 Roundtable, Chairman Jay Clayton announced that Commissioner Roisman would lead the Commission’s efforts to improve the proxy voting process and infrastructure.[11] In his opening remarks at the Commission’s August 21 meeting, Commissioner Roisman indicated that the Releases were the first of several matters that the Commission may consider in the near future relating to its proxy voting rules.[12] Other matters that Commissioner Roisman mentioned would likely be considered “in the near future” include proposed reforms to the rules addressing proxy advisory firms’ reliance on proxy solicitation exemptions and the rules regarding the thresholds for shareholder proposals announced as part of the Commission’s Spring 2019 Regulatory Flexibility Agenda.[13]

Summary of the Proxy Voting Advice Release

The Proxy Voting Advice Release, developed by the Commission’s Division of Corporation Finance, addresses two topics: the Commission articulates its view that proxy voting advice provided by proxy advisory firms generally constitutes a “solicitation” subject to the federal proxy rules, and the Commission provides an interpretation and additional guidance on the applicability of the federal proxy rules to proxy voting advice that is designed to influence the voting decisions of a proxy advisory firm’s clients.

Proxy Voting Advice Constitutes a Solicitation Under the Federal Proxy Rules

As explained in the Proxy Voting Advice Release, under Rule 14a-1(l) of the Securities Exchange Act of 1934 (the “Exchange Act”), a “solicitation” includes “a communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy.” This includes communications seeking to influence the voting of proxies, even if the person issuing the communication does not seek authorization to act as a proxy and may be indifferent to its ultimate outcome. Communications that constitute “solicitations” under Rule 14a-1(l) are subject to the information and filing requirements of the federal proxy rules. However, Exchange Act Rule 14a-2(b)(1) provides an exemption from the Commission’s information and filing requirements (but not from the anti-fraud rules) for “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.”

Based on this background, in the Proxy Voting Advice Release the Commission explains that its interpretation is informed by the purpose, substance and circumstances under which the proxy voting advice is provided. Where a proxy advisory firm markets its expertise in the research and analysis of voting matters to assist a client in making proxy voting decisions by providing voting recommendations, the proxy advisory firm is not “merely performing administrative or ministerial services.” Instead, the Commission believes that providing such proxy voting recommendations constitutes a solicitation because the recommendations are “designed to influence the client’s voting decision.” Importantly, the Commission believes that such recommendations constitute a solicitation even where a proxy advisory firm bases its recommendations on its client’s own tailored voting guidelines or the client ultimately decides not to follow the proxy voting recommendations.^[14]

The Commission makes clear that its interpretation does not prevent a proxy advisory firm from relying on the exemptions from the federal proxy rules information and filing requirements under Exchange Act Rule 14a-2(b)(1).^[15] Nevertheless, the Commission’s interpretation is an important foundational basis for any subsequent regulation of proxy advisory firms that addresses conditions for the availability of Rule 14a-2(b)(1).

Proxy Voting Advice Remains Subject to Exchange Act Rule 14a-9

In the second part of the Proxy Voting Advice Release, the Commission emphasizes that even where a proxy advisory firm’s voting advice is otherwise exempt from the information and filing requirements of the federal proxy rules under Exchange Act Rule 14a-2(b)(1), that voting advice remains subject to the anti-fraud provisions of Exchange Act Rule 14a-9. Accordingly, when issuing proxy voting advice, proxy advisory firms may not make materially false or misleading statements or omit material facts that would be required to make the voting advice not misleading.

Exchange Act Rule 14a-9 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. In addition, solicitations may not omit any material fact necessary in order to make the solicitation false or misleading. Of particular importance for proxy voting advice based on the research and analysis of proxy advisory firms, Exchange Act Rule 14a-9 also extends to opinions, reasons, recommendations or beliefs that are disclosed as part of a solicitation. Where such opinions, recommendations or similar views are provided, disclosure of the underlying facts, assumptions, limitations and other information may need to be disclosed so that these views do not raise concerns under the rule.

Depending on the materiality of the information and the particular circumstances, the Commission indicates that proxy advisory firms may need to disclose additional information to avoid issues under Exchange Act Rule 14a-9, including:

- an explanation of the firm’s methodology used to formulate its voting advice on a particular matter;

- non-public information sources and the extent to which the information from these sources differs from the publicly available disclosures; and
- any 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.

Summary of the Proxy Voting Responsibilities Release

Developed by the Commission's Division of Investment Management, the Proxy Voting Responsibilities Release clarifies how an investment adviser's fiduciary duties to its clients inform the investment adviser's proxy voting responsibilities, particularly where investment advisers retain proxy advisory firms to assist in some aspect of their proxy voting responsibilities. Under Rule 206(4)-6 of the Investment Advisers Act of 1940, an investment adviser that assumes proxy voting authority must implement policies and procedures that are reasonably designed to ensure it makes voting decisions in the best interest of clients. The Commission reiterates throughout the Proxy Voting Responsibilities Release that proxy voting must be consistent with the investment adviser's fiduciary duties and in compliance with Rule 206(4)-6.

The Proxy Voting Responsibilities Release sets forth six examples of considerations investment advisers should evaluate when discharging their fiduciary duties in connection with proxy voting. The Commission emphasizes that this list of considerations is non-exhaustive, and while its guidance is generally phrased as considerations or actions investment advisers "should" evaluate, the Commission further indicates that these examples are not the only way for investment advisers to discharge their fiduciary duties when voting proxies.

1. Determine the scope of the investment adviser's proxy voting authority and responsibilities

If an investment adviser agrees to assume proxy voting authority, the scope of the voting arrangements should be determined between the investment adviser and each of its clients on an individual basis. The Commission emphasizes that any proxy voting arrangements must be subject to full and fair disclosure and informed consent.

Among the variety of potential approaches to proxy voting arrangements, the Commission provides several examples to which an investment adviser and its client may appropriately agree, including the investment adviser exercising proxy voting authority pursuant to specific parameters designed to serve the best interests of the client based on the client's individual investment strategy, the investment adviser refraining from exercising proxy voting authority under agreed circumstances or the investment adviser voting only on particular types of proposals based on the client's express preferences.

2. Demonstrate that the investment adviser is making voting determinations in its clients' best interests and in accordance with its proxy voting policies and procedures

The Commission indicates that investment advisers must at least annually review and document the adequacy of its proxy voting policies and procedures, including whether the policies and procedures are reasonably designed to result in proxy voting in the best interest of the investment adviser's clients.

Because clients often have differing investment objectives and strategies, if an investment adviser has multiple clients then it should consider whether voting all of its clients' shares under a uniform voting policy is in the best interest of each individual client. Alternatively, an investment adviser should consider whether it should implement voting policies that are in line with the particular investment strategies and objectives of individual clients. An investment adviser should also consider whether its voting policy or policies should be tailored to permit or require more detailed analysis for more complex matters, such as a corporate event or a contested director election.

In addition, where an investment adviser retains a proxy advisory firm to provide voting advice or execution services, the investment adviser should consider undertaking additional steps to evaluate whether its voting determinations are consistent with its voting policies and in the best interests of its clients.

3. Evaluate any proxy advisory firm in advance of retaining it

Before retaining a proxy advisory firm, investment advisers should consider whether the proxy advisory firm has the capacity and competency to adequately analyze the matters for which it is providing voting advice. The Commission indicates that the scope of the investment adviser's proxy voting authority and the services for which the proxy advisory firm has been retained should inform the considerations that the investment adviser undertakes.

Such consideration could include an assessment of the adequacy and quality of the proxy advisory firm's staffing, personnel and/or technology. In addition, investment advisers should consider the proxy advisory firm's process for obtaining input from issuers and other clients with respect to its voting policies, methodologies and peer group design.

4. Evaluate processes for addressing potential factual errors, incompleteness or methodological weakness in a proxy advisory firm's analysis

An investment adviser should have policies and procedures in place to ensure that its proxy voting decisions are not based on materially inaccurate or incomplete information provided by a proxy advisory firm. By way of example, the Commission suggests that an investment adviser should consider periodically reviewing its ongoing use of the proxy advisory firm's research or voting advice, including whether any potential errors, incompleteness or weaknesses materially affected the research or recommendations that the investment adviser relied on.

In addition, the Commission indicates that investment advisers should consider the proxy advisory firm's policies and procedures to obtain current and accurate information, including the firm's engagement with issuers, efforts to correct identified material deficiencies, disclosure regarding its sources of information and its methodologies for issuing voting advice and the firm's consideration of facts unique to the issuer or proposal.

5. Adopt policies for evaluating proxy advisory firms' services

Where an investment adviser has retained a proxy advisory firm to assist with its proxy voting responsibilities, the investment adviser should adopt policies and procedures that are designed to evaluate the services of the proxy advisory firm to ensure that votes are cast in the best interests of the investment adviser's clients.

The Commission indicates that investment advisers should consider implementing policies and procedures to identify and evaluate a proxy advisory firm's conflicts of interest on an on-going basis and evaluate the proxy advisory firm's "capacity and competency" to provide voting advice and execute votes in accordance with the investment adviser's instructions. In addition, investment advisers should consider how and when the proxy advisory firm updates its methodologies, guidelines and voting advice.

6. Determine when to exercise proxy voting opportunities

An investment adviser is not required to exercise every opportunity to vote in either of two circumstances—where the investment adviser and its client have agreed in advance that the investment adviser's proxy voting authority is limited under certain circumstances and where the investment adviser and its client have agreed in advance that the investment adviser has authority to cast votes based on the best interests of the client.

In both situations, the investment adviser's action must be in accordance with its prior agreement with its client. Moreover, where an investment adviser may refrain from voting because doing so is in the best interest of its client, the investment adviser should first consider its duty of care to its client in light of the scope of services it has agreed to assume.

Practical Considerations

Just as the Commission was divided in approving the Releases, reactions to the Releases are likely to vary among participants in the proxy process. For example, public companies may both view the Releases as a positive step and believe that additional Commission action is needed to address the errors, conflicts of interests and other challenges with proxy advisory firms.

The Commission was limited in the actions it could take via interpretation and issuing guidance in the Releases. However, the Commission signaled that the Staff is working on proposed rules "to address proxy advisory firms' reliance on the proxy solicitation exemptions in Exchange Act Rule 14a-2(b)." Given that the rulemaking process can be time-consuming, the Releases provide helpful immediate guidance heading into the 2020 proxy season. That said, it remains to be seen whether and to what extent the proxy advisory firms and their investment adviser-clients will adjust their practices in response to the Releases. For example, the proxy advisory firms may increase the disclosures included in their reports, particularly when they are relying on debated premises such as studies asserting that certain corporate governance or sustainability actions increase shareholder value. They may also be less willing to rely on information provided either by proponents or activists unless that information has been filed with the Commission. Investment advisers inclined to vote lock-step with proxy advisory firm recommendations may be more willing to engage with companies in advance of voting.

Similarly, the Commission’s statements on the application of Rule 14a-9 to proxy advisory firm reports and recommendations^[16] may affect various proxy advisory firm practices due to the threat (real or perceived) of public companies commencing litigation against these firms in the event that statements in a proxy advisory firm’s report are viewed as materially false or misleading. For example, it is common to see parties in contested solicitations commence litigation under Rule 14a-9 challenging the other side’s solicitation materials. It is not hard to envision similar litigation playing out in the future when there are differences of opinion as to whether a proxy advisory report contains information that is either inaccurate or misleading, or where it simply omits information that leaves the disclosed information materially misleading. As a result, proxy advisory firms may change their practices for vetting and issuing their voting recommendation reports; for example, the firms may be more inclined to provide drafts of their reports to public companies in advance of the reports being issued.

[1] The two most influential proxy advisory firms are Institutional Shareholder Services (“ISS”) and Glass, Lewis & Co.

[2] Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice, Exchange Act Release No. 34-86721 (Aug. 21, 2019), *available at* <https://www.sec.gov/rules/interp/2019/34-86721.pdf>.

[3] Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Investment Advisers Act Release No. IA-5325 and Investment Company Act Release No. IC-33605 (Aug. 21, 2019), *available at* <https://www.sec.gov/rules/interp/2019/ia-5325.pdf>.

[4] See Commissioner Robert J. Jackson, Jr., “Statement on Proxy-Advisor Guidance” (Aug. 21, 2019), *available at* <https://www.sec.gov/news/public-statement/statement-jackson-082119>; Commissioner Allison Herren Lee, “Statement of Commissioner Allison Herren Lee on Proxy Voting and Proxy Solicitation Releases” (Aug. 21, 2019), *available at* <https://www.sec.gov/news/public-statement/statement-lee-082119>.

[5] *Concept Release on the U.S. Proxy System*, Release No. 34-62495, 75 FR 42982 (July 22, 2010), *available at* <https://www.sec.gov/rules/concept/2010/34-62495.pdf>.

[6] For additional information on the 2010 concept release, please see our client alert dated July 22, 2010, *available at* <https://www.gibsondunn.com/securities-and-exchange-commission-issues-concept-release-seeking-public-comment-on-u-s-proxy-system/>.

[7] Staff Legal Bulletin No. 20 (June 30, 2014), *available at* <http://www.sec.gov/interps/legal/cfslb20.htm>.

[8] For additional information regarding SLB 20, please see our client alert dated July 1, 2015, *available at* <https://www.gibsondunn.com/sec-staff-releases-guidance-regarding-proxy-advisory-firms/>.

- [9] See Securities and Exchange Commission, “Spotlight on Proxy Process” (Nov. 15, 2018), *available at* <https://www.sec.gov/proxy-roundtable-2018>.
- [10] See Securities and Exchange Commission Webcast Archive, “Roundtable on the Proxy Process” (Nov. 15, 2018), *available at* https://www.sec.gov/video/webcast-archive-player.shtml?document_id=111518roundtable.
- [11] See Chairman Jay Clayton, “Remarks for Telephone Call with SEC Investor Advisory Committee Members” (Feb. 6, 2019), *available at* <https://www.sec.gov/news/public-statement/clayton-remarks-investor-advisory-committee-call-020619>.
- [12] See Commission Elad L. Roisman, “Statement at the Open Meeting on Commission Guidance and Interpretation Regarding Proxy Voting and Proxy Voting Advice” (Aug. 21, 2019), *available at* <https://www.sec.gov/news/public-statement/statement-roisman-082119>.
- [13] See Agency Rule List - Spring 2019, *available here*.
- [14] In contrast, ISS previously asked the Commission to confirm that “a registered investment adviser who is contractually obligated to furnish vote recommendations based on client-selected guidelines does not provide ‘unsolicited’ proxy voting advice, and thus is not engaged in a ‘solicitation’ subject to the Exchange Act proxy rules.” Letter from Gary Retelny, President and CEO, ISS, to Brent J. Fields, Secretary, Commission (Nov. 7, 2018), *available at* <https://www.sec.gov/comments/4-725/4725-4629940-176410.pdf>.
- [15] For additional information regarding the Staff’s views on the availability of such exemptions for proxy advisory firms, please see our client alert regarding SLB 20 dated July 1, 2015, *available at* <https://www.gibsondunn.com/sec-staff-releases-guidance-regarding-proxy-advisory-firms/>.
- [16] The solicitation exemption in Rule 14a-2(b)(3) explicitly does not also provide an exemption from Rule 14a-9.



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Gibson Dunn’s lawyers are available to assist with any questions you may have regarding these issues. To learn more about these issues, please contact the Gibson Dunn lawyer with whom you usually work, or any of the following lawyers:

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