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SEC Issues Guidance on Investment Advisers' Use of Proxy Firms and Application of Proxy Rules to Voting Recommendations; Proposes to Narrow Certain Exemptions to Proxy Rules—Part 1

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At an open meeting held on August 21, 2019, the Securities and Exchange Commission (SEC) voted along party lines to issue two guidance statements in connection with its long-anticipated review of the role of proxy advisory firms in the proxy process.[1] The first guidance statement (IA Release), which primarily interprets the Investment Advisers Act of 1940, outlines specific considerations and due diligence practices for investment advisers that engage proxy advisory firms for assistance in fulfilling their proxy voting responsibilities with respect to client securities.[2] The second guidance statement (Exchange Act Release), which interprets the proxy provisions of (and related rules under) the Securities Exchange Act of 1934 (Exchange Act), sets forth the SEC's view that recommendations from proxy advisory firms generally constitute "solicitations" under the federal proxy rules, thereby subjecting proxy recommendations to antifraud rules and liability under the Exchange Act.[3] In addition, at a subsequent open meeting held on November 5, 2019, the SEC again voted along party lines to propose amendments (Proposed Amendments) that would impose additional obligations on proxy advisory firms seeking to rely on certain exemptions from the federal proxy rules.[4]

Although the SEC issued the IA Release and Exchange Act Release (collectively, Releases) as interpretative guidance rather than through the notice-and-comment rulemaking process, the Releases have the potential to impose significant new burdens on proxy advisory firms and the investment advisers that use them.[5] In particular, the IA Release sets forth the SEC's views on factors that investment advisers should consider when engaging and reviewing relationships with proxy advisory firms, as well as practices that investment advisers should consider in their ongoing use of such firms, including—in a departure from previous Staff guidance—factors and practices that relate to a proxy advisory firm's engagement with, and receipt of, timely input from the corporate issuers of securities for which proxies are solicited. Depending on the manner of the implementation of this guidance by the SEC and

its Staff, the IA Release has the potential to result in significantly greater compliance difficulties, additional costs and tighter timeframes for investment advisers throughout the proxy process, and accordingly may lead to the reduced use of proxy advisory firms by investment advisers that find it excessively burdensome to engage the personnel and systems to implement the new considerations advanced by the IA Release. In addition, the SEC's issuance of the Exchange Act Release may have the effect of facilitating future enforcement actions or private litigation alleging that proxy advisory firms have made materially inaccurate statements relating to their voting recommendations.

Part 1 of this article reviews certain background law, guidance, and policy concerns regarding the use of proxy advisory firms. Part 2, appearing in an upcoming issue of *The Investment Lawyer*, continues this review, and then discusses potential legal and practical consequences of the Releases. Although the SEC did not indicate a current intent to take further action regarding an investment adviser's proxy voting responsibilities,[6] it has been reported that the SEC may be considering additional rules directly applicable to proxy advisory firms.[7] The Proposed Amendments appear to be an example of such additional rules and are summarized below.

A Contested Framework: The Proxy Rule and Egan-Jones and ISS No-Action Letters

In 2003, the SEC adopted Rule 206(4)-6 under the Advisers Act (Proxy Rule) to integrate into the federal securities laws certain aspects of an investment adviser's fiduciary duties in the context of proxy voting.[8] The Proxy Rule requires that: (1) an investment adviser with proxy voting authority must implement policies and procedures reasonably designed to ensure that the investment adviser votes proxies in the best interest of its clients; and (2) such procedures provide for the ongoing identification and resolution of material conflicts of interest that may arise between the investment adviser and its clients.[9] In the Proxy Rule adopting release, the SEC indicated that one method of resolving an investment adviser's conflicts of interest with its clients would be for the investment adviser to base its proxy voting decisions on the recommendations of an "independent third party" pursuant to a predetermined policy.[10]

In 2004, shortly after the adoption of the Proxy Rule, the Staff of the SEC's Division of Investment Management (IM Staff) published the Egan-Jones Proxy Services (Egan-Jones) and Institutional Shareholder Services (ISS) no-action letters to clarify: (1) the circumstances under which the IM Staff would consider a third party to be "independent," such that an investment adviser's reliance on its voting recommendations could "cleanse" that investment adviser's conflicts of interest; and (2) the level of due diligence an investment adviser could reasonably perform to ascertain a proxy advisory firm's independence; the latter would generally include "a thorough review of the proxy voting firm's conflict procedures and the effectiveness of their implementation," but would not need to consist of "a case-by-case evaluation" of a proxy advisory firm's conflicts of interest.[11] Although the IM Staff cautioned that the appropriate level of due diligence would ultimately "depend[] on all of the relevant facts and circumstances" concerning a proxy advisory firm and its potential conflicts, the Egan-Jones and ISS no-action letters were believed by many stakeholders to have facilitated a compliance framework that permitted investment advisers facing conflicts of interest to substantially rely on proxy advisory firms in fulfilling some of their proxy voting responsibilities, provided that the investment advisers could satisfy themselves as to the adequacy of the firms' conflicts procedures. Some commentators characterized the letters as having a greater impact, arguing that they facilitated the "delegation" by some investment advisers of their proxy voting responsibilities to the proxy advisory industry.

Policy Issues: The Concept Release (2010) and Staff Legal Bulletin No. 20 (2014)

Since its establishment in the 1980s, the proxy advisory industry has been concentrated in a few firms, primarily the recipient of the ISS no-action letter, Institutional Shareholder Services, Inc. (ISS), and Glass, Lewis & Co., LLC (Glass Lewis), which ultimately has grown into ISS's largest competitor. Together, ISS and Glass Lewis have been cited as having a 97 percent share of the proxy advisory market.[12] This consolidation of the proxy advisory industry led many corporate issuers to express the view that these firms hold unduly significant and unaccountable influence in corporate elections and governance matters, especially with respect to "say-on-pay" votes, where criticism has alleged that these firms have disproportionately shaped contemporary executive compensation practices for public companies.[13] Some stakeholders viewed the continued growth and influence of proxy advisory firms as a partial consequence of the guidance in the Proxy Rule adopting release and the subsequent Egan-Jones and ISS no-action-letters.

Corporate issuers' expressed concerns regarding proxy advisory firms have been a long-standing focus for the SEC and its Staff, as well as for Congress.[14] Partly in response to these concerns, the SEC issued a 2010 concept release (Concept Release) that sought public comment on a number of issues that had been raised regarding the proxy system, among other proxy-related matters.[15] In particular, the Concept Release inquired as to: (1) the potential conflicts of interest of proxy advisory firms, such as ISS, that provide both voting recommendations to investors and corporate governance consulting to issuers; (2) the risk that voting recommendations might be based on flawed analyses or data; and (3) the potential concern that proxy advisory firms may base recommendations on an improper "one-size-fits-all" governance approach. Following a hearing on the influence of proxy advisory firms held by the House of Representatives Financial Services Subcommittee in June 2013,[16] then-Commissioner Daniel Gallagher expressed his belief that some investment advisers might "view their responsibility to vote on proxy matters with more of a compliance mindset than a fiduciary mindset" as a result of the Egan-Jones and ISS no-action letters, and that the letters accordingly should be withdrawn.[17] The SEC held a public roundtable in December 2013 to discuss further the policy questions that had been raised regarding use of proxy advisory firms by investment advisers.

Subsequently, in July 2014, the IM Staff and the Staff of the SEC's Division of Corporation Finance (CF Staff) co-issued Staff Legal Bulletin No. 20 (Proxy Bulletin),[18] which did not rescind but instead effectively restated the duties set forth in the Egan-Jones and ISS no-action letters with greater specificity and additional considerations. Citing to the letters in approval, the Proxy Bulletin reaffirmed that investment advisers that retain proxy advisory firms should: (1) implement policies and procedures to identify and address any conflicts of interest of the retained proxy advisory firms; and (2) perform reasonable due diligence on proxy advisory firms, including a thorough review of a proxy advisory firm's conflicts procedures and a review of any material changes thereto on an ongoing basis.

Furthermore, in apparent response to corporate issuers' expressed view that proxy advisory firms' recommendations might be based on flawed analyses or data, the Proxy Bulletin stated that an investment adviser retaining a proxy advisory firm should ascertain that the firm has the "capacity and competency to adequately analyze proxy issues, which includes the ability to make recommendations based on materially accurate information." The Proxy Bulletin also indicated that an investment adviser wanting to demonstrate compliance with its proxy policies and procedures may consider periodically back-testing samples of proxy votes cast on behalf of its clients, especially "a sample of proxy votes that relate to certain proposals that may require more

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analysis." In sum, the Proxy Bulletin provided additional considerations and more specific due diligence requirements relating to investment advisers' use of proxy advisory firms, but did not otherwise change the compliance framework articulated in the Proxy Rule adopting release and the Egan-Jones and ISS no-action letters.[19]

The Proxy Bulletin also addressed the application of the federal proxy rules to proxy advisory firm recommendations by restating the SEC's view "that the furnishing of proxy voting advice constitutes a 'solicitation' [for purposes of Rule 14a-1(*l*) under the Exchange Act] subject to the information and filing requirements of the federal proxy rules."[20] The CF Staff clarified how proxy advisory firms might avail themselves of the exemptions to these requirements set forth in Rules 14a-2(b)(1) and 14a-2(b)(3) under the Exchange Act, which often have been relied on by proxy advisory firms in the course of their services. Importantly, the Proxy Bulletin did not address the application of the proxy antifraud provision (Rule 14a-9 under the Exchange Act) to proxy recommendations.

Continued Debate: The Roundtable and Withdrawal of the Egan-Jones and ISS No-Action Letters

In light of continued debate among many stakeholders regarding the role of proxy advisory firms, Chairman Clayton held a public roundtable on the proxy voting process in November 2018 (Roundtable), and advised the IM Staff to include the following topics in the Roundtable's agenda:

- Whether current legal requirements have resulted in over-reliance on proxy advisory firms by investment advisers;
- Whether corporate issuers have an appropriate opportunity to contest proxy advisory firms' recommendations, especially when a recommendation is based on flawed information;
- Whether proxy advisory firms are adequately transparent regarding their voting policies and procedures, such that stakeholders (including corporate issuers) may understand how proxy advisory firms have formulated their particular recommendations;
- Whether proxy advisory firms cause a conflict of interest by providing both voting recommendations to investors and corporate governance consulting to issuers or other conflicts of interest, and, if so, whether such conflicts are adequately disclosed and mitigated; and
- The appropriate regulatory regime for proxy advisory firms and whether the Egan-Jones and ISS no-action letters, as well as the Proxy Bulletin, should be modified, rescinded or supplemented.

Shortly before the Roundtable, the IM Staff responded to Chairman Clayton by rescinding the Egan-Jones and ISS no-action letters. However, the IM and CF Staff did not withdraw the Proxy Bulletin. Rather, the Proxy Bulletin remained in effect pending further consideration as part of the Roundtable's overall process, even though the Proxy Bulletin effectively restated the now-withdrawn letters.[21]

At the Roundtable's panel discussion, the representatives of corporate issuers did not focus on the general concern that investment advisers over-relied on proxy advisory firms. Instead, their primary expressed concern regarded the lack of a defined, consistent and viable process to correct perceived factual errors that might influence recommendations or reports from proxy advisory firms to their clients. The representatives of the proxy advisory industry were generally receptive to this concern, and they discussed processes whereby corporate issuers could access and dispute factual errors in data before the issuance of a related recommendation or report (for example, through a data room). However, the proxy advisory firm representatives stressed that access to such data would be provided only in a manner that would not compromise the forthcoming recommendation or report by giving

corporate issuers advance notice of the proxy advisory firm's judgments or conclusions. An investment adviser representative stated in agreement that providing corporate issuers greater involvement in the process of developing proxy advisory firm recommendations could serve to diminish the independence of proxy advisory firms and, therefore, their utility to investment advisers in connection with the investment advisers' proxy voting responsibilities.

At the conclusion of the Roundtable panel, Chairman Clayton expressed his view that "some changes were warranted" to the proxy advisory framework as a result of the Roundtable, putting stakeholders on notice of anticipated action in the SEC's 2019 agenda.[22]

Commission Guidance on Investment Advisers' Use of Proxy Advisory Firms

The IA Release is the result of the SEC's deliberations on investment advisers' proxy voting responsibilities approximately nine months after the Roundtable. It neither withdraws nor explicitly calls into question the Proxy Bulletin, but instead builds on the Proxy Bulletin and further develops specific considerations and due diligence practices for investment advisers with proxy voting authority, especially for those that engage proxy advisory firms.[23] However, the IA Release provides new, and a greater number of, specific considerations, and thereby has the potential to impose significant new burdens on proxy advisory firms and the investment advisers that use them. As detailed in Part 2, certain of the considerations and practices advanced by the IA Release focus on a proxy advisory firm's coordination with issuers, reflecting the Roundtable's prior inquiry into whether issuers are given an appropriate opportunity to participate in the recommendation process. The IA Release also states that an investment adviser should consider conducting a heightened issuer- or matter-specific analysis where a vote might be highly contested, such as in connection with major corporate events or certain elections for directors, as well as where the investment adviser's proxy voting policies and procedures do not already address how the investment adviser should vote on a particular matter. The extent of the impact of this guidance ultimately will depend on its implementation by the SEC, the IM Staff and the SEC's Office of Compliance Inspections and Examinations (OCIE); but, as a general matter, the inclusion of this guidance will enable a greater level of SEC Staff scrutiny regarding proxy voting arrangements.

The IA Release should be understood, at a minimum, to build on the withdrawal of the Egan-Jones and ISS no-action letters by more clearly disavowing the compliance framework that was perceived by some to have arisen as a result of those letters. Specifically, the IA Release challenges the notion (perceived or real) that an investment adviser facing conflicts of interest may, if it finds a proxy advisory firm's conflicts procedures adequate, substantially rely on or "delegate" to the proxy advisory firm in the course of fulfilling the investment adviser's proxy voting responsibilities. Instead, the IA Release stresses the affirmative character of an investment adviser's proxy voting responsibilities, stating that: (1) an investment adviser's fiduciary duties require it to "form a reasonable belief that its voting determinations are in the best interest of the client"; and (2) an investment adviser must consequently "conduct a reasonable investigation into matters on which the adviser votes." An investment adviser that uses the assistance of a proxy advisory firm thus should take steps to "sufficiently evaluate the [proxy advisory firm] in order to ensure that the investment adviser casts votes in the best interests of its clients." Similarly building upon the withdrawal of the Egan-Jones and ISS letters, the IA Release clarifies that basing proxy voting decisions on a proxy advisory firm's recommendations may not be sufficient for an investment adviser to resolve any conflicts of interest it may have with respect to voting client proxies. The controversial

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"cleanse" language of Egan-Jones is replaced in the IA Release with a cautionary acknowledgment that an investment adviser's use of a proxy advisory firm's voting recommendations "may mitigate the investment adviser's potential conflict of interest, [but] does not relieve that investment adviser of its" fiduciary duties. Taken together, these statements emphasize the SEC's views on the fiduciary basis and scope of an investment adviser's proxy voting responsibilities.

With this framework, the IA Release sets out to describe the responsibilities of an investment adviser as a fiduciary in the context of proxy voting. To this end, it leverages recent SEC guidance from June 2019 stating that the Advisers Act imposes a federal fiduciary duty on investment advisers.[24] The guidance in the IA Release is generally characterized in this respect as "provid[ing] examples to help facilitate investment advisers' compliance with their proxy voting responsibilities," with the clarification that "these examples are not the only way by which investment advisers could comply with their principles-based fiduciary duty imposed on them by the Advisers Act." However, notwithstanding this characterization, the IA Release includes many potentially prescriptive statements indicating that an investment adviser "should consider" certain factors and practices in order to generally comply with its fiduciary duties, without explicitly indicating whether or how other principles-based approaches would suffice for this purpose.

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NOTES

1 Chairman Jay Clayton and the two Republican Commissioners, Commissioner Hester M. Peirce and Commissioner Elad L. Roisman, voted to approve each guidance statement, whereas Commissioner Robert J. Jackson Jr. and Commissioner Allison Herren Lee, the two Democratic Commissioners, dissented. Commissioner Roisman has led the SEC's overall evaluation of the proxy process. *See* Commissioner Elad L. Roisman, Statement at the Open Meeting on Commission Guidance and Interpretation Regarding Proxy Voting and Proxy Voting Advice (Aug. 21, 2019) (Statement of Commissioner Roisman) (overviewing the SEC's efforts and Commissioner Roisman's views on the impact of the new guidance statements).

2 *See Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers,* Rel. No. IA-5325 (Aug. 21, 2019). The IA Release was published under Form N-1A, Form N-2, Form N-3 and Form N-CSR, in addition to the Advisers Act, in connection with guidance in the IA Release concerning registered funds that invest in voting securities and are required to disclose their proxy voting policies and procedures in their statements of additional information (for registered open-end funds) or on Form N-CSR (for registered closed-end funds).

3 *See Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice,* Rel. No. 34-86721 (Aug. 21, 2019). The federal proxy rules include the rules promulgated by the SEC under Section 14 of the Exchange Act. A "solicitation" under the federal proxy rules also is subject to public filing requirements, for which an exemption may be available.

4 *See Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice,* Rel. No. 34-87457 (Nov. 5, 2019).

5 The public statements of the Commissioners who voted to approve the Releases express their view that the Releases represent only a limited development of the legal framework applicable to proxy advisory firms and their use by investment advisers. *See* Chairman Jay Clayton, Statement at Open Meeting on Commission Guidance and Interpretation Regarding Proxy Voting and Proxy Voting Advice (Aug, 21, 2019) ("The[] potential actions discussed

in the guidance are not new."); Commissioner Hester M. Peirce, Statement at the Open Meeting on Commission Guidance and Interpretation Regarding Proxy Voting and Proxy Voting Advice (Aug. 21, 2019) ("In issuing today's guidance, we are not building a new regulatory regime, but are explaining the contours of an existing one."); Statement of Commissioner Roisman, *supra* n.1 ("[The] Commission guidance stays true to the [investment advisers' proxy voting rule adopted in 2003]'s flexible, principles-based approach in discussing investment advisers' proxy voting responsibilities, updates and elevates the portions of [Staff Legal Bulletin No. 20, discussed further in the text] that may be relevant for investment advisers today, and underscores the importance of the adviser serving its clients' best interest."). However, the Commissioners who voted against publishing the guidance statements disagreed. *See* Commissioner Allison Herren Lee, Statement on Proxy Voting and Proxy Solicitation Releases (Aug. 21, 2019) (Statement of Commissioner Lee) ("I understand there is a view that today's actions do not go beyond the staff guidance issued in 2014. But I do not agree. Staff views like those expressed in Staff Legal Bulletin 20 are non-binding and cannot create legal rights or obligations. Commission action, on the other hand, is different and commands attention and compliance.... It may be that some of these specific measures are warranted, but the Commission has made a substantive policy choice without formally seeking input, justifying that choice to the public, or even identifying any benefits for investors.").

6 *See* Statement of Commissioner Roisman, *supra* n.1 ("Some have called for the Commission to impose new obligations on investment advisers with respect to their proxy voting, such as requiring them to conduct pass-through voting or restricting their use of proxy advisory firms. But, after thoroughly considering the reasons behind such requests—namely, the desire to make sure advisers serve clients' best interests and maintain accountability for voting their proxies—I am not convinced such new prescriptive requirements would best achieve these objectives.").

7 *See* Andrew Ackerman, "SEC Takes Action Aimed at Proxy Advisers for Shareholders," *Wall Street Journal* (Aug. 21, 2019).

8 *Proxy Voting by Investment Advisers,* Rel. No. IA-2106 (Jan. 23, 2003), at nn. 2-3 and accompanying text (describing the Proxy Rule as building upon an investment adviser's fiduciary duties of care and loyalty in the context of proxy voting).

9 By its terms, the Proxy Rule applies only to investment advisers that "are registered or required to be registered" under the Advisers Act. However, any investment adviser, regardless of its registration status, is subject to certain fiduciary duties and general antifraud liability under the Advisers Act. *See Commission Interpretation Regarding Standard of Conduct for Investment Advisers,* Rel. No. IA-5248 (June 5, 2019) (Fiduciary Interpretation), at n. 32. Therefore, unregistered investment advisers that have the authority to vote proxies on behalf of their clients also should consider the Proxy Rule and its related guidance as instructive.

10 This statement was the sole Commission-level guidance that had been published regarding an investment adviser's proxy voting responsibilities prior to the recent publication of the Fiduciary Interpretation and the IA Release.

11 *See* Egan-Jones Proxy Services, SEC Staff No-Action Letter (May 27, 2004) (withdrawn on Sept. 13, 2018), at n. 6 and accompanying text; Institutional Shareholder Services, Inc., SEC Staff No-Action Letter (Sept. 15, 2004) (withdrawn on Sept. 13, 2018). Prior to their withdrawal, the Egan-Jones and ISS letters were relied upon by many investment advisers in considering and structuring relationships with proxy advisory firms, as well as determining the appropriate level of due diligence to perform on such firms, particularly in cases where an investment adviser may have a conflict of interest in determining how to vote client securities.

12 *See* Ackerman, *supra* n.7.

13 Rule 14a-21 under the Exchange Act requires companies soliciting proxies for a shareholder meeting at which directors will be elected to include a separate

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resolution subject to a shareholder advisory vote to approve the compensation of any named executive officers.

14 *See, e.g.*, Government Accountability Office, Report to the Chairman, Subcommittee on Economic Policy, Committee on Banking, Housing, and Urban Affairs, U.S. Senate: Corporate Shareholder Meetings—Proxy Advisory Firms' Role in Voting and Corporate Governance Practices (June 2007).

15 *Concept Release on the U.S. Proxy System,* Rel. No. IA-3052 (July 14, 2010).

16 At this hearing, former SEC Chairman Harvey L. Pitt, advocating on behalf of the US Chamber of Commerce, claimed that "ISS and Glass Lewis ha[d] become the de facto standard setters for corporate governance policies in the U.S." Statement of the US Chamber of Commerce, Capital Markets and Government Sponsored Enterprises Subcommittee Hearing entitled "Examining the Market Power and Impact of Proxy Advisory Firms" (June 5, 2013).

17 Daniel M. Gallagher, Remarks before the Society of Corporate Securities and Governance Professionals (July 11, 2012); *see also Dechert OnPoint:* Is the Pendulum Swinging? SEC Commissioner Gallagher Expresses Concerns About Reliance on Proxy Advisors.

18 Securities and Exchange Commission, Divisions of Investment Management and Corporation Finance, Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms, Staff Legal Bulletin No. 20 (June 30, 2014).

19 For additional discussion of the Egan-Jones and ISS no-action letters and the Proxy Bulletin, please refer to "A Vote in Favor of Balance and Care in Policies Regarding the Use of Proxy Advisors," *The Investment Lawyer*, Vol. 21, No. 9 (Sept. 2014).

20 *See* Proxy Bulletin, *supra* n.18; *see also* Concept Release, *supra* n.13, at n. 244 & accompanying text ("As a general matter, the furnishing of proxy voting advice constitutes a 'solicitation' subject to the information and filing requirements in the proxy rules.").

21 *Cf.* Commissioner Robert J. Jackson Jr., Statement on Shareholder Voting (Sept. 14, 2018) (stating that "the law governing investor use of proxy advisors is no different [after the withdrawal of the Egan-Jones and ISS no-action letters] than it was [before their withdrawal]" and expressing concern that the SEC's "efforts to fix corporate democracy will be stymied by misguided and controversial efforts to regulate proxy advisors," which "has long been a top priority for corporate lobbyists").

22 For further information regarding the Roundtable and the effect of the withdrawal of the Egan-Jones and ISS no-action letters, please refer to *Dechert OnPoint*: SEC Staff Withdraws Guidance on Proxy Firms and Holds Proxy Roundtable; Chairman Clayton Indicates that SEC Will Act in 2019.

23 *See* IA Release, *supra* n.2, at nn. 23 and 28 (stating, without disapproval, that the Proxy Bulletin represents Staff views, and adopting the Proxy Bulletin's question-and-answer format); *see also* Statement of Commissioner Roisman, *supra* n.1 (describing the IA Release as "updat[ing] and elevat[ing] the portions of [the Proxy Bulletin] that may be relevant for investment advisers today").

24 *See id.* at pp. 1-4; *see also* Fiduciary Interpretation, *supra* n.8. Prior to the Fiduciary Interpretation, many stakeholders understood the Advisers Act to recognize and integrate aspects of an investment adviser's fiduciary duties that arise under applicable state law, rather than to impose a federal fiduciary duty.

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