SEC Issues Proxy Voting Guidance for Investment Advisers and Proxy Advisory Firms

Recently, the Securities and Exchange Commission issued guidance to investment advisers on their proxy voting responsibilities under the Investment Advisers Act of 1940, including their reliance on proxy advisory firms (such as Institutional Shareholder Services ("ISS") and Glass Lewis & Co.) to provide research and analysis and make voting recommendations on matters subject to a shareholder vote (the "Investment Adviser Guidance"). At the same time, the Commission issued an interpretation and guidance to proxy advisory firms summarizing the application of the proxy rules under the Securities Exchange Act of 1933 to their proxy voting advice (the "Proxy Advisory Firm Guidance"). Characterized as a clarification of current law, both sets of guidance were effective upon publication in the Federal Register in mid-September.

This Thoughtful Pay Alert summarizes the key portions of the new guidance affecting proxy advisory firms and provides our initial observations on how it could impact technology and life sciences companies going forward.

Investment Adviser Guidance

Generally, under the federal securities law investment advisers owe their clients a duty of care and loyalty with respect to the services undertaken on the clients' behalf, including proxy voting. Among other things, as mandated by SEC rule, an investment adviser who exercises voting authority with respect to client securities must adopt and implement written policies and procedures that are reasonably designed to ensure that the adviser votes proxies in the best interests of its clients.

The Investment Adviser Guidance clarifies how an investment adviser's fiduciary duty (as well as the applicable SEC rules) relate to the adviser's proxy voting on behalf of clients, particularly where the adviser engages a proxy advisory firm. The guidance addresses two main topics: how an investment adviser and its client can define the scope of the adviser's authority to vote proxies on behalf of its clients and, more specifically, how an investment adviser should go about engaging and overseeing proxy advisory firms to ensure that it is satisfying its proxy voting duties appropriately.

With respect to this latter topic, the Investment Adviser Guidance provides a series of suggestions on how investment advisers should evaluate proxy advisory firms to ensure that they are acting in a manner that enables the adviser to appropriately exercise its fiduciary responsibilities:

- Retaining a Proxy Advisory Firm. When deciding whether to retain (or continue retaining) a proxy advisory firm, an adviser should consider various factors about the firm, such as its capacity and competency to adequately analyze the matters for which the adviser is responsible for voting (which may include evaluating its staff, personnel, and/or technology).

- Accuracy of Information. Upon retaining a proxy advisory firm, an adviser should adopt and implement policies and procedures that are reasonably designed to ensure that the firm's voting determinations are not based on materially inaccurate or incomplete information (which may include a periodic review of the adviser's ongoing use of the firm's research or voting recommendations).

- Conflicts of Interest and Business Changes. On an ongoing basis, an adviser should adopt and implement policies and procedures that are reasonably designed to sufficiently evaluate the firm's services in order to ensure that the adviser casts votes in the best interests of its clients (which may include policies and procedures to identify and evaluate the firm's conflicts of interest, as well as updates regarding business changes that could affect the firm's capacity and competency to provide voting recommendations or to execute votes in accordance with the adviser's voting instructions).

Observations. While much of the Investment Advisers Guidance tends to reinforce existing Commission and SEC Staff pronouncements on the proxy voting responsibilities of investment advisers, it goes into greater detail on how investment advisers should evaluate a proxy advisory firm's interaction with issuers – the subject of their proxy voting recommendations. For example, in evaluating a proxy advisory firm, the guidance suggests that an investment adviser should consider such factors as whether the firm:

- maintains an effective process for seeking timely input from issuers, clients, and third parties with respect to its proxy voting policies and methodologies (including the development of

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peer groups that are used to make recommendations about Say-on-Pay votes);

- has effective policies and procedures for obtaining current and accurate information about the matters included in its research and on which it makes voting recommendations – and its willingness to engage with issuers for this purpose and to correct any errors or misunderstandings in their reports or analyses; and
- considers factors unique to a specific issuer or proposal when evaluating a matter subject to a shareholder vote.

These examples almost ensure that, at a minimum, proxy advisory firms may need to review the guidance carefully and consider whether their current methodologies and processes provide adequate opportunity for issuer input and feedback. In addition, the proxy advisory firms may need to be more responsive to input from investment advisers which will be looking to make sure that they have adequately discharged their responsibilities under the Advisors Act.

Proxy Advisory Firm Guidance

The Proxy Advisory Firm Guidance confirms that the proxy voting advice provided by the proxy advisory firms generally constitutes a "solicitation" under the proxy rules because it essentially consists of recommendations that are intended to result in the procurement, withholding, or revocation of a proxy. As such, these solicitations are subject to the applicable filing and information delivery requirements of the proxy rules unless the conditions of the available exemption are satisfied (which is typically the case when it comes to proxy advisory firm voting recommendations). Even so, the Proxy Advisory Firm Guidance clarified that solicitations including proxy voting advice must comply with the antifraud provisions of the proxy rules. These provisions prohibit a solicitation from containing any statement that is false or misleading or from omitting any statement that would cause the solicitation to be false or misleading.

These prohibitions extend to opinions or recommendations that are disclosed by a proxy advisory firm as part of a solicitation. Further, where such opinions or recommendations are provided, disclosure of the underlying facts, assumptions, limitations, and other information may be needed to avoid raising antifraud concerns. As specified in the Proxy Advisory Firm Guidance, to avoid a potential violation of the antifraud provisions, a proxy advisory firm must be sufficiently transparent about the methodology it uses to develop its voting recommendations, and about the sources of information that it uses in preparing its reports. Interestingly, in situations where the proxy voting advice is based on a methodology that uses a group of peer companies selected by the proxy advisory firm, this disclosure may need to include the identities of the peer group members and the reasons for selecting those peer group members, as well as, if material, why the peer group members differ from those selected by the issuer.

Further, to the extent that the proxy voting advice is based on third party information sources, the firm must disclose those sources and explain the extent to which the information from those sources differs materially from the issuer's public disclosures Finally, it must disclose any potential or actual conflicts of interest in sufficient detail so that the client can assess the relevance of those conflicts.

Observations. It remains to be seen whether the Proxy Advisory Firm Guidance will result in significant changes in the way the proxy advisory firms currently conduct their businesses. Since the guidance does not create any direct new obligations, it's possible that technology and life sciences companies will notice differences only on the margins; for example, in the way that the firms formulate their policy updates and/or provide information in their proxy reports, including additional information about the development of their self-constructed peer groups. On the other hand, to avoid raising antifraud concerns, we may see enhanced transparency about the analytics used to develop voting recommendations, including in areas where the proxy advisory firms have historically been reluctant to share details about their methodologies.

In addition, by confirming that their proxy voting advice is subject to the antifraud provisions of the proxy rules, the Proxy Advisory Firm guidance has laid out a means for companies to challenge their proxy voting recommendations. Thus, we may see the proxy advisory firms become more amenable to providing draft reports in advance to a wider range of companies when they contain agenda items that are likely to be controversial or contested so as to minimize concerns that the information contained therein is inaccurate or misleading.

Conclusion

Observers view the guidance as the initial (but relatively muted) step in a long-overdue review and overhaul of the proxy voting process. While it is difficult to predict future SEC action, it is believed that the Commission is planning next to take up proposed reforms to the exemptions to the proxy solicitation rules which are relied upon by the proxy advisory firms and the rules regarding the share ownership thresholds for submitting a shareholder proposal, perhaps by the end of the year.■

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