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SEC Issues Interpretive Guidance for Investment Advisors and Proxy Advisors

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On August 21, 2019, long-anticipated guidance was released by the Securities and Exchange Commission (SEC) that will require investment advisors (or IAs) to exercise more due diligence in voting and following proxy advisor (or PA) recommendations[1]. The guidance may also subject PAs, including Institutional Shareholder Services Inc. (ISS) and Glass Lewis & Co. (GL), to a higher level of liability under the securities laws if their recommendations contain any incorrect information. While this guidance fell short of strictly regulating investment advisors' reliance on proxy advisors, and proxy advisor activity itself, it will cause both entities to exercise a higher level of care in formulating voting recommendations and casting votes.

Because this new guidance is deemed to be an interpretation, rather than a new rule, it is effective immediately. The SEC has also noted that the guidance is not prescriptive. As a result, it is unclear what the immediate impact of the rules may be for our clients. Some outcomes could include:

- More transparency from GL and ISS as to application of their methodologies;
- More pressure on IAs and PAs to consider individual facts and circumstances about their clients and those clients' particular strategies, rather than applying one-size-fits-all approaches;
- More pressure on both IAs and PAs to render opinions that are based on extremely accurate facts and understandings of matters on which they are voting, including compensation-related items such as say-on-pay and equity plan approvals;
- Extreme concentration in the proxy advisor market as increased legal costs may put too much pressure on smaller firms trying to compete (i.e., firms other than GL and ISS);
- More work for IAs and PAs as they will will likely want to establish an audit process to comply with some of the guidelines (which may in turn result in higher fees); and/or
- More scrutiny where ISS and GL are retained by companies to perform consulting services but are also providing voting recommendations.

At this juncture, however, there do not appear to be any particular actions our clients need to take.

This memo provides some background on the issues and outlines the highlights of the new guidance.

Background

Under federal security laws, investment advisors are fiduciaries that owe their clients duties of care and loyalty with respect to services provided, including proxy voting. When an IA votes its client's securities, it must adopt and implement policies designed to ensure that votes are cast in the best interest of that client. One of the many problems with this system

is that IAs generally don't have the time to conduct extensive research on behalf of all of their client investments and the various issues up for vote. As a result, many hire proxy advisors to conduct the research and make recommendations about how to cast client votes.

Back in 2004, the SEC issued two no-action letters which indicated that one way IAs could show that proxies were voted in their clients' best interest and fulfill their fiduciary duty was to vote based on the recommendations of a PA. Many claim that these letters institutionalized the over-reliance on the PAs. To make matters worse, PAs were generally not subject to any of the stringent rules imposed on IAs and have been criticized as "unregulated regulators" given the influence they now have on voting decisions.

After hearing ten years of criticism about undue proxy advisor influence, the Divisions of Investment Management and Corporation Finance issued SEC Staff Legal Bulletin No. 20 (SLB 20) in 2014[2], which contained due diligence guidance that should be followed by IAs if they were using PA advice (i.e., the IA could not blindly follow PA recommendations without making some level of its own due diligence on the issues). However, the 2004 interpretation letters were not retracted and SLB 20 seemed to have little impact on practices.

The two 2004 no-action letters were finally withdrawn in September of 2018 in anticipation of the SEC's 2018 Proxy Roundtable[3], during which the SEC engaged in extensive discussion around the issue of PA influence. The culmination of this fifteen year-old controversy resulted in two sets of new guidance being issued, as detailed below.

Voting Responsibilities of Investment Advisors

The SEC guidance provides a series of six non-exclusive examples that are intended to facilitate an IA's compliance with their principles-based fiduciary duties to clients.

If the IA engages the services of a PA, it is instructed to:

- **Conduct due diligence when using a PA to assist with voting decisions.** An IA should consider whether the PA has the capacity and competency to responsibly issue recommendations, including whether the PA has appropriate staffing, personnel, and/or technology. It must also assess whether the PA has an effective process for seeking input from PA clients and companies for items such as voting policies, methodologies, and peer group constructions, including say-on-pay votes. On this topic, the guidance offers specific examples of recommended due diligence, including:
    - How the PA constructs peer groups and how it does or does not take into account the unique characteristics regarding the client, such as the client's size, its governance structure, its industry and any particular practices unique to that industry, its history, and its financial performance;
    - Whether the PA has adequately disclosed its methodologies in formulating voting recommendations, so that the IA can understand the factors underlying the PA's voting recommendations;
    - The nature of any third-party information sources the PA uses; and
    - When and how the PA will engage with clients and third parties.
- An IA's due diligence must also include a review of a PA's policy on conflicts of interest. Examples may include assessing:
    - Whether the PA has adequate policies and procedures to identify, disclose, and address actual and potential conflicts of interest, including (1) conflicts relating to the provision of proxy voting recommendations and proxy voting services generally, (2) conflicts relating to activities other than providing proxy voting

recommendations and proxy voting services, and (3) conflicts presented by certain affiliations;
- Whether the PA's policies and procedures provide for adequate disclosure of the PA's actual and potential conflicts with respect to the services the PA provides to the IA (this disclosure could include details on, for example, whether the client has received consulting services from the PA, and if so, the amount of compensation paid to the firm, or whether a proponent of a shareholder proposal or an affiliate of the proponent is or has been a client of the PA); and
- Whether the PA's policies and procedures utilize technology in delivering conflicts disclosures that are readily accessible (for example, usage of online portals or other tools to make conflicts disclosure transparent and accessible).

Pearl Meyer Observation: These guidelines clearly take into account company frustration about the lack of transparency of "black box" calculations typical of proxy advisor recommendations. They may also help to alleviate some of the perceived randomness in PA voting recommendations. It addresses issues inherent with providing consulting advice to a client but also providing voting recommendations on the same client. Whether and to what extent the current "firewall" espoused by PAs will stand up to this guidance remains to be seen.

With so much due diligence now required, a new cost barrier to entering the PA sphere may have been created, thereby concentrating all PA business in the hands of the two bigger players.

- **Proactively address PA errors, incompleteness, or potentially methodological weaknesses.** Investment advisors should periodically review the accurateness of the basis on which the proxy advisor bases its recommendations. IAs should consider: (1) how PAs get information from clients and how they ensure the data is accurate, as well as whether there is a process for the IA to access the client's views about the PA recommendations in a timely manner; (2) the PA's efforts to correct material deficiencies in its analysis; (3) the PA's disclosure to the IA about its sources of information and methodologies used in formulating its recommendations; and (4) the PA's consideration of factors unique to a specific client or proposal.
- **Implement policies to evaluate PA advice.** An IA should maintain policies or procedures to identify or evaluate a PA's conflict of interest, and capacity and competency to provide recommendations or execute votes in accordance with the IA's instructions. An IA should also review whether the PA updates its methodologies, guidelines, and voting recommendations on an ongoing basis, including in response to feedback from clients and their shareholders.

IAs are also generally instructed to:

- **Agree on scope of voting duties with their clients.** If an IA takes on voting responsibilities, there must be clarity about which items it will vote upon and its methodology for voting. Some examples of possible voting arrangements that could be agreed upon (subject to full and fair disclosure and informed consent) may include: (1) the IA voting according to client instructions or in a certain way for particular shareholder proponents; (2) the IA will only vote on certain proposals such as M&A; or (3) the IA will not vote where the cost of voting is high, the client benefit is low, and/or where the vote is not reasonably expected to have a material effect on the value of the client's investment. An agreement may be made for the IA to take on all voting

determinations, but the IA remains subject to compliance with fiduciary duties.

- **Take steps to demonstrate they are making voting determinations in their client's best interest.** IAs should consider whether voting all of its clients' shares under a uniform policy would be in the best interest of each of its clients, or whether its policies should be tailored to individual clients based on their own investment strategies and objectives. IAs should also annually review and assess the adequacy of their own policies to make sure votes continue to be cast in the best interest of their clients. If an IA does use a PA, it should likewise assess whether it thinks the PA is making decisions in the best interest of the client.
- **Refrain from voting in certain scenarios.** An IA should not vote if it has agreed in advance with a client that it will not be voting on the issue at hand, or if the IA determines that refraining would be in the best interest of the client (e.g., where cost exceeds benefits). However, the IA cannot decline to vote if doing so would violate its duty of care in light of the scope of services for which it and the client had previously agreed.

Increased Liability of Proxy Advisors in Making Recommendations

The federal proxy rules apply where there is "solicitation" which includes, among other things, communications 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. This interpretation will increase PA exposure and liability for inaccuracies.

The solicitation rules applicable to PAs prohibit them from making materially false or misleading statements or omitting material facts. In order to avoid a potential violation, the guidelines suggest the PA disclose the following:

- **Methodology:** Include an explanation of the methodology used to formulate its voting advice on a particular matter (including any material deviations from the provider's publicly announced guidelines, policies, or standard methodologies for analyzing such matters) where the omission of such information would render the voting advice materially false or misleading. For example, if the PA relies on a peer group for making compensation decisions, it must identify peer group members, the rationale for selecting those members, and why it differs from the company's peer group.
- **Third-Party Information:** If voting advice is based on information other than the company's public disclosures, such as third-party information sources, there must be disclosure about these information sources and the extent to which the information from these sources differs from the public disclosures provided by the company if such differences are material and the failure to disclose the differences would render the voting advice false or misleading.
- **Conflicts:** Include disclosure about 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.

Pearl Meyer Observation: These additional disclosures will likely result in increased legal and compliance costs, likely resulting in barriers to entry into the proxy advisory business. However, some of the commissioners have pointed out that this guidance is not prescriptive. Therefore, PA firms may choose to ignore the guidance and continue to provide business on both sides of the house. How this plays out is anyone's guess.

What's Next?

The guidance passed 3-2 with Commissioners Clayton, Peirce, and Roisman voting for, and Commissioners Jackson and Lee voting against. The dissenting commissioners voiced concerns that the new guidance will increase the voting power of large IAs because smaller ones may not have the resources to conduct the new diligence requirements and may simply not vote. They are also concerned that the guidance may disincentivize smaller PAs from entering the market, thereby concentrating the entire market to only a few companies (presumably ISS and GL). Finally, some commissioners were very concerned that because the SEC categorized the new guidance as interpretative guidance rather than as a new rule, it is effective immediately without the public input and commentary that often precedes agency regulatory action. This means that there has been no cost, benefit, and economic impact analysis open to the public. Therefore, the extent of the extra effort and the expenses associated with compliance are an unknown. We are hopeful that the silver lining will include far more transparency in voting methodology as well as accuracy from the big proxy advisory players.

We will be carefully monitoring this process to fully understand and report on impacts and consequences.

[1] https://www.sec.gov/rules/interp/2019/34-86721.pdf and https://www.sec.gov/rules/interp/2019/ia-5325.pdf

[2] https://www.sec.gov/interps/legal/cfslb20.htm

[3] https://www.sec.gov/divisions/investment/imannouncements/im-info-2018-02.pdf

About the Author

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