

SEC Adopts Guidance Impacting Voting Recommendations from Proxy Advisory Firms

In two related releases issued on August 21, the SEC updated its guidance and interpretations to heighten the scrutiny given to the voting recommendations made by proxy advisory firms such as Institutional Shareholder Services Inc. (ISS) and Glass, Lewis & Co. and the investment advisors that rely on those recommendations. In the [first release](#), the SEC provided guidance to investment advisors about the steps they should take in order to fulfill their fiduciary duties when they utilize proxy advisory firms. In the [second release](#), the SEC made it clear that voting recommendations provided by proxy advisory firms are “solicitations” subject to the federal proxy rules, including the antifraud provisions.

In recent years, the use of proxy advisory firms by investment advisors and other institutional investors has become more widespread and the services offered by such firms have expanded. The SEC’s guidance was adopted in response to concerns that proxy advisory firms exercise substantial influence over shareholder votes even though they are unregulated, may have conflicting interests and may sometimes issue recommendations that contain factual inaccuracies.

The guidance is effective immediately, just in time to play an important role in the upcoming proxy season. Investment advisors and proxy advisory firms will need to review their policies and practices and may need to make substantial adjustments, especially in light of the relatively short period of time between the availability of a company’s proxy statement and the date of the related shareholder meeting.

Guidance for Investment Advisors that Utilize Proxy Advisory Firms

An investment advisor and its client can agree on the scope of the advisor’s voting authority through full and fair disclosure and informed consent. An investment advisor that assumes proxy voting authority must make voting determinations consistent with its fiduciary duties and in compliance with Rule 206(4)-6 under the Investment Advisers Act of 1940, which includes the need for the investment advisor to conduct a reasonable investigation into matters on which the advisor votes and to vote in the best interest of

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the client.

When making voting determinations on behalf of clients, many investment advisors retain proxy advisory firms to perform a variety of functions and services. In the August 21 guidance, the SEC warned investment managers about outsourcing their voting responsibilities to proxy advisory firms and set forth a number of recommendations for satisfying their principles-based fiduciary duties when they retain a proxy advisory firm to assist them in some aspect of their proxy voting responsibilities.

When an investment advisor is considering whether to retain or continue retaining a proxy advisory firm to provide research or voting recommendations as an input to the advisor's voting decisions, they should consider, among other things:

- whether the proxy advisory firm has the capacity and competency to adequately analyze the matters for which the investment advisor is responsible for voting;
- the adequacy and quality of the proxy advisory firm's staffing, personnel and technology;
- whether the proxy advisory firm has an effective process for seeking timely input from issuers and proxy advisory firm clients with respect to, for example, its proxy voting policies, methodologies and peer group constructions, including for "say-on-pay" votes;
- how the proxy advisory firm, in constructing peer groups, takes into account the unique characteristics of the issuer, such as the issuer's size, its governance structure, its industry and any particular practices unique to that industry, its history and its financial performance;
- whether a proxy advisory firm has adequately disclosed to the investment advisor its methodologies in formulating voting recommendations, so that the investment advisor can understand the factors underlying the proxy advisory firm's voting recommendations;
- the nature of any third-party information sources that the proxy advisory firm uses as a basis for its voting recommendations; and
- the steps it should take to develop a reasonable understanding of when and how the proxy advisory firm would expect to engage with issuers and third parties.

An investment advisor should also consider the effectiveness of the proxy advisory firm's policies and procedures for obtaining current and accurate information relevant to matters included in its research and on which it makes voting recommendations. As part of this assessment, investment advisors should consider, and in certain cases may wish to communicate with proxy advisory firms, about the firm's

- engagement with issuers, including the firm's process for ensuring that it has complete and accurate information about the issuer and each particular matter, and the firm's process, if any, for investment advisors to access the issuer's views about the firm's voting recommendations in a timely and efficient manner;
- efforts to correct any identified material deficiencies in the proxy advisory firm's analysis;
- disclosure to the investment advisor regarding the sources of information and methodologies used in formulating voting recommendations or executing voting instructions; and
- consideration of factors unique to a specific issuer or proposal when evaluating a

matter subject to a shareholder vote.

Guidance is also included regarding the steps an investment advisor should consider taking when it becomes aware of potential factual errors, incompleteness or methodological weaknesses in the proxy advisory firm's analysis that may materially affect one or more of the investment advisor's voting determinations.

An investment advisor that retains a proxy advisory firm to provide voting recommendations or voting execution services should consider additional steps to evaluate whether the investment advisor's voting determinations are consistent with its voting policies and procedures and in the client's best interest before the votes are cast. Examples of some steps that an investment advisor could use to evaluate its compliance include:

- sampling "pre-populated" votes shown on the proxy advisory firm's electronic voting platform before such votes are cast;
- considering additional information that may become available regarding a particular proposal, such as additional proxy soliciting materials or other information conveyed by an issuer or shareholder proponent to the investment advisor; and
- considering whether a higher degree of analysis may be necessary or appropriate to assess whether any votes it casts on behalf of its client are cast in the client's best interest, such as in merger transactions or contested elections.

Proxy Advisory Firm Voting Recommendations Are Subject to Proxy Rules

The SEC also updated its guidance and interpretations to provide that proxy voting advice generally constitutes a "solicitation" under the federal proxy rules and, while it may be exempt from the information and filing requirements of the Securities Exchange Act of 1934, it is subject to the antifraud provisions of Rule 14a-9 under the Exchange Act.

The SEC stated that the definition of "solicitation" is broad and includes, among other things, a "communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy," even where the person is not seeking authorization to act as a proxy or is indifferent to the outcome of the matter being voted on. The SEC noted that proxy advisory firms typically provide their voting recommendations to their clients shortly before a shareholder meeting with the expectation that those recommendations will be used by their clients when making their voting decisions. Therefore, the SEC concluded that voting advice provided by a firm marketing its expertise in researching and analyzing proxy issues for purposes of helping its clients make proxy voting determinations (not merely performing administrative or ministerial services) should be considered a solicitation subject to the federal proxy rules, even if the proxy advisory firm is providing recommendations based on its application of the client's own tailored voting guidelines.

While the SEC made it clear that proxy voting advice may be exempt from the information and filing requirements of the federal proxy rules, even exempt solicitations remain subject to the antifraud provisions of the Exchange Act. Specifically, Rule 14a-9 prohibits any solicitation from containing any statement which is false or misleading with

respect to any material fact, or omitting to state any material fact necessary in order to make the statements therein not false or misleading. 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 be needed so that these views do not raise Rule 14a-9 concerns.

The SEC recommends that the provider of the proxy voting advice should consider whether, depending on the particular statement, it may need to disclose the following types of information in order to avoid a potential violation of Rule 14a-9:

- 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;
- to the extent that the proxy voting advice is based on information other than a company's public disclosures such as third-party information sources, 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; and
- 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.

By issuing this recent guidance, the SEC is moving ahead on its agenda to address proxy reform issues, this time through Commission-level interpretations of principles that are already part of the existing regulatory framework. In these two releases, the SEC is seeking to increase the transparency and accountability of proxy advisory firms and thereby level the shareholder voting playing field. We can expect further action by the SEC as it continues to consider other proxy reforms, including the submission threshold rules for shareholder proposals and various "proxy plumbing" initiatives.