

Investment Management

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SEC Further Clarifies Proxy Voting Responsibilities of Investment Advisers

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The Securities and Exchange Commission (SEC) recently issued additional guidance to investment advisers pertaining to proxy voting, including the fiduciary duty under Rule 206(4)-6 of the Investment Advisers Act of 1940 (the Advisers Act), and required disclosures under the Investment Company Act of 1940 (the Investment Company Act).¹

In question-and-answer format, the Commission set forth best practices for investment advisers engaged in proxy voting, including establishing and exercising the scope of the investment adviser's authority and responsibilities, demonstrating that voting determinations are in a client's best interest, and additional considerations when retaining proxy advisory firms to assist with discharging proxy voting duties. The SEC's guidance is summarized below:

1. Scope of Investment Adviser's Proxy Voting Authority and Responsibilities

As detailed in the SEC's recent guidance, all investment advisers owe fiduciary duties to their clients under the Advisers Act. An investment adviser's fiduciary duty as it relates to proxy voting will vary with the scope of the voting authority assumed by the investment adviser. An investment adviser and its client may shape the scope of the advisory relationship, including voting authority, through full and fair disclosure by the investment adviser and informed

consent by the client.² Under all circumstances, an investment adviser that assumes proxy voting authority for a client must make voting determinations consistent with its fiduciary duty and in compliance with Rule 206(4)-6 of the Advisers Act, which requires said investment adviser to adopt and implement policies and procedures that are reasonably designed to ensure execution of its voting authority is in their clients' best interest.

The Commission outlines two situations in which an investment adviser is not required to exercise its voting authority on behalf of its client:

- a. the client has agreed in advance to limit the investment adviser's voting authority; or
- b. the investment adviser determines that it is in its client's best interest to refrain from voting (e.g., cost to the client of voting the proxy exceeds the expected benefit to the client).

In making such a determination, an investment adviser must consider its duty of care to its client as defined under their contractual relationship.

2. Investment Adviser's Proxy Voting Policies and Procedures and Duty of Care

An investment adviser with voting authority may satisfy its duty of care by gaining a reasonable understanding of its client's objectives and

¹ The Guidance is available at <https://www.sec.gov/rules/interp/2019/ia-5325.pdf>.

² The SEC's Interpretation Regarding Standard of Conduct for Investment Advisers is available at: <https://www.sec.gov/rules/interp/2019/ia-5248.pdf>. The Firm's Client Alert Regarding Standard of Conduct for Investment Advisers is available at <https://www.lowenstein.com/media/5027/20190702-investment-management-sec-clarifies-federal-fiduciary-duties-of-investment-advisers.pdf> ("The scope of a relationship, the specific nature of a client, and the actual material facts or conflicts influence the level of detail needed for full and fair disclosure . . . Full and fair disclosure requires sufficiently specific detail so that clients can understand a material fact or a conflict of interest and make an informed decision to consent to the relationship.")

making voting determinations that are in its client's best interest. Investment advisers also have an obligation under Rule 206(4)-6 of the Advisers Act to "adopt and implement written policies and procedures that are reasonably designed to ensure that the investment adviser votes proxies in the best interest of its clients." The SEC suggests that an investment adviser consider the following factors when evaluating whether voting determinations are in a client's best interest and in accordance with the investment adviser's proxy voting policies and procedures:

a. Uniform or Custom Proxy Voting Policies and Procedures

— Whether it is in its client's best interest to adopt and implement uniform or bespoke proxy voting policies and procedures, taking into account their client's investment strategy and objectives;

b. Reasonably Designed Investigations into Voting Matters

— Whether to conduct a more detailed analysis of a specific issue or matter to ensure that voting determinations are not based on materially inaccurate or incomplete information. When making this determination, an investment adviser should consider the potential effect of the vote on the value of its client's investments. Investment advisers' proxy voting policies and procedures should include the factors that it will consider when determining which voting matters require company-specific evaluation, and how the investment adviser will evaluate voting determinations on those matters; and

c. Sampling Proxy Votes to Evaluate Compliance with Rule 206(4)-6

— Whether to sample proxy votes – and/or adopt additional measures, as necessary – to determine compliance with policies and procedures and ensure that votes were cast in its clients' best interest. Investment advisers can employ a sampling methodology annually to evaluate compliance with Rule 206(4)-6 of the Advisers Act³ and assess the adequacy of a proxy advisory firm's voting recommendations, if applicable.

3. Evaluating Proxy Advisory Firms

An investment adviser should conduct appropriate diligence when retaining a

proxy advisory firm for research or voting recommendations. The measures an investment adviser takes to determine whether to retain a proxy advisory firm may vary based on the scope of the investment adviser's voting authority and the services the proxy advisory firm is engaged to perform. The SEC's guidance did not specifically address the frequency with which this due diligence should be conducted or how it should be documented.

The SEC suggests that investment advisers evaluate, as applicable, whether the proxy advisory firm:

- Has the capacity and competency to properly analyze proxy voting matters, including the adequacy and quality of its staffing, personnel, and technology;
- Has an effective process in place for obtaining input on a timely basis from issuers and proxy advisory firm clients regarding its proxy voting policies, methodologies, and peer group constructions;
- Adequately discloses and updates its methodologies and guidelines in formulating voting recommendations (to help investment advisers understand factors underlying the firm's voting recommendations);
- Uses third-party information sources as a basis for its voting recommendations, and if so, the nature of this information;
- Has policies and procedures that adequately identify, evaluate, disclose, and address actual and potential conflicts of interest; and/or
- Has policies and procedures to effectively obtain current and accurate information relevant to its voting recommendations.

Investment advisers should adopt and implement comprehensive policies and procedures to review and assess proxy advisory firms and their services. Investment advisers should also consider requiring proxy advisory firms to provide regular, ongoing updates regarding relevant business changes.

If an investment adviser is made aware of potential factual errors, methodological weaknesses, or other defects or inadequacies in a proxy advisory firm's analysis that may materially affect the investment adviser's voting determination, then it should conduct a reasonable investigation into the matter (as described above).

³ Under Rules 206(4)-7 and 204-2(a)(17)(ii) of the Advisers Act, an investment adviser is also obliged to review and document, at a minimum on an annual basis, the adequacy of its proxy voting policies and procedures and the effectiveness of their implementation.

Takeaways

Investment advisers with proxy voting authority make voting determinations on a wide range of matters submitted to shareholders under a variety of facts and circumstances. The SEC's guidance provides examples to help investment advisers formulate and execute their proxy voting responsibilities in accordance with regulatory expectations.

In advance of next year's proxy season, the SEC encourages investment advisers and proxy advisory firms to review their proxy voting policies and procedures. Investment advisers and proxy advisory firms would be well served

by reviewing and updating, as appropriate, their proxy voting policies and procedures in light of the new SEC guidance. Additionally, in the course of an investment adviser's annual compliance program review, we recommend that it includes proxy advisory firms in its vendor due diligence schedule.

Please contact one of the listed authors of this Alert or your regular Lowenstein Sandler contact if you have any questions with respect to the SEC's guidance regarding proxy voting responsibilities of investment advisers or would like assistance reviewing and updating your proxy voting policies and procedures in response to this guidance.

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