

In the Best Interests of a Client: Proxy Voting and the Retention of Advisory Firms

August 28, 2019

The Securities and Exchange Commission (the “SEC”) published guidance (the “Guidance”) regarding the proxy voting responsibilities of investment advisers under Rule 206(4)-6 under the Investment Advisers Act of 1940 (the “Advisers Act”), and Form N-1A, Form N-2, Form N-3, and Form N-CSR under the Investment Company Act of 1940.¹ Rule 206(4)-6 requires an adviser to adopt and implement written policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of its clients. The SEC also released an interpretation regarding the applicability of certain federal proxy rules to proxy voting advice under Section 14 of the Securities Exchange Act of 1934, as amended.²

The Guidance is important for a number of reasons:

- It advances the SEC’s efforts to reaffirm and clarify an adviser’s fiduciary duty, this time in the context of voting proxies. Importantly, it also addresses approaches an investment adviser may take to limit its authority to vote proxies.
- It focuses, in particular, on an adviser’s use of proxy advisory firms in fulfilling its proxy voting responsibilities and provides specific suggestions on how to evaluate these firms.
- It stresses an adviser’s obligation to ensure that the information used by the adviser in making voting decisions, and by a proxy advisory firm in making voting recommendations, is materially accurate and complete.
- Finally, it emphasizes the need for investment advisers to review the adequacy of their proxy voting policies and procedures annually as part of their annual review required by Advisers Act Rule 206(4)-7.

¹ *Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers*, Release No. IA-5235 (Aug. 21, 2019), available [here](#).

² We have prepared a separate Client Update summarizing the Section 14 interpretive release, available [here](#).

While the Guidance is not intended establish new law, dissenting Commissioners suggested that it may establish new requirements that will increase costs to investment advisers and investors. Investment advisers should review their proxy voting policies in light of the Guidance.

Proxy Voting and an Adviser's Fiduciary Duty

An adviser's fiduciary duty under the Advisers Act comprises a duty of care and a duty of loyalty.³ The duty of care "requires an investment adviser to provide investment advice in the best interests of its client, based on the client's objectives," and the duty of loyalty requires an investment adviser to "eliminate or make full and fair disclosure of all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which is not disinterested such that a client can provide informed consent to the conflict."⁴

In the context of proxy voting, an adviser's duty of care requires the adviser to form a reasonable belief that its voting determinations are in the best interests of the client, which includes an investigation reasonably designed to ensure that the voting determination is not based on materially inaccurate or incomplete information. An adviser should also determine the extent to which it has conflicts of interest in connection with voting proxies. The Guidance, using a question and answer format, provides examples to help facilitate an adviser's compliance with its fiduciary duties, noting that specific obligations owed to a client depend on the scope of voting authority assumed by the adviser.

Guidance

Define the Scope of the Adviser's Authority to Vote Proxies on Behalf of Each Client.

An adviser is not required to accept the authority to vote a client's securities. If it does so, an adviser and its client may agree on the scope of the adviser's authority. Voting arrangements may restrict voting authority to specific parameters (e.g., voting in accordance with the recommendation of the issuer's management or voting in favor of

³ For more information on the standard of conduct applicable to investment advisers, please refer to our Client Update, available [here](#).

⁴ *Commission Interpretation Regarding Standard of Conduct of Investment Advisers*, Release No. IA-5248 (June 5, 2019), available [here](#).

all proposals made by a particular shareholder proponent) or to limited matters of importance to the client (e.g., corporate events or contested elections).

An adviser may also agree in advance with a client to abstain from voting in limited circumstances, such as where the cost of voting would be high or the benefit to the client would be low, including instances where casting a vote would not be reasonably expected to have a material effect on the value of the client's investment. While the adviser's fiduciary duty cannot be waived, the application of the duty in the context of proxy voting will vary depending on the scope of the voting authority assumed by the adviser.

Determine When to Exercise Voting Authority.

An adviser may not be required to exercise a voting authority if (i) voting the proxy is outside of the scope of the adviser's voting arrangement with the client or (ii) the adviser has determined, in light of the scope of services to which it and the client have agreed, that refraining is in the best interests of the client. For example, an adviser may abstain from exercising its proxy if it determines that the cost of voting the proxy exceeds the expected benefit to the client. In these instances, however, the SEC has noted that the costs to be considered would necessarily have to be additional costs to the client, such as where the adviser casts a vote on a foreign security that could involve the additional cost of hiring a translator or traveling to a foreign country.

Demonstrate That the Adviser Is Making Voting Determinations in a Client's Best Interest and in Accordance with the Adviser's Policies and Procedures.

Matters that Require Increased Scrutiny

Certain matters, such as corporate events (mergers and acquisitions, dissolutions, conversions or consolidations), contested elections, highly contested or controversial matters, or matters not covered by the adviser's policies and procedures, may require more detailed analysis than might generally be applied to routine matters. In these instances, an adviser should identify the factors it will review, such as the potential effect of the vote on the value of the client's investments.

Evaluating Voting Determinations

Reasonable measures should be taken to determine whether voting determinations are consistent with the adviser's policies and procedures. To do so, an adviser should consider evaluating a sample of votes on an annual basis or, where an adviser engages a proxy advisory firm, a sample of "pre-populated" votes before votes are cast.

Consideration of Additional Information

If an adviser engages a proxy advisory firm, it may wish to assess how additional information that may become available and could reasonably affect the voting determination is used by the proxy advisory firm in making voting recommendations.

Advisers with Multiple Clients

Given that advisers may have multiple clients with different investment strategies, an adviser should consider whether voting all of its clients' shares in accordance with different policies or a uniform voting policy would be in the best interests of each of its clients.

In any case, an adviser must review *and document*, at least annually, the adequacy of its voting policies and procedures to ensure that they are reasonably designed and implemented to ensure that the adviser casts votes in the best interests of each of its clients.

Evaluate a Proxy Advisory Firm Before Retaining It.

An adviser's assessment of a proxy advisory firm will depend on the scope of the adviser's voting authority and the type of functions and services that the adviser wishes the proxy advisory firm to perform. Therefore, certain aspects of the Guidance may be less relevant if a proxy advisory firm is engaged only for purposes of executing votes according to detailed voting instructions, such that the firm's discretion is limited.

General Considerations

An adviser should consider the proxy advisory firm's (i) capacity and competency to analyze the matters for which the adviser is responsible for voting, which may include the adequacy and quality of the firm's staffing, personnel, and technology; (ii) process for seeking timely input from *issuers* and clients with respect to voting policies, peer group construction, and "say-on-pay" votes; (iii) disclosures of methodologies used in formulating voting recommendations; and (iv) use and nature of third-party information sources. The reference to seeking input from issuers met with some resistance from a dissenting Commissioner, who suggested that it may undermine the reliability and independence of a proxy advisory firm's recommendations and create unnecessary burdens on issuers.⁵

Policies and Procedures

An adviser should review the proxy advisory firm's policies and procedures to assess how the firm will implement the adviser's voting instructions. An adviser should also reasonably assess whether the firm's policies and procedures provide for adequate

⁵ See Commissioner Alison Herren Lee, *Statement of Commissioner Allison Herren Lee on Proxy Voting and Proxy Solicitation Releases* (Aug. 21, 2019), available [here](#).

identification and disclosure of actual and potential conflicts of interest, especially those that may occur when the proxy advisory firm is engaged in making voting recommendations and the issuer has received consulting services from the proxy advisory firm.

Establish Processes for Addressing Potential Factual Errors, Potential Incompleteness, or Potential Methodological Weaknesses in a Proxy Advisory Firm's Analysis.

An adviser should conduct a reasonable investigation into the proxy advisory firm's policies and procedures to determine that they are reasonably designed to ensure that the adviser's voting determinations are not based on materially inaccurate or incomplete information. Thus, an adviser should consider periodically reviewing its use of the proxy advisory firm's research or voting recommendations including the extent to which factual errors, incompleteness, or methodological weaknesses materially affect the firm's research or recommendations. Additionally, an adviser should consider reviewing the proxy advisory firm's effectiveness in obtaining current and accurate information, engagement with issuers, efforts to correct any material deficiencies in the firm's analysis, disclosures regarding the source of information and methodologies used in formulating voting recommendations or executing voting instructions, and consideration of factors specific to an issuer.

Assess Impact of Material Changes in a Proxy Advisory Firm's Services or Operations.

An adviser's policies and procedures should provide for sufficient evaluation of a proxy advisory firm in order to assess material changes that can alter the effectiveness of the proxy advisory firm's services and policies and procedures. Accordingly, an adviser may consider requiring that the proxy advisory firm update the adviser on business changes that the adviser considers material and may assess whether the firm appropriately updates its methodologies, guidelines, and voting recommendations on an ongoing basis and in response to feedback.

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As an interpretation, the Guidance is not subject to notice or comment. The Guidance will become effective immediately upon its publication in the Federal Register.

Please do not hesitate to contact us with any questions.

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