Schulte Roth&Zabel

Memorandum

New SEC Proxy Voting Guidance — What Private Fund Managers Need to Do

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The U.S. Securities and Exchange Commission and the SEC staff have long maintained that a tailored proxy voting policy, consistently applied, is part of a registered investment adviser's fiduciary duty to its clients. The SEC recently issued guidance ("Proxy Guidance")[1] that details several issues that investment advisers should address in their proxy voting policies.

The Proxy Guidance was approved by a split 3 – 2 vote of the SEC, and some industry representatives have suggested it should be withdrawn and re-proposed subject to notice and comment. Unless and until such action is taken, the Proxy Guidance reflects the SEC's views as to advisers' obligations and the SEC staff can be expected to rely on such guidance in administering their examination and enforcement program.

Background

The Proxy Guidance is grounded in the SEC's position (as set forth in the "Fiduciary Interpretation"[2] issued earlier this year) that "investment advisers owe each of their clients a fiduciary duty under the Advisers Act" which "must be viewed in the context of the agreed-upon scope of the relationship between the adviser and the client." The Fiduciary Interpretation specified that voting decisions fall within the (fiduciary) duties of care and loyalty owed to clients by investment advisers.

In addition, Investment Advisers Act Rule 206(4)-6 specifically requires registered investment advisers that seek "to exercise voting authority with respect to client securities" 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.

Many fund managers engage proxy advisory firms from their research and recommendations, and many advisers empower them to cast ballots on behalf of the investment fund clients. Some public companies and other commenters challenged what they saw as the increasing power of these proxy advisory firms and, in response, the SEC engaged in a sustained outreach effort over the past decade seeking comments and offering guidance, including the issuance of a 2010 SEC concept release,[3] a 2014 Staff Legal Bulletin,[4] and several roundtables.

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[1] *See* "Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers," Aug. 21, 2019, available here.

[2] *See* "Commission Interpretation Regarding Standard of Conduct for Investment Advisers," Release No. IA-5248, June 5, 2019, 84 FR 33669, at 33671, July 12, 2019.

[3] *See* "Concept Release on the U.S. Proxy System," Release No. 34-62495, July 14, 2010, 75 FR 42982, July 22, 2010.

[4] *See* "Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms," Staff Legal Bulletin No. 20 (IM/CF), June 30, 2014, available here.

How the Proxy Guidance Applies to Private Fund Managers

Private fund managers' proxy voting practices can be divided into three categories (and some managers will employ more than one of these categories for different situations):

- Managers that engage a proxy advisory firm to provide research and recommendations, but weigh each vote themselves and make specific decisions on how to vote;
- Managers that elect not to vote proxies for their clients' holdings because they have determined that any benefits of voting are outweighed by the costs directly or indirectly borne by its clients; and
- Managers that engage a proxy advisory firm to assess situations and empower the proxy advisory firm to vote on behalf of the manager's clients.

The Proxy Guidance contains directives and advice for each of these categories of managers.

Provisions Applicable to All Managers

Irrespective of which category a particular manager falls into, there are a number of points made in the Proxy Guidance that should be considered by all private fund managers, including the following.

Annual Reviews. The Proxy Guidance makes it clear that the SEC expects an investment adviser to review and document, "no less frequently than annually," the overall adequacy of its proxy voting program. The SEC noted that such a review allows the adviser to confirm that its voting policies and procedures have been:

- Reasonably formulated (both in the abstract and in actual operation); and
- Effectively implemented.

Most registered investment advisers cover proxy voting in their annual compliance review under Rule 206(4)-7.

Compliance Confirmations. The SEC states that a registered investment adviser "should consider reasonable measures to determine that it is casting votes on behalf of its clients consistently with its voting policies and procedures." The Proxy Guidance suggests that reviewing a sampling of voting decisions, presumably by a compliance officer, is a viable way for an adviser to evaluate its compliance with Rule 206(4)-6 and confirm compliance with the manager's policies and procedures.

To the extent that a manager does not have some kind of forensic compliance review process for its proxy voting program, the manager should consider whether such a review would be a useful improvement to the compliance program.

Multiple Clients. The Proxy Guidance also focuses on how the actions of an investment adviser should change when the adviser has multiple clients; in fact, the SEC questioned whether a single policy for all of the adviser's clients would be in the best interest of each of its clients. To drive this point home, in a footnote, the SEC included language that said "nothing in [Rule 206(4)-6] prevents an investment adviser from having different policies and procedures for different clients or different categories of clients."

Given this focus, all managers with more than one client relationship should consider reviewing how the existing proxy voting policy or policies address the various investment programs that it administers, and documenting the results of that review. To the extent that multiple voting policies are warranted, the manager should consider what consents and disclosures may be appropriate.

Managers That Make Specific Voting Decisions

The Proxy Guidance expressly states that advisers exercising voting authority must "conduct a reasonable investigation into matters on which the adviser votes and to vote in the best interest of the client." The SEC notes that any conflict of interest the adviser has in connection with a proxy vote must be carefully addressed. The SEC also indicates that a "reasonable investigation" should consider whether particular votes request a more detailed analysis (e.g., mergers and acquisitions). Given the focus on this topic, private fund managers should consider reviewing how they would demonstrate that their investment personnel are satisfying this responsibility.

Managers That Abstain from Voting

The Proxy Guidance confirms that an investment adviser is not required to cast votes on behalf of its clients, but this ability to abstain is limited only to two situations:

- Where an investment adviser and the client have agreed in advance to limit the conditions under which the investment adviser would exercise voting authority; and
- When an investment adviser has determined that refraining from voting is in the best interest of that client (such as where the adviser determined that the cost to the client of voting the proxy exceeds the expected benefit to the client).

The SEC did caution, however, that — when abstaining under a "best interests" analysis — the adviser is still subject to the undertakings it made to its clients and, more broadly, to its duty of care.

In light of this guidance, private fund managers that do not vote, either on a categorical basis (like, e.g., many quantitative managers) or a case-by-case basis, should consider preparing an assessment of the foundation for such a determination, which should include an assessment of the disclosures made to clients.

Managers That Employ a Proxy Advisory Firm

The primary focus of the Proxy Guidance is on advisers' use of proxy advisory firms. The guidance applies not only to firms that empower proxy advisory firms to formulate positions and cast ballots on behalf of an adviser's clients, but also to advisers that utilize proxy firms for research and recommendations while retaining the ultimate decisions for itself.

Additional Steps. The Proxy Guidance recommends that advisers employing a proxy advisory firm "consider additional steps to evaluate whether the investment adviser's voting determinations are consistent with its voting policies and procedures and in the client's best interest before the votes are cast." Note that there are three elements in that one sentence:

- Evaluating whether the votes cast are "consistent with" the adviser's voting policies and procedures;
- Evaluating whether the votes cast are "in the client's best interest"; and
- Performing these evaluations "before the votes are cast."

Examples of "additional steps" proposed in the Proxy Guidance include reviews of the proposed voting slates (perhaps on a sampled basis) and additional substantive analysis of proposed votes on matters that are contested or controversial, that are not subject to any specific guidance in the manager's policies, or that may have been recommended prior to new information coming into the market.

Capacity and Competence Assessment. The SEC also has suggested that an adviser – as a condition of continued engagement – should evaluate the "capacity and competence" of any proxy advisory firm, suggesting a focus on "the proxy advisory firm's staffing, personnel, and/or technology." In that vein, the Proxy Guidance further recommends that the adviser "should also consider whether the proxy advisory firm has an effective process for seeking timely input from issuers and proxy advisory firm clients" in formulating its recommendations; in other words, the adviser's investment staff should understand:

- How the proxy adviser formulates its recommendations;
- How it deals with conflicts of interests (examples of several kinds of conflicts are included in the Proxy Guidance); and
- How it utilizes technology in disclosing conflicts.

The adviser should also consider whether the proxy advisory firm is updating its methodologies, guidelines and voting recommendations on an ongoing basis.

Effectiveness. In particular, the Proxy Guidance states that an investment adviser should consider the "effectiveness" of the proxy advisory firm's process for obtaining "current and accurate information" related to matters on which is makes voting recommendations. The SEC guidance suggests that advisers consider matters such as how a proxy advisory firm engages with issuers and ensures that it has complete and accurate information; how the firm tries to identify and correct deficiencies in its analysis; the quality of the proxy advisory firm's disclosure of these matters to the adviser; and whether and how the adviser employs factors specific to a given issuer or proposal.

Investigating Errors. Situations where an adviser becomes aware of potential factual or methodological errors in a proxy advisory firm's work are also raised, with the SEC suggesting that an adviser "should conduct a reasonable investigation into the matter" and, more generally, review its own policies and procedures to ensure that they have been "reasonably designed to ensure that its voting determinations are not based on materially inaccurate or incomplete information." Managers should consider whether they have feedback systems in place to deal with proxy adviser errors and make changes accordingly.

Next Steps

With the publication of the Proxy Guidance, the SEC has indicated that private fund managers of all stripes need to reassess and likely augment their proxy voting policies and procedures. This new guidance indicates that expectations of oversight and involvement in the proxy voting process have

increased, particularly for the compliance functions, and chief compliance officers should assess what resources and processes are needed to respond.

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