Compliance Corner

Proxy Voting by Investment Advisers: One Sentence and Eleven+ Years of Experience

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In 2003, the SEC adopted Rule 206(4)-6 under the Investment Advisers Act of 1940 (Advisers Act) requiring registered advisers to adopt written policies and procedures that are reasonably designed to ensure that they vote proxies in the best interests of their clients. At the time, advisers with proxy voting authority were instructed that the policies must address how they confront material conflicts between their interests and those of their clients. It was also suggested that an adviser could demonstrate that a "vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendation of an independent third party." The flexibility afforded by this sentence has been utilized by advisers since 2003, creating new issues that the SEC staff and others have sought to address recently.

This article revisits the requirements of Rule 206(4)-6 and the fiduciary duties underlying those requirements and explores common practices employed by advisers in their proxy voting policies, including the use of various services offered by proxy voting firms. It highlights some of the concerns raised with following the voting recommendations of proxy voting firms and concludes with several items that advisers may wish to consider in connection with selecting such firms in light of the conflicts to which such firms are subject and the SEC staff's focus on those conflicts.

Rule 206(4)-6, Common Policy Practices and Underlying Duties

Rule 206(4)-6 requires advisers to adopt written policies and procedures reasonably designed to ensure that proxies are voted in the best interests of clients. The written policies must address how an adviser addresses material conflicts that may arise between the adviser's interests and those of the adviser's clients. The Rule also requires advisers to disclose to clients how a client may obtain information from the adviser about how it voted the client's securities and to describe to clients the policies and that the policies will be furnished to a client upon request.

An adviser's proxy voting policies established pursuant to the Rule typically consist of both voting guidelines and procedures covering the proxy voting process. Voting guidelines address how an adviser will vote on particular issues, such as election of directors, corporate governance issues, anti-takeover measures and social and environmental issues. The guidelines provide one measure for addressing an adviser's conflicts of interest. In the case of a conflict, an adviser may establish a requirement to adhere to guidelines in voting client proxies, prohibiting overrides of such guidelines that might occur due to incentives created by conflicts. Procedures typically cover the process for identifying conflicts of interest and for disclosing the proxy voting policies and how clients might obtain a copy of such policies and their voting records. The procedures often also address periodic review of the procedures, recordkeeping and testing requirements, and responsible persons for administering the policy.

As the SEC noted upon adoption, the Rule incorporates the fiduciary duties of care and loyalty that an adviser owes to each of its clients. The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies. The duty of loyalty requires an adviser to cast votes in a manner consistent with the best interests of its clients, free of conflicts that could affect how the adviser votes.

The Rule and the duty of care do not require an adviser with proxy voting authority to vote every client proxy. In some cases, an adviser may determine that it is in the client's best interest not to vote a proxy, for instance, when the cost or effort involved in voting the proxy outweighs the benefit of voting the proxy for the client (as is often the case with foreign securities). Further, and as recently recognized by the SEC staff in Staff Legal Bulletin No. 20 (IM/CF), the scope of an adviser's delegated

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proxy voting authority can limit its obligations to a client. The SEC staff has cautioned, however, that an adviser that has assumed full responsibility for voting client proxies may not simply adopt a policy of not voting any client proxies.

Use of Third-Party Proxy Voting Firms

As noted above, the SEC suggested that an adviser could demonstrate that a proxy vote was not the product of a conflict of interest if the vote occurred in accordance with a pre-determined policy to follow the recommendations of an independent third party. Given this flexibility and the time-consuming nature of analyzing proxy issues and processing proxy votes, advisers with proxy voting authority have increasingly looked to the services of third-party proxy voting firms to fulfill some or most of their proxy voting obligations.

Proxy voting firms offer a number of services to advisers wishing to outsource work related to the proxy voting process, including, among other things:

- administrative and back office functions (*e.g.,* receipt and execution of proxies according to the proxy voting firm's own guidelines or specific instructions provided by a client, and ballot pre-population analysis on how a client would likely vote on proxies);
- research and analysis services (*e.g.,* a report on proposed votes accompanied by statistics, facts and analysis);
- voting recommendations based on the firm's own voting guidelines; and
- expertise and recommendations in drafting proxy voting guidelines.

While the SEC permitted reliance by an adviser on a policy to vote based on the recommendations of an independent third party, it stated in its adoption of Rule 206(4)-6 that such policy must be designed to further the interests of clients rather than those of the adviser. In a 2009 enforcement action, the SEC sanctioned an adviser for voting in accordance with the recommendations of a proxy voting firm when that firm's recommendations served to benefit the adviser's interest in attracting and retaining certain clients. While the firm's recommendations may have been in the best interests of certain of the adviser's clients, they were not in the best interests of all of the adviser's clients. In choosing to rely upon the recommendations of a proxy voting firm, an adviser should consider whether that firm's recommendations would be in the best interests of the adviser's clients. The adviser should at the same time address in its own proxy voting policy any potential conflicts it may have in relying on the proxy voting firm's recommendations.

Potential Conflicts of Interest of a Proxy Voting Firm

Many calls for regulation of proxy voting firms have centered on the issue of conflicts of interest within these firms, including concerns over situations in which these firms provide services despite significant conflicts. For example, in an August 2014 working paper published by the Washington Legal Foundation, SEC Commissioner Daniel Gallagher urged structural changes to the oversight and regulation of proxy voting firms in reaction to what he viewed as overreliance on such firms' recommendations despite a myriad of conflicts.

Certain proxy voting firms offer advisory services to public companies on the development and structure of proposals, and subsequently provide voting recommendations on such proposals. Specifically, an issuer might use advisory services offered by a proxy voting firm to structure governance and proxy proposals so as to avoid "no" voting recommendations from the very same firms. Arguably, a proxy voting firm might tend to be more lenient in making voting recommendations for companies using its services. Conflicts also arise for proxy voting firms that provide services to asset management clients that are owned by public companies.

As a result of such conflicts, Gallagher concluded in his working paper that SEC guidance is necessary to clarify that institutional investors must take responsibility for proxy voting, rather than rely entirely on the recommendations of proxy voting firms. He also suggested that the SEC should explore the issue further and consider possible reforms, such as the creation of a universal code of conduct applying to proxy voting firms and requirements promoting increased accountability and transparency.

SEC Staff Legal Bulletin and Retention and Oversight of Proxy Voting Firms

The Staff Legal Bulletin, issued in June 2014, addressed expectations with respect to the selection and ongoing oversight of proxy voting firms by advisers. The Bulletin also promoted the use of robust proxy voting policies and procedures by advisers to assist in such oversight functions. The staff urged that advisers review and consider possible changes to existing proxy voting policies, which the staff said should be done at least in advance of next year's proxy voting season, and noted that policies should be reviewed no less frequently than annually to ensure proper implementation.

An adviser's duty to vote client securities in the best interests of clients cannot be wholly delegated to a proxy voting firm; the adviser must maintain oversight of the proxy voting firm, which, as noted in the Bulletin, should include review of conflicts of interest that may arise.

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The Bulletin suggested, among other things, that in order to demonstrate compliance with an adviser's duty with respect to oversight of a proxy voting firm, an adviser might periodically sample proxy votes executed by a proxy voting firm to determine compliance with the adviser's proxy voting policies and procedures.

Key Considerations for Advisers

Due to increasing focus on proxy voting, and in response to the Staff Legal Bulletin and other commentary, such as that provided in the Gallagher working paper, an adviser would be well advised to:

- *Carefully review again, and amend if necessary, its proxy voting policies in light of its business activities and client circumstances.*

  In assessing the need for changes to its policies an adviser should consider:

  - the consistency of the proxy voting guidelines with the investment objectives of clients;
  - the voting guidelines' treatment of issues relevant to a client's strategy (*e.g.,* socially responsible investment strategies);
  - procedures to identify and address potential conflicts of interest;
  - procedures for effecting and determining the propriety of exceptions to, or overrides of, the voting guidelines; and
  - requirements for reporting proxy voting matters to the client.

- *Review client advisory contracts to determine the extent of its proxy voting authority.*
- *Re-analyze any conflicts of interest it may have in voting client proxies with respect to specific issuers.*
- *Review service contracts with proxy voting firms and evaluate the services provided by such firms.*

Proxy voting services. If an adviser engages a proxy voting firm to implement the adviser's specific proxy voting guidelines, the adviser should determine the firm's ability to implement those guidelines and the extent to which the adviser may wish to vote directly in certain circumstances. An adviser might specify in its contract that proxy votes are to be escalated to the adviser when:

- voting guidelines are silent or unclear on an issue, or specify that an issue is to be decided on a case-by-case basis;
- proxies contain high profile or material matters; or
- there is a conflict of interest.

Conflicts of interest. An adviser should conduct due diligence on a proxy voting firm's business, reviewing information on material events affecting the firm's organization that might create conflicts of interest and on information barriers to prevent conflicts of interest from influencing the firm's vote recommendations. An adviser should request updates from a proxy voting firm on any changes to the firm's business or internal policies that could create conflict situations.

Quality of services. An adviser should consider a proxy voting firm's capacity and competency to provide detailed research and to adequately analyze proxy issues to make informed voting recommendations in areas where the adviser has less expertise relating to an issue or the relevant market. The adviser should consider whether obtaining lower cost services results in sacrifices in the quality of research and recommendations proffered by such firms, cookie cutter approaches to proxy issues and occasional recommendations based on material factual errors. The adviser may request that a proxy voting firm complete a due diligence questionnaire to ascertain this information.

- *Request ongoing information from proxy voting firms engaged by the adviser.*

An adviser may request, among other things, information and reports on the following:

- voting records, including reports on new or novel issues, overrides, conflicts, voting errors, votes against management and votes that were not cast;
- other businesses and services in which the proxy voting firm is engaged that might lead to conflicts for the firm in providing voting recommendations, including information on the firm's engagements with issuers;
- voting protocols and processes (if a firm is effecting proxy voting on the adviser's behalf);
- disaster recovery system and recordkeeping process (the adviser should confirm that the proxy voting firm backs up records and has a process for addressing cyber security threats); and
- policies and procedures for ensuring the integrity and confidentiality of client records.

Conclusion

The involvement in the proxy voting process by advisers has garnered increased attention in recent years as the use of third-party proxy voting firms has become more prevalent and worries concerning overreliance on those firms have grown. As a result of the increased focus on this matter, advisers should pay close attention to their due diligence and oversight of services provided by proxy voting firms.

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