

# Investment Management Alert

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## SEC Applies Fiduciary Duties Analysis to Voting Obligations

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On August 21, 2019, the Securities and Exchange Commission (SEC) voted 3 to 2 to adopt new interpretive guidance (the “Voting Interpretation”) applicable to investment advisers regarding their proxy voting responsibilities as a fiduciary.<sup>1</sup> While the Voting Interpretation provides guidance that would be helpful for registered investment advisers in crafting their proxy voting policies, the Voting Interpretation is intended to apply to all investment advisers irrespective of their registered status. The following is a summary of the Voting Interpretation and [a checklist](#) to aid in updating compliance manuals to address these issues.

The Voting Interpretation restates and expands previous staff guidance<sup>2</sup> regarding the scope of the voting obligations and considerations for the retention of proxy advisory firms in a manner consistent with the SEC’s final interpretation of investment adviser fiduciary duties<sup>3</sup> (the “Fiduciary Interpretation”) adopted in the summer of 2019. Contemporaneously with the adoption of the Voting Interpretation, the SEC also adopted a separate interpretation that proxy advisory firms are making a “proxy solicitation” when they recommend votes to their clients and are subject to the antifraud requirements of Regulation 14A under the Securities Exchange Act of 1934.<sup>4</sup>

The Voting Interpretation states, “investment advisers are fiduciaries that owe each of their clients duties of care and loyalty with respect to services undertaken on the client’s behalf, including voting.” Investment advisers therefore must make voting determinations that are in the best interest of the client in light of a reasonable understanding of the client’s objectives and not place the investment adviser’s own interests ahead of the client’s interests. While retaining a proxy advisory firm would help mitigate potential conflicts of interest with its exercise of voting authority, the investment adviser would still have ultimate responsibility for making the voting investment decisions in the best interests of its clients, providing full and fair disclosure of potential conflicts of interest and obtaining informed consent from its clients.

### Obligations When Voting

#### Duty of Care When Providing Advice

### Contact Information

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The Voting Interpretation suggests that investment advisers focus on material matters, such as mergers and contested elections, and the effect of those events on the value of its clients' investments. Investment advisers should consider including the factors that it would consider in its votes on those material matters in its proxy-voting policies. In making voting decisions, investment advisers should ensure that they are acting on information that is complete and accurate in all material respects.

## Costs

As with the Fiduciary Interpretation, the Voting Interpretation requires investment advisers to consider the costs and the benefits of voting. For example, investment advisers must consider the costs of forgoing loan interest payments to recall shares when determining whether to vote. In addition, if the client would not expect any benefit for the vote (such as a client that typically does not hold long after the record date), the adviser and the client may wish to constrain the scope of voting activities.

## Conflicts of Interests

Investment advisers should consider the interests of each client separately when making voting decisions and apply differing voting policies for clients with differing interests. Investment advisers facing a conflict of interest could also consider deferring to a proxy advisory firm or consulting the client.<sup>5</sup>

## Considerations for Retaining a Proxy Advisory Firm

### Required Diligence When Retaining Proxy Advisory Firms

As with other service providers, the SEC expects that investment advisers perform thorough diligence regarding whether the proxy advisory firm has the "capacity and competency to adequately analyze the matters for which the investment adviser is responsible for voting" by examining the adequacy and quality of the proxy advisory firm's staffing, personnel, technology, processes and procedures.<sup>6</sup> As part of the analysis, the investment adviser should assess (i) the factors that the proxy advisory firm uses in making voting recommendations, (ii) the third-party information that the firm utilizes, (iii) the firm's interaction with issuers and third parties, and (iv) the firm's processes for identification and addressing conflicts of interest.<sup>7</sup> The investment adviser should also ensure that the proxy advisory firm makes specific disclosure regarding the conflicts of interest for the particular vote, such as whether the firm has provided advisory services to the subject of the vote and the amount of the compensation it received. The conflict may not be as relevant and the amount of diligence needed may not be as extensive if the proxy advisory firm is only performing administrative functions or voting according to a formula set by the investment adviser.

### Supervision of Proxy Advisory Firm Votes

Investment advisers that have a retained proxy advisory firm must evaluate whether the firm's recommendations are consistent with the investment adviser's proxy voting policies before it casts votes. An investment adviser could fulfill its obligations by sampling the proxy advisory firm's prepopulated votes, ensuring that the proxy advisory firm has policies and procedures to take into consideration subsequent information (such as a director vote becoming contested) and applying a higher level of analysis of the recommended vote for material matters. If the investment adviser becomes aware of proxy advisory firm relying on incorrect or incomplete information in

making proxy recommendations, the investment adviser should conduct a reasonable investigation into the matter and the proxy advisory firm's policies and procedures and consider the continued use of the proxy advisory firm.

Investment advisers must continue to evaluate the proxy advisory firm during the course of the relationship. To help satisfy its obligations, an investment adviser may require the proxy advisory firm to (i) notify the investment adviser of any business changes that the adviser has specified as material and (ii) update its methodologies, guidelines and voting recommendations on an ongoing basis.

### Shaping Obligations

If an investment adviser has discretion over an investment account, the investment adviser would have implicit voting discretion. The Voting Interpretation, however, allows the investment adviser and its clients to shape the investment adviser's voting responsibilities by agreement, so long as there is full and fair disclosure and informed consent to the voting arrangement. The Voting Interpretation lists several potential structures for voting advice, including but not limited to:

- Preagreed voting determinations, such as a default vote in favor of management or shareholder proponents (potentially subject to conditions).
- Agreeing not to vote if the act of voting would impose costs on the client without conferring a benefit.
- Agreeing to focus exclusively on the high value events such as mergers and contested elections.

If an investment adviser has not limited its voting obligations by agreement, an investment adviser "should consider whether it is fulfilling its duty of care to its client in light of the scope of services to which it and the client have agreed" if it is not voting securities.

### Appendix

#### Proxy Voting Policies Checklist

- Written policies must be designed to ensure that votes are in the best interests of clients considered in light of the client's interests and the investment adviser does not place the adviser's interests ahead of the client's.
  - *Complete and accurate information.* Investment advisers have the duty to ensure that their decisions are made based on complete and accurate information.
  - *Costs considered.* The costs, including opportunity costs, of voting should be considered in making voting decisions, including whether to recall securities.
  - *Obligations scoped by agreement.* Obligations may be limited by agreement to just vote as to particular items or not to vote.
- Written policies must address how the adviser addresses material conflicts that arise.
  - *Consider each client separately.* Policies should address the interests of each client and consider adopting differing policies for each client to the extent that their interests differ, such as due to differing strategies and objectives.

- *Full disclosure of conflicts.* Conflicts of interests should be fully and fairly disclosed to investors and consented to on an informed basis.
- *Potential outside source.* An investment adviser may seek to mitigate conflicts through a third party, such as a proxy advisory firm.
- Policies when investment adviser is voting.
  - *Potential approaches*
    - The investment adviser focuses on matters that would have a material impact on the value of the stock or other securities (such as contested elections or mergers for equity securities or amendments for debt securities) and votes with management on immaterial matters.
    - The investment adviser agrees not to vote if, for example, it has a short holding window and would not likely hold the stock on the date of the relevant vote.
    - The investment adviser discloses a predetermined voting policy with formulaic results.
  - *Factors that would be considered in reaching voting decisions should be described.*
- Potential policies when using a proxy advisory firm.
  - *Diligence on capabilities.* Perform diligence on the proxy advisory firm with respect to its capacity and competency to analyze potential voting recommendations and its staffing, personnel, technology and procedures.
  - *Policies for information assessment.* An investment adviser must also ensure that the proxy advisory firm has adequate policies and procedures to ensure that the information relied upon is complete, accurate and up-to-date.
    - *Specifically consider* (either in policies or elsewhere documented):
      - The factors that the proxy advisory firm uses in making recommendations.<sup>8</sup>
      - The third-party information on which the proxy advisory firm relies.
      - Interaction between the proxy advisory firm and issuers and third parties.
      - The proxy advisory firm’s processes for identification, mitigation and specific disclosure of conflicts of interest.<sup>9</sup>
    - *Evaluate recommendations in light of IA’s policies before voting.* An investment adviser must evaluate whether the proxy advisory firm’s recommendations are consistent with the investment adviser’s proxy voting policies before it casts the recommended votes.
    - *Follow up if concerns arise.* An investment adviser must reasonably investigate the proxy advisory firm if it has reason to believe that the proxy advisory firm is relying on incomplete information.
    - *Bring-down representations periodically.* Consider requiring periodic representations from the proxy advisory firm regarding its policies, changes to its business and conflicts.

<sup>1</sup>“Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers,” Advisers Act Release 5325 available at <https://www.sec.gov/rules/interp/2019/ia-5325.pdf>.

<sup>2</sup> See Staff Legal Bulletin 20 available at <http://www.sec.gov/interps/legal/cfs1b20.htm>.

<sup>3</sup> See our previous alert available at <https://www.akingump.com/en/news-insights/sec-adopts-new-interpretation-of-fiduciary-duty.html>.

<sup>4</sup> See SEC Interpretive Release, “Commission Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice” Exchange Act Release 86721 (Aug. 21, 2019) available at <https://www.sec.gov/rules/interp/2019/34-86721.pdf>. Note, however, that proxy advisory firms are typically exempt from filing a proxy statement under Rule 14a-2(b)(3). See 17 C.F.R. § 240.14a-2.

<sup>5</sup> The SEC has previously brought an enforcement action when an investment adviser adopted proxy-voting policies that were friendly to union clients for all of its clients to help attract new clients. See Advisers Act Release 2872 (May 7, 2009) available at <https://www.sec.gov/litigation/admin/2009/ia-2872.pdf>.

<sup>6</sup> For example, an investment adviser may want to consider the proxy advisory firm’s methodologies for “say on pay votes” and how it constructs the peer group.

<sup>7</sup> Specific conflicts of interests to assess include, but are not limited to, (i) provision of services other than proxy voting recommendations or other proxy-related services or (ii) affiliations with persons who have taken a position on the vote, such as owners, lenders or significant sources of business.

<sup>8</sup> Proxy advisory firms typically publish these factors, which may be downloaded and retained on a periodic basis to document the file. Ensure that the correct list of factors is being retained. Also consider if the factors that are chosen are appropriate to the particular client or otherwise create a conflict of interest between the adviser and the client or between clients.

<sup>9</sup> Disclosure of conflicts of interest should be retained for files and should be assessed for whether to continue the relationship with the proxy advisory firm if the conflicts are material.

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