

SEC Issues Interpretive Guidance on Proxy Advisory Firms

The guidance addresses the voting responsibilities of investment advisers and how they use proxy advisory firms. It also calls for additional information from proxy advisory firms.

At an open meeting on August 21, 2019, the U.S. Securities and Exchange Commission (SEC) voted 3-2 to publish two sets of interpretive guidance, effective immediately, dealing with proxy advisory firms and their use by investment advisers. The [Investment Advisers Guidance](#) addresses the voting responsibilities of investment advisers including with respect to their use of a proxy advisory firm to assist them with their proxy voting responsibilities while the [Proxy Solicitation Guidance](#) provides clarity to the SEC's interpretation of the proxy solicitation rules as they relate to the voting guidance provided by proxy advisory firms.

The Investment Advisers Guidance sets the stage for investment advisers to pressure proxy advisory firms to:

- Be more responsive to correct errors noted by companies
- Understand each company's unique situation when providing voting guidance
- Provide investment advisers access to a company's views about the proxy advisory firm's recommendations
- Enforce a more transparent process

The Proxy Solicitation Guidance encourages proxy advisory firms to make the following changes to the voting reports they provide to their investment adviser clients to ensure the advice they are giving does not contain materially false or misleading statements or omit material facts:

- An explanation of the methodology used to formulate its voting advice on a particular matter
- Information regarding any third-party information sources used to render voting advice
- Disclosure regarding material conflicts of interest so that the institutional investor can assess the relevance

We expect Institutional Shareholder Services (ISS) and Glass Lewis — together representing 97% of the market share for proxy advisory firms — to address the issues discussed in both sets of guidance in time for the 2020 proxy season.

Investment Advisers Guidance

The SEC's Investment Adviser Guidance makes clear that investment advisers are fiduciaries to their clients, and ultimately, the investors in their funds — most of whom are the general public investing through their 401(k) plans. As such, they must fulfill their fiduciary duty when retaining a proxy advisory firm.

In a Q&A format, the SEC asks and answers six questions relating to the fiduciary duties of an investment adviser in the proxy voting process and the hiring of a proxy advisory firm to help with the proxy review and voting.

The answers demonstrate the SEC's focus on the responsibility of each investment adviser to ensure that the proxy advisory firm it hires is effectively implementing the voting policies that the institutional investor and its client agreed upon and are focused on the issues that have been highlighted throughout the years with respect to voting recommendations of proxy advisory firms. One such example is the SEC's reminder that the investment adviser must understand the proxy advisory firm's policies as to how it considers additional proposal information that may become available after a company files its proxy statement — such as a supplemental filing made by a company in response to a proxy voting report — as well as how votes should be conducted for controversial or highly contested matters.

The answers also require each investment adviser to ensure the proxy advisory firm is equipped to discharge the investment adviser's duties on its behalf. The guidance states that “an investment adviser should consider, among other things, whether the proxy advisory firm has the capacity and competency to adequately analyze the matter for which the investment adviser is responsible for voting.” It suggests to discharge its duty the investment adviser should consider:

- The adequacy and quality of the proxy advisory firm's staffing, personnel and technology,
- Whether the proxy advisory firm has an effective process for seeking *timely* input from both companies and investment advisers with regard to its proxy voting policies, methodologies for determining a recommendation for each proposal and peer group constructions, including for say on pay votes, and
- Whether it provides for context-specific, non-boilerplate disclosure of the proxy advisory firm's actual and potential conflicts of interest; that includes whether a company has received consulting services from an affiliate of a proxy advisory firm and, if so, the amount of compensation paid.

In addition, the Q&A specifically addresses how an investment adviser should evaluate the proxy advisory firm's analysis with respect to a company's say-on-pay proposal. It suggests the investment adviser understand and agree with how the proxy advisory firm constructs a company's peer group for analysis, whether the proxy advisory firm takes into account the unique characteristic of the company (e.g., size, governance structure, industry, history, financial performance, etc.), and whether it provides information as to its methodologies for formulating its voting recommendations (including the use of third-party information sources). In addition, the investment adviser should make sure it has a reasonable understanding of when and how the proxy advisory firm would expect to engage with both companies and third parties.

The Q&A addresses the steps investment advisers should take if they become aware of potential factual errors or weaknesses in a proxy advisory firm's analysis that may materially affect how the investment adviser would vote on a particular matter. The SEC suggests that the investment adviser consider how the proxy advisory firm ensures that it has complete and accurate information about a company and that it provides the investment adviser with timely access to a company's views about the proxy advisory firm's recommendations and efforts to correct any identified material deficiencies in its analysis.

The SEC also states that it believes investment advisers should consider requiring the proxy advisory firm they retain to update them on relevant business changes impacting their capacity and competency to provide independent voting advice or carry out voting instructions and ensure they update their methodologies, guidelines and voting recommendations on an ongoing basis in response to feedback from companies and shareholders.

Proxy Solicitation Guidance

The Proxy Solicitation Guidance commences with the SEC's position that a proxy solicitation includes, among other things, a "communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy," and includes communications by a person seeking to influence the voting of proxies by shareholders, regardless of whether the person itself is seeking authorization to act as a proxy. This applies even if the proxy advisory firm is using the investment adviser's custom voting policy. That's because the proxy advisor must still make judgments as to the applicability of a given fact pattern to the investment adviser's custom policy. The Proxy Solicitation Guidance focuses on Rule 14a-9, the anti-fraud rule, and its applicability to a proxy advisory firm's voting advice as most other exclusions from the proxy solicitation rules are available to proxy advisory firms such as the information and filing requirements for solicitations.

The Proxy Solicitation Guidance provides three specific examples where a proxy advisory firm must disclose additional information in its voting advice, where present, in order to render the advice it provides not materially false or misleading in violation of Rule 14a-9:

- an explanation of the methodology used to formulate its voting advice on a particular matter (including any material deviations from the proxy advisory firm's publicly-announced guidelines, policies, or standard methodologies for analyzing such matters) where the omission of such information would render the voting advice materially false or misleading
 - **Aon View:** The SEC specifically references disclosure of a proxy advisory firm's own selected company peer group, along with any reasons that the peer companies differ from those selected by the subject company. This may address many companies' concerns that a proxy advisory firm's selected peer group tends to skew its pay-for-performance analysis in an unfavorable manner. In practice, the requirement to disclose deviations from a company's disclosed peers should have the effect of encouraging the proxy advisory firms to evaluate a company's proxy peer group from an exceptions-based standpoint (i.e., assume appropriateness of the selected peers and explain any affirmative changes to the group) as opposed to the current practice, under which the proxy advisory firms derive a company peer group independently (albeit in some cases with some deference to the subject company's selected group).
- to the extent that the proxy voting advice is based on information other than the company's public disclosures, such as third-party information sources, disclosure about these information sources and the extent to which the information from these sources differs from the public disclosures if such differences are material and the failure to disclose the differences would render the voting advice false or misleading
 - **Aon View:** Many companies have raised concerns about undisclosed sources used in creating proxy advisory firms' voting recommendations. Such sources include third-party research or publications, commercial or financial information databases or ratings or rankings published by third parties. Disclosure of these information sources in proxy voting reports should help to

ensure that such third parties provide only verifiable information that companies can respond to, and that proxy advisory firms carefully evaluate the influences that these outside firms have on the voting recommendations issued by proxy advisory firms.

- disclosure about material conflicts of interest that arise in connection with providing the proxy voting advice in reasonably sufficient detail so that the proxy advisory firm client can assess the relevance of those conflicts
 - **Aon View:** This point is particularly relevant to companies that use ISS' corporate consulting services (ISS Corporate Services or ICS). ISS has historically declined to disclose in its research reports whether the subject company has received consulting services from ICS on the basis that such disclosure, if made public, could create a material conflict of interest (or the appearance of a conflict of interest) that would taint their proxy voting advice. Retaining ICS is not prohibited, but disclosure of the use of a consulting firm affiliated with a proxy advisory firm could cause investment advisers and their clients to question the validity of the proxy firm research or choose another proxy advisory firm.

Next Steps

If you have questions about what this guidance means for your organization or other corporate governance issues and want to speak with one of our experts, please write to rewards-solutions@aon.com.

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