CLIENT UPDATE

SEC ISSUES GUIDANCE WITH RESPECT TO PROXY ADVISORY FIRMS AND PROXY VOTING BY INVESTMENT ADVISERS

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On June 30, 2014, the SEC issued Staff Legal Bulletin No. 20 from the Division of Investment Management and the Division of Corporation Finance, providing guidance about investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms and the availability and disclosure requirements of the exemptions to the federal proxy rules that are relied upon by proxy advisory firms. The guidance, which is in the form of 13 Q&As, provides interpretative relief under the SEC's existing rules rather than establishing more comprehensive reform to the regulation and disclosure obligations of proxy advisory firms. The guidance reflects an attempt to respond to some of the ongoing concerns recently debated at the December 2013 SEC proxy advisory roundtable which examined the influence of proxy advisory firms, their potential conflicts of interest, and the transparency and accuracy of their recommendations.

Investment advisers and proxy advisory firms should begin to review their policies and procedures in light of the guidance and are expected to conform their systems and processes in accordance with SLB No. 20 in advance of the 2015 proxy season. A copy of SLB No. 20 is available at http://www.sec.gov/interps/legal/cfslb20.htm.

PROXY VOTING RESPONSIBILITIES OF INVESTMENT ADVISERS

The SEC takes the view that, as a fiduciary, an investment adviser owes each of its clients a duty of care and loyalty with respect to services undertaken on a client's behalf, including proxy voting. Rule 206(4)-6 under the Investment Advisers Act of 1940 (the "Proxy Voting Rule") requires a registered investment adviser to adopt and implement written policies and procedures that are reasonably designed to ensure that the investment adviser votes proxies in the best interests of its clients. Under related no-action letters, the staff of the SEC's Division of Investment Management has confirmed that an investment adviser may demonstrate that its proxy voting is free of conflicts if it votes in accordance with a pre-determined policy based on the recommendations of an independent third party (subject to certain conditions discussed below.) Various commentators and trade groups have expressed concern that these no-action letters have contributed to the outsize power and influence of proxy advisory firms and may permit investment advisers to satisfy their duties to vote proxies in the best interests of their clients by blindly following or delegating that decision-making power to proxy advisory firms.

The Q&As address several questions concerning the scope of an investment adviser's duties under the Proxy Voting Rule, including the type of "due diligence" that the investment adviser should undertake in determining whether proxies have been voted in the best interests of clients and in retaining a proxy advisory firm and relying on its recommendations

Proxy Voting Policies and Procedures

To demonstrate compliance with the Proxy Voting Rule, the Q&As state that an investment adviser should review, at least annually, the adequacy of its proxy voting policies and procedures for effective implementation. Examples of steps an investment adviser can take include periodically sampling proxy votes for compliance and reviewing a sample of proxy votes that relate to certain proposals that may require more analysis.

Responsibilities with Respect to Voting Proxies

The Proxy Voting Rule does not require that investment advisers and clients agree that the adviser will undertake all of the proxy voting responsibilities. While acknowledging that clients often delegate to their investment advisers the authority to vote proxies completely, the Q&As reiterate that an investment adviser and its clients have broad flexibility to delineate the adviser's responsibilities in exercising proxies. Examples of more limited delegations include arrangements in which a client and adviser agree that:

- the time and costs associated with the mechanics of voting proxies with respect to certain types of proposals or issuers may not be in the client's best interest;
- the investment adviser should exercise voting authority as recommended by management of the company or in favor of all proposals made by a particular shareholder proponent, subject to certain exceptions (such as a contrary instruction from the client); or
- the investment adviser will abstain from voting any proxies at all, regardless of whether the client undertakes to vote the proxies itself.

The Q&As emphasize, however, that to the extent an investment adviser assumes proxy voting authority, it must do so in compliance with the Proxy Voting Rule.

Duties When Engaging Proxy Advisory Firms

The Q&As make clear that an investment adviser has an affirmative duty to evaluate any proxy advisory firms it engages and to oversee the ongoing work of such firm. When considering whether to retain or continue retaining a proxy advisory firm, investment advisers should ascertain, among other things, whether the proxy advisory firm has the capacity and competency to adequately analyze proxy issues. Factors to consider include (i) the adequacy and quality of the firm's staffing and personnel and (ii) the robustness of its policies and procedures established to ensure that its proxy voting and recommendations are based on current and accurate information. In addition, such policies and procedures should be designed to identify and address any conflicts of interest and any other considerations that the investment adviser believes would be appropriate in considering the nature and quality of the services provided by the proxy advisory firm.

An investment adviser that retains a proxy advisory firm should also adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the proxy advisory firm in order to ensure that the investment adviser votes proxies in the best interests of its clients. The investment adviser should establish and implement measures reasonably designed to identify and address the proxy advisory firm's conflicts that can arise on an ongoing basis, for example by requiring the proxy advisory firm to update the investment adviser of changes to the proxy advisory firm's business or its conflict policies and procedures.

Finally, the Q&As state that an investment adviser should confirm that the proxy advisory firm has the ability to make voting recommendations based on materially accurate information. If the investment adviser determines that a proxy advisory firm's

recommendation was based on a material factual error that causes the adviser to question the process by which the proxy advisory firm develops its recommendations, the investment adviser should take reasonable steps to investigate the error (taking into account, among other things, the nature of the error and the related recommendation) and seek to determine whether the proxy advisory firm is taking reasonable steps to seek to reduce similar errors in the future.

The staff's emphasis on the investment adviser's policies and procedures to address proxy voting issues and the use of proxy advisory firms serves as a reminder that the failure to adopt or implement such policies and procedures as part of the investment adviser's compliance program could also provide the SEC with a basis for finding violations of Advisers Act Rule 206(4)-7 (requiring an investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violation, by the adviser and its supervised person, of the Advisers Act).

PROXY ADVISORY FIRMS AND CONFLICTS DISCLOSURE

Exemptions from the Federal Proxy Rules

In the remaining Q&As, the Division of Corporation Finance provides guidance on the availability and requirements of the existing exemptions for proxy advisory firms from the information and filing requirements of the federal proxy rules under Exchange Act Rule 14a-2(b).

Exchange Act Rule 14a-2(b)(1) provides an exemption for solicitations by a person who does not seek the power to act as a proxy. The Q&As clarify that:

- If a proxy advisory firm's activities are limited to distributing reports containing voting recommendations and it does not solicit the power to act as proxy for the client(s) receiving the recommendations, it may rely on the exemption in Rule 14a-2(b)(1) so long as the other requirements of the exemption are met.
- However, such exemption would not be available if the proxy advisory firm allows a client (such as an institutional investor) to establish, in advance of receiving proxy materials for a particular meeting, general guidelines or policies that the proxy advisory firm will apply to vote on behalf of the client. This would, in the Staff's view, result in the firm having solicited the "power to act as a proxy" for the client.

Proxy advisory firms often provide voting services that would make them ineligible to rely on the Rule 14a-2(b)(1) exemption. Exchange Act Rule 14a-2(b)(3) provides another exemption for the furnishing of proxy voting advice pursuant to a business relationship if

certain conditions are satisfied. For example, the exemption is available if the person gives financial advice in the ordinary course of business; discloses to the recipient of the advice any significant relationship with the company or any of its affiliates, or a security holder proponent of the matter on which advice is given, as well as any material interests of the person in such matter; receives no special compensation for furnishing the advice from any person other than the recipient of the advice and others who receive similar advice and does not furnish the advice on behalf of any person soliciting proxies or on behalf of a participant in a contested election.

Disclosure of Significant Relationships and Material Interests

Many issuers and others have expressed concern about the lack of transparency and disclosure with respect to potential and perceived conflicts of interest of the proxy advisory firms. The Q&As provide guidance on disclosures that would be required by a proxy advisory firm in order to rely on Rule 14a-2(b)(3) when the firm:

- provides consulting services (such as those currently provided by ISS) to a company on a matter that is the subject of a voting recommendation; or
- provides a voting recommendation to its clients on a proposal sponsored by another client.

In those cases, the proxy advisory firm would need to assess whether a "significant" relationship with the company or security holder proponent exists or whether it otherwise has any "material interest" in the matter that is the subject of the voting recommendation. A relationship would be considered "significant" or a "material interest" would exist if knowledge of the relationship or interest would reasonably be expected to affect the recipient's assessment of the reliability and objectivity of the advisor and the advice. If the firm determines a significant relationship or material interest exists, it must provide notice and disclosure to the recipient of the advice (i.e., the investor client) that is sufficient to enable the recipient to understand the nature and scope of the relationship or interest, including the steps taken, if any, to mitigate the conflict and allow the recipient to make an assessment about the reliability or objectivity of the recommendation.

The Q&As clarify that boilerplate disclosure or a statement that the proxy advisory firm will provide the information about significant relationships or material interests upon request will not satisfy the disclosure requirement. However, the Q&As do not go beyond the letter of Rule 14a-2(b)(3) to provide a specific format or mandate public disclosure. The disclosure may be made publicly or between only the proxy advisory firm and the client.

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Please do not hesitate to contact us with any questions.

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