

Client Alert

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SEC Staff Offers Guidance Regarding Investment Advisers and Proxy Advisory Firms

By Jay G. Baris and Marty Dunn

The SEC's Division of Investment Management and Division of Corporation Finance published joint guidance on June 30, 2014 regarding investment advisers' responsibilities in voting client proxies, and two exemptions from the federal proxy rules that are often relied upon by proxy advisory firms.

The staff noted that the guidance may require investment advisers and proxy advisory firms to make changes to their systems and processes. In this regard, the staff stated its expectation that these changes should be made promptly, "but in any event in advance of next year's proxy season."

INVESTMENT ADVISERS

- *Compliance with fiduciary duty.* An investment adviser's fiduciary duties require that adviser to cast proxy votes in a manner that is in accordance with the clients' best interests and the adviser's proxy voting procedures. The staff provided examples of how to demonstrate compliance with this obligation, including:
 - o Sampling proxy votes to ensure they comply with proxy voting policies
 - o Reviewing sample proxy votes to determine if the issues require more analysis
 - o Confirming at least annually, as part of an ongoing compliance program, that the investment adviser's proxy voting policies are being implemented effectively and continue to be designed to provide that proxies are voted in the best interests of clients
- *Voting every proxy not required.*
 - o Advisers and their clients may agree by contract on the manner in which they will delegate proxy voting authority
 - o Some arrangements may provide for the adviser not to assume all proxy voting authority
 - o Examples of these arrangements include, *among other things*:
 - A client may agree that the benefits may not justify the time and cost of evaluating certain proposals or issuers
 - A client may agree that the adviser may vote all proposals consistent with management's recommendations or in favor of all proposals made by a particular shareholder proponent, absent a contrary instruction for the client or a determination by the adviser that voting a different way would further the clients' investment strategies

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- A client may agree that the adviser will abstain from voting any proxies, whether or not the client chooses to vote them
- A client may agree that the adviser will focus resources only on particular types of proposals based on the client's preference
- *Selecting a proxy advisory firm*
 - o Investment advisers 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, the adviser could require the proxy advisory firm to update the investment adviser of business changes the investment adviser considers relevant (i.e., with respect to the proxy advisory firm's capacity and competency to provide proxy voting advice) or conflict policies and procedures
- *Ongoing oversight of proxy advisory firms*
 - o Advisers should implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the proxy advisory firm to ensure that the investment adviser, acting through the proxy advisory firm, continues to vote proxies in the best interests of its clients
 - o Advisers should determine that the proxy advisory firm has the capacity and competency to adequately analyze proxy issues, including the ability to make voting recommendations based on materially accurate information that it receives and analyzes

PROXY ADVISORY FIRMS

- *Application of proxy rules to proxy advisory firms*
 - o Generally proxy advisory firms are subject to federal proxy rules, because their advice constitutes a "solicitation" of proxies; however, proxy advisory firms are exempt from the information and filing requirements if they comply with the requirements of exemptions contained in Rule 14a-2(b)
- *Rule 14a-2(b)(1)*
 - o Rule 14a-2(b)(1) generally exempts persons who do not seek the power to act as a proxy for a security holder
 - o Proxy advisory firms would not be able to rely on this exemption if they allow the client to establish, in advance of receiving proxy materials for particular shareholder meetings, general guidelines or policies that the proxy advisory firm will apply to vote on behalf of the client (even where the authority was revocable by the client)
 - o Proxy advisory firms that limit their activities to distributing reports containing recommendations may rely on the exemption

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- *Rule 14a-2(b)(3)*
 - o Rule 14a-2(b)(3) generally exempts persons that furnish proxy voting advice to another person with whom a business relationship exists, subject to conditions
 - A business relationship includes, for example, providing financial advice in the ordinary course of business, provided that the proxy advice is incidental to this relationship and does not involve special compensation
 - o A proxy advisory firms must first determine whether it has a significant relationship with an issuer or a security holder proponent or whether it has an a material interest in the proxy proposal
 - What constitutes “significant” or a “material interest” will depend on the facts and circumstances
 - o A proxy adviser must clearly disclose to the client whether it has a “significant relationship or material interest” that could present a conflict of interest
 - Boilerplate disclosures will not be sufficient
 - Disclosure of a significant relationship or material interest is an affirmative duty; it is not sufficient to provide disclosures only upon request
 - Disclosure should be made publicly or in such a way as to allow the client to assess the nature of the significant relationship or interest

In light of this guidance, investment advisers and proxy advisory firms should review the adequacy of their policies, procedures and practices, and revise them accordingly, before the onset of the 2015 proxy voting season.

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