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Client Alert

SEC Guidance Regarding Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms

EXEQUITY

Independent Board and Management Advisors

On June 30, 2014, the U.S. Securities and Exchange Commission (SEC) issued Staff Legal Bulletin No. 20 (SLB 20),[1] which provides guidance for investment advisers concerning their proxy voting responsibilities as well as discusses the availability of exemptions from the proxy rules for proxy advisory firms, e.g., Institutional Shareholder Services, Inc. and Glass Lewis & Co., LLC.

SLB 20 presents its guidance in a question and answer format, with a total of thirteen questions—five for investment advisers and eight for proxy advisers. Much of the SEC's guidance in SLB 20 is already standard industry practice. SLB 20 does not set forth any new rules. Instead, the guidance is mainly a reminder of the actions that investment advisers and proxy advisory firms must undertake. As such, the new guidance represents more of a warning shot to proxy advisory firms than a meaningful curb on their current activities.

SLB 20 reiterates that proxy advisers who only provide vote recommendations are not considered engaged in solicitation, and therefore are not bound by the proxy solicitation rules.

Investment Adviser Guidance

SLB 20's questions revolve around voting proxies and using a proxy adviser:

- The guidance provides examples of how investment advisers can demonstrate that proxy votes are cast in clients' best interests and in accordance with the investment advisers' proxy voting procedures. Examples include periodically sampling proxy votes to determine whether they complied with the investment adviser's proxy voting policies and procedures and reviewing a sampling of proxy votes that relate to certain proposals that may require more analysis. In addition, the guidance suggests that investment advisers review, at least annually, the adequacy of their proxy voting policies.

- The investment adviser and the client have the flexibility to determine the scope of the investment adviser's obligation to exercise proxy voting authority; however, if the investment adviser assumes such authority, it must do so in compliance with the proxy voting rules.

[1] SLB 20 is available at: http://www.sec.gov/interps/legal/cfslb20.htm.

- When considering retaining a proxy advisory firm, the investment adviser should ascertain, among other things, whether the proxy advisory firm has the capacity and competency to adequately analyze proxy issues, considering the adequacy and quality of the proxy adviser's staffing and personnel, and the robustness of its policies and procedures regarding its ability to (1) ensure that its proxy voting recommendations are based on current and accurate information, and (2) 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.

- If a proxy advisory firm or other third party is retained to assist with proxy voting responsibilities, the investment adviser should adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight in order to ensure that the investment adviser, acting through the proxy advisory firm, continues to vote proxies in the best interests of its clients. If a proxy advisory firm is retained, 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.

- When ascertaining whether a proxy advisory firm has the capacity and competency to adequately analyze proxy issues, the investment adviser should consider the proxy advisory firm's ability to make voting recommendations based on materially accurate information.

Proxy Adviser Guidance

SLB 20 also offers guidance for proxy advisory firms:

- Proxy advisory firms are only subject to the federal proxy rules when they engage in "solicitation," which includes "the furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy." Additionally, as the SEC has stated, the furnishing of proxy voting advice constitutes a "solicitation" subject to the information and filing requirements of the proxy rules.

- If given the discretion to vote a client's shares, the proxy advisory firm will be considered engaging in "solicitation" for purposes of the proxy rules and cannot rely on the exemption from the proxy rules for "any solicitation by or on behalf of any person who does not, at any time during such solicitation, seek directly or indirectly, either on its own or another's behalf, the power to act as a proxy for a security holder and does not furnish or otherwise request, or act on behalf of a person who furnishes or requests, a form of revocation, abstention, consent or authorization."[2]

- If the proxy advisory firm limits activities to distributing reports containing proxy vote recommendation(s) and does not solicit the power to act as proxy for its client(s) receiving the vote recommendations, the proxy advisory firm could rely on the above exemption under the proxy rules.

- If the proxy advisory firm cannot qualify for the above exemption from the proxy rules, another available exemption applies if a person gives advice to another person with whom a business relationship exists, subject to certain requirements, including: the advice is given in the ordinary course of business; disclosure is made of 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; no special commission or remuneration for furnishing the advice from any person other

[2] SEC Rule 14a-2(b)(1).

than the recipient of the advice and others who receive similar advice is received; and the advice is not furnished on behalf of any person soliciting proxies or on behalf of a participant in a contested election.

- If the proxy advisory firm provides services or a vote recommendation on a proposal sponsored by a client, the proxy advisory firm needs to assess whether the relationship with the company or security holder proponent is significant or whether it otherwise has any material interest in the matter that is the subject of the voting recommendation, and the proxy advisory firm must disclose to the recipients of the voting recommendation any such relationship or material interest. Determining what constitutes a "significant" relationship or a "material interest" depends on the facts and circumstances.

- If the proxy advisory firm determines that a significant relationship or a material interest exists requiring disclosure, it must provide notice of the presence of such significant relationship or material interest. Boilerplate language that indicates that such a relationship or interest may or may not exist does not satisfy this requirement. The disclosure should 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 provide sufficient information to allow the recipient to make an assessment about the reliability or objectivity of the vote recommendation.

- The proxy advisory firm cannot satisfy such disclosure requirement by stating that the information about significant relationships or material interests will be provided upon request; it must affirmatively provide this information.

- The proxy rules do not require that the disclosure of a significant relationship or material interest be included in the report containing the proxy voting recommendations. Instead, the disclosure should be provided in such a way to permit clients to assess both the advice provided and the nature and scope of the disclosed relationship or interest at or about the same time that the client receives the advice. A proxy advisory firm can make this disclosure publicly or only to the client.

Conclusion

SLB 20's guidance does not break any new ground *per se* and does not introduce any new proxy rules for investment advisers or proxy advisory firms. The SEC has also not addressed the rulemaking petition filed in April by business groups asking the SEC to reconsider its "resubmission thresholds" for shareholder proposals that appear on proxy statements.[3]

The SEC's earlier guidance that the use of a proxy advisory firm could help investment advisers satisfy their fiduciary obligations regarding the voting of proxies[4] helped increase the use and influence of proxy advisory firms. We will have to wait and see whether the SEC decides to revise that earlier guidance. For example, does it make sense to require a mutual fund company that is following and investing according to an index to vote the proxies of companies in that index? There are arguments for both sides on that

[3] Petition submitted by Thomas Quaadman, Vice President, Center for Capital Market Competitiveness, U.S. Chamber of Comments, *Request for rulemaking to amend Rule 14a-8 under the Securities Exchange Act of 1934 regarding of resubmission of Shareholder Proposals* (April 9, 2014), available at: http://www.sec.gov/rules/petitions/2014/petn4-675.pdf. Under SEC guidelines, a shareholder activist can resubmit substantively identical proposals year after year, as long as at least 10% of shareholders vote for the proposal.

[4] *See* Egan-Jones Proxy Services: No-Action letter dated May 27, 2004, available at: http://www.sec.gov/divisions/investment/noaction/egan052704.htm, and the Institutional Shareholder Services, Inc.: No-Action letter dated September 15, 2004, available at: http://www.sec.gov/divisions/investment/noaction/iss091504.htm.

point. If the SEC issues further guidance in this area, it may have significant repercussions for public companies, especially those held by indexed funds if those funds conclude that under revised guidance they no longer have an obligation to vote shares.

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