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CLIENT MEMORANDUM

SEC Staff Provides Proxy Voting Guidance for Investment Advisers and Proxy Advisory Firms

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The SEC staff recently published guidance, in Q&A format, on the responsibilities of investment advisers in voting proxies and selecting and retaining proxy advisory firms (questions 1-5) and on the availability and requirements of the two exemptions from the federal proxy rules most often relied upon by proxy advisory firms (questions 6-13).[1] The guidance answers several of the questions explored in the SEC's 2010 concept release on proxy voting[2] and is likely to affect investment advisers' compliance functions and proxy advisory firms' operations. The SEC staff noted that investment advisers and proxy advisory firms "may want or need to make changes to their current systems and processes in light of this guidance" and pointedly stated that it expects any necessary changes to be made promptly, but not later than the 2015 proxy season.

Investment Advisers

Every investment adviser is a fiduciary to its clients and owes each client a duty of care and loyalty with respect to, among other things, voting proxies, and an investment adviser that is registered or required to be registered with the SEC has a

1 Staff Legal Bulletin No. 20 (June 30, 2014).

2 Concept Release on the U.S. Proxy System, Release No. 34-62495 (July 14, 2010); *see* Willkie Farr & Gallagher LLP, *SEC Issues Concept Release on Proxy Mechanics* (July 16, 2010)

duty to exercise voting authority with respect to client securities in accordance with written policies and procedures reasonably designed to ensure that the investment adviser votes the proxies in the best interests of its clients.

Demonstration of compliance

The guidance provides that investment advisers should take certain steps to demonstrate compliance with this obligation, including reviewing, no less than annually, the adequacy of their proxy voting policies and procedures to ensure they have been implemented effectively. The SEC staff also indicated that an investment adviser could further demonstrate compliance by, among other things, periodically sampling proxy votes to review whether they complied with its proxy voting policy and procedures or specifically reviewing a sample of proxy votes that relate to certain proposals that may require additional analysis.

Permissible proxy policies

An investment adviser, the SEC staff confirmed, is not required to agree with its clients to undertake any or all of the proxy voting responsibilities. Where a client has delegated to the investment adviser authority to vote proxies on behalf of the client, the investment adviser and the client may agree to a variety of arrangements with respect thereto, including an agreement (1) not to vote proxies with respect to particular types of proposals, (2) to focus only on certain types of proposals based on the client's preferences, (3) to abstain from voting proxies at all, or (4) to vote in a manner recommended by management of the issuer absent a determination by the investment adviser that a particular proposal should be voted in a different manner.

Selection and retention of a proxy advisory firm

Whenever an investment adviser selects a proxy advisory firm to provide proxy voting recommendations, the adviser should ascertain, among other things, that the proxy advisory firm has the capacity and competency to adequately analyze proxy issues. To determine whether a proxy advisory firm has the requisite capacity and competency, the SEC staff indicated that the investment adviser could, among other things, consider the adequacy and quality of the proxy advisory firm's staffing and personnel and the robustness of the proxy advisory firm's policies and procedures regarding its ability to (i) ensure that its proxy voting recommendations are based on current and accurate information and (ii) identify and address any conflicts of interest. An investment adviser should also evaluate any other considerations that the investment adviser believes are appropriate given the circumstances.

An investment adviser that has retained a proxy advisory firm should adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the proxy advisory firm to ensure that the investment adviser continues to vote proxies in the best interests of its clients. Part of these policies and procedures, the SEC staff noted, should be focused on identifying and addressing the proxy advisory firm's conflicts of interest on an ongoing basis. An investment adviser could, the SEC staff provided, require that the proxy advisory firm update the investment adviser regarding any business changes or conflict policies and procedures that the investment adviser deems relevant. The SEC staff also indicated that if an investment adviser determines that any of the proxy advisory firm's recommendations

are based on a material factual error, then the proxy advisory firm's capacity and competency should be called into question. The investment adviser should then question the processes by which the proxy advisory firm develops its recommendations and the investment adviser should use reasonable steps to investigate the error and ensure that the proxy advisory firm is taking adequate steps to reduce similar errors in the future.

Proxy Advisory Firms

Application of Federal Proxy Rules

The guidance clarifies that when a proxy advisory firm dispenses proxy voting advice it engages in a "solicitation" and, as a general matter, is subject to the SEC's proxy rules. However, two proxy rule exemptions typically provide relief to proxy advisory firms from most of the requirements of the proxy rules (other than, notably, the antifraud provision): (i) Rule 14a-2(b)(1) under the Securities Exchange Act of 1934 (the "Exchange Act"), where the proxy advisory firm provides recommendations but does not seek to obtain voting authority from its clients (the "Recommendation Exemption"), and (ii) Rule 14a-2(b)(3) under the Exchange Act, where the proxy advisory firm provides voting advice to a party with which it has an existing business relationship and certain other conditions are satisfied (the "Business Relationship Exemption").

Rule 14a-2(b)(1) – Recommendation Exemption

The key to the Recommendation Exemption is that the proxy advisory firm does not seek or obtain voting authority over its clients' shares. In its guidance, the SEC staff advises that the Recommendation Exemption is not available where a client, such as an institutional investor, retains a proxy advisory firm to assist it in establishing general proxy voting guidelines and policies and also authorizes that firm to exercise its discretion and vote in a manner consistent with them. The SEC staff concludes, in the guidance, that by exercising its discretion to apply the guidelines and policies and vote on particular proposals, the proxy advisory firm has solicited the power to act as proxy, even if the authority is revocable by the client.

By contrast, the guidance makes clear that if a proxy advisory firm only distributes reports containing its recommendations and does not solicit the power to act as proxy for its clients, the proxy advisory firm would not be precluded from relying on the Recommendation Exemption.

Rule 14a-2(b)(3) – Business Relationship Exemption

If the Recommendation Exemption is not available, a proxy advisory firm may be able to rely on the Business Relationship Exemption for furnishing voting advice to a person with whom a business relationship exists. The exemption would be available if the proxy advisory firm (i) gives financial advice in the ordinary course of business, (ii) discloses to the recipient of the advice any significant relationship with the company or any of its affiliates, or with a shareholder proponent of the matter on which advice is given, as well as any material interest of the firm in such matter, (iii) receives no special compensation for furnishing the advice from any person other than the recipient of the advice and those who receive

similar advice, and (iv) does not furnish the advice on behalf of any person soliciting proxies or on behalf of a participant in a contested election.

In assessing whether disclosure of a relationship or interest is required in order to rely on the Business Relationship Exemption, the guidance indicates that the proxy advisory firm should consider the services being offered to the company or shareholder proponent, the compensation received by the proxy advisory firm in connection with rendering such services, and the extent to which the advice given to the advisory client relates to the same subject matter as the transaction giving rise to the relationship with, or interest in, the company or shareholder proponent. The guidance further explains that a relationship would be significant or an interest material if knowledge of the relationship or interest would be expected to affect the recipient's view of the reliability or objectivity of the advisor and the advice.

If the proxy advisory firm concludes that a significant relationship or material interest exists, it must give the recipient of the advice notice that the relationship or interest exists and disclose to the recipient sufficient information to allow an understanding of the nature and scope of the issue, including any steps taken to mitigate the conflict of interest. The disclosure does not necessarily have to be included in any report that contains the voting advice or publicly disclosed, but it must be communicated in a manner that will allow the client to assess the reliability and objectivity of the advice. Accordingly, the guidance states that boilerplate language indicating that a significant relationship or a material interest may or may not exist does not provide adequate notice, nor does a statement that information about significant relationships or material interests will be provided upon request.

Practical Consequences for Investment Advisers and Proxy Advisory Firms

The new guidance should be seen as providing investment advisers and proxy advisory firms with notice of the standards with which their compliance functions and operations will be evaluated by the SEC staff in the future. We expect to see these compliance functions and operations coming under increased scrutiny in the very near future. An investment adviser should, as soon as feasible, review its proxy voting policies, compliance manual and proxy advisory firm agreements in light of the guidance and maintain records documenting that review, because the guidance envisions investment advisers conducting the review and making any necessary changes promptly.

If you have any questions concerning the matters described in this memorandum, please contact Michael A. Schwartz (212-728-8267, mschwartz@willkie.com), Mark A. Vandehaar (212-728-8720, mvandehaar@willkie.com), Jared B. Nicholson (212-728-8103, jnicholson@willkie.com), Timothy A. Kahn (202-303-1133, tkahn@willkie.com) or the Willkie attorney with whom you regularly work.

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