
July 2, 2014

SEC Issues Guidance on Proxy Advisory and Voting Services

The SEC Divisions of Investment Management and Corporation Finance have issued long-awaited guidance related to investment advisers' proxy voting responsibilities and their related use of proxy advisory firms (such as Institutional Shareholder Services and Glass Lewis) and enhanced conflicts disclosure by proxy advisory firms. Staff Legal Bulletin No. 20 relies heavily on existing SEC rules and guidance in these areas and reflects four key themes:

- Investment advisers have an ongoing responsibility to ensure that proxy votes are cast in accordance with their voting policies and procedures and in their clients' best interests;
- Investment advisers have flexibility to design voting arrangements with their clients and may delegate their proxy voting responsibilities to proxy advisory firms, subject to certain conditions;
- Conflicts disclosure by proxy advisory firms providing services other than voting recommendations must be enhanced; and
- Proxy advisory firms are reminded that they operate outside the application of most of the SEC's proxy rules only if they meet the conditions set forth in one of two specific exemptions.

Investment advisers' ongoing responsibility to ensure that proxy votes are cast in accordance with their voting policies and procedures and in their clients' best interests

The SEC's existing rules require investment advisers to have written policies and procedures that are reasonably designed to ensure that advisers vote proxies in the best interests of their clients, which policies, according to SLB No. 20, must be reviewed at least annually. Investment advisers must further conduct ongoing reviews of any proxy voting to ensure that voting is being conducted in accordance with their policies and procedures and in their clients' best interests, for example, by sampling proxy votes from time to time or by topic to ensure compliance.

Investment advisers have flexibility to design voting arrangements with their clients and can delegate their proxy voting responsibilities to proxy advisory firms, subject to the requirement that they are acting in their clients' best interests

SLB No. 20 clarifies that investment advisers and their clients have flexibility to determine appropriate voting arrangements, which could include agreements to vote all or some of their equity securities, to always vote in favor of management or a specific shareholder proponent, to abstain from voting any shares or to focus only on certain types of proposals. Investment advisers and their clients may agree that the time and costs associated with the mechanics of voting on certain proposals or issuers may not be in their clients' best interest.

SLB No. 20 also clarifies that an investment adviser's proxy voting duties may be delegated to a proxy advisory firm, but that prior to retaining such a firm, the investment adviser must determine that the firm has sufficient capacity and competency to adequately analyze proxy issues. The investment adviser should consider, among other factors, the quality and adequacy of the proxy advisory firm's staff and the robustness around how the firm develops its voting recommendations (including ensuring that the recommendations are based on current and accurate information) and how the firm identifies and addresses conflicts of interests. The investment adviser should also establish procedures reasonably designed to provide sufficient ongoing oversight of the proxy advisory firm, including measures that are reasonably designed to identify and address proxy advisory firm conflicts on an ongoing basis (such as by requiring the proxy advisory firm to update the investment

adviser of relevant business changes or other conflict policies and procedures). Finally, if the investment adviser determines that its proxy advisory firm made a voting recommendation based on material factual error, the adviser must take reasonable steps to investigate the error and determine that the proxy advisory firm is taking reasonable steps to reduce such errors in the future.

Conflicts disclosure by proxy advisory firms that provide services other than voting recommendations (such as voting solutions) must be enhanced

When making voting recommendations, a proxy advisory firm providing these additional services must determine whether its relationship with the company or any shareholder proponent is significant or whether it has any material interest in the subject matter of the vote (including by examining the type of service being provided, the compensation received and the relationship between the voting recommendation and the particular transaction with the company or proponent). A relationship would be considered significant or an interest would be considered material if knowledge of the relationship or interest would reasonably be expected to affect the recipient's assessment of the reliability and objectivity of the proxy advisory firm and advice.

If a significant relationship or material interest exists, the proxy advisory firm must disclose the relationship or interest with enough detail to enable the recipient of the advice to understand the nature and scope of the relationship or interest and the steps taken to mitigate the conflict and to assess the reliability or objectivity of the recommendation. Boilerplate disclosure that a relationship may or may not exist is insufficient, as is a statement that such information will be provided upon request. The disclosure must be made so as to allow the client to assess the advice provided and the relationship or interest at or about the same time that the client receives the voting recommendation, although such disclosure may be made publicly or privately between the proxy advisory firm and the client.

Proxy advisory firms are exempted from most of the SEC's proxy rules because of two specific provisions and are reminded that they must meet the conditions to the exemptions in order to continue their reliance thereon

SLB No. 20 reiterates that proxy advisory firms would generally be subject to the SEC's proxy rules if not for two specific exemptions. Rule 14a-2(b)(1) is available to proxy advisory firms that provide only voting recommendations, but not if the firms also provide other services, such as allowing an investor to establish, before receiving proxy materials for a particular shareholder meeting, general guidelines or policies that the proxy advisory firms would then apply to vote on behalf of the investor because that would constitute a solicitation of the "power to act as a proxy" in violation of the exemption. Proxy advisory firms that provide other services could rely on the Rule 14a-2(b)(3) exemption from the proxy rules, but only if the firms provide adequate disclosure of conflicts (as described above) and meet the exemption's other conditions, including that the proxy advisory firms render such advice in the ordinary course of business, receive no special commission or remuneration for furnishing the advice from any person other than the recipient of the advice and others who receive similar advice and do not furnish the advice on behalf of any person soliciting proxies or on behalf of a participant in a contested election.

SLB No. 20 consists of 13 questions and answers and can be found at <http://www.sec.gov/interps/legal/cfslb20.htm>.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Ariel J. Deckelbaum
212-373-3546
ajdeckelbaum@paulweiss.com

Ross Fieldston
212-373-3075
rfieldston@paulweiss.com

Justin G. Hamill
212-373-3189
jhamill@paulweiss.com

Jeffrey D. Marell
212-373-3105
jmarell@paulweiss.com

Raphael M. Russo
212-373-3309
rrusso@paulweiss.com

Robert B. Schumer
212-373-3097
rschumer@paulweiss.com

Steven J. Williams
212-373-3257
swilliams@paulweiss.com

Frances F. Mi
212-373-3185
fmi@paulweiss.com

Hank Michael
212-272-3892
hmichael@paulweiss.com