No Action Letters Omnibus, Egan-Jones Proxy Services, Securities and Exchange Commission, (May 27, 2004)

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References:

Investment Advisers Act of 1940, Section 206(4); Rule 206(4)-6

_____Washington Service Bureau Summary_____

Headnote

…In guidance regarding the circumstances under which a third party that provides proxy advice may be considered independent under rule 206(4)-6 of the Investment Advisers Act, the staff notes that investment advisers need procedures in place to ensure that their third-party proxy services are independent. Since investment advisers face many potential conflicts, many chose to retain third-party proxy services and the staff notes that even in cases where a proxy vote coincides with the interests of the investment adviser, such a vote is not necessarily in conflict if the investment adviser acted on the advice of a thirdparty that followed a pre-determined policy. The staff adds, however, that the investment adviser should take measures to insure that the thirdparty is independent of the investment adviser. An independent thirdparty cannot have any material business, professional or other relationships with the investment adviser. While a proxy voting firm's independence is not necessarily compromised if the proxy firm receives compensation from an issuer for corporate governance advice, the staff adds that in such cases the investment adviser needs to ascertain that the proxy firm has the capacity and competence to analyze proxy issues and that it can make recommendations in an impartial manner in the best interests of its adviser clients. Since the proxy service may have a conflict with regard to certain issuers, investment advisers should establish procedures to address on an ongoing basis possible conflicts with the thirdparty. For example, the staff recommends that the adviser require its proxy service to disclose any relationships the service has with an issuers whose proxies are subject to a vote by the investment adviser. Funds, in accordance with rule 206(4)-6, should provide their clients with disclosure on how they guarantee that their thirdparty advisers are independent and how conflicts will be addressed. The fund's registration statement should include disclosure if a thirdparty makes voting recommendations, and it should also disclose the thirdparty's policies and procedures.

[INQUIRY LETTER]

December 16, 2003

Mr. Douglas Scheidt

Associate Director and Chief Counsel

Division of Investment Management

United States Securities and Exchange Commission

450 Fifth Street, N.W.

Washington, D.C. 20549

Re.: Proxy Voting by Investment Advisors

Dear Mr. Scheidt:

In Section II. A. 2. b. of the Security & Exchange Commission's Final Rule on Proxy Voting by Investment Advisors [17 CFR Part 275; release No. IA-2106; File No. S7-38-02] ("the Rule"), the following language appears in the second paragraph under "Resolving Conflicts of Interest":

"Advisers today use various means of ensuring that proxy votes are voted in their clients' best interest and not affected by the advisers' conflicts of interest. 23 An adviser that votes securities based on a pre-determined voting policy could demonstrate that its vote was not a product of a conflict of interest if the application of the policy to the matter presented to shareholders involved little discretion on the part of the adviser. 24 Similarly, an adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, ***based upon the recommendations of an independent third party*** [my italics]."

We respectfully request guidance with respect to the definition, in the preceding paragraph, of the term "independent." For example, does the fact that a firm providing proxy research and recommendations (a "Proxy Research Firm") also receives compensation on corporate governance issues from a corporation that is being researched, affect its independence? Also, in such a case, is the Proxy Research Firm required to disclose the existence of its compensation arrangement and the amount of its compensation? Also, is a fund that uses a proxy adviser that accepts compensation from companies regarding which it provides proxy research and recommendations, required to disclose that fact in its registration statement or otherwise in connection with its disclosure of its votes?

In the interest of saving you research time, below are comments from two published articles on the issue of a firm providing proxy research and recommendations and also providing consulting on corporate governance/ proxy matters:

" " "These two things can't coexist," " says Ted White, director of corporate governance for [Proxy Research Firm] client CalPERS, California's $133 billion state-employee pension fund. " "It's a whole lot like the audit industry was. You can't build your business model around a conflict." " "

"[Nell] Minow is now editor of the Corporate Library, which will soon release its own board ratings; her firm does not do business with the companies it evaluates. " "It would compromise our credibility to take any money from them," " she says."

We would greatly appreciate your comments on this area and look forward to hearing from you.

Very truly yours,

/s/

Kent S. Hughes

Managing Director

[STAFF REPLY LETTER]

May 27, 2004

Kent S. Hughes

Managing Director

Egan-Jones Proxy Services

61 Station Road

Haverford, PA 19041

Dear Mr. Hughes:

In your letter dated December 16, 2003, you ask for guidance concerning investment advisers that use the recommendations of independent third parties to vote client proxies. Your inquiry generally relates to the circumstances under which a third party may be considered independent under Rule 206 (4)-6 under the Investment Advisers Act of 1940 (the “Advisers Act”), which was adopted by the Commission to address the voting of proxies by investment advisers on behalf of their advisory clients. [1] This letter confirms and expands upon the guidance that we provided to Egan-Jones Proxy Services (“Egan-Jones”) on January 15, 2004. [2]

An investment adviser may face direct and indirect conflicts of interest in voting the proxies of its clients, including its fund clients, when it has the discretionary authority to vote the proxies. [3] For instance, if a broker-dealer that is affiliated with an investment adviser provides investment banking services to an issuer that is soliciting proxies, that relationship could influence the adviser to vote its clients' proxies in its affiliate's interest, rather than in the best interests of its clients, thus breaching the adviser's fiduciary duty of loyalty to its clients. [4] To address these and other conflicts, the Commission adopted Rule 206(4)-6 under the Advisers Act to require registered investment advisers to adopt and implement policies and procedures that are designed to ensure that their clients' proxies are properly voted, material conflicts are avoided and fiduciary obligations are otherwise fulfilled.

In the Rule 206(4)-6 Adopting Release, the Commission indicated that an investment adviser could demonstrate that its vote of its clients' proxies was not a product of a conflict of interest if the adviser voted the proxies in accordance with a pre-determined policy based on the recommendations of an independent third party. [5] An investment adviser that votes client proxies in accordance with a pre-determined policy based on the recommendations of an independent third party will not necessarily breach its fiduciary duty of loyalty to its clients even though the recommendations may be consistent with the adviser's own interests. In essence, the recommendations of a third party that is in fact independent of an investment adviser may cleanse the vote of the adviser's conflict. [6]

An investment adviser that retains a third party to make recommendations regarding how to vote its clients' proxies should take reasonable steps to verify that the third party is in fact independent of the adviser based on all of the relevant facts and circumstances. A third party generally would be independent of an investment adviser if that person is free from influence or any incentive to recommend that the proxies should be voted in anyone's interest other than the adviser's clients. Such a person generally could not be an “affiliated person” of the investment adviser as that term is defined in the Advisers Act, or have any material business, professional, or other relationship with the investment adviser. [7] For example, a person that provides services to an investment adviser's employee benefit plan in exchange for compensation may be inclined to recommend that the proxies should be voted in the interests of the adviser in order to curry favor and maintain its business relationship with the adviser. [8]

In your letter, you ask whether a proxy voting firm would be considered to be an independent third party if the firm receives compensation from an issuer (“Issuer”) for providing advice on corporate governance issues.

We believe that the mere fact that the proxy voting firm provides advice on corporate governance issues and receives compensation from the Issuer for these services generally would not affect the firm's independence from an investment adviser. [9]

An investment adviser should not, however, conclude that it is appropriate to follow the voting recommendations of an independent proxy voting firm without first ascertaining, among other things, whether the proxy voting firm (a) has the capacity and competency to adequately analyze proxy issues, and (b) can make such recommendations in an impartial manner and in the best interests of the adviser's clients. An investment adviser could breach its fiduciary duty of care to its clients by voting its clients' proxies based upon the proxy voting firm's recommendations with respect to an Issuer because the proxy voting firm could recommend that the adviser vote the proxies in the firm's *own* interests, to further its relationship with the Issuer and its business of providing corporate governance advice, rather than in the interests of the adviser's clients. The proxy voting firm's relationship with an Issuer thus may present a conflict of interest that is in addition to any conflict of interest that the investment adviser may have.

Accordingly, an investment adviser should obtain information from any prospective independent third party to enable the adviser to determine that the third party is in fact independent, and can make recommendations for voting proxies in an impartial manner and in the best interests of the adviser's clients. An investment adviser should establish and implement procedures to identify and address conflicts that can arise on an ongoing basis concerning the third party. [10] For instance, under the circumstances that you describe in your letter, the procedures should require a proxy voting firm that is called upon to make a recommendation to an investment adviser regarding the voting of an Issuer's proxies to disclose to the adviser any relevant facts concerning the firm's relationship with an Issuer, such as the amount of the compensation that the firm has received or will receive from an Issuer. That information will enable the investment adviser to determine whether the third party can make recommendations about how to vote the clients' proxies in an impartial manner and in the best interests of the clients, or whether the adviser needs to take other steps to vote the proxies. [11]

Rule 206(4)-6 under the Advisers Act requires an investment adviser to adopt and implement written policies and procedures that are designed to ensure that its clients' proxies are voted in the clients' best interests, to describe these policies and procedures to their clients, and to provide a copy of these procedures to clients upon request. [12] Those procedures should address the use of any independent third party to make recommendations regarding the voting of the proxies of an investment adviser's clients if the use of an independent third party is a material part of the adviser's proxy voting policies. We note that, similarly, a fund must disclose to its shareholders the policies and procedures that it follows for voting proxies, in particular, the procedures that the fund follows when a vote presents a conflict between the interests of the fund shareholders, on the one hand, and those of the fund's investment adviser, principal underwriter, or any affiliated person of the fund, its investment adviser, or its principal underwriter, on the other. [13] In addition, if applicable, a fund must disclose in its registration statement that an independent third party makes voting recommendations, or otherwise votes the fund's proxies, and must also disclose the policies and procedures used by the third party to vote the fund's proxies. [14]

We hope that this information is helpful. Please note that we take no position regarding whether an investment adviser should hire Egan-Jones as an independent third party to vote the proxies of the investment adviser's clients. The decision to hire Egan-Jones in that capacity rests entirely with the investment adviser. If you have additional questions, you may telephone Kathleen L. Knisely, Senior Counsel, or Alison M. Fuller, Assistant Chief Counsel, at 202-942-0659.

Very truly yours,

/s/

Douglas Scheidt

Associate Director and Chief Counsel

Footnotes

1 *See* Investment Advisers Act Release No. 2106 (Jan. 31, 2003) (adopting Rule 206(4)-6)("Rule 206(4)-6 Adopting Release"). The Commission also adopted Rule 30b1-4 under the Investment Company Act of 1940 (the "Company Act"), which requires registered investment companies ("funds") annually to file with the Commission their proxy voting records on new Form N-PX. *See* Investment Company Act Release No. 25922 (Jan. 31, 2003). In addition, the Commission amended Forms N-1A and N-2 under the Company Act to add Items 13 and 16, respectively, which require funds to disclose their proxy voting policies and procedures. *Id.*

2 Telephone conversation on January 15, 2004 among Kathleen L. Knisely and Alison M. Fuller of the staff and Sean Egan and Gale Gillespie of Egan-Jones.

3 The board of directors (the "Board") of a fund typically delegates the responsibility for voting fund proxies to the fund's investment adviser.

4 As the Commission explained in the Rule 206(4)-6 Adopting Release, an investment adviser (or its affiliate) may manage a pension plan, administer employee benefit plans, or provide brokerage, underwriting, insurance or banking services to a company whose management is soliciting proxies. The investment adviser's failure to vote in favor of management may harm the adviser's relationship with the company. The adviser also may have business or personal relationships with other proponents of proxy proposals, participants in proxy contests, corporate directors or candidates for directorships. For example, the adviser may manage money for an employee group, or an executive of the adviser may have a spouse or other close relative who serves as a director or executive of a company. *See* Rule 206(4)-6 Adopting Release. *See also In the Matter of Deutsche Asset Management*, Investment Advisers Act Release No. 2160 (August 19, 2003).

5 The Commission also indicated that an adviser could adopt and implement a policy of disclosing to its clients the conflict of interest and obtain its clients' consents before voting the shares. *See* Rule 206(4)-6 Adopting Release.

6 We note that an investment adviser would not cleanse itself of its conflict of interest by hiring an independent third party to make proxy voting recommendations when the adviser already knows that the third party's recommendations are consistent with the adviser's own interest.

7 *See* Section 202(a)(12) of the Advisers Act (defining "affiliated person"). *Cf.* Section 2(a)(4)(vii) of the Company Act (defining “interested person). *See also* Investment Company Act Release No. 24083 (Oct. 14, 1999) (discussing when a material business or professional relationship may impair the independence of a prospective independent director of a fund).

8 We also note that a third party might not be in fact independent of an investment adviser due to a material business or professional relationship with an affiliated person of the adviser. For instance, a third party might not be independent if it had a material business relationship with an investment adviser's broker-dealer affiliate that provides investment banking services to the issuer that is soliciting the proxies.

9 Similarly, the provision of services by a third party to an investment adviser's client would not necessarily affect the independence of that third party. *See generally* Evergreen Investment Management Company (pub. avail. Feb. 13, 2002) (the staff agreed not to recommend enforcement action under Section 17(a) of the Company Act concerning a transaction between certain funds and persons that were affiliated with the funds. In connection with the transaction, the funds hired their unaffiliated custodian to act as a fiduciary in voting the funds' proxies because the vote presented a conflict of interest for the funds' investment adviser).

10 We note that, as part of its proxy voting procedures, an investment adviser could obtain a representation from an independent third party, each time that the third party makes a voting recommendation, that the third party faces no conflict of interest with respect to the vote.

11 The investment adviser could, for instance, allow the independent third party to vote only the proxies of issuers with respect to which the third party had no conflict of interest, or the adviser could itself vote those proxies, provided that the adviser had no conflict of interest of its own with respect to the issuers.

12 *See* Rule 206(4)-6 Adopting Release.

13 *See* Item 13, Form N-1A. You ask whether a fund that uses an independent third party to make proxy voting recommendations must disclose that the third party has an agreement with the Issuer to provide corporate governance advice in exchange for compensation ("compensation agreement"). Form N-1A does not specifically require a fund to disclose to its shareholders the existence of such a conflict of interest. As with any information that Form N-1A does not specifically address, a fund must evaluate whether disclosure regarding a compensation agreement is necessary to make any statements, including any statements regarding the fund's proxy voting policies, not misleading. *See*, *e.g.*, Section 34(b) and Rule 8b-20 under the Company Act.

14 *See* Investment Company Act Release No. 25922 (Jan. 31, 2003).