U.S. Securities and Exchange Commission

Division of Investment Management
Division of Corporation Finance
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Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms

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Summary: The Division of Investment Management is providing guidance about investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms. The Division of Corporation Finance is providing guidance on the availability and requirements of two exemptions to the federal proxy rules that are often relied upon by proxy advisory firms.

Supplementary Information: The statements in this bulletin represent the views of the Division of Investment Management and the Division of Corporation Finance. This bulletin is not a rule, regulation or statement of the Commission. Further, the Commission has neither approved nor disapproved its content.

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Question 1. As a fiduciary, an investment adviser owes each of its clients a duty of care and loyalty with respect to services undertaken on the client's behalf, including proxy voting.[1] Further, the Commission's rules provide that it is a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment adviser registered or required to be registered with the Commission to exercise voting authority with respect to client securities unless the adviser, among other things, adopts and implements written policies and procedures that are reasonably designed to ensure that the investment adviser votes proxies in the best interest of its clients ("Proxy Voting Rule").[2] What steps could an investment adviser take to seek to demonstrate that proxy votes are cast in accordance with clients' best interests and the adviser's proxy voting procedures?

Answer. Compliance could be demonstrated by, for example, periodically sampling proxy votes to review whether they complied with the investment adviser's proxy voting policy and procedures. The investment adviser also

could specifically review a sample of proxy votes that relate to certain proposals that may require more analysis. In addition, as part of an investment adviser's ongoing compliance program, it should review, no less frequently than annually, the adequacy of its proxy voting policies and procedures to make sure they have been implemented effectively, including whether these policies and procedures continue to be reasonably designed to ensure that proxies are voted in the best interests of its clients.[3]

Question 2. Is an investment adviser required to vote every proxy?

Answer. The Proxy Voting Rule does not require that investment advisers and clients agree that the investment adviser will undertake all of the proxy voting responsibilities. We understand that in most cases, clients delegate to their investment advisers the authority to vote proxies relating to equity securities.[4] We further understand that, in general, clients usually delegate this authority completely, without retaining authority to vote any of the proxies. The staff notes that investment advisers and their clients also may agree to this type of delegation, as well as other proxy voting arrangements in which the adviser would not assume all of the proxy voting authority. Some agreements between investment advisers and their clients may include the following arrangements:

- An investment adviser and its client may agree that the time and costs associated with the mechanics of voting proxies with respect to certain types of proposals or issuers may not be in the client's best interest.

- An investment adviser and its client may agree that the investment adviser should exercise voting authority as recommended by management of the company or in favor of all proposals made by a particular shareholder proponent, as applicable, absent a contrary instruction from the client or a determination by the investment adviser that a particular proposal should be voted in a different way if, for example, it would further the investment strategy being pursued by the investment adviser on behalf of the client.

- An investment adviser and its client may agree that the investment adviser will abstain from voting any proxies at all, regardless of whether the client undertakes to vote the proxies itself.

- An investment adviser and its client may agree that the investment adviser will focus resources on only particular types of proposals based on the client's preferences.

As these non-exclusive examples demonstrate, an investment adviser and its client have flexibility in determining the scope of the investment adviser's obligation to exercise proxy voting authority. [5] We reiterate, however, that an investment adviser that assumes proxy voting authority must do so in compliance with the Proxy Voting Rule.

Question 3. What are some of the considerations that an investment adviser may wish to take into account if it retains a proxy advisory firm to assist it in its proxy voting duties?

Answer. When considering whether to retain or continue retaining any particular proxy advisory firm to provide proxy voting recommendations, the staff believes that an investment adviser should ascertain, among other

things, whether the proxy advisory firm has the capacity and competency to adequately analyze proxy issues.[6] In this regard, investment advisers could consider, among other things: the adequacy and quality of the proxy advisory firm's staffing and personnel; the robustness of its 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 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.

***Question 4*.** Does an investment adviser have an ongoing duty to oversee a proxy advisory firm that it retains?

Answer. The staff believes that an investment adviser that has retained a third party (such as a proxy advisory firm) to assist with its proxy voting responsibilities should, in order to comply with the Proxy Voting Rule, adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the third party in order to ensure that the investment adviser, acting through the third party, continues to vote proxies in the best interests of its clients. [7] In addition, the staff notes that a proxy advisory firm's business and/or policies and procedures regarding conflicts of interest could change after an investment adviser's initial assessment, and some changes could alter the effectiveness of the policies and procedures and require the investment adviser to make a subsequent assessment. Consequently, the staff has stated that 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,[8] such as by requiring 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.

Question 5. What are an investment adviser's duties when it retains a proxy advisory firm with respect to the material accuracy of the facts upon which the proxy advisory firm's voting recommendations are based?

Answer. As stated above, it is the staff's position that an investment adviser that receives voting recommendations from a proxy advisory firm should ascertain that the proxy advisory firm has the capacity and competency to adequately analyze proxy issues, which includes the ability to make voting recommendations based on materially accurate information.[9] For example, an investment adviser may determine that a proxy advisory firm's recommendation was based on a material factual error that causes the adviser to question the process by which the proxy advisory firm develops its recommendations. In such a case, the staff believes that the investment adviser should take reasonable steps to investigate the error, taking into account, among other things, the nature of the error and the related recommendation, and seek to determine whether the proxy advisory firm is taking reasonable steps to seek to reduce similar errors in the future.

Question 6. When is a proxy advisory firm subject to the federal proxy rules?

Answer. A proxy advisory firm would be subject to the federal proxy rules when it engages in a "solicitation," which is defined under Exchange Act Rule 14a-1(*l*) to include "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." As a general matter, the Commission has stated that the furnishing of proxy voting advice constitutes a "solicitation" subject to the information and filing requirements of the federal proxy rules.[10] Providing recommendations that are reasonably calculated to result in the procurement, withholding, or revocation of a proxy would subject a proxy advisory firm to the proxy rules. Exchange Act Rule 14a-2(b) provides exemptions from the information and filing requirements of the federal proxy rules that a proxy advisory firm may rely upon if it meets the requirements of the exemptions.

Question 7. Where a shareholder (such as an institutional investor) retains a proxy advisory firm to assist in the establishment of general proxy voting guidelines and policies and authorizes the proxy advisory firm to execute a proxy or submit voting instructions on its behalf, and permits the proxy advisory firm to use its discretion to apply the guidelines to determine how to vote on particular proposals, may the proxy advisory firm providing such services rely on the exemption from the proxy rules in Exchange Act Rule 14a-2(b)(1)?

Answer. No. Rule 14a-2(b)(1) provides an exemption from most provisions of the federal 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." The exemption would not be available for a proxy advisory firm offering a service that allows the client to establish, in advance of receiving proxy materials for a particular shareholder meeting, general guidelines or policies that the proxy advisory firm will apply to vote on behalf of the client.

In this instance, the proxy advisory firm would be viewed as having solicited the "power to act as a proxy" for its client. This would be the case even if the authority was revocable by the client.

Question 8. If a proxy advisory firm only distributes reports containing recommendations, would it be able to rely on the exemption in Rule 14a-2(b)(1)?

Answer. Yes. To the extent that a proxy advisory firm limits its activities to distributing reports containing recommendations and does not solicit the power to act as proxy for the client(s) receiving the recommendations, the proxy advisory firm would be able to rely on the exemption, so long as the other requirements of the exemption are met.

Question 9. To the extent that Rule 14a-2(b)(1) is not available to a proxy advisory firm, either for the reason specified in the answer to Question 7 or otherwise, is there any other exemption from the proxy rules that might apply?

Answer. Yes. Exchange Act Rule 14a-2(b)(3) exempts the furnishing of proxy voting advice by any person to another person with whom a business relationship exists, subject to certain conditions. [11] The exemption is available if the person gives financial advice in the ordinary course of business; discloses to the recipient of the advice 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; receives 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 does not furnish the advice on behalf of any person soliciting proxies or on behalf of a participant in a contested election.

Question 10. If a proxy advisory firm provides consulting services to a company on a matter that is the subject of a voting recommendation or provides a voting recommendation to its clients on a proposal sponsored by another client, would the proxy advisory firm be precluded from relying on Rule 14a-2(b)(3)?

Answer. In order to rely on Rule 14a-2(b)(3), a proxy advisory firm would need to first assess whether its relationship with the company or security holder proponent[12] is significant or whether it otherwise has any material interest in the matter that is the subject of the voting recommendation and disclose to the recipient of the voting recommendation any such relationship or material interest. Whether a relationship would be "significant" or what constitutes a "material interest" will depend on the facts and circumstances. In making such a determination, a proxy advisory firm would likely consider the type of service being offered to the company or security holder proponent, the amount of compensation that the proxy advisory firm receives for such service, and the extent to which the advice given to its advisory client relates to the same subject matter as the transaction giving rise to the relationship with the company or security holder proponent. A similar inquiry would be made for any interest that might be material. A relationship generally would be considered "significant" or a "material interest" would exist if knowledge of the relationship or interest would reasonably be expected to affect the recipient's assessment of the reliability and objectivity of the advisor and the advice.

Question 11. If a proxy advisory firm determines that it has a significant relationship or a material interest that requires disclosure for purposes of relying on Rule 14a-2(b)(3), what must it disclose?

Answer. The proxy advisory firm must provide the recipient of the advice with disclosure that provides notice of the presence of a significant relationship or a material interest. We do not believe that boilerplate language that such a relationship or interest may or may not exist provides such notice. In addition, we believe 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 recommendation.

Question 12. Does the disclosure requirement in Rule 14a-2(b)(3) permit a proxy advisory firm to state only that information about significant relationships or material interests will be provided upon request?

Answer. No. Rule 14a-2(b)(3) imposes an affirmative duty to disclose significant relationships or material interests to the recipient of the advice. We do not believe that providing the information upon request would satisfy the requirement in the rule.

Question 13. Does disclosure of a significant relationship or material interest have to be provided in a document that conveys a voting recommendation or advice, such as the proxy advisory firm's report about a company, and must it be publicly available?

Answer. Rule 14a-2(b)(3) does not specify where the required disclosure should be provided. A proxy advisory firm should provide the disclosure in such a way as to allow the client 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. This disclosure may be made publicly or between only the proxy advisory firm and the client.

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The staff recognizes 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. The staff expects any necessary changes will be made promptly, but in any event in advance of next year's proxy season.

1 Proxy Voting by Investment Advisers, Release No. IA-2106, at n. 2 and accompanying text (Jan. 31, 2003) ("Proxy Voting Release"), citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963) (interpreting Section 206 of the Investment Advisers Act of 1940 ("Advisers Act")).

2 Rule 206(4)-6 under the Advisers Act.

3 See Rule 206(4)-7 under the Advisers Act (e.g., requiring investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violation, by the adviser and its supervised person, of the Advisers Act). See also Rule 38a-1 under the Investment Company Act of 1940 ("1940 Act") (e.g., requiring each registered investment company to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund, including policies and procedures that provide for the oversight of compliance by the registered investment company's investment adviser, among others).

4 See Proxy Voting Release.

5 See id. at n. 19 ("The scope of an adviser's responsibilities with respect to voting proxies would ordinarily be determined by the adviser's contracts with its clients, the disclosures it has made to its clients, and the investment policies and objectives of its clients.")

6 See Egan-Jones Proxy Services, SEC Staff Letter (May 27, 2004) ("Egan-Jones") and Institutional Shareholder Services, Inc., SEC Staff Letter (Sept. 15, 2004) ("ISS").

7 See Rule 206(4)-7 under the Advisers Act and Rule 38a-1 under the 1940 Act.

8 See Egan-Jones and ISS.

9 Id.

10 See Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Release No. 34-16104 (Aug. 13, 1979).

11 In 1992, the Commission noted that "advice given with respect to matters subject to a shareholder vote by . . . proxy advisory services in the ordinary course of business is covered by the exemption provided by [Rule 14a-2(b)(3)], so long as the other requirements of that exemption are met." See Regulation of Communications Among Shareholders, Release No. 34-31326 (Oct. 16, 1992).

12 Rule 14a-8 does not require that the identity of the shareholder proponent be disclosed in the proxy statement. Therefore, there may be instances in which the proxy advisory firm has no knowledge that the proponent is a client. In such a case, we do not believe that there would be a duty to investigate who the proponent is. To the extent that the identity of the proponent is unknown, there is little concern that the relationship would affect the proxy advisory firm's recommendation regarding that proposal.

http://www.sec.gov/interps/legal/cfslb20.htm
