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CORPORATE, SECURITIES AND FINANCIAL SERVICES ALERT

July 2014

What Investment Advisers Need to Know About Using Proxy Advisers

On June 30, 2014, the SEC issued long-awaited guidance on an investment adviser's use of third-party proxy advisory firms such as ISS and Glass Lewis. Due to a number of regulatory developments over the past ten years, investment advisers have largely outsourced to third-party proxy advisory firms the function, if not the actual responsibility, of voting their clients' stock. Further complicating matters, a proxy advisory firm may also advise the public company proponent or a stockholder proponent on the very same stockholder matter on which it is advising an investment adviser. Those who expected the SEC to subject proxy advisers to direct SEC oversight will be greatly disappointed. The guidance seeks to provide more transparency by reinforcing the existing regulatory framework. The new SEC guidance is designed to shed light on the activities of the proxy advisory firms by looking to investment advisers to more aggressively police the activities of proxy advisory firms.

As a result of the new guidance, investment advisers should consider taking the following actions:

1. Review at least annually their written voting policies and procedures so that they are reasonably designed to ensure that proxies are voted in the best interests of their investor clients.

2. Prior to retaining a proxy adviser, conduct due diligence on the proxy adviser's capabilities and processes employed to analyze proposals to be voted on by stockholders and to identify and address potential conflicts of interest.

3. On an ongoing basis, oversee and monitor a proxy adviser's policies and procedures to determine whether the proxy adviser's advice is based on accurate information and free of undisclosed material conflicts of interest.

4. Regularly "stress test" a sample of particularly complex stockholder proposals by "auditing" how the proxy adviser performed, by reviewing the accuracy of the information used by the proxy adviser and the soundness of the analysis employed by the proxy adviser to arrive at a recommendation and by inquiring of the proxy adviser whether there existed any undisclosed conflict of interest in the matter voted upon.

Based on the results of the above actions, consider whether to advocate that proxy advisers adopt enhanced procedures to:

A. Afford all public companies (not just S&P 500 companies) the opportunity to "fact check" and comment upon a recommendation report before it has been finalized; and

B. Disclose any instance where the proxy adviser may be advising on, or within the past few years had advised on, a public company issuer or other parties interested in any stockholder matter for which the proxy adviser is making a voting recommendation, including the fees received by the proxy adviser from the public company or other interested parties.

The Duties of Care and Loyalty

In today's public equity market, the influence of institutional investors, such as hedge funds, mutual funds, pension funds, insurance companies, foundations, and endowments, cannot be overstated. In the 75 years since the enactment of federal laws regulating investment companies and investment advisers, institutional ownership of public companies has increased from less than 10% to more than 60%. Institutional investors typically convey discretionary voting authority to their investment adviser, thereby authorizing the investment adviser to vote their stock.

Unlike a broker-dealer that is subject to a less stringent "suitability" standard, an investment adviser is a fiduciary to its investor clients and must act in their best interests. An investment adviser owes its clients the duties of care and loyalty with respect to all services undertaken on the investors' behalf, including the voting of proxies. The duty of care requires an investment adviser that has authority to vote its clients' proxies to monitor corporate events and to vote the shares in the clients' interests. The duty of loyalty requires an investment adviser to cast proxy votes in a manner consistent with the best interests of its clients and to not subrogate its clients' interests to its own.

Since many investment advisers are part of a large financial institution with affiliates that provide many kinds of financial services to different constituencies, such as investment banking and merger and acquisition services to public companies, it is possible that the interest of the investor client may be opposed to the interest of the collective financial institution. For example, an investment adviser that votes against a public company's stockholder proposal concerning the compensation of its executives may jeopardize its investment banking affiliate's opportunity to be retained by the public company to underwrite its public offering or advise on its proposed acquisition.

SEC Regulations

In 2003 the SEC adopted Rule 206(4)-6 to "cleanse" potential conflicts of interest that may arise in voting

a client's proxies where an investment adviser or its affiliates have a material relationship with a public company or another proponent of a proposal under consideration by the company's stockholders. The rule requires an investment adviser, among other things, to adopt and implement written policies and procedures that are reasonably designed to ensure that the adviser votes proxies in the best interests of its institutional investor clients, which must include procedures for addressing material conflicts that may arise between the adviser's interest and the interests of its clients.

As a result of the adoption of the rule and certain SEC no-action letters interpreting the rule, investment advisers have adopted policies and procedures that in large measure rely on third-party proxy advisers to determine how a client's proxy should be voted and in many instances have authorized the proxy adviser to vote the proxies. ISS and Glass Lewis control over 90% of the market for proxy advisory services.

Proxy advisers avoid direct SEC regulation by qualifying for one of two exceptions: either (a) the proxy adviser provides only voting recommendations but does not vote the shares ("Solicitation Exemption") or (b) in its ordinary course of business, a proxy adviser maintains a business relationship with the investment adviser and the proxy adviser (i) discloses to the investment adviser any **significant relationship** with the public company or any of its affiliates or a security holder proponent including any **material interests** the proxy adviser may have in the matter, (ii) receives no compensation for furnishing the advice other than from other investment advisers, and (iii) does not furnish the advice on behalf of any person soliciting proxies or on behalf of a participant in a contested election ("Full Disclosure Exemption"). A relationship would be considered "significant" or an interest would be "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 adviser and its advice.

What's Next?

Proxy advisers may rethink their "one-stop shop" business model and cease to provide voting capabilities to their investment adviser clients in order to rely on the Solicitation Exemption. Should that occur, (a) new players may enter the arena to provide the "back office" services necessary to vote proxies for investment advisers or (b) investment advisers may bring those back-office services in-house. Alternatively, proxy advisers may cease to provide consulting services to public companies and other stockholder proponent constituencies. It is more likely that proxy advisers will provide enhanced disclosure of their relationships and interests with other constituencies sufficient to enable their investment adviser clients to understand the nature and scope of the intertwined relationships or interests. Proxy advisers should assume that any matter for which they provide a voting recommendation to their investment adviser clients and also advise either the public company or a stockholder proponent is significant and requires enhanced disclosure, including disclosure of the revenues to be received from the public company or other interested party in connection with the specific stockholder meeting, a fulsome description of the history of the relationship, and the process by which the proxy adviser sought to address the multiple interests.

To discuss this issue further, please contact Howard M. Berkower at 212.609.6824 or hberkower@mccarter.com.

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