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A Vote in Favor of Balance and Care in Policies Regarding the Use of Proxy Advisors

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Each Spring, between April and June, many investment advisers receive proxies relating to hundreds (or perhaps thousands) of companies held in their clients' portfolios. Advisers are asked to vote on a variety of management-sponsored proposals relating to traditional matters of corporate governance, including advisory votes on executive compensation, as well as shareholder proposals encompassing board terms and independence, social and political spending, and environmental matters, among others.

The dominant role of proxy advisory firms in shareholder democracy, their opaque nature, and potential conflicts of interest have been the subject of US Securities and Exchange Commission (SEC) and Congressional inquiries recently, as well as the focus of non-US regulators.[1] This article discusses recent developments relating to voting of proxies by investment advisers, and other fiduciaries, and suggests that policies addressing the role of proxy advisors in the voting process should be the subject of careful consideration and reflection.

I. Background

A. Role of Proxy Advisory Firms

Over 75 percent of all shares of public companies are estimated to be held in accounts managed by investment advisers. These advisers often rely on third party "proxy advisory firms" for a variety of services that may include providing analysis and recommendations on the matters presented for shareholder vote by an issuer in its proxy statements; voting proxies based on investor instructions[2] (which may be based on consultation with an investor or customized in accordance with an investor's pre-established voting policies); providing corporate governance research; and performing administrative tasks associated with voting, including tracking voting decisions.

Advisers rely on the services of proxy advisory firms to varying degrees. Depending on the adviser, they may rely on the proxy advisor's policies almost exclusively, or use the proxy advisor as an additional source of input in examining trends, or as a means to supplement dialogues with an issuer, among other things. Presently, two proxy advisory firms, MSCI Institutional Shareholder Services, Inc. and Glass Lewis & Co., LLC, are cited as providing 97 percent of all proxy advisory services. Together, they are estimated to account for the manner in which 38 percent of proxies are voted annually by institutional shareholders.[3]

B. Relevant Law

The courts and regulatory agencies have recognized that under the federal statutory scheme, investment advisers have significant fiduciary duties to

their clients in the context of proxy voting. Detailed rules have been issued to govern the manner in which advisers and other fiduciaries fulfill their important duties regarding the voting of proxies.

(i) Rule 206(4)-5

In 2003, the SEC adopted Rule 206(4)-6 (Proxy Voting Rule) under the Investment Advisers Act of 1940 (Advisers Act), which requires registered advisers[4] that have proxy voting discretion to adopt policies and procedures reasonably designed to ensure that they vote proxies in the best interests of their clients – and to disclose their policies, and how they actually voted for client accounts, to their relevant clients.[5] At the same time that it adopted the Proxy Voting Rule, the SEC underscored its belief that one of an adviser's fiduciary duties is to vote proxies.[6]

Specifically, in the adopting release for Rule 206(4)-6 (Release), the SEC stated that "an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting."[7] Additionally, the SEC noted that the "duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies" and the duty of loyalty requires that "the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own." The SEC went further, stating that even before the adoption of the Proxy Voting Rule, "the adviser [was] an agent and fiduciary of its clients; it already [owed] them a fiduciary duty to vote proxies in the clients' best interest, and must provide them with information on how their proxies were voted."

The SEC also noted that, although advisers may encounter conflicts of interest in voting proxies (for example, if they are asked to vote proxies with respect to affiliated companies), those conflicts could be avoided if the adviser has a pre-determined policy of delegating responsibility for voting proxies to an independent third party.[8] However, if the adviser did encounter a conflict, the SEC stated that, in the context of advisers to investment companies:

> [A]n adviser to an investment company would satisfy its fiduciary obligations under the Advisers Act if, before voting the proxies, it fully discloses its conflict to the investment company's board of directors or a committee of the board and obtains the board's or committee's consent or direction to vote the proxies.[9]

(ii) Egan-Jones and Institutional Shareholder Services No-Action Letters

Shortly after the Proxy Voting Rule was adopted by the SEC, in 2004 the SEC Staff issued two no-action letters, *Egan-Jones Proxy Services (Egan-Jones)* and *Institutional Shareholder Services* (*ISS*), that broadened the scope of the SEC's statements in the Release.[10] In *Egan-Jones*, the SEC Staff was asked for clarification regarding methods investment advisers could employ to avoid conflicts of interest. The SEC Staff stated that "investment advisers need procedures in place to ensure that their third-party proxy services are independent." The SEC Staff stated that a third party would be independent "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." Additionally, an independent 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."[11] Further, the SEC Staff noted "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."[12]

In the *ISS* no-action letter, the SEC Staff was asked for further clarification "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," which Institutional Shareholder Services noted was previously addressed in the *Egan-Jones* no-action letter. The SEC Staff stated:

> [A]n investment adviser could breach its fiduciary duty of care to its clients by voting its clients' proxies based upon a proxy voting firm's recommendations because the firm could recommend that the adviser vote the Issuer's proxies in the firm's own interests, to further its relationship with the Issuer and its business of providing corporate services, rather than in the interests of the adviser's clients.

In addition, the SEC Staff noted the following steps to ensure that an investment adviser fulfills its duty of care when voting its clients' proxies: (i) "a case-by-case evaluation of the proxy voting firm's relationships with Issuers;" (ii) "thorough review of the proxy voting firm's conflict procedures and the effectiveness of their implementation;" and (iii) "other means reasonably designed to ensure the integrity of the proxy voting process." Further, in reviewing a proxy voting firm's conflict procedures, an investment adviser should "assess the adequacy of those procedures in light of the particular conflicts of interest that the firm faces in making voting recommendations," "have a thorough understanding of the proxy voting firm's business and the nature of the conflict[s]" that business presents, "assess whether the firm's conflict procedures negate the conflicts," and "whether the proxy voting firm has fully implemented the conflict procedures."[13]

These letters are widely followed by the industry and are viewed as essentially allowing advisers to determine, in accordance with the SEC's statements in the Release and the terms of the letters, that voting proxies in reliance on the independent proxy advisory firm's voting recommendations as to proxy matters will insulate the voting decision from any conflicts of interest the adviser may have (and otherwise discharge the adviser's fiduciary duties and meet the requirements of the Proxy Voting Rule that votes be cast in the client's best interest). Indeed, since 2004, many advisers have routinely relied on proxy advisory firms to avoid the substantial costs they might incur in undertaking an analysis of each and every proxy matter during proxy season.

(iii) ERISA

The development of guidance under the Employee Retirement Income Security Act of 1974 (ERISA) provides further context for the manner in which practices regarding proxy voting have developed. ERISA is the statute that comprehensively regulates private US employee benefits, and among its fully "reticulated"[14] provisions is a set of provisions governing fiduciary conduct.[15] These provisions have significant practical significance in light of the substantial concentration of investment capital in ERISA plans, and, especially, in pension plans governed by ERISA. In addition, a number of non-ERISA public plans may, at least informally, refer to developments under ERISA as a guide for their own conduct.[16]

Section 404(a)(1)(B) of ERISA requires ERISA fiduciaries to act "with the care, skill, prudence, and diligence that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." ERISA practitioners have been known to refer to this standard as a "prudent expert" (as opposed to prudent person) standard, and to focus on the importance of "procedural prudence" as fiduciaries endeavor to comply with, and to demonstrate compliance with, their fiduciary obligations. It is out of this general prudence requirement, together with the requirement in Section 404(a)(1)(A) that fiduciaries act for the "exclusive purpose" of providing benefits and defraying reasonable administrative expenses, that the development of proxy-related guidance has arisen.

Thus, the US Department of Labor (DOL) has historically focused on the importance of proxy voting as a part of the exercise of fiduciary duties under ERISA.[17] Over time, proxy voting has become a significant focus under ERISA, with efforts being made to identify which fiduciaries have responsibility for proxy voting,[18] and otherwise to establish

appropriate processes regarding the exercise of voting rights.

In 2008, the DOL's consideration of matters relating to proxy voting coalesced in Interpretive Bulletin 08-2,[19] which, among other things, states that fiduciary duties relating to the management of plan assets include a duty to exercise voting rights and adopt policies relating to proxy voting, and more generally to manage voting rights appurtenant to shares of stock. The following excerpt from Interpretive Bulletin 08-02 provides important and useful insight into how the DOL views the procedural and substantive requirements of ERISA as applied to proxy voting:

> The fiduciary act of managing plan assets that are shares of corporate stock includes the management of voting rights appurtenant to those shares of stock. … As a result, the responsibility for voting or deciding not to vote proxies lies exclusively with the plan trustee except to the extent that either (1) the trustee is [properly] subject to the direction of a named fiduciary … ; or (2) the power to manage, acquire or dispose of the relevant assets has been [properly] delegated by a named fiduciary to one or more investment managers …. Where the authority to manage plan assets has been delegated to an investment manager … , no person other than the investment manager has authority to make voting decisions for proxies appurtenant to such plan assets except to the extent that the named fiduciary has reserved to itself (or to another named fiduciary so authorized by the plan document) the right to direct a plan trustee regarding the voting of proxies.
>
> If the plan document or investment management agreement provides that the investment manager is not required to vote proxies, but does not expressly preclude the investment manager from voting proxies, the investment manager would have exclusive responsibility for proxy voting decisions. Moreover, an investment manager would not be relieved of its own fiduciary responsibilities by following directions of some other person regarding the voting of proxies, or by delegating such responsibility to another person. …
>
> The fiduciary duties described at ERISA Sec. 404(a)(1)(A) and (B), [sic] require that, in voting proxies, regardless of whether the vote is made pursuant to a statement of investment policy, the responsible fiduciary shall consider only those factors that relate to the economic value of the plan's investment and shall not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives. Votes shall only be cast in accordance with a plan's economic interests. If the responsible fiduciary reasonably determines that the cost of voting (including the cost of research, if necessary, to determine how to vote) is likely to exceed the expected economic benefits of voting, or if the exercise of voting results in the imposition of unwarranted trading or other restrictions, the fiduciary has an obligation to refrain from voting … In making this determination, objectives, considerations, and economic effects unrelated to the plan's economic interests cannot be considered. The fiduciary's duties under ERISA Sec. 404(a)(1)(A) and (B) also require that the named fiduciary appointing an investment manager periodically monitor the activities of the investment manager with respect to the management of plan assets, including decisions made and actions taken by the investment manager with regard to proxy voting decisions. …
>
> It is the view of the Department that compliance with the duty to monitor necessitates

> proper documentation of the activities that are subject to monitoring. Thus, the investment manager or other responsible fiduciary would be required to maintain accurate records as to proxy voting decisions, including, where appropriate, cost-benefit analyses … Moreover, if the named fiduciary is to be able to carry out its responsibilities under ERISA Sec. 404(a) in determining whether the investment manager is fulfilling its fiduciary obligations in investing plans assets in a manner that justifies the continuation of the management appointment, the proxy voting records must enable the named fiduciary to review not only the investment manager's voting procedure with respect to plan-owned stock, but also to review the actions taken in individual proxy voting situations.[20]

II. Role of Proxy Advisory Firms

As noted above, partly as a result of the *Egan Jones* and *ISS* letters, many investment advisers rely heavily on proxy advisory firms to assist them in voting proxies; since it is often impractical to perform due diligence on every individual proxy measure. However, there is growing frustration among issuers that proxy advisory firms have become "gatekeepers" of corporate governance applying a "one-size-fits-all" approach to considering management proposals. This frustration has been exacerbated recently with the enactment of "say on pay" rules[21] that require approval of corporate compensation practices – and has resulted in advisers placing increased reliance on proxy advisory firms for recommendations. As illustrated below, the policy issues raised by the broader role of proxy advisory firms in corporate governance has been the subject of debate in recent years.

A. 2010 Proxy Concept Release

In 2010, the SEC issued a release, which inquired about the role of advisory firms (Proxy Concept Release).[22] In the Proxy Concept Release, the Commission noted that proxy advisory firms are not subject to the proxy filing requirements under the Exchange Act, because they do not engage in "solicitations,"[23] but generally are required to register as investment advisers.

In the Proxy Concept Release, the Commission noted concerns and complaints expressed by those in the industry. Among these, are the conflicts of interest posed based on the fact that proxy advisory firms often offer corporate governance consulting services to the same issuers whose proxies are the subject of their recommendations to clients. More significant, however, from the perspective of issuers, is the fact that voting recommendations by proxy advisory firms may be made based on materially inaccurate or incomplete data, their analysis may not be accurate[24] and that proxy advisory firms may base their recommendations on a one-size-fits-all governance approach with little opportunity for dialogue with the issuers that are affected by their recommendations. In the Proxy Concept Release, the SEC requested comment from the industry based on these concerns.

B. More Recent Policy Concerns

More recently, the House of Representatives Financial Services Subcommittee held hearings regarding the influence that the firms have on corporate governance through their analysis and voting recommendations.[25] As noted above, issuers have complained loudly about the influence of proxy advisory firms. Echoing their concerns, Harvey L. Pitt, a former Chairman of the SEC, testified at the hearings on behalf of the US Chamber of Commerce.[26] He summarized the issues, as follows:

> Unfortunately, advice provided by ISS and Glass Lewis is not tailored to the interests of the shareholders of each firm's investment portfolio manager clients, nor is it formulated with any consideration of the stated policies and purposes of the portfolios housing the equity securities to which the recommendations relate. Given the huge percentage of the

> vote likely controlled by ISS and Glass Lewis, the failure of an issuer to comply with those firms' preferred policies saddles issuers with a large number of negative votes *before voting has even begun*. Proxy advisors, therefore, also can affect valuations and the ultimate outcomes of contests and specific transactional matters. *As a result, ISS and Glass Lewis have become the de facto standard setters for corporate governance policies in the U.S.*[27]

One of the SEC Commissioners also has expressed, in a series of published remarks, his view that the *Egan-Jones* and *ISS* no-action letters should be withdrawn.[28] In 2013, the Commissioner indicated that as a result of the no-action letters, he believed investment advisers may "view their responsibility to vote on proxy matters with more of a compliance mindset than a fiduciary mindset."[29] In the Commissioner's opinion, the no-action letters should be replaced by guidance indicating that advisers should be exercising their fiduciary duty in voting shares, "rather than engaging in rote reliance on proxy advisory firm recommendations." This perspective has been echoed by other Commissioners as well.[30]

In December 2013, the Staff of the SEC also held a roundtable to discuss the role of proxy advisors and invited further public comment.[31] Among the topics presented for discussion were investor reliance on proxy advisory services and the issues identified in the Proxy Concept Release, including, among other things, the transparency and accuracy of recommendations made by proxy advisory firms and potential conflicts of interest.

III. SEC Staff Bulletin on Proxy Voting

Perhaps reacting to the more recent policy concerns noted above, in July 2014, the SEC's Division of Investment Management, along with the Division of Corporate Finance, released a Staff legal bulletin (Bulletin) covering various issues involved with proxy voting.[32] Although the SEC has not withdrawn the *Egan-Jones* and *ISS* letters the Bulletin places pressure on investment advisers and proxy voting advisors to assure that issuers have greater opportunity to challenge some of the decisions made by proxy advisors.

In the Bulletin, the Staff of the Division of Investment Management (IM Staff) provided guidance as to the responsibilities of investment advisers in voting client proxies and retaining proxy advisory firms. The Bulletin provides helpful insight as to the IM Staff's view of an investment adviser's obligations when retaining a proxy advisory firm to assist it in complying with its fiduciary duties with respect to proxy voting and the Proxy Voting Rule.

The Bulletin also sets forth relevant factors that investment advisers may wish to consider when retaining a proxy advisory firm and means by which advisers can oversee any proxy advisory firms that they have retained. Implementing policies and procedures for evaluating and overseeing proxy advisory firms can help demonstrate that the investment adviser has complied with its fiduciary duties, the Proxy Voting Rule and the Compliance Program Rule,[33] and should reduce the chances that proxy advisory firm conflicts of interest or errors could negatively impact the investment adviser or its clients.[34] The IM Staff has indicated that it expects that investment advisers who do not already include these types of provisions in their policies and procedures or processes in place will implement them "promptly, but in any event in advance of next year's proxy season."

A. Overview of the Legal Bulletin

The IM Staff first provided examples of steps that investment advisers may wish to take to demonstrate that proxy votes are being cast in accordance with their clients' best interests and in a manner that is consistent with the investment adviser's own proxy voting policies and procedures. The IM Staff also noted that, although there are many different types of proxy arrangements that may be agreed to between

investment advisers and clients, a registered investment adviser must always exercise proxy authority in compliance with the SEC's Proxy Voting Rule.

As discussed below, the IM Staff addressed factors that it believes an investment adviser should consider when determining whether to retain a proxy advisory firm to assist the investment adviser in discharging its obligations to clients with respect to proxy voting matters. Further, the IM Staff discussed how an investment adviser who retains a proxy advisory firm should exercise reasonable ongoing oversight of that proxy voting firm – focusing, particularly, on the potential conflicts of interest to which proxy advisory firms may be subject, as well as an investment adviser's duties with respect to the material accuracy of the facts relied upon by proxy voting firms in formulating a recommendation.

B. Investment Adviser Recommendations

In light of the fiduciary duties owed by an investment adviser to its clients and the particular requirements imposed on registered investment advisers by the Proxy Voting Rule, the IM Staff suggested the following steps that investment advisers can take to demonstrate that proxy votes are cast in accordance with clients' best interests and the investment adviser's proxy voting policies and procedures:

- periodically sampling proxy votes to review whether they complied with the investment adviser's proxy voting policy and procedures; and
- review[ing] a sample of proxy votes that relate to certain proposals that may require more analysis.[35]

Additionally, consistent with the Compliance Program Rule, the IM Staff suggested that an investment adviser should review (at least 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."

C. Types of Proxy Arrangements

The IM Staff noted that the Proxy Voting Rule does not require that investment advisers be responsible for voting proxies on behalf of clients. Rather, investment advisers and clients may agree as to the authority, if any, that an investment adviser will exercise, including for example: (i) client grants to the investment adviser complete authority to vote proxies; (ii) client agrees that the investment adviser will not vote certain types of proxy proposals; (iii) client instructs the investment adviser to vote proxies as recommended by the management of the company, unless the investment adviser receives different instructions from the client; (iv) client and investment adviser agree that the adviser will abstain from voting all proxies, regardless of whether the client votes proxies itself; and (v) client instructs the investment adviser to focus resources only on particular types of proposals based on the client's preferences.[36] The IM Staff emphasized that, whenever a registered investment adviser assumes any degree of voting authority, it must exercise that authority in a manner that is consistent with the Proxy Voting Rule.

D. Proxy Advisory Firm Factors

Portions of the guidance from the Staff of the Division of Corporate Finance relating to proxy advisory firms that may be of particular relevance to investment advisers included discussions of the services that a proxy advisory firm may provide to an investment adviser and the disclosures that must be made by proxy advisory firms to investment advisers regarding the proxy advisory firm's potential conflicts of interest. In addition, the IM Staff discussed certain factors that it believes an investment adviser should consider when retaining a proxy advisory firm. In particular, the IM Staff emphasized that an investment adviser should consider "whether the proxy advisory firm has the capacity and competency

to adequately analyze proxy issues." Factors that the IM Staff suggested advisers might consider include:

- the adequacy and quality of the proxy advisory firm's staffing and personnel;
- 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 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.[37]

E. Investment Adviser Oversight

The IM Staff cited prior guidance indicating its view that investment advisers have an ongoing duty to oversee any proxy advisory firm retained. Under the Proxy Voting Rule, investment advisers who have proxy voting authority must adopt written policies and procedures reasonably designed to ensure that the adviser is voting proxies in its clients' best interests. In the IM Staff's view, this would include oversight procedures when a proxy advisory firm is retained and, since a proxy advisory firm's business and/or policies and procedures regarding conflicts of interest can change over time, the investment adviser should also "establish and implement measures reasonably designed to identify and address the proxy advisory firm's conflicts that can arise on an ongoing basis." The IM Staff suggested that an investment adviser might satisfy this "by requiring the proxy advisory firm to update the investment adviser of business changes the investment adviser considers relevant … or [changes in the proxy advisory firm's] conflict policies and procedures."

The IM Staff also addressed its expectation that "an investment adviser that receives voting recommendations from a proxy advisory firm should ascertain that the proxy voting firm has the … ability to make voting recommendations based on materially accurate information." If an investment adviser discovers that a proxy voting recommendation was based on materially inaccurate information, the adviser might reasonably question the proxy advisory firm's processes and, in the IM Staff's view, such an adviser "should take reasonable steps to investigate the error." In doing so, the IM Staff suggested that the investment adviser consider the nature of the error, its effect on the related recommendation, and the measures the proxy advisory firm is undertaking to reduce similar types of errors in the future.

IV. Conclusions

Regardless of the extent to which regulation of corporate governance might be appropriate, concerns that the power to alter corporate practices effectively rests with a small group of largely unregulated private firms may be well-founded. Requiring advisers to devote additional resources to evaluate significant proxy matters could give issuers a greater opportunity to seek support for their proposals and lessen the influence of the proxy advisory firms. At the same time, however, any changes to the present system should seek to balance the costs that may be imposed on advisers and shareholders of undertaking individualized due diligence efforts on routine or immaterial proxy matters.

Statements by individual SEC Commissioners and the most recent Bulletin evidence the fact that the SEC may be interested in reducing the compliance oriented, wooden adherence to the advice of proxy advisors that has been created over time. The Bulletin also suggests that the role of proxy advisors should be the subject of careful consideration and reflection by advisers, perhaps opening the door for issuers to challenge the one-size-fits all approach previously taken by proxy advisory firms.

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NOTES

1 *See, e.g.,* European Securities and Markets Authority (ESMA), *Final Report on The Proxy Advisor Industry*, (Feb. 19, 2013); Organisation for Economic Co-operation and Development (OECD), *Corporate Governance Working Papers No. 8: Who Cares? Corporate Governance in Today's Equity Markets* (Apr. 2013), available at *http://www.oecd.org/naec/Who%20Cares_Corporate%20Governance%20in%20Today's%20Equity%20Markets.pdf*; Canadian Securities Administrators (CSA), *Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms* (June 21, 2012).

2 In many cases, investors hold their securities in omnibus accounts at intermediaries, including brokers-dealers and banks. These investors are considered "beneficial owners" of shares. Only the intermediaries themselves appear on the records of the issuer as "legal holders" or "registered shareholders" entitled to vote proxies directly. Beneficial owners receive "voter instruction forms" (sometimes referred to as VIFs) that are used to instruct the intermediary how to vote the shares that it holds on their behalf.

3 US House of Representatives Committee on Financial Services Majority Committee Staff Memorandum entitled *June 5 Subcommittee on Capital Markets hearing on Examining the Market Power and Impact of Proxy Advisory Firms* (May 31, 2013), available at *http://financialservices.house.gov/uploadedfiles/060513_cm_memo.pdf*.

4 By its terms, the Proxy Voting Rule applies only to advisers that "are registered or required to be registered" under the Advisers Act. However, any investment adviser, regardless of its registration status, is subject to certain fiduciary duties and the Advisers Act's general anti-fraud provisions. Unregistered advisers having proxy voting authority should, therefore, also consider the guidance as instructive.

5 Although not the focus of this article, we note that mutual funds also must disclose their proxy voting policies and voting records on Form N-PX. *See also*, Bew, Robyn and Fields, Richard, "Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisors," 2 (June 2012), available at *http://www.irrcinstitute.org/pdf/Voting_Decisions_at%20US_Mutual_Funds.pdf*.

6 *Proxy Voting by Investment Advisers Final Rule*, SEC Rel. No. IA-2106 (Mar. 10, 2003).

7 *Id.*; *see also*, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963) (interpreting Section 206 of the Advisers Act).

8 *Id.* (stating that advisers must "adopt and implement written policies and procedures that are reasonably designed to ensure that you vote client securities in the best interest of clients, which procedures must include how you address material conflicts that may arise between your interests and those of your clients").

9 *Id.* at n.20.

10 Egan-Jones Proxy Services, SEC No-Action Letter (May 27, 2004), and Institutional Shareholder Services, Inc., SEC No-Action Letter (Sept. 15, 2004).

11 *See* Advisers Act § 202(a)(12) (defining "affiliated person"); *see also SEC Interpretation: Matters Concerning Independent Directors of Investment Companies*, SEC Rel. No. IC-24083 (Oct. 14, 1999) (discussing under the Investment Company Act of 1940 when a material business or professional relationship may impair the independence of a prospective independent director of a fund); *cf.* Investment Company Act of 1940 § 2(a)(4)(vii) (defining interested person).

12 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, SEC No-Action Letter (Feb. 13, 2002) (the Staff agreed not to recommend enforcement action under §17(a) of the Investment Company

Act of 1940 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).

13 For example, when assessing a proxy voting firm's conflict procedures, an investment adviser should consider whether the procedures effectively (i) preclude the natural persons who make the firm's proxy voting recommendations from obtaining access to information about the firm's business relationships with issuers and (ii) insulate those persons from direct or indirect influence by the firm's employees who know of those relationships. In addition, an investment adviser should consider, among other things, evaluating the frequency with which the proxy voting firm recommends voting in favor of the management of issuers that have engaged the firm to provide corporate services. An investment adviser should also consider how the conflict procedures address a proxy voting firm's voting recommendation concerning an issuer that makes payments to the firm for corporate services, which are the single largest source of revenue for the firm.

14 Nachman Corp. v. PBGC, 446 U.S. 359, 361 (1980).

15 ERISA, title I, subt. B, pt. 4.

16 It has been suggested in the proxy-voting context that a number of public pension plans may not always "follow [the] herd" when it comes to proxy voting and, in particular, may be diverging from the recommendations of proxy advisors. *See* Barry B. Burr, "4 Pension Plans Not Following Herd with Proxy Votes," *Pens. & Invs.* (Apr. 1, 2013).

17 *See, e.g.,* DOL letter to Helmut Fandl, Avon Products, Inc. (Feb. 23, 1988)*;* DOL Letter from to Robert A.G. Monks, Institutional Shareholder Services, Inc. (Jan. 23, 1990).

18 *Cf.* DOL Field Assistance Bulletin 2008-01 (relating generally to the assignment of fiduciary duties to identified responsible fiduciaries).

19 Interpretive Bulletin 08-2 has been incorporated into the DOL's regulations at 29 C.F.R. § 2509.08-2.

20 29 C.F.R. § 2509.08-2 (footnotes omitted).

21 *See*, *Shareholder Approval of Executive Compensation and Golden Parachutes Compensation*, SEC Rel. Nos. 33-9178, 34-63768 (Jan. 25, 2011) (Implementing Section 14A of the Exchange Act, requiring shareholder advisory votes on executive compensation).

22 *Concept Release on the U.S. Proxy System*, SEC Release Nos. 34-62495, IA-3052, IC-29340 (July 14, 2010), available at *http://www.sec.gov/rules/concept/2010/34-62495.pdf*.

23 Under Rule 14a-1(l)(iii) of the Securities Exchange Act of 1934 (Exchange Act), the "solicitation" of proxies includes "[t]he 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." *See also Broker-Dealer Participation in Proxy Solicitations*, SEC Rel. No. 34-7208 (Jan. 7, 1964) (whether or not a particular communication constitutes a solicitation depends both upon the specific nature and content of the communication and the circumstances under which it is transmitted). In 1979, the SEC adopted Exchange Act Rule 14a-2(b)(3) which exempts firms furnishing proxy voting advice from the Exchange Act's filing requirements if the advisor: renders financial advice in the ordinary course of its business; discloses any significant relationship it has with the relevant issuer or any of its affiliates, or with a shareholder proponent of the matter on which advice is given, in addition to any material interest of the advisor in the matter to which the advice relates; does not receive any special commission or remuneration for furnishing the proxy voting advice from anyone other than the recipients of the advice; and does not furnish proxy voting advice on behalf of any person soliciting proxies. *See generally Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally*, SEC Rel. No. 34-16104 (Aug. 13, 1979) (relating to shareholder communications, shareholder participation in the

corporate electoral process and corporate governance generally). Most services provided by proxy voting advisors fall within the exemption. *See generally id*.

[24] The Commission noted in the Proxy Concept Release that "as a fiduciary, the proxy advisory firm has a duty of care requiring it to make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information."

[25] Capital Markets and Government Sponsored Enterprises Subcommittee Hearing entitled *Examining the Market Power and Impact of Proxy Advisory Firms* (June 5, 2013).

[26] *Statement of the US Chamber of Commerce*, Capital Markets and Government Sponsored Enterprises Subcommittee Hearing (June 5, 2013).

[27] *See id.* (emphasis in original) (citing J. Glassman & J. Verret, "How to Fix our Broken Proxy Advisory System," Mercatus Center, George Mason University (Apr. 16, 2013), available at *http://mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf*, and Ertimur, Yonca, Ferri, Fabrizio and Oesch, David, "Shareholder Votes and Proxy Advisors: Evidence from Say on Pay," 7th Annual Conference on Empirical Legal Studies Paper (Feb. 25, 2013) (since updated), available at *http://www0.gsb.columbia.edu/mygsb/faculty/research/pubfiles/5857/shareholder_votes.pdf*).

[28] Similar concerns are reflected in the Proxy Concept Release. *See also, e.g.*, GAO Report to Congress, Corporate Shareholder Meetings – Issues Relating to Firms That Advise Institutional Investors on Proxy Voting (June 2007) (attributing the growth in the use of proxy voting advisers, in part, to the Commission's Proxy Voting Rule).

[29] Commissioner Daniel M. Gallagher, Remarks before the Society of Corporate Secretaries and Governance Professionals (July 11, 2013); Commissioner Daniel M. Gallagher, Remarks at the 12th European Corporate Governance Law Conference (May 17, 2013) (expressing similar views and stating "I am concerned that unless these no-action letters are reviewed and possibly revisited, the SEC may find it difficult to ensure that fiduciaries are conducting proper due diligence with respect to proxy votes"); Commissioner Daniel M. Gallagher, Remarks before the Corporate Directors Forum (Jan. 29, 2013); Commissioner Daniel M. Gallagher, Remarks at Georgetown University's Center for Financial Markets and Policy Event (Oct. 30, 2013); Commissioner Daniel M. Gallagher, Remarks at Transatlantic Corporate Governance Dialogue Conference: The Realities of Stewardship for Institutional Owners, Activist Investors and Proxy Advisors (Dec. 3, 2013); Commissioner Daniel M. Gallagher, Remarks to the Forum for Corporate Directors, Orange County (Jan. 24, 2014).

[30] *See, e.g,* Opening Statement of Commissioner Michael S. Piwowar at the Proxy Advisory Services Roundtable (Dec. 5, 2013):

> By requiring advisers to vote on every single matter – irrespective of whether such vote would impact the performance of investment portfolios – our previous actions may have unintentionally turned shareholding voting into a regulatory compliance issue, rather than one focused on the benefits for investors. This is an unfortunate result, not merely because it may have served to entrench an anti-competitive duopoly, but more importantly because it is inconsistent with our investor protection mandate. For these reasons, we should rectify this situation immediately.

[31] *See*, *Proxy Advisory Firm Roundtable*, SEC Rel. No. 34-70929 (Nov. 22, 2013) (Providing notice and requesting comments).

[32] Division of Investment Management, "Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms," Staff Legal Bulletin No. 20 (IM/CF) (June 30, 2014). For additional discussion of the Bulletin, *see* Dechert OnPoint, *SEC IM Staff Issues Guidance on Proxy Voting Responsibilities of Investment Advisers* (July 21, 2014), available at *http://sites.edechert.com/10/3517/july-2014/*

sec-im-staff-issues-guidance-on-proxy-voting-responsibilities-of-investment-advisers.asp.

33 The Compliance Program Rule, among other things, requires an adviser to perform an annual review of the adequacy and effectiveness of implementation of the policies and procedures adopted by the investment adviser under the Advisers Act. Rule 206(4)-7(b). *See Programs of Investment Companies and Investment Advisers*, SEC Rel. No. IA-2204 (Dec. 24, 2003).

34 Proxy firms, some of which are registered as investment advisers under the Advisers Act, have also drawn fire for having inadequate policies and procedures. In a recent administrative proceeding brought against a proxy firm that was a registered adviser, the SEC found that the firm had violated Section 204A of the Advisers Act by failing to establish and enforce policies and procedures reasonably designed to prevent the misuse of material, nonpublic proxy voting information provided to the firm by its institutional shareholder clients. *See In re Institutional Shareholder Services, Inc.*, SEC Rel. No. IA-3611 (May 23, 2013).

35 Bulletin, Q&A 1.

36 As a general matter, where an adviser otherwise has discretionary authority, but the adviser and client agree that the adviser will not have authority to vote proxies, the contract (or another document) should include a provision evidencing that the adviser will not have such authority.

37 Bulletin, Q&A 3.