July 2014

J.P.Morgan

DR Advisor Alert

SEC Issues Guidance on Investment Adviser Use of Proxy Advisory Firms and on Exemptions from Proxy Rules for Proxy Advisory Firms

Introduction

On June 30, 2014, the U.S. Securities and Exchange Commission (SEC) published Staff Legal Bulletin 20 ("SLB 20" or "Bulletin"), which provides guidance on investment adviser's responsibilities when voting client proxies and retaining proxy advisory firms, such as ISS and Glass Lewis & Co. SLB 20 also provides guidance on the availability and requirements of two exemptions from federal proxy rules that are available to proxy advisory firms. The following is an overview of the SEC's bulletin.

Investment Advisers Voting Responsibilities

Under the Investment Advisers Act of 1940, an investment adviser, as a fiduciary "owes each of its clients a duty of care and loyalty with respect to services undertaken on the client's behalf, including proxy voting." In furtherance of this duty, Rule 206(4)-6 under the Investment Advisers Act (the "Proxy Voting Rule") provides that an investment adviser must maintain "written policies and procedures that are reasonably designed to ensure that the investment adviser votes proxies in the best interest of its clients." This requirement applies when an investment adviser receives authorization to exercise voting authority on behalf of a client.

Investment adviser proxy voting policies and procedures

As a form of guidance, SLB 20 gives examples of how an investment adviser could demonstrate that its proxy votes are cast in clients' best interests and in accordance with its proxy voting policies and procedures. Examples include: (a) periodically sampling votes to determine if they complied with the policies and procedures; and (b) reviewing a sample of proxy votes that relate to certain proposals that may require more analysis. The SEC recommends that investment advisers should in any event review at least annually the adequacy of their policies and procedures to ensure they have been implemented effectively, including whether they continue to be reasonably designed to ensure that proxies are voted in the best interests of the adviser's clients.

Arrangements for exercising proxy voting authority

SLB 20 states that an investment adviser and its client have flexibility in determining the scope of the adviser's obligation to exercise proxy voting authority. In the Bulletin, the SEC notes, for example, that the Proxy Voting Rule does not require an investment adviser and its client to agree that the adviser will undertake all of the client's proxy voting responsibilities, although clients usually delegate to investment advisers the authority to vote on all proxies. In addition to this type of delegation, investment advisers and their clients also may agree to other voting arrangements in which the adviser would not assume all proxy voting authority.

As guidance, the bulletin provides illustrative and non-exclusive examples of permissible voting arrangements between an investment adviser and a client. They may agree that:

- the time and costs associated with the mechanics of voting proxies with respect to certain types of proposals or issues may not be in the client's best interest;
- 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;
- the investment adviser will abstain from voting any proxies at all, regardless of whether the client undertakes to vote the proxies itself; or
- the investment adviser will focus resources on only particular types of proposals based on the client's preferences.

Investment Advisers' Retention and Oversight of Proxy Advisory Firms

Considerations for retaining a proxy advisory firm

When an investment adviser is considering whether to retain or continue retaining a proxy advisory firm to provide voting recommendations, SLB 20 states it should "ascertain, among other things, whether the proxy advisory firm has the capacity and competency to adequately analyze proxy issues." This process could include determinations regarding the adequacy and quality a proxy advisory firm's staffing and personnel as well as the robustness of the 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 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."

Ongoing oversight of a proxy advisory firm

In order to comply with the Proxy Voting Rule, an investment adviser should adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of a proxy advisor to ensure that, when acting in accordance with a proxy advisor's recommendations, the investment adviser continues to vote proxies in the best interests of its clients. In its Bulletin, the SEC places particular emphasis on conflicts of interest, stating 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."

Accordingly, an investment adviser "should establish and implement measures reasonably designed to identify and address the proxy advisory firm's conflicts that can arise on an ongoing basis, 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."

Material accuracy of facts upon which voting recommendations are based

SLB 20 also states that an investment adviser, as part of its oversight of a proxy advisory firm, should ascertain that the proxy advisor "has the capacity and competency to adequately analyze proxy issues, which includes the ability to make voting recommendations based on materially accurate information." If an investment adviser determines, for example, that a proxy advisor's recommendation was based on a material factual error that causes the adviser to question the process by which the proxy advisor makes recommendations, the investment adviser must take reasonable steps to investigate the error. Such an investigation should take into account, among other things, the nature of the error and the related recommendation. The investment advisor should also seek to determine if the proxy advisory firm is taking reasonable steps to seek a reduction in such errors.

Federal Proxy Rule Exemptions Available to Proxy Advisory Firms

SLB 20 confirms that a proxy advisory firm is subject to federal proxy rules whenever it provides "recommendations that are reasonably calculated to result in the procurement, withholding, or revocation of a proxy." However, Rule 14a-2(b) under the Securities Exchange Act of 1934 (the "Exchange Act") provides proxy advisers certain exemptions from the information and filing requirements of the proxy rules.

Exemptions under Rule 14a-2(b)(1)

Subparagraph (1) of Exchange Act Rule 14a-2(b) exempts proxy advisors from most provisions of the federal proxy rules to the extent that an advisor does not seek the power to act as a proxy for a shareholder and does not furnish or request any revocation, abstention, consent or authorization. The exemption under Exchange Act Rule 14a-2(b)(1) would not be available to 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 SEC views the proxy advisor as having solicited the "power to act as a proxy" for its client, which prevents the advisor from relying on the exemption.

However if a proxy advisory firm that limits its activities to distributing reports containing recommendations and does not solicit the power to act as a proxy for any client that receives the recommendations, it would be able to rely on the exemption in Rule 14a-2(b)(1), provided it meets the other requirements of the exemption.

Exceptions under Rule 14a-2(b)(3)

Under Exchange Act Rule 14a-2(b)(3), the furnishing of proxy voting advice by any advisor to another person with whom a business relationship exists is exempt from the federal proxy rules, if the advisor:

- 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 advisor 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.

According to SLB 20, a proxy advisory firm can rely on Rule 14a-2(b)(3) exemption when providing consulting services to a company on a matter that is the subject of a voting recommendation or providing a voting recommendation to its clients on a proposal sponsored by another client, provided the firm meets certain conditions. In such instances, the proxy advisor firm would need to "assess whether its relationship with the company or security holder proponent 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." The Bulletin states that "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."

With regard to disclosure of a significant relationship or a material interest to the recipient of a voting recommendation, the SEC does not believe that "boilerplate language that such a relationship or interest may or may not exist" provides adequate notice. SLB 20 specifies that "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." The Bulletin further states that Rule 14a-2(b)(3) "imposes an affirmative duty to disclose significant relationships or material interests to the recipient of the advice." In other words, such disclosure should be made proactively and not just when requested by the recipient. Additionally, the disclosure requirement cannot be satisfied merely by notifying clients that the relevant information will be provided upon request.

Although Rule 14a-2(b)(3) does not specify where disclosure of significant relationships or material interests should be provided, SLB 20 states that it should be done in a way that allows the recipient of voting advice "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."

Application of SLB 20 Guidance by Investment Advisers and Proxy Advisory Firms

SLB 20 concludes that "investment advisers and proxy advisory firms may want or need to make changes to their current systems and processes" based on the Bulletin's guidance. The SEC puts such firms on notice that it "expects any necessary changes will be made promptly, but in any event in advance of next year's proxy season."

To learn more about SLB 20, visit: https://www.sec.gov/interps/legal/cfslb20.htm.

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