



**Risk Management Update  
September 2014**

**PROXY VOTING CONSIDERATIONS FOR USING THIRD-PARTY VENDORS**

Investment advisers registered with the Securities and Exchange Commission (“SEC”) are not required, but have the option to vote proxies on behalf of their clients. Rule 206(4)-6 of the Investment Advisers Act of 1940, as amended (the “Advisers Act”) requires SEC registered investment advisers that have elected to vote proxies on behalf of their clients to adopt written proxy voting policies and procedures reasonably designed to ensure that votes are cast in the best interest of clients. Additionally, such policies and procedures must address how advisers handle conflicts of interest pertaining to proxy voting, provide information on how clients may obtain information on how the firm cast proxies on their behalf, and include an offer to provide the firm’s complete proxy policy upon request.

Some investment advisory firms who have authority to vote proxies for their clients elect to utilize the services of a third-party proxy voting vendor (a “Proxy Advisory Firm”). Proxy Service Providers offer a variety of services, including proxy research and voting recommendations, along with voting administration and recordkeeping.

In recent months, proxy voting activities by investment advisers, and specifically the use of Proxy Advisory Firms and conflicts of interest that may arise surrounding these arrangements, are undergoing regulatory scrutiny. This risk management update provides insight into some of the SEC’s more recent concerns and outlines due diligence tips firms should consider when using a Proxy Advisory Firm.

**Regulatory Considerations**

In November 2013, the SEC held a roundtable discussion on the use of Proxy Advisory Firms by investment advisers<sup>1</sup>. The participants included representatives from investment advisers, broker-dealers, law firms, proxy advisory firms, and issuers. The focus of their discussions surrounded, among other things, conflicts of interest in using Proxy Advisory Firms, whether the recommendations are transparent and accurate, and to what extent investors are relying on the recommendations provided by these firms.

A few months later, the SEC’s Division of Investment Management and Division of Corporate Finance issued a Staff Legal Bulletin,<sup>2</sup> which provided guidance in a Q&A format for investment advisers regarding certain aspects of their proxy voting responsibility that included, among other things:

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<sup>1</sup> For complete information, including a webcast recording, see <http://www.sec.gov/spotlight/proxy-advisory-services.shtml>.

<sup>2</sup> See Staff Legal Bulletin No. 20 (IM/CF) - “Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms” (Jun. 30, 2014), available at [http://www.sec.gov/interps/legal/cfslb20.htm#\\_ftnref1](http://www.sec.gov/interps/legal/cfslb20.htm#_ftnref1).

- Steps for demonstrating that votes are cast in the best interest of clients;
- Suggestions on types of delegation arrangements between advisers and clients;
- Considerations when hiring Proxy Advisory Firms; and
- Clarification on an investment adviser’s ongoing responsibility for oversight of Proxy Advisory Firms.

Below is a summary of the SEC’s main expectations as well as respective examples of compliance controls for firms to consider as outlined in the Staff Legal Bulletin.

- Examine the competency of those retained to assist with proxy voting. Assess how the Proxy Advisory Firm ensures that recommendations are based on current and accurate information and inquire about the process to be used by the investment adviser if a concern arises.
  - Compliance Control Example: *“... 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.”*
- Adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the Proxy Advisory Firm in order to ensure that the investment adviser, acting through the third party, continues to vote proxies in the best interests of its clients.
  - Compliance Control Example: *“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 client.”*
- Ascertain that the Proxy Advisory Firm has the capacity and competency to adequately analyze proxy issues, including the ability to make voting recommendations based on materially accurate information.
  - Compliance Control 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.”*

## Due Diligence Tips

While an investment adviser may employ a Proxy Advisory Firm to assist with proxy voting, this does not relieve the firm of their fiduciary obligations and responsibilities to clients. To fulfill its fiduciary duties, the investment adviser must conduct adequate due diligence and oversight of the vendor's activities. As discussed above, for those advisers that employ Proxy Advisory Firms, the SEC expects them to take reasonable steps to ensure the adequacy of the Proxy Advisory Firm's policies and procedures, and to determine whether conflicts of interest are properly identified, addressed, and disclosed.

To help accomplish these mandates, investment advisers should obtain the following information from Proxy Advisory Firms, both initially and ongoing thereafter:

1. Identity of all business functions and affiliations
2. Description of business relationships with issuers, including compensation arrangements
3. Steps and controls utilized to determine risks and conflicts
4. Documentation on identified conflicts and steps taken for elimination or mitigation
5. Confirmation on the review frequency of policies and procedures
6. Internal controls to adhere to issuer "black out" periods
7. Noted deficiencies by internal and external audits/exams
8. Disclosures provided to clients and prospects
9. Types of barriers implemented to prevent flow of voting information between conflicting departments
10. List of any factual errors that occurred within the last 12 months

Additionally, investment advisers should obtain written representations from Proxy Advisory Firms confirming that no conflicts were known during the voting of each proxy.

For more information, including additional compliance control suggestions and regulatory considerations in relation to proxy voting and the use of Proxy Advisory Firms, please call us at (619) 278-0020. Thank you.

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