SEC ADOPTS RULES REGARDING PROXY VOTING BY INVESTMENT ADVISERS

On January 31, 2003 the U.S. Securities and Exchange Commission (the "SEC") adopted new rules under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), that require each adviser registered under the Advisers Act that exercises proxy voting authority over client securities to:

- adopt and implement written policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of its clients;
- describe these proxy voting procedures to its clients and to provide copies of the proxy voting policies and procedures to clients upon request; and
- disclose to its clients how they may obtain information on how the adviser voted their proxies.

The new rules are contained in SEC Release No. IA-2106; the adopting release is available at http://www.sec.gov/rules/final/ia-2106.htm.

Adviser Fiduciary Duties — Care and Loyalty

Under the Advisers Act, an adviser is a fiduciary of its clients, owing them duties of care and loyalty with respect to all services provided by the adviser on their behalf, including the voting of proxies. The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies. The duty of loyalty requires that the adviser vote the proxies in a manner consistent with the best interests of the client.

A number of potential conflicts of interest may exist between an adviser and its clients with the potential to affect the voting of proxies. For example, the adviser or affiliates of the adviser may provide advisory, brokerage, underwriting, banking or insurance services to a company that is soliciting proxies. Failure to vote proxies in management's favor may harm the adviser's (or affiliate's) relationship with the company.

The new rules discussed below are designed to prevent conflicts of interest between an adviser and its clients from affecting the manner in which they vote clients' proxies.

Proxy Voting Policies and Procedures

Under new Rule 206(4)-6, advisers that exercise voting authority with respect to client securities must adopt proxy voting policies and procedures. The policies and procedures must:

- be in writing;
- be reasonably designed to ensure that the adviser votes proxies in the best interest of clients; and

- describe how the adviser addresses material conflicts between its interests and client interests with respect to proxy voting.[1]

The new rules do not mandate specific policies or procedures that must be adopted by advisers. The rule is designed to provide advisers with flexibility to adopt policies and procedures that are suitable to their businesses and tailored to nature of the conflicts they face. In the adopting release, the SEC acknowledged that some advisers (including many small firms that are not part of a larger financial services group) may face few or no material conflicts of interests. In these instances, the policies and procedures may be very simple.[2] Advisers that regularly encounter material conflicts of interest with their clients will be expected to adopt and implement more detailed and substantial policies and procedures.

Voting of Client Proxies. As a preliminary matter, the adviser's procedures should address the manner in which it fulfills its duty of care obligations to monitor corporate actions and vote client proxies. Although not a requirement of the new rules, an adviser may consider incorporating into its procedures a designation of the personnel responsible for (i) monitoring corporate actions, (ii) making voting decisions, and (iii) the timely submission of proxy votes.

Resolving Conflicts of Interest. The adviser's policies and procedures under the rule must address how the adviser resolves material conflicts of interest with its clients. Here again, the new rules allow for flexibility in crafting these policies and procedures. In the adopting release, the SEC indicated that an adviser's policy of providing meaningful disclosure to clients of conflicts and obtaining client consent before voting proxies would satisfy the rule's requirements. Alternative policies and procedures short of disclosure and consent may also meet the rule's requirements. However, in the absence of client disclosure and consent, the adviser (i) must take other steps designed to ensure that the proxies are voted in the clients' best interest and (ii) must be prepared to demonstrate that its procedures resulted in a decision to vote the proxies based on the clients' best interest and was not the product of the conflict. The SEC has indicted that it will review the effectiveness of an adviser's policies and procedures based on how well they insulate the decision on how to vote client proxies from the conflict.

An adviser designing policies and procedures to comply with the new rules might consider the following:

- a procedure by which the adviser votes proxies according to a pre-determined voting policy that involves little discretion on the part of the adviser[3];

- a procedure by which the adviser votes proxies according to a pre-determined voting policy based upon the recommendation of a third party[4]; or

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[1] Advisers Act Rule 206(4)-6.

[2] Although, in no event will mere boilerplate suffice. See Release No. IA-2106 (January 31, 2003) at fn 16. ("Procedures that merely declare that all proxies will be voted in the best interests of clients would not be sufficient to meet the rule's requirements.")

[3] An example of such a situation would be an adviser voting proxies against a management proposal to amend the company's articles of incorporation to include "poison pill" anti-takeover provisions where the adviser's proxy voting policies conclude that the existence of "poison pills" generally works against the interest of a company's shareholders in achieving a market-efficient stock price. However, this procedure would be of little utility in situations where the application of the voting policy to the matter presented is ambiguous.

- a procedure by which the client engages a party other than the adviser to determine how the proxies should be voted.

Disclosure of Policies and Procedures

Under Rule 206(4)-6, advisers must describe their proxy voting policies and procedures to their clients and must, upon request, provide a copy of their polices and procedures to clients. The description should be a concise summary of the policies and procedures and it should indicate that a copy of the adviser's policies and procedures is available upon request. Advisers may make this disclosure by any means as long as the disclosure is not "buried" in a longer document. It is anticipated that most advisers will meet this disclosure requirement:

- by including the description of proxy voting policies and procedures with a periodic account statement;
- delivering the disclosure in a separate mailing; or
- by including the disclosure in the adviser's brochure required by Rule 204-3 and mailing the revised brochure together with a letter identifying the new disclosure to existing clients.

Voting Information Disclosure

Rule 206(4)-6 also requires advisers to disclose to their clients how they can obtain information from the adviser about how their securities were voted. We anticipate that most advisers will find that it is most efficient to include this information in a revision to their Rule 204-3 brochures. An adviser that does not already have such procedures in place should adopt procedures for supplying voting information to their clients upon request.

Recordkeeping

In connection with new Rule 206(4)-6 regarding proxy voting policies and procedures, the SEC has also amended its recordkeeping rules[5] to require that advisers retain:

- their proxy voting policies and procedures;
- proxy statements received regarding client securities;
- records of votes cast on behalf of clients;
- written client requests for proxy voting information and written adviser responses to any client request (whether oral or written) for proxy voting information; and
- any documents prepared by the adviser material to making a voting decision or memorializing the voting decision.

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[4] Institutional Shareholder Services is an example of a third party that might be utilized under this type of policy.
[5] Advisers Act Rule 204-2.

With respect to proxy statements received regarding client securities, an adviser may rely on the SEC's electronic EDGAR system rather than maintaining its own copies. Also, if the adviser utilizes a third party (such as a proxy voting service) in voting proxies for client securities, it may rely on the proxy statements and voting records of maintained by the third party (as long as the adviser obtains an undertaking from the third party to provide copies of the documents promptly upon request). The records described above (other than proxy statements filed on EDGAR or records maintained by third parties) must be maintained in an appropriate office of the adviser for two years; after two years the records must be kept for an additional three years but may be moved to an "easily accessible place".

Required Compliance Dates

Advisers must comply with new Rule 206(4)-6 and the amendments to the recordkeeping rules by August 6, 2003. By this date, advisers must have adopted and implemented the required proxy voting policies and procedures, provided clients with a description of these policies and procedures and disclosed to clients how they may obtain information from the adviser about how the adviser voted the clients' securities.

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