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Throwing Out the Baby with the Bathwater—The Dangers of Inadvertently Selling Attorney-Client Privilege in Sale Transactions

Tracy A. Romano Associate

Imagine you own a company that you want to sell. You hire lawyers, find a buyer and sell the company. The transaction is structured as a merger, the merger agreement is governed by Delaware law and the entities involved are Delaware entities. Sometime after closing, the buyer sues you for fraudulent inducement. You are horrified to learn that the buyer found, on the company's computer system, communications between you and your lawyers regarding the merger and wants to use those communications as evidence against you in the litigation. You quickly go to court, asserting attorney-client privilege, and request that the court prevent the buyer's use of those communications between you and your lawyers during the litigation.

You lose.

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The court explained that . . . the attorney-client privilege and, therefore, the attorney-client privilege, as with all other privileges of the target company, passed to the surviving corporation by operation of law.

What Went Wrong?

The scenario described above mirrors the facts of a case heard by the Delaware Chancery Court in the case *Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLP* (Del. Ch. Nov. 15, 2013) (Great Hill).

The court examined the section of the Delaware General Corporation Law (the DGCL) pertaining to the rights of constituent and surviving corporations following a merger (Section 259), and determined that the plain language of the statute provides that, among other things, after a merger, "all property, rights, *privileges*, powers and franchises" (emphasis added) become the property of the surviving corporation. The court explained that one of the most obvious examples of privilege is the attorney-client privilege and, therefore, the attorney-client privilege, as with all other privileges of the target company, passed to the surviving corporation by operation of law. This is not, however, as straightforward as it sounds.

What Could Have Been Done to Prevent This?

The court made it clear in its opinion that parties can contractually negotiate to prevent attorney-client privilege from transferring to the surviving corporation of the merger. In other words, parties can exclude attorney-client privilege from those privileges that pass to the surviving corporation by operation of law.

If I Am the Seller, What Do I Need to Put into a Contract to Exclude Attorney-Client Privilege From the Sale?

While the court cited examples of merger agreements that contained provisions excluding attorney-client privilege from a sale, it did not provide any specific language that has to be included in merger agreements in order to be effective.

From the perspective of sellers, merger agreements should explicitly state that all attorney-client privileged communications relating to the transaction are retained by the sellers and, if applicable, their stockholder representative. Some sellers may try to reach beyond communications relating to the transaction itself and provide that all attorney-client privileged communications are retained by the sellers. This will often be unacceptable to buyers because, as buyers of the company, they will want to purchase not only the assets, but the information surrounding the assets.[1] In drafting the provision, sellers may refer to Section 259 of the DGCL, in order to be clear that the section will not apply to attorney-client privileged communications. An example of the proposed seller-friendly language addressing this issue is set forth below (such

1 For example, if the assets include a piece of real property that is the subject of an environmental claim, the buyers would want to own the privileged communications pertaining to such claim. If, instead, the privilege applies to the communications about disclosure of that claim for purposes of the disclosure schedule for the transaction, the seller might argue that this privilege should be retained by the seller's stockholders.

language, the Great Hill Language). Defined or capitalized terms should, of course, be conformed to the definitions elsewhere in the merger agreement:

> "Parent and Merger Sub acknowledge and agree that [insert name of law firm] ("Law Firm") has represented the Company [over a period of time including][2] in connection with the negotiation, preparation, execution and delivery of this Agreement and the consummation of the transactions contemplated hereby, and that the Stockholders, their affiliates and their respective partners, officers, directors, employees and representatives (including the Stockholder Representative) (each a "Stockholder Group Member" and collectively, the "Stockholder Group Members") have a reasonable expectation that Law Firm will represent them in connection with any litigation, claim, obligation or other dispute (each a "Claim") involving any Stockholder Group Member, on the one hand, and Parent, Merger Sub, the Surviving Corporation and/or any of their respective affiliates and representatives (each a "Parent Group Member" and collectively the "Parent Group Members"), on the other hand, arising under this Agreement or the transactions contemplated hereby.[3] Parent, the Company and Merger Sub hereby, on behalf of themselves, the Surviving Corporation and the other Parent Group Members, irrevocably acknowledge and agree that any attorney-client privilege arising from communications prior to the Effective Time between any one or more officers, directors, employees or stockholders of the Company, on the one hand, and Law Firm, on the other hand, [whether related to this Agreement, the transactions contemplated hereby, or otherwise,][4] shall be excluded from the property, rights, privileges, powers, franchises and other interests that are possessed by and/or vested in the Surviving Corporation at the Effective Time pursuant to Section 259 of the Delaware General Corporation Law or otherwise, that such attorney-client privilege shall be deemed held by the Stockholder Representative for the benefit and on behalf of the Stockholder Group Members, and that no Parent Group Member shall have any right to waive any such attorney-client privilege at any time after the Effective Time."

Are There Any Other Actions Sellers Should Take in Response to the Great Hill Decision?

Retaining Possession of Privileged Information

The buyer in Great Hill also argued, alternatively, that seller's actions (i.e., allowing the privileged information to remain with the target company post-closing) amounted to a waiver of attorney-client privilege. The seller asserted in response that waivers of attorney-client privilege are not lightly inferred by the courts. Since the court decided that the attorney-client privilege passed to the buyer by operation of law, it did not need to decide whether attorney-client privilege was waived by the seller; however, the court did point

2 Include only if applicable.

3 This first sentence references the relationship between the law firm and the selling stockholders, which gives context to both this provision as well as the provision ensuring the continued legal representation of the selling stockholders by the law firm post-closing, discussed below.

4 As discussed above, an attempt to reach privileged communications unrelated to the transaction may be problematic to the buyer.

out that the seller did not take "any action to ensure that those attorney-client communications did not pass to the surviving corporation in bulk and remain in the surviving corporation's full possession and control *for an entire year*." The court classified these inactions by seller as a "lengthy failure to take any reasonable steps to ensure the Buyer did not have access to the allegedly privileged communications."

In response to the court's observation, sellers should consider taking measures to make as clear as possible that privileged communications are not available to the buyers post-merger. For example, sellers should consider segregating and then removing communications between the lawyers and the sellers from the company's servers before closing. Sellers could provide in the merger agreement that the sellers are entitled to remove these communications (and keep them post-closing) and that they own the property rights to the privileged information. There are, however, practical problems that will probably make it impossible to be complete in this segregation and removal, even if buyers were agreeable.

Sellers should consider taking measures to make as clear as possible that privileged communications are not available to the buyers post-merger.

For example, even if all the privileged email communication is kept in folders, there will still likely be voicemails and archived copies of emails still left on the surviving corporation's servers or other computer systems following closing. Because of this logistical hurdle, sellers may also provide in the merger agreement that the buyers expressly disclaim the right to assert a waiver of attorney-client privilege solely due to the fact that copies of privileged information have been left in the possession of the target company post-closing. An example of the proposed seller-friendly language clarifying that information in the hands of the Seller Stockholder Group can be retained and providing a disclaimer of a right to seek a waiver is set forth below:

> "To the extent that files of the Law Firm in respect of its engagement by the Stockholder Group Members constitute property of the Surviving Corporation, only the Stockholder Group Members shall hold such property rights. Furthermore, Parent, the Company and Merger Sub hereby, on behalf of themselves, the Surviving Corporation and the other Parent Group Members, irrevocably (i) acknowledge and agree that the Stockholder Group Members shall have the right to retain, or cause Law Firm to retain, any such documentation or information in the possession of Law Firm or such Stockholder Group Members at the Effective Time and (ii) disclaim the right to assert a waiver by any Stockholder Group Member with regard to the attorney-client privilege solely due to the fact that such information is physically in the possession of the Surviving Corporation after the Effective Time."

The sellers could also include a provision in the merger agreement that the buyer agrees not to voluntarily access any privileged information in the possession of the target company post-closing and/or obligate the buyer to deliver privileged information found by the buyer to the seller post-closing. These steps, like those described above, are in part an attempt to make clear to a court that there was no inadvertent waiver and that the sellers took as many steps as possible to remove access, legal or physical, from the buyer as to the privileged communications at closing. Buyers may, however, push back on any provisions that impose affirmative obligations on them post-closing, such as returning documents or promising not to access documents, as overburdensome.

Preventing Buyers from Waiving Sellers' Retained Attorney-Client Privilege Post-Closing

Sellers must be concerned about the possibility that buyers might waive the sellers' attorney-client privilege in their future dealings. The sellers may want to provide expressly in the merger agreement that the buyers and the surviving corporation agree not to disclose any attorney-client privileged information in litigation arising after the effective time of the merger between the buyers and any persons other than the sellers (and if such disclosure is required by judicial order, require prompt notification to the sellers and cooperation with the sellers to prevent disclosure). An example of the proposed seller-friendly language addressing this issue is set forth below:

> "In the event that any Claim arises after the Effective Time between any Parent Group Member and a Person other than a Stockholder Group Member, such Parent Group Member shall not disclose any documentation or information that is subject to an attorney-client privilege referenced in [*insert clause that includes the Great Hill Language*] above without the prior written consent of the Stockholder Representative; provided, that if such Parent Group Member is required by judicial order or other legal process to make such disclosure, such Parent Group Member shall promptly notify the Stockholder Representative of such requirement (without making disclosure) and shall provide the Stockholder Representative with such cooperation and assistance as shall be necessary to enable the Stockholder Representative to prevent disclosure by reason of such attorney-client privilege. This Section [●] is for the benefit of the Stockholder Group Members and Law Firm and such Persons are intended third-party beneficiaries of this Section [●]."

Ensuring Continued Legal Representation Post-Closing

While not addressed in Great Hill, another related issue sellers should keep in mind is the ability of their (and the target company's) law firm to continue to represent them in post-closing claims relating to the merger. A single law firm often represents the target company and the sellers; even where that is not the case, the law firm representing the target company is often in the best position to represent the selling stockholders in post-closing litigation. While it would be possible for the sellers to engage another law firm to assist with post-closing claims, getting the new law firm up to speed on the transaction would be time consuming and costly. Post-closing, a buyer could however assert that there is a conflict of interest with the law firm's continued representation of the seller. To avoid this, sellers can include in the merger agreement express permission from the buyers for the law firm to represent the sellers post-closing in claims arising out of the merger. An example of the proposed seller-friendly language addressing this issue is set forth below:

> "Parent, the Company and Merger Sub hereby, on behalf of themselves, the Surviving Corporation and the other Parent Group Members, irrevocably consent to Law Firm's representation after the Effective Time of any Stockholder Group Member in any Claim arising under this Agreement or the transactions contemplated hereby, and consent to and waive any conflict of interest arising therefrom."

In addition to ensuring that the same law firm can represent the sellers post-closing, sellers may also want to include in the merger-agreement language a provision whereby the buyers expressly consent to disclosure by the law firm to the selling stockholders of information obtained during the course of the law firm's representation of the target company, regardless of whether the information was disclosed prior to or after the Effective Time and regardless of whether the information is subject to any attorney-client privilege or confidentiality obligation to the Company. This way, there is no ambiguity over what the law firm can disclose to the selling stockholders. An example of the proposed seller-friendly language addressing this issue is set forth below:

> "Parent, the Company and Merger Sub hereby, on behalf of themselves, the Surviving Corporation and the other Parent Group Members, irrevocably consent to the disclosure by Law Firm to any Stockholder Group Member of any documentation or information obtained by Law Firm during the course of its representation of the Company or any affiliate of the Company prior to the Effective Time, whether related to this Agreement, the transactions contemplated hereby, or otherwise, whether or not such disclosure is made prior to or after the Effective Time and whether or not the documentation or information disclosed is subject to any attorney-client privilege or confidentiality obligation to the Company, any affiliate of the Company or any other Person."

The Great Hill Decision Seems Like a Big Deal for Sellers. Why Didn't My Lawyers Advise Me to Retain Attorney-Client Privilege in the Past?

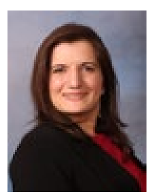
Before Great Hill, the case that was relied upon for the issue of attorney-client privilege in a merger transaction was the New York Appellate Court case *Tekni-Plex, Inc. v. Meyner and Landis* (N.T. Ct. App. No. 185, Oct. 22, 1996) (Tekni-Plex). In Tekni-Plex, the court held that, while pre-closing attorney-client communications regarding general business operations did pass to the surviving corporation, pre-closing privileged communications about the merger negotiations did *not* pass to the surviving entity or the buyer, and instead, remained with the seller. The court in Great Hill distinguished the Tekni-Plex case, concluding that the TekniPlex decision was based on policy reasons related to the court's analysis of New York attorney-client privilege law, and not Section 259 of the DGCL.

Will Other Jurisdictions Follow Great Hill?

There is no way of knowing how a court in another jurisdiction will rule on whether or not, absent a contractual provision to the contrary, attorney-client privilege passes to the surviving corporation in a merger. It is important to note that attorney-client privilege may be viewed as an evidentiary matter to which the court will apply its state law, and not the law of the corporation's domicile or the governing law of the contract. In other words, if the acquired corporation is incorporated in Delaware and the merger agreement is governed by Delaware law, but privilege is asserted in a case brought in Minnesota, the court may apply Minnesota law to resolve the privilege issue.

Conclusion

Great Hill teaches us that sellers cannot assume that, absent a specific provision, attorney-client privilege remains with them post-closing. It is important, on a going-forward basis, that clients focus on this issue. Buyers should expect this issue to be raised in a sell-side draft agreement or response and will want to consider their policies regarding this issue. Sellers may include in transaction documents provisions designed to provide that the stockholders retain attorney-client privileged communications post-closing. Sellers also may seek to provide contractually that control of any materials is in the hands of the seller stockholder group—not the buyer—post-closing, and that the buyer disclaims the right to assert a waiver to those materials.



Tracy A. Romano
Associate
tracy.romano@kayescholer.com
+1 212 836 8859

Delaware Chancery Court Offers Guidance on the Negotiation of Contingent Payment Provisions and Post-Closing Actions Affecting Payouts

Diane Holt Frankle *Partner*

A recent Delaware Chancery Court case decided by Vice Chancellor Glasscock offers practical guidance to both buyers and sellers who are negotiating "earnout" or other contingent payment provisions in acquisition agreements. These provisions are quite common and allow buyers and sellers to "bridge the gap" when the company being acquired has bright prospects but the buyer is not willing to pay unless the prospects are realized. Not surprisingly, the sellers often expect a payout under the earnout provision, and litigation often ensues if a payout becomes difficult or impossible because of buyer actions or failure to take agreed-upon actions after the closing. In AMERICAN CAPITAL ACQUISITION PARTNERS, LLC V. LPL HOLDINGS, INC. (Del. Ch. Feb. 3, 2014) (*American Capital*), Vice Chancellor Glasscock confronts the application of the implied covenant of good faith and fair dealing to the parties' agreement and negotiations.

In *American Capital*, the plaintiffs were the former owners and officers and directors of a business providing technology and open architecture investment management solutions for trust departments of financial institutions. The buyer provided an integrated platform of technology, brokerage and investment advisory services to financial advisors, and acquired the target company to expand services and support that could be provided to trust departments of its existing customers. The stock purchase agreement (SPA) included an earnout based on 2013 gross margin with up to a maximum of $15 million in additional payouts if prescribed targets were achieved. Employment agreements provided additional compensation to three executives of the target if the target hit revenue targets in 2011, 2012 and 2013.

The case was before Vice Chancellor Glasscock on a motion to dismiss the complaint, which asserted claims for breach of the implied covenants of good faith and fair dealing, breaches of contract, fraudulent inducement and fraud. Plaintiffs asserted two arguments to support a finding of breach of the implied covenant of good faith and fair dealing:

1. Because of the contingent purchase price provision in the SPA and the revenue targets in the employment agreements, the buyer had an affirmative obligation to make technological adaptations to provide custody services to its customers, thus permitting the company to hit those targets; and
2. Buyer breached the implied covenant by shifting employees and customers from the target to another affiliate to intentionally impede the target's ability to generate revenue and thereby avoid the earnout and compensation payments otherwise due.

Vice Chancellor Glasscock explained that the implied covenant of good faith and fair dealing "serves a gap-filling function by creating obligations only where the parties to the contract did not anticipate some contingency, and had they thought of it, the parties would have agreed at the time of contracting to create that obligation." He makes it clear that this implied covenant does not give a plaintiff a license to rewrite the contract just because the plaintiff "failed to negotiate for protections that, in hindsight, would have made the contract a better deal." In applying this principle to the two arguments made by plaintiff and the facts of this case, the Vice Chancellor gives future contracting parties some useful guidance.

The Failure of the Buyer to Take Actions Anticipated by the Parties' Discussions, but not Included as an Affirmative Covenant under the Written Agreement, Is Not a Breach of Implied Covenant of Good Faith and Fair Dealing

First, the Vice Chancellor addressed the plaintiff's argument that there should be an implied duty for the buyer to make technological adaptations to integrate the custody services being offered by the target. This issue was apparently discussed by the parties at length at the time the SPA was being negotiated. Indeed, plaintiffs claim that they chose this bidder because of expected synergies from the custody services, and had discussed the fact that the computer-based system used by the buyer to provide custodial services would require adaptations. Apparently, plaintiffs did diligence on the buyer's data servicing capabilities.

Plaintiff could have added a covenant requiring the buyer to make those adaptations, or to use its best efforts to do so. Plaintiffs chose not to insist on such a covenant, apparently lulled by oral promises by the buyer during negotiations that the adaptations would be made. It turned out that the systems could not be easily adapted in a way compatible with the target's business model. Post-closing, the buyer had an incentive not to make the adaptations, whether for cost reasons or to avoid the contingent compensation payments.

Lesson number one from this case is that if the achievement of earnout targets depends on some future action being taken by the buyer, and the parties acknowledge that some future action will be required, then sellers must negotiate a covenant obligating such future action.

Plaintiffs argued that it was "anticipated and assumed . . . that buyer would modify its system . . . to permit generation of net revenues by the target," and that failure to make the technological adaptations "frustrated the purpose and violated the spirit" of the agreements. Vice Chancellor Glasscock had no sympathy for plaintiff, however, holding that the integration clause defeated plaintiff's argument. Bottom line, the contract as written is the entire agreement on all negotiated points. The Vice Chancellor thus makes clear that where an issue is raised and discussed, the implied covenant of good faith and fair dealing will not operate to add a provision the parties could have added at the time, just because one side wishes the provision had been included.[1]

1 The Vice Chancellor also dismisses an argument that the covenant to calculate fees necessarily obligated the entity to generate fees, and thus to provide the adaptation. The language only obligates the buyer to calculate revenue if such revenue exists, and in no way obligates the buyer to generate revenue.

For a seller negotiating a contingent payment, lesson number one from this case is that if the achievement of earnout targets depends on some future action being taken by the buyer, and the parties acknowledge that some future action will be required, then sellers must negotiate a covenant obligating such future action, and provide third-party beneficiary language for the beneficiaries of the earnout or compensation provisions.

Affirmative Action to Thwart Benefit of the Bargain Can Be a Breach of the Implied Covenant of Good Faith and Fair Dealing

Second, plaintiffs argued that the buyer "pivoted" sales from the acquired company to another separate subsidiary. The target was allegedly told to stand down from existing relationships and the buyer allegedly caused the target to stop servicing clients and waived fees owed by seller's existing clients. According to the complaint, the buyer reassigned some of the acquired company's employees to the other subsidiary, and the acquired company's staff was told to "discourage prospective clients and current clients from using [target's] services."

These affirmative actions by the buyer were viewed very differently by the Vice Chancellor than the failure to take an action the buyer had not promised to take under the agreements discussed above. The Vice Chancellor concluded that these allegations were sufficiently specific to support a claim that the defendants breached the implied covenant of good faith and fair dealing. The court made clear his view of the equities based on the allegations before him. He observed that the contingent purchase price provision in the SPA, the compensation targets in the employment agreements and the provision regarding the calculation of revenue to determine payments under the two agreements demonstrate that "had the parties contemplated that the Defendants might *affirmatively act to gut [the acquired company] to minimize payments under the SPA and employment agreements*, the parties would have contracted to prevent" the buyer from shifting revenue from the acquired company to the buyer's other subsidiary.

Defendants also argued that plaintiffs had failed to adequately plead damages, since they had not demonstrated that, but for defendants actions, the acquired company would have hit the targets that trigger additional payments under the earnout or the employment agreements. The Vice Chancellor rejected this argument as well, noting that plaintiffs had pleaded that they had "forewent offers from other potential buyers for larger upfront payments." Further, the court notes that it is at least a reasonably conceivable inference that had the buyer not interfered with the acquired company's ability to generate revenue, it would have reached its revenue targets sufficient to trigger payments under the SPA and the employment agreements.

Buyers can take away practical guidance here which is important to consider in negotiating earnout provisions and in operating a business subject to such contingent payment provisions post-closing. First, it is possible to negotiate affirmatively for a right to modify personnel and operations of the target, although such a right is often limited by a covenant to act in good faith not to prevent the achievement of the contingent payment targets. In any case, buyers need to keep in mind that affirmative actions by a buyer that appear to be attempts to thwart the benefit of the bargain may give rise to a claim of a breach of the implied covenant of good faith and fair dealing.

The allegations here suggest the motivation of the buyer was not simply to run its business efficiently, but rather was affirmatively to prevent the plaintiffs from achieving the earnout. The Delaware Chancery Court, sitting in equity, will not be sympathetic to a party's actions to thwart the other party from the negotiated benefit of its bargain.[2]

On similar grounds, the Vice Chancellor also denied the motion to dismiss a breach of contract claim that the provision requiring the parties to operate the acquired company in a manner allowing the measurement of the acquired company's revenue had the intent to protect plaintiffs' right to payments under both the SPA and the employment agreements. He held that the purpose of the clause was to provide a mechanism to determine if plaintiffs are entitled to additional compensation, and that the "alleged attempt to shift business from [the acquired company] thwarts the [buyer's] ability to calculate revenue properly ascribed to" the acquired company.

It is worth noting that in the first instance above, the Vice Chancellor found no breach of the covenant of good faith and fair dealing where buyer had no obligation to take an action and indeed took no action, despite a request by plaintiffs to do so. In the second instance, he found a breach where the *buyer took affirmative actions* that did not appear to be expressly permitted under the agreement and which seemed to run counter to the benefit of the bargain struck by the parties.

Fraudulent Inducement Claims Cannot Survive Broad Non-Reliance Clauses; Fraudulent Representations Must Be Specific to Permit Reasonable Reliance

Plaintiffs also brought claims for fraudulent inducement, arguing that they relied on conversations with management about the abilities of the buyer's team to integrate technology and their plans to do so for the acquired company. Plaintiffs argue that buyers concealed their technical limitations, knowing plaintiffs would rely on public statements. These allegations are claims of "extra-contractual statements that amount to fraud."

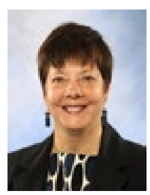
A fraudulent inducement claim falls in the face of a broad non-reliance clause. Plaintiffs had two separate contracts, the SPA, which had an anti-reliance clause, and employment agreements which had integration clauses, but no anti-reliance clauses. With respect to the SPA, plaintiffs attempted to avoid the very broad non-reliance clause by arguing that as a technical matter the clause did not bar reliance on representations made by a subsidiary not included in the definition of buyer under the SPA. In finding that the SPA non-reliance clause was a bar to the fraudulent inducement claim, the Vice Chancellor observed that "no reasonable person would agree to such a clause in the belief that an action based on representations could survive." Bottom line, these non-reliance clauses will be enforced and they mean what they say.

2 Interestingly, this topic of the right of buyer to make changes to the acquired company post-closing did not appear to come up in the negotiations in the case at hand, or the integration clause might have operated to prevent the claim; this is not so surprising, however. Many contingent payment provisions are silent on the buyer's right to modify operations, simply because the negotiation of an express right to modify operations at the buyer's discretion creates suspicion as to the buyer's motives.

As to the claim that plaintiffs were fraudulently induced to enter into the employment agreements, the court found that the plaintiffs failed to allege any affirmative statements or material omissions upon which plaintiff could have reasonably relied. The statements alleged with particularity did not affirmatively state the buyer's ability or intent to make technological adaptations for the target's benefit, but rather talked generally about capabilities and intent; from the facts alleged, plaintiffs appear to have simply made unfounded assumptions on the basis of generalities about buyer's capabilities and synergies. The lesson here is, again, that wishing will not make it so in commercial agreements. Thus, if expectations of future payout require the other party to take affirmative actions, the party expecting the payout has to provide expressly for the obligation.

Conclusion

Contingent payment provisions are here to stay. Parties should consider whether the payments can only be achieved if buyer takes some future actions and, if so, negotiate specific provisions governing those future obligations. Parties, however, should not assume that actions taken after closing that appear to thwart the very purpose of the contract will be permitted absent express contractual language permitting such actions. This case is also a very clear expression of the Delaware courts' continuing view that contracts mean what they say and should be enforced as written and negotiated.



Diane Holt Frankle
Partner
diane.frankle@kayescholer.com
+1 650 319 4518

Antitrust Guidelines for Small Deals

Jennifer B. Patterson Partner and *Claudia R. Higgins* Partner

In recent years, there has been an increase in the number of antitrust cases involving consummated transactions that were not subject to the premerger reporting requirements of the Hart-Scott-Rodino Act (HSR Act). Several recent post-closing merger challenges by the Department of Justice Antitrust Division (DOJ) and the Federal Trade Commission (FTC) illustrate this trend and demonstrate the government's willingness to scrutinize relatively small transactions to enforce the antitrust laws. Companies considering a transaction can avoid becoming entangled in these costly and drawn-out challenges—or at least effectively anticipate and prepare for them—by following a few guidelines.

Premerger antitrust analysis need not necessarily be lengthy or costly . . .

Three antitrust enforcement actions in January 2014 demonstrate that it is always wise to seek antitrust advice for any proposed transaction at an early stage—without regard for whether pre-merger notification is required—so that during negotiations, the parties can each make an informed judgment about the potential antitrust risk of the proposed transaction. The three cases, which are now object lessons for seeking early antitrust advice, are described in more detail below. Premerger antitrust analysis need not necessarily be lengthy or costly, particularly for a deal small enough that it need not be notified, and it should not cause delay if it is begun while the parties are conducting due diligence.

Antitrust Guidelines for Small Deals

Simply put, an antitrust lawyer will first look for indications that the parties to the potential transaction are each others' primary competitors (such as in each of the cases discussed below) or two of only a handful of competitors in a market, which would mean that there may be antitrust risk unless new entrants or smaller competitors would be readily able to ramp up as robust competitors after the acquisition. Similarly, if one of the merging companies is a supplier to the other company, and the transaction might foreclose competition at either the supplier or customer level, the transaction may raise antitrust risk as well. If neither of these factors is present, no further analysis would likely be necessary.

If further analysis is needed, the specific steps in most settings are straightforward:

- At the outset, an antitrust lawyer will review key strategic plan and marketing documents along with documents analyzing the proposed transaction in the context of the acquiring party's business. This review can be limited to a discrete set of documents of the type that would be submitted in an HSR filing.
- The attorney will typically also need to discuss day-to-day competitive decision-making with one or two knowledgeable business people to obtain further information about the company and other companies also in the industry, the markets in

which the companies compete, the parties' relative market shares and the purpose and expected effect of the transaction.

- In these discussions with business people, the attorney will also explore and assess the likelihood that customers, competitors or rival bidders may complain to the antitrust agencies, or that the merger may be depicted in the business press (which the agencies regularly monitor) as posing competitive concerns.

- The attorney can then advise the company of the possible antitrust risks of the deal. The company is then able to factor any risks into the terms of the deal or make an informed decision not to proceed.
- Most often, the antitrust analysis can be done by a two-person team of an antitrust partner and an associate, and it can take place while other due diligence activities are underway, so as not to delay the progress of the transaction.
- The antitrust attorneys will also counsel the company and its advisors about using shorthand descriptions of competition in the industry, which taken out of context may be problematic if an investigation by government antitrust enforcers later ensues. For example, in the *Bazaarvoice* and *St. Luke's* cases described below, the parties' own words were powerful evidence against their transactions, and alternative expressions may have been more accurate and less likely to provide a basis for challenging the transactions as anticompetitive.
- Antitrust counsel can also assess the risks and benefits of seeking agency review even though no HSR filing is required. While a DOJ business review letter or an FTC opinion obtained in this way may provide some comfort to the merging parties, such a request could lead to demands for further information from the agencies. Also, such a review does not preclude the agencies from challenging the merger post-closing. Nonetheless, in some circumstances, an advance approach to the antitrust agencies may be advisable.

This antitrust analysis could be conducted in a matter of days or a week or two, depending on the availability of the documents and key business people. To keep costs in line, an experienced associate could do the heavy lifting, with guidance from a partner.

Recent Cases

St. Luke's Health System/Saltzer Medical Group

On January 24, 2014, the US District Court for the District of Idaho found after a 19-day trial that St. Luke's, a healthcare system in Nampa, Idaho, violated the antitrust laws when it acquired Saltzer Medical Group, Idaho's largest independent, multi-specialty physician practice group, 13 months earlier in a transaction that did not require an HSR filing. In the suit filed jointly by the FTC and the Idaho Attorney General last March, the court found that the combined entity included 80 percent of the primary care physicians in Nampa and that the two providers were each others' "closest substitutes." Relying on the parties' own documents, the court found that the transaction was anticompetitive because it would increase health care costs by enabling the combined entity to (1) negotiate higher reimbursement rates from insurers that would be passed on to consumers and (2) raise rates for ancillary services such as X-rays. The court ordered St. Luke's to fully divest itself of Saltzer's physicians and assets and to take any other action needed to unwind the transaction. *St. Alphonsus Med. Ctr.-Nampa, Inc. v. St. Luke's Health Sys.*, 2014 U.S. Dist. LEXIS 9264 **6-8 (D. Id., Jan. 24, 2014).

Bazaarvoice/PowerReviews

On January 8, 2014, the US District Court for the Northern District of California ruled in favor of the DOJ after a three-week trial, finding that Bazaarvoice, the leading provider of Ratings and Reviews (R&R) platforms, violated the antitrust laws by acquiring its primary rival, PowerReviews, 18 months earlier in a transaction that did not require an HSR filing. The court found that PowerReviews was Bazaarvoice's "closest and only serious competitor" in the market for R&R platforms. The court rejected Bazaarvoice's argument that the relevant market was much broader and also included other social commerce products such as online forums, Q&A platforms, blogs and social networks amounting to a lot of dynamic actual and potential post-merger competition. *United States v. Bazaarvoice, Inc.*, 2014 U.S. District LEXIS 3284, *82 (N.D. Cal., Jan. 8, 2014). In finding against Bazaarvoice, the court gave substantial weight to internal documents stating the parties' expectation that the transaction would "eliminate" Bazaarvoice's primary competitor and reduce price erosion.

The relatively small investment in time and money in doing an antitrust analysis of a non-reportable deal should be weighed against the significant delay and expense of a post-closing investigation.

The court has yet to rule on the final remedy. The DOJ's proposed remedy would require Bazaarvoice to sell all of PowerReviews' assets. Bazaarvoice would also be required to provide syndication services to the divestiture buyer, to enable the buyer to develop its own customer base and syndication network. Bazaarvoice would further have to waive trade-secret restrictions for any of its employees hired by the buyer, to enable the buyer to leverage Bazaarvoice's post-merger research and development efforts. The DOJ maintains that its proposal is intended to compensate for the deterioration of PowerReviews' business caused by Bazaarvoice's failure to invest in research and development for the PowerReviews platform and its migration of customers away from the PowerReviews platform to its own product.

Heraeus/Minco

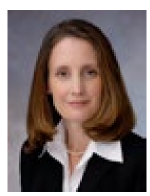
On January 2, 2014, the DOJ issued a complaint and accompanying settlement agreement in connection with the 2012 acquisition of Midwest Instrument Co. Inc. (Minco) by Heraeus Electro-Nite Co., LLC. The $42 million transaction was below the HSR filing threshold. Before the 2012 acquisition, Heraeus and Minco were each other's principal competitors in selling sensors and instruments used by steel producers to measure and monitor the temperature and composition of molten steel. Their market shares were 60 and 35 percent, respectively.

Under the settlement, Heraeus will divest two U.S. Minco facilities it acquired and integrated into its overall business more than a year ago. Second, it will be required to provide training and technical support to the new competitor under close regulatory oversight by the DOJ to ensure that the new competitor is effectively equipped to market and sell against Heraeus. Third, Heraeus will be required to waive its existing non-compete agreements with certain former employees. Finally, if Heraeus wishes to purchase any company in this market during the upcoming decade, it will be required to provide the DOJ detailed premerger notifications (and observe HSR-like waiting periods), without regard for whether the transaction would meet HSR filing requirements. The settlement is now pending approval in the United States Federal District Court for the District of Columbia.

Conclusion

The relatively small investment in time and money in doing an antitrust analysis of a non-reportable deal should be weighed against the significant delay and expense of a post-closing investigation. Unlike with premerger notifications, the DOJ and FTC have no regulatory deadlines within which to complete a post-closing investigation. Courts likewise have no deadlines within which to resolve a lawsuit challenging a consummated deal. Defendants also have a greater incentive to litigate longer and harder after a deal is closed and an acquired company has been integrated. A company could thus be subjected to a prolonged period of uncertainty, and then be required to unwind a deal years after it closed. In addition, because divestiture sales are ordinarily completed under significant pressure, they often cannot be expected to bring full value. Besides the cost of counsel (and likely economics experts as well), the time and resources a company spends dealing with an investigation or lawsuit could also lead to lost business opportunities or otherwise disadvantage the company compared to competitors. Finally, the post-settlement (or post-judgment, in a litigated resolution) remedies—such as long-term reporting requirements or waiver of noncompete or trade-secret provisions—impose continuing cost and burden on the company. All of these costs can sometimes near or exceed the value of the transaction itself.

In sum, a company should not be "penny wise and pound foolish" when it comes to assessing possible antitrust risks in a small, non-reportable deal.



Jennifer B. Patterson
Partner
jennifer.patterson@kayescholer.com
+1 212 836 8740

Claudia R. Higgins
Partner
claudia.higgins@kayescholer.com
+1 202 682 3653

Will Proxy Advisory Firms Be Reined In by the SEC? Some Takeaways from the SEC's Roundtable

Nicholas O'Keefe *Partner*

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Introduction

The SEC's Division of Corporation Finance held a roundtable (the Roundtable) on December 5, 2013 to discuss topics related to the growth of the proxy advisory industry and current issues relating to their services. The Roundtable was part of the SEC's review of whether reform of the industry is required and, if so, whether the reform should take the form of SEC rulemaking or guidance, or industry initiatives.[1] Roundtable participants included representatives from institutional investors, investment advisers, issuers, academia, law firms, consultants, associations and the two main proxy advisory firms in the US, Institutional Shareholder Services Inc. (ISS) and Glass Lewis & Co. LLC (Glass Lewis).

This article summarizes the Roundtable discussions and some of the takeaways for issuers.

Part I. Background

Growth of the Proxy Advisory Industry

The proxy advisory industry has grown significantly over the last three decades. The growth is frequently attributed in part to a significant growth in assets managed by institutional investors, such as investment advisers, pension plans, employee benefit plans, bank trust departments and mutual funds. It is also attributed to regulatory developments, such as:

- the 1988 "Avon Letter" issued by the Department of Labor;[2]
- passage of the Sarbanes-Oxley Act of 2002 (and the governance failures that led to it);
- the SEC's adoption in 2003 of Rule 206(4)-6 under the Investment Advisers Act of 1940 (the Advisers Act);[3]
- amendment in 2010 of NYSE Rule 452 so as to prohibit discretionary voting by brokers in director elections; and
- adoption of say-on-pay rules required under the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) (Dodd-Frank).

These regulatory developments have led to a more shareholder-centric model of governance with increased voting burdens for institutional investors. Proxy advisory firms have

1 The Roundtable followed a comprehensive 2010 SEC Concept Release on the proxy voting system, a portion of which focused on many of the issues discussed at the Roundtable.

2 Letter, dated February 23, 1988, from the Deputy Assistant Secretary of the Pension Welfare Benefits Administration to Mr. Helmuth Fandl, Chairman of the Retirement Board of Avon Products, Inc. The Avon Letter took the position that managers of employee benefit plan assets have a fiduciary obligation to vote proxies associated with shares owned by the plan.

3 Rule 206(4)-6 requires registered investment advisers to adopt policies and procedures reasonably designed to ensure that proxies are voted in the best interests of clients.

responded by providing institutional investors services regarding matters such as issue analysis and vote recommendation, vote execution, research on governance issues, and mitigation of conflicts of interest.

The two largest proxy advisory firms, ISS and Glass Lewis, collectively account for 97 percent of the market in the US.[4] ISS is a division of MSCI Inc., a US, publicly traded company, and is a registered investment adviser under the Advisers Act. Glass Lewis was formed in 2003, is owned by the Ontario Teachers' Pension Plan and is not a registered investment adviser under the Advisers Act.

Regulation of Proxy Advisory Firms

There are two principal ways that proxy advisory firms may be subject to federal securities laws: under federal proxy rules and under the Advisers Act.

The activities of proxy advisory firms fall within the broad definition of "solicitation" under the proxy rules. The furnishing of proxy voting advice is therefore generally subject to the information and filing requirements under the proxy rules. However, Exchange Act Rule 14a-2(b)(3) exempts the furnishing of proxy voting advice from most of the proxy rules[5] if certain criteria are met, including that the adviser discloses to the advice recipient any significant relationship with the registrant or its affiliates, or the proponent of any matter on which advice is given, and any material interest of the adviser in such matters.[6]

Activities of proxy advisory firms also expose them to regulation under the Advisers Act. A person is an "investment adviser" subject to regulation under the Advisers Act if the person, "for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."[7] In falling within this definition, proxy advisory firms are subject to the antifraud provisions under Section 206 of the Advisers Act, and owe fiduciary duties to their clients pursuant to Section 206, regardless of whether or not they are registered with the SEC.[8] Proxy advisers that are registered as investment advisers with the SEC[9] are subject to additional regulations, including

4 Roundtable comments by Harvey Pitt. Egan-Jones is a much smaller proxy advisory firm that was formed in 2002. Marco Consulting Group is another small player, which was established in 1988 to provide investment advisory services to Taft-Hartley plans. A fifth company, Proxy Governance, Inc., was formed in 2004 but ceased operations at the end of 2010.

5 Proxy voting advice remains subject to Rule 14a-9, which prohibits false or misleading statements or omissions of material facts.

6 Rule 14a-2(b)(3) also requires that (i) the advisor renders financial advice in the ordinary course of business; (ii) the advisor receives no special remuneration for furnishing the advice from any person other than a recipient of the advice and other persons who receive similar advice; and (iii) the advice is not furnished on behalf of any person soliciting proxies.

7 Advisers Act § 202(a)(11).

8 See *Transamerica Mortgage Advisers, Inc. v. Lewis*, 444 U.S. 11, 17 (1979).

9 Investment advisers are generally prohibited from registering if they have less than $25 million in assets under management, which for proxy advisory firms is typically the case. Investment advisers that are not registered with the SEC remain subject to regulation by states. Advisers Act § 203A(c) gives the SEC authority to exempt advisers from the registration prohibition in certain circumstances. Some proxy advisory firms register under Advisers Act Rule 203A-2(b), which is an exemption created by the SEC for pension consultants.

SEC filing obligations;[10] the requirement to adopt, implement and review various policies and procedures;[11] and certain record-keeping obligations.[12]

Part II. The Roundtable

The Roundtable first considered factors related to the growth, nature and impact of the proxy advisory industry. The Roundtable then considered two specific issues that have frequently been cited as concerns about the industry: conflicts of interest by proxy advisory firms and the accuracy and transparency of the vote recommendation process. One of the Roundtable participants also described an initiative in Europe to implement a comply-or-explain code of conduct for proxy advisory firms.

1. Growth, Nature and Impact of the Industry

Factors Contributing to the Use of Proxy Advisory Firms

The discussion regarding the growth of the proxy advisory industry focused on the types of market demand and regulatory changes described in Part I above.

Rule 206(4)-6: There was a recognition that Rule 206(4)-6 under the Advisers Act and the Egan-Jones[13] and ISS[14] "no-action" letters that followed it increased the demand for proxy advisory firm services. Repeal of the no-action letters is one potential tool available to the SEC if it determines that the influence of proxy advisory firms needs to be curtailed. Rule 206(4)-6 requires registered investment advisers to adopt policies and procedures reasonably designed to ensure that proxies are voted in the best interests of clients.[15] The no-action letters made it easy for investment advisers to satisfy this requirement by relying on the voting recommendation of proxy advisory firms. The Roundtable participants were divided as to whether the Rule itself, or the no-action

10 They must file a Form ADV with the SEC containing required disclosures, including information about conflicts of interest with advisory clients. Advisers Act Rule 203-1.

11 Advisers Act Rule 206(4)-7 requires them to adopt, implement and review policies and procedures that are reasonably designed to prevent the adviser or its supervised persons from violating the Advisers Act. Advisers Act § 204A requires them to establish, maintain and enforce policies and procedures reasonably designed to prevent the misuse of material non-nonpublic information.

12 Advisers Act Rule 204-2.

13 The Egan-Jones no-action letter indicated that a proxy advisory firm recommendation may cleanse a portfolio manager's conflict, and the fact that a proxy advisory firm may be compensated by the issuer for other services does not render the firm interested. Egan-Jones Proxy Services No-Action Letter (May 27, 2004).

14 The ISS no-action letter clarified that although portfolio managers had to inquire about the independence and procedures of proxy advisory firms, they could base their due diligence on generic conflict procedures and did not have to diligence specific voting issues. Institutional Shareholder Services, Inc. No-Action Letter (September 15, 2004).

15 Rule 206(4)-6 was adopted in the wake of allegations that Hewlett-Packard pressured Deutsche Asset Management to change its vote in connection with the HP-Compaq merger in 2002.

letters, were primarily to blame.[16] There is considerable doubt that merely retracting the no-action letters, without amending the Rule, would be an effective way of reversing the regulatory incentive to use proxy advisory firms that the Rule and no-action letters created.

Change in Governance Norms: Several participants expressed the view that changes in governance norms have created an increased demand for proxy advisory firms. For example, the large increase in the number of shareholder proposals, including as a result of the recent adoption of Dodd-Frank, increased the workload on portfolio managers. The shift to majority voting also contributed to the growth of the proxy advisory industry by expanding their influence. The shift allowed proxy advisory firms to influence a greater range of actions that had traditionally been within the responsibility of the board through the threat of "withhold" recommendations in director elections for noncompliant directors.

Market Demand: Several participants expressed the view that growth of the proxy advisory industry was driven more by the business demands of institutional investors than any regulatory incentive. One of the early ISS employees[17] stated that ISS only began providing proxy advisory services in the 1980s because prospective clients asked it to. The CEO of Glass Lewis stated that Glass Lewis had similar origins. Glass Lewis started operations in 2003, which was a time when institutional investors were starting to develop more robust proxy governance programs. They asked Glass Lewis for help developing and implementing these programs.

Data Regarding the Influence on Proxy Voting

One participant[18] cited data showing a significant correlation between ISS recommendations and vote outcome. The data was from studies that examined the roles of ISS vote recommendations in uncontested elections, and showed the following:

- for management proposals, a negative ISS vote recommendation is associated with about 13.6–20.6 percent fewer votes for management;
- for individual directors, a negative ISS vote recommendation translates to 14–19 percent fewer votes;
- for say-on-pay proposals, a negative ISS recommendation is associated with about 24 percent fewer votes.

16 Harvey Pitt, who was the SEC Chairman when the Rule was adopted, placed the blame on the no-action letters. Yukako Kawata, a law firm partner who advises investment advisers, expressed her view that it was Rule 206(4)-6 that forced portfolio managers into using proxy advisory firms. Ms. Kawata stated that the problem for investment advisers was that the Rule required them to adopt procedures that would address material conflicts of interest that could arise between the adviser and the client. The only viable option among those provided for under the Rule was to base the voting decision on the recommendation of an independent third party. Ms. Kawata said that prior to adoption of the Rule, investment advisers could analyze a conflict and conclude that despite the conflict, the proposed vote was nonetheless in the best interest of their clients. But it was no longer clear you could do that after the release came out.

17 Nell Minow, the first General Counsel of ISS.

18 Mark Chen, Associate Professor of Finance, Georgia State University.

The studies, however, are subject to varying interpretations.[19] While the data could indicate that big ISS clients simply outsourced their votes to ISS, other possible explanations include that ISS brought new information that influenced institutional investors, or that the views of ISS on corporate governance matters were consistent with the views of many of ISS' clients. This latter explanation is supported by the similarity among voting policies of many of the large institutions.[20]

The data also does not convey the complete story regarding the impact of proxy advisory firms. Some participants pointed out that it does not take into account the impact the proxy advisory firms have on boards of directors. Boards often factor the voting policies and potential reactions of ISS and Glass Lewis into their decision-making processes.

A representative of Glass Lewis provided data illustrating the extent to which Glass Lewis' clients follow the Glass Lewis recommendation. The representative said that of Glass Lewis' 900 voting institutional clients, 80 percent have custom voting policies. However, the degree of customization of these varies, and some may be very similar to the Glass Lewis policy. Of the clients that follow the Glass Lewis policy, these clients deviate from Glass Lewis' recommendations some of the time.[21]

The Use of Proxy Advisory Firms by Institutional Investors

Large Institutions: A representative of BlackRock gave a description of BlackRock's relationship with proxy advisory firms, which the representative viewed as comparable to that of other large institutional investors and investment advisers.[22] The following are some of the key points:

- ***Research and Data Services***: BlackRock uses proxy advisory firms primarily to synthesize and normalize the data, which is a very important service given that on some days BlackRock may be voting on as many as 30 meetings. The data is one of many inputs in the proxy voting decision.[23]

19 Both extremes of the debate were represented at the Roundtable. One view, by representatives of the shareholder-centric view of governance, was that the proxy advisory firms performed a valuable information gathering process for institutional investors, and were not responsible for the investors' votes. Evidence of their modest impact on voting impact on voting results was that only 72 companies had failed Say-on-Pay recommendations in 2013 through the time of the Roundtable. Representatives of the board-centric view of governance viewed ISS as controlling $4 trillion of votes without any economic interest in the shares.

20 Lynn Turner, Managing Director, LitiNomics, Inc., stated that the correlation of proxy advisory firm recommendations to voting outcomes turned on the fact that in order for management to get a majority vote in director elections, management needed to pick up votes from the top 15 asset managers. But if you look at the voting guidelines of these asset managers, they are all very consistent both with each other and with the recommendations of ISS and Glass Lewis. According to Mr. Turner, the consistency is due to having common views on corporate governance.

21 Katherine Rabin, CEO of Glass Lewis, gave the following statistics regarding voting by clients that follow the Glass Lewis voting policy at meetings from January 1, 2013 through June 17, 2013: (i) with regard to votes on the separation of chair and CEO, the clients overrode Glass Lewis' recommendation with respect to 21 percent of their shares; (ii) with regard to votes on majority voting, the clients overrode Glass Lewis' recommendation with respect to 11 percent of their shares; and (iii) with regard to votes on political contributions, the clients also overrode Glass Lewis' recommendation with respect to 11 percent of their shares.

22 Michelle Edkins, Managing Director and Global Head of Corporate Governance and Responsible Investments, BlackRock Inc. Anne Sheehan, Director of Corporate Governance, CalSTRS, expressed a similar view about the way CalSTRS uses proxy advisory firms.

23 BlackRock may also refer back to the proxy statement, speak to the company, talk with portfolio managers, or look at the track history with the company.

- ***Voting Decisions***: BlackRock makes its own decision how to vote on a case-by-case basis. The underlying voting principle is to achieve a voting outcome that best supports and promotes the economic interests of BlackRock's clients. Issuers should feel free to contact BlackRock directly with regard to voting issues.
- ***Voting Policies***: BlackRock does not defer to ISS or Glass Lewis voting policies. It has its market-specific policies for every major market in the world posted on its website. It reviews the policies every year and also works with proxy advisory firms on their policy formation processes, including with respect to developments from the prior proxy season and anticipated issues for the following proxy season.
- ***Choice of Proxy Advisory Firms***: BlackRock uses both ISS and Glass Lewis research globally and subscribes to additional market specific research in those markets where it exists.
- ***Voting Platform***: BlackRock uses ISS to help implement its voting, which is administratively challenging given the large number of US and international shareholder meetings.[24]

The BlackRock representative expressed a view that institutional investors could address misinformation about the investors' use of proxy advisory firm services through measures such as:

- posting on their websites information about how the investors use the investors' policies, how they use the services of ISS and Glass Lewis, and what in-house resources the investors have; and
- including high-level summary statistics of voting patterns in Form N/PX filings

Small Institutions: According to a representative of the Investment Adviser Association, smaller investment advisers tend to rely more heavily on the research and recommendations of proxy advisory firms.[25] However, they retain ultimate fiduciary responsibility for proxy voting and the ability to override the recommendations of the proxy advisory firms. There are also thousands of investment advisers that do not use proxy advisory firms at all.

Institutional Investor Oversight of Proxy Advisory Firms: There was a general recognition that investment advisers have a duty to exercise due diligence in selecting a proxy advisory firm and voting policies, as well as an obligation to exercise oversight of their performance. The large institutions have the resources to exercise greater oversight. For example, according to the BlackRock representative, BlackRock participates in ISS policy reviews, provides feedback to ISS when it disagrees or sees errors in ISS' analyses, annually reviews ISS' performance on operational matters, reviews ISS conflicts to see they are appropriately mitigated and considers ISS performance enhancements for the upcoming year.

24 BlackRock votes at about 3,700 company meetings a year in the U.S., and about 15,000 globally.

25 Karen Barr, General Counsel of the Investment Advisor Association, stated that there are almost 11,000 investment advisers registered with the SEC, and more than half of them have ten or fewer employees. The 99 largest investment advisers, which manage $100 billion or more in assets, represent greater than 50 percent of aggregate assets managed by all investment advisers.

Competition among Investment Advisory Firms

There are significant barriers to entry in the proxy advisory industry, according to the former President and COO of Proxy Governance Inc., which ceased operations in December 2010.[26] Barriers to entry are due to factors such as:

- ***Significant Coverage Obligations***: There are 40,000 securities globally, and to attract even a medium-sized institutional investor, a proxy advisory firm would have to cover about 10,000 securities, including 4,000 in the US and 6,000 outside the US. Moreover, securities outside the US are much more difficult to deal with than US securities.
- ***Low Margin Business***: Net income is about 10 percent of revenue, and EBITDA is about 25 percent. That will not attract quality risk capital.
- ***High Technology Costs***: Significant technology is required on the research side in order to upload and analyze the quantitative information and present it to an analyst, who then has to factor in qualitative information and make a decision. Proxy advisory firms also need very robust voting platforms. The platforms must have the capacity for the clients to put in their own voting policies, because clients rarely follow proxy advisory firms across the board.
- ***High Switching Costs***: Most large- and medium-sized institutions have developed their own technology to integrate with the systems of their existing proxy advisory firms. Switching to a new proxy advisory firm is burdensome and takes six to nine months to complete.

2. Specific Issues Regarding Proxy Advisory Firms

The Roundtable focused on two types of issues that are commonly raised in connection with proxy advisory firms: conflicts of interest and the accuracy and transparency of their recommendations.

Conflicts of Interest of Proxy Advisory Firms

Several areas were raised as presenting conflicts of interest, the principal ones being as follows:

- ***ISS Both Makes Proxy Voting Recommendations to Institutional Investors and Advises Issuers on How to Ensure the Recommendations Are Favorable***: There was a general recognition that it presents a conflict of interest for ISS (i) to generate revenue from institutional investors, through the ISS voting recommendations, by judging issuers' corporate governance, and (ii) to also generate revenue from issuers by advising the issuers on what governance steps the issuers need to take so as to avoid an adverse ISS judgment. Some participants thought this should be prohibited, and some thought that ISS should give greater disclosure regarding this type of conflict. A representative of ISS at the Roundtable

26 According to Michael Ryan, Vice President, Business Roundtable and former President and COO of Proxy Governance, Inc.: "it's almost virtually impossible to start up a proxy advisory firm today in any meaningful way that's going to attract . . . reasonable market share."

defended the practice in light of ISS' strong firewalls between its advisory side and its corporate side.[27]

- ***Proxy Advisory Firms Make Voting Recommendations on Shareholder Proposals Made by the Firms' Clients or by Parties Promoted by the Firms' Clients***: For example, if CalSTRS (or one of its affiliates) puts forward a shareholder proposal at an issuer's annual meeting, ISS will issue a voting recommendation to ISS clients as to whether or not to vote in favor of the CalSTRS proposal. However, CalSTRS is a client of ISS, and so ISS will have an incentive to support the CalSTRS proposal. There was a general recognition that this creates a conflict and should at least warrant disclosure.[28] The conflict also calls into question availability of the proxy rule exemption for proxy voting advice (Rule 14a-2(b)(3)), which requires disclosure to the advice recipient of any significant relationship with the proponent of the shareholder proposal. While both ISS and Glass Lewis typically disclose these conflicts in their reports, there is an issue as to whether their disclosures are sufficient. [29]

- ***The Customers of Proxy Advisory Firms Have Too Much Influence over the Firms' Voting Recommendations***: Participants disagreed as to whether this created a significant conflict. One Roundtable participant noted that proxy advisory firms have changed recommendations as a result of pressure from their customers. Other participants, on the other hand, stressed that institutional investors and proxy advisory firms are approached by parties on both sides of voting issues and there is nothing inherently wrong with that.[30] Moreover, Glass Lewis has been criticized in the past for not being willing to discuss voting issues with interested parties.[31]

27 Gary Retelny, President of Institutional Shareholder Services, Inc. ("ISS"), said that ISS has physical barriers and significant compliance rules and codes. The corporate team is on a separate floor that requires separate keys to enter. ISS clients have access to lists of all clients on the corporate side. The corporate client names are not disclosed in research reports, so as to prevent the research organization from learning the names. Many ISS clients receive the list of corporate client names on a monthly basis, and many others receive it on a quarterly or annual basis. The ISS firewalls are monitored aggressively. ISS had a review of its policies undertaken by Sullivan & Cromwell. In a November 29, 2007 letter that is posted on the ISS website, Sullivan & Cromwell stated its view that the firewalls and other measures ISS employs effectively manage the conflict between the advisory side and the corporate side.

28 Ms. Sheehan stressed, however, that CalSTRS' proposals are not rubber stamped by ISS and Glass Lewis.

29 Mr. Turner gave an example of Glass Lewis' report on the Canadian Pacific vote, where the report disclosed that Ontario Teachers had a 1.33 percent ownership position in Canadian Pacific. According to Mr. Turner, Glass Lewis should also have disclosed that Ontario Teachers was a proponent of the change. Mr. Turner described another situation involving a board election at Keryx Biopharmaceuticals, where one of the candidates was on the Glass Lewis advisory board. Glass Lewis noted the advisory board role, although did not also disclose that the individual was one of Glass Lewis' founders and former executive officers. Mr. Turner stated that he believed that disclosure of any conflict should be fulsome.

30 Mr. Retelny stated that the ISS reports are based on publicly available information, which is the reason that issuers often file Forms 8-K after conversations with ISS.

31 Ms. Rabin stated that Glass Lewis gets accused of talking to different people who are interested in voting proposals. For years, Glass Lewis managed potential conflicts by not talking to interested parties, but were accused of being in an ivory tower and being completely inaccessible. Now there is a big push by issuers to open up the research reports before they are published. So Glass Lewis now participates in conference calls with both sides on the call. The calls are recorded and made publicly available on the Glass Lewis website.

- ***The Ownership Structure of Proxy Advisory Firms Presents Conflicts***: ISS is owned by a public company and Glass Lewis by a government pension plan. Conflicts issues arising from ownership structure present similar issues to those described above relating to passing judgment on proposals of clients. [32]

The general view was that where conflicts could be addressed by disclosure, generic disclosure was insufficient and language concerning the specific conflict was required.

Accuracy and Transparency of Proxy Advisory Firm Reports

The three principal concerns about ISS and Glass Lewis voting recommendations were:

- ***Recommendations Are Based on One-Size-Fits-All Policies and Firms Lack resources to Tailor***: The notion that proxy advisory firms neither sufficiently tailor recommendations to specific issuers nor have the resources to be able to do so was a concern of many Roundtable participants. One person noted that the disclaimer on ISS reports states that the ISS research team analyzes proxy issues and completes vote recommendations for more than 40,000 meetings in more than 100 worldwide markets, through the work of more than 200 analysts fluent in more than 25 languages. Those figures indicate that each analyst has a huge amount of work to do, and thus it is inevitable that mistakes will be made.

- ***Issuers Are Not Provided Sufficient Time or Opportunity for Input***: ISS typically issues its reports about two weeks after issuers mail their proxy statements, which leaves two to three weeks for issuers to address inaccuracies in the ISS reports. ISS also tries to provide S&P 500 issuers with 24–48 hours to comment on reports before they are released. Glass Lewis typically does not provide issuers the ability to comment prior to release. Both firms will consider updates to reports to correct inaccuracies that are pointed out after the reports are issued. There was a concern that this process runs the risk that inaccurate information is disseminated in reports and issuers have insufficient time to correct the inaccuracies without postponing their shareholder meetings.[33]

- ***Voting Policies Are Adopted Without Sufficient Empirical Evidence that They Enhance Shareholder Value***: The ISS policies do not appear to be driven by empirical analysis, but are based on an outreach to clients and nonclients. The ISS representative described the voting policies as being as inclusive and global as possible. Policies are updated by an internal policy board based on annual surveys that clients and nonclients are welcome to respond to, as well as roundtables held around the world. Draft policies are provided for comment before being finalized. Summaries of finalized policies are posted on the ISS website. The representative described the extent to which the views of the various constituencies are included in its policies as "a little bit art, a little bit science."

32 One participant suggested that proxy advisory firms would present less conflicts if they were operated according to a public utility model as opposed to being run as for-profit private companies.

33 Mr. Retelny stated that ISS collects data on companies throughout the year so that it is in a position to prepare its reports in the limited period of time that it has after reviewing the issuer's proxy statement.

3. EU Code of Conduct

Ms. Rabin of Glass Lewis described how Europe, Australia and Canada had issued consultations that focused wholly or partly on the proxy advisory industry. In February 2013, the European Securities Market Authority (ESMA) published a final report (the ESMA Final Report) on its findings and recommendations resulting from its consultation. The ESMA Final Report found no clear evidence of market failure regarding how proxy advisory firms interact with investors and issuers, and so ESMA decided not to introduce binding regulations. However, it found areas where a coordinated effort of the proxy advisory industry would foster better understanding and assurance among other stakeholders. At the time of the report's publication, ESMA announced the formation of a drafting committee containing proxy advisers, including Ms. Rabin. Other members included representatives from ISS Europe, IVOX in Germany, PIRC and Manifest in the UK, and Proxinvest in France. The drafting committee prepared a set of principles that were released for public consultation on October 28, 2013, with the consultation period ending on December 20, 2013.[34]

The code (the Code of Conduct) is a comply-or-explain model. The draft Code of Conduct released in October of last year consisted of just three principles:

- Principle One (service quality): "Signatories aim to offer services that are delivered in accordance with agreed client specifications. Signatories should have and publicly disclose a research policy and, if applicable, 'house' voting guidelines."
- Principle Two (conflicts of interest management): "Signatories should have and publicly disclose a conflicts-of-interest policy that details their procedures for addressing potential or actual conflicts of interest that may arise in connection with the provisions of services."
- Principle Three (communications policy): "Signatories should have and publicly disclose their policy (or policies) for communication with issuers, shareholder proponents, other stakeholders, media and the public."

The Principles are supported by guidance that provides additional background and context. The Code of Conduct is expected to be finalized and put in place in March 2014. The participants in the process have indicated that they intend to implement the finalized Code of Conduct on a worldwide basis. ESMA has reserved the right to review the Code of Conduct in two years and has made clear that it will act if the code has not worked.

SEC Commissioner Gallagher stated his belief that the Code of Conduct was a positive step, but he referenced the ineffectiveness of the 2003 IOSCO code for ratings agencies, which was also a comply-or-explain model. He stated that the Code of Conduct should therefore not be the end of the debate.

34 A copy of the draft Code of Conduct is available at the following url: http://bppgrp.info/?page_id=31.

Part III. Takeaways from the Roundtable

The Roundtable discussion indicated a common recognition that proxy advisory firms provide important services for institutional investors. It seems clear that the proxy advisory industry is here to stay. However, many participants, representing both issuers and investors, expressed concerns about conflicts of interest in the industry. Issuer representatives were also very vocal about risks associated with proxy advisory firms disseminating inaccurate information shortly before meeting dates, particularly given the large percentage of votes that the firms' clients represent. It seems likely that some reform of the industry will be undertaken.

Timing and Scope of Reform Initiatives

The Roundtable served more as a forum for airing views than reaching consensus on the appropriateness and details of reform. However, there were some indications that any reform in the near term is likely to be through a self-regulatory initiative. The SEC is unlikely to adopt rules in the near future, and if it does adopt rules they are likely to be quite narrowly tailored.

- ***Self-Regulatory Initiative***: As made clear by Mr. Pitt, the SEC has a very full agenda, and this initiative is not very high on its priorities list. Moreover, it is unclear that something as simple as retracting the Egan-Jones and ISS no-action letters would have a beneficial impact. A self-regulatory initiative appears the most likely near-term option, particularly given that one is already underway in Europe. The effectiveness of the Code of Conduct will depend significantly on the policies that proxy advisory firms adopt under it.
- ***Scope of SEC Action***: If the Code of Conduct fails to address the types of concerns expressed in the Roundtable, the SEC may take action when its agenda is less crowded. Given the value of the services that proxy advisory firms provide to institutional investors, and the risk that heavy regulation could increase barriers to entry and further entrench the two dominant firms, SEC regulation is likely to be quite tailored. For example, many of the conflicts of interest concerns could be addressed through mandatory disclosure, which could be accomplished within the framework of the Advisers Act. Some of the concerns about accuracy could be addressed through requiring reports to be made available to issuers and filed with the SEC, perhaps on a confidential basis, in a specified period of time before their issuance. This could be accomplished under either the Advisers Act or Exchange Act Rule 14a-2(b)(3).[35]

The Roundtable discussion also made clear that issues associated with proxy advisory firms are part of larger problems relating to the proxy voting process. Many of the participants stressed the ultimate responsibility of institutional investors in the proxy voting process. Rules clarifying the institutional investors' voting responsibilities, as well as their due diligence and oversight obligations vis-à-vis proxy advisory firms and inability to broadly outsource voting responsibilities to the firms,

35 The SEC has also noted that an alternative regulatory approach would be through an additional regulatory scheme similar to that for addressing conflicts of interest applicable to Nationally Recognized Statistical Rating Organizations. The rules could require disclosure of conflicts and require proxy advisory firms to file periodic reports, similar to Forms NRSRO.

are potentially part of the solution. Many other issues were also discussed in the SEC's 2010 Concept Release on the U.S. Proxy System.[36]

Practical Issues for Companies

Issuers do not need to sit idly by and wait for the SEC's regulatory agenda to free up and for the impact of the Code of Conduct to become clear. The Roundtable discussion indicated a few steps that issuers can take in the meantime:

- ***Outreach to Institutional Investors***: Issuers have significantly increased their engagement with institutional investors in connection with proxy votes over the last few years. Institutions represented at the Roundtable expressed a willingness to engage in discussions with management. Representatives of large institutions emphasized that the proxy advisory recommendations were only some of the inputs used in determining how to vote. Issuers should continue with the outreach to their larger institutional shareholders and actively develop their relationships with these institutions so that the institutions have a better understanding of the issuers' business operations, growth plans and governance processes.
- ***Review Proxy Advisory Firm Reports***: Both ISS and Glass Lewis indicated that they are willing to correct errors in their reports even after the reports have been released. The factual accuracy of these reports is one of the topics in the crosshairs for regulatory action. Issuers should promptly review reports for accuracy and pressure the proxy advisory firms to correct errors.
- ***Respond to Proxy Advisory Surveys***: Mr. Retelny of ISS indicated that ISS attempts to be as inclusive as possible in obtaining feedback to its policy updates. He stated that in its 2013 survey, ISS received feedback from approximately 150 institutions and 350 corporations. Many corporations are therefore already participating in the ISS survey. While it is unclear how much influence they have had, more corporations should try to become involved in the process. At a minimum, increased participation by corporations cannot harm the prospects for having their views heard, but decreased participation can. Moreover, Mr. Retelny indicated that ISS is reaching out to corporate directors in order to obtain their input. Corporate directors should therefore also be encouraged to get involved in the process.
- ***Policing Conflicts***: Conflicts of interest are also one of the main areas that the SEC is considering for regulatory action. Issuers should actively pressure proxy advisory firms to fully disclose any conflicts that they become aware of. Institutional investors also appeared sensitive to the issue of proxy advisory firm conflicts. Issuers should also bring such conflicts to their attention.
- ***Code of Conduct***: Issuers should familiarize themselves with the Code of Conduct when it is adopted, and with the policies that proxy advisory firms adopt under it. In the event of shortcomings of the policies or violations under them, these can be pointed out to both the SEC and ESMA as evidence that the Code of Conduct is insufficient and a regulatory solution should be actively pursued.

36 See note 1.

- ***Engagement in Regulatory Process***: The SEC is still in the process of analyzing the proxy advisory industry and the need for regulation. ESMA has publicly stated that it will review the development of the Code of Conduct within two years after publication of the ESMA Final Report and may reconsider pursuing a regulatory strategy instead of a voluntary code at that time. Issuers who have specific examples of the failures of proxy advisory firms should consider communicating their views to the SEC and ESMA so that they can be taken into account in regulatory deliberations. Views can be communicated directly or through industry associations, such as the Business Roundtable.[37]

Nicholas O'Keefe
Partner
nicholas.okeefe@kayescholer.com
+1 650 319 4522

37 Issuers can also support the broader reforms to the proxy voting process identified at the end of the preceding section.

Cayman Islands Monetary Authority Issues Guidance for Regulated Cayman Islands Mutual Funds

Simon Firth Partner

Introduction

In December 2013, the Cayman Islands Monetary CIMA (CIMA) issued its Guidance for Regulated Mutual Funds (the Guidance) following consultation on draft guidance earlier in the year. The Guidance concerns the oversight, direction and management of a Cayman Islands regulated mutual fund[1] (a Fund) and provides the governing body of a Fund (Governing Body) and its operators[2] (Operators) with guidance on the minimum expectations for the sound and prudent governance of the Fund.

The size, nature and complexity of a Fund are fundamental factors in determining the adequacy and suitability of its governance framework.

The Guidance therefore affects many Cayman Islands funds—whether established as corporations, limited partnerships or trusts—including hedge, private equity and real estate funds. This article sets out and comments on the key provisions of the Guidance under the headings below.

The Guidance sets out the key corporate governance principles pertaining to the Governing Body and Operators, and is not intended as a prescriptive or exhaustive guide to CIMA's expectations with regard to the governance of a Fund. The governance structure of a Fund must be appropriate and suitable to enable effective oversight. The size, nature and complexity of a Fund are fundamental factors in determining the adequacy and suitability of its governance framework.

Oversight Function

The Governing Body is the board of directors where the Fund is a corporation, the general partner where the Fund is an exempted limited liability partnership and the trustees where the Fund is a unit trust. It has ultimate responsibility for effectively overseeing and supervising the activities and affairs of the Fund.

The Governing Body should monitor and regularly take steps to satisfy itself that the Fund and its service providers conduct the Fund's affairs in accordance with all applicable laws, regulations, rules, statements or principles, statements of guidance, and anti-money laundering or related requirements for combating terrorist financing, including those of the Caymans Islands and the CIMA. This will

1 As defined in the Cayman Islands Mutual Funds Law (2013 Revision) (as amended), and including any fund licensed or administered under that Law. A fund which has 15 or fewer investors, a majority of whom are capable of appointing or removing the operator of the fund, is not a regulated mutual fund and the Guidance does not apply to it.

2 As defined in the Funds Law, and being: in the case of a Fund which is a company, a director; in the case of the Fund which is a partnership, a general partner; and in the case of a Fund which is a trust, a trustee.

include the Governing Body requesting appropriate information from the Fund's service providers or professional advisers, and directing then to rectify any noncompliance with applicable laws, etc. as above.

The Governing Body should require regular reporting from the Fund's investment manager and other service providers to enable it to make informed decisions and to oversee and supervise the Fund adequately.

Comment: Many Funds are managed by investment advisers who are regulated by all or any of the U.S. Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC) and the UK Financial Conduct Authority (FCA), and are indirectly affected by the regulatory obligations imposed by these regulators on those advisers. That includes the long reach of the EU Alternative Investment Managers Directive (AIFMD) which, for example, defines the liabilities of a Fund's "alternative investment fund manager" ("AIFM") and its depositary. This new wave of regulation means that a Fund's Governing Body needs to be regularly updated and apprised of regulatory developments and how they impact the Fund.

Conflicts of Interest

The Governing Body of the Fund and its Operators must suitably identify, disclose, monitor and manage all its conflicts of interest and must document the disclosed conflicts of interest.

Comment: Identifying and managing conflicts of interest is also incumbent on regulated investment managers and advisers.

Governing Body Meetings

The Governing Body of the Fund should meet at least twice a year in person or via a telephone or video conference call. Where the circumstances of size, nature and complexity of the Fund necessitate it, the Governing Body should meet more frequently so as to enable it to fulfil its responsibilities effectively.

Where necessary, the Governing Body shall request the presence of its service providers at its meetings. The Operators are responsible for ensuring that a full, accurate and clear written record is kept of the Governing Body's meetings.

Comment: For many Funds with independent professional directors, four meetings a year has become the norm.

Operators' Duties

The Guidance not only covers the responsibilities of the Governing Body, but those of its individual operators as well—although much of the Guidance concerning Operators can be construed as applying to the Governing Body. CIMA makes the distinction because in its view the responsibilities of the board as a collective and the duties of directors as individuals are to be differentiated in terms of the Guidance.

Under the Guidance an Operator must:

- be independent and exercise independent judgment, always acting in the best interests of the Fund and taking into consideration the interests of its investors as a whole and/or, where applicable, the creditors of the Fund;

- operate with due skill, care and diligence;
- make relevant enquiries where issues are raised with it;
- communicate adequate information to the Fund's investors where it is properly able to disclose that information;
- act honestly and in good faith at all times; and
- ensure it has sufficient capacity to apply its mind to overseeing and supervising each Fund of which it is an Operator and to all matters falling within the scope of its responsibilities. Consequently, before taking on any additional funds, the Operator should always ensure that it is able to perform the functions and duties of an Operator in a responsible and effective manner in accordance with relevant laws, regulations, rules, statements of principles and the provisions of the Guidance.

Comment: The final bullet above alludes to concerns raised to CIMA about Fund directors who take on multiple directorships (see "Assessment of the Guidance" below). Investor expectations are that a director's fund directorships should not exceed 20, and for larger, more complex funds, fewer than that.

The Guidance is a codification of good corporate governance practice, and does not introduce any concepts that are alien to a well-governed fund.

Upon registration of a Fund with the CIMA, and on a continuing basis, the Operator is responsible for ensuring that:

- the constitutional and offering documents of the Fund comply with Caymans Islands law;
- the investment strategy and conflicts of interest policy of the Fund are clearly described in the offering documents; and
- the offering documents describe the equity interests in all material respects and contain such other information as is necessary to enable a prospective investor to make an informed decision as to whether or not to subscribe for or purchase interests in the Fund.

Comment: This is a minimum standard, and all funds offered outside a small circle of "friends and family" have for many years issued comprehensive offering documents, and the AIFMD requires EU AIFMs to make detailed and comprehensive disclosures about the funds they manage to both investors and regulators.

Concerning a Fund's service providers, the Operator:

- is responsible for approving their appointment and removal, the terms of the contracts with each of them, and for ensuring that its investors and the CIMA are notified of any changes to these appointments;
- retains ultimate responsibility for functions delegated to them and should regularly monitor and supervise the delegated functions;
- should review all of its service provider contracts to ensure that roles and responsibilities are clearly defined;

- is responsible for regularly assessing the suitability and capability of its service providers;
- must regularly monitor whether the investment manager is performing in accordance with the Fund's investment criteria, investment strategy and restrictions.

The Operator should:

- inform itself of the Fund's investment activities, performance and financial position as necessary, and at all material times;
- review and approve the Fund's financial results and audited financial statements;
- regularly monitor the Fund's net asset valuation policy so that the calculation of its net asset value is being calculated in accordance with this policy;
- ensure that it has sufficient and relevant knowledge and experience to carry out its duties as an operator; and
- ensure that it provides suitable oversight of the risk management of the Fund, ensuring its risks are always appropriately managed and mitigated, with material risks being discussed at the Governing Body meeting and the Governing Body taking appropriate action where necessary.

Comment: The AIFMD defines the activity of managing a fund as comprising both portfolio and risk management, and the AIFM is able to delegate one of those functions as long as it does not do so to the extent that it becomes a "letter-box entity." A fund can be a self-managed fund under the AIFMD and, in that case, its directors must have sufficient skill and experience to perform one of the AIFM functions and to oversee a delegated function. An emerging fund structure under AIFMD is the self-managed fund where the risk management function is performed by the directors, or a committee of them, requiring "Operators" of such a Fund to have significantly more involvement with its business than the traditional nonexecutive director.

Relations with CIMA

The Operator should conduct the Fund's affairs with CIMA in a transparent and honest manner, always disclosing to the CIMA any matter which could materially and adversely affect the financial soundness of the Fund, and any noncompliance with applicable law and regulations.

Assessment of the Guidance

The Guidance is essentially a tentative codification of good corporate governance practice, and does not introduce any concepts that are alien to a well-governed fund. The Guidance is just that—guidance. It does not take the form of regulatory rules, and so compliance with it is not mandatory, but represents the minimum standard expected by sophisticated investors. Indeed, many such investors would in any case test a Fund's corporate governance as part of their due diligence.

Nevertheless, the very existence of the Guidance is a sign of increasing focus on Fund governance and reflects the offshore centres' awareness of the need to adapt their regimes to match higher regulatory standards. The Guidance serves as a codification of standards of offshore Fund governance at least expected by Fund investors.

Finally, CIMA is expected this year to create a searchable database of directors of Cayman funds. This activity is already stirring some debate, not least of all because it is suspected that some directors may hold scores of directorships and will not relish the spotlight falling on them.

Simon Firth
Partner
simon.firth@kayescholer.com
+44 (0)20 7105 0583