



Securities Law ALERT ■

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SEC Staff Issues Guidance for Investment Advisers and Proxy Advisory Firms

On June 30, 2014, the SEC's Division of Investment Management and Division of Corporation Finance provided guidance in Staff Legal Bulletin No. 20 (the "Bulletin"),¹ related to registered investment advisers and proxy advisory firms. Two key takeaways from the Bulletin are:

- Proxy advisory firms will be required to disclose to their clients any significant conflicts of interest related to the matter on which they are making a voting recommendation (such as a consulting relationship with the subject company).
- Although investment advisers are still expected to use proxy advisory firms widely, they must regularly monitor the voting recommendations of the proxy advisory firms to ensure that they are in the best interests of their clients rather than simply establishing general guidelines.

Background

Investment advisers and institutional investors retain proxy advisory firms, such as Institutional Shareholder Service (ISS) and Glass Lewis, to prepare analysis and voting recommendations for proposals presented to the shareholders of portfolio companies. In addition, these proxy advisory firms advise companies on how to improve their corporate governance policies and develop proposals to present to shareholders for their vote. The voting recommendations of proxy advisors are widely considered to be highly influential in determining the outcome of a shareholder vote.

The SEC issued the Bulletin in part as a response to some of these concerns regarding proxy advisory firms. Specifically, in 13 Q&As, the Bulletin addresses (i) investment advisers' initial and continuing responsibilities regarding retaining proxy advisory firms to assist with voting recommendations and voting proxies, and (ii) the applicability of the proxy rules to proxy advisory firms and the availability of established exemptions to such rules to proxy advisory firms.

¹ The Staff Legal Bulletin is available at: <http://www.sec.gov/interp/leg/cfs1b20.htm>.

Investment Advisers' Duties Regarding Proxy Advisory Firms

The Bulletin clarifies that pursuant to Section 206 of the Investment Advisers Act of 1940, investment advisers owe each of their clients a duty of care and loyalty with respect to proxy voting services provided on their behalf by proxy advisory firms.

- When retaining a proxy advisory firm, an investment adviser should determine whether the firm has the capacity and competency to adequately analyze the issues, including its ability to make recommendations based on accurate information and identify and address conflicts of interest.
- An investment adviser that has retained a proxy advisory firm should implement procedures reasonably designed to ensure that the investment adviser votes in the best interests of its clients, including periodically sampling proxy votes or specifically reviewing proxy votes on particular issues.
- Investment advisers should also implement measures reasonably designed to ascertain whether the proxy advisory firm has the capacity and competency to adequately analyze proxy issues based on materially accurate information and to assess on an ongoing basis the proxy advisory firm's conflicts of interest.
- Clients are not required to delegate to their investment advisers complete authority to undertake all of the proxy voting responsibilities. Investment advisers and clients may make other arrangements that define or limit the scope of the investment adviser's proxy voting authority, including by agreeing that all shares will be voted with management or that the costs associated with voting proxies in certain situations may not be in the client's best interest.

Applicability of Proxy Rules to Proxy Advisory Firms

A proxy advisory firm is subject to the proxy rules when it engages in a "solicitation," which would include the furnishing of proxy voting advice by providing recommendations that are reasonably calculated to result in the procurement, withholding or revocation of a proxy. The Bulletin provides guidance regarding two exemptions from the proxy rules provided by the Securities Exchange Act of 1934, as amended.

- The proxy rules provide an exemption for any solicitation by a person who does not seek to act as a proxy for a security holder and does not furnish or request a form of revocation, abstention, consent or authorization (Rule 14a-2(b)(1)).
 - According to the Bulletin, a proxy advisor may rely on this exemption to the extent that it distributes reports containing recommendations only and does not solicit the power to act as a proxy for the clients receiving the recommendations.
 - A proxy advisor would not be able to rely on this exemption in a situation where it allows a client to establish general guidelines that the proxy advisor will apply to vote on behalf of the client in advance of receiving proxy materials for a meeting.
- The proxy rules also provide an exemption for proxy voting advice that is given from one person to another with whom a business relationship exists (Rule 14a-2(b)(3)), provided:
 - the advice is given in the ordinary course of business;
 - the proxy advisor discloses to the recipient any significant relationship with the company or proponent of the matter and any material interests in the matter being voted on;

- the proxy advisor receives no special commission or remuneration from any person other than the recipient of the advice; and
- the proxy advisor does not furnish the advice on behalf of any person soliciting proxies or the participant in a contested election.
- According to the Bulletin, to rely on the exemption provided by Rule 14a-2(b)(3), a proxy advisory firm must assess whether it has a significant relationship with the company or security holder proponent of the matter, or if it has any other material interest in the matter that is the subject of the recommendation.
 - The advisory firm should assess all of the relevant facts and circumstances to determine if a conflict exists, including (i) the type of services being offered, (ii) the amount of compensation, and (iii) the extent to which the advice relates to the same subject matter as the transaction giving rise to the relationship with the company or proponent.
 - If a proxy advisory firm determines it does have a conflict, it must affirmatively disclose that relationship or interest to the recipient of the voting advice.
 - Disclosure should enable the recipient to understand the nature of the interest and the steps taken to mitigate the conflict. The disclosure should be provided in a manner and place which allows the client to simultaneously assess both the advice provided and nature of the conflict, but does not have to be public.

What Are the Implications of the SEC's Guidance?

The Bulletin addresses two issues of concern related to proxy advisory firms: (i) potential conflicts of interest, and (ii) overreliance on proxy advisor voting recommendations, although issuers may believe that the SEC should still regulate proxy advisory firms.

▪ ***Conflicts of Interest***

- Shareholders have expressed concerns regarding potential conflicts of interest of proxy advisory firms based on their dual role of advising both investors and public companies on governance and voting issues.
- The Bulletin will require proxy advisors relying on certain exemptions from the proxy rules to affirmatively disclose conflicts of interests to recipients of voting advice.
- This will represent an important change from the current policy of ISS, which has been described as a policy of telling investors that further information regarding its consulting clients is available upon request.

▪ ***Overreliance on Proxy Advisors***

- Companies and corporate trade groups have argued that proxy advisors exercise too much influence over corporate governance issues and are not responsive to the concerns of individual companies.
- The Bulletin will require investment advisers to review their proxy policies and procedures to ensure that proxies are being voted in the best interests of their clients and that proxy advisers have the capacity and competency to make voting recommendations.

- However, even if investment advisers comply with these requirements, they will likely still retain the ability to substantially rely on proxy advisors for voting proxies rather than making individualized voting decisions.

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