

Commissioner Gallagher Says SEC Rules Led to the Rise of Proxy Advisory Firms

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Commissioner Gallagher recently [lamented](#) that the SEC has played a “significant role” in the rising influence of proxy advisory firms and the increasing willingness of investors to rely on them. He blamed the rules adopted in 2003 under the Investment Advisers Act, which focused on an investment adviser’s fiduciary obligation to its clients when the adviser has the authority to vote its clients’ proxies.

Those rules address the SEC’s concerns about potential conflicts when an adviser votes a client’s securities on matters that affect its own interests. For example, if a broker-dealer that is affiliated with an adviser provides investment banking services to an issuer that is soliciting proxies, the SEC believes that relationship could influence the adviser to vote its clients’ proxies in its affiliate’s interest, rather than in the best interests of its clients. As a result, Rule 206(4)-6 under the Advisers Act requires registered investment advisers to adopt and implement policies and procedures designed to ensure that their clients’ proxies are properly voted.

An investment adviser can demonstrate the absence of a conflict if the adviser voted the proxies in accordance with a policy based on the recommendations of an independent third party, even though the recommendations may be consistent with the adviser’s own interests. The SEC staff later issued two no-action letters, one to [Egan-Jones](#) and another to [ISS](#), affirming that “the recommendations of a third party that is in fact independent of an investment adviser may cleanse the vote of the adviser’s conflict.” The Staff also indicated that a proxy advisory firm could be considered independent even if it was paid fees by issuers for other services.

Commissioner Gallagher stated that the SEC may find it difficult to ensure that fiduciaries are conducting proper due diligence with respect to proxy votes unless these no-action letters are reviewed and possibly revisited. He raised a number of questions that he believes should be asked about the advisory firms, including whether they should be subject to proxy solicitation rules and how they can be held accountable for their recommendations.

The no-action letters, in fact, already contain certain requirements regarding an adviser’s reliance on a proxy voting firm, including ascertaining that the firm has both the capacity and competency to adequately analyze proxy issues and make such recommendations in an impartial manner. This may involve obtaining information about the firm’s relationship with an Issuer, such as the amount of compensation the firm has received or will receive from an Issuer. An adviser’s procedures should address the use of third parties to make proxy voting recommendations if material. After a request for clarification from ISS, the SEC Staff noted that the steps an investment adviser takes in evaluating a proxy voting firm depends on the facts and circumstances, and need not always be done on a case-by-case basis.

Commissioner Gallagher also blamed the SEC disclosure requirements for turning proxy statements into “law school text books,” and therefore, “who can blame an investor for not voting when reading a proxy and voting a proxy card evoke memories of studying for a final exam?”

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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