

SEC Guidance on Use of Proxy Advisory Firms for Voting Proxies

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The SEC has issued its long-awaited **guidance** on proxy advisory firms, in the form of Staff Legal Bulletin No. 20 from the Division of Investment Management and the Division of Corporation Finance. Current rules have encouraged the prominence of proxy advisory firms by (1) permitting investment advisers to satisfy their obligation to vote on their clients' behalf in a "conflict-free manner" if they vote based on the recommendations of independent third parties and (2) exempting these firms from the rules that otherwise apply to any persons soliciting votes or making recommendations on proxy matters. Those who were hoping for a strong gesture in the direction of greater regulation of and public transparency concerning firms like ISS and Glass Lewis are likely to be disappointed by SLB 20, which consists of a largely anodyne set of 13 questions and answers summarizing investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms, as well as the availability and requirements of two exemptions to the federal proxy rules that are often relied upon by proxy advisory firms.

Executive Summary

SLB 20 addresses both the investment advisers' role in proxy voting and their duties and responsibilities if they retain proxy advisory firms to assist in the fulfillment of their voting obligations. It does not revoke prior no-action letters issued by the Staff that provided that investment advisers could demonstrate their proxy voting was free of conflicts if they voted in accordance with a pre-determined policy based on the recommendations of an independent third party. Those letters have been the subject of much controversy and were often criticized, including by some of the SEC commissioners, as helping give rise to the power of proxy advisory firms to sway ballot items.

SLB 20 makes clear that investment advisers are required to vote in accordance with their clients' wishes, including not voting at all, only voting on some matters, or voting in favor of management or certain proponents. To appropriately carry out their voting responsibilities, according to SLB 20, investment advisers should establish policies and procedures, which may include the ability to retain third parties that provide voting recommendations. Investment advisers that retain proxy advisory firms for this purpose should undertake due diligence to ensure that those firms have the capacity and competency to adequately analyze proxy issues. In this regard, SLB 20 suggests that advisers consider whether proxy advisory firms have proper resources and robust policies and procedures regarding conflicts of interest, and are providing voting recommendations based on accurate information, including investigating any material factual errors made by proxy advisory firms that affect the voting recommendations.

The Staff guidance then describes the exemptions available to proxy advisory firms from the filing and disclosure requirements of the federal proxy rules. In reliance upon those exemptions, certain disclosures regarding significant relationships or a material interest must be made. Advocates of greater public disclosure have focused, for example, on conflicts of interest that could arise from consulting services that ISS provides, or where shareholder proponents of proposals or those nominating dissidents in proxy contests are clients of a proxy advisory firm. While SLB 20 appears to require proxy advisory firms to give more specific disclosure to clients than is currently being made, it is unlikely to satisfy those who were seeking transparency surrounding these potential conflicts, since public disclosure is not mandated.

Overall, SLB 20 reiterates and emphasizes existing guidance regarding the use of proxy advisory firms by investment advisers and strengthens the need for the firms to provide additional information regarding

potential conflicts to their clients. It does not cover many of the issues that companies have been advocating for some time, including basic questions regarding the accessibility of the voting reports that would allow all companies (not just S&P 500 companies) to receive draft reports from ISS or receive a free report from Glass Lewis, or requests to make public the underlying methodologies that give rise to the proxy advisory firms' voting policies.

As a result, the guidance is likely to disappoint those seeking groundbreaking changes that would ultimately curb or diminish the influence of the proxy voting firms, and its impact will probably not be felt by companies.

Investment Advisers and Proxy Voting

Responsibilities of investment advisers to vote proxies. Investment advisers and their clients do not need to agree that the adviser will undertake all of the proxy voting responsibilities. In most cases, however, clients delegate to their investment advisers the authority to vote proxies relating to equity securities completely. This type of delegation is permissible, as well as other arrangements where the adviser does not assume all of the proxy voting authority. SLB 20 provides a set of examples that demonstrates fairly broad flexibility, including agreements between investment advisers and their clients (a) not to vote proxies with respect to certain types of proposals; (b) to vote consistently with management's recommendations or in favor of all proposals made by a particular shareholder proponent absent contrary client instructions or an alternative determination by the adviser if it would further the client's investment strategy; (c) to have the investment adviser abstain from voting any proxies at all; or (d) to focus resources only on particular types of proposals in keeping with the clients' preferences.

Responsibilities of investment advisers to establish voting policies. Existing SEC proxy voting rules provide that it is fraudulent or deceptive for a registered investment adviser to exercise voting authority with respect to client securities unless the adviser adopts and implements written policies and procedures reasonably designed to ensure that such adviser votes proxies in the best interest of its clients. To ensure compliance, SLB 20 states that an adviser should review at least annually the adequacy of its proxy voting policies and procedures for effective implementation. Proxy votes can be sampled periodically, and the investment adviser could also specifically sample proxy votes that relate to certain proposals that may require more analysis.

Responsibilities of investment advisers toward proxy advisory firms. In considering whether to retain any particular proxy advisory firm to provide voting recommendations, an investment adviser should ascertain whether the firm has the capacity and competency to adequately analyze proxy issues. For this purpose, SLB 20 stated that an adviser could consider the adequacy and quality of the proxy advisory firm's staffing and personnel and the robustness of the firm's policies and procedures regarding its ability to (1) ensure that voting recommendations are based on current and accurate information and (2) identify and address any conflicts of interest.

An investment adviser that retains a proxy advisory firm should have policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the firm in order to ensure that the investment adviser, acting through the proxy advisory firm, continues to vote proxies in the best interests of its clients. If, for example, a proxy advisory firm's recommendation was based on a material factual error and caused the adviser to question the firm's process for developing recommendations, SLB 20 indicates that the investment adviser should take reasonable steps to investigate the error, including by assessing efforts by the proxy advisory firm to reduce future errors. Investment advisers should also establish and implement measures to identify and address the proxy advisory firm's conflicts that can arise on an ongoing basis, such as by requiring the firm to update the investment adviser of business changes that the investment adviser considers relevant.

Proxy Advisory Firms and Proxy Voting

Proxy Advisory Firms' General Exemption from Solicitation Rules. Exchange Act Rule 14a-2(b) exempts proxy advisory firms from the information and filing requirements of the federal proxy rules. Distributing reports containing voting recommendations is permissible. However, the exemption under Exchange Act Rule 14a-2(b)(1) is not available if a proxy advisory firm allows a client to establish, in advance of receiving proxy materials for a particular meeting, general guidelines or policies that the proxy advisory firm will apply to vote on behalf of the client, as this would cause the firm to be viewed as having solicited the "power to act as a proxy" for its client.

Instead, Exchange Act Rule 14a-2(b)(3) exempts the furnishing of proxy voting advice by any person to another person with whom a business relationship exists, subject to certain conditions. The exemption is available if, for example, the proxy advisory firm gives financial advice in the ordinary course of business; discloses to the recipient of the advice any significant relationship with the company or any of its affiliates, or a shareholder proponent of the matter on which advice is given, as well as any material interests of the person in such matter; receives no special compensation for furnishing the advice from any person other than the recipient of the advice and others who receive similar advice; and does not furnish the advice on behalf of any person soliciting proxies or on behalf of a participant in a contested election.

Proxy Advisory Firms' Disclosure of Conflicts to Rely on Solicitation Exemption. SLB 20 addresses (1) the provision of consulting services by ISS to companies and (2) when a proxy advisory firm provides voting recommendations about a proposal sponsored by one of its clients. In those cases, to take advantage of the exemptions described above, a firm would need to assess whether its relationship with the company or shareholder proponent is significant or whether it otherwise has any material interest in the matter that is the subject of the voting recommendation, which depends on the facts and circumstances such as the types of services being offered, the amount of compensation and the extent to which the advice given to its advisory client relates to the same subject matter as the transaction giving rise to the relationship with the company or shareholder proponent.

If a proxy advisory firm determines that it has a significant relationship or a material interest that requires disclosure, then the firm must provide the recipient of the advice (the investor) with disclosure that provides notice of the relationship or interest. This is not satisfied with boilerplate language that such a relationship or interest may or may not exist, or that detailed information will be provided upon request.

The disclosure must provide sufficient information to enable the client to understand the nature and scope of the relationship or interest, including the steps taken, if any, to mitigate the conflict, so that the client can make an assessment about the reliability or objectivity of the recommendation. The disclosure may, but is not required to, be made publicly. Instead, it may be given only to the client, though it must be provided at the same time as the client receives advice from the proxy advisory firms.

While the impact of SLB 20 remains to be seen, it will likely do little to quell the ongoing debate as to the role of proxy advisory firms in shareholder meetings, and their influence will continue to concern companies.

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