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CORPORATE GOVERNANCE & INVESTMENT FUNDS AND ADVISERS UPDATE

SEC Staff Guidance May Lessen Investment Adviser Demand for – While Also Raising the Costs of Providing – Proxy Advisory Services

Recently issued SEC staff guidance addresses concerns that have been raised about proxy advisory firms by emphasizing that the investment adviser that retains and pays a proxy advisory firm is uniquely positioned to monitor the proxy advisory firm and is required to actively oversee the firm if it wants to benefit from the firm's services to discharge its fiduciary duty. As a result of the greater oversight exercised by all of their investment adviser clients, the proxy advisory firms will presumably respond by enhancing their policies, processes and procedures, as well as the transparency of these policies, processes and procedures. In turn, the corporate community may indirectly benefit to some degree.

Over the past decade, the growing influence of proxy advisory firms on shareholder voting, executive compensation and corporate governance practices has caused no small degree of consternation and concern among public companies. In addition to the perceived power of the highly-concentrated proxy advisory industry to effectively coordinate shareholder voting, criticisms have been raised about the general opacity and lack of nuanced analysis underlying vote recommendations, the potential conflicts that arise when proxy advisors also provide consulting services to public companies and the inherent pressures in the proxy advisor business model that appear to cause these firms to continually push the envelope on corporate governance changes. Federal legislation and Securities and Exchange Commission ("SEC") rules and guidance are perceived to have played a role in the growth of proxy advisor influence. Not surprisingly, the corporate community–through organizations such as The Business Roundtable, the U.S. Chamber of Commerce, and the Society of Corporate Secretaries and Governance Professionals–as well as members of Congress and even several SEC Commissioners have pressed the SEC to consider whether additional regulation of this industry is warranted.

On June 30, the SEC's Division of Corporation Finance and Division of Investment Management (the "Staff") jointly published guidance relating to both proxy advisory firms and their investment adviser clients in the form of 13 questions and answers in Staff Legal Bulletin No. 20 (the "Bulletin") (available at http://www.sec.gov/interps/legal/cfslb20.htm). The Bulletin addresses issues related to:

- Investment adviser responsibilities related to the voting of proxies;
- Investment adviser considerations regarding retention and oversight of proxy advisory firms; and

- Two exemptions to the proxy solicitation rules on which proxy advisory firms rely.

While the Staff's guidance does not directly address many of the concerns raised to date about proxy advisors, it may cause investment advisers that engage proxy advisory firms to act as better watchdogs regarding the quality of the services the proxy advisory firms provide, and it may even prompt some investment advisers to reduce their reliance on these services. The guidance also could raise the costs for proxy advisors to provide quality services.

This Update briefly reviews background developments leading up to the Staff's guidance, summarizes the guidance provided in the Bulletin, discusses those issues that investment advisers may need to consider in assessing whether changes to their systems and processes related to proxy voting and reliance on proxy advisors are necessary, and addresses how the guidance is likely to impact proxy advisors.

Background Developments

Institutional investors now hold approximately 60 percent of publicly traded stock, up from less than 20 percent in the 1960s according to the Organisation for Economic Co-operation and Development.[i] These institutions–with portfolios of securities issued by hundreds or even thousands of companies–often lack the manpower to analyze and vote on the high number of proxy items that relate to their portfolio companies every year during the five-month proxy season. For some institutions, the traditional solution was either to not vote or to vote fairly lock-step along the lines of board and management recommendations, in the absence of unusual circumstances. Alternative approaches that have grown considerably under the influence of SEC rules are for institutional investors to rely on blanket policies to vote their shares regarding particular issues or to outsource voting decisions to proxy advisors who rely on similar policies.

Proxy advisory firms provide analysis and vote recommendations on proxy statements to clients, including investment advisers, pension plans, employee benefit plans, bank trust departments and funds. Proxy advisory firms also may undertake vote execution and related administrative tasks on behalf of their clients. Some firms may also advise public company clients on issues related to executive compensation, employee stock ownership plans and corporate governance. As noted in the SEC's Concept Release on the U.S. Proxy System,[ii] although proxy advisory firms meet the definition of "investment adviser" when they provide certain services and thus are subject to certain provisions of the Investment Advisers Act of 1940 (the "Advisers Act"), generally they do not have sufficient assets under management to register with the SEC (although one firm, Institutional Shareholder Services, Inc. ("ISS"), has registered as an investment adviser pursuant to an exemption available for pension consultants).

Two firms–ISS and Glass, Lewis & Co. LLC ("Glass Lewis")–are estimated to share about 97% of the market for proxy voting advice.[iii] It is estimated that, depending on the share ownership structure, a proxy advisor's vote recommendation can sway more than 20% of votes cast.[iv] The power and concentration of the proxy advisory industry is the outgrowth of many causal factors, including the increasing concentration of share ownership in institutional hands and the interest in governance issues and demand by many institutional investors for advice in this area. SEC policy guidance helped to increase demand for proxy advisory services by emphasizing (1) the duties of investment advisers to act in their clients' interests with respect to proxy voting and (2) the role that reliance on third-party proxy plays in evidencing fulfillment of those duties. Demand for proxy advisory services was also stimulated as an unintended consequence of the increased federal regulation of governance matters

that gave shareholders greater voting rights with respect to traditional corporate governance matters, including, for example, the shareholder advisory vote on say-on-pay required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. Outlined in the box below are some of the key regulatory events that presaged the SEC Staff guidance.

Key Events Relevant to the SEC Staff Guidance

- **Letter on Fiduciary Standards from Alan D. Lebowitz, Deputy Assistant Secretary, Department of Labor to Helmuth Fandl, Avon Products, Inc. (February 23, 1988)**, available at http://www.lens-library.com/info/dolavon.html, reminding pension fund advisors subject to the Employee Retirement Income Security Act of 1974 ("ERISA") that their fiduciary obligations to manage plan assets include decisions as to how proxies should be voted.

- **Letter on Fiduciary Standards from Harvey L. Pitt, SEC Chairman, to John P. M. Higgins, President, Ram Trust Services (February 12, 2002)**, noting lack of explicit guidance in the Advisers Act regarding investment advisers' obligations with respect to voting proxies on behalf of clients, and stating that "[w]e believe, however, that an investment adviser must exercise its responsibility to vote the shares of its clients in a manner that is consistent with the general antifraud provisions of the Advisers Act, as well as its fiduciary duties under federal and state law to act in the best interests of its clients."

- **SEC Final Rule: Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585 (2003), Rule 206(4)-6**, available at http://www.gpo.gov/fdsys/pkg/FR-2003-02-07/pdf/03-2952.pdf, applying traditional concepts of fiduciary obligations, including duties of care and loyalty, in emphasizing the obligations of registered investment advisers with respect to proxy voting where their clients have given them proxy voting authority–even where that authority is not explicit in the advisory agreement but is implied via a delegation of discretion. Rule 206(4)-6 requires registered investment advisers with discretionary authority for proxy voting to (a) adopt written policies and procedures reasonably designed to ensure that they vote proxies in the best interests of their clients; and (b) disclose both their voting policies and how they actually voted their client accounts. However, according to the SEC Staff, the Rule was not intended "to suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the client's interest, such as when the cost of voting the proxy exceeds the expected benefit to the client." Id. at 6587. An investment adviser can demonstrate that a vote associated with client securities was not tainted by a potential conflict of interest (for example, as relates to managing a pension plan, administering an employee benefits plan, or providing brokerage, underwriting, insurance or banking services to a company whose proxies are to be voted), if voted "in accordance with a pre-determined policy, based upon the recommendations of an independent third party."

- **SEC Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies (2003)**, available at http://www.sec.gov/rules/final/33-8188.htm, requiring, among other things, that registered management investment companies (a) disclose in their registration statements (or on Form N-CSR, in the case of a closed-end fund) the policies and procedures that they use to determine how to vote proxies relating to portfolio securities; and (b) file with the SEC, and make available to shareholders, specific proxy votes cast for the preceding 12-month period ended June 30.

Key Events Relevant to the SEC Staff Guidance (continued)

- **2004 SEC No Action Letters: Investment Advisers Act of 1940 – Rule 206(4): Institutional Shareholder Services, Inc., SEC Letter to Mari Ann Pisarri, September 15, 2004**, available at http://www.sec.gov/divisions/investment/noaction/iss091504.htm, and **Egan-Jones Proxy Services, SEC Letter to Kent S. Hughes, May 27, 2004 (the "Egan-Jones Letter")**, available at http://www.sec.gov/divisions/investment/noaction/egan052704.htm, clarifying that voting in reliance on an independent proxy advisory firm's voting recommendations will insulate an investment adviser from any conflicts of interest and otherwise support the discharge of the investment adviser's fiduciary duties, but also warning (in the Egan-Jones Letter) that "[a]n investment adviser should not, however, conclude that it is appropriate to follow the voting recommendations of an independent proxy voting firm without first ascertaining, among other things, whether the proxy voting firm (a) has the capacity and competency to adequately analyze proxy issues; and (b) can make such recommendations in an impartial manner and in the best interests of the adviser's clients."

- **SEC Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42,982 (July 22, 2010) (the "2010 Concept Release")**, available at http://www.sec.gov/rules/concept/2010/34-62495fr.pdf, among other things seeking comment on potential regulation of proxy advisory firms and noting that certain proxy advisory firm activities may fall within the broad definition of a proxy solicitation under the Securities Exchange Act of 1934 (the "Exchange Act") and therefore be subject to the federal proxy rules if the proxy advisor does not otherwise qualify for an exemption from those rules.

- **Hearing Before the Subcommittee on Capital Markets and Government Sponsored Enterprises of the House Committee on Financial Services, on "Examining the Impact of Proxy Advisory Firms," 113th Cong. (2013)**, available at http://financialservices.house.gov/uploadedfiles/113-27.pdf **, and SEC, "Proxy Advisory Firms Roundtable," December 5, 2013**, available at http://www.sec.gov/spotlight/proxy-advisory-services.shtml, providing opportunity to consider (a) the unintended consequences of encouraging investment advisers to rely on proxy advisory firm recommendations in order to satisfy their fiduciary duties to their clients; and (b) concerns about the effect of the proxy advisory industry on corporate governance standards, proxy advisor voting policies and market power, and potential conflicts of interest.

- **Best Practice Principles for Providers of Shareholder Voting Research & Analysis (the "Principles"), March 2014**, available at www.bppgrp.info, setting forth a self-regulatory code of conduct agreed to by a coalition of U.S. and European proxy advisory firms, including ISS, Glass Lewis, IVOX Gmbh, Manifest Information Services Ltd, PIRC Ltd and Proxinvest, following the recommendations of the European Securities and Markets Authority (ESMA), to be adopted by proxy advisors on a "comply-or-explain" basis. The Principles address service quality, conflicts of interest management and communications policy. ESMA will review the industry's implementation of the Principles in 2016.

Summary of the Staff Bulletin

The Bulletin provides guidance, in the form of 13 questions and answers, on investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms and on the availability and requirements of two exemptions to the federal proxy rules that are relied upon by proxy advisory firms. The guidance does not provide any significant surprises but emphasizes points that have been made in earlier SEC rules and guidance.

A. Guidance Relating to Investment Advisers

1. According to the guidance, compliance with (a) fiduciary duties of care and loyalty owed by an investment adviser to clients where the adviser has discretion to vote proxies; and (b) such adviser's written policies and procedures, which are reasonably designed to ensure that proxies are voted in the best interest of its clients, can be demonstrated by:
    - Periodically sampling proxy votes and specifically reviewing a sample of those proxy votes that relate to certain proposals requiring more analysis.
    - At least annually reviewing the adequacy and effectiveness of the adviser's voting policies and procedures.
2. Investment advisers are not required to vote every proxy, subject to their contractual arrangements with their clients. For example, the parties may agree that:
    - The time and costs associated with proxy voting "with respect to certain types of proposals or issuers" may not be in the client's best interest.
    - The investment adviser should vote as recommended by company management or in support of proposals made by a particular shareholder, absent a specific instruction from the client or a determination by the investment adviser that a different vote would further the investment strategy being pursued.
    - The investment adviser should abstain from voting all proxies, regardless of whether the client undertakes to vote the proxies itself.
    - The investment adviser can focus its voting resources only on particular types of proposals reflecting client preferences.
3. In considering whether to retain a proxy advisory firm to provide proxy voting recommendations, an investment adviser should ascertain whether the proxy advisory firm has the capacity and competency to adequately analyze proxy issues, and this includes consideration of:
    - The adequacy and quality of the proxy advisory firm's staffing and personnel.
    - The robustness of the proxy advisory firm's policies and procedures regarding its ability to:
        - Ensure that proxy voting recommendations are based on current, accurate information; and
        - Identify and address any conflicts of interest and any other appropriate considerations.

4. An investment adviser should also adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight to ensure that proxies are voted in the best interests of its clients. After the initial assessment, the investment adviser should attend to changes in the proxy advisory firm's business, policies and procedures that could impact quality, raise conflicts of interest or impact how conflicts of interest are handled.

5. An investment adviser that receives voting recommendations from a proxy advisory firm should ascertain that the proxy advisory firm has the capacity and competency to adequately analyze proxy issues, which includes the ability to make voting recommendations based on materially accurate information. This includes taking into account whether the proxy advisory firm is taking reasonable steps to seek to reduce errors.

B. Guidance Relating to Proxy Advisory Firms

6. Furnishing proxy voting advice constitutes a "solicitation" subject to the information and filing requirements of the federal proxy rules. Unless an exemption applies, a proxy advisory firm is required to file its advice as soliciting material with the SEC, which would presumably adversely affect the firm's business model as its clients would be able to read the firm's advice for free. There are two possible exemptions from the proxy rules that could apply to a proxy advisory firm–Exchange Act Rule 14a-2(b)(1) and Rule 14a-2(b)(3).

7. Rule 14a-2(b)(1) provides an exemption for "any solicitation by or on behalf of any person who does not, at any time during such solicitation, seek directly or indirectly, either on its own or another's behalf, the power to act as a proxy for a security holder and does not furnish or otherwise request, or act on behalf of a person who furnishes or requests, a form of revocation, abstention, consent or authorization." To the extent that a proxy advisory firm limits its activities to distributing reports containing recommendations and does not solicit the power to act as proxy for the client(s) receiving the recommendations, the proxy advisory firm may rely on this exemption, so long as the other requirements of the exemption are met.

8. Rule 14a-2(b)(1) is not available for a proxy advisory firm offering a service that allows the client to establish, in advance of receiving proxy materials for a particular shareholder meeting, general guidelines or policies that the proxy advisory firm will apply to vote on behalf of the client, since the proxy advisory firm would be viewed as having solicited the "power to act as a proxy" for its client. This applies even if the authority is revocable by the client.

9. Exchange Act Rule 14a-2(b)(3) exempts from proxy rules the furnishing of proxy voting advice by any person to another person with whom a business relationship exists, if certain conditions are met. The exemption is available if the person:

    - 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 with 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 commission or remuneration 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.

10. If a proxy advisory firm provides consulting services to a company on a matter that is the subject of a voting recommendation or provides a voting recommendation to its clients on a proposal sponsored by another client, the proxy advisory firm must determine, based on the facts and circumstances, whether its relationship with the company or shareholder proponent is significant or if the proxy advisory firm otherwise has any material interest in the matter that is the subject of the voting recommendation. In making such a determination, a proxy advisory firm would likely consider:

    - The type of service being offered to the company or shareholder proponent;
    - The amount of compensation that the proxy advisory firm receives for such service; 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.

    A similar inquiry would be made for any interest that might be material. A relationship generally considered "significant" or a "material interest" would exist if knowledge of the relationship or interest would reasonably be expected to affect the recipient's assessment of the reliability and objectivity of the proxy advisory firm and the advice.

11. If a proxy advisory firm determines that a significant relationship or a material interest exists for purposes of relying on Rule 14a-2(b)(3), it must provide the recipient of the advice with disclosure that provides notice of the presence of such significant relationship or material interest. Boilerplate language that such a relationship or interest may or may not exist is insufficient. The disclosure should enable the recipient to understand the nature and scope of the relationship or interest, including the steps taken, if any, to mitigate the conflict, and provide sufficient information to allow the recipient to make an assessment about the reliability or objectivity of the recommendation.

12. A proxy advisor cannot meet the disclosure requirement in Rule 14a-2(b)(3) by stating that information about significant relationships or material interests will be provided upon request.

13. A proxy advisor need not disclose a significant relationship or material interest in the same document that conveys a vote recommendation and need not make it publicly available. However, the disclosure should be provided in such a way as to allow the client to assess both the advice provided and the nature and scope of the disclosed relationship or interest at or about the same time that the client receives the advice.

The Staff noted that the guidance provided in the Bulletin may lead investment advisers and proxy advisory firms to determine that changes to their current systems and processes are necessary and that any necessary changes should be made "promptly"–meaning at the latest "in advance of next year's proxy season."

Practice Pointers

The Bulletin's guidance addresses some but not all of the concerns that have been raised about proxy advisory firms by emphasizing the applicability of existing regulations. While there are no direct consequences for public companies, the focus of the Bulletin on compliance with SEC regulation by the investment adviser clients of proxy advisory firms may help to improve the quality of proxy advisor analysis–including by reducing reliance

on fairly rigid one-size-fits-all policies–and increase transparency with respect to potential conflicts from consulting services. Some investment advisers may decide to lessen their reliance on proxy advisors. The guidance emphasizes that investment advisers cannot simply presume that proxy advisory firms have the bandwidth or the ability to implement their investment adviser clients' voting guidelines responsibly, especially given the crush of votes required during proxy season. Rather, investment advisers have the duty to oversee any proxy advisory firm they retain, which oversight would include ascertaining that the proxy advisory firm has the capacity and competency to adequately analyze proxy issues, such as the ability to make voting recommendations based on materially accurate information. This diligence may well lead to greater investment in analytic capacity by the proxy advisory firms–and an increase in the cost of providing their services.

In light of the guidance, investment advisers should:

- Conduct and memorialize due diligence on the capacity and competency of any proxy advisory firm prior to retention;
- Establish and implement measures reasonably designed to identify and address the proxy advisory firm's conflicts that can arise on an ongoing basis (such as by requiring the proxy advisory firm to update the investment adviser of business changes or other factors the investment adviser considers relevant);
- Periodically review the operation of voting guidelines, both to confirm the effectiveness of the proxy advisor in accurately implementing the proxy voting guidelines and to potentially reconsider whether the guidelines themselves continue to operate in the best interests of clients and investors;
- Provide feedback to proxy advisory firms about their development and use of proxy voting in light of clients interests, including when it is determined that a proxy advisory firm's analyses are inadequate or incorrect;
- Conduct periodic reviews of the proxy advisory firm's performance, including by requesting updated information about its staffing, its analytic framework, its ability to provide tailored advice that considers the circumstances of each company, error rates and systems designed to avoid errors, policies with respect to conflicts and disclosures of conflicts, changes in the business that may raise conflicts and any regulatory action involving the firm; and
- Advocate that proxy advisory firms disclose any conflicts of interest relating to a company on which voting advice is being provided–or relating to a shareholder proponent–in meaningful (non-boilerplate) terms in the same document that the advice is being provided, so that investment advisers can assess.

Investment advisers who use proxy services will need to step up their initial and ongoing diligence on these providers–particularly in light of the specific demands and complexity of the voting challenges that face client portfolios. After all, investment advisers ultimately retain the fiduciary responsibility for proxy voting of client securities.

At the same time as the guidance elaborates on the investment advisers' oversight responsibility with respect to the proxy advisory firms they retain, the guidance gives investment advisers a way out–by reminding them, in pointed fashion, that the fiduciary duties of investment advisers do not require that they vote every proxy. Rather, an investment adviser and its client may agree that the investment adviser will abstain from voting any proxies at all, or can vote on some proposals, but not all. If the costs of proxy voting, including the costs

associated with retaining a proxy advisory firm, outweigh the benefits to the investment adviser and its client, then the investment adviser and client can agree not to participate in proxy voting at all.

The regulatory objective of these 13 questions and answers is left unstated, but we infer it to be as follows: *the investment adviser that retains and pays a proxy advisory firm is uniquely positioned to monitor the proxy advisory firm and is required to actively oversee the firm if it wants to benefit from the firm's services to discharge its fiduciary duty. As a result of the greater oversight exercised by all of their investment adviser clients, the proxy advisory firms will presumably respond by enhancing their policies, processes and procedures, as well as the transparency of these policies, processes and procedures. In turn, the corporate community may indirectly benefit to some degree*. For example, many commenters on the SEC's 2010 Concept Release commented that issuers should have the opportunity to review and comment on drafts of the proxy advisory firm's reports. While the guidance does not mandate that proxy advisory firms provide issuers with the opportunity to review and comment on the firms' reports about them, the guidance specifically states that the investment adviser should ascertain that the proxy advisory firm has the ability to make voting recommendations based on materially accurate information. The most effective and efficient way in which a proxy advisory firm can ensure that its information about a company is materially accurate is to show that information to the company in advance of publication for its review and comment.

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[i] Serdar Çelik and Mats Isaksson (2014), "Institutional investors and ownership engagement", *OECD Journal: Financial Market Trends*, Vol. 2013/2, at 96, http://www.oecd.org/corporate/institutional-investors-ownership-engagement.pdf.

[ii] SEC Concept Release on the U.S. Proxy System No. 140, 75 Fed. Reg. 42,982, 43,010 (July 22, 2010).

[iii] James K. Glassman & Hester Peirce, *How Proxy Advisory Services Became So Powerful*, Mercatus ON POLICY 1 (Mercatus Center at George Mason University), June 18, 2014, *available at* http://mercatus.org/sites/default/files/Peirce-Proxy-Advisory-Services-MOP.pdf.

[iv] Matteo Tonello et. al, *The Influence of Proxy Advisory Firm Voting Recommendations*, THE CONFERENCE BOARD (Apr. 8, 2012, 7:43 AM), http://blogs.law.harvard.edu/corpgov/2012/04/08/the-influence-of-proxy-advisory-firm-voting-recommendations/.