Client Alert

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SEC Staff Releases Guidance on Investment Advisers and Proxy Advisory Firms

On June 30, 2014, the SEC Divisions of Investment Management and Corporation Finance released guidance to investment advisers and proxy advisory firms in the form of 13 Questions and Answers. The guidance, which is published in Staff Legal Bulletin No. 20 ("SLB 20") and available at http://www.sec.gov/interps/legal/cfslb20.htm, addresses (1) investment advisers' responsibility when voting client proxies and retaining proxy advisory firms and (2) the availability and requirements of two exemptions to federal proxy rules often relied upon by proxy advisory firms. Although many commentators have been requesting more regulation over proxy advisory firms, this guidance does not overhaul the existing legal framework.

Background

Proxy advisory firms have emerged in recent years as a powerful force in influencing proxy voting by institutional investors. Although there are several niche players in the industry, the market is dominated by Institutional Shareholder Services Inc. (ISS) and Glass Lewis & Co. LLC (Glass-Lewis). Proxy advisory firms are often criticized on various grounds, including (1) issuing recommendations based on incorrect assumptions, calculations or methodologies, (2) failing to provide advance copies of their recommendations except to the largest US public companies, (3) applying a one-size-fits-all approach to corporate governance matters, and (4) creating conflicts of interest by issuing recommendations to investors on how to vote on shareholder proposals while also offering consulting services to the same public companies submitting such proposals. Proxy advisory firms also face a challenging business environment. ISS, for example, issues recommendations on approximately 39,000 companies in 115 countries each year. In addition, most of the proposals in the United States are considered during a three-month period each year. At the same time, ISS is under pressure from its clients to minimize costs.

The guidance issued in SLB 20, as summarized below, will likely disappoint observers who were hoping the Commission would seek to regulate the operations of proxy advisory firms in a more comprehensive and robust fashion. Nearly four years have elapsed since the Commission most recently considered enhanced regulation of proxy advisory firms.[1] As a result, it seems unlikely that the Commission will pursue additional regulations soon, even though many commentators continue to call for greater transparency into the methodologies by which proxy advisory firms make voting recommendations and more vigorous disclosure of conflicts of interest.

Proxy Voting by Investment Advisers

Investment advisers owe a duty of care and loyalty when undertaking services on behalf of their clients, including proxy voting. Current SEC rules require investment advisers to adopt and implement written policies and procedures reasonably designed to ensure investment advisers vote proxies in the best

[1] *See* Concept Release on the US Proxy System, Release Nos. 34-62495; IA-3052; IC-29340; File No. S7-14-10 (July 14, 210).

interests of their clients (the "Proxy Voting Rule").[2] At least annually, investment advisers should review the adequacy of their proxy voting policies to verify they are being effectively implemented and are still reasonably designed to serve their clients' best interests. Investment advisers can demonstrate their compliance with this rule by periodically sampling proxy votes to verify compliance with their policies and procedures.

Although in most cases clients delegate to their investment adviser all their proxy voting authority, the Proxy Voting Rule grants flexibility in determining the scope of the investment adviser's voting authority. SLB 20 includes a nonexclusive list of examples of alternative arrangements clients and investment advisers can establish, including ones in which they determine:

- the time and costs associated with certain types of proposals or issuers may not be in the client's best interest;
- to vote as recommended by management or in favor of all proposals made by a particular shareholder proponent absent contrary instructions;
- to abstain from voting any proxies; or
- to focus resources on only particular types of proposals.

Investment advisers that retain proxy firms to assist with their proxy voting responsibilities must perform sufficient due diligence to "ascertain that the proxy advisory firm has the capacity and competency to adequately analyze proxy issues." In making that determination, investment advisers may consider the adequacy of the proxy advisory firm's staffing and personnel and the robustness of its policies concerning identifying and addressing conflicts of interest and ensuring the accuracy of the information used to make its proxy voting recommendations.

Exemption of Proxy Advisory Firms from SEC's Proxy Solicitation Rules

Proxy advisory firms engage in "solicitation" when they furnish recommendations "to security holders … reasonably calculated to result in the procurement, withholding or revocation of a proxy," but Exchange Act Rule 14a-2(b) exempts them from the information and filing requirements of federal proxy rules so long as they provide only voting recommendations ("Voting Recommendation Exemption"). The Voting Recommendation Exemption is not available when a proxy firm allows its client to establish, in advance of receiving proxy materials for a particular shareholder meeting, general guidelines that the proxy advisory firm (not the client) uses to vote the proxies. Such a "power to act as a proxy" is not allowed under the Voting Recommendation Exemption.

SLB 20 goes on to explain, even when the Voting Recommendation Exemption is not available, Rule 14a-2(b)(3) exempts the furnishing of proxy voting advice from federal proxy rules so long as a business relationship is present, subject to certain conditions ("Business Relationship Exemption"). The Business Relationship Exemption is available if the proxy advisory firm (1) gives financial advice in the ordinary course of business, (2) receives no special commission for furnishing the advice other than from the recipient, (3) does not furnish advice for a person or company soliciting proxies or on behalf of a participant in a contested election, and, most notably, (4) discloses to the recipient of the advice any significant relationship the advisory firm has with the company or the proponent subject to the advice recommended.

The Business Relationship Exemption recognizes the potential conflict of interest when a proxy advisory firm provides voting recommendations concerning a company while also providing consulting services to that same company. Therefore, the Business Relationship Exemption is available only if:

[2] Rule 206(4)-6 under the Investment Advisers Act of 1940.

- the proxy advisory firm has assessed whether its relationship to the company is "significant," meaning the relationship would reasonably "affect the recipient's assessment of the reliability and objectivity of the advisor and the advice"; and

- after determining there is a "significant" relationship, the proxy advisory firm affirmatively discloses to the potential recipient of the advice the nature and scope of the relationship, including any steps taken to mitigate the conflict of interest.

Notably, the proxy advisory firm needs to disclose only the "significant" relationship to its client. The proxy advisory firm is not required to make this disclosure public or share it with the company or proponent subject to this potentially biased recommendation.

Conclusion

The guidance provided in SLB 20 merely clarifies current rules applicable to investment advisers and reiterates the availability of two often-used exemptions to federal proxy rules for proxy advisory firms. It does not modify the staff no-action letters that some commentators have criticized as fueling the current controversy. Although the guidance notes that investment advisers and proxy advisory firms may want or need to make changes to their current systems and processes in light of the guidance provided, issuers will likely not notice the effects of any such changes. Nevertheless, the guidance clarifies that furnishing proxy voting advice will generally constitute a "solicitation" under the federal proxy rules, which also subjects proxy advisory firms to potential antifraud liability under Rule 14a-9. Moreover, public companies that purchase consulting services from proxy advisory firms are entitled to more robust conflict of interest disclosure from the advisory firm.

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