Cooley

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After years of releases, roundtables and recommendations, the SEC's Divisions of Investment Management and Corporation Finance have posted Staff Legal Bulletin No. 20, "**Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms**." The new guidance seeks to reinforce the responsibilities of investment advisers as voters by reinvigorating their due diligence and oversight obligations with respect to any proxy advisory firms, such as ISS and Glass Lewis, on which they rely. In addition, the guidance strengthens, to a limited extent, the disclosure obligations of proxy advisory firms in connection with conflicts of interest. This Staff Legal Bulletin represents long-promised guidance intended to address some of the frequently voiced criticisms that proxy advisory firms wield too much influence—with too little accountability—in corporate elections and other corporate matters and that they are often subject to undisclosed conflicts of interest that may affect their vote recommendations. For example, in a 2013 speech, **SEC Commissioner Gallagher** lamented the increased willingness of investment advisers to outsource their proxy analysis responsibilities to proxy advisory firms and the resulting "increased influence by proxy advisory firms over investors and the companies in which they invest." Similarly, **SEC Commissioner Piwowar** has observed that he saw "many similarities between the current situation with proxy advisory firms and the pre-crisis situation with credit rating agencies, including an unhealthy over-reliance on their recommendations by investors."

However, while the issue has been steeping for several years, the new guidance, while helpful, is pretty weak tea in comparison to the potential requirements that were floated in connection with the SEC's proxy plumbing concept release or the 2010 report from the NYSE Commission on Corporate Governance. These bolder ideas included mandatory proxy advisory firm registration, requiring proxy advisory firms to provide more transparency regarding their policies and methodologies and the extent of research involved to formulate specific voting recommendations, requiring any conflicts of interest and the procedures to manage them to be described in filed reports and requiring proxy advisor recommendations to be filed with the SEC.

Guidance related to obligations of investment advisers

The first set of questions (from the Division of Investment Management) addressed in the Bulletin relates to the relationship of investment advisers and proxy advisory firms. By way of background, as fiduciaries, investment advisers owe their clients duties of care and loyalty with respect to services provided, including proxy voting. Accordingly, in voting client securities, an investment adviser must adopt and implement policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interest of its clients. Prior SEC staff no-action guidance has indicated that one way advisers may demonstrate that proxies are voted in their clients' best interest is to vote client securities based on the recommendations of an independent third party, which serves to "cleanse" the vote of any conflict on the part of the investment adviser. Historically, investment advisers have frequently looked to proxy advisory firms to fill this role. As a result, the staff's prior guidance has often been criticized for having "institutionalized" the role of—and, arguably, the over-reliance of investment advisers on—proxy advisory firms, in effect transforming them into *faux* regulators.

In the new guidance, the staff indicates additional steps that an investment adviser could take to demonstrate that proxy votes are cast in accordance with clients' best interests. These include periodically sampling proxy votes to review whether they complied with the investment adviser's proxy voting policy and procedures and reviewing a sample of proxy votes that relate to certain proposals that may require more analysis. In addition, investment advisers are urged to review, at least annually, the adequacy of their proxy voting policies and procedures to make sure they have been implemented effectively and continue to be reasonably designed to ensure that proxies are voted in the best interests of their clients. Our understanding is that many of these actions are already part of most investment advisers' standard practices.

Under the new guidance, investment advisers also are advised to "adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the third party in order to ensure that the investment adviser, acting through the third party, continues to vote proxies in the best interests of its clients," including measures to identify and address the proxy advisory firm's conflicts on an ongoing basis. For example, the investment adviser should ascertain, among other things, "whether the proxy advisory firm has the capacity and competency to adequately analyze proxy issues." In addition to considering the adequacy and quality of the proxy advisory firm's staffing and personnel, the adviser must consider the "robustness" of the firm's policies and procedures regarding its ability (1) to "identify and address any conflicts of interest and any other considerations that the investment adviser believes would be appropriate in considering the nature and quality of the services provided by the proxy advisory firm," and (2) to "ensure that its proxy voting recommendations are based on current and accurate information." If an investment adviser determines that a recommendation was based on a "material factual error that causes the adviser to question the process by which the proxy advisory firm develops its recommendations," the investment adviser "should take reasonable steps to investigate the error, taking into account, among other things, the nature of the error and the related recommendation, and seek to determine whether the proxy advisory firm is taking reasonable steps to seek to reduce similar errors in the future."

Guidance related to proxy advisory firms

The next set of questions (from the Division of Corporation Finance) addressed in the Bulletin relates to when a proxy advisory firm is subject to the federal proxy rules and how proxy advisory firms can qualify for exemptions to those rules. It is in connection with the exemptions that the staff has enhanced the disclosure obligations of proxy advisory firms.

A proxy advisory firm would be subject to the federal proxy rules if it engages in a "solicitation," as defined under Rule 14a-1(l). Generally, the SEC "has stated that the furnishing of proxy voting advice constitutes a 'solicitation' subject to the information and filing requirements of the federal proxy rules. Providing recommendations that are reasonably calculated to result in the procurement, withholding, or revocation of a proxy would subject a proxy advisory firm to the proxy rules." However, a proxy advisory firm may be able to rely on the exemptions from the proxy information and filing requirements under Rule 14a-2(b).

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 clients receiving the recommendations, it may be able to claim exemption under Rule 14a-2(b)(1) (so long as the other requirements of the exemption are met). However, where a proxy advisory firm assists in the establishment of general proxy voting guidelines and policies, executes a proxy or submits voting instructions on behalf of a shareholder, and uses its discretion to apply the guidelines to determine how to vote on particular proposals, the proxy advisory firm may not rely on the Rule 14a-2(b)(1) exemption. Rule 14a-2(b)(1) "would not be 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. In this instance, the proxy advisory firm would be viewed as having solicited the 'power to act as a proxy' for its client. This would be the case even if the authority was revocable by the client."

If Rule 14a-2(b)(1) is not available, a proxy advisory firm may instead be able to rely on the exemption provided by Rule 14a-2(b)(3), which exempts the furnishing of proxy voting advice by any person to another person with whom a business relationship exists, subject to certain conditions. To rely on the exemption, the firm must:

- give financial advice in the ordinary course of business;
- disclose *to the recipient of the advice* any significant relationship with the company or any of its affiliates, or a security holder proponent of the matter on which advice is given, as well as any material interests of the firm in such matter;
- receive 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

- not furnish the advice on behalf of any person soliciting proxies or on behalf of a participant in a contested election.

For example, 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, to determine whether it could rely on Rule 14a-2(b)(3), the firm would need to (1) assess whether its relationship with the company or security holder proponent (if known) is significant or whether it otherwise has any material interest in the matter and (2) disclose to the recipient of the voting recommendation any such relationship or material interest. Of course, "significance" and "materiality" depend on the facts and circumstances, including "the type of service being offered to the company or security holder 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 security holder proponent. A similar inquiry would be made for any interest that might be material. A relationship generally would be 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 advisor and the advice." Given that many institutional investors have custom policies developed by, and delegate proxy voting to, proxy advisory firms, it is likely that this is the exemption on which proxy advisory firms frequently rely.

If there is a significant relationship or a material interest, the proxy advisory firm will now need to provide real "notice," including "the nature and scope of the relationship or interest, including the steps taken, if any, to mitigate the conflict." In any event, the currently common boilerplate advising that a relationship or interest may or may not exist would not provide adequate notice. The disclosure will also need to provide sufficient information to allow the recipient to make an assessment about the reliability or objectivity of the recommendation. While ISS may be particularly impacted here because it also provides consulting services, Glass Lewis is owned by the Ontario Teachers' Pension Plan Board, which reportedly sometimes takes activist positions, and both firms may be in positions to issue recommendations on shareholder proposals brought by their investor clients. The proxy advisory firm would not satisfy Rule 14a-2(b)(3) by stating only that information about significant relationships or material interests will be provided upon request (which is also common practice now). Under the rule, the firm would have an "affirmative duty to disclose significant relationships or material interests to the recipient of the advice."

Rule 14a-2(b)(3) does not specify where the required disclosure should be provided, and the staff does not expressly require that the disclosure be included in the proxy advisory firm's report about a company. However, the firm is advised to "provide the disclosure 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. This disclosure may be made publicly or between only the proxy advisory firm and the client." The proxy advisory firms have historically made this information available to their clients only upon request.

Observations and commentary

- As noted above, the new guidance is a far cry from the more rigorous regulation of proxy advisory firms that was originally anticipated and, we believe, is unlikely to eliminate the controversy concerning proxy advisory firms. While the staff's guidance provides a welcome focus on procedures for ensuring factual accuracy and addressing factual errors, it does so by reinforcing the responsibilities of investment advisers. A more effective approach may have been to require that all proxy advisory firms provide advance copies of their recommendations to all issuers, free of charge, for purposes of fact-checking prior to release. Currently, ISS provides advance copies of the reports for fact-checking only to companies in the S&P 500; for any other issuers, ISS will provide them without charge only after publication. Glass Lewis does not provide any previews of its reports and charges companies for copies of their reports after publication. While the two key proxy advisory firms will typically correct factual errors and alert their investor clients subsequent to publication of their reports, where recommendations involving judgment calls are based on factual errors, companies sometimes find that the firms are reluctant to change those published recommendations, even if the underlying facts have shifted. Although certainly not a perfect substitute for advance fact-checking of an ISS report, ISS's QuickScore data verification tool, available to the Russell 3000, may help to ensure the accuracy of data in the ISS annual meeting report because the QuickScore data is also used by analysts evaluating companies' proposals and issuing vote recommendations. We encourage companies to use that free tool to verify that the data underlying their ISS QuickScores is accurate. We also encourage Glass Lewis to either provide companies with some mechanism to fact check its reports or data or, at a minimum, provide companies with copies of reports issued for their own meetings at no charge so that companies may verify the factual accuracy of the data underlying the analyses and recommendations.

- The new guidance also amps up the obligations of investment advisers to conduct appropriate due diligence when they retain a proxy advisory firm to make voting recommendations, particularly with respect to factual errors. At the same time, it is possible that these reinforced obligations may enhance investment advisers' leverage in requiring proxy advisory firms to adopt more stringent policies and procedures regarding accuracy and disclosure. Although the threshold for materiality appears high and there is no apparent due diligence obligation on the part of investment advisers to uncover material factual errors, companies should be sure to review the proxy advisory firms' reports for factual accuracy. In the event of factual error, companies should consider, as a strategic matter, whether to contact the proxy advisory firm to alert it to the inaccuracy. If the firm agrees, it will then issue an alert to its clients revising the report to correct the factual error. Another way that investment advisers may be apprised of factual errors is through information provided by affected issuers in public filings that contest the advisory firm's recommendation or during engagement meetings and calls intended to solicit stockholders' votes. Companies may want to consider disclosing factual errors to their large institutional holders and investment advisers that follow the recommendations of proxy advisory firms to provide an impetus for investment advisers to confirm that the proxy advisory firm is taking reasonable steps to seek to reduce similar errors in the future.
- With regard to disclosure of conflicts of interest, we understand that ISS maintains a firewall designed to preclude the staffs that perform proxy analyses and advisory research from obtaining access to information about ISS' consulting relationships with corporate issuers. The SEC has stated that disclosure of conflicts of interest may be limited to clients only, and ISS may choose to avoid public disclosure to maintain that firewall. However, neither ISS nor Glass Lewis indicates that any wall exists between the staffs that perform proxy analyses and entities that are proponents of shareholder proposals and also clients of ISS's or Glass Lewis's research function. Accordingly, and particularly in light of the absence of clear ethical protections in those situations, we would hope that the conflict would be disclosed at the same time and in the same manner as the recommendation.

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