

Wachtell Lipton discusses Commissioner Gallagher's Critiques of Proxy Advisory Firms

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In a [speech](#) last week to the Society of Corporate Secretaries & Governance Professionals, SEC Commissioner Daniel M. Gallagher voiced “grave concerns,” which we have long [shared](#), as to “whether investment advisers are indeed truly fulfilling their fiduciary duties when they rely on and follow recommendations from proxy advisory firms.” He also said:

“It is troubling to think that institutional investors, particularly investment advisers, are treating their responsibility akin to a compliance function carried out through rote reliance on proxy advisory firm advice rather than actively researching the proposals before them and ensuring that their votes further their clients’ interests.”

The Commissioner also indicated he was “very concerned” that two SEC staff no-action letters from 2004, which he noted were not approved by the Commission and did not necessarily represent the view of the Commission or the Commissioners, had “unduly increased the role of proxy advisory firms in corporate governance” by “essentially mandating the use of third party opinions.”

We have previously expressed similar concerns that the U.S. economy and the real interests of long-term investors and their beneficiaries are being undermined by over-reliance on proxy advisory firms by institutional investors. We continue to believe that disintermediating proxy advisory firms increases the likelihood that long-term investors, and the companies in which they invest, can constructively resolve governance and other issues in a case-by-case manner that reflects the specific context in which the issues arise, rather than through rote application of one-size-fits-all criteria devoid of direct engagement on the merits.

While regulatory changes to address these problems have yet to be adopted, the Department of Labor and the Commission, including by way of the SEC’s June 2010 Concept Release on the U.S. Proxy

System, have consistently raised questions regarding fiduciary responsibility in the context of the outsourcing of proxy voting decisions. Congressional attention is also being brought to bear as shown by last month's House subcommittee hearing "Examining the Market Power and Impact of Proxy Advisory Firms." A May 2013 [paper](#) out of the Stanford business school, cited by Commissioner Gallagher in his speech, notes a statistically negative stock market reaction to compensation program changes made in response to criticisms by proxy advisory firms.

Faced with no-action letter guidance from the SEC that encourages reliance on proxy advisory firm recommendations as a means to avoid potential liability and at times deluged by the number of voting decisions facing them, institutional investors admittedly face difficulties in consistently exercising independent judgment, notwithstanding their fiduciary obligation to do so. We [applaud](#) those institutional investors who have, notwithstanding these difficulties, risen to the challenge and applied long-term value-oriented, situation-specific, and pragmatic perspectives to governance and other issues. An illustrative example is provided by [BlackRock](#), which makes its voting decisions independently of proxy advisory firm and applies its own guidelines "pragmatically" out of recognition that "good corporate governance is complex," noting that "[f]rom a shareholder point of view, it involves in-depth analysis and an appreciation that there are different ways to run a company well." BlackRock has also committed to a "fair, respectful and open-minded airing of views" as part of advance engagement with issuers and has reiterated its willingness to "support unconventional approaches where we expect that they'll serve the interests of long-term shareholders."

Among other reforms for regulating proxy advisory firms, Commissioner Gallagher proposed in his speech that the Commission replace the previous staff letters blessing the outsourcing of voting decisions with Commission-level guidance that would discourage "rote reliance" on proxy advisory firm recommendations and instead help ensure that institutional shareholders are carrying out their fiduciary duties and complying with the original intent of the SEC's rules. We would view that as a step in the right direction.