

July 1, 2014

SEC Issues Regulatory Guidance on Proxy Advisory Firms and Proxy Voting Responsibilities

Yesterday the Staff of the Securities and Exchange Commission's Divisions of Investment Management and Corporation Finance issued regulatory guidance (in the form of a [user-friendly Q&A](#)) concerning the proxy voting responsibilities of investment advisers (such as fund managers), the use of proxy advisory firms and the applicability of the proxy rules to such firms. The Staff also made clear their expectation that proxy advisory firms and investment advisers will change current processes and systems to conform to the new guidance "promptly, but in any event in advance of next year's proxy season."

This welcomed guidance is part of the Commission's ongoing focus on the integrity of the proxy voting process and reflects the concerns that have been expressed, [most cogently by Commissioner Daniel M. Gallagher in several speeches](#), regarding reliance on proxy advisory firms. Although the guidance does not eliminate the fundamental structural concerns that such vast power has been given to a small group of companies that own no shares, are largely unaccountable and appear to have business imperatives to create ever-evolving "best practices," it will hopefully lead to more thoughtful and responsible use of proxy voting advice and propel further action to ensure greater disclosure regarding conflicts of interest, lack of transparency and other concerns that have been expressed concerning the proxy advisory industry.

Of particular note, the Staff Legal Bulletin:

- Confirms that rote outsourcing of voting discretion to proxy advisory firms without engaging in continual, ongoing, and active oversight is inconsistent with an investment adviser's fiduciary duties to its clients. In particular, institutions that choose to retain a proxy advisory firm must allocate appropriate resources and exercise on-going oversight to, among other things, ensure that proxy voting recommendations "are based on current and accurate information," evaluate the advisory firm's "capacity and competency" and stay current on the firm's actual practices. Where material factual errors are discovered or brought to an advisers' attention (by an issuer or otherwise), the Staff indicates that such matters cannot be ignored but should be investigated, including as to what steps the proxy advisory firm is taking to reduce similar errors in the future.
 - In this regard, we encourage investors to require, as a compliance and oversight matter, that any proxy advisory firms to whom they subscribe implement a standardized process for advance issuer review and dialogue on proxy advisory reports during the drafting process and to include the issuer's response in the final published version of its reports to the extent there remain any outstanding issues.
- Rejects the notion that proxy advisory firm recommendations fall outside the ambit of the proxy rules and confirms that the furnishing of proxy voting advice generally constitutes a "solicitation." Accordingly, proxy advisory firms are subject to potential Rule 14a-9 liability for false or misleading statements involving material facts or omissions. With respect to the proxy rules, the guidance limits the ability of proxy advisory firms to rely on exemptions from certain information and filing requirements where the firms may have solicited the "power to act as a proxy" for their clients.

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- Confirms that investment advisers are not required to vote every proxy or at every meeting. Instead, advisers and their clients have broad flexibility to determine the extent to which proxy voting authority should be exercised (if at all) and may decide, among other options, to: generally abstain from voting or focus on only a subset of particular proposals or items; determine upfront to vote in accordance with the recommendations of the Board of Directors or in favor of proposals made by a particular shareholder proponent; or make other arrangements, including determining that the “time and costs associated with the mechanics of voting proxies with respect to certain types of proposals or issuers may not be in the client’s best interest.”
 - It is possible that this guidance may result in some investment advisers and shareholders opting not to vote on various issues (which could magnify the voices of activists or lead to distortions in the character and quality of information conveyed by reported “votes cast”). The guidance, however, should give confidence to portfolio managers and investors who are considering an efficient default rule providing that, absent a contrary instruction from the beneficial owner, shares should be voted in accordance with the recommendations of the entity that is subject to fiduciary duties and managing the enterprise in which the investor has chosen to invest – the company’s board of directors.
- Clarifies that where an investment adviser does vote, it must adopt – and follow – reasonably designed protocols to ensure that proxies are in fact voted in the best interests of its clients. At a minimum, the Staff expects investment advisers to review, no less frequently than annually, whether policies and procedures are being implemented effectively, whether they continue to be reasonably designed and what changes are necessary.
- With respect to conflicts of interest, requires specific, non-generic disclosure to be made of the nature and scope of significant relationships or material interests in the matter that is the subject of a voting recommendation (either publicly or directly to the client) and warns that “boilerplate language” stating that potentially conflicting relationships or interests “may or may not exist” is insufficient, and that offering to provide information only “upon request” also falls short. The Staff also indicates that provided disclosure must be sufficient to enable the voting recommendation’s reliability or objectivity to be assessed.
 - Although the guidance suggests that proxy advisers may only be strictly required to make these conflict disclosures to their clients, we expect that they would choose to disclose publicly so that their highly influential proxy reports are not misleading.

This SEC Staff-level guidance is a step in the right direction towards addressing the outsized role of proxy advisory firms in corporate governance and economic matters. However, we believe that further Staff, Commission-level or legislative action will be necessary to increase the overall accountability of proxy advisory firms, resolve conflicts of interests and address the lack of transparency into their methodologies and analyses. In the meantime, we continue to encourage investors to exercise their own independent, informed judgments on voting matters, reject the rote application of one-size-fits-all criteria and engage constructively and directly with issuers in a case-by-case, pragmatic manner.

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