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Corporate Governance Update: Important Proxy Advisor Developments

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As 2014 winds down and 2015 approaches, proxy advisory firms—and the investment managers who hire them—are finding themselves under increased scrutiny. Staff guidance issued by the Securities and Exchange Commission at the end of June[1] and a working paper published in August by SEC Commissioner Daniel M. Gallagher[2] both indicate that oversight of proxy advisory services will be a significant focus for the SEC during next year's proxy season. Under the rubric of corporate governance, annual proxy solicitations have become referenda on an ever-widening assortment of corporate, social, and political issues, and, as a result, the influence and power of proxy advisors—and their relative lack of accountability—have become increasingly problematic.[3] The SEC's recent actions and statements suggest that the tide may be turning. Proxy advisory firms appear to be entering a new era of increasing accountability and potentially decreasing influence, possibly with further, more significant, SEC action to come.

The proxy advisory industry currently is dominated by two firms, Institutional Shareholder Services (ISS) and Glass Lewis & Co. With nearly 100% market share between them,[4] their widespread influence in shareholder activism and

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[1] Securities and Exchange Commission Staff Legal Bulletin No. 20, "Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms," June 30, 2014 ("SLB 20"), available at www.sec.gov/interps/legal/cfslb20.htm.

[2] Commissioner Daniel M. Gallagher, U.S. Securities and Exchange Commission, "Outsized Power and Influence: The Role of Proxy Advisers," Washington Legal Foundation Critical Legal Issues Working Paper Series, No. 187, Aug. 2014 ("Gallagher Paper"), available at http://www.wlf.org/upload/legalstudies/workingpaper/GallagherWP8-14.pdf.

[3] *See, e.g.,* U.S. Chamber of Commerce, Center for Capital Markets Competitiveness, "Best Practices and Core Principles for the Development, Dispensation, and Receipt of Proxy Advice," March 2013, at 2, available at www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Best-Practices-and-Core-Principles-for-Proxy-Advisors.pdf.

[4] *See* U.S. Chamber of Commerce, Center for Capital Markets Competitiveness, *supra,* at 3 (estimating that the two firms together have 97% market share).

proxy voting has resulted in calls from the business community for greater SEC supervision of their business practices, potential conflicts of interest, and transparency.[5]

The SEC will monitor shareholder voting decisions and corporate board elections in 2015 to evaluate the effect of the SEC staff's recent guidance.[6] It is clear that the SEC expects investment advisers to take a more active role in overseeing proxy advisory firms and holding these firms accountable both for the quality of their recommendations and the business practices that produce them. By leveraging the influence of their clients, it appears that the SEC hopes to put pressure on proxy advisors to reform from within. However, as many shareholder activists are also clients of these firms, it may not be easy to promote change.

Need for Reform

Commentators have for years lamented the undue influence of proxy advisory firms in corporate elections. James R. Copland of the Manhattan Institute has observed that an ISS recommendation in favor of a given shareholder proposal increases the approval vote by, on average, fifteen percentage points.[7] In other words, as Copland puts it, "At least when it comes to shareholder proposals, a small, thinly funded outfit with 600 employees in Rockville, Maryland, is acting like an owner of fifteen percent of the total stock market."[8] In some instances, ISS's influence can be even greater. In 2014, for example, shareholder proposals related to social and political issues received average support of 29% with ISS's support, and only 5% if ISS recommended against.[9] That is, ISS directly influenced nearly a quarter of the votes cast on these matters. Because the SEC's rules for resubmission of a failed proposal by a shareholder in the next year's proxy statement require that the proposal have received up to 10% of the vote

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[5] *See* Gallagher Paper, *supra*, at 12; *see also* Holly Gregory, "SEC Guidance May Lessen Investment Adviser Demand for Proxy Advisory Services," Sidley Austin LLP Update, July 29, 2014, available at blogs.law.harvard.edu/corpgov/2014/07/29/sec-guidance-may-lessen-investment-adviser-demand-for-proxy-advisory-services/; Yin Wilczek, "Congress Will Act If SEC Fails To Move on Proxy Advisors," Bloomberg BNA, June 27, 2014, available at www.bna.com/congress-act-sec-n17179891633/.

[6] *See* Thomson Reuters Tax & Accounting News, "Scrutiny of Proxy Advisers to Continue," July 28, 2014 (citing statements by Keith Higgins, director of the SEC's Division of Corporate Finance, on July 24, 2014) available at https://tax.thomsonreuters.com/media-resources/news-media-resources/checkpoint-news/daily-newsstand/scrutiny-proxy-advisers-continue/.

[7] *See* James R. Copland, "SEC Needs To Rethink Its Rules on Proxy Advisory Firms," Washington Examiner, July 24, 2014, available at washingtonexaminer.com/article/2551268#!.

[8] *Id.*

[9] Sullivan & Cromwell LLP, "2014 Proxy Season Review," June 25, 2014, at 16 ("S&C Proxy Review"), available at http://www.sullcrom.com/siteFiles/Publications/SC_Publication_2014_Proxy_Season_Review.pdf.

(depending on how many years it has been submitted),[10] the significant voting impact of an ISS recommendation can empower a proponent to resubmit a proposal year after year, imposing costs on the company and creating waste and negative publicity to the detriment of the company and its shareholders.

The problem of waste is exacerbated by the fact that ISS's voting recommendations, on topics from compensation to social issues, have been dramatically out of line with voting results. One example is cumulative voting: ISS has supported 96% of proposals to adopt cumulative voting; however, out of 107 such proposals at Fortune 200 companies between 2006-2012, only one received majority support.[11] As Copland notes, "The significant influence of ISS on corporate proxy voting—along with the large, systemic gap between its preferences and those observed in shareholders' actual votes—raises questions about whether shareholder voting is working effectively to improve share value."[12]

Proxy advisors' influence, elevated to great heights by two 2004 no-action letters noted below, received an additional boost in 2010 from the passage of the Dodd-Frank Act. The legislation's enshrinement of say-on-pay votes in the annual shareholder meeting raised the stakes for the shareholder vote and provided an annual opportunity for activist shareholders to, with the help of ISS, put public pressure on corporate issuers.[13] The Manhattan Institute's Copland observes that a negative recommendation from ISS on an executive compensation proposal has the effect of reducing shareholder support for it by 17 percentage points.[14]

In the 2014 proxy season, ISS's negative recommendations increased and voting results for directors were low, reflecting activist shareholders' perception that directors were insufficiently responsive to their concerns. One possible cause is a change in ISS's policies, which now call for withhold recommendations for directors who did not, after the prior annual meeting, implement a shareholder proposal that received a majority of votes cast (as opposed to votes outstanding).[15] This policy change likely has had the effect of incentivizing companies to avoid a vote by agreeing to adopt reforms

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[10] Securities Exchange Act of 1934, Rule 14a-8(i)(12).

[11] *See* James R. Copland, "Politicized Proxy Advisers vs. Individual Investors," Wall St. J., Oct. 7, 2012 ("Copland 2012"), available at online.wsj.com/news/articles/SB10000872396390444620104578012252125632908.

[12] *See id.*

[13] *See* David F. Larcker et al., "The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions," The Conference Board Director Notes, April 2012, available at www.conference-board.org/retrievefile.cfm?filename=TCB-DN-V4N5-12.pdf&type=subsite.

[14] *See* Copland 2012, *supra*.

[15] *See* S&C Proxy Review at 1.

proposed by shareholders, particularly if a proposal is likely to meet ISS's new, lower standard and thus—if not adopted before the next shareholder meeting—lead to a withhold-the-vote recommendation for directors in the following year. The influence of ISS therefore does not merely affect vote results themselves, but also boards' decisions as to which proposals actually will come to a vote.[16]

Recent SEC Guidance

On June 30, 2014, the SEC's Divisions of Corporate Finance and Investment Management released new guidance regarding investment advisers' responsibilities relating to proxy voting and their reliance upon proxy advisory firms. Under the "Proxy Voting Rule," investment advisers have a fiduciary duty to their clients to vote their proxies in the clients' best interests. Staff Legal Bulletin 20 (SLB 20) prompts investment advisers to take an active role on behalf of their clients, particularly in evaluating and overseeing any proxy advisory firm they may engage to help them fulfill their voting responsibilities. Investment advisers are required to adopt and implement written policies and procedures designed to ensure that they comply with the Proxy Voting Rule. The guidance states that investment advisers should take steps to demonstrate compliance, including reviewing, at least annually, the adequacy of their proxy voting policies and procedures to ensure that they are reasonably designed and being effectively implemented. SLB 20 suggests using proxy vote sampling to ensure that votes have been properly cast.

A key point emphasized in SLB 20 is that the Proxy Voting Rule does not require that investment advisers vote every proxy or take on all of a client's proxy voting responsibilities.[17] Although the SEC had previously conveyed this message in other materials,[18] many investment managers interpreted two 2004 no-action letters[19] to indicate that they were required to vote on all matters. This interpretation led to heavy reliance on proxy advisory firms, as investment advisers largely outsourced their voting responsibilities.[20] The recent guidance refutes this interpretation and suggests a variety

[16] *See id.* at 6.

[17] SLB 20, Answer to Question 2; *see also* Gallagher Paper, *supra*, at 3, 13.

[18] *See, e.g.*, Investment Advisers Act Rel. No. 2106 ("We do not 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 best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client."), available at http://www.sec.gov/rules/final/ia-2106.htm.

[19] Institutional Shareholder Services, Inc., SEC Staff Letter (Sept. 15, 2004), available at http://www.sec.gov/divisions/investment/noaction/iss091504.htm, Egan Jones Proxy Services, SEC Staff Letter (May 27, 2004), available at www.sec.gov/divisions/investment/noaction/egan052704.htm.

[20] "Reforming the Proxy Advisory Racket," WSJ Review & Outlook, July 22, 2014, available at online.wsj.com/articles/reforming-the-proxy-advisory-racket-1405986992.

of arrangements in which a client and an investment adviser may allocate the proxy voting responsibilities between them as dictated by the best interests of the client. Possible alternatives include focusing resources only on particular types of proposals or establishing default voting parameters for proposals made by management or certain shareholder proponents. At the extremes, the parties may agree that the adviser will vote all of the client's proxies, or not vote any proxies at all, regardless of whether the client votes them itself. The adviser and client may use a cost-benefit analysis and the preferences of the client to determine the best arrangement for fulfilling proxy voting responsibilities.[21]

SLB 20 urges investment advisers to be demanding clients themselves when it comes to their proxy advisory firms. The guidance states that, when considering whether to retain or continue utilizing a proxy advisory firm, an investment adviser should make certain that the firm "has the capacity and competency to adequately analyze proxy issues."[22] In addition to the quality of the firm's personnel, investment advisers are urged to consider the "robustness" of the proxy advisory firm's policies and procedures designed (a) to ensure that proxy voting recommendations are based on current, accurate information and (b) to identify and address any conflicts of interest and other considerations affecting the nature and quality of the advice and services provided.[23] Moreover, the Proxy Voting Rule requires that an investment adviser must oversee a proxy advisory firm on an ongoing basis to ensure that the firm continues to guide proxy voting in the best interests of the investment adviser's clients. If an investment adviser determines that a proxy advisory firm's recommendation was based on inaccurate information, the adviser should investigate the error and determine whether such errors are being addressed by the proxy advisory firm. Corporate issuers should take note of this guidance and be proactive in reviewing the information in proxy voting reports and submitting any necessary corrections. The guidance emphasizes the fact that a proxy advisory firm's business or conflicts policies can change from time to time, requiring an investment adviser to reassess its use of the proxy advisor. Accordingly, investment advisers should monitor changes in a proxy advisory firm's conflicts or

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[21] SLB 20 clarifies that a proxy advisory firm engages in a "solicitation" under the federal proxy rules when it furnishes proxy advice. SLB 20, Answer to Question 6; *see also* Securities and Exchange Act of 1934 Rule 14a-1(*l*) and Release No. 34-31326 (Oct. 16, 1992). Proxy advisory firms are therefore subject to the antifraud and other provisions of the proxy rules unless an exemption applies; merely distributing reports containing recommendations would not qualify as a solicitation. SLB 20, Answer to Question 8; *see also* Securities and Exchange Act of 1934 Rule No. 14a(2(b)(1) and Rule No. 14 a(2(b)(3). However, an exemption would not apply to a proxy advisory firm that allowed a client to establish general guidelines or policies, in advance of receiving proxy materials, that the firm would use to vote on behalf of its client. SLB 20, Answer to Question 7.

[22] SLB 20, Answer to Question 3.

[23] The U.S. Chamber of Commerce's Center for Capital Markets Competitiveness has released a set of best practices and core principles for proxy advisory firms that is a useful reference for investment advisers and proxy advisors alike. *See* U.S. Chamber of Commerce, Center for Capital Markets Competitiveness, *supra*.

conflicts policies by, for example, requiring updates from the proxy advisory firm as to these matters.

For their part, proxy advisory firms are instructed to be more forthcoming with respect to conflict-of-interest disclosures, which are required when a material conflict exists. SLB 20 states that where a proxy advisory firm provides consulting services to a company on a matter that is also the subject of a voting recommendation (or provides a voting recommendation to clients on a proposal sponsored by another client, or has any other interest in a matter), it must make a fact-specific determination as to whether its relationship with the company or proponent is significant or its interest material. Generally speaking, the SEC considers "significant" and "material" any element that would reasonably affect a client's assessment of the reliability and objectivity of the proxy advisor's advice. If necessary, the proxy adviser must then take affirmative steps to disclose the relationship to the client receiving the voting recommendation. The guidance states explicitly that disclosure of a conflict cannot be boilerplate; rather, it should provide the recipient of the disclosure with sufficient information to understand the nature and scope of the conflict, including any steps taken to mitigate it, in order that the client may be able to assess the recommendation. Interestingly, despite the SEC's push for more robust disclosure, the conflicts disclosure need not be provided publicly so long as it is provided to the client in a timely and relevant manner designed to allow the client to assess both the advice and the conflict at once. Investment advisers, recognizing the increasing significance of conflicts in the proxy advisory industry, may wish to require proxy advisory firms to disclose potential conflicts more broadly than is legally required so that the investment adviser itself can decide what it considers material. In some cases, investment advisers may wish to independently investigate and verify the disclosures provided by proxy advisers to ensure that they do not inadvertently breach their fiduciary duties to their clients by relying on inaccurate information.

The SEC notes that "investment advisers and proxy advisory firms may want or need to make changes to their current systems and processes in light of this guidance" and expects such changes in advance of the 2015 proxy season. Investment advisers should be mindful that they, and not the proxy advisors, are the entity that must fulfill a fiduciary duty to a client. Because of this, investment advisors should promptly evaluate (and create a record of their evaluation of) one or more proxy advisory firms to support a decision to hire one of them or continue to retain such services. From there, investment advisers should, as advised by SLB 20, ensure that their policies and procedures relating to ongoing oversight of a proxy advisory firm are effective and up-to-date.

<u>U.S., Canadian and European Reforms</u>

Commissioner Gallagher, in a working paper published in August, indicated that he supports additional reforms relating to proxy advisors. He observed that "over the past decade, the investment adviser industry has become far too entrenched in its reliance on these firms, and there is therefore a risk that the firms will not take full advantage of the new guidance to reduce that reliance."[24] Promising to closely monitor whether SLB 20 will ameliorate current problems, Commissioner Gallagher noted that public companies may be disregarded by proxy advisory firms and institutional investors when they have concerns about inaccurate information being used to create voting recommendations. His interest and engagement in this issue is such that he has asked that these companies send copies of their shareholder communications directly to his office.

Commissioner Gallagher has suggested that the two 2004 no-action letters should be withdrawn and replaced with Commission-level guidance reminding institutional investors of their responsibility to fulfill their fiduciary duties by taking the lead on voting decisions rather than deferring automatically to proxy advisory firms. He is not alone in this view; former SEC Chairman Harvey Pitt as well as Congressman Patrick McHenry have made similar proposals.[25] Though he stops short of calling for comprehensive regulation, Commissioner Gallagher supports the idea of a universal code of conduct for proxy advisory firms to increase transparency and promote accountability and best practices.[26]

A recent proposal by the European Commission (EC), cited with approval by Commissioner Gallagher, would come close to implementing a universal code of conduct. This spring, the EC released a proposal for legislation designed to improve the accuracy and reliability of advice from proxy advisory firms.[27] The EC report calls for action at the European Union level and emphasizes the broad-based need for increased transparency from proxy advisory firms. Under the proposed law, proxy advisors would be required to disclose, on an annual basis, substantial information relating to how their voting recommendations are determined, including their methodologies, their information sources, whether they have taken into account market, legal, and regulatory conditions, and the extent and nature of any dialogues they may have with the companies that are the subject of their recommendations.[28] Further, proxy advisory firms would be required to promptly disclose any actual or potential conflicts or business relationships that could

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[24] Gallagher Paper, *supra*, at 16.

[25] *See* David Scileppi, "Congress to the Rescue?: Congressman Hints at Legislation To Rein in Proxy Advisory Firms," The Securities Edge, June 27, 2014, available at www.thesecuritiesedge.com/2014/06/congress-to-the-rescue-congressman-hints-at-legislation-to-reign-in-proxy-advisory-firms/.

[26] Gallagher Paper, *supra*, at 17.

[27] European Commission, "Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement (Apr. 9, 2014), available at ec.europa.eu/internal_market/company/docs/modern/cgp/shrd/140409-shrd_en.pdf.

[28] *Id.* at Article 3i, "Transparency of proxy advisors."

influence their recommendations, along with any actions they have taken to reduce or eliminate such conflicts.[29]

Canada, too, is increasing pressure on proxy advisors to be more transparent and accountable. In April, the Canadian Securities Administration (CSA) published for comment proposed guidance for proxy advisory firms.[30] The policy-based approach would provide recommendations for best practices and disclosures on the part of proxy advisors. The proposed guidance highlights conflicts of interest, stating that "[e]ffective identification, management and mitigation of actual or potential conflicts of interest are essential in ensuring the ability of the proxy advisory firm to offer independent and objective services to a client."[31] Additional guidance focuses on transparency, accuracy, tailored governance recommendations, and communications with clients, market participants, the media and the public.[32]

2015 Proxy Season

At best, proxy advisors play an important role in making investment managers more informed, efficient stewards of their clients' proxy voting. However, their influence has become so significant that it is crucial that their recommendations be as worthwhile, transparent, and objective as possible. As the focus shifts to the 2015 proxy season, companies should be mindful of the SEC's increased scrutiny of investment advisers' voting and use of proxy advisory firms. Corporate issuers can and should be proactive in obtaining and reviewing proxy voting reports relating to the company and promptly requesting any needed corrections of incorrect information. In cases of material misstatements or confusion created by the proxy voting reports, companies may wish to add their own corrections to their proxy materials or other shareholder communications. Companies should, as always, continue to engage directly with their large shareholders and make the case for supporting the recommendations of the board. Healthy communication with issuers will help enable institutional investors to make their own independent, informed decisions about voting matters.

A separate issue that has not been widely discussed is whether the proxy advisory firms should be required to make their reports public, since they influence such a large segment of the voting population. Although the proxy advisory firms currently

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[29] *Id.*

[30] Canadian Securities Administration Notice and Request for Comment, Proposed National Policy 25-201, "Guidance for Proxy Advisory Firms," Apr. 24, 2014 ("CSA Proposal"), available at www.bcsc.bc.ca/Securities_Law/Policies/Policy2/PDF/25-201__NP_Proposed___April_24__2014/. The comment period closed on June 23, 2014.

[31] *Id.* at 2.

[32] *Id.* at 7-8.

are not required to publicly file their reports, if the goal is increased transparency, perhaps this should change. As the SEC monitors the proxy advisory firms in the coming months, appropriate consideration should be given to modernizing the antiquated proxy voting system and determining what additional steps, if any, should be taken to regulate these firms and their influence on public companies.

Companies concerned about the undue influence of proxy advisors have an engaged advocate in Commissioner Gallagher, and momentum may be building, both in the United States and abroad, toward further reform in this area. The upcoming proxy season will be a key time for the SEC to observe any ramifications of SLB 20 and to consider next steps. Fundamentally, the SEC has, with SLB 20, reminded investment managers that their fiduciary duties are incompatible with inattentive overreliance on proxy advisors. It remains to be seen what effect the new guidance will have, but if it proves to be effective, it may herald a new era of decreasing relevance for proxy advisory firms.