SEC issues Staff Legal Bulletin after four-year comprehensive review of proxy system

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Abstract

Purpose – To provide an overview of the guidance for proxy firms and investment advisers included in the Staff Legal Bulletin released this year by the Securities and Exchange Commission (SEC) after its four-year comprehensive review of the proxy system.

Design/methodology/approach – Discusses briefly the context in which the SEC’s review was conducted; the general themes of the guidance provided; the most notable aspects of the guidance; and the matters that were expected to be, but were not, addressed by the SEC.

Findings – The guidance does not go as far in regulating proxy advisory firms as many had anticipated it would. The key obligations specified in the guidance are imposed on the investment advisers who engage the proxy firms. The responsibilities, policies and procedures mandated do not change the fundamental paradigm that has supported the influence of proxy firms – that is, investment advisers continue to be permitted to fulfill their duty to vote client shares in a “conflict-free manner” by voting based on the recommendations of independent third parties, and continue to be exempted from the rules that generally apply to persons who solicit votes or make proxy recommendations.

Practical implications – The SEC staff states in the Bulletin that it expects that proxy firms and investment advisers will conform to the obligations imposed in the Bulletin “promptly, but in any event in advance of [the 2015] proxy season.”

Originality/value – Practical guidance from experienced M&A lawyers.

Keywords United States, Securities and Exchange Commission (SEC), Investment advisers, Proxy advisory firms, Proxy system, Staff Legal Bulletin

On June 30, the SEC released a 7-page Staff Legal Bulletin, in the form of 13 Q&A’s, summarizing the results of a comprehensive review of the proxy system. The guidance does not go as far in regulating proxy advisory firms as many had anticipated it would. The obligations specified in the guidance are imposed on the investment advisers who engage the proxy firms. The Staff states in the Bulletin that it expects that proxy firms and investment advisers will conform to the obligations imposed in the Bulletin “promptly, but in any event in advance of next year’s proxy season.”

The context of the review, as reflected in the concept release that four years ago sought public comment on an extensive list of issues, was a consensus that significant structural and procedural changes in share ownership and voting had necessarily affected and increased the importance of proxy voting. The elimination of the broker discretionary vote in director elections, the widespread adoption of majority voting in the election of directors, and the rise of shareholder activism had intensified concerns about the increasing use, influence and power of proxy advisory firms over the voting of securities of companies in which they have no direct economic interest and may have potential conflicts of interest.
The guidance in the Bulletin is grounded in the concept that investment advisers, as fiduciaries, owe their clients a duty of care and loyalty, including with respect to proxy voting services undertaken on the clients’ behalf. (See Q&A #1) Thus, the Bulletin indicates, investment advisers cannot rely on proxy firms to vote clients’ shares without providing active and ongoing oversight of that function – including with respect to the proxy firm’s “capacity and competency,” the accuracy of the information on which the proxy firm’s voting recommendations are based, and the nature of and response to the proxy firm’s conflicts of interest.

The Bulletin emphasizes the issues of potential conflicts of interest and lack of transparency in proxy advisory firms’ voting recommendations. Of course, the SEC’s Proxy Voting Rule requires that, for an investment adviser to exercise voting authority with respect to client securities, the adviser must adopt and implement written policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interest of its clients. In this regard, the Bulletin provides that, when an adviser engages a proxy firm to provide proxy voting recommendations, the adviser should determine whether the proxy firm has the “capacity and competency to adequately analyze proxy issues,” taking into account the quality of the staff, as well as the policies and procedures that the proxy firm has in place to ensure that (i) its voting recommendations are based on “current and accurate information” and (ii) its conflicts of interest are “identified and addressed”. (See Q&A ##1, 3).

The most notable aspects of the Bulletin are:

- **Proxy advisory firms must disclose their conflicts of interest to the investment adviser.** The concept release had noted concern about the undisclosed conflicts of interest that proxy firms might have in formulating their voting recommendations. These conflicts can include dual client relationships, such as providing consulting services to a company on a matter that is the subject of a voting recommendation, or providing a voting recommendation to its clients on a proposal sponsored by another client. The Bulletin effectively requires disclosure, by the proxy firm to the investment adviser, of the proxy firm’s conflicts of interest with respect to voting recommendations, on an ongoing basis. The staff states in the Bulletin that investment advisers should establish and implement measures “reasonably designed to identify and address the proxy advisory firm’s conflicts that can arise on an ongoing basis.” (See Q&A ##3, 4) In addressing the availability of an exemption from the proxy rules, the Bulletin states that, in that context, disclosure of conflicts relating to material interests of the proxy firm in certain persons or entities cannot be provided by boilerplate language or by language that states that the information will be provided upon request. Further, the disclosure should “enable the recipient to understand the nature and scope of the relationship or interest, including the steps taken, if any, to mitigate the conflict, and provide sufficient information to allow the recipient to make an assessment about the reliability or objectivity of the recommendation.” The Bulletin notes that the disclosure “may be made publicly or between only the proxy advisory firm and the client.” (See Q&A ##11-13)

- **Investment advisers have a duty to oversee their proxy advisers.** The Bulletin imposes on investment advisers a duty of “ongoing oversight” of the proxy firms they retain. This oversight duty requires that the investment adviser adopt and implement policies and procedures “reasonably designed [...] to ensure that the investment adviser, acting through the [proxy firm], continues to vote proxies in the best interests of its clients.” The Bulletin provides as examples of such policies and procedures measures requiring the proxy firm to provide to the investment adviser updates about “business changes” that affect the proxy firm’s “capacity and competency to provide proxy voting advice,” as well as changes in its conflict policies and procedures. (See Q&A ##3-4)

- **Investment advisers have a duty to investigate their proxy advisers’ errors.** The Bulletin provides that it is the investment adviser’s responsibility to “ascertain that the proxy
advisory firm has the capacity and competency to adequately analyze proxy issues, which includes the ability to make voting recommendations based on materially accurate information.” As an example of the investment adviser’s duty in this regard, the Bulletin provides that, in the case where an investment adviser “may determine that a proxy advisory firm’s 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 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.” (See Q&A #3, 5)

- **Investment advisers and their clients have broad flexibility in their proxy voting arrangements.** The Bulletin confirms that an investment adviser is not required to vote every proxy at every shareholder meeting. Rather, investment advisers and their clients may agree to a variety of arrangements as to when and how the adviser will exercise its proxy voting authority. (See Q&A #2)

- **Other matters.** Other matters covered by the Bulletin relate to when a proxy firm is subject to the federal proxy rules and when it can rely on the exemptions from the proxy rules in SEC Rules 14a-2(b)(1) and 14-a-2(b)(3). (See Q&A #6-13) The Bulletin confirms that the furnishing of proxy voting advice generally constitutes a “solicitation” (see Q&A #6); and limits reliance on exemptions where the proxy firm may have solicited from its client the “power to act as a proxy” (see Q&A #7).

- **Ideas NOT addressed in the Bulletin.** A number of issues raised in the SEC’s concept release four years ago are NOT addressed in the Bulletin – including the ideas that proxy advisory firms be required to register with the SEC (note that ISS is registered); that voters be required to certify on the proxy form that they hold the full economic interest in the shares being voted (or to what extent their economic interest in the shares was shorted or hedged); that the issuer be required to disclose its shareholder meeting agenda before the record date (so that investors who had loaned shares could recall them); that a person be required to hold a pure long position in the underlying shares in order to vote by proxy, or could vote only to the extent of his or her net long position; that investors with no or negative economic interests be required to wait until after a cooling-off period to vote; that “empty voting” be prohibited, especially if the shareholder has a negative economic interest in the company; and that different record dates be required for determining the shareholders entitled to notice of a meeting and the shareholders entitled to vote at the meeting. Of course, the imposition of some of these requirements would have represented a much greater change to the system.

The responsibilities, policies and procedures mandated by this article do not change the fundamental paradigm that has supported the influence of proxy firms – that is, investment advisors continue to be permitted to fulfill their duty to vote client shares in a “conflict-free manner” by voting based on the recommendations of independent third parties, and continue to be exempted from the rules that generally apply to persons who solicit votes or make proxy recommendations.

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