

Will the SEC Tame the Proxy Advisory Firms?

Will the Securities and Exchange Commission (SEC) do what corporate America has been unable to do, tame the growing influence of the proxy advisory firms?

Many corporate boards and business trade groups have observed with increasing alarm the growing influence of proxy advisory firms, in general, and one proxy advisory firm in particular, Institutional Shareholder Services (ISS). Mr. Tom Donahue, the president of the U.S. Chamber of Commerce, has raised further concerns by noting the apparent conflict of interest inherent in the ISS business model. Under this business model, ISS provides advice on proxy voting to institutional shareholders and advice to corporations as to how they may enhance their corporate governance practices and, ultimately, voting outcomes. Mr. Donahue further contends that due to this conflicted business model and ISS' near monopoly position in the proxy advisory business, some form of regulatory oversight is needed. Those remarks were made back in 2006 at a National Association of Realtors Regional Summit.

Apparently, the SEC has now taken those remarks to heart.

The proxy advisory firms now find themselves in the SEC's regulatory crosshairs.

Last month the SEC issued a little noticed 150 page concept release ("Release") on the U.S. proxy system. The Release reviews the current state of the U.S. proxy system and seeks public comment as to concerns that have been raised regarding "the accuracy, reliability, transparency, accountability and integrity of the proxy system, **as well as possible regulatory responses to these concerns.**" Among these concerns is the role and influence of proxy advisory firms.

Meridian Compensation Partners will be submitting a comment letter on the Release and welcomes input from interested parties.

The Release discusses and examines the following aspects of proxy advisory firms: (i) the role of proxy advisory firms, (ii) the impact of SEC rulemaking on the growing use and influence of proxy advisory firms, (iii) the current regulation of proxy advisory firms and (iv) concerns about the role of proxy advisory firms. To address these concerns, the Release suggests possible regulatory reforms.

Role of Proxy Advisory Firms

The Release notes that over the past 25 years institutional investors, including investment advisers, pension plans, employee benefit plans, bank trust departments and trust funds, have substantially increased their use of proxy advisory firms to meet their fiduciary obligations. According to the Release, these investors look to proxy advisory firms to perform a variety of functions, including the following:

- Analyze and make voting recommendations on the matters presented for shareholder vote and included in the issuers' proxy statements;
- Execute votes on the institutional investors' proxies in accordance with the investors' instructions, which may include voting the shares in accordance with a customized proxy voting policy resulting from consultation between the institutional investor and the proxy advisory firm, the proxy advisory firm's proxy voting policies or the institution's own voting policy;

- Assist with the administrative tasks associated with voting and keeping track of the large number of voting decisions;
- Provide research and identify potential risk factors related to corporate governance; and
- Help mitigate conflict of interest concerns raised when the institutional investor is casting votes in a matter in which its interest may differ from the interest of its clients.

The Release further notes that institutional clients compensate proxy advisory firms on a fee basis for providing such services, and proxy advisory firms typically represent that their analysis and recommendations are prepared with a view toward maximizing long-term share value or the investment goals of the institutional client.

Impact of SEC Rulemaking

The SEC acknowledges that it played a role in the increased use of proxy advisory firms. The Release cites a 2007 Government Accounting Office (GAO) Report to Congress that attributed the rising use of proxy voting advisers, in part, to rules adopted by the SEC under the Investment Adviser Act. Under these rules, investment advisers have a fiduciary duty to vote client securities in the best interest of the client. This relatively high standard of care has encouraged investment advisers to seek assistance and recommendations from proxy advisory firms to ensure appropriate and prudent voting of client securities.

SEC rules also require an investment adviser to adopt procedures to address material conflicts that may arise between the adviser's interests and those of its clients. To comply with this requirement, SEC rules expressly provide for the use of proxy advisory firms. Specifically, SEC rules permit an investment adviser to demonstrate that a vote was not a product of a conflict of interest if it voted client securities in accordance with a pre-determined policy ***based upon the recommendations of an independent third party.***

Current Regulation of Proxy Advisors

What may come as a surprise to some is that proxy advisory firms currently are subject to the following federal securities law as noted in the Release:

- Proxy advisory firms are subject to the prohibition on making false and misleading statements pursuant to rules under the Securities Exchange Act.
- Under certain circumstances, a proxy advisory firm may meet the definition of "investment adviser" under the Investment Advisers Act in which case the firm owes fiduciary duties to its advisory clients.
- Proxy advisors must comply with certain antifraud provisions of the Investment Advisers Act, regardless of whether the advisor has registered as an investment adviser.
- Under certain circumstances, proxy advisory firms may be required to register as investment advisers with the SEC (in fact, a number of proxy advisory firms are currently registered with the SEC). As a registered investment adviser, a proxy advisory firm would be subject to a number of additional regulatory requirements that are intended to provide certain protections for the firm's clients.

Perhaps the most important SEC rule applicable to proxy advisory firms is the one that exempts such firms from the proxy solicitation rules. In 1979, the SEC adopted rules that provide for this exemption for proxy advisors who satisfy certain conditions. Specifically, the advisor:

- Must render financial advice in the ordinary course of its business;

- Must disclose to the person receiving advice any significant relationship it has with the issuer or any of its affiliates, or with a shareholder proponent of the matter on which advice is given, in addition to any material interest of the advisor in the matter to which the advice relates;
- May not receive any special commission or remuneration for furnishing the proxy voting advice from anyone other than the recipients of the advice; and
- May not furnish proxy voting advice on behalf of any person soliciting proxies.

As a general matter, proxy advisory firms meet these conditions. Without such an exemption, proxy advisory firms could be subject to the information and filing requirements under the proxy solicitation rules.

Concerns About the Role of Proxy Advisory Firms

The Release identifies the following potential issues about the role of proxy advisory firms:

- **Conflicts of Interest.** To the extent that conflicts of interest on the part of proxy advisory firms are insufficiently disclosed and managed, shareholders could be misled and informed shareholder voting could be impaired. The Release identifies the following to be the most commonly cited conflicts of interest:
 - A proxy advisory firm provides voting recommendations on matters put to a shareholder vote while also offering consulting services to the issuer or a proponent of a shareholder proposal on the very same matter. The issuer in this situation may purchase consulting services from the proxy advisory firm in an effort to garner the firm's support for the issuer when the voting recommendations are made.
 - A proxy advisory firm provides corporate governance ratings on issuers to institutional clients, while also offering consulting services to corporate clients so that those issuers can improve their corporate governance ranking.
 - When owners or executives of the proxy advisory firm have significant ownership interests in or serve on the board of directors of, issuers with matters being put to a shareholder vote on which the proxy advisory firm is offering vote recommendations.
- **Lack of Transparency in Formulating Voting Recommendations.** To the extent that proxy advisory firms develop, disseminate and implement their voting recommendations without adequate accountability for informational accuracy in the development and application of voting standards, informed shareholder voting could be impaired. The Release notes that some commentators have expressed the concern that voting recommendations by proxy advisory firms may be made based on materially inaccurate or incomplete data, or that the analysis provided to an institutional client may be materially inaccurate or incomplete. To remedy this possibility, issuers have expressed a desire for a process to correct inaccuracy. Some have suggested that additional oversight mechanisms could improve the likelihood that the voting recommendations are based on materially accurate and complete information.
- **Inadequate Oversight.** Proxy advisory firms may be controlling or significantly influencing shareholder voting without appropriate oversight and without having an actual economic stake in the issuer.

The SEC asks for public comment regarding the appropriate means of addressing these issues, including the application of the proxy solicitation rules and the Investment Advisers Act registration provision to proxy advisory firms. Interestingly, the Release addresses head-on Mr. Donahue's characterization of ISS' monopoly position by asking the public to comment on whether these issues are affected by the fact there is one dominant proxy advisory firm in the marketplace, ISS, whose long-standing position, according to the GAO, "has been cited by industry analysts as a barrier to competition."

Potential Regulatory Response

The Release suggests several regulatory approaches for addressing conflict of interest and accuracy concerns.

To address potential conflicts of interest, the Release sets forth the following potential regulatory responses:

- Require more specific disclosures regarding the presence of a potential conflict of interest.
- Provide additional guidance on the fiduciary duty of proxy advisors who are investment advisers to deal fairly with clients and prospective clients and to disclose fully any material conflict of interest.
- Promulgate rules similar to those addressing conflicts of interest on the part of credit rating agencies (e.g., such rules could prohibit certain conflicts of interest and require proxy advisory firms to file periodic disclosures, akin to Form NSRO filed by credit rating agencies, describing any conflicts of interest and procedures to manage them).

To address accuracy and transparency issues, the Release sets forth the following potential regulatory responses:

- Increase disclosure regarding the extent of research involved with a particular recommendation and the extent and/or effectiveness of its controls and procedures in ensuring the accuracy of issuer data.
- Require disclosure of policies and procedures for interacting with issuers, informing issuers of recommendations, and handling appeals of recommendations.
- Require proxy advisory firms to file their voting recommendations with the SEC as soliciting material, at least on a delayed basis, to facilitate independent evaluation by market participants of the quality of those recommendations.

Request for Comments

The SEC is requesting comments on whether it should clarify existing regulations or propose additional regulations to address concerns about the existence and disclosure of conflicts of interest on the part of proxy advisory firms, and about the accuracy and transparency of the formulation of their voting recommendations. In that regard, the SEC is seeking views generally on proxy advisory firms and invites comment on an extensive list of questions that are appended to the end of this article. Comments are due on or before October 20, 2010.

Observations and Outlook

The Release effectively captures the principal issues that many investors and boards have identified regarding proxy advisory firms. To further bolster the SEC's awareness of these and other issues, boards, companies and investors now have an excellent opportunity to express their views regarding proxy advisory firms and suggestions for regulatory reform. Whether the SEC takes the next step and issues proposed rules remains to be seen. The issuance of the Release does **not** obligate the SEC to engage in any future rulemaking.

In the very near term, we do not see the SEC issuing any proposed rules on proxy advisory firms (or the other matters covered by the Release) given its full rulemaking plate. However, over the mid- and long-term, the Release certainly could lay the groundwork for significant rulemaking on proxy advisory firms.

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SEC Questions on Proxy Advisory Firms

- Do proxy advisory firms perform services for their clients in addition to or different from those noted above?
- Is additional regulation of proxy advisory firms necessary or appropriate for the protection of investors? Why or why not? If so, what are the implications of regulation through the Advisers Act or the proxy solicitation rules under the Exchange Act? Are any other regulatory approaches equally or better suited to provide appropriate additional regulation? Are there regulatory approaches used in connection with NRSROs that may be appropriate to consider applying to proxy advisory firms?
- Are there conflicts of interest (other than those described above) when a proxy advisory firm provides services to both investors, including shareholder proponents, and issuers? If so, are those conflicts appropriately addressed by current laws, regulations and industry practices?
- Are there conflicts of interest where a proxy advisory firm is itself a publicly held company? If so, what are they and how should they be addressed?
- What policies and procedures, if any, do proxy advisory firms use to ensure that their voting recommendations are independent and not influenced by the fees they receive for services to corporate clients or shareholder proponent clients?
- Is the disclosure that proxy advisory firms currently provide to investor clients regarding conflicts of interest adequate? Would specific disclosure of potential conflicts and conflict of interest policies be sufficient or is some other form of regulation necessary (e.g., prohibiting such conflicts)?
- Do issuers modify or change their proposals to increase the likelihood of favorable recommendations by a proxy advisory firm?
- Do issuers adopt particular governance standards solely to meet the standards of a proxy advisory firm? If so, why do issuers behave in this manner?
- Should proxy advisory firms be required to disclose publicly their decision models for approval of executive compensation plans? Would this alleviate concerns regarding potential conflicts of interest when issuers pay consulting fees for access to such models?
- What is the competitive structure of the market for proxy advisory firms and what are the reasons for it? Does competition vary across the types of services provided by the proxy advisory firms or the subset of issuers that they cover? Does the industry's competitive structure affect the quality of the recommendations? If there is, as we understand it, one proxy advisory firm that has a significantly larger market share than other firms, does that affect the quality of the recommendations made by that proxy advisory firm or by other proxy advisory firms? Are there any other effects caused by the fact that there is one dominant proxy advisory firm?
- How do institutional investors use the voting recommendations provided by proxy advisory firms? What empirical data exists regarding how, and to what extent, institutional investors vote consistently, or inconsistently, with such recommendations?
- What criteria and processes do proxy advisory firms use to formulate their recommendations and corporate governance ratings? Does the lack of a direct pecuniary interest in the effects of their recommendations on shareholder value affect how they formulate recommendations and corporate

governance ratings? Would greater disclosure about how recommendations and corporate governance ratings are generated and how voting recommendations are made affect the quality of the ratings and the recommendations?

- Are existing procedures followed by proxy advisory firms sufficient to ensure that proxy research reports provided to investor clients are materially accurate and complete? If not, how should proxy advisory firms be encouraged to provide investors with the information they need to make informed voting decisions?
- If additional oversight is needed, should it be in the form of regulatory oversight or issuer involvement? Would requiring delayed public disclosure of voting recommendations be an appropriate means to promote accurate voting recommendations?