

**U.S. Chamber of Commerce  
Corporate Governance Update:**

**Public Company Initiatives  
in Response to  
the SEC Staff's Guidance on**

# **PROXY ADVISORY FIRMS**



**CENTER FOR CAPITAL MARKETS**  
**COMPETITIVENESS**



## Executive Summary

This Corporate Governance Update is intended to alert public companies of the June 2014 Securities and Exchange Commission (SEC) Staff Guidance, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisors and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms* (SEC Staff Guidance) regarding responsibilities for the development and dispensation of proxy advice. Accordingly, this update describes several approaches that public companies may use to ensure that the concepts of the SEC Staff Guidance are implemented in the best interest of public company shareholders.

The SEC Staff Guidance was issued due to concerns surrounding the increasingly outsized role and influence of proxy advisory firms on corporate governance matters in the United States and globally. Two firms—Institutional Shareholder Services (ISS) and Glass-Lewis—control a combined 97% of the proxy advisory industry, yet have been roundly criticized for operating with serious conflicts of interest, frequent adoption of “one-size-fits-all” voting recommendations, and conducting policy making that is largely done outside the public eye.

The SEC Staff Guidance provides, among other things, clarity surrounding the SEC’s Proxy Voting Rule, reinforces the requirement that fiduciary duties govern all aspects of the development and receipt of proxy advice, and reaffirms that enhancing shareholder value must be the core consideration when rendering proxy-voting advice and making proxy-voting decisions.

This Corporate Governance Update highlights three main issues that public companies could focus on in light of the guidance: communication with proxy advisory firms, dealing with proxy advisory firm conflicts of interest, and communication with institutional investors.

**Communication with Proxy Advisory Firms:** Public companies can serve their shareholders by maintaining a continuous dialogue with proxy

advisory firms in order to correct erroneous or stale information, or to address any troublesome recommendations that do not advance the best interests of the shareholders.

**Dealing with Proxy Advisory Firm Conflicts of Interest:** Public companies can take steps to verify proxy advisory firm conflicts identification and remediations, and bring any deficiencies to the attention of the advisory firm or, if necessary, the SEC.

**Communication with Institutional Investors:** Public companies should continue to engage in year-round, regular communications with institutional investors, to develop and maintain a relationship of trust and confidence, and also provide public companies with an opportunity to bring concerns about the actions (or inaction) of proxy advisory firms to the attention of investors.



The U.S. Chamber of Commerce (Chamber) is the world's largest business federation, representing more than 3 million businesses and organizations of every size, sector, and region. The Chamber formed the Center for Capital Markets Competitiveness (CCMC) to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy. It is an important priority of the CCMC to advance an effective and transparent corporate governance system that encourages shareholder communication and participation.

The CCMC has long advocated for proxy advisory firms to be more transparent and accountable in the development and dispensation of proxy advice and to ensure that conflicts of interest are disclosed and addressed in order to prevent corporate governance failures.

In 2013, the CCMC released *Best Practices and Core Principles for the Development, Dispensation, and Receipt of Proxy Advice* (Chamber Principles).<sup>1</sup> The Chamber Principles focused on the proxy voting practices of proxy advisory firms, public companies, and investment portfolio management organizations; discussed core principles applicable to those activities; and recommended improvements and systems to bring about transparency and accountability for proxy advisory firms and to foster stronger corporate governance.

On June 30, 2014, the Securities and Exchange Commission's staff issued Legal Bulletin Number 20, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*.<sup>2</sup> This Corporate Governance Update alerts public companies to the SEC Staff Guidance and describes several approaches public companies may wish to consider to ensure that the concepts of the SEC Staff Guidance are implemented in connection with the retention

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1 The Chamber Principles can be found at <http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/Best-Practices-and-Core-Principles-for-Proxy-Advisors.pdf>.

2 The SEC Staff Guidance can be found at <http://www.sec.gov/interps/legal/cfs1b20.htm>.

of proxy advisory firms and how they research, formulate, and ensure the accuracy of the proxy voting advice they render.

## Background

Over the years, proxy advisory firms have played an increasingly outsized role in imposing their views of appropriate corporate governance on corporations and their shareholders. These firms purport to evaluate every issue for which corporate proxies are solicited, in the United States and globally, and their recommendations are demonstrably influential in how proxy votes are cast.<sup>3</sup> In the United States, two proxy advisory firms—Institutional Shareholder Services Inc. and Glass Lewis & Co. LLC (Glass Lewis)—constitute 97% of the proxy advisory industry and are the *de facto* corporate governance standard setters for public companies.<sup>4</sup>

Despite their disproportionate influence on corporate governance, proxy advisory firms have been criticized by U.S. and global regulators, academics, institutional investors, shareholders, and others for, among other things,

- Serious (and frequently undisclosed or inadequately disclosed) conflicts of interest—ISS, for example, offers consulting services to the same companies about which it renders proxy voting advice, while Glass Lewis,<sup>5</sup> for example, frequently offers recommendations that coincide with the views of its shareholder activist ownership;

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3 See, e.g., Government Accountability Office, *Corporate Shareholder Meetings: Issues Relating to Firms That Advise Institutional Investors on Proxy Voting* (June 2007) (GAO Report), available at <http://www.gao.gov/new.items/d07765.pdf>; and J. Glassman and J. Verret, *How to Fix Our Broken Proxy Advisory System* (Glassman and Verret), available at [http://mercatus.org/sites/default/files/Glassman\\_ProxyAdvisorySystem\\_04152013.pdf](http://mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf).

4 See GAO Report, *supra* n. 3, at p. 13; Glassman and Verret, *supra* n. 3, at p. 8.

5 Glass Lewis is owned by two large government pension funds, one of which is an activist investor.



- “One-size-fits-all” voting advice that ignores the effect of their recommendations on the economic well-being of shareholders;<sup>6</sup>
- Industry concentration;
- Policy making that is largely conducted outside the public eye; and
- Errors in analysis and a lack of due diligence, in part due to the vast number of issues they purport to cover, with a relatively small staff.<sup>7</sup>

The Chamber Principles addressed these deficiencies, and sought to foster a collaborative effort to ameliorate them. Thus, the Chamber Principles noted that some portfolio managers make clear in their voting policies that they use proxy advice as one of several sources in formulating their own independent voting decisions—an approach that is consistent with the interests and investment objectives of their investors—while other portfolio managers were not, and are not, structured to enable voting policies that

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- 6 Proxy advisory firms that offer “one-size-fits-all” recommendations—generic recommendations disseminated to most clients that do not vary in any significant manner to reflect the specific attributes of each client that receives these recommendations—are unlikely to render significant assistance to portfolio managers in their efforts to promote and enhance their investors’ best economic interests. *See, e.g.,* Chamber Principles, *supra* n. 1, at p. 3; J. Glassman and H. Peirce, *How Proxy Advisory Services Became So Powerful*, Mercatus on Policy (June 2014), at p. 2, available at <http://mercatus.org/sites/default/files/Peirce-Proxy-Advisory-Services-MOP.pdf> (“One-size-fits-all recommendations miss the nuances of particular corporations”).
- 7 For example, ISS states that it has a global staff of 250 individuals who analyze, research, and prepare recommendations on the 250,000 voting issues on which it offers advice. *See* ISS, *Best Practice Principles for Providers of Shareholder Voting Research & Analysis: ISS Compliance Statement*, at §1 (June 10, 2014), available at <http://www.issgovernance.com/file/duediligence/BPP-ISS-ComplianceStatement-1406010.pdf>. Similarly, Glass Lewis states that it has a global staff of 200 individuals who perform the same functions. *See* Glass Lewis website, *About Us*, <http://www.glasslewis.com/about-glass-lewis/>. If one “does the math,” it is clear that, *on average*, each ISS analyst is responsible for researching and preparing reports on 1,000 issues in the truncated period of the usual “proxy season.” Glass Lewis purports to analyze fewer issues, but has fewer analysts available to do so, ensuring that its analysts are equally overwhelmed with their responsibilities in a very short period of time.

would achieve the same results.<sup>8</sup> The Chamber Principles offered guidance on how proxy advice should be tailored to meet the objective of enhancing shareholder value and returns, and processes portfolio managers should employ to fulfill their fiduciary obligations.

Following release of the Chamber Principles, the House Subcommittee on Capital Markets and Government Sponsored Enterprises held a hearing on June 5, 2013, titled *Examining the Market Power and Impact of Proxy Advisory Firms*, at which the Chamber testified.<sup>9</sup> That hearing developed a detailed record that further amplified the nature of concerns about the manner in which proxy advisory firms develop and finalize their voting recommendations, and the conflicts of interest to which they are subject.

On December 5, 2013, the SEC held a Roundtable on Proxy Advisory Firms, in which the Chamber participated.<sup>10</sup> While the roundtable featured the participation of a broad range of investors, businesses, lawyers, and proxy advisors, all with differing perspectives about the functioning of proxy advisory firms, there was a consensus among participants—other than those representing the largest proxy advisory firms—with respect to two major concerns regarding proxy advisory firms and the performance of their activities:

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8 See Hon. D. Gallagher, *Outsized Power & Influence: The Role of Proxy Advisers*, Wash. L. Found. Critical Legal Issues Working Paper Series No. 187 (Aug. 2014), at pp. 10–11, available at <http://www.wlf.org/upload/legalstudies/workingpaper/GallagherWP8-14.pdf>.

9 See <http://financialservices.house.gov/uploadedfiles/hhrg-113-ba16-wstate-hpitt-20130605.pdf> (testimony of former SEC Chairman Harvey Pitt on behalf of the Chamber).

10 See Transcript of the SEC Roundtable on Proxy Advisory Firms (Dec. 5, 2013), at pp. 24–27, 158–159 (remarks of former SEC Chairman Harvey Pitt), available at <http://www.sec.gov/spotlight/proxy-advisory-services/proxy-advisory-services-transcript.txt>. See also, Letter from the Chamber to SEC Chair Mary Jo White, outlining issues of importance in advance of the SEC roundtable, which can be found at <http://www.centerforcapitalmarkets.com/wp-content/uploads/2014/02/2013-12-3-Chamber-SEC-Roundtable-Letter.pdf>.



- First, that these firms are afflicted by significant specific conflicts of interest that are often undisclosed (or inadequately disclosed); and
- Second, that proxy advisory firms' processes, and especially how they develop their voting recommendations, are not sufficiently transparent.

## SEC Staff Guidance

Six months after the proxy advisory firm roundtable, the SEC Staff Guidance was published. It addressed issues and concerns raised at the roundtable, providing clarity about the SEC's Proxy Voting Rule<sup>11</sup> and the availability of exemptions for proxy advisory firms from the SEC's proxy solicitation requirements.<sup>12</sup> The Proxy Voting Rule requires that SEC-registered portfolio managers adopt policies describing how portfolio securities are voted to further their clients' financial best interests. The exemptions for proxy advisory firms from the SEC's proxy solicitation requirements depend, among other things, on the absence (or full disclosure) of conflicts of interest to which the proxy advisory firms are (or may be) subject.

The SEC Staff Guidance structures its substantive advice as a response to specific questions. The three constituency groups affected by the SEC Staff Guidance—proxy advisory firms, portfolio managers, and public companies—must focus their attention on five overarching principles:

- Fiduciary duties permeate and govern all aspects of the development, dispensation, and receipt of proxy advice;

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11 Investment Advisers Act Rule 206-4(6), 17 C.F.R. §275.206(4)-6 (2014).

12 Securities Exchange Act Rule 14a-2(b)(3), 17 C.F.R. §240.14a-2(b)(3).



- Enhancing and promoting shareholder value must be the core consideration in rendering proxy-voting advice as well as making proxy-voting decisions;
- The proper role of proxy advisory firms vis-à-vis proxy voting is to provide accurate and current information to assist those with voting power to further the economic best interests of those who entrust their assets to portfolio managers and are the beneficial shareholders of public companies. If proxy advisory firms exceed that role—for example, by effectively exercising (or being granted) a measure of discretion over how shares are voted on specific proposals, or by failing to make proper disclosure regarding specific conflicts of interest afflicting a proxy advisory firm in connection with voting recommendations it is making—proxy advisory firms so employed, and those engaging them, incur serious legal and regulatory consequences;
- Clarity is provided as to the scope of portfolio managers' obligations to exercise a vote on proxy issues, and it emphasizes the broad discretion portfolio managers have—subject to appropriate procedures and safeguards—to refrain from voting on every, or even any, proposal put before shareholders for a vote; and
- In light of the direction provided, proxy advisory firms, portfolio managers, and public companies need to reassess their current practices and procedures, and adopt appropriate changes necessitated by the SEC Staff Guidance.

To help stakeholders implement policies and practices that embody these principles, the SEC Staff Guidance suggests methodologies that can be employed in selecting, overseeing, and assessing the performance of proxy advisory firms; an articulation of the nature and manner of proper conflict disclosures required of proxy advisors; and a clarification of when portfolio managers are required to vote securities. Most significant, the guidance confirms the primacy of enhancing shareholder value that must be the basis for proxy advisory firm recommendations.



## Issues Public Companies Should Focus On

Although the SEC Staff Guidance directly addresses obligations of proxy advisory firms and investment portfolio manager organizations, public companies need to understand these obligations, and should consider various approaches we outline to ensure that the concepts articulated in the SEC Staff Guidance are implemented in the best interests of public company shareholders.

### Communication with Proxy Advisory Firms

The SEC Staff Guidance reiterates the fundamental principle that fiduciary duties govern all aspects of the development, dispensation, and receipt of proxy advice, and emphasizes the need for proxy advisory firms to adhere to the highest level of due diligence, accuracy, and promotion of shareholder value. Public companies can serve their shareholders and enhance the ability of proxy advisory firms and portfolio managers to fulfill their fiduciary and other duties by:

- Asking proxy advisory firms for the opportunity for input both before and after proxy advisory firms' recommendations are finalized;
- Because public companies may be unable to provide input *prior* to the issuance of adverse proxy advisory firm recommendations, public companies should certainly make their views known promptly after adverse proxy advisory firm recommendations are issued;
- Formally notifying proxy advisory firms *and* portfolio managers holding their securities if the public company does not believe that it was afforded an adequate opportunity for input *before* proxy advisory firms finalized their recommendations;

- Alerting proxy advisory firms, portfolio managers, and others (including SEC staff) about instances reflecting proxy advisory firms' reliance on inaccurate or stale data;
- Advising proxy advisory firms, portfolio managers, and others of proxy advisory firm unresponsiveness to public company indications of significant errors, misjudgments, noncurrent data, or mistaken assumptions;
- Examining recommendations about their companies, and advising proxy advisory firms and their clients if specific proxy advisory firm recommendations do not advance the economic best interests of public company shareholders, appear to reflect "one-size-fits-all" recommendations, or would foster deleterious consequences (and the reasons underlying those conclusions);
- If public companies are not satisfied that proxy advisory firms have appropriately corrected problematic recommendations brought to their attention, public companies should advise portfolio managers of their concerns; and
- Public companies should bring erroneous, stale, or non-economically beneficial proxy advisory firm recommendations to the attention of the SEC and its staff.

Given the lack of clarity regarding the ways in which proxy advisory firms establish their voting policies, and how they determine whether their recommendations enhance actual shareholder value, public companies can play an important role in determining *how* selected proxy advisory firms generate guidance recommendations, and on what bases their recommendations are predicated. In addition, the SEC Staff Guidance clarifies that a portfolio manager that effectively outsources voting responsibility to proxy advisory firms is acting inconsistently with applicable fiduciary obligations and contravening other obligations borne by portfolio managers. As a result, public companies should consider implementing the following practices:



- Preparing (in advance of proxy season) materials articulating positions vis-à-vis significant issues to be submitted to a shareholder vote, addressing major rationales supporting a view contrary to the views the public company intends to espouse;
- Consistent with SEC proxy solicitation rules, disseminating or otherwise making materials addressing shareholder voting issues available to proxy advisory firms, current investors, company social media outlets, various media outlet representatives covering the public companies, street name holders of public company securities, and SEC staff;
- Formally seeking opportunities to meet with proxy advisory firms on issues subject to shareholder votes—in advance of proxy advisory firm issuance of recommendations (if possible), and immediately after recommendations are made—to ensure that predicates for recommendations are accurate and up to date;
- Contemporaneously documenting proxy advisory firm responses to meeting requests, as well as substantive discussions at any meetings;
- Formally requesting that proxy advisory firms provide previews of recommendations they anticipate making vis-à-vis issues to be submitted to public company shareholders for a vote;
- Contemporaneously documenting proxy advisory firm responses to preview requests (and any substantive discussions about ensuing proxy advisory firm recommendations); and
- Monitoring proxy advisory firm recommendations for accuracy or reliance on outdated information.

## Dealing with Proxy Advisory Firm Conflicts of Interest

At the SEC's roundtable, a consensus was reached that the two biggest problems raised by the operations of proxy advisory firms were conflicts of interest and a lack of transparency regarding their operations.

The resulting SEC Staff Guidance treats the issue of conflicts in the context of its analysis of the conditions that must be met before a proxy advisory firm will be deemed exempt from the SEC's proxy soliciting disclosure and filing requirements. The exemptive rule specifically applicable to proxy advisory firms establishes a fundamental conflict disclosure requirement, obligating proxy advisory firms to disclose to their clients three broad categories of information:

- Significant relationships the proxy advisory firm has with the proponent of the proposal on which the proxy advisory firm is rendering advice;
- Any material interest the proxy advisory firm may have in the outcome of voting on the particular matter on which it is advising; and
- Any significant relationships the proxy advisory firm has with the subject public company or any of its affiliates.

The obligation imposed on proxy advisory firms—to disclose potential conflicts *before* their clients act on those recommendations—is a crucial linchpin that may exempt proxy advisory firms from the proxy solicitation disclosure and filing requirements.

As a result, public companies may wish to consider the following important issues in this context:

- Public companies should take steps to verify the nature of proxy advisory firm conflict identification, management, remediation, and responsiveness, to assist institutional investors in making their required assessments of proxy advisory firm policies and procedures;
- To the extent evidence exists of difficulties on the part of one or more proxy advisory firms in implementing the SEC Staff Guidance, public companies should endeavor to make that information known to proxy advisory firms so they can remedy



any perceived deficiencies in their conflict policies and procedures, as well as advise portfolio managers of any shortcomings in conflict identification, disclosure, management, and remediation; and

- These issues should also be brought to the attention of the SEC.

## Communication with Institutional Investors

The SEC Staff Guidance clarified that neither the Proxy Voting Rule nor an institutional investor's fiduciary duties obligates that investor to vote on *every* issue presented to the shareholders of portfolio companies. Given that the SEC Staff Guidance makes clear that institutional investors could make a determination, after securing investor agreement, as to the extent of their responsibility to vote portfolio securities, public companies should also consider adopting the following recommendations in communicating with major institutional investors:

- Putting in place a year-round, regular communication program with major institutional investors, among the goals of which should be:
  - Developing and maintaining a relationship of trust and confidence with important shareholders;
  - Consistent with SEC rules prohibiting selective disclosure of material, nonpublic information,<sup>13</sup> apprising portfolio managers of plans, issues likely to arise, and perspectives on current conditions affecting the public company;
  - Understanding institutional investor assessments of management as well as of past, current, and anticipated public company performance; and

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13 See SEC Regulation FD, 17 CFR §§243.100-243.103.

- Developing strategic positions vis-à-vis likely institutional investor changes to voting policies and practices.
- Bringing to the attention of major institutional investors observed deficiencies in proxy advisory firms' conflict identification, disclosure, management, and remediation, as well as any inadequacies observed with proxy advisory firms' implementation of the SEC Staff Guidance.



## Conclusion

The SEC Staff Guidance is a positive first step toward bringing more transparency and rationality to the current system of proxy voting advice. While the shareholders of public companies—whose interests the proxy advisory system is ultimately meant to serve—stand to benefit, it remains to be seen whether proxy advisory firms will take this opportunity to improve the transparency and efficacy of their business operations. Public companies therefore have a unique and important role to play in order to achieve a more desirable system of proxy voting advice. We hope that this Corporate Governance Update serves as a useful guide and stimulates further discussion for public companies so that the full potential of the SEC Staff Guidance can be achieved.





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