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Alert
SEC Disclosure and Corporate Governance

Two New Proxy Advisory Firm Developments: What They Mean for Corporate Issuers

ISS 2015 Benchmark Policy Survey

SEC Staff Legal Bulletin 20

Proxy advisory firms have been a challenging fact of life for corporate issuers for many years. Various factors have played a role in increasing the influence of these firms, including the Department of Labor's 1988 Avon letter requiring ERISA trustees to vote pension plan shares in accordance with fiduciary duties,[1] SEC rulemaking in 2003 requiring investment advisers to vote proxies in the best interests of their clients,[2] and the advent of say-on-pay advisory votes mandated by Dodd-Frank.[3] Recently, there have been a variety of US and international efforts to review and reform the proxy advisory industry.[4]

In this Alert, against this backdrop, we discuss two new developments relating to proxy advisory firms and their implications for corporate issuers:

- ISS 2015 Benchmark Policy Survey, launched on July 17, 2014
- SEC Staff Legal Bulletin No. 20 ("SLB 20"),[5] issued on June 30, 2014

ISS 2015 Benchmark Policy Survey

In accordance with its customary practice, ISS is seeking input on policy questions that ISS has said will "underpin" its benchmark voting policy for the 2015 proxy season. Feedback is due by **August 29, 2014** (as discussed below). Draft policy revisions are scheduled to be released in October, with comments due within 30 days.

Several of the survey questions indicate that ISS is considering providing more detailed guidance around its existing broad policies relating to risk oversight and pay magnitude. For example, according to its existing policy, ISS will, under "extraordinary circumstances," recommend that shareholders vote "against" directors for material failures of risk oversight.[6] This policy resulted in several recent high-profile negative recommendations against directors for cybersecurity breaches and other circumstances it viewed as risk oversight failures. Another example is its existing policy that "high pay opportunities relative to industry peers" may constitute a "problematic pay practice" warranting a recommendation "against" a company's say-on-pay proposal and/or certain directors.[7]

The questions also signal a new focus by ISS on defensive governance provisions many companies adopt *pre*-IPO and increased attention to board gender diversity. Moreover, they suggest that ISS is at least willing to consider the dilemma of what it calls "cross-market companies" -- companies incorporated outside the US that are full US registrants listed only on a US exchange -- which, at least in some respects, ISS has been evaluating under its non-US standards.

The survey questions are also notable in that they do *not* cover director tenure and independent chairs, which were included as consultation topics in ISS' long-term benchmark policy consultation period launched in February 2014. Director tenure continues to be a factor considered by ISS in its determination of a company's QuickScore governance rating. It remains to be seen whether ISS is shelving director tenure as a potential policy change for now, only to resurrect it for the 2016 proxy season.

The survey questions of relevance to US companies relate to compensation, governance and environmental/social issues, as follows:[8]

- **Compensation:**
  - *Absolute magnitude of compensation:* Regardless of company performance, is there an absolute magnitude of compensation that causes concern, and if so, how would that absolute magnitude be determined? Are proportional and/or absolute limits on CEO compensation supported and what tools may be appropriate for determining excessive pay magnitude (e.g., peer comparisons, comparisons to other named executive officers, proportion of corporate earnings or revenue)?
  - *Relationship between performance-based compensation award goals and award values:* What should the relationship be between goals governing performance-based compensation awards, and the sizes of the awards themselves? Are performance goals set independently of target awards? Are target award levels modified if performance goals are significantly reduced? Does the compensation committee have broad discretion to set goals and target awards?
  - *Forward-looking compensation program disclosure:* How should ISS use forward-looking disclosures of changes to a company's executive compensation structure in its pay-for-performance evaluation? Can "positive changes to the pay program" mitigate pay-for-performance concerns for the year under review? How specific should disclosures be about such pay program changes (e.g., metrics, performance goals, award values, effective dates)?
  - *Equity plan evaluation:* As part of its new "balanced scorecard" for equity plan evaluation, how should ISS weigh each of the following three factors: Plan Cost (e.g., economic and/or voting power dilution), Plan Features (e.g., vesting acceleration provisions, liberal share recycling), and Company Practices (e.g., historical burn rates, use of performance-based grants)?
- **Governance:**
  - *Accountability for risk and audit oversight:* How, and in what circumstances, should shareholders hold directors accountable for material failures of risk oversight? What factors should investors consider in determining whether to ratify the audit committee's selection of the company's outside auditor (e.g., audit firm tenure)?
  - *Unilateral adoption or amendment of bylaws:* How, and in what circumstances, should directors be held accountable for adopting provisions that restrict shareholder rights, without the consent of shareholders? Should this depend on the type of bylaw/charter amendment? Should directors be held accountable if "shareholder-unfriendly" provisions were adopted prior to the company's IPO?
  - *Boardroom gender diversity:* How do investors consider gender diversity when evaluating director elections?
  - *Cross-market companies:* How should ISS treat companies that are incorporated in one region but are listed for trading primarily in another, such as US companies that have re-incorporated in other countries for various reasons, including preferential tax treatment, but maintain (sometimes exclusively) their US listing?

- **ESG:**
  - *Quantitative performance goals:* When is it appropriate for companies to set relevant quantitative environmental and social performance goals, and what alternatives might be acceptable?

ISS has stated that it will publish the results of its survey near the end of September 2014.

SLB 20 Highlights

As noted above, the issuance of SLB 20 follows US and international efforts, which have intensified over the past several months, to review and reform the proxy advisory industry. Staff-level interpretive guidance focusing on proxy advisory firms and investment advisers might seem at first glance to represent a fairly modest response to these calls for reform, but we believe that SLB 20 ultimately may help corporate issuers in their ongoing efforts to ensure the accuracy and completeness of proxy advisory firm voting recommendations. Below, we highlight issues of particular importance to corporate issuers. We discuss in the Appendix the specific application of SLB 20 to proxy advisory firms and investment advisers.

Notably, SLB 20 was issued in the form of a Staff Legal Bulletin -- and not an interpretive release or other action requiring action by the Commission itself -- so does not tighten or otherwise amend any of the underlying exemptions from the proxy rules that may be available to proxy advisory firms. In summary, SLB 20:

- Clarifies that voting recommendations constitute proxy "solicitations" which at a minimum bring into play the proxy antifraud provisions of Rule 14a-9 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Where a proxy advisory firm is unable to rely on an exemption, full compliance with the proxy filing and disclosure rules may be required
- Increases pressure on proxy advisory firms to provide disclosure to investment advisers and other recipients of proxy voting advice with respect to the firm's conflicts, competency and capacity to provide such advice
  - A proxy advisory firm must affirmatively provide information relating to conflicts to recipients of the firm's advice -- it will not suffice for the firm to make the information available on request. While a proxy advisory firm is not required to make this information available to the broader public, antifraud considerations may prompt improved public disclosure of conflicts of interest on the part of such firms
  - Requires investment advisers that retain proxy advisory firms to determine whether these firms have "the capacity and competency to adequately analyze proxy issues." SLB 20 offers detailed guidance on how investment advisers can fulfill their obligations to evaluate the nature and quality of proxy advisory services, including an obligation to determine whether a particular firm's voting recommendations are based on "materially accurate" information, and whether that firm has any conflicts of interest that might affect its objectivity
    - SLB 20 provides additional gloss to two SEC Staff no-action letters issued in 2004 that describe the due diligence measures that registered investment advisers (as well as those advisers who should register but have not) are required to undertake when seeking proxy voting advice from an independent third party[9]
- Clarifies that investment advisers are not obligated to vote *every* proxy in order to discharge their fiduciary duties to clients. Instead, investment advisers and clients have flexibility in determining the scope of the adviser's obligation to exercise proxy voting authority
- Sets forth several steps that an investment adviser could take to demonstrate compliance with its fiduciary duty to vote proxies in the best interests of its clients and in accordance with the adviser's own proxy voting procedures, including proxy vote sampling and review of the investment adviser's proxy voting policies and procedures

  - Encourages advisers to take reasonable steps to investigate any material factual errors known to the adviser that cause the adviser to question the process by which such firm develops its recommendations, and for such adviser to seek to determine whether the proxy advisory firm is taking reasonable steps to reduce similar future errors
- States that investment advisers and proxy advisory firms "may want or need" to modify existing policies and procedures in light of the new guidance, and that the Staff expects any necessary changes to be made "promptly, but in any event in advance of next year's proxy season"

Although it remains to be seen how proxy advisory firms and investment advisers will respond in practice to SLB 20, it is unlikely that this guidance will dampen the influence of proxy advisory firms to any great extent. SLB 20 does, however, respond to frustrations expressed by corporate issuers about their ability to review and correct errors underlying proxy advisory firm voting recommendations, and may have the beneficial effect of motivating proxy advisory firms to expand opportunities for more meaningful issuer pre-publication review and comment on draft voting reports to assure the integrity and accuracy of data underlying the voting recommendations contained in those reports.

Moreover, it is possible that enhanced conflict disclosures could act as a "red flag" to investors with respect to whether certain reports or specific recommendations of an advisory firm warrant a closer look. At the end of the day, the spectre of potential antifraud liability exposure, which issuers themselves remain free to invoke through corrective supplemental proxy soliciting materials -- coupled with the SEC Staff's emphasis on the fiduciary obligations of investment advisers to monitor the accuracy and completeness of the factual underpinnings of advisory firms' voting advice -- may result in improved proxy advisory firm disclosures and more refined, issuer-specific voting recommendations.

What To Do Now?

Corporate issuers should:

- Communicate company views on proxy voting issues by participating in ISS' 2015 Benchmark Policy Survey before the August 29, 2014 deadline
  - The survey can be accessed at https://www.surveymonkey.com/s/2015_ISS_Policy_Survey
- Continue to carefully review proxy voting reports relating to the company -- with input from outside counsel and compensation consultants, as appropriate -- and notify the relevant proxy advisory firm of any errors as soon as possible
  - ISS currently provides draft versions of its proxy voting reports to S&P 500 companies for fact-checking purposes, provided the company has elected to participate in the review process by registering contact details with ISS before ISS' deadline (which for 2014, was 30 days before the meeting date, or January 31, 2014 for meetings during the 2014 proxy season)
    - Company contact information can be provided using the form available at this link: http://www.issgovernance.com/iss-draft-review-process-u-s-issuers/
    - Companies should build time for review of draft ISS reports into the annual meeting timeline, to ensure the availability of in-house personnel and advisors as appropriate when the draft is released -- generally 14-28 days before the meeting -- particularly given the time for review is typically 48 hours but can be less than 24 hours
    - Given the guidance in SLB 20, it is possible that ISS could begin to provide draft reports to a broader range of companies -- not just the S&P 500 -- and allow more time for review

- Feedback as to errors or omissions in Glass Lewis reports can be communicated to Glass Lewis via the portal on its website, available at http://www.glasslewis.com/issuer/ under "Reporting a Data Discrepancy"
  - Although Glass Lewis does not provide advance drafts -- and its CEO recently reiterated Glass Lewis' commitment to *not* engaging with issuers during the solicitation period -- its CEO stated that the new Glass Lewis "data report" will permit issuers to review a data version of the proxy voting report and will be released for comment during fall 2014 in preparation for a global roll-out next year[10]
- Consider highlighting material factual errors in additional definitive proxy materials or other shareholder communications, which some companies have done in response to proxy advisory firm say-on-pay voting recommendations, to ensure that they are appropriately brought to the attention of shareholders. As noted above, investment advisers that are relying on proxy advisory firm advice are now obligated under SLB 20 to "take reasonable steps to investigate the error" and to "seek to determine whether the proxy advisory firm is taking reasonable steps to seek to reduce similar errors in the future"[11]
- Before engaging a proxy advisory firm to provide consulting services, consider the possible impact of conflict of interest disclosures relating to such services that such firm may make and, in particular, whether investors might view certain proposals in a more positive or negative light as a result
- Ensure that shareholder engagement efforts continue to focus on why shareholders should generally defer to the board's recommendations, given the fiduciary nature of board oversight, particularly where there are no performance issues or other red flags that would warrant special attention

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If you have any questions on these matters, please do not hesitate to speak to your regular contact at Weil, Gotshal & Manges LLP or to any member of Weil's Public Company Advisory Group:

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We thank our colleague Rebecca Grapsas for her contribution to this alert.

Appendix

SLB 20 Guidance – The Nuts and Bolts

Q&As Relating to Application of the Federal Proxy Rules to Proxy Advisory Firms

SLB 20 includes eight (of 13) Q&As discussing the application of the federal proxy rules to proxy advisory firms, and the availability of certain exemptions from the filing and line-item disclosure requirements of these rules. The Staff reiterated the SEC's longstanding position that the furnishing of proxy voting advice constitutes a "solicitation" subject to the full array of proxy information and filing requirements, absent an exemption.[12] There are two alternative exemptions set forth in Exchange Act Rule 14a-2(b) that proxy advisory firms generally rely on. Even if exempt from the informational and filing requirements of the federal proxy rules, the provision of proxy voting advice remains subject to the prohibition on false and misleading statements set forth in the antifraud provisions of Rule 14a-9.[13]

Exchange Act Rule 14a-2(b)(1). An exemption is available where the proxy advisory firm distributes reports containing voting recommendations, *provided* the firm does not solicit the power to act as proxy for any client receiving the recommendations, and certain other conditions as set forth in the exemption are met.

- SLB 20 clarifies that the Rule 14a-2(b)(1) exemption would *not* be available if the firm offers a service that allows the client to establish, in advance of receiving proxy materials for a particular shareholder meeting, general guidelines or policies that the proxy advisory firm will apply to vote on behalf of the client[14] -- a firm offering this type of service would therefore need to rely on the exemption set forth in Exchange Act Rule 14a-2(b)(3)

Exchange Act Rule 14a-2(b)(3). An alternative exemption is available where the proxy advisory firm furnishes proxy voting advice to a person with whom the firm has a business relationship, if each of the following conditions is met:

- Such advice is rendered in the ordinary course of the advisory firm's business
- The firm *discloses* to the recipient of the advice any *significant relationship* with the company which is the subject of the report or any of its affiliates, or a security holder proponent of the matter on which advice is given, as well as any *material interests* of the proxy advisory firm in such matter or matters
  - SLB 20 states that whether a relationship would be "significant" or what constitutes a "material interest" will "depend on the facts and circumstances," and in making its determination, the proxy advisory firm would likely consider the type of service being offered, the amount of compensation received by the firm for such service and the extent to which the advice given to its advisory client relates to the same subject matter as the transaction giving rise to the relationship with the company or security holder proponent
    - A footnote to SLB 20 confirms that proxy advisory firms are not under a duty to investigate who a shareholder proponent is, in instances where the proponent's identity has not been disclosed (as permitted by Exchange Act Rule 14a-8)[15]
  - According to SLB 20, a "relationship generally would be considered 'significant' or a 'material interest' would exist if knowledge of the relationship or interest would reasonably be expected to affect the recipient's assessment of the reliability and objectivity of the advisor and the advice"[16]

- If a significant relationship or material interest exists, SLB 20 states that disclosure of such relationship or interest must be provided:
  - In a way that provides notice to the recipient of the proxy voting advice (i.e., investors) -- "boilerplate" language that such a relationship or interest may or may not exist is insufficient,[17] as is undertaking to provide such information "upon request"[18]
  - To 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
  - To allow the client to assess the advice provided and the nature and scope of the disclosed relationship or interest at or about the same time that the client receives the advice -- the conflicts disclosure need not be included in the proxy voting report or disclosed publicly[19]
- The firm receives no special commission or remuneration for furnishing the proxy voting advice from any person other than a recipient of the advice and other persons who receive similar advice
- The proxy voting advice is not furnished on behalf of any person soliciting proxies or on behalf of a participant in a contested election

SLB 20 clarifies that the Rule 14a-2(b)(3) exemption may be available to a proxy advisory firm that:

- Is not eligible to rely on the Rule 14a-2(b)(1) exemption, whether because it has been engaged by an investor to assist with the establishment of general proxy voting guidelines and policies, is authorized to execute a proxy or submit voting instructions on the investor's behalf, and is permitted to use its discretion to apply the guidelines to determine how to vote on particular proposals (as discussed above), or for any other reason[20]
- Provides consulting services to a company on a matter that is the subject of a voting recommendation or provides a voting recommendation to its clients on a proposal sponsored by another client[21]

Q&As Relating to Compliance by Investment Advisers with Proxy Voting Fiduciary Duties

SLB 20 includes five Q&As relating to the fiduciary duty of investment advisers to vote proxies in the best interests of the client and the SEC's Proxy Voting Rule that requires investment advisers exercising voting authority with respect to client securities to adopt and implement written policies and procedures that are reasonably designed to ensure that the adviser votes proxies in the best interests of the client.[22]

As SLB 20 makes clear, this guidance covers both SEC-registered investment advisers and those unregistered advisers the SEC believes should be registered. While the SLB is silent on whether the SEC Staff intends to follow up during registered adviser examinations to assess compliance with SLB 20, we think that this is a distinct possibility.

SLB 20 clarifies that investment advisers and clients have flexibility in determining the scope of the adviser's obligation to exercise proxy voting authority -- the Proxy Voting Rule does not *require* that investment advisers and clients agree that the adviser will undertake *all* of the proxy voting responsibilities. In short, investment advisers are not required to vote *every* proxy. SLB 20 provides a non-exclusive list of examples of how an investment adviser and client could structure their agreement in connection with the adviser's exercise of proxy voting authority, including 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

- The adviser vote in accordance with management's recommendations or in favor of proposals made by a particular shareholder proponent, absent contrary instruction from the client or determination by the adviser
- The adviser abstain from voting proxies
- The adviser focus resources on only particular types of proposals based on the client's preferences[23]

In addition, SLB 20 sets forth several steps that an investment adviser could take to demonstrate compliance with its fiduciary duty to vote proxies in the best interests of the client and in accordance with the adviser's own proxy voting procedures, including:

- Periodically sample proxy votes to review whether they are in compliance with the adviser's proxy voting policy and procedures, and specifically review a sample of proxy votes that relate to certain proposals that may require more analysis[24]
- Review at least annually the adequacy of the adviser's proxy voting policies and procedures to ensure they have been implemented effectively, including whether they continue to be reasonably designed to ensure that proxies are voted in the best interests of the client[25]
- If the adviser retains a proxy advisory firm (or other third party) to provide proxy voting recommendations or otherwise to assist the adviser in carrying out its proxy voting duties, the adviser should:
  - Ascertain among other things whether the proxy advisory firm has the *capacity* and *competency* to adequately analyze proxy issues, by considering with respect to such firm:
    - The adequacy and quality of staffing and personnel
    - The robustness of policies and procedures regarding such firm's ability to ensure that its proxy voting recommendations are *based on current and accurate information,* and identify and address any conflicts of interest and other considerations that the adviser believes would be appropriate in considering the nature and quality of the services provided by the proxy advisory firm[26]
  - Adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of such firm in order to ensure that the adviser, acting through the firm, continues to vote proxies in the best interests of its clients, including measures reasonably designed to identify and address the proxy advisory firm's conflicts that can arise on an ongoing basis such as by requiring such firm to update the adviser of business changes the investment adviser considers relevant (i.e., with respect to the proxy advisory firm's capacity and competency to provide proxy voting advice) or conflict policies and procedures[27]
- In the event that an adviser determines that a proxy advisory firm's recommendation is based on a material factual error that causes the adviser to question the process by which such firm develops its recommendations:
  - Take reasonable steps to investigate the error, taking into account the nature of the error and the related recommendation
  - Seek to determine whether the proxy advisory firm is taking reasonable steps to seek to reduce similar errors in the future[28]

ENDNOTES

1. Letter from Alan D. Lebowitz, Deputy Assistant Secretary, Department of Labor, to Helmuth Fandl, Chairman of the Retirement Board, Avon Products, Inc. (February 23, 1988) 1988 ERISA LEXIS 19. The letter, in a footnote, reiterated the substantive position of the Department of Labor that "[t]o act prudently in the voting of proxies (as well as in all other fiduciary matters), a plan fiduciary must consider those factors which would affect the value of the plan's investment."
2. SEC Release No. IA-2106, Proxy Voting by Investment Advisers (January 31, 2003), *available at* http://www.sec.gov/rules/final/ia-2106.htm.
3. Exchange Act Rule 14a-21, implementing Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.
4. *See, e.g.,* SEC, Proxy Advisory Services Roundtable (December 5, 2013), *available at* http://www.sec.gov/spotlight/proxy-advisory-services.shtml; SEC Release No. 34-62495, Concept Release on the US Proxy System (July 14, 2010), *available at* http://www.sec.gov/rules/concept/2010/34-62495.pdf (the "Proxy Concept Release"). For an overview of several other developments in proxy advisory firm regulation and best practices, *see* our Alert, Heads Up for 2014 Proxy Season (November 27, 2013), *available at* http://www.weil.com/news/pubdetail.aspx?pub=12351.
5. Staff Legal Bulletin No. 20 (IM/CF), Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms (June 30, 2014), *available at* http://www.sec.gov/interps/legal/cfslb20.htm.
6. ISS, 2014 U.S. Proxy Voting Summary Guidelines (March 12, 2014) at 12, *available at* http://www.issgovernance.com/file/2014_Policies/ISSUSSummaryGuidelines2014March12.pdf.
7. *Id.* at 40.
8. A complete set of the policy survey questions is available at http://www.issgovernance.com/file/publications/2015-iss-policy-survey.pdf.
9. Institutional Shareholder Services, Inc., SEC Staff No-action Letter (September 15, 2004), *available at* http://www.sec.gov/divisions/investment/noaction/iss091504.htm; Egan-Jones Proxy Services, SEC Staff No-action Letter (May 27, 2004), *available at* http://www.sec.gov/divisions/investment/noaction/egan052704.htm.
10. Comments by Katherine Rabin, Chief Executive Officer, Glass, Lewis & Co., LLC, Webcast hosted by the Society of Corporate Secretaries & Governance Professionals (July 10, 2014).
11. SLB Q&A 5.
12. Exchange Act Rule 14a-2(b). *See* SLB Q&A 6. Note that in a recent letter to counsel to an SEC Commissioner, the CEO of Glass Lewis stated that Glass Lewis "does not believe that its activities involve the solicitation of proxies within the meaning of the proxy rules," but that, in any case, Glass Lewis meets the conditions of exemptions to the proxy solicitation rules set forth in Exchange Act Rules 14a-2(b)(1) and 14a-2(b)(3). Letter from Katherine Rabin, Chief Executive Officer, Glass, Lewis & Co., LLC, to Allison Herren Lee, Counsel to SEC Commissioner Kara Stein (June 13, 2014), *available at* http://www.sec.gov/comments/4-670/4670-15.pdf.
13. Exchange Act Rule 14a-9. *See* Proxy Concept Release, note 4, above, at 109.
14. *See* SLB Q&A 8.
15. *See* SLB Q&A 10, fn. 12.
16. *See* SLB Q&A 10.
17. *See* SLB Q&A 11.
18. *See* SLB Q&A 12.
19. *See* SLB Q&A 13.
20. *See* SLB Q&A s 7, 9.
21. *See* SLB Q&A 10.
22. Rule 206(4)-6 under the Investment Advisers Act of 1940, as amended.
23. *See* SLB Q&A 2.
24. *See* SLB Q&A 1.
25. *See* SLB Q&A 1.
26. *See* SLB Q&A 3.
27. *See* SLB Q&A 4.
28. *See* SLB Q&A 5.