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Meridian Client Update

SEC Issues Guidance on Proxy Advisory Firms

On August 21, 2019, the Securities and Exchange Commission (“SEC”) issued guidance covering the role that proxy advisory firms play in the proxy voting process and the use of proxy advisory firms by investment advisers.

Despite reports to the contrary, the guidance (which does not carry the weight of law) does not represent meaningful federal oversight of proxy advisory firms. In fact, Institutional Shareholder Services (ISS) and Glass Lewis already largely comply with the guidance. We do not anticipate that the guidance will result in any significant change in the operations of ISS or Glass Lewis.

The SEC has hinted at future rule-making in this area. Whether any future SEC rule will subject the proxy advisory firms to a meaningful regulatory regime remains to be seen.

Summarized below is each of the two sets of guidance issued by the SEC.

The Applicability of Proxy Rules to Proxy Voting Advice

Under one set of guidance, the SEC clarified that proxy advisors’ proxy voting advice (e.g., vote recommendations) generally constitutes a solicitation under the federal proxy rules. Proxy solicitations must satisfy Rule 14a-9, which requires solicitations to be free from false or misleading statements or omissions of material facts. A proxy advisory firm’s failure to comply with the requirements of Rule 14a-9 could subject it to legal sanctions and penalties.

To avoid potential noncompliance with Rule 14a-9, the guidance suggests that a proxy advisory firm may need to disclose information on: (i) its methodology used to formulate its voting advice, (ii) the source of third-party information (other than information publicly disclosed by the registrant) used to develop its proxy voting advice, and (iii) conflict of interests.

Meridian comment. ISS and Glass Lewis largely make the foregoing suggested disclosures. Both provide extensive public disclosure of proxy voting methodologies and include in a company’s proxy research report the methodology used to determine particular vote recommendations. In addition, both disclose the use of third-party derived information and conflicts of interest that arise in connection with the provision of proxy voting advice.

However, the Staff or Commission (as well as investment advisers) may find ISS’s and Glass Lewis’ current compliance with the suggested disclosures problematic in the following respects:

- The absence of disclosure on the inner workings of the proxy advisory firms’ proprietary models used to develop vote recommendations (e.g., ISS Equity Plan ScoreCard model, which is used to develop ISS’s vote recommendation on an issuer’s equity plan proposal).
- The limited disclosures explaining the use of subjective measures to develop vote recommendations.

Guidance on Proxy Voting Responsibilities of Investment Advisers

In this set of guidance, the SEC reiterates the fact that investment advisers owe each of their clients a duty of care and loyalty with respect to services they undertake on the clients' behalf, including proxy voting. Rule 206(4)-6 under the Advisers Act requires an investment adviser that exercises voting authority on client securities to adopt and implement written policies and procedures that are reasonably designed to ensure that the investment adviser votes proxies in the best interest of its clients.

Among other items, the guidance specifically covers when an investment adviser retains a proxy advisory firm and receives vote recommendations or vote execution services from the proxy advisor.¹

Investment Adviser's Retention of a Proxy Advisory Firm

The guidance provides that prior to retaining a proxy advisory firm, an investment adviser should assess the following aspects of the firm: (i) its competency; (ii) issuer and client input on proxy voting policies, methodologies and peer group construction; (iii) its methodologies used to determine vote recommendations; (iv) its use of third party information sources; (v) its engagement with issuers and third parties; and (vi) its conflict of interests policies and procedures.

Meridian comment. In undertaking such an assessment, investment advisers may find the following aspects of ISS's and Glass Lewis' operations problematic:

- The enormous volume of proxies reviewed by ISS and Glass Lewis by permanent and seasonal employees during a compressed time period may give rise to concerns by investment advisers whether these proxy advisors have the capacity and competency to undertake a thorough review of these proxies.
- Unlike ISS, Glass Lewis does not formally engage with clients or third parties on the development or modification of its proxy voting policies.
- Both ISS and Glass Lewis include in their respective proxy research reports the analysis underlying their vote recommendations. However, these analyses can be inconsistent across issuers on the same subject.
- In cases where ISS is providing consulting services through its consulting arm to an issuer for which it develops a vote recommendation, ISS will disclose directly to an investment adviser client a list of such issuers. However, ISS does not disclose the amount of consulting fees paid by such issuers.

Investment Adviser's Use of Proxy Advisor's Vote Recommendation and Election Voting Platform

An investment adviser's vote decision must remain consistent with its proxy voting policies and the best interests of its clients. To ensure compliance with the foregoing requirement, the guidance provides that the investment adviser should undertake the following steps when it receives proxy voting recommendations and/or vote execution services from a proxy advisory firm: (i) sample the proxy advisory firm's pre-populated electronic voting platform to ensure votes are being properly cast, (ii) consider the proxy advisory firm's policies and procedures for incorporating post-proxy filing information that may become available regarding a proposal, and (iii) consider whether a more detailed analysis may be necessary or appropriate to determine how to vote on a particular proposal.

Meridian comment. These due diligence items should not prove problematic for ISS or Glass Lewis.

¹ The guidance also covers a range of other items, including: (i) the investment adviser relationship with clients, (ii) the manner in which an investment adviser may demonstrate that it is making vote determinations in the best interests of clients, and (iii) the extent to which an investment adviser is required to vote a client's proxy. This Client Update does not cover these items.

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The ***Client Update*** is prepared by Meridian Compensation Partners' Governance and Regulatory Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.

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