



SEC Commissioner Daniel Gallagher Offers Advice to Public Companies On Handling Proxy Advisory Firms

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Commissioner Daniel M. Gallagher of the Securities and Exchange Commission (“SEC”) authored a working paper, published last month by the Washington Legal Foundation, regarding the outsized power and influence of proxy advisory firms.¹ In his paper, Commissioner Gallagher provides his view of the most important aspects of Staff Legal Bulletin No. 20 (“SLB 20”), in which the SEC staff recently “moved toward addressing some of the serious issues” resulting from the emergence of proxy advisory firms as a dominant player in American corporate governance. Notably, Gallagher also offers some critical advice to public companies engaging with proxy advisory firms.

STAFF LEGAL BULLETIN NO. 20

SLB 20, issued on June 30, 2014, provides guidance regarding the duties and obligations of proxy advisory firms and investment advisers who retain such firms.² While expressing concern that the SEC’s guidance “does not go far enough,” Gallagher regards SLB 20 as “a good initial step in addressing the serious deficiencies currently plaguing the proxy advisory process.” Specifically, Gallagher notes that SLB 20 clarifies three important principles:

1. **Flexibility in Proxy Voting Arrangements.** An investment adviser and its client need not agree that the investment adviser will vote every proxy. Rather, “an investment adviser and its client have flexibility in determining the scope of the investment adviser’s obligation to exercise proxy voting authority.”³
2. **Continuing Duty to Monitor Proxy Advisers.** An investment adviser that has retained a proxy advisory firm is required to adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the proxy advisory firm. This duty includes ensuring that the proxy advisory firm has the capacity and competency to

¹ See Commissioner Daniel M. Gallagher, “Outsized Power & Influence: The Role of Proxy Advisers,” Washington Legal Foundation (August 2014).

² See U.S. Securities and Exchange Commission, Division of Investment Management & Division of Corporation Finance, “Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms,” Staff Legal Bulletin No. 20 (June 30, 2014).

³ *Id.*

address conflicts of interest and to make voting recommendations based on current and materially accurate information.

3. **Disclosure of Proxy Advisers' Significant Relationships.** To the extent that a proxy advisory firm would like to avail itself of certain exemptions from the proxy rules, it must disclose to recipients of voting recommendations any "significant relationships" or "material interests" in the matter subject to the voting recommendation. This disclosure must enable the recipient to understand the nature of the relationship or interest; boilerplate language will not suffice.

COMMISSIONER GALLAGHER'S ADVICE

In addition to highlighting the key aspects of SLB 20, Gallagher offers advice to public companies regarding the second of its three core principles – investment advisers' continuing duty to monitor proxy advisory firms. Gallagher notes that where a proxy advisory firm issues a recommendation based on materially false or inaccurate information, the issuer sometimes has difficulty getting the proxy advisory firm "to acknowledge these claims, much less review them and determine whether to revise its recommendation in light of the corrected information."⁴ While Gallagher "encourage[s] companies to attempt to work with proxy advisers," he also stresses the importance of companies bringing such "misconduct by proxy advisers to the attention of their institutional shareholders." Gallagher advises that if a company experiences "difficulties in getting the proxy advisory firm to respond to the company's concerns about the accuracy of the information on which the recommendation is based" and contacts its institutional investors in this regard, the company should copy Gallagher's office on its correspondence.

THE POTENTIAL IMPORTANCE OF GALLAGHER'S ADVICE

Gallagher's advice seems to address the heart of the issue surrounding proxy advisory firms, which Gallagher termed a "classic agency problem." As some commentators have observed, proxy advisory firms (unlike management or boards of directors) have neither a financial interest in the companies for which they advise voting choices nor a fiduciary duty owed to the corporations about which they are making recommendations. Additionally, with each of the major proxy advisory firms run as a for-profit entity, some have noted that the natural economic interest of proxy advisory firms is to increase their own profits for financially-oriented owners. As a result, these critics have concluded that proxy advisory firms – hired to determine which voting decisions maximize shareholder value – have no incentive to make the correct determination and are not accountable to the public.

So "how do we make sure that the investment adviser is voting [] shares in the investor's best interest, and not the adviser's?"⁵ It is this fundamental question that Gallagher appears to tackle by encouraging companies to converse directly with investment advisers regarding

⁴ Gallagher, "Outsized Power & Influence: The Role of Proxy Advisers," at 14-15.

⁵ *Id.* at 2.

unresponsive proxy advisers (and to copy his office on correspondence). Gallagher's advice seems aimed at ensuring that investment advisers have "skin in the game" – that they are reminded of their own fiduciary duties and thus have an incentive to act in investors' best interests.

While SLB 20, in itself, may not result in meaningful changes regarding the influence of proxy advisory firms – particularly because it does not address the "agency problem" – Gallagher's advice suggests that public companies may have at their disposal a tool to amplify the intended effects of SLB 20. It remains to be seen whether companies will show a willingness to initiate potentially uncomfortable dialogues with their institutional investors in an attempt to advance the bulletin's objectives.

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If you have any questions or would like additional information, please do not hesitate to contact [Yafit Cohn](mailto:yafit.cohn@stblaw.com) at (212) 455-3815 or yafit.cohn@stblaw.com, or any other member of the Firm's Public Company Advisory Practice.

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