

August 2010

SEC Takes a Look at Proxy Advisory Firms

Introduction

As part of our continuing efforts to keep our clients and friends informed of corporate governance developments related to executive compensation, we are providing our comments on a July 2010 concept release issued by the Securities Exchange Commission (“SEC”) that discusses, as part of a larger review of the U.S. proxy system, the role and legal status of proxy advisory firms.

The SEC is responding to concerns expressed by market participants that proxy advisory firms significantly influence shareholder voting without having any actual ownership interest in the issuer, a “misalignment” between voting power and economic interest that can affect confidence in the legitimacy of the proxy voting system. Significant concerns are also expressed that proxy advisory firms may be subject to conflicts of interest or may fail to conduct sufficient research, resulting in voting recommendations based on erroneous or incomplete facts. With the publication of the concept release the SEC is asking for comments on, among other things, improving disclosure of potential conflicts of interest, improving regulatory oversight over the formation of voting recommendations and requiring eventual public disclosure by proxy advisory firms of their voting recommendations in SEC filings. The concept release can be viewed at <http://www.sec.gov/rules/concept/2010/34-62495.pdf> (relevant sections can be found on pages 104 – 126).

The SEC’s review will be of significant interest to the boards and management of many Canadian issuers. Canadian proxy voting outcomes are affected by the voting recommendations of U.S. based proxy advisors in the same way and largely to the same extent as are those in the U.S. The most influential proxy advisor in Canada, namely, ISS (until recently RiskMetrics or “RMG”), is a U.S. based company (as is the second largest, Glass Lewis). Any changes to the operations or business model of proxy advisors resulting from the SEC’s review will undoubtedly affect how they carry on business in Canada. For many Canadian issuers who share concerns about proxy

advisors, the SEC's review is a welcome development and one that will be followed with keen interest. In this briefing, we summarize the key issues related to proxy advisory firms covered in the release, including potential regulatory responses and the specific questions to which interested parties are being asked to respond.

Background

Role of Proxy Advisors

The concept release points out several reasons that the influence of proxy advisors is on the rise:

1. Increasingly large percentage of shares owned by institutional shareholders combined with their fiduciary obligation to vote all shares on behalf of the beneficiaries
2. Large number of resolutions to be voted on each year, including those involving significant policy questions and corporate governance issues (this will increase dramatically in the U.S. with the arrival of mandatory Say on Pay in January 2011) as well as complex mergers and other transactions
3. Lack of time and resources on the part of institutional investors to meet their fiduciary obligation

Some critics suggest that some institutional shareholders may be less than committed to carrying out their fiduciary obligations with respect to proxy voting and may find it less burdensome to outsource voting responsibilities.

Concerns about the Role of Proxy Advisors

While the release refers briefly to two additional concerns with proxy advisory firms, namely, their influence over voting "without appropriate oversight" and the repercussions of having one dominant player (ISS), its focus is on potential conflicts of interest and the lack of accuracy and transparency in the formulation of voting recommendations. Hugessen's experience confirms that these are the issues that generate the most significant antipathy towards advisors – particularly ISS - on the part of issuers and their advisors in both Canada and the U.S.

Conflicts of Interest

The potential conflict generating the most concern arises when proxy advisors provide both voting recommendations to investors and consulting services to issuers (the ISS business model). An issuer, for example, may buy consulting services in the hope of gaining support when voting recommendations are made to shareholders. Or the proxy advisors provide corporate governance ratings on issuers to investors while offering consulting services to the issuers to help them improve those same ratings.

Standard attempts to deal with this potential conflict, by the use of a generic disclosure statement such as ISS uses to the effect that the proxy advisor “may” have a consulting relationship with the issuer, and without any description of the nature of any relationship, are met, as the release notes, with widespread dissatisfaction even when firewalls have been set up between corporate consulting and proxy research departments.

The release also mentions the potential conflict that can arise under a business model where the owners of the proxy advisor have a significant ownership interest in or sit on the board of the proxy advisor and the owners also hold an interest in an issuer with shareholder matters on which the proxy advisor is making voting recommendations (the Glass Lewis/Ontario Teachers Plan Pension Board model).

Potential solutions

The SEC requests comments on the following specific actions that could be taken to address conflict concerns:

- Revise the proxy solicitation rules to require more specific disclosure of the presence of a potential conflict
- Provide additional guidance on the existing fiduciary duty of proxy advisors as “investment advisors”, registered under the Advisors Act, to disclose fully any material conflict of interest or propose a specific rule to that effect
- Create a targeted “investment advisor” registration for proxy advisors, based on the unique nature of their business and its impact, with appropriate registration requirements

- Adopt regulations similar to those applying to credit rating agencies, for example, prohibiting certain conflicts of interest and requiring the filing of periodic disclosures to describe conflicts and procedures to manage them

Additional regulatory oversight through the adoption of any of these proposals should go some way towards alleviating concerns over potential conflicts of interest. An outright prohibition against providing services to issuers and investors (rather than merely disclosure of potential conflicts of interest), would undoubtedly be the preference of many issuers.

Lack of Accuracy and Transparency in Formulating Voting Recommendations

The second major concern with proxy advisors is that their voting recommendations may be based on materially inaccurate or incomplete data or analysis. This concern is aggravated by the perception that proxy advisors, as the SEC states in the concept release “may be unwilling, as a matter of policy, to accept any communication with issuers or reconsider recommendations in light of such communications”. Further, even if voting recommendations are changed following interactions with issuers, practical considerations may make it difficult for a revised proxy to be submitted in time. For these reasons, and as the release points out, many issuers want to be able to review a draft of the report, at least for accuracy.

Note to Clients – In our experience working with the board and management of various clients, ISS has been generally responsive to issuers’ initiatives to discuss and address issues covered in ISS’ reports. Key to securing a satisfactory outcome would appear to be the timely direct involvement of a board member, e.g., Chair of the Board or Compensation Committee, with well-informed support.

It would appear that without additional clarification from the SEC and absent new rules, existing U.S. regulations do not provide sufficient tools to address concerns about accuracy and accountability. Proxy solicitation rules do not require proxy firms to have procedures in place to ensure that research or analysis is materially accurate or complete, although the firms are subject to antifraud provisions that should deter misleading or inaccurate advice. They are also subject to a fiduciary duty, as investment advisors, to take reasonable care to determine recommendations are not based on materially inaccurate or incomplete information.

The release also mentions in this context the concern, commonly voiced, that proxy advisory firms are prone to a one-size-fits-all governance approach which can lead to inappropriate voting recommendations that will nonetheless be followed by shareholders. For example, some

view a blanket prohibition on options for directors, regardless of a company's stage of growth, to be impractical and unrealistic. Similarly, others consider a permanent ban on an issuer's one-time CEO being considered an independent member of the issuer's board, regardless of circumstances or the passage of time, to be inappropriate.

Potential solutions

The SEC is asking specifically for comments on whether additional oversight mechanisms could help and sets out a number of possible approaches:

- require proxy advisors to disclose the extent of research involved with a particular recommendation and any controls and procedures in place to ensure accuracy of data
- require proxy advisors to disclose policies and procedures for interacting with issuers, including:
 - informing issuers of recommendations, and
 - handling appeals of recommendations
- require proxy advisors to file their voting recommendations with the SEC, at least on a delayed basis

Again, any or all of these approaches could help to ameliorate concerns. However, a combination of a requirement to disclose policies for interaction with issuers and a requirement to publicly file recommendations is most likely to have the desired effect; in particular, a requirement to file recommendations ex post facto with the SEC – public disclosure will enable market participants to assess the quality of voting recommendations over time and draw their own conclusions as to their utility and contribution to the proxy voting system.

Request for Comment

In addition to the specific requests for comment discussed above, commentators are asked for their views on proxy firms generally and invited to comment on 19 specific questions (some of which overlap with the questions above).

The questions generally fall under one of three types:

1. those (the majority) that are seeking additional information on which to base any policy decisions
2. those looking for an assessment or opinion of the existing situation
3. those asking for a view as to the best way to solve perceived existing problems

Given that Canadian issuers face the same issues with respect to the same proxy advisory firms as do U.S. issuers, some Canadian issuers may undoubtedly view it as appropriate to submit a written response to the SEC. While some of the questions are clearly more suitable for U.S. domestic market participants, the release places no restrictions on who can comment and it is not uncommon, given the influence SEC decisions can have on the global governance debate, for interested parties from other countries to submit comments. Regardless of whether there is an intention to submit comments, it may be worthwhile for directors and especially governance/compensation committee members to review the questions (a list is attached) not only to learn more about the SEC's considerations but also to clarify their own position on certain aspects of the issue.

ISS Reviews Issuer “Engagement Process”

Interestingly, ISS' most recent policy outreach survey sought input from institutional investors and issuers on its issuer “engagement process”, asking, for example, whether participants believe it is vital for issuers to provide input on company specifics prior to the publication of ISS' report or for ISS to engage with issuers seeking to “cure” issues following a report's publication. The results of the annual survey are used as a basis for formulating ISS' policies and this appears to be the first time that the survey has addressed ISS' own engagement process.

Summary

The concept release is part of a process that is attempting to address long-standing concerns about proxy advisors that are shared by many Canadian issuers and their boards. With Say on Pay, compensation committees in particular may be focusing on proxy advisors' potential influence on voting outcomes. We will continue to keep you informed on the SEC's progress in this area and its implications for Canadian issuers and their directors.

For further information or to schedule a discussion about this topic, please contact any one of the following consultants:

Toronto

Ken Hugessen at 416-868-4422, khugessen@hugessen.com

Georges Soaré at 416-868-4416, gsoare@hugessen.com

Paul Hooper at 416-847-4629, phooper@hugessen.com

Catherine McCall at 416-868-4421, cmccall@hugessen.com

Calgary

Scott Munn (Calgary) at 403-441-6297, smunn@hugessen.com

Hugessen Consulting is an independent consulting firm dedicated to meeting the executive compensation consulting requirements of boards and their compensation committees. With offices in Toronto and Calgary, the firm's mission is to be the leading provider of advice on executive compensation, performance measurement and assessment, and related governance to the compensation committees of medium and large companies in Canada, the U.S., and the U.K.

Visit www.hugessen.com

SEC's Questions related to Proxy Advisors

In addition to asking commentators for views on proxy advisory firms generally, the SEC has asked for comments on the following questions:

1. Do proxy advisory firms perform services for their clients in addition to or different from those noted above?
2. 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 Nationally Recognized Statistical Ratings Organizations that may be appropriate to consider applying to proxy advisory firms?
3. 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?
4. 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?
5. 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?
6. 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)?
7. Do issuers modify or change their proposals to increase the likelihood of favorable recommendations by a proxy advisory firm?

8. 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?
9. 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?
10. 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?
11. How do institutional investors use the voting recommendations provided by the proxy advisory firms? What empirical data exists regarding how, and to what extent, institutional investors vote consistently, or inconsistently, with such recommendations?
12. 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 effect 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?
13. 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?
14. 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?

15. Do proxy advisory firms control or significantly influence shareholder voting without appropriate oversight? If so, is there empirical evidence that demonstrates this control or significant influence? If such proxy advisory firms do control or significantly influence shareholder voting, is that inappropriate, and if so, should the Commission take action to address it? If so, what specific action should the Commission take?
16. Are there any proxy advisory firms that cannot rely on an exemption to the prohibition on Advisors Act registration? If so, why do the exemptions not apply to those proxy advisory firms?
17. Do proxy advisory firms operate the kind of national business that the Advisors Act Section 203A(c) was designed to address? Should we create an additional exemption from the prohibition on federal registration for proxy advisory firms to register as investment advisors? If so, what standard should we use?
18. Do the current regulatory requirements for registered investment advisors adequately address advisors whose business is primarily providing proxy voting services? If we consider new rulemaking in this area, what should the rules address? Should we amend Form ADV to require specific disclosures by registered investment advisors that are proxy advisory firms?
19. Do proxy advisory firms maintain an audit trail for votes cast on behalf of clients? Do proxy advisory firms monitor whether votes cast are appropriately counted, and if so, how?