Communications Issues for REITs – Analysts, Investors & Social Media Meeting

Wednesday, April 1st
11:15am – 12:30pm
JW Marriot Desert Ridge Resort & Spa
Phoenix, AZ

Moderator:
David Bonser, Head-Equity & US Debt Capital Markets, Hogan Lovells LLP

Panelists:
Kay Tidwell, EVP & General Counsel, Hudson Pacific Properties, Inc.
Jerry Cummins, Partner, Sidley Austin LLP
Julian Kleindorfer, Partner, Latham & Watkins LLP

NAREIT®

NAREIT's Law, Accounting
& Finance Conference

JW Marriott Desert Ridge Resort & Spa
Phoenix, AZ

Regulation FD

March 31-April 2, 2015

Regulation FD - Purpose

- How are we sure everyone gets the same important information at the same time?
  - Problem: “Selective disclosure” of material nonpublic information to securities analysts, institutional shareholders and others but not to the public causes an imbalance in disclosure system
  - Response: In 2000, the SEC adopted Regulation FD (Fair Disclosure) requiring an issuer that discloses material nonpublic information to securities market professionals or to a security holder to make public disclosure of such information
  - Goal: To “level the playing field” between small and institutional investors

Regulation FD – The Rule

- Disclosures of material nonpublic information concerning the company or its securities
- Made by (i) a director, (ii) an executive officer or (iii) an IR person to
- (i) securities industry professionals or (ii) security holders who are likely to trade on the information
- That are not exempt

Violate Regulation FD

Applying Materiality Standards

- Amorphous definitions established by case law
  - Information is material if (i) “there is a substantial likelihood that a reasonable shareholder would consider it important” in making an investment decision or (ii) there is a substantial likelihood that it “would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available”
- Information regarding certain topics will almost always be considered material:
  - Earnings (including ballpark guidance)
  - Sales figures
  - Significant transactions
  - Changes in control
  - Difficulties with auditors
- Confirmation of prior guidance contains a significant risk of an FD violation as such confirmation itself may be material (including statements like “has not changed” or “still comfortable with”)

Communications Not Covered by Regulation FD

- Communications by persons who are not (i) senior officials (i.e., directors or executive officers) or (ii) IR personnel
- Communications to persons who are not (i) securities industry professionals or (ii) security holders who are likely to trade on the information
- Communications of non-material information
- Exempt communications

Exempt Communications

- Communications made to a person who owes a duty of confidence (e.g., attorney, investment banker or accountant)
- Communications made to a person who expressly agrees to maintain the disclosed information in confidence (which need not be in writing)
  - Communications made to ratings agencies were previously exempt from Reg FD but the SEC removed that exemption in 2010 as required by the Dodd-Frank Act. Nevertheless, engagement letters between companies and ratings agencies generally include confidentiality provisions, so the change to the rule has little substantive effect
- Communications made in connection with many types of registered securities offerings

Timing of Public Disclosure

- Intentional or planned disclosures
  - Examples: planned remarks, speeches, presentations, letters to a public audience
  - Timing: Requires prior or **simultaneous** disclosure to the public of any material information
- "Non-intentional" selective disclosures
  - Examples: Responses to questions, unscripted interviews, unplanned comments
  - Requires disclosure to the public of any material information within the later of **24 hours** or the commencement of the **next day's trading on the NYSE** after a senior official learns of the selective disclosure.

Methods of Public Disclosure

- Disclosure must be made by a method or combination of methods that are “reasonably designed to provide broad, non-exclusionary distribution of the information to the public”
- Compliant methods include:
  - filing (or furnishing) a Form 8-K with the SEC
  - disseminating a press release through a widely circulated news or wire service
  - conference calls, press conferences or webcasts (with adequate notice and access)
  - in some cases posting material on company website or through social media

Is Website Posting Public Disclosure

- SEC released guidance in 2008
- Public companies must consider whether:
  - a company website is a “recognized channel of distribution”
  - posting disseminates the information in a manner making it available to the marketplace in general
  - there has been a reasonable waiting period for investors and the market to react to the posted information
- What steps has company taken to identify website as channel of distribution? Is website posting publicized through an email alert?

Evaluating Whether Social Media Disclosures are "Public"

- In April 2013, the SEC issued guidance on the application of Reg FD to disclosures made through social media in its Report of Investigation of Netflix
- According to prior Reg FD guidance regarding websites, a company makes "public" disclosure when it distributes information "through a recognized channel of distribution."
- Whether a company's social media channel is a "recognized channel of distribution" will depend on the steps the company has taken to alert the market to its social media channel and its disclosure practices—as well as the use by investors and the market of the company's social media channel
- Companies are required to conduct a thorough facts and circumstances analysis to conclude that disclosures made via a social media channel will be a "recognized channel of distribution" and thus "public" for Reg FD purposes

Consequences of Violating Reg FD

- Possibility of SEC enforcement action
- Does not create private right of action
- Sanctions against company and individual
  - Cease-and-desist order in administrative action
  - Injunction and/or monetary penalties in civil action
- Could complicate Exchange Act reporting
  - SEC position that failure to comply with Reg FD is a violation of disclosure controls and procedures could complicate control disclosures and CEO and CFO SOX certifications

SEC Enforcement Actions under Regulation FD

- Though adopted in 2000, no actions until November 2002
- 2002: Four actions disclosed simultaneously in November (*Raytheon, Secure Computing, Siebel Systems I, Motorola*)
- 2003: One action (*Schering-Plough*)
- 2004: Two actions (*Siebel Systems II, Senetek*)
- 2005: One action (*Flowserve*)
- 2007: One action (*Electronic Data Systems*)
- 2009: One action (*Black*)
- 2010: Two actions (*Presstek, Office Depot*)
- 2011: One action (*Fifth Third Bancorp*)
- 2013: One action (*First Solar*)

Lessons From SEC Enforcement Actions

- Need for coordination in communications policy and understanding what has been publicly disclosed
  - Particular sensitivity to statements that could be seen to contradict previous public disclosure
- Extreme caution in discussing forward-looking information (particularly earnings guidance) in private meetings with analysts and investors
- Disclosures at industry conferences can lead to Reg FD violations if not broadly available to the public
- Material information can be conveyed by <u>how</u> something is said as well as by <u>what</u> is said
- Importance of adopting and complying with a corporate disclosure policy
  - Anything relating to or impacting earnings will be considered material
  - Establish procedures for rapid public dissemination in the event of “non-intentional” selectively disclosed information
- SEC has increasingly imposed financial penalties on officers and companies for Reg FD violations

Early SEC Enforcement Actions

- ***Raytheon*** - Raytheon's CFO held one-on-one telephone calls with sell-side analysts. During the calls, the CFO indicated that the analysts' quarterly EPS estimates were based on incorrect assumptions regarding the seasonality of Raytheon's earnings and were therefore too high. The analysts all lowered their estimates. Raytheon provided no comparable quarterly guidance in its publicly-accessible investor calls.

- ***Secure Computing*** - Secure Computing entered into a contract that would clearly have a material impact on earnings. The CEO disclosed the contract to two portfolio managers from investment advisory companies prior to public announcement. A Reg FD violation was found notwithstanding that the company issued a press release on the evening of the same day on which the CEO made the second of his two nonpublic disclosures.

Early SEC Enforcement Actions

- ***Siebel Systems I*** - During Q&A session at invitation-only conference hosted by bank, CEO made optimistic comments regarding short-term results. This was in direct contradiction to negative statements that he had made three weeks earlier on a publicly-accessible earnings call. Siebel's stock price and trading volume increased sharply on day of conference. Siebel paid $250,000 penalty as part of settlement.

- ***Motorola*** - Motorola disclosed in press release that it was experiencing "significant" weakness in sales and orders. After seeking the advice of in-house counsel, Director of IR called analysts individually and explained that "significant" means 25% or more. SEC concluded that in-house counsel was incorrect in advising that this clarification was not material nonpublic information. Nevertheless determined not to take enforcement action on ground that advice of counsel was sought and given in good faith.

Early SEC Enforcement Actions

- ***Schering-Plough***
  - CEO and Director of IR had one-on-one Q&A sessions with four institutional investors. SEC contended that during these meetings, CEO, “through a combination of spoken language, tone, emphasis and demeanor . . . disclosed negative and material, nonpublic information” regarding the company. Immediately after the meetings, analysts downgraded stock and trading volume increased significantly.
  - SEC imposed $1 million fine on Schering-Plough and $50,000 fine on CEO.

Early SEC Enforcement Actions

- ***Siebel Systems II***
  - During earnings call, CEO expressed pessimism and refused to answer questions about deals in pipeline.
  - At private meetings with analysts and investors three weeks later, CFO, with Director of IR present, made statements that "materially contrast with the negative public statements" previously made by CEO. CFO answered questions that CEO ducked regarding transactions in pipeline.
  - Stock price and volume spiked on day after disclosures.
  - GC asked CFO and Director of IR what was said at meeting. They each indicated that no material nonpublic information was disclosed.
  - SEC brought complaint against Siebel itself and against the CFO and Director of IR individually.

Siebel Systems II (Cont'd)

- Complaint notes that the Director of IR had been appointed after Siebel I and charged with doing everything possible to comply with Reg FD.
  - In his own job description, Director of IR identified one job priority was to "fully comply with Regulation FD." This was given a 10% weighting, which the SEC suggested showed it was a low priority.
- Complaint notes that company did little to improve its compliance with Reg FD following Siebel I.
  - No formal training was given. No policy was promulgated or additional safeguards implemented.
- Siebel elected to fight SEC rather than settle complaint.
- In August 2005, district court threw out complaint, stating that Reg FD does not require management to become "linguistic experts" who "only utter verbatim statements that were previously publicly made."
- No violation of Reg FD because the private statements did not constitute material nonpublic information.

Early SEC Enforcement Actions

- ***Senetek***
  - Two firms engaged by Senetek PLC prepared and submitted for review draft research reports containing financial projections about the company for the 2002 fiscal year.
  - Senetek's CEO and CFO provided the firms with revisions to their financial projections based on material nonpublic information, but did not disclose that information to the public.
  - The nonpublic data provided by the CEO and CFO caused the firms to lower the revenues and earnings projections contained in their final reports from those included in the draft reports.
  - SEC brought administrative action against Senetek resulting in Senetek consenting to a cease-and-desist order.

Early SEC Enforcement Actions

- ***Flowserve***
  - On two occasions during 2002, Flowserve publicly lowered its earnings guidance. On October 22, 2002, it reaffirmed its lowered guidance in a press release.
  - On November 19, the CEO reaffirmed the lowered guidance in a non-webcast meeting with analysts.
  - On November 20, an analyst who attended the meeting issued a report stating that Flowserve had reaffirmed.
  - On November 21, Flowserve's stock price was up 6% and volume was up 75%.
  - On November 21, after the close of trading, Flowserve issued a Form 8-K regarding the reaffirmation.
  - SEC charges company, CEO and Director of IR.
  - Charges are settled, company pays $350,000 fine, CEO pays $50,000 fine.

More Recent SEC Enforcement Actions

- ***Electronic Data Systems***
  - EDS entered into “capped collar contracts” which required cash payments by EDS if EDS’ stock price fell below a certain threshold. In 2002, following a disappointing earnings announcement, EDS stock fell far enough to trigger the settlement requirement.
  - Prior to public disclosure, EDS personnel informed analysts of settlement obligation and that it intended to settle its $225 million obligation under the contracts by issuing commercial paper. Public disclosure was made 5 days after first analyst was notified.
  - In 2007, SEC took enforcement action, despite no direct earnings impact of the settlement; SEC concluded that payment was material to EDS.
  - However, EDS admitted to various other violations of the securities laws:
    - Derivative contracts at issue had not been properly disclosed in EDS’ 10-Ks and 10-Qs
    - FCPA violation

More Recent SEC Enforcement Actions

- ***SEC v. Christopher A. Black***
  - Black was CFO of American Commercial Lines and served as ACL's designated investor relations contact.
  - On Monday, June 11, 2007, ACL revised its previously-issued 2007 earnings guidance. In the release, ACL stated that the company expected "2007 second quarter results to look <u>similar to the first quarter</u>." (Emphasis added). First quarter EPS were $0.20.
  - During that week, Black and ACL's CEO met with analysts covering ACL's stock.
  - Following the meetings, ACL's CEO requested that Black send a "recap" email to the analysts (not all of whom had been present for all meetings) summarizing the information discussed in the analyst meetings.
  - ACL's CEO instructed Black to send the email by close of business on Friday, June 15, 2007. CEO also instructed Black to provide a draft of the email to outside counsel prior to sending it.
  - Black was unable to finalize the email to analysts before close of business on Friday, June 15, 2007. Before leaving work, Black forwarded the email to his personal email account so that he might work on it over the weekend.
  - Sometime before leaving work on June 15th, however, Black received an updated internal analysis indicating that ACL's EPS for the second quarter could be as low as $0.13 (much lower than the first quarter's actual results).

SEC v. Black (Cont'd)

- On Saturday, June 16, 2007, Black sent an email from his personal email account to eight sell-side analysts who covered ACL.
  - Email provided additional detail regarding the previously-disclosed weakness in shipping volumes.
  - In addition, stated that the company expected that "EPS for the second quarter will likely be in the neighborhood of about a <u>dime below that of the first quarter based on this pressure</u>." (Emphasis added).
- Black never provided his email to anyone else at ACL, or to outside counsel, before transmission.
- Upon learning of Black's email, ACL notified the SEC. Within two months after the incident, Black announced plans to leave ACL.
- In September 2009, the SEC filed an enforcement proceeding against Black, but not against ACL. In determining not to bring charges against ACL, the SEC noted:
  - "Culture of compliance" created at ACL as a result of Reg FD training
  - Black's sole responsibility for the violation; Black acted outside of the controls established by ACL to prevent such disclosures
  - Prompt filing of a Form 8-K
  - ACL's "extraordinary cooperation" with the SEC's investigation
- Black consented to a settlement and agreed to pay a fine of $25,000.

Recent SEC Enforcement Actions

- ***SEC v. Presstek***
  - Edward Marino was Presstek's CEO, and 1 of 3 persons authorized to speak to investors, analysts and other securities industry professionals.
  - Presstek maintained an internal policy of "corporate silence" beginning on the 15th day of the last month of any given quarter.
  - In September 2006, Marino was informed that Presstek's forecast for the quarter would be lower than expected and that a preliminary announcement would be made in early October 2006 to report such performance.
  - On the morning of September 28, 2006, Marino spoke with the managing partner of a registered investment advisor regarding Presstek's lower-than-expected financial performance for the third quarter.

SEC v. Presstek (Cont'd)

- Specifically, Marino stated that "[s]ummer [was] not as vibrant as [they] expected in North America and Europe" and that although "Europe [had] gotten better since [the summer]" it was "overall a mixed picture [for Presstek's performance that quarter]."
- Promptly after the telephone conversation, the registered investment advisor sold substantially all of its Presstek holdings. Presstek's stock price dropped approximately 19%.
- At or about 12:01 a.m. on September 29, 2006, Presstek issued its preliminary announcement for the third quarter 2006, stating that its performance was below its earlier publicly disclosed estimates. That day, Presstek's opening stock price was 20% lower than the prior day's closing price, and its closing price was 10% lower than the prior day's closing price.
- Presstek settled the SEC's charges for $400,000.
- Marino settled the SEC's charges that he aided and abetted Presstek's violations by agreeing to pay a $50,000 civil penalty.

SEC v. Presstek (Cont'd)

- Though the facts look similar to those in Black, SEC instituted enforcement action against Presstek but not American Commercial Lines.
  - Both executives behaved similarly and each alone were responsible for violating the policy.
  - The companies both had disclosure policies in place to prevent improper disclosures by company officials.
  - Each company promptly disclosed the information to the public upon learning of the selective disclosure and took significant remedial actions to prevent future violations.

- However, SEC noted that ACL had:
  - "cultivated an environment of compliance" by
    - training its employees regarding the requirements of Reg FD
    - adopting policies that implemented controls to prevent violations
  - self-reported the violation to the SEC staff the day after it was discovered and
  - subsequently provided "extraordinary cooperation" with the SEC's investigation.

- Significantly, the SEC did not make any similar comments with respect to Presstek.

Recent SEC Enforcement Actions

- ***SEC v. Office Depot***
  - In October 2010, SEC charged Office Depot and two of its executives with violations of Reg FD for making statements to analysts that included implicit warnings about declining earnings.
  - SEC alleged that the company executives made telephone calls to analysts in an attempt to encourage them to lower previous estimates, which company executives deemed no longer feasible.
  - In February and April 2007, Office Depot held two public conference calls in which CEO and CFO (i) described a business model which contemplated mid- to upper-teens EPS growth over the long-term and (ii) warned that its largest business segments were facing a softening in demand. In early May, in another publicly available investor conference, Office Depot made similar disclosures.
  - In late May, CEO alerted Board of Directors that Office Depot would not meet the analysts' consensus EPS estimate for the second quarter and that senior management was discussing a strategy for advance communication to avoid a complete surprise to the market.
  - In mid June, CEO and CFO jointly decided that instead of telling analysts that Office Depot would not meet expectations, the company would talk individually with each of its eighteen analysts "just to touch base" and to point them towards earnings releases of comparable companies noting slowed growth, noting that such releases were "interesting" and repeating warnings of a softening economy.

SEC v. Office Depot (Cont'd)

- The Director of IR made these calls initially on Friday, June 22. Over the weekend he reported back to the CEO and CFO and they both encouraged the calls to continue on Monday, June 25.
- Also on Monday, the CEO obtained an update on analyst estimates, which were still a bit too high. In response, the CFO asked the Director of IR to call the top 20 institutional investors and relay same talking points, which was done on Tuesday.
- More than one analyst expressed concern that the company had not released the information to the public, and the executives noted that the analysts were lowering their estimates in response to the calls; nevertheless, the executives continued to encourage the calls.
- Office Depot filed Form 8-K on Thursday, six days after the calls initially began. From Friday to Thursday, the stock price dropped 7.7%.

SEC v. Office Depot (Cont'd)

- Office Depot and the executives settled the charges. The company agreed to pay a $1 million penalty and each of the executives agreed to pay a $50,000 penalty and sign a cease-and-desist order.

Recent SEC Enforcement Actions

- ***Fifth Third Bancorp***
  - In May 2011, Fifth Third selectively disclosed to certain investors its intention to redeem a class of its trust preferred securities (TruPS) for approximately $25 per share. The securities were then trading at approximately $26.50 per share.
  - Fifth Third did not issue a Form 8-K or other public notice of the redemption until it became aware that investors with knowledge of the redemption were selling the securities to purchasers who were unaware of the redemption.
  - In settling the charges with the SEC, Fifth Third agreed to compensate harmed investors, adopt various additional policies and procedures relating to the redemption of securities and sign a cease-and-desist order. No civil penalty was imposed upon Fifth Third based on its cooperation with the investigation.

Recent SEC Enforcement Actions

- ***SEC v. Polizzotto***
  - After learning that the U.S. Department of Energy would not award First Solar, Inc. one of the loan guarantees that it had sought from the DOE, Polizzotto, the head of investor relations of First Solar, communicated privately with more than 30 analysts and investors to notify them that there was a "low probability" that First Solar would receive that guarantee but there was a "high probability" it would receive others.
  - Less than 10 days before that, First Solar's CEO had expressed confidence at an investor conference that First Solar would receive the lost guarantee.
  - In-house counsel had specifically advised Polizzotto (and others at First Solar) by email that news of the failure to obtain the loan guarantee could not be selectively disclosed, including in response to questions from analysts and investors.
  - Polizzotto had sent internal emails noting that the news was "material" and could create a "huge concern."

SEC v. Polizzotto (Cont'd)

- At the time of Polizzotto's disclosures, First Solar had not received a formal notice from the DOE, but knew of its decision. At the time of Polizzotto's statements, analyst reports regarding Congressional oversight of the loan guarantee program had resulted in concern within the solar industry regarding the DOE's ability to move ahead with the guarantee.
- These concerns had resulted in numerous inbound calls to First Solar's IR department and an 8% drop in First Solar's stock price.
- The SEC did not charge First Solar, citing its "extraordinary cooperation" with the SEC's investigation, as well as its cultivation of an "environment of compliance through the use of a disclosure committee that focused on compliance with Regulation FD". The SEC also noted that First Solar had immediately discovered Polizzotto's misconduct and had issued a press release regarding the matter early on the next day following the disclosures and quickly self-reported the matter to the SEC.
- The SEC settled with Polizzotto for a $50,000 fine and a cease-and-desist order.

LATHAM&WATKINS

Number 1419 October 18, 2012

Client Alert

Latham & Watkins Corporate Department

Giving Good Guidance: What Every Public Company Should Know

Every public company must decide whether and to what extent to give the market guidance about future operating results. Questions from the buy side will begin at the IPO road show and will likely continue on every quarterly earnings call and at investor meetings and conferences between earnings calls. The decision whether to give guidance and how much guidance to give is an intensely individual one. There is no one-size-fits-all approach in this area. The only universal truths are (1) a public company should have a policy on guidance and (2) the policy should be the subject of careful thought.

The purpose of this *Client Alert* is to provide an updated discussion of the issues that CEOs, CFOs and audit committee members should consider before formulating a guidance policy.[1] In Annex A, we answer some frequently asked questions about guidance and offer some practical guidelines to consider when drafting a guidance policy.

"It is possible to give guidance in a deliberate and careful way without incurring undue liability, and it is also possible to make critical mistakes that can have significant economic consequences under the federal securities laws and in the financial markets."

A Review of the Basics

Public companies are not required by stock exchange rules or the SEC's rules to provide investors with projections of future operating results.[2] However, investors and analysts can be demanding, and many public companies elect to provide the market with guidance about their expectations for the future. The decision to give guidance can spring from a desire to share good news with investors in order to help the market get to a higher valuation for the company's stock or it can spring from a desire to correct analysts' overly optimistic earnings expectations. Whatever the motivation, the legal landscape should be carefully understood before management takes the plunge. It is possible to give guidance in a deliberate and careful way without incurring undue liability. It is also possible to make critical mistakes that can have significant economic consequences under the federal securities laws and in the financial markets.

Primary Liability Provisions

There are a number of provisions in the federal securities laws that can create liability for forward-looking statements. In the context of a public offering, Section 11 and Section 12 of the Securities Act of 1933 impose liability on issuers, their officers and directors, and underwriters for misstatements of material fact or omissions of material facts necessary to make included statements not misleading. Rule 10b-5 under the Securities Exchange Act of 1934 imposes liability in a broadly similar manner, although the burden of proof on a plaintiff bringing a Rule 10b-5 claim is higher.[3] Rule 10b-5 applies to statements made in the context of securities offerings as well as in periodic reports and day-to-day communications with analysts and investors. Because of the potential for liability, it is prudent for those giving guidance to speak carefully, completely and deliberately.

Safe Harbors

The Private Securities Litigation Reform Act of 1995 (PSLRA) enacted safe harbor provisions in both the Securities Act and the Exchange Act for forward-looking statements[4] that are (1) identified as such and (2) accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."[5] These safe harbors also provide protection where a plaintiff fails to prove that a statement was made with actual knowledge that the statement was false or misleading if made by a natural person, or was made by or with the approval of an executive officer if made by a company.[6] The PSLRA safe harbor provisions do not apply in the context of an IPO or to enforcement proceedings brought by the SEC.

Forward-Looking Statements

The federal courts have held that forward-looking statements that are accompanied by appropriate cautionary language do not give rise to a claim for liability under the federal securities laws because the predictive statement read in context with the risk disclosure is not misleading as a matter of law. However, despite the broad protections of the PSLRA's safe harbor, boilerplate cautionary language may not be sufficient. Some courts have declined to allow the protections of the safe harbor where risk disclosures did not change over time or did not identify the risks that ultimately caused the prediction not to come to pass. Specific, robust and dynamic cautionary language is often the best defense to a review of forward-looking statements that may (especially with the benefit of hindsight) ultimately prove to be inaccurate.[7] As a result, public companies should routinely evaluate and tailor cautionary language for each significant forward-looking statement. Any areas of heightened risk or known uncertainties warrant fact-specific disclosures that are customized to the particular risks underlying each forward-looking statement. Well-crafted disclosure can serve as a shield against future challenges if good-faith predictions of future results do not materialize.

Whether to Update

Although the PSLRA explicitly states that it does not "impose upon any person a duty to update a forward-looking statement,"[8] some courts have suggested that a duty to update may apply if events transpire that cause a company's prior disclosure to become materially inaccurate, even though that prior disclosure was accurate when made.[9] There is no requirement that a public company immediately make public all material facts that come into its possession on a real-time basis,[10] but where a public company's affirmative and definitive prior statement becomes clearly and materially false, it should consider issuing a clarifying, correcting or updating statement.

What does all this mean for public companies? Among other things, it means a company can answer the question "Are you in merger negotiations with XYZ, Inc.?" with a "no comment" and not be obligated to later update that statement if it enters into merger negotiations.[11] However, if the answer to the first question was "This company will never enter into merger negotiations with XYZ, Inc.," then the company may want to consider an updating disclosure if merger negotiations begin in earnest. In other words, once the decision to speak on a particular topic — expected earnings for the year, for example — is made, it may be problematic to stop talking about it in the future as the facts change.

Considering whether to update earnings guidance is particularly complicated and depends very much on the facts and circumstances at hand. The analysis should always begin with a review of what was said in the first place. As an example, let's consider a company that issues guidance only once per year, in the first quarter, projecting earnings for the full year then in progress. In order to answer the question whether our hypothetical company needs to update its guidance every quarter as more facts become available and its expectations about the likely outcome for the full year move around, we must first ask what was said when the guidance was originally issued. Did the company specifically say that it would not be updating the full-year guidance every quarter? Did the company say it would only update guidance if a material corporate transaction occurs?

The next series of questions to consider focuses on the facts that have transpired since the original guidance was issued. Is it obvious that the original guidance no longer holds because of well-understood changes in industry trends or market conditions or an intervening acquisition or disposition? Did the original guidance include a clear explanation of the assumptions on which it was based? Is it clear that those assumptions have not come to pass? Has the Wall Street analyst community revised its estimate of full-year earnings down to a level that the company believes it can deliver?

Still other questions focus on the unique facts of the company's circumstances. Is the company in a line of business where it is difficult to know how the year will turn out until the last bottle of New Year's champagne has been poured? Will the company realistically be able to avoid questions from analysts about the continuing validity of its earlier guidance? All of these considerations will come into play in analyzing the legal landscape and deciding whether to confirm or update prior guidance. Also very relevant to the decision is the investor relations department's desire to avoid unpleasant surprises among the company's constituents. An important further complication, which we will discuss below, is whether the company is selling or purchasing its own securities.

Regulation FD

Regulation FD's prohibition on selective disclosure of material nonpublic information must also be taken into account in any discussion of whether to give or update guidance.

Regulation FD and subsequent SEC enforcement actions have effectively eliminated the historical practice of privately "walking" analysts' earnings estimates up or down to avoid unpleasant surprises at quarter-end or year-end. Guiding analysts about future earnings is still permissible under Regulation FD, so long as the analysts and the general public learn all material information at the same time.

Updating or confirming prior guidance is treated the same way under Regulation FD — it's all fine as long as the public gets the same material information at the same time that the analysts do. Therefore, the question "Are you still comfortable with your guidance for this year?" is right in the center of Regulation FD's bull's eye. When answering that question, Regulation FD considerations need to be taken into account. An officer who provides direct or indirect guidance to an analyst regarding earnings forecasts "takes on a high degree of risk under Regulation FD."[12]

Two Basic Questions

Many companies will sort through the overlapping webs of safe harbors, case law and liability provisions and conclude that guidance is simply not worth the headaches. Other companies will conclude that the benefits of managing market expectations outweigh these headaches and will take the guidance plunge. The remainder of this *Client Alert* is aimed at providing some practical suggestions on how to survive as a giver of guidance.

How Far to Go

The most basic decision is whether to give guidance on a quarter-by-quarter basis or on a year-by-year basis. The next question is how far forward to project results. There is no one-size-fits-all answer here. Some businesses are stable and predictable. For them, predicting earnings on a quarter-by-quarter basis may be an option. Many energy companies, for example, have presold the majority of their output multiple years into the future. A company with a predictable earnings stream is in a very different position than a company with unpredictable operating results.

Businesses with lumpy revenue streams or that experience seasonality or weather issues may not feel they can make quarterly projections prudently. A September 2012 survey performed by the National Investor Relations Institute (NIRI) found that guidance-giving companies most often communicate annual estimates only. The most common frequency for communicating those estimates is on a quarterly basis.[13] Even the most stable businesses typically elect not to provide earnings guidance beyond the year in progress, although some businesses will provide long-term estimates or goals for longer periods.

What to Say

Directly related to the decision of how far forward to look when guiding investors is the decision of what to say about the periods in question. Guidance takes many forms, not just earnings per share for the year. Some companies will guide investor expectations by giving a range of anticipated earnings per share or simply by saying that they are "comfortable with the Wall Street analysts' consensus" regarding earnings per share for the year. However, explicitly blessing a specific analyst's estimate can be viewed under the case law as "adopting" it, which has the same liability considerations as issuing guidance directly. This casual approach to guidance usually does not offer an opportunity to include appropriate cautionary disclosure and should generally be avoided.

Many companies prefer to provide the market with forecasts of an Adjusted Net Income or Adjusted EBITDA metric that excludes the impact of expected (or unexpected) non-recurring, non-cash and/or unusual items. Adjusted measures of operating performance are easier to predict accurately since they are unaffected by many of the income statement items that impact earnings per share. Of course, public release of these non-GAAP financial measures will need to comply with Regulation G.[14]

Other companies stop their numerical guidance at the revenue line, projecting only a targeted revenue growth in percentage terms. Revenue-only guidance may be supplemented with a comment about profit margins — "We expect to see an improvement in profit margins as we do not expect anticipated revenue increases to be accompanied by a corresponding increase in our fixed costs" — or not. Still another form of guidance involves non-financial measures — "We expect to open 25 new company-owned stores this year" or "We currently expect to complete construction of the facility in the fourth quarter of 2012."[15] There is no limit to the forms that guidance can take. What is appropriate for one company in one industry may be totally inappropriate for another company, even one in the same industry.

Guidance Guidelines

Scope

Each company's decision of what to say and how far to go needs to be made in light of the nature of its industry and the circumstances of its business. Careful thought should be given to the tradeoff that going further down the income statement presents — more precise information will please analysts in the short run but it can create sharper liability issues in the long run. Much more agility is needed to predict earnings per share successfully than to predict revenue, Adjusted Net Income, Adjusted EBITDA or another "normalized" measure of performance that is less likely to be affected by surprises on the business front or in the accounting literature. We recommend that companies only give guidance on a metric that they feel comfortable they can accurately predict.

Cautionary Statements

All good guidance should be accompanied by dynamic, carefully tailored cautionary statements. These disclaimers should temper the predictions of a rosy future with a balanced discussion of what could go wrong. Risk factor disclosure should also be appropriately updated with each publication — don't just use the same old boilerplate from prior years. It is also helpful if some of the material assumptions on which the guidance is based are disclosed and if the company's risk factors tie to the achievement of those assumptions. A 10 percent increase in earnings that is premised on cutting redundant overhead costs is not the same as a 10 percent increase that is premised on a substantial increase in market share. The point of cautionary language is to explain what goes into the sausage so investors can make their own intelligent decisions about the likelihood of the projected outcome actually being realized. Good cautionary disclosure can be an effective insurance policy against future liability if the guidance turns out to be incorrect.

The Delivery

It is best if guidance and the related cautionary disclosures are given in a controlled environment. The most popular forums are the year-end or quarter-end press release and the related quarterly earnings calls. The press release and the script for an earnings call are usually the subject of a greater degree of oversight than any casual encounter, and earnings calls are always Regulation FD-driven events since the public is invited to listen in and a recording is typically available on the company's website for a period of time after the call. Many companies prefer to give guidance orally on their earnings calls and do not produce a written version of their statements for the related earnings press release. For a CFO who is comfortable sticking tightly to a prepared script, this is a perfectly acceptable choice. For others, putting it down in writing in the earnings release may be a wise precaution. Regardless of the method of delivery of guidance, every company should carefully evaluate its internal processes for preparing and providing guidance.

The earnings release or call should include carefully tailored disclaimer language and the actual guidance statements should be carefully vetted and scripted. Oral forward-looking statements should be accompanied by an oral statement that cautionary disclosures are contained in a readily available written document. Similarly, statements regarding non-GAAP financial measures should identify where the required reconciliations can be found.

Anticipating Questions

There are at least three good reasons to anticipate the questions about guidance that analysts are likely to ask on an earnings call. First, there are some questions the company will want to answer. If the answer has not been scripted, it may not come out with all of the nuance that is appropriate. Second, there are some questions the company will not want to answer. It helps to have worked out in advance which questions the company is prepared to answer and which questions merit only a "no comment" response. Finally, Regulation FD frowns on answering follow-up questions in private calls or meetings where the public does not have access, so what is said on the earnings call will set the boundaries of what can be discussed in private meetings between earnings calls. Answering questions that were asked on the earnings call or providing additional detail on topics that have been covered at an appropriate level of materiality on the earnings call will generally be acceptable in follow up one-on-one investor meetings. Venturing into territories that were not covered on the earnings call in subsequent private meetings can raise selective disclosure issues under Regulation FD.

Updating or Confirming Prior Guidance

When management begins to doubt whether the company's actual results will be in line with prior guidance, the decision whether to make a public statement to that effect is entirely dependent on context — all facts and circumstances must be considered. As always, the analysis should start with a review of what was said in the first place. Did the company say that it would confirm annual guidance every quarter? Did the company say that it would not? Is it obvious from the facts that the prior guidance is no longer reliable (due to an important acquisition, disposition or industry development)?

If a company expects to exceed its prior guidance by a modest amount, it is probably safe to keep that information confidential and pleasantly surprise the investment community. On the other hand, if a company is reasonably sure that it will miss the mark by a material amount, intervening events or market pressures may force an out-of-sequence guidance update. Context is everything. For a company repurchasing its own shares or one involved in a going-private transaction, the fact that current guidance is materially low may be problematic. In the context of a securities offering, the opposite is true — materially high guidance is the concern. Managing expectations to maintain credibility, provide transparency and avoid unpleasant surprises is always the goal.

Below is a list of key considerations to keep in mind when giving guidance:

10 Rules for Giving Good Guidance

1. Designate a limited number of company personnel to communicate with analysts and investors about future plans and prospects.
2. Adopt an appropriate guidance policy early and follow it.
3. Do not rely on boilerplate. Explain the assumptions underlying each forward-looking statement and disclose the risks that may cause anticipated results not to be realized — the cautionary statements should be tailored to fit the guidance.
4. Have prepared remarks reviewed by counsel and stick to the script.
5. Remember Regulation FD: Disclose guidance and other material information only in an FD-compliant manner.
6. Do not be afraid to say "no comment" in response to questions or to deflect uncomfortable questions by restating the company's guidance policy.
7. Do not comment on or redistribute analysts' reports, and only review advance copies of analysts' reports for factual errors.
8. Remember Regulation G: Include appropriate disclosure for non-GAAP financial measures where required.
9. Continually evaluate whether changed circumstances argue in favor of an update of prior disclosures.
10. Be particularly sensitive to Rules 1 through 9 in the context of an intervening event between quarterly earnings releases and calls such as an offering of securities, share repurchase program or acquisition, or when insiders are buying or selling company securities.

Special Considerations

Securities Offerings

The pendency of a securities offering creates special issues for guidance-giving companies. It is rare to find written guidance in a prospectus or offering memorandum and most earnings releases are furnished on Form 8-K rather than filed and hence are not incorporated by reference into the offering document. This means that guidance is rarely part of the landscape for purposes of Section 11 of the Securities Act.[16] However, there remains an important question of whether the prior guidance can be considered part of the offering for Section 12 and Rule 10b-5 purposes. The answer depends on the facts and circumstances. Where the prior guidance was given only orally at an earnings call many months previously, and if no reference is made to the prior guidance in the selling process, it may be possible to argue successfully that it is not part of the liability file for Section 12 purposes.[17] That fact pattern could occur, for example, in a block trade context where there is no road show. However, where actual results are expected to be materially lower than the prior guidance, most companies elect to stay out of the market until they can properly adjust investor expectations by amending or updating their prior guidance.[18] Even when it is possible to conclude that there is no legal duty to do so, investor relations considerations usually prevail. It is easy to see how a new investor who purchased securities at a time when the prior guidance indicated earnings per share for the year in the range of $1.05 to $1.10 might feel wronged if shortly after his or her purchase the company reports earnings per share of $0.90. In the context of a securities offering, managing expectations becomes even more important. Investors who get what they expected generally don't sue issuers. Disappointed investors sometimes do.

In the event of an out-of-sequence guidance update prior to a securities offering, special consideration should be given as to whether the update constitutes an "offer" under the Securities Act.[19] The SEC has adopted a number of safe harbors to protect various activities that are either harmless or necessary to the proper functioning of the capital markets.

Rule 168 is a non-exclusive safe harbor from Section 5(c)'s prohibition on pre-filing offers (and from Section 2(a)(10)'s definition of prospectus) that is available only to reporting issuers with a history of making similar public disclosures. It allows a reporting issuer and certain widely traded non-reporting foreign private issuers to make continued regular release or dissemination of "factual business information" and "forward-looking information,"[20] but not information about an offering or information released as part of offering activities. Rule 168 is not available to underwriters.

Disclosure of Rule 168 information is permitted at any time, including before and after the filing of a registration statement, but only if:

- the issuer has previously released or disseminated Rule 168 information in the ordinary course of its business and
- the timing, manner and form in which the information is released is materially consistent with similar past disclosures.

For the information to be considered previously released in the ordinary course of business, the method of releasing or disseminating the information, and not just the content, is required to be materially consistent with prior practice.[21] The SEC has acknowledged that one prior release could establish a sufficient track record,[22] although it has also cautioned that an issuer's release of "new types of financial information or projections just before or during a registered offering will likely prevent a conclusion" that the issuer regularly releases that information.[23]

What should public companies do in light of the Rule 168 safe harbor? Because Rule 168 looks to track record, public companies should establish a pattern of issuing information and then stick to it. Concluding that the safe harbor for any particular situation is available is going to be easier if there is a prior record of releasing the same general information on reasonably similar timing.

Share Repurchase Programs

Like pending offerings or strategic transactions, share repurchases require careful attention to guidance practices since the potential for liability under Rule 10b-5 exists equally in all of these contexts.[24] However, there are some important differences. Few purchasers in an offering will be disappointed if the company's guidance turns out to have been unduly conservative and earnings come in higher than projected. Shareholders who sold stock back to the company following gloomy projections, on the other hand, may feel aggrieved if subsequent actual earnings are strong. In other words, overly conservative guidance given during, or before commencing, a share repurchase program can be just as problematic as overly rosy guidance in the context of a securities offering.

The key to avoiding liability is careful forethought to the timing of the guidance and the share repurchases. For example, consider limiting share repurchases to time periods that closely follow guidance announcements. The more closely in time the repurchases follow the guidance, the less likely that intervening events have undermined the guidance. Companies with particularly active share repurchase programs may want to consider adopting and closely monitoring blackout trading windows and utilizing Rule 10b5-1 plans executed during open trading windows.

Insider Sales

A decision not to update guidance may restrict the ability of executives and other insiders to sell shares of their company's stock. If the company learns facts causing management to conclude that prior guidance may no longer be accurate, both the underlying facts and management's conclusion could later be found to be material information. If insiders sell shares before the stale guidance is updated, regulators and plaintiffs could take the position that those transactions constituted improper insider trading. Accordingly, if events undermine the accuracy of earlier public guidance, it may be wise to suspend executive purchases and sales of stock in order to avoid allegations of insider trading.

Mergers and Acquisitions

Companies often provide guidance about the effects of significant corporate transactions — "We expect this transaction to be accretive to our earnings next year." These statements are subject to all of the concerns in this *Client Alert* generally, including the risk of liability under Rule 10b-5 and, if there is a registration statement to be filed in connection with the transaction, Sections 11 and 12. These statements also need to be considered in the context of the incremental statutory liability imposed by the proxy and tender offer rules. Regulation M-A may require documents containing these statements to be filed with the SEC. In business-combination transactions, companies must also closely monitor public statements of their financial advisors, information agents and proxy solicitors that might be attributed to the company for purposes of compliance with Regulation FD and the other issues discussed in this *Client Alert*. Statements made in the context of merger or acquisition transactions may influence voting decisions, tender decisions and purchase and sale decisions by both the company's and the target's shareholders, which increases the number of potential claimants. The many additional variables (such as the combined results of the two companies and synergies) to be taken into account when giving guidance in these circumstances make giving guidance in the context of mergers and acquisitions particularly complex.

Conclusions

Be Deliberate

The decision whether and to what extent to give guidance should be made in a deliberate manner and should be the subject of careful internal control, including discussion with counsel. Each company's situation is unique — there is no one-size-fits-all solution to earnings guidance because each decision is fact-intensive. Plan ahead about how and when guidance will be given and script the statements carefully. Make sure to explain the critical assumptions underlying projected results so investors can evaluate those projections fairly.

Get a Policy and Stick to It

Consistency can be very helpful, both from an investor relations perspective and from a liability perspective. Having a policy and following it can go a long way.[25] Companies should tell investors when guidance will be given so investors know what to expect. For example, a company should tell investors that its policy is to give guidance once a year in March concurrently with the year-end earnings release, covering expectations for the year in process. The company should then not update its guidance during the course of the year except in extraordinary circumstances, such as a securities offering or a material acquisition or disposition. This way, in between planned updates, the company can deflect investor questions by explaining that it is the company's policy not to comment on prior guidance out of cycle.

Be Vigilant With Respect to Updates

A company should not simply follow its guidance policy blindly. Particularly in the context of securities offerings, sales by insiders or share repurchase programs, companies need to be alert to market expectations. Circumstances that might cause a company to want to update guidance can occur very quickly and at inopportune times, and companies need to be able to act quickly in this era of instant information flow. All of the key players should coordinate and communicate when the need arises so that informed judgments can be made as to what to say to the market and when.

Involve Counsel

Viewed with hindsight, overly optimistic guidance can result in financial cost to the company and its directors and officers. Legal counsel should be part of the quality control and risk/reward evaluation process. It is not always true that the investor relations department wants more information projected and lawyers want less. In practice, giving good guidance can only be done by balancing the benefits to the company and the associated risks, and counsel can assist in this balancing act.

Annex A

Frequently Asked Questions

Set forth below are some frequently asked questions about how and when to give and update guidance.

Q: A company normally issues annual guidance in its year-end earnings release and updates that guidance during subsequent quarterly earnings releases. The company no longer expects to meet its previously published guidance. Should the company revise its guidance downward ahead of the next regularly scheduled quarterly earnings release?

A: It depends. The company should review what was said in the previously published guidance. Did the company say it would update its guidance between scheduled earnings releases? Did it say that it would not? Was it silent on the matter? Many companies have a general no-update policy, but companies sometimes do not make that clear in each earnings release. Updating previously published guidance between scheduled earnings releases is not common practice and the company should consider all facts and circumstances before updating guidance ahead of the next regularly scheduled earnings release. If a major corporate event has occurred, such as a material acquisition or disposition, it may be obvious that the previously published guidance is no longer operative, which may lessen the pressure for an early update.

Q: What about a similar scenario, where the company is near the end of its quarter and the midpoint of its current estimates for the year in progress is not in line with previously published guidance. Should the company revise or adjust guidance downward prior to the next earnings release?

A: The starting point of the analysis is always the same. What was said in the first instance and what does the market expect? Will the market be surprised if the company's results do not square with previously published guidance? Does the midpoint of the estimates show that the company is going to miss the bottom end of the previously announced range by a material amount? Revising or adjusting guidance downward may be an option if there is a compelling reason to provide an out-of-sequence update and the company is reasonably sure that its results will not be in line with guidance. In most cases, however, the update can wait until the next regularly scheduled earnings release. In other words, if the company's guidance policy is to give updates quarterly, then the company should follow its policy absent compelling circumstances.

Q: The company plans to attend an annual industry conference that takes place between earnings releases. Can the company pre-release a guidance update prior to the conference?

A: Yes, if there is a good reason to do so, after considering all facts and circumstances. Departing from a regular policy of giving guidance only on designated earnings releases should not be undertaken lightly, but may be necessary on occasion. For example, if there is a compelling need to update customers on expected future results — a situation that sometimes arises in the troubled-company context — then have at it. Absent a compelling reason to depart from established policy, follow the policy. As always, any updates need to occur in a manner that complies with Regulation FD.

Q: The company is near the end of its quarter and some of the analysts' estimates are higher than the results the company expects to report for the quarter and even higher than the company's previously announced guidance. Can the company meet privately with the analysts to talk them down?

A: No. This is an easy one. Regulation FD requires that when issuers disclose material information, they must make broad public disclosure of that information. Talking down an industry analyst is providing material nonpublic information to that analyst and is not allowed in any manner that does not comply with Regulation FD. Some issuers handle the rogue analyst situation by issuing a press release (or making statements on an earnings call) emphasizing the factors that the company believes will make it difficult to achieve the overly optimistic results predicted by the outlying analysts. Most companies decline to get drawn into specific public disavowals of rogue analysts' estimates.

Q: The company issued annual guidance in its year-end earnings release in March. It's now June and the company is about to launch a public offering of its common stock. The company still expects to meet (or slightly exceed) its published guidance. Can the company put a slide in the road show deck that reiterates its annual guidance?

A: This is tricky. The presence of the slide may imply that the company is confirming its annual guidance, which is effectively the same as publishing new guidance. That raises the question of whether the confirmation is itself material nonpublic information. Depending on the circumstances, there may be an argument that a reaffirmation of prior guidance is not material, but if any significant amount of time has passed between the original public guidance and the private reaffirmation, the private statement is likely to be considered material nonpublic information. If a guidance update or confirmation is material, then a public press release would be appropriate under Regulation FD.

However, an out-of-sequence guidance release, particularly where guidance is being increased, raises other issues in the context of an offering. An SEC Staff Compliance and Disclosure Interpretation (C&DI) of Regulation FD suggests that a company's reference to prior guidance will not necessarily be deemed to convey material nonpublic information as long as the company makes clear that (a) the prior guidance was issued as of the earlier date and (b) the company is not currently reaffirming the earlier guidance.[26] That C&DI could be read to support the position that a road show slide citing the earlier earnings guidance (and giving the date it was issued) is not problematic from a Regulation FD perspective. Such a slide may be an option for management teams that are able to stick tightly to the road show script and can avoid commenting on the slide in a way that would implicitly confirm the prior guidance as of the date of the road show. However, many companies elect not to venture into this tricky territory and do not comment on guidance during their road shows, except perhaps to say "We publish our annual guidance in March and it is our policy not to update guidance between earnings releases." Those companies rely on the market's understanding that it would not be appropriate to sell securities without updating outstanding guidance if the issuer felt that the prior guidance had become too high.

Q: What if the company wants to confirm or increase its guidance immediately prior to launching an offering?

A: This is another difficult scenario. The first question is whether the increased guidance is an offer under the Securities Act. Rule 168's safe harbor for regularly released factual business information or forward-looking information is available for the same type of information as previously released in the ordinary course of business. Increasing guidance between earnings releases is not in most companies' ordinary playbook, but a company that has done so at least once before (perhaps outside the context of an offering) may be able to get comfortable that it has an adequate track record for an increase in guidance to fall within the safe harbor. If a company has no such track record, the proximity of the increase in guidance to the launch of the offering would be another uncomfortable fact in the analysis of whether the communication might constitute an offer. The next question is whether the new guidance will be considered to be part of the Section 12 file associated with the upcoming offering. Depending on the new guidance's proximity to the launch of the offering, it may well be. Bottom line: Confirming or increasing guidance within days of launching an offering is potentially problematic unless part of a company's regular routine or, at least, its prior experience.

Q: The company wants to launch an offering next week but it does not expect to meet its prior guidance for the quarter in progress. Can the company revise guidance downward just before launching its offering?

A: Yes. This is good corporate citizenship. In fact, absent unusual circumstances, we would not recommend launching an offering without correcting prior guidance that has proved overly optimistic. Updating guidance to reduce the market's expectations ordinarily would not be considered to be an offer under the Securities Act. Even if it were deemed an offer, the company's Exchange Act obligation to communicate with its investors should trump any Securities Act restrictions on offers.

Q: Economic uncertainty has prevented the company from consistently meeting its guidance. Can the company discontinue providing guidance?

A: Yes. A number of companies ceased to provide guidance in 2009–2010 as a result of the financial crisis. Bear in mind, however, that there may be an adverse market reaction when a company discontinues giving guidance. One likely consequence is that the spread may widen between the highest and lowest analyst estimates.

Q: The company just announced an increase in its annual guidance and the market reacted very favorably. How long does the company need to wait before launching an offering?

A: It depends. The first question is whether the Rule 168 safe harbor is available for the announcement. Did the increase in guidance occur in a regularly scheduled earnings release or call? If not, does the company have a track record of adjusting guidance between earning calls? These would be good facts for the Rule 168 analysis. If the Rule 168 safe harbor is not available, the more prudent course would be to hold off launching the offering for a period of time sufficiently long to break the connection between the increase in guidance and the offering. How long is that? The answer will depend on the extent of the increase in guidance, the company's post-announcement trading activity compared to historical trading patterns and all other relevant facts and circumstances. The analysis under Section 12 is the same. More time between the guidance update and the launch of the offering is better than less time.

Q: The company just completed its fiscal quarter. Can it disclose preliminary financial data on that quarter in the offering memorandum?

A: Yes. This is more in the nature of "Recent Developments" disclosure than true guidance and is done all the time. For some good advice on how to provide this type of information, see our *Client Alert* "Recent Developments in Recent Developments—Using Flash Numbers in Securities Offerings," available at http://

www.lw.com/thoughtLeadership/4189-RecentDevelopmentsInRecentDevelopments-Using-Flash-NumbersinSecuritiesOfferings.

Q: The company's CFO sent an email to a group of internal personnel indicating that the company will likely miss its previously announced earnings guidance. The CFO's email inadvertently included an industry analyst as an addressee. What should the company do?

A: Time is of the essence. The company must either publicly disclose the information or obtain from the analyst an express confidentiality agreement, written or oral, within the later of 24 hours or the next trading day's opening bell. Regulation FD requires simultaneous public disclosure for any intentional disclosure of material nonpublic information and prompt public disclosure for any non-intentional disclosure that is made selectively. For this purpose, "prompt" means as soon as is reasonably practicable but in no event later than 24 hours (or before the next opening bell, if later) after a director, executive officer or investor relations official of the company learns about a non-intentional disclosure of material nonpublic information.

Q: The company has just announced its intention to publicly offer its securities, and the company's CFO wants to discuss the planned public offering during the upcoming earnings call. The CFO will also be discussing guidance and other forward-looking information during the call. Is it OK to mention the offering?

A: It would be best not to mention the planned offering during the earnings call. The CFO's desire to discuss a recently announced public offering during an earnings call is understandable — after all, investors are likely to be interested in the topic and it was just publicly announced. The rub is the Securities Act's broad (and broadly interpreted) definition of offer. Most companies rely on the press release to notify the market about the upcoming offering and refrain from discussing it during the earnings call other than to refer to the press release.

Q: The company's offering of securities will affect its previously announced guidance, either through the issuance or repayment of debt that changes interest expense or the increased dilution resulting from more outstanding shares. Should the company update its guidance during the offering?

A: The impact that the offering will have on the company's income statement and balance sheet is usually disclosed in the offering document, so most companies do not update prior guidance. Since the Rule 168 safe harbor would probably not apply, as discussed above, most companies will wait until their next regular guidance update to factor in the results of the offering.

Endnotes

[1] This *Client Alert* is an update to the *Client Alert* we published on giving good guidance on March 2, 2007.

[2] This *Client Alert* does not address the SEC's encouragement to include forward-looking information in Management's Discussion and Analysis. *See, e.g., Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations*, Release No. 33-8056 (Jan. 22, 2002), text at note 8 ("Disclosure is mandatory where there is a known trend or uncertainty that is reasonably likely to have a material effect on the registrant's financial condition or results of operations."). In our experience, MD&A does not typically include earnings guidance, although more and more public companies include some kind of forward-looking statements in their MD&A under a caption entitled "Outlook" or something similar.

[3] Rule 10b-5 generally requires a plaintiff to demonstrate that a defendant acted with *scienter* — that is, either intent to deceive, manipulate or defraud or recklessness (beyond mere negligence).

[4] These statements include, among other things, projections of revenues, income, earnings, capital expenditures, dividends, capital structure or other financial items, plans and objectives for future operations, products or services and related assumptions. *See* definition of "forward-looking statement" in Securities Act Section 27A(i)(1)(A) and Exchange Act Section 21E(i)(1)(A).

[5] Securities Act Section 27A(c)(1)(A)(i); Exchange Act Section 21E(c)(1)(A)(i).

[6] *See* Securities Act Section 27A(c)(1)(B) and Exchange Act Section 21E(c)(1)(B).

[7] The case law underscores the importance of providing detailed, robust and regularly customized cautionary language for each significant forward-looking statement. *See, e.g., Slayton v. American Express*, 604 F.3d 758 (2d Cir. 2010) (finding that the company's forward-looking statement was not immunized by the PSLRA safe harbor's "meaningful cautionary language" prong because the cautionary language in the company's Form 10-Q was too vague to be "meaningful"). For further information on the Slayton opinion and its implication for public companies, see our *Client Alert* "Second Circuit Wades Into the PSLRA Safe Harbor — The Lessons of *Slayton v. American Express* for Forward-Looking Statements," available at http://www.lw.com/thoughtLeadership/2nd-circuit-addresses-pslra-safe-harbor.

[8] Securities Act Section 27A(d); Exchange Act Section 21E(d).

[9] A duty to update should be distinguished from a duty to correct. The duty to correct potentially applies when a statement that was believed to be correct when made turns out to have been incorrect when made.

[10] The NYSE and Nasdaq rules for listed companies contain requirements for prompt disclosure of material information, but these requirements have not been understood to apply to internal projections or forecasts of future operating results.

[11] *See Basic Inc. v. Levinson*, 485 U.S. 224, 239 n.17 (U.S. 1988).

[12] *Selective Disclosure and Insider Trading,* Release No.33-7881 (Aug. 15, 2000), text following n.47.

[13] National Investor Relations Institute "Guidance Practices and Preferences, 2012 Survey Report" (Sept. 5, 2012) [hereinafter "NIRI Guidance Survey Report"] (survey results received from approximately 360 NIRI corporate members).

[14] Regulation G requires SEC-reporting companies that publicly disclose non-GAAP financial measures to provide an accompanying presentation of the most directly comparable GAAP financial measure and a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure. *See* Regulation G, Rule 100(a). The GAAP reconciliation is only required for forward-looking financial measures "to the extent available without unreasonable efforts." *Id*. Rule 100(a)(2). For further information on Regulation G and the use of non-GAAP financial measures, see our *Client Alert* "Adjusted EBITDA Is Out of the Shadows as Staff Updates Non-GAAP Interpretations," available at http://www.lw.com/thoughtLeadership/non-gaap-financial-measures.

[15] Nearly half of guidance-giving companies provide non-financial guidance, such as statements about market conditions or industry information. However, the number of companies providing non-financial guidance has been decreasing over the past several years. *See* NIRI Guidance Survey Report.

[16] Section 11 only applies to guidance if it is included (or incorporated by reference) in the prospectus for a public offering, which is highly unusual. In these rare circumstances, companies should consider the SEC requirements for projections. *See* Item 10(b) of Regulation S-K.

[17] For a discussion of the information considered to be part of the Section 11 file and the Section 12 file for purposes of liability under the Securities Act, see our *Client Alert* "The Bought Deal Bible: A User's Guide to Bought Deals and Block Trades," available at http://www.lw.com/thoughtLeadership/the-bought-deal-bible.

[18] Companies should carefully consider the consequences of providing or updating guidance in road show meetings if the information provided at the road show is not made public. In addition, companies should also consider the impact on the offering of saying "no comment" in response to questions about previous guidance.

[19] Section 2(a)(3) of the Securities Act defines the term "offer" expansively to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." Given the breadth of this language, it can be difficult to say with certainty what is or is not an offer under this definition. For a thorough review of the law and the lore surrounding "offers," see our *Client Alert* "The Good, the Bad and the Offer: Law, Lore and FAQs," available at http://www.lw.com/thoughtLeadership/how-to-navigate-publicity-and-offers-of-securities.

[20] Under Rule 168, "factual business information" means: (i) factual information about the issuer, its business or financial developments, or other aspects of its business; (ii) advertisements of, or other information about, the issuer's products or services and (iii) dividend notices. "Forward-looking information" means: (i) projections of an issuer's revenues, income or loss, earnings or loss per share, capital expenditures, dividends, capital structure, or other financial items; (ii) statements about management's plans and objectives for future operations, including plans or objectives relating to the products or services of the issuer; (iii) statements about the issuer's future economic performance, including statements generally contemplated by the issuer's MD&A and (iv) assumptions underlying or relating to the foregoing.

[21] *See Securities Offering Reform*, Release No. 33-8591 (July 19, 2005) at 63 n.81.

[22] *Id*. at 64.

[23] *Id*.

[24] Compliance with Rule 10b-18 creates a limited safe harbor for share repurchase programs. However, that safe harbor only protects issuers from liability for market manipulation under Sections 9(a)(2) and 10(b) of the Exchange Act. It does not shield against liability for materially false statements and omissions or insider trading.

[25] The SEC has stated that the "existence of an appropriate policy, and the issuer's general adherence to it, may often be relevant to determining the issuer's intent with regard to a selective disclosure." *Regulation FD Release*, n.90.

[26] *See SEC Division of Corporation Finance*, Compliance and Disclosure Interpretations, Regulation FD, Question 101.01.

If you have any questions about this *Client Alert*, please contact one of the authors listed below or the Latham attorney with whom you normally consult:

Nathan Ajiashvili
+1.212.906.2916
nathan.ajiashvili@lw.com
New York

Alexander F. Cohen
+1.202.637.2284
alexander.cohen@lw.com
Washington, D.C.

Kirk A. Davenport II
+1.212.906.1284
kirk.davenport@lw.com
New York

Jeff G. Hammel
+1.212.906.1260
jeff.hammel@lw.com
New York

Steven B. Stokdyk
+1.213.891.7421
steven.stokdyk@lw.com
Los Angeles

Joel H. Trotter
+1.202.637.2165
joel.trotter@lw.com
Washington, D.C.

IM

Guidance Update

March 2014 | No. 2014-04

GUIDANCE ON THE TESTIMONIAL RULE AND SOCIAL MEDIA

From time to time, we have been asked questions concerning the nature, scope and application of the rule that prohibits investment advisers from using testimonials in their advertisements. In addition, in the past several years, we have been asked a number of questions concerning investment advisers' use of social media. We are now providing this guidance concerning registered investment advisers' use of social media and their publication[1] of advertisements that feature public commentary about them that appears on independent, third-party social media sites.[2]

We understand that use of social media has increased the demand by consumers for independent, third-party commentary or review of any manner of service providers, including investment advisers. We recognize that social media has facilitated consumers' ability to research and conduct their own due diligence on current or prospective service providers. Through this guidance, we seek to clarify application of the testimonial rule as it relates to the dissemination of genuine third-party commentary that could be useful to consumers.

Specifically, we seek through this guidance to assist firms in applying section 206(4) of the Investment Advisers Act of 1940 ("Advisers Act") and rule 206(4)-1(a)(1) thereunder ("testimonial rule") to their use of social media.[3] The guidance, in the form of questions and answers, also seeks to assist investment advisers in developing compliance policies and procedures reasonably designed to address participation in this evolving technology, specifically with respect to the publication of any public commentary that is a testimonial.

Consistent with previous staff guidance, we believe that in certain circumstances, as described below, an investment adviser's or investment advisory representative's ("IAR's") publication of all of the testimonials about the investment adviser or IAR from an independent social media site on the investment adviser's or IAR's own social media site or website would not implicate the concern underlying the testimonial rule.[4]

BACKGROUND

Section 206(4) generally prohibits any investment adviser from engaging in any act, practice or course of business that the Commission, by rule, defines as fraudulent, deceptive or manipulative. In particular, rule 206(4)-1(a)(1) states that:

> *[i]t shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business . . . for any investment adviser registered or required to be registered under [the Advisers Act], directly or indirectly, to publish, circulate, or distribute any advertisement which refers, directly or indirectly, to any testimonial of any kind concerning the investment adviser or concerning any advice, analysis, report or other service rendered by such investment adviser.*

Rule 206(4)-1(a)(1) was designed to address the nature of testimonials when used in investment advisory advertisements. When it adopted the rule, the Commission stated that, in the context of investment advisers, it found ". . . such advertisements are misleading; by their very nature they emphasize the comments and activities favorable to the investment adviser and ignore those which are unfavorable."[5] The staff has stated that the rule forbids the use of a testimonial by an investment adviser in advertisements "because the testimonial may give rise to a fraudulent or deceptive implication, or mistaken inference, that the experience of the person giving the testimonial is typical of the experience of the adviser's clients."[6]

Whether public commentary on a social media site is a testimonial depends upon all of the facts and circumstances relating to the statement. The term "testimonial" is not defined in the rule, but the staff has consistently interpreted that term to include a "statement of a client's experience with, or endorsement of, an investment adviser."[7] Depending on the facts and circumstances, public commentary made directly by a client about his or her own experience with, or endorsement of, an investment adviser or a statement made by a third party about a client's experience with, or endorsement of, an investment adviser may be a testimonial.[8]

The staff also has stated that an investment adviser's publication of an article by an unbiased third party regarding the adviser's investment performance is not a testimonial, unless it includes a statement of a client's experience with or endorsement of the adviser.[9] The staff also has stated that an adviser's advertisement that includes a partial client list that does no more than identify certain clients of the adviser cannot be viewed either as a statement of a client's experience with, or endorsement of, the adviser and therefore is not a testimonial.[10] Such an advertisement could nonetheless violate section 206(4) and rule 206(4)-1(a)(5) if the advertisement is false or misleading.[11]

The staff no longer takes the position, as it did a number of years ago, that an advertisement that contains non-investment related commentary regarding an IAR, such as regarding an IAR's religious affiliation or community service, may be deemed a testimonial violative of rule 206(4)-1(a)(1).[12]

The following questions and answers are intended to provide more guidance.

Third-party commentary

Q1. *May an investment adviser or IAR publish public commentary that is an explicit or implicit statement of a client's experience with or endorsement of the investment adviser or IAR on the investment adviser's or IAR's social media site?*

A1. Generally, staff believes that such public commentary would be a testimonial within the meaning of rule 206(4)-1(a)(1) and its use in an advertisement by an investment adviser or IAR would therefore be prohibited.

- For example, if an investment adviser or IAR invited clients to post such public commentary directly on the investment adviser's own internet site, blog or social media site that served as an advertisement for the investment adviser or IAR's advisory services, such testimonials would not be permissible.

Q2. *May an investment adviser or IAR publish the same public commentary on its own internet or social media site if it comes from an independent social media site?*

A2. When an investment adviser or IAR has no ability to affect which public commentary is included or how the public commentary is presented on an independent social media site; where the commentators' ability to include the public commentary is not restricted;[13] and where the independent social media site allows for the viewing of <u>all</u> public commentary and updating of new commentary on a real-time basis, the concerns underlying the testimonial prohibition may not be implicated.

As described in more depth below, publication of public commentary from an independent social media site would not raise any of the dangers that rule 206(4)-1(a)(1) was designed to prevent if:

- the independent social media site provides content that is independent of the investment adviser or IAR;
- there is no material connection between the independent social media site and the investment adviser or IAR that would call into question the independence of the independent social media site or commentary; and

- the investment adviser or IAR publishes all of the unedited comments appearing on the independent social media site regarding the investment adviser or IAR.[14]

Under these circumstances, an investment adviser or IAR may include such public commentary in an advertisement without implicating the concerns underlying the testimonial rule.

If, however, the investment adviser or IAR drafts or submits commentary that is included on the independent social media site, the testimonial rule generally would be implicated. Also, if the investment adviser or IAR is allowed to suppress the publication of all or a portion of the commentary, edit the commentary or is able to organize or prioritize the order in which the commentary is presented, the testimonial rule generally would be implicated.

Q3. *What content is not independent of an investment adviser or IAR and what is a material connection that would call into question the independence of a site or commentary?*

A3. Commentary would not be independent of an investment adviser or IAR if the investment adviser or IAR directly or indirectly authored the commentary on the independent social media site, whether in their own name, a third party's name, or an alias, assumed or screen name.

An investment adviser or IAR would have a material connection with a site or commentary that would call into question the independence of the site or commentary if, for example, the investment adviser or IAR: (1) compensated a social media user for authoring the commentary, including with any product or service of value; or (2) prioritized, removed or edited the commentary.[15]

- For example, an investment adviser could not have a supervised person submit testimonials about the investment adviser on an independent social media site and use such testimonials in advertisements without implicating the testimonial rule.

- An investment adviser or IAR could not compensate a client or prospective client (including with discounts or offers of free services) to post commentary on an independent social media site and use such testimonials in advertisements without implicating the testimonial rule.

Q4. *May an investment adviser or IAR publish testimonials from an independent social media site in a way that allows social media users to sort the criteria?*

A4. An investment adviser or IAR's publication of testimonials from an independent social media site that directly or indirectly emphasizes commentary favorable to the investment adviser or IAR or de-emphasizes commentary unfavorable to the investment adviser or IAR would implicate the prohibition on testimonials. The investment adviser may publish only the totality of the testimonials from an independent social media site and may not highlight or give prominence to a subset of the testimonials.

- Investment adviser or IAR sites may publish the testimonials from an independent social media site in a content-neutral manner, such as by chronological or alphabetical order, which presents positive and negative commentary with equal prominence.

- Social media users, however, are free to personally display the commentary and sort by any criteria, including by the lowest or highest rating. Investment adviser and IAR sites may facilitate a user's viewing of the commentary by providing a sorting mechanism as long as the investment adviser or IAR site does not itself sort the commentary.

Q5. *May an investment adviser or IAR publish testimonials from an independent social media site that includes a mathematical average of the public commentary?*

A5. Publication by an investment adviser or IAR of such testimonials from an independent social media site would not raise any of the dangers that rule 206(4)-1(a)(1) was designed to prevent if the independent social media site were designed to make it equally easy for the public to provide negative or positive commentary about an investment adviser or IAR.

- Investment advisers or IARs could publish testimonials from an independent social media site that include a mathematical average of the commentary provided that commenters themselves rate the investment advisers or IARs based on a ratings system that is not designed to elicit any pre-determined results that could benefit any investment adviser or IAR.

- The independent social media site, the investment adviser and the IAR may not provide a subjective analysis of the commentary.[16]

Inclusion of on Investment Adviser Advertisements on Independent Social Media Site

Q6. *May an investment adviser or IAR publish public commentary from an independent site if that site also features the investment adviser or IAR's advertising?*

A6. The existence of an investment adviser or IAR's advertisement within the architecture of an independent site that also contains independent public commentary does not, in combination, create a prohibited testimonial or otherwise make the advertisement false or misleading, provided that the investment adviser complies with the material connection and independence factors described above and provided that the advertisement is easily recognizable to the public as a sponsored statement.

- In other words, an advertisement would not cause the investment adviser or IAR's publication of the independent social media site's commentary to violate rule 206(4)-1 where (1) it would be readily apparent to a reader that the investment adviser or IAR's advertisement is separate from the public commentary featured on the independent social media site and (2) the receipt or non-receipt of advertising revenue did not in any way influence which public commentary is included or excluded from the independent social media site.

Reference to Independent Social Media Site Commentary Investment Adviser Non-Social Media Advertisements

Q7. *May an investment adviser or IAR refer to public commentary from an independent social media site on non-social media advertisements* (*e.g.*, newspaper, radio, television)*?*

A7. An investment adviser or IAR could reference the fact that public commentary regarding the investment adviser or IAR may be found on an independent social media site, and may include the logo of the independent social media site on its non-social media advertisements, without implicating the testimonial rule.

- For example, an IAR could state in its newspaper ad "see us on [independent social media site]," to signal to clients and prospective clients that they can research public commentary about the investment adviser or IAR on an independent social media site.

- In contrast, an investment adviser or IAR may not publish any testimonials from the independent social media site on the newspaper ad without implicating the testimonial rule.[17]

Client lists

Q8. Would a list or photographs of "friends" "or "contacts" on an investment adviser or IAR's social media site that is viewable by the general public be considered a testimonial or otherwise violate section 206(4) or rule 206(4)-1?

A8. It is common on social media sites to include a communal listing of contacts or friends. The staff has stated that an advertisement that contains a partial client list that does no more than identify certain clients of the adviser cannot be viewed either as a statement of a client's experience with, or endorsement of, the investment adviser, and therefore is not a testimonial.[18] Such an advertisement, however, could be false or misleading under rule 206(4)-1(a)(5) depending on the facts and circumstances.

- If the contacts or friends are not grouped or listed so as to be identified as current or past clients of an IAR, but are simply listed by the social media site as accepted contacts or friends of the IAR in the ordinary course, such a listing of contacts or friends generally would not be considered to be in violation of rule 206(4)-1(a)(1).

- However, if an IAR attempts to create the inference that the contacts or friends have experienced favorable results from the IAR's investment advisory services, the advertisement could be considered to be in violation of section 206(4) and rule 206(4)-1.

Fan/Community Pages

Q9. Individuals unconnected with a particular investment adviser or IAR may establish "community" or "fan" or other third-party sites where the public may comment on a myriad of investment topics, along with commentary regarding an investment adviser firm or individual IARs. Do such sites raise concerns under rule 206(4)-1?

A9. In the ordinary course, a third party's creation and operation of unconnected community or fan pages generally would not implicate rule 206(4)-1. We strongly caution investment advisers and supervised persons when publishing content from or driving user traffic to such sites (including through hyperlinks to such sites), particularly if the site does not meet the material connection and independence conditions described above. The Commission has stated that:

> *any SEC-registered investment adviser (or investment adviser that is required to be SEC registered) that includes, in its web site or in other electronic communications, a hyperlink to postings on third-party web sites, should carefully consider the applicability of the advertising provisions of the [Advisers Act]. Under the Advisers Act, it is a fraudulent act for an investment adviser to, among other things, refer to testimonials in its advertisements.*[19]

Endnotes

1 For purposes of this guidance, "publication" refers to any form of real-time broadcast through social media or the Internet whether by hyperlinking, posting, live-streaming, tweeting, or forwarding or any similar public dissemination and, does not relate to advertisements on non-Internet or non-social media sites, such as paper, television or radio. Social media allows for instantaneous updating of posted commentary and concurrent viewing of *all of* the comment history; in contrast, paper, television and radio are static media that reflect public commentary at a particular point in time and are limited media that would typically not reproduce all of the available public commentary simultaneously (often due to cost, space and other considerations).

2 As used herein, "independent social media sites" refers specifically to third-party social media sites that predominantly host user opinions, beliefs, findings or experiences about service providers, including investment advisory representatives or investment advisers (*e.g.*, Angie's List). An investment adviser's or IAR's own social media profile or account that is used for business purposes is not an "independent social media site."

3 This *IM Guidance Update* only addresses the use by a firm or IARs of social media sites for business purposes. This Update does not address the use by individuals of social media sites for purely personal reasons. This Update does not seek to address any obligations under state law of social media for business use. In addition, this guidance does not seek to address the use of social media sites by broker-dealers.

4 Any such advertisements also must comply with rule 206(4)-1(a)(5).

5 Investment Advisers Act Rel. No. 121 (Nov. 2, 1961) (adopting rule 206(4)-1).

6 *See* Richard Silverman, Staff No-Action Letter (pub. avail. March 27, 1985).

7 *See* Cambiar Investors, Inc., Staff No-Action Letter (pub. avail. Aug. 28, 1997) ("Cambiar").

8 *See* DALBAR, Inc., Staff No-Action letter (pub. avail. March 24, 1998) ("DALBAR").

9 *See* New York Investors Group, Inc., Staff No-Action Letter (pub. avail. Sept. 7, 1982); Stalker Advisory Services, Staff No-Action Letter (pub. avail. Feb. 14, 1994). *See also* Kurtz Capital Management, Staff No-Action Letter (pub. avail. Jan. 22, 1988).

10 *See* Cambiar, supra note 7.

11 *Id. ("*For example, the inclusion of a partial client list in an adviser's advertisement has the potential to mislead investors if the clients on the list are selected on the basis of performance and this selection bias is not adequately disclosed. A list that includes only advisory clients who have experienced above-average performance could lead an investor who contacts the clients for references to infer something about the adviser's competence or about the possibility of enjoying a similar investment experience that the investor might not have inferred if criteria unrelated to the client's performance had been used to select the clients on the list or if the selection bias was fully and fairly disclosed.").

12 *See* Dan Gallagher, Staff No-Action Letter (pub. avail. July 10, 1995). Advisers that publish advertisements regarding non-investment related commentary remain subject to the fiduciary responsibilities imposed by section 206(1) and (2) of the Advisers Act. Thus an adviser cannot use social media to perpetrate affinity frauds, which are investment scams that prey upon members of identifiable groups, such as religious or ethnic communities, the elderly, or professional groups. Affinity frauds can target any group of people who take pride in their shared characteristics, whether they are religious, ethnic, or professional. *See* http://www.sec.gov/investor/pubs/affinity.htm.

13 Some independent social media sites may have member fees or subscriptions payable by users. An investment adviser or IAR's publication of public commentary from a site that charges member or subscription fees to public users would not call into question the independence of the independent social media site for purposes of our views herein.

14 Independent social media sites may have editorial policies that edit or remove public commentary violative of the site's own published content guidelines (*e.g.*, prohibiting defamatory statements; threatening language; materials that infringe on intellectual property rights; materials that contain viruses, spam or other harmful components; racially offensive statements or profanity). An investment adviser or IAR's publication of public commentary that has been edited according to such an editorial policy would not call into question the independence of the independent social media site for purposes of the staff's views herein.

15 As explained in Q6 below, any arrangement whereby the investment adviser or IAR compensated the independent social media site, including with advertising or other revenue, in order to publish or suppress the publication of anything less than the totality of the public commentary submitted could render any use by the IAR or investment adviser on its social media site violative of the prohibition on testimonials.

16 *See* DALBAR, supra note 8.

17 *See* supra note 1.

18 *See Cambiar, supra* note *7*.

19 *See* Commission Guidance on the Use of Company Websites at note 83, Investment Company Act Rel. No. 28351 (Aug. 1, 2008). *See also SEC Interpretation: Use of Electronic Media*, Investment Company Act Rel. No. 24426 (May 4, 2000).

This *IM Guidance Update* summarizes the views of the Division of Investment Management regarding various requirements of the federal securities laws. Future changes in laws or regulations may supersede some of the discussion or issues raised herein. This *IM Guidance Update* is not a rule, regulation or statement of the Commission, and the Commission has neither approved nor disapproved of this *IM Guidance Update*.

The Investment Management Division works to:

- protect investors
- promote informed investment decisions and
- facilitate appropriate innovation in investment products and services

through regulating the asset management industry.

If you have any questions about this IM Guidance Update, please contact:

Catherine Courtney Gordon
Chief Counsel's Office/Public Inquiry
Phone: 202.551.6825
Email: IMOCC@sec.gov

U.S. Securities and Exchange Commission

Division of Investment Management
Division of Corporation Finance
Securities and Exchange Commission

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 (IM/CF)

Action: Publication of IM/CF Staff Legal Bulletin

Date: June 30, 2014

Summary: The Division of Investment Management is providing guidance about investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms. The Division of Corporation Finance is providing guidance on the availability and requirements of two exemptions to the federal proxy rules that are often relied upon by proxy advisory firms.

Supplementary Information: The statements in this bulletin represent the views of the Division of Investment Management and the Division of Corporation Finance. This bulletin is not a rule, regulation or statement of the Commission. Further, the Commission has neither approved nor disapproved its content.

Contacts: For further information relating to investment advisers, please contact the Division of Investment Management's Office of Chief Counsel by calling (202) 551-6825 or by e-mailing IMOCC@sec.gov. For further information relating to the proxy rules, please contact the Division of Corporation Finance's Office of Chief Counsel by calling (202) 551-3500 or by submitting a web-based request form at https://tts.sec.gov/cgi-bin/corp_fin_interpretive.

Question 1. As a fiduciary, an investment adviser owes each of its clients a duty of care and loyalty with respect to services undertaken on the client's behalf, including proxy voting.[1] Further, the Commission's rules provide that it is a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment adviser registered or required to be registered with the Commission to exercise voting authority with respect to client securities unless the adviser, among other things, adopts and implements written policies and procedures that are reasonably designed to ensure that the investment adviser votes proxies in the best interest of its clients ("Proxy Voting Rule").[2] What steps could an investment adviser take to seek to demonstrate that proxy votes are cast in accordance with clients' best interests and the adviser's proxy voting procedures?

Answer. Compliance could be demonstrated by, for example, periodically sampling proxy votes to review whether they complied with the investment adviser's proxy voting policy and procedures. The investment adviser also could specifically review a sample of proxy votes that relate to certain proposals that may require more analysis. In addition, as part of an investment adviser's ongoing compliance program, it should review, no less frequently than annually, the adequacy of its proxy voting policies and procedures to make sure they have been implemented effectively, including whether these policies and procedures continue to be reasonably designed to ensure that proxies are voted in the best interests of its clients.[3]

Question 2. Is an investment adviser required to vote every proxy?

Answer. The Proxy Voting Rule does not require that investment advisers and clients agree that the investment adviser will undertake all of the proxy voting responsibilities. We understand that in most cases, clients delegate to their investment advisers the authority to vote proxies relating to equity securities.[4] We further understand that, in general, clients usually delegate this authority completely, without retaining authority to vote any of the proxies. The staff notes that investment advisers and their clients also may agree to this type of delegation, as well as other proxy voting arrangements in which the adviser would not assume all of the proxy voting authority. Some agreements between investment advisers and their clients may include the following arrangements:

- An investment adviser and its client may agree 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.

- An investment adviser and its client may agree that the investment adviser should exercise voting authority as recommended by management of the company or in favor of all proposals made by a particular shareholder proponent, as applicable, absent a contrary instruction from the client or a determination by the investment adviser that a particular proposal should be voted in a different way if, for example, it would further the investment strategy being pursued by the investment adviser on behalf of the client.

- An investment adviser and its client may agree that the investment adviser will abstain from voting any proxies at all, regardless of whether the client undertakes to vote the proxies itself.

- An investment adviser and its client may agree that the investment adviser will focus resources on only particular types of proposals based on the client's preferences.

As these non-exclusive examples demonstrate, an investment adviser and its client have flexibility in determining the scope of the investment adviser's obligation to exercise proxy voting authority. [5] We reiterate, however, that an investment adviser that assumes proxy voting authority must do so in compliance with the Proxy Voting Rule.

Question 3. What are some of the considerations that an investment adviser may wish to take into account if it retains a proxy advisory firm to assist it in its proxy voting duties?

Answer. When considering whether to retain or continue retaining any particular proxy advisory firm to provide proxy voting recommendations, the staff believes that an investment adviser should ascertain, among other things, whether the proxy advisory firm has the capacity and competency to adequately analyze proxy issues.[6] In this regard, investment advisers could consider, among other things: the adequacy and quality of the proxy advisory firm's staffing and personnel; the robustness of its policies and procedures regarding its ability to (i) ensure that its proxy voting recommendations are based on current and accurate information and (ii) identify and address any conflicts of interest and any other considerations that the investment adviser believes would be appropriate in considering the nature and quality of the services provided by the proxy advisory firm.

Question 4**.** Does an investment adviser have an ongoing duty to oversee a proxy advisory firm that it retains?

Answer. The staff believes that an investment adviser that has retained a third party (such as a proxy advisory firm) to assist with its proxy voting responsibilities should, in order to comply with the Proxy Voting Rule, adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the third party in order to ensure that the investment adviser, acting through the third party, continues to vote proxies in the best interests of its clients. [7] In addition, the staff notes that a proxy advisory firm's business and/or policies and procedures regarding conflicts of interest could change after an investment adviser's initial assessment, and some changes could alter the effectiveness of the policies and procedures and require the investment adviser to make a subsequent assessment. Consequently, the staff has stated that investment advisers should establish and implement measures reasonably designed to identify and address the proxy advisory firm's conflicts that can arise on an ongoing basis,[8] such as by requiring the proxy advisory firm to update the investment 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.

Question 5. What are an investment adviser's duties when it retains a proxy advisory firm with respect to the material accuracy of the facts upon which the proxy advisory firm's voting recommendations are based?

Answer. As stated above, it is the staff's position that an investment adviser that receives voting recommendations from a proxy advisory firm should ascertain that the proxy advisory firm has the capacity and competency to adequately analyze proxy issues, which includes the ability to make voting recommendations based on materially accurate information.[9] For example, an investment adviser may determine that a proxy advisory firm's recommendation was based on a material factual error that causes the adviser to question the process by which the proxy advisory firm develops its recommendations. In such a case, the staff believes that the investment adviser should take reasonable steps to investigate the error, taking into account, among other things, the nature of the error and the related recommendation, and seek to determine whether the proxy advisory firm is taking reasonable steps to seek to reduce similar errors in the future.

Question 6. When is a proxy advisory firm subject to the federal proxy rules?

Answer. A proxy advisory firm would be subject to the federal proxy rules when it engages in a "solicitation," which is defined under Exchange Act Rule 14a-1(*l*) to include "the furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy." As a general matter, the Commission has stated that the furnishing of proxy voting advice constitutes a "solicitation" subject to the information and filing requirements of the federal proxy rules.[10] Providing recommendations that are reasonably calculated to result in the procurement, withholding, or revocation of a proxy would subject a proxy advisory firm to the proxy rules. Exchange Act Rule 14a-2(b) provides exemptions from the information and filing requirements of the federal proxy rules that a proxy advisory firm may rely upon if it meets the requirements of the exemptions.

Question 7. Where a shareholder (such as an institutional investor) retains a proxy advisory firm to assist in the establishment of general proxy voting guidelines and policies and authorizes the proxy advisory firm to execute a proxy or submit voting instructions on its behalf, and permits the proxy advisory firm to use its discretion to apply the guidelines to determine how to vote on particular proposals, may the proxy advisory firm providing such services rely on the exemption from the proxy rules in Exchange Act Rule 14a-2(b)(1)?

Answer. No. Rule 14a-2(b)(1) provides an exemption from most provisions of the federal proxy rules for "any solicitation by or on behalf of any person who does not, at any time during such solicitation, seek directly or indirectly, either on its own or another's behalf, the power to act as a proxy for a security holder and does not furnish or otherwise request, or act on behalf of a person who furnishes or requests, a form of revocation, abstention, consent or authorization." The exemption would not be available for a proxy advisory firm offering 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.

In this instance, the proxy advisory firm would be viewed as having solicited the "power to act as a proxy" for its client. This would be the case even if the authority was revocable by the client.

Question 8. If a proxy advisory firm only distributes reports containing recommendations, would it be able to rely on the exemption in Rule 14a-2 (b)(1)?

Answer. Yes. To the extent that a proxy advisory firm limits its activities to distributing reports containing recommendations and does not solicit the power to act as proxy for the client(s) receiving the recommendations, the proxy advisory firm would be able to rely on the exemption, so long as the other requirements of the exemption are met.

Question 9. To the extent that Rule 14a-2(b)(1) is not available to a proxy advisory firm, either for the reason specified in the answer to Question 7 or otherwise, is there any other exemption from the proxy rules that might apply?

Answer. Yes. Exchange Act Rule 14a-2(b)(3) exempts the furnishing of proxy voting advice by any person to another person with whom a business relationship exists, subject to certain conditions. [11] The exemption is available if the person gives financial advice in the ordinary course of business; discloses to the recipient of the advice any significant relationship with the company 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 person in such matter; receives no special commission or remuneration for furnishing the advice from any person other than the recipient of the advice and others who receive similar advice; and does not furnish the advice on behalf of any person soliciting proxies or on behalf of a participant in a contested election.

Question 10. If a proxy advisory firm 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, would the proxy advisory firm be precluded from relying on Rule 14a-2(b)(3)?

Answer. In order to rely on Rule 14a-2(b)(3), a proxy advisory firm would need to first assess whether its relationship with the company or security holder proponent[12] is significant or whether it otherwise has any material interest in the matter that is the subject of the voting recommendation and disclose to the recipient of the voting recommendation any such relationship or material interest. Whether a relationship would be "significant" or what constitutes a "material interest" will depend on the facts and circumstances. In making such a determination, a proxy advisory firm would likely consider the type of service being offered to the company or security holder proponent, the amount of compensation that the proxy advisory firm receives 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 similar inquiry would be made for any interest that might be material. 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.

Question 11. If a proxy advisory firm determines that it has a significant relationship or a material interest that requires disclosure for purposes of relying on Rule 14a-2(b)(3), what must it disclose?

Answer. The proxy advisory firm must provide the recipient of the advice with disclosure that provides notice of the presence of a significant relationship or a material interest. We do not believe that boilerplate language that such a relationship or interest may or may not exist provides such notice. In addition, we believe the disclosure should 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.

Question 12. Does the disclosure requirement in Rule 14a-2(b)(3) permit a proxy advisory firm to state only that information about significant relationships or material interests will be provided upon request?

Answer. No. Rule 14a-2(b)(3) imposes an affirmative duty to disclose significant relationships or material interests to the recipient of the advice. We do not believe that providing the information upon request would satisfy the requirement in the rule.

Question 13. Does disclosure of a significant relationship or material interest have to be provided in a document that conveys a voting recommendation or advice, such as the proxy advisory firm's report about a company, and must it be publicly available?

Answer. Rule 14a-2(b)(3) does not specify where the required disclosure should be provided. A proxy advisory firm should provide the disclosure in such a way as to allow the client to assess both 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. This disclosure may be made publicly or between only the proxy advisory firm and the client.

* * * * *

The staff recognizes that investment advisers and proxy advisory firms may want or need to make changes to their current systems and processes in light of this guidance. The staff expects any necessary changes will be made promptly, but in any event in advance of next year's proxy season.

1 Proxy Voting by Investment Advisers, Release No. IA-2106, at n. 2 and accompanying text (Jan. 31, 2003) ("Proxy Voting Release"), citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963) (interpreting Section 206 of the Investment Advisers Act of 1940 ("Advisers Act")).

2 Rule 206(4)-6 under the Advisers Act.

3 See Rule 206(4)-7 under the Advisers Act (e.g., requiring investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violation, by the adviser and its supervised person, of the Advisers Act). See also Rule 38a-1 under the Investment Company Act of 1940 ("1940 Act") (e.g., requiring each registered investment company to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund, including policies and procedures that provide for the oversight of compliance by the registered investment company's investment adviser, among others).

4 See Proxy Voting Release.

5 See id. at n. 19 ("The scope of an adviser's responsibilities with respect to voting proxies would ordinarily be determined by the adviser's contracts with its clients, the disclosures it has made to its clients, and the investment policies and objectives of its clients.")

6 See Egan-Jones Proxy Services, SEC Staff Letter (May 27, 2004) ("Egan-Jones") and Institutional Shareholder Services, Inc., SEC Staff Letter (Sept. 15, 2004) ("ISS").

7 See Rule 206(4)-7 under the Advisers Act and Rule 38a-1 under the 1940 Act.

8 See Egan-Jones and ISS.

9 Id.

10 See Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Release No. 34-16104 (Aug. 13, 1979).

11 In 1992, the Commission noted that "advice given with respect to matters subject to a shareholder vote by . . . proxy advisory services in the ordinary course of business is covered by the exemption provided by [Rule 14a-2(b)(3)], so long as the other requirements of that exemption are met." See Regulation of Communications Among Shareholders, Release No. 34-31326 (Oct. 16, 1992).

12 Rule 14a-8 does not require that the identity of the shareholder proponent be disclosed in the proxy statement. Therefore, there may be instances in which the proxy advisory firm has no knowledge that the proponent is a client. In such a case, we do not believe that there would be a duty to investigate who the proponent is. To the extent that the identity of the proponent is unknown, there is little concern that the relationship would affect the proxy advisory firm's recommendation regarding that proposal.

http://www.sec.gov/interps/legal/cfslb20.htm

Home | Previous Page Modified: 06/30/2014

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).[1] 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*.[2] 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

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/cfslb20.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.[3] 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.[4]

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,[5] for example, frequently offers recommendations that coincide with the views of its shareholder activist ownership;

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.

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;[6]
- 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.[7]

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 polices 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

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.[8] 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.[9] 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.[10] 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:

---

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[11] and the availability of exemptions for proxy advisory firms from the SEC's proxy solicitation requirements.[12] 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;

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,[13] 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

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.

CENTER FOR CAPITAL MARKETS COMPETITIVENESS®

1615 H Street, NW
Washington, DC 20062
www.CenterForCapitalMarkets.com
Tel 202-463-3162