Client Alert

September 2018

Proxy Advisory Firm Guidance Withdrawn by the SEC

On September 13, 2018, the staff (the "Staff") of the Division of Investment Management of the Securities and Exchange Commission (the "SEC") issued a statement announcing that, effective immediately, the Staff was withdrawing two widely-followed no-action letters issued in 2004 to two proxy advisory firms.[1] These letters had been viewed by some commentators as having led to an overreliance on recommendations made by proxy advisory firms, such as Institutional Shareholder Services ("ISS"), without sufficient consideration of potential conflicts of interest by such proxy advisory firms in issuing voting recommendations.

In its announcement, the Staff indicated that the withdrawal of these no-action letters is meant to "facilitate the discussion" at a previously-announced SEC Roundtable on the Proxy Process, expected to be held in November 2018 (the "Roundtable"). While it is impossible to predict whether the Roundtable will result in any proposed rulemaking by the SEC or legislation addressing the role of proxy advisory firms, the withdrawal of these two letters is welcomed by the issuer community and may be indicative of renewed commitment to proxy advisory firm reform by the SEC and Congress.[2]

Background

In 2003, the SEC adopted Rule 206(4)-6[3] under the Investment Advisers Act of 1940[4] (the "IAA"), requiring that a registered investment adviser (an "RIA") under the IAA that exercises voting authority over client proxies must adopt policies and procedures reasonably designed to ensure that the RIA votes proxies in the best interests of clients, to disclose to clients information about those policies and procedures, and to disclose to clients how to obtain information on how the RIA has voted the clients' proxies. In the Rule 206(4)-6 Adopting Release (the "Adopting Release"),[5] the SEC indicated that an RIA could demonstrate that its vote of its clients' proxies was not a product of a conflict of interest if the RIA voted the proxies in accordance with a predetermined policy based on the recommendation of an "***independent***" third party (emphasis added).

The withdrawn no-action letters to Egan-Jones Proxy Services ("Egan-Jones") and ISS had provided non-binding guidance from the Staff on how to determine whether a proxy advisory firm is, in fact, an independent third party for purposes of the Adopting Release test. In the Egan-Jones letter, the Staff stated that "the mere fact that the proxy voting firm provides advice on corporate governance issues and receives compensation from the issuer for these services generally would not affect the firm's independence from an investment adviser." In the ISS letter, the Staff indicated that

[1] Available at https://www.sec.gov/news/public-statement/statement-regarding-staff-proxy-advisory-letters.

[2] According to the *Wall Street Journal*, the SEC's withdrawal "came after a letter from six Republican senators asking the Government Accountability Office last month to rule whether the SEC overreached in issuing the letters." https://www.wsj.com/articles/public-companies-score-a-win-in-fight-to-limit-reach-of-proxy-advisers-1536862260.

[3] 17 CFR 275.206(4)-6.

[4] 15 U.S.C. § 80b-1, *et seq*.

[5] Available at https://www.sec.gov/rules/final/ia-2106.htm.

> "a case-by-case evaluation of a proxy voting firm's potential conflicts of interest is not the exclusive means by which an investment adviser may fulfill its fiduciary duty of care to its clients in connection with voting client proxies according to the firm's recommendation… Whether an investment adviser breaches or fulfills its fiduciary duty of care when employing a proxy voting firm depends upon all of the relevant facts and circumstances. Consistent with its fiduciary duty, an investment adviser should take reasonable steps to ensure that, among other things, the firm can make recommendations for voting proxies in an impartial manner and in the best interests of the adviser's clients. Those steps may include a case by case evaluation of the proxy voting firm's conflict procedures and the effectiveness of their implementation, ***and/or other means reasonably designed to ensure the integrity of the proxy voting process***." (emphasis added)

Together, the two withdrawn no-action letters had been criticized by some commentators for having encouraged the growth in influence of proxy advisory firms' roles in the corporate governance of U.S. public companies over the past decade.

Reaction

The Staff's withdrawal of the two no-action letters was met by immediate and diverging reactions by commentators. A representative of the Center for Capital Markets Competitiveness at the U.S. Chamber of Commerce called the withdrawal "a pretty significant step towards reform of the proxy advisory industry," while House Financial Services Committee Chairman Jeb Hensarling issued a statement that "[t]he market power of proxy advisory firms demands greater accountability for these firms' actions and the information that they provide institutional investors."[6] According to ISS General Counsel Steven Friedman, "[c]orporate lobbyists have created a mythology surrounding these letters in an attempt to undermine the important work we do for our sophisticated institutional investor clients."[7] Glass Lewis issued a statement asserting that "while the SEC withdrew these no-action letters … the law in this area has not changed. Indeed, it has always been the law that an investment adviser, as a fiduciary to its clients, is required to take steps to avoid having a conflict of interest influence its decisions on behalf of clients."[8] This sentiment was echoed by SEC Commissioner Robert J. Jackson, Jr., who stated that "the law governing investor use of proxy advisors is no different today than it was [prior to withdrawal of the no-action letters]."[9]

Implications

The withdrawal of these two no-action letters may be evidence of renewed SEC commitment to proxy advisory firm reform. In addition, SEC Chairman Jay Clayton also released an additional statement on September 13, 2018, emphasizing that all guidance issued by the SEC, such as Compliance and Disclosure Interpretations, Staff Legal Bulletins, and various public statements and speeches, is non-binding and creates no enforceable legal rights or obligations. Chairman Clayton's statement may weaken future reliance on Staff Legal Bulletin No. 20 ("SLB 20"),[10] which seeks to reinforce the fiduciary

[6] Press release, *Hensarling Statement Regarding SEC Staff Proxy Advisory Letter Withdrawals* (Sept. 13, 2018), available at https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=403951.

[7] Dave Michaels, *Public Companies Score a Win in Fight to Limit Reach of Proxy Advisers*, Wall. St. J., Sept. 13, 2018, available at https://www.wsj.com/articles/public-companies-score-a-win-in-fight-to-limit-reach-of-proxy-advisers-1536862260.

[8] Glass Lewis Response to SEC Statement Regarding Staff Proxy Advisory Letters (Sept. 14, 2018), available at http://www.glasslewis.com/glass-lewis-response-to-sec-statement-regarding-staff-proxy-advisory-letters/.

[9] Remarks of Commissioner Robert J. Jackson Jr., *Statement on Shareholder Voting* (Sept. 14, 2018), available at https://www.sec.gov/news/public-statement/statement-jackson-091418.

[10] "Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms" (June 30, 2014), available at https://www.sec.gov/interps/legal/cfslb20.htm.

duties of RIAs when voting on behalf of clients by delineating RIAs' due diligence and oversight obligations with respect to their reliance on proxy advisory reforms. The Staff declined to withdraw SLB 20 simultaneously with the withdrawal of the Egan-Jones and ISS no-action letters.[11]

Together with the withdrawal of the two no-action letters, the SEC's actions last week may have increased the uncertainty with which RIAs will be able to rely on the voting recommendations of proxy advisory firms absent additional proposed rulemaking by the SEC or new legislation by Congress. The most recent topical bill presented in Congress, The Corporate Governance Reform and Transparency Act of 2017 (H.R. 4015), passed the House of Representatives late last year, but remains before the U.S. Senate and is unlikely to be acted upon prior to the mid-term Congressional elections in November 2018. While it is impossible to foresee whether the Roundtable ultimately will lead to proposed rulemaking by the SEC, it seems clear that the SEC will have achieved its stated goal of "facilitating the discussion" at the Roundtable with its actions last week.

Authors

James V. Davidson
jdavidson@HuntonAK.com

Anthony J. Eppert
anthonyeppert@HuntonAK.com

Steven M. Haas
shaas@HuntonAK.com

Scott H. Kimpel
skimpel@HuntonAK.com

W. Lake Taylor Jr.
tlake@HuntonAK.com

[11] SLB 20 cites the withdrawn Egan-Jones and ISS no-action letters to support the Staff's views set forth therein.