Sept. 18, 2018

SEC Signals Changing Views on Regulation of Proxy Advisory Firms

In recent years, the friction between public companies and proxy advisory firms—companies that provide proxy vote recommendations to institutional fund managers and other investment advisers—has intensified. Public issuers contend that two firms have a duopoly on the proxy advisory services market and wield an outsized role in setting corporate governance norms. Of particular frustration to some issuers are the two companies' allegedly progressive views, made manifest in the recommendations they give to investment advisers, on "ESG" issues (environmental, social, governance). The two firms also offer corporate governance consulting services to issuers—including the very same issuers upon whose proxy solicitations the firms advise investment advisers—which many issuers see as an inherent conflict of interest. For their part, proxy advisory firms (and, to some extent, investment advisers who rely on them to advise on thousands of proxy questions each year) contend that they offer neutral, independent advice and serve a vital role in maintaining the efficiency of public capital markets.

The friction between issuers and proxy advisory firms has spilled into the legislative arena. In December 2017, the House of Representatives passed the **Corporate Governance Reform and Transparency Act of 2017**, which would require proxy advisory firms to register with the SEC (in their own category of registrants) and give the SEC rule-writing authority to govern the industry. The Senate Banking Committee held a **hearing** on legislative proposals to improve corporate governance in July 2018, at which proxy advisor reform legislation was discussed.

The SEC is now engaged on the issue. On Sept. 13, 2018, the Division of Investment Management announced the withdrawal, effective immediately, of prior guidance announced in no-action letters dated May 27, 2004, to Egan-Jones Proxy Services ("EJPS") and Sept. 15, 2004, to Institutional Shareholder Services, Inc. ("ISS").[1] The withdrawal of the no-action letter guidance did not affect guidance on proxy advisory firms issued in Staff Legal Bulletin No. 20, which largely tracked the guidance in the no-action letters, but it does raise questions about the current commission's views on proxy advisory firms and where regulatory policy may be headed.[2] The SEC plans to hold a **roundtable on the proxy process** in November 2018.

Background

Section 206(4) of the Investment Advisers Act of 1940 (the "Advisers Act") prohibits a registered investment adviser from engaging in "any act, practice, or course of business which is fraudulent, deceptive, or manipulative."[3] Rule 206(4)-6, promulgated in 2003 to construe this statute, requires an investment adviser using a proxy advisory service to "adopt and implement written policies and procedures that are reasonably designed to ensure that you vote client securities in the best interest of clients, which procedures must include how you address material conflicts that may arise between your interests and those of your clients."[4]

Around the time this rule took effect, Egan-Jones was a proxy advisory firm that maintained two business lines: a proxy recommendation/voting service for investment advisers, and a business that consulted issuers on best

[1] Consistent with the withdrawal of the no-action letters, the SEC has removed the letters from their website. The authors of this article will provide you a copy upon request; the letters are also commercially available through online law databases.
[2] SEC Staff Legal Bulletin No. 20, Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms (June 30, 2014), https://www.sec.gov/interps/legal/cfslb20.htm.
[3] 15 U.S.C. § 80b-6(4).
[4] 17 C.F.R. § 275.206(4)-6(b).

practices in corporate governance. Egan-Jones filed a no-action letter request with the commission in 2003 asking whether its corporate governance consulting relationships with issuers rendered it non-independent for purposes of complying with Rule 206(4)-6. In 2004, the staff issued a no-action letter to EJPS clarifying that its consulting arrangements with issuers did not, by itself, mean that EJPS could not be independent for purposes of offering proxy advisory services to investment advisers:

In your letter, you ask whether a proxy voting firm would be considered to be an independent third party if the firm receives compensation from an issuer ("Issuer") for providing advice on corporate governance issues. We believe 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.

The EJPS no-action letter gave some comfort to investment advisers, but its language limited its applicability to a proxy advisory firm's relationship with respect to a particular issuer, not to the issuer community in general. Under the EJPS no-action letter, the investment adviser retained an ongoing duty to vet the proxy advisory firm's relationship with each issuer to ensure that there were no specific conflicts of interest that might override or call into question the general safe harbor of reliance upon the firm's conflict of interest policies and procedures.

On Sept. 15, 2004, ISS wrote to the staff to ask that they "elaborate" on the EJPS no-action letter guidance and clarify that an investment adviser's evaluation of the proxy advisory firm's potential conflicts on an issuer-by-issuer basis is not an absolute requirement of satisfying Rule 206(4)-6. In response, the staff clarified:

You [ISS] contend that 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 recommendations. We agree. You believe that an investment adviser may instead determine that a proxy voting firm is capable of making impartial recommendations in the best interests of the adviser's clients based on the firm's conflict procedures.

The no-action letter then described how an investment adviser may assess the adequacy of a proxy advisory firm's independence/conflict policies and procedures and confirmed the duty of the investment adviser to continually monitor the proxy firm's adherence to those policies.

Withdrawal of the EJPS and ISS No-Action Letters; The Road Ahead

In assessing the impact of the withdrawal of the EJPS and ISS no-action letters, it is important to bear in mind that a no-action letter simply represents the view of the staff on a particular securities law topic. This reality was recently underscored in a Sept. 13, 2018, **public statement** by SEC Chairman Jay Clayton: "The Commission's longstanding position is that all staff statements are nonbinding and create no enforceable legal rights or obligations of the Commission or other parties." (In fact, SEC Commissioner Robert Jackson, Jr., offered informal remarks to media outlets dissenting from the withdrawal of the no-action letters.) And despite the withdrawal of the

comment letters, the SEC's 2014 guidance, issued in Staff Legal Bulletin No. 20 and containing much of the same guidance as in the no-action letters, remains intact.[5]

Still, investment advisers should be wary of the commission's changing views on proxy advisors. In its press release on the withdrawal of the no-action letters, the staff articulated their hope that the withdrawal would spark discussion at an upcoming SEC roundtable on proxy advisors to be held in November 2018. Issuers and investment advisers should pay close attention to these developments and related efforts on proxy access, including submission and resubmission thresholds. For more information, including how to become engaged with Congress or the SEC on these issues, please contact one of the authors of this article.

Travis J. Norton
Of Counsel
tnorton@bhfs.com
202.872.5287

Thomas J. Krysa
Shareholder
tkrysa@bhfs.com
303.223.1270

This document is intended to provide you with general information regarding regulation of proxy advisory firms. The contents of this document are not intended to provide specific legal advice. If you have any questions about the contents of this document or if you need legal advice as to an issue, please contact the attorneys listed or your regular Brownstein Hyatt Farber Schreck, LLP attorney. This communication may be considered advertising in some jurisdictions.

[5] SEC Staff Legal Bulletin No. 20, *supra* n. 2.