ROPES & GRAY

ALERT

Asset Management

September 19, 2018

SEC Withdraws Two No-Action Letters Regarding Use of Proxy Advisory Firms – Chairman Clayton Issues Statement Regarding Staff Views

On September 13, 2018, the Division of Investment Management (the "Division") issued an Information Update (the "Update") in which it announced the withdrawal of two no-action letters concerning the circumstances under which a third-party proxy advisory firm may be considered independent under Rule 206(4)-6 under the Advisers Act. That Rule was adopted by the SEC in 2003 to ensure that investment advisers vote proxies in the best interest of their clients and provide clients with information about how their proxies are voted.[1]

In the Rule 206(4)-6 adopting release, the SEC stated that an investment adviser could demonstrate that its vote of its clients' proxies was not a product of a conflict of interest if the adviser voted the proxies in accordance with a pre-determined policy based on the recommendations of an "independent" proxy advisory firm. The two withdrawn no-action letters concerned whether a proxy advisory firm would be considered independent if the proxy advisory firm receives compensation from an issuer for providing advice on corporate governance issues (or otherwise had a potential conflict of interest that could make the proxy advisory firm incapable of making impartial recommendations).

In 2014, the Division affirmed the substance of the two letters in a Staff Legal Bulletin for the purpose of "providing guidance about investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms." Last week's Update referred to, but did not withdraw, the Staff Legal Bulletin. Therefore, notwithstanding the Division's withdrawal of the two no-action letters, the Update should not have any practical effect at this time on investment advisers that rely on proxy advisory firms.

Background

In a July 30, 2018 statement, SEC Chairman Jay Clayton announced that the SEC staff will be hosting a "Roundtable on the Proxy Process" in the fall of 2018. The Update noted that the roundtable is expected to be held in November 2018 and that, in developing the agenda for the roundtable, the SEC staff has been considering "whether prior staff guidance about investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms should be modified, rescinded or supplemented." This simply repeats the last item from the portion of Chairman Clayton's July 30, 2018, statement in which he also listed the following items among the potential topics to be discussed at the roundtable:

> Proxy Advisory Firms
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> Proxy advisory firms provide a number of services related to proxy voting, which include aggregating and standardizing information, providing platforms for managing votes, and providing voting recommendations. Areas that may warrant particular attention include:

[1] On the same day that Rule 206(4)-6 was adopted, the SEC also (i) adopted Rule 30b1-4 under the 1940 Act, requiring registered funds to file with the SEC their proxy voting records on new Form N-PX and (ii) amended Forms N-1A and N-2, requiring open-end and closed-end funds to disclose their proxy voting policies and procedures.

- Whether various factors, including legal requirements, have resulted in investment advisers to funds and other clients relying on proxy advisory firms for information aggregation and voting recommendations to a greater extent than they should . . .

- Whether there is sufficient transparency about a proxy advisory firm's voting policies and procedures so that companies, investors, and other market participants can understand how the advisory firm reached its voting recommendations on a particular matter . . .

- Whether there are conflicts of interest, including with respect to related consulting services provided by proxy advisory firms, and, if so, whether those conflicts are adequately disclosed and mitigated . . .

- [W]hether prior staff guidance about investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms should be modified, rescinded, or supplemented.

Observations

The Update did not explain the Division's rationale for withdrawing the two no-action letters, Egan-Jones Proxy Services (May 27, 2004) ("*Egan-Jones*") and Institutional Shareholder Services, Inc. (Sept. 15, 2004) ("*ISS*"). The Update merely noted the upcoming roundtable and stated, "[t]aking into account developments since 2004, the staff has determined to withdraw these letters, effective today . . . in order to facilitate the discussion at the Roundtable."

- In *Egan-Jones*, the SEC staff confirmed that a third-party proxy advisory firm could be considered to be an independent third party if the proxy advisory firm receives compensation from an issuer for providing advice on corporate governance issues. The SEC staff listed additional requirements to be satisfied by the investment adviser seeking to rely on such a proxy advisory firm's recommendations, including obtaining information on an ongoing basis from any third-party proxy advisory firm to permit the investment adviser to determine that the proxy advisory firm is, in fact, independent, and that it can make recommendations for voting proxies in an impartial manner and in the best interests of the adviser's clients.

- In *ISS*, the SEC staff agreed that a case-by-case evaluation of a proxy advisory firm's potential conflicts of interest was not the sole manner by which an investment adviser may fulfill its Rule 206(4)-6 obligations and fiduciary duty of care to clients regarding voting client proxies according to the proxy advisory firm's recommendations. More specifically, the SEC staff confirmed that an investment adviser may instead determine that a proxy advisory firm is capable of making impartial recommendations in the best interests of the adviser's clients based on the proxy advisory firm's conflict procedures, provided that the investment adviser has (among other things) conducted a thorough review of the proxy advisory firm's conflict procedures and the effectiveness of their implementation, as well as other means reasonably designed to ensure the integrity of the proxy voting process.

The Update also stated that the Division looks forward to receiving information from stakeholders at the roundtable, "including on the staff guidance in Staff Legal Bulletin No. 20 (June 30, 2014)" (available here).[2] Critically, Staff Legal Bulletin No. 20, citing *Egan-Jones* and *ISS*, stated that:

- In retaining proxy advisory firms, investment advisers could consider, among other things, "the robustness of its policies and procedures regarding its ability to . . . identify and address any conflicts of interest and any

[2] The official title of Staff Legal Bulletin No. 20 is "Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms."

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."

- 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, such as by requiring the proxy advisory firm to update the investment adviser of business changes the investment adviser considers relevant . . . or conflict policies and procedures."

In short, Staff Legal Bulletin No. 20 largely memorialized the no-action assurances provided in *Egan-Jones* and *ISS*, and it was not withdrawn by the Update. Therefore, the Division's withdrawal of *Egan-Jones* and *ISS* should not have any practical effect at this time on investment advisers that, relying on Staff Legal Bulletin No. 20, retain proxy advisory firms. As a substantive matter, the intended goal or benefit of withdrawing the two no-action letters remains unclear to us.

Nonetheless, while the Update does not immediately affect investment advisers that rely on independent proxy advisory firms, it is clear that the SEC intends to reexamine the regulatory regime for proxy advisory firms, including earlier SEC staff guidance regarding investment advisers' responsibilities in retaining proxy advisory firms. The November Roundtable is the first step of that reexamination. We will keep you apprised of material developments.

Chairman Clayton's Statement on SEC Staff Views

On the same day that the Division issued the Update, Chairman Clayton issued a public statement in which he reiterated the SEC's "longstanding position . . . that all staff statements are nonbinding and create no enforceable legal rights or obligations of the Commission or other parties." He also stated that:

> Several weeks ago, I instructed the directors of the Division of Enforcement and the Office of Compliance Inspections and Examinations to further emphasize this distinction to their staff. More generally, our divisions and offices, including but not limited to the Division of Corporation Finance, the Division of Investment Management and the Division of Trading and Markets, have been and will continue to review whether prior staff statements and staff documents should be modified, rescinded or supplemented in light of market or other developments.

Chairman Clayton's instructions may help to explain the Division's withdrawal of *Egan-Jones* and *ISS* in the Update. However, it is not clear whether Chairman Clayton had an additional motive that led him to issue his public statement weeks after his instruction to the SEC's divisions and offices. Interestingly, two days earlier, on September 11, 2018, in an Interagency Statement, the Federal Reserve Board, the Bureau of Consumer Financial Protection, the Federal Deposit Insurance Corporation, the National Credit Union Administration and the Office of the Comptroller of the Currency confirmed that "supervisory guidance does not have the force and effect of law" but, instead, "supervisory guidance outlines the agencies' supervisory expectations or priorities and articulates the agencies' general views regarding appropriate practices for a given subject area."

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