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SEC No-Action Letters on Investment Adviser Responsibilities in Voting Client Proxies and Use of Proxy Voting Firms

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As reported in our prior Client Alert, the Securities and Exchange Commission ("SEC") issued a statement in July announcing that it will host a roundtable regarding the U.S. proxy process. The roundtable, expected to be held in November, will give the SEC an opportunity to discuss with market participants various topics, including the hotly debated role of proxy voting firms. On September 13, 2018, the Division of Investment Management of the SEC (the "Staff") issued an Information Update stating that in developing the roundtable agenda, the Staff has been considering whether prior SEC guidance on the responsibilities of investment advisers with regard to voting client proxies and retaining proxy voting firms should be "modified, rescinded or supplemented." As part of this process, the Staff announced that it has revisited no-action letters it issued in 2004 to Egan-Jones Proxy Services ("*Egan-Jones*") and Institutional Shareholder Services ("*ISS*") that provided guidance regarding the reliance of investment advisers on the recommendations of proxy voting firms and determined to withdraw these letters effective immediately.

Background

Under Rule 206(4)-6 of the Investment Advisers Act of 1940 ("Rule 206(4)-6"), it is fraudulent and deceptive for investment advisers to exercise voting authority with respect to client securities unless, among other things, they adopt and implement written policies and procedures designed to ensure they vote the securities in the best interests of the clients, which procedures must include how the advisers address conflicts between them and their clients. In the adopting release for Rule 206(4)-6, the SEC stated that investment advisers have a fiduciary duty of care and loyalty to their clients with respect to proxy voting and emphasized that their policies and procedures must address how they resolve material conflicts of interest with clients before voting their proxies. The release goes on to state that an investment adviser could demonstrate that a vote of client securities was not a product of a conflict of interest if it voted, in accordance with a pre-determined policy, based upon the recommendations of an "independent" third party.

Egan-Jones and *ISS*

In *Egan-Jones*, the Staff provided guidance on the circumstances under which a third party, such as a proxy voting firm, may be considered "independent" under Rule 206(4)-6 and the steps an investment adviser should take to verify that the third party is in fact independent in order to cleanse the vote of any conflict. The Staff specifically addressed whether a proxy voting firm would be considered independent if it receives compensation from a company for providing advice on corporate governance issues. 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." However, the investment adviser must first ascertain whether the proxy voting firm has the "capacity and competency" to analyze proxy issues and can make recommendations in an impartial manner and in the best interests of the clients. In addition, the investment adviser should have procedures requiring the proxy voting firm to disclose "any relevant facts concerning the firm's relationship with an Issuer, such as the amount of the compensation that the firm has received or will receive from an Issuer."

In *ISS*, the Staff was specifically asked by Institutional Shareholder Services to agree with its view that an investment adviser may determine that a proxy voting firm can dispense voting recommendations in an impartial manner and in the best interests of the adviser's clients based on the procedures implemented by the firm to insulate the firm's voting recommendations from its relationships with companies rather than a review of the firm's relationship with individual companies on a case-by-case basis. The Staff agreed 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." Without taking a position regarding Institutional Shareholder Services' specific conflicts policies and procedures, the Staff stated that the steps taken by an adviser to fulfill this fiduciary duty to clients may include a "thorough review of the proxy voting firm's conflict procedures and the effectiveness of their implementation" and provided guidance on how investment advisers should examine and assess a proxy voting firm's conflict procedures.

Over the years, investment advisers have embraced a view that their reliance on the voting recommendations of proxy voting firms, in accordance with the guidance provided by the Staff in *Egan-Jones* and *ISS* and subsequently issued guidance, will insulate their client voting decisions from any conflicts of interest while allowing them to discharge their fiduciary duty of care and loyalty to their clients with respect to proxy voting.

Reactions and Implications

The withdrawal of the no-action letters has been reported by the media as a "win" for Republicans in Congress, the U.S. Chamber of Commerce and corporate lobbyists who believe proxy voting firms such as Institutional Shareholder Services and Glass Lewis have too much influence over corporate voting decisions, are not adequately held accountable for their recommendations and should be more heavily regulated.

However, it may be premature for critics of proxy voting firms to claim victory. SEC guidance issued in 2014 (Staff Legal Bulletin No. 20) regarding investment advisers' responsibilities in

voting client proxies and retaining proxy voting firms is still in effect. In response to the announcement, Steven Friedman, General Counsel of Institutional Shareholder Services, stated that “Corporate lobbyists have created a mythology surrounding these letters” and that their withdrawal “does not change the law, does not change the manner in which institutional investors are able to use proxy advisory firms, nor does it change the approach that institutions need to take in performing diligence on their proxy advisory firms.”

SEC Commissioner Robert Jackson was similarly critical of the announcement, stating that the questions suddenly raised by the Staff are “long-resolved” and that the laws governing the use of proxy voting firms have not changed. He also expressed concern that the SEC’s efforts to address “proxy plumbing” issues “will be stymied by misguided and controversial efforts to regulate proxy advisors.” According to Commissioner Jackson, “Regulating proxy advisors has long been a top priority for corporate lobbyists, who complain that advisors have too much power. There is, of course, little proof of that proposition, and the empirical work that’s been done in the area makes clear that that claim is vastly overstated.”

The impact the withdrawal of the no-action letters will have on shareholder activism is unclear. While large institutional investors are becoming less dependent on proxy voting firms, the influence wielded by the voting recommendations of these firms on the outcomes of contested elections is not insignificant. Investment advisers may now face uncertainty as to whether their continued reliance on these voting recommendations is contrary to their fiduciary duty of care and loyalty to their clients. A statement released by SEC Chairman Jay Clayton concurrently with the announcement that SEC staff guidance is non-binding and does not create enforceable legal rights or obligations may add to this uncertainty.

We will continue to monitor developments relating to the role of proxy voting firms and other “proxy plumbing” topics that will be reviewed during the SEC roundtable in November.