

SEC Withdraws No Action Letters on Proxy Advisory Firms

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In order to facilitate discussion on the role of proxy advisory firms at the upcoming Roundtable on the Proxy Process, which is scheduled for November 2018, the SEC staff has determined to withdraw two no action letters that provided comfort to investment advisers in relying on proxy advisory firm recommendations:

- In *Egan-Jones Proxy Services (May 27, 2004)*, the staff had confirmed that by voting based on the recommendations of an independent proxy advisory firm, an investment adviser could demonstrate the absence of a conflict of interest, and the fulfillment of fiduciary duties, provided that the investment adviser should first ascertain, among other things, whether the proxy advisory firm "(a) has the capacity and competency to adequately analyze proxy issues and (b) can make such recommendations in an impartial manner and in the best interests of the adviser's clients."
- In *Institutional Shareholder Services, Inc. (September 15, 2004)*, the staff had confirmed that investment advisers should evaluate the independence of proxy advisory firms based on the facts and circumstances, and that a number of ways include a thorough review of the firm's conflict procedures and the effectiveness of their implementation; case-by-case evaluation of the proxy advisory firm's relationship with issuers; or other means to ensure the integrity of the firm.

The withdrawal of these no action letters opens up for discussion, and creates uncertainty around, the circumstances in which investors may rely on proxy advisory firm recommendations and when a firm may be considered independent. The withdrawal is the latest development in the call for additional rulemaking around proxy advisory firms. Last December, the House passed the Corporate Governance Reform and Transparency Act of 2017, which would require proxy advisory firms to register with the SEC, disclose potential conflicts of interest and codes of ethics and publicize methodologies for formulating proxy recommendations. Then earlier this year, six members of the Senate Banking, Housing and Urban Affairs Committee sent letters to ISS and Glass Lewis requesting information regarding their eligibility for exemption from proxy rules, accuracy of reporting and potential conflicts of interest. The SEC staff has not to date signaled any changes to its guidance in Staff Legal Bulletin No.20, which among other topics, addresses considerations that an investment adviser may wish to take when it retains a

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proxy advisory firm, an investment adviser's ongoing duty to oversee a proxy advisory firm that it retains, and an investment adviser's duties to ascertain the material accuracy of the facts upon which a firm's recommendations are based. The impact of proxy advisory firms' recommendations on institutional investor voting is debated. A study by Choi, Fisch and Kahan (2010) found that proxy advisory firms have modest influence on voting outcomes, with an estimate that ISS recommendations shift 6%-10% of investor voting. Similarly, a survey by Rivel (2016) found that only 7% of institutional investors say that proxy advisory firms are the "most influential" contributors to their policies, and that generally established best practices are the primary source of their voting policies and decisions. A study by McCahery, Sautner, and Starks (2016) of 143 institutional investors concluded that they rely on the advice of proxy advisory firms to complement their decision making, rather than relying on them exclusively. However, investor voting decisions often are highly correlated with proxy advisory firm recommendations. According to a report published by the Manhattan Institute in May 2018, a sample of voting records for 713 institutional investors in 2017 showed that they are significantly likely to vote in accordance with proxy advisory firm recommendations across a broad spectrum of governance issues. For example, 95% of institutional investors vote in favor of a say on pay proposal when ISS recommends for it, while only 68% vote in favor when ISS is opposed. This correlation may suggest that proxy advisory firms have more influence than institutional investors appreciate or acknowledge. It may also indicate that governance practitioners form a community, whether they work for investors or proxy advisory firms, and that they develop and are influenced by a common set of trends and "best practices," resulting in investor voting policies that synch with ISS or Glass Lewis voting policies.