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SEC Takes Closer Look at Conflicts of Interest at Proxy Advisory Firms

The SEC has rescinded two No Action Letters relating to investment advisers' use of proxy advisory firms. Interested parties can weigh in prior to a November roundtable on the topic.

The SEC has ramped up its scrutiny of proxy advisory firms. Earlier this month, the agency made the unusual decision to rescind the findings from two No Action Letters that were issued by SEC staff in 2004. The No Action Letters allowed an investment adviser to vote proxies based on the advice of a proxy advisor, even though the proxy advisor may have conflicts of interest that could taint their research. The letters asserted that investment advisers could rely on proxy advisory firms' maintenance of policies and procedures to alleviate conflicts, without consideration of potential conflicts on a case-by-case basis.

At the same time the letters were revoked, the SEC noted that a previously announced roundtable about proxy advisors will be held in November 2018, offering stakeholders the opportunity to weigh in on the potential impact of the rescission of the letters.

The SEC last held a roundtable on the role of proxy advisors in April 2014. Following that meeting, the agency released Staff Legal Bulletin No. 20 (SLB 20), which strengthened investment advisers' responsibility to oversee their proxy advisors. However, SLB 20 also reaffirmed the No Action Letters by indicating that investment advisers should not examine potential proxy firm conflicts on a case-by-case basis, but instead on a business/policy level.

What Does This Mean?

The revocation of the letters implies that investment advisers must now review any votes cast on the advice of proxy advisory firms on a case-by-case basis. As a result, we think it's likely that investment advisers who currently rely on the advice of proxy advisory firms — either in whole or in part — will depend less on proxy advisors, bringing more of their proxy voting operations in-house. If this occurs, we could expect the influence of proxy advisory firms over corporate governance to wane over time, as investment advisers would be expected to adopt their own substantive corporate governance standards (to the extent they are not currently). This result becomes more likely if the SEC places proxy voting on its annual exam priorities list — a topic that is likely to be addressed at the upcoming roundtable.

There was mixed reaction in Washington following the news. A representative for the U.S. Chamber of Commerce lauded the move, as did House Financial Services Committee Chairman Jeb Hensarling, who stated, "The proxy advisory firm duopoly is in serious need of reform and SEC attention." However, Hensarling added that it is

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fortunate that the move is not legally binding because “regulation through enforcement and staff guidance hinders innovation and confidence in accessing our capital markets.”

For their part, ISS and Glass Lewis said the revocation of the letters won’t change the way they operate. “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,” Glass Lewis said in a statement.

We will continue to update our clients on this issue as we closely follow roundtable discussions in November. If you have any questions and want to speak with a member of our compensation consulting group, please write to consulting@radford.com.

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