SULLIVAN & CROMWELL LLP

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SEC Staff Withdraws Proxy Advisory Guidance Ahead of Fall Roundtable on Proxy Process

Withdrawal of Interpretive Letters Issued in 2004 to Institutional Shareholder Services, Inc. and Egan-Jones Proxy Services

Yesterday, the SEC's Division of Investment Management withdrew two interpretive letters issued in 2004 to Egan-Jones Proxy Services ("Egan-Jones") and Institutional Shareholder Services, Inc. ("ISS"). The letters described some of the guidelines under which an investment adviser could rely on a proxy advisory firm as an independent third party for purposes of making proxy voting recommendations. In particular, the letters focused on the steps an investment adviser should take to ensure that voting recommendations were made in an impartial manner and that the proxy advisory firm's potential conflicts of interest were addressed. The SEC staff stated that it was providing notice of withdrawal to facilitate discussion at the SEC's Roundtable on the Proxy Process, expected to be held in November 2018.

The Division of Investment Management, however, did not withdraw Staff Legal Bulletin No. 20, issued on June 30, 2014 ("SLB 20"), which also provides guidance about investment advisers' responsibility in voting client proxies and retaining proxy advisory firms.

Also yesterday, SEC Chairman Jay Clayton released a statement emphasizing that all SEC staff statements are non-binding and create no enforceable legal rights or obligations, as compared to rules and regulations promulgated by the Commission itself, which have the force and effect of law. The five federal banking regulators issued a similar statement on Tuesday. Chairman Clayton has also requested the SEC's divisions and entities to review prior staff statements and documents and consider whether they should be modified, rescinded or supplemented in light of market conditions.

SUMMARY OF THE WITHDRAWN LETTERS

The Egan-Jones and ISS letters described the circumstances under which a proxy advisory firm could be an independent third party for purposes of making proxy recommendations to an investment adviser even though the proxy advisory firm receives compensation from an issuer for providing advice on corporate governance issues. Rule 206(4)-6 under the Investment Advisers Act of 1940 (the "Proxy Rule") generally requires an investment adviser to adopt and implement written policies and procedures that are reasonably designed to ensure that its clients' proxies are voted in the clients' best interests and resolve direct and material conflicts of interest in voting proxies on behalf of its clients.

In the Egan-Jones letter, issued May 27, 2004, the Division of Investment Management staff indicated that "the mere fact that a proxy [advisory] 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." Therefore, the Division of Investment Management staff recommended that an investment adviser should ascertain whether the proxy advisory firm (1) has the capacity and competency to adequately analyze proxy issues and (2) can make recommendations impartially and in the best interest of the investment adviser's clients. The letter suggested that the investment adviser obtain information from the proxy voting firm on an ongoing basis, including any information about the proxy voting firm's relationship with any issuer with respect to which a recommendation was being made.

The second letter, issued to ISS, elaborated that an investment adviser also could satisfy its fiduciary duty under the Proxy Rule by thoroughly reviewing a proxy advisory firm's conflict procedures. The Division of Investment Management staff recommended that the investment adviser thoroughly understand the proxy voting firm's business, the nature of the conflict of interest and whether the conflict procedures negate the conflict and have been fully implemented.

The Egan-Jones and ISS letters have been cited by some as leading to an overreliance on recommendations made by proxy advisory firms without due consideration of the full scope of the conflicts they face. A provision directing the SEC to withdraw the Egan-Jones and ISS letters was included in the Corporate Governance Reform and Transparency Act of 2017 (H.R. 4015), which passed in the House late last year and is currently before the Senate.

IMPLICATIONS

At this time, we cannot draw definitive conclusions on the impact on investment adviser firms from the withdrawal of the Egan-Jones and ISS letters. Although those letters have been withdrawn, the SEC staff did not withdraw SLB 20, which was adopted after the Egan-Jones and ISS letters, cites the letters as authority and also provides guidance as to oversight of the conflicts proxy advisory firms face. It is clear, however, that proxy advisory firms' potential conflicts of interest is an area of renewed attention for the

SEC, and investment advisers may want to review their policies and procedures relating to oversight of these conflicts in advance of any further SEC action. We anticipate that the SEC will issue additional guidance or rulemaking in this area, although time will be limited given the desire to take into account the discussion at the roundtable and the coming proxy season.

Later yesterday afternoon, House Financial Services Committee Chairman Jeb Hensarling released a statement reacting to the withdrawal of the Egan-Jones and ISS letters, stating that "[t]he market power of proxy advisory firms demands greater accountability for these firms' actions and the information that they provide institutional investors." In addition, Representative Hensarling commended Chairman Clayton "for affirming the fact that guidance is legally non-binding and for emphasizing the guidance distinction to Commission staff."

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CONTACTS

New York

Francis J. Aquila	+1-212-558-4048	aquilaf@sullcrom.com
John E. Baumgardner Jr.	+1-212-558-3866	baumgardnerj@sullcrom.com
Robert E. Buckholz	+1-212-558-3876	buckholzr@sullcrom.com
Catherine M. Clarkin	+1-212-558-4175	clarkinc@sullcrom.com
Audra D. Cohen	+1-212-558-3275	cohena@sullcrom.com
H. Rodgin Cohen	+1-212-558-3534	cohenhr@sullcrom.com
Heather L. Coleman	+1-212-558-4600	colemanh@sullcrom.com
Donald R. Crawshaw	+1-212-558-4016	crawshawd@sullcrom.com
Robert W. Downes	+1-212-558-4312	downesr@sullcrom.com
Mitchell S. Eitel	+1-212-558-4960	eitelm@sullcrom.com
William G. Farrar	+1-212-558-4940	farrarw@sullcrom.com
Matthew M. Friestedt	+1-212-558-3370	friestedtm@sullcrom.com
Joseph B. Frumkin	+1-212-558-4101	frumkinj@sullcrom.com
Alexandra D. Korry	+1-212-558-4370	korrya@sullcrom.com
Stephen M. Kotran	+1-212-558-4963	kotrans@sullcrom.com
John P. Mead	+1-212-558-3764	meadj@sullcrom.com
Mark J. Menting	+1-212-558-4859	mentingm@sullcrom.com
Scott D. Miller	+1-212-558-3109	millersc@sullcrom.com
Robert W. Reeder III	+1-212-558-3755	reederr@sullcrom.com
Melissa Sawyer	+1-212-558-4243	sawyerm@sullcrom.com
Glen T. Schleyer	+1-212-558-7284	schleyerg@sullcrom.com
William D. Torchiana	+1-212-558-4056	torchianaw@sullcrom.com

Marc Trevino	+1-212-558-4239	trevinom@sullcrom.com
Krishna Veeraraghavan	+1-212-558-7931	veeraraghavank@sullcrom.com
Washington, D.C.		
Janet T. Geldzahler	+1-202-956-7515	geldzahlerj@sullcrom.com
Eric J. Kadel, Jr.	+1-202-956-7640	kadelej@sullcrom.com
Robert S. Risoleo	+1-202-956-7510	risoleor@sullcrom.com
Los Angeles		
Patrick S. Brown	+1-310-712-6603	brownp@sullcrom.com
Eric M. Krautheimer	+1-310-712-6678	krautheimere@sullcrom.com
Alison S. Ressler	+1-310-712-6630	resslera@sullcrom.com
Palo Alto		
Scott D. Miller	+1-650-461-5620	millersc@sullcrom.com
Sarah P. Payne	+1-650-461-5669	paynesa@sullcrom.com
John L. Savva	+1-650-461-5610	savvaj@sullcrom.com
London		
Nikolaos G. Andronikos	+44-20-7959-8470	andronikosn@sullcrom.com
Kathryn A. Campbell	+44-20-7959-8580	campbellk@sullcrom.com
John O'Connor	+44-20-7959-8515	oconnorj@sullcrom.com
Richard A. Pollack	+44-20-7959-8404	pollackr@sullcrom.com
Paris		
William D. Torchiana	+33-1-7304-5890	torchianaw@sullcrom.com
Frankfurt		
Krystian Czerniecki	+49-69-4272-5525	czernieckik@sullcrom.com
Melbourne		
Robert Chu	+61-3-9635-1506	chur@sullcrom.com
Sydney		
Waldo D. Jones Jr.	+61-2-8227-6702	jonesw@sullcrom.com
Tokyo		
Izumi Akai	+81-3-3213-6145	akaii@sullcrom.com
Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com
Hong Kong		
Garth W. Bray	+852-2826-8691	brayg@sullcrom.com
Michael G. DeSombre	+852-2826-8696	desombrem@sullcrom.com
Chun Wei	+852-2826-8666	weic@sullcrom.com