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Brian D. Stewart

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# DISCLOSURE OF THE IRRELEVANT? – IMPACT OF THE SEC’S FINAL PROXY VOTING DISCLOSURE RULES

*Brian D. Stewart\**

## INTRODUCTION

On several recent occasions, Harvey Pitt, then acting Chairman of the Securities and Exchange Commission (“SEC”), discussed the importance of proxy voting disclosure by investment advisers and mutual funds to ensure that such fiduciary obligations are performed in the best interests of their clients/shareholders.<sup>1</sup> On September 20, 2002, the SEC acted on Chairman Pitt’s concerns by introducing two proposals.<sup>2</sup> One

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\* Vice President/Attorney of the Legal Advisory Department and Anti-Money Laundering Officer of Merrill Lynch Investment Managers, L.P. B.A., 1992, College of William & Mary; J.D., 1999, Villanova University School of Law; formerly Associate in the Financial Services, Bankruptcy and Restructuring Departments of Reed Smith LLP. The author gratefully acknowledges the contribution of Fabio Battaglia, Assistant Vice President of Merrill Lynch Investment Managers, L.P., in the preparation of this article.

1. See Chairman Harvey L. Pitt, Speech by SEC Chairman: Remarks Before the Investment Company Institute, 2002 General Membership Meeting (May 24, 2002), available at <http://www.sec.gov/news/speech/spch562.htm> (last visited Sept 10, 2003); Letter from Harvey L. Pitt, SEC Chairman, to John P. M. Higgins, President, RAM Trust Services (Feb. 12, 2002) [hereinafter Pitt, Remarks], available at <http://www.thecorporatelibrary.com/special/pitt/pitt-higgins.pdf> (last visited Sept 10, 2003).

2. Disclosure of Proxy Voting Policies and Proxy Voting Records By Registered Management Investment Companies, Investment Company Act Release No. 25739, 17 C.F.R. §§ 239, 249, 274 (Sept. 20, 2002) [hereinafter Investment Company Proxy Release Proposal]; Proxy Voting By Investment Advisors, Investment Advisors Act Release No. 2059, 17 C.F.R. § 275 (Sept. 20, 2002) [hereinafter Investment Adviser Proxy Release Proposal].

proposal required open-end and closed-end investment companies to disclose their proxy voting policies and procedures as well as actual votes cast relating to portfolio securities they hold.<sup>3</sup> The other proposal required registered investment advisers (excluding smaller advisers<sup>4</sup>) that exercise voting authority over client proxies to adopt and implement proxy voting policies that meet certain fiduciary standards and to make certain disclosures to clients concerning the advisers' proxy voting record.<sup>5</sup> On January 23, 2003, after reviewing the most comment letters in recent SEC rule-making history, the SEC approved the two proposals, with minor modifications.<sup>6</sup> Unfortunately, while providing no practical benefit to investors in their investment decision-making process, these new rules effectively impose onerous and costly obligations on funds and their advisers.

In addition, as pointed out by one investment management company in a letter to the SEC,

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3. See generally Investment Company Proxy Release Proposal, *supra* note 2.

4. Investment advisers who are exempt from compliance with the SEC's investment adviser proxy voting disclosure rules include: (i) advisers who are registered with state securities authorities (i.e. advisers with less than \$25 million in total assets under management, 15 U.S.C. § 80b-3a); and (ii) advisers relying on Section 203(b) of the Investment Advisers Act of 1940 (i.e. advisers with 14 or fewer clients in any twelve-month period who do not hold themselves out generally to the public as investment advisers and who do not act as investment advisers to registered investment companies, 17 U.S.C. § 80b-3b). Investment Advisor Proxy Release Proposal, *supra* note 2, at 11.

5. Investment Advisor Proxy Release Proposal, *supra* note 2, at 17.

6. Disclosure of Proxy Voting Policies and Proxy Voting Records By Registered Management Investment Companies, Investment Company Act Release No. 25922, 17 C.F.R. §§ 239, 249, 270, 274 (Jan.31, 2003) [hereinafter the Investment Company Proxy Release]; Proxy Voting By Investment Advisors, Investment Advisors Act Release No. 2106, 17 C.F.R. §§ 275 (Jan. 31, 2003) [hereinafter Investment Advisor Proxy Release]; The SEC received over 8,000 comment letters relating to proxy voting disclosure. The majority of comment letters (sent by individual investors and past and present labor union employees) supported the SEC's proposals. By and large, financial services firms approved of disclosing proxy voting policies and procedures but vigorously opposed disclosure of actual votes. Investment Company Proxy Release, at 17.

[T]hese proposals are inconsistent with the concept of a mutual fund whereby individual investors pool their investments into a common vehicle and delegate investment management and administration to the fund's investment manager and corporate oversight to the fund's Board of Directors. The mutual fund vehicle was not intended to be a substitute for, or operate as, a separately managed account for each investor. In the latter case, the investor receives individual advice on a portfolio of securities and has beneficial ownership in each of those securities. As a result, the investor also has the right to direct the voting of the proxies of each company held in that portfolio.<sup>7</sup>

## I. BACKGROUND

Federal securities laws and regulations do not currently regulate how investment advisers vote proxies on behalf of clients. The SEC has previously considered the issue of proxy voting disclosure on two separate occasions (in 1971 and 1978), but ultimately withdrew the proposed rules.<sup>8</sup> However, as former Chairman Pitt noted,

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7. Letter from Brian T. Zino, President, J. & W. Seligman & Co. Incorporated to Jonathon G. Katz, Secretary, Securities and Exchange Commission (Dec. 6, 2002), *available at* <http://www.sec.gov/rules/proposed/s73602/btzino1.htm> (last visited Sept 10, 2003).

8. More recently, in July 1978, the SEC proposed Rule 14a-3(b)-11, under the Securities Exchange Act of 1934, which would have required certain institutions to disclose their proxy voting policies and procedures as well as certain information about actual proxy votes (although not every actual vote). Proposed Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Securities Exchange Act Release No. 14970 at II.B (July 18, 1978). The Commission subsequently withdrew the proposal, in part, in response to concerns that it would have applied to only some institutional investors and not others, such as banks and pension plans. *See* Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Securities Exchange Act Release No. 15385 (Dec. 6, 1978), 43 Fed. Reg. 58533 (Dec. 14, 1978).

[A]n investment adviser must exercise its responsibility to vote the shares of its clients in a manner that is consistent with the general antifraud provisions of the Investment Advisers Act of 1940, as well as its fiduciary duties under federal and state law to act in the best interests of its clients.<sup>9</sup>

Despite these fiduciary standards, former Chairman Pitt, together with certain labor and socially responsible investing organizations, pressed for explicit regulation of mutual fund and investment adviser proxy voting activities.<sup>10</sup> In the Investment Company Proxy Release, the SEC determined that the required disclosure of a fund's proxy voting policies and actual votes is intended to enable "shareholders to monitor their funds' involvement in the governance activities of portfolio companies" which, in turn, will encourage funds to become more engaged in

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9. Pitt, Remarks, *supra* note 1.

10. See, e.g., Rulemaking Petition letter from Amy Domini, Domini Social Investments, LLC to Harvey L. Pitt, Chairman, Securities and Exchange Commission (Nov. 27, 2001), available at <http://www.domini.com/common/pdf/SEC-Letter.pdf> (last visited Sept 10, 2003); Rulemaking Petition letter from C. Thomas Keegel, General Secretary-Treasurer, International Brotherhood of Teamsters to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Jan. 18, 2001), available at <http://www.funddemocracy.com/Teamsters%20Petition.htm> (last visited Sept. 10, 2003); Rulemaking Petition letter from Richard L. Trumka, American Federation of Labor and Congress of Industrial Organizations to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Dec. 20, 2000), available at <http://www.funddemocracy.com/AFL-CIO%20Petition.htm> (last visited Sept. 10, 2003); Rulemaking Petition letter from Richard L. Trumka, American Federation of Labor and Congress of Industrial Organizations to Harvey L. Pitt, Chairman, Securities and Exchange Commission, (July 30, 2002), available at <http://www.aflcio.org>.

In late November 2003, several months after the adoption of the Investment Company Proxy Release, and in the wake of recent mutual fund scandals involving market-timing and late-trading transactions, the U.S. House of Representatives passed the Mutual Funds Integrity and Fee Transparency Act of 2003 (the "MFIFTA"). If unchanged by the U.S. Senate, section 109 of MFIFTA would codify disclosure of actual proxy votes by registered investment companies by amending section 30 of the Investment Company Act of 1940. As of the date of this Article, the U.S. Senate has not acted on this matter and is not scheduled currently to do so until at least January 2004.

portfolio company governance activities.<sup>11</sup> The SEC's expectation is that increased shareholder activity with respect to mutual funds can have a potential "dramatic impact on shareholder value" and the value of capital market investors at large.<sup>12</sup> However, except for citing statistics which demonstrate the growth and widespread popularity of mutual funds<sup>13</sup>, the SEC failed to set forth specific facts supporting these assertions. Strikingly, the SEC did not proffer any evidence that funds and investment advisers vote in a manner that undermines the value of a portfolio company. On the contrary, fund advisers have every reason to vote in a manner that will enhance the value of portfolio companies. Few would argue that the compensation and success of an investment adviser typically depends on the adviser's ability to increase the value of its clients' holdings.

In addition, the SEC asserted that requiring disclosure of proxy voting activities could "illuminate potential conflicts of interest and discourage voting that is inconsistent with fund shareholders' best interests."<sup>14</sup> Again, the SEC failed to buttress this argument by citing examples of investment advisers improperly exercising their proxy voting power on behalf of client funds.

One probable explanation for the lack of evidence demonstrating the need for proxy voting disclosure regulation is that the proxy voting proposals were precipitated by extraneous factors that extend way beyond the above-cited reasons. Indeed, the Investment Company Proxy Release contains a specific acknowledgment by the SEC that the recent corporate scandals (such as Enron, WorldCom, Global Crossing, Adelphia, Tyco, etc.) underscore the need for an increased role by mutual funds in corporate governance.<sup>15</sup> The release not so subtly implied that if mutual funds were to play a more active role in "monitoring the stewardship" of the companies in which they invest, such

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11. See Investment Company Proxy Release, *supra* note 6, at 6.

12. *Id.*

13. *Id.* at 5-6.

14. *Id.* at 17.

15. See *id.* at 11-12.

scandals could be prevented.<sup>16</sup> The final rules place an inappropriate burden on mutual funds and advisers, neither of which has been associated in any way with the types of accounting scandals that have contributed to decreasing investor confidence and inundated the media. Most issues on which funds' portfolio companies seek shareholder approval are not the types of issues that would have prevented the corporate frauds of which shareholders, including mutual funds, legitimately complain. For example, as a general matter, shareholders are not asked to approve officer compensation packages or particular acquisitions or dispositions of subsidiaries or derivative securities.

## II. INVESTMENT COMPANY PROXY RELEASE

### A. Disclosure of Proxy Voting Policies

The final rule requires open-end and closed-end funds that invest in "voting securities" to include in their statements of additional information (SAI) a description of their proxy voting policies and procedures.<sup>17</sup> Annual and semi-annual reports of open-end and closed-end funds are required to disclose that the proxy voting policies are available electronically or upon request.<sup>18</sup> Additionally, closed-end funds are required to describe their proxy voting policies annually on newly adopted Form N-CSR.<sup>19</sup>

### B. Scope of Proxy Voting Disclosure

The final rules specifically require that the description of proxy voting policies include a discussion of policies used for votes that present "a conflict of interest between the interests of

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16. See *id.* at 12.

17. See *id.* at Form N-1A, Item 13(f) and Form N-2, Item 18.16.

18. See *id.* at Form N-1A, Item 22(b)(7), Item 22(c)(5); Form N-2, Item 23, Instructions 4.g and 5.e.

19. See *id.* at Form N-CSR, Item 7.

[f]und shareholders, on the one hand, and those of the [f]und's investment adviser, principal underwriter or any affiliated person of the [f]und, its investment adviser, or its principal underwriter on the other."<sup>20</sup> Further, if the fund elects to delegate its proxy voting obligations to its investment adviser (or another third party) and the adviser (or other third party) uses its own policies in making voting decisions on behalf of the fund, the final rules require disclosure of a description of the adviser's (or third party's) policies.<sup>21</sup>

Moreover, based on the Investment Company Proxy Release, the SEC expects that the description of the proxy voting policies include disclosure of:

i) The extent to which a fund delegates its proxy voting decisions to its investment adviser or another third party, or relies on recommendations of a third party;

ii) Policies and procedures relating to matters that may affect substantially the rights or privileges of the holders of securities to be voted; and

iii) Policies regarding the extent to which the proxy voting policies support or give weight to the views of management of a portfolio company.<sup>22</sup>

The SEC also expects the disclosure to cover the proxy voting policies' treatment of more specific corporate governance matters (e.g., changes to capital structure, stock option plans, corporate governance matters and social and corporate responsibility issues).<sup>23</sup>

### C. Proxy Voting Record Disclosure

Open-end and closed-end funds will be required to file their proxy voting records annually on newly adopted Form N-PX (for the twelve-month period ended June 30, by no later than August

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20. *Id.* at Form N-1A, Item 22(b)(7) , Item 22(c)(5); Form N-2, Item 23, Instructions 4.g and 5.e.

21. *See id.*

22. *Id.* at 21.

23. *Id.* at 22.



31 of each year).<sup>24</sup> The proxy voting record must include the following information as to each matter considered at a fund portfolio company's shareholder meeting: (a) issuer's name; (b) exchange ticker symbol of the portfolio security; (c) CUSIP number of the portfolio security; (d) shareholder meeting date; (e) brief identification of the matter voted on; (f) whether the matter was proposed by the issuer or by a security holder; (g) how the fund cast its vote (*e.g.*, for or against the proposal, or abstain); (h) whether the fund cast its vote for or against management; and (i) whether the fund cast its vote on the matter.<sup>25</sup> Disclosure related to whether a fund failed to vote a particular proxy may potentially expose a fund to liability as plaintiffs' lawyers use this information to support allegations of breaches of fiduciary duty by a fund and/or its adviser to shareholders. As a result, in order to minimize a fund's exposure to potential liability, funds and their advisers will most likely attempt to vote on every item with respect to all proxies.

Fortunately, the SEC did not incorporate into the Investment Company Proxy Release its proposal requiring shareholder reports to include detailed disclosure regarding any votes cast during the reporting period that were inconsistent with the fund's proxy voting policies.<sup>26</sup> Without a doubt, this disclosure would have increased a fund's exposure to claims alleging misleading prospectus disclosure (because the 'inconsistent' vote cast would be in violation of the proxy voting policies disclosed in the fund's SAI).

For obvious practical reasons, the proxy voting record disclosures represent the most onerous portion of the proposals. Although funds and their advisers record how they vote proxies for each of their portfolio securities, the comprehensive data for each proxy required to be assembled and maintained for the reporting period will require firms to expend significant amounts

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24. *See id.* at Form N-PX, General Instruction A.

25. *See id.* at Form N-PX, Item 1.

26. *See id.* at Form N-1A, Item 22(b)(8) and Item 22(c)(6); Form N-2, Item 23.4.h and Item 23.5.f.

of time, finances, technology and other resources.<sup>27</sup> In particular, third party proxy service providers already perform this task for several of the larger mutual fund complexes. Even if the investment adviser concludes that certain matters considered at a shareholder meeting are clearly insignificant as to both the fund's net asset value and the market value of the company this information will still have to be assembled, formatted and maintained for a period not less than five years.<sup>28</sup>

D. Proposed Modifications to the Investment Company Proxy Release

While few would balk at the reasonableness of a requirement to disclose proxy voting policies (and most fund complexes and investment advisers did not oppose this requirement<sup>29</sup>), mandating disclosure of a fund's proxy voting record appears to be far less valuable because of the irrelevancy of most, if not all, of the information to the investor.<sup>30</sup> Undoubtedly, these records are less relevant to investors than records of a fund's portfolio

27. Letter from Craig S. Tyle, General Counsel, Investment Company Institute to Nathan Knuffman, Desk Officer, Securities and Exchange Commission Office of Management and Budget, and Jonathan G. Katz, Secretary, Securities and Exchange Commission, at II.B. (Mar. 13, 2003), *available at*

[http://www.ici.org/statements/cmltr/03\\_sec\\_proxy\\_est\\_com.html#P26\\_10412](http://www.ici.org/statements/cmltr/03_sec_proxy_est_com.html#P26_10412) (last visited Sept. 10, 2003).

28. *Id.*

29. See Statement from Matthew P. Fink, President, Investment Company Institute, ICI Issues Statement on SEC Proxy Vote Disclosure Rule (Jan. 23, 2003) ("The mutual fund industry supports the SEC's rules requiring funds to: adopt proxy voting policies; adopt procedures that guide their voting in potential conflict situations; disclose their policies and procedures to the SEC and fund shareholders; and retain proxy voting records for SEC examiners"), *available at*

[http://www.ici.org/issues/dis/03\\_news\\_proxy\\_final.html](http://www.ici.org/issues/dis/03_news_proxy_final.html) (last visited Sept. 10, 2003).

30. See Letter from Craig S. Tyle, General Counsel, Investment Company Institute to Jonathon G. Katz, Secretary, Securities and Exchange Commission, at VI.A.1. (Dec. 6, 2002), *available at*

[http://www.ici.org/issues/dis/02\\_sec\\_proxy\\_com.html#P49\\_19884](http://www.ici.org/issues/dis/02_sec_proxy_com.html#P49_19884) (last visited Sept. 10, 2003).

securities transactions or of violations of codes of ethics (information as to both are not currently disclosed to investors).

### 1. Role of Directors

For more than twenty years the SEC has consistently looked to independent directors as arbiters of conflicts of interest. In prior rule-making proposals and speeches, the SEC has repeatedly stated that independent directors are the watchdogs for fund investors and their primary role is to police potential conflicts of interest.<sup>31</sup> Accordingly, the SEC has relied upon directors to protect funds and their shareholders from potential conflicts of interest in numerous areas, such as affiliated transactions.<sup>32</sup> Indeed, after the SEC adopted rules and rule amendments to enhance the independence and effectiveness of fund directors in early 2001,<sup>33</sup> the staff indicated its intention to rely even more heavily on directors to police possible conflicts of interest.<sup>34</sup> The SEC has not suggested nor does the investment

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31. See, e.g., Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24082, 17 C.F.R. § 239, 240, 270, 274 (Oct. 14, 1999) at 16 ("independent directors play an important role in representing and guarding the interests of investors. As has been stated many times, Congress intended these directors to be 'independent watchdogs' for investors and to 'supply an independent check on management.'") (citations omitted).

32. See Paul Roye, Director, Division of Investment Management, Securities and Exchange Commission, Speech by SEC Staff: Remarks Before the Securities Law Developments Conference Investment Company Institute Education Foundation (Dec. 9, 1999) ("Historically, the Commission's exemptive rules and orders, particularly those permitting transactions between a fund and its affiliates, have relied to a significant degree on the oversight provided by the fund's board, and especially its independent directors."), available at <http://www.sec.gov/news/speech/speecharchive/1999/spch336.htm> (last visited Sept. 10, 2003).

33. See Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24816, 17 C.F.R. §§ 239, 240, 270, 274 (Jan. 2, 2001).

34. See Paul Roye, Director, Division of Investment Management, Securities and Exchange Commission, Speech by SEC Staff: Mutual Fund and Investment Management Conference (March 19, 2001):

management community believe that proxy voting raises conflict of interest concerns that are greater than those in areas in which the SEC or the Investment Company Act of 1940 (the "1940 Act") already relies primarily on fund directors to police conflicts of interest.<sup>35</sup> Surprisingly, the SEC's two proxy voting disclosure proposals and the subsequent final rules are silent as to an enhanced role for directors in this regard.

Rather than mandating such expensive disclosure, which provides little utility to investors, it seems entirely consistent for the SEC to propose specific board oversight requirements which would provide a more direct, effective, and less costly means of dealing with potential conflicts of interest than the final rules. For example, the SEC could mandate that fund directors approve proxy voting policies and procedures. Instead of purchasing individual stocks and directly voting proxies, investors choose to invest in mutual funds for, among other things, diversification and receipt of professional management. Consistent with such professional management, shareholders would gain the benefit of the board of directors' direct oversight of a fund management's exercise of proxy votes consistent with approved guidelines.

Historically, boards of directors have monitored the portfolio management services provided by the investment advisers of their funds.<sup>36</sup> As part of these traditional oversight responsibilities, fund boards have the ability to both monitor effectively a fund's participation in corporate governance activities of portfolio companies and promote a fund's active role

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Our fund governance initiative was a recognition that the SEC continually faces the formidable challenge of applying the existing regulatory framework that helped ensure the integrity of the industry, while providing a regulatory scheme that can keep pace with the increased competition and the vast technological changes that have been ongoing in the securities markets. As we work to keep pace and modernize the regulatory structure to accommodate the increased competitiveness and globalization of the fund industry, we will need to increasingly rely on fund directors to vigorously perform their 'watchdog' duties on behalf of fund shareholders.

*Id.*, available at <http://www.sec.gov/news/speech/spch470js.htm> (last visited Sept. 10, 2003).

35. See Letter from Craig S. Tyle, *supra* note 30, at VI.A.2.b.

36. See Role of Independent Directors of Investment Companies, *supra* note 31.

in corporate governance generally. In contrast, while shareholders are best positioned to monitor their investments and make decisions with respect to investments in funds, shareholders are not in a position to provide effective investment adviser oversight on an operating basis. This is so even when shareholders know that conflicts exist (for example, when an investment adviser executes brokerage transactions through an affiliate). In addition, the proposed disclosure of a fund's proxy voting record will show only whether and how a fund voted on particular matters, no more or less. It will not show whether, or to what extent, a fund is involved in governance activities, and will not enable shareholders, as a body, to provide any guidance or oversight to an investment adviser.

## 2. Applicable Funds

The Investment Company Proxy Release applies to all funds that invest in "voting securities" and excludes funds that invest exclusively in non-voting securities, with no de minimis exception.<sup>37</sup> For example, if a fixed income fund invests a negligible portion of its assets in a preferred stock that has voting rights, it would be subject to the final rule and would be required to make this disclosure in each of its SAs and annual reports. But, it is highly unlikely that this information will be relevant to typical fixed income investors who have little or no expectation that their fund will acquire an equity investment or such other voting interest in a portfolio company. By way of further example, if the issuer of a tax-exempt security held by a municipal bond fund undergoes a restructuring or bankruptcy and subsequently issues a voting security, such detailed disclosure is required by the fund. The final rule should not apply in these contexts as investors are not concerned with this information when deciding which fund to acquire or redeem. The final rule should be modified to provide for a broader exception for any fund that invests 75 percent or more of its assets in non-voting securities, *e.g.*, taxable and tax-exempt funds.

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37. See Investment Company Proxy Release, *supra* note 6, at 18.

### 3. Broaden the Exposure

The SEC stated in the Investment Company Proxy rule proposal that "requiring greater transparency of proxy voting by funds may . . . benefit all investors and not just fund shareholders."<sup>38</sup> It is objectionable that the SEC desires to use mutual funds as the vehicle to effect changes for the benefit of "all investors." The 1940 Act requires funds to be managed in the best interests of their shareholders.<sup>39</sup> As noted elsewhere, the SEC has significantly underestimated the costs of compliance with its proxy voting disclosure rules.<sup>40</sup> It is unfair to single out fund shareholders and force them to bear the burdens of the SEC's broader objectives.<sup>41</sup>

If disclosure of proxy votes is a way to achieve the SEC's goal of getting institutional investors to be "more engaged"<sup>42</sup> then it would seem that the SEC should want all companies over which it has jurisdiction to disclose their votes.<sup>43</sup> But the SEC has not required this. Under the Investment Adviser Proxy Final Rule, advisers are only required to disclose their votes if they are acting

38. Investment Company Proxy Release Proposal, *supra* note 2, at 17.

39. See Investment Company Act of 1940, 15 U.S.C. § 80a-1(b)(2) (2003).

40. See Letter from Craig S. Tyle, *supra* note 30, at II.B.

41. For example, an investment manager of ERISA assets is obligated to keep records of its proxy votes exercised on behalf of the plan to enable the named fiduciary of the plan to review periodically the actions taken. The investment manager is not required to disclose its proxy votes to the plan beneficiaries or otherwise make this information public. According to the Department of Labor, under ERISA, a named fiduciary that delegates the management of ERISA assets to an investment manager must periodically monitor the activities of the investment manager, including decisions made and actions taken by the investment manager with regard to proxy voting decisions. In order for the named fiduciary to be able to carry out its monitoring responsibilities, the proxy voting records must enable the fiduciary to review not only the investment manager's voting procedure with respect to plan-owned stock but also to review the actions taken in individual proxy voting situations. See Department of Labor, Interpretive Bulletin relating to written statements of investment policy, including proxy voting policy or guidelines, 29 C.F.R. § 2509.94-2.

42. Investment Company Proxy Release, *supra* note 6, at 17.

43. See Letter from Craig S. Tyle, *supra* note 30, at VI.A.3.

as advisors to funds.<sup>44</sup> The SEC has made no proposals to require disclosure by advisers to pension funds, hedge funds or issuers.<sup>45</sup> Outside of the SEC's jurisdiction, bank trust departments, pension plans and insurance companies also have no obligation to disclose their votes.<sup>46</sup>

#### 4. Confidentiality

Over the last few years, confidential proxy voting has been one of the most important corporate governance initiatives supported by many investor groups.<sup>47</sup> Confidential voting is said to minimize conflicts of interest by reducing pressure from management to vote a particular way.<sup>48</sup> Now, some of these same activists and investor groups are among the most vocal supporters of the new rules requiring investment companies to disclose proxy votes.<sup>49</sup> The new rules make investment companies the only class of investors prohibited from voting confidentially.<sup>50</sup> This will have the effect of subjecting investment companies to the very pressures and conflicts that the rule proponents have been concerned about.<sup>51</sup> Management will be able to retaliate against funds by limiting access to company personnel.<sup>52</sup> Smaller funds will be even more susceptible to this pressure.<sup>53</sup> Rules meant to reduce conflicts of interest will have the opposite effect.

#### 5. Proxy Items Covered

In order to lessen the administrative burden of gathering and maintaining proxy voting records with respect to every item acted on by companies in a fund's portfolio, the final rules

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44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.* at VI.B.2.

48. *See id.*

49. *See id.*

50. *See id.*

51. *See id.*

52. *See id.*

53. *See id.*

should be amended to include a *de minimis* exception. For example, no records should be required to be disclosed or maintained when: (i) the matter to be voted on is routine and uncontested; (ii) the portfolio security makes up less than one percent of the fund's portfolio; (iii) the portfolio owns less than one percent of the security; (iv) or the fund owns an amount which would require it to comply with Section 13G of the Securities Exchange Act of 1934; and (v) the matter relates to a portfolio security in an index fund due to its passive investment characteristics. These types of exceptions would enable funds and their investment advisers to avoid spending valuable time and resources on disclosure that is necessarily irrelevant to the investment decision-making process. By reducing the vast quantity of the proxy voting record disclosure, shareholders could focus on the meaningful votes cast by the fund.

#### 6. Proxy Voting Record Disclosure and Format

Funds should maintain information regarding its proxy voting policies and votes as part of a fund's records, but funds should not be required to make voting records available to shareholders. Such records are open to the SEC's inspection and examination staff, and if there is any material deviation from the stated proxy voting policies involving conflicts of interest, the SEC has ample enforcement authority to deal with such occurrences.

Alternatively, proxy voting record disclosure could be improved by requiring only voting record summaries (as recommended by TIAA-CREF, among others), as opposed to item-specific disclosure. For example, the disclosure could display an aggregate number of: (i) abstention votes cast, (ii) votes cast in support of or against management, or (iii) votes cast as recommended by a third party voting service. In fact, in the rule proposals the SEC specifically requested comment on whether this type of formatted disclosure provides relevant and adequate information.<sup>54</sup> More data organized in a concise,

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54. See Investment Company Proxy Release Proposal, *supra* note 2, at 30-31.



statistically relevant way may help investors focus on management's overall voting performance.

### 7. Politicization Effect

If funds are required to publicly disclose their proxy votes, the voting process will become politicized and conflicts of interest will be created.<sup>55</sup> The agendas of many special interest groups will often be inconsistent with the goal of maximizing economic value for shareholders.<sup>56</sup> Pressure from these groups will inevitably distract fund management from this goal.<sup>57</sup> Threats from outside groups to withdraw their member's investments from a fund will create a conflict of interest for a fund manager who is obligated to vote in the overall interests of shareholders.<sup>58</sup> Again, the new SEC rules on investment company proxy voting will have an effect opposite to what its proponents intend.<sup>59</sup>

### 8. SAI Disclosure

In light of the proxy voting record disclosure required in annual and semi-annual reports, it is both duplicative and unnecessary for disclosure also to be included in SAIs and inconsistent with the SEC's "plain English"<sup>60</sup> policies established in 1998. SEC Chairman, Arthur Levitt stated in 1997,

As lawyers and regulators have loaded up the prospectus with more and more information, that document has strayed from its primary purpose of helping people decide whether to invest in a particular company or fund. Today, many prospectuses, by their very length and complexity, tend to obscure the essential information that would help people make investment decisions.

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55. See Letter from Craig S. Tyle, *supra* note 30, at VI.B.3.

56. See *id.*

57. See *id.*

58. *Id.*

59. *Id.*

60. Securities and Exchange Commission, Division of Corporate Finance, Updated Staff Legal Bulletin No. 7, Plain English Disclosure (Jun. 7, 1999).

One of the main targets of our Plain English initiative is the SEC itself. We recognize that we share responsibility for the state of the modern prospectus. Our passion for full disclosure has resulted in fact-bloated reports, and prospectuses that are more redundant than revealing. It turns out that more disclosure does not always mean better disclosure and that – especially in an environment that virtually inundates us with data – too much information can be as much a curse as too little.<sup>61</sup>

Through the “plain English” policies, the SEC promoted fund disclosure documents that effectively communicated essential information to investors, i.e. by focusing on information that will help investors decide whether to invest in a particular fund.<sup>62</sup> If the fund’s own shareholder meeting results are not required to be disclosed in SAIs (but are discussed in annual reports), the SEC should not require funds to devote greater attention in the SAI of meetings of underlying security investments.

The SEC noted in a footnote to its proxy disclosure rule proposals that it did not intend to use disclosure requirements as a means of regulating conduct of funds, because funds are already subject to extensive substantive regulation under the 1940 Act.<sup>63</sup> However, without adequate discussion, the Investment Company Proxy Release requires funds to specifically note whether or not their proxy vote was against management’s view.<sup>64</sup> Intentionally or not, this result effectively regulates a fund’s conduct.

As an alternative to the Final Rule to require SAIs to include a description of the proxy voting policies, the SEC could require a fund attach its comprehensive proxy voting policies as an exhibit to the fund’s registration statement (in Part C), thereby

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61. Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Speech to the American Savings Education Council, (July 23, 1997), available at <http://www.sec.gov/news/speech/speecharchive/1997/spch171.txt> (last visited Sept 10, 2003).

62. See Registration Form Used by Open-end Management Investment Companies, Investment Company Act Release No. 23064, 17 C.F.R. §§ 230, 232, 239, 240, 270, 274 (March 13, 1998).

63. See Investment Company Proxy Release, *supra* note 6.

64. See *id.* at Form N-PX, Item 1(i).

eliminating irrelevant SAI disclosure to the investment decision-making process, and at the same time, assuring that the proxy voting policies are available on file for SEC examination.

### III. INVESTMENT ADVISER PROXY RELEASE

Together with the Investment Company Proxy Release, the SEC approved the Investment Adviser Proxy Release, pursuant to which the SEC adopted new Rule 206(4)-6 under the Investment Advisers Act of 1940 (the Advisers Act).<sup>65</sup> Under Rule 206(4)-6, any exercise of voting authority by a registered investment adviser on behalf of a client will be deemed fraudulent, unless the adviser adopts and implements proxy voting policies, describes to clients and furnishes upon their request, its proxy voting policies, and discloses to clients how to obtain its proxy voting record.<sup>66</sup>

#### A. Proxy Voting Policies

Rule 206(4)-6 requires advisers to adopt and implement written proxy voting policies that are "reasonably designed to ensure that [the adviser] votes client securities in the best interests of clients."<sup>67</sup> Rule 206(4)-6 also requires that those policies be described to clients and furnished to the client upon request.<sup>68</sup> The Investment Adviser Proxy Release states that advisers may choose any means to make this disclosure, provided that it is clear, not "buried" in a longer document, and received by clients within 180 days after publication.<sup>69</sup> For example, the requirement to describe the adviser's policies could be satisfied by disclosure in the adviser's brochure furnished to clients.<sup>70</sup> However, neither proposed or final Rule 206(4)-6 provides adequate guidance as to the SEC's expected content of such "reasonably designed"

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65. See Investment Advisers Act of 1940, 15 U.S.C. § 80b (2003).

66. See Investment Adviser Proxy Release, *supra* note 6, at 8.

67. *Id.* at § 275.206(4)-6(a).

68. *Id.* at § 275.206(4)-6(b).

69. *Id.* at 23.

70. *Id.*

policies, other than to require that the procedures address circumstances in which the investment adviser resolves potential conflicts between the interests of the adviser vis-à-vis its client.<sup>71</sup> The Investment Adviser Proxy proposed and final Releases, however, provide additional direction by “suggesting” that the procedures identify personnel responsible for (a) monitoring corporate actions, (b) making voting decisions; and (c) ensuring that proxies are submitted in a timely manner.<sup>72</sup>

### B. Conflicts of Interest

Although the SEC has required investment advisers to draft procedures which describe how the adviser resolves material conflicts of interest when they arise between the adviser’s interests and those of its clients, the SEC did not provide additional guidance in this important area other than describing a few circumstances where an adviser may have a material conflict with its client.<sup>73</sup> Such non-exclusive circumstances include where an adviser: (i) manages or administers an employee benefit plan or pension plan for, or provides brokerage, underwriting, insurance or banking services to, a company whose management is soliciting proxies; (ii) has a relationship with a company that may be harmed if the adviser fails to vote in favor of management; (iii) has a business or personal relationship with participants in a proxy contest, corporate directors or candidates for directorships (including where an adviser’s officer has a spouse or other close relative who serves as a director or executive of a company)<sup>74</sup>; and (iv) receives 12b-1 fees from a mutual fund as a source of compensation and is solicited by the fund to vote client proxies approving an increase in fees deducted from the fund’s assets pursuant to the 12b-1 plan.<sup>75</sup> The SEC has

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71. *Id.* at § 275.206(4)-6(a).

72. *Id.* at 14 n.17.

73. *Id.* at 15.

74. *Id.* at 5.

75. *Id.* at 12 n.15.

stated that whether a conflict is "material" depends on the facts and circumstances in a specific situation.<sup>76</sup>

### C. Proxy Voting Authority

There is no debate when the advisory contract explicitly delegates proxy voting authority to the adviser. However, the SEC has stated that when an advisory contract is silent, proxy voting authority may be implied to the adviser if the contract contains an overall delegation of discretionary authority.<sup>77</sup> It is strongly suggested that advisers revise advisory contracts or make some other disclosure to clients if the adviser believes that the client did not intend to delegate proxy voting authority.<sup>78</sup> In situations where clients request the adviser's advice with respect to voting certain proxies, such advice may be given without triggering Rule 206(4)-6 provided the adviser does not have proxy voting authority.<sup>79</sup> However, an investment adviser who provides proxy voting advice is subject to the Investment Advisers Act's general anti-fraud provisions and must disclose any material conflicts of interest, if any, that it may have in connection with providing the advice.<sup>80</sup>

An adviser may not resolve conflicts of interest by abstaining from a vote. Coinciding with its general fiduciary obligations, advisers must exercise proxy voting authority in the best interests of the client. Thus, abstaining may indeed resolve the adviser's conflict of interest but it may not necessarily be in the client's best interest.<sup>81</sup> Although an investment adviser with proxy voting authority has certain fiduciary obligations, an adviser is not required to become a "shareholder activist," i.e. an adviser is not required to "actively engage in soliciting proxies or supporting or opposing matters before shareholders."<sup>82</sup> Practically speaking, an

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76. *Id.* at 5 n.5.

77. *Id.* at 9.

78. *Id.* at 10 n.10.

79. *Id.* at 9.

80. *Id.* at 10 n.11.

81. *Id.* at 17 n.23.

82. *Id.* at 14 n.19.

adviser will weigh the costs and benefits to its clients when determining whether to engage in shareholder activism.<sup>83</sup>

#### D. Proxy Voting Records

Rule 206(4)-6 requires investment advisers to disclose to clients how to obtain the adviser's proxy voting record with respect to securities held in the client's portfolio.<sup>84</sup> Similar to the disclosure of the adviser's proxy voting policies, the SEC suggested that this disclosure could be made in the adviser's brochure.<sup>85</sup> However, unlike the Investment Company Proxy Release, Rule 206(4)-6 does not prescribe the nature, format, or scope of the proxy voting record made available to clients. Without these detailed disclosure requirements, some clients may request, and put advisers in the unenviable position of producing voluminous proxy voting records. The SEC stated that it does not believe it is even necessary to prescribe a client's right to this information because a "client already has the right to information about how that client's securities were voted."<sup>86</sup>

#### E. Record-Keeping

Rule 204-2 under the Investment Advisers Act of 1940 has also been amended to require advisers to keep certain relevant proxy voting records,<sup>87</sup> including the following:

- i) the proxy voting policies and procedures required under Rule 206(4)-6;
- ii) a copy of each proxy statement that the investment adviser receives regarding client securities;
- iii) a record of each vote cast by the investment adviser on behalf of a client;

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83. *Id.*

84. *Id.* at § 275.206(4)-6(b).

85. *Id.* at 19 n.26.

86. *Id.* at 19 n.27. *See also* Restatement (Second) of Agency § 381.

87. *Id.* at § 275.204-2(c).

iv) a copy of any document created by the adviser that was material to making a decision how to vote proxies on behalf of a client or that memorializes the basis for that decision; and

v) a copy of each written client request for information on how the adviser voted proxies on behalf of the client, and a copy of any written response by the investment adviser to any (written or oral) client request for information on how the adviser voted proxies on behalf of the requesting client.<sup>88</sup>

This recordkeeping requirement in final form is somewhat less cumbersome than the proposed language because investment advisers can satisfy the requirement by relying on a third party to make and retain copies of proxy statements and records of actual votes.<sup>89</sup> Additionally, the Investment Adviser Proxy Release Proposal would have required investment advisers to keep records of all "communications received and internal documents" materially related to the proxy voting decision.<sup>90</sup> Several of the other items already are publicly available for SEC inspection.

#### F. Proposed Modifications to the Investment Adviser Proxy Release

##### 1. Proxy Voting Policies

First, the SEC should reformulate the ambiguous standard requiring adoption of proxy voting policies that are "reasonably designed to ensure that proxies are voted in the client's best interests."<sup>91</sup> Rather, the SEC should adopt the same approach it followed in the Investment Company Proxy Release and provide explicit guidance through Rule 206(4)-6 or otherwise in connection with those areas the SEC expects such policies to address.

Second, the SEC should clarify its requirement that advisers provide clients a "description"<sup>92</sup> of the adviser's proxy voting

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88. *Id.*

89. *Id.* at 21-22.

90. See Investment Adviser Proxy Release Proposal, *supra* note 2, at 25.

91. Investment Adviser Proxy Release, *supra* note 6, at § 275.206(4)-6(a).

92. *Id.* at § 275.206(4)-6(c).

policies. Specifically, the SEC could flesh out Rule 206(4)-6 by providing direction as to the nature, format, and scope of the description. Such direction would allow advisers to avoid burdensome and voluminous client disclosures by stating clearly that the disclosure should be limited to a brief description. Rule 206(4)-6 already entitles clients to be furnished with their adviser's complete proxy voting policies upon their request, to the extent any clients express an interest in obtaining additional information.<sup>93</sup>

### 2. Proxy Voting Record

The Investment Adviser Proxy Release requires advisers to provide proxy voting records to clients upon their request.<sup>94</sup> This requirement should be limited to instances where the assembly of the information is reasonable and feasible. Moreover, the proxy voting information sent to requesting clients should be limited to a format as noted above regarding the disclosure of actual proxy voting records required to be provided by open-end and closed-end funds.<sup>95</sup>

### 3. Securities of Privately Held Companies

The SEC's new rule 206(4)-6 and all related discussion is silent as to whether it is intended to apply to investment adviser's votes in connection with privately held securities. This matter particularly affects advisers who, on behalf of clients, make venture capital and private equity investments. Notwithstanding that an adviser who invests in privately held companies may be solicited to vote on a significantly larger number of items than is required for most publicly held companies, presumably Rule 206(4)-6 applies equally to privately held companies. Such clarification from the SEC, perhaps in a disclosure format of "Frequently Asked Questions" is appropriate.

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93. *Id.*

94. *Id.* at § 275.206(4)-6(b).

95. See discussion *supra* Part II.D.6.



*Notes & Observations*