PROXY VOTING BY MUTUAL FUNDS AND INVESTMENT ADVISERS

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PROXY VOTING ISSUES FOR ADVISERS

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I. SUMMARY

Traditionally, mutual funds and investment advisers have been viewed as largely "passive" investors when it comes to proxy voting. Funds and advisers typically have voted in favor of management's proxy recommendations and, if unhappy with management, sold the stock, rather than challenging management on corporate governance matters through proxies.

Recent corporate scandals have created renewed investor interest in corporate governance and have underscored the need for institutional investors, such as mutual funds, to focus on this issue. In response, the Securities and Exchange Commission ("SEC") in January 2003 adopted new rules and form amendments that are designed to increase the transparency of proxy voting by mutual funds.[1] The SEC also believes that proxy voting decisions can play an important role in maximizing the value of clients' investments. Greater transparency, the SEC believes, may encourage funds and advisers to become more involved in corporate governance matters affecting their portfolio companies, which may benefit all investors, including fund shareholders and other adviser clients.

In summary:

- **Mutual Funds** – Rule 30b1-4 under the Investment Company Act of 1940 ("ICA") requires, generally for year beginning on June 30, 2003, a fund to:
  - ❖ Disclose its proxy voting policies and procedures in its registration statement; and

[1] The new proxy rules for funds were adopted in Investment Co. Act Rel. No. 25922 (Jan. 31, 2003) ("Release 25922"). The new rules for advisers were adopted in Investment Advisers Act Rel. No. 2106 (Jan. 31, 2003) ("Release 2106"). For purposes of discussion, this outline focuses on mutual funds, i.e., open-end management investment companies. However, the new requirements also apply to closed-end funds and insurance company separate accounts organized as management investment companies that offer variable annuity contracts.

- ❖ File with the SEC and make available to its shareholders its actual proxy voting record annually.[2]

- **Advisers –** Rule 206(4)-6 under the Investment Advisers Act of 1940 ("IAA") requires, effective August 6, 2003, an adviser to:
  - ❖ Adopt proxy voting policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of clients; and
  - ❖ Disclose to clients information about those policies and procedures.[3]

II. PROXY VOTING REQUIREMENTS FOR MUTUAL FUNDS

A. Authority

According to the SEC, because a mutual fund beneficially owns its portfolio securities, the fund's board of directors, acting on the fund's behalf, has the right and obligation to vote proxies on the fund's portfolio securities. However, the SEC recognizes that, as a practical matter, the board typically delegates proxy voting responsibility to the fund's investment adviser as part of the adviser's general responsibility to manage the fund's assets, subject to the board's continuing oversight. A fund adviser is a fiduciary that owes the fund a duty of "utmost good faith, and full and fair disclosure."[4] The SEC believes that an adviser's fiduciary duty extends "to all functions undertaken on the fund's behalf, including the voting of proxies relating to the fund's portfolio securities."[5] Therefore, an adviser who votes proxies on behalf of a fund must do so consistent with the best interests of the fund and its shareholders.

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2 See Release 25922.

3 See Release 2106.

4 Release 25922, citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).

5 Release 25922.

B. New Requirements for Funds

Under the new rules, funds are required to disclose their proxy voting policies and procedures and their actual proxy voting record, as discussed below.

1. Disclose Proxy Voting Policies and Procedures

A fund must disclose in its Statement of Additional Information ("SAI") the policies and procedures that it uses in deciding how to vote proxies.[6] Where proxy voting responsibility is delegated to the adviser, the board can adopt the adviser's policies and procedures for the fund, rather than designing its own.

A fund's disclosure should discuss the procedures a fund uses when deciding how to vote proxies on issues presenting a conflict between the interests of fund shareholders and those of the fund's investment adviser, principal underwriter, or certain of their affiliates, if any. This disclosure also should include any policies or procedures of a fund's adviser or any third party proxy voting service the fund uses to vote proxies. The SAI also must disclose that the fund's actual proxy voting record for the most recent 12-month period ending on June 30 is available. These disclosures must be provided in fund filings made on or after July 1, 2003.[7]

A fund may satisfy this disclosure requirement by including a copy of the policies and procedures themselves. The SEC was unsympathetic to requests for relief by funds with multiple sub-advisers, and the rules require that if a fund has multiple sub-advisers, its disclosure must include a description of <u>each</u> sub-adviser's policies and procedures or the actual policies and procedures of <u>each</u> sub-adviser.

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6 This requirement applies to all funds except those that invest exclusively in non-voting securities.

2. Disclose Actual Proxy Voting Record – Form N-PX

The SEC believes that fund shareholders have a fundamental right to know how their funds vote proxies on their behalf. New Rule 30b1-4 under the ICA requires that, beginning in 2004, funds will be required to file annually new Form N-PX, which will contain the fund's complete proxy voting record. These filings must be made by August 31 for 12 month periods ending on June 30 of each year. Thus, funds will be required to make their first Form N-PX filing by August 31, 2004, for the 12 months ending June 30, 2004.

For each matter on which a fund is entitled to vote, the fund will be required to disclose the following nine matters:

- Name of the issuer of the security;
- Exchange ticker symbol;
- CUSIP number;[8]
- Shareholder meeting date;
- Brief identification of the matter voted upon;
- Whether the matter was proposed by the issuer or by a security holder;
- Whether the fund voted on the matter;
- How the fund voted; and
- Whether the fund voted with or against management.

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7 The SEC noted that funds may file pursuant to Rule 485(b) when making their first annual update complying with the new requirements (provided that the post-effective amendment otherwise meets the rule's conditions for immediate effectiveness).

8 A fund may omit this information for certain portfolio securities, particularly foreign securities, if it is not available through reasonably practicable means.

A fund's actual proxy voting record must be made available to shareholders. The fund can choose to do so upon request or on the fund's website (if applicable). If the actual record is requested, the fund must send the most recently filed Form N-PX within three business days of receipt of the request, by first class mail or other means designed to ensure equally prompt delivery. If a fund chooses to make this information available on its website, it must do so as soon as reasonably practicable after filing the report with the SEC, which means the same day, absent unforeseen circumstances. In addition, the actual record will be available on the SEC's website.

Finally, the SEC did not adopt the proposed requirement that a fund disclose in its annual and semiannual report proxy actions that were inconsistent with the fund's policies and procedures, in response to comments that this would be burdensome and expensive and not meaningful to investors.

3. Disclose How to Obtain Proxy Voting Information

A fund must disclose in its SAI and its shareholder reports that fund's actual proxy voting record is available in the following manners:

- **Toll Free Number -** Without charge, upon request, by calling a specified toll free (or collect) telephone number. If the fund (or a financial intermediary through which fund shares are purchased or sold) receives a request, the fund (or financial intermediary) must send the description within three business days of receipt of the request, by first class mail or other means designed to ensure equally prompt delivery; or

- **Website** - On the fund's website,[9] if applicable, or both. A fund must make this information available on its website as soon as reasonably practicable after filing the report with the SEC, which means the same day, absent unforeseen

[9] A fund is not required to make available on or through its website any information from reports on Form N-PX that precede the most recently filed version.

circumstances. A fund can satisfy this requirement by hyperlinking to a proxy voting service's site or to the SEC's EDGAR site.

In addition, the fund's actual proxy voting record will be available on the SEC's website at http://www.sec.gov.

A fund's shareholder reports also must disclose that a description of the fund's proxy voting procedures is available in the same manners. The shareholder report requirement is effective for all shareholder reports sent on or after August 31, 2004.[10]

III. PROXY VOTING REQUIREMENTS FOR ADVISERS

A. Authority

The SEC noted that the Federal securities laws do not specifically address how an adviser must exercise its proxy voting authority for clients. But as a fiduciary, an adviser owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting:[11]

- **Duty of Care** – Requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies (though an adviser is not required to vote every proxy)
- **Duty of Loyalty** – Requires an adviser to cast proxy votes in a manner consistent with the best interests of clients and not to subrogate clients' interests to its own.

B. New Requirements for Advisers

New Rule 206(4)-6 under the IAA requires advisers to adopt proxy voting policies and procedures, to disclose to clients information about those policies and procedures, and to disclose

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[10] A fund can satisfy its obligation to provide a description of its policies and procedures by providing a copy of the policies and procedures themselves.

[11] Release 2106, citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).

to clients how they may obtain information on how the adviser has voted their proxies.[12] In addition, amendments to Rule 204-2 under the IAA require advisers to maintain certain records relating to proxy voting, all as discussed below.

1. Adopt Proxy Voting Policies and Procedures

Advisers that exercise voting authority with respect to client securities must adopt proxy voting policies and procedures.[13] They must be in writing and must be reasonably designed to ensure that the adviser votes proxies in the best interests of clients.[14] The SEC declined to adopt specific policies and procedures for advisers, noting that a "one size fits all" approach to policies and procedures would be unworkable. The SEC intended to leave to advisers the flexibility to craft policies and procedures that are suitable to their businesses (and the nature of the conflicts they face).[15] The SEC also suggested that effective procedures should, at a minimum, identify personnel responsible for monitoring corporate actions, those responsible for making voting decisions, and those responsible for ensuring that proxies are submitted in a timely manner.

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12 The rule applies to all investment advisers registered with the SEC that exercise proxy voting authority over client securities. In addition, the rule applies when the advisory contract is silent but the adviser's voting authority is implied by an overall delegation of discretionary authority. If an adviser believes that application of the rule to it would be inappropriate, the SEC suggested that they revise their advisory contracts (or make other disclosure to clients) to make explicit their lack of responsibility for voting proxies. See Release 2106 at n. 10.

13 The rule does not prevent an adviser from having different proxy voting policies and procedures for different clients.

An adviser must provide clients with a concise summary of its proxy voting policies and procedures and, upon request, provide clients with a copy of those policies and procedures. An adviser also must disclose to clients how they can obtain information from the adviser on how their securities were voted.

14 An adviser can seek assistance from a proxy voting service or can delegate responsibility for voting proxies to a committee, though such delegation does not alter the adviser's fiduciary duty.

15 An adviser would be free to develop different policies for different clients. For example, an adviser may maintain one set of policies for Taft-Hartley clients and another for institutional accounts, including mutual funds.

The SEC believes that an adviser needs to have procedures in place that are designed to monitor corporate actions and vote client proxies, but the SEC emphasized that an adviser is not required to vote every proxy. While an adviser may not ignore or neglect its proxy voting obligations, the SEC acknowledged that there may be times when refraining from voting is in the client's best interests, such as when the adviser determines that the cost of voting exceeds the expected benefit to clients (e.g., casting a vote on a foreign security may require hiring a translator or traveling to the foreign country to vote in person).[16]

2. Resolve Material Conflicts of Interest

An adviser's proxy voting policies and procedures should be designed to enable the adviser to resolve material conflicts of interest with its clients before voting their proxies. They should describe how the adviser addresses material conflicts between its interests and those of its clients with respect to proxy voting. The SEC noted that some advisers, including many smaller firms, are unlikely to face material conflicts of interest, and their procedures could be very simple.

The SEC noted that an adviser can satisfy the new rule by disclosing a conflict to clients and obtaining their consent before voting. Absent such disclosure and consent, the SEC believes that an adviser must take other steps to ensure that the proxy voting decision is based on the best interests of clients and is not the product of the conflict. In addition, the SEC specifically noted that the adviser must be able to demonstrate that the steps it took resulted in a vote based on its clients' best interests.

The SEC has emphasized that proxy voting policies and procedures need to address material conflicts between the interests of shareholders and the interests of the investment adviser/sub-

[16] The SEC also pointed out that "[a]n adviser's fiduciary duties do not *necessarily* require the (continued).

adviser or its affiliates. If an adviser has a material conflict of interest, it either must fully disclose the conflict to its clients before voting the client's proxies or must have adopted policies and procedures that are designed to ensure that client proxies are properly voted, that material conflicts are avoided, and fiduciary obligations are otherwise fulfilled. Given the practical difficulty of making full disclosure of all potential conflicts, we expect that most advisers will instead seek to address conflicts by adopting policies and procedures to cover them.

Advisers may wish to consider the following three-step process to address conflicts of interest: (a) identify all potential conflicts of interest; (b) determine which conflicts, if any, are material; and (c) establish procedures to ensure that the adviser's proxy voting decisions are based on the best interests of clients and are not the product of the conflict (depending on the size and structure of the adviser (and its affiliates), it may be more efficient to combine the first and second steps).

a) Identify Conflicts of Interest

The first step for an adviser is to identify all potential conflicts between its interests and those of fund shareholders. This first step requires the adviser to evaluate the nature of its material business relationships to assess which, if any, might place the interests of the adviser in conflict with those of its clients, as well as those of its affiliates. The SEC has acknowledged that, depending on the nature of an adviser's business and the conflicts of interest which may arise, procedures to address conflicts may be simple or complex.

Potential conflicts of interest are most likely to fall within the following three general categories:

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adviser to become a 'shareholder activist' . . . ." See Release 25922, supra (emphasis added).

- **Business Relationships** – The adviser (or an affiliate) has a substantial business relationship with the company or a proponent of a proxy proposal relating to the company (e.g., an employee group) such that failure to vote in favor of management (or the proponent) could harm the adviser's relationship with the company (or proponent). For example, the adviser manages money for a company or an employee group, manages pension assets, administers employee benefit plans, leases office space from the company, or provides brokerage, underwriting, insurance, banking or consulting services to the company. Or, the adviser has an investment banking affiliate that does work for the company, or the adviser's affiliate otherwise has a significant relationship with the company such that it might have an incentive to encourage the adviser to vote in favor of management. Clearly, business relationships are the most significant source of potential conflicts for an adviser;

- **Personal Relationships** – The adviser (or an affiliate) has a personal relationship with other proponents of proxy proposals, participants in proxy contests, corporate directors, or candidates for directorships; and

- **Familial Relationships** – The adviser (or an affiliate) may have a familial relationship relating to a company (e.g., a spouse or other relative who serves as a director of a public company).

b) Determine Which Conflicts are Material

Having identified all situations relating to proxy voting where an adviser's interests may be in conflict with those of fund shareholders, the next step is for the adviser to determine whether any of these conflicts is "material." The SEC has not provided any specific guidance in the new rules as to how an adviser should analyze or determine whether a conflict is "material" for purposes of proxy voting, and therefore advisers should look to the traditional materiality analysis under the federal securities laws, i.e., that a "material" matter is one that is reasonably likely to be viewed as important by the average shareholder.

Whether a conflict is material in any case will, of course, depend on the facts and circumstances. However, in considering the materiality of a conflict, we suggest that an adviser take a two-step approach:

1. **Financial Based Materiality** - An adviser may wish to address the materiality of most conflicts by setting a threshold dollar amount which triggers further review. For example, an adviser's procedures could provide that a conflict will be presumed to be non-material unless it involves at least 1% of the adviser's annual revenue or a specific dollar amount (e.g., $1,000,000). The dollar amounts should be based on the adviser's circumstances, and an adviser may use different dollar amounts depending on the proximity of the conflict (e.g., a lower number if the conflict arises through an affiliate rather than directly with the adviser). For conflicts of interest involving affiliates, an adviser also may wish to institute information blocking procedures (similar to those used for material non-public information) that would be designed to insulate those responsible for making proxy voting decisions from influences from other parts of the organization.

2. **Non-Financial Based Materiality** - Second, an adviser needs to establish procedures designed to identify non-financial based potential conflicts. For example, in the case of potential personal or familial conflicts, an adviser should identify those employees most likely to be affected by them (e.g., portfolio managers, members of any proxy committee, and possible senior management) and institute a procedure to obtain regular information from covered persons about potential conflicts of interest.

c) Establish Procedures to Address Material Conflicts

In instances where a material conflict exists, the adviser can address the conflict by a number of means:

- **Use Predetermined Voting Policy** - An adviser could vote according to a pre-determined voting policy. Such a policy must be designed to further the interests of the clients rather than the adviser. It should be sufficiently specific and allow for little discretion on the part of the adviser (i.e., the proposal at issue is not one which the policy states the adviser will consider on a case-by-case basis). However, the SEC noted that an adviser could not, consistent with its fiduciary duty, adopt a pre-determined policy to vote in favor of the management of companies with which it does business.

- **Use a Proxy Voting Service for All Proxies** - A second approach to resolving the conflict would be to vote all proxies according to the policies of an independent third-party, such as a proxy voting service. For advisers who are part of a large financial services firm, this option may provide the only cost efficient method for addressing conflicts of interest.

- **Use a Proxy Voting Service for Specific Proposals** - A third approach would be to use a proxy voting service (or other independent third party) to recommend how proxies that involve a conflict should be voted.

- **Seek Board Guidance** – Finally, an adviser could seek guidance from the fund's board of directors on matters involving a conflict. A conflict could be addressed by having the board vote all proxies involving a conflict or by having the board ratify proxy voting decisions by the adviser. The SEC believes that a fund adviser would satisfy its fiduciary obligations under the IAA if, before voting proxies, it

fully discloses its conflict to the fund board or a committee of the board (e.g., the independent directors) and obtains the board's or committee's consent or direction to vote proxies.[17]

3. Maintain Records

An adviser must retain five types of records relating to proxy voting:

- Proxy voting policies and procedures;
- Proxy statements received for client securities;[18]
- Records of votes cast on behalf of clients;[19]
- Records of client requests for proxy voting information; and
- Any documents prepared by the adviser that were material to making a proxy voting decision or that memorialized the basis for the decision.

[17] The SEC believes that an adviser cannot satisfy its fiduciary responsibilities to clients by merely refraining from voting proxies, as such proxies would not be voted in the best interests of clients.

[18] An adviser may rely on proxy statements filed on EDGAR instead of keeping copies or, if applicable, rely on statements maintained by a proxy voting service provided that the adviser has obtained an undertaking from the service that it will provide a copy of the statements promptly upon request.

[19] An adviser may rely on records of proxy votes maintained by a proxy voting service (subject to the undertaking described in the prior footnote).