

[My Account](#)

Viewpoints

Fund proxy voting: What's the board's role?

December 21, 2020

By Sara P. Crovitz, Stradley Ronon



In the last few years, the financial press has increasingly focused on how institutional investors, particularly mutual funds, impact the public companies in which they invest.[1] Whether controversial director elections, shareholder proposals related to ESG themes, or the threat of common ownership in particular industries, articles point to the power of asset managers to influence behavior at public companies. Regulators, too, have focused on whether asset managers vote proxies consistent with their fiduciary duties, and regulators have also adjusted the contours of these fiduciary duties. Regulators have been particularly sensitive to asset manager use of proxy advisory firms to assist with voting fund shares due to public company criticism of proxy advisory firms.

In the last few years, the Securities and Exchange Commission has held roundtables, issued staff and Commission guidance, and recently proposed rules relating to proxy advisory firms. The Department of Labor is expected to issue additional guidance soon. In light of this spotlight on fund proxy voting, this article summarizes the current regulation and highlights some practical considerations for fund directors.

Current regulation

Fund directors have a role. Fund proxy voting requires significant resources. During the 2017 proxy season, for example, funds cast more than 7.6 million votes, and the average mutual fund voted on 1,504 separate proxy proposals.[2]

Fund directors have the legal right to vote proxies on behalf of the funds. Many (but not all) boards delegate the full spectrum of functions related to proxy voting to the fund's adviser, and sometimes to sub-advisers, in recognition that voting is an integral part of the investment management process. The board, however, continues to have oversight responsibility.

Advisers are fiduciaries. As a fiduciary,[3] a fund adviser or sub-adviser that has been delegated authority to vote proxies on behalf of a fund must vote such proxies in the best interest of the fund. Moreover, an adviser that exercises voting authority must adopt policies and procedures that describe how the adviser addresses any material conflicts with regard to voting.[4]

SEC guidance may call for additional resources. In August 2019, the SEC issued guidance clarifying how an investment adviser's fiduciary duty relates to its proxy voting on behalf of clients, including funds, particularly if the investment adviser retains a proxy advisory firm.[5] In particular, the SEC guidance discusses, among other things:

- How an investment adviser and its client may agree upon the scope of the investment adviser's authority and responsibilities to vote proxies;
- What steps an investment adviser could take to demonstrate it is making voting determinations in a client's best interest and in accordance with the investment adviser's proxy voting policies and procedures;
- Whether an investment adviser must exercise every opportunity to vote a proxy for a client;
- Considerations that an investment adviser should take into account if it retains a proxy advisory firm to assist it in discharging its proxy voting duties;
- Steps for an investment adviser to consider if it becomes aware of potential factual errors, potential incompleteness, or potential methodological weaknesses in the proxy advisory firm's analysis that may materially affect one or more of the investment adviser's voting determinations; and
- How an investment adviser could evaluate the services of a proxy advisory firm.

In general, while the SEC guidance appears to provide advisers certain increased flexibility,[6] it also includes prescriptive detail regarding what an adviser must do to fulfill its duty of care with regard to proxy voting, particularly when using a proxy advisory firm for administrative purposes (i.e., to assist with the process of voting) or for research or recommendations with regard to how to vote a proxy. For example, the guidance indicates that advisers should conduct a "reasonable investigation" of "potential factual errors, potential incompleteness or potential methodological weaknesses" that may affect a voting determination, including the proxy advisory firm's process to access the issuer's views about the firm's voting recommendations "in a timely and efficient manner." Thus, the SEC guidance may require

additional advisory resources to be spent on proxy voting and may increase compliance risk. The two main proxy advisory firms, in response to the SEC guidance, issued detailed information that the proxy advisory firms believe advisers could rely on to continue to use their services.[7]

SEC proposal regarding proxy advisory firms

In November 2019, the SEC proposed a rule that would (1) clarify that a proxy advisory firm's voting advice constitutes a solicitation, (2) require additional conflict disclosure by proxy advisory firms in voting advice, (3) provide public companies up to two opportunities to review the proxy advice before it is delivered to clients, (4) provide public companies the opportunity to require in the advice that is delivered to clients a hyperlink to the public company's written statement on that advice, and (5) enumerate specific examples of what may constitute misleading statements by proxy advisory firms.[8] If adopted, the proposed amendments would increase costs for proxy advisory firms and may shorten the amount of time fund advisers and sub-advisers have to review proxy advice prior to voting for funds and other clients. Moreover, if adopted as proposed, a fund adviser's determination to vote in accordance with a proxy advisory firm recommendation when such recommendation is subject to a public company written statement could be subject to increased scrutiny.[9]

Practical considerations: Directors are responsible for proxy voting on behalf of the fund. Fund boards rarely retain authority to vote proxies and frequently delegate this function to advisers.[10] Specifically, most boards delegate to the adviser (or in some cases, the adviser and sub-advisers) both the administrative function and substantive decision-making with regard to proxy voting. Even where a board delegates the full spectrum of functions to an adviser, it must understand and have confidence in the processes put in place by the adviser.[11] The board also must approve and annually review the adequacy of a fund's and adviser's policies and procedures related to proxy voting as part of the fund's compliance program. The board also must understand the parameters of and be comfortable with any delegation to sub-advisers or use of proxy advisory firms.

Some considerations for boards that delegate proxy voting functions to advisers (or sub-advisers):

- Understand what resources the adviser employs to support proxy voting. Depending on factors such as the size of the adviser and strategy of the fund, the level of resources may vary.
 - For example, some larger asset managers have a team of employees dedicated to engagement with public companies and proxy voting. Funds that focus on an ESG strategy may need to devote more resources to proxy voting. Smaller advisers and funds whose investment strategy is less equity-focused may rely on one or two advisory employees to monitor that votes are cast as intended according to pre-determined guidelines.
- Understand which functions, if any, are carried out by external service providers, such as proxy advisory firms. For example, an adviser may engage a proxy advisory firm to process votes, assist

with regulatory filings, provide research, and/or provide voting recommendations or voting guidelines.

- For some funds that use a manager-of-managers model or allocate sleeves to different sub-advisers, sub-advisers may be delegated authority to vote as part of the investment management process. Directors in such instances should (a) understand which functions are managed by the adviser and which by sub-advisers, (b) understand the resources employed by any sub-adviser and how it uses any proxy advisory firm, and (c) understand how the adviser assesses the performance of the sub-adviser in this respect.
- Understand the process the adviser uses to determine when it has a conflict, how the adviser's process addresses conflicts (e.g., use of committees, firewalls or third-party service providers) and how the adviser will disclose conflicts to the board or otherwise provide appropriate reporting to the board (e.g. exceptions reports relating to votes cast in error or outside of guidelines).
- Periodically review fund and adviser proxy voting policies and procedures. In light of recent SEC guidance, directors may wish to consider whether such policies and procedures should address circumstances where the adviser may not cast votes. In addition, such policies and procedures should address adviser review and oversight of any proxy advisory firms that provide services related to the fund's voting.

Sara P. Crovitz is a partner with Stradley Ronon. She provides counsel on all aspects of investment company and investment adviser regulation and is part of a team serving as counsel to independent trustees of a number of business development companies and closed-end funds. Prior to joining Stradley Ronon, Crovitz was the deputy chief counsel and associate director in the Division of Investment Management, having served at the SEC for more than 20 years.

[1] The focus on funds is partly due to the fact that funds are the only institutional investors required to publicly disclose how they vote. In particular, a fund must annually disclose on Form N-PX a record of how it voted proxies relating to portfolio securities.

[2] Funds and Proxy Voting: Funds Vote Thoughtfully and Independently, ICI Viewpoints (Nov. 7, 2018). Of the over 24,000 proposals by the largest 3000 public companies, 98% were management proposals and 2% were shareholder proposals. Funds voted 94% with management proposals and overall 34.6% in favor of shareholder proposals (funds voted 49% in favor of shareholder rights proposals, 36% on environmental proposals and 12% on social proposals).

[3] In adopting rule 206(4)-6 under the Advisers Act, the SEC indicated that the duty of care requires an adviser with proxy voting authority to vote proxies, thus making proxy voting one of few such explicitly recognized duties of care (along with best execution and suitability). Proxy Voting by Investment Advisers, Advisers Act Release No. 2106 (Jan. 31, 2003) (the "Adviser Rule Release").

[4] In the Adviser Rule Release, the SEC stated that if an investment adviser had a conflict with regard to voting, one way to address that conflict would be to have a third party assist in determining how to vote: “[A]n adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendation of an independent third party.”

[5] Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Securities and Exchange Commission, Investment Advisers Act Rel. No. 5325 (Aug. 21, 2019).

[6] For example, the SEC guidance indicates that an adviser and its client could agree to limit which proxies the adviser should vote if that is in the best interest of the client. In addition, the SEC guidance clarifies that a fund and its adviser could agree not to restrict the use of securities for lending to preserve the right to vote in circumstances where such voting would impose opportunity costs on the fund.

[7] ISS FAQs Regarding Recent Guidance from the U.S. Securities and Exchange Commission Regarding Proxy Voting Responsibilities of Investment Advisers (Oct. 2019), and Glass Lewis Due Diligence: A Resource for Investment Advisers on Glass Lewis Policies and Procedures (Oct. 2019).

[8] Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice, Release No. 38-87457 (Nov. 5, 2019).

[9] As already noted, the SEC guidance indicates that advisers should conduct a reasonable investigation into potential factual errors. The rule proposal goes so far as to ask in the request for comments whether proxy advisory firms should be required to disable the automatic submission of votes unless a client clicks on the hyperlink and/or accesses the public company’s response or otherwise confirms any pre-populated voting choices before the proxy advisory firm submits the votes to be counted.

[10] If a board retains authority to make substantive decisions with regard to proxy votes, as fiduciaries to the fund, the directors must vote in the best interest of the fund. While rule 206(4)-6 under the Advisers Act and SEC guidance related to that rule do not specifically apply to directors, it would be prudent to consider the contours of directors’ fiduciary duty in light of that rule and guidance.

[11] A board’s oversight is subject to its general fiduciary duty, and the protections of the “business judgment” rule should apply so long as the board is fully informed and does not put its interests above those of the fund and its shareholders.

Most Read

A Seat at the Table

Under new chair, JPMorgan Funds to review board practices

The JPMorgan Funds board has started off the New Year with new leadership following the retirement on Dec. 31 of Chairman Matthew Goldstein, who served in ...

10 Things

10 Things...Boards will face in 2020 (and beyond)

The end of the decade is just weeks away, and mutual fund boards are looking ahead to 2020 and the issues and challenges that may land ...

Viewpoints

Op-Ed: Whither valuation guidance?

The Securities and Exchange Commission should issue valuation guidance for investment companies. When I was chief counsel in the SEC's Division of Investment Management from 1997 ...

10 Things

10 Things...to expect of incoming fund directors

When a mutual fund board brings on a new independent director, the onboarding process can be all-encompassing (and many would argue it should be). Obviously, there ...

© 2020 MONTEAGLE RIDGE MEDIA, LLC.

© Design 2015 By BRAINLAB STUDIO