

# Oversight of Fund Proxy Voting

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This paper is designed to inform and assist ICI members and their boards of directors generally with respect to their responsibilities relating to proxy voting of fund portfolio securities. This paper focuses primarily on issues under the securities laws and does not address requirements that may arise under the Employee Retirement Income Security Act (ERISA). This paper is not intended to express any legal opinion or conclusion concerning any specific action, policy, or procedure. It should not be relied upon as a substitute for appropriate professional legal advice.

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# OVERSIGHT OF FUND PROXY VOTING

## I. INTRODUCTION

Directors of registered management investment companies (funds) that invest in equity securities of publicly traded companies have certain responsibilities related to voting proxies for those companies.<sup>1</sup> A fund's board of directors typically delegates decisions about the voting of portfolio company proxies to the fund's investment adviser, in recognition that proxy voting is part of the investment advisory process. This delegation is subject to the board's continuing oversight. When fund investment advisers vote proxies on behalf of a fund, they must do so in a manner consistent with their fiduciary duty to manage the fund in the best interests of the fund and its shareholders. Pursuant to SEC rules, a fund and/or its adviser adopts policies and procedures designed to ensure that proxies for portfolio securities are voted in the best interests of the fund and its shareholders and to address conflicts that may arise between the interests of the adviser and those of fund shareholders with respect to proxy voting decisions.<sup>2</sup> Unlike other shareholders, funds must publicly disclose the votes they cast each year by filing Form N-PX with the SEC.

This paper:

- » Discusses the responsibilities of fund boards of directors in overseeing proxy voting of fund portfolio securities<sup>3</sup>
- » Considers various arrangements that funds and their advisers use to vote proxies, as well as other proxy voting issues that can arise for specific categories of funds or particular investment practices
- » Attempts to identify the major issues that boards are likely to face in establishing and overseeing a fund's proxy voting policy
- » Offers suggestions for board consideration in evaluating and resolving proxy voting issues.

As with other aspects of fund operations, there is no “one-size-fits-all” approach to fund proxy voting or board oversight of the voting process. As a result, funds and their advisers and boards seek to establish practices that are effective and workable in their particular circumstances.

## II. BOARD OVERSIGHT OF PROXY VOTING

A fund's board of directors, acting on the fund's behalf, is responsible for the voting of proxies for portfolio securities. As a practical matter, fund boards typically delegate proxy voting to the fund's investment adviser. The nature and extent of this delegation may vary. While broad delegation of proxy voting responsibilities is very common, boards may follow other approaches, such as relying on the adviser to implement a fund's proxy voting policy but not vesting the adviser with voting discretion. The investment adviser, in turn, may rely on a third-party proxy voting service to perform one or more elements of the functions delegated by the board.

When the proxy voting function has been delegated, a fund's board has the responsibility to continue to oversee that function. This oversight responsibility is an aspect of the board's general fiduciary duties of care, loyalty, and good faith. A board's oversight of a fund's proxy voting should be subject to the “business judgment rule,” which provides that courts will not find a board liable or second-guess its decisions so long

as the board has exercised reasonable judgment in carrying out its duties and has not placed its interests above the interests of the fund and its shareholders.<sup>4</sup> There are various ways boards can fulfill their oversight responsibility with respect to proxy voting, and the approach taken by a board will depend heavily on the unique facts and circumstances of the fund(s) that it oversees.

## A. PROXY VOTING POLICIES

Perhaps the most tangible board oversight responsibility with respect to proxy voting is the establishment and review of a fund's proxy voting policy. A fund's board can adopt a separate fund policy or may adopt or rely on the investment adviser's policy. A board also may elect to adopt the policy recommended by a proxy voting service.

A proxy voting policy is part of a fund's compliance program, and subject to the board approval and review requirements of the SEC's fund compliance rule.<sup>5</sup> That rule requires a board to approve a fund's compliance policies—including its proxy voting policy—based on the board's determination that the policies are "reasonably designed to prevent violation of the Federal Securities Laws."<sup>6</sup> The compliance rule also requires a fund's board to review the adequacy of the fund's compliance policies, including its proxy voting policy, at least annually. This is typically accomplished through the annual review of fund compliance policies conducted by a fund's chief compliance officer (CCO), who is required by the compliance rule to report to the board at least annually on the operation of the funds' compliance policies and any material changes, violations, or weaknesses of the policies.

### 1. *Factors for the board to consider*

The factors a board may wish to consider in assessing a proxy voting policy include:

- » ***Consistency of the policy with the fund's investment objectives.*** Is the policy's treatment of various kinds of proposals supportive of, and not inconsistent with, the fund's investment objectives and strategies?
- » ***Treatment of potential conflicts of interest.*** Does the policy contain effective mechanisms to address potential conflicts of interest? As discussed below and in the Appendix, there are a number of ways a proxy voting policy may address the potential conflicts of interest that may arise in connection with proxy voting.
- » ***Treatment of specific categories of proposals.*** Does the policy describe how the fund will vote on specific categories of proposals, or indicate whether the fund will instead consider some or all proposals on a case-by-case basis? There may be instances in which the board will determine that it would be prudent to routinely vote for proposals made by portfolio companies. For example, the fund may have a policy of routinely voting for portfolio company nominees in uncontested elections of directors. Other categories of proposals that proxy voting policies may cover include those relating to anti-takeover provisions and shareholder rights, board structure and election process, and compensation-related issues. A board may want to consider whether and how a fund's policy should address these types of proposals. For example, for stock option proposals, the board may consider whether the policy should establish the degree of dilution of existing shareholders that will be acceptable or the expense of the options to be granted in proportion to earnings; for board structure and election process proposals, the board may consider whether to address how a fund will vote on

measures such as a separate non-executive chairperson, a majority of independent directors, and/or staggered board seats.

- » ***Treatment of social issues.*** Should the policy address the criteria used to evaluate and vote on environmental, social, and governance issues? These issues may be particularly important for “socially responsible funds,” which typically vote proxies according to both socially responsible and financial criteria. These funds often support and may even sponsor proposals requesting that portfolio companies adopt socially responsible policies and practices. The boards and advisers of socially responsible funds are subject to the same fundamental fiduciary duties with respect to proxy voting as the boards and advisers of other funds.
- » ***Policy exceptions.*** Does the policy establish an appropriate process for making determinations that exceptions from the proxy voting policy are warranted, and for periodically reviewing exceptions? It also may be desirable for the policy to address how these exceptions will be reported to the board.

## ***2. Reports to the board***

A fund’s board should identify what kinds of proxy voting reports it wants to receive as well as the frequency of those reports. The board should work with the fund’s adviser to determine whether these reports will be provided by the fund’s adviser, its CCO, or a third-party proxy voting service. The nature and frequency of reports to be provided to the board may be specified in a fund’s proxy voting policy, or the board may request this information separately.

A report on all proxy votes may be too voluminous, particularly for large funds or large fund complexes. Consequently, a board may wish to request reports only on certain proxy votes—for example, on an exception basis, with respect to votes that departed from the proxy voting policy, were contrary to the portfolio company management’s recommendation, or involved potential conflicts of interest for the adviser, other fund affiliates or any voting service to which voting was delegated. In an effort to discern whether potential conflicts had a material impact on votes cast, a board may wish to request a report that compares the voting pattern for proposals of portfolio companies that have business relationships with the adviser to the voting pattern for proposals of companies that do not.

Absent unusual circumstances, the board typically receives “exception reports” retroactively. If there have been no exceptions in the prior period, the report can so note.

## **B. PROXY VOTING BY INVESTMENT ADVISERS**

### ***1. The role of investment advisers in proxy voting***

Where proxy voting authority has been delegated to an investment adviser, voting proxies becomes part of the adviser’s investment management function and is subject to the adviser’s fiduciary duties.<sup>7</sup> These fiduciary duties generally require an investment adviser to cast proxy votes in a manner consistent with the best interests of the fund and its shareholders, to disclose and address actual or potential conflicts of interest, and not to elevate its own interests over those of the fund and its shareholders. An adviser need not vote every proxy, however, and there may be occasions when voting a proxy is not in the best interests of a fund and its shareholders. For example, as discussed further below, the benefits of casting a vote for a proxy solicited by a foreign issuer may be outweighed by the burdens associated with voting foreign proxies. The

SEC has cautioned, however, that an adviser that has assumed the responsibility of voting fund proxies may not simply adopt a “policy” of not voting any proxies at all.<sup>8</sup>

In addition, investment advisers are subject to their own proxy voting rule.<sup>9</sup> This rule requires that an investment adviser adopt and implement policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of its clients (including any funds for which it acts as investment adviser), and that the procedures address material conflicts that may arise between the adviser’s interests and those of its clients. Consequently, where an investment adviser has been delegated proxy voting authority by a fund’s board, both its general fiduciary duties and the SEC’s regulations require the adviser to vote proxies in the best interests of the fund and its shareholders.<sup>10</sup>

Investment advisers use a number of approaches in voting a fund’s proxies, based on the adviser’s and the fund’s particular circumstances. Some investment advisers vest proxy voting authority in the same individuals responsible for making investment decisions for a particular fund—that is, the portfolio managers. Others may use non-portfolio management personnel to vote proxies. Still others may use a proxy voting committee comprised of officers or employees of the adviser, including, in some cases, the CCO. Another approach adopted by some investment advisers is the use of unaffiliated third-party proxy voting services.<sup>11</sup> Many investment advisers use a combination of these approaches.

Regardless of the approach used, not all investment advisers or portfolio managers will have the same view of the effect of a particular proposal, or which vote will be in the best interests of a fund and its shareholders. For example, there are differences of opinion on the benefits of various corporate governance measures, such as requiring cumulative voting. Also, factors such as an individual fund’s investment objectives and strategies may lead to different judgments and conclusions by different advisers or portfolio managers about the expected impact of proxy proposals (e.g., a merger proposal). Similarly, a particular adviser or portfolio manager might reach different judgments or conclusions with respect to different funds (e.g., a socially responsible fund and a non-socially responsible fund). As a result, proxy votes on a given portfolio company proposal might vary even within a single investment adviser or fund complex.

## ***2. Board delegation and oversight of adviser proxy voting***

As discussed above, fund boards often delegate proxy voting to a fund’s investment adviser as part of the adviser’s general management of fund assets, subject to the board’s continuing oversight. In connection with this delegation and continuing oversight, there are several questions a board may consider to satisfy itself that the fund’s portfolio company proxies will be voted in a manner that is timely and consistent with the fund’s proxy voting policy.<sup>12</sup> For example:

- » ***What processes does the adviser have to timely review and vote proxies?*** The board might request a description of how an adviser processes proxy votes from notification and receipt through actual voting and return of the proxy, including:
  - » ***How does the adviser monitor portfolio company proxy statements?*** The board might inquire whether the adviser has procedures in place to monitor whether the fund’s service providers forward all portfolio company proxies in time for the adviser to vote them. One mechanism to monitor the receipt of proxies is to compare the proxies received to the fund’s portfolio holdings.

- » ***How does the adviser promote timely voting of proxies?*** The board might ask the adviser to describe the procedures used to return the proxies it receives in time for votes to be counted at the portfolio company's shareholder meeting.
- » ***Does the adviser have the time and/or resources to monitor and execute a fund's portfolio company proxies?***
  - » ***Does the adviser have adequate staffing to handle the fund's proxy voting requirements?*** In order to assess the adequacy of staffing, the board might request that the adviser describe the personnel responsible for reviewing, researching, and executing the proxies, including their experience and training. The adviser may determine that it would be more efficient to outsource these functions to a third-party proxy voting service, which is discussed in more detail below.
  - » ***Does the adviser have sufficient physical infrastructure to handle the fund's proxy voting requirements?*** The board might request assurance, for example, that the adviser has adequate software, hardware, or other equipment.
- » ***Does the adviser consistently meet proxy voting deadlines?*** If there is a pattern or excessive number of missed proxy voting deadlines, the board might question whether the adviser's procedures are effective or whether the adviser has devoted sufficient resources to proxy voting.
- » ***Does the adviser have a process for the timely filing of the fund's Form N-PX?*** The board might request information about the resources that the adviser has devoted to compiling a fund's voting record, such as personnel responsible for compiling the record, and for preparing and filing the fund's Form N-PX.

### ***3. Board oversight of potential adviser conflicts of interest***

From time to time, a fund's investment adviser may face a potential conflict of interest in connection with a fund proxy vote. The Appendix discusses various mechanisms that advisers use to identify and resolve conflicts of interest. A board that has delegated voting discretion to the adviser should have an understanding of the process the adviser will follow to identify and resolve potential conflicts of interest in the best interests of the fund and its shareholders. There are a number of questions that a board may consider, such as:

- » ***What procedures does the adviser have to highlight votes raising potential conflicts?*** The board might request a description of the procedures that the adviser uses when it receives a portfolio company proxy statement to identify whether the adviser may have a potential conflict.
- » ***What is the adviser's process for resolving conflicts?*** The board might inquire whether the adviser has specified personnel or committees responsible for resolving conflicts. In the event a board is retroactively reviewing an adviser's resolution of a conflict, the board might consider whether the adviser properly followed its own procedures for conflict resolution. If the vote was an exception to the adviser's proxy voting policy, the board might determine whether the proper exception procedures were followed. In addition to confirming that procedures were properly followed, a board may request and evaluate the adviser's explanation of how and why its resolution of the conflict was in the best interests of the fund and its shareholders.
- » ***Should the board review conflicts before a proxy vote is cast?*** In most instances, it may be impractical for an adviser to seek prior specific direction from a fund's board. In general, advisers



should be able to resolve potential conflicts by following pre-established conflict resolution policies, if practicable. In unusual circumstances, where the standing policy does not adequately address a potential conflict, it may be appropriate for an adviser to consult with or notify a fund’s board, board committee, or other designated directors about the adviser’s proposed resolution. In these circumstances, the board also may retroactively review the potentially conflicted proxy vote and consider amending the proxy voting policy in an effort to prevent similar occurrences in the future.

- » ***How will the adviser disclose potential conflicts and their resolution to the board?*** The board may request periodic reports regarding proxy votes of portfolio companies that raised potential conflicts for the adviser, together with a description of how the conflicts were resolved.

Consideration of whether a conflict has been appropriately resolved in the best interests of the fund and its shareholders is subject to the board’s reasonable business judgment. This requires that the board be free of conflicts, prudently consider the information it deems relevant to its analysis, and consult with legal counsel or other experts as needed. Directors who may have a potential conflict also must take appropriate action—including disclosing the conflict to the board and potentially recusing themselves from participation in the matter.

## C. THIRD-PARTY PROXY VOTING SERVICES

### ***1. The role of third-party proxy voting services***

A fund or its adviser may avail itself of third-party proxy voting services. These proxy voting services typically offer a number of different services to funds and advisers, including:

- » Formulating proxy voting policies, typically using the service’s default policies as a starting point and offering the ability for customization to meet a fund’s or adviser’s particular needs and specifications
- » Researching a portfolio company’s proxy proposals, which may include assessment of director nominees, background information on the company (such as its adherence to corporate governance “best practices”), and analysis of shareholder proposals or competing director nominees
- » Providing notification and reminders of upcoming proxy votes
- » Providing coverage and translation services with respect to foreign issuers
- » Communicating voting recommendations and rationales
- » Executing voting instructions
- » Recording and reporting proxy voting records
- » Preparing and/or filing Form N-PX for funds.

A fund or adviser may use all or some of these services. For example, an adviser may receive recommendations and accompanying analysis, but still reserve voting authority in its own discretion. Or, an adviser may establish default voting policies with the service and authorize the service to automatically vote according to those policies, with the adviser retaining discretion to override those voting policies and vote the proxies itself when it deems it appropriate to do so. Similarly, an adviser may arrange for the service to cast fund proxy votes, but have a fund administrator file the fund’s Form N-PX based on data feeds from the service.

Funds may choose to use a third-party proxy voting service for a variety of reasons. These services may provide administrative efficiencies where, for example, a fund complex has many funds and perhaps thousands of individual portfolio securities to vote, as well as the obligation to report those votes on Form N-PX. In this situation, delegating proxy voting functions to a third-party proxy voting service may be more cost-effective than establishing a large staff to handle these tasks.<sup>13</sup> There may be cost savings not only in the mechanical voting of proxies, but also in researching all of the individual proposals. Administrative efficiencies also may be achieved for smaller advisers or fund complexes that have limited resources to handle proxy voting functions in-house.

A third-party proxy voting service may also offer protection against potential conflicts between the interests of the adviser and those of fund shareholders. For example, the SEC has stated that an adviser could demonstrate that a proxy vote was not the product of a conflict of interest if it voted the fund's portfolio securities in accordance with a predetermined policy based upon the recommendations of an independent third party.<sup>14</sup>

Even where a third-party proxy voting service is primarily responsible for voting proxies of a fund's portfolio securities, a fund or adviser may wish to establish procedures allowing the adviser to override the proxy voting service and direct a fund's vote where the adviser believes it is particularly important to do so. In these circumstances, the adviser might provide a board with periodic reports on the circumstances surrounding any proxy votes that the adviser decided to override.

As the discussion above suggests, it may be appropriate for fund boards and advisers to weigh the costs against the benefits to determine whether and to what extent to use a third-party proxy voting service.

## ***2. Board oversight of third-party proxy voting services***

A fund's board may choose to be involved to varying degrees in the selection and approval of third-party proxy voting services.<sup>15</sup> For example, the board might base its approval on the recommendations of the fund's adviser or delegate the selection to the fund's adviser, subject to board oversight. In considering the use of a third-party proxy voting service, the fund's board may wish to take into account matters such as:

- » The service's reputation in the marketplace
- » Any recent material events affecting the service's business organization (e.g., a buyout)
- » The service's philosophy regarding corporate governance issues and shareholder activism, as reflected in the service's default voting policies
- » The service's ability to implement customized voting policies that are specific to the fund or its adviser
- » The extent to which the service would permit the fund or its adviser to vote on specific proposals directly, if desired
- » The process the service uses to identify and address any conflicts of interest it may have.

A board may delegate to a fund's adviser the day-to-day oversight of a third-party proxy voting service. This oversight of third-party proxy voting services often focuses on, among other things, the "mechanical" ability of the service to timely vote the fund's proxies consistent with the fund's or the service's established policies and maintain an accurate record of the proxy votes cast, as well as the service's ability to timely and correctly prepare and file the fund's Form N-PX. A board or adviser might therefore wish to receive

periodic reports from the third-party proxy voting service to monitor performance on such quality issues as the service's adherence to customized policies, proportion of missed votes, and accuracy and timeliness in the preparation and filing of the fund's Form N-PX. A board or adviser may want to request that a service identify and disclose any conflicts that may arise for the service in voting a fund's proxies.

#### **D. BOARD VOTING OF FUND PROXIES**

As discussed above, it is unusual for fund boards to directly engage in voting proxies. As with other fund management functions, boards typically serve in an oversight role. A small number of boards have decided, however, that rather than delegate proxy voting responsibility, the board will vote proxies itself. As in the case where the adviser has voting authority, a board need not vote every proxy, as there may be occasions when voting a proxy is not in the best interests of a fund and its shareholders.

In considering this approach, a board should first determine whether one or more of its members have the expertise necessary to analyze portfolio company proxy statements, or have access to staff or consultants that possess such expertise. It is also important to conclude that the time and resources devoted to proxy voting will not detract from performance of board duties that cannot be delegated or from other important responsibilities entrusted to the board. In many cases, the cost of retaining proxy voting authority, in terms of time and resources, may be prohibitive compared to delegating authority to the fund's adviser or a third-party proxy voting service.

A board that has decided to retain proxy voting authority, whether on a regular or occasional basis, can vote proxies in any number of ways. It may divide up responsibility among the various directors, or establish a committee of directors devoted to analyzing and voting proxies. Presumably, a board could also hire its own staff to analyze and vote proxies. Although this might reduce the demands on directors, it likely would entail significant costs and would not eliminate but only shift the focus of the board's oversight responsibilities.

While retaining voting authority has the advantage of eliminating any potential conflicts of interest vis-à-vis the fund's adviser, it would remain necessary to have a process for identifying and addressing any potential conflicts of interest that individual directors themselves might have.

### **III. OTHER PROXY VOTING ISSUES**

Certain kinds of funds or certain investment practices raise particular proxy voting issues, described below, that fund boards may have to address from time to time.

#### **A. SUBADVISERS/MANAGERS OF MANAGERS**

Funds often employ subadvisers, whose duties may range from managing a designated "sleeve" of a fund's portfolio to managing the entire fund portfolio. Some fund complexes use a manager of managers approach, where the primary responsibility of the investment adviser of the funds is to select, monitor and, as needed, replace subadvisers.

Boards of funds using subadvisers should consider whether the subadviser will be responsible for voting a fund's proxies and, if so, whether to adopt the proxy voting policy of the subadviser. Where funds or fund complexes use multiple subadvisers, boards may consider the desirability of adopting a single proxy voting policy to promote consistency and uniformity in votes cast. In addition, an adviser who is responsible for

overseeing the activities of multiple subadvisers may find it administratively challenging to track and monitor multiple subadvisers' proxy voting policies. On the other hand, it may be equally challenging for a subadviser that manages multiple fund portfolios to tailor its operations to comply with different proxy voting policies of the funds for which it serves as subadviser. Accordingly, some subadvisers may be reluctant to accept the responsibility of voting proxies for a fund that has a policy that differs from the subadviser's policy.

If a fund determines that it is appropriate to adopt a subadviser's policy, the policy would still be subject to the board approval and review requirements of the SEC's fund compliance rule, discussed above. Regardless of who has voting responsibility and which policy is used, the most important considerations are that portfolio company proxies be voted in the best interests of the fund and its shareholders, the board receive satisfactory reports enabling it to effectively oversee the policy, and the fund's Form N-PX be accurately and timely filed.

## **B. AFFILIATED FUNDS OF FUNDS**

Another fund structure that raises unique proxy voting issues is an affiliated fund of funds. In such an arrangement, the adviser for the fund of funds is also the adviser for an underlying fund in which the fund of funds invests. A potential conflict may arise if the underlying fund issues a proxy soliciting votes on a proposal that would directly benefit the adviser. For example, if the proposal involves approval of an advisory contract arising from a sale of the adviser or an advisory fee increase, then the adviser could have a potential conflict in voting the underlying fund shares held by the fund of funds in favor of the proposal.

There are several possible ways to resolve such potential conflicts. First, the adviser could follow its standing conflict resolution procedures. Second, the adviser could vote in accordance with the recommendation of the underlying fund's board. This would be particularly appropriate if the underlying fund's board also oversees the fund of funds because, in making its recommendation, the board can weigh the benefits to the shareholders at both the underlying fund and fund of funds level. In most cases, the interests of the shareholders at both levels should be aligned. By voting consistently with the underlying fund board's recommendation, the adviser is effectively following the recommendation of the fund of funds' board too.

A third alternative is for the fund of funds to vote its shares of the underlying fund in the same proportion as the votes of the other beneficial shareholders of the underlying fund. Under this "echo voting" approach, the fund of funds would merely amplify the votes already received from the other underlying fund shareholders. The adviser's potential conflict is therefore extinguished by replicating the voting preferences expressed by the underlying fund's other shareholders.

## **C. FOREIGN SECURITIES**

Voting proxies of foreign issuers, as compared to those of domestic companies, can entail significant costs. These costs may include the cost of translating proxy statements or travel to attend shareholder meetings. Administrative obstacles also may arise. For example, funds often do not receive timely notice of, or adequate information related to, proxy votes for foreign securities they own. In addition, in certain countries, shares that will be voted must be held by a designated depository during a period of time commencing shortly before the date of the shareholder meeting and lasting until the meeting has taken place and the shares are returned to the fund's custodian bank ("share blocking") resulting in the inability to sell the shares during

that time. The SEC has acknowledged that funds and advisers may determine that refraining from voting is in a fund's best interest in some circumstances, such as where the costs involved in voting exceed any anticipated benefit to the fund.<sup>16</sup>

#### **D. SECURITIES LENDING**

Funds frequently enter into securities lending programs in order to generate extra income, thus increasing the fund's total return. Securities lending programs are subject to certain conditions set forth in no-action letters issued by the SEC staff many years ago.<sup>17</sup> One of these conditions is that a loan must be terminated and the security recalled to vote proxies for loaned securities if fund management has knowledge that "a material event will occur affecting an investment on loan."<sup>18</sup> The SEC staff has not explicitly addressed this matter since it issued those letters. Many fund advisers employ a cost-benefit analysis to determine whether the cost of voting a proxy for a security on loan exceeds the expected benefit to the fund of voting the proxy. In performing this analysis, advisers may take into account practical considerations, such as the administrative burden of retrieving the securities. Advisers also may consider the size of a fund's holding in the security on loan and the likelihood that the vote will have a significant impact on the value of the holding. Advisers weigh these types of factors against the financial benefits they expect the fund to derive by keeping the security on loan.

### **IV. CONCLUSION**

Funds, their boards, and their advisers must take the responsibility to vote portfolio security proxies very seriously. Fund boards typically delegate this responsibility to the fund's adviser, in recognition that proxy voting is part of the investment process. Fund directors play an important oversight role to ensure that proxy voting is carried out in the best interests of funds and their shareholders. The manner in which boards fulfill their oversight responsibility appropriately varies among funds depending on the facts and circumstances.

## APPENDIX

### IDENTIFYING AND RESOLVING INVESTMENT ADVISER CONFLICTS OF INTEREST

Investment advisers have developed a number of techniques for identifying and resolving potential conflicts of interest that can arise in connection with voting fund proxies. An adviser may be able to determine in advance which funds and other significant business relationships are likely to give rise to proxy voting conflicts. For example, an investment adviser may have a potential conflict of interest when faced with a proxy solicited by an issuer whose retirement plan the adviser or an affiliate manages, or for which it serves as administrator, or an issuer that distributes the adviser's funds. An adviser also may have a potential conflict of interest when deciding how to vote on a proposal sponsored or supported by a shareholder group that is a client of the adviser. Identifying these and other potential conflicts of interest may be a more formidable task for investment advisers that are part of large financial organizations with numerous affiliates—each with its own client base and business relationships. Some advisers have designated personnel responsible for determining whether the portfolio company appears on a list of companies with which the adviser or an affiliate has a material business relationship. In many situations, potential voting conflicts may only be identifiable on a case-by-case basis, requiring an adviser's compliance and investment personnel to be sensitive and vigilant in monitoring proxy solicitations.

Advisers utilize a variety of techniques to limit the possibility that conflicts of interest might improperly influence voting decisions. One common approach is to adhere to the adviser's predetermined voting policy in voting proxies. This effectively results in an adviser limiting its own voting discretion on individual votes, thus limiting its susceptibility to influence by considerations outside the proxy voting process. A potential advantage of this approach is that, as long as it adheres to its policy, the adviser can resolve potential conflicts by voting consistently with its policy, regardless of whether the vote also was consistent with the adviser's interests. (This assumes, of course, that the predetermined policy was originally designed—as it should be—to further the interests of the fund and its shareholders.)

From time to time the adviser may have good cause to deviate from the predetermined policy. In addition, it may not be possible to anticipate every voting situation, and the adviser may encounter proxy proposals that are not covered by its pre-determined policy (e.g., mergers) and which may involve a potential conflict. An adviser could develop special procedures to handle these situations—for example, by requiring that exceptions or new situations be referred to a committee and reported to the fund's board.

An adviser also could avoid potential conflicts of interest by voting in accordance with the recommendations of a third-party proxy voting service. Even where an adviser has delegated proxy voting to a third-party voting service, the adviser must still adopt policies to address potential conflicts of interest if the adviser retains any discretion to override the service's recommendation and vote differently. An adviser could address potential conflicts arising from vote overrides by establishing a procedure to obtain approval for overrides from a committee and report vote overrides to the fund's board.

Another mechanism advisers may employ to protect against the possibility that conflicts of interest will improperly affect proxy votes is the establishment of “firewalls” or “ethical walls.” Using this technique, advisers screen off personnel responsible for proxy voting from personnel who may be susceptible to potential conflicts, such as an adviser's marketing or client relations personnel, or investment banking or other affiliates of the adviser that may have business relationships with the portfolio company.<sup>19</sup> The firewalls would not necessarily require physical separation so long as the adviser's or its affiliate's personnel

understand that it is a violation of the adviser's policy to discuss proxy proposals with voting personnel who are "behind the wall."

In the event a conflict does arise, there are a number of ways that an adviser might address it. One way is to obtain voting instructions or consent from the fund's board, a board committee, or other designated directors. This approach is not without its drawbacks: it eliminates the benefit of the adviser's investment expertise; and it imposes demands on the directors, whom it may be difficult to assemble—even by telephone—when there are tight proxy voting deadlines. Another potential drawback is that an adviser or subadviser may need to seek feedback from more than one fund board, committee, or group of directors. For an adviser or subadviser that manages numerous funds with different boards of directors, this approach may simply not be feasible.

Another way to address potential conflicts of interest with director involvement could be to establish a proxy voting committee that is comprised of both adviser personnel and one or more fund directors. An advantage of this approach is that it allows for board representation in resolving conflicts while retaining access to the adviser's insight and expertise. On the other hand, time constraints may make even limited director involvement impractical. This structure may also prove difficult where an adviser advises funds in separate complexes—as a subadviser, for example—because it may not be feasible to arrange for board representation from each fund complex.

Another approach to address potential conflicts of interest is to notify the fund's board, a board committee, or designated directors of the potential conflict and the proposed resolution of that conflict, if practicable. The advantage of this approach is that it gives directors a potential opportunity to impact the resolution before the vote is cast.

Yet another alternative that an adviser may use is a proxy voting committee comprised of senior officers and/or portfolio managers of the adviser—without fund board representation. Although this approach lacks the advantage of involving the board in the resolution of potential conflicts, it often represents a more viable option, particularly for an adviser or subadviser that advises numerous funds with different boards of directors. An advantage of this approach is that it does not impose an absolute constraint on the adviser's ability to exercise its judgment and discretion in determining how a proxy should be voted. If the adviser's proxy committee employs sufficient safeguards for addressing potential conflicts—for example, by including representatives of the CCO or chief legal officer in discussions of potential proxy voting conflicts—then there may be reasonable assurance that potential conflicts will be properly analyzed and resolved in the best interests of the fund and its shareholders.



## ENDNOTES

- <sup>1</sup> At the end of 2007, mutual funds and other registered investment companies held approximately 27 percent of U.S. corporate equity securities. Investment Company Institute, *2008 Investment Company Fact Book*, at 11. Proxy voting is primarily an issue for equity funds because equity securities typically entitle the owner to vote at shareholder meetings (such securities are sometimes referred to as “voting securities”). Funds that primarily hold fixed-income securities are affected to a much lesser extent because fixed-income securities generally have limited or no voting rights.
- <sup>2</sup> The SEC adopted proxy voting rules for funds in 2003. See *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, SEC Release No. IC-25922 (Jan. 31, 2003) (Investment Company Proxy Voting Release). The rules generally require a fund to: (i) describe the policies and procedures that govern the voting of proxies for fund portfolio securities (proxy voting policy) in certain SEC filings; and (ii) disclose annually how the fund cast its proxy votes by filing Form N-PX with the SEC. The SEC provided examples of general issues that would be appropriate for a proxy voting policy to address, including: (i) the extent to which a fund delegates its proxy voting decisions to its investment adviser or another third party, or relies on the recommendations of a third party; (ii) how a fund votes on matters that may affect substantially the rights or privileges of the holders of the securities to be voted; and (iii) the extent to which a fund will support or give weight to the views of management of a portfolio company. The SEC has indicated that a fund’s board may design its own proxy voting policy or may adopt the adviser’s policy. A board also may elect to adopt the policy recommended by a proxy voting service. In all cases, the fund must disclose how the policy addresses situations where a vote presents a conflict between the interests of a fund’s shareholders, on the one hand, and those of its investment adviser, principal underwriter, or their affiliates, on the other.
- <sup>3</sup> For an analysis of the proxy voting records of funds in 160 of the largest fund families in the 12 months ending June 30, 2007, see Investment Company Institute Research Perspective, Vol. 14, No. 1 (July 2008).
- <sup>4</sup> See Fed. Regulation of Securities Comm., Am. Bar Ass’n Section of Bus. Law, *Fund Director’s Guidebook* § 10 (3d ed. 2006).
- <sup>5</sup> Rule 38a-1 under the Investment Company Act of 1940 (1940 Act). The board’s approval and review requirements also apply where a fund is relying on the proxy voting policy of its adviser or subadviser.
- <sup>6</sup> Rule 38a-1(a)(1) and (2). For these purposes, the applicable “Federal Securities Laws” would include a fund’s requirement to disclose its proxy voting policy and file Form N-PX, as well as an adviser’s requirement to maintain proxy voting procedures and related records under Rules 206(4)-6 and 204-2, respectively, under the Investment Advisers Act of 1940 (Advisers Act).
- <sup>7</sup> Investment Company Proxy Voting Release at 3.
- <sup>8</sup> *Proxy Voting by Investment Advisers*, SEC Release No. IA-2106 (Jan. 31, 2003) (Adviser Proxy Voting Release), n.23.
- <sup>9</sup> Advisers Act Rule 206(4)-6.
- <sup>10</sup> The SEC has stated, however, that “[a]n adviser’s fiduciary duties to a client do not necessarily require the adviser to become a ‘shareholder activist’ by, for example, actively engaging in soliciting proxies or supporting or opposing matters before shareholders. As a practical matter, advisers will determine whether to engage in such activism based on its costs and expected benefits to clients.” Adviser Proxy Voting Release, n.19. Cf. Department of Labor, Advisory Opinion 2007-07A (Dec. 21, 2007).
- <sup>11</sup> As discussed in more detail in Section II.C, these services will vote proxies on behalf of a fund or adviser, either according to the service’s internal voting policies or according to policies provided by the fund or adviser.
- <sup>12</sup> This discussion would be equally applicable where proxy voting authority has been delegated to one or more fund subadvisers.



<sup>13</sup> In some cases, the costs of third-party proxy voting services are borne by the funds in a fund complex. In other cases, these costs are assumed by the adviser or shared between funds and their adviser. The specific payment arrangements are typically the result of negotiations between a fund's board and its adviser.

<sup>14</sup> Adviser Proxy Voting Release at 5.

<sup>15</sup> For a discussion of board oversight of certain other service providers, see *Board Oversight of Certain Service Providers*, Independent Directors Council Task Force Report (June 2007).

<sup>16</sup> Adviser Proxy Voting Release, n.18 and accompanying text.

<sup>17</sup> See, e.g., State Street Bank & Trust Company, SEC No-Action Letter (Sept. 29, 1972).

<sup>18</sup> *Id.*

<sup>19</sup> See, e.g., *In re Deutsche Asset Management*, Advisers Act Release No. 2160 (Aug. 19, 2003) (alleged failure of an adviser to disclose a material conflict of interest to its clients prior to voting client proxies in a contested merger, where an affiliate of the adviser was an investment bank that was retained by a party to the proxy contest).



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