

Report on Funds' Use of Proxy Advisory Firms

January 2015



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I. Background and Introduction

Proxy voting is important to registered investment companies (“funds”) in their capacity as institutional investors. Funds are the beneficial owners of their portfolio securities, and they seek to maximize the value of their voting securities in part through proxy voting.

As part of its fiduciary duty to shareholders, a fund’s board of directors, acting on behalf of the fund, is responsible for the voting of proxies relating to the fund’s portfolio securities. A fund’s board typically delegates proxy voting responsibilities to the fund’s investment adviser in recognition that proxy voting is part of the investment management process.¹ While the nature and extent of this delegation may vary, it remains subject to the board’s continuing oversight.²

When a fund adviser votes proxies, it must do so in a manner consistent with its own fiduciary duties to the fund, and without regard to the fund adviser’s business interests. In addition, a fund adviser must adopt and implement policies and procedures reasonably designed to ensure that it votes proxies in the best interest of the fund, and those policies and procedures must address material conflicts that may arise between the interests of the adviser and the fund with respect to proxy voting decisions.³

A fund must (i) describe in its registration statement the policies and procedures that it uses to determine how to vote proxies relating to portfolio securities⁴ and (ii) file with the Securities and Exchange Commission (SEC) and make available to shareholders the fund’s records of how it voted proxies relating to its portfolio securities.⁵ A fund’s proxy voting policy⁶ is part of its compliance program and subject to the board approval and review requirements of Investment Company Act Rule 38a-1.

¹ Indeed, while fund boards may follow other approaches in voting fund proxies, broad delegation of proxy voting responsibilities to fund advisers is the predominant approach.

² See *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, SEC Release No. IC-25922 (January 31, 2003) (“Investment Company Proxy Voting Release”), at 3. Unless otherwise indicated, this report assumes that the fund board has delegated proxy voting responsibilities, subject to board oversight, to the fund adviser. In addition, the term *fund adviser* is used throughout this report because the information in the report is directed to investment advisers in their capacity as advisers to funds only.

³ See Rule 206(4)-6 under the Investment Advisers Act of 1940 (“Advisers Act”); see also *Proxy Voting by Investment Advisers*, SEC Release No. IA-2106 (January 31, 2003) (“Adviser Proxy Voting Release”). Pursuant to this rule, a fund adviser must also (i) disclose how clients (including funds) may obtain information about how the adviser voted with respect to their securities and (ii) describe its proxy voting policies and procedures to clients and, upon request, provide them with a copy of those policies and procedures.

⁴ See Item 17(f) of Form N-1A (registration statement for open-end funds), Item 18 of Form N-2 (registration statement for closed-end funds), and Item 20 of Form N-3 (registration statement for separate accounts organized as management investment companies). Closed-end funds must also include similar disclosure under Item 7 of their annual Form N-CSR filings.

⁵ See Rule 30b1-4 under the Investment Company Act of 1940 (“Investment Company Act”); see generally the Investment Company Proxy Voting Release.

⁶ The SEC has stated that a fund board could adopt the investment adviser’s policies and procedures, rather than design and adopt distinct policies and procedures for the fund. See the Investment Company Proxy Voting Release at 5.

Fund boards and fund advisers take their proxy voting responsibilities seriously and devote substantial resources to this function.⁷ Because of the number of portfolio securities funds hold and the number of shareholder meetings held by issuers of those securities, efficient and informed proxy voting is a large undertaking. For example, during a 12-month period, ICI research has found that there were more than 20,000 proxy proposals for the 3,000 largest publicly traded U.S. companies.⁸ During that same period, the largest registered fund families cast nearly 4 million separate proxy votes for these particular companies, or an average of nearly 5,000 unique proposals per fund family.⁹ Typically, funds and fund advisers do not have the infrastructure and expertise to handle efficiently all functions related to proxy voting,¹⁰ and therefore they hire third parties such as proxy advisory firms to assist them in carrying out their proxy voting responsibilities.

SEC staff recently released a staff legal bulletin that provides guidance about investment advisers' proxy voting responsibilities and the exemptions to the federal proxy rules that are commonly relied upon by proxy advisory firms.¹¹ The bulletin is the most recent source of guidance from the SEC staff about proxy advisory firms, and provides the staff's broadest discussion to date of an investment adviser's responsibilities in overseeing services provided to it by a proxy advisory firm.¹²

⁷ This report discusses only a fund adviser's oversight of proxy advisory firms. Other aspects of fund proxy voting have been discussed in prior ICI and IDC publications. For example, a broader discussion of fund proxy voting and the roles played by fund boards and fund advisers is provided in *Oversight of Fund Proxy Voting*, Independent Directors Council and Investment Company Institute, July 2008 ("IDC/ICI Proxy Paper"). See also Collins, "Proxy Voting by Registered Investment Companies: Promoting the Interests of Fund Shareholders, 2008," *ICI Research Perspective* 14, no. 1 (July 2008), for a discussion of funds' proxy voting practices.

⁸ See Collins, "Trends in Proxy Voting by Registered Investment Companies, 2007-2009," *ICI Research Perspective* 16, no. 1 (November 2010), at 4.

⁹ *Id.* at 11.

¹⁰ Funds generally do not have employees of their own, so hiring service providers is a common feature of fund operations. See *Board Oversight of Certain Service Providers*, Independent Directors Council Task Force Report, June 2007.

¹¹ See *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*, Staff Legal Bulletin No. 20 (June 30, 2014) ("Bulletin").

¹² Prior to the bulletin, the SEC and SEC staff had addressed in more limited ways investment advisers' use of proxy advisory firms. The Adviser Proxy Voting Release states that, among other ways, an investment adviser could demonstrate that a proxy vote was not a product of a conflict of interest of the adviser if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party. This release does not otherwise address the role of proxy advisory firms in investment advisers' proxy voting processes. SEC staff issued two no-action letters in 2004 (Egan-Jones Proxy Services, SEC No-Action Letter [May 27, 2004] ["Egan-Jones No-Action Letter"], and Institutional Shareholder Services, Inc., SEC No-Action Letter [September 15, 2004] ["ISS No-Action Letter"]) to clarify the foregoing statement in the Adviser Proxy Voting Release regarding how an investment adviser could resolve conflicts of interest that it may face in voting clients' proxies. Finally, the SEC's *Concept Release on the U.S. Proxy System*, SEC Release No. IC-29340 (July 14, 2010) ("Concept Release"), included a discussion of (i) the role and legal status of proxy advisory firms, (ii) concerns about their role, and (iii) potential regulatory responses.

The bulletin recognizes that fund advisers may want or need to evaluate and as necessary make changes to their “current systems and processes” in light of the guidance,¹³ and ICI and IDC understand that some fund advisers have shared, or are in the process of sharing, their findings with their fund boards. To assist fund advisers as they conduct these evaluations, ICI and IDC drew upon the expertise of a member working group to develop a report that focuses on funds’ use of proxy advisory firms. Appendix B identifies the working group members.

Recognizing that funds receive different types and levels of services from proxy advisory firms, the report is organized in a question and answer format, so that readers may focus on items that are of particular interest to them.¹⁴ The questions and answers are organized under the following broad topics: (i) proxy advisory firm services generally, (ii) board oversight of proxy advisory firms, (iii) fund adviser due diligence and oversight of proxy advisory firms, and (iv) miscellaneous considerations related to proxy advisory firm oversight. Appendix A provides references to additional resources, including SEC releases and staff guidance, as well as ICI and IDC publications and other resources.

II. Proxy Advisory Firm Services Generally

What services do proxy advisory firms provide?

Proxy advisory firms provide a number of services that fund advisers may find useful in carrying out their proxy voting responsibilities, including the following:

- » Assisting with the administrative tasks associated with proxy voting, including keeping track of meeting dates and voting instructions, executing proxies in accordance with clients’ instructions (which may include voting in accordance with a fund’s proxy voting guidelines that the proxy advisory firm inputs into its system as part of the fund’s account setup), generating voting reports, providing coverage and translation services with respect to foreign issuers, and compiling information for funds’ annual proxy voting filings with the SEC on Form N-PX
- » Analyzing, providing research, and making voting recommendations on the matters presented for shareholder vote, which fund advisers may take into account to varying degrees in deciding how to vote

¹³ The SEC staff’s expectation is that this will be done “promptly, but in any event in advance of next year’s [i.e., the 2015] proxy season.”

¹⁴ This report is not intended to reflect best practices or to be a model for funds, fund boards, and fund advisers to follow, nor is it intended to be comprehensive. Rather, the information is meant to assist funds, fund boards, and fund advisers as they consider how to fulfill their proxy advisory firm oversight responsibilities. Many of these entities already may be taking actions described in this report, while others may determine that some of the report’s information is not applicable or appropriate given their particular arrangements.

- » Providing research and commentary on trends in prior and upcoming proxy seasons (e.g., shareholder proposals and voting patterns) and general and specific forms of aggregated data, such as data relevant to executive compensation advisory votes
- » Assisting with the formulation of and amendments to proxy voting guidelines, which may be customized or may mirror the standard guidelines of the proxy advisory firm
- » Helping fund advisers mitigate conflict of interest concerns raised when a fund adviser is casting votes on a matter in which its interest may differ from that of the fund¹⁵

III. Board Oversight of Proxy Advisory Firms

What is a fund board's responsibility with respect to the selection and oversight of proxy advisory firms?

A fund board may choose to be involved to varying degrees in the selection and approval of proxy advisory firms and in overseeing proxy advisory firms' performance.¹⁶ The board typically delegates to the fund adviser the day-to-day oversight of the proxy advisory firm.¹⁷ The board could determine to approve a proxy advisory firm based on the fund adviser's recommendation, or it could delegate the selection of the proxy advisory firm to the fund adviser, subject to the board's oversight.

What processes could a board follow to oversee proxy advisory firm performance?

The board's oversight practices with respect to proxy advisory firms generally flow from its oversight practices for proxy voting and service providers generally. Where the board has delegated to the fund adviser the responsibility to provide day-to-day oversight of the proxy advisory firm, the board will rely on the fund adviser to report to it on the firm's performance. Reporting about proxy advisory firms could be included within more general reports or presentations on proxy voting.

¹⁵ See Concept Release at 106 and the IDC/ICI Proxy Paper at 6 for a general discussion of services that proxy advisory firms provide. With respect to resolving conflicts of interest faced by fund advisers, use of proxy advisory firms is just one means of doing so. See *supra*, note 12. See also the appendix to the IDC/ICI Proxy Paper for a discussion of the various ways in which fund advisers identify and resolve potential conflicts of interest that may arise in connection with voting fund proxies.

¹⁶ See IDC/ICI Proxy Paper at 7; see also *Board Oversight of Certain Service Providers*, Independent Directors Council Task Force Report, June 2007, for general guidance regarding how fund boards may evaluate potential service providers and exercise ongoing oversight.

¹⁷ A subadviser may manage some or all of the fund's assets. The subadviser's responsibilities may include voting the fund's proxies with respect to the assets it manages, and the subadviser may use a proxy advisory firm to assist it. The subadviser's proxy voting policy would be subject to the requirement for board review and approval under the SEC's fund compliance rule. See Investment Company Act Rule 38a-1 (which, among other things, requires board approval and annual review of each investment adviser's policies and procedures) and *Compliance Programs of Investment Companies and Investment Advisers*, SEC Release No. IA-2204 (December 17, 2003), at 5-6 and n.17 (stating the SEC's expectation that an adviser's policies and procedures address portfolio management processes, including proxy voting, and noting that subadvisers are a type of service provider to which Rule 38a-1 applies). See *Board Oversight of Subadvisers*, Independent Directors Council Task Force Report, January 2010, at 14 and IDC/ICI Proxy Paper at 8-9 for a discussion of board oversight of a subadviser's proxy voting arrangements.

The board (with the assistance of counsel) and the fund adviser generally will determine the frequency of board reports that include information about proxy advisory firms and the type of information to include in the reports. The topics addressed in board reports as well as their frequency vary and generally depend on the level and types of proxy advisory firm services used. For example, where the fund adviser uses the proxy advisory firm for administrative services only, reports including information about the proxy advisory firm may be more limited and less frequent than would be the case if the fund adviser relied upon the proxy advisory firm's research analysis and voting recommendations as well. Moreover, rather than receive information about all aspects of the proxy advisory firm's services provided to a fund over a given period, the board might prefer exception-based reports. Topics for inclusion in board reports might include:

- » The list or types of services offered by the proxy advisory firm and those services that are being used by the fund adviser
- » The fund adviser's processes for overseeing proxy advisory firms, including the type of information the fund adviser receives from a proxy advisory firm in connection with its oversight
- » The fund adviser's assessment of the proxy advisory firm's capacity and competency to assist it with proxy voting functions on behalf of the fund, which could include information about the quality of the proxy advisory firm's services (e.g., its adherence to customized policies, proportion of missed votes, and accuracy and timeliness in the preparation and filing of the fund's Form N-PX) and the robustness of the proxy advisory firm's policies and procedures regarding its ability to identify and address any potential conflicts of interest that it may face
- » Any material changes or events (such as changes in ownership of or a regulatory action against the proxy advisory firm)

The board reports might include updates (e.g., annual) of pertinent information, such as the proxy advisory firm's guidelines and how the fund adviser uses (or does not use) them.¹⁸

In some cases, proxy advisory firms make presentations at board meetings to educate fund boards about their services.

¹⁸ In addition to regular reports, a board might receive a presentation about its fund adviser's review of its current systems and processes in light of the guidance in the bulletin.

IV. Fund Adviser Due Diligence and Oversight of Proxy Advisory Firms

A. General Considerations

What are a fund adviser's general responsibilities with respect to proxy voting?

A fund adviser owes the fund that it manages a duty of care and loyalty with respect to services undertaken on its behalf, including proxy voting,¹⁹ and a fund adviser with voting authority must adopt and implement policies and procedures reasonably designed to ensure that it votes proxies in the best interest of the fund.²⁰ Assuming the fund board has delegated proxy voting responsibilities to the fund's adviser, the fund adviser is responsible for proxy voting on behalf of the fund, even if it hires a proxy advisory firm to provide certain forms of assistance.²¹

How do a fund adviser's proxy advisory firm oversight responsibilities compare to those related to other service providers?

A fund adviser's oversight of proxy advisory firms is broadly similar to its oversight of any other service provider it may hire to assist it in carrying out a function that it has undertaken to perform. Therefore, in evaluating its proxy advisory firm oversight program, a fund adviser may wish to consider first how it currently exercises oversight of its key service providers. Many of the principles and practices used in those settings are equally applicable to oversight of proxy advisory firms. The fund adviser then can tailor the program for proxy advisory firms based on considerations unique to those firms.

What are some general elements of any oversight program for proxy advisory firms?

The scope of the program will depend on the particular services provided to the fund. If the services that a proxy advisory firm provides are solely administrative, for example, then the scope of ongoing oversight would be more limited than if a fund adviser also uses the proxy advisory firm for proxy voting recommendations or assistance with proxy voting guideline formulation or both. In addition, the oversight program and the fund adviser's due diligence efforts thereunder should be documented.²²

¹⁹ See Adviser Proxy Voting Release at 2, and Bulletin, Question 1.

²⁰ See *supra*, note 3.

²¹ A subadviser may manage some or all of the fund's assets and have day-to-day proxy voting authority. See *supra*, note 17. If the subadviser has proxy voting authority and is using a proxy advisory firm, the information in this report with respect to the fund adviser would generally apply to the subadviser.

²² See SEC ComplianceAlert (July 2008).

B. Initial Due Diligence

If a fund adviser is considering hiring a proxy advisory firm, what could the fund adviser consider covering as part of its initial due diligence review of that proxy advisory firm?

As an overarching principle, when selecting a proxy advisory firm, a fund adviser should consider whether the proxy advisory firm has the capacity and competency to assist with the relevant proxy voting functions.²³ A fund adviser also should consider the anticipated costs and benefits of doing so, as well as those of the alternatives (e.g., use of another proxy advisory firm or service provider, or handling some or all of the functions in-house). A fund adviser typically will consider the nature and quality of services to be provided, quality and experience of the personnel, stability of the organization, competitiveness of pricing, and any potential conflicts of interest to which the proxy advisory firm may be subject.²⁴

Depending on the services to be provided, other matters that a fund adviser may wish to consider or evaluate as part of an initial due diligence review include:

- » Basic organizational information, including information about the proxy advisory firm's owners and affiliates, its internal structure, and key departments (e.g., research,²⁵ operations, information technology, legal, compliance, management, and client service)
- » General information about the proxy advisory firm's (and if applicable, its owners') financial condition,²⁶ and its commitment to this line of business
- » Information about the range of services provided by the proxy advisory firm, how they would complement the fund adviser's capabilities, and what the precise division of responsibilities would be between the proxy advisory firm and the fund adviser
- » Whether the proxy advisory firm has adequate experience, expertise, and resources with respect to the services it would provide to the fund adviser. This inquiry could solicit information about:
 - » The aforementioned departments, along with information about key personnel in each (e.g., education, relevant experience, and tenure with the proxy advisory firm)
 - » The level and quality of servicing, along with the frequency and means of communication (e.g., periodic reporting) it can expect from the proxy advisory firm

²³ See Bulletin, Question 3.

²⁴ See *infra*, Section IV.G. for a discussion of evaluating potential conflicts of interest faced by proxy advisory firms, including factors a fund adviser may consider in evaluating a proxy advisory firm's conflict procedures and the effectiveness of their implementation.

²⁵ See *infra*, Section IV.F. for a discussion of research and recommendations.

²⁶ Registered investment advisers are required to provide certain information about their financial condition to clients pursuant to Item 18 of Part 2A of Form ADV. See *infra*, note 27.

- » The ease of use and capabilities of the proxy advisory firm’s voting platform
- » The extent to which the proxy advisory firm itself relies on third parties for certain services
- » Recent material events affecting the proxy advisory firm (e.g., changes in ownership)
- » Specific terms of the proposed service agreement
- » Certain items related to the proxy advisory firm’s status as a registered investment adviser, if applicable²⁷
- » Information about the proxy advisory firm’s relevant insurance policies
- » The proxy advisory firm’s policies and procedures, compliance systems, and related employee training and education. Policies and procedures to consider reviewing include, as applicable, those related to:
 - » Conflicts of interest
 - » The minimization, identification, and disclosure to clients of errors²⁸
 - » The use and safeguarding of material nonpublic information (including that of the fund adviser) / privacy policies
 - » Communications with issuers and clients
 - » Business continuity and disaster recovery
- » Summaries of internal audits, including whether any relevant weaknesses or issues were uncovered (and if so, how they were addressed)
- » Any other recent reports on the proxy advisory firm’s internal controls, and other reports or measures of the proxy advisory firm’s effectiveness in carrying out its proxy voting responsibilities
- » Information about the proxy advisory firm’s information/data security resources and controls²⁹
- » The proxy advisory firm’s legal and regulatory history, including a description of any relevant legal actions brought against the proxy advisory firm by a regulator or private party
- » Reasonableness of fees in light of services, and how services and fees compare to those of other proxy advisory firms

²⁷ If a proxy advisory firm is a registered investment adviser, a fund adviser may wish to inquire about or review certain items related to registration, such as Form ADV filings, SEC examinations and administrative proceedings, codes of ethics, and annual reviews of compliance policies and procedures. Such an inquiry could be appropriate for both initial and ongoing due diligence reviews.

²⁸ See *infra*, Section IV.H. for a discussion of errors.

²⁹ See ICI’s Information Security Resource Center, particularly “What to Ask When Assessing Information Security Programs,” for specific questions a fund adviser may wish to ask.

The means of conducting evaluations will vary from adviser to adviser, and could include phone calls, written correspondence (including questionnaires), on-site due diligence visits to the proxy advisory firm, visits from the proxy advisory firm, or some combination thereof.

C. Ongoing Due Diligence

Once a fund adviser has hired a proxy advisory firm, how frequently should it evaluate the proxy advisory firm thereafter?

After a fund adviser has completed its review of a proxy advisory firm and its operations and hired the firm, the fund adviser should exercise ongoing oversight of the proxy advisory firm.³⁰ The SEC staff has stated that investment advisers, as part of their ongoing compliance programs, should review no less frequently than annually the adequacy of their proxy voting policies and procedures.³¹ A fund adviser should evaluate whether the proxy advisory firm has performed its duties consistent with the policies and procedures with similar frequency.

There are a number of ways that a fund adviser may keep apprised of significant developments affecting its business relationship with the proxy advisory firm. For example, a fund adviser may schedule recurring reviews or communications with the proxy advisory firm. The frequency and depth of these reviews and communications likely will depend on the nature and extent of the services the proxy advisory firm provides. In addition to a fund adviser's reviews and communications, a proxy advisory firm will sometimes proactively notify the fund adviser of materially significant developments in a proxy advisory firm's business, either on its own initiative or based on expectations set forth by the fund adviser.³²

As part of its ongoing business relationship, a fund adviser could consider providing the proxy advisory firm with performance feedback, as a means of improving performance and the working relationship. This is particularly important when the proxy advisory firm's services are not meeting the fund adviser's expectations. Depending on the nature of the matter, a fund adviser could request a response and follow up as appropriate.

³⁰ See Bulletin, Question 4.

³¹ See Bulletin, Question 1; see also Advisers Act Rule 206(4)-7 and Investment Company Act Rule 38a-1.

³² See Bulletin, Question 4. ICI and IDC understand that proxy advisory firms have different means of proactively conveying information to their clients, including through proprietary platforms and websites that a fund adviser can monitor and review as appropriate. ICI and IDC also understand that proxy advisory firms periodically host conferences and conference calls to cover certain topics of interest. A fund adviser may wish to participate in these forums if the subject matter is relevant to the services it receives from the proxy advisory firm.

What could the fund adviser consider covering as part of its ongoing oversight and due diligence program?

Subsequent reviews could address the proxy advisory firm's actual performance on behalf of the fund since the last review.³³ To this end, a fund adviser could consider ways of assessing proxy advisory firm performance (e.g., whether voting instructions were properly submitted, information regarding any material operational or research-related errors, quality of research reports (if applicable), quality and responsiveness of servicing, etc.).

As part of its ongoing oversight, a fund adviser could request that the proxy advisory firm provide, or provide information about:

- » Material changes (including those pending) to information previously provided by the proxy advisory firm, including that related to:
 - » Operations and ownership structure
 - » Key personnel and resources
 - » Key policies and procedures
- » Adoption of new policies and procedures
- » Initiatives undertaken to improve services or operations
- » Summaries of internal audits and any reviews/audits conducted by third parties, including whether any relevant weaknesses or issues were uncovered (and if so, how they were addressed)³⁴
- » Any relevant legal actions brought against the proxy advisory firm by a regulator or private party
- » Any items identified for follow-up during the period in question or from the previous review

What should a fund adviser do if it learns of material changes to a proxy advisory firm's business?

A fund adviser should evaluate those changes to assess whether the proxy advisory firm continues to have the capacity and competency to adequately provide the relevant proxy services.³⁵

³³ The fund adviser could also consider revisiting certain of the initial review topics discussed above as appropriate.

³⁴ See *supra*, note 27 for additional potential areas of inquiry for a proxy advisory firm that is a registered investment adviser.

³⁵ Cf. Bulletin, Question 4, and the Egan-Jones and ISS No-Action Letters.

D. Oversight of Administrative Functions

How could a fund adviser exercise oversight of administrative functions performed by a proxy advisory firm?

As an initial matter, when a fund adviser begins a business relationship with a proxy advisory firm or launches a new fund to which the proxy advisory firm will provide certain services, the proxy advisory firm, working with the fund adviser and fund custodian, establishes an account for each fund containing the necessary instructions and preferences (e.g., the fund's particular proxy voting guidelines to be applied to proxy proposals). A fund adviser could review this account set-up information to determine if it properly reflects its instructions. Likewise, a fund adviser could review any subsequent changes made to this information and may also consider additional periodic reviews.

If a proxy advisory firm is responsible for releasing voting instructions on behalf of a fund, the fund adviser should periodically assess whether the proxy advisory firm has properly done so.³⁶ This could include reviewing whether:

- » the proxy advisory firm has submitted voting instructions for all of the fund's shares that the fund adviser intended to vote; and
- » those instructions were consistent with the fund adviser's voting instructions, whether based on application of proxy voting guidelines or otherwise.³⁷

E. Proxy Voting Guideline Formulation and Use

What types of proxy voting guidelines do fund advisers establish, and what are some general considerations in their formulation and maintenance?

Subject to board approval, fund advisers may formulate and maintain proxy voting guidelines specifying how they will vote on behalf of their funds on various kinds of proxy proposals. For instance, the guidelines may specify the circumstances under which the fund adviser generally will vote for or against director nominees, executive compensation plans, or social or environmental issues. A fund adviser (or the proxy advisory firm) then votes on specific proxy proposals in accordance with the guidelines. Use of guidelines helps ensure consistency in proxy voting and can help protect against potential conflicts of interest.

³⁶ See Bulletin, Question 1.

³⁷ If a fund adviser uses guidelines and the proxy advisory firm generally has standing instructions to vote in accordance with those guidelines, the fund adviser should periodically review the proxy advisory firm's work in this area. *See id.* For example, the fund adviser could consider reviewing random samples of votes cast, non-routine votes, and/or those votes related to securities in which a fund has a significant economic interest.

Fund advisers that use proxy voting guidelines may adopt: (i) guidelines with no reference to those of a proxy advisory firm, and no input from a proxy advisory firm; (ii) customized guidelines, with varying degrees of similarity to a proxy advisory firm’s standard guidelines and input from the proxy advisory firm; or (iii) a proxy advisory firm’s standard guidelines. Irrespective of a proxy advisory firm’s involvement, the guidelines should reflect the fund adviser’s and board’s views about how to act in the best interest of the fund. Additionally, the fund adviser and the fund board should review the guidelines, including any material changes, at least annually.³⁸

What else could a fund adviser consider if the proxy voting guidelines reflect input from a proxy advisory firm?

A fund adviser that is using or is considering using a proxy advisory firm’s standard guidelines or its own customized guidelines with input from a proxy advisory firm also may wish to consider the following:

- » As part of its initial review, the proxy advisory firm’s standard proxy voting guidelines (including variations thereof that may be of interest—for example, regional- or country-specific guidelines); the reasoning behind the guidelines; the proxy advisory firm’s internal process for reviewing, formulating, and revising its guidelines; and whether the guidelines are consistent with the fund’s best interest.
- » On an ongoing basis, a proxy advisory firm’s material changes to its standard proxy voting guidelines, the reasoning behind those changes,³⁹ and whether the fund adviser wishes to amend its guidelines to incorporate any of those changes.

Will proxy voting guidelines alone provide a sufficient basis for all proxy votes?

No. An application of proxy voting guidelines, no matter how detailed, to proxy proposals will not always yield obvious voting decisions. Some proxy proposals will not have a corresponding guideline that is clearly applicable, and often a fund adviser’s guidelines will require “case-by-case” evaluations of certain complicated or fact-specific proposals (such as merger proposals). For those situations, many fund advisers use proxy advisory firms’ research and recommendations as one resource.

³⁸ See *supra*, note 31.

³⁹ To the extent that it is relevant, a fund adviser may wish to inquire about whether applicable changes in laws, regulations, or norms have been reflected in a proxy advisory firm’s standard regional- or country-specific guidelines.

F. Proxy Advisory Firm's Research and Recommendations

How could a fund adviser assess a proxy advisory firm's proxy voting research capabilities?

As part of its initial review (and subsequent reviews, as appropriate), a fund adviser may wish to assess the resources that a proxy advisory firm dedicates to proxy research and analysis. In doing so, a fund adviser could evaluate the relationship of those resources to the proxy advisory firm's coverage of issuers. In making this evaluation, a fund adviser could request information about the number of issuers the proxy advisory firm typically covers each year, the number of research reports it typically issues each year, and the number of analysts (and other personnel) that are dedicated to proxy research and analysis. As part of initial due diligence, a fund adviser also could review sample research reports to help assess their usefulness.

To the extent that a proxy advisory firm covers foreign issuers, a fund adviser could make a similar assessment of the resources dedicated to that specific coverage. In addition, a fund adviser could inquire about the proxy advisory firm's knowledge of local market conditions and regulations, and whether its guidelines and methodologies reflect them.

What could a fund adviser consider in connection with a proxy advisory firm's voting recommendations?

To understand how a proxy advisory firm analyzes proxy voting proposals and arrives at its ultimate voting recommendations, a fund adviser could inquire about the following:

- » The extent to which the proxy advisory firm's standard guidelines determine ultimate recommendations
- » The information relied upon and parties typically consulted
- » The methodologies and models that influence the proxy advisory firm's recommendations, particularly for those subjects on which the proxy advisory firm formulates recommendations on a "case-by-case" basis⁴⁰

⁴⁰ As part of subsequent reviews, a fund adviser could inquire about whether changes have been made to any policies and methodologies underlying research that materially change the emphasis of the research and resulting recommendations. Cf. Bulletin, Question 4.

G. Proxy Advisory Firm’s Potential Conflicts of Interest

How could a fund adviser evaluate the potential conflicts of interest to which a proxy advisory firm may be subject?

Whether and the degree to which a fund adviser should evaluate these potential conflicts of interest depends on the services it receives from the proxy advisory firm. Assessing a proxy advisory firm’s potential conflicts of interest is especially important for those fund advisers that rely on a proxy advisory firm’s voting recommendations. A fund adviser that does so should consider whether the proxy advisory firm can make recommendations that are in the best interest of the fund, the fund adviser’s guiding principle in voting fund proxies.⁴¹ As with any fund service provider, a fund adviser should have an understanding of a proxy advisory firm’s:

- » organizational structure, affiliates, lines of business, clientele, and other business relationships, and whether they could give rise to any potential conflicts of interest; and
- » processes for identifying, mitigating, and disclosing its potential conflicts of interest.

A fund adviser could make a determination regarding a proxy advisory firm’s impartiality by conducting a thorough review of the proxy advisory firm’s conflict procedures and the effectiveness of their implementation.⁴² Taking this approach, a fund adviser could consider assessing:

- » The proxy advisory firm’s business and the nature of the conflicts that the business presents
- » The adequacy of the proxy advisory firm’s conflict procedures in light of the particular conflicts the proxy advisory firm faces in making voting recommendations, and whether the proxy advisory firm’s conflict procedures negate those conflicts⁴³
- » Whether the proxy advisory firm has fully implemented its conflict procedures

A fund adviser could undertake this evaluation at least annually, with the frequency depending in part on the nature and extent of services provided by the proxy advisory firm.

⁴¹ See Advisers Act Rule 206(4)-6(a).

⁴² See ISS No-Action Letter. Alternatively, the fund adviser may consider obtaining from the proxy advisory firm, on a case-by-case basis, any relevant facts regarding the proxy advisory firm’s relationship with the issuers of securities, particularly any compensation the proxy advisory firm has received or will receive from such issuers in connection with contracts for services. See Egan-Jones No-Action Letter. The no-action letters offer other possibilities for working with proxy advisory firms that face potential conflicts of interest, and fund advisers may wish to consider them in light of operational feasibility.

⁴³ The SEC staff notes in the ISS No-Action Letter that in doing so “an investment adviser should consider whether the procedures effectively (a) preclude the natural persons who make the firm’s proxy voting recommendations from obtaining access to information about the firm’s business relationships with [i]ssuers and (b) insulate those persons from direct or indirect influence by the firm’s employees who know of those relationships.” For instance, if a proxy advisory firm maintains “firewalls” between different lines of business designed to help ensure that proxy advisory personnel are not influenced by other business interests, a fund adviser could evaluate the effectiveness of those firewalls. Such an inquiry could include asking about the features of the firewalls, who monitors the firewalls, any exceptions to the general prohibition on information sharing, whether there have been any breaches and how they were handled, and what improvements have been made to them. See *also* Bulletin, Questions 3 and 4.

What should fund advisers understand about proxy advisory firms' potential conflicts-related disclosure requirements under federal law?

Rule 14a-2(b)(3) under the Securities Exchange Act of 1934 provides an exemption from the information and filing requirements of the federal proxy rules applicable to “solicitations.” Proxy advisory firms commonly rely on this exemption.⁴⁴ To do so, a proxy advisory firm first must assess, if applicable, the significance of its relationship with the company or shareholder proponent, or the materiality of its interest in any such matter; if the proxy advisory firm determines it has a significant relationship or material interest, then it must provide the recipient of the advice with notice of the relationship or interest.⁴⁵

Depending on the nature and extent of services provided by the proxy advisory firm, a fund adviser should understand how the proxy advisory firm is assessing “significance” and “materiality” and providing the necessary disclosure (e.g., in the research report itself or by another means) in fulfilling this requirement. When a proxy advisory firm makes such conflict-related disclosure, that information may be relevant to a fund adviser relying on the related research report and recommendation.⁴⁶ If the report’s analysis or recommendation appears to be inconsistent with the proxy advisory firm’s guidelines, methodologies, or its prior recommendations for proposals with similar fact patterns, or other information that the fund adviser is considering, then the fund adviser could consider seeking clarification from the analyst preparing the report.

H. Review of and Response to Errors

How could a fund adviser generally approach errors related to proxy voting?

At times, it is possible for a fund adviser or a proxy advisory firm to make errors in carrying out its proxy voting functions. While errors in this context can take many forms, they generally can be categorized as (i) operational errors (e.g., a proxy advisory firm could neglect to submit voting instructions on behalf of a fund, fail to vote proxies in accordance with the applicable guidelines, improperly record data for a fund’s Form N-PX filing, or improperly set up a fund’s account), or (ii) errors related to research or analysis (e.g., making an error in a research report).

⁴⁴ The SEC staff bulletin reiterated the SEC’s view that furnishing proxy voting advice constitutes a “solicitation” subject to the information and filing requirements of the federal proxy rules, absent an exemption. Rule 14a-2(b)(3) provides an exemption from certain provisions of the federal proxy rules for “[t]he furnishing of proxy voting advice by any person (the “advisor”) to any other person with whom the advisor has a business relationship” provided certain conditions are satisfied, most notably in this context that “[t]he advisor disclose...to the recipient of the advice any significant relationship with the registrant or any of its affiliates, or a security holder proponent of the matter on which advice is given, as well as any material interests of the advisor in such matter.”

⁴⁵ See Bulletin, Questions 10 and 11.

⁴⁶ Cf. the Egan-Jones No-Action Letter and Bulletin, Question 11.

When a fund adviser learns of a material error made by a proxy advisory firm, it should take reasonable steps to investigate the error and seek to determine whether the proxy advisory firm is taking reasonable steps to seek to reduce similar errors in the future.⁴⁷ For instance, with respect to a voting-related operational error, a fund adviser may ask the proxy advisory firm to determine the effect of the error on the vote's ultimate outcome. With respect to research, a proxy advisory firm and an issuer may disagree regarding whether a disputed item is in fact erroneous or instead reflects a difference in policy or opinion. If a fund adviser learns of such a disagreement (e.g., through communication with the issuer), it should evaluate the nature of the disagreement and consider how it may impact its voting decision.⁴⁸

How could a fund adviser evaluate a proxy advisory firm's ability to minimize errors and issue accurate and current research reports?

As with any third-party service provider it may employ, a fund adviser could consider the types of errors that it could encounter in its relationship with a proxy advisory firm and then review a proxy advisory firm's policies, procedures, and controls to determine if they are reasonably designed to minimize the occurrence of such errors. For those fund advisers that consult a proxy advisory firm's research reports, the fund adviser may wish to consider the proxy advisory firm's ability to present clear, accurate, and current information in its research reports, including:

- » The process by which reports are reviewed internally and externally and revised
- » How the proxy advisory firm evaluates claims of errors and rectifies them when necessary⁴⁹
- » How and when a proxy advisory firm updates its research and recommendations for other reasons (e.g., in response to new information contained in subsequent regulatory filings from issuers)
- » The proxy advisory firm's process for reevaluating its policies and procedures after learning of errors

⁴⁷ See Bulletin, Question 5.

⁴⁸ Cf. Bulletin, Question 5.

⁴⁹ ICI and IDC understand that proxy advisory firms have processes for amending reports when they discover errors and subsequently notifying their clients. A fund adviser could monitor these amendments for purposes of (i) evaluating the proposals in question and (ii) its ongoing assessment of the proxy advisory firm's competence.

V. Miscellaneous Considerations

A. Review of Policies and Procedures

Should proxy voting policies and procedures and other related materials address the use and oversight of a proxy advisory firm?

The SEC staff’s legal bulletin states that “an investment adviser that has retained a third party (such as a proxy advisory firm) to assist with its proxy voting responsibilities should, in order to comply with the Proxy Voting Rule [i.e., Advisers Act Rule 206(4)-6], adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the third party in order to ensure that the investment adviser, acting through the third party, continues to vote proxies in the best interests of its clients.”⁵⁰ The SEC has recognized in the context of proxy voting that investment advisers have the flexibility to craft policies and procedures suitable to their businesses,⁵¹ and, accordingly, proxy voting policies and procedures will vary depending on the nature and extent of the services received from proxy advisory firms.⁵²

B. Review of Proxy Voting Disclosure

What types of disclosures should funds make regarding their use of proxy advisory firms?

Funds must describe in their registration statements (and, for closed-end funds, in their annual Form N-CSR filings) the policies and procedures that they use to determine how to vote proxies relating to portfolio securities.⁵³ The SEC provided examples of general policies and procedures with respect to which disclosure would be appropriate, including “[t]he extent to which the fund delegates its proxy voting decisions to its investment adviser or another third party, or relies on the recommendations of a third party.”⁵⁴ More generally, the SEC made clear that funds “should be allowed the flexibility to determine the content that would be appropriate for this disclosure.”⁵⁵ Accordingly, fund disclosure will vary depending on, among other things, the nature and extent of the services received from proxy advisory firms.

⁵⁰ The SEC staff cites Advisers Act Rule 206(4)-7 and Investment Company Act Rule 38a-1 in support of this statement. Similarly, in the Egan-Jones No-Action Letter, the SEC staff stated that procedures “should address the use of any independent third party to make recommendations regarding the voting of the proxies of an investment adviser’s clients if the use of an independent third party is a material part of the adviser’s proxy voting policies.”

⁵¹ See Adviser Proxy Voting Release at 4.

⁵² More detailed information about a fund adviser’s use and oversight of a proxy advisory firm may appear in an operating manual or “desktop” procedures.

⁵³ See *supra*, note 4. Under these disclosure requirements, funds are also required to disclose “any policies and procedures of the [f]und’s investment adviser, or any other third party, that the [f]und uses, or that are used on the [f]und’s behalf, to determine how to vote proxies relating to portfolio securities.” Similarly, registered investment advisers must briefly describe in their Forms ADV their voting policies and procedures if they have, or will accept, authority to vote client securities. See Item 17 to Part 2A of Form ADV.

⁵⁴ See Investment Company Proxy Voting Release at 5.

⁵⁵ *Id.*

Appendix A: Additional Resources

SEC Releases

- » *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, SEC Release No. IC-25922 (January 31, 2003), available at www.sec.gov/rules/final/33-8188.htm.
- » *Proxy Voting by Investment Advisers*, SEC Release No. IA-2106 (January 31, 2003), available at www.sec.gov/rules/final/ia-2106.htm.
- » *Compliance Programs of Investment Companies and Investment Advisers*, SEC Release No. IA-2204 (December 17, 2003), available at www.sec.gov/rules/final/ia-2204.htm.
- » *Concept Release on the U.S. Proxy System*, SEC Release No. IC-29340 (July 14, 2010), available at www.sec.gov/rules/concept/2010/34-62495.pdf.

SEC Staff No-Action Letters

- » Egan-Jones Proxy Services, SEC No-Action Letter (May 27, 2004), available at www.sec.gov/divisions/investment/noaction/egan052704.htm.
- » Institutional Shareholder Services, Inc., SEC No-Action Letter (September 15, 2004), available at www.sec.gov/divisions/investment/noaction/iss091504.htm.

SEC Staff Guidance

- » SEC ComplianceAlert (July 2008), available at www.sec.gov/about/offices/ocie/complialert0708.htm.
- » *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms*, Staff Legal Bulletin No. 20 (June 30, 2014), available at www.sec.gov/interps/legal/cfs1b20.htm.

IDC/ICI Publications and Other Resources

- » *Board Oversight of Certain Service Providers*, Independent Directors Council Task Force Report, June 2007, available at www.idc.org/pdf/21229.pdf.
- » *Oversight of Fund Proxy Voting*, Independent Directors Council and Investment Company Institute, July 2008, available at www.ici.org/pdf/ppr_08_proxy_voting.pdf.

- » “Proxy Voting by Registered Investment Companies: Promoting the Interests of Fund Shareholders, 2008,” *ICI Research Perspective* 14, no. 1 (July 2008), available at www.ici.org/pdf/per14-01.pdf.
- » *Board Oversight of Subadvisers*, Independent Directors Council Task Force Report (January 2010), available at www.idc.org/pdf/idc_10_subadvisers.pdf.
- » “Trends in Proxy Voting by Registered Investment Companies, 2007–2009,” *ICI Research Perspective* 16, no. 1 (November 2010), available at www.ici.org/pdf/per16-01.pdf.
- » *ICI Information Security Resource Center—What to Ask When Assessing Information Security Programs*, available at www.ici.org/info_security/questions.

Appendix B: Proxy Advisory Firm Oversight Working Group

Donna Anderson
Global Corporate Governance Analyst
T. Rowe Price Associates, Inc.

Paul Freeman
Independent Director
Deutsche Funds

Paul Beste
Chief Operating Officer
Heartland Advisors, Inc.

David Genova
Global Investments Director
Invesco Ltd.

Glenn Booraem
Principal
Vanguard Group, Inc.

Linda Giuffre
Chief Compliance Officer/Treasurer
Bridgeway Capital Management

Maria Damico
Senior Legal Counsel
Fidelity Investments

Scott Goebel
General Counsel
Fidelity Management & Research Company

James Delaplane
Principal, Securities and ERISA Regulation
Vanguard Group, Inc.

Kimberly Novotny
Associate General Counsel
Franklin Templeton Investments

Michelle Edkins
Managing Director, Global Head of Corporate
Governance and Responsible Investment
BlackRock

Bonnie Saynay
Head of Proxy Governance and Administration
Invesco Ltd.



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1401 H Street, NW, Washington, DC 20005-2148 202-326-5800



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