



MUTUAL FUND DIRECTORS FORUM

The FORUM for FUND INDEPENDENT DIRECTORS

Report of the
Mutual Fund Directors Forum

Practical Guidance for Fund Directors on Oversight of Proxy Voting

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Working Group

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American Funds

BlackRock

Columbia Management

Fidelity Management & Research Company

Franklin Templeton Funds

ING Funds

MFS Investment Management

OppenheimerFunds, Inc.

Pioneer Investment Management USA, Inc.

Putnam Funds

T. Rowe Price Associates, Inc.

TIAA-CREF

I. Introduction

Through proxy voting, mutual funds have substantial power to influence corporate governance around the world. As the owners of the shares held in their portfolios, funds have the right, and possibly an obligation,¹ to receive proxy materials and vote on matters presented to shareholders for a vote at shareholder meetings. Considering that funds own over a quarter of the outstanding shares of U.S. stocks, this represents an enormous amount of the voting power in the United States alone.²

The task of voting proxies is no small endeavor. Each proxy season, fund complexes must cast a large number of votes, often thousands, in a relatively short amount of time. Proxies must be voted in the best interest of fund shareholders and the voting record is subject to public scrutiny. Fund Boards are responsible for adopting proxy voting procedures that govern this intricate process. This paper explores the following decision points that fund directors should take into consideration:

1. To What Extent Should Proxy Voting Duties Be Delegated?
2. How Should Third Party Proxy Firms Be Utilized?
3. To What Extent Should Investment Professionals Be Involved in the Voting Process?
4. What Process Should Be Used for Overriding a Fund's Voting Guidelines?
5. Should Funds in the Same Complex Be Permitted to Split Votes?
6. How and When Should Funds Engage with Portfolio Companies on Upcoming Votes?
7. How Should Conflicts of Interest Be Handled?
8. How Should Funds Handle Proxy Voting for Their Loaned Securities?

To put these decision points in context, the paper also summarizes common proxy voting structures and processes used throughout the industry. Finally, the report discusses processes and procedures used by Boards to oversee the proxy voting process. This paper is based largely on discussions with directors and management representatives from fund families of all sizes (representing over 50% of U.S. mutual fund assets under management)³ and two of the major proxy voting service providers.

Under federal⁴ and state law, fund directors have a responsibility to oversee their fund's affairs, including the voting of the fund's proxies. This oversight duty is part of the directors' general fiduciary duties of care and loyalty. Therefore, although a Board may delegate proxy voting duties to an adviser or other third party, the Board retains ultimate oversight responsibility and must exercise reasonable judgment when overseeing the funds' proxy voting process.

Boards are also legally required to approve and annually review their funds' proxy voting procedures as part of the funds' compliance program. Under the Investment Company Act of 1940, as amended, Boards must determine that the funds' proxy voting procedures are "reasonably designed to prevent violation of the Federal Securities Laws by the fund, and by each investment adviser, principal underwriter, administrator, and transfer agent of the fund."⁵

A fund's proxy voting procedures detail the process for voting fund proxies, including the role of the fund directors and any responsibilities that have been delegated to the adviser, subadviser and/or proxy voting service. The procedures also often include voting guidelines that state how particular proxy votes will be cast.⁶ For example, voting guidelines often include rules that specify when a fund will vote for or against a certain type of proposal, or they may provide that certain voting issues be considered on a "case-by-case" basis.⁷

Funds are required to make certain disclosures regarding proxy voting to shareholders. Each fund must describe its proxy voting policies and procedures in its registration statement⁸ and annually file with the SEC information about any proxy votes made during the previous year.⁹

When the Board has delegated proxy voting to an adviser or subadviser (referred to herein collectively as the "adviser"), the Board may choose to have the adviser's proxy voting policies govern the fund's proxies. In these situations, the fund's proxy voting procedures typically reference the adviser's procedures and call for the periodic review of the adviser's policies.¹⁰ It is important to note that if the adviser has been delegated proxy voting authority, the adviser itself is subject to additional regulation. The Investment Advisers Act of 1940 requires advisers that exercise voting authority over clients' proxy voting to adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of clients, discloses to its clients information about those policies and procedures and also discloses to clients how they may obtain information on how the adviser has voted their proxies.¹¹

II. What Concepts Should Boards Consider When Establishing and Evaluating Proxy Voting Processes and Procedures?

In establishing or evaluating their funds' proxy voting procedures, there are a number of broad concepts Boards may wish to consider that will help determine how to best structure a fund's voting processes and procedures. This section discusses some of these key concepts. Section III and the Appendix provides additional context on these decision points by describing common proxy voting processes and procedures used throughout the industry.

A. To What Extent Should Proxy Voting Duties Be Delegated?

The threshold decision a Board must consider when determining how to structure its funds' proxy voting process is which voting responsibilities will be retained by the Board and which will be delegated. A few Boards have decided to retain voting authority over all of their funds' proxy votes. However, the majority of Boards delegate some or all voting power to an adviser. In situations where the Board has delegated its voting authority, the Board retains oversight responsibilities and may have some voting discretion in specified situations.

The following are examples of how some Boards participate in fund voting decisions:

- No Delegation: Board Retains All Voting Authority. A few Boards do not delegate any voting authority. The Board makes all voting decisions and the adviser usually serves in an administrative role. This model is discussed in more detail in Section III and the Appendix.
- Partial Delegation: Board Provides Input on High Profile Votes, Material Votes or Novel Issues Not Covered by Proxy Policies. Some Boards that delegate voting authority to a third party still choose to be involved on certain votes, such as those that are high profile, of particular interest to the Board, or that involve novel issues that are not covered under the fund's proxy guidelines. The level of involvement by Boards on these key votes varies – some Boards may want to make the voting decisions, others may provide in-depth advice on the issue, and some may only want to receive a report about how the adviser intends to vote so that they can raise concerns if necessary.

However a Board chooses to be involved, it should decide what type of procedure will be used. The Board should determine what types of information should be considered and who should be involved in the process – for example, the full Board, a committee, or a Board or committee chair. One Board we are aware of assigns a Board committee member to research the vote at issue and present it to the committee responsible for proxy voting. The committee then discusses the matter and provides feedback to the adviser. The committee also reports its discussions to the full Board.

If the ultimate voting decision represents a new policy stance or shift in current policy then the Board also should consider whether the fund's voting guidelines should be amended at the same time.

- Partial Delegation: Board Determines Votes when Adviser has Conflict of Interest. As discussed later in this section under “*How Should Conflicts of Interest Be Handled?*”, some Boards become involved in the voting process when an adviser has a conflict of interest concerning a vote. For example, many proxy voting procedures call for votes to be elevated to the Board when the adviser does not believe it is able to recommend a vote without the appearance of bias (e.g., if the adviser wants to override the proxy voting guidelines in favor of a company with which the adviser has a potential conflict of interest).

B. How Should Third Party Proxy Firms Be Utilized?

It is important for Boards to understand the role that proxy service vendors play in their funds' proxy voting process. Vendors offer a variety of services which most fund complexes use to at least some degree. For some funds, vendors may assist solely with administrative functions, while for others, vendors may play a key role in the proxy voting process (for more information, see the discussion regarding proxy voting models in Section III and the Appendix).

The following is a list of some of the proxy vendor services that are often used by funds:

- **Administrative/Back Office Functions**

- Receipt and Execution. Most fund groups use proxy service vendors to perform some administrative or back office functions. For example, proxy service providers will monitor the receipt of ballots and execute votes according to fund instructions.
- Pre-population. Some fund groups also use vendors to perform an initial analysis of how a fund would likely vote under the fund's own custom policies (not the vendor's policies). Funds using this service typically have the vendor pre-populate the fund's vote in its voting software. Adviser personnel then analyze each vote and make the final determination of how it will be cast. Many fund groups find this service makes the voting process more efficient.
- Casting Votes According to Specific Instructions. Some fund groups use a proxy service vendor to cast votes according to a fund's custom voting guidelines. In these arrangements, the vendor executes routine votes where the fund's voting policy is clear. The vendor is typically asked to escalate to the adviser any votes where the guidelines are silent on the issue, the guidelines are unclear on the matter or the guidelines specify that the vote is to be analyzed on a "case-by-case" basis. Fund groups who use this vendor service typically have the adviser oversee this process to ensure the votes are cast in accordance with the funds' procedures. The adviser usually conducts a retroactive review of the votes cast and any votes missed and may have regular meetings with the vendor about how the policies are being implemented.
- **Use of Vendor Research and Analysis.** Most fund groups use research and analysis reports from one or more proxy service vendors. Vendors typically offer a report on each proposed vote which contains relevant statistics, facts and analysis. The vendor may provide information on financial performance, executive compensation and board membership and convey insight gained from the vendor's engagement with portfolio companies. Fund groups often find that these reports are a helpful resource in making their own voting determinations, especially in markets where the proxy team and/or investment professionals have less expertise or lack relevant language skills (such as smaller foreign markets).
- **Using Vendor Vote Recommendations for Reference.** Proxy service vendors also offer vote recommendations based on the vendor's own guidelines. Some fund

groups include these recommendations as part of the total mix of information used to decide how to cast votes that are being considered on a case-by-case basis. These fund groups do not automatically follow a vote recommendation, but they will take it under consideration when evaluating the matter.¹²

- **Following Vendor Vote Recommendations.** Some funds vote all of their proxies according to proxy service vendor voting recommendations while others may follow vendor recommendations for specific types of votes. Often fund complexes use this service as a cost-effective means to gain expertise they otherwise lack. For example, some fund advisers do not have personnel specializing in corporate governance issues and others lack expertise on specific issues or markets. Some fund families also use vendor recommendations as a way to handle votes involving a potential conflict of interest. By deferring to a vendor, the conflict of interest of the adviser and/or fund may be avoided because the adviser and Board do not take an active role in determining the vote.¹³
- **Use Vendor Expertise to Draft Voting Guidelines.** Some fund groups use a proxy service vendor to assist them in creating or updating their voting guidelines. A vendor may be able to offer additional experience and expertise to the funds, which may be especially helpful on complicated voting issues.

Boards should be aware that vendors may have potential conflicts of interest themselves. Some vendors advise public companies about how to structure a proposal to be voted on at a shareholder meeting and then make vote recommendations to funds about how to vote on that proposal.¹⁴ Vendors may also have a conflict if they provide proxy voting services to an asset management client that is owned by a publicly listed company (the vendor could end up providing vote recommendations and analysis on that company's proxy). Most proxy service vendors have taken steps to mitigate the potential influence of conflicts of interest, such as establishing internal firewalls or disclosing the conflict to its clients.¹⁵ However, it is important that those involved in the funds' proxy voting process be aware of these potential conflicts of interest and understand how they are handled by the vendors.¹⁶

C. To What Extent Should Investment Professionals Be Involved in the Voting Process?

In establishing proxy voting processes and procedures, funds need to consider whether and how to involve investment professionals, such as portfolio managers and analysts, in the process. The majority of actively-managed fund complexes appear to involve investment professionals in the process to some degree.¹⁷

Common responsibilities given to investment professionals include:

- Voting Authority Over Some or All Votes. Some fund complexes give complete voting discretion to the portfolio managers of the fund that holds the portfolio company (see the discussion on *Model 2(c): Board Delegates to Adviser's Portfolio Managers* in Section III and the Appendix). Other fund families give portfolio managers voting authority over certain specified types of votes – for example, portfolio managers

may have the power to decide votes pertaining to specific issues, such as mergers and acquisitions, or portfolio managers may have discretion over all votes that are required to be considered on a case-by-case basis.

- Input on All or Certain Votes. Some fund groups seek input from investment professionals on all or certain types of votes. In these situations, the portfolio manager or analyst does not make the final voting decision, but the investment professional's recommendation is considered as one factor in the decision making process.
- Overrides. Most fund groups allow portfolio managers to recommend that the fund cast a vote contrary to its stated voting guidelines. As discussed in more detail in "*What Process Should Be Used for Overriding a Fund's Voting Guidelines?*" below, overrides should only be permitted pursuant to established processes and procedures.

On the other hand, some actively-managed fund complexes choose to exclude investment professionals from the proxy voting process as much as possible. Funds that take this position, however, often still seek input from investment professionals on issues where they have unique expertise. For example, with respect to votes regarding mergers and acquisitions, investment professionals are often in the best position to evaluate whether the transaction would benefit the fund; on executive compensation issues, they can provide insight on whether pay is commensurate with performance; and on social and environmental issues, investment professionals may have the most expertise on whether and how the vote may affect the company's operations and performance.

Those who believe investment professionals should play a limited role in proxy voting argue that investment professionals have a potential bias toward management. Portfolio managers and analysts often work closely with their funds' portfolio companies and may be hesitant to vote against management's recommendation for fear that it would harm their relationship with the company. In addition, minimizing investment professionals' involvement in the proxy voting process could reduce the potential for inappropriate influence by portfolio companies, proxy solicitors and other third parties.

Despite these concerns, many believe that the expertise of investment professionals who actively manage funds is too valuable to ignore. They believe that proxy voting is part and parcel to the investment process and that investment professionals are the ones with the most extensive knowledge of the portfolio companies and their operations. Smaller complexes with fewer resources, including limited or no experienced corporate governance personnel, may be especially interested in leveraging their resources by utilizing the expertise of investment professionals.

Those fund complexes that choose to involve investment professionals in the voting process usually try to limit the effect of any bias toward management by including non-investment professionals in the process. Their participation helps to ensure that the portfolio managers' or analysts' recommendations and input are reasonable and ap-

appropriate for the funds. How non-investment professionals are involved in the process will vary depending on the particular circumstances of the funds and its proxy voting procedures. At least one fund family requires a recommendation from both a portfolio manager and the proxy management team for every pending vote. Fund families also usually have a non-investment professional review and/or approve any override request, and the rationale therefore, from a portfolio manager. In addition, if the adviser has an internal proxy voting committee charged with overseeing the voting process (“Proxy Voting Committee”), it usually has at least one non-investment professional as a member. These committee members usually come from the proxy governance, legal and/or compliance teams.

D. What Process Should Be Used for Overriding a Fund’s Voting Guidelines?

Many Boards have adopted proxy voting guidelines that are rule-based,¹⁸ specifying how a fund will vote depending on the fund’s specific circumstances.¹⁹ Most of these funds also have a process for overriding a voting guideline when circumstances warrant. Usually, a request to override the proxy guidelines comes from an investment professional or a member of the proxy team. If the fund complex has a Proxy Voting Committee, the Committee is usually charged with approving the override request. If the fund group does not have a Proxy Voting Committee, a proxy governance team (a group of personnel that specialize in corporate governance and proxy voting) along with legal and/or compliance may be required to approve the request. If voting discretion resides with the Board, the Board or its designee (e.g., the Board chair) will usually have final approval over the override request. While the exact process for approving the override will vary, the Board should understand the process for overrides, what information will be considered in approving an override and who will be involved in the decision to override a guideline.

E. Should Funds in the Same Complex Be Permitted to Split Votes?

Another issue for funds and their Boards to consider is whether they should allow funds in the same family to split their votes (*i.e.*, allow two funds to vote differently on the same vote for the same portfolio company).

Many fund groups have a policy that they will strive to vote proxies in the best interests of fund shareholders. Some believe that in order to do this, the fund family should ascertain the best vote for all of the funds’ shareholders and then vote all shares owned by funds in the complex the same way.

Other fund families believe that the vote that is in the best interest for shareholders of one fund may be different from that which is best for the shareholders of another fund. To try to ensure that votes are being cast in the best interest of each fund’s shareholders, these complexes will allow split votes (although some ask that disagreeing portfolio managers attempt to come to an agreement before a split vote is permitted).²⁰

Still, other fund complexes strike a middle ground and allow funds to split votes

on specific issues. For example, many fund groups allow funds to split votes on merger and acquisition transactions on the belief that the impact of the transaction could vary for each fund depending on the fund's investment objectives, strategies and other portfolio holdings.

F. How and When Should Funds Engage with Portfolio Companies on Upcoming Votes?

Most fund families are open to engaging with portfolio companies on voting issues. During proxy voting season, portfolio companies often reach out to funds with information about upcoming votes, and funds will also contact portfolio companies with questions. Many fund managers have reported that engagement by portfolio companies increased with the introduction of “say-on-pay” votes.

It is also common for portfolio companies to engage fund complexes before proxy season begins. Portfolio companies are typically interested in what changes will be made to the funds' proxy voting guidelines for the upcoming season and may discuss specific policies with the fund complexes.

Fund families that hold a significant position in a company may also use methods outside of the proxy voting process to try to improve corporate governance. For example, a fund family may agree to vote for an issuer's proposal on the condition that the company agrees to consider other policy changes in the future.

Depending on who is involved in the proxy voting process, engagement may be made by the proxy governance team, investment professionals or both. If both proxy governance and investment personnel are involved in the voting process, they typically make an effort to ensure that everyone involved in the process receives the same information. In addition, in fund complexes where the Board retains voting discretion, the lead Board member responsible for voting often receives contact from issuers, generally after the votes are cast.

Post-Vote Reporting. Several fund groups also contact issuers after votes are cast, either through letters, by phone, or in some geographic areas, in person. For fund groups where the fund Board retains voting discretion, the Board chair may routinely send out letters explaining the Board's vote. The Board may choose to send out these types of letters for all votes or only for certain types of votes (e.g., when a vote is cast against management).

Fund families where the Board does not retain full voting discretion do not usually have a specific process for communicating with portfolio companies after voting. These fund groups typically believe that they are able to communicate any necessary information to the portfolio companies during the proxy voting process. Adviser personnel may send a letter after the vote in special circumstances, such as if they believe their vote needs further explanation or they wish to communicate directly with the portfolio company's board (rather than its personnel) about how the fund voted.

G. How Should Conflicts of Interest Be Handled?

An important consideration in establishing or reviewing proxy voting procedures is how potential conflicts of interest are handled. Proxy voting decisions should be made in the best interest of fund shareholders and not in the interest of other parties. However, when an adviser has been delegated proxy voting responsibilities, conflicts of interest may exist between the adviser and its vendors, broker-dealers, institutional clients and affiliates. For example, a fund adviser that also runs a pension business could be in the position of determining how a fund will vote the shares of one of the adviser's large pension clients. The potential exists for the adviser to make a decision based on the pension client's business relationship with the adviser (or an anticipated business relationship) and not on what is in the best interest of the fund. The proxy voting procedures approved by fund Boards often state that proxies must be voted in the best interest of fund shareholders, but determining the best method to identify potential conflicts of interest is typically delegated to the adviser.

The following are some examples of approaches employed to handle an adviser's potential conflicts of interest (some fund groups may use a combination of these):

- Firewall Between Client Groups and Proxy Voting Team. Most fund advisers that have other institutional clients isolate the fund proxy voting process from those departments and individuals that primarily deal with client management, marketing or sales. By keeping these two functions separate, the potential for influence from a large institutional client on fund voting is reduced.
- Follow Voting Policy. Conflicts of interest can be mitigated by following a fund's proxy voting guidelines and not allowing overrides if a potential conflict of interest exists. It is important to note that this approach only works when the guidelines are clear on how to vote given the specific circumstances. Votes that must be dealt with on a case-by-case basis would have to be handled in an alternative manner.
- Vote According to a Proxy Service Vendor's Recommendations. Some fund policies state that a fund will follow a proxy service vendor's vote recommendation whenever the adviser has a potential conflict of interest. Often the policy will only call for a fund to defer to a proxy vendor when the fund's guidelines don't specify how to vote (*i.e.*, the fund must analyze the vote on a case-by-case basis). Funds may also defer to a proxy vendor when the adviser does not feel it can appear to be unbiased, such as if shares of the portfolio company at issue are owned by the adviser.
- Disclosure/Non-Disclosure and Review. Some funds have implemented a system where a potential conflict of interest is identified and disclosed to every person involved in the voting process. Those who follow this approach believe that it encourages those making voting decisions to take extra care to be unbiased. Alternatively, some fund groups take the opposite approach and employ procedures to ensure that potential conflicts of interest are not disclosed during the proxy voting process.

Those who follow this approach believe that personnel who do not know of a conflict of interest are less likely to be influenced by it.

Whether the conflict is disclosed or not, most fund groups require that vote recommendations involving a potential conflict of interest be subject to an extra layer of review by the legal, compliance and/or conflicts departments. Some fund complexes also require those who made the vote recommendations to certify that they were not influenced by the potential conflict of interest. As part of their oversight role, directors also may receive a voting report on those votes that involved potential conflicts of interest.

- **Board Vote.** Some Boards mitigate an adviser's potential conflict of interest by elevating the voting decision to the Board or to a designated Board member. For example, at least one fund complex requires the Board to approve a vote where the adviser is recommending an override of the voting guidelines in a way that is favorable to the party involved in the conflict. Votes where the adviser does not believe it can make an unbiased decision (or a decision that appears unbiased) may also be elevated to the Board or to a designated Board member.
- **Abstain.** Some funds may choose to abstain from a vote if a conflict of interest is involved.

Fund directors may also have potential conflicts of interest—for example if a director of a fund is also a board member of a company owned by the fund. This could result in the fund director having to decide how the fund will vote on his or her own re-election to the portfolio company's board. Fund directors who have potential conflicts of interest will usually recuse themselves from the voting decision.

H. How Should Funds Handle Proxy Voting for Their Loaned Securities?

Funds that engage in securities lending should also consider how proxy voting will be handled for securities on loan.²¹ Typically when a mutual fund lends its securities, the right to vote those borrowed securities at a shareholder meeting is also transferred to the borrower.²² Therefore, the fund is not able to vote those securities unless it recalls them, terminating the loan and receiving the securities before the record date.

Funds may handle securities on loan in a variety of ways:

- **Recall Loaned Securities if the Vote is Material.** Most fund groups recall securities on loan only if the vote is material. Materiality can be evaluated in several ways. Most fund families believe a vote is material if the economic value of voting the securities outweighs the cost of recalling the securities (mainly, lost revenue).²³ Generally, the economic value of casting a vote is less than the cost of recalling, either because the vote will not have a large economic consequence or because the outcome of the vote will not be affected by the fund voting its shares on loan. However, sometimes a fund family may consider a vote to be material for qualitative reasons. For example, a portfolio manager may believe there is value in voting the shares as a way to send a message to the company, even if the fund's vote will not affect the outcome.

- Recall All Loaned Securities. Some fund groups have a policy to attempt to recall any and all securities on loan before the record date as long as they receive timely notice of the shareholder meeting.²⁴
- Litmus Test. Some funds follow a litmus test on when they recall securities. For example, they may have a policy to only recall securities if the fund owns more than a certain percentage of the company's stock.

III. Proxy Voting Models: How Does the Industry Currently Structure its Proxy Voting Practices and Procedures?

As discussed, there are a number of concepts that funds must consider when establishing or evaluating methods and processes to vote proxies (“proxy voting models”). To help put these decision points in context, the following is an overview of proxy voting models that are commonly used throughout the industry. No two proxy voting models are alike; however for ease of understanding we have grouped proxy voting models into three general categories. Additional information about each of these models can be found in the Appendix.

Model 1: Board Retains All Voting Authority. In these proxy voting models, the Board has retained all voting authority.

Model 2: Voting Authority Delegated to Adviser. In these proxy voting models, the Board has delegated voting authority to the fund's adviser. This category is divided into further subgroups based on the type of adviser personnel that are charged with overseeing the voting process. Fund groups typically use one of the following structures:

Model 2(a): Board Delegates to Adviser's Proxy Voting Committee. Many funds vest voting authority in an adviser-level Proxy Voting Committee that is made up of personnel from various departments, often including a representative from legal/compliance, a representative from the proxy governance staff and, in some cases, investment professionals.

Model 2(b): Board Delegates to Adviser's Proxy Governance Staff. Some funds vest all voting authority in a proxy governance team that specializes in corporate governance and proxy voting. The team may have assistance and input from investment professionals.

Model 2(c): Board Delegates to Adviser's Portfolio Managers. Some funds allow portfolio managers to make voting decisions for all the shares held in their fund.

Model 3: Board Delegates to Proxy Service Vendor. In these models, voting authority largely resides with an independent proxy service vendor who votes according to Board approved voting guidelines that may be created using proxy service vendor input and recommendations.

IV. Board Oversight of Proxy Voting

Boards are required to oversee the proxy voting process as part of their fiduciary duties. The fund's specific processes and procedures will influence how much time and what type of information the Board needs to fulfill its responsibilities.

Some of the threshold governance decisions a Board need to make include the following:

- Full Board or Committee Jurisdiction. Directors need to decide whether it is appropriate and desirable to delegate proxy voting responsibilities to a Board committee. The approach a Board chooses to take will depend on the Board's specific characteristics, including the number of directors that serve on the Board, the Board's current committee structure, and the extent of the Board's involvement in the proxy voting process. Those who delegate to committees may ask the committee to report back to the full Board on certain matters.
- Number of Meetings. Boards also vary on how many meetings they devote to proxy voting. At a minimum Boards should annually review the proxy voting procedures and receive a report about votes that have been cast during the previous year. Some Boards routinely discuss proxy voting more frequently (anywhere between 2-4 times a year) and many discuss any pressing issues as the need arises. As discussed above, Boards who have not delegated proxy voting authority, and therefore are integrally involved in the voting process, usually also have a Board or committee chair that is in constant contact with the adviser.
- Types of Reports. Directors also need to consider what information would be most useful to help them oversee proxy voting. Information can be presented in a variety of ways, including reports of raw data (e.g., a list of all votes reported), statistical analysis that may include voting trends and benchmarking, and summaries that include third party analysis and commentary. Boards receive a wide variety of reports and each Board needs to determine what amount and type of information will be most useful to them in fulfilling their duties. *Below are some of the types of reports that some Boards receive:*
 - **Voting Report** – A list of how votes were cast (e.g., for, against, or abstained);
 - **Analysis** – An analysis of why votes were cast a certain way;
 - **New or Novel Issues** – Information about votes cast on issues not covered by the proxy voting guidelines;
 - **Overrides** – Information about instances where voting policy was overridden and the rationale therefore;
 - **Conflicts of Interest** – Information about how votes were cast when a conflict of interest was present;
 - **Votes Against Management** – Information about votes cast against the recommendation of the portfolio company's management;

- **Benchmarking** – Statistics comparing a fund’s record against its peers and/or a proxy service vendor’s recommendations;
 - **Votes That Differ From Institutional Accounts with the Same Adviser** – Disclosure regarding any vote where institutional accounts served by the adviser voted differently than the mutual funds. This typically occurs when the institutional accounts have different voting guidelines than the mutual funds;
 - **Votes Not Cast** – A report on how many fund proxies were not voted in time to be counted at the shareholder meeting or were not voted due to share blocking,²⁵ lack of power of attorney or other administrative impediments;
 - **Errors** – Information about errors made in voting;
 - **Engagement** – Information about engagement with issuers;
 - **Recall of Loaned Securities** – Information about securities on loan that were or were not recalled; and
 - **N-PX Filings** – Information on the timely filing of Form N-PX (an annual required filing regarding proxy votes cast by mutual funds).
- **Management Presentations.** Boards should consider how often they want the adviser to make in-person proxy voting presentations. Typically, the adviser reviews any reports given to the Board on proxy voting. Additionally, many advisers annually review the proxy voting procedures with the Board and suggest amendments to the procedures. At the end of proxy voting season, some advisers also present an overview of the proxy season to the Board, highlighting any novel issues that arose. On an ad hoc basis, Boards may also ask advisers to present about specific proxy issues – most recently, many Boards received presentations on say-on-pay votes.

V. Conclusion

In sum, there is no “one” way for funds to handle proxy voting. In approving and annually reviewing their funds’ proxy voting procedures, Boards should ensure that they understand the processes and procedures used for voting fund proxies and be comfortable that they are appropriate for their funds. Boards should also take care in overseeing the voting process and ask any questions they feel are necessary to fully understand how important issues, such as conflicts of interest, are addressed.

Notes

- 1 See Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies (IC-25922) (Jan. 31, 2003) (stating “[b]ecause a mutual fund is the beneficial owner of its portfolio securities, the fund’s board of directors, acting on the fund’s behalf, has the right and the obligation to vote proxies relating to the fund’s portfolio securities). Each shareholder vote has an economic value because of its ability to affect corporate change. Although funds may choose to abstain from voting a proxy for a number of valid reasons, the fact that a certain degree of economic value may be lost should be considered. This loss may be de minimus depending on the size of the position the fund holds in the company).
- 2 See *e.g.*, 2012 Investment Company Factbook (stating that in 2011, U.S. Investment companies owned 29% of U.S. equity stocks).
- 3 Based on data regarding assets and market share of fund managers reported by Strategic Insight, an Asset International Company (June 2012).
- 4 See § 36 of the Investment Company Act of 1940, as amended.
- 5 17 C.F.R. § 270.38a-1 (2012).
- 6 Voting guidelines are often the same for all funds in one complex, but may be customized for funds that have a specific focus – for example, socially responsible funds.
- 7 Some Boards require their funds to abstain from all votes on social issues because they believe fund shareholders would have differing views on how the shares should be voted.
- 8 Item 17(f) of Form N-1A. “Unless the Fund invests exclusively in non-voting securities, describe the policies and procedures that the Fund uses to determine how to vote proxies relating to portfolio securities, including the procedures that the Fund uses when a vote presents a conflict between the interests of Fund shareholders, on the one hand, and those of the Fund’s investment adviser; principal underwriter; or any affiliated person of the Fund, its investment adviser, or its principal underwriter, on the other. Include any policies and procedures of the Fund’s investment adviser, or any other third party, that the Fund uses, or that are used on the Fund’s behalf, to determine how to vote proxies relating to portfolio securities.”
- 9 17 C.F.R. § 270.30b1-4 (2012).
- 10 Fund families with multiple advisers may adopt the proxy voting policies of several advisers. In these situations, the proxy voting policy of each adviser usually governs the assets under that adviser’s control.
- 11 17 C.F.R. § 275.206(4)-6 (2012).
- 12 It is worth noting that there are some fund groups that will never consider the voting recommendations of proxy service vendors in their deliberations. These fund groups typically have large in-house resources that include a well-established and experienced proxy governance team (personnel that specialize in corporate governance and proxy voting).
- 13 See, *e.g.*, Egan-Jones Proxy Services, SEC Staff No-Action Letter (May 27, 2004) (“Egan-Jones No-Action Letter”).
- 14 See, *e.g.*, Concept Release On The U.S. Proxy System (IC-29340) (July 26, 2010) (“Concept Release”); Egan-Jones No-Action Letter.

- 15 See, e.g., Concept Release.
- 16 The SEC staff has stated in a no-action letter that advisers that retain a third party to make recommendations on how to vote fund proxies must take “reasonable steps to verify that the third party is in fact independent of the adviser based on all of the relevant facts and circumstances.” According to the letter, “[a] third party generally would be independent of an investment adviser if that person is free from influence or any incentive to recommend that the proxies should be voted in anyone’s interest other than the adviser’s clients.” Egan-Jones No-Action Letter.
- 17 It is important to note that this decision point may not be relevant for index-based fund families or funds using quantitative strategies. The portfolio managers and investment analysts supporting these funds do not usually have expertise about the companies held by the fund since investments are chosen based on an index or a quantitative process. Many complexes with both passively-managed funds and actively-managed funds will vote the passively-managed funds’ shares in accordance with how the actively-managed funds’ shares are voted.
- 18 Some fund families analyze every vote on a case-by-case basis. These fund groups typically adopt voting guidelines that are guidance rather than hard and fast rules. In these situations, there is no need for an override process because the decision makers (e.g., the Proxy Voting Committee, portfolio managers or proxy team) are able to vote however they believe is in the best interest of the fund’s shareholders.
- 19 Even within rule-based voting guidelines, certain voting areas are usually designated as “case-by-case” decisions that the fund or its delegate will have to consider individually. For example, most merger and acquisition votes are handled on a case-by-case basis.
- 20 Fund families that vest voting discretion in their investment professionals are also likely to permit split votes. As discussed above in Section II in “*What Concepts Should Boards Consider When Establishing and Evaluating Proxy Voting Processes and Procedures?—To What Extent Should Investment Professionals Be Involved in the Voting Process?*”, those fund families that give voting discretion to investment professionals usually believe that voting is closely tied with the investment process and, as such, each portfolio manager is in the best position to determine what is in the best interest of fund shareholders. Following this reasoning, it makes sense that portfolio managers should be permitted to make their own decisions for their fund, even if they come to a different conclusion than other portfolio managers in the complex.
- 21 Additional information and guidance for fund directors on securities lending is available in the Mutual Fund Directors Forum report titled: Practical Guidance for Fund Directors on the Oversight of Securities Lending (May 2012) (available at http://www.mfdf.org/newsroom/article/report_sec_lend/).
- 22 See, e.g., Concept Release.
- 23 It is often challenging for funds to obtain enough information to make a materiality determination in time to recall the security. In order to vote a security, it must be recalled before the record date and proxy statements are not typically mailed out until after the record date has passed. See Concept Release.
- 24 Most funds do not have a policy to recall all non-U.S. securities on loan because it’s impracticable due to insufficient advance notice of proxy materials, record dates or vote cut-off dates.
- 25 Share blocking is a mechanism used by certain countries in which shares are frozen and may not be traded for a specified period of time prior to a meeting of shareholders.

Common Proxy Voting Models

Model 1: Board Retains All Voting Authority

<u>Description and Defining Characteristics</u>	<u>Key Benefits of Model</u>
<p>A few Boards have decided to retain full voting authority and delegate administrative functions to the adviser. Routine votes are usually handled by the adviser who casts votes according to Board approved guidelines; however, the Board retains ultimate voting authority and makes vote determinations in non-routine situations.</p> <p><i>Non-routine situations may include:</i></p> <ul style="list-style-type: none"> • <u>“Overrides.”</u> Votes where either the Board decides or the adviser recommends that a vote be cast contrary to the voting guidelines. • <u>“Case-by-case” or “refer” votes.</u> Votes on matters that the Board has determined require case-by-case analysis of the specific facts and circumstances. Examples of votes that typically receive this treatment are those associated with compensation, mergers and acquisitions, and auditor independence. • <u>Votes Not Addressed by Proxy Voting Procedures.</u> New or unique votes that are not addressed by proxy voting procedures and need further analysis before a vote can be cast. <p>When Boards decide to retain the ability to make voting decisions in non-routine situations, they typically vest this power in a Board chair, a Board committee or the chair of the Board committee. In addition, some Boards require that the full Board ratify any decisions made by that committee or chair. When a committee is charged with making vote determinations, the committee chair has usually been given the authority to act when quick decisions are needed.</p> <p>The Board, committee, or chair will generally have assistance from dedicated staff. They may receive a variety of information to help them make each voting decision, including voting recommendations and analysis from the fund's portfolio manager or investment analyst, and/or one or more proxy service vendors. They or their staff also usually have a working relationship with someone from the adviser's corporate governance team who can provide additional information and answer any questions.</p>	<ul style="list-style-type: none"> • Board retains full control over votes cast • Potential conflicts of interest of the adviser are handled through Board involvement

Model 2(a): Board Delegates to Adviser’s Proxy Voting Committee

<u>Description and Defining Characteristics</u>	<u>Key Benefits of Model</u>
<p>Several Boards have delegated most or all of their voting authority to the adviser. The process that the adviser uses to vote proxies varies among fund groups, but for many advisers, the voting decisions are made by an internal Proxy Voting Committee and a corporate governance team. The exact division of voting authority between these two groups varies among fund complexes. At a minimum, the Proxy Voting Committee is generally responsible for reviewing and recommending amendments to the proxy voting guidelines. This is important because the guidelines specify what factors will be considered on any voting issue and may dictate how the fund will vote on specific issues. Most Proxy Voting Committees review the voting guidelines on an annual basis, but will consider changes off-cycle if the need arises.</p> <p>Proxy Voting Committee Duties. Depending on the unique circumstances of a fund complex and its adviser, Proxy Voting Committees are charged with varying responsibilities.</p> <p><i>Below are some of the duties that Proxy Voting Committees may have in the proxy voting process:</i></p> <ul style="list-style-type: none"> • <u>Proxy Voting Committee Decides All Votes.</u> A Proxy Voting Committee may be responsible for voting every proxy. The Committee of one fund complex that follows this model considers a variety of information for every vote including a summary of the proposal and other relevant data gathered by a proxy analyst, as well as vote recommendations from an investment analyst and the proxy governance team. • <u>Proxy Voting Committee Decides Non-Routine Votes.</u> A more common approach is to charge the Proxy Voting Committee with overseeing the voting process and the power to make non-routine voting decisions, such as overrides, case-by-case votes or votes on which the voting guidelines are silent.¹ Proxy Voting Committees also may be charged with handling potential conflicts of interest as discussed earlier. Proxy Voting Committees that only make vote determinations on non-routine votes are usually assisted by a proxy governance team that handles all routine votes. The Committees may also receive input from portfolio managers about the pending vote. 	<ul style="list-style-type: none"> • Systematic and organized method to bring the knowledge, experience and perspectives of personnel from a variety of departments into proxy voting decisions • Delegating voting responsibilities to an adviser reduces the amount of Board time and resources spent on proxy voting

¹ Proxy Voting Committees may also be used to help a fund complex avoid splitting votes (see “*What Concepts Should Boards Consider When Establishing and Evaluating Proxy Voting Processes and Procedures?—Should Funds in the Same Complex Be Permitted to Split Votes?*”). For example, one fund family, which normally allows portfolio managers to determine how to vote case-by-case votes, will elevate the voting decision to the Committee if the portfolio managers of multiple funds can’t agree. The Proxy Voting Committee will consider the arguments of each portfolio manager and then make the ultimate decision on how all of the funds will vote their shares.

Model 2(a) (continued): Board Delegates to Adviser’s Proxy Voting Committee

<u>Description and Defining Characteristics</u>	<u>Key Benefits of Model</u>
<p>Information considered by the Proxy Voting Committee in deciding non-routine votes will vary by complex. In determining how to cast votes that are considered on a case-by-case basis, at least one fund family requires its Proxy Voting Committee to consider all of the following: (1) a portfolio manager/investment analyst’s vote recommendation and reasoning; (2) analyses from proxy service vendors; (3) discussions with the issuer and (4) how the fund has previously voted on similar issues. With respect to override votes, the Proxy Voting Committee is often used as a control device to help ensure that overrides are being made in the best interest of the fund. The Proxy Voting Committee will typically receive the override request, and rationale therefore, when determining how to vote.</p> <ul style="list-style-type: none"> • <u>Proxy Voting Committee Provides Voting Oversight Only.</u> Another approach is to vest a Proxy Voting Committee with overseeing proxy voting, but no day-to-day voting authority. In this model, a proxy governance team generally is responsible for casting the votes. The governance team may receive input from the fund portfolio managers on specified categories of votes – for example, votes on economic transactions, votes where the proxy governance team is recommending a vote against management or instances where the fund owns a specified percentage of shares. <p>The Proxy Voting Committee oversees the voting activity in a variety of ways, including (a) reviewing and recommending amendments to the proxy voting guidelines, (b) offering consultation on controversial, sensitive or high profile votes, (c) reviewing and monitoring overrides to the voting guidelines, (d) handling conflicts of interest and/or (e) generally overseeing the voting process and votes cast by the proxy team or service provider.</p> <p>Proxy Voting Committee Membership and Governance. In our experience, Proxy Voting Committees usually consist of between 3-15 people. Typically, a representative from legal and/or compliance is either a member of the Committee or a non-voting participant in Committee discussions. Other members of the Committee may include proxy governance staff and/or investment professionals. If investment professionals serve on the Committee, there is generally an effort to make sure they represent the various strategies and markets used by the funds (either by including the Chief Investment Officer or multiple portfolio managers). No fund group we spoke to has an official rotation policy for Committee members. Proxy Voting Committees generally meet at least quarterly and more often if necessary to discuss pending votes.</p>	

Model 2(b): Board Delegates to Adviser’s Proxy Governance Staff

<u>Description and Defining Characteristics</u>	<u>Key Benefits of Model</u>
<p>Some fund groups vest all voting authority in the proxy governance team of the adviser (a group of personnel that specialize in corporate governance and proxy voting). The proxy governance team may receive input from legal and/or portfolio managers on certain types of votes (e.g., votes on economic transactions or votes not covered by policy), but generally the team is responsible for casting all votes for the fund in accordance with the Board approved proxy guidelines. The proxy governance team also is responsible for reviewing and recommending amendments to the voting policy and guidelines.</p> <p>In this model, the proxy governance team must be large enough to handle the volume of votes received. There is typically a proxy governance team leader who oversees the process and is consulted on certain types of votes (e.g., votes that are high profile or are contrary to voting guidelines or precedence). The proxy governance team staff also usually works closely together to ensure consistency in their approach and to get additional feedback on specific votes</p>	<ul style="list-style-type: none"> • Vests voting responsibility in a team of personnel experienced in corporate governance and proxy voting matters • Delegating voting responsibilities to an adviser reduces the amount of Board time and resources spent on proxy voting

Model 2(c): Board Delegates to Adviser’s Portfolio Managers

<u>Description and Defining Characteristics</u>	<u>Key Benefits of Model</u>
<p>Another proxy voting model gives voting discretion to the portfolio manager of the fund that owns the shares being voted. This model is typically only used for actively-managed portfolios, because these portfolio managers tend to have in-depth experience and knowledge about the portfolio companies and their proxy proposals.</p> <p>Under this model, a proxy management team of the adviser typically provides information about an upcoming vote to the portfolio managers, including research, analysis and a voting recommendation. The proxy management team also facilitates communication between portfolio managers when multiple funds own stock in the company. Although portfolio managers may collaborate on the matter, the portfolio managers almost always have the final say on how the votes in their portfolio will be cast. In fact, the fund’s voting guidelines are often adopted as non-binding guidance and a portfolio manager has complete discretion to vote contrary to those guidelines.</p>	<ul style="list-style-type: none"> • Every vote is decided by those with specific knowledge of the portfolio companies and their operations, as well the fund’s investments • Delegating voting responsibilities to an adviser reduces the amount of Board time and resources spent on proxy voting

Model 2(c) (continued): Board Delegates to Adviser’s Portfolio Managers

<u>Description and Defining Characteristics</u>	<u>Key Benefits of Model</u>
<p>Funds using this model may have an adviser-level committee that is responsible for reviewing the policy guidelines and procedures each year. The internal committee members would typically include a member of the proxy governance staff, a member from legal, and portfolio managers representing a wide variety of fund strategies. This type of committee has substantially fewer powers and responsibilities than the Proxy Voting Committee described in Model 2(a): Board Delegates to Adviser’s Proxy Voting Committee.</p>	

Model 3: Board Delegates to Proxy Service Vendor

<u>Description and Defining Characteristics</u>	<u>Key Benefits of Model</u>
<p>Some funds delegate voting responsibility to an independent proxy service vendor who votes according to Board approved voting guidelines that may be created using proxy service vendor input and recommendations. Funds that choose this model often find that it is more cost efficient than hiring a full time proxy governance staff. Some funds, especially those that are not actively-managed, may choose to follow this model because they believe the proxy service vendor provides a level of knowledge and expertise on the portfolio companies and voting issues that is valuable. Voting according to vendor recommendations is also used to handle potential conflicts of interest that the Board or adviser may have, because the adviser and Board do not take an active role in determining the vote². If voting responsibility has been delegated to a proxy service vendor, the adviser usually provides oversight of the vendor’s services. Additional information about the use and oversight of proxy service vendors is discussed in Section II(B): <i>“How Should Third Party Proxy Firms Be Utilized?”</i></p>	<ul style="list-style-type: none"> • Vendors may provide additional knowledge, expertise and perspective to the voting process • Potential adviser conflicts of interest are handled through vendor involvement • Cost efficient • Delegating voting responsibilities to a vendor reduces the amount of Board time and resources spent on proxy voting

² See, e.g., Egan-Jones No-Action Letter.



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