

“N-PX and the New Proxy Landscape”

By Clifton D. Petty, Ph.D., Pension Consultants, Inc.

Overview

Proxy cards often appear about as interesting as a mortgage loan application. It may be tempting to toss the card and assume that management’s recommendations are solid. But just as it could be detrimental to your personal finances to sign off on a mortgage without reading the fine print, we believe that it could be risky for fiduciaries to take a pass on proxy review. And recent regulatory changes will significantly raise the stakes for proxy review and voting.

New Disclosure of Mutual Fund Proxy Voting

The SEC set August 31, 2004, as the deadline by which investment companies must disclose their proxy voting records. This new disclosure, labeled N-PX by the Securities and Exchange Commission, must also include the fund’s policies and procedures for voting their proxies. Together with recent rule changes regarding proxy disclosure of the policies and procedures of Board Nominating Committees, a new proxy landscape is quickly emerging.

In a sense, the new requirements for disclosure of proxy voting and policies were inevitable “next steps.” Corporate shareholder activism has increased sharply in the post-Enron period. According to the Investor Responsibility Research Center, shareholder proxy proposals increased from 802 in 2002, to 1,082 in 2003. And 1,147 proposals had already been filed by June, 2004.¹ Connect this strong interest in corporate governance reforms to the central role of mutual funds in investment action, and the new voting transparency requirements are not surprising. Mutual funds holds \$2.0 trillion in publicly traded U.S. corporate assets, or 18% of all publicly traded U.S. corporate equity (up from 7.4% in 1992).²

Standing in the Proxy Intersection: Funds as both Investor-Voters and Corporation-Targets

Although mutual funds are subject to the same proxy rules as their “corporate” cousins, mutual fund proxy activity has remained relatively subdued over the past few years. We would like to make two observations on this contrast between the busy corporate proxy card and the quiet mutual fund proxy card. First, most of the activity will remain centered on corporations other than investment companies (e.g., Walt Disney). Because they are investing in the corporations, mutual funds are characteristically situated in the “investor camp” on proxy issues. Second, we expect the traditional proxy pattern to change somewhat over the next few years. Shareholder attention and activism is likely to shift toward mutual funds in the coming months, and at the least, new SEC requirements will foster a wave of new mutual fund proxy proposals.

In short, shareholders want action and the only way to ensure action is to monitor the voting of the mutual funds that hold their shares. **Mutual funds are uniquely situated as both powerful voters of corporate proxies, and the target of new mutual fund (corporation) proxy proposals.**

The ICI and other mutual fund industry representatives expressed vigorous opposition to proxy vote disclosure, citing such concerns as unhealthy pressures from special interest groups and a loss of “independent voting.”⁴ But on the other side of this coin, the SEC received 8,000 letters during the comment period, and according to the Commission the “overwhelming majority supported the proposals and urged us to adopt the proposed amendments.”⁵



We are cautiously optimistic that the new proxy requirements will improve transparency. We also believe that the information on fund policies and voting behavior will be most useful in monitoring and evaluating mutual funds.

Background: Proxy Rules

In a recent white paper on the changes in mutual fund governance rules,⁶ we noted that stiffening the objective criteria for independent board composition and chairmanship would likely shift the battle from meeting objective composition and leadership targets to the more subjective arguments over classification of a particular director as “independent.” In a similar way, it is likely that stiffening the disclosure requirements for proxy policy and voting may heighten pressure on the criteria that corporations and investment companies use to qualify (or exclude) a proxy proposal. For this reason, we include here a brief overview of the rules on proxy proposals.

Proxy Proposals and their Qualification

Broadly, the two sources for proxy vote proposals are *corporate management* and *shareholders*. Management generally initiates proposals on the election of board members, selection of auditors, approval of matters related to executive compensation, and questions concerning any major changes in organization or ownership (e.g., mergers, acquisitions). In addition, management may propose a shareholder vote on other issues, depending upon the intensity of shareholder interest and strategic importance of the particular issue.

Shareholders may also generate proxy card proposals, subject to certain SEC rules. These rules cover three areas:

1. **Eligibility requirements:** The shareholder who initiates a proposal must own \$2,000 in market value (or 1% of outstanding shares) of the company, and hold this investment position continuously for one year prior to submission of the proposal, and through the date of the meeting of shareholders.
2. **Procedural requirements:** The SEC requires a shareholder to meet certain deadlines, submit their proposal in writing, limit the length to 500 words, and make any necessary revisions according to a timetable designed to allow the company to carefully prepare proxy cards.
3. **Exclusion criteria:** This is the area of proxy rules where the “rubber meets the road.” Generally speaking, the hurdles for eligibility and procedural requirements are not tough to meet. Most proxy proposals are rejected on the basis of exclusion criteria. These criteria allow management to rightfully exclude a proposal from the company’s proxy card.

Most proxy exclusion criteria are specific, and intended to protect companies from frivolous or harmful proposals. For example, companies may exclude the following types of proposal: a) personal grievance; special interest; b) violation of law; c) absence of power/authority (issues beyond company’s power to control). But one exclusion rule is more open-ended, and perennially controversial. Management may rightfully exclude a proposal that relates to “management functions.” The SEC amplifies this rule in the following manner: “[A company may exclude a shareholder proposal] if the proposal deals with a matter relating to the company’s ordinary business operations.”⁷ The spirit of this criterion is sensible—companies should not be required to make everyday management decisions through the expensive and time-consuming proxy process. But the broad nature of this exclusion rule affords management significant room to maneuver in regards to excluding shareholder proposals. Together with eligibility, and procedural requirements, the thirteen (13) exclusion criteria form a fairly high hurdle for placing a shareholder proposal on a company proxy card.

What about Mutual Fund Proxies?

For those mutual funds organized as corporations, the rules governing the qualification of proxy proposals (i.e., eligibility, procedures, and exclusion criteria) are identical to those described in the previous discussion.



In addition to the basic proxy rules for corporations, the SEC has recently made changes that specifically target investment company proxies.

The New Proxy Requirements for Investment Companies

Proxy Disclosure of Board Nominating Committee Policy and Procedures

The SEC has recently announced two major changes to proxy requirements. The first of these rule changes became effective January 1, 2004, and requires all corporations to make additional disclosures describing the work of the Board Nominating Committee. Specifically, the new Nominating Committee Functions and [Shareholder] Communication rule requires corporations to include the following items in their proxy statements:

1. A company's determination whether to have a nominating committee;
2. The nominating committee's charter, if any;
3. The process for identifying and evaluating candidates;
4. The minimum qualifications for board membership.⁸

Although these requirements apply to all corporations, their application to investment companies may be particularly important. On June 23, 2004, the SEC amended investment company governance rules to require independent composition and leadership of mutual fund boards. The new independence requirements highlight the role of Fund Nominating committees. Almost all mutual funds will be required to change their board composition and/or leadership over the next eighteen months, and Board Nominating Committees will play the central role in these changes.

Proxy Voting Policies and Proxy Voting Record Disclosure

The second major development in the proxy arena is the new SEC rule requiring investment companies to disclose their proxy voting policies, and more controversially, their proxy voting record. This new rule, which fostered the new N-PX reporting form, became effective April 14, 2003. The first batch of N-PX reports will cover the period from July 1, 2003 to June 30, 2004.

The SEC based this new disclosure requirement on three principal arguments. First, the Commission believes that N-PX will improve transparency and investor confidence. Second, the SEC argued that the disclosures would encourage fund managers to vote their proxies conscientiously. And finally, and perhaps most importantly, the Commission argued that these new rules would force funds to disclose how they "address...conflicts of interest in determining how to vote their proxies."⁹

While the SEC did not prescribe specific elements to be included in proxy voting policies, it cited examples of such elements as the degree to which the fund delegated voting responsibilities to an investment advisor, and the procedures used to address conflicts of interest that may arise between shareholder interests and fund manager interests. An example of such a conflict of interest is the situation in which the corporation proposes an executive compensation plan that is not in shareholders' interests, and at the same time, the fund hopes to solicit pension fund business from the corporation that made the proxy proposal.

Regarding its voting record, investment companies are required to include the following in their N-PX:

- Information identifying each security (e.g., ticker, CUSIP)
- Shareholder meeting date
- Matter voted on
- Whether the matter was a Management or Shareholder proposal
- Whether the fund cast its vote, and how
- Whether the fund cast its vote for or against management



The Commission rejected proposals for additional detail, including flagging votes that were cast in a manner “inconsistent” with proxy voting policy, and categorizing votes by topic or area of concern (e.g., environmental issues).

Some Important Implications of the New Proxy Rules

First, we believe that it is important to view these new proxy rules in association with other recent changes in investment company governance. For example, the disclosure of Nominating Committee policies appears linked to the new requirements for greater *independence* (75% independent directors and independent chairman). The SEC is clearly convinced that a holistic approach is required. While we agree in principle with this assumption, it may prove difficult to determine which recent changes are helping, which are hurting, and which are simply adding little or no value.

Certainly the effectiveness of these new proxy requirements is dependent on the other recent governance rule changes. Assuming for the moment that the governance and proxy framework that the SEC has constructed is a reasonably stable one, we see the following specific implications of the new proxy rules:

1. Stronger emphasis on Fiduciary responsibility: Plan sponsors will find the logic of these new rules quite familiar. The SEC made extensive use of fiduciary reasoning in crafting the new requirements. The emphasis on fiduciary responsibility was also clearly evident in the Commission’s rejection of some of the industry’s arguments against the proposals. For example, some industry spokespersons argued that they did not perceive strong investor interest in proxy voting. This argument was met by the SEC rebuttal that the disclosures would benefit investors irrespective of current level of interest in the issue: “...the availability of proxy voting information may increase shareholder interest in the future. Second, these arguments do not consider the external benefits that all fund investors may obtain if, as discussed above, disclosure increases the incentives for fund managers to vote their proxies more carefully, and thereby improve corporate performance and enhance shareholder value.”¹⁰
2. Spotlight on conflicts of interest: The new requirements apply a fresh approach to conflicts of interest—they simply assume them as natural elements of both proxy voting and board nomination. Instead of a myriad of “what if” requirements, the new rules cut to the chase. Funds and their investment advisors who vote proxies on behalf of their clients¹¹ must address conflicts of interest head-on in their proxy policies.
3. The forest and the trees: We believe that the SEC appropriately rebuffed the requests of some to package voting data in executive summaries, or to sort by topic of proposals, and percentage of votes for/against. Instead, the new rules require that proxy voting data be reported in a comprehensive and raw form. We agree that this will simplify reporting, and reduce associated costs for the funds. But perhaps equally important, we expect this reporting format to provide the most useful database for analysis of fund policy and voting patterns.

The first N-PX forms should be rolling out in the next few months. The new disclosures of proxy voting policies will be included in the next round of *Statement of Additional Information (SAI)* reports. These disclosures, particularly N-PX, are likely to be hefty. It might be tempting to ignore them as a few more voluminous, regulation-driven documents. However, we believe that the voting data may contain important information about both the funds, and the corporations in which the funds invest.

First, we recommend keeping an eye on the proxy gate—shareholders who are blocked by exclusion rules will likely cry foul. Many of the exclusions will be invoked for sound business reasons, but it is also likely that the number of “management functions” exclusions will increase. For example, corporate officers are likely to invoke



proxy rules to exclude unwelcome proposals on such issues as executive compensation. Mutual funds may encourage such exclusion, knowing that otherwise they will be required to register a vote that must be now be publicly reported. But strong winds are blowing in the other direction, and shareholders will no doubt press hard to get key issues on the proxy card.

The once quiet mutual fund proxy card is also likely to light up with new proposals. Fund management will certainly initiate proposals to meet the new governance and proxy requirements. But mutual fund officers will also likely face a new wave of shareholder proposals on such issues as fee structure, investment policy, and executive compensation.

The ground rules for proxy voting have changed, and it seems likely that the changes are here to stay. While we expect the SEC to make adjustments to the new proxy rules, the contours of reform are clear. Investors will be offered a more clear view of how funds vote their shares, and of the policies that guide their votes. Additional sunlight will also be cast on the Board Nominating Committee, a central player in investment company governance.

Plan sponsors, and the funds in which they invest, hold most of the cards when it comes to proxy voting. In the new proxy environment, the role of fiduciaries in carefully reviewing and voting these proxies will be more important than ever.



Endnotes

- ¹ According to proxy data from the Investor Responsibility Research Center.
- ² "Flow of funds accounts of the United States: Flows and outstandings, third quarter 2002.
- ³ Securities Industry Factbook 71 (2002), Securities Industry Association.
- ⁴ "ICI issues statement on SEC proxy vote disclosure rule," Press release of statements by Investment Company Association President Michael P. Fink, January 23, 2003.
- ⁵ "Final Rule: Disclosure of proxy voting policies and proxy voting records by registered investment management companies, Securities and Exchange Commission, Effective date: April 14, 2003, see discussion section, p. 4.
- ⁶ Pension Consultants, Inc. White Paper 101, "Changing drivers: The leadership of mutual fund boards and recently amended SEC requirements.
- ⁷ SEC Proxy Rules on shareholder proposals, § 240, 14a-8 (Note: See Question 9, Item 7 for "management functions" exclusion).
- ⁸ "Final Rule: Disclosure regarding nominating committee functions and communications between security holders and boards of directors," Securities and Exchange Commission, Effective Date: January 1, 2004, pp. 3-5.
- ⁹ "Final Rule: Disclosures of proxy voting policies..." *ibid*, p. 20.
- ¹⁰ "Final Rule: Disclosure of proxy voting policies..." *ibid*, p. 21.
- ¹¹ SEC Rule 204 (4-6), effective March 10, 2003, requires investment advisors who vote proxies on behalf of their clients to *directly* address "potential conflicts of interest" in their proxy voting policy.

