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PUBLIC INTEREST COMMENT

PROXY VOTING BY MUTUAL FUND INVESTMENT ADVISERS

CALEB N. GRIFFIN
Assistant Professor, University of Arkansas School of Law

BRIAN R. KNIGHT
Director and Senior Research Fellow, Program on Innovation and Governance, Mercatus Center at George Mason University

ANDREW N. VOLLMER
Senior Affiliated Scholar, Mercatus Center at George Mason University

Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers
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Thank you for the opportunity to comment on the proposals in Enhanced Reporting of Proxy Votes by Registered Management Investment Companies, 86 Fed. Reg. 57478 (October 15, 2021). We are scholars who research, write, and teach in the area. Caleb Griffin's research concentrates on corporate law and governance. Brian Knight is the director of the Program on Innovation and Governance at the Mercatus Center at George Mason University. Andrew Vollmer is a scholar at the Mercatus Center and formerly taught securities regulation at the University of Virginia School of Law and served as deputy general counsel at the Securities and Exchange Commission (SEC). The Mercatus Center is dedicated to bridging the gap between academic ideas and real-world problems and to advancing knowledge about the effects of regulation on society. This comment is not submitted on behalf of any other person or group.

The SEC's proposal would change the form that certain investment companies, such as mutual funds, use to disclose proxy votes to the public. In our view, the proposal would perpetuate and entrench the wrong approach to the question of proxy voting on behalf of fund investors.

We urge the SEC to consider a more direct and effective approach as described later in this comment. Registered management investment companies should have an obligation to make a good-faith effort to (a) seek investors' input on important issues related to how their investment is voted and (b) vote in reasonable accord with such input. We do not address the portion of the proposal that would have investment advisers report votes on executive compensation matters to investors.

THE PROPOSAL

The proposal is to amend Form N-PX to make the public disclosure of proxy voting information by funds more usable to the investors in the funds. At the moment, Rule 30b1-4 of the Investment Company Act requires funds to report their proxy voting records on Form N-PX annually and publicly.[1] The obligation to issue public reports of a fund's proxy voting is connected to the duty of the investment advisers for the funds to vote client securities in the best interest of the clients.[2]

The purpose of improving Form N-PX is to achieve benefits the SEC sought when originally adopting the form: "(1) To provide better information to investors who wish to determine to which fund managers they should allocate their capital, and whether their existing fund managers are adequately maximizing the value of their shares; (2) to deter fund voting decisions that are motivated by considerations of the interests of a fund's adviser rather than the interests of the fund's investors; and (3) to provide stronger incentives for fund managers to vote their proxies carefully."[3] These benefits are related to the obligation of fund advisers to vote proxies in the best interests of the investors.

Not all the commissioners have indicated support for the proposal. Commissioner Hester Peirce asks whether the SEC should eliminate mandatory public disclosure of fund votes. She also questions whether adoption of the proposal would likely produce benefits that exceed costs and expresses concern that adoption could have unpredictable effects on shareholder votes and shareholder relationships with corporations.[4]

PROBLEMS WITH THE PROPOSAL

The problem with the proposal and with the rule requiring public disclosure of the proxy votes cast by funds is that the obligation falls considerably short of the objective of having fund advisers vote proxies in the best interests of fund investors. The best interest standard gives fund advisers too much latitude to vote proxies in favor of their own interests rather than the interests of fund investors, and requiring public disclosure of past proxy votes by a fund does not provide a sufficient incentive for funds and their advisers to vote proxies in the interests of the investors.

As a threshold matter, it is important to remember that the ultimate owners of the shares in the fund and the votes that come with those shares are the fund investors and not the fund itself or the investment adviser to the fund. When funds vote these shares, they are voting in a fiduciary capacity, using shares bought with their investors' money and not their own.

The best interest standard for proxy voting by fund managers has not fulfilled its promise. Academic research shows "that index funds are not meaningfully constrained to act in their

1. 17 C.F.R. § 270.30b1-4 (2021).
2. See Rule 206(4)-6 under the Investment Advisers Act. 17 C.F.R. § 275.206(4)-6 (2021); Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers, 86 Fed. Reg. 57,478, 57,479 (Oct. 15, 2021) (to be codified at 17 C.F.R. pts. 232, 240, 249, 270, 274).
3. Enhanced Reporting of Proxy Votes, 86 Fed. Reg. at 57,503 (Oct. 15, 2021).
4. Hester M. Peirce, *Statement on Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers*, SEC. AND EXCH. COMM'N (Sept. 29, 2021), https://www.sec.gov/news/public-statement/peirce-open-meeting-2021-09-29.

investors' best interests and that index fund investors' interests likely do not determine voting decisions" for the largest money managers.[5]

As a result, funds and advisers can yield to incentives to vote in favor of their own interests, which might or might not be aligned with investors' interests. As the proposed rule and other scholarship note, these conflicts can include business ties between portfolio companies and fund advisers, efforts by fund management to curry favor with corporate management to get future business, efforts by investment funds to attract new investors and increase assets under management by supporting causes that are popular with certain investors (even if the causes are not likely to improve financial performance), and votes to further the fund managers' personal policy preferences (even if the underlying investors do not agree).[6]

For several reasons, the obligation of funds to file Form N-PX disclosing their historical proxy votes is not adequate to cause fund advisers to vote in the best interests of investors. First, a disclosure rule puts the burden on fund investors to evaluate whether a fund and adviser vote proxies in the best interests of the investors and shifts the burden away from the fund and adviser. The SEC acknowledges that, with the information in the forms, "investors would be able to select funds that suit their preferences more efficiently" and would be able "to monitor their funds' involvement in the governance activities of portfolio companies."[7] That policy turns the obligation of a fund adviser upside down. Rather than investors having the burden to investigate post hoc a fund's votes and the subsequent burden of switching into a more like-minded fund family, funds should have the burden to discern and vote in meaningful accord with their investors' interests.

Second, a disclosure rule reveals votes cast in the past by an adviser. Investors are not able to change those votes even if they believe the votes are not in the investors' interests. The SEC does not cite evidence that past voting practices are predictive of future votes. The entire utility of the SEC's proposal rests on this implicit assumption, but nothing in the present rules prevents funds from deviating from past voting behavior. Disclosure therefore has limited value.

Third, although the SEC might assume that disclosure allows fund investors who disagree with proxy votes to redeem their shares and reinvest in a different fund with a fund manager that votes proxies in a more compatible way, many investors face obstacles to such a change. Exiting a fund requires investors to liquidate their positions and pay taxes on gains. This creates a clear disincentive for investors to leave funds, even if they disagree with how the shares they ultimately own are voted.

The problem is even more acute in the case of the trillions of dollars of equity in employer-sponsored retirement funds. These funds are important parts of employees' compensation and provide both convenience and a tax-advantaged ability to invest. However, because employers

5. Caleb N. Griffin, *Environmental and Social Voting at Index Funds*, 44 DEL. J. CORP. L. 167, 171 (2020); *see also* Paul G. Mahoney & Julia D. Mahoney, *The New Separation of Ownership and Control: Institutional Investors and ESG*, 2 COLUM. BUS. L. REV. 840, 863 (2021) (discussing how a state pension fund claimed that a public policy position was in the best interest of the fund beneficiaries); Caleb N. Griffin, *We Three Kings: Disintermediating Voting at the Index Fund Giants*, 79 MD. L. REV. 954, 956 (2020).
6. *See* Enhanced Reporting of Proxy Votes, 86 Fed. Reg. at 57,504; *see also* Michal Barzuza et al., *Shareholder Value(s): Index Fund Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243, 1261–62, 1285–86, 1304, 1309 (2020) (arguing that index funds are active in voting on social issues because those issues appeal to millennials, millennials will inherit massive wealth, and the large mutual fund companies compete to profit from fees for managing that wealth); Griffin, *We Three Kings*, *supra* note 5, at 977; Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381 (2020).
7. Enhanced Reporting of Proxy Votes, 86 Fed. Reg. at 57,503; Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6,563, 6,565 (Feb. 7, 2003).

sponsor and select which funds will be available, investors might not be able to change their asset manager without leaving their job and possibly losing out on retirement benefits. Although proxy voting is important, it is unrealistic to expect investors to leave their job or incur negative tax consequences for the sole purpose of improving proxy voting alignment with their asset manager. Thus, the ability of investors to "self-sort" into funds with like-minded asset managers on the basis of disclosure of past proxy voting practices is severely limited.

Another reason that disclosure is inadequate to ensure that funds vote in the best interests of investors is that voting itself is only part of how fund managers use their investors' assets to impact corporate governance. "Engagements," the often-opaque meetings between corporate managers and fund representatives, are explicitly favored over proxy voting as a channel to influence management.[8] These meetings can allow funds to influence corporate activity without having to resort to a vote because of the implicit threat to vote against management if corporate leadership doesn't adopt the fund's favored policies. If such an effort is successful, there might be no vote at all because the company has already acceded to the fund's demands. However, it is the funds' ability to vote shares paid for by investors that gives funds leverage in these engagements. Therefore, investors may have their shares used in a way counter to their best interests without them ever realizing it.

A BETTER WAY FOR PROXY VOTES TO BE CONSISTENT WITH THE BEST INTERESTS OF FUND INVESTORS

Registered management investment companies should be required to seek the views of fund investors before voting proxies. The SEC has implicitly acknowledged the need for investment advisers to solicit input from fund investors rather than relying on guesses: "Where an investment adviser has assumed the authority to vote on behalf of its client, the investment adviser, among other things, must have a reasonable understanding of the client's objectives and must make voting determinations that are in the best interest of the client. . . . [F]or an investment adviser to form a reasonable belief that its voting determinations are in the best interest of the client, it should conduct an investigation reasonably designed to ensure that the voting determination is not based on materially inaccurate or incomplete information."[9]

Currently, most asset managers make no effort to obtain a "reasonable understanding of the client's objectives" with respect to how client shares should be voted. Because most funds solicit no meaningful input from investors regarding their voting determinations, they arguably fail the requirement to "conduct an investigation reasonably designed to ensure that the voting determination is not based on materially inaccurate or incomplete information." In our opinion, in most circumstances, an investigation of investors' best interests cannot be materially accurate and complete if it lacks any meaningful input from the investors themselves.

Instead of perpetuating the status quo, in which funds vote in a manner largely untethered from their investors' interests, the SEC should require fund managers to conduct a genuine inquiry into the voting preferences of the fund investors. Registered management investment companies

8. Griffin, *Environmental and Social Voting*, *supra* note 5, at 186.
9. Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, 84 Fed. Reg. 47,420, 47,421 (Sept. 10, 2019).

should have an obligation to make a good-faith effort to (a) seek investors' input on important issues related to how their investment is voted and (b) vote in reasonable accord with such input.

Fund managers could be given discretion and flexibility to implement the obligation. Many approaches are possible.

For example, rather than soliciting granular investor views on each of tens of thousands of issues up for a vote within a fund's portfolio each year, funds could periodically solicit broad, categorical input on investors' voting preferences and apply such preferences to the fund's votes across all portfolio companies. Some of the SEC's proposed categories of votes might be useful, but fund advisers might prefer to develop more suitable and informative categories. This categorical pass-through voting strikes a balance between facilitating investor involvement in shareholder democracy and the recognition that investors, particularly index fund investors, may be rationally apathetic about votes at any single portfolio company of the hundreds in which they are invested. Relative to traditional proxy voting, categorical pass-through voting both reduces the required effort and increases the resulting impact of investor participation in corporate democracy.

In a powerful demonstration of the feasibility of pass-through voting, BlackRock, the world's largest asset manager, recently announced that it would implement pass-through voting for certain institutional clients in some index strategies.[10] BlackRock's move illustrates that pass-through voting is both realistic and attainable. It is also of far greater utility to investors than mere post hoc disclosure of BlackRock's proxy votes. Our recommendation is that this approach be extended to all investors in all registered management investment companies.

CONCLUSION

Although the SEC's proposal to amend Form N-PX is motivated by an admirable desire to improve the accountability of fund managers for how they vote other people's shares, the disclosure of historical proxy votes is fundamentally inadequate to address the problem. An actual solution would require funds to make a good faith and reasonable effort to determine the voting preferences of the underlying investors and cast votes consistent with those preferences. Doing so would require more substantive changes than just the amendment of a form. As the SEC considers how to vindicate the rights of ultimate owners to have the shares they purchase voted in a manner consistent with their beliefs and best interests, it will need to determine that it has solid statutory authority for any steps it takes or obtain additional authority from Congress.

10. *Working to Expand Proxy Voting Choice for Our Clients*, BLACKROCK, https://www.blackrock.com/corporate/about-us/investment-stewardship/proxy-voting-choice (last visited Oct. 26, 2021).