



Federal Register

Thursday,
September 26, 2002

Part V

Securities and Exchange Commission

17 CFR Parts 239, 249, 274, and 275
Disclosure of Proxy Voting Policies and
Proxy Voting Records by Registered
Management Investment Companies and
Investment Advisors; Proposed Rules

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 239, 249, and 274

[Release Nos. 33-8131, 34-46518, IC-25739; File No. S7-36-02]

RIN 3235-A164

Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Securities and Exchange Commission is proposing amendments to its forms under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940 to require registered management investment companies to provide disclosure about how they vote proxies relating to portfolio securities they hold. Under the proposed amendments, registered management investment companies would be required to disclose the policies and procedures that they use to determine how to vote proxies relating to portfolio securities. The proposals also would require registered management investment companies to file with the Commission and to make available to their shareholders the specific proxy votes that they cast in shareholder meetings of issuers of portfolio securities.

DATES: Comments must be received on or before December 6, 2002.

ADDRESSES: To help us process and review your comments more efficiently, comments should be sent by one method only.

Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Comments also may be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7-36-02; this file number should be included in the subject line if electronic mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. Electronically submitted comment letters also will be posted on the Commission's Internet Web site (<http://www.sec.gov>).¹

¹ We do not edit personal identifying information, such as names or electronic mail addresses, from electronic submissions. You should submit only

FOR FURTHER INFORMATION CONTACT:

Christian L. Broadbent, Attorney, Nicholas C. Milano, Jr., Senior Counsel, or Paul G. Cellupica, Assistant Director, Office of Disclosure Regulation, Division of Investment Management, (202) 942-0721, at the Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549-0506.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") is proposing for comment amendments to Forms N-1A [17 CFR 239.15A; 274.11A], N-2 [17 CFR 239.14; 274.11a-1], and N-3 [17 CFR 239.17a; 17 CFR 274.11b], the registration forms used by management investment companies to register under the Investment Company Act of 1940 ("Investment Company Act") and to offer their securities under the Securities Act of 1933 ("Securities Act"), and amendments to proposed Form N-CSR [17 CFR 249.331; 17 CFR 274.128], a form that we recently proposed under the Securities Exchange Act of 1934 ("Exchange Act") and the Investment Company Act to be used by registered management investment companies to file certified shareholder reports with the Commission under the Sarbanes-Oxley Act of 2002.²

Executive Summary

We are proposing form amendments that would do the following:

- Require a management investment company registered under the Investment Company Act of 1940 ("fund") to disclose in its registration statement (and, in the case of a closed-end fund, Form N-CSR) the policies and procedures that it uses to determine how to vote proxies relating to portfolio securities; and
- Require a fund to file with the Commission and make available to its shareholders, upon request and free of charge, the fund's proxy voting record. A fund would be required to disclose in its annual and semi-annual reports to shareholders and in its registration statement the methods by which shareholders may obtain information about proxy voting. A fund also would be required to disclose in its annual and semi-annual reports to shareholders information regarding any proxy votes that are inconsistent with its proxy voting policies and procedures.

In a companion release, we are also publishing proposed amendments that would require registered investment

information that you wish to make available publicly.

² See Investment Company Act Release No. 25723 (Aug. 30, 2002) [67 FR 57298 (Sept. 9, 2002)]; Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (2002).

advisers to adopt and implement written policies and procedures reasonably designed to ensure that proxies are voted in the best interests of their clients, disclose to clients information about the advisers' proxy voting policies and procedures, disclose to clients how they may obtain information on how the adviser voted their proxies, and retain records relating to voting proxies on client securities.³

I. Introduction and Background

As of December 2001, mutual funds⁴ held \$3.4 trillion in U.S. corporate stock, representing approximately 19% of all publicly traded U.S. corporate equity.⁵ This represents a dramatic increase from only 6.4% a decade earlier.⁶ Millions of individual American investors, in turn, hold shares of equity mutual funds, relying on these funds—and the value of the corporate securities in which they invest—to fund their retirements, their childrens' educations, and their other basic financial needs.⁷ Yet, despite the enormous influence of mutual funds in the capital markets and their huge impact on the financial fortunes of American investors, funds have been reluctant to disclose how they exercise their proxy voting power with respect to portfolio securities.⁸ We believe that the

³ See Investment Advisers Act Release No. 2059 (Sept. 20, 2002).

⁴ For simplicity, this Section of the release focuses on mutual funds (*i.e.*, open-end management investment companies). An open-end management investment company is an investment company, other than a unit investment trust or face-amount certificate company, that offers for sale or has outstanding any redeemable security of which it is the issuer. See Sections 4 and 5(a)(1) of the Investment Company Act [15 U.S.C. 80a-4 and 80a-5(a)(1)]. Our proposed amendments, however, would apply to all registered management investment companies, except where noted. This includes both closed-end management investment companies and insurance company separate accounts organized as management investment companies that offer variable annuity contracts.

⁵ Investment Company Institute, *Mutual Fund Fact Book 62* (42nd ed. 2002); Securities Industry Association, *Securities Industry Fact Book 71* (2002).

⁶ Securities Industry Fact Book, *supra* note , at 71.

⁷ Mutual Fund Fact Book, *supra* note , at 37. Approximately 93 million individual investors hold shares of mutual funds. *Id.* Shares of equity mutual funds are held through 164.8 million shareholder accounts. *Id.* at 63. A single individual may hold mutual fund shares through multiple accounts.

⁸ See John Wasik, *Speak Loudly—Or Lose Your Big Stick*, *The Financial Times*, July 24, 2002, at 76 (only eight retail mutual fund groups that openly disclose how they vote on proxies). We have previously prepared reports commenting on the role of institutional investors in the corporate accountability process and their impact on portfolio companies. See Division of Corporation Finance, SEC, Staff Report on Corporate Accountability (Sept. 4, 1980) (printed for the use of Senate Comm. on Banking, Housing and Urban Affairs, 96th Cong., 2d Sess.) (hereinafter SEC, Staff Report on

time has come to consider increasing transparency of proxy voting by mutual funds. This increased transparency would enable fund shareholders to monitor their funds' involvement in the governance activities of portfolio companies, which could have a dramatic impact on shareholder value.⁹

Mutual funds are formed as corporations or business trusts under state law and, as in the case of other corporations and trusts, must be operated for the benefit of their shareholders.¹⁰ Because 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. As a practical matter, however, the board generally delegates this function to the fund's investment adviser as part of the adviser's general management of fund assets, subject to the board's continuing oversight. The investment adviser to a mutual fund is a fiduciary that owes the fund a duty of "utmost good faith, and full and fair disclosure."¹¹ This fiduciary duty extends to all functions undertaken on the fund's behalf, including the voting of proxies relating to the fund's portfolio securities. An investment adviser voting proxies on behalf of a fund, therefore, must do so in a manner consistent with the best interests of the fund and its shareholders.¹²

Corporate Accountability); SEC, Institutional Investor Study Report (Mar. 10, 1971) (printed for the use of House Comm. on Interstate and Foreign Commerce, 92nd Cong., 1st Sess.) (hereinafter SEC, Institutional Investor Study Report).

⁹ We have received three rulemaking petitions urging that we adopt rules requiring funds to disclose both the policies and guidelines followed by the funds in determining how to vote on proxy proposals, and the record of actual proxy votes cast. See Rulemaking Petition by Domini Social Investments, LLC (Nov. 27, 2001); Rulemaking Petition by the International Brotherhood of Teamsters (Jan. 18, 2001); Rulemaking Petition by the American Federation of Labor and Congress of Industrial Organizations (July 30, 2002 and Dec. 20, 2000). The rulemaking petitions are available for inspection and copying in File No. 4-439 in the Commission's Public Reference Room.

¹⁰ See generally James M. Storey & Thomas M. Clyde, *Mutual Fund Law Handbook* § 7.2 (1998); Allan S. Mostoff & Olivia P. Adler, *Organizing an Investment Company—Structural Considerations* § 2.4 in *The Investment Company Regulation Deskbook* (Amy L. Goodman ed., 1997).

¹¹ *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (interpreting Section 206 of the Investment Advisers Act of 1940). Cf. Section 36(b) of the Investment Company Act [15 U.S.C. 80a-35] (investment adviser of a fund has a fiduciary duty with respect to the receipt of compensation paid by the fund).

¹² See Investment Advisers Act Release No. 2059, *supra* note . See also SEC, Staff Report on Corporate Accountability, *supra* note , at 391 (fiduciary principle applies to all aspects of investment management, including voting). Cf. Dep't of Labor, Interpretive Bulletins Relating to the Employee

Traditionally, mutual funds have been viewed as largely passive investors, reluctant to challenge corporate management on issues such as corporate governance.¹³ Funds have often followed the so-called "Wall Street rule," according to which an investor should either vote as management recommends or, if dissatisfied with management, sell the stock.¹⁴ In recent years, however, some funds, along with other institutional investors, have become more assertive in exercising their proxy voting responsibilities.¹⁵ The increased assertiveness by mutual funds in the voting of proxies may have a number of causes. In some instances, funds have come to hold such large positions in a particular portfolio company that they cannot easily sell the company's stock if the company's management is performing poorly.¹⁶ The investment policies of index funds generally do not permit them to sell poorly performing investments, and thus these funds may become active in corporate governance in order to maximize value for their shareholders.¹⁷

Recent corporate scandals have created renewed investor interest in issues of corporate governance and have underscored the need for mutual funds and other institutional investors to play a more active role in corporate

Retirement Income Security Act of 1974, 29 CFR 2509.94-2 (2002) (fiduciary act of managing employee benefit plan assets consisting of equity securities includes voting of proxies appurtenant to those securities).

¹³ See, e.g., SEC, Staff Report on Corporate Accountability, *supra* note 8, at 404 (investment managers have routinely supported management slates of director nominees); Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 Cardozo L. Rev. 1419, 1430-31 (2002) (discussing mutual fund passivity in corporate governance). See generally John C. Coffee, Jr., *The SEC and The Institutional Investor: A Half-Time Report*, 15 Cardozo L. Rev. 837 (1994) (institutional investors have historically been passive investors); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520 (1990) (shareholder voting has historically been passive).

¹⁴ See SEC, Staff Report on Corporate Accountability, *supra* note 8, at 392 (describing "Wall Street Rule").

¹⁵ See, e.g., Aaron Lucchetti, *A Mutual-Fund Giant Is Stalking Excessive Pay*, Wall Street Journal, June 12, 2002, at C1 (Fidelity has voted against management recommendations involving stock-option plans); Kathleen Day, *Prodding For Disclosure of Funds' Proxy Votes*, Washington Post, Apr. 8, 2001, at H1 (Domini Social Equity Fund voted against management proposal to issue additional stock options for directors).

¹⁶ See Palmiter, *supra* note 13, at 1435-1436 (as holdings have increased, mutual funds have realized that they cannot easily sell blocks of poorly performing stock).

¹⁷ See Kathleen Pender, *The Influence of Indexing on the Markets*, San Francisco Chronicle, June 23, 2002, at G1 (some index funds are more likely to vote proxies because they generally cannot sell portfolio securities consistent with their investment policies).

governance.¹⁸ The increased equity holdings and accompanying voting power of mutual funds place them in a position to have enormous influence on corporate accountability. As major shareholders, mutual funds may play a vital role in monitoring the stewardship of the companies in which they invest.

Moreover, in some situations the interests of a mutual fund's shareholders may conflict with those of its investment adviser with respect to proxy voting.¹⁹ This may occur, for example, when a fund's adviser also manages or seeks to manage the retirement plan assets of a company whose securities are held by the fund.²⁰ In these situations, a fund's adviser may have an incentive to support management recommendations to further its business interests.

Yet, in spite of the substantial institutional voting power held by mutual funds, the increasing importance of the exercise of that power to fund shareholders, and the potential for conflicts of interest with respect to the exercise of fund proxy voting power, limited information is available regarding how funds vote their proxies. At present, the Commission's rules do not require mutual funds to disclose either their proxy voting policies and procedures or their proxy voting records.²¹ Several mutual fund complexes voluntarily provide information to investors, often on their websites, about the policies and procedures that they use to determine

¹⁸ See, e.g., Josh Friedman, *Vanguard to Turn More Activist in Proxy Voting*, Los Angeles Times, Aug. 22, 2002, at B3 (Vanguard imposing stricter corporate governance guidelines in light of recent events); Tom Hamburger, *Union Targets Corporate Change*, Wall Street Journal, July 30, 2002, at A2 (workers should use pension funds and votes to compel changes in corporate behavior); Beth Healy, *Big Investors Assuming a More Activist Stance*, Boston Globe, July 11, 2002, at C1 (big investors say they are taking a more activist stance after financial scandals at Enron, Global Crossing, and WorldCom); Russ Wiles, *Funds May Have More to Say on Governance*, Chicago Sun-Times, June 3, 2002, at F53 (investors taking a closer look at corporate governance issues as a result of Enron).

¹⁹ See, e.g., Aaron Bernstein & Geoffrey Smith, *Can You Trust Your Fund Company?*, BusinessWeek Online, Aug. 8, 2002 (AFL-CIO argues that conflicts of interest lead mutual funds to vote with management).

²⁰ For additional examples of potential conflicts of interest involving investment advisers, see Investment Advisers Act Release No. 2059, *supra* note 3, at Section 1, "Background."

²¹ In general, investment companies are organized either as business trusts in Delaware or Massachusetts, or as corporations in Maryland. The applicable state statutes do not specifically permit shareholders to inspect books and records relating to proxy voting by funds with respect to portfolio securities. See Del. Code Ann. tit. 12, § 3801-3824 (2001); Mass. Gen. Laws. Ann. ch. 182, § 1-14 (2002); Md. Code Ann., Corporations § 2-512 (2001).

how to vote proxies and, in some cases, their actual proxy voting decisions.²² The Internet provides a medium for these funds to make information about their proxy voting available to shareholders quickly and in a cost-effective manner. We applaud these voluntary efforts of mutual funds to disclose proxy voting information to shareholders, and we encourage all funds to provide similar information without delay.

We believe, however, that the time has now arrived for the Commission to consider requiring mutual funds to disclose their proxy voting policies and procedures, and their actual voting records.²³ Proxy voting decisions by

funds may play an important role in maximizing the value of the funds' investments, having an enormous impact on the financial livelihood of millions of Americans. Further, requiring greater transparency of proxy voting by funds may encourage funds to become more engaged in corporate governance of issuers held in their portfolios, which may benefit all investors and not just fund shareholders. Finally, shedding light on mutual fund proxy voting could illuminate potential conflicts of interest and discourage voting that is inconsistent with fund shareholders' best interests. Advances in technology over the last 30 years, specifically the Internet, allow this disclosure of proxy voting records to be readily accessible at low cost.

II. Discussion

We are proposing to amend the registration forms for funds, and recently proposed Form N-CSR, to require the disclosure of fund proxy voting policies and procedures as well as actual proxy votes cast.²⁴

A. Disclosure of Policies and Procedures With Respect To Voting Proxies Relating to Portfolio Securities

We are proposing to require funds that invest in voting securities to disclose in their statements of additional information ("SAIs") the policies and procedures that they use to determine how to vote proxies relating to securities held in their portfolios.²⁵ This would include the procedures that a 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 principal underwriter, on the other. It also would include any policies and procedures of a 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.²⁶ For example, if a fund delegates proxy voting decisions to its investment adviser and the adviser uses its own policies and procedures to vote the fund's proxies, disclosure of the adviser's policies and procedures would be required.

For open-end management investment companies that continuously offer their shares and maintain an updated registration statement, the required SAI disclosure will result in continuous investor access, upon request, to current proxy voting policies and procedures. Because closed-end funds do not offer their shares continuously, and are therefore generally not required to maintain an updated SAI to meet their obligations under the Securities Act of 1933,²⁷ we are also proposing to require closed-end funds to disclose their proxy voting policies and procedures annually on Form N-CSR.²⁸

We would expect that funds' disclosure of their policies and procedures would include general policies and procedures, as well as policies with respect to voting on specific types of issues. The following are examples of general policies and procedures that some funds include in their proxy voting policies and procedures and with respect to which disclosure would be appropriate:

- The extent to which the fund delegates its proxy voting decisions to its investment adviser or another third party, or relies on the recommendations of a third party;
- Policies and procedures relating to matters that may affect substantially the rights or privileges of the holders of securities to be voted; and
- Policies regarding the extent to which the fund will support or give weight to the views of management of the company.

The following are examples of specific types of issues that are covered by some funds' proxy voting policies and procedures and with respect to which disclosure would be appropriate:

- Corporate governance matters, including changes in the state of incorporation, mergers and other

²² See Calvert Group, Ltd. <www.calvertgroup.com> (visited July 25, 2002) (proxy voting policies and votes cast); Domini Social Investments LLC <www.domini.com> (visited July 25, 2002) (proxy voting policies and votes cast); Fidelity Management & Research Company <www.fidelity.com> (visited Sept. 4, 2002) (proxy voting policies); PAX World Management Corporation <www.paxfund.com> (visited July 25, 2002) (proxy voting policies and votes cast); Teachers Insurance and Annuity Association of America-College Retirement and Equities Fund <www.tiaa-cref.org> (visited Sept. 8, 2002) (proxy voting policies); The Vanguard Group <www.vanguard.com> (visited Sept. 5, 2002) (proxy voting policies).

²³ Twice in the past we have considered requiring funds to provide information about proxy voting with respect to portfolio securities. See Notice of Proposal to Amend Forms N-8B-1, N-8B-3, N-8B-4, N-5, and N-1Q To Require Registered Investment Companies To Disclose with Greater Specificity Their Policies on Involvement in the Affairs of Their Portfolio Companies, Investment Company Act Release No. 6853 (Dec. 1, 1971) [36 FR 25434 (Dec. 31, 1971)] (proposed amendments would have required registered investment companies to disclose their policies and procedures for considering proxy materials of portfolio companies); Notice of Withdrawal of Proposal to Amend Forms N-8B-1, N-8B-3, N-8B-4, N-5, and N-1Q To Require Registered Investment Companies To Disclose with Greater Specificity Their Policies on Involvement in the Affairs of Their Portfolio Companies, Investment Company Act Release No. 9295 (May 20, 1976) [41 FR 21796 (May 28, 1976)]; Proposed Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Securities Exchange Act Release No. 14970 (July 18, 1978) [43 FR 31945 (July 24, 1978)] (proposed rules would have required registered investment companies and other institutional investors to disclose their proxy voting policies and procedures for equity securities held for their own account or the account of others, and the number of times they voted for or against management or abstained from voting on any contested matter); Proposed Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, Withdrawal of Proposed Rule and Amendments, Securities Exchange Act Release No. 15385 (Dec. 6, 1978) [43 FR 58533 (Dec. 14, 1978)]. In 2000, we proposed amendments to Form ADV, the registration form for investment advisers, that would require registered investment advisers to disclose their proxy voting practices. See Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV, Investment Advisers Act Release No. 1862 (Apr. 5, 2000) [65 FR 20524 (Apr. 17, 2000)]. These amendments remain pending.

²⁴ Form N-1A [17 CFR 239.15A; 17 CFR 274.11A] is the registration form for open-end management investment companies. Form N-2 [17 CFR 239.14; 17 CFR 11a-1] is the registration form for closed-end management investment companies. Form N-3 [17 CFR 239.17a; 17 CFR 274.11b] is the registration form for separate accounts organized as management investment companies that offer variable annuity contracts.

²⁵ The SAI is part of a fund's registration statement and contains information about a fund in addition to that contained in the prospectus. The SAI is required to be delivered to investors upon request and is available on the Commission's Electronic Data Gathering, Analysis, and Retrieval System ("EDGAR").

²⁶ Proposed Item 13(f) of Form N-1A; Proposed Item 18.16 of Form N-2; Proposed Item 20(o) of Form N-3. See Section 2(a)(3) of the Investment Company Act [15 U.S.C. 80a-2(a)(3)] (defining affiliated person).

²⁷ Pursuant to rule 8b-16(b) under the Investment Company Act [17 CFR 270.8b-16(b)], closed-end funds are not required to file amendments to their registration statements (including their SAIs) in order to comply with their Investment Company Act registration obligations, provided that they include specified information in their annual reports to shareholders.

²⁸ Item 3 of proposed Form N-CSR.

corporate restructurings, and anti-takeover provisions such as staggered boards, poison pills, and supermajority provisions;

- Changes to capital structure, including increases and decreases of capital and preferred stock issuance;
- Stock option plans and other management compensation issues; and
- Social and corporate responsibility issues.

We also are proposing to require that a fund disclose in its shareholder reports that a description of the fund's proxy voting policies and procedures is available (i) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (ii) on the fund's website, if applicable; and (iii) on the Commission's Web site at <http://www.sec.gov>.²⁹ The proposals also would require a fund to send this description of the fund's proxy voting policies and procedures within three business days of receipt of the request, by first-class mail or other means designed to ensure equally prompt delivery.³⁰

We request comment generally on the disclosure of policies and procedures that funds use to determine how to vote proxies relating to securities held in their portfolios and specifically on the following issues.

- Should we require funds to disclose their policies and procedures with respect to voting proxies of portfolio securities?
- Should we provide greater specificity with regard to the disclosure that funds are required to make? For example, should our forms expressly require disclosure of any or all of the specific matters enumerated above or of any other specific matters?
- Is the SAI (and, for closed-end funds, Form N-CSR) the appropriate location for funds to disclose their policies and procedures with respect to voting proxies relating to portfolio securities? Will our proposals provide adequate access to fund proxy voting policies and procedures by fund shareholders and prospective investors? Should the disclosure be included in a document that is delivered to every shareholder?

B. Disclosure of Proxy Voting Record

We also are proposing to require each fund to file with the Commission its

proxy voting record and make this record available to its shareholders. In addition, a fund would be required to disclose in its annual and semi-annual reports to shareholders information regarding any proxy votes that are inconsistent with its proxy voting policies and procedures.

Disclosure of Complete Proxy Voting Record

The Commission is proposing to require a fund to file its complete proxy voting record as part of its report on proposed Form N-CSR. Today's proposals would add a new item to proposed Form N-CSR, which would require a fund to disclose the following information for each matter relating to a portfolio security considered at any shareholder meeting held during the period covered by the report and with respect to which the fund was entitled to vote:

- The name of the issuer of the portfolio security;
- The exchange ticker symbol of the portfolio security;
- The Council on Uniform Securities Identification Procedures ("CUSIP") number for the portfolio security;
- The shareholder meeting date;
- A brief identification of the matter voted on;
- Whether the matter was proposed by the issuer or by a security holder;
- Whether the fund cast its vote on the matter;
- How the fund cast its vote (*e.g.*, for or against proposal, or abstain; for or withhold regarding election of directors); and
- Whether the fund cast its vote for or against management.³¹

A fund also would be required to make its proxy voting record available to its shareholders. Specifically, the proposals would require a fund to disclose in its SAI, as well as annual and semi-annual reports to shareholders, that the fund's proxy voting record is available (i) without charge, upon request, by calling a specified toll-free (or collect) telephone number, (ii) on the fund's Web site, if applicable, and (iii) on the Commission's Web site.³² The proposals also would require a fund, upon receipt of a request for its proxy voting record, to send the information disclosed in response to Item 2 of the Fund's most recently filed Form N-CSR.³³ Funds

would be required to send this information within three business days of receipt of the request, by first-class mail or other means designed to ensure equally prompt delivery.³⁴

Our proposals would require that a fund's proxy voting policies and procedures and proxy voting record be publicly available through filings with us. They also would require that this information be readily available to fund shareholders, without charge, and that shareholders be apprised of how this information may be obtained. We believe that these proposals strike an appropriate balance—ensuring that a description of a fund's proxy voting policies and procedures, as well as its proxy voting record, are readily available to interested fund shareholders without imposing on funds, and their shareholders, unnecessary costs that would be associated with the distribution of this information to every shareholder of a fund.³⁵

We considered whether to provide funds greater flexibility in determining the medium through which to make their proxy voting information available to their shareholders, so that a fund could, for example, meet this obligation exclusively through website access. We concluded that, at this time, requiring funds to make the information available to investors who call a toll-free (or collect) telephone number would ensure the most widespread access to this information by all investors. While the percentage of households with Internet access has increased considerably in recent years, it remains substantially lower than the percentage with access to telephones.³⁶

We note, however, that we have taken steps to encourage issuers and market intermediaries to communicate with and deliver information to investors

Item 18.16 and proposed Instruction 6 to Item 23 of Form N-2; Proposed Instruction to Item 20(o) and proposed Instruction 6 to Item 27(a) of Form N-3.

³⁴ *Id.*

³⁵ *Cf.* Rulemaking Petition by Domini Social Investments, LLC (Nov. 27, 2001); Rulemaking Petition by the International Brotherhood of Teamsters (Jan. 18, 2001); Rulemaking Petition by the American Federation of Labor and Congress of Industrial Organizations (July 30, 2002, and Dec. 20, 2000) (requesting that the Commission require funds to provide their proxy voting information on the Internet and make paper copies available upon request).

³⁶ *See* Economics and Statistics Administration & National Telecommunications and Information Administration, A Nation Online: How Americans Are Expanding Their Use of the Internet, at 3 (Feb. 2002) (50.5% of households had Internet access as of Sept. 2001); Federal Communications Commission, Telephone Subscribership In the United States, at 1 (Feb. 2002) (95.1% of households had telephone service as of July 2001).

²⁹ *See* Proposed Item 22(b)(7) and 22(c)(5) of Form N-1A; Proposed Instructions 4.g. & 5.e. to Item 23 of Form N-2; Proposed Instructions 4(vii) & 5(v) to Item 27(a) of Form N-3.

³⁰ Proposed Instructions to Items 22(b)(7) and 22(c)(5) of Form N-1A; Proposed Instruction 6 to Item 23 of Form N-2; Proposed Instruction 6 to Item 27(a) of Form N-3.

³¹ Item 2 of proposed Form N-CSR.

³² *See* Proposed Items 13(f) and 22(b)(7) & (c)(5) of Form N-1A; Proposed Item 18.16 and Proposed Instructions 4.g. and 5.e. to Item 23 of Form N-2; Proposed Item 20(o) and Proposed Instructions 4(vii) and 5(v) to Item 27(a) of Form N-3.

³³ Proposed Instructions to Items 13(f), 22(b)(7), and 22(c)(5) of Form N-1A; Proposed Instruction to

through the Internet.³⁷ The increased availability of information through the Internet has helped to promote transparency, liquidity, and efficiency by making information available to investors quickly and in a cost-effective manner. We encourage each fund to make its proxy voting information available to its shareholders on its website, if it has one.

We request comment generally on the proposed disclosure of a fund's proxy voting record and specifically on the following issues.

- What would be the costs of requiring funds to file with the Commission their proxy voting records on Form N-CSR, and to make these records available to their shareholders? Are there less costly alternative means of requiring funds to disclose their proxy voting records?
 - What would be the benefits to fund shareholders and others of having funds' proxy voting records disclosed?
 - Is Form N-CSR the appropriate location for the disclosure of a fund's proxy voting record? We have proposed, but not yet adopted, Form N-CSR. If we ultimately do not adopt Form N-CSR to implement the certification requirement of Section 302 of the Sarbanes-Oxley Act of 2002, should we nevertheless adopt Form N-CSR as a medium for a fund to disclose its proxy voting record? If not, how should a fund file its proxy voting record with the Commission? Should the information simply be filed together with the reports to shareholders currently required to be filed with the Commission pursuant to rule 30b2-1 under the Investment Company Act?³⁸
 - Is it sufficient to require that a fund's proxy voting record be made available to investors or should we require a fund to deliver its proxy voting record to each investor? For example, should a fund's complete proxy voting record be included in its reports to shareholders?
 - Should a fund be permitted to meet its obligation to disclose its proxy voting record exclusively through posting the required information on its website?
 - The proposal would require funds to disclose their proxy voting records semi-annually. Will this provide sufficiently frequent disclosure to investors? Should we require funds to disclose their proxy voting records more

³⁷ See, e.g., Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports, Securities Act Release No. 8128 (Sept. 5, 2002) [67 FR 58479 (Sept. 16, 2002)] (requiring companies to include disclosure in their annual reports on Form 10-K about availability on company websites of reports on Forms 10-K, 10-Q, and 8-K).

³⁸ 17 CFR 270.30b2-1.

frequently? If so, through what means? Would less frequent disclosure, e.g., annually, be sufficient?

- Are we proposing to require too much or too little information to be disclosed in proposed Form N-CSR? For example, should we limit the disclosure to contested matters, not require disclosure with respect to any categories of "routine" matters, or otherwise limit the types of matters with respect to which disclosure is required? Could funds generically disclose their votes on any categories of matters, e.g., votes with management (or votes as recommended by an independent third-party proxy voting service) on certain categories of issues? Would this type of summary disclosure provide investors with adequate information? Should we require additional information, e.g., information about how other funds in the fund complex have voted?
 - Our proposed requirements to disclose proxy voting policies and procedures and proxy voting records would only apply to registered management investment companies. Should the proposed disclosure requirements also extend to unit investment trusts ("UITs")?³⁹ If so, how should they apply? UITs do not include SAIs in their registration statements.⁴⁰ In addition, UITs do not transmit reports to shareholders.⁴¹ Likewise, we have not proposed that UITs file proposed Form N-CSR. If the proxy voting disclosure requirements were to extend to UITs, where, and how frequently, should they make the required disclosure of their proxy voting policies and procedures and proxy voting records (e.g., prospectus, annual report on Form N-SAR, a newly created form, sponsor's website)? How would UITs alert investors to the availability of the information since they do not file SAIs, or transmit reports to shareholders? Should UITs only be

³⁹ A unit investment trust is "an investment company which (A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities; but does not include a voting trust." Section 4(2) of the Investment Company Act [15 U.S.C. 80a-4(2)].

⁴⁰ Currently, UITs register under the Investment Company Act on Form N-8B-2 [17 CFR 274.12] and register their securities under the Securities Act of 1933 on Form S-6 [17 CFR 239.16].

⁴¹ Cf. Rule 30e-2 under the Investment Company Act [17 CFR 270.30e-2] (requiring registered unit investment trusts substantially all of the assets of which consist of securities issued by a management investment company to transmit to their shareholders semi-annually a report containing all of the applicable information and financial statements or their equivalent required to be included in reports of the management investment company for the same fiscal period).

required to disclose proxy voting information annually because, unlike management investment companies, they are not currently subject to semi-annual reporting requirements? Are there any other modifications to the proposed disclosure requirements that would be appropriate in the case of UITs? If we extend the proposed proxy voting requirements to UITs, should we exempt UITs that invest exclusively in mutual funds, such as UITs that offer variable annuities and variable life insurance, since the underlying mutual funds would be covered?

Disclosure of Proxy Votes That Are Inconsistent With Fund's Policies and Procedures

We also are proposing to require a fund to disclose in its annual and semi-annual reports to shareholders proxy votes (or failures to vote) that are inconsistent with the fund's proxy voting policies and procedures.⁴² The information that would be required would include the same information required by proposed Form N-CSR with respect to disclosure of the fund's complete proxy voting record.⁴³ In addition, the fund would be required to disclose the reasons why the fund voted, or failed to vote, in a manner inconsistent with its proxy voting policies and procedures.⁴⁴

We believe that when a fund votes the proxies of its portfolio securities in a manner inconsistent with the fund's stated policies and procedures, a heightened risk exists that a conflict of interest may be present. Therefore, in these instances, it is appropriate that funds include information about the vote in reports that are delivered to all shareholders. We believe that this will provide shareholders with the best opportunity to evaluate the propriety of the proxy voting decision and will serve as a strong deterrent to voting decisions that are not in the best interests of shareholders.

We request comment generally on the disclosure of proxy votes that are inconsistent with a fund's policies and procedures and specifically on the following issues.

- Should we require disclosure in reports to shareholders of proxy votes

⁴² See Proposed Items 22(b)(8) & (c)(6) of Form N-1A; Proposed Instructions 4.h. & 5.f. to Item 23 of Form N-2; Proposed Instructions 4(viii) & 5(vi) to Item 27(a) of Form N-3.

⁴³ See Item 2 of proposed Form N-CSR. See also discussion supra Section II.B., "Disclosure of Complete Proxy Voting Record."

⁴⁴ See Proposed Items 22(b)(8)(x) & (c)(6)(x) of Form N-1A; Proposed Instructions 4.h.(10) & 5.f.(10) to Item 23 of Form N-2; Proposed Instructions 4(viii)(j) & 5(vi)(j) to Item 27(a) of Form N-3.

that are inconsistent with a fund's proxy voting policies and procedures? Is it necessary or appropriate to require delivery (as opposed to availability) of this information to all shareholders?

- Should information about any other aspects of a fund's actual proxy voting record be required to be included in reports to shareholders? For example, should a fund be required to include in its reports to shareholders its votes on contested matters, management compensation issues, director elections, or any other matters?

III. General Request for Comments

The Commission requests comment on the amendments proposed in this release, whether any further changes to our rules or forms are necessary or appropriate to implement the objectives of our proposed amendments, and on other matters that might have an effect on the proposals contained in this release.

IV. Paperwork Reduction Act

Certain provisions of the proposed amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 [44 U.S.C. 3501, *et seq.*], and the Commission is submitting the proposed collections of information to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The titles for the collections of information are: (1) "Form N-1A under the Investment Company Act of 1940 and Securities Act of 1933, Registration Statement of Open-End Management Investment Companies"; (2) "Form N-2—Registration Statement of Closed-End Management Investment Companies"; (3) "Form N-3—Registration Statement of Separate Accounts Organized as Management Investment Companies"; and (4) "Form N-CSR—Certified Shareholder Report of Registered Management Investment Companies." An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number.

Form N-1A (OMB Control No. 3235-0307), Form N-2 (OMB Control No. 3235-0026), and Form N-3 (OMB Control No. 3235-0316) were adopted pursuant to Section 8(a) of the Investment Company Act [15 U.S.C. 80a-8] and Section 5 of the Securities Act [15 U.S.C. 77e]. We issued a release proposing Form N-CSR on August 30, 2002, pursuant to Section 8(a) of the Investment Company Act [15 U.S.C. 80a-8] and Section 13 of the Securities Exchange Act [15 U.S.C. 78m].

We are proposing amendments to require funds holding equity securities to disclose the policies and procedures that they use to determine how to vote the proxies of their portfolio securities. We are also proposing to require disclosure of the actual voting record with respect to such proxies. We believe that the changes we propose today will enhance the transparency of fund proxy voting and will allow shareholders to monitor whether funds are voting portfolio securities in the best interests of shareholders.

Form N-1A

Form N-1A, including the proposed amendments, contains collection of information requirements. The likely respondents to this information collection are open-end funds registering with the Commission on Form N-1A. Compliance with the disclosure requirements of Form N-1A is mandatory. Responses to the disclosure requirements are not confidential.

The current hour burden for preparing an initial Form N-1A filing is 801 hours per portfolio. The current annual hour burden for preparing post-effective amendments of Form N-1A is 99 hours per portfolio. The Commission estimates that, on an annual basis, 193 portfolios file initial registration statements on Form N-1A and 7,525 file post-effective amendments on Form N-1A. Thus, the current total annual hour burden for the preparation and filing of Form N-1A is 899,568 hours.

We estimate that the proposed amendments would increase the hour burden per portfolio per filing of an initial registration statement by 8 hours and would increase the hour burden per portfolio per filing of a post-effective amendment to a registration statement by 2 hours. Thus, if the proposed amendments to Form N-1A are adopted, the total annual hour burden for all funds for preparation and filing of initial registration statements and post-effective amendments to Form N-1A would be 916,162 hours.

Form N-2

Form N-2, including the proposed amendments, contains collection of information requirements. The likely respondents to this information collection are closed-end funds registering with the Commission on Form N-2. Compliance with the disclosure requirements of Form N-2 is mandatory. Responses to the disclosure requirements are not confidential.

The current hour burden for preparing an initial Form N-2 filing is 536.7 burden hours per filing, and the current

annual hour burden for preparing post-effective amendments of Form N-2 is 101.7 hours per filing. The Commission currently estimates that, on an annual basis, 140 respondents file an initial registration statement on Form N-2 and 38 file post-effective amendments on Form N-2. Thus, the current total annual hour burden for the preparation and filing of Form N-2 is 79,003 hours.

We estimate that the proposed amendments would increase the hour burden per filing of an initial registration statement by 8 hours and would increase the hour burden per filing of a post-effective amendment to a registration statement by 2 hours. Thus, if the proposed amendments to Form N-2 are adopted, the total annual hour burden for all funds for preparation and filing of initial registration statements and post-effective amendments on Form N-2 would be 80,198.6 hours.

Form N-3

Form N-3, including the proposed amendments, contains collection of information requirements. The likely respondents to this information collection are separate accounts, organized as management investment companies and offering variable annuities, registering with the Commission on Form N-3. Compliance with the disclosure requirements of Form N-3 is mandatory. Responses to the disclosure requirements are not confidential.

The current annual hour burden for preparing an initial registration statement on a Form N-3 is 907.2 hours per portfolio. The current annual hour burden for preparing post-effective amendments of Form N-3 is 148.4 hours per portfolio. The Commission estimates that, on an annual basis, no initial registration statements will be filed on Form N-3 and 60 post-effective amendments will be filed on Form N-3. The estimated average number of portfolios per filing is 4, bringing the estimated total number of portfolios in post-effective amendments to Form N-3 filings annually to 240. Thus, the current total burden hours for the preparation and filing of Form N-3 is 35,616 hours.

We estimate that the proposed amendments would increase the hour burden per portfolio of an initial registration statement by 8 hours and would increase the hour burden per portfolio of a post-effective amendment to a registration statement by 2 hours. Thus, if the proposed amendments to Form N-3 are adopted, the total annual hour burden for all funds for preparation and filing of initial

registration statements and post-effective amendments on Form N-3 would be 36,096 hours.

Form N-CSR

Proposed Form N-CSR, including the proposed amendments, contains collection of information requirements. The respondents to this information collection would be management investment companies subject to rule 30e-1 under the Investment Company Act of 1940 registering with the Commission on Forms N-1A, N-2, or N-3. Compliance with the disclosure requirements of Form N-CSR is proposed to be mandatory. Responses to the disclosure requirements are not confidential.

We previously estimated that the hour burden for preparing a proposed Form N-CSR would be 5 hours per filing. We also estimated that 3,700 registered investment companies would file Form N-CSR on a semi-annual basis for a total of 7,400 filings. Thus, we estimated that the total annual hour burden for the preparation and filing of Form N-CSR would be 37,000 hours.⁴⁵

We estimate that the proposed amendments would increase the hour burden per filing of a Form N-CSR by 10 hours. Thus, if the proposed amendments to Form N-CSR are adopted, the total annual hour burden for all funds for preparation and filing of Form N-CSR would be 111,000 hours.⁴⁶

Shareholder Reports

Rule 30e-1, including the proposed amendments to Forms N-1A, N-2, and N-3, contains collection of information requirements.⁴⁷ Compliance with the disclosure requirements of rule 30e-1 is mandatory. Responses to the disclosure requirements will not be kept confidential.

There are approximately 3,700 management investment companies subject to rule 30e-1. We estimate that the current hour burden for preparing and filing semi-annual and annual shareholder reports in compliance with rule 30e-1 is 202.5 hours. We estimate that the proposed amendments would increase the hour burden of complying

with rule 30e-1 by 10 hours. Thus, if the proposed amendments are adopted, the total hour burden of complying with rule 30e-1 would be 212.5 hours, for a total annual burden to the industry of 786,250 hours.

Request for Comments

We request your comments on the accuracy of our estimates. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to: (i) Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of burden of the proposed collection of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) evaluate whether there are ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct the comments to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 3208, New Executive Office Building, Washington, DC 20503, and should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 5th Street, NW, Washington, DC 20549-0609, with reference to File No. S7-36-02. OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication of this release. Consequently, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release.

V. Cost/Benefit Analysis

The Commission is sensitive to the costs and benefits imposed by its rules. We propose to require funds to provide disclosure about how they vote proxies of the portfolio securities they hold. Funds would be required to disclose in their registration statements their policies and procedures used to determine how to vote proxies relating to portfolio securities, and to include disclosure about the availability of the fund's proxy voting record. This disclosure would be included in the statement of additional information ("SAI"), which is not part of the fund's prospectus but is delivered to investors free of charge upon request. We are also

proposing to require a fund to file with the Commission semi-annually, as part of its reports on proposed Form N-CSR, its complete proxy voting record for the period covered by the report. Our proposals would also require a fund to include in its annual and semi-annual reports to shareholders disclosure that this record, and the fund's proxy voting policies and procedures, are available (i) without charge, upon request from the fund, (ii) on the fund's website, if applicable, and (iii) on the SEC website. Finally, our proposals would require disclosure in shareholder reports of any proxy votes that are inconsistent with the fund's policies and procedures.

A. Benefits

The proposed form amendments will benefit fund investors, by providing them with access to information about how funds vote their proxies. To the extent that investors would choose among funds based on their proxy voting policies and records, in addition to other factors such as expenses and investment policies, investors will be better able to select funds that suit their particular preferences.

In some situations the interests of a mutual fund's shareholders may conflict with those of its investment adviser with respect to proxy voting. This may occur, for example, when a fund's adviser also manages or seeks to manage the retirement plan assets of a company whose securities are held by the fund. In these situations, a fund's adviser may have an incentive to support management recommendations to further its business interests. Our proposals would require funds to disclose how they address such conflicts of interest in determining how to vote their proxies, and would also require funds to identify any proxy votes that are inconsistent with their stated voting policies. This disclosure requirement should benefit fund shareholders by deterring voting decisions that are motivated by considerations of the interests of the fund's adviser rather than the interests of fund shareholders.

Moreover, the proposed rules could increase funds' focus on corporate governance. This could result in better decisionmaking in particular corporate governance matters, which may enhance shareholder value of the issuers of portfolio securities, and may, in turn, benefit both investors in the fund and other investors in these issuers. These benefits are difficult to quantify. We note that assets held in equity funds account for approximately 19% of the market capitalization of all publicly

⁴⁵ See Investment Company Act Release No. 25723 (Aug. 30, 2002) [67 FR 57298 (Sept. 9, 2002)].

⁴⁶ This increase in hour burden includes that imposed by Item 3 of proposed Form N-CSR with respect to policies and procedures used by a closed-end fund in determining how to vote proxies relating to portfolio securities.

⁴⁷ The proposed amendments are to Forms N-1A, N-2, and N-3. Rule 30e-1(a) under the Investment Company Act of 1940 [17 CFR 270.30e-1(a)] requires funds to include in the shareholder reports the information that is required by the fund's registration statement form.

traded U.S. corporate equity.⁴⁸ We request comment on the extent and magnitude of the effect that requiring disclosure of proxy voting guidelines and decisions by funds would have on corporate governance, and on the U.S. economy generally.

B. Costs

The proposed amendments would lead to some additional costs for funds, which may be passed on to fund shareholders.

Our proposals would require new disclosure by a fund regarding its proxy voting policies and records, in its SAI and its annual and semi-annual reports to shareholders. These costs would include both internal costs (for attorneys and other non-legal staff of a fund, such as computer programmers, to prepare and review the required disclosure) and external costs (for printing and typesetting of the disclosure).⁴⁹ First, our proposals would require disclosure of the fund's proxy voting policies and procedures, and disclosure about the availability of its proxy voting record, in the fund's SAI. Because the SAI is typically not typeset and is only provided to shareholders upon request, we estimate that the external costs per investment company of this additional disclosure in the SAI would be minimal. For purposes of the Paperwork Reduction Act, we have estimated that the disclosure requirements would add 18,270 hours to the burden of completing Forms N-1A, N-2 and N-3.⁵⁰ We estimate that this additional burden would equal total internal costs of \$1,259,534 annually, or \$340 per investment company.⁵¹

⁴⁸ See Securities Industry Fact Book, *supra* note 5, at 71.

⁴⁹ Based on the Division's review of materials submitted by various mutual fund complexes, we believe that most registered management investment companies currently maintain policies and procedures used to determine how to vote proxies relating to portfolio securities.

⁵⁰ This would represent 16,594 additional hours for Form N-1A, 1,196 additional hours for Form N-2, and 480 additional hours for Form N-3.

⁵¹ These figures are based on a Commission estimate that approximately 3,700 management investment companies would be subject to the proposed amendments and an estimated hourly wage rate of \$68.94. The estimate of the number of investment companies is based on data derived from the Commission's EDGAR filing system. The estimated wage rate figure is based on published hourly wage rates for compliance attorneys in New York City (\$74.22) and programmers (\$27.91), and the estimate, based on the Commission staff's discussions with certain fund complexes, that attorneys and programmers would divide time equally on compliance with the proxy voting disclosure requirements, yielding a weighted wage rate of \$51.065 $((\$74.22 \times .50) + (\$27.91 \times .50)) = \$51.065$. See Securities Industry Association, *Report on Management & Professional Earnings in the Securities Industry 2001* (Oct. 2001). This

Second, with respect to annual and semi-annual reports to shareholders, funds would be required to include disclosure about the availability of information regarding the fund's proxy voting policies and procedures, and proxy voting record, and to disclose any proxy votes that were inconsistent with the fund's proxy voting policies and procedures. We estimate that to comply with these disclosure requirements, a typical fund would need to include at most one additional page in its annual and semi-annual reports to shareholders, at a typesetting cost of \$55 per page and a printing cost of \$0.025 per page.⁵² We estimate that a typical fund may have, on average, 30,000 shareholder accounts;⁵³ therefore, the additional disclosure in shareholder reports would cost approximately \$1610 $(\$0.025 \times 30,000 \text{ shareholder accounts, plus } \$55) \times 2 \text{ reports per year}$ in external costs per fund. Based on the Commission's estimate of 3700 registered management investment companies, we estimate these external costs would be \$5,957,000 for the industry as a whole. In addition, we estimate that these disclosure requirements would add 37,000 burden hours for management investment companies required to transmit shareholder reports, or 10 hours per fund, equal to internal costs of \$2,550,780 for the industry annually, or \$689 per investment company.⁵⁴

Third, our proposals also would require funds to file with the Commission information regarding each matter relating to a portfolio security considered at any shareholder meeting held during the period covered by the report on proposed Form N-CSR, and to make available to their shareholders the information contained in proposed Form N-CSR. We estimate that the external costs per investment company of this additional disclosure would be minimal. In addition, we estimate that these disclosure requirements would add 74,000 burden hours to Form N-CSR, or 20 hours per management

weighted wage rate was then adjusted upward by 35% for overhead, reflecting the costs of supervision, space, and administrative support, to obtain the total per hour internal cost of \$68.94 $(51.065 \times 1.35) = \$68.94$.

⁵² This estimate is based on information provided to the Division of Investment Management by registered investment companies regarding printing and typesetting costs for prospectuses and SAIs.

⁵³ This estimate regarding the average number of shareholder accounts per typical fund is derived from data provided in the Mutual Fund Fact Book, *supra* note 5, at 63, 64.

⁵⁴ These figures are based on a Commission estimate that approximately 3,700 investment companies would be subject to the proposed amendments and an estimated hourly wage rate of \$68.94. See *supra* note.

investment company filing on Form N-CSR annually. We estimate that this burden would be \$5,101,560 in total internal costs annually, or \$1,379 per investment company.⁵⁵

Therefore, based on this analysis, we estimate that the total external and internal costs of the additional disclosure that would be required by the proposed amendments would be \$14,868,874. We request comment on the nature and magnitude of our estimates of the costs of the additional disclosure that would be required if our proposals were adopted.

Because the proposed amendments may have the effect of inducing fund advisers and fund boards to devote more resources to articulating their proxy voting policies and procedures in more detail, and to monitoring proxy voting decisions, they may result in higher expenses and advisory fees for funds. Some of these expenses may be passed on to shareholders. We request comment on the extent to which the proposed amendments would increase costs to funds and their shareholders as well as affect shareholder value.

C. Request for Comments

We request comments on all aspects of this cost-benefit analysis, including identification of any additional costs or benefits of, or suggested alternatives to, the proposed amendments. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

VI. Consideration of Burden on Competition; Promotion of Efficiency, Competition, and Capital Formation

Section 23(a)(2) of the Exchange Act requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. Section 23(a)(2) also prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.⁵⁶ In addition, section 2(c) of the Investment Company Act, section 2(b) of the Securities Act, and section 3(f) of the Exchange Act require the Commission, when engaging in rulemaking that requires it to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.⁵⁷

⁵⁵ *Id.*

⁵⁶ 15 U.S.C. 78w(a)(2).

⁵⁷ 15 U.S.C. 77(b), 78c(f), and 80a-2(c).

The proposed amendments are intended to provide greater transparency for fund shareholders regarding the management of their investments in funds. The changes may improve efficiency. The enhanced disclosure requirements would provide shareholders with greater access to proxy voting policies and decisions of the funds in which they invest, which would promote more efficient allocation of investments by investors and more efficient allocation of assets among competing funds. The proposed amendments may also improve competition, as enhanced disclosure may prompt funds to seek to provide better-informed investors with improved products and services. Finally, the effects of the proposed amendments on capital formation are unclear. Although, as noted above, we believe that the proposed amendments would benefit investors, the magnitude of the effect of the proposed amendments on efficiency, competition, and capital formation is difficult to quantify, particularly given that most funds do not currently provide the type of disclosure contemplated by the proposed amendments.

We request comment on whether the proposed amendments, if adopted, would impose a burden on competition. We also request comment on whether the proposed amendments, if adopted, would promote efficiency, competition, and capital formation. Commenters are requested to provide empirical data and other factual support for their views if possible.

VII. Initial Regulatory Flexibility Analysis

This Initial Regulatory Flexibility Analysis ("Analysis") has been prepared in accordance with 5 U.S.C. 603, and relates to the Commission's proposed form amendments under the Securities Act, the Exchange Act, and the Investment Company Act to require funds to provide disclosure about how they vote proxies of portfolio securities they hold. Under the proposed amendments, funds would be required to disclose in their registration statements the policies and procedures that they use to determine how to vote the proxies of portfolio securities. The proposal also would require funds to file with the Commission and to make available to their shareholders, upon request and without charge, a document containing the information required by proposed Form N-CSR.

Specifically, a fund would be required to disclose in its statement of additional information ("SAI") its policies and procedures used to determine how to

vote proxies of the securities held in its portfolio, and to provide disclosure regarding the availability of its proxy voting record to shareholders. The proposals also would require a fund to file with the Commission, as part of its reports on proposed Form N-CSR, its complete proxy voting record for the period covered by the report. Finally, the proposals also would require a fund to include in its annual and semi-annual reports to shareholders disclosure that this record, and the fund's proxy voting policies and procedures, are available

(i) without charge, upon request from the fund, (ii) on the fund's Web site, if applicable, and (iii) on the SEC Web site, and to include disclosure about any proxy votes cast by the fund that are inconsistent with its policies and procedures.

A. Reasons for, and Objectives of, Proposed Amendments

As we have noted above, proxy voting decisions may play an important role in maximizing the value of a fund's investments for its shareholders. Requiring funds to disclose specific proxy voting information could enable shareholders to make an informed assessment as to whether funds are utilizing proxy voting for the benefit of fund shareholders. We are proposing these amendments because we believe that requiring management investment companies to disclose their proxy policies and procedures as well as voting records will result in greater transparency for fund shareholders regarding the overall management of their investments. We also believe it is possible to achieve this improved disclosure quickly and inexpensively because of the advancements in technology over the last 30 years, such as the Internet.

B. Legal Basis

The Commission is proposing amendments to Forms N-1A, N-2, N-3, and N-CSR pursuant to authority set forth in sections 5, 6, 7, 10, 19(a), and 28 of the Securities Act [15 U.S.C. 77e, 77f, 77g, 77j, 77s(a), and 77z-3], sections 10(b), 13, 15(d), 23(a), and 36 of the Exchange Act [15 U.S.C. 78j(b), 78m, 78o(d), 78w(a), and 78mm], and sections 6(c), 8, 24(a), 30, and 38 of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-8, 80a-24(a), 80a-29, and 80a-37].

C. Small Entities Subject to the Rule

For purposes of the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies,

has net assets of \$50 million or less as of the end of its most recent fiscal year.⁵⁸ Approximately 205 out of 3700 investment companies that would be affected by this rule meet this definition.⁵⁹

D. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed amendments would require a fund to disclose in its SAI its policies and procedures used to determine how to vote proxies for the securities held in its portfolio, and to provide disclosure regarding the availability of its proxy voting record to shareholders. The proposals would also require a fund to file with the Commission, as part of its reports on proposed Form N-CSR, its complete proxy voting record for the period covered by the report. Finally, the proposals would require a fund to include in its annual and semi-annual reports to shareholders disclosure that this proxy voting record, and the fund's proxy voting policies and procedures, are available (i) without charge, upon request, from the fund, (ii) on the fund's Web site, if applicable, and (iii) on the SEC Web site, and to include disclosure about any proxy votes cast by the fund that are inconsistent with its policies and procedures.

The Commission estimates some one-time formatting and ongoing costs and burdens that would be imposed on all funds, but which may have a relatively greater impact on smaller firms. These include the costs related to disclosing proxy voting policies and procedures to fund shareholders; filing proxy voting records with the Commission on proposed Form N-CSR; and disclosing voting records via the Internet, U.S. mail, or other means. These costs also could include expenses for computer time, legal and accounting fees, information technology staff, and additional computer and telephone equipment. However, we believe, based on consultations with a number of fund complexes, including smaller fund complexes, that many investment companies presently collect in-house or outsource proxy voting information on a basis at least as current as semi-annually

⁵⁸ 17 CFR 270.0-10.

⁵⁹ This estimate is based on figures compiled by Division of Investment Management staff regarding investment companies registered on Form N-1A, Form N-2, and Form N-3. In determining whether an insurance company separate account is a small entity for purposes of the Regulatory Flexibility Act, the assets of insurance company separate accounts are aggregated with the assets of their sponsoring insurance companies. Investment Company Act rule 0-10(b) [17 CFR 270.0-10(b)]. Currently, no insurance company separate account filing on Form N-3 qualifies as a small entity.

and, therefore, that the marginal cost increases for most funds would be minimal.

The Commission solicits comment on the effect the proposed amendments would have on small entities.

E. Duplicative, Overlapping or Conflicting Federal Rules

There are no rules that duplicate, overlap, or conflict with the proposed amendments.

F. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objective, while minimizing any significant adverse impact on small issuers. In connection with the proposed amendments, the Commission considered the following alternatives: (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the proposed amendments for small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the proposed amendments, or any part thereof, for small entities.

The Commission believes at the present time that special compliance or reporting requirements for small entities, or an exemption from coverage for small entities, would not be appropriate or consistent with investor protection. The proposed disclosure amendments would provide shareholders with greater transparency regarding a fund's proxy voting policies and procedures, as well as records of votes cast. Different disclosure requirements for small entities, such as reducing the level of proxy voting disclosure that small entities would have to provide shareholders, may create the risk that those shareholders would not receive sufficient information to make an informed evaluation as to whether the fund's board and its investment adviser are complying with their fiduciary duties to vote proxies of portfolio securities in the best interest of fund shareholders. We believe it is important for the proxy disclosure that would be required by the proposed amendments to be provided to shareholders by all funds, not just funds that are not considered small entities.

We have endeavored through the proposed amendments to minimize the regulatory burden on all funds, including small entities, while meeting our regulatory objectives. Small entities

should benefit from the Commission's reasoned approach to the proposed amendments to the same degree as other investment companies. Further clarification, consolidation, or simplification of the proposals for funds that are small entities would be inconsistent with the Commission's concern for investor protection. Finally, we do not consider using performance rather than design standards to be consistent with our statutory mandate of investor protection in the present context.

G. Solicitation of Comments

The Commission encourages the submission of written comments with respect to any aspect of this analysis. Comment is specifically requested on the number of small entities that would be affected by the proposed amendments and the likely impact of the proposals on small entities. Commenters are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. These comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed amendments are adopted, and will be placed in the same public file as comments on the proposed amendments themselves. Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Comments also may be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7-36-02; this file number should be included on the subject line if e-mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549-0102. Electronically submitted comment letters also will be posted on the Commission's Internet Web site (<http://www.sec.gov>).⁶⁰

VIII. Consideration of Impact on the Economy

For purposes of the Small Business Enforcement Fairness Act of 1996,⁶¹ a rule is "major" if it results or is likely to result in:

- an annual effect on the economy of \$100 million or more;

⁶⁰ We do not edit personal identifying information, such as names or electronic mail addresses, from electronic submissions. You should submit only information that you wish to make available publicly.

⁶¹ Pub. L. 104-21, Title II, 110 Stat. 857 (1996).

- a major increase in costs or prices for consumers or individual industries; or

- significant adverse effects on competition, investment, or innovation.

The Commission requests comment on the potential impact of the proposed amendments on the U.S. economy on an annual basis. Commenters are requested to provide empirical data to support their views.

IX. Statutory Authority

The Commission is proposing amendments to Forms N-1A, N-2, N-3, and proposed Form N-CSR pursuant to authority set forth in sections 5, 6, 7, 10, 19(a), and 28 of the Securities Act [15 U.S.C. 77e, 77f, 77g, 77j, 77s(a), and 77z-3], sections 10(b), 13, 15(d), 23(a), and 36 of the Exchange Act [15 U.S.C. 78j(b), 78m, 78o(d), 78w(a), and 78mm], and sections 6(c), 8, 24(a), 30, and 38 of the Investment Company Act [15 U.S.C. 80a-6(c), 80a-8, 80a-24(a), 80a-29, and 80a-37].

List of Subjects

17 CFR Parts 239 and 249

Reporting and recordkeeping requirements, Securities.

17 CFR Part 274

Investment companies, Reporting and recordkeeping requirements, Securities.

Text of Proposed Rule and Form Amendments

For the reasons set out in the preamble, the Commission proposes to amend title 17, chapter II of the Code of Federal Regulations as follows:

PART 239—FORMS PRESCRIBED UNDER THE SECURITIES ACT OF 1933

1. The authority citation for part 239 continues to read in part as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77sss, 78c, 78l, 78m, 78n, 78o(d), 78u-5, 78w(a), 78ll(d), 79e, 79f, 79g, 79j, 79l, 79m, 79n, 79q, 79t, 80a-8, 80a-24, 80a-26, 80a-29, 80a-30, and 80a-37, unless otherwise noted.

* * * * *

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

2. The authority citation for part 249 continues to read in part as follows:

Authority: 15 U.S.C. 78a, *et seq.*, unless otherwise noted.

* * * * *

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

3. The authority citation for part 274 is amended by adding the following citations to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, and 80a-29, unless otherwise noted.

Section 274.101 is also issued under secs. 3(a) and 302, Pub. L. 107-204, 116 Stat. 745.

Section 274.128 is also issued under secs. 3(a) and 302, Pub. L. 107-204, 116 Stat. 745.

4. Form N-1A (referenced in §§ 239.15A and 274.11A) is amended by:

- a. In Item 13, adding paragraph (f); and
- b. In Item 22, adding paragraphs (b)(7) and (8) and (c)(5) and (6).

These amendments read as follows:

Note: The text of Form N-1A does not, and these amendments will not, appear in the *Code of Federal Regulations*.

Form N-1A

* * * * *

Item 13. Management of the Fund

* * * * *

(f) *Proxy Voting Policies.* 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. Also, state that shareholders may obtain information regarding how the Fund voted proxies relating to portfolio securities (1) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (2) on the Fund's website, if applicable; and (3) on the Commission's Web site at <http://www.sec.gov>.

Instruction. When a Fund (or financial intermediary through which shares of the Fund may be purchased or sold) receives a request for information regarding how the Fund voted proxies relating to portfolio securities, the Fund (or financial intermediary) must send the information disclosed in response to

Item 2 in the Fund's most recently filed Form N-CSR within 3 business days of receipt of the request by first-class mail or other means designed to ensure equally prompt delivery.

* * * * *

Item 22. Financial Statements

* * * * *

(b) * * *

(7) A statement that the Fund's proxy voting record for the period covered by the report, and a description of the policies and procedures that the Fund uses to determine how to vote proxies relating to portfolio securities, are available (i) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (ii) on the Fund's Web site, if applicable; and (iii) on the Commission's Web site at <http://www.sec.gov>.

Instruction. When a Fund (or financial intermediary through which shares of the Fund may be purchased or sold) receives a request for the Fund's proxy voting record, or a request for a description of the policies and procedures that the Fund uses to determine how to vote proxies, the Fund (or financial intermediary) must send the information disclosed in response to Item 2 in the Fund's most recently filed Form N-CSR, in the case of a request for the Fund's proxy voting record, or the information disclosed in response to Item 13(f) of this Form, in the case of a request for a description of the Fund's policies and procedures, within 3 business days of receipt of the request by first-class mail or other means designed to ensure equally prompt delivery.

(8) In the case of each matter relating to a portfolio security considered at any shareholder meeting held during the period covered by the report and with respect to which the Fund was entitled to vote and voted (or failed to vote) in a manner that was inconsistent with the Fund's proxy voting policies and procedures disclosed pursuant to Item 13(f), the following information:

- (i) The name of the issuer of the portfolio security;
- (ii) The exchange ticker symbol of the portfolio security;
- (iii) The Council on Uniform Securities Identification Procedures ("CUSIP") number for the portfolio security;
- (iv) The shareholder meeting date;
- (v) A brief identification of the matter voted on;
- (vi) Whether the matter was proposed by the issuer or by a security holder;
- (vii) Whether the Fund cast its vote on the matter;

(viii) How the Fund cast its vote (e.g., for or against proposal, or abstain; for or withhold regarding election of directors);

(ix) Whether the Fund cast its vote for or against management; and

(x) The reasons why the Fund voted, or failed to vote, in a manner that was inconsistent with its proxy voting policies and procedures.

(c) * * *

(5) A statement that the Fund's proxy voting record for the period covered by the report, and a description of the policies and procedures that the Fund uses to determine how to vote proxies relating to portfolio securities, are available (i) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (ii) on the Fund's Web site, if applicable; and (iii) on the Commission's Web site at <http://www.sec.gov>.

Instruction. When a Fund (or financial intermediary through which shares of the Fund may be purchased or sold) receives a request for the Fund's proxy voting record, or a request for a description of the policies and procedures that the Fund uses to determine how to vote proxies, the Fund (or financial intermediary) must send the information disclosed in response to Item 2 in the Fund's most recently filed Form N-CSR, in the case of a request for the Fund's proxy voting record, or the information disclosed in response to Item 13(f) of this Form, in the case of a request for a description of the Fund's policies and procedures, within 3 business days of receipt of the request by first-class mail or other means designed to ensure equally prompt delivery.

(6) In the case of each matter relating to a portfolio security considered at any shareholder meeting held during the period covered by the report and with respect to which the Fund was entitled to vote and voted (or failed to vote) in a manner that was inconsistent with the Fund's proxy voting policies and procedures disclosed pursuant to Item 13(f), the following information:

- (i) The name of the issuer of the portfolio security;
- (ii) The exchange ticker symbol of the portfolio security;
- (iii) The Council on Uniform Securities Identification Procedures ("CUSIP") number for the portfolio security;
- (iv) The shareholder meeting date;
- (v) A brief identification of the matter voted on;
- (vi) Whether the matter was proposed by the issuer or by a security holder;
- (vii) Whether the Fund cast its vote on the matter;

(viii) How the Fund cast its vote (e.g., for or against proposal, or abstain; for or withhold regarding election of directors);

(ix) Whether the Fund cast its vote for or against management; and

(x) The reasons why the Fund voted, or failed to vote, in a manner that was inconsistent with its proxy voting policies and procedures.

* * * * *

5. Form N-2 (referenced in §§ 239.14 and 274.11a-1) is amended by:

a. In Item 18, adding paragraph 16;

b. In Item 23, removing “and” from the end of Instruction 4.e.;

c. In Item 23, removing the period from the end of Instruction 4.f. and in its place adding a semi-colon;

d. In Item 23, adding Instructions 4.g. and 4.h.;

e. In Item 23, removing “and” from the end of Instruction 5.c.;

f. In Item 23, removing the period from the end of Instruction 5.d. and in its place adding a semi-colon;

g. In Item 23, adding Instructions 5.e. and 5.f.;

h. In Item 23, redesignating

Instruction 6 as Instruction 7; and

i. In Item 23, adding new Instruction 6.

These amendments read as follows:

Note: The text of Form N-2 does not, and these amendments will not, appear in the *Code of Federal Regulations*.

Form N-2

* * * * *

Item 18. Management

* * * * *

16. Unless the Registrant invests exclusively in non-voting securities, describe the policies and procedures that the Registrant uses to determine how to vote proxies relating to portfolio securities, including the procedures that the Registrant uses when a vote presents a conflict between the interests of the Registrant’s shareholders, on the one hand, and those of the Registrant’s investment adviser; principal underwriter; or any affiliated person (as defined in section 2(a)(3) of the 1940 Act (15 U.S.C. 80a-2(a)(3)) and the rules thereunder) of the Registrant, its investment adviser, or its principal underwriter, on the other. Include any policies and procedures of the Registrant’s investment adviser, or any other third party, that the Registrant uses, or that are used on the Registrant’s behalf, to determine how to vote proxies relating to portfolio securities. Also, state that shareholders may obtain information regarding how the Registrant voted proxies relating to

portfolio securities (i) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (ii) on the Registrant’s Web site, if applicable; and (iii) on the Commission’s Web site at <http://www.sec.gov>.

Instruction. When a Registrant (or financial intermediary through which shares of the Registrant may be purchased or sold) receives a request for information regarding how the Registrant voted proxies relating to portfolio securities, the Registrant (or financial intermediary) must send the information disclosed in response to Item 2 in the Registrant’s most recently filed Form N-CSR within 3 business days of receipt of the request by first-class mail or other means designed to ensure equally prompt delivery.

* * * * *

Item 23. Financial Statements

* * * * *

Instructions:

* * * * *

4. * * * * *
 g. a statement that the Registrant’s proxy voting record for the period covered by the report, and a description of the policies and procedures that the Registrant uses to determine how to vote proxies relating to portfolio securities, are available (1) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (2) on the Registrant’s Web site, if applicable; and (3) on the Commission’s Web site at <http://www.sec.gov>; and

h. in the case of each matter relating to a portfolio security considered at any shareholder meeting held during the period covered by the report and with respect to which the Registrant was entitled to vote and voted (or failed to vote) in a manner that was inconsistent with the Registrant’s proxy voting policies and procedures most recently disclosed pursuant to Item 18.16 of this Form or Item 3 of Form N-CSR, the following information:

- (1) the name of the issuer of the portfolio security;
- (2) the exchange ticker symbol of the portfolio security;
- (3) the Council on Uniform Securities Identification Procedures (“CUSIP”) number for the portfolio security;
- (4) the shareholder meeting date;
- (5) a brief identification of the matter voted on;
- (6) whether the matter was proposed by the issuer or by a security holder;
- (7) whether the Registrant cast its vote on the matter;
- (8) how the Registrant cast its vote (e.g., for or against proposal, or abstain;

for or withhold regarding election of directors);

(9) whether the Registrant cast its vote for or against management; and

(10) the reasons why the Registrant voted, or failed to vote, in a manner that was inconsistent with its proxy voting policies and procedures.

5. * * * * *

e. a statement that the Registrant’s proxy voting record for the period covered by the report, and a description of the policies and procedures that the Registrant uses to determine how to vote proxies relating to portfolio securities, are available (1) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (2) on the Registrant’s Web site, if applicable; and (3) on the Commission’s Web site at <http://www.sec.gov>; and

f. in the case of each matter relating to a portfolio security considered at any shareholder meeting held during the period covered by the report and with respect to which the Registrant was entitled to vote and voted (or failed to vote) in a manner that was inconsistent with the Registrant’s proxy voting policies and procedures most recently disclosed pursuant to Item 18.16 of this Form or Item 3 of Form N-CSR, the following information:

- (1) the name of the issuer of the portfolio security;
 - (2) the exchange ticker symbol of the portfolio security;
 - (3) the Council on Uniform Securities Identification Procedures (“CUSIP”) number for the portfolio security;
 - (4) the shareholder meeting date;
 - (5) a brief identification of the matter voted on;
 - (6) whether the matter was proposed by the issuer or by a security holder;
 - (7) whether the Registrant cast its vote on the matter;
 - (8) how the Registrant cast its vote (e.g., for or against proposal, or abstain; for or withhold regarding election of directors);
 - (9) whether the Registrant cast its vote for or against management; and
 - (10) the reasons why the Registrant voted, or failed to vote, in a manner that was inconsistent with its proxy voting policies and procedures.
6. When a Registrant (or financial intermediary through which shares of the Registrant may be purchased or sold) receives a request for the Registrant’s proxy voting record, or a request for a description of the policies and procedures that the Registrant uses to determine how to vote proxies, the Registrant (or financial intermediary) must send the information disclosed in response to Item 2 in the Registrant’s most recently filed Form N-CSR, in the

case of a request for the Registrant's proxy voting record, or the information most recently disclosed in response to Item 18.16 of this Form or Item 3 of Form N-CSR, in the case of a request for a description of the Registrant's policies and procedures, within 3 business days of receipt of the request by first-class mail or other means designed to ensure equally prompt delivery.

- 6. Form N-3 (referenced in §§ 239.17 and 274.11b) is amended by:
 - a. In Item 20, adding paragraph (o);
 - b. In Item 27(a), removing "and" from the end of Instruction 4(v);
 - c. In Item 27(a), removing the period from the end of Instruction 4(vi) and in its place adding a semi-colon;
 - d. In Item 27(a), adding Instructions 4(vii) and 4(viii);
 - e. In Item 27(a), removing "and" from the end of Instruction 5(iii);
 - f. In Item 27(a), removing the period from the end of Instruction 5(iv) and in its place adding a semi-colon;
 - g. In Item 27(a), adding Instructions 5(v) and 5(vi);
 - h. In Item 27(a), redesignating Instruction 6 as Instruction 7; and
 - i. In Item 27(a), adding new Instruction 6.

These amendments read as follows:

Note: The text of Form N-3 does not, and these amendments will not, appear in the Code of Federal Regulations.

Form N-3

* * * * *

Item 20. Management

* * * * *

(o) Unless the Registrant invests exclusively in non-voting securities, describe the policies and procedures that the Registrant uses to determine how to vote proxies relating to portfolio securities, including the procedures that the Registrant uses when a vote presents a conflict between the interests of the Registrant's contractowners, on the one hand, and those of the Registrant's investment adviser; principal underwriter; or any affiliated person (as defined in Section 2(a)(3) of the 1940 Act (15 U.S.C. 80a-2(a)(3)) and the rules thereunder) of the Registrant, its investment adviser, or its principal underwriter, on the other. Include any policies and procedures of the Registrant's investment adviser, or any other third party, that the Registrant uses, or that are used on the Registrant's behalf, to determine how to vote proxies relating to portfolio securities. Also, state that contractowners may obtain information regarding how the Registrant voted proxies relating to

portfolio securities (i) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (ii) on the Registrant's Web site, if applicable; and (iii) on the Commission's Web site at <http://www.sec.gov>.

Instruction. When a Registrant (or financial intermediary through which shares of the Registrant may be purchased or sold) receives a request for information regarding how the Registrant voted proxies relating to portfolio securities, the Registrant (or financial intermediary) must send the information disclosed in response to Item 2 in the Registrant's most recently filed Form N-CSR within 3 business days of receipt of the request by first-class mail or other means designed to ensure equally prompt delivery.

Item 27. Financial Statements

(a) * * *

Instructions:

* * * * *

4. * * *

(vii) a statement that the Registrant's proxy voting record for the period covered by the report, and a description of the policies and procedures that the Registrant uses to determine how to vote proxies relating to portfolio securities, are available (A) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (B) on the Registrant's Web site, if applicable; and (C) on the Commission's Web site at <http://www.sec.gov>; and

(viii) in the case of each matter relating to a portfolio security considered at any shareholder meeting held during the period covered by the report and with respect to which the Registrant was entitled to vote and voted (or failed to vote) in a manner that was inconsistent with the Registrant's proxy voting policies and procedures disclosed pursuant to Item 20(o), the following information:

- (A) the name of the issuer of the portfolio security;
- (B) the exchange ticker symbol of the portfolio security;
- (C) the Council on Uniform Securities Identification Procedures ("CUSIP") number for the portfolio security;
- (D) the shareholder meeting date;
- (E) a brief identification of the matter voted on;
- (F) whether the matter was proposed by the issuer or by a security holder;
- (G) whether the Registrant cast its vote on the matter;
- (H) how the Registrant cast its vote (e.g., for or against proposal, or abstain; for or withhold regarding election of directors);

(I) whether the Registrant cast its vote for or against management; and
(J) the reasons why the Registrant voted, or failed to vote, in a manner that was inconsistent with its proxy voting policies and procedures.

5. * * *

(v) a statement that the Registrant's proxy voting record for the period covered by the report, and a description of the policies and procedures that the Registrant uses to determine how to vote proxies relating to portfolio securities, are available (A) without charge, upon request, by calling a specified toll-free (or collect) telephone number; (B) on the Registrant's Web site, if applicable; and (C) on the Commission's Web site at <http://www.sec.gov>; and

(vi) in the case of each matter relating to a portfolio security considered at any shareholder meeting held during the period covered by the report and with respect to which the Registrant was entitled to vote and voted (or failed to vote) in a manner that was inconsistent with the Registrant's proxy voting policies and procedures disclosed pursuant to Item 20(o), the following information:

- (A) the name of the issuer of the portfolio security;
 - (B) the exchange ticker symbol of the portfolio security;
 - (C) the Council on Uniform Securities Identification Procedures ("CUSIP") number for the portfolio security;
 - (D) the shareholder meeting date;
 - (E) a brief identification of the matter voted on;
 - (F) whether the matter was proposed by the issuer or by a security holder;
 - (G) whether the Registrant cast its vote on the matter;
 - (H) how the Registrant cast its vote (e.g., for or against proposal, or abstain; for or withhold regarding election of directors);
 - (I) whether the Registrant cast its vote for or against management; and
 - (J) the reasons why the Registrant voted, or failed to vote, in a manner that was inconsistent with its proxy voting policies and procedures.
6. When a Registrant (or financial intermediary through which shares of the Registrant may be purchased or sold) receives a request for the Registrant's proxy voting record, or a request for a description of the policies and procedures that the Registrant uses to determine how to vote proxies, the Registrant (or financial intermediary) must send the information disclosed in response to Item 2 in the Registrant's most recently filed Form N-CSR, in the case of a request for the Registrant's proxy voting record, or the information disclosed in response to Item 20(o) of

this Form, in the case of a request for a description of the Registrant's policies and procedures, within 3 business days of receipt of the request by first-class mail or other means designed to ensure equally prompt delivery.

* * * * *

PART 274—FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940

7. Form N-CSR (referenced in §§ 249.331 and 274.128; as proposed in 67 FR 57298 (9/9/02)) is amended by:

- a. Redesignating Item 2 as Item 4; and
- b. Adding new Items 2 and 3 to read as follows:

Note: The text of Form N-CSR does not, and these amendments will not, appear in the Code of Federal Regulations.

Form N-CSR

* * * * *

Item 2. Proxy Voting Records.

Disclose the following information for each matter relating to a portfolio security considered at any shareholder meeting held during the period covered by the report provided pursuant to Item 1 and with respect to which the registrant was entitled to vote:

- (1) The name of the issuer of the portfolio security;
- (2) The exchange ticker symbol of the portfolio security;
- (3) The Council on Uniform Securities Identification Procedures ("CUSIP") number for the portfolio security;
- (4) The shareholder meeting date;
- (5) A brief identification of the matter voted on;
- (6) Whether the matter was proposed by the issuer or by a security holder;
- (7) Whether the registrant cast its vote on the matter;
- (8) How the registrant cast its vote (e.g., for or against proposal, or abstain; for or withhold regarding election of directors); and
- (9) Whether the registrant cast its vote for or against management.

Instruction. In the case of a registrant that offers multiple series of shares, provide the information required by this Item separately for each series. The term "series" means shares offered by a registrant that represent undivided interests in a portfolio of investments and that are preferred over all other series of shares for assets specifically allocated to that series in accordance with Rule 18f-2(a) under the Investment Company Act of 1940 (17 CFR 270.18f-2(a)).

Item 3. Disclosure of Proxy Voting Policies and Procedures for Closed-End Management Investment Companies

A closed-end management investment company that, pursuant to Item 1, is including a copy of an annual report transmitted to stockholders must, unless it invests exclusively in non-voting securities, describe the policies and procedures that it uses to determine how to vote proxies relating to portfolio securities, including the procedures that the company uses when a vote presents a conflict between the interests of its shareholders, on the one hand, and those of the company's investment adviser; principal underwriter; or any affiliated person (as defined in section 2(a)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(3)) and the rules thereunder) of the company, its investment adviser, or its principal underwriter, on the other. Include any policies and procedures of the company's investment adviser, or any other third party, that the company uses, or that are used on the company's behalf, to determine how to vote proxies relating to portfolio securities.

* * * * *

By the Commission.

Dated: September 20, 2002.

Margaret H. McFarland,
Deputy Secretary.

[FR Doc. 02-24409 Filed 9-25-02; 8:45 am]

BILLING CODE 8010-01-P

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

[Release No. IA-2059; File No. S7-38-02]

RIN 3235-AI65

Proxy Voting By Investment Advisers

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule.

SUMMARY: The Commission is publishing for comment a new rule and rule amendments under the Investment Advisers Act of 1940 that would address an investment adviser's fiduciary obligation to clients who have given the adviser authority to vote their proxies. Under our proposal, an investment adviser that exercises voting authority over client proxies would be required to adopt and implement policies and procedures that are reasonably designed to ensure that the adviser votes proxies in the best interest of clients, disclose to clients information about those procedures and policies and how clients

may obtain information on how the adviser has voted their proxies, and retain certain records relating to proxy voting. The rule and rule amendments are designed to assure that advisers vote proxies in the best interest of their clients and provide clients with information about how their proxies are voted.

DATES: Comments must be received on or before December 6, 2002.

ADDRESSES: To help us process and review your comments more efficiently, comments should be sent by hard copy or e-mail, but not by both methods.

Comments sent by hardcopy should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Comments may also be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7-38-02; if e-mail is used, this file number should be included on the subject line. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. Electronically submitted comment letters also will be posted on the Commission's Internet Web site (<http://www.sec.gov>).¹

FOR FURTHER INFORMATION CONTACT: Daniel S. Kahl, Senior Counsel, or Jamey Basham, Special Counsel, at 202-942-0719, Office of Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0506.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission" or "SEC") is requesting public comment on proposed rule 206(4)-6 [17 CFR 275.206(4)-6] and proposed amendments to rule 204-2 [17 CFR 275.204-2] under the Investment Advisers Act of 1940 [15 U.S.C. 80b] ("Advisers Act" or "Act").

I. Background

Investment advisers today have discretionary investment authority with respect to almost \$19 trillion dollars of assets, including large holdings in equity securities.² In most cases, these

¹ We do not edit personal or identifying information, such as names or E-mail addresses, from electronic submissions. Submit only information you wish to make publicly available.

² Approximately \$7 trillion of these assets are held by mutual funds. In a companion release, we are also publishing proposed amendments that would require mutual funds to disclose policies and procedures they use to vote proxies on their portfolio securities, and to make available to their

advisers are given authority to vote proxies relating to equity securities on behalf of their clients.³ The enormity of this voting power gives advisers significant ability collectively, and in many cases individually, to affect the outcome of shareholder votes and to substantially influence the governance of corporations.⁴ Advisers are thus in a position to have a significant effect on the future of corporations and the value of securities held by advisory clients.

The federal securities laws do not specifically address how advisers must exercise their voting authority. Under the Advisers Act, an investment adviser is, however, a fiduciary that owes its clients a duty of "utmost good faith, and full and fair disclosure of all material facts," as well as an affirmative obligation "to employ reasonable care to avoid misleading" its clients.⁵ An adviser owes its client a fiduciary duty with respect to all services undertaken on the client's behalf, including the voting of proxies.⁶ An adviser's fiduciary duty includes the duty of care and the duty of loyalty to clients. The duty of care requires an adviser given authority to vote proxies to monitor corporate events and to vote the

proxies.⁷ The duty of loyalty requires an adviser to vote proxies in a manner consistent with the best interest of its client and precludes the adviser from subrogating the client's interest to its own.⁸

The Commission is concerned with conflicts of interest between advisers and their clients. Advisers today frequently have business interests that may expose them to pressure to vote in a manner that may not be in the best interest of their clients.⁹ Many advisers (or their affiliates) manage assets, administer employee benefit plans, or provide brokerage, underwriting, insurance, or banking services to companies whose management is soliciting proxies. Failure to vote proxies in favor of the management of such a company may harm the adviser's relationship with the company, particularly when there is a contested matter before shareholders. In some cases, the adviser may have a business relationship, not with the company, but with a proponent of a proxy proposal, that may affect how it casts client votes. For example, the adviser may manage money for an employee group.

Other types of conflicts may affect how advisers vote client proxies. The adviser may have personal and business relationships with participants in proxy contests, corporate directors or candidates for corporate directorships, or the adviser may have a personal interest in the outcome of a particular matter before shareholders. For

example, an executive of the adviser may have a spouse or other relative who serves as a director of a company or who is employed by the company.

These conflicts are not new. We described them in detail in our 1971 report to Congress on Institutional Investors.¹⁰ In 2000, we expressed concern about these conflicts and proposed to require advisers to disclose to clients the policies that they had in place, if any, to address these conflicts.¹¹ The Department of Labor has recognized that they can adversely affect the management of employee benefit plans.¹²

Under the Act, an adviser with a material conflict of interest must fully disclose that conflict to its client before voting the client's proxy. Many advisers, instead, have adopted policies and procedures that are designed to ensure that client proxies are properly voted, material conflicts are avoided, and fiduciary obligations are otherwise fulfilled.¹³ Not all advisers have these procedures in place, not all advisers that have procedures make them available to their clients, and not all advisers that vote client proxies make the votes available to clients. The importance of proxy voting by investment advisers—both to their clients and to our system of corporate governance—as well as the

shareholders the specific proxy votes they cast. See *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, Investment Company Act Release No. 25739 (Sept. 20, 2002).

³ In the mid 1990s, the Commission approved rule changes submitted by the New York Stock Exchange, the National Association of Securities Dealers, Inc., and the American Stock Exchange to allow investment advisers to receive proxy materials and to vote proxies on behalf of the beneficial owners of securities. See, e.g., *Order Approving Proposed Rule Changes by the NASD*, Securities Exchange Act Release No. 35681 (May 5, 1995) [60 FR 25749 (May 12, 1995)].

⁴ See generally Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the U.S., Flows and Outstandings, First Quarter 2002* (June 6, 2002) (at table L. 213) (data indicate institutional investors control approximately 50% of the outstanding corporate equities in the United States); A. A. Sommer, Jr., *Symposium: Defining the Corporate Constituency: Corporate Governance in the Nineties: Managers vs. Institutions*, 59 U. Cin. L. Rev. 357 (Fall 1990) (discussing the "profound" effects of institutional ownership and the inevitable influence it will have on management conduct, the laws governing corporations and fiduciaries, and the American economy); Beth Healy, *Big Investors Assuming a More Activist Stance*, The Boston Globe, July 11, 2002, at C1 (discussing an activist stance by several large institutional investors on corporate governance issues).

⁵ *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (interpreting section 206 of the Advisers Act [15 U.S.C. 80b-6]).

⁶ Unlike the anti-fraud provisions in other provisions of the federal securities laws, section 206 is not limited to fraud in connection with securities transactions. The relevant provisions of section 206 do not refer to dealings in securities, but are stated in terms of the effect of the prohibited conduct on clients. Sections 206(1), 206(2), and 206(4) [15 U.S.C. 80b-6(1), 80b-6(2), 80b-6(4)].

⁷ We do not mean to suggest, however, that an adviser that fails to vote a proxy would thereby violate its fiduciary obligations to its client under the Act. There may be good reasons for an adviser to refrain from voting a proxy when, for example, the cost of voting the proxy exceeds the expected benefit. An adviser may not, however, ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies.

⁸ The scope of the adviser's responsibilities with respect to voting proxies would ordinarily be determined by the adviser's contract with its client, and the investment objectives and policies of its client. We are not addressing in this release the extent to which advisers must or should become "shareholder activists," such as actively engaging in soliciting proxies or supporting or opposing matters before shareholders. As a practical matter, advisers will determine whether to engage in such activism based on a cost-benefit analysis of the considered activism. See Robert C. Pozen, *Institutional Investors: The Reluctant Activists*, Harv. Bus. Rev., Jan.-Feb. 1994, at 140. In conducting this analysis, the adviser might consider the size of the client's position in the company, the nature of the action proposed to be taken, the cost of the particular course of action, and the probable effect of the proposed action, if any, on the value of the client's securities.

⁹ See Employee Benefit Research Institute Issue Brief, *Voting Private Pension Proxies: Some New Evidence and Some Old Questions*, (Sept. 1987) (No. 70 at 21) (reporting 65% of investment managers surveyed experienced direct or indirect pressure regarding proxy voting).

¹⁰ U.S. Securities and Exchange Commission, *Institutional Investor Study Report of the Securities and Exchange Commission*, in H.R. Doc. No. 92-64, Part 5.E, at 2749-2763; See also Betty Linn Krikorian, *Fiduciary Standards in Pension and Trust Fund Management* (1989), at 210-219; James E. Heard and Howard D. Sherman, *Investor Responsibility Research Center, Conflicts of Interest in the Proxy Voting System* (1987).

¹¹ *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV*, Investment Advisers Act Release No. 1862 (Apr. 5, 2000) [65 FR 20524 (Apr. 17, 2000)] at n. 192. In addition, former Commissioner Carey highlighted similar concerns about proxy voting by advisers in a December 1999 speech; Paul R. Carey, Remarks to the Investment Company Institute Procedures Conference (Dec. 9, 1999), (available at <<http://www.sec.gov/news/speech/speecharchive/1999/spch335.htm>>).

¹² Department of Labor, *Interpretive Bulletin Relating to Written Statements of Investment Policy, Including Proxy Voting Guidelines*, 29 CFR 2509.94-2 (2001) ("DOL Interp. Bulletin"). The bulletin states that under the Employee Retirement Income Security Act of 1974 [29 U.S.C. 1001, et. seq.] ("ERISA") the fiduciary act of managing ERISA assets includes the voting of proxies, and in voting those proxies the fiduciary may only consider the best interest of plan participants. Many investment advisers are "investment managers," that are delegated authority to manage plan assets and vote plan proxies under ERISA. When managing plan assets and voting proxies, advisers are also subject to the fiduciary standards of ERISA.

¹³ See generally Association for Investment Management and Research, *Standards of Practice Handbook, The Code of Ethics and The Standards of Professional Conduct* (1999) (Eighth Edition at 161) (discussing elements of a proxy voting system to allow investment advisers to meet their fiduciary obligation when voting proxies).

many conflicts faced by advisers suggest a need for the Commission to address proxy voting by investment advisers under the Advisers Act. Therefore, the Commission is proposing a new rule under the Advisers Act designed to prevent material conflicts of interest from affecting the manner in which advisers vote client proxies.

II. Discussion

We propose a new rule under section 206(4) of the Act that would require certain advisers to adopt and implement procedures for voting proxies, describe those procedures to their clients, and disclose how clients may obtain information about how the adviser has voted proxies. We are also proposing amendments to rule 204-2 under the Advisers Act to require advisers to keep certain records regarding their proxy votes on behalf of clients.

A. Rule 206(4)-6

Under proposed rule 206(4)-6, it would be a fraudulent, deceptive, or manipulative act, practice or course of business within the meaning of section 206(4) of the Act for an investment adviser to exercise voting authority with respect to client securities, unless: the adviser has adopted and implements written policies and procedures that are reasonably designed to ensure that the adviser votes proxies in the best interest of its clients, the adviser discloses to clients how they may obtain information on how the adviser voted their proxies, and the adviser has disclosed its proxy voting procedures to its clients.¹⁴ We describe each of the elements of the rule below.¹⁵

1. Advisers Subject to the Rule

a. Registered Advisers. The rule would apply to advisers registered with the Commission that have voting authority with respect to client securities. Rule 206(4)-6, like our other anti-fraud rules under the Advisers Act, would not apply to smaller advisers that are registered with state securities authorities. Since the enactment of the National Securities Markets Improvement Act in 1996 (“NSMIA”), we have deferred to state securities

¹⁴ Section 206(4) of the Act [15 U.S.C. 80b-6(4)] gives the Commission authority to adopt rules “reasonably designed to prevent such acts, practices, and courses of business as are fraudulent, deceptive or manipulative.” We are proposing rule 206(4)-6 as a means that we believe is reasonably necessary to prevent advisers from defrauding their clients in connection with the exercise of their proxy voting authority.

¹⁵ Nothing in this proposal reduces or alters any fiduciary obligation applicable to any investment adviser (or person associated with any investment adviser).

authorities the regulation of these advisers, which do not have voting authority over substantial amounts of assets.¹⁶ The rule would also not apply to advisers that rely on an exemption from registration under section 203(b) of the Act,¹⁷ such as those advisers that have had fewer than 15 clients during the last twelve months, which we do not examine and to which most other provisions of the Act do not apply.

• We request comment on the scope of proposed rule 206(4)-6. Should the rule apply to state-registered advisers? Should it apply to advisers that rely on an exemption from registration under section 203(b) of the Act?

b. Advisers with Voting Authority. Because we are concerned primarily with the proper exercise of voting authority of client proxies, only advisers that have voting authority would be subject to the rule.¹⁸ Advisers whose clients retain voting authority would not be required to adopt procedures or policies and would not be required to make any disclosures to clients under the rule. The rule would therefore not apply if an adviser provides a client with advice only as to how the client should vote a proxy. We are concerned that applying the rule to such advisers could result in numerous unintentional violations of the rule if, for example, a financial planner that never votes client proxies (and thus does not have policies and procedures and has not made the required disclosures) were to respond to a question from a client. The Advisers Act’s general anti-fraud provisions would continue to apply, requiring the

¹⁶ See section 203A of the Advisers Act, [15 U.S.C. 80b-3a], enacted as part of Title III of NSMIA. Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of the U.S. Code). NSMIA allocated regulatory authority for advisers with less than \$25 million of assets under management to state securities authorities. After NSMIA, our authority under section 206 continues to extend to state-registered advisers. However, when we adopted rules implementing NSMIA in 1997, we revised the anti-fraud rules under section 206 to apply only to SEC-registered investment advisers because the rules “contain prophylactic provisions, and that after the effective date of [Title III of NSMIA] the application of these provisions to state-registered advisers is more appropriately a matter of state law.” *Rules Implementing Amendments to the Investment Advisers Act of 1940*, Investment Advisers Act Release No. 1633 (May 15, 1997) [62 FR 28112 (May 22, 1997)].

¹⁷ 17 U.S.C. 80b-3(b).

¹⁸ Some advisory contracts do not explicitly give the adviser voting authority. Instead, the adviser’s authority to vote proxies is implied in the overall delegation of authority provided in the advisory contract, power of attorney, trust instrument or other document. Advisers entering into such contracts would be subject to the rule. *Cf.* DOL Interp. Bulletin, *supra* note (if the investment management agreement does not expressly preclude the investment manager from voting proxies, the investment manager has the exclusive responsibility for voting).

planner to disclose any material conflict that it may have to the client receiving the advice.

• Comment is requested regarding whether we should require all registered advisers to have policies and procedures.

• Are there circumstances where an adviser with authority to vote client proxies should be exempt from the rule’s requirements?

• In some cases, clients retain some authority over the proxy vote, *e.g.*, the client retains voting authority with respect to certain issues or the contract provides that the adviser should consult with the client on voting matters. How should the rule apply in these circumstances?

2. Written Policies and Procedures

Rule 206(4)-6 would require investment advisers subject to the rule to adopt and implement written policies and procedures that are reasonably designed to ensure that the adviser votes proxies in the best interest of clients.¹⁹ Although advisers’ proxy voting policies typically include a number of common elements,²⁰ we are not proposing to specify the procedures or policies that advisers must adopt. Investment advisers registered with us have such different types of conflicts and organizational structures that we believe a “one-size-fits-all” approach would not work.²¹

The rule would, however, contain three requirements. First, the proxy voting policies and procedures must be written.²² Second, they must describe

¹⁹ Proposed rule 206(4)-6(a). Nothing in the proposed rule would prevent an adviser from having different policies and procedures for different clients. Thus, the board of directors of an investment company could adopt and require an investment adviser to use different policies and procedures than the adviser uses with respect to its other clients.

²⁰ These common elements frequently deal with policies on particular types of matters that may be presented to shareholders, such as changes in corporate governance, changes in corporate structures, adoption or amendments to compensation plans (including stock options) and matters involving social issues or corporate responsibility. See *supra* note 2, *Disclosure of Proxy Voting Policies and Proxy Voting Records By Registered Management Investment Companies*, at Section II.A.

²¹ Advisers registered with the Commission have assets under management that range from \$580,000,000 to \$7,020. While 4,923 are organized as corporations (of which 3,265, or 66%, have financial industry affiliations), 367 are organized as sole proprietorships (of which 118, or 32%, have financial industry affiliations). While 94 of our advisers have more than 1,000 employees, 5204 have 10 or fewer. Information obtained from SEC—registered investment adviser Form ADV filings as of September 9, 2002.

²² “Written” policies and procedures would, of course, include documents in electronic format. See

how the adviser addresses material conflicts between its interests and those of its clients with respect to proxy voting. Finally, the policies and procedures must address how the adviser resolves those conflicts in the best interest of clients. The rule thus incorporates the standard that we believe applies to advisers as fiduciaries under the Advisers Act.²³ We have included the standard in the proposed rule to clarify the obligation of advisers and to require that the best interest of clients be the focus of the policies and procedures.²⁴

In addition, we believe effective proxy voting policies and procedures of an adviser should identify personnel responsible for monitoring corporate actions, describe the basis on which decisions are made to vote proxies, and identify personnel (or groups) involved in making voting decisions and those responsible for ensuring that proxies are submitted in a timely manner. The extent to which the adviser relies on the advice of third parties or delegates to committees should also ordinarily be covered by the policies. Of course, the scope of the policies and procedures will turn on the nature of the adviser's advisory business, the types of securities portfolios it manages, and the extent to which clients, such as registered investment companies, have adopted their own procedures.²⁵

Many advisers may also be subject to fiduciary standards under ERISA and state common law.²⁶ We believe that the "best interest" standard in the proposed rule is not inconsistent with those laws in any material respect.

- Is the standard we have set forth in the rule clear?

Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery Of Information, Investment Advisers Act Release No. 1562 (May 9, 1996) [61 FR 24643 (May 15, 1996)].

²³ See discussion above in Section I of this release.

²⁴ The rule would not preclude an adviser from seeking assistance in collecting and voting proxies from, for example, a proxy voting service. Nor would the rule prevent an adviser from delegating authority to, for example, a committee. The adviser's delegation would not alter in any way the fiduciary responsibilities of the adviser.

²⁵ Procedures that merely declare that all proxies will be voted in the best interests of clients would not be sufficient to meet the requirement of the proposed rule that the investment adviser adopt "policies and procedures" designed to assure that proxies are voted in the best interests of clients.

²⁶ Under ERISA, a person becomes a fiduciary to a plan by rendering it investment advice for a fee or other compensation. Section 3(21)(A)(ii) of ERISA [29 U.S.C. 1002(21)(a)(ii)]. An ERISA fiduciary must discharge its duties solely in the interest of the plan participants and for the exclusive purpose of providing benefits to plan participants with the care, prudence, and diligence that a prudent person would use. Section 404(a)(1) of ERISA [29 U.S.C. 1104(a)(1)].

- Are there conflicts with other laws that we should address?
- Should we include in the text of the rule additional required policies and procedures?
- Alternatively, should we include in our adopting release additional policies and procedures that we believe are "best practices" for advisers to adopt? Commenters favoring additional policies and procedures should give specific recommendations.

3. Disclosure of How Clients Can Obtain Information on Votes

Rule 206(4)–6 would also require an adviser subject to the rule to disclose to clients how they can obtain information from the adviser on how the adviser voted their proxies.²⁷ We propose this provision for similar reasons to those we set forth in our companion release that would require investment companies to disclose how they have voted their proxies.²⁸ We believe that "sunshine" on these votes will lead advisers to pay greater attention to their fiduciary obligations. Fully informed clients will serve as a check on their advisers' exercise of voting authority: clients who disapprove of how advisers vote their proxies may decide to reclaim the responsibility to vote proxies, provide the adviser with instructions on how to vote their proxies, or seek a different adviser whose voting policies they approve.

Our proposal—which would require disclosure of how a client can obtain information—would not prescribe a right to that information. We assume that clients have a right to information about how their own proxies have been voted.²⁹ And, unlike our investment company proposals, the proposed rule would not prescribe the nature, format,

²⁷ Proposed rule 206(4)-6(b). The requirement to disclose how a client can obtain information from the adviser on how it voted client securities could be satisfied by disclosure in the adviser's brochure. See *supra* note 11, *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV* (proposal to require advisers that have or will accept authority to vote client proxies to include in their brochures a description of their voting policies and procedures, including what means a client can pursue to find out how the adviser voted the client's proxies in particular solicitations).

²⁸ See *supra* note 2, *Disclosure of Proxy Voting Policies and Proxy Voting Records By Registered Management Investment Companies*.

²⁹ The advisory contract could, however, limit a client's right to information about how the adviser has voted her proxy. See Restatement (Second) of Agency § 381 ("[u]nless otherwise agreed, an agent is subject to a duty to use reasonable efforts to give his principal information which is relevant to affairs entrusted him * * *"). We believe that a contract that denied information to the client about how the adviser has voted proxies would be highly unusual and, unless initiated by the client, very troublesome in light of an adviser's fiduciary obligations.

or scope of the information that must be disclosed. Many clients may not be interested in how the adviser votes. Those who are interested would typically only be entitled to know how the adviser has voted his or her proxies (and not those of other clients), and may need (or want) information only about one or a few critical votes. Requiring an adviser to prepare a list of votes for each client (most of whom may never request the information), specifying the time periods the information must cover (which time periods may not be responsive to a particular request), and the content of the information provided in the lists seems to us unnecessarily burdensome. Therefore, we would leave those decisions to clients and their advisers, which we would expect to be responsive to client requests.

- We request comment on our assumption that clients have the right to information about how their shares have been voted. Have advisers denied this information to clients? Should we include in the rule a right to this information? If so, what should be the scope of the right? For how many years should the adviser be required to retain information about votes and produce it upon request for a client?

- Should the rule prescribe the content and format of required disclosures, as would the investment company rules we are proposing? If so, should the content and format of the required disclosure be different in any way from the proposed investment company rules?

4. Describe Policies and Procedures to Clients

Finally, the proposed rule would require advisers subject to the rule to describe their proxy voting policies and procedures to clients and, upon request, furnish a copy of the policies and procedures to clients.³⁰ This disclosure would help clients understand how the adviser votes proxies and permit clients to select advisers whose procedures and policies meet their expectations.³¹

³⁰ Proposed rule 206(4)–6(c). The requirement to describe the adviser's policies and procedures could be satisfied by disclosure in the adviser's brochure. See *supra* note , discussing *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV* (SEC proposal to require advisers to include this information in their brochure).

³¹ In 1971, we recommended adoption of a similar requirement because we believed that "[T]his type of public disclosure would focus the obligation of institutions to act in the interests of their beneficiaries and lead to their setting up procedures for systematic attention to questions of stockholder voting * * * the beneficiary should be able to choose the institutional manager whose policies on investment management appear to him most appropriate. The only way in which this can be

Disclosure should also serve to encourage more effective policies and procedures.³²

B. Amendments to Rule 204-2

We are also proposing to amend rule 204-2 under the Advisers Act to require advisers subject to rule 206(4)6 to keep relevant records.³³ These records would permit our examiners to ascertain compliance with the rule. They would also be necessary for an adviser to comply with the proposed requirement to disclose how the adviser has voted proxies for clients.

Under the proposed rule amendments, each adviser subject to rule 206(4)-6 would be required to keep its proxy voting policies and procedures, records of proxy statements received, records of votes cast, records of all communications received and internal documents created that were material to the voting decision, and a record of each client request for proxy voting records and the adviser's response.³⁴ We are proposing to require advisers to maintain proxy voting books and records in an easily accessible place for five years, the first two years in an appropriate office of the investment adviser.³⁵

III. General Request for Comment

The Commission requests comment on the rule and amendments proposed in this release, suggestions for other additions to the rule and amendments, and comment on other matters that might have an effect on the proposals contained in this release. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, the Commission also requests information regarding the potential impact of the proposed rule and amendments on the economy on an annual basis. Commenters should provide empirical data to support their views.

done is to give beneficiaries full information about the policies followed." Letter from SEC Commissioner Richard B. Smith to Congress, transmitting the Institutional Investor Study Report (March 10, 1971), *reprinted in*, H.R. Doc No. 92-64, Part 1 (1971).

³² The provisions of section 206 of the Act would be applicable to an investment adviser that disclosed its policies and procedures but then materially deviated from them.

³³ Those investment advisers subject to ERISA must already maintain "adequate and accurate" records as to the voting of ERISA plan proxies to permit monitoring by the plan trustee or other named fiduciary. See DOL Interp. Bulletin, *supra* note 12.

³⁴ Proposed rule 204-2(c)(2).

³⁵ Proposed rule 204-2(e)(1). These are the same retention requirements that apply to most books and records under current rule 204-2.

IV. Paperwork Reduction Act

The proposed rule and amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.³⁶ One of the collections of information is new. The Commission has submitted this new collection to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The title of this new collection is "Rule 206(4)-6;" OMB has not yet assigned it a control number. The other collection of information takes the form of amendments to a currently-approved collection titled "Rule 204-2," under OMB control number 3235-0278. The Commission has also submitted the amendments to this collection to the OMB for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

The collection of information under rule 206(4)-6 is necessary to assure that investment advisers that vote proxies for their clients vote those proxies in their clients' best interest and provide their clients information about how their proxies were voted. This collection of information is mandatory. The respondents are investment advisers registered with us that vote proxies with respect to clients' securities. Clients of these investment advisers use the information collected to assess investment advisers' proxy voting policies and procedures and to monitor the adviser's performance of its proxy voting activities. Responses to the disclosure requirements are not kept confidential.

The collection of information under rule 204-2 is necessary for the Commission staff to use in its examination and oversight program. This collection of information is mandatory. The respondents are investment advisers registered with us that vote proxies with respect to clients' securities. Responses provided to the Commission in the context of its examination and oversight program are generally kept confidential.³⁷ The records that an adviser must keep in accordance with rule 204-2 must generally be retained for not less than five years.³⁸

³⁶ 44 U.S.C. 3501 to 3520.

³⁷ See section 210(b) of the Advisers Act [15 U.S.C. 80b-10(b)].

³⁸ See rule 204-2(e) [17 CFR 275.204-2(e)].

A. Rule 206(4)-6

According to our records, 6,203 of the 7,687 total advisers registered with the Commission manage client assets on a discretionary basis.³⁹ For purposes of estimating the paperwork burden for investment advisers under proposed rule 206(4)-6, we will infer that these advisers vote proxies on behalf of one or more clients in connection with providing discretionary asset management services.⁴⁰ We further estimate that each of these advisers would be required to spend on average 10 hours annually documenting its proxy voting procedures under the requirements of the proposed rule, for a total burden of 62,030 hours.⁴¹ In preparing this estimate, we have taken into account the fact that many advisers subject to ERISA because they manage plan assets already have proxy voting procedures in place which can serve as the basis of the adviser's procedures under the proposed rule.

The proposed rule also would require these advisers to describe their proxy voting policies and procedures to clients. The attendant paperwork burden is already incorporated in a collection of information titled "Form ADV," which is currently approved by OMB under control number 3235-0049.⁴² In addition, the proposed rule would require these investment advisers to provide copies of their proxy voting policies and procedures to clients upon request. While we estimate that SEC-registered advisers have, on average, 670

³⁹ Based on our records of information submitted to us by investment advisers in Part 1 of Form ADV, 6,203 SEC-registered investment advisers report that they provide continuous and regular supervisory or management services for client securities portfolios on a discretionary basis.

⁴⁰ This estimate potentially overstates the number of advisers that would be subject to the rule. Part 1 of ADV does not require investment advisers to describe whether they vote proxies on behalf of clients. Nor does Part 1 require advisers to describe whether securities managed by the adviser are voting securities as opposed to, for example, government or other debt obligations for which proxy voting issues never arise.

⁴¹ $6,203 \times 10 = 62,030$.

⁴² In April of 2000, we proposed amendments to Form ADV, Part 2 that would require investment advisers that vote client proxies to describe their proxy voting policies and procedures in their brochure. *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV*, Investment Advisers Act Release No. 1862 (April 5, 2000) [65 FR 20524 (April 17, 2000)]. An adviser could satisfy the disclosure requirements under proposed rule 206(4)-6(b) and (c) by describing its policies and procedures in its brochure. See *supra* notes 27 and 30. In connection with our April 2000 proposal, when we obtained OMB approval for our amendments to the Form ADV collection that would result from the proposed changes to Part 2, we included the paperwork burden of describing any proxy voting policies and procedures in a firm's brochure.

clients each,⁴³ we estimate that, on average, at least 90 percent of each of these adviser's clients would find the adviser's description of its policies sufficiently informative, and ten percent at most, or 67 clients of each adviser on average, would request copies of the underlying policies and procedures.⁴⁴ We estimate that it would take these advisers 0.1 hours per client to deliver copies of the policies and procedures, for a total burden of 41,560 hours.⁴⁵

Accordingly, we estimate that proposed rule 206(4)–6 would increase the annual aggregate burden of collection for SEC-registered investment advisers by a total of 103,590 hours.⁴⁶

B. Rule 204–2

The currently-approved annual aggregate burden of collection under rule 204–2 is 1,582,293 hours. This approved annual aggregate burden was based on estimates that 8,100 advisers were subject to the rule, and each of these advisers spend an average of 195.34 hours each preparing and preserving records in accordance with the rule. Updating those prior calculations based on current information from SEC-registered investment advisers, however, we would now estimate that 7,687 are subject to the rule. We would continue to estimate that each of these advisers spend an average of 195.34 hours each preparing and preserving records in accordance with the rule. These current data would decrease the annual aggregate burden under the rule to 1,501,578.5 hours,⁴⁷ which is a reduction of 80,714.5 hours.⁴⁸

The proposed amendments to rule 204–2 would require registered investment advisers that vote client proxies to maintain specified records

with respect to those clients. These advisers must maintain copies of their policies and procedures that would be required under proposed rule 206(4)–6, as well as copies or records of each proxy statement received with respect to the securities of clients for whom the adviser exercises voting authorities. These advisers must also maintain a record of each vote cast, as well as a record of all communications received and all internal documents created that were material to the adviser's decision on the vote. In addition, the adviser would be required to maintain a record of each client request for proxy voting information and the adviser's response. The adviser would be required to maintain these records in the same manner, and for the same period of time, as other books and records are currently required to be maintained under rule 204–2(e)(1).

We estimate that these proposed amendments would increase the average annual collection burden of an adviser subject to the amendments by 20 hours, to 215.34 hours.⁴⁹ As discussed above in connection with proposed rule 206(4)–6, we estimate that 6,203 advisers exercise voting authority on behalf clients and will thus be subject to this additional burden, for an annual aggregate burden increase of 124,060.⁵⁰ The average annual burden for SEC-registered investment advisers under rule 204–2 would accordingly increase from 195.34 hours to 211.48 hours.⁵¹

C. Request for Comment

We request comment whether these estimates are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to:

- evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility;
- evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information;
- determine whether there are ways to enhance the quality, utility, and

clarity of the information to be collected; and

- determine whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons wishing to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 3208, Washington, DC 20503, and also should send a copy to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549–0609 with reference to File No. S7–38–02. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives the comment within 30 days after publication of this release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7–38–02, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street, NW, Washington, DC 20549.

V. Cost-Benefit Analysis

We are sensitive to the costs and benefits resulting from our rules. While investment advisers exercise enormous proxy voting power as part of their discretionary management of their clients' securities, the federal securities laws do not specifically address how advisers must exercise this voting authority. Proposed rule 206(4)–6 is designed to ensure that advisers vote client securities in the client's best interest and to provide clients information on how their securities are voted.

Investment advisers today have discretionary investment authority with respect to almost \$19trillion of assets, including large holdings in equity securities. In most cases, these advisers are given authority to vote proxies on equity securities on behalf of their clients. Under the Advisers Act, investment advisers are fiduciaries that must act in their clients' best interest with respect to functions undertaken on behalf of their clients, including these proxy voting activities. An adviser's fiduciary duty includes the duty of care and the duty of loyalty to clients. For an

⁴³ See *Custody of Funds or Securities of Clients by Investment Advisers*, Investment Advisers Act Release No. 2044 (July 18, 2002) [67 FR 48579 (July 25, 2002)].

⁴⁴ $670 \times 10\% = 67$.

⁴⁵ $0.1 \times 67 \times 6,203 = 41,560$. In connection with submitting this collection of information to OMB, the Commission has also prepared an estimate of the aggregate annual cost to affected firms of this annual aggregate hour burden. We anticipate that investment advisers would likely use compliance professionals to document their firms' proxy voting policies and procedures. We estimate the hourly wage for compliance professionals to be \$60, including benefits. We anticipate that investment advisers would likely use clerical staff to deliver copies of proxy voting policies in response to clients' requests. We estimate the hourly wage for clerical staff to be \$10, including benefits. Accordingly, we estimate the annual aggregate cost of collection to be $\$4,137,400$ ($(62,030 \text{ hours} \times \$60 \text{ per hour}) + (41,560 \text{ hours} \times \$10 \text{ per hour}) = \$4,137,400$).

⁴⁶ $62,030 + 41,560 = 103,590$.

⁴⁷ $7,687 \times 195.34 = 1,501,578.5$.

⁴⁸ $1,582,293 - 1,501,578.5 = 80,714.5$.

⁴⁹ $195.34 + 20 = 215.34$.

⁵⁰ $20 \times 6,203 = 124,060$. In connection with submitting this collection of information to OMB, the Commission has also prepared an estimate of the aggregate annual cost to affected firms of this annual aggregate hour burden. We anticipate that investment advisers would likely use compliance clerical staff to maintain the records required under the proposed amendments. We estimate the hourly wage for compliance clerical staff to be \$13.20, including benefits. Accordingly, we estimate the annual aggregate cost of collection to be $\$1,637,592$ ($124,060 \text{ hours} \times \$13.20 \text{ per hour} = \$1,637,592$).

⁵¹ $(1,501,578.5 \text{ current hours} + 124,060 \text{ additional hours} = 1,625,638.5 \text{ aggregate burden hours}) / 7,687 \text{ SEC-registered investment advisers} = 211.48$.

adviser that has been given authority to vote proxies, the duty of care includes the duty to monitor corporate events and vote proxies; the duty of loyalty requires the adviser to vote proxies in a manner consistent with the best interest of its client and precludes the adviser from subrogating the client's interest to its own.

The Commission is concerned with conflicts of interest between advisers and their clients. Advisers (or their affiliates) frequently manage assets, administer employee benefit plans, or provide brokerage, underwriting, or insurance services to companies whose management is soliciting proxies. These business interests may expose advisers to pressure to vote in favor of management. Other business relationships may expose advisers to pressure to vote in favor of the proponent of a proxy question, such as when an adviser manages money for an employee group. In other instances, advisers may be exposed to pressure as a result of personal relationships with participants in proxy contests, corporate directors, or candidates for directorships.

The importance of proxy voting by investment advisers—both to their clients and to our system of corporate governance—as well as the many conflicts faced by advisers suggest a need for the Commission to address proxy voting by investment advisers under the Advisers Act. While many advisers have adopted policies and procedures designed to ensure that client proxies are properly voted, material conflicts are avoided, and fiduciary obligations are fulfilled, others do not have these procedures in place.

Therefore, the Commission is proposing a new rule under the Advisers Act designed to prevent material conflicts of interest from affecting the manner in which advisers vote client proxies. We have identified certain costs and benefits of the proposed rule and rule amendments. We request comment on the costs and benefits of the proposed rule amendments, and encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or any additional costs or benefits.

A. Background

Proposed rule 206(4)–6 is designed to ensure that advisers vote client securities in the client's best interest and to provide clients information on how their securities are voted. The proposed rule would require an SEC-registered investment adviser that votes client proxies to adopt written policies

and procedures reasonably designed to ensure the adviser votes proxies in the best interest of the client, including procedures to address any material conflict that may arise between the interest of the adviser and the client. The proposed rule would also require the adviser to describe these policies and procedures to clients, and to provide copies of the policies and procedures to clients upon their request. In addition, the proposed rule would require these advisers to disclose to clients how they may obtain information from the adviser about how the adviser voted their proxies.

We are not proposing to specify the procedures or policies that advisers must adopt under the proposed rule. Investment advisers registered with us have such different types of conflicts and organizational structures that we believe a “one-size-fits-all” approach would not work. The rule would, however, require written procedures that describe how the adviser addresses material conflicts between its interests and those of its clients with respect to proxy voting, and how the adviser resolves those conflicts in the best interest of clients. The rule thus incorporates the standard that we believe applies to advisers as fiduciaries under the Advisers Act.

We are also proposing amendments to rule 204–2 under the Advisers Act that would require registered investment advisers that vote client proxies to maintain specified records with respect to those clients. These advisers would be required to maintain copies of the policies and procedures to be required under proposed rule 206(4)–6, as well as copies or records of each proxy statement received with respect to the securities of clients for whom the adviser votes proxies. These advisers must also maintain a record of each vote cast, as well as a record of all communications received and all internal documents created that were material to the adviser's decision on the vote. In addition, the adviser would be required to maintain a record of each client request for proxy voting information and the adviser's response. These records would permit our examiners to ascertain compliance with the rule. They would also be necessary for an adviser to comply with the proposed requirement to disclose how the adviser has voted proxies for clients.

Based on advisers' filings with us, we estimate that the majority of investment advisers registered with us vote proxies on behalf of their clients. SEC-registered advisers are not currently required to submit information to us describing their proxy voting practices. However,

according to our records as of September 9, 2002, 6,203 of the 7,687 total advisers registered with us manage client assets on a discretionary basis.⁵² Since in most instances advisers with discretionary investment authority are given authority to vote proxies relating to equity securities under management, it is likely that significant numbers of these 6,203 advisers vote proxies on behalf of one or more clients in connection with providing discretionary asset management services.⁵³

B. Benefits

Advisory clients will receive benefits from the proposed amendments. The proxy voting procedures contemplated under the rule will ensure that advisers have a system in place designed to identify and address any material conflicts of interest with respect to each proxy voted by the adviser on a client's behalf, and to vote the proxy in the client's best interest. Many advisers may be exposed to varying types of conflicts from differing sources, and it benefits clients when advisers take special measures to ensure that all conflicts are properly addressed.

The proposed rule would also require these advisers to describe their proxy voting policies and procedures to clients, and require the adviser to furnish copies of the policies and procedures to clients upon request. Clients will benefit from this disclosure by gaining an understanding of how the adviser votes proxies. Clients will be in a better position to determine whether their adviser's policies and procedures meet their expectations.

In addition, the proposed rule requires advisers to disclose to their clients how they can obtain information on how the adviser voted their proxies. Fully informed clients will serve as a check on their advisers' exercise of voting authority: clients who disapprove of how advisers vote their proxies may decide to reclaim the responsibility to vote proxies, provide the adviser with instructions on how to vote their proxies, or seek a different adviser whose voting policies they approve.

These potential benefits to clients are difficult to quantify. In addition, some

⁵² This estimate is based on information submitted by SEC-registered advisers in Form ADV, Part 1 [17 CFR 279.1]. 6,203 SEC-registered investment advisers reported that they provide continuous and regular supervisory or management services for client securities portfolios on a discretionary basis.

⁵³ Because Part 1 of Form ADV does not require advisers to describe the types of securities for which they hold discretionary investment authority, some of these advisers may only manage securities for which proxy voting issues never arise, such as government or other debt obligations.

clients may already be receiving some of these benefits in certain instances; applicable law entitles clients to their adviser's fiduciary care and loyalty in connection with proxy voting, as well as information about how their proxies were voted, and some advisory firms have adopted policies and procedures addressing proxy voting. To the extent clients are receiving these benefits as a matter of practice, the potential benefit of having these practices institutionalized through a rule is also difficult to quantify.

C. Costs

The proposed rule and rule amendments would impose some costs on advisers that vote client proxies. These advisers would incur costs in connection with establishing and operating the procedures contemplated by the proposed rule, and in connection with expanding their recordkeeping systems to include new material on proxy voting. These advisers would also incur costs in preparing descriptions of their policies and procedures for clients, as well as in responding to client requests for copies of the advisers' policies and procedures. Finally, these advisers would incur costs in responding to any client requests for information about how the adviser voted the client's proxies.

The initial and ongoing compliance costs imposed by the proposed rule would vary significantly among advisers based on several factors that are as diverse as the differing types of advisory firms and clients affected by the proposal. For example, firms that invest their clients' assets in numerous equity issues must review more proxy votes than firms that invest their clients' assets in few equity issues.⁵⁴ Firms with a wide diversity of business and individual advisory clients may be more likely to face conflicts than other firms, and firms that are part of financial organizations that provide other financial services may face more conflicts than stand-alone firms. Clients of a "social investing" firm may be keenly interested in the firm's proxy voting practices, but the firm is likely to have already developed systems that would largely address the proposed requirements. Clients of other firms may be interested in how the adviser votes only rarely, with regard to high-profile proxy contests, and the firm's cost of responding to client inquiries is likely to be small.

⁵⁴ For example, the firm is a fixed income manager, which does not manage voting equity securities, or the firm does not manage significant client assets.

In addition, we believe that many advisers that would be affected by the proposed rule have already developed proxy voting policies and procedures, and would incur fewer new costs as a result. Investment advisers subject to ERISA because they manage retirement plan assets vote client proxies in many instances, and through our investment adviser inspection program, we have determined that this group of advisers typically has proxy voting policies and procedures in place. These advisers could likely use some, or all, of these procedures to meet the obligations under the proposed rules. Moreover, many of these advisers are the larger firms that would likely incur the most costs associated with the proposed rules.

In connection with estimating the annual aggregate burden of the proposed rule and amendments for purposes of the Paperwork Reduction Act, Commission staff has estimated that advisory firms affected by the rule will incur staff salary and benefit costs aggregating approximately \$5,775,000 to prepare and maintain the documents and records required under the proposal.⁵⁵ This is an aggregate estimate, and each firm's individual costs in this regard will vary depending on the nature of the firm's advisory business and clients, as discussed above. Moreover, many firms that are subject to ERISA because they manage retirement plan assets already have proxy voting policies and procedures in place, as discussed above, and are already incurring some portion of these costs.

D. Request for Comment

- The Commission requests comment on the potential costs and benefits identified in this release, as well as any

⁵⁵ As discussed *supra* note 45, we anticipate that investment advisers would likely use compliance professionals to document their firms' proxy voting policies and procedures, for an aggregate annual average of 62,030 hours at an average wage and benefit cost of \$60 per hour, for an aggregate cost of \$3,721,800. We anticipate that investment advisers would likely use clerical staff to deliver copies of proxy voting policies in response to clients' requests, for an aggregate annual average of 41,560 hours at an average wage and benefit cost of \$10 per hour, for an aggregate cost of \$415,600. As discussed *supra* note 50, we anticipate that investment advisers would likely use compliance clerical staff to maintain the records required under the proposed amendments, for an aggregate annual average of 124,060 hours at an average wage and benefit cost of \$13.20 per hour, for an aggregate cost of \$1,637,592. $\$3,721,800 + \$415,600 + \$1,637,592 = \$5,774,992$. For these estimates, we used wage and benefit rates published by the Securities Industry Association. See Securities Industry Association, *Report on Management and Professional Earnings in the Securities Industry 2001* (Oct. 2001); *Report on Office Salaries in the Securities Industry* (Oct. 2001).

other costs or benefits that may result from the proposal.

- We encourage commenters to identify, discuss, analyze, and supply relevant data regarding these or additional costs and benefits.

VI. Initial Regulatory Flexibility Analysis

The Commission has prepared the following Initial Regulatory Flexibility Analysis ("IRFA") regarding proposed rule 206(4)-6 and proposed amendments to rule 204-2 in accordance with section 3(a) of the Regulatory Flexibility Act.⁵⁶

A. Reasons for Proposed Action

While investment advisers exercise enormous proxy voting power as part of their discretionary management of their clients' securities, the federal securities laws do not specifically address how advisers must exercise this voting authority. Investment advisers today have discretionary investment authority with respect to almost \$19 trillion of assets, including large holdings in equity securities. In most cases, these advisers are given authority to vote proxies on equity securities on behalf of their clients. Under the Advisers Act, investment advisers are fiduciaries that must act in their clients' best interest with respect to functions undertaken on behalf of their clients, including these proxy voting activities. An adviser's fiduciary duty includes the duty of care and the duty of loyalty to clients. For an adviser that has been given authority to vote proxies, the duty of care includes the duty to monitor corporate events and vote proxies; the duty of loyalty requires the adviser to vote proxies in a manner consistent with the best interest of its client and precludes the adviser from subrogating the client's interest to its own.

The Commission is concerned with conflicts of interest between advisers and their clients. Advisers (or their affiliates) frequently manage assets, administer employee benefit plans, or provide brokerage, underwriting, or insurance services to companies whose management is soliciting proxies. These business interests may expose advisers to pressure to vote in favor of the management. Other business relationships may expose advisers to pressure to vote in favor of the proponent of a proxy question, such as when an adviser manages money for an employee group. In other instances, advisers may be exposed to pressure as a result of personal relationships with participants in proxy contests, corporate

⁵⁶ 5 U.S.C. 603(a).

directors, or candidates for directorships.

The importance of proxy voting by investment advisers—both to their clients and to our system of corporate governance—as well as the many conflicts faced by advisers suggest a need for the Commission to address proxy voting by investment advisers under the Advisers Act. While many advisers have adopted policies and procedures designed to ensure that client proxies are properly voted, material conflicts are avoided, and fiduciary obligations are fulfilled, others do not have these procedures in place. Therefore, the Commission is proposing a new rule under the Advisers Act designed to prevent material conflicts of interest from affecting the manner in which advisers vote client proxies.

B. Objectives and Legal Basis

Proposed rule 206(4)–6 is designed to ensure that advisers vote client securities in the client's best interest and to provide clients information on how their securities are voted. The proposed rule would require an investment adviser that votes client proxies to adopt written policies and procedures reasonably designed to ensure the adviser votes proxies in the best interest of the client, including procedures to address any material conflict that may arise between the interest of the adviser and the client. The proposed rule would also require the adviser to disclose to clients information about those procedures and policies and how clients may obtain information on how the adviser has voted their proxies. The Commission is also proposing amendments to rule 204–2 to require advisers that vote client proxies to keep certain records regarding the proxy votes.

The proposed rule and amendments will serve three main objectives. First, the written policies and procedures required under proposed rule 206(4)–6 are designed to ensure that an adviser voting proxies on behalf of its client fulfills its fiduciary duties, including its duty to address any material conflict between the adviser's interests and those of its client. Second, the disclosures required under proposed rule 206(4)–6 are designed to provide clients with a greater understanding of their adviser's proxy voting practices, permit clients to determine whether their adviser's policies and procedures meet their expectations, and serve as a check on their advisers' exercise of voting authority if they disapprove of votes cast on their behalf. Third, the amendments to rule 204–2 will clarify the recordkeeping obligations an adviser

has with respect to voting client securities and provide our examiners a means to assess compliance with proposed rule 206(4)–6.

The Commission is proposing rule 206(4)–6 pursuant to the authority set forth in sections 206(4) and 211(a) of the Advisers Act [15 U.S.C. 80b–6(4) and 80b–11(a)] and amendments to rule 204–2 pursuant to the authority set forth in sections 204 and 206(4) of the Advisers Act [15 U.S.C. 80b–4 and 80b–6(4)]. Section 206(4) gives us authority to issue rules designed to prevent fraudulent, deceptive, or manipulative acts or practices. Section 211 gives us authority to clarify, by rule, persons and matters within our jurisdiction and to prescribe different requirements for different classes of persons, as necessary or appropriate to the exercise of our authority under the Act. Section 204 gives us authority, by rule, to require an investment adviser to make and keep records.

C. Small Entities Subject to Rule

Under Commission rules, for the purposes of the Advisers Act and the Regulatory Flexibility Act, an investment adviser generally is a small entity if it: (i) Has assets under management having a total value of less than \$25 million; (ii) did not have total assets of \$5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of \$25 million or more, or any person (other than a natural person) that had \$5 million or more on the last day of its most recent fiscal year.⁵⁷ The Commission estimates that as of September 9, 2002 approximately 138 SEC-registered investment advisers that might potentially be affected by the rule were small entities.⁵⁸

⁵⁷ 17 CFR 275.0–7(a).

⁵⁸ This estimate is based on the information submitted by SEC-registered advisers in Part 1 of Form ADV. Advisers are not required to describe on Part 1 whether they vote proxies on behalf of their clients. These 138 small advisers report on their Part 1 that they provide continuous and regular supervisory or management services for client securities portfolios on a discretionary basis. For purposes of estimating the number of small advisers that might vote client proxies and thus be subject to the proposal, we will infer that these 138 advisers vote proxies on behalf of one or more clients in connection with providing discretionary asset management services. This estimate potentially overstates the number of small advisers that would actually be subject to the rule. For example, the assets under discretionary management at some of these firms may consist of government or other debt obligations for which proxy voting issues never arise.

D. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed rule and rule amendments would impose no new reporting requirements. The proposed rule and rule amendments would create certain new compliance and recordkeeping requirements. The proposed rule imposes a new compliance requirement by making it unlawful for an SEC-registered investment adviser to vote proxies on behalf of clients unless the adviser has adopted written policies and procedures on proxy voting. The proposed rule amendments impose new recordkeeping requirements by requiring these advisers to maintain certain records regarding proxy voting.

Small advisers would only expend efforts to meet these new compliance and recordkeeping requirements to the extent these advisers have authority to vote proxies on behalf of their clients. Advisers typically vote client proxies in connection with managing client assets on a discretionary basis, and small advisers engage in discretionary asset management on a limited scale. Therefore, it is likely that these advisers will make relatively few proxy votes on behalf of their clients, and will not have to dedicate significant resources to comply with the compliance and recordkeeping amendments in connection with those votes.

E. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no rules that duplicate or conflict with the proposed rule. Proposed rule 206(4)–6 overlaps with certain provisions of ERISA.⁵⁹ Pursuant to the Department of Labor's interpretation of sections 402, 403, and 404 of ERISA, an investment manager that has delegated authority to manage plan assets has a fiduciary obligation to vote proxies that affect the value of plan investments unless the investment management contract expressly precludes the manager from voting proxies.⁶⁰ The interpretation also states that the investment manager is required to maintain records as to proxy voting.⁶¹ The provisions of ERISA do not apply to all investment advisers registered with us, but do apply to those investment advisers that meet the ERISA definition of investment

⁵⁹ 29 U.S.C. 1001, *et. seq.*

⁶⁰ Dept. of Labor, Interpretive Bulletin Relating to Written Statements of Investment Policy, Including Proxy Voting Guidelines, 29 CFR 2509.94–2 (2001).

⁶¹ *Id.*

manager.⁶² We do not believe our proposed rule and rule amendments conflict with the obligations that an investment adviser may have under ERISA.

F. Significant Alternatives

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objectives, while minimizing any adverse impact on small entities. In connection with the proposed rule, the Commission considered the following alternatives: (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for such small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the rule, or any part thereof, for such small entities.

The Commission has drafted proposed rule 206(4)–6 to permit each firm subject to the rule to design and structure its own policies and procedures in light of the firm's operational structure and the particular types of conflicts encountered by the firm in connection with its unique business and clients. In the same way, the proposed amendments to rule 204–2 would permit each firm to develop its own system for capturing and retaining the requisite information. In connection with considering whether to establish differing compliance or recordkeeping requirements or timetables for small entities, as well as whether to use performance rather than design standards, the Commission believes at this time that the flexibility already built in to the proposal adequately addresses these alternatives.

In considering whether to attempt to clarify, consolidate, or simplify the compliance and recordkeeping requirements under the rule for small entities, the Commission believes at this time that the proposal achieves the appropriate balance between simplicity and investor protection, and any further simplification would unacceptably compromise such protection. The minimum criteria specified for proxy voting procedures and client disclosures under proposed rule 206(4)–6 are designed to ensure advisers vote proxies

in the best interest of their clients and provide clients information about how their securities are voted. Elimination of some or all of these criteria would potentially impede achievement of that objective. Similarly, in establishing the categories of records to be retained under the proposed amendments to rule 204–2, the records described by the rule are all necessary if the Commission is to be able to evaluate advisers' compliance with proposed rule 206(4)–6 as part of the Commission's inspection program.

Finally, the Commission believes that it would be inconsistent with the purposes of the Advisers Act to exempt small entities from the proposed rule and rule amendments. The proposed policies and procedures are designed to ensure clients are afforded the full protections attendant to an adviser's fiduciary duties as recognized by the Adviser's Act when an adviser is voting their proxies. The proposed disclosure requirements would provide advisory clients with information about its adviser's proxy voting policies and procedures and instruct clients how to obtain information on how the adviser voted their proxies. Different disclosure requirements would leave some advisory clients without the requisite information necessary to assess their adviser's proxy voting practices. Since the protections of the Advisers Act are intended to apply equally to clients of both large and small advisory firms, it would be inconsistent with the purposes of the Act to specify different requirements for small entities.

G. Solicitation of Comment

We encourage written comments on matters discussed in the IRFA. In particular the Commission seeks comment on:

- The number of small entities that would be affected by the proposed rule and rule amendments; and
- Whether the effects of the proposed rule and rule amendments on small entities would be economically significant.

Commenters are asked to describe the nature of any effect and provide empirical data supporting the extent of the effect.

VII. Statutory Authority

We are proposing new rule 206(4)–6 pursuant to our authority set forth in sections 206(4) and 211(a) of the Advisers Act [15 U.S.C. 80b–6(4) and 80b–11(a)].

We are proposing amendments to rule 204–2 pursuant to our authority set forth in sections 204 and 206(4) of the Advisers Act [15 U.S.C. 80b–4 and 80b–6(4)].

List of Subjects in 17 CFR Part 275

Reporting and recordkeeping requirements, Securities.

Text of Proposed Rule

For the reasons set out in the preamble, title 17, chapter II of the Code of Federal Regulations is proposed to be amended as follows:

PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

1. The authority citation for part 275 continues to read in part as follows:

Authority: 15 U.S.C. 80b–2(a)(11)(F), 80b–2(a)(17), 80b–3, 80b–4, 80b–6(4), 80b–6a, 80b–11, unless otherwise noted.

* * * * *

2. Section 275.204–2 is amended by:

- a. Redesignating paragraph (c) introductory text, paragraphs (c)(1) and (c)(2) as paragraph (c)(1) introductory text, paragraphs (c)(1)(i) and (c)(1)(ii) respectively;

- b. Adding new paragraph (c)(2); and
- c. Revising paragraph (e)(1).

The additions and revisions read as follows:

§ 275.204–2 Books and records to be maintained by investment advisers.

* * * * *

(c) * * *

(2) Every investment adviser subject to paragraph (a) of this section that exercises voting authority with respect to client securities shall, with respect to those clients, make and retain the following:

(i) All policies and procedures required by § 275.206(4)–6.

(ii) A copy of each proxy statement that you receive regarding client securities.

(iii) A record of each vote cast by the investment adviser on behalf of a client.

(iv) A record of all oral and a copy of all written communications received and memoranda or similar documents created by the investment adviser that were material to making a decision on voting client securities.

(v) A record of each client request for proxy voting information and the investment adviser's response, including the date of the request, the name of the client, and date of the response.

* * * * *

(e)(1) All books and records required to be made under the provisions of paragraphs (a) to (c)(1)(i), inclusive, and (c)(2) of this section (except for books and records required to be made under the provisions of paragraphs (a)(11) and (a)(16) of this section), shall be maintained and preserved in an easily

⁶² An investment manager under ERISA is any plan fiduciary, other than a trustee or named fiduciary, who has the power to manage plan assets, has acknowledged its fiduciary status, and is either an investment adviser (registered with the SEC or the states), bank, or insurance company. Section 3(38) of ERISA [29 U.S.C. 1002(38)].

accessible place for a period of not less than five years from the end of the fiscal year during which the last entry was made on such record, the first two years in an appropriate office of the investment adviser.

* * * * *

3. Section 275.206(4)-6 is added to read as follows:

§ 275.206(4)-6 Proxy voting.

If you are an investment adviser registered or required to be registered under section 203 of the Act (15 U.S.C. 80b-3), it is a fraudulent, deceptive, or

manipulative act, practice or course of business within the meaning of section 206(4) of the Act (15 U.S.C. 80b-6(4)), for you to exercise voting authority with respect to client securities, unless you:

(a) Adopt and implement written policies and procedures that are reasonably designed to ensure that you vote client securities in the best interest of clients, which procedures must include how you address material conflicts that may arise between your interests and those of your clients;

(b) Disclose to clients how they may obtain information from you about how

you voted with respect to their securities; and

(c) Describe to clients your proxy voting policies and procedures and, upon request, furnish a copy of the policies and procedures to the requesting client.

By the Commission.

Dated: September 20, 2002.

J. Lynn Taylor,

Assistant Secretary.

[FR Doc. 02-24410 Filed 9-25-02; 8:45 am]

BILLING CODE 8010-01-P