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SEC Should Reject Complex, Costly “Pass-Through” Proxy Voting

By Paul Schott Stevens

Policymakers and regulators at the US Securities and Exchange Commission (SEC) have renewed their interest in proxy voting issues recently. Among the items under discussion at an upcoming SEC Roundtable is the idea that a fund would only be allowed to vote on portfolio company proxies after the fund asks its own shareholders how the fund should vote. In essence, this would “pass through” to fund shareholders the decision of how corporate proxies would be exercised. Even the briefest consideration demonstrates how misguided and impractical the idea is—and why it should go no further.

First, a single fund may invest in hundreds and even thousands of portfolio companies, each with its own annual meeting agenda that may include two or more items for voting. In 2017, for example, the average mutual fund voted on 1,504 separate proxy proposals.

A single fund also may have hundreds of thousands or even millions of shareholders. Those shareholders—young adults saving for a house, parents saving for college, owners of individual retirement accounts, and other Main Street investors—for the most part do not have the time, expertise, or particular views on the myriad of matters, some of them quite complex, that are subject to proxy voting. The “information costs” to fund shareholders of mastering these issues would be extreme.

How do we know this? When funds themselves must solicit proxies from their own shareholders, they find it very difficult to get individual shareholders to vote on matters directly affecting the funds they’ve selected. How much more difficult would it be to get them to respond to a flurry of requests for their views concerning items on the annual meeting agendas of hundreds of companies whose shares are held in the fund?

Second, any pass-through voting or other consultation process would be exceptionally costly and operationally complex. We can estimate roughly how expensive pass-through voting would be based on the analysis we conducted in 2006, when the New York Stock Exchange proposed barring brokers from voting proxies on behalf of their customers for the election of fund directors. ICI analyzed the costs of obtaining retail shareholder proxy votes then and estimated that this one change would double the cost of a typical proxy.

That was just for one proxy solicitation. Passing through and obtaining retail shareholder views on proxies for many hundreds or even thousands of portfolio companies to the estimated 87 million US investors who own stock mutual funds would generate astronomical new costs for shareholders, who bear these costs as fund expenses.

Driving these costs are the many steps funds would need to take to implement pass-through voting, including:

- identifying the shareholders of record, including those who invest through intermediary omnibus positions;
- coordinating with intermediaries and their vendors to verify the number of shares each underlying shareholder of an omnibus position holds as of the record date for each underlying security;
- sorting out different shareholder positions for different securities held within the fund’s portfolio;
- providing in some form timely communications about the issues subject to the companies’ proxies, presumably including passing along corporate proxy materials to each fund shareholder;
- sending multiple notices to fund shareholders to encourage participation;

- tracking and tabulating the shareholder feedback;
- determining the most appropriate way in which to cast votes, given that it's unlikely that all—or even a majority—of fund shareholders will respond, and that their preferences will vary on each relevant agenda item;
- and—the biggest hurdle of all—addressing the fact that shareholders are largely indifferent to proxies in general.

All of these challenges would need to be overcome within the short time frame of the proxy voting period, typically 60 days. Moreover, because most US corporations have a December 31 fiscal year-end, companies tend to flood investors' mailboxes with annual proxies between April and June of each year. The sheer volume of proxies a fund receives for its portfolio holdings would create additional logistical and operational issues for a fund to solicit and track shareholder input on a proxy for every holding in its portfolio (and across the fund complex) over a few months. The impact simply would be enormous, and the additional costs could materially affect investor returns.

Clearly, the notion of passing through the responsibility to vote corporate proxies did not originate with funds or their shareholders. Where then did the idea come from? Some of the voices behind this idea include the so-called Main Street Investors Coalition, backed by groups like the National Association of Manufacturers and the American Council for Capital Formation, who want to limit funds' and other institutional investors' ability to vote in favor of shareholder proposals related to environmental, social, and governance issues. Commentators have questioned the degree to which this coalition in fact represents "mom-and-pop investors."

Nonetheless, the questions raised by the group are getting attention. Recently, SEC Chairman Jay Clayton stated, "A majority of Main Street America's dollars are invested in vehicles where the investor…is not the voting shareholder. Often voting power rests in the hands of investment advisers who owe a duty to vote proxies in a manner consistent with the best interests of funds and their shareholders. A question I have is: are voting decisions maximizing the funds' value for those shareholders?"

ICI would respond to this question with a resounding "yes." Funds have a fiduciary duty to vote corporate proxies in a manner consistent with the best interest of fund shareholders. Independent directors on fund boards establish the policies and procedures that govern the way in which the adviser will vote, and they oversee this process on an ongoing basis. Registered funds in the United States are unique among institutional investors in that they must disclose how they vote proxies every year—company by company, agenda item by agenda item. It is a transparent process, and one to which they apply considerable expertise precisely to maximize the value of the fund's investments by conscientiously considering those matters subject to shareholder voting.

That thoughtful exercise of the proxy franchise in the best interests of the fund and its shareholders is a crucial part of portfolio management, one of the central services that shareholders expect fund advisers to provide. Advisers are already meeting Chairman Clayton's challenge to ensure that "voting decisions [are] maximizing the funds' value for those shareholders." Pass-through voting—forcing advisers to impose that burden on shareholders, at great complexity and expense—would be a giant step in the wrong direction.

Paul Schott Stevens was President and CEO of ICI.

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