SEC's Proxy Voting Proposal Could Shake Up Private Funds

By **Marc Elovitz, Adriana Schwartz and Kelly Koscuiszka** (November 30, 2021)

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On Sept. 29, the U.S. Securities and Exchange Commission proposed Rule 14Ad-1, which would require institutional investment managers subject to Section 13(f) reporting requirements to annually disclose their proxy votes on executive compensation matters.[1]

Currently, only registered funds are required to disclose their say-on-pay votes. If the rule is adopted, the universe of managers required to disclose their compensation votes would significantly broaden and would include many private fund managers for the first time.

While the requirements of the proposed rule may seem to be largely administrative, the public disclosure of proxy voting information may affect how investment managers approach such voting.

Although the new rule was mandated by the Dodd-Frank Act more than a decade ago, the proposal comes at a time when the SEC is heavily focused on enhanced reporting as part of its ambitious environmental, social and corporate governance agenda, and directly addresses the governance component of ESG.

Summary of the Proposed Rule

The proposed rule would require institutional investment managers subject to the reporting requirements of Section 13(f) of the Securities Exchange Act[2] to annually report on Form N-PX their voting on executive compensation.

This would include votes on the approval of executive compensation, the frequency of executive compensation and executive compensation tied to a business combination or sale.

Under the proposed rule, managers would be required to disclose: (1) the number of shares voted, or instructed to be voted, (2) how those shares were voted — i.e., for, against proposal or abstain; and (3) the number of shares the reporting person loaned and did not recall.

This last requirement is intended to help investors better understand how a fund's lending of securities might affect the fund's voting practices.[3]

The reporting requirements of Section 13(f) typically apply to a manager that exercises investment discretion over $100 million or more in securities designated as Section 13(f) securities regardless of whether the manager is registered with the SEC.

Importantly, under the proposed rule, covered fund managers would have to disclose their say-on-pay votes for any security over which they exercise voting power — including securities that do not fall under Section 13(f). Further, the proposed rule has no de minimus threshold in terms of either size of position or length of time held. The annual filing would be due by Aug. 31 of each calendar year for the most recent 12-month period ended June

30.

Potential Impacts of the Proposal

Although the proposed rule initially may seem like just another reporting and compliance task, the impact of the rule on investment fund managers may reach beyond mere housekeeping.

Each of the three types of information on executive compensation votes required by the rule — how many votes are cast, how they are cast and how many shares were lent out, and whose votes were thus not cast by the fund — has the potential to affect how the manager pursues the fund's investment strategy.

To start, the requirement to disclose executive compensation votes would make managers take public positions on what are often contentious issues — and to be prepared to justify those positions to investors, activists and company management. Many fund managers tell investors that they take corporate governance into account when managing their funds, but the proposed rule would put that issue under a public spotlight.

Funds that market themselves as ESG funds are likely to face additional scrutiny of these types of votes. Managers of funds where voting is not central to the investment strategy — such as algorithmic funds — may find the proposed rule creates logistical hurdles as well as offering a confusing public picture as to the manager's approach on proxy voting. Funds that do not vote their shares would be required to report their abstention from voting.[4]

How a manager casts votes may well affect that manager's relationship with investors, activists and management. While the proposed rule does contain a confidentiality provision, the SEC cautions that confidential treatment would only be granted in "narrowly tailored circumstances," such as when a corresponding confidential treatment is granted on Form 13F.[5]

The publicly available Form 13F reports are widely analyzed and discussed in the press and among market participants, despite the fact that they provide a narrow snapshot of the firm's investments by reporting only holdings from the end of the calendar quarter. Proposed Rule 14Ad-1 would add an extra data point by requiring the reporting of securities over which the manager held voting power as of the record date of a say-on-pay vote.

The SEC requested comments on whether managers should be permitted to omit votes on securities that were not held as of the end of a calendar quarter — and thus would not be reported on Form 13F — and whether they should permit or require any disclosure on Form N-PX or elsewhere to explain differences between information reported on Form N-PX and information reported on Form 13F.[6]

Finally, the requirement that managers report how many shares they have lent out of a security where there is an executive compensation vote may present a skewed picture. Say-on-pay votes are advisory and not binding on the companies, and voting the shares requires the manager to forego the benefits of income from stock lending that the funds would otherwise gain.

Further, an increase in shares being called back so that fund managers can participate in say-on-pay votes could affect the ability of market participants to sell short by decreasing the supply of shares available to borrow during the time period surrounding a vote.

The SEC argues that the requirement to disclose loaned securities gives investors greater transparency into whether a fund manager has decided to recall a loaned security to vote or essentially determined not to vote.[7] But it is important to note that while the rule would provide investors with the end result, the rule would not provide any insight into the manager's process for weighing the relative benefits of voting versus lending.

If the rule is enacted in its current form, private fund managers need to be prepared not only for increased transparency on their executive compensation votes, but for the potentially changed dynamics of proxy voting by fund managers.

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[1] "Enhanced Reporting of Proxy Votes by Registered Management Investment Companies; Reporting of Executive Compensation Votes by Institutional Investment Managers," Exchange Act Release No. 34-93169 (Sept. 29, 2021), available here.

[2] The proposed rule would not amend Form 13F, but, rather, would require firms required to file Form 13F also to file Form N-PX and disclose their votes on say-on-pay proposals.

[3] SEC supra note 1, at 43-44.

[4] See id. at 27-31.

[5] See id. at 89.

[6] See id at 32.

[7] Id. at 51.