Securities and Exchange Commission

17 CFR Part 275

[Release No. IA-2106; File No. S7-38-02]

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PROXY VOTING BY INVESTMENT ADVISERS

Agency: Securities and Exchange Commission

Action: Final rule

Summary: The Commission is adopting a new rule and rule amendments under the Investment Advisers Act of 1940 that address an investment adviser's fiduciary obligation to its clients when the adviser has authority to vote their proxies. The new rule requires an investment adviser that exercises voting authority over client proxies to adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of clients, to disclose to clients information about those policies and procedures, and to disclose to clients how they may obtain information on how the adviser has voted their proxies. The rule amendments also require advisers to maintain certain records relating to proxy voting. The rule and rule amendments are designed to ensure that advisers vote proxies in the best interest of their clients and provide clients with information about how their proxies are voted.

Dates:
Effective Date: March 10, 2003.
Compliance Date: August 6, 2003.

For Further Information Contact: Daniel S. Kahl, Senior Counsel, or Jennifer L. Sawin, Assistant Director, 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") is adopting new rule 206(4)-6 [17 CFR 275.206(4)-6] and 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").1

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I. Background

Investment advisers registered with us have discretionary authority to manage $19 trillion of assets on behalf of their clients, including large holdings in equity securities. In most cases, clients give these advisers authority to vote proxies relating to equity securities. This enormous voting power gives advisers significant ability collectively, and in many cases individually, to affect the outcome of shareholder votes and influence the governance of corporations. Advisers are thus in a position to significantly affect the future of corporations and, as a result, the future value of corporate securities held by their clients.

The federal securities laws do not specifically address how an adviser must exercise its proxy voting authority for its clients. Under the Advisers Act, however, an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting.2 The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies.3 To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own.

An adviser may have a number of conflicts that can affect how it votes proxies. For example, an adviser (or its affiliate) may manage a pension plan, administer employee benefit plans, or provide brokerage, underwriting, insurance, or banking services to a company whose management is soliciting proxies.4 Failure to vote in favor of management may harm the adviser's relationship with the company. The adviser may also have business or personal relationships with participants in proxy contests, corporate directors or candidates for directorships. For example, an executive of the adviser may have a spouse or other close relative who serves as a director or executive of a company.5

Our concern with these conflicts and how they affect clients of advisers led us to propose, on September 20, 2002, new rule 206(4)-6 and amendments to rule 204-2.6 The proposals were designed to prevent material conflicts of interest from affecting the manner in which advisers vote clients' proxies. We proposed to require advisers to adopt and implement policies and procedures for voting proxies in the best interest of clients, to describe the procedures to clients, and to tell clients how they may obtain information about how the adviser has actually voted their proxies.

We received several thousand comment letters; nearly all supported adoption of the rule.7 Commenters, including many advisers and groups representing advisers, agreed that advisers should have proxy voting procedures, and supported clients' right to information on how their proxies are voted. Several, however, urged that we revise the proposed recordkeeping requirements of rule 204-2 to make them less burdensome on advisers. We are today adopting rule 206(4)-6 as proposed, and are adopting amendments to rule 204-2 with certain changes that respond to issues raised by commenters.

II. Discussion

A. Rule 206(4)-6, Proxy Voting

Under rule 206(4)-6, it is 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 (i) the adviser has adopted and implemented written policies and procedures that are reasonably designed to ensure that the adviser votes proxies in the best interest of its clients, (ii) the adviser describes its proxy voting procedures to its clients and provides copies on request, and (iii) the adviser discloses to clients how they may obtain information on how the adviser voted their proxies.8

1. Advisers Subject to the Rule

The rule applies, as proposed, to all investment advisers registered with us that exercise proxy voting authority over client securities. While several commenters urged that we create exceptions, none offered persuasive arguments why an adviser that accepts voting authority ought not be required to have procedures in place to ensure that it meets its fiduciary obligations to clients.9

Advisers that have implicit as well as explicit voting authority must comply with rule 206(4)-6. The rule thus applies when the advisory contract is silent but the adviser's voting authority is implied by an overall delegation of discretionary authority.10 The rule does not apply, however, to advisers that provide clients with advice about voting proxies but do not have authority to vote the proxies.11

2. Policies and Procedures

Under rule 206(4)-6, advisers that exercise voting authority with respect to client securities must adopt proxy voting policies and procedures.12 The policies and procedures must be in writing. They must be reasonably designed to ensure that the adviser votes in the best interest of clients.13 And they must describe how the adviser addresses material conflicts between its interests and those of its clients with respect to proxy voting.14 Most commenters supported these requirements, and many advisers informed us that they already had written policies in place.

We did not propose, and are not adopting, specific policies or procedures for advisers. Nor are we, as some commenters requested, providing a list of approved procedures. Investment advisers registered with us are so varied that a "one-size-fits-all" approach is unworkable. By not mandating specific policies and procedures, we leave advisers the flexibility to craft policies and procedures suitable to their businesses and the nature of the conflicts they face. As noted by some commenters, some advisers (including many smaller firms) are unlikely to face any material conflicts of interest, in which case their procedures could be very simple.15

An adviser's proxy voting policies and procedures should be designed to enable the firm to resolve material conflicts of interest with its clients before voting their proxies. As we discussed above, these obligations involve both a duty to vote client proxies and a duty to vote them in the best interest of clients.16

a. Voting Client Proxies

The duty of care requires an adviser with voting authority to monitor corporate actions and vote client proxies. Therefore, the adviser should have procedures in place designed to ensure that it fulfills these duties.17 We do not suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the client's best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client.18 An adviser may not, however, ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies. 19

b. Resolving Conflicts of Interest

An adviser's policies and procedures under the rule must also address how the adviser resolves material conflicts of interest with its clients. Some commenters urged us to approve methods that would resolve material conflicts. Clearly, an adviser's policy of disclosing the conflict to clients and obtaining their consents before voting satisfies the requirements of the rule and, when implemented, fulfills the adviser's fiduciary obligations under the Advisers Act.20 In the absence of client disclosure and consent,21 we believe that an adviser that has a material conflict of interest with its clients must take other steps designed to ensure, and must be able to demonstrate that those steps resulted in, a decision to vote the proxies that was based on the clients' best interest and was not the product of the conflict.22

Advisers today use various means of ensuring that proxy votes are voted in their clients' best interest and not affected by the advisers' conflicts of interest.23 An adviser that votes securities based on a pre-determined voting policy could demonstrate that its vote was not a product of a conflict of interest if the application of the policy to the matter presented to shareholders involved little discretion on the part of the adviser.24 Similarly, an adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party. An adviser could also suggest that the client engage another party to determine how the proxies should be voted, which would relieve the adviser of the responsibility to vote the proxies.25 Other policies and procedures are also available; their effectiveness (and the effectiveness of any policies and procedures) will turn on how well they insulate the decision on how to vote client proxies from the conflict.

3. Disclose How to Obtain Voting Information

Rule 206(4)-6 requires advisers to disclose to clients how they can obtain information from the adviser on how their securities were voted.26 Commenters supported advisers' disclosure of actual votes.27 Many advisers indicated that their clients, particularly institutional clients, do request this information and that the advisers already have procedures in place to facilitate clients' access to this information.

Many investors urged that rule 206(4)-6 require that advisers publicly disclose how they vote their client proxies. In a companion release, we are today adopting rules requiring that investment companies publicly disclose how they vote their proxies.28 We are requiring public disclosure as a means of informing fund shareholders how the fund (or its adviser) voted proxies of the shareholders' fund. Public disclosure is unnecessary for advisers to communicate to each client how the adviser has voted that client's proxies. Moreover, public disclosure of proxy votes by some advisers would reveal client holdings and thus client confidences. We have determined, therefore, not to require advisers to disclose their votes publicly.

4. Describe Policies and Procedures

Rule 206(4)-6 also requires advisers to describe their proxy voting policies and procedures to clients, and upon request, to provide clients with a copy of those policies and procedures.29 Commenters strongly supported this requirement, which we are adopting as proposed. The description should be a concise summary of the adviser's proxy voting process rather than a reiteration of the adviser's policies and procedures, and should indicate that a copy of the policies and procedures is available upon request. If a client requests a copy of the policies and procedures, the adviser must supply it.

B. Rule 204-2, Recordkeeping

Investment advisers expressed significant concerns with the compliance burdens of the proposed recordkeeping requirements and suggested several improvements. We are adopting the amendments to rule 204-2 with modifications that should substantially reduce those compliance burdens. Under rule 204-2, as amended, advisers must retain (i) their proxy voting policies and procedures; (ii) proxy statements received regarding client securities; (iii) records of votes they cast on behalf of clients; (iv) records of client requests for proxy voting information,30 and (v) any documents prepared by the adviser that were material to making a decision how to vote, or that memorialized the basis for the

decision.31 In response to suggestions from commenters, the amendments permit an adviser to rely on proxy statements filed on our EDGAR system instead of keeping its own copies, and to rely on proxy statements and records of proxy votes cast by the adviser that are maintained with a third party such as a proxy voting service, provided that the adviser has obtained an undertaking from the third party to provide a copy of the documents promptly upon request.

III. Effective Date

New rule 206(4)-6 and the amendments to rule 204-2 are effective thirty days after publication. Advisers must comply with the new rule and amendments within 180 days after publication. By this date, advisers subject to the new rule must have adopted and implemented the required proxy voting policies and procedures. Also by this date, advisers must have provided clients with a description of their policies and procedures, and disclosure of how the clients may obtain information from the adviser on how it voted with respect to their securities.

Advisers may choose any means to make this disclosure, provided that it is clear, not "buried" in a longer document, and received by clients within 180 days after publication. For example, an adviser could send clients the disclosure together with a periodic account statement, deliver it in a separate mailing, or include it in its brochure (or Part II of Form ADV). Advisers that use their brochure or Part II to make the disclosure must deliver (not merely offer) the revised brochure to existing clients within 180 days after publication, and should accompany the delivery with a letter identifying the new disclosure.

IV. Cost-Benefit Analysis

A. Background

The Commission is sensitive to the costs and benefits resulting from its rules. While investment advisers typically exercise proxy voting authority as part of their discretionary management of client securities, the federal securities laws do not specifically address how advisers must exercise this power. New rule 206(4)-6 is designed to ensure that advisers that have proxy voting authority vote clients' securities in the clients' best interest and provide clients with information on how their securities are voted. In addition, these advisers must keep records that permit the Commission to confirm their compliance with rule 206(4)-6.

Investment advisers registered with us have discretionary authority to manage $19 trillion on behalf of their clients, including large holdings in equity securities. In most cases, clients give these advisers authority to vote proxies relating to equity securities. This enormous voting power gives advisers significant ability collectively, and in many cases individually, to affect the outcome of shareholder votes and influence the governance of corporations. Advisers are thus in a position to significantly affect the future of corporations and, as a result, the future value of corporate securities held by their clients.

Under the Advisers Act, an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting. The duty of care requires an adviser that has authority to vote its client's proxies to monitor corporate events and to vote the proxies. To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own.

An adviser may have conflicts that can affect how it votes proxies. For example, the adviser (or its affiliate) may manage a pension plan, administer employee benefit plans, or provide brokerage, underwriting, insurance, or banking services to a company whose management is soliciting proxies. Failure to vote in favor of management may harm the adviser's relationship with the company. The adviser may also have business or personal relationships with other proponents of proxy proposals, participants in proxy contests, corporate directors or candidates for directorships. For example, the adviser may manage money for an employee group, or an executive of the adviser may have a spouse or other close relative who serves as a director or executive of a company. Our concern with these conflicts and how they affect clients of advisers led us to propose, on September 20, 2002, new rule 206(4)-6 and amendments to rule 204-2.32

New rule 206(4)-6 is designed to prevent material conflicts of interest from affecting the manner in which advisers vote clients' proxies. The rule requires SEC-registered investment advisers that have authority to vote clients' proxies to adopt written policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interest of its clients, including procedures to address any material conflict that may arise between the interest of the adviser and the clients. The adviser must describe these policies and procedures to clients, provide copies of the policies and procedures to clients upon their request, and disclose to clients how they may obtain information from the adviser about how the adviser has voted their proxies.

The amendments to rule 204-2 under the Advisers Act require SEC-registered investment advisers that vote client proxies to maintain specified records with respect to those clients. These records will permit our examiners to ascertain the advisers' compliance with new rule 206(4)-6.

Based on advisers' filings with us, we estimate that the majority of investment advisers registered with us will be subject to the new rule. 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 advisers registered with us manage client assets on a discretionary basis.33 Because 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 their discretionary asset management services.34

The Commission has given consideration to the costs of new rule 206(4)-6 and amendments to rule 204-2, as well as the benefits. In the Proposing Release we requested comment and specific data regarding these costs and benefits. The comments we received were mostly general in nature and are discussed below. We received one comment that included data and estimated the cost of our proposal to be slightly higher than our figure. In light of the changes we are making to the rules as adopted, we believe our original figures accurately estimate the costs of the rule and rule amendments.

B. Benefits

Rule 206(4)-6 will, we believe, provide several important benefits to advisory clients. Requiring advisers to have written proxy voting policies and procedures that address material conflicts of interest will benefit clients by ensuring that their advisers do resolve conflicts in the clients' best interests. Requiring advisers to describe their proxy voting policies and procedures to clients and to furnish copies to clients upon request will benefit clients by allowing them to understand how their advisers vote proxies. Clients will also be in a better position to evaluate whether their advisers' policies and procedures meet their own objectives and expectations. Many individuals commented that they do want their advisers' policies and procedures to be available to them. Clients who do not approve of how their adviser votes 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. Finally, requiring advisers to disclose to their clients how the clients can obtain information on how the advisers voted their proxies will benefit clients by allowing them to be fully informed about how their shares were voted and to confirm that their advisers are following their voting policies and procedures.

The benefit of codifying these practices through a rule is difficult to quantify, for two reasons. First, commenters confirmed that some advisory clients are already receiving these benefits as a matter of practice. Many advisers commented that they already have proxy voting policies and procedures in place, and that they already provide much of this information to clients. Second, the adviser is an agent and fiduciary of its clients; it already owes them a fiduciary duty to vote proxies in the clients' best interest, and must provide them with information on how their proxies were voted.

C. Costs

The Commission anticipates that rule 206(4)-6 and the amendments to rule 204-2 will impose certain costs on advisers that have voting authority over client securities.35 Advisers that do not yet have proxy voting policies and procedures in place will incur costs in connection with establishing them. Because the

rule does not require specific policies and procedures, but permits the adviser flexibility to craft policies and procedures suitable to its business and conflicts, we believe that the costs will vary significantly from adviser to adviser based on factors such as size, investment philosophy, and clientele. Moreover, a number of very large advisers -likely the firms that would require the most detailed and complex policies and procedures - commented that they already had proxy voting policies and procedures in operation. Advisers that have established policies and procedures may incur only limited costs in revising them to meet the rule's requirements.

Advisers will also incur costs in preparing descriptions of their voting policies and procedures, furnishing the descriptions to clients (and furnishing copies of the policies and procedures upon request), responding to client requests for actual proxy votes, and keeping records as required by the rule amendments.

Although a number of advisers indicated that their cost to comply with the proposed recordkeeping requirements would be significant, they did not provide specific data. Advisers with relatively few staff indicated that they believed that complying with the recordkeeping requirements would require them to hire an additional employee, while large advisers chiefly commented on the requirement to maintain records that were material to the voting decision. We have narrowed the recordkeeping requirements from the proposal to incorporate several recommendations from commenters. Under the rule amendments as adopted, advisers may retrieve proxy statements from the Commission's EDGAR system rather than maintaining copies, and may rely on a third party to make and keep copies of proxy statements and records of votes. Further, the final rule substantially narrows the requirements for keeping documents material to the adviser's voting decision. We believe that these changes significantly reduce the costs involved.

V. Paperwork Reduction Act

As set forth in the Proposing Release, new rule 206(4)-6 and the amendments to rule 204-2 contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").36 The titles for the collections of information are "Proxy Voting by Investment Advisers" and "Books and Records to be Maintained by Investment Advisers." The Commission submitted the new collection of information, Proxy Voting by Investment Advisers, 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 collection for information for rule 206(4)-6 has been approved by OMB; the OMB control number is 3235-0571 (expires November 30, 2005). The collection of information for rule 204-2 was previously approved under OMB control number 3235-0278 (expires November 30, 2005). 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.

A. Rule 206(4)-6

Under rule 206(4)-6, an investment adviser that exercises voting authority over clients' securities must adopt written proxy voting policies and procedures, describe the procedures to clients, make them available to clients upon request, and inform clients how they can obtain information about how their securities were voted. We requested comment on the recordkeeping burden of rule 206(4)-6, but received no responses.

In the Proposing Release, we estimated that, on average, an adviser would spend 10 hours annually documenting its proxy voting policies and procedures.37 For purposes of estimating the number of advisers that would be affected by the new rule, we assumed that all advisers with discretion to manage clients' assets also had discretion to vote clients' securities and would thus be subject to the rule.38 We received no comments on this assumption. According to our records, 6,203 of the 7,687 total advisers registered with the Commission manage client assets on a discretionary basis.39 We therefore estimated advisers' total burden for establishing proxy voting policies and procedures to be 62,030 hours.40

The rule also requires 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 3235-0049.41 In addition, the rule also requires these investment advisers to provide copies of their proxy voting policies and procedures to clients upon request. According to our records, SEC-registered advisers have, on average, 670 clients each; we had estimated that, on average, at least 90 percent of each of these adviser's clients would find the adviser's description of its proxy voting policies sufficiently informative, and ten percent at most (or 67 clients of each adviser on average), would request copies of the full policies and procedures.42 We had also estimated that it would take an adviser 0.1 hours per client to deliver copies of the policies and procedures, for a total burden of 41,560 hours.43 Advisers commented that very few clients currently request copies of proxy voting policies and procedures. We are not changing our original estimates at this time, because advisers may experience an increase in client requests as a result of the disclosure required under the rule.

We are adopting rule 206(4)-6 as proposed. Accordingly, the estimated annual aggregate burden of collection for rule 206(4)-6 remains 103,590 hours.44 This collection of information is mandatory, and responses to the disclosure requirements are not kept confidential.

B. Rule 204-2

Rule 204-2 sets forth the requirements for maintaining and preserving specified books and records by investment advisers. 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. Responses provided to the Commission in the context of its examination and oversight program are generally kept confidential.45 The records that an adviser must keep in accordance with rule 204-2 must generally be retained for not less than five years.46

As amended, rule 204-2 requires registered investment advisers that vote client proxies to maintain specified records with respect to those clients. The records must be maintained in the manner, and for the period of time, as other books and records under rule 204-2(c). Advisers subject to rule 206(4)-6, Proxy Voting by Investment Advisers, must maintain copies of their proxy voting policies and procedures, as well as copies or records of each proxy statement received with respect to the securities of clients for whom the adviser exercises voting authority. These advisers must also maintain a record of each vote cast, as well as certain records pertaining to the adviser's decision on the vote. In addition, the adviser must maintain a record of each written client request for proxy voting information, and all written responses by the investment adviser to written or oral client requests for proxy voting information.

We received numerous comments on how to minimize the burden of this collection of information. In response to these comments, we have substantially modified the rule amendments. Under the adopted amendments to rule 204-2, advisers may use a third party service provider to maintain proxy statements and proxy votes if the service provider undertakes to provide copies of those records promptly on request. Many advisers, particularly advisers that vote proxies on hundreds or thousands of companies, already retain a proxy voting service that they may be able to rely on under the amendments as adopted. In addition, advisers may rely on the Commission's EDGAR system to meet the requirement that they maintain proxy statements. We have also amended the requirement that advisers maintain client requests for proxy voting information, and the advisers' responses, by requiring only the retention of written client requests and of advisers' written responses to any client request, whether oral or in writing.47 Finally, we narrowed the requirement that an adviser maintain records of documents material to the adviser's decision on how to vote. The revised rule requires advisers to maintain only documents that they created that were material to making the voting decision.48

In the Proposing Release, we estimated that the proposed amendments would increase the average annual collection burden of an adviser subject to the amendments by 20 hours, to 215.34 hours.49 Based on the comments we received, we continue to estimate that the annual collection burden will increase 20 hours per adviser, on average. Many commenters indicated that the recordkeeping burdens as proposed were significant, which we interpreted to mean in excess of our original estimate of 20 hours. However, we believe 20 hours is an accurate estimate of the burden, in light of the changes we have made to the final version of the recordkeeping amendments. 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

VI. Summary of Final Regulatory Flexibility Analysis

An Initial Regulatory Flexibility Analysis ("IRFA") was published in the Proposing Release. No comments were received on the IRFA. The Commission has prepared a Final Regulatory Flexibility Analysis ("FRFA"), in accordance with 5 U.S.C. 604, regarding rule 206(4)-6 and amendments to rule 204-2. The following summarizes the FRFA.

The FRFA discusses the need for, and objectives of, the new rule and rule amendments that require certain advisers to adopt proxy voting policies and procedures and maintain certain proxy voting records. The rule is designed to ensure that advisers vote clients' securities in the clients' best interest, and that the adviser addresses how it resolves material conflicts of interest.

The FRFA also discusses the effect of the rule and rule amendments on small entities. For purposes of the Advisers Act and the Regulatory Flexibility Act, an investment adviser generally is considered 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.52 Of the 6,203 advisers the Commission estimates will be affected by the new rule, the FRFA estimates that 138 are likely to be small entities.

As discussed in the FRFA, the rule and rule amendments do not impose new reporting requirements, but do impose recordkeeping requirements on advisers, including small advisers, that exercise voting authority over client securities. The FRFA notes that advisers, generally vote client proxies only when they are managing client assets on a discretionary basis. Small advisers engage in discretionary asset management on a limited scale, and thus should not have to dedicate significant resources to meet the compliance and recordkeeping requirements in connection with their proxy votes.

The FRFA discusses alternatives considered by the Commission in adopting the new rule and rule amendments that might minimize adverse effects on small advisers, including: (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.

We believe that the flexibility built into the rule provides for differing compliance requirements for small entities. We do not believe that further clarification, consolidation, or simplification of compliance and reporting requirements for small entities or an exemption from the coverage of the rule for small entities would be consistent with investor protection and the fiduciary duty an adviser owes to its clients. The new rule and rule amendments use performance, rather than design standards, in the sense that that they require policies and procedures to ensure votes are in the best interest of clients, rather than specifying specific elements of the policies and procedures.

The FRFA is available for public inspection in File No. S7-38-02. A copy of the FRFA may be obtained by contacting Daniel S. Kahl, Senior Counsel, Securities and Exchange Commission, 450 Fifth Street NW, Washington DC 20549-0506.

VII. Consideration of Promotion of Efficiency, Competition, and Capital Formation

Section 202(c) of the Advisers Act requires 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.53

As discussed above, the rule and rule amendments will require investment advisers that have authority to vote clients' securities to adopt and implement written policies and procedures designed to ensure that votes are cast in the clients' best interest. Although we recognize that compliance programs, including proxy voting programs, may require advisers to expend resources that they could otherwise use in their primary business, we expect that the rules and rule amendments may indirectly increase efficiency in a number of ways. Advisers would be required to carry out their proxy voting in an organized and systematic manner, which may be more efficient than their current approach. Requiring all advisers with voting authority to adopt proxy voting policies and procedures, and meet recordkeeping requirements, may enhance efficiency further by encouraging third parties to create new resources and guidance to which industry participants can refer in establishing, improving, and implementing their proxy voting procedures. In addition, proxy voting policies and procedures may focus advisers on their fiduciary duties in voting client securities, thus increasing efficiency by deterring securities law and common law fraud violations.

Because the rule and rule amendments apply equally to all advisers that exercise voting authority over clients' securities, we do not anticipate that any competitive disadvantages would be created. To the contrary, the rule and rule amendments may encourage competition by raising clients' awareness about advisers' proxy voting and facilitating the differentiation of services offered by various advisers.

We anticipate that the rule and rule amendments may have a limited indirect effect on capital formation. The rule and rule amendments will likely increase investor confidence in investment advisers by making proxy voting more transparent and encouraging increased emphasis on proxy voting by advisers. Because capital formation is influenced by investor confidence in the markets, we believe that the rule could have a positive effect on capital markets.

VIII. Statutory Authority

We are adopting 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 adopting 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)].

Text of Rule and Rule Amendments

List of Subjects in 17 CFR Part 275

Reporting and recordkeeping requirements, Securities

For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is 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) Copies of all policies and procedures required by § 275.206(4)-6.

(ii) A copy of each proxy statement that the investment adviser receives regarding client securities. An investment adviser may satisfy this requirement by relying on a third party to make and retain, on the investment adviser's behalf, a copy of a proxy statement (provided that the adviser has obtained an undertaking from the third party to provide a copy of the proxy statement promptly upon request) or may rely on obtaining a copy of a proxy statement from the Commission's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system.

(iii) A record of each vote cast by the investment adviser on behalf of a client. An investment adviser may satisfy this requirement by relying on a third party to make and retain, on the investment adviser's behalf, a record of the vote cast (provided that the adviser has obtained an undertaking from the third party to provide a copy of the record promptly upon request).

(iv) A copy of any document created by the adviser that was material to making a decision how to vote proxies on behalf of a client or that memorializes the basis for that decision.

(v) A copy of each written client request for information on how the adviser voted proxies on behalf of the client, and a copy of any written response by the investment adviser to any (written or oral) client request for information on how the adviser voted proxies on behalf of the requesting client.

* * * * *

(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 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.

Margaret H. McFarland
Deputy Secretary

Dated: January 31, 2003

ENDNOTES

1 Unless otherwise noted, when we refer to rule 204-2 or any paragraph of the rule, we are referring to 17 CFR 275.204-2 of the Code of Federal Regulations in which the rule is published, as amended by this release, and when we refer to rule 206(4)-6 or any paragraph of the rule, we are referring to 17 CFR 275.206(4)-6 of the Code of Federal Regulations as adopted by this release.

2 See 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]).

3 As we discuss later in this Release, we do not mean to suggest that an adviser that does not exercise every opportunity to vote a proxy on behalf of its clients would thereby violate its fiduciary obligations to those clients under the Act.

4 The adviser may also have a business relationship not with the company but with a proponent of a proxy proposal that may affect how it casts votes on clients' securities. For example, the adviser may manage money for an employee group.

5 Whether the adviser's relationships with these other parties creates a material conflict will depend on the facts and circumstances. However, even in the absence of efforts by these parties to persuade the adviser how to vote, the value of the relationship to the adviser can create a material conflict. The Supreme Court has made it clear that the Advisers Act was intended to eliminate or expose advisers' unconscious biases as well as conscious ones. Capital Gains, supra note 2, at 191-192.

6 Proxy Voting by Investment Advisers, Investment Advisers Act Release No. 2059 (Sept. 20, 2002) [67 FR 60841 (Sept. 26, 2002)] ("Proposing Release").

7 The Proposing Release was issued with a companion release proposing 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 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) [67 FR 60827 (Sept. 26, 2002)] ("Fund Proposing Release"). Commenters submitted ten different types of form letters; five of these (approximately 2800 letters) and a large number of other letters were submitted in response to both the Proposing Release and the Fund Proposing Release. In addition, some letters submitted in response to the Proposing Release also raised points pertaining to the Fund Proposing Release, and vice versa.

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

9 We note that, while we are not creating an exception for smaller firms, as some commenters suggested, smaller firms without financial industry affiliates are likely to have few or even no potential conflicts of interest relating to proxy voting, in which case their procedures could be much simpler and compliance with the rule would be commensurately less burdensome.

10 Several commenters argued that the rule should not apply to advisers that have not received explicit authority to vote proxies. Advisers who believe that the application of the rule to them would be inappropriate could revise their advisory contracts (or make other disclosure to clients) to make explicit their responsibility (or lack of responsibility) for voting proxies.

11 The Advisers Act's general anti-fraud provisions would, however, continue to require such advisers to disclose any material conflict to the clients receiving the advice.

12 Rule 206(4)-6(a).

13 Nothing in the rule prevents 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.

14 Advisers' proxy voting policies and procedures should address (although the rule does not require) how the adviser will vote proxies (or what factors it will take into consideration) when voting on particular types of matters, such as changes in corporate governance structures, adoption or amendments to compensation plans (including stock options) and matters involving social issues or corporate responsibility. The policies and procedures of an adviser whose advisory activities are limited to investments in investment companies would, of course, address different matters, including, for example, approval of advisory contracts, distribution plans ("12b-1 plans"), and mergers.

15 Even the smallest firm, however, may from time to time have conflicts of interests with clients. For example, an adviser that is solicited to vote client proxies approving an increase in fees deducted from mutual fund assets pursuant to a 12b-1 plan has a conflict of interest with its clients invested in the fund if the fees are a source of compensation for the adviser.

16 While the rule allows for flexibility, it does not allow for mere boilerplate. Procedures that merely declare that all proxies will be voted in the best interests of clients would not be sufficient to meet the rule's requirements.

17 We suggested in the Proposing Release that effective procedures should identify personnel responsible for monitoring corporate actions, those responsible for making voting decisions, and those responsible for ensuring that proxies are submitted timely. Commenters felt that less detail could suffice and asked whether it was necessary for procedures to name individuals. Under the rule, advisers can write procedures that fit their firm. In a firm with few employees, those roles may be self-evident. Large firms, however, may need to clarify which department or group of employees has what responsibility in order to guard against non-compliance.

18 For example, casting a vote on a foreign security may involve additional costs such as hiring a translator or traveling to the foreign country to vote the security in person.

19 The scope of an adviser's responsibilities with respect to voting proxies would ordinarily be determined by the adviser's contracts with its clients, the disclosures it has made to its clients, and the investment policies and objectives of its clients. An adviser's fiduciary duties to a client do not necessarily require the adviser to become a "shareholder activist" by, for example, 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 its costs and expected benefits to clients. Cf. Department of Labor, Interpretive Bulletin Relating to Written Statements of Investment Policy, Including Proxy Voting Guidelines, 29 CFR 2509.94-2 at § 3 (2001).

20 In this regard, we believe that an adviser to an investment company would satisfy its fiduciary obligations under the Advisers Act if, before voting the proxies, it fully discloses its conflict to the investment company's board of directors or a committee of the board and obtains the board's or committee's consent or direction to vote the proxies.

21 An adviser seeking a client's consent must provide the client with sufficient information regarding the matter before shareholders and the nature of the adviser's conflict to enable the client to make an informed decision to consent to the adviser's vote. Boilerplate disclosure in a client brochure regarding generalized conflicts would be inadequate.

22 Courts have taken a similar approach with respect to the business judgment rule afforded directors of corporations. When corporate directors take action notwithstanding their conflict of interest, they lose the deference that they normally receive under the "business judgment rule," and must demonstrate that their corporate action was fair to the corporation and its shareholders. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993). "The rationale for employing the intrinsic fairness standard is that where corporate fiduciaries, because of a conflict, are disabled from safeguarding the interests of the stockholders to whom they owe a duty, the Court will furnish compensatory procedural safeguards by imposing upon the fiduciaries an exacting burden of establishing the utmost propriety and fairness of their actions." Van de Walle v. Unimation, Inc. 1991 Del. Ch. LEXIS 27, at 30 (Mar. 6, 1991).

23 We believe an adviser that has assumed the responsibility of voting client proxies cannot fulfill its fiduciary responsibilities to its clients by merely refraining from voting the proxies. Such proxies would not be voted in the best interest of the clients.

24 Of course, the pre-determined policy must be designed to further the interests of clients rather than the adviser. Thus, an adviser could not, consistent with its duty, adopt a pre-determined policy of voting proxies in favor of the management of companies with which it does business. We recognize, however, that in many cases, voting policies are not sufficiently specific to determine how the vote will be cast.

25 See, e.g., Evergreen Investment Management Company, LLC, SEC Staff No-Action Letter at n. 6 (Feb. 13, 2002) (client mutual fund hired third party to vote proxies in merger contest involving the adviser's parent corporation).

26 Rule 206(4)-6(b). We expect most advisers will make this disclosure in their written brochure required under rule 204-3 [17 CFR 275.204-3].

27 The rule does not prescribe a client's right to this information because we do not believe a prescription is necessary. Although a few commenters suggested that the rule should prescribe a right, other commenters including investment advisers agreed with us that a client already has the right to information about how that client's securities were voted. See Restatement (Second) of Agency § 381.

28 Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Investment Company Act Release No. 25922 (Jan. 31, 2003).

29 Rule 206(4)-6(c).

30 As adopted, the amendments only require an adviser to keep all written requests from clients and any written response from the adviser (to either a written or an oral request).

31 Rule 204-2(c)(2). These records (other than proxy statements on file with our EDGAR system or maintained by a third party and proxy votes maintained by a third party) must be maintained in an easily accessible place for five years, the first two in an appropriate office of the investment adviser. Rule 204-2(e)(1). These are the same retention requirements that apply to most other books and records under rule 204-2.

32 See supra note 6.

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

34 Part 1A of Form ADV does not require advisers to describe the types of securities for which they hold discretionary investment authority. Some advisers that report having discretionary assets under management may manage only securities for which proxy voting issues do not arise, such as government or other debt obligations.

35 In connection with estimating the annual aggregate burden of the proposed rule and amendments for purposes of the Paperwork Reduction Act, the Commission staff has estimated that advisory firms subject to 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. 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. See Proposing Release at n. 45.

36 44 U.S.C. 3501 to 3520.

37 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 that can serve as the basis of the adviser's procedures under the new rule.

38 This estimate potentially overstates the number of advisers that would be subject to the rule. Part 1A of ADV does not require investment advisers to describe whether they vote proxies on behalf of clients. Nor does Part 1A require advisers to describe whether the securities they manage are voting securities as opposed to, for example, government or other debt obligations for which proxy voting issues do not arise.

39 Based on our records of information submitted to us by investment advisers on Part 1A 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 6,203 x 10 = 62,030.

41 In April of 2000, we proposed amendments to Part 2 of Form ADV 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 new rule 206(4)-6(b) and (c) by describing its policies and procedures in its brochure. See supra note 26. 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.

42 670 x 10% = 67.

43 0.1 x 67 x 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 hours x $60 per hour) + (41,560 hours x $10 per hour) = $4,137,400).

44 62,030 + 41,560 = 103,590.

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

46 See rule 204-2(e).

47 "Written" policies and procedures would, of course, include documents in electronic format. See 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)].

48 The proposed amendments would have required a record of all oral and a copy of all written communications received and memoranda or similar documents created by the adviser that were material to making a decision on voting client securities.

49 195.34 + 20 = 215.34.

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

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

52 17 CFR 275.0-7(a).

53 15 U.S.C. 80b-2(c). Section 204 of the Advisers Act, which is part of our statutory authority for the proposed recordkeeping amendments for investment advisers under rule 204-2, permits us to prescribe recordkeeping rules that we determine are necessary or appropriate in the public interest or for the protection of investors. Also in this Release, we are adopting new rule 206(4)-6, under other statutory provisions that do not express the same public interest standard, and are not covered by section 202(c). In the interest of comprehensiveness, we nevertheless have included rule 206(4)-6 in our section 202(c) analysis.