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## REGULATORY MONITOR

### SEC UPDATE

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#### **Could Charitable or Financial Incentives Improve Fund Shareholder Participation in the Proxy Process?**

When it comes to proxy voting, funds registered under the Investment Company Act of 1940, as amended (1940 Act) (funds), face unique challenges. Unlike operating companies, which often are able to rely on institutional shareholders to achieve quorum and voting requirements, funds rely heavily on retail shareholders who are less likely to vote. The percentage of retail ownership in funds is increasing and low retail participation in funds makes the proxy process difficult and expensive and poses serious risks, including the risk that certain proposals will not be approved, or even voted upon, if quorum cannot be achieved.<sup>1</sup>

The Securities and Exchange Commission (SEC) has examined proxy solicitation and related issues periodically for several years, including at its November 2018 roundtable regarding the proxy process, but has not issued any proposed rules or guidance to address these issues. Absent any relief from the SEC, in an effort to increase shareholder engagement, some public companies and funds have developed alternative methods to encourage shareholder participation in the proxy process.

#### **Challenges for Funds**

Listed closed-end funds generally are required to hold annual meetings of shareholders to elect directors and vote on other matters. Open-end funds are not required to hold annual shareholder meetings, but they periodically must solicit shareholder approval for certain nonroutine matters, such as changes to a fund's fundamental investment policies, a potential merger, or a new investment advisory agreement or material amendment thereto.

If a fund cannot attain quorum and garner enough votes to ensure a proposal is approved, the fund may need to adjourn its shareholder meeting and, as a result, incur delays and additional solicitation expenses;<sup>2</sup> it may even need to set a new record date. If these efforts are not successful, the consequences can be severe—mergers might be abandoned, investment advisory agreements could lapse, and, in each case, funds and/or advisers would forfeit incurred expenses.

Funds often find it difficult and expensive to satisfy quorum requirements (except for routine matters on which brokers may vote in their discretion),<sup>3</sup> even when shareholders appear to favor a proposal (based on a high percentage of votes being cast for the proposal). The requisite quorum and voting requirements generally are memorialized in a fund's organizational documents or set by state law;

however, the 1940 Act requires certain actions to be approved by “a majority of the outstanding voting securities.”<sup>4</sup> This standard requires that more than half of a fund’s shares are represented at the shareholder meeting and also is the threshold for proposals frequently challenged or presented by activist shareholders, such as the approval or termination of an investment advisory agreement and certain mergers. In addition, certain state statutes may require even higher voting standards for specific types of transactions.

Given the high percentage of retail shareholders and the high voting thresholds, funds need to convince a very large number of shareholders to simply vote. Funds typically have relied primarily on two expensive and arguably inefficient methods, which result in significant additional costs, to solicit shareholders after distributing their proxy statements: (1) mailing additional solicitation materials and (2) calling shareholders. However, advance consent generally is required to contact shareholders via their wireless telephone numbers, including by text. Solicitations are further complicated for contested proposals, as votes cannot be taken by phone.<sup>5</sup>

### **Alternative Methods Used by Some Issuers to Increase Shareholder Participation**

Any efforts that result in an incremental increase in shareholder voting can have a huge impact on the overall cost of the solicitation. Operating companies and funds have attempted to increase voting participation by offering charitable donations, direct financial incentives, and/or expanded communications. While it may be difficult to measure whether these actions actually led to more shareholder votes, some claim a dual benefit of increased participation rates and increased shareholder engagement.<sup>6</sup> Recent examples of these alternate approaches include:

- A business development company (BDC) posted a YouTube video in anticipation of an upcoming annual shareholder meeting (as well as filed a script of the video with the SEC) at which shareholders would be asked to approve the issuance of new shares at a discount to its then-current net asset value. In the short video, the president of the BDC advocated the reasons that shareholders should approve the proposal. According to a source, the video received over 7,000 views and resulted in thousands of investors changing their proxies to approve the proposal.<sup>7</sup>
- A large global bank made a \$1 charitable donation to Habitat for Humanity on behalf of every shareholder account that voted. The bank saw a 41 percent increase in shareholder participation year-over-year and has donated approximately \$900,000 to charity. The bank also saw an increase in pro-management votes.<sup>8</sup>
- A national bank made a charitable donation of \$1 to Junior Achievement USA for each retail shareholder account that voted online or enrolled in electronic delivery of proxy materials.
- A global financial services company instituted a Shareholder Vote Incentive Program several years ago, which offers shareholders who vote their shares the choice of an environmentally friendly tote bag or a donation to a tree-planting campaign. The company previously offered shareholders a \$5 gift card if shareholders transferred their registered shares to brokerage accounts, in order to save paper and energy. Since the inception, the company has planted more than 730,000 trees (through its partnership with American Forests) and has provided 630,000 environmentally friendly tote bags to its shareholders.<sup>9</sup>
- An investment adviser to a fund complex agreed to pay to shareholders (solely out of the adviser’s own funds) an incentive fee in the amount of 3 percent of the value of a shareholder’s shares if the shareholder votes in favor of a proposal to convert from an open-end mutual fund to a closed-end fund.<sup>10</sup>

- Certain fund complexes that offer online account access have notified shareholders when they log in to their online accounts of outstanding proxies and prompted them to go to the appropriate proxy-voting website.
- One of the largest consumer goods companies in the United States relied heavily on social media and even launched a separate Website that focused solely on the proxy battle at hand. The Website included a link to a letter from the CEO that questioned the motivations of the activist. The company also used a variety of online advertising methods to communicate with shareholders, including social media advertising (which were filed with the SEC) to draw shareholders to the website.

Using any of these types of options is challenging since there is no clear regulatory guidance. Funds that wish to implement alternative methods in an effort to increase shareholder participation should keep in mind the appropriate proxy rules and the broad definition of “solicitation.”<sup>11</sup> Advisers and fund boards should consider the costs associated with these methods and the likelihood of success, that is, increased shareholder participation, ideally at lower cost. In addition, voting incentives that involve payments to shareholders, or charitable contributions made on their behalf, may raise tax issues or additional reporting obligations. For example, with respect to charitable contributions, a determination should be made regarding whether income is received by shareholders followed by deemed charitable contributions by them. The small amount per person may limit any reporting obligation or risk to individual shareholders. Advisers and funds would need to determine whether the adviser or the fund would pay for any donations, consider any tax benefit of the donator, and evaluate the allocable tax benefit of that donation.

Pursuing creative options, such as those mentioned in this column, provides new opportunities to engage with fund shareholders and potentially

increase shareholder participation. As with anything new, these options involve some risks, which warrant a careful cost-benefit analysis. To the extent that any contributions or other incentives are paid from fund assets, an adviser and fund board would have to carefully analyze the use of fund assets, the allocation of costs among multiple funds, the potential for a joint transaction, and any potential savings in the overall proxy solicitation cost, keeping in mind the current state of regulatory guidance, the potential cost of any regulatory inquiry, the potential risk of litigation, such as a derivative lawsuit challenging the use of fund assets, and reputational issues, including due to the charity supported or type of incentive given. Until the SEC proposes new proxy rules or interpretations (and perhaps even after it does), in the right circumstances, these types of options may provide useful tools for funds to increase shareholder participation.

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#### NOTES

- <sup>1</sup> See, e.g., Letter from Paul Schott Stevens, President and CEO, Investment Company Institute (ICI), to the Vanessa Countryman, Acting Secretary, SEC (June 11, 2019), <https://www.sec.gov/comments/4-725/4725-5658296-185774.pdf>.
- <sup>2</sup> A recent survey by the ICI found that a number of fund complexes had spent more than \$1 million on proxy campaigns, and one fund complex spent more than \$100 million. See *supra* n.1. That amount exceeded the most expensive proxy contest identified by Barron's, which cost \$60 million. Vito J. Racanelli, “How to Fix a Broken Proxy Voting System,” *Barron's* (Sept. 13, 2018), <https://www.barrons.com/articles/how-to-fix-a-broken-proxy-voting-system-1536868259>.
- <sup>3</sup> Under stock exchange rules, brokers who hold shares for their clients in “street name” typically have the authority (but are not required) to vote those shares in their discretion on proposals that the exchange

deems routine (such as the uncontested election of directors for a fund or ratification of auditors) and for which the brokers have not received voting instructions from their clients. The brokers, however, are not allowed to vote on proposals determined to be “non-routine,” which include many of the proposals funds regularly submit to shareholders.

<sup>4</sup> Section 2(a)(42) of the 1940 Act defines “a majority of the outstanding voting securities” as the vote of shareholders owning the lesser of (i) 67 percent or more of the voting securities of the fund present at the meeting, if the holders of more than 50 percent of the outstanding voting securities of the fund are present or represented by proxy; or (ii) more than 50 percent of the outstanding voting securities of the fund.

<sup>5</sup> See Telephone Consumer Protection Act of 1991, 47 U.S.C. § 227.

<sup>6</sup> See *supra* ns.8–9.

<sup>7</sup> See Jason Van Steenwyk, Social Media Campaign Sways Proxy Vote at Prospect Capital, *Global Inv. Spotlight* (December 10, 2014).

<sup>8</sup> See <https://www.labrador-company.com/be-creative-when-grabbing-investors-attention/>.

<sup>9</sup> See <https://www.prudential.com/links/about/shareholder-engagement>.

<sup>10</sup> According to the proxy statement, third-party shareholders also had to (i) not revoke their proxies, (ii) hold all of their voting shares through the conversion, and (iii) be part of the minimum required vote necessary to approve both proposals. In addition, the fee would only have been paid if both proposals in the proxy statement were approved.

<sup>11</sup> Both the courts and the SEC have construed solicitations broadly to bring within the limits of the proxy rules any communication that, under the totality of relevant circumstances, is considered “part of a continuous plan ending in a solicitation and which prepare(s) the way for its success.” See Release No. 34-29315 (June 17, 1991) [56 FR 28987, 28989]. See, e.g., *Long Island Lighting Company v. Barbash*, 779 F. 2d 793 (2d Cir. 1985).

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