SEC Brings Second Case Alleging Improper Proxy Voting by an Adviser

On May 7, 2009, the SEC issued an order (Order) instituting administrative and cease-and-desist proceedings against INTECH Investment Management LLC, a registered investment adviser (INTECH), and David E. Hurley, an executive vice president and the chief operating officer of INTECH, alleging violations of Investment Advisers Act Rule 206(4)-6 (Proxy Voting Rule). This is only the second case instituted by the SEC alleging violations by an adviser in voting proxies, and it imposed relatively severe penalties—$350,000 in fines and naming an individual.

Background

The Proxy Voting Rule became effective on August 6, 2003. According to the adopting release for the Proxy Voting Rule, "[t]he 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 . . . [is] 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." In the adopting release, the SEC offered the following examples of conflicts of interest in voting 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 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." The adopting release also recognized that an adviser could rely upon a third-party service to provide it with proxy voting procedures and that cost-benefit concerns could shape how the adviser adopts and implements its proxy voting procedures. ("[S]ome advisers (including many smaller firms) are unlikely to face any material conflicts of interest, in which case their procedures could be very simple." . . . "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.")

In 2003, the SEC instituted an action against an investment adviser alleging that it should have disclosed a material conflict of interest arising from intervention by an affiliated investment bank, which was advising a party to a merger transaction, in the proxy voting decision of the investment adviser on that merger. The adviser was ordered to pay a penalty of $750,000; no individuals were named.

The INTECH Case

On very different facts, the SEC recently instituted and settled an enforcement action against INTECH. In determining how to vote the securities of clients that had delegated proxy voting authority to INTECH, the adviser relied upon the proxy voting recommendations of a third-party proxy voting service – Institutional Shareholder Services (ISS) – that offered multiple recommendation platforms. In 2002, INTECH selected an ISS recommendation platform that generally recommended votes in accordance with management recommendations. In 2003, INTECH switched to an ISS

recommendation platform that followed the voting recommendations of the AFL-CIO (PVS Guidelines). At the time INTECH switched platforms, INTECH was participating in an annual AFL-CIO survey (Survey) used by the AFL-CIO to rank investment advisers. The Order alleged that INTECH switched to the PVS Guidelines in order to improve its Survey score, which it believed would help it to obtain and retain union-affiliated clients, and because certain of its existing union-affiliated clients complained about INTECH's management-friendly voting record. The Order found that INTECH's proxy voting policies (Policies) did not address the potential conflict of interest created by following the PVS Guidelines and that INTECH did not describe the Policies sufficiently to its clients because it did not disclose such potential conflict or that the PVS Guidelines followed AFL-CIO proxy voting recommendations. The Order notes that, after the SEC staff began inquiring about INTECH's proxy voting in 2005, INTECH offered its clients the choice of opting out of the PVS Guidelines, and that approximately 27 percent of clients chose to do so.

The Order discussed an adviser's duties to its clients, noting that "an adviser must cast [its] proxy votes in a manner consistent with the best interests of its client and must not subrogate a client's interest to its own." The Order stated that the Proxy Voting Rule was "designed to prevent material conflicts of interest from affecting the manner in which advisers vote" client proxies. The Order acknowledged that the Proxy Voting Rule permits advisers to use a predetermined voting policy, such as the PVS Guidelines. The SEC's objection appears to be that, because INTECH saw some potential benefit to itself from changing its voting platform, its use of the PVS Guidelines was not "designed to further the interests of clients rather than [itself]."

In light of the Order, we believe that advisers may want to consider reviewing their disclosure to clients regarding their proxy voting policies in order to ensure that all potential conflicts of interest are identified and disclosed. We also believe that advisers may want to review their proxy voting policies to ensure that they would be comfortable justifying to the SEC staff that such policies are consistent with the best interests of all of such adviser's clients. Advisers with highly diverse client bases may want to consider whether the adoption of multiple predetermined voting policies would be necessary to allow such justification.

If you have additional questions related to the Order, please contact your usual Ropes & Gray adviser.