Davis Polk

Private Equity Regulatory Update - November 2022

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In this issue, we discuss, among other things, recently adopted rule amendments on "say-on-pay" voting disclosures by institutional investment managers and proposed new oversight requirements for certain services outsourced by investment advisers.

Rules and Regulations

SEC adopts rules to enhance proxy voting disclosure by investment funds and require disclosure of "say-on-pay" votes for institutional investment managers

The amendments to Form N-PX enhance the information investment funds report about their proxy votes. The amendments also require institutional investment managers to disclose how they voted on executive compensation, or so-called "say-on-pay" matters.

On November 2, 2022, the Securities and Exchange Commission (SEC) adopted amendments to Form N?PX to enhance the information mutual funds, exchange-traded funds (ETFs), and other registered management investment companies (collectively, registered funds) currently report annually about their proxy votes. The SEC also adopted new Rule 14Ad-1 under the Securities Exchange Act of 1934, as amended (Exchange Act) and amendments to Form N-PX requiring institutional investment managers subject to Section 13(f) of the Exchange Act (managers) to report annually on Form N-PX how they voted proxies on executive compensation, or so-called "say-on-pay" matters.

The amendments will become effective July 1, 2024. Therefore, managers and registered funds will be required to file their first reports on the amended Form N-PX by August 31, 2024, with these reports covering the period of July 1, 2023

to June 30, 2024.

Say-on-pay vote disclosure for institutional investment managers

New Rule 14Ad-1 under the Exchange Act requires institutional investment managers[1] subject to Section 13(f) of the Exchange Act[2] to report on Form N-PX each say-on-pay vote over which the manager exercised voting power. The new rule completes implementation of Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[3]

The SEC also adopted the following three amendments to Form N-PX that permit joint reporting of say-on-pay votes by managers, or by managers and registered funds, to avoid duplicative reporting:

- An amendment permitting a single manager to report say-on-pay votes in cases where multiple managers exercise voting power;
- An amendment permitting a fund to report its say-on-pay votes on behalf of a manager exercising voting power over some or all of the fund's securities; and
- An amendment permitting affiliates to file joint reports on Form N-PX notwithstanding that they do not exercise voting power over the same securities.

In all three cases, the nonreporting manager is required to file a "notice" or "combination" Form N-PX identifying each manager or fund reporting on its behalf. Further, where another manager or fund reports say-on-pay votes on a manager's behalf, the report on Form N-PX that includes the manager's votes is required to identify the manager on whose behalf the filing is made and separately identify the securities over which the nonreporting manager exercised voting power.

Managers that request confidential treatment of certain or all the positions reported on their Form 13F may request that such information also be treated as confidential on their Form N-PX. The SEC stated, however, that it believes that confidential treatment could be justified only in narrowly tailored circumstances and generally would not be merited solely in order to prevent proxy voting information from being made public.

Form N-PX amendments

The amendments to Form N-PX will:

- Require registered funds, and managers with respect to say-on-pay votes, to tie the description of each proxy voting matter to the issuer's form of proxy and to categorize each matter by type to help investors identify votes of interest and compare voting records;
- Require registered funds, managers with respect to say-on-pay votes, to disclose how their securities lending activity impacted their voting; and
- Prescribe how registered funds, and managers with respect to say-on-pay votes, organize their reports and require them to use a structured data language to make the reports easier to analyze.

Each of these amendments is described below.

Identification of proxy voting matters and categories

Currently, registered funds often use different language to describe a particular proxy proposal and do not categorize their proxy votes by type. The lack of a standardized description for each proposal can make it difficult to compare how funds voted on a particular proposal. To address this, the SEC now requires registered funds, and managers with respect to say-on-pay votes, to identify proxy voting matters reported on Form N-PX in the same order and using the same language as on the issuer's form of proxy. As modified from the proposed amendment, this requirement will only apply to proxy votes if a form of proxy, or a proxy card, in connection with a matter is subject to rule 14a-4 under the Exchange Act, which requires the form of proxy to identify each voting matter. Additionally, in cases where an SEC proxy card is not available, the amendments require that where abbreviations are used on the form, they must be used consistently, and the abbreviation must be either generally understood or used in the issuer's description of the voting matter.

The amendment also requires registered funds, and managers with respect to say-on-pay votes, to categorize each proxy voting matter reported on Form N-PX so that investors can focus on the topics they find important. The amendment differs from the proposal in that the proposed categorization has been modified to reduce the number of categories and eliminate the use of sub-categories so as to minimize confusion on how to categorize matters. The adopted standardized

categories include:

- **Director elections** (as changed from the proposal, this category is limited to elections, and other board matters are now categorized as “corporate governance”);
- **Section 14A say-on-pay votes** (no change from the proposal);
- **Audit-related** (no change from the proposal);
- **Investment company matters** (no change from the proposal);
- **Shareholder rights and defenses** (no change from the proposal);
- **Extraordinary transactions** (no change from the proposal);
- **Capital structure** (as changed from the proposal, this category encompasses the proposed category, “security issuance”);
- **Compensation** (no change from the proposal);
- **Corporate governance** (as changed from the proposal, this category encompasses board matters other than director elections and the proposed category “meeting governance”);
- **Environment or climate** (no change from the proposal);
- **Human rights or human capital/workforce** (no change from the proposal);
- **Diversity, equity, and inclusion** (no change from the proposal);
- **Other social issues** (as changed from the proposal, this category encompasses the proposed category “political activities”); and
- **Other** (no change from the proposal).

When categorizing a particular voting matter, a registered fund or manager is required to select all categories applicable to the matter.

Quantitative disclosures and securities lending

Investors currently do not have transparency into when funds do not cast votes because their securities are out on loan. To address this, the amendment requires registered funds, and managers with respect to say-on-pay votes, to disclose on Form N-PX (1) the number of shares that were voted (or, if not known, the number of shares that were instructed to be cast), (2) how those shares were voted (e.g., for or against proposal, or abstain) and (3) the number of shares that were loaned and not recalled for voting. The SEC noted that, in addition to providing context for understanding how securities lending activities affect registered fund and manager voting practices, the disclosure would allow an investor to understand the magnitude of split votes (i.e., when a registered fund or manager votes in multiple ways on the same matter).

Structured data language and standardized reporting format

Reports on Form N-PX are currently required to be filed in HTML or ASCII. The SEC now requires registered funds, and managers with respect to say-on-pay votes, to file reports on Form N-PX in an eXtensible Markup Language (XML)-based structured data language, which would make it easier to analyze the data. The amendments standardize the order of the Form N-PX disclosure requirements and require a registered fund that offers multiple series of shares to provide Form N-PX disclosure separately by series.

Website availability of fund proxy voting records

The SEC also adopted amendments to Forms N-1A, N-2, and N-3 that require registered funds to disclose that their proxy voting records are publicly available on (or through) their websites (if the registered fund has a website) and available upon request, free of charge in both cases. A registered fund can make its proxy voting record available through its website by providing a direct link on its website to its Form N-PX report on the SEC’s Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system.

SEC proposes new oversight requirements for certain services outsourced by investment advisers

On October 26, 2022, the SEC proposed new rule 206(4)-11 and rule amendments under the Investment Advisers Act of 1940, as amended (Advisers Act) that prohibit SEC-registered investment advisers from outsourcing certain services or functions to service providers and third-party recordkeepers without meeting minimum due diligence and monitoring requirements. The new requirements are designed to protect investors and ensure that the outsourcing is consistent with investment advisers' obligations to their clients.

Background

In its proposing release, the SEC noted that the complexity and variety of investment opportunities and investor demands have evolved greatly since the Advisers Act was adopted. The simultaneous demand for cost-efficiency has led many advisers to outsource certain functions to third-party service providers. The types of outsourced functions range from those that support an investment adviser's core advisory services and processes, such as portfolio management, trading and risk management and robo-advisory services, to those related to middle- and back-office functions, such as settlement services or valuation services. According to the proposing release, while strategic outsourcing could increase access to specializations, reducing hiring burdens on investment advisers, and reduce risks related to advisers offering functions they are not equipped to perform, there is risk that clients could be significantly harmed if the service providers to whom such functions are outsourced are not properly monitored and managed. The SEC noted that outsourcing has the potential to defraud, mislead or deceive clients, and could have a material negative impact on clients, for example with inaccurate pricing and performance information on which clients may rely to make decisions regarding hiring or retaining investment advisers. The SEC also noted that certain conflicts of interest may exist for service providers, such as if an index provider holds an investment that it adds to its widely followed index. The SEC takes the position, therefore, that it would be deceptive sales practice and contrary to public interest were investment advisers to outsource key functions without taking appropriate steps to ensure that the clients will have the same protections investment advisers owe them under their fiduciary duties.

Scope and application of the proposed rule and amendments

The proposed rule would apply to SEC-registered advisers that seek to outsource recordkeeping or functions (covered functions) that (1) are necessary to provide advisory services in compliance with the federal securities laws, and (2) if not performed or performed negligently, would be reasonably likely to cause a material negative impact on the adviser's clients or on the adviser's ability to provide investment advisory services. In the proposing release, the SEC noted that while the determination of what is a covered function would depend on the facts and circumstances, functions that are related to an adviser's investment decision-making process and portfolio management, such as providing investment guidelines and portfolio accounting services, as well as compliance functions, would generally meet the first element of the definition, though this would generally not include functions performed by marketers and solicitors. The SEC then noted that outsourced functions that are reasonably likely to cause a material negative impact on the client if not performed or performed negligently could include those that could cause a material financial loss or a material disruption of the adviser's operations. Clerical, ministerial, utility, and general office functions or services would be explicitly excluded from the proposed rule. The primary requirements for SEC-registered advisers introduced by the proposed rule and amendments include:

– Due diligence before retention of a service provider or third-party recordkeeper:

Prior to retaining a service provider or third-party recordkeeper to perform a covered function or recordkeeping, an advisor must perform due diligence to reasonably determine that the intended outsourcing is appropriate, considering the following factors:

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- Nature and scope of the function;
- Potential risk, risk mitigation, and risk management relating to performance of the function by the service provider or third-party recordkeeper;
- Service provider's or third-party recordkeeper's competence, capacity, and resources necessary to perform the function;
- Service provider's or third-party recordkeeper's material subcontracting arrangements related to the covered function;
- Coordination with the service provider or third-party recordkeeper for federal securities law compliance; and
- Orderly termination of the performance of the function.

– Periodic monitoring of the service provider's or third-party recordkeeper's performance

- Periodic reassessment of the selection of the service provider or third-party recordkeeper under the due diligence requirements of the rule
- Maintenance of books and records regarding service provider, and third-party recordkeeper, due diligence and monitoring performed
- Reporting on Form ADV census-type information relating to the service providers
- In the case of a third-party recordkeeper, obtaining reasonable assurances that the third-party recordkeeper will:
  - Adopt and implement internal processes and/or systems for making and/or keeping records that meet the requirements of the recordkeeping rule applicable to the books and records being maintained on behalf of the adviser;
  - Make and/or keep records that meet all of the requirements of the recordkeeping rule applicable to the adviser;
  - Provide access to electronic records; and
  - Ensure the continued availability of records if the third-party recordkeeper's relationship with the adviser or its operations cease.

Comments are due on or before December 27, 2022. The SEC proposes to require advisers registered or required to be registered to comply with the proposed rule starting ten months from the rule's effective date. If the proposed amendments are adopted, they would have a significant impact on the due diligence and monitoring obligations of SEC-registered advisers.

1 The term "institutional investment manager" includes any person, other than a natural person, investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person.

2 Section 13(f) of the Exchange Act requires an institutional investment manager to file a report with the SEC if it exercises investment discretion with respect to accounts holding certain equity securities (Section 13(f) securities) having an aggregate fair market value on the last trading day of any of the preceding 12 months of at least $100 million. Rule 13f-1 under the Exchange Act requires that institutional investment managers file quarterly reports on Form 13F if the accounts over which they exercise investment discretion hold an aggregate of more than $100 million in Section 13(f) securities.

3 Section 951 of the Dodd-Frank Act added new Section 14A to the Exchange Act. This section generally requires public companies to hold nonbinding shareholder advisory votes to: (1) approve the compensation of its named executive officers; (2) determine the frequency of such votes, with the option of every 1, 2, or 3 years; and (3) approve "golden parachute" compensation in connection with a merger or acquisition (collectively, say-on-pay votes). Section 14A(d) of the Exchange Act requires that every manager report at least annually how it voted on say-on-pay votes, unless such vote is otherwise required to be reported publicly. In 2010, the SEC proposed rules to implement Section 14A(d) of the Exchange Act that would have required managers to file their record of say-on-pay votes with the SEC annually on Form N-PX, and would have amended Form N-PX to accommodate the new manager filings. The 2010 proposal was never finalized.