INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

February 20, 2007

ICI Letter Concerning NYSE Proxy Voting Proposal, February 2007

February 20, 2007

The Honorable Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: NYSE Proxy Voting Proposal

Dear Chairman Cox:

I am writing to update you on the Investment Company Institute's position and our serious concerns about the proposal by the New York Stock Exchange ("NYSE") to eliminate discretionary broker voting for uncontested elections of investment company directors. As we discussed in our prior letter to you,[1] the proposal has enormous cost implications for investment companies ("funds") and their shareholders, implications that the NYSE simply disregarded in developing and advancing the proposal for the Commission's consideration.

The Institute has a long-standing policy of supporting strong corporate governance and believes that the benefits of the proposal may exceed its costs with respect to certain corporate issuers. At least as applied to funds, however, there are no demonstrable benefits, and certainly none that come close to offsetting its costs.[2] Because the elections that are the subject of the NYSE proposal are uncontested, the same directors, in virtually every case, will be elected whether or not funds and their shareholders bear these steep additional costs. We are aware of no fund shareholders who have voiced dissatisfaction with the current proxy voting process as it relates to the uncontested election of directors. Nor do we believe the current process entails any detrimental effects on funds or fund governance. As the old adage goes – if it ain't broke, don't fix it. This has never been more apt than it is here.

That the proposal should have been advanced so far with little or no analysis of its impact on funds is indicative of the fundamentally flawed rulemaking process that the NYSE followed, as described below. To avoid this problem in the future, we urge that the Commission by rule require that the NYSE (and all other self-regulatory organizations) perform an appropriate cost/benefit analysis prior to submitting any regulatory proposal to the Commission. Such a mandate will help to assure that future NYSE and other self-regulatory rulemakings appropriately take into account considerations of efficiency, competition, and capital formation (elements that the Commission itself by statute must entertain).

Table of Contents

Institute Efforts to Inform the NYSE of the Detrimental Impact of its Proposal

The Institute has taken numerous steps to inform the NYSE of the adverse consequences for funds and their shareholders if this proposal is adopted. Regrettably, our efforts to assert the economic interests of funds and their shareholders in this context have been met with indifference. In June 2005, the Institute wrote to the NYSE's Proxy Working Group expressing our concerns regarding the impact of the proposal on funds. These concerns related to the difficulties and unnecessary costs the proposal would cause for funds in achieving quorums and related delays in electing fund directors.3 Despite this, the Proxy Working Group Report made no mention of the effect of their recommendations on funds or fund shareholders. In July 2006, in response to the recommendation of the NYSE's Proxy Working Group that discretionary broker voting for the uncontested election of directors be eliminated,4 the Institute wrote to the NYSE staff reiterating our concerns.5 In August 2006, the NYSE staff informally advised us that, because of concerns raised by the Institute and others, the NYSE board had determined to defer taking action on the Working Group's recommendations until 2008. Despite these assurances, in October 2006, the NYSE filed the current rule proposal with the Commission that tracked the Working Group's recommendation and that did not include any provisions to alleviate or address the injurious effect of the proposal on fund shareholders. 6 Ironically, while the NYSE and the Proxy Working Group both recognized that the proposal may increase proxy solicitation costs for issuers in general, as far as we can tell, at no time did they collect or examine any cost data to measure the extent of costs that would be specifically incurred by funds and their shareholders if discretionary broker voting is eliminated.

To fill the critical information gap left by the NYSE's failure to perform any meaningful cost/benefit analysis, the Institute took it upon itself to survey its members to assess the impact of the proposal on funds and their shareholders, and prepared a research report with its findings in December 2006, 7 which we shared with the NYSE. 8 Finally, last month, we met with the NYSE staff to discuss the Institute's report and our concerns with the proposal. Despite all of these efforts, we understand that the proposal still has not been amended by the NYSE to address its adverse impact on funds.

Proposed Alternatives to Eliminating Discretionary Broker Voting

The Institute urges that the current system of discretionary broker voting be retained with respect to funds, as we are unaware of any substantial reasons for a change. There are, however, abundant reasons not to change the system in the way the NYSE proposes. As we discussed more fully in our previous letter to you, the NYSE proposal will have adverse effects on funds for several reasons. The proposal will create significant difficulties for funds in achieving quorums, and, in turn, will occasion unnecessary delays in electing fund directors. In addition, to encourage shareholders to vote their proxies, funds will be forced to adjourn meetings and/or engage in multiple solicitations, thereby significantly increasing costs to funds. The proposal also will have a disproportionate impact on funds as opposed to operating companies. Because funds have a far higher proportion of retail shareholders than most operating companies and retail shareholders are less likely than institutional investors to vote their proxies, funds will incur disproportionately greater costs from the elimination of discretionary broker voting.

In our meetings, several alternatives to eliminating discretionary broker voting also have been suggested by the NYSE staff, including adopting a proportional voting system, lowering quorum requirements, or adding the shareholder ratification of auditors to fund proxies. For the reasons discussed below, all of these alternatives have serious shortcomings and should be rejected in the absence of any compelling reason to change the current system.

Adopting a Proportional Voting System

Under a proportional voting system, uninstructed shares would be voted in the same proportion as instructed shares, with no minimum amount of instructed shares being required. Before considering whether proportional voting is a viable solution to funds' concerns and prior to finally proposing it as an alternative to the elimination of discretionary broker voting, it would seem incumbent upon the NYSE to address a variety of issues relating to the potential costs and operation of such a system.[9]

First and foremost, the NYSE should be required to conduct a comprehensive analysis of the costs that would be imposed on funds by proportional voting. Adequate time also should be provided to evaluate, and comment on, the particular proportional voting system that would be implemented. For example, the NYSE and the Commission would have to consider whether to implement such a system on an individual broker-by-broker basis, or in a way that aggregates all votes cast across all brokers. If implemented at the individual broker level, the views of active minority shareholders will have a greater effect on the outcome of the vote, particularly if their shares are held at one (or more) broker(s) with a large number of uninstructed shares. In the case of closed-end funds, dissident shareholders could manipulate voting results if a broker-by-broker proportional voting system is adopted. With respect to an aggregate system, the NYSE and the Commission would have to determine who will aggregate votes and whether that entity will vote the uninstructed shares or pass the vote back to the broker with voting instructions. For both systems, the NYSE and the Commission would have to determine whether instructed shares should be voted in proportion to all votes cast at the meeting or in proportion to instructed shares held in street name.

In addition, it would be necessary to determine whether proportional voting will be used with respect to all non-routine issues, or only for the uncontested elections of directors. If proportional voting is required for all non-routine issues, it will be important to clarify that funds can use proportional voting to obtain approval of non-routine matters that currently require a supermajority vote under the Investment Company Act.[10] It would be critical to the success of proportional voting for the brokerage community to fully support such a system as brokers may be required to take on additional responsibilities that they do not have today.[11] Finally, rules likely would have to be developed and put into place to implement those additional responsibilities.

Lowering Quorum Requirements

Lowering quorum requirements also has been raised as a possible alternative to eliminating discretionary broker voting. This proposed alternative poses significant problems as well. For example, funds would have serious difficulties in changing their quorum requirements. State law would need to be amended in some jurisdictions where funds are domiciled. Funds also would need to seek shareholder approval to amend their charters, declarations of trust, and/or by-laws to change quorum requirements. Because such an amendment would itself be a non-routine issue, the same problems created by the NYSE proposal in achieving a quorum would exist.[12] Moreover, there likely would have to be a large reduction in funds' quorum requirements to have a measurable impact on costs because of the low rate at which beneficial shareholders return their proxies. Funds might have to reduce their quorum requirements to twenty-five percent of outstanding shares or even lower to avoid re-solicitations.[13] Such a scenario seems to diminish, rather than enhance, shareholder rights. For these reasons, while reducing quorum requirements may, in theory, help decrease the number of proxy re-solicitations and the likelihood of adjournments, lowering quorum requirements should not be viewed as an acceptable solution for the problems created by the NYSE proposal.

Adding Shareholder Ratification of Auditors to the Proxy

Another proposed alternative to the elimination of discretionary broker voting that has been raised involves adding shareholder ratification of auditors to the proxy. The NYSE currently views shareholder ratification of auditors as a routine matter. Because brokers would be permitted to vote on this issue, adding it to a proxy containing the uncontested election of directors may help assure a quorum. Asking funds to take this action for the sole purpose of achieving a quorum, however, is an unacceptable way to resolve issues associated with the proposal. Funds have not been required to ratify the selection of fund auditors since 2001, when the Commission adopted Rule 32a-4 under the Investment Company Act of 1940.[14] It therefore would be illogical and inappropriate for the Commission to put funds in a position of choosing between seeking a shareholder vote on the ratification of auditors or being forced to incur the costs and difficulties associated with re-solicitations and adjournments for the uncontested election of directors. There also is no assurance that in the future the NYSE will continue to view the ratification of auditors as a routine matter, potentially putting funds in the exact same position that they are in today.[15]

* * *

For all these reasons, we urge that the Commission leave unchanged a process that for years has worked efficiently and effectively for funds and their shareholders. At a minimum, we ask that any changes to this process take into account fully and carefully the cost implications for the nation’s 94 million fund investors. We appreciate your continued consideration of, and timely attention to, this important matter. If you have any questions regarding our views or would like additional information, please contact me at 202/326-5901.

Sincerely,

Paul Schott Stevens
President

cc: The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Annette L. Nazareth
The Honorable Kathleen L. Casey

Andrew R. Donohue, Director, Division of Investment Management
Erik R. Sirri, Director, Division of Market Regulation
John W. White, Director, Division of Corporation Finance
Jonathan Sokobin, Deputy Chief Economist, Office of Economic Analysis
U.S. Securities and Exchange Commission

Catherine R. Kinney, President and Co-Chief Operating Officer
NYSE Group, Inc.

ENDNOTES

1 See Letter from Paul Schott Stevens, President, Investment Company Institute to the Honorable Christopher Cox, Chairman, U.S. Securities and Exchange Commission, dated December 18, 2006.

2 Others share this view. The Committee on Capital Markets Regulation, an independent, bipartisan committee composed of corporate and financial leaders established to set forth recommendations on ways to improve the efficiency and competitiveness of the U.S. capital markets, acknowledged the difficulties that the proposal would cause for funds. While the Committee supported the application of the NYSE proposal to corporate issuers in its interim report, the Committee stated that it believes that the application of the proposal to voting by mutual fund shareholders “should be reconsidered in light of the practicalities of such situations.” See Interim Report of the Committee on Capital Markets Regulation, November 30, 2006 (as revised December 5, 2006) at p. 128.

3 Letter from Frances M. Stadler, Deputy Senior Counsel, Investment Company Institute, to Mr. Larry Sonsini, Chairman, NYSE Proxy Working Group, dated June 3, 2005 (“June 2005 Letter”).

4 See Report and Recommendations of the Proxy Working Group to the New York Stock Exchange (June 5, 2006).

5 See Letter from Elizabeth R. Krentzman, General Counsel, Investment Company Institute to Catherine R. Kinney, President and Chief Operating Officer, NYSE Group, Inc., dated July 18, 2006 (“July 2006 Letter”).

6 See NYSE File No. SR-2006-92. As proposed, brokers will not be permitted to vote on the uncontested election of directors for any shareholder meeting held on or after January 1, 2008.

7 Costs of Eliminating Discretionary Broker Voting on Uncontested Elections of Investment Company Directors, Investment Company Institute (December 18, 2006).

8 Letter from Paul Schott Stevens, President, Investment Company Institute to Catherine R. Kinney, President and Chief Operating Officer, NYSE Group, Inc., dated December 18, 2006 and letter from Paul Schott Stevens, President, Investment Company Institute to Richard Ketchum, Chief Executive Officer, NYSE Regulation, dated December 18, 2006.

9 The Institute previously recommended proportional voting as a fallback to the NYSE's proposal to eliminate broker discretionary voting after our initial examination of the Proxy Working Group's recommendations. See July 2006 Letter and June 2005 Letter. Given the significant costs and disproportionate impact on funds of the NYSE's proposal identified in our subsequent research and the complex issues that regulators must address in connection with proportional voting, we now have serious reservations about the feasibility of this approach.

10 Under the Investment Company Act, certain matters, such as changes to fundamental investment policies, must be approved by the vote of a majority of the fund's outstanding voting securities. Section 2(a)(42) of the Investment Company Act defines "the vote of a majority of the outstanding voting securities" in a technical way. It is defined as "the vote, at the annual or special meeting of the security holders of a fund duly called (A) of 67 per centum or more of the voting securities present at such meeting, if the holders of more than 50 percentum of the outstanding securities of such fund are present or represented by proxy; or (B) of more than 50 percentum of the outstanding voting securities of the fund, whichever is less." In most cases, because fewer than 50 percent of votes are returned, funds must obtain 67 percent (or a supermajority) of all votes returned. Because broker non-votes or abstentions are counted as present for quorum purposes, they are, practically speaking, counted as a vote against the proposal. This means that a greater number of beneficial shareholder votes will be required to obtain the requisite percentage (67 percent) of the votes present needed to pass these types of proposals.

11 One approach being considered by the Proxy Working Group is to permit "client-directed voting." Under this approach, shareholders will instruct their brokers how to vote on their behalf (e.g., always vote in support of, or in opposition to, management's recommendations regarding director candidates.). We understand that brokers are apprehensive to incur any liability in connection with keeping records of shareholder preferences or to be burdened with contacting their entire customer base initially and possibly periodically thereafter.

12 The difficulties funds face achieving approval of matters requiring a supermajority vote will not be eased by lowering quorum requirements or adding shareholder ratification of auditors to the proxy.

13 The quorum necessary to avoid re-solicitations will vary among funds based on the expected voting response of their shareholders. The Institute's research shows that beneficial shareholders tend to return their proxies at a fairly low rate. With respect to half of the funds whose shareholder voting patterns were analyzed, beneficial owners voted less than 32 percent of shares held in street name.

14 Rule 32a-4 eliminates the requirement that fund shareholders ratify the selection of auditors for any fund with an audit committee composed wholly of independent directors. Fund audit committees typically consist entirely of independent directors.

15 See, e.g., Proxy Working Group Report at p.9 (finding that a number of corporate governance commentators have indicated that auditor ratification should not be a “routine” matter in today’s environment, particularly given the role of the auditor as “gatekeeper”).
