The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

December 6, 2002

ICI Comments on SEC Fund Proxy Voting Proposal, December 2002

December 6, 2002

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

RE: Proxy Voting by Investment Companies and Investment Advisers File Nos. S7-36-02 and S7-38-02

Dear Mr. Katz:

The Investment Company Institute[1] appreciates the opportunity to comment on the proposals by the Securities and Exchange Commission relating to proxy voting by investment companies and investment advisers.[2] This extensive package of proposals responds to rulemaking petitions that were filed by one mutual fund organization and by interest groups seeking information about votes cast by mutual funds.[3]

I. Introduction and Summary of Comments

As a preliminary matter, we would like to make clear one essential point: mutual funds and their advisers take, and have always taken, the responsibility to vote proxies very seriously. Advisers to mutual funds, as part of their fiduciary responsibilities, must exercise proxy voting solely in the best interests of the funds. Our experience with our members is that they fully comply with these standards, and we are aware of no evidence to the contrary.

This does not mean, however, that it is inappropriate for the SEC to undertake rulemaking in this area. SEC rules that supplement general fiduciary standards can help ensure that all funds and fund advisers have the necessary procedures in place to vote proxies and can facilitate oversight and enforcement by the Commission. Making available to fund shareholders information about the procedures for voting proxies can help those who are interested to better understand the proxy voting process.

For these reasons, the Institute supports most aspects of the Commission's proposals. We particularly support: (1) requiring investment advisers to funds to adopt written policies and procedures designed to ensure that proxies are voted in the interest of fund shareholders; (2) requiring those policies and procedures to address potential conflict of interest situations; (3) requiring funds to make disclosures to shareholders regarding their proxy voting policies and procedures; and (4) requiring advisers to funds to maintain records regarding proxy voting. If these requirements are adopted by the Commission, mutual funds and their advisers will become subject to standards with respect to proxy voting that go well beyond those applicable to any other financial institutions and intermediaries.

Unfortunately, however, the Commission's proposals do not end there. Instead, they would require mutual funds (and closed-end funds)—alone among all financial institutions and investors—to disclose publicly detailed information about each and every proxy vote they cast. They also would require funds to prepare extensive disclosures regarding any proxy votes that are "inconsistent" with the funds' policies and procedures. In so doing, the Commission would subject funds—and funds alone—to substantial new costs and burdens. And, it would do so in the absence of any evidence of need or benefit to fund shareholders.

The Fund Release suggests two reasons for imposing these unprecedented requirements upon funds. Neither, we submit, is sufficient. First, the Commission suggests that its proposals will address conflicts of interest on the part of fund advisers. But it offers no evidence of such conflicts. Nor does it explain why the body that Congress and the SEC historically have relied upon to address potential conflicts in numerous other areas—the fund's board of directors—will be somehow unable to perform this task in the case of proxy voting. Second, the Commission claims that its proposals will encourage funds to become "more engaged" in corporate governance, which will benefit "all investors." But it offers no evidence that funds are not sufficiently "engaged" now. Nor does it explain why it is appropriate to impose duties and costs upon funds—and only funds—to benefit other investors.

The Fund Release also ignores the harmful effects of the proposals to require funds to disclose publicly all of their proxy votes and to disclose "inconsistent" votes in shareholder reports. As is discussed in more detail below, the Commission's estimates regarding the costs that funds (and ultimately their shareholders) would incur in implementing these proposals are seriously understated.

Equally troubling are the more subtle—but still real—ill effects that these proposals will have on funds. For example, a growing number of investor advocates believe that keeping proxy votes confidential can be an important way to resist pressure from corporate management. Indeed, these advocates have made numerous proxy proposals in recent years to require corporations to adopt confidential voting. The Commission's proposal would deprive funds, and funds alone, of this benefit. Thus, ironically, the proposal to disclose proxy votes could actually increase conflict of interest situations for funds, rather than mitigate such conflicts.

Another unfortunate consequence of these proposals is that the process of voting proxies will become highly politicized. It is readily apparent that the authors of the rulemaking petitions underlying these proposals are not primarily motivated by a desire to seek higher returns for fund investors. Rather, they wish to pressure funds to vote in a manner that furthers their own social and political agendas—agendas that often may be inconsistent with the economic interests of fund shareholders. Although we are confident that funds and their advisers will not succumb to such pressure, they will be forced to expend resources to respond to and resist these efforts—resources that could otherwise be put to better use on behalf of fund shareholders.

Finally, disclosure of “inconsistent” votes in shareholder reports will incorrectly suggest that such votes are problematic, when in fact they, like other votes, are instances in which fund advisers are applying their judgment as to what is in the best interests of the fund and its shareholders. Consequently, this proposal is likely to encourage funds either to adopt very general proxy voting guidelines or to apply their guidelines in a rigid and mechanical fashion—neither of which would be in the interests of fund shareholders.

There is simply no evidence of any need that would justify the adoption of rules that would impose these costs and harms on funds and their shareholders. All of the Commission's objectives and all of the potential benefits to fund investors could be realized by (1) adopting the other aspects of the proposals (such as the requirement for all fund advisers to have written policies and procedures and the recordkeeping requirements) and (2) requiring fund directors to approve proxy voting policies and procedures and to oversee the implementation of those policies and procedures.

We recognize that, in the current environment, it may be difficult for the Commission to consider modifying proposals that have been touted as promoting good corporate governance, increasing transparency, and enhancing disclosure to investors. Nevertheless, we are convinced that an objective analysis will show that the proposed disclosures regarding individual proxy votes and “inconsistent” votes are not needed to accomplish these goals and would in fact be harmful to funds and their shareholders.

Our views are discussed in more detail below. We first provide some background information on how funds exercise their proxy voting responsibilities. We then comment upon the many aspects of the proposals that we support, including the requirements to adopt, and make disclosures regarding, proxy voting policies and procedures, as well as the recordkeeping requirements. Our comments on the proposals to require funds to disclose their actual proxy votes and to disclose “inconsistent” votes in their reports to shareholders follow.

II. Mutual Fund Proxy Voting Practices

Mutual funds consider the voting of proxies of companies in which they invest to be part of the investment process. Accordingly, the vast majority of proxies that funds receive are voted. The primary exception is where proxy voting is impractical or impossible, as can be the case for certain foreign equity securities in particular.[4] For example, funds may not receive proxy information for foreign securities in a timely manner. In addition, some foreign jurisdictions impose obstacles to the voting of shares, such as requiring shares to be voted in person or “shareblocking.”[5]

Our understanding is that mutual funds follow a variety of different approaches in voting proxies. Most fund groups have policies and procedures that govern how proxies are voted. In many cases, the fund’s board of directors adopts or approves these policies and procedures. In other cases, the fund relies on policies and procedures developed by the fund’s adviser. Funds that utilize subadvisers handle proxy voting responsibilities in different ways; in some cases, the primary adviser retains proxy voting responsibilities, while in other cases the subadvisers are responsible. Many fund groups rely on recommendations from outside groups, such as Institutional Shareholder Services, to vote on particular matters.

Some fund policies and procedures contain guidelines regarding how a fund will vote on certain types of matters. We understand that frequently these guidelines are flexible in the sense that they allow for exceptions on a case-by-case basis. This flexibility allows for thoughtful consideration of each proposal in keeping with the fund adviser’s fiduciary responsibilities.

Pursuant to their guidelines, or as a matter of practice, funds frequently will vote with management on many types of proposals. This is not surprising; most funds are unlikely to hold shares of a company unless they have a basic level of confidence in the company’s management. At the same time, funds do vote against management proposals in cases where they believe it is in the best interests of fund shareholders to do so.[6] Funds also use a variety of other methods to address concerns they may have with management. For example, some fund groups—particularly larger ones—work “behind the scenes” with management on issues of concern to them. In such cases, a fund’s vote with management may have been based on management’s agreement to take some other action that the fund believed was beneficial to shareholders. Fund groups also may discuss contested matters with other shareholders in order to garner support for concessions from management.

Perhaps the area where the need for judgment is greatest involves votes on significant business matters, such as mergers. These voting decisions are closely akin to the investment decisions that fund advisers must make. Obviously, as with investment decisions, different funds and fund advisers may (and do) reach different conclusions based on the particular fund’s investment objectives and on their own best assessment as to what the economic consequences on the issuer will be if the proposal is adopted.

Fund groups also employ a variety of practices designed to address any potential conflicts of interest that may arise in connection with proxy voting. For example, some fund advisers that are responsible for voting proxies report certain votes to the fund’s board of directors. Fund advisers also may use some form of internal review (e.g., by legal or compliance personnel). Others impose firewalls between themselves and affiliates that may have business relationships with portfolio companies. It also is our understanding that fund groups generally prohibit personnel who may have conflicts of interest (e.g., personnel involved in marketing 401(k) plan administration or other services to institutions) from playing any role in proxy voting.

Moreover, it is important to note that many fund advisers do not have any significant conflicts of interest in voting proxies. Some advisers, for example, do not engage in activities other than investment management, are not part of a larger organization that engages in other lines of business, and have few publicly traded clients.

III. Adoption of Proxy Voting Policies and Procedures

The Commission has proposed to require investment advisers, including advisers to investment companies, that vote proxies to adopt written policies and procedures designed to ensure that they vote proxies in the best interests of their clients. Consistent with our understanding of common practices of fund advisers, the Advisers Release notes that many advisers have adopted policies and procedures in furtherance of their fiduciary obligations.7

We agree with the Commission that proxy voting is sufficiently important to warrant requiring all funds and their advisers to meet this standard.8 Accordingly, we support this proposal, including, in particular, the requirement that these policies and procedures address how material conflicts of interest will be resolved.

We note, however, that no other regulated entities are legally required to have such policies and procedures. The Department of Labor does not require investment managers under the Employee Retirement Income Security Act of 1974 (“ERISA”) to have written policies and procedures that govern how they will vote individual proxies. The Commission does not require broker-dealers that vote proxies on behalf of their customers to have such policies and procedures. We also are unaware of any requirements for banks, insurance companies, or other financial institutions to have such policies and procedures. Thus, if the proposal is adopted, registered funds and investment advisers will be the only entities required to have such policies and procedures. Nonetheless, we believe that the benefits of such a requirement support its adoption by the Commission.

IV. Disclosure of Proxy Voting Policies and Procedures

The Commission has proposed to require funds to make available to their shareholders a description of their proxy voting policies and procedures. Investment advisers similarly would be required to disclose to their clients a description of their proxy voting policies and procedures, and to furnish a copy of their policies and procedures to clients upon request. Where the client is a fund, the disclosure would be made to the fund’s board, consistent with other disclosures required of fund advisers under the Investment Advisers Act.9

The Institute supports these proposals even though other financial intermediaries would not be subject to comparable disclosure requirements.10 If adopted, they would ensure that interested investors could obtain information about a fund’s proxy voting policies and procedures, including procedures to address any possible conflicts of interest.

In addition, the Institute agrees that the appropriate place for this disclosure is in the statement of additional information.11 It seems quite clear that most fund investors would not consider this information to be central to an investment decision. Thus, requiring the proposed disclosure in fund prospectuses would run contrary to the disclosure principles enumerated by the Commission when it simplified the fund prospectus in 1998.12 Including information about proxy voting policies and procedures in the SAI achieves an appropriate balance by making it available to shareholders who are interested without obscuring information that is essential to an investment decision.

V. Recordkeeping of Proxy Voting Materials

Under the Commission’s proposals, investment advisers would be required to keep a copy of their proxy voting policies and procedures, as well as records of all proxy statements received, proxy votes cast, communications received and documents created that were material to a voting decision, and requests from clients for proxy voting records and the adviser’s response. The records would be required to be kept for five years, the first two years in an appropriate office of the adviser.

In general, the Institute supports these recordkeeping requirements. They will facilitate the Commission’s ability to oversee the process by which advisers vote proxies. This, in turn, should make it easier for the Commission staff to discover any cases in which an adviser may have voted proxies in a manner inconsistent with its fiduciary responsibilities (e.g., due to conflicts of interest). It also will act as a deterrent to such practices. In fact, for this reason, we recommend that similar recordkeeping requirements be adopted under the Investment Company Act to cover those instances where a fund’s adviser does not have responsibility for voting the fund’s proxies.

We do, however, recommend several modifications to the proposed recordkeeping requirements.

First, we recommend that advisers not be required to keep copies of all proxy statements received. In some cases, this could require the maintenance of thousands of voluminous documents. Moreover, most proxy statements are already required to be filed with the Commission, and are available on the Commission’s EDGAR system.

Second, we recommend that advisers not be required to keep records of every request from a client for voting information. It is not clear what the purpose of such a requirement would be or what information could be gleaned from such records. We note that the Commission does not require fund advisers to retain records of requests for information in other areas.[13]

Third, we recommend that, in the case of proxy voting materials that are maintained or prepared by a third party that votes on behalf of an adviser, advisers not be required to duplicate and keep these records. We suggest that if advisers can retrieve promptly these records from a third party, the advisers be deemed to be in compliance with the recordkeeping requirements.[14]

Finally, we recommend that the Commission not require advisers to keep records of oral communications. It would be impracticable to record only those oral communications that relate to proxy voting and, consequently, advisers likely would need to memorialize (at least initially) all oral communications and then segregate records of those oral communications that relate to proxy voting. Thus, we believe that it would be enormously burdensome and costly to comply with this requirement.[15] The practical effect of such a requirement may be to discourage fund personnel from speaking with issuers on any matter, thereby discouraging the “behind-the-scenes” discussions with management referred to above. We also note that no similar recordkeeping requirement applies to other decisions by investment advisers that are equally, if not more, important to their clients (e.g., oral communications regarding whether or not to purchase, sell, or hold a security).

VI. Disclosure of Proxy Votes Cast

The Commission has proposed to require all mutual funds and closed-end funds to file on a semi-annual basis with the Commission, and thus make publicly available, a record of each matter the fund was entitled to vote upon with respect to every voting security held by the fund in its portfolio. In addition, funds would be required to furnish these records to their shareholders upon request.

The Institute strenuously opposes this proposal. It is contrary to the best interests of fund shareholders. It is not necessary to achieve any legitimate policy objective. Its costs and potential harms to funds and their shareholders outweigh any perceived benefits.

A. Disclosure of Proxy Votes Would Not Benefit Fund Shareholders

1. Information about Actual Votes Is Not Material to Mutual Fund Investors

In deciding whether to require mutual funds to disclose certain information, the Commission must consider whether the information would be material to fund investors. Indeed, just a few years ago, the Commission, with the strong support of the mutual fund industry, undertook a major overhaul of the fund prospectus in an effort to focus it on key information relevant to an investment decision.16 Disclosure of proxy votes clearly does not meet this criterion.

Our members report that they receive virtually no requests from shareholders for proxy voting information.17 Indeed, the Commission itself recognizes that there may be limited interest by investors in information about actual votes. In the Advisers Release, it states that "[m]any advisory clients may not be interested in information about votes."18 We do not understand why fund investors would be any different in this regard.

Moreover, for those investors who may view proxy voting practices as an important consideration, the Commission's proposal to require all funds to furnish disclosure regarding their proxy voting policies and procedures would ensure that they would have access to relevant information. There would be little, if any, additional benefit in also requiring disclosure of actual votes cast, as it is highly unlikely that any single proxy vote would have a material effect on an investor's return.19 In addition, the sheer volume of the disclosure that would be required would further undermine its utility to fund shareholders.20

2. The Commission's Proposal Is Not Necessary to Address Conflicts of Interest

a. There Is No Evidence of Abuses
The Commission suggests that one of the benefits of disclosure of voting records would be to discourage voting motivated by conflicts of interest. The Commission provides no evidence, however, of any fund failing to vote its proxies in the best interests of its shareholders due to a conflict of interest. This is not surprising. As noted above, fund groups employ a variety of practices to address potential conflict of interest situations and many—especially small fund groups—have no material conflicts of interest. Moreover, we note that the proposal to require investment advisers to have written policies and procedures that specifically address how material conflicts of interest are resolved is designed to address concerns with potential conflicts in the proxy voting process. The Commission offers no reason why this solution is considered to be adequate with respect to all advisory clients other than registered investment companies.

b. Fund Boards Should Police Potential Conflicts of Interest
Even if the existence of potential conflicts of interest warrants the adoption of special rules for investment companies, there is a better way to address these concerns—by relying on fund boards of directors, including independent directors. As the Commission repeatedly has stated, independent directors are the watchdogs for fund investors and their principal role is to police potential conflicts of interest.[21] Accordingly, the Commission has relied upon them to protect funds and their shareholders from potential conflicts of interest in numerous areas, such as where funds engage in permitted transactions with affiliates. Indeed, after the Commission adopted rules and rule amendments to enhance the independence and effectiveness of fund directors in early 2001,[22] the Commission and the staff indicated their intention to rely even more heavily on directors to police possible conflicts of interest. [23] We do not believe, nor has the Commission suggested, that proxy voting raises conflict of interest concerns that are greater than those in areas in which Congress or the Commission already relies on fund directors to police conflicts of interest.

As discussed above, many fund groups today rely on fund directors to oversee proxy voting and to help guard against conflicts of interest. We believe that requiring all funds to adhere to these practices would provide a more direct and effective, and less costly, means of dealing with potential conflicts than the vote disclosure approach proposed by the Commission. We therefore recommend that the Commission mandate that fund directors approve proxy voting policies and procedures, including policies and procedures for addressing potential conflicts of interest. In addition, in order to exercise their ongoing oversight responsibilities effectively, fund directors should receive reports concerning actual votes cast.

Our recommendation would, in effect, require fund advisers to provide the fund’s directors with the disclosure that, under the proposals for investment advisers, would have to be made available to other advisory clients upon request. For example, in the case of an investment adviser to a pension plan, the adviser would be required to disclose how to obtain information about individual proxy votes to the plan fiduciary. It would not be required to make this disclosure to the plan beneficiaries. We believe the same approach should be followed for investment companies—disclosure should be made to the fund’s directors. This would be consistent with the role of fund directors as representatives of the fund as a whole. It also would be consistent with comparable Department of Labor standards that require investment managers to furnish information regarding proxy voting to plan fiduciaries rather than plan beneficiaries.[24]

In addition to director oversight, the proposed recordkeeping requirements for investment advisers would help to protect against potential conflicts. If these requirements are adopted (including the additional requirement for funds we recommend), the Commission would be able to utilize its examination authority to review votes cast by fund advisers in potential conflict situations. We understand that the Commission recently has focused on, and has requested information about, proxy voting policies and records during its examinations of mutual fund complexes. We believe that as part of routine examinations, the Commission effectively could review mutual fund voting practices.

3. It Is Not Appropriate to Impose Burdens on Mutual Funds to Benefit Others

The Commission suggests in the Fund Release that another benefit of the proposal is that the disclosure would “encourage funds to be more engaged . . . which may benefit all investors and not just fund shareholders.”[25] As an initial matter, we disagree with the suggestion that funds are not sufficiently “engaged.”[26] As discussed above, mutual funds take their obligation to vote proxies very seriously and may go further at times, for example, by engaging in "behind-the-scenes" discussions with management to promote changes.[27] Furthermore, any concerns in this area would be addressed effectively by requiring funds and their advisers to have proxy voting policies and procedures and to describe them to investors, and by subjecting fund proxy voting to board oversight.[28]

Our more fundamental objection, however, is to the Commission's apparent desire to use mutual funds as an instrument to effect changes for the benefit of "all investors." The Investment Company Act requires funds to be managed in the best interests of their shareholders. As we discuss below, the Commission's proposal on disclosure of individual proxy votes will impose significant costs on funds and their shareholders. It is simply unfair to single out one class of investors—mutual funds—and force them to bear the burdens of the Commission's broader objectives.

If the Commission truly believes that it is important for institutional investors to become "more engaged" and that public disclosure of those institutions' proxy votes will achieve this end, it would seem appropriate for the Commission to require all entities over which it has jurisdiction to disclose publicly their votes. But it has not done so.[29] The companion proposal for investment advisers does not require advisers to disclose publicly their votes (unless, of course, they are acting as advisers to funds). Thus, investment advisers to pension plans will not be required to disclose their votes. Similarly, advisers to hedge funds will not be required to disclose their votes. The SEC has not proposed to require broker-dealers to disclose their votes. The Commission also has not proposed requiring issuers to disclose how each of their shareholders voted on items in their proxies. And, of course, entities outside the SEC's jurisdiction (e.g., bank trust departments, pension plans, and insurance companies) will be under no such obligation. Contrary to reports in the media, pension plans are not required to disclose to plan beneficiaries how the plan voted proxies, and the vast majority do not.[30]

The Institute is not suggesting that the SEC should expand the scope of the proposed disclosure requirement to include all entities under its jurisdiction. We believe that, for the same reasons that this proposal is inappropriate for mutual funds, it is likely inappropriate for others as well. But the Commission cannot fairly reconcile narrowly targeting its proposal to mutual funds, and mutual funds alone, with the objective of benefiting "all investors."

B. Disclosure of Votes Cast Will Harm Investors

1. The Commission Underestimates the Cost of Disclosure

Requiring funds to disclose publicly their proxy votes will result in funds and their shareholders incurring substantial and unnecessary costs. The cost-benefit analysis in the Fund Release greatly underestimates these costs.

The Commission estimates the costs of complying with the Form N-CSR proposal to be slightly less than $1,400 per fund. It arrives at this figure by estimating that the new requirements will add 20 hours annually to the time required to prepare the form and that the average hourly wage applicable will be slightly less than $70.00. External costs are estimated to be "minimal." For the entire fund industry, the total cost is estimated to be slightly over $5.1 million.

Even if the SEC's estimate is correct, it nonetheless represents a significant cost. The $5.1

million estimate is an annual cost. The Commission, as well as many commenters, has frequently analyzed the cumulative effect of annual costs for mutual funds by measuring these costs over a period of time, such as twenty years.31 Calculating the out-of-pocket cost to mutual fund investors over a twenty-year period would produce a total of $102 million.32 As described in more detail below, we estimate a much higher (and more realistic) cumulative cost to fund shareholders of approximately $839 million over twenty years. It is hard to justify imposing this level of cost on fund investors, especially in light of the lack of demonstrable offsetting benefits.

There are several reasons why we estimate a cost that is so much higher than the SEC's estimated cost. First, the Commission omits any start-up or one-time transition costs. Fund groups, however, will be forced to establish systems or make arrangements with outside vendors to capture the information in question. These costs will be greater in some cases, such as foreign holdings. Based on a survey of members conducted for the Institute by Ernst & Young LLP, we estimate such start-up costs to be, on average, approximately $3,380 per fund.33

The Commission's cost estimate also seems to assume that the costs will be similar for all funds. This is not the case. Costs will vary depending on the number of overall holdings and the number of foreign holdings, among other factors. (Proxies for the latter are far more likely to be voted manually, which will require funds to input the information into their systems. In addition, foreign proxies typically contain more proposals than those of U.S. issuers.) Moreover, funds that use more than one subadviser will have to obtain and aggregate information from those subadvisers. Thus, some funds and their shareholders will bear heavier burdens.

In addition, many fund groups rely on outside service providers to vote their proxies. These service providers often will provide funds with information about individual proxy votes in electronic form. Other fund groups, however, do not outsource their proxy voting in this manner. For these fund groups, the costs will be substantially higher. The Commission's cost-benefit analysis does not take this into account.34

Based on our survey, we estimate that, on average, a fund would incur ongoing costs of approximately $5,530 per year to comply with the proposed disclosure requirements.

There also are other costs that the SEC's analysis fails to take into account. For example, it is impossible to know whether, and to what extent, this disclosure will prompt inquiries from fund shareholders. Funds, nevertheless, will be forced to train shareholder servicing personnel to respond to any inquiries. Based on the responses to our survey, we estimate an initial average start-up cost of $1,050 per fund and an annual average cost of $3,180 per fund to manage shareholder inquiries that will result from the required disclosure in Form N-CSR.

Finally, the Commission's proposal to require funds to disclose publicly their proxy votes will result in other harms to funds and their shareholders, such as the loss of ability to vote proxies confidentially, and the costs and distractions from responding to outside pressure groups. While it is impossible to quantify these costs, they are real, and should have been factored into the SEC's analysis.35

Taking all of the above into account, we believe that a more realistic estimate of the costs that the fund industry, and hence fund shareholders, would incur under the Form N-CSR proposal would be a transition cost of $20.8 million and annual recurring costs of $40.9

million.36 (This does not include the costs from loss of confidentiality and responding to outside groups.) Over a twenty-year period, total out-of-pocket costs would be approximately $839 million.37

We note that the costs and burdens of proxy vote disclosures are not lost on the proponents of this proposal, at least when it comes to disclosing their own proxy votes. AFL-CIO investment director William Patterson recently stated that “we’re never going to get to a point where we can disclose all the votes ourselves” because of their many holdings.38

Given that the SEC could achieve most, if not all, of its intended benefits by adopting other parts of its proposals, we submit that the SEC simply cannot justify requiring funds to disclose publicly their proxies on cost-benefit grounds.

2. Funds Would Lose The Ability to Vote Confidentially

In recent years, many investor groups have endorsed confidential voting as a means to reduce potential pressure from management to vote in a particular way and thus minimize the possibility that shareholders will be subject to conflicts of interest.39 (With confidential voting, a corporation that has another business relationship with an investor will not know how that investor voted.)40 Indeed, proxy proposals mandating confidential voting practices rank among the most important corporate governance initiatives sought by investor groups and other activists. Interestingly, among the leading proponents of confidential voting are the rule petitioners.41

While confidential voting is not currently the norm, a growing number of major corporations have adopted it.42 If the Commission’s proposal is adopted, however, funds will be the only class of investors to be denied confidential voting across-the-board. This could subject them to the very pressures about which investor advocates have been concerned, such as retaliatory actions by corporate management if a fund votes against management (e.g., restricting access by portfolio managers to company personnel). Small funds that lack sufficient leverage to otherwise gain access to company personnel may be especially vulnerable to this sort of pressure. It is ironic that proposals that were intended to address conflicts of interest on the part of funds would have the effect of making unavailable to them a mechanism specifically designed to enable investors to resist pressure from the management of portfolio companies and/or other parties.43

3. Requiring Funds to Disclose Publicly Their Proxy Votes Will Politicize Proxy Voting
As discussed above, it is our experience that mutual funds today diligently exercise their proxy voting responsibilities in order to ensure that their votes are cast in a manner that is in the best interests of fund shareholders. The proxy voting process, however, inevitably will be politicized if funds are forced to disclose publicly their proxy votes, to the detriment of fund shareholders.

It is clearly the case that some of the more vocal proponents of disclosure of fund proxy votes are motivated primarily by their own social or political agendas. One does not have to disagree with those agendas in order to recognize that they frequently will be inconsistent with the objectives of many mutual funds. For example, a proposal by a fund portfolio company to make an acquisition of a foreign company may enable the portfolio company to move certain operations offshore, thereby saving labor costs and enhancing returns to shareholders. But such a proposal likely would be opposed by representatives of organized labor.44

Forcing funds to disclose publicly their proxy votes will subject them to pressure from these outside groups. This will inevitably lead to distractions (e.g., responding to picketing), which will detract from a fund's ability to concentrate on the management of its portfolio.[45] It also may subject funds to new conflicts of interest. For example, some groups may threaten to encourage their members and others to pull their investments out of a fund complex unless the funds' adviser votes in a certain way. If the fund feels that voting in the way recommended by the group is not in the best interests of its shareholders, the fund will be placed in a conflict situation.[46] While we are confident that fund advisers will, consistent with their fiduciary duties, be able to resist these pressures, it seems incongruous for the Commission to propose a rule that will likely increase, rather than decrease, funds' exposure to conflicts of interest in the proxy voting process.

The Investment Company Act was enacted, in large part, because of concerns that funds were being managed not in the best interests of their shareholders, but to serve the interests of others, such as fund managers. For over sixty years, the SEC has administered the Act in order to ensure that the interests of fund shareholders are paramount. We submit that it would be inconsistent with this philosophy, and unfair to fund shareholders, for the Commission not to resist proposals that could result in funds being used to serve the interests of outside groups.

VII. Disclosure of Votes Inconsistent with a Fund's Policies and Procedures

The Commission also has proposed to require funds to disclose in their shareholder reports any votes that are "inconsistent" with the fund's policies and procedures. The Institute strongly opposes this proposal. We do not believe that the disclosure would be of any benefit to fund shareholders; it is more likely to be confusing than enlightening. It also is not necessary to address conflicts of interest. The effects of the proposal will only be harmful; in order to comply, funds will either have to assume heavy costs or "dumb down" their proxy voting policies, which would be inconsistent with the Commission's overriding objective.

A. Disclosure of "Inconsistent" Votes Would Not Benefit Fund Shareholders

The proposed shareholder report disclosure requirement would not provide useful information to fund shareholders. As is discussed above, many fund proxy voting guidelines are not as rigid as the Commission seems to assume they are. Fund advisers may generally vote a certain way on a specified type of proposal, but reserve the right to vote differently in particular cases. For example, a fund adviser may generally vote against poison pills, but reserve the ability to vote for such a proposal in a particular case, such as where it would provide a portfolio company with a degree of flexibility in evaluating a takeover bid without imposing an insurmountable barrier to potential acquirers. Reserving the right to exercise this type of judgment is presumably what one would expect of an investment professional subject to fiduciary standards. It would appear, however, that, under the Commission's proposal, funds would be required to identify these types of votes as "inconsistent" and thus subject to the proposed disclosure requirement.

Such disclosure is only apt to be confusing to fund shareholders, as it will inevitably suggest that these types of "exception" votes are somehow problematic. This concern will be addressed only partially through the explanatory language that funds will be forced to include.[47] Moreover, the lengthy disclosures that would result will run counter to the Commission's goal of improving the readability of shareholder reports,[48] as disclosure about proxy voting would assume a completely disproportionate role in the context of shareholder reports. Funds (correctly) are not required to provide in their shareholder reports an explanation of specific investment decisions, even though such decisions likely would have a greater impact on shareholders than individual proxy votes.

The Fund Release suggests that a primary purpose of the proposed shareholder report disclosure is to discourage voting motivated by potential conflicts of interest. The Release states that votes of proxies in a manner inconsistent with a fund's policies and procedures indicate a "heightened risk . . . that a conflict of interest may be present."[49] As the example set forth above indicates, however, such votes can occur for many reasons that do not raise any conflict of interest concerns and are instead motivated solely by what is in the best interests of fund shareholders. Moreover, as discussed above, the Commission can address any concerns over conflicts of interest by adopting specific board oversight requirements and conducting compliance inspections and examinations.

B. Disclosure of "Inconsistent" Votes Would Harm Fund Shareholders

While providing no discernible benefits to fund shareholders, the Commission's proposed shareholder report disclosure would result in substantial costs and/or other harmful effects. The potentially lengthy explanations the Commission's proposal would entail will require analysis, drafting and review by legal and other professionals, as well as consultation with the persons who made the determination to vote the proxy. In addition, proxy proposals inevitably will arise that do not fall squarely within a stated policy or guideline. These too will require analysis and review, presumably by senior legal or compliance personnel. Printing and mailing costs also would rise because of the increased length of the shareholder reports. Moreover, if the Commission includes this disclosure as part of the Form N-CSR, it may be subject to CEO and CFO certification, which will add another layer of significant costs.[50] Based on our survey, we estimate that the cost of complying with the shareholder report disclosure requirements would be approximately $3,250 per fund per year, for an industry aggregate of $15.2 million.[51] Over a twenty-year period, total out-of-pocket costs would be over $300 million.[52]

It is likely that many funds will seek to avoid these costs (as well as the unwarranted negative implications of disclosing "inconsistent" votes). There are two ways in which funds could do so. First, they could adopt very general guidelines. This, however, would defeat the purpose of requiring funds to disclose their guidelines in the first place. Alternatively, they could adopt very rigid guidelines, and remove most or all elements of judgment from the process of voting proxies. It is hard to see how fund shareholders would benefit, however, from denying them the ability to rely on the judgment of the firm they have chosen to manage their investments in voting proxies. Either approach would result in a "dumbing down" of proxy voting policies and procedures, to the detriment of fund investors.

For all of these reasons, we strongly urge the Commission not to adopt this aspect of its proposals. [53]

VIII. Conclusion

The Commission's proposals on proxy voting contain many positive elements, and we strongly support them. We believe that the Commission's overall objectives could be fully achieved by (1) adopting the beneficial aspects of the proposals and (2) requiring fund directors to approve proxy voting policies and procedures and to oversee the implementation of those policies and procedures. Together, these steps would help ensure that proxies continue to be voted in the best interests of fund shareholders.

At the same time, we believe that the proposals to require public disclosure of actual votes cast and disclosure of “inconsistent” votes in fund shareholder reports would not provide any additional material benefits to fund shareholders. Instead, their effects will likely be harmful to shareholders in several ways. Accordingly, we urge the Commission not to adopt these aspects of the proposals.

At a minimum, we would recommend that the Commission proceed by adopting the remainder of the proposals (as well as rules implementing our suggestions on the role of fund directors) and thereafter undertaking a study of proxy voting practices by funds under these new rules before adopting requirements to disclose actual votes cast and “inconsistent” votes. This deliberative approach would achieve the Commission’s overall goals without unnecessarily burdening, or inadvertently harming, funds and their shareholders.

Questions regarding our comments or requests for additional information should be directed to the undersigned at (202) 326-5815, Amy Lancellotta at (202) 326-5824, or Jennifer Choi at (202) 326-5810.

Sincerely,

Craig S. Tyle
General Counsel

cc: The Honorable Harvey L. Pitt
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid

Paul F. Roye
Director, Division of Investment Management

ENDNOTES

1 The Investment Company Institute is the national association of the investment company industry. Its membership includes 8,955 open-end investment companies (“mutual funds”), 533 closed-end investment companies, and six sponsors of unit investment trusts. Its mutual fund members have assets of about $6.216 trillion, accounting for approximately 95 percent of total industry assets, and over 90.2 million individual shareholders.

2 Investment Company Act Release No. 25739 (Sept. 20, 2002), 67 Fed. Reg. 60828 (Sept. 26, 2002) (“Fund Release”); Investment Advisers Act Release No. 2059 (Sept. 20, 2002), 67 Fed. Reg. 60841 (Sept. 26, 2002) (“Advisers Release”).

3 Rulemaking Petition by Domini Social Investments, LLC (Nov. 27, 2001); Rulemaking Petition by the International Brotherhood of Teamsters (Jan. 18, 2001); Rulemaking Petition by the American Federation of Labor and Congress of Industrial Organizations (Dec. 20, 2000 and July 30, 2002).

4 The Commission recognizes that, "[t]here may be good reasons for an adviser to refrain from voting a proxy where, for example, the cost of voting the proxy exceeds the expected benefit." Advisers Release, supra note 2, at 60842, n.7.

5 The practice of "shareblocking" requires investors either not to exercise their voting rights or to surrender the right to dispose of their shares for a defined period of time.

The Institute has been at the forefront of efforts to combat restrictions and impediments on the rights of mutual funds to vote shares overseas. In 2000, we published a study of corporate governance rules and practices in eleven jurisdictions around the world to provide a better understanding of shareholder rights issues that mutual funds face internationally. See Investment Company Institute, Global Corporate Governance Issues for Mutual Funds (2000), at http://www.ici.org/pdf/rpt_corp_gov.pdf.

6 For example, many funds' proxy voting policies provide that the funds will vote against proposals that, in their judgment, would result in excessive management compensation.

7 Advisers Release, supra note 2, at 60842.

8 Although the Commission's proposals do not require specifically that funds adopt proxy voting policies and procedures (and require only the disclosure of such policies and procedures), we presume that funds that do not rely on their advisers' proxy voting policies and procedures would have their own.

9 As a matter of practice, fund advisers provide disclosures to a fund's board of directors to satisfy requirements to make other disclosures to their fund clients. See, e.g., Section 206(3) of the Advisers Act (requiring disclosure to clients regarding principal transactions); Rule 206(3)-2 under the Advisers Act (requiring disclosure to clients regarding agency cross transactions).

10 The Institute agrees with the Commission's decision not to apply the proposed requirements to disclose proxy voting policies and procedures and proxy voting records to unit investment trusts. Due to the static nature of UIT portfolios, the disclosure requirements applicable to UITs do not contemplate the need to provide unitholders with updated information (except to the extent a UIT's sponsor voluntarily maintains a secondary market in trust units). Thus, as the Fund Release recognizes, none of the existing required UIT disclosure documents (i.e., prospectuses and annual reports on Form N-SAR) are particularly well-suited to the purpose of periodically disclosing information about a UIT's proxy voting policies and procedures to unitholders. For example, if UITs were required to provide such disclosure in their prospectuses, the information would not be updated except for those UITs for which there is a secondary market. Alternatively, if the disclosure were included in Form N-SAR, it would be unlikely that unitholders would access the information. Moreover, although some UIT sponsors maintain websites, this is not required (nor should it be) and, in any event, disclosure on the sponsor's website would not provide an ideal solution for various reasons (e.g., a sponsor may leave the business of sponsoring UITs, with its existing UITs continuing to operate under the trustee's supervision). The numerous logistical issues presented lead us to conclude that the benefits of requiring the disclosure from UITs would not outweigh the associated costs.

11 We also agree with the Commission that closed-end funds should be required to include disclosures about their proxy voting policies and procedures annually on Form N-CSR because these funds are not required to file amendments to their registration statements

(including their SAIs). We urge the Commission not to require certification, however, of this disclosure. We continue to believe that only financial information included in proposed Form N-CSR should be required to be certified and that it is inappropriate and beyond the intent of the Sarbanes-Oxley Act to require investment companies to certify non-financial information. See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated Oct. 16, 2002 (commenting on the Commission's proposal to require certification of management investment company shareholder reports).

12 See Investment Company Act Release No. 23064 (Mar. 13, 1998), 63 Fed. Reg. 13916 (Mar. 23, 1998). Such principles include the following: "A fund's prospectus principally should include essential information about the fundamental characteristics of, and risks of investing in, the fund. . . . Funds should limit disclosure in prospectuses generally to information that is necessary for an average or typical investor to make an investment decision." 63 Fed. Reg. at 13919.

13 See, e.g., Item 1(b)(1) of Form N-1A (SAI and shareholder reports must be made available upon request but records of such requests are not required to be kept).

14 Cf. Letter from Barry E. Simmons, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated Apr. 19, 2001 (commenting on proposed rule amendments to permit electronic recordkeeping by investment companies and investment advisers). The Institute's letter noted that Rule 31a-3 under the Investment Company Act specifically contemplates that required fund records may be prepared or maintained by a third party and recommended that the Commission amend the recordkeeping rules for investment advisers to give specific recognition to similar types of arrangements. See also First Call Corp., SEC No-Action Letter (Sept. 6, 1995) (records maintained by a computerized on-line service (rather than the adviser) would satisfy the requirements of Rule 204-2(a)(7) under the Advisers Act if arrangements between the service and the adviser ensured that the adviser and the SEC staff could obtain access to the records on a timely basis).

15 Based on a survey of member complexes (see infra note 33), we estimate that the industry would incur costs of approximately $4,600 per fund annually to comply with this recordkeeping requirement.

16 See supra note 12 and accompanying text.

17 In a campaign to pressure the Commission to adopt these disclosure requirements, several groups have formed a website encouraging individuals to email to the Commission form letters in support of the proposals. The website does not attempt to inform investors of the potential costs (or the harm) in making this information public. We believe many investors who submitted comments supporting the proposals to the Commission would reevaluate this position if they were informed accurately of the potential harm and cost to mutual funds and their shareholders. Indeed, this is borne out by recent events; shareholders in TIAA-CREF's College Retirement Equities Fund recently voted against a shareholder proposal to require the fund to report to participants how it voted its proxies on shareholder resolutions involving social and environmental issues and how it has integrated those issues into its investment decisions and dealings with portfolio companies. Even though TIAA-CREF investors are generally regarded as being more "activist" than typical mutual fund shareholders, the proposal was overwhelmingly rejected. (Shareholders voted 76.45 percent against and 18.77 percent in favor of the proposal with 4.78 percent

abstaining.) See Arden Dale, TIAA-Cref Participants Reject Proxy Disclosure Measure, Dow Jones News Service, Nov. 7, 2002; College Retirement Equities Fund Proxy Statement for Annual Meeting To Be Held on November 7, 2002.

18 Advisers Release, supra note 2, at 60844.

19 The chances that a particular fund's vote would change the outcome of a proxy contest will be small in most cases. (This is especially so in the case of funds with relatively small holdings in an issuer.) Consequently, it is highly unlikely that any individual fund's vote will have an effect on the economic prospects of a portfolio company. And, to the extent it does, any impact on the fund's performance will be lessened if the company is only a single holding in a diversified mutual fund.

20 A fund with many holdings, such as an index fund, may have to disclose detailed information about thousands of individual votes.

21 See, e.g., Investment Company Act Release No. 24082 (Oct. 14, 1999), 64 Fed. Reg. 59826, 59828 (Nov. 3, 1999) (". . . independent directors play an important role in representing and guarding the interests of investors. As has been stated many times, Congress intended these directors to be the 'independent watchdogs' for investors and to 'supply an independent check on management.'") (Citations omitted.)

22 Investment Company Act Release No. 24816 (Jan. 2, 2001), 66 Fed. Reg. 3734 (Jan. 16, 2001).

23 See, e.g., Investment Company Act Release No. 25259 (Nov. 8, 2001), 66 Fed. Reg. 57602, 57604 (Nov. 15, 2001) (noting that the adoption of rules and rule amendments to enhance the independence of fund directors gave the Commission "greater confidence in proposing the amendments [to rule 17a-8] that independent directors will be in a position . . . to prevent abuses."); remarks of Paul Roye, Director, Division of Investment Management, SEC, at the ICI 2001 Mutual Funds and Investment Management Conference (Mar. 19, 2001) (stating that, "As we work to keep pace and modernize the regulatory structure to accommodate the increased competitiveness and globalization of the fund industry, we will need to increasingly rely on fund directors to vigorously perform their 'watchdog' duties on behalf of fund shareholders.").

24 An investment manager of ERISA assets is obligated to keep records of its proxy votes exercised on behalf of the plan to enable the named fiduciary of the plan to review periodically the actions taken. The investment manager is not required to disclose its proxy votes to the plan beneficiaries or otherwise make this information public. According to the Department of Labor, under ERISA, a named fiduciary that delegates the management of ERISA assets to an investment manager must periodically monitor the activities of the investment manager, including decisions made and actions taken by the investment manager with regard to proxy voting decisions. In order for the named fiduciary to be able to carry out its monitoring responsibilities, the proxy voting records must be maintained by the investment manager and the proxy voting records must enable the named fiduciary to review not only the investment manager's voting procedure with respect to plan-owned stock but also to review the actions taken in individual proxy voting situations. See Department of Labor, Interpretive Bulletin 94-2, 29 CFR 2509.94-2. See also Advisers Release, supra note 2, at 60845.

25 Fund Release, supra note 2, at 60830.

26 The mutual fund industry has consistently sought to achieve corporate governance reforms that would enhance the ability of mutual funds to exercise their rights as shareholders. For example, the Institute has supported requiring shareholder approval of stock option plans. See Letter from Dorothy M. Donohue, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated Nov. 1, 2002. The Institute also supported several of the recommendations made by the New York Stock Exchange's Corporate Accountability and Listing Standards Committee Report to improve corporate governance and listing standards. See Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to James L. Cochrane, Senior Vice President, NYSE, dated July 19, 2002. Even those advocating more disclosure about mutual fund voting recognize the role mutual funds have played in corporate governance. "This story of mutual fund passivity, although perhaps once valid, is changing. In the last several years, mutual funds have become important participants in U.S. corporate governance." Alan R. Palmiter, Mutual Fund Voting of Portfolio Shares: Why Not Disclose?, 23 Cardozo L. Rev. 1419, 1435 (2002).

27 Of course, the costs and benefits of a contemplated action must be considered before a fund engages in such activity. In the Advisers Release, the Commission notes that, "[a]s a practical matter, advisers will determine whether to engage in such activism based on a cost-benefit analysis of the considered activism." Advisers Release, supra note 2, at 60842 n.8.

28 It also should be noted that it is far from clear that increased activism on the part of shareholders necessarily will lead to an increase in the value of issuer securities. See Roberta Romano, Less Is More: Making Institutional Activism a Valuable Mechanism of Corporate Governance, 18 Yale J. on Reg. 174, 177 (2001); Diane Del Guercio and Jennifer Hawkins, The Motivation and Impact of Fund Activism, 52 J. Fin. Econ. 293, 295 (1999).

29 In July 1978, the SEC proposed Rule 14a-3(b)(11) under the Securities Exchange Act of 1934, which would have required certain institutions to disclose their proxy voting policies and procedures as well as certain information about actual proxy votes (although not every actual vote). The Commission subsequently withdrew the proposal, in part, in response to concerns that it would have applied to only some institutional investors and not others, such as banks and pension plans. See Securities Exchange Act Release No. 15385 (Dec. 6, 1978), 43 Fed. Reg. 58533 (Dec. 14, 1978).

30 The California Public Employees' Retirement System ("CalPERS"), in fact, routinely discloses on a voluntary basis only a fraction of its total proxy votes. For the 2000 proxy voting season, for example, CalPERS reports that it discloses about 11 percent of its votes. (It voted proxies for 1,950 domestic companies and 684 international companies, and it discloses votes cast in its top 300 equity holdings).

31 See, e.g., Securities and Exchange Commission, Mutual Fund Investing: Look at More Than a Fund's Past Performance, at http://www.sec.gov/investor/pubs/mfperform.htm (illustration of the effect of a 1percent difference in fund expenses on an investor's cumulative return over a twenty-year period).

32 The $102 million figure is understated, as it makes no allowance for increases in costs due to inflation, nor does it incorporate an estimate of foregone earnings (i.e., the cumulative loss in investment returns that investors would otherwise have gained if the $5.1 million annual cost had been invested in equity securities). The foregone earnings that would result from the costs estimated by the SEC over a twenty-year period (assuming a 5

percent annual return) total an additional $67 million, resulting in a total cost of $169 million. These calculations use the standard formula for computing the future value of a series of annual investments. See Frank J. Fabozzi, A Review of the Time Value of Money, in The Handbook of Fixed-Income Securities, 34-36 (Frank J. Fabozzi & T. Dessa Fabozzi eds., 1995). This methodology is similar to the SEC's mutual fund cost calculator, which reflects, in addition to out-of-pocket costs, an estimate of foregone earnings as a result of fund expenses. See http://www.sec.gov/investor/tools/mfcc/mfcc-int.htm.

33 The Ernst & Young LLP survey was conducted in November 2002. Ernst & Young LLP interviewed eight fund complexes, ranging from relatively small complexes to very large ones. Despite the limited sample, we believe it offers a far more reasonable estimate of costs than that contained in the Fund Release.

34 It is true that these fund groups could likewise enter into arrangements with outside service providers. We submit, however, that it is not appropriate for the Commission to, in essence, require this by regulatory fiat. Moreover, the Commission's cost-benefit analysis ignores the fact that fund groups that do enter into these arrangements as a result of the proposed requirements will incur additional costs.

35 To the extent that funds decide to outsource proxy voting as a result of the Commission's proposal, another indirect cost may be that those firms that funds retain to give recommendations on proxy votes will themselves become subject to greater pressure from corporate management and outside groups as their market share and influence increases.

36 ICI data indicate that there were approximately 4,700 funds holding equity securities on June 30, 2002. Consequently, these estimates are based upon 4,700 mutual funds. (The SEC's cost estimate, in contrast, assumed that only 3,700 funds would be subject to the new requirements.)

37 This estimate assumes that the start-up cost is incurred in the first year and the annual recurrent cost is incurred in the first year and the subsequent 19 years. No adjustment is made to the recurrent cost for inflation. If foregone earnings ($566 million) are included, the total cost to fund shareholders over a twenty-year period would be approximately $1.4 billion, assuming a 5 percent annual return.

38 Judith Burns, SEC Votes to Seek Comment on Mutual-Fund Proxy Disclosure, Dow Jones Business News, Sept. 19, 2002.

39 See Corporate Governance Policies, Council of Institutional Investors, at http://www.cii.org (Core Policy #1 provides in part that "[c]onfidentiality should be automatic and permanent and should apply to all ballot items.")

40 See IRRC Corporate Governance Service 2002 Background Report F: Voting Issues: Confidential and Cumulative Voting, January 2002. Confidential voting "can be especially important for professional money managers who may have business relationships that may be jeopardized by their voting positions." Council of Institutional Investors Shareholder Proposal: Confidential Voting, Supporting Statement (http://www.cii.org visited on Oct. 10, 2002).

41 According to a recent study by the Investor Responsibility Research Center, unions have been one of the two main groups that continually submit shareholder proposals for

confidential voting since the late 1990s. IRRC Corporate Governance Service 2002 Background Report F: Voting Issues: Confidential and Cumulative Voting, January 2002. It is unfortunate that, although unions believe confidential voting is important to alleviate pressure on shareholders from management to vote a certain way, they apparently do not believe this right should be available to mutual funds and their investment advisers.

42 One of our members estimates that approximately 25-30 percent of those corporations that comprise the Standard & Poor's 500 have adopted confidential voting.

43 Eliminating the ability to vote confidentially also could have other unfortunate consequences. For example, to encourage companies to change a management policy, some funds may wish to threaten that they will go public with their disagreement with management on a certain matter. The Commission's proposals, which would force all votes of mutual funds to be made public, would eliminate this method of persuasion.

44 Of course, a fund may legitimately adopt investment policies that take into account various criteria, such as labor or environmental policies, in making its investment decisions.

45 The AFL-CIO had threatened to picket the offices of one of our members because of a vote cast in favor of a proposal that the AFL-CIO opposed. If such a threat had materialized, the fund group likely would have had to implement a number of measures in response including, for example, hiring public relations specialists to deal with the negative publicity that these outside groups might have generated as well as hiring extra personnel to provide additional security for the fund complex. Moreover, senior management would have needed to devote significant amounts of its time to deal with this type of situation.

46 Some may claim that this would not be a conflict situation because fund investors also have their own views on social and political matters and funds should take these views into account in managing their portfolios. This represents a fundamental misconception of what a mutual fund is. Mutual funds are not investment clubs, where investment decisions (or decisions on proxy voting) are made by polling the club's members. Instead, fund investors select a fund based on the fund's stated objectives and policies, among other criteria. It would clearly be unfair to many fund shareholders if a fund was pressured by other shareholders to take into account, after the fact, social or political criteria that were not part of the fund's investment objectives and policies.

47 As is discussed below, many funds will likely attempt to avoid this result by changing their proxy voting policies in such a manner that will minimize or eliminate the occurrence of votes that could be deemed to be "inconsistent."

48 See Remarks of Harvey L. Pitt, Chairman, SEC, at the ICI 2002 General Membership Meeting (May 24, 2002) (stating that the Commission wants to improve shareholder reports by focusing on "making disclosure more understandable and accessible to investors."); remarks of Paul Roye, Director, Division of Investment Management, SEC, at the ICI 2001 Mutual Funds and Investment Management Conference (Mar. 19, 2001) (stating that the "goal [of improving shareholder reports] is to provide information to investors that they desire, when they need it, while avoiding information overload.").

49 Fund Release, supra note 2, at 60832.

50 The Commission has the authority to require funds to include non-financial information in shareholder reports pursuant to Section 30(f) of the Investment Company Act. Section

30(c) of the Investment Company Act specifically directs the Commission in exercising its authority under Section 30(f) to seek to avoid unnecessary reporting by, and minimize the compliance burdens on, registered investment companies and their affiliated persons. 15 U.S.C. § 80a-29(c).

51 This figure was based on cost estimates from three large and two medium-size fund complexes. The other three fund complexes included in the survey did not believe they would have inconsistent votes that would need to be disclosed.

52 Employing the same methodology described above in note 32, foregone earnings resulting from these costs over the twenty-year period (assuming a 5 percent annual return) would be about $200 million. Combined with the out-of-pocket costs, the total costs to fund shareholders would be over $500 million.

53 The Commission requests comment on whether funds should be required to include in shareholder reports votes on contested matters, management compensation issues, director elections, or any other items. As with inconsistent votes, we believe that this information would not be useful to and in fact might confuse fund shareholders. Moreover, this type of information, along with the disclosure of inconsistent votes, would further overwhelm and, thus detract from, other more important information in shareholder reports.