

December 8, 2002

BY ELECTRONIC AND U.S. MAIL

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

Re: File No. S7-36-02

Dear Mr. Katz:

Fund Democracy¹ welcomes this opportunity to provide further comments on the Securities and Exchange Commission's proposal to require registered investment companies ("mutual funds" or "funds") to disclose their proxy-voting policies and records ("proxy-voting disclosure").

In its first comment letter, dated October 21, 2002, Fund Democracy expressed its support for the proposal and strongly recommended that the Commission amend the proposal to require more useable disclosure of proxy voting information and full disclosure of fund managers' conflicts of interest. In this letter, Fund Democracy responds to the principal arguments against the rule made by the Investment Company Instituted in its letter dated December 6, 2002.

ICI Argument #1: Proxy Voting Disclosure Will Set a Higher Standard for Funds

In a variety of respects, the ICI complains that the proposed proxy voting disclosure requirements are unfair because they do not apply to all proxy votes. The most obvious defect in this argument is its assumption that mutual fund rules should aspire to the lowest common denominator. The fact that the Department of Labor has failed to require the disclosure of proxy votes, for example, is not by itself a reason to oppose such disclosure. Under the ICI's reasoning, the Commission should not require mutual funds to comply with a wide range of rules that the Department of Labor has not adopted, such as the fee table and standardized performance reporting.

¹ Fund Democracy, a nonprofit membership organization, provides a voice for mutual fund shareholders by publishing articles that target mutual fund practices, policies and rules that are harmful to fund shareholders and by lobbying legislators and regulators on mutual fund reform issues. Fund Democracy also has led a number of legal challenges to practices that harm shareholders' interests. Fund Democracy was founded in 2000 by Mercer Bullard, a law professor at the University of Mississippi and a former Assistant Chief Counsel at the Commission.

The ICI also ignores a fundamental difference between mutual funds and other entities regulated by the SEC that vote proxies on behalf of the beneficial owners of the securities held by these entities. Advisory and brokerage clients can negotiate the terms of the financial services they receive. Mutual fund shareholders cannot. The degree of collective action that would be required of shareholders to force their funds to disclose their proxy votes is prohibitively expensive and impracticable. For this reason, federal law imposes dozens of requirements on mutual funds that shareholders could not be expected to privately negotiate, including daily pricing and redemption, standardized fee calculation and disclosure, prophylactic affiliated transaction prohibitions, and standardized performance reporting and advertising. These requirements do not apply in other contexts where they can be and are privately negotiated between financial services providers and their clients.

Indeed, the most fundamental principle of federal securities regulation is that the public offering of securities necessitates public disclosure of material information. That the ICI misunderstands this principle is evidenced by its analogy to the SEC's failure to require "issuers to disclose how each of their shareholders voted on items in their proxies." ICI Part VI.A.3. The difference here is that direct holders of securities *know* how their proxies are voted because these holders vote the proxies themselves. Mutual fund shareholders do not know how their proxies are voted because the mutual fund industry will not reveal this information to them.

ICI Argument #2: Disclosure Will "Politicize" the Proxy Voting Process

Fund Democracy agrees with the ICI's contention that disclosing proxy votes will expose funds' votes to the dynamics of corporate democracy. Shareholders have the right to vote proxies for a reason: corporate democracy ensures that companies are held accountable to their ultimate owners. The ICI denigrates the value of corporate democracy, however, by pejoratively describing shareholders' interest in how funds vote proxies as a "politicization" of the corporate democratic process and arguing that funds' votes will be influenced by "outside groups" to the detriment of fund shareholders.

As the ICI knows, however, fund managers are prohibited from considering the interests of any parties (including "outside groups") other than fund shareholders when voting proxies. As stated by the ICI, "fund advisers will, consistent with their fiduciary duties, be able to resist these pressures" from outside groups. ICI Part VI.B.3.

The ICI's real concern is not that outside groups will directly pressure fund managers, but that they "may threaten to encourage *their members and others* to pull their investments out of a fund complex unless the funds' adviser votes a certain way." ICI Part VI.B.3, emphasis added. Fund Democracy agrees that outside groups will do precisely that, as well they should.

Much to the dismay of the fund industry, fund shareholders actually have complex interests. They represent the full panoply of Americans' social and political views. This is why they have invested over \$2 trillion in socially screened portfolios.²

In recognition of the diversity of shareholders' views and the importance of fundamental principles of democracy and free speech, proxy rules are designed to encourage and protect the kind of communication that the ICI disparages as "threatening." The First Amendment is intended to protect precisely the kind of picketing engaged in by the AFL-CIO and about which the ICI complains, just as it protects the fund industry's use of "public relations specialists to deal with the negative publicity" generated by the picketing. ICI Part VI.B.3.

The ICI complains that "[m]utual funds are not investment clubs, where investment decisions (or decisions on proxy voting) are made by polling the club's members." ICI Footnote 46. But the SEC has not proposed that fund shareholders be polled regarding every proxy vote made by their funds; it has merely proposed that funds disclose how they voted. Only through such disclosure can fund shareholders – who also may be union members, Republicans, anti-abortion activists, and members of many different social and political groups – take into account funds' proxy votes when making their investment decisions.

The ICI argues that it would be unfair to other shareholders if some shareholders "pressured" a fund to vote a certain way. Yet elsewhere in its letter the ICI applauds fund groups that "work 'behind the scenes' with management on issues of concern to them" and "discuss contested matters with other shareholders in order to garner support for concessions from management." ICI Part II. Is this also "unfair" to other shareholders of such portfolio companies? Shareholder activism not only is fair, it is integral to the success of corporate democracy and essential to the health of our financial markets.

The ICI argues that if shareholders knew how their funds were voting proxies, they might sell their shares or use the tools of corporate democracy to influence how their funds voted. The ICI's solution to this "threat" is to keep shareholders in the dark about funds' votes. This position facially contradicts the most basic principles of corporate democracy and should be rejected by the Commission.

ICI Argument #3: Conflicts of Interest Do Not Harm Investors

The ICI argues that there is no evidence the funds have ever voted proxies against the best interests of their shareholders. First, the argument that no fund has ever voted in favor of management in part to retain or obtain investment banking, 401(k) or other business defies common sense. The argument that the fund industry is populated entirely

² 2001 SRI Trends Report, Social Investment Forum (Nov. 28, 2001), at <http://www.socialinvest.org/areas/news/2001-trends.htm>.

by saints who are entirely immune to material temptation contradicts what we know of basic human nature.

Second, the recent litigation between Walter Hewlett and the Hewlett-Packard Company (“HP”) provides substantial evidence of the potential for fund managers’ conflicts of interest to influence how they vote proxies of portfolio companies.³ As discussed in greater detail in Fund Democracy’s October 21 letter, Hewlett presented substantial evidence that, among other things, HP asked Deutsche Bank Asset Management (“DBAM”) to vote in favor of HP’s merger with Compaq Computer Corporation (“Compaq”) in return for giving investment banking and other business to DBAM’s parent, Deutsche Bank, and that DBAM complied with this request.

Furthermore, the ICI itself concedes that fund managers have conflicts of interest when voting proxies. For example, the ICI notes that “many fund advisers do not have any significant conflicts of interests in voting proxies.” ICI Part II. This necessarily means that at least some fund advisers *do* have significant conflicts of interest, yet the ICI believes that these conflicts should be concealed from investors.

The ICI further acknowledges that funds have significant conflicts of interest by arguing that confidential voting is necessary to protect funds from pressure from issuers that have other “business relationships” with fund manager. ICI Part VI.2. While Fund Democracy agrees with the ICI that issuers use these relationships to influence how funds vote the issuer’s shares, it believes that confidential voting in this context will provide no meaningful protection. It is naïve to think that issuers who might pressure funds that vote against management will not pressure funds that instead refuse to reveal how they voted. The best protection against such pressure is full public disclosure of both the votes and the funds’ conflicts of interest.

In fact, the ICI’s letter reveals that the problem of conflicts of interest is worse than previously believed. The ICI states that “fund groups *generally* prohibit personnel [who are] involved in marketing 401(k) plan administration of other services to institutions from playing any role in proxy voting.” ICI Part II. This shocking admission that funds *ever* permit 401(k) administrators to participate *in any way* in fund proxy votes is by itself sufficient grounds to require disclosure not only of proxy votes and conflicts of interest, but also of the role played by these personnel in voting proxies.

In the Hewlett case, the court found that the mere involvement of Deutsche Bank executives in arranging a conference call between HP and DBAM personnel “raise[d] clear questions about the integrity of the internal ethical wall that purportedly separates Deutsche Bank’s asset management division from its commercial division.”⁴ The ICI’s

³ Walter B. Hewlett, et. al v. Hewlett-Packard Company, C.A. No. 19513-NC (Del. Ct. Chancery Apr. 30, 2002), at <http://www.funddemocracy.com/HP%20Decision.pdf>.

⁴ Id. at 39-40.

admission also raises “questions about the integrity of the internal ethical wall” maintained by funds between the proxy voting process and other business interests. The court implied that it would have found the HP-induced, direct participation of Deutsche Bank executives in the DBAM proxy decision, which the ICI indicates would be accepted practice at some fund complexes, to provide sufficient evidence to prove Hewlett’s vote-buying claim.⁵

Permitting 401(k) marketing personnel to play *any role* in fund managers’ proxy voting decisions violates minimum compliance standards. All funds should have procedures in place that prohibit 401(k) marketers from participating in proxy voting to ensure that fund proxy votes will not be affected by the fund manager’s desire to obtain 401(k) or other business from the companies whose shares the manager is voting.

In light of the ICI’s admission, Fund Democracy hereby requests that the SEC require funds that permit such 401(k) personnel to participate in proxy voting decisions to disclose this fact and explain why this is consistent with the fund’s fiduciary duty to shareholders. (This would be in addition to requiring disclosure of fund managers’ business relationships with portfolio companies whose proxies they vote, as discussed in Fund Democracy’s October 22 comment letter.)

ICI Argument #4: Shareholders Should Rely Exclusively on Independent Fund Directors

Fund Democracy agrees with the ICI that independent fund directors should play a greater role in monitoring funds’ proxy voting and protecting shareholders against conflicts. ICI Part VI.A.2.b. It is not clear, however, why the ICI believes that improved policing by fund directors requires that fund shareholders be kept in the dark about proxy votes. Id.

Fund directors serve as watchdogs in many situations where the practices they oversee are also disclosed to investors. For example, fund directors negotiate funds’ contracts with their advisers, oversee funds’ distribution arrangements, and review funds’ brokerage practices. Fund fees, distribution arrangements and brokerage costs and soft dollar practices also are disclosed to investors so that they, too, can monitor their funds’ practices. The Commission’s proposal recognizes that proxy voting, like other information that already is publicly disclosed, can be material to investors’ investment decisions.

⁵ Id. at 40.

ICI Argument #5: Unit Investment Trusts Should be Excluded from Disclosure Requirements

The ICI states that it “agrees with the Commission’s decision not to apply the proposed requirements . . . to unit investment trusts.” ICI Footnote 10. In fact, the Commission has made no such decision and has requested comment on this issue. For the same reasons that proxy voting disclosure will benefit mutual fund shareholders, such disclosure would benefit investors in unit investment trusts (“UITs”).

The argument for applying the requirements to UITs is actually stronger than for other funds. The only way that a manager of a static portfolio of securities can enhance the value of the portfolio is to use the corporate governance process to cause management to better maximize shareholder value. The same argument applies to index mutual funds, which will be subject to the disclosure requirements. Investors in UITs, like mutual fund shareholders, are entitled to know how fund managers are voting proxies.

ICI Argument #6: Disclosure Is Too Expensive

The ICI claims that the SEC’s estimate of the costs of the proxy disclosure proposal is too low. The Commission estimates that the total annual cost would be approximately \$14.5 million for 3,700 funds holding \$3.4 trillion in U.S. corporate stock, or approximately 0.00043% of equity fund assets.⁶ This expense would equal approximately \$0.09 for each of the 164.8 million accounts in U.S. equity mutual funds. The ICI estimates that the total cost would be \$40.9 million (ICI Part VI.B.1),⁷ or approximately 0.0012% of equity fund assets and \$0.25 for each account. Even assuming the ICI’s estimates -- which it has a strong incentive to inflate -- are accurate, the benefits of proxy voting disclosure are well worth the minimal cost.

ICI Argument #7: Investors Are Not Interested in Funds’ Proxy Votes

Perhaps the ICI’s most remarkable assertion is that investors are not “interested” in how their funds vote proxies. ICI Part VI.A.1. In fact, there is no question that a large number of Fidelity’s shareholders would be “interested” to know that the Fidelity funds

⁶ This amount is substantially less than the \$30 million in membership dues paid to the Investment Company Institute, the lobbying arm of the fund management industry. Most of these dues are paid by funds and their shareholders. Mike Garrity, Conflict of Interest? Financial Planning Interactive (June 5, 2000), at http://www.financial-planning.com/Investments/Mutual_Funds/20000605102.html (describing lawsuit filed against Investment Company Institute for violating Investment Company Act by representing the interests of fund management while being financed by mutual funds and their shareholders).

⁷ It is worth noting that this is only slightly more than the \$30 million in membership dues paid to the ICI, which acts primarily as the lobbying arm of the fund management industry. Most of these dues are paid by funds and their shareholders. Mike Garrity, Conflict of Interest? Financial Planning Interactive (June 5, 2000), at http://www.financial-planning.com/Investments/Mutual_Funds/20000605102.html (describing lawsuit filed against Investment Company Institute for violating Investment Company Act by representing the interests of fund management while being financed by mutual funds and their shareholders).

voted to retain Frank Savage, a former Enron director, as a director at Lockheed Martin. There also is no question that these shareholders would be “interested” to know that Fidelity provides 401(k) services to Lockheed Martin, and that Fidelity might have felt pressured to vote in favor of Savage in order retain Lockheed’s 401(k) business.

The ICI’s position also is contradicted by the fact that over 7,500 letters in favor of the SEC’s proposal have been electronically submitted to the SEC, and fewer than 10 have opposed the proposal.⁸ No SEC proposal has ever received such an overwhelmingly positive response from investors. In the words of one commentator, this outpouring of public support “obliterates”⁹ the ICI argument that “the biggest outcry for [proxy voting disclosure] has come not from individual investors.”¹⁰

Conclusion

Fund Democracy again commends the Commission for proposing that funds be required to publicly disclose proxy-voting information and strongly recommends that it promptly adopt the proposed rules.

Sincerely,

Mercer Bullard
Founder and President

cc (U.S. mail only):

The Honorable Harvey L. Pitt
The Honorable Cynthia A. Glassman
The Honorable Harvey J. Goldschmid
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
Paul F. Roye, Esq.
Robert E. Plaze, Esq.
Susan Nash, Esq.

⁸ Additional evidence of widespread support was provided when 19% of shareholders of TIAA-CREF’s College Retirement Equities Fund recently voted to require the Fund to disclose its proxy votes. For a proposal opposed by management to receive almost 20% of the vote the first time it was presented to shareholders is a remarkable demonstration of the depth of support for disclosure of fund proxy votes.

⁹ Morgenson, Why Don’t Mutual Funds Vote in the Sunlight? The New York Times (Dec. 1, 2002).

¹⁰ Sahoo, Industry Battles Against Proxy Disclosure, Ignites.com (Sep. 24, 2002) (quoting Investment Company Institute spokesman).