

Fund Democracy, Inc.

October 21, 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 comment 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").²

Fund Democracy strongly supports the Commission's proposal, which will enable shareholders to consider proxy-voting information when making investment decisions, as discussed in Part I below. Rather than permitting mutual fund managers to selectively disclose proxy votes and policies in order to market their funds, the rule will require that funds disclose all proxy votes, thereby enabling investors to be fully informed about funds' proxy voting when evaluating different funds. Proxy-voting disclosure also will ensure that capital is allocated to the most efficient uses.

Fund Democracy believes, however, that the proposed rule falls short in two crucial respects. First, the rule fails to require delivery of proxy-voting disclosure in a way that will be useable to investors (see Part II below). To address this problem, fund Democracy strongly recommends that the SEC create and implement a pilot proxy-voting

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. Fund Democracy expresses its appreciation to Winston T. Shows III and Thomas E. Walker, Jr., both of whom are law students at the University of Mississippi School of Law, for their valuable assistance in the preparation of this letter.

² Fund Democracy intends to file a second comment letter on this rule proposal, in which it will respond further to public comments on the rule. Fund Democracy therefore requests that the Commission (in order of preference): (1) post the text of all public comments on its web site, (2) post a list of all comments on its web site, and/or (3) include a list of all comments in the public comment file at the Commission's public reference room. If at least one of these steps is not taken, it will be impossible for members of the public to know whether they have reviewed all public comments that have been submitted, as comment letters sometimes disappear from the Commission's public comment file.

disclosure program that would provide proxy-voting information in an accessible, easily manipulated format while imposing the lowest possible cost on shareholders.

Second, the rule fails to effectively address fund managers' conflicts of interest when they have an economic or business interest in the proxies that they vote (see Part III below.) Accordingly, Fund Democracy strongly recommends that the Commission require funds to fully disclose such conflicts in order to enable investors to evaluate the significance of such conflicts and to deter self-dealing by fund managers.

In Part IV, Fund Democracy rebuts some of the principal arguments against proxy-voting disclosure made by the fund industry.

I. The Role of Proxy-Voting Records in Investment Decisions

Mutual funds play a central role in the allocation of capital in America. As noted by the Commission,

“[a]s of December 2001, mutual funds held \$3.4 trillion in U.S. corporate stock, representing approximately 19% of all publicly traded U.S. corporate equity. . . . Yet, despite the enormous influence of mutual funds in the capital markets and their huge impact on the financial fortunes of American investors, funds have been reluctant to disclose how they exercise their proxy voting power with respect to portfolio securities.”³

From 1985 to 2000, mutual funds' share of institutional ownership of U.S. equities increased from 11.9% to 61.6%.⁴

Funds' reluctance to disclose proxy-voting information means that investors who want to consider this information when making investment decisions are prevented from doing so. Further, depriving the marketplace of proxy-voting information prevents the value of proxy-voting policies and records from being fully incorporated into investors' decisions, thereby resulting in the misallocation of capital.

America's system of democratic capitalism depends fundamentally on the allocation of capital in accordance with the values expressed by millions of individual investment decisions. A central purpose of securities regulation is generally to maximize individuals' ability to express their values – be those values economic, social, or political

³ Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Investment Company Act Release No. 25739, Part I (Sep. 20, 2002) (“Proxy Voting Release”).

⁴ Palmiter, Mutual Voting of Portfolio Shares: Why Not Disclose? Research Paper No. 02-09, at 9 (July 2002), at http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID269337_code010509140.pdf?abstractid=269337.

– through their individual investment decisions, and thereby maximize their wealth as measured by the economic, social, political or other assets they value most.

The rapid growth of social investment funds over the last few years demonstrates the growing importance of qualitative criteria to investors when evaluating mutual funds.⁵ These investors seek value measured not only by high past investment returns, low fees, diversification, low turnover or other quantifiable data, but also by qualitative measures, such as a fund's position on poison pills, investments in arms manufacturers, or portfolio manager compensation. Investors may consider these qualitative factors as simply another means of enhancing the likelihood of high future investment returns, or they may seek to allocate their capital to achieve other private or public goods.

There is no doubt that how funds vote proxies implicates the qualitative values of many investors. Unfortunately, investors who want to express their values, *i.e.*, fully maximize their wealth, by considering proxy voting when evaluating mutual funds are limited to considering the tiny group of funds that disclose proxy-voting information.

An investor who wishes to consider proxy-voting policies and records when deciding between two typical funds is effectively prevented from doing so. The result is that an investor's capital is misallocated to the extent that she would have allocated her capital differently if all relevant information, including proxy-voting information, had been available to her. Mandating proxy-voting disclosure will allow proxy-voting policies and records to be fully "valued" by the marketplace.

The fund industry argues that the market should decide whether proxy-voting information is made publicly available, but this misidentifies the market and misunderstands the dynamics of investment decisionmaking. Investors cannot make rational, fully informed decisions unless they have access to all relevant information. Such access is also necessary to the efficient allocation of capital. While mutual fund managers should be permitted to decide how they vote proxies, they should not be permitted to decide for investors whether funds' proxy votes matter.⁶

A number of fund managers even believe that they should be allowed to selectively disclose only those fund proxy policies and votes that will help generate sales of fund

⁵ From 1999 to 2001, socially screened portfolios under professional management grew 1.5 times as fast as all managed assets to over \$2 trillion. 2001 SRI Trends Report, Social Investment Forum (Nov. 28, 2001), at <http://www.socialinvest.org/areas/news/2001-trends.htm>.

⁶ In expressing its opposition to requiring the disclosure of proxy-voting records, the Investment Company Institute has argued that "fund investors are not interested in the actual votes cast for a particular portfolio security. Fund investors typically invest in a fund to gain the management expertise of the fund's portfolio manager. Evaluating the proposals of management of portfolio companies is part of the investing discipline, which investors typically prefer to leave to fund managers." Letter from Mary S. Podesta, Senior Counsel, Investment Company Institute, to the General Secretariat, International Organization of Securities Commissions (Sep. 27, 2002), at http://www.ici.org/02_iosco_cis_voting_com.html.

shares, and to conceal votes of which investors might disapprove. For example, Fidelity “refuses to disclose how it votes on any shareholder proposals,”⁷ but this did not deter Fidelity’s general counsel from selectively revealing “Fidelity’s policy to always vote against management on three items: antitakeover measures, excessively dilutive stock option plans, and plush golden parachutes for departing executives.”⁸ Fidelity has refused, however, to disclose votes that are more likely to be viewed negatively by investors, such as whether it voted for a former Enron director who recently was reelected to a directorship with Lockheed Martin.⁹

Such self-serving cherry picking would violate anti-fraud rules in other contexts, but it apparently has become accepted practice in the fund industry.¹⁰ Mandating full proxy-voting disclosure will prevent funds from engaging in such blatantly selective disclosure.¹¹

The proposed proxy-voting disclosure rule takes a significant step toward ensuring that investors will be able to consider more relevant information when making investment decisions. The rule is lacking, however, in two major respects. The rule fails to ensure

⁷ AFL-CIO, *Activists Tell Fidelity Investments to Disclose Shareholder Votes*, www.aflcio.org/news/2002/0731_fidelity.htm (July 31, 2002); cf. Fidelity Investments, *Fidelity Group of Mutual Funds and Corporate Governance*, www.fidelity.com (“We know that shareholders rightfully look to Fidelity to be responsive to matters relating to corporate governance.”).

⁸ *Can You Trust Your Fund Company?* BusinessWeek Online (Aug. 8, 2002); see also Morris-Eck, *Time to Bow to the Inevitable*, eFinancial News, 2002 WL 100603217 (Sep. 23, 2002) (Bill Miller, a Legg Mason fund manager, withheld votes for directors at six companies in his funds’ portfolios); Jaffe, *Vanguard Proxy Guidelines Worth a Look*, Tulsa World, 2002 WL 7132553 (Sep. 1, 2002) (Vanguard CEO stating that Vanguard will vote against executive compensation that has the effect of diluting Vanguard’s proportionate ownership in the company). Selective disclosure of proxy votes also gives funds an unfair advantage over other funds that disclose all of their proxy votes. For example, Fidelity, Pax World and Domini Social Investments all have voted against certain stock-option plans, yet only the latter two managers disclose all of their votes, including those that might not be as widely popular as anti-stock-option votes. Luchetti, *A Mutual-Fund Giant is Stalking Excessive Pay*, Wall Street Journal at C1 (June 12, 2002) (Fidelity); Kathleen Day, *Prodding for Disclosure of Funds’ Proxy Votes*, Washington Post (Apr. 8, 2001) (Domini); Pax World Web site at <http://www.paxfund.com/bfproxy/index.htm>.

⁹ Weinberg, *Fund Manager Knows Best*, Forbes, 2002 WL 23192513 (Oct. 14, 2002). This vote is one of a number of recent proxy battles that have garnered significant attention, including the votes on the HP-Compaq merger and Stanley Works’ proposed reincorporation in Bermuda. These are precisely the kinds of votes where one could reasonably expect mutual fund investors to want to know how their funds voted.

¹⁰ See, e.g., *In the Matter of Stellar Management, Inc.*, Admin. Proceeding File No. 3-8383 (June 6, 1994) (sanctioning investment adviser for violating antifraud rules by selectively disclosing past recommended securities without disclosing all past recommendations). In 1990, Fidelity reportedly “dropped its opposition to a Pennsylvania antitakeover bill when a large Pennsylvania company threatened to switch the firm’s pension plan to Vanguard.” Palmiter, *supra* note 4, at 15.

¹¹ Cf. *Selective Disclosure and Insider Trading*, Securities Act Release No. 7881 (Aug. 15, 2000) (adopting Regulation FD, which prohibits issuers from selectively disclosing nonpublic material information).

that: (1) proxy-voting information will be useable by investors, and (2) investors can evaluate whether fund managers' conflicts of interest are improperly influencing their voting of proxies. These weaknesses in the rule proposal are discussed in Parts II and III below.

II. The Useability of Proxy-Voting Information

A. Introduction

As discussed above, the greatest value of the proposed proxy-voting disclosure rule lies in the dissemination of more information to the markets. Although the rule effectively requires the *public disclosure* of proxy-voting information, it fails to ensure that the market will be able to *use* the information. As discussed further below, the SEC should amend the proposed rule to require that proxy-voting information be provided in an electronic format that is easy to access and analyze.

The proposed rule will require funds, in their semiannual and annual shareholder reports: (1) to state that their proxy-voting policies, procedures and records are available upon request and on the Internet, and (2) to disclose any proxy votes that are inconsistent with their policies and/or procedures. In their Statements of Additional Information ("SAIs"), funds will include their proxy-voting policies and procedures and state that their voting records are available upon request and on the Internet. Funds will disclose their voting records in Form N-CSR.¹² Disclosure on the Internet means on the fund's web site, if applicable (*i.e.*, only if the fund has a web site), and on the Commission's site in its Electronic Data Gathering and Retrieval system ("Edgar").

B. The Useability of Proxy-Voting Information

Unfortunately, the proposed proxy-voting rule mistakenly equates information availability with information access and/or useability. This Part II.B describes the practical problems that investors and their information intermediaries will encounter when attempting to find and interpret proxy-voting information.

Consider the investor who wishes to review a single fund's proxy-voting information. The investor will have no reason to know that the fund's shareholder report explains where the information is, and even if the investor peruses the entire shareholder report, a single statement that the information was available in the SAI or on the Internet could easily be missed. If the investor finds this statement, he will have to request a copy and

¹² For each vote, a fund will disclose: (1) the name of the issuer of the portfolio security and the security's ticker symbol and CUSIP number; (2) the shareholder meeting date, matter voted on and whether it was proposed by management or a shareholder; (3) whether the fund cast its vote; (4) whether the fund abstained, approved or rejected the proposal (or withheld, in the election of directors); and (5) whether the fund cast its vote for or against management.

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wait three more days, or attempt to locate the SAI on the Internet. Both approaches are fraught with practical obstacles.

In many cases, the investor will not be able to obtain a paper copy of the SAI. Fund Democracy has frequently requested an SAI, and many financial journalists have reported the same experience, only to be told by the fund's telephone representative that there was no such document. If the investor experiencing the same resistance stands his ground and is able to convince the telephone representative that the SAI exists, the document may never arrive, as often has happened to Fund Democracy and many financial journalists.

Once the investor has the SAI, he will have to find the relevant section containing the fund's proxy-voting policies. The proxy-voting information will not be required to be identified separately in the SAI's table of contents, where it generally will be included in the section entitled "Fund Management" or some similar term that bears no obvious relation to proxy voting. The investor will then be required to read the entire SAI or locate the proxy-voting information by making educated guesses about the section in which it might be located.

Although accessing proxy-voting information on the Internet should be easier than finding it in a paper document, it often will be more difficult. On Edgar, funds generally are not organized by the name of the fund, but by "registrant." More often than not, the name of the registrant is different from the name of the fund. Investors typically do not know, and have no reason to know, the name of a fund's registrant, and therefore will be unable to access any fund filings. If the investor knows the name of the registrant, she is unlikely to know that the SAI is part of the filings listed on Edgar as "486" filings or as part of the fund's registration statement, as the documents are generally described in Edgar.

Once the registration statement has been located, the investor's task is far from over. Fund filings on Edgar generally are provided as a continuous stream of text with no internal hyperlinks, and there is no reference to the SAI on the first page (or screen) that appears on an Edgar registration statement. Rather, the investor first sees the prospectus, which typically does not mention the SAI until the last page. If this intrepid investor nonetheless finds the SAI by searching the term "Statement of Additional Information" repeatedly, the investor then will have to conduct another term search for the proxy-voting information because, as mentioned above, there will be no reference to the information in the table of contents (which is not, in any case, hyperlinked to subparts of the document).

Assuming the investor knows the correct terms to search and finds the proxy-voting information, the investor may not recognize the information once it has been located. For example, the information may be indecipherable because information in fund filings, especially tabular information, occasionally appears in Edgar in hypertext markup language that can be read only if it is cut and pasted as source code in a web browser or web editor.

For a number of reasons, the foregoing illustration *understates* the difficulties investors will encounter if they wish to consider proxy-voting information when evaluating different mutual funds.

First, the foregoing problems will be multiplied by the fact that proxy-voting policies and proxy-voting records will be in *two different documents*. It is difficult enough obtaining and accessing information in an SAI without having to request and/or access information in a completely new form, Form N-CSR (assuming that investors appreciate that they must request two documents in order to obtain one type of information). Fund telephone representatives will be even less likely to believe that Form N-CSR exists and will be less likely to follow-through on a request that it be mailed. If Form N-CSR is formatted similar to the format of Form N-SAR (the form for a fund's semi-annual report), the information will be even more difficult to access electronically because almost all information on Form N-SAR must be reformatted in order to understand it.

Second, the foregoing illustration assumes that the investor wishes to review proxy-voting information for only one fund. A principal purpose of providing proxy-voting information is, of course, to enable investors to compare multiple funds' proxy-voting policies and records.¹³ Yet the likelihood of investors persevering through the difficulties described above for five or six funds, much less one, is remote. An investor who wishes to review proxy-voting information for six funds must place six separate phone calls, or endure six separate Edgar searches, to locate twelve separate documents (and SAI and Form N-CSR for each fund). The investor then must find the information in the twelve separate paper or web documents and collate the information himself in order to compare the different funds.

Finally, the foregoing illustration assumes an extremely self-motivated investor, whereas a principal purpose of requiring proxy-voting disclosure is to disseminate proxy-voting information to more passive investors who would like to consider proxy-voting information when making investment decisions, but are discouraged by the Herculean efforts required to find and understand the information.

Indeed, the markets are full of instances in which healthy competition depends on requiring the disclosure of information that, in the absence of regulatory intervention, would otherwise be effectively available only to self-directed, highly motivated consumers. For example, self-directed investors were able, in theory, to calculate a fund's fees before the Commission required that funds make this process easier by providing a fee table in the prospectus, just as self-directed investors were able (to use a more recent example) to determine the effects of fees on their investment returns before

¹³ A 1996 study by the Investment Company Institute found that 74% of investors "compare several mutual funds before making a purchase decision." The Profile Prospectus: An Assessment by Mutual Fund Shareholders, Investment Company Institute 21 (1996).

the Commission posted its fund fee calculator on its web site. Yet the fee table and the fee calculator have had a profound impact on investors' appreciation of fund fees; their ability to take fees into account when making investment decisions; and price competition in the fund industry.

Another aspect of the useability problem is the effect that the proposed rule will have on financial journalists and third party information providers such as Morningstar. (Included as third party information providers are financial publications that regularly publish collections of comparative information on funds.)

As the Commission has recognized, investors rank fund prospectuses low on their lists of preferred sources of mutual fund information. One study showed that prospectuses were considered the fifth-best source of information, behind employer-provided written materials, financial publications, family or friends, and brokers.¹⁴ Thus, information provided by third-party information providers (on which employers and brokers base a substantial part of their information) indirectly ranks first and fourth, information provided by financial journalists ranks second, and information provided by both financial publications and information providers (on which family and friends base their information) indirectly ranks third. (There is no evidence that investors ever consult SAIs or will consult Form N-CSR). Accordingly, it is critical that financial journalists and third-party information providers be able to collect and analyze proxy-voting information.

Financial journalists and third party information providers will encounter, however, many of the same problems described above. Fund Democracy has spoken with many financial journalists who have related difficulties in obtaining, accessing and analyzing information in fund filings, especially SAIs, identical to those described above. Financial journalists also have related that the inaccessibility of information has made it uneconomical to write about issues they believe that investors want to understand.

For example, earlier this year a number of journalists expressed to Fund Democracy a strong interest in comparing the investments made by fund directors of different funds in the funds they oversee. The SEC recently required that this information be disclosed in SAIs because a "director who holds shares in the complex will tend to be aligned with the interests of other shareholders" and this information is relevant to an investor's evaluation of a fund.¹⁵ These journalists were consistently frustrated in their attempts, however, because of the difficulty of ferreting out the information from the SAI. This means that financial journalists, who are a major source on information used by investors

¹⁴ Registration Form Used by Open-End Management Investment Companies, Investment Company Act Release No. 22528 at n.6 (Feb. 27, 1997) (citing Report on the OCC/SEC Survey of Mutual Fund Investors 12-13 (June 26, 1996)).

¹⁵ Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24082, at Part II.E.2 (Oct. 15, 1999).

to evaluate funds, are effectively prevented from using the information about fund directors' investments, which substantially defeats the purpose of the disclosure requirement.

Fund Democracy has also discussed with third party information providers the useability of fund disclosure. These providers are generally more sophisticated and have greater dedicated research staff than financial journalists and therefore can more easily locate fund information in fund filings. For example, third party information providers such as Morningstar have become extremely proficient at enabling investors to do a one-click comparison of a selected list of funds based on their fees, investment return, portfolio turnover and a host of other quantitative factors.

These providers generally have avoided, however, collecting and analyzing nonquantitative information. Such information is not formatted in a way that makes it cost-effective to compile and analyze it for public distribution. In most cases, such as the collection of information about fund directors' investments in their funds mentioned above, collecting the information would be extremely labor intensive because it is not presented in a way that can be economically translated into easy comparisons across different funds. For this reason, third party information providers will avoid proxy-voting information as well.

Further, academics and shareholder advocates also play a critical role in improving competition in the securities markets and shareholder protection by collecting and analyzing publicly available information and communicating their findings to regulators and investors (typically through financial journalists). For example, a 1994 academic study of the spreads at which NASDAQ securities traded had a profound impact on the regulation of that market.¹⁶ Academics and shareholder advocates encounter the same barriers, as described above, that frustrate the efforts of investors, financial journalists and third party information providers to effectively penetrate and use the SEC's disclosure system.

Finally, the Commission staff itself often is frustrated in its inability to access its own data to produce information that it can use to more effectively regulate the financial services industry. The Commission conducts very little analysis of the efficacy of its rules, principally due to resource and budget constraints. When the Commission does conduct such analysis, it routinely relies on and pays outside vendors to collect and analyze information that they collect from the Commission's own databases.

¹⁶ Christie and Schultz, Why Do Nasdaq Market Makers Avoid Odd-Eighth Quotes? 49 J. Fin. 1813 (1994); see generally, Nasdaq Price Spreads alleged to be Wider Than They Need to Be, Wall Street Journal, 1994 WL-WSJ 290739 (May 27, 1994); Paltrow, Study Suggests Collusion Among Brokerage Firms, Los Angeles Times, 1994 WL 2169545 (May 26, 1994).

For example, between 1992 and 2000 the Commission granted exemptions to numerous funds to sell their shares in the secondary market (“exchange-traded funds” or “ETFs”). These exemptions were premised largely on the representations made by funds that ETF shares would not trade at premiums or discounts to their net asset value (“NAV”). These representations were repeated by funds in sales materials and Commission filings. The Commission apparently never studied the prices at which ETFs actually traded, however, in part because that information was not publicly available in a useable form.

Fund Democracy, with the assistance of Thomson Financial, collected data showing that some ETFs routinely traded at persistent, significant premiums or discounts.¹⁷ On the basis of this data, Fund Democracy and the Consumer Federation of America asked the Commission to hold a hearing on a pending ETF exemptive application to consider whether this information should be disclosed. As a result, the Commission now conditions ETF exemptions on the public disclosure of charts that show the difference between ETF secondary market prices and their net asset values over time. This example illustrates that publicly available information, e.g., the trading prices and NAVs of ETFs, often has little or no value to the market unless the information is required to be provided in a useable format.

In summary, the effectiveness of the proposed proxy-voting rule will be substantially reduced unless the Commission revises the means and format of disclosure. Under the proposed rule, proxy-voting information will be publicly available only in a technical sense, as the significant practical difficulties of actually finding and using the information will prevent investors and their information intermediaries -- financial journalists, third party information providers, academics, shareholder advocates, and even SEC staff -- from effectively using the information.¹⁸ The following Part II.C proposes a low cost pilot disclosure program that would solve the difficulties described above and truly provide for publicly available *and useable* proxy-voting information.

C. Pilot Proxy-Voting Disclosure Program

Ideally, the Commission would provide all fund information in a format that was easy to find, download, sort and analyze. This could be accomplished, for example, by exploiting the advantages offered by Extensible Markup Language, or XML. Fund Democracy recognizes, however, that it would be unrealistic for the Commission to attempt such a comprehensive Edgar overhaul prior to the adoption of the proxy-voting proposal, or to delay the adoption of the proposal pending completion of such an overhaul.

¹⁷ See Fund Democracy, Memorandum in Support of Hearing Request (May 4, 2000), at http://www.funddemocracy.com/hearing_request_docs.htm.

¹⁸ Over the last decade, this author -- as a fund shareholder, fund industry lawyer, SEC Assistant Chief Counsel, shareholder activist, financial journalist, third party information provider and academic -- has encountered firsthand, and can personally attest to, all of the problems described above.

Nonetheless, the proxy-voting proposal provides an excellent opportunity for the Commission to begin translating the information databases it manages into more useable formats. Toward this end, Fund Democracy proposes that the Commission institute a pilot proxy-voting disclosure program whereby proxy-voting information would be provided on the Commission web site in a separate database that included flexible retrieval, sorting and analysis features.

For example, the database could include proxy-voting information for the 100 largest U.S. domestic equity funds, which would cover approximately 35% of total U.S. equity fund assets (\$1.175 trillion).¹⁹ The database could be separated into standardized fields for, among other things, the name of the fund (not the name of the registrant), the date and subject of the vote, the name of the issuer, the recommendation of management, how the fund voted, whether the fund voted with management, and whether the fund's affiliates have any business relationships with the issuer. The database could include links to the fund's proxy-voting policies and procedures, which could also be divided into fields representing common proxy issues (e.g., staggered boards, poison pills), which similarly could be searchable by any field.

The database would enable investors and other information intermediaries to select: (1) a group of funds and determine how they voted on a particular proxy issue; (2) a single fund and determine how the fund voted on a group of proxy issues; (3) two funds and determine the correlation between their voting with management and the existence of a conflict of interest (*i.e.*, a business relationship between the portfolio company and fund affiliates). These comparisons could be done in a matter of seconds, a process that, under the proposed rule's disclosure requirements, might take days of intensive labor, if such comparisons could be completed at all.

The pilot proxy-voting disclosure program would substantially increase the utility of proxy-voting disclosure and represent an important first step for the Commission in developing disclosure systems that emphasize the useability of information as much as its availability. Fund Democracy strongly recommends that the Commission require the creation and implementation of a pilot proxy-voting disclosure system.

III. Conflicts of Interest

The second major weakness in the proposed proxy-voting disclosure rule is its failure to require disclosure of fund managers' conflicts of interest when voting fund proxies.

As stated by the Commission, "in some situations the interests of a mutual fund's shareholders may conflict with those of its investment adviser with respect to proxy

¹⁹ Total assets of 100 largest domestic U.S. equity funds provided by Annette Larsen, Senior Data Analyst, Morningstar Inc.

voting.”²⁰ These situations include when the fund manager or an affiliate manages a portfolio company’s 401k plan, provides investment banking services to a portfolio company, or has other business arrangements with a portfolio company.²¹ The Commission has recognized that these fund managers therefore “may have an incentive to support management recommendations to further its business interests” to the detriment of fund shareholders.²²

Indeed, the recent litigation between Walter Hewlett and the Hewlett-Packard Company (“HP”) highlighted the potential for fund managers’ conflicts of interest to influence how they vote proxies of portfolio companies.²³ In that lawsuit, Hewlett alleged, among other things, that 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. DBAM, a large international fund manager, had voting authority over 17 million shares of HP stock.

After DBAM decided to vote its HP shares against the merger, HP’s CEO left a voice mail message for HP’s CFO asking him to contact Deutsche Bank and stating that HP might have to do “something extraordinary for those two to bring ‘em over the line here” (*i.e.*, for two Deutsche Bank executives to secure a favorable vote from DBAM).²⁴ The Deutsche Bank executives subsequently arranged and attended a meeting between the HP CEO and CFO and DBAM, after which DBAM changed its vote. At the time, Deutsche Bank had various commercial relationships with HP, was providing services in connection with the merger, and desired to continue and expand its business relationship with HP in the future.

The court found that the facts “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.”²⁵ In the absence of a smoking gun indicating an explicit *quid*

²⁰ Proxy Voting Release Part I; see also Bullard, Are Ballots Too Secret? Fund Advisers Should Tell How They Vote Proxies, *TheStreet.com* (Jan. 4, 2001), at <http://www.thestreet.com/funds/mercerbullard/1240302.html> (“It is well known that mutual funds are subject to strong conflicts of interest that may affect their voting decisions,” says Sarah Teslik of the Council of Institutional Investors. “The fact that mutual funds resist disclosure suggests their voting is influenced by factors other than the financial interests of the people whose money they are investing, and they don’t want that discovered.”)

²¹ Can You Trust Your Fund Company, supra note 8 (“It’s quite clear that [mutual] funds have to be very cautious in voting against their own [401(k)] clients,” says John Bogle, founder of rival Vanguard Group.”).

²² Proxy Voting Release Part I.

²³ *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>.

²⁴ *Id.* at 25-26.

²⁵ *Id.* at 39-40.

pro quo, however, the court was compelled to conclude that Hewlett had presented insufficient evidence to support his vote-buying claim.

The HP-Compaq litigation provides a strong argument for proxy-voting disclosure for two reasons. First, the case is a stark illustration of the potential for conflicts of interest to influence how fund managers vote proxies. Second, the case demonstrates the difficulty of policing such conflicts of interest, where the *quid pro quo* need only be implied, and meeting the burden of proof effectively depends on producing an explicit, but extraordinarily rare, smoking gun memorandum. Such conflicts of interest generally are not susceptible of proof, and disclosure therefore is the only effective means of deterring self-dealing by conflicted fund managers (short of prohibiting all business relationships between fund managers and their funds' portfolio companies).

Remarkably, the fund industry considers even the possibility that fund managers could be influenced by their own economic interests when voting proxies to be "absurd."²⁶ This blind denial of the reality of fund managers' conflicts, as expressly recognized by the Commission and illustrated by the HP-Compaq litigation, sounds strangely like the denials issued by investment banking firms regarding "absurd" allegations that their analysts' investment recommendations might be influenced by the firms' interest in winning investment banking business from issuers that the analysts cover.²⁷

With new revelations of blatantly biased analysis making headlines every day, what now seems "absurd" is the idea that analysts' recommendations *would not* be influenced by the possibility of annual \$20 million paychecks.²⁸ Fund managers seem to believe that they, as a group, occupy a higher moral plane than the rest of humanity and therefore are

²⁶ Friedman, SEC Proposes Proxy Vote Disclosure Rule, L.A. Times, 2002 WL 2504947 (Sep. 20, 2002) (quoting Fidelity spokesman stating that argument that a fund company might be influenced by a conflict of interest "was absurd"). Fidelity funds were the third-largest holder of Lockheed Martin stock when Frank Savage, a former Enron director, was reelected to Lockheed's board. Fidelity, which services Lockheed's 401(k) plan, declined to disclose how it voted the Lockheed shares it controls, commenting that the mere "suggestion of a possible conflict between 401(k) management and proxy votes is 'absurd.'" Hansard, Mutual Funds Feel the Heat From Enron, Investment News, 2002 WL 9500011 (May 20, 2002) and Weinberg, Fund Manager Knows Best, Forbes, 2002 WL 23192513 (Oct. 14, 2002).

²⁷ Knight, Merrill Lynch's Not-So-Sweet Buy and Buy, Washington Post, 2002 WL 19154159 (Apr. 15, 2002) (claim by Merrill that negative inferences, drawn from warning from analyst to investment banker that analyst might begin rating companies honestly, were "just plain wrong"). Mutual funds' record of almost never voting against management also echoes analysts' record of almost never assigning sell ratings. See Palmiter, *supra* note 4, at 13-14 (mutual funds follow the "Wall Street Rule" of voting routinely with management).

²⁸ Gasparino, Raghavan and Blumenstein, Citigroup Now Has New Worry: What Grubman Will Say, Wall Street Journal, 2002 WL-WSJ 3408344 (Oct. 10, 2002) (analyst who allegedly tailored recommendations to help win investment banking business made \$20 million annually).

immune to the temptation of earthly rewards. If this claim is not “absurd,” it certainly is open to question.

Fund Democracy recognizes the Commission’s express recognition of fund managers’ conflicts of interest, but believes that the proposed rule’s treatment of these conflicts is inadequate. The Commission proposes to mitigate fund managers’ conflicts of interest in two ways. First, the proposed rule will require funds to disclose the procedures used to address conflicts of interest. Second, the rule will require funds to disclose votes that are inconsistent with the fund’s proxy-voting procedures.

The disclosure of compliance procedures will not achieve its desired goal. Would the Commission propose to mitigate analysts’ conflicts merely by requiring that they disclose how their investment bank employers “address” the conflicts?²⁹ Regulators have uniformly rejected this approach in favor of disclosure of analysts’ actual conflicts of interests.³⁰

Requiring disclosure only of funds’ procedures for mitigating conflicts of interest is the equivalent of requiring analysts only to disclose that Chinese walls make them independent of their investment bank employers. The limitations of this solution are self-evident in the analyst context. It is no less inadequate in the proxy-voting context, as illustrated by the questionable “integrity” of Deutsche Bank’s Chinese wall criticized by the court in the HP vote-buying case.

The disclosure of proxy votes that are inconsistent with the fund’s proxy-voting procedures (“inconsistent votes”) also may accomplish nothing, and may even harm fund shareholders. Funds generally craft proxy-voting policies that are broad enough to permit managers to make case-by-case exceptions that are in the fund’s best interests. These votes may be “consistent” with the fund’s policies while being motivated by the fund manager’s self-interest, about which shareholders will be left in the dark.

The Commission argues:

“that when a fund votes the proxies of its portfolio securities in a manner inconsistent with the fund’s stated policies and procedures, a heightened risk exists that a conflict of interest may be present. [Disclosure of inconsistent votes] will provide shareholders with the best opportunity to

²⁹ See Lester, Pardon Us While We Be Skeptical, Kansas City Star, 2002 WL 15324477 (Apr. 16, 2002) (Merrill Lynch arguing that emails in which analysts disparaged stocks they were recommending were taken out of context and *that the firm has instituted internal controls to prevent conflicts of interest from affecting stock recommendations*).

³⁰ E.g., Exchange Act Release No. 45908 (May 10, 2002) (approving amendments to NASD Rule 2210 and NYSE Rule 472 that require broker-dealers to disclose investment banking relationships with companies that are the subject of analysts’ research reports).

evaluate the propriety of the proxy voting decision and will serve as a strong deterrent to voting decisions that are not in the best interests of shareholders.”³¹

The correlation between inconsistent votes and conflicts of interest is illusory. On the one hand, funds that might be influenced by conflicts of interest will draft broad proxy-voting policies and never be subject to the disclosure requirement because they will not vote inconsistently with their proxy-voting policies. On the other hand, funds with no conflicts of interest that draft tight proxy-voting policies will raise a red flag for shareholders every time they make an exception to the policies. The latter situation may harm shareholders because such funds will have an incentive to: (1) draft broad proxy-voting policies even if they believe that narrow policies would be better for shareholders, (2) ensure that all votes are consistent with proxy-voting policies even when an inconsistent proxy vote is in shareholders’ best interests; and/or (3) accompany disclosure of inconsistent votes with a statement that the fund has no conflicts of interest regarding that issuer, which will confuse investors.

In short, the proposed rule will require disclosure of an inconsistent vote when there is no conflict of interest, and not require disclosure of a consistent vote when there is a conflict interest. This will only deter tightly drafted proxy-voting policies, and will not afford “shareholders with the best opportunity to evaluate the propriety of the proxy voting decision.”

It is not voting inconsistently with a fund’s policy that suggests a conflict of interest; it is the conflict of interest that suggests a conflict of interest. The “best opportunity to evaluate the propriety of the proxy voting decision” therefore would be provided by requiring disclosure of conflicts of interest.

Accordingly, Fund Democracy strongly urges the Commission to require meaningful disclosure of fund managers’ conflicts of interest regarding the voting of proxies. The rule could specifically require disclosure of any fees received by fund affiliates from issuers whose proxies the fund has voted over the last three years or who have scheduled or announced a shareholder meeting to occur within the following 12 months. Funds also should be required to highlight all votes cast that support management’s position when a fund affiliate has a conflict of interest, such as by having to include a separate line item for such votes in the fund’s voting records or placing an asterisk by the record of the vote.

IV. Industry Objections to Proxy-Voting Disclosure

The fund industry has objected to the Commission’s proposal on a number of grounds, none of which withstands close scrutiny. The industry’s claim, for example, that there is no popular demand for proxy-voting disclosure, which is discussed in Part IV.A, misrepresents broad-based support for the SEC’s proposal and misunderstands the

³¹ Proxy Voting Release Part II.B.

dynamics of regulatory reform. The industry claims that fund managers will succumb to outside influences when voting proxies and vote against the interests of fund shareholders, see Part IV.B, but for to this to occur the funds would have to violate their fiduciary duty to vote only in the best interests of shareholders. Finally, the claim that proxy-voting disclosure will be too costly is contrary to fact (see Part IV.C).

A. Lack of Popular Demand for Proxy-Voting Disclosure

The fund industry has objected to the proposal on the same ground it raises to virtually every initiative designed to benefit shareholders: that shareholders have not demanded *en masse* that the reform be adopted.³² It is unclear whether the industry imagines that such shareholder demand can only be demonstrated by millions of investors marching in the streets, flooding the SEC with letters, or staging sit-ins at fund managers' offices.

Whatever actions the industry believes would evidence investor support, its argument entirely misunderstands the practical exigencies of government regulation. Under the industry's standard of mass protest, the fee table, standardized performance, rule 12b-1 fee, contingent deferred sales loads, and a host of other fundamental mutual fund features would not exist. Each of these features was enacted by the Commission without the mass public outcry that the industry imagines is a necessary predicate to regulatory reform. Indeed, Vanguard Group, America's second largest fund complex, exists and operates only by reason of a series of exemptions granted by the SEC that few shareholders were even aware of, much less demanding, at the time Vanguard's applications were pending.³³

B. Outside Influences

Remarkably, members of the fund industry have asserted that disclosure of proxy votes would permit outside interest groups to influence fund votes to the detriment of fund shareholders,³⁴ notwithstanding that fund managers have a fiduciary obligation to vote their shares solely in the best interests of fund shareholders. As noted by the Commission, a fund manager's fiduciary duty to the fund and its shareholders:

³² For example, the industry has argued that "the biggest outcry for this has come not from individual investors." Sahoo, Industry Battles Against Proxy Disclosure, Ignites.com (Sep. 24, 2002) (quoting Investment Company Institute spokesman).

³³ See, e.g., In the Matter of Wellington Fund, Inc., Investment Company Act Release Nos. 8644 (Jan. 17, 1975) (notice) & 8676 (Feb. 18, 1975) (order) (permitting operation of Vanguard as internally managed mutual fund).

³⁴ Schroeder, Mutual Funds Could be Forced to Disclose Their Proxy Votes, Wall Street Journal, 2002 WL-WSJ 3406631 (Sep. 20, 2002) (proxy-voting "disclosure could 'politicize mutual-fund investing' because 'votes are supposed to be cast for the benefit of all investors rather than special-interest groups'" (quoting Investment Company Institute spokesman)).

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“extends to all functions undertaken on the fund's behalf, including the voting of proxies relating to the fund's portfolio securities. An investment adviser voting proxies on behalf of a fund, therefore, must do so in a manner consistent with the best interests of the fund and its shareholders.”³⁵

The industry has not explained precisely how outside pressure would interfere with fund managers' fulfilling their fiduciary voting obligations, but if this is a genuine concern for some fund managers, Fund Democracy requests that the Commission investigate their proxy-voting policies and procedures to ensure that they are complying with federal and state law.

The fund industry also has implied that corporate governance activists, particularly groups viewed as supporting liberal causes, will exert undue influence over funds' votes,³⁶ but there is no reason why the new disclosure rules will favor any particular political, social, or economic agenda. Fund shareholders are members of unions, the National Rifle Association, the Sierra Club, the Republican Party, and other groups that have a wide variety of agendas.

The fund industry's real concern is not that outside groups will influence *fund managers*, but that they will influence *fund shareholders*. After all, with more than 90 million Americans invested in mutual funds, many of these groups' memberships are probably dominated by fund shareholders. These groups have an influential voice precisely because they are supported by such members/fund shareholders. Is it contrary to fund shareholders' interests to enable them, as members of these groups, to further their groups' interests by choosing funds based on how the funds vote proxies?³⁷

The central purpose of the proposed proxy-voting rule is allow mutual fund proxy voting to become part of the marketplace of competing ideas about the allocation of capital in a democratic society. The participation of interest groups in this process through the actions of their members who are fund shareholders will further this purpose.

³⁵ Proxy Voting Release Part I (footnote omitted).

³⁶ Sahoo, Industry Battles Against Proxy Disclosure, Ignites.com (Sep. 24, 2002) (“the biggest outcry for this has come not from individual investors but from a number of special interest groups. These groups could pressure funds on issues that have nothing to do with fiduciary responsibility to shareholders but pertain more to their own agendas, like environmental concerns or labor issues. That politicizes the proxy voting process when it should be about voting in shareholders' financial interests.” (quoting Investment Company Institute spokesman)).

³⁷ In fact, if there is the potential for improper influences to infect mutual fund proxy voting, it is not external influences competing openly in the market place of ideas, but internal influences derived from fund managers' hidden conflicts of interests. See, supra, Part III.

C. Cost

Finally, the fund industry has complained about the cost of complying with the proposed disclosure requirements. First, fund management has a fiduciary duty to vote proxies of portfolio companies in the best interests of the fund and its shareholders, and managers therefore already should be keeping records of proxy-voting policies and procedures and records of fund votes. The rule proposal should not require any additional collection of information.

Second, the costs of printing and formatting the information will be, as indicated by the SEC's cost analysis, minuscule. The Commission estimates that the total 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.³⁸ This expense would equal approximately \$0.09 for each of the 164.8 million accounts in U.S. equity mutual funds. Fund Democracy also notes that if the Commission were to adopt disclosure requirements similar to the pilot proxy-voting disclosure program discussed in Part III.C and eliminate other filing requirements, these costs could be substantially reduced.

Third, a number of small fund complexes already provide proxy-voting information, yet these funds' expense ratios are well within average ranges.³⁹ The cost of proxy-voting disclosure to large funds should be substantially smaller because they can spread the fixed costs of compliance over a much larger asset base. In other words, the already *de minimis* costs discussed in the preceding paragraph will be, comparatively, even smaller for the funds whose managers have complained most vociferously about increased costs.

Finally, fund managers have tacitly acknowledged the value of proxy-voting information by selectively disclosing their position on certain proxy votes in an attempt to appeal to investors on certain issues (see *supra*, discussion accompanying notes 6-8). The fund industry is arguing, in effect, that it will be too expensive to provide the proxy-voting information necessary to correct the misleading impression created by fund managers' own selective proxy-voting disclosure.

³⁸ 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).

³⁹ The average expense ratio for a U.S. equity mutual fund was 1.28% in 2001. Investment Company Institute, Total Shareholder Costs of Mutual Funds: An Update 2 (Sep. 2002), at <http://www.ici.org/pdf/fm-v11n4.pdf>. The expense ratios of representative funds that disclose their proxy votes are as follows: Calvert Social Investment Fund-Equity (Class A): 1.28% (prospectus, Apr. 15, 2002); Citizens Core Growth Fund: 1.34% (prospectus, Nov. 1, 2001); Domini Social Equity Fund: 0.92% (prospectus, Nov. 20, 2001); MMA Praxis Core Stock Fund (Class A): 1.20% (prospectus, May 1, 2002); Pax World Growth Fund: 1.53% (prospectus, Aug. 15, 2002); Walden Social Equity Fund: 1.00% (Morningstar.com, October 20, 2002).

V. Conclusion

Fund Democracy commends the Commission for proposing that funds be required to publicly disclose proxy-voting information, and strongly recommends that it amend the proposed rule to require more useable disclosure of this information and full disclosure of fund managers' conflicts of interest.

Sincerely,

Mercer Bullard
Founder and President

cc (U.S. mail only):

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The Honorable Cynthia A. Glassman
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