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Comment Letter on Issues Relating to Collective Investment Funds, October 2002

September 27, 2002

General Secretariat
International Organization of Securities Commissions (IOSCO)
Plaza de Carlos Trías Bertrán, 7
Planta 3
28020 Madrid
Espana

Dear Sir or Madam:

The Investment Company Institute[1] appreciates the opportunity to comment on "Collective Investment Schemes as Shareholders: Responsibilities and Disclosure," a report prepared by Standing Committee 5—Investment Management of IOSCO's Technical Committee. The report discusses a number of regulatory and disclosure issues relating to the exercise of voting rights by collective investment schemes (CIS) and their investment managers. Specifically, the report reviews industry and regulatory responses to three questions posed by the Committee and presents the Committee's views on what the appropriate regulatory responses to these questions should be.

The Institute applauds the Committee for undertaking to study a significant topic and raising important issues for further discussion. The report surveys the regulatory framework and industry practice and provides a balanced approach for regulators to consider in responding to regulatory issues that are raised by CIS participation in corporate governance. In this letter, we respond to the questions the Committee asks and provide the Committee with information about the policies, procedures, and practices of funds with respect to voting of portfolio securities. We hope that this information helps the Committee in continuing the dialogue on these important issues.

Fiduciary Duties

The Committee asks whether a CIS is required to exercise voting and other shareholder rights or otherwise become involved in the governance of corporations in its portfolio. Under US law, voting and other shareholder rights are considered fund assets. Consequently, investment advisers to funds have a duty to act in the interests of the fund and its shareholders with respect to issues that may affect the value of fund investments, and advisers generally exercise voting and other rights attached to the fund's portfolio securities in fulfilling this obligation. Nonetheless, exercising voting rights is one aspect of the overall fiduciary duties that investment advisers owe to their clients. To act in the best interest of the fund, investment advisers must carefully consider all the factors relevant to the exercise of voting rights, including the costs and benefits to the funds of such exercise. Where the costs of voting are significant, for example, with respect to foreign securities,[2] those costs may outweigh the potential benefits of voting to the funds. Therefore, we agree with the Committee that there are circumstances in which an investment adviser may conclude properly that it will not vote or take other action as a shareholder if it believes this decision is in the best interests of the fund and its shareholders.[3]

Decision to Exercise Voting Rights

In its report, the Committee asks who can make decisions about voting and other shareholder rights attached to a fund's portfolio securities and how these decisions should be made. As a general matter, who makes decisions about voting for a fund may be affected by particular regulatory requirements in a jurisdiction, industry practice, or the individual facts and circumstances of a fund.[4] The Institute believes that collective investment schemes should be given discretion to develop their own decision-making process within this framework. Individual funds are in the best position to determine which entities or persons should be involved (and the extent of their involvement) in making decisions about voting shares of portfolio securities.

Moreover, the Institute believes that flexibility regarding which entity or person executes the voting responsibility is necessary because the CIS structure differs around the world. Regardless of who takes the lead in making these decisions, we agree with the Committee's report that any actions taken must be in the best interest of the fund and not in the interest of the decision maker.

In practice, funds in the United States vary with respect to who takes the lead in making decisions about voting rights. For some funds, the fund boards of directors establish policies and procedures for voting portfolio securities, while for other funds, the investment advisers prepare policies and procedures and keep the board of directors informed on a regular basis. In either case, the policies and procedures typically set forth the persons who would participate in the decision-making process with respect to particular proxy votes.[5] They also may set forth how the fund will vote on certain matters, such as anti-takeover proposals.

In discussing who should execute the voting rights of portfolio companies and how votes will be cast, the Committee's report raises an important issue with respect to potential conflicts of interest that may arise between the decision maker and the fund. We believe that a variety of approaches can be used to address potential conflicts of interest. Many industry members have developed policies and procedures that provide the means to address conflict of interest situations by establishing guidelines regarding when and how votes of portfolio securities should be cast. We are of the view that it would be reasonable for securities regulators to expect funds to utilize policies and procedures for dealing with potential conflicts but that regulators should not detail specific requirements for how these situations must be resolved except to require that all decisions be made solely in the interest of the fund and its shareholders.

Disclosure of Voting

The Committee asks whether a collective investment scheme should provide information to its investors about how the fund's rights as a shareholder would be exercised. We believe that disclosure to investors of fund voting policies and procedures could be helpful. This information could assist investors in obtaining a general understanding of the fund's policies with respect to the voting of its portfolio securities and permit investors to choose funds with voting policies that best match the investors' preferences. It also could assure investors that funds have appropriate procedures to address any possible conflicts of interest that may exist between the fund and its investment adviser.

We believe, however, 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. Given the uncertainty of the benefit of this information to fund shareholders,[6] we agree with the Committee's report that advisers should have the discretion to disclose how they voted a particular block of securities on a case by case basis.[7]

* * *

The Institute appreciates the important role that collective investment schemes are playing with respect to corporate governance in the global securities market. We believe that investment advisers have an obligation to treat voting and other shareholder rights attached to a fund's portfolio securities as an important asset of the fund and to exercise those rights in the best interest of the fund. Recognizing that responsibilities with respect to voting rights are only a part of the overall fiduciary duties that are owed to the fund, the investment adviser must carefully consider the costs and benefits associated with exercising the voting rights of a particular portfolio company.

To ensure that any action taken with respect to voting rights is in the best interest of the fund, we believe that collective investment schemes should be given flexibility to determine which entity or person should execute the voting responsibility. For US funds, the policies and procedures for voting portfolio securities typically set forth the persons who would participate in the decision-making process with respect to proxy votes. In this respect, we would support disclosure of fund voting policies and procedures, which investors might find helpful, and support giving collective investment schemes discretion to disclose how they voted on particular portfolio securities.

We would be pleased to answer any questions or discuss any of these issues further. You may contact me at (202) 326-5826 or at podesta@ici.org or Jennifer S. Choi at (202) 326-5810 or atjchoi@ici.org.

Very truly yours,

Mary S. Podesta
Senior Counsel

ENDNOTES

[1] The Investment Company Institute is the national association of the US investment company industry. Its membership includes 8,973 open-end investment companies ("mutual funds"), 514 closed-end investment companies, and six sponsors of unit investment

trusts. Its mutual fund members have assets of about $6.363 trillion, accounting for approximately 95 percent of total industry assets, and over 87.8 million individual shareholders.

[2] In the case of foreign securities, it may be difficult for a fund to vote because it may not be possible to obtain voting materials or have the materials translated in sufficient time to be able to exercise the voting rights or portfolio companies may be located in jurisdictions that require physical attendance at shareholder meetings to vote.

[3] The Committee's report notes that the UK Myners Report discussed the failure of managers to take an "activist stance" because of other business interests and recommended that all pension fund trustees incorporate the principle of the US Department of Labor Interpretative Bulletin into fund management mandates. It is important to note that the Myners Report did not recommend that fund managers become involved in a particular corporate governance issue if the costs outweigh the benefits to their clients or the proposal is based on a public interest argument about shareholder social responsibilities. The Myners Report was of the view that the Interpretative Bulletin articulates the duties of managers to intervene in companies by voting or otherwise "where there is a reasonable expectation that doing so might raise the value of the investment." It also is important to note that the Myners Report stated that it did not believe that the Department of Labor principle means compulsory voting in all cases but that voting is one of the central means by which shareholders can influence the companies in which they have holdings. Recently, the SEC also noted that "[t]here may be good reasons for an adviser to refrain from voting a proxy when, for example, the cost of voting the proxy exceeds the expected benefit." See Proxy Voting by Investment Advisers, Investment Advisers Act Release No. 2059 (Sept. 20, 2002) at n.7.

[4] For example, in situations where a fund employs several sub-advisers to manage a portion of its portfolio, the particular circumstances of that arrangement may dictate who should make the decisions about voting for the fund.

[5] Fund policies, for example, may provide that the fund's portfolio manager will be consulted with respect to matters affecting the security's valuation, such as a proposed merger.

[6] In fact, disclosure of actual votes cast (either before or immediately after a vote) potentially could be detrimental to the interest of the fund and its shareholders. As part of the investment process, investment advisers routinely make assessments of the management of the portfolio company, and disagreements over a management proposal of the portfolio company could signal an intention of the fund to sell its shares in that company if the proposal is adopted. We are concerned that in these circumstances information regarding actual votes could be used to front-run funds to the detriment of fund shareholders.

[7] Some funds in the United States have chosen to disclose information about the votes that they cast. Others have made disclosures in particular cases.
