Funds and Proxy Voting

When a shareholder vote is required or sought, funds, like other issuers, must obtain both the requisite quorum and the necessary vote for the issue that is the subject of the proxy. Matters in which a shareholder vote is required are characterized as "routine" or "non-routine." Under NYSE Rule 452, NYSE members (primarily brokers and banks) are allowed to vote shares for which they have not received instructions from the beneficial owner by a date specified in the proxy materials on certain routine proposals. This practice is commonly referred to as "discretionary broker voting." The vast majority of fund shareholders buy fund shares through intermediaries, including intermediaries that are NYSE member firms subject to Rule 452.

With respect to both closed-end funds and open-end funds, uncontested elections of directors, the ratification of independent accountants and increases in the number of authorized shares of common stock are considered "routine" matters. "Non-routine" matters include many issues that state law or the Investment Company Act require to be presented to shareholders for the vote of a specified number or percentage of outstanding shares. These matters include proposed amendments to advisory agreements and proposed agreements and plans of reorganization.

NYSE Proxy Working Group

In April 2005, the NYSE created a Proxy Working Group to review current NYSE rules regulating the proxy voting process. In June 2006, the Working Group issued a report containing several recommendations with respect to the NYSE's proxy voting rules and, in general, with respect to the proxy voting process.[2]

Specifically, the Working Group recommended that the NYSE amend Rule 452 to make the uncontested election of directors a "non-routine" matter. The Working Group asserted that shareholder voting for directors is a critical component of good corporate governance, even where an election of directors is uncontested, and therefore brokers should no longer be permitted to vote the shares of beneficial owners who do not give specific voting instructions.[3]

There is no indication that the Working Group considered broker voting specifically in the context of funds when formulating its recommendations. To the contrary, it appears from the Proxy Working Group Report that its focus was on the status of broker voting in the context of operating companies. While we believe that shareholder voting for directors is an important component of a

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[2] *See Report and Recommendations of the Proxy Working Group to the New York Stock Exchange* (June 5, 2006) ("Proxy Working Group Report").

[3] The Working Group considered recommending the elimination of Rule 452 in its entirety but concluded that Rule 452 continues to have an important role in the proxy process, particularly with respect to allowing issuers to achieve a quorum for regular meetings.

strong corporate governance structure, eliminating discretionary broker voting for the uncontested election of directors in the context of funds will not increase or empower fund shareholder voting. In fact, we are not aware of any fund shareholders who have voiced dissatisfaction with the current proxy voting process as it relates to the uncontested election of fund directors. Nor do we believe the current process entails any detrimental effects on funds or fund governance.

Eliminating discretionary broker voting will create significant difficulties for funds in achieving quorums and getting directors elected. These concerns are not theoretical. As discussed in detail below, our members report significant difficulties in achieving quorums and getting matters approved when brokers are not permitted to vote. To get matters approved, it is frequently necessary for funds to engage soliciting firms and conduct multiple mailings, the costs of which can be significant. Even with these measures, funds often must adjourn meetings due to an inadequate voting response. Changing approval of directors from a "routine" to a "non-routine" matter will greatly exacerbate this problem.[4] Because the elections that are the subject of the NYSE proposal are uncontested, the same directors, in virtually every case, will be elected whether or not funds and their shareholders bear the additional costs. For these reasons, the Institute strongly recommends that the current system of discretionary broker voting be retained with respect to funds.[5]

NYSE Proposal to Eliminate Discretionary Broker Voting and Institute Report on Proposal's Impact on Funds

In October 2006, the NYSE filed a rule proposal with the SEC which would effectuate the Proxy Working Group's recommendation to eliminate discretionary broker voting for the uncontested

[4] As investors, 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. Therefore, whether the election of directors is deemed a routine or a non-routine matter will have little, if any, effect on the voting practices of funds as investors. *See* Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated December 6, 2002 (Institute letter regarding proxy voting by investment companies and investment advisers). To the extent that the companies in which funds invest are subject to higher costs in connection with solicitation of proxies, funds will share that burden along with other investors in the company.

[5] The Institute has taken numerous steps to inform the NYSE and the Proxy Working Group of the adverse consequences for funds and their shareholders if discretionary broker voting is eliminated. In June 2005, prior to the issuance of the Proxy Working Group Report, the Institute wrote to the Working Group expressing our concerns regarding the impact of the proposal on funds. Letter from Frances M. Stadler, Deputy Senior Counsel, Investment Company Institute, to Mr. Larry Sonsini, Chairman, NYSE Proxy Working Group, dated June 3, 2005 ("June 2005 Letter"). In July 2006, in response to the recommendation of the Proxy Working Group that discretionary broker voting be eliminated, the Institute wrote to NYSE staff reiterating our concerns. *See* Letter from Elizabeth R. Krentzman, General Counsel, Investment Company Institute to Catherine R. Kinney, President and Chief Operating Officer, NYSE Group, Inc., dated July 18, 2006 ("July 2006 Letter").

election of directors.[6] For the reasons discussed below, the Institute urges that investment companies be excluded from the NYSE proposal.[7]

The rule proposal applies to proxies relating to both closed-end funds and open-end funds whose shares are held through NYSE member firms. While the NYSE and the Proxy Working Group both recognized that eliminating discretionary broker voting may increase proxy solicitation costs for issuers in general, we understand that they did not collect or examine any cost data to measure the extent of costs that would be specifically incurred by funds and their shareholders if discretionary broker voting were eliminated. That the NYSE's proposal could advance so far in the absence of such fundamental analysis is of great concern to the Institute. We strongly recommend that, going forward, the SEC by rule, or Congress by law, require that all self-regulatory organizations perform a formal cost/benefit analysis prior to submitting regulatory proposals to the SEC.

To inform the regulatory process, the Institute surveyed its members to assess the impact of the NYSE rule proposal on funds and their shareholders and prepared a report with its findings in December 2006,[8] which we shared with the NYSE and the SEC.[9] Our report concluded that the rule proposal will have a disproportionate impact on funds as compared to operating companies, will create significant difficulties for funds in achieving quorums and electing fund directors, and will cause funds to incur significant and unnecessary costs - costs which ultimately will be borne by fund shareholders.

Eliminating Broker Voting Will Have a Disproportionate Impact on Funds

Investment companies have a far higher proportion of retail shareholders than most operating companies. Because retail shareholders are less likely than institutional investors to vote their proxies (many institutional investors have a fiduciary responsibility to do so), eliminating broker voting will have a disproportionate impact on funds, and funds will incur greater costs from the elimination of discretionary broker voting. Our research indicated that while retail shareholders hold about forty-

[6] *See* NYSE File No. SR-2006-92.

[7] The Institute understands that the NYSE intends to amend the rule proposal to exclude investment companies from the scope of the proposal.

[8] Costs of Eliminating Discretionary Broker Voting on Uncontested Elections of Investment Company Directors, Investment Company Institute (December 18, 2006) ("ICI Broker Voting Report"). A copy of the report is attached as Exhibit A.

[9] Letter from Paul Schott Stevens, President, Investment Company Institute to Catherine R. Kinney, President and Chief Operating Officer, NYSE Group, Inc., dated December 18, 2006, letter from Paul Schott Stevens, President, Investment Company Institute to Richard Ketchum, Chief Executive Officer, NYSE Regulation, dated December 18, 2006, and letter from Paul Schott Stevens, President, Investment Company Institute, to the Honorable Christopher Cox, Chairman, U.S. Securities and Exchange Commission, dated December 18, 2006. *See also* letter from Paul Schott Stevens, President, Investment Company Institute, to the Honorable Christopher Cox, Chairman, U.S. Securities and Exchange Commission, dated February 20, 2007.

eight percent of the value of operating company shares, they hold about sixty-four percent of the value of mutual fund shares. This disparity is even greater for closed-end funds, where retail investors own about ninety-eight percent of the value of shares.[10]

Funds Will Have Difficulties Achieving A Quorum if Broker Voting is Eliminated

NYSE members hold a substantial portion of fund shares in street name. Our research indicated that half of funds sold through sales forces had at least eighty percent of the fund's total shares outstanding held in this manner. Our report found that beneficial shareholders tend to return their proxies at a fairly low rate - approximately thirty-two percent of fund shares held in street name were voted. In contrast, when brokers are permitted to vote uninstructed shares, almost all shares (ninety-three percent) held in street name were voted. Eliminating broker voting for fund shares held in street name will create significant difficulties for funds in achieving a quorum, and, in turn, electing fund directors.

An uncontested director election by its nature is highly unlikely to elicit strong interest or participation from rank and file fund shareholders, only fifteen percent of whom ascribe significance to information about a mutual fund's directors when selecting a fund, according to a 2006 Institute survey.[11] Consider, for example, an uncontested election of directors of money market funds. Beneficial owners of money market funds understandably consider these funds to be a cash management tool akin to a bank account, and they are unlikely to evidence high interest in voting proxies at all, much less voting them in an uncontested election of directors.[12]

Fund Proxy Costs Will More than Double With the Elimination of Broker Voting

Because a significant number of fund shareholders choose not to vote shares held in street name, funds are forced to incur increased costs taking steps necessary to encourage shareholders to vote their proxies. Our research showed that these costs are significant. Because funds will have to engage in multiple solicitations, typical proxy solicitation costs will more than double from $1.65 to $3.68 for each shareholder account. Fund expense ratios will rise between one to two basis points, on average, with some funds' expense ratios increasing more than five basis points.[13]

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[10] ICI Broker Voting Report at pp.3-4.

[11] See Understanding Investor Preferences for Information, Investment Company Institute (2006).

[12] To illustrate the difficulties in attempting to achieve a quorum for a proxy vote of money market fund shareholders, the largest money market fund alone has 4.8 million shareholder accounts. Source: Strategic Insight Simfund (data as of March 2007).

[13] To obtain approval of non-routine matters, it is frequently necessary for funds to engage soliciting firms and conduct multiple mailings, the cost of which can be significant. Even with these measures, funds often must adjourn meetings due to an insufficient voting response. Our research indicated that no shareholder meeting in our entire sample with only routine matters on the agenda required a re-solicitation of shareholders or was adjourned for lack of a quorum. This result was due

Alternatives to the Elimination of Broker Proxy Voting

Several alternatives to alleviate the effects of eliminating discretionary broker voting have been suggested, including adopting a proportional voting system, lowering quorum requirements, or adding the shareholder ratification of auditors to fund proxies. For the reasons discussed below, the Institute believes these alternatives would not sufficiently address funds' concerns with the elimination of discretionary broker voting for the uncontested elections of directors and are not an adequate substitute to excepting funds from the NYSE proposal.

Proportional Voting

The alternative that has received the most attention and consideration is the adoption of a proportional voting system. Under a proportional voting system, uninstructed shares would be voted in the same proportion as instructed shares, with no minimum amount of instructed shares being required. Proportional voting may have certain practical advantages, such as facilitating reaching a quorum. Nevertheless, before considering whether proportional voting is a viable solution to funds' concerns and proposing it as an alternative to the elimination of discretionary broker voting, it would seem incumbent upon the NYSE and SEC to address a variety of issues relating to the potential costs and operation of such a system.[14]

First and foremost, a comprehensive analysis of the costs that would be imposed on funds by proportional voting must be conducted. Adequate time also should be provided to evaluate, and comment on, the particular proportional voting system that would be implemented. For example, it is unclear whether proportional voting would be implemented on an individual broker-by-broker basis, or in a way that aggregates all votes cast across all brokers. If implemented at the individual broker level, the views of active minority shareholders will have a greater effect on the outcome of the vote, particularly if their shares are held at one (or more) broker(s) with a large number of uninstructed shares.[15] In the case of closed-end funds, dissident shareholders could manipulate voting results if a broker-by-broker proportional voting system is adopted. With respect to an aggregate system, the entity that would aggregate votes would have to be determined, as well as whether that entity will vote the uninstructed shares on behalf of each broker. For both systems, it would have to be determined

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to the high rate at which brokers vote. In contrast, more than half of shareholder meetings in our sample with at least one non-routine matter required at least one re-solicitation.

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

[15] The Working Group stated that it was concerned that with broker-by-broker proportional voting the results can be skewed if one particular broker has a large number of uninstructed shares. Proxy Working Group Report at p.17.

whether instructed shares should be voted in proportion to all votes cast at the meeting or in proportion to instructed shares held in street name.

It also will be necessary to determine whether proportional voting will be used with respect to all non-routine issues, or only for uncontested elections of directors. If proportional voting is required for all non-routine issues, it will be important to clarify that funds can use proportional voting to obtain approval of non-routine matters that currently require a supermajority vote under the Investment Company Act.[16]

Lowering Quorum Requirements

Lowering quorum requirements has been raised as a possible solution to funds' concerns with the elimination of discretionary broker voting. This proposal raises significant problems. For example, funds would have serious difficulties in changing their quorum requirements. State law would need to be amended in some jurisdictions where funds are domiciled. Funds also would need to seek shareholder approval to amend their charters, declarations of trust, and/or by-laws to change quorum requirements. Because such an amendment would itself be a non-routine issue, the same problems created by eliminating discretionary broker voting in achieving a quorum would exist. Moreover, there likely would have to be a large reduction in funds' quorum requirements to have a measurable impact on costs because of the low rate at which beneficial shareholders return their proxies. Such a scenario seems to diminish, rather than enhance, shareholder rights.

Adding Shareholder Ratification of Auditors to the Proxy

Another proposed solution to funds' concerns with the elimination of discretionary broker voting involves adding shareholder ratification of auditors to the proxy. The NYSE currently views shareholder ratification of auditors as a routine matter. Because brokers would be permitted to vote on this issue, adding it to a proxy containing the uncontested election of directors may help assure a quorum. Asking funds to take this action *for the sole purpose* of achieving a quorum, however, is an unacceptable way to resolve issues associated with the proposal. Funds have not been required to ratify the selection of fund auditors since 2001, when the SEC adopted Rule 32a-4 under the Investment

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

Company Act of 1940.[17] It therefore would be illogical and inappropriate for the SEC to put funds in a position of choosing between seeking a shareholder vote on the ratification of auditors or being forced to incur the costs and difficulties associated with resolicitations and adjournments for the uncontested election of directors. There also is no assurance that in the future the NYSE will continue to view the ratification of auditors as a routine matter, potentially putting funds in the exact same position that they are in today.[18]

Shareholder Education and Communication Between Issuers and Shareholders

The difficulties created if discretionary broker voting is eliminated would be compounded by the fact that shareholders typically do not understand the proxy process, typically choose not to vote, and in most cases, cannot be contacted by the issuers who would urge them to vote. In our July 2006 letter, prior to the NYSE's filing of its proposal to eliminate discretionary broker voting, we recommended that the NYSE continue to allow brokers to vote uninstructed shares on uncontested director elections until certain steps are taken: (1) shareholders are sufficiently educated about the proxy process and the importance of voting so that they exercise their right to vote; and (2) the SEC revises its rules to permit issuers to contact their shareholders. We believe these efforts must go hand-in-hand with any initiatives to reform the proxy voting process.

Shareholder Education

As the Proxy Working Group Report notes, there appears to be a general lack of understanding in the investor community with respect to the proxy voting process and few investors realize the significant burdens and costs that are often incurred if they do not send in their proxy votes. We therefore believe that it is critical that any changes to the proxy voting process be accompanied by a significant effort to educate shareholders about the mechanics of proxy voting and its importance to issuers. Only after such an effort is undertaken and it is found that shareholder voting has increased should the elimination of discretionary broker voting be considered.

Communication Between Issuers and Shareholders

As discussed above, a majority of shares, including investment company shares, are held in "street name," by brokers, banks, or their depositories. Shareholders choose whether issuers may contact them. Shareholders who object to having their names and addresses disclosed to issuers are

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

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

Exhibit A

Costs of Eliminating Discretionary Broker Voting on Uncontested Elections of Investment Company Directors

December 18, 2006

INVESTMENT COMPANY INSTITUTE

Costs of Eliminating Discretionary Broker Voting on Uncontested Elections of Investment Company Directors

December 18, 2006

INVESTMENT COMPANY INSTITUTE

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Executive Summary

BACKGROUND

Under New York Stock Exchange ("NYSE") Rule 452, NYSE members—which consist primarily of brokers and banks—are allowed to vote uninstructed proxies for their customers who beneficially own the stock on routine items at shareholder meetings. This practice is commonly referred to as discretionary broker voting. Currently, an uncontested election of directors is considered a routine item, and NYSE members are allowed to vote proxies for beneficial owners who have not returned their proxies within 10 days of the date of the shareholder meeting.

In June 2006, the NYSE's Proxy Working Group recommended the elimination of discretionary broker voting by NYSE members in an uncontested election of directors.[1] The NYSE subsequently filed a rule proposal with the Securities and Exchange Commission ("SEC"), which, if approved by the SEC, would effectuate this change to discretionary broker voting for uncontested elections of directors. If approved, the rule proposal would apply to proxies relating to closed-end funds and mutual funds whose shares are held through NYSE member firms.

Investment companies generally hold shareholder meetings when required by state law or the Investment Company Act of 1940 and as otherwise needed to conduct corporate business. In addition, closed-end funds listed on the NYSE and other exchanges are required to hold annual shareholder meetings at which the election of directors is a matter presented for shareholder vote. Often, the election of directors is the only matter put before closed-end shareholders at annual meetings.

SURVEY DESIGN

The Investment Company Institute ("Institute") surveyed members regarding their experiences with shareholder voting to assess the impact of the NYSE's rule proposal.[2] We received information with respect to105 shareholder meetings of both closed-end funds and mutual funds from 40 different fund complexes. Many funds were able to provide complete information on types of matters presented for shareholder vote, quorum requirements, number of re-solicitations and adjournments, and total proxy solicitation costs for their most recent shareholder meetings.

Rochelle Antoniewicz, ICI Senior Economist, prepared this report.

[1] See *Report and Recommendation of the Proxy Working Group to the New York Stock Exchange* (June 5, 2006).

[2] A copy of the survey is provided in the Appendix.

Automatic Data Processing, Inc. ("ADP") reviewed 881 fund shareholder special and annual meetings held in 2005 and, based on this review, provided information on the portion of fund shares held in street name, the portion of fund shares voted by brokers, and the portion of fund shares held by objecting beneficial owners—critical pieces of information necessary to assess the effect of discretionary broker voting on the ability of funds to obtain the required quorum and vote needed to elect directors.[3]

KEY FINDINGS

Our key findings on the effect of eliminating discretionary broker voting for uncontested elections of directors of investment companies are summarized below.

- Eliminating discretionary broker voting will have a disproportionate impact on funds as compared to operating companies because funds have a higher proportion of retail investors.

- NYSE members hold a substantial portion of fund shares in street name. Half of closed-end funds and mutual funds sold through sales forces had over 80 percent of the fund's total shares outstanding held in street name.

- If discretionary broker voting is eliminated, typical proxy costs are estimated to more than double from $1.65 per shareholder account to $3.68 per shareholder account because many funds will have to engage in multiple solicitations. Even with re-solicitations, more shareholder meetings will be adjourned.

- Beneficial owners tend to return their proxies at a fairly low rate, and discretionary broker voting is an important mechanism for achieving quorum in uncontested elections of directors. Typically, only about one-third of mutual fund shares held in street name are voted by beneficial owners.

- Conservative analysis indicates that fund expense ratios could rise by approximately 1 to 2 basis points owing to higher proxy costs. For funds with smaller average account balances and more than the normal difficulties in obtaining voted proxies, expense ratios could increase by as much as 5 basis points.

- Small fund advisers are likely to bear a significant burden from the elimination of discretionary broker voting because many will have to assume higher proxy costs given the competitive nature of the mutual fund industry. Additional costs on small fund advisers create disincentives for entrepreneurs to enter the industry and push fund advisers with thin profit margins out of the business.

[3] Respondents to the Institute's survey were largely unable to provide this information.

Factors Affecting Total Proxy Costs From Eliminating Discretionary Broker Voting

In our assessment of the difficulties associated with eliminating discretionary broker voting, we examined several factors that will affect total proxy costs:

- Retail ownership of fund shares;
- NYSE members' holdings of fund shares;
- Voting response by beneficial owners of fund shares held in street name;
- Shares held by beneficial owners that cannot be contacted directly by funds; and
- Frequency of re-solicitations and adjournments of shareholder meetings with non-routine matters.

LARGE RETAIL OWNERSHIP CREATES A DISPROPORTIONATE IMPACT ON FUNDS

The portion of shares held by retail investors will significantly affect the cost of soliciting votes in an uncontested election of directors, as institutional investors are more likely to vote their shares than are retail shareholders.[4] Investment advisers to closed-end funds and mutual funds, for example, have a duty of care requirement to monitor corporate actions and vote client proxies in many instances. Fiduciaries to private pension plans—typically plan sponsors—are subject to similar requirements under ERISA.

Many large and mid-sized publicly traded operating companies have a majority of their shares held by institutional investors and will be less affected by the elimination of discretionary broker voting. Based on analysis ADP provided to the NYSE's Proxy Working Group, for NYSE-listed operating companies with more than five thousand shareholders, beneficial owners voted, on average, roughly 60 percent of the companies' total shares outstanding. Many of these voted shares are likely from institutional holders. Private pension plans and registered investment companies hold almost 40 percent of publicly traded operating companies' market value. As shown in Figure 1, retail shareholders are estimated to hold a little less than half of the aggregate value of operating companies' publicly traded stock.

Many funds have a majority of their shares held by retail shareholders and will have significant difficulties in achieving a quorum and obtaining the required votes to elect directors. In the aggregate, retail shareholders are estimated to hold about two-thirds of mutual fund assets and nearly all closed-end fund assets (Figure 1). Moreover, private pension plans hold only about 20 percent of mutual fund assets, including money market assets. While these aggregate figures are useful, they tend to mask any dispersion that may be present. In examining

[4] Institutional investors include private and government pension plans, investment advisers, insurance companies, depositories, municipalities, and proprietary accounts of brokers and dealers.

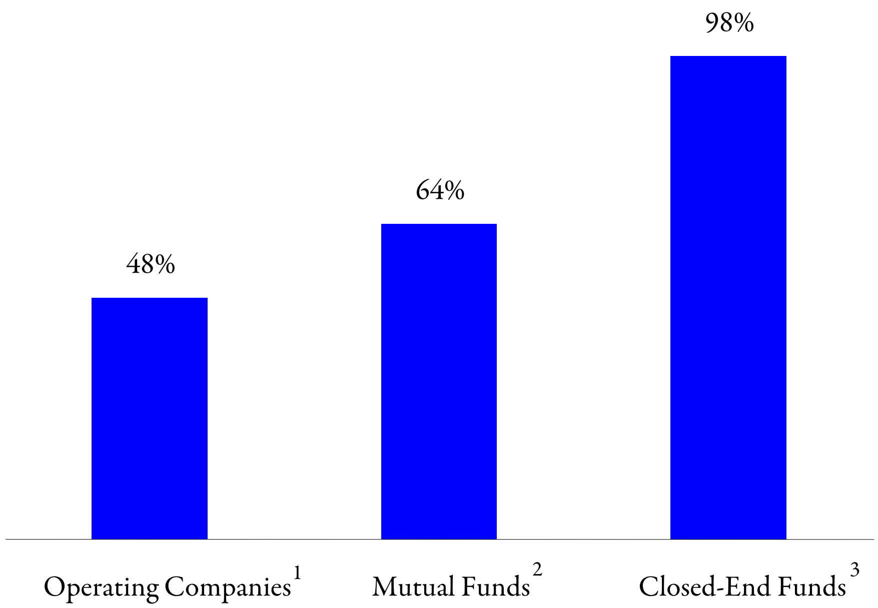
the distribution of retail holdings of mutual funds more closely, we found that for half of mutual funds, retail shareholders hold at least 82 percent of the fund's assets. The high percentage of retail shareholders helps to explain why, on average, only about one-third of beneficial owners with shares held in brokerage and bank nominee accounts voted their shares on routine matters.

Figure 1

Estimated Retail Holdings of Operating Companies and Funds

Percent of Aggregate Market Value of Shares

Year-End 2005



1. ICI calculation based on data from World Federation of Exchanges and the Federal Reserve Board; includes shares of foreign operating companies held by U.S. residents.
2. ICI calculation based on data from ICI Institutional Survey and Federal Reserve Board; includes money market funds.
3. ICI calculation based on data from two large fund complexes with 25 percent of total closed-end fund assets under management.

NYSE Members' Holdings of Fund Shares Are Substantial

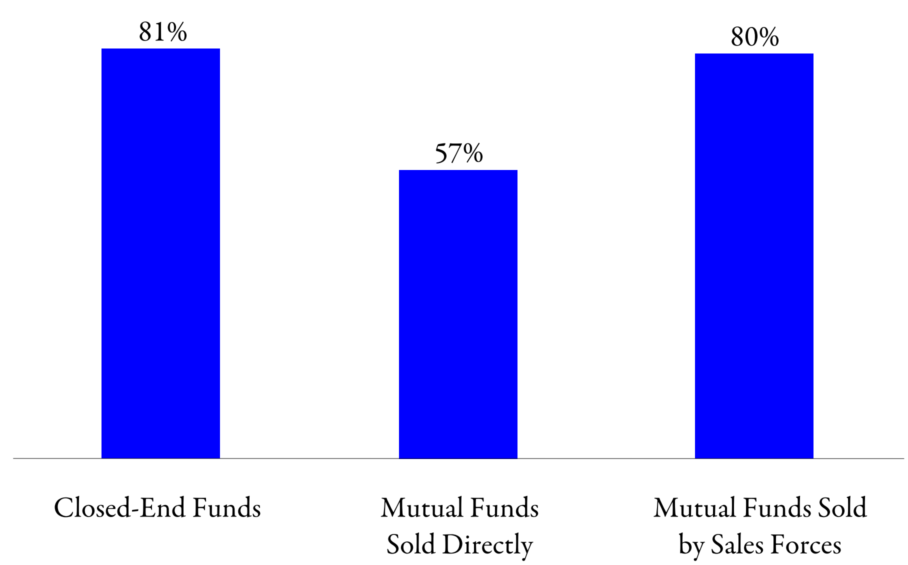
Another factor that will affect the cost of eliminating discretionary broker voting is the portion of fund shares held by NYSE members. The vast majority of investment company shareholders buy fund shares through intermediaries, including intermediaries that are NYSE member firms. Consequently, for many funds (particularly those that distribute to retail investors through financial advisers at national wirehouses, regional broker-dealers and banks) a substantial portion of their shares is held in "street name."[5] ADP estimated that street holdings of closed-end fund shares ranged from a minimum of close to 70 percent to a maximum of 100 percent. Half of closed-end funds had at least 81 percent of their total outstanding shares held in street name (Figure 2).

Mutual funds also have a significant portion of their shares held in street name. For mutual funds sold via sales forces (either proprietary or non-proprietary), shares held in street name ranged from 78 percent to 100 percent of total fund shares, with a median of 80 percent —similar to that of closed-end funds. Even mutual funds that are marketed directly to investors had a considerable amount of their shares held in street name. As shown in Figure 2, half of mutual funds sold directly had at least 57 percent of total shares outstanding held in street name. Direct-sold mutual funds often are offered on platforms or supermarkets, and these shareholder accounts generally are held in street name.

Figure 2

Percent of Fund Shares Held in Street Name

Median



Source: ADP

[5] "Street name" is used to identify accounts held by banks and brokers in nominee name on behalf of the beneficial owners. Not all banks and brokers are NYSE members, and ADP was unable to separate NYSE members from non-NYSE members in their analysis. We believe, however, that the majority of banks and brokers with accounts held in street name are NYSE members and that ADP's results provide a reasonable assessment of NYSE members' holdings of fund shares.

Beneficial Owners of Fund Shares Held in Street Name Return Proxies At a Fairly Low Rate

Another factor that affects the cost of eliminating discretionary broker voting is the voting response by beneficial owners. The more apt voters are to vote on the first solicitation of the proxy, the less costly it will be to eliminate discretionary broker voting. Beneficial owners of fund shares held in street name, however, return their proxies at a fairly low rate on routine items. Based on data collected by the Institute, the quorum requirement for a little over 60 percent of shareholder meetings pertaining to an election of directors was a **majority** of outstanding shares. Consequently, in an uncontested election of directors, discretionary broker voting is often important for funds to achieve a quorum.

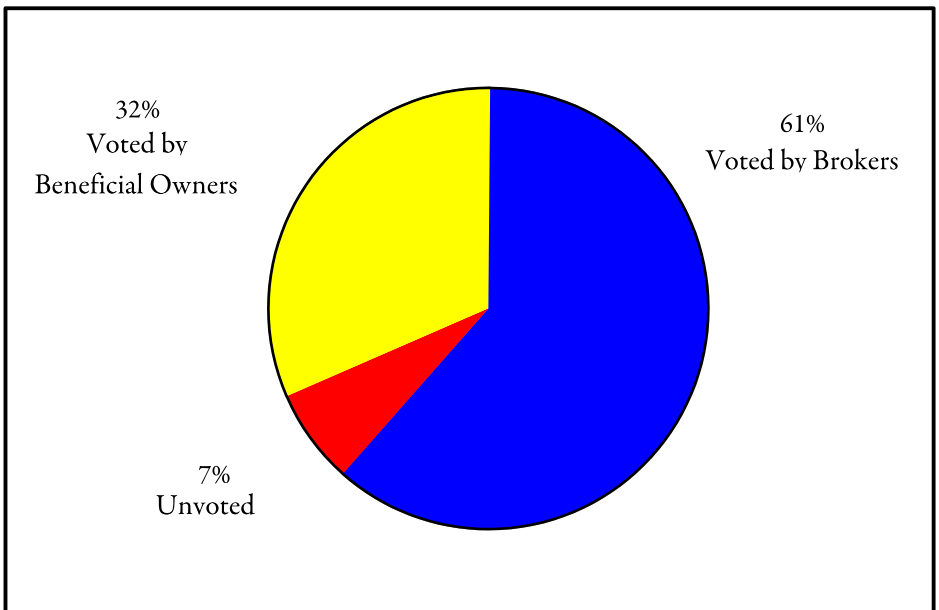
Based on ADP's analysis of voted proxies across both closed-end funds and mutual funds, beneficial owners for half of the funds voted on routine matters at most 32 percent of their shares held in street name (Figure 3). When brokers were allowed to vote, their votes accounted for at least 61 percent of shares held in street name for half of the funds. Overall, half of funds had at least 93 percent of street-held shares voted when discretionary broker voting was allowed.

Figure 3

All Funds

Percent of Fund Shares Held in Street Name

Median



Source: ADP

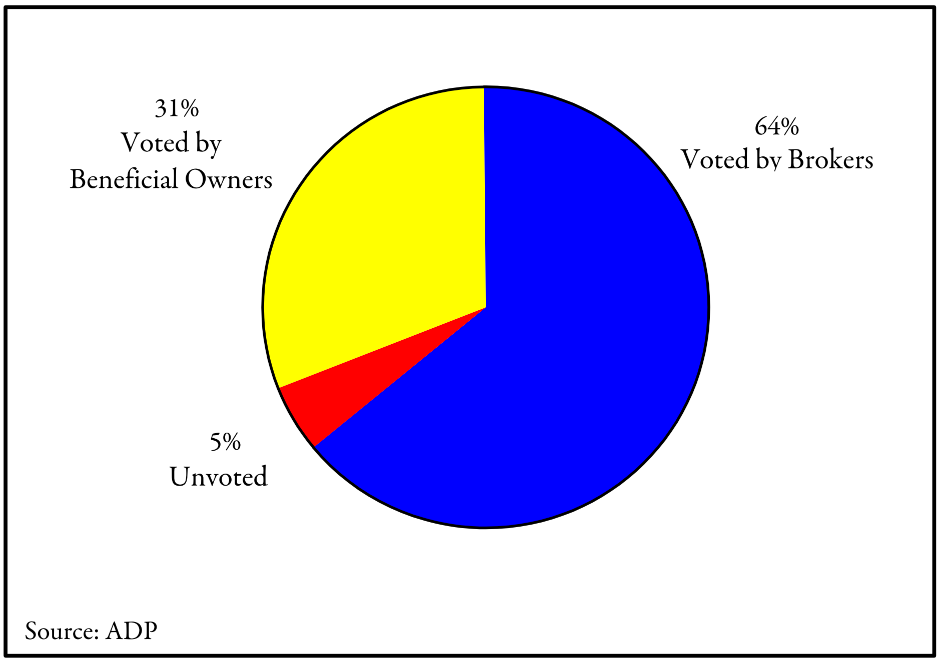
Even though closed-end fund shareholders are solicited annually by their funds to elect directors, many shareholders still do not vote. As shown in Figure 4, for half of closed-end funds, beneficial owners voted at most 31 percent of their shares held in street name. Shares voted by brokers for half of closed-end funds accounted for at least 64 percent of shares held in street name. As a result, for half of closed-end funds, at least 95 percent of shares held in street name were voted when brokers voted.

Figure 4

Closed-End Funds

Percent of Fund Shares Held in Street Name

Median



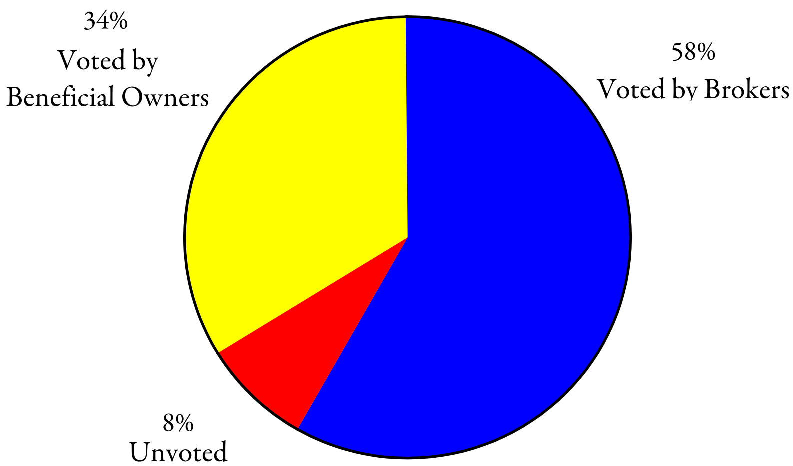
For mutual funds, most beneficial owners of shares also do not vote. For half of mutual funds, beneficial owners' votes on routine matters accounted for at most 34 percent of shares held in street name (Figure 5). Shares voted by brokers for half of mutual funds accounted for at least 58 percent of shares held in street name. For half of mutual funds, at least 92 percent of street-held shares were voted when brokers were allowed to vote.

Figure 5

Mutual Funds

Percent of Fund Shares Held in Street Name

Median



Source: ADP

By way of example, we considered the typical situation facing a closed-end fund with a majority quorum requirement. The average closed-end fund has about 80 percent of its shares held in street name and 20 percent held directly—nearly all of the fund's shares are held by retail investors. We know from ADP that beneficial owners typically vote 31 percent of their street-held shares.[6] As a result, a closed-end fund can expect beneficial owners with shares held in street name to vote one-quarter (.80*.31) of its outstanding total shares. Even if the closed-end fund could obtain votes from all of its remaining 20 percent of shares outstanding, the fund would only have a total of 45 percent of its outstanding shares voted—25 percent from

[6] This typical voting response by beneficial owners is likely representative of the response to an initial solicitation for an uncontested election of directors because ratification of auditors—the only other routine matter—is rarely presented for vote to fund shareholders.

beneficial owners of shares held in street name and 20 percent from direct investors. Consequently, the typical closed-end fund would fall short of a majority quorum in an uncontested election of directors without discretionary broker voting and without undertaking additional measures to solicit votes of beneficial owners.

Mutual funds, which also tend to have a significant percentage of their shares held in street name and have similar voting responses by beneficial owners, will face comparable difficulties in achieving quorum if discretionary broker voting is eliminated for uncontested elections of directors. For mutual funds, these difficulties in reaching quorum will be heightened if the SEC adopts its proposal to increase the required percentage of independent directors on mutual fund boards to 75 percent. As noted in the Institute's comment letter on the proposal, mutual funds are likely to need more frequent shareholder meetings for the election of directors because the board will have less flexibility to adjust to director turnover.[7]

Funds Cannot Communicate Directly With Some Shareholders

One of the challenges for funds in obtaining a quorum in the absence of discretionary broker voting is that in many cases they are prohibited from communicating directly with shareholders. Brokers invite their customers to choose whether closed-end funds, mutual funds, and other issuers whose shares they own may contact them. Based on ADP's analysis, for half of funds, at least 52 percent of shares held in street name are owned by shareholders who have indicated that issuers cannot contact them (Figure 6). Shareholders who object to having their names and addresses disclosed to issuers are called "Objecting Beneficial Owners" or "OBOs." SEC rules prohibit banks and brokers from providing funds with the names of OBOs. Shareholders who do not object to having their names and addresses given to issuers are called "Non-Objecting Beneficial Owners" or "NOBOs."

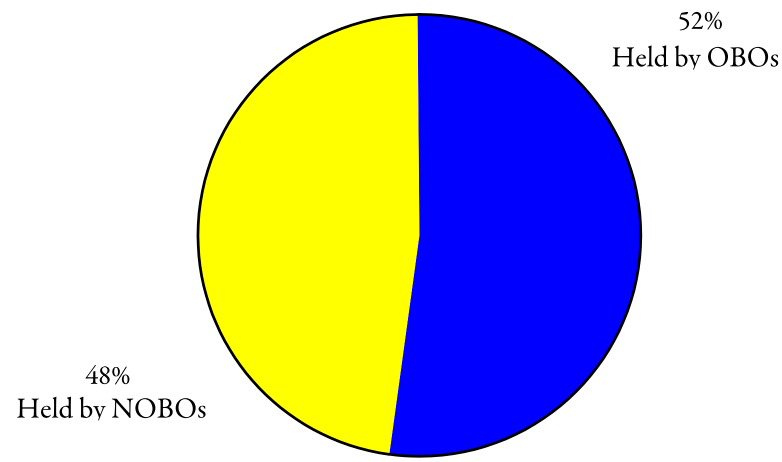
[7] *See* Letter from Elizabeth Krentzman, General Counsel, Investment Company Institute, to Nancy M. Morris, Secretary, Securities Exchange Commission, dated August 21, 2006.

Figure 6

All Funds

Percent of Fund Shares Held in Street Name

Median



Source: Investment Company Institute

Half of funds—those with a minority of their shareholders classified as NOBOs—have a limited pool of shareholders from whom they are allowed to solicit proxy votes over the phone. When funds are uncertain of obtaining a quorum, they encourage shareholders to vote via follow-up mailings or phone solicitation. While all shareholders receive reminder mailings,[8] at times, more intensive efforts are necessary for funds to obtain quorum. In these cases, funds often will focus their energies on NOBO shareholders. NOBOs can be contacted by either the fund or by a third-party proxy solicitor to obtain their votes over the phone.[9]

[8] ADP sends reminder mailings to OBOs. Funds, third-party proxy solicitors, or ADP send reminder mailings to NOBOs.

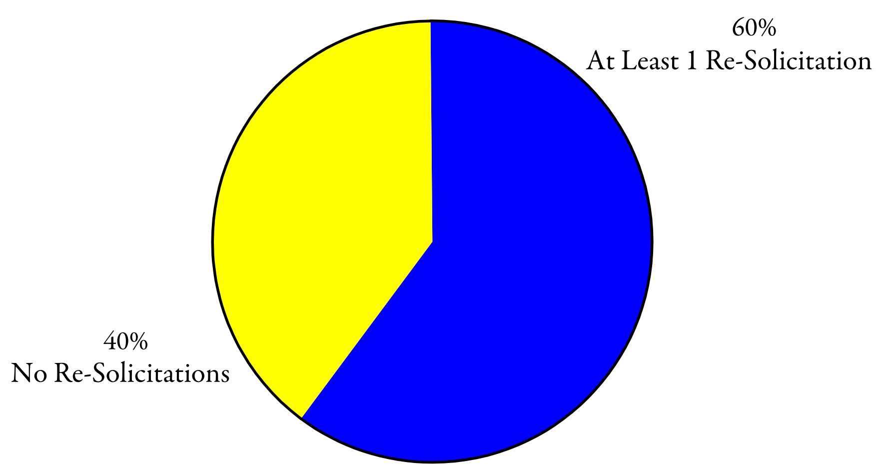
[9] Although phone solicitation is quite costly, some funds incur the expense to avoid the disruption caused by an adjournment of a shareholder meeting.

Re-Solicitations and Adjournments of Fund Shareholders Will Increase

If discretionary broker voting is eliminated for uncontested elections of directors, funds can expect to re-solicit shareholders and adjourn shareholder meetings at a higher frequency. Based on the Institute's survey, not a single shareholder meeting with only routine matters, such as an uncontested election of directors and/or ratification of auditors, on the slate required a re-solicitation of shareholders or was adjourned for lack of quorum. This result is expected because of the high rate at which brokers vote. In contrast, nearly 60 percent of shareholder meetings that contained at least one non-routine matter required at least one re-solicitation of shareholders (Figure 7).

Figure 7

Re-Solicitations of Shareholder Meetings With at Least One Non-Routine Matter

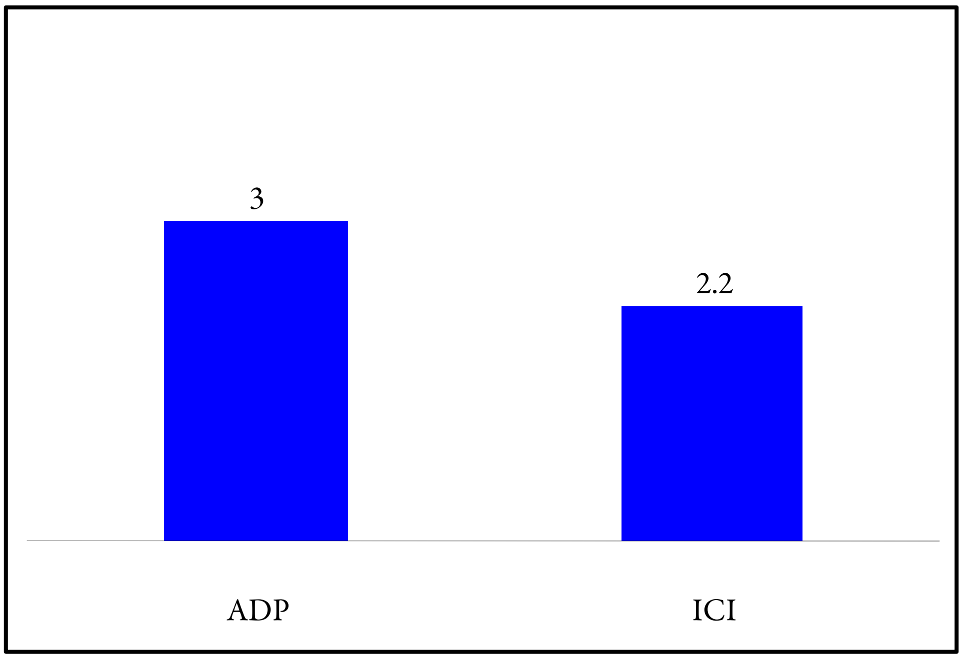


Source: Investment Company Institute

Funds that must re-solicit shareholders can expect, on average, to have to contact shareholders between 2 to 3 times to obtain quorum. Tabulations by both ADP and the Institute are reasonably consistent with one another (Figure 8). The maximum number of re-solicitations in the Institute's survey was 5 re-solicitations of shareholders.

Figure 8

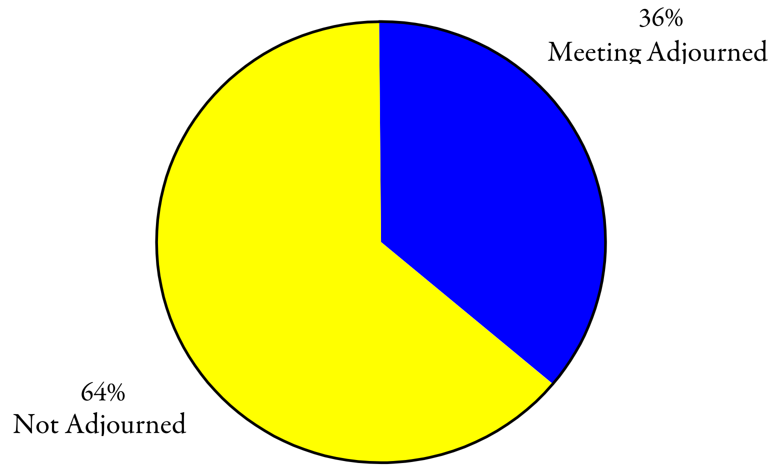
Average Number of Re-Solicitations of Shareholders



Despite re-solicitation efforts, some funds needed to adjourn shareholder meetings due to insufficient voting response by shareholders. Based on the Institute's survey, a little more than one-third of shareholder meetings with at least one non-routine matter were adjourned (Figure 9).

Figure 9

Adjournments of Shareholder Meetings With at Least One Non-Routine Matter

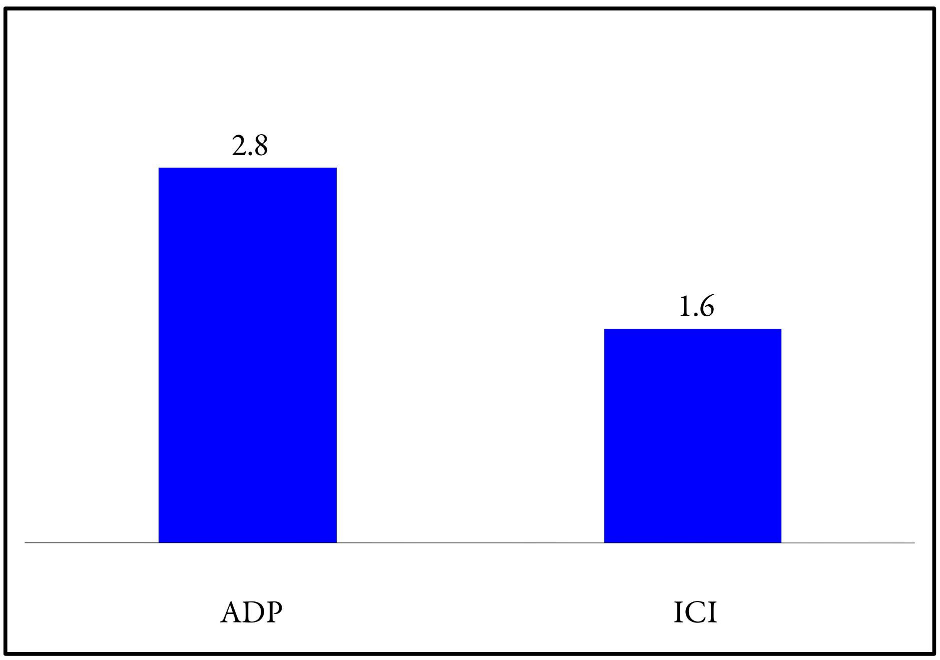


Source: Investment Company Institute

Funds that must adjourn shareholder meetings can expect, on average, to adjourn roughly between 2 to 3 times. As shown in Figure 10, tabulations by both ADP and the Institute again are reasonably consistent with one another. In ADP's analysis, one fund experienced a maximum of 17 adjournments of a shareholder meeting. The Institute's survey had a maximum of 5 adjournments of a shareholder meeting.

Figure 10

Average Number of Times Shareholder Meetings Were Adjourned



Impact on Fund Industry from Eliminating Discretionary Broker Voting

We assessed the impact on the fund industry from eliminating discretionary broker voting by:

- Estimating the increase in proxy costs for funds based on the typical voting response by fund shareholders under routine and non-routine scenarios;
- Estimating increases in fund expense ratios based on a range of voting responses by fund shareholders under a non-routine scenario; and
- Analyzing the competitive effect on small fund advisers.

PROXY COSTS FOR FUNDS WILL RISE SUBSTANTIALLY

If brokers are not permitted to exercise discretionary voting authority on uncontested elections of directors, we estimate that typical proxy costs will more than double from $1.65 per shareholder account to $3.68 per shareholder account (Figure 11). In order to assess the impact of eliminating discretionary broker voting, we examined proxy costs in two scenarios. The baseline scenario, which we call "Routine," is one in which all items on the shareholder agenda are routine and brokers are allowed to vote.[10] The other scenario, which we call "Non-Routine," is when there is at least one non-routine item on the shareholder meeting slate.[11] For ease of comparison, we scaled the proxy costs by shareholder accounts.[12] More detailed results of our analysis are shown in Table 1.

[10] Based on the Institute's survey, shareholder meetings with a routine slate are fairly common. Roughly one-third of the 105 shareholder meetings had a routine slate. In nearly all of the routine meetings, shareholders were voting on the election of directors.

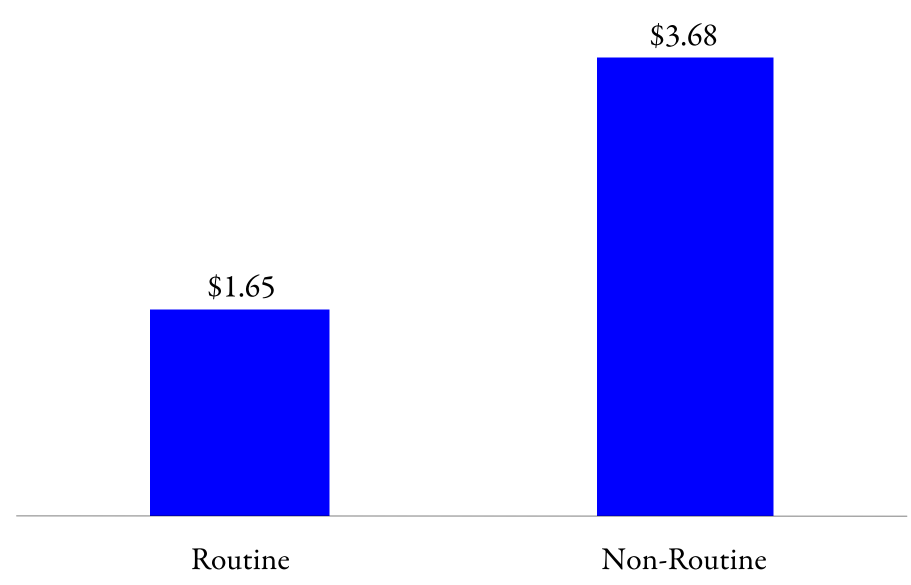
[11] The results are little changed if we only examine shareholder meetings in which all items on the shareholder agenda are non-routine. The presence of even one non-routine matter on the shareholder agenda significantly increased proxy costs.

[12] We derived cost estimates per shareholder account by looking through street holdings to the number of accounts held by beneficial owners. When possible, ADP provided the number of proxy items mailed—a good indicator of the number of shareholder accounts when ADP handled the entire proxy solicitation. The ADP figures also took into consideration householding, a common practice used to reduce mailing costs by bundling multiple proxy materials that are sent to a single address. When figures from ADP were unavailable or ADP did not handle the entire proxy solicitation, we used confidential data submitted to ICI on number of shareholder accounts by share class for mutual funds. We also examined the number of shareholder accounts reported on Form N-SAR filed with the SEC. If we found that we still did not have an accurate measure of shareholder accounts, we eliminated the proxy costs associated with those accounts from the analysis.

Figure 11

Fund Proxy Costs Per Shareholder Account

Median



Source: Investment Company Institute

Given the difficulties that funds face in obtaining votes from shareholders, funds often engage a third-party proxy solicitor to strategize timing, mailing, and phone follow-ups to help funds achieve a quorum. The Institute's survey collected all-in proxy costs for shareholder meetings. These proxy costs included charges for printing, mailing, and any services provided by proxy solicitors hired by the fund. We believe that the fund complexes that completed the Institute's survey are representative of the industry's experience with proxy voting by shareholders. As shown in Figures 8 and 10, ICI and ADP's figures on average number of re-solicitations and adjournments were quite comparable.

Several factors, all of which stem from shareholders' failure to vote, contribute to the increased proxy costs for Non-Routine shareholder meetings. One factor that can add up to $0.60 cents per item mailed is that funds frequently will send proxy materials that contain non-routine matters to shareholders via first class mail rather than at the cheaper bulk rate.[13] First

[13] Many funds send proxy materials with only routine items to shareholders at bulk rate, which depending on the weight of the package can be considerably less expensive than first class mail. For example, a one-page letter with a proxy postcard typically costs $0.28 to mail at the bulk rate. The same package typically costs $0.87 to mail at the first class rate. We do not have data on the frequency with which fund shareholders have consented to receive proxy materials electronically. For those shareholders that have opted for e-delivery, proxy solicitation costs would be less than for those who receive materials by regular mail.

class mail is faster than bulk mail. Understandably, many funds seek to take advantage of the full proxy period before the shareholder meeting so that if re-solicitations are necessary there will be sufficient time to avoid an adjournment.

Re-soliciting shareholders to encourage them to vote is expensive.[14] Besides sending additional mailings at the first class rate, funds may re-send proxy materials to shareholders by overnight delivery in an effort to obtain their vote by the deadline. Proxy costs escalate when funds have to use phone solicitation to persuade shareholders to vote. For example, one fund in the Institute's survey had a maximum of $9.97 per shareholder account in proxy costs (Table 1). For this fund, phone solicitation accounted for 44 percent of its total proxy costs of approximately $172,000.

In addition, funds can spend far more than expected on proxy solicitations. One major fund complex that conducted a complex-wide proxy solicitation estimated total proxy costs of $5.2 million in their definitive proxy material filings with the SEC. After 4 re-solicitations of shareholders and 2 meeting adjournments, proxy costs ultimately amounted to $19.2 million—3.7 times the original estimate.

Table 1

Fund Proxy Costs Per Shareholder Account

Minimum	$0.95	$1.12
25th Percentile	$1.27	$2.76
Median	**$1.65**	**$3.68**
75th Percentile	$2.39	$5.54
Maximum	$3.42	$9.97
Mean	**$1.85**	**$4.37**
Number of Meetings	26	57

Source: ICI calculations based on proxy costs from ICI Survey of Shareholder Voting and number of shareholder accounts from ADP, N-SAR, and confidential internal ICI data.

[14] Even if the OBO/NOBO distinction were eliminated, allowing funds to contact all of their shareholders directly "to get out the vote," re-solicitations still would be costly.

MANY SHAREHOLDERS WILL PAY MORE IN FUND EXPENSE RATIOS

Ultimately, fund shareholders will bear much of the burden of increased proxy solicitation costs. Fund expense ratios will increase if discretionary broker voting is disallowed for uncontested elections of directors, and if no other component of fund expenses declines. Typically, funds pay proxy costs, particularly for the election of directors, as part of the fund's total expenses.[15]

We conservatively estimate that fund expense ratios typically will rise between 1 to 2 basis points if funds have to change the treatment of an uncontested election of directors from a routine matter to a non-routine matter. For equity mutual funds, their expense ratios could increase as much as 5 basis points or more. In Tables 2 through 4, we provide a range of outcomes for the estimated increase in fund expense ratios for closed-end funds, equity mutual funds, and bond mutual funds.

In each case, the amount of the anticipated increase in the expense ratio of a given fund depends on two key factors: (1) the average account size; and (2) the amount of the increase in proxy costs per account. In short, the increase in the expense ratio will be larger when average account sizes are smaller and the increase in proxy costs is higher.

In the example provided below, we describe the calculation that is the basis for each of the figures shown in Tables 2 through 4. Closed-end fund shareholders typically pay about 117 basis points in fees and expenses.[16] For an average account size of $22,000, this translates into $257.40 in fees and expenses each year.[17] Closed-end funds are required to hold annual shareholder meetings in which they must elect the board of directors. Often, this is the only matter presented for shareholder approval. Consequently, current total fees and expenses of a closed-end fund most likely include proxy costs under a Routine scenario, which we estimate to be a median of $1.65 per shareholder account. If discretionary broker voting for uncontested elections of directors is disallowed, we estimate that the median proxy cost will increase to $3.68 per shareholder account. To assess the impact of this proposal on the expense ratio, we recalculated total fees and expenses under a Non-Routine scenario, holding management fees and other expenses constant. In this case, fees and expenses increase to $259.43 per year, pushing up the asset-weighted average annual expense ratio by nearly 1 basis point.

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[15] These proxy costs are generally included in the fund's annual operating expenses under the category "Other Expenses" listed on Form N-1A filed with the SEC. Occasionally, the fund's adviser will assume all or part of the proxy costs. In some instances, the sub-adviser will assume the proxy costs for the approval of a new sub-advisory agreement.

[16] To assess the costs investors currently pay across all closed-end funds, we used the asset-weighted average expense ratio for all closed-end funds.

[17] $22,000*.0117 = $257.40.

Example

Closed-end funds

Asset-weighted expense ratio = 117 basis points[18]

Average account size = $22,000[19]

	Routine	**Non-Routine**
Management Fees & Other Expenses	$255.75	$255.75
Proxy Costs	$1.65	$3.68
Total Fees & Expenses	$257.40	$259.43

Expense ratio under non-routine scenario = ($259.43/$22,000)*10,000 = 117.9 basis points.
Change in the expense ratio = 117.9 – 117 = 0.9 basis point.

As noted above, this calculation depends on the average account size and the amount of the increase in proxy costs. In the example shown above, the average account size of $22,000 was from one large closed-end fund complex. Other closed-end funds may have smaller or larger average account sizes.[20] For demonstration purposes, let's assume that one-quarter of closed-end funds have average account sizes of $11,000 (one-half of the $22,000), and one-quarter of closed-end funds have average account sizes of $44,000 (double the $22,000).

As shown in Table 2, for closed-end funds with an $11,000 average account balance, shareholders can expect the expense ratios of their fund to rise between 1 to 3.5 basis points. This range reflects the varying degrees of shareholder response in voting their proxies. If shareholders vote fairly readily, they likely will incur a $2.76 per account charge (the 25th percentile cost of a Non-Routine proxy), which would increase the fund's annual expense ratio by one basis point. However, if greater efforts such as phone solicitations and multiple mailings are required to obtain shareholder votes, then shareholders could easily incur a $5.54 (the 75th percentile cost of a Non-Routine proxy) or more per account charge, which would increase the fund's expense ratio by at least 3.5 basis points.

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[18] Figure based on ICI calculations of expense data for 2005 from Strategic Insight Simfund 4.0 database.

[19] Figure based on calculation from a large closed-end fund complex.

[20] Research conducted by the Institute in 1998 indicated that the median amount of household financial assets held in closed-end funds was $12,000, while the average was $41,500 (ICI Fundamentals, U.S. Household Ownership of Closed-End Fund in 1998, April 1999).