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**ABLE BUT NOT WILLING:
THE FAILURE OF MUTUAL FUND ADVISERS TO ADVOCATE FOR
SHAREHOLDERS' RIGHTS****

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Abstract

This study examines how investment advisers (“Advisers”) to large mutual fund families cast proxy votes on shareholder-sponsored, corporate governance resolutions. It links the amount of assets the Adviser managed at defined contribution (“DC”) retirement plans as of year-end 2005 to the overall percentage of proxies it cast in favor of 11 key categories of governance proposals at US- listed corporations during the 2006 proxy season.

These data reveal that for the ten largest fund families, the amount of DC assets under management by the Adviser is negatively correlated with support for shareholder governance resolutions. However, when the sample size is expanded to reach to lower tier fund families, this negative correlation is much weaker. These results support prior research findings that Advisers who have important business interests in the DC channel place those interests in asset gathering ahead of their fiduciary duties. Moreover, these data suggest that corporate governance reformers cannot rely upon large fund families to act in the interest of shareholders at large in their efforts to shift power from management.

This paper recognizes that Advisers to mutual funds are just one of the many intermediaries who stand between the underlying, risk-taking investor and the corporate managers who control the investor’s capital. Indeed, when the underlying investor is a participant in an employer-sponsored retirement plan many intermediaries are legally bound as fiduciaries to the investor. Yet, the incentives to favor corporate managers over investors appear to overwhelm these obligations.

Accordingly, this paper explores how investors who are many links away from the corporations in which they place their money at risk may be empowered. Among the suggestions is to borrow from British reforms by creating a uniform set of best practices for corporate governance. Fund Advisers would be required to report and justify any departure from casting proxy votes (related to management or shareholder proposals) in line with best practices. Ideally, this “comply or explain” practice would be inserted at each link of the intermediation chain – from the corporation all the way to the underlying investor.

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I. Introduction

Approximately 77.7 million individuals in the US invest in equities through stock mutual funds.¹ When these investors put their money to work and at risk, they depend upon strong corporate governance structures at corporations (“portfolio companies”) held by the mutual funds that they own. Unlike direct retail investors who can take action to influence corporate governance,² these 77.7 million individuals depend upon mutual fund advisers (“Advisers”) to advocate for them. Yet, when it comes to pushing portfolio companies for shareholder governance reforms, mainstream fund families remain passive. Even in areas where fund Advisers have an affirmative duty to act on behalf of the funds they manage (and thus to benefit the underlying investors in those funds), they fall short. Subject to a fiduciary standard, mutual fund Advisers owe a duty of care and loyalty with respect to all services performed on behalf of the mutual funds owners. This includes an obligation to monitor corporate events and to cast proxy votes in the best interests of funds.³ Yet data show that mainstream fund Advisers overwhelmingly cast votes in favor of management and against shareholder advisory resolutions on matters including corporate governance.⁴

Many theories have been advanced for the reluctance of fund Advisers to take an active or even passively supportive role in matters of shareholder empowerment. Under one, the “conflict of interest theory,” fund Advisers favor corporate management (or disfavor corporate shareholders) because of existing or potential business ties with corporate managers. While many have argued that conflicts of interest influence Advisers to act in pro-management, anti-shareholder ways, very little empirical research has emerged thus far to support such claims.

¹ Investment Company Institute and the Securities Industry Association, “Equity Ownership in America, 2005,” 2005, Figure 48, page 44.

² Direct retail investors would include those shareholders who own shares in their brokerage accounts. While these shares may be held in street name on the books and records of the corporation, these investors, do have the ability to vote, even if they often do not, and they have the ability to take other actions, such as to introduce shareholder resolutions, initiate lawsuits and so on.

³ *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963). Also see Tamar Frankel and Clifford E. Kirsch, *Investment Management Regulation*. (Durham: Carolina Academic Press, 1998). Under the antifraud provisions of the Advisers Act, Advisers are held to a fiduciary standard which applies “throughout its course of conduct” (p. 72). Also see, SEC Release for Final Rule: Proxy Voting by Investment Advisers, 17 CFR Part 275 and The Fund Proxy Voting Rule.

⁴ Research has revealed that fund families tend to support substantially similar proposals by management with great frequency than proposals by shareholders. The Corporate Library reveals that mainstream mutual fund families favor resolutions that are sponsored by management over resolutions sponsored by shareholders. This can be seen in two ways. First, the overall average support of management resolutions for all fund families studies was ninety two percent (92%). In comparison, the overall average support for shareholder sponsored resolutions for these fund families was thirty seven percent (37%) and of corporate governance matters alone (48%). The second more dramatic example of the inconsistent treatment can be seen where the subject matter of the resolution was generally the same. The four categories noted were (1) board declassification, (2) majority voting for directors, (3) severance pay and (4) simple majority voting. When management proposed such resolutions, overall support by fund families was 97%, 92%, 95% and 93 % respectively. In comparison, when shareholders proposed these types of resolutions, support was significantly lower, overall for fund families at 87.7%, 60.1%, 68.8% and 80.9% respectively.

Accordingly, I sought to explore whether a shareholder empowerment behavior is associated with a fund Adviser's economic interests. I linked the 2006 corporate proxy voting records on eleven key corporate governance topics for the ten largest fund families to the defined contribution ("DC") assets under management of each family's Adviser for the year-ended December 31, 2005. The result was a statistically meaningful negative correlation between DC assets and support for shareholder resolutions. Specifically, the analysis revealed that the greater the dependency of the fund Adviser upon the DC channel for asset management business, the less likely the fund family will be to support shareholder-sponsored governance resolutions.

Next, I considered possible explanations for this correlation, other than a conflict-of-interest. I have grouped these into the following categories: (1) Wall Street Rule, (2) Alignment of Economic Interests, (3) Legal and Political Obstacles, (4) Cost-Benefit and the Free Rider Problem (5) More Effective Behind-the-Scenes, (6) Fiduciary Duty, (7) Contract, (8) No Shareholder Demand, (9) Lack of Confidentiality, (10) Special-Interest Agenda and (11) Lack of Expertise While these defenses may work to explain passivity in some types of activism, none are solid explanations in the case of these corporate governance-related proxy votes.

In response to the results, this paper explores a range of reforms that would help make mutual fund Advisers less dependent upon corporate clients and more accountable to investors. These include: (a) Separation of Money Management from Retirement Plan Record Keeping, (b) Pass-through Proxy Voting and Proxy Assignments, (c) Default Proxy Assignments, (d) Best Practices for Proxy Voting and "Comply or Explain", (e) Uniform Disclosure "Product Label" for Proxy Policies and Procedures, (f) Choice at the Point-of-Sale and (g) A Voting Suitability Requirement.

In its conclusion, this paper takes a broader perspective, suggesting that corporate governance scholars and reformers use the mutual fund case to reexamine the prevailing framework which is largely based upon the agency problem recognized in 1932 by Adolf Berle and Gardiner Means. Berle and Means saw a shift between the 19th and 20th Century business enterprises. "Persons other than those who had ventured their wealth" were directing industry.⁵ They recognized that the separation of ownership from control would lead to "directors or titular managers who can employ the proxy machinery to become a self-perpetuating body, even though as a group they own but a fraction of the shares outstanding."⁶ They identified the agency problem as a conflict between the interest of management and owners, whereby management "can serve their own pockets better by profiting at the expense of the company than by making profits for it."⁷

In response to the fruition of their observations, much of corporate governance work focuses on that power balance between management and owners, and seeks to find ways to enhance shareholders rights. Or, the work looks to the failure of the boards of directors to look out for shareholders. Leading corporate governance scholar, John Coffee Jr. observed, "Academics tend to plough and re-plough the same furrow over and over. Nowhere is this truer than in the case of the scholars of corporate governance, who have studied the board of directors and shareholders

⁵ Adolf Berle, Jr. and Gardiner C. Means, *The Modern Corporation and Private Property*. (New York: Macmillan, 1947) at page 2.

⁶ *Id* at page 5.

⁷ *Id* at page 122.

endlessly.” In the world beyond academia, the effort to “shift control of the company from the board to shareholders has been constant and increasing.”⁸

For those who subscribe to a shareholder-centric vision of corporate governance, focusing just on direct shareholders ignores how much capitalism’s environment has changed. The concentration of ownership through pooled investment vehicles, such as mutual funds, and the growth of retirement savings plans, has led to a further revolution, an Intermediation Revolution. A staggering 69.4% of US equities are owned by institutional investors.⁹ In fact, ownership is concentrated with 100 institutions who own 52% of US equities.¹⁰ Yet these institutional owners are often collective investment vehicles like state and union pension funds and mutual funds. In other words, they are legally-constructed vehicles through which individual savers put their money at risk. Yet, those who make decisions as to the direction of those investments and those who exercise the legal rights of ownership are not the real investors, but managers or “registered investment advisers”. While “working people through their savings today hold the majority of stock in the most powerful enterprises in the world,”¹¹ they are not even mere legal owners anymore. Thus, ownership is now separated again. Investment has been separated from legal title. Investors who are the risk-takers are now pushed further away from the decision-makers, and the agency problem is amplified.

Accordingly, we should shift our focus from empowerment of *shareholders* to the empowerment of the underlying equity *investors*. More than just a semantic distinction, this new framework would recognize that institutional shareholders (such as mutual fund Advisers) cannot be expected to wrest power from or demand accountability from corporate managers. The intermediaries who stand between investors and corporate managers have their own interests, which are often at odds with the investors who trust them, and at times aligned with corporate management. This is seen in the arena of proxy voting. Accordingly, the first set of reforms to help not just investors in mutual funds, but also corporate shareholders at large, should start there.

II. Background on Mutual Funds

Mutual funds hold tremendous wealth, are ubiquitous savings vehicles for individual investors and have consolidated power. In terms of wealth, as of the year-ended 2006, assets in mutual funds worldwide stood at \$21.8 trillion. Of that, approximately 48%, or \$10.4 trillion was held in US- mutual funds.¹² In terms of ubiquity, the U.S. has approximately 90 million mutual fund

⁸ Martin Lipton, “Keynote Address to the 25th Annual Institute on Federal Securities,” Miami, FL, February 7, 2007 at page 4. Expressing these views with regret, Lipton commented on what he called the “threat that the shareholder activist movement will wrest control from boards entirely.”

⁹ Stephen Davis, Jon Lukomnik and David Pitt-Watson, *The New Capitalists: How Citizen Investors are Reshaping the Corporate Agenda*. (Boston: Harvard Business School Press) at page 4.

¹⁰ John C. Bogle, *The Battle for the Soul of Capitalism*, (New Haven: Yale University Press, 2005) at page 171.

¹¹ Id. at page 5. “When savers don’t feel and act like owners, corporations are free to behave as if they are unaccountable” at page 10.

¹² Investment Company Institute, “2007 Investment Company Fact Book,” 47th edition, page 15. US mutual funds include funds for which the portfolio includes foreign issues.

shareholders.¹³ Nearly half of all US households (51.8 million households) own *stocks* through mutual funds.¹⁴ That is, approximately 77.7 million Americans invest in equities through stock mutual funds.¹⁵ There are more than 4,000 individual equity mutual funds in the US with more than \$4 trillion in assets. With holdings of approximately 25% of outstanding US stock, the bloc voting power of mutual funds can sway election outcomes on matters from board directorships and executive compensation to shareholder governance and social issues. Notwithstanding the number of mutual funds in total, their power is very concentrated. The top 5 mutual fund families have about 37% of all assets, the top 10 have about 48% and the top 25, have 71%.¹⁶

The growth and power of mutual funds corresponds closely to the initiation of the 401(k) and other defined contribution retirement plans. Since the launch of these vehicles, the percentage of US household assets held in mutual funds has increased from 2.7% to 22%.¹⁷ As of year-end 2006, there were \$2.7 trillion in 401(k) plan assets, 51.9% of which was invested in equity mutual funds.¹⁸ This is up from just \$385 billion in 1990. Presently, nearly 2/3 of fund investors do so through employer-sponsored retirement plans.¹⁹

Notwithstanding the wealth, ubiquity and power of mutual funds, few appreciate their role in matters of corporate governance. Fewer have undertaken empirical research to measure correlations between industry conflicts-of-interest and proxy voting behavior. Prior to discussing the findings from my research on these correlations, first, I will provide some relevant background on the mutual fund business.

A. Structure and Distribution Channels

A Mutual fund is a legal construct, a business trust or corporation which pools customer money to invest in a portfolio of securities. Most funds are invested in stocks, bonds or money market instruments. Some own a mixture. A mutual fund that holds corporate stocks is considered to be the shareholder of that corporation. The person (or institution) who invests money in the mutual fund is considered to be the shareholder of the mutual fund.

Mutual fund shareholders vary. Some shareholders are individual investors who directly purchase their shares from the mutual fund firm, or who purchase them through the use of a broker. These shareholders are retail investors. Other shareholders are institutions, such as corporations or retirement plans.²⁰ The needs of shareholders vary, as do the types of funds they

¹³ Investment Company Institute, "Research Commentary," January 2006.

¹⁴ Investment Company Institute and the Securities Industry Association, "Equity Ownership in America, 2005," Page 9.

¹⁵ *Id.* Figure 48, page 44.

¹⁶ Investment Company Institute, Research Commentary, January 2006, figure 2.

¹⁷ Investment Company Institute, "2007 Investment Company Fact Book," 47th edition, page 3.

¹⁸ *Id.* page 78.

¹⁹ Investment Company Institute, "Research Commentary," January 2006.

²⁰ In much of the Investment Company Institute data, however, individuals who own mutual funds through retirement plans are counted as fund "shareholders" though, in fact, they are plan participants, with the plan itself the shareholder.

might choose. For example a corporation might purchase shares of an institutional money market fund as a place to “park” daily cash flow in order to earn interest income overnight. Unlike with other pooled investment vehicles, mutual funds are very liquid. By law mutual funds must redeem shares for cash upon a shareholder’s request at that day’s closing price, with proceeds distributed usually next day, but no more than 7 days.

In the case of equity funds, where the mutual fund owner is not a *direct* shareholder of the portfolio company, he or she instead is a *beneficial owner* of the portfolio company. For example, a mutual fund owner who is an individual person, is the beneficial owner, who puts his or her capital at risk. The mutual fund owner experiences the gain or loss as the value of the stock and other investments in the fund increase or decline.²¹

Typically, a mutual fund has no employees. It has a board of trustees or a board of directors. Because the mutual fund is usually a shell, this board takes action on its behalf. In theory, the mutual fund board “hires” an investment adviser to manage the investments within the fund. Among other things, this Adviser is a fiduciary and owes the fund a duty of “utmost good faith and full and fair disclosure.”²² To be sure, notwithstanding the title, the Adviser provides not just advice to the fund, but also discretionary management services. In addition, in theory, the board hires a transfer agent to keep track of customer information, a principal underwriter to advertise and sell shares of the mutual fund to customers, a custodian to safe-keep fund assets, auditors and other service providers.

In reality, though, the mutual fund Adviser runs the show. The Adviser is often a wholly owned subsidiary of a financial services firm. Some such “adviser firms” are known as “fund families” or “fund complexes” given the numerous mutual funds that each adviser firm launches and sustains. The Adviser may be a private or a public corporation. The Adviser firm that launches the fund initially selects a slate of directors to be elected by the fund shareholders and continues to nominate directors on a periodic basis. Some of these directors are also employees of the firm. Others are “outside” directors unaffiliated with the Adviser firm. The directors meet on a regular basis, often monthly to ratify various agreements and fulfill legal requirements.

The initial sponsor is nearly always hired by the board to manage the fund. This has been the case since the origin of investment trusts and mutual funds.²³ The Adviser hires portfolio managers, individual employees who make investment decisions for the fund. The mutual fund shareholders initially approve the mutual fund Advisory contract, but thereafter, the board has this authority. Annually, the mutual fund Adviser “negotiates” its fees with the board of directors. Additionally, the adviser firm is hired to perform many other services for the fund. In theory, the board could fire the Adviser firm, but this only extremely rarely happens. Mutual funds are essentially captive to their creators. John Bogle, founder and former chairman of the

²² *Capital Gains* and Section 36(b) of the 1940 Act, 15 U.S.C. 80a-35.

²³ John Kenneth Galbraith, *The Great Crash 1929*, (Boston: Mariner/Houghton Mifflin, 1997). (“The sponsoring firm normally executed a management contract with its offspring. Under the usual terms, the sponsor ran the investment trust, invested its funds, and received a fee based on a percentage of capital or earnings.” Page 50)

Vanguard Fund contends that structure of mutual funds “gives managers near-total dominion over fund shareholders.”²⁴

Mutual fund shareholders purchase fund shares through a number of different distribution channels. Some individuals purchase shares directly through the fund complex either from the fund underwriter or an affiliated (or unaffiliated) broker-dealer. This is known as the retail channel. Others “purchase” shares through their defined contribution (“DC”) plan that is sponsored by their employer. This is known as the retirement channel. In the retirement channel, though, the retirement plan is the legal owner of fund shares. The employee is considered a “plan participant” and merely directs the plan to make investments of his or her pre-tax wages in accordance with his or her instructions. In this structure, the plan participant is the investor who takes the economic risk, but he or she is not legally deemed an owner of the mutual fund or the portfolio company. In this way he or she is distanced even more from the location of control over the capital he has at risk.

The most significant distribution channel for equity mutual funds is the retirement channel. Thanks to special tax treatment, tremendous incentives have been created to encourage workers to invest their wages into mutual funds held by retirement plans. In the US, the primary forms of private pension plans are defined benefit and defined contribution plans. A defined benefit plan promises an employee a set amount of money upon retirement. This set amount of money is calculated according to variables set out in the plan. These variables differ from company to company but include such factors as the number of years the employee works for the company before retirement, the employee’s final salary or an average of the last few years of the employee’s salary as well as his or her age at retirement. With defined benefit plans, also known as traditional pension plans, the employer (as opposed to the employee) takes the investment risk. A DC plan (such as those known popularly by the various sections of the Internal Revenue Code under which they are governed: 401(k), 403(b) or 457) shift the risk to the employee.

Others purchase shares through affiliated or unaffiliated investment advisers at banks or brokerage houses or other advisory firms. These advisory firms act as a “front office” and the fund complex or another organization often acts as the “back office” processing customer orders and sending statements. This is known as the intermediary channel. If an owner purchases mutual fund shares through the intermediary channel, he or she is still an owner of fund shares, even though his or her identity, address and other personal information may not be fully disclosed on the books of the fund. Some institutions (such as a corporation investing overnight cash) are mutual fund customers and purchase shares directly through the fund complex. This is known as the institutional channel.²⁵

B. Benefits and Costs

Mutual funds benefit market participants differently. For direct shareholders who hold shares through the retail or intermediary channel, and for indirect shareholders who hold fund shares through a retirement plan, benefits include the ability to invest a relatively small amount of

²⁴. Bogle at 142.

money and yet have access to the expertise of professional money managers. Individual shareholders also benefit from achieving a diverse portfolio of securities that would otherwise be difficult to hold efficiently given the small dollars invested.

For the Advisers who manage mutual funds, benefits include the payment of management fees based upon the dollar value of the assets managed. In other words, mutual fund Advisers get paid regardless of performance. From a financial perspective, performance is important as the better the portfolio securities perform; the larger the pool of assets under management and thus the greater the Adviser fees. In addition, good relative performance leads to more shareholders sending their money into the pool for investment and thus more assets and larger management fees. And, relatively poor performance results in a greater flight of assets from a fund, leading to owner “redemptions” (taking cash out of the pool), and thus lower management fees.

Benefits for Advisers also include payment of management fees by millions of individual investors without the need to invoice and collect from them. This is the case because the management fee (and expenses) are built-in to (i.e. automatically deducted from) the net assets of the fund. This means when an investor buys into the fund (whether through the retail, intermediary or retirement channel), what he or she pays per share includes the management fee. The daily value of each fund share is based upon the value of portfolio securities (net of management fees and expenses) divided by shares outstanding. This daily value is, known as the net asset value (commonly referred to as the “NAV”). When an investor wants to cash out of the fund, which he or she can do, on demand, the amount the customer gets for his or her shares is based upon this NAV. Such a benefit is not insignificant. Individual investors need not be negotiated with, invoiced or found. Fee payment is instantaneous with, no loss of float income for the fund or the fund’s Adviser.

Advisers of funds also benefit from their ability to use fund assets to attract new investment dollars. This money is also automatically deducted from the portfolio, and thus “built in” to the NAV. While the amount paid to attract more assets, whether through advertising or other means of distribution, must be disclosed, this benefit is very real. Advisers use the assets of existing investors to bring in future investors. Some may argue that this is also a benefit to fund investors. The theory would be that economies of scale exist when the pool of assets grow larger. However, this is very dependent upon the actual size of the fund. Experience has shown that exceedingly large multi-billion dollar funds become unwieldy.²⁶ Accordingly, fund complexes often close funds that get too large to new customers (while allowing existing investors to continue purchasing).

Fund Advisers also have ready access to the resources needed to operate the fund. Some of these resources include money deducted from the portfolio assets and also disclosed, in a generalized way as a fund expense. However, sometimes the resources taken from the fund have value but are not clearly monetized. One example is commissions paid out of fund assets to brokerage firms. In theory these payments are made to brokerage firms in exchange for actual services. For example, the fund Adviser may need to buy and sell portfolio securities. Given the multi-billion dollars in securities bought and sold, brokerage firms are very eager to be hired to execute these

²⁶ Bogle at 170.

transactions. In theory brokerage houses should compete to earn this business, and in theory, offer lower fees.

In practice, however, fund Advisers have directed brokerage business to certain brokerage firms in exchange for research. This is known as “soft dollars.” The research should benefit fund customers. However, if not, then fund assets are being used by the Adviser to benefit the Adviser. Moreover, many fund firms operate “directed brokerage” programs through which the Adviser takes fund assets and pays brokerage commissions to firms that did not actually execute trades. These payments are made to reward the brokerage firm for helping to sell fund shares to the brokerage firms own customers.

Sell-side participants and the market generally also benefit from the existence of mutual funds. Investment banks have a ready market for large issuances of debt and equity instruments.²⁷ For example, instruments like mortgage-backed securities, asset-backed commercial paper and other complex derivatives are engineered to allow for banks to keep laying off risk for business endeavors like sub-prime mortgage lending, automobile sales, and low credit municipal securities. Besides creating liquidity through fixed income funds, equity mutual funds help maintain a ready market for IPOs and a liquid secondary market in securities.

Just as mutual funds present positive benefits to market participants and the market generally, they also have their detriments or costs. At one end of the spectrum are those who consider actively managed mutual funds to be a bad deal for customers.²⁸ Illinois Senator Peter G. Fitzgerald (R) challenged the entire structure of the industry:

“The governance structure of a typical mutual fund is a study in institutionalized conflict of interest. Until we eliminate the conflicts, lots of mutual funds will continue to engage in behavior that benefits fund managers at the expense of fund shareholders.”²⁹

Some critics suggest that individuals are better served by an index fund that would have lower expenses. Given that even the most successful money managers have difficulty beating the market by more than 1 – 2% points each year, critics believe that most actively managed funds will be able to beat an index only if such funds have extremely low expenses.³⁰ According to these critics, the top 20% of equity mutual funds with the highest expenses charged an average of 1.85% more than the 20% with the lowest expenses. However, those top funds earned 1.91 % less.³¹ Stated in more stark terms, an investment of \$10,000 for the twenty-year period beginning 1985 and ending 2005 would return a profit of \$109,800 if invested in the S&P 500 index. In

²⁷ “Funds serve as an important source of capital in the equity and fixed-income markets. Investment companies are among the largest investors in U.S. stocks, commercial paper, and state and local government debt.” 2007 *Investment Company Fact Book*, 47th Edition.

²⁸ See Bogle: “Cost incurred by equity fund investor alone – largely management fees and operating expenses – have increased from a mere \$15 million in 1950 to \$37 billion in 2004.” P. 154.

²⁹ Senator Peter G. Fitzgerald, opening statement before the Subcommittee on Financial Management, the Budget, and International Security hearing entitled, “Mutual Funds: Trading Practices and Abuses That Harm Investors,” U.S. Senate, November 3, 2003.

³⁰ Jason Zweig, “Your Funds May be Making You Rich . . . But You’re Also Getting Robbed,” *Money*, February, 1997.

³¹ *Id.*

contrast, that same \$10,000 investment would produce just \$62,900 in profit if invested in an average actively-managed fund.³²

Pooling of assets through mutual funds creates mutual fund investors who are indirect owners. Being an owner of a public company carries a bundle of rights and expectations. Including within those is a right the right to vote at annual or special meetings. This shareholder franchise though, is a limited one, even for direct shareholders. A mutual fund that pools assets also pools voting rights. The mutual fund customer loses the ability to vote those shares in the portfolio company. Those rights get aggregated with other customers’.

Such voting rights aggregation has a number of effects. One effect is a silencing vis-a-vis other shareholders. Consider this example. If investor A were to invest \$100,000 directly into a selection of corporate stocks (all at \$100 per share) and investor B were to invest \$1,000 in the same group of stocks, investor A would have 1,000 votes and B just 10. Each could vote differently, investor A for a shareholder resolution and B against. However, if they both owned shares in a mutual fund with holdings in the same selection of corporate stock, the mutual fund Adviser would cast all of its votes in one direction, let’s say against the shareholder resolution. In this way, investor A, though she or he had 100 times the investment does not have 100 times the voice. In fact, Investor A has no voice on the matter. Meanwhile, B’s voice has been amplified. Voting rights aggregation also impacts shareholders “outside” the mutual fund. Other true owners of corporate stock lose out when they are a part of a minority voice on a topic when a mutual fund votes on the other side of an issue or fails to vote entirely.

Another cost to mutual fund investment is that sometimes, large customers are given special treatment to the detriment of small investors. Some of this preferential treatment is lawful and some is not. Unlawful examples involve allowing larger investors to engage in “hot money” transactions that are inconsistent with the fund prospectus and “after hour trading.”

Another cost to mutual fund investment is lost advocacy beyond the voting context. Unlike a direct shareholder, a fund shareholder may not introduce a shareholder resolution in a portfolio company’s proxy materials. In addition, a mutual fund customer may not participate in a securities class action settlement. Instead, mutual fund customers rely upon the mutual fund to collect settlement amounts on behalf of the funds. A recent lawsuit contends that mutual funds have left millions if not billions of dollars “on the table” for failing to file notice of claims in class action lawsuits. In January of 2005, more than 40 mutual fund managers were sued for failing to file claims in securities class action settlements. According to the allegations, up to \$2 billion of settlement payments were left unclaimed.³³

C. Regulation

Mutual funds are highly regulated under the U.S. federal securities laws. Unlike operating companies (i.e. General Motors, IBM, and Microsoft), which are largely subject to state corporate law, mutual funds are governed by federal corporate law. What this means is that the

³² Bogle at 163.

³³ Institutional Shareholder Services, The Fiduciary Duty to File Claims in Securities Class Action Settlements, January 2005. Available at <http://www.issproxy.com/pdf/FiduciaryResponsibilitytoFileClaims012005.pdf>

structure and operations of funds are governed by the Investment Company Act of 1940 (the “1940 Act”). Unlike operating companies which issue new shares upon an IPO (or secondary offering), mutual funds are continually offering shares. Thus, the advertising and sale of fund shares to the public is governed by the Securities Act of 1933 (the “1933 Act”). The distribution of fund shares is additionally governed by the Securities and Exchange Act of 1934 (the “1934 Act”). The mutual fund manager or “Adviser” is regulated under the Advisers Act of 1940 (the “Advisers Act”).

Each of these statutes has corresponding Securities and Exchange Commission regulations. In addition the SEC rules, a body of less formal rulemaking in the form of no-action letters and exemptive relief allows mutual funds, their Advisers and other service providers to seek comfort or assurance that they are not running afoul of legal mandates or prohibitions.

The 1940 Act requirements and prohibitions were enacted to address the abuses that were seen in the early twentieth century involving pooled investment vehicles known as “investment companies.” As the act has been amended over the years, these changes are also attempts to protect investors. The first open-end mutual fund was launched in 1924,³⁴ and not long after that, investors were being exploited. At the heart of the law is the goal of protecting investors from unscrupulous fund sponsors who put their interests ahead of their customers.³⁵ Then SEC Commissioner Robert E. Healy articulated this in the legislative history. “In the opinion of the [SEC], and the industry itself, this legislation is needed to protect small investors from breaches of trust upon the part of unscrupulous managements and to provide such investors with a regulated institution for the investment of their savings.”³⁶

In other words, the law recognizes that an inherent conflict of interest exists between an investor and a money manager³⁷. Moreover, the 1940 Act and the Advisers Act implicitly acknowledges that the standard common law fiduciary duty was not enough to prevent harm to investors. In the seminal Supreme Court Decision on this matter, *S.E.C. v. Capital Gains Research Bureau, Inc.*, the Court found that the antifraud provisions of the Advisers Act apply “throughout the course of conduct.”

Thus various sections of the 1940 Act, attempt to remedy the abuses through mandated disclosure to investors, prohibitions on self-dealing transactions, governance structure

³⁴ Robert Pozen, *The Mutual Fund Business*, (Cambridge: The MIT Press, 1998) citing the Investment Company Institute, *1997 Mutual Fund Fact Book*, 37th edition (In 1924, the Massachusetts Investors Trust was launched with just \$50,000 in assets invested in 45 stocks.)

³⁵ According to Joel Seligman in *The Transformation of Wall Street*, 224 (Boston: Northeastern University Press 1995), “The basic sin of the investment bankers who formed investment companies before the 1929 crash had been self-interest.”

³⁶ Tamar Frankel and Clifford E. Kirsch, *Investment Management Regulation*. (Durham: Carolina Academic Press, 1998) at 29 quoting the Investment Trust Study. Investment Company Act of 1940 and Investment Advisers Act of 1940, H.R. Rep. No. 76-2639, at 6 – 10.

³⁷ The Investment Company Act of 1940, 15 U.S.C. Sec. 80a-1. (“The national interest and the interest of investors are adversely affected --when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies’ security holders”.)

requirements, limitations on leveraging of fund assets and bans on other transactions that would allow the fund sponsor (the Adviser) to siphon off investor money. Equally significant, is the requirement of mutual fund shareholder consent before changes are made to the fund objectives. Moreover, the requirement that the fund board of trustees or directors contain a certain minimum percentage of “outside” individuals reflected the hope that the board, if not fully captive to the Adviser, would better protect the mutual fund customers.

In the area of conflicts of interest, the Act targeted known practices and concerns. Particularly suspect are activities under which the Adviser (or any of its affiliated companies) is hired to perform a service for the mutual fund. The concern was that the Adviser would overly influence the mutual fund to pay it more than a fair market rate for its services. Other concerns grew from an Adviser having many mutual funds under its management. An Adviser with a centralized trading desk, has a strong incentive to direct favorable trades to some mutual funds and the bad trades to others. Adviser firms made sure that they were the shareholders of the pools that received the good trades. Other abuses included “front running” where the Adviser and its employees would buy securities for their own account before they bought them on behalf of the mutual fund. To the extent the mutual fund purchases would drive up the price of the instrument, the Adviser would have benefited from a lower price.

Advisers, often investment banks would also “dump” poorly performing securities into the funds, which being captive, would purchase them at above market prices.³⁸ Some mutual funds were captive purchasers of security issuances underwritten by their sponsor/Advisers. According to John Kenneth Galbraith, “Many of the sponsors were investment banking firms, which meant, in effect that the firm was manufacturing securities it could then bring to market.”³⁹ Other concerns related to an Adviser having the fund borrow excessively in order to increase the assets within the fund and creating a different class of shares to be held by the Adviser, which would have fewer obligations for the debt.⁴⁰

In their treatise on investment management, Tamar Frankel and Clifford E. Kirsch note “Under the 1940 Act, the prohibition on conflicts of interest is far stricter than under state corporate laws. The only body that might allow such transactions in conflicts is the Commission. . . . In addition, the Act expands the group of persons subject to the prohibition far beyond the traditional family of fiduciaries, by defining the term affiliates very broadly and imposing the prohibitions not only on affiliates but also on affiliates of affiliates, and affiliates of some non-affiliates.”⁴¹

Notwithstanding the broad scope and detailed requirements and prohibitions of the 1940 Act, this bill was considered to be “watered down”. Ironically, prominent investment bankers falsely presaged the demise of the mutual fund industry, commenting that “it is quite possible [the]

³⁸ Joel Seligman, *The Transformation of Wall Street* 224 (Boston: Northeastern University Press 1995).

³⁹ Galbraith at page 51.

⁴⁰ The Investment Company Act of 1940, 15 U.S.C. Sec. 80a-1. (“The national interest and the interest of investors are adversely affected --when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities”.)

⁴¹ Frankel and Kirsch at page 50.

legislation [may] hamstring and shackle the ⁴²operations of investment companies to such an extent that their usefulness may cease to exist.”

Given that mutual funds are distributed through retirement plans, another federal law, the Employee Retirement Income Security Act (“ERISA”) applies with its corresponding Department of Labor regulations. Enough cannot be said about the correlation between the enactment of ERISA and the growth of the mutual fund industry. As noted above, there is a close relationship between the triumph of the mutual fund and the 401(k) plan as dominant savings vehicles for US investors. The percentage of US household assets held in mutual funds has increased from 2.7% to 22%. ⁴³ As of year-end 2006, there were \$2.7 trillion in 401(k) plan assets, 51.9% of which was invested in equity mutual funds.⁴⁴

Concerns over conflict of interest lies at the heart of the ERISA law and related regulations. Moreover, regulators with heightened concerns for investor protection recognized the intersection between pension funds and mutual funds. In addition, concerns that the chain of intermediation left “true owners” voiceless was addressed by the Department of Labor in 1994.⁴⁵ The DOL made clear that “the voting of proxies is a fiduciary act of plan asset management.” Few of the 47 million Americans invested in 401(k) plans comprehend fees they pay.⁴⁶ In an effort to address this, the DOL has increased the amount of information it requires to be filed publicly by employers who sponsor 401(k) plans (“Plan Sponsors”). Effective 2008, the DOL is requiring plan sponsors to disclose in their annual filing (on form 5500) more detail on fees paid to mutual fund Advisers related to overseeing 401(k) plans.

Additionally, other federal and state laws affect mutual funds. They include the Sarbanes-Oxley Act, which requires mutual funds to certify internal controls. Also various federal and state banking and commercial transactions regulations related to fund transfers apply to the flow of cash to and from the complex.

The mutual fund industry has also been the beneficiary of recent business-generating regulation. The Pension Protection Act of 2006 allows investment managers to provide advice to 401k plan participants. The DOL provided guidance on February 2, 2007, which allows for varying fees to be charged to the participant based on the type of investment option so long as the corporate affiliate and person through which the advice is provided does not receive varying compensation on that basis.⁴⁷

⁴² Seligman, 228, quoting Arthur H. Bunker of Lehman Corporation. Cf. Bunker also admitted that only if the law were passed, would the industry’s name be cleared and investor confidence regained.

⁴³ Investment Company Institute, “2007 Investment Company Fact Book,” 47th edition, page 3.

⁴⁴ Id. page 78.

⁴⁵ Department of Labor, Interpretive Bulletins Relating to the ERISA 1974, 59 FED. REG.38860 (July 29, 1994).
Fix this cite

⁴⁶ “The Quarter Ahead: Spotlight on 401(k) Costs,” *WSJ*, April 3, 2007.

⁴⁷ Dale Halonen, “Rule Hurts Advice Givers But Helps Fund Companies,” *Pensions and Investments*, February 19, 2007 “The beneficiaries are the people who want to squeeze more fees out of people's retirement savings," said Damon Silvers, associate general counsel for the AFL-CIO.’

III. Background on Corporate Governance in the US and UK and the Mutual Fund Proxy Voting Rule

A. Corporate Governance Perspectives

The term “corporate governance” is used at various times for varying purposes. In the most general sense, corporate governance refers to the rights and responsibilities, or the balance of power among the managers, boards and shareholders of publicly-traded corporations. However, corporate governance also describes broader concepts concerning the role and accountability of corporations within society. It would be difficult to find a person who would claim to oppose strengthening corporate governance. However, few agree on the elements of good corporate governance. Beneath the variation, though, a framework can be seen. This framework emanates from a series of divisions in perspective as to the underlying principles upon which corporations should be governed.

1. Corporate Governance Divided: Agency Perspective vs. Stakeholder Perspective:

The foundational division is between those with an agency perspective and those with a stakeholder perspective. A person with an agency perspective believes a corporation should function for the benefit of shareholders. Recognizing the agency problem inherent in diffusely held corporations, those with this perspective believe managers should be accountable to the owners of the corporation. They rely in part upon legal frameworks, such as the fiduciary duties, to support their views.

In contrast, those with a stakeholder perspective see corporate accountability more broadly. They would claim that corporations need to serve all important stakeholders, beyond just shareholders. Included within a list of such stakeholders might be employees, suppliers, customers, the local community, the environment, future generations and perhaps anyone impacted significantly by externalities resulting from corporate operations. Some in suggest that this is not really corporate governance, but instead the field of “corporate social responsibility”. However, many who write and speak of corporate governance do so in reference to the role a corporation plays within society.

The agency perspective is associated with agency theory and is often considered to be the Anglo-American model. Whereas, the stakeholder perspective is considered to be the European-Japanese model.⁴⁸

2. Agency Perspective Divided: Director-Centric vs. Shareholder-Centric:

Those with an agency perspective are divided between the “director-centric” and “shareholder-centric camps. While both camps recognize the agency problem, they see different solutions. Those with a director-centric perspective, see the boards of directors acting effectively as guardians of shareholders’ interests. Much of state corporate law is grounded in this perspective. Shareholders seeking redress directly against corporations are often shut out of courthouse because they are told their avenue is through the board. Should they be unhappy about

⁴⁸ Cynthia A. Williams and John M. Conley, “An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct,” *Cornell International Law Journal*, Vol 38, page 493 (2005).

management behavior, courts explain that they may elect new board members. I would include within this group theorists who oppose shareholder empowerment on the basis that market forces (such as the market for corporate control) can correct the agency problem.

In contrast, the shareholder-centric find systemic problems in the processes for selecting corporate boards and view corporate boards as either beholden to management, self-interested, or not sufficiently dependent upon shareholders, or all-of-the-above. Shareholder-centric thinkers are often called shareholder activists and seek reforms to shift the balance of power away from managers and boards to shareholders. The battleground between those with a director-centric vs. a shareholder-centric perspective is being played out at the SEC with the recent proposed rulemaking concerning shareholder access to corporate proxy materials for bylaw changes related to the election of directors.⁴⁹

3. Shareholder-Centric Divided: Shareholder Democracy Perspective vs. Shareholder Profit Maximization Perspective:

There is a further division among the shareholder-centric. One group would support governance rules and practices that give shareholders increased voice, or make governance more democratic. Another group would like the rules and practices set so that only those corporate governance elements that can be shown to increase long-term shareholder value are institutionalized. Members of this shareholder profit maximization group, however, might disagree as to what governance provisions matter. There are more than 100 different elements used for rating corporate governance between ISS, S&P and the Corporate Library, though some are common to each system.⁵⁰ Some have taken a step to identify them. E.g., In a recent study, Bebchuk found 6 provisions, the presence of which were associated with lower firm valuations and abnormal returns in a study from 1990 – 2003.⁵¹

B. Comply or Explain in the UK

Some laws governing US and UK corporations are quite similar. For example in both jurisdictions, the fiduciary duties owed to shareholders are grounded in common law principles. However, the regulatory regimes have many distinctions. In the US, basic corporate law principles come from the 50 states (primarily Delaware), often resulting in a “race to the bottom” in terms of shareholder rights vs. managers. In the UK, there is uniform corporate law through the Company Act.

In the US, beyond state corporate law, corporate governance is covered in part in federal securities laws and regulations as well as the federal Sarbanes-Oxley statute and related rules, including stock exchange listing requirements. In practice, corporate governance standards vary from company to company, with many outside standard-bearing institutions, such as proxy

⁴⁹ Securities and Exchange Commission, Proposed Rule: Shareholder Proposals Related to the Election of Directors, 17 CFR, Part 240, Release No. 34-56161; IC-27914; File No. S7-17-07, July 27, 2007. Also see, Securities and Exchange Commission, Proposed Rule, Shareholder Proposals, Release No. 34-56160; IC-27913; File No. S7-16-07, July 27, 2007.

⁵⁰ Charkham.

⁵¹ These provisions were Staggered Boards, Supermajority Requirements for Mergers, Limits to Shareholder Bylaw Amendments, Supermajority Requirements for Charter Amendments, Poison Pills and Golden Parachutes.

advisory services and others holding out factors and formulas for rating corporate governance behavior.

In contrast, in the UK, corporate governance standards are uniform and more comprehensive. They take the form of main and supporting principles and provisions and are located in the 2003 Combined Code on Corporate Governance. The Combined Code applies to all companies incorporated in the UK or listed on the London Stock Exchange. It contains a listing of practices considered to be hallmarks of good corporate governance. For example, provisions include that the roles of Chairman of the Board and CEO should not be filled by the same individual.

Adherence to the principles within the Combined Code is voluntary. However, in their annual reports, a company must disclose how it has complied with the principles of the Combined Code. It must also confirm that it has complied with the Combined Code and if it has departed from these principles, it must also explain its behavior.⁵² It is up to shareholders to monitor compliance and engage actively with managers both on the absence of necessary explanations and the quality of the explanations. Accordingly, the comply-or-explain regime is considered to be a shareholder-enforced system. In contrast, the US approach is that of regulator-enforced rules.

The “comply-or-explain” approach was intended to allow corporate managers the flexibility to depart from a general governance principle in specific instances. Whether this approach accomplishes the goals it was designed to meet, is the topic of discussion and research.⁵³

C. Proxy Voting and Shareholder Proposals Overview

Among the chief legal rights of US corporate shareholders are the rights to attend annual (and special) meetings, to vote at such meetings and to present proposals to the corporation for vote by other shareholders. Because the vast majority of shareholders do not physically attend meetings, if they do choose to vote, they do so by grant of proxy. Accordingly, by law, when corporations send to shareholder a notice to announce the upcoming meeting, they also include materials that enable shareholders to vote by proxy (through the mail, telephone or internet). These materials include the management’s slate of directors as well as other voting items. Therefore, shareholders who wish to make proposals at a corporation’s annual meeting, need to have such proposals included within the mailed proxy materials. Such shareholders rely upon a 1934 Act Rule 14a-8, which, subject to eligibility requirements and certain carve-outs, requires corporations to include shareholder proposals within the official proxy materials.

Shareholders who for one year have continuously held \$2,000 or 1% of securities outstanding are entitled to submit proposals to corporate management. Management may refuse to include such proposals within the proxy materials if they fall into one of 13 exclusions. In addition, if the proposal was already voted upon in previous years and failed to receive a certain threshold of

⁵² The UK Combined Code on Corporate Governance (2003 version).

⁵³ Sridhar Arcot, Valentina Bruno and Antoine Faure-Grimaud, “Corporate Governance in the UK: Is the “Comply or Explain” Approach Working?” London School of Economics, Working Paper, December 2005.

shareholder support, it may be excluded. As noted both above and below, proxy voting on shareholder resolutions is not just a right of mutual fund Advisers, but a legal duty, whether pursuant to ERISA or the federal securities laws.

D. The Mutual Fund Proxy Voting Rule

Since the launch of the first mutual fund in the early 20th Century, journalists, politicians and academics have identified incentives and sought to eliminate opportunities for those who manage fund assets to favor their own economic interests over that of their investors.⁵⁴ According to John Kenneth Galbraith, in 1929, Paul Cabot wrote in the *Atlantic Monthly* that “dishonesty, inattention, inability, and greed” were evident in the fledgling fund industry. As is the case with most regulatory reform, widespread or notorious examples of abuses lead to public outrage and then to rule making. Notwithstanding their public protests to the contrary, many industry leaders were privately pleased about the increasing regulation, hoping it would clean up the reputation of the industry, and thus increase investor confidence and ultimately profits. As a result, much of the complicated SEC regulation of mutual fund operations and sales are designed to thwart the temptations to put mutual fund Advisers’ interests ahead of fund investors.

This pattern of well-publicized examples of abuse by investment advisers, followed by suspicion of widespread malfeasance, then public outcry, culminating in SEC regulation was recently repeated, leading to the Proxy Voting Rules. One of the precipitating events involved a corporate takeover battle at Hewlett-Packard. In January of 2002, Hewlett-Packard hired the investment banking division of Deutsche Bank to assist with a planned merger with Compaq. Hewlett-Packard agreed to pay Deutsche Bank \$1 million dollars up front plus another \$1 million upon completion of the merger.

A few months later, on Friday, March 3, 2002, the investment advisory division of Deutsche Bank (DeAm) voted against the merger; it cast 17 million proxies on H-P stock it controlled for its advisory clients. On the following Monday, H-P management learned of the vote and contacted senior managers at Deutsche Bank. By March 19, 2002, after learning that the investment banking division was secretly working for H-P on the merger and that H-P had an important relationship with the bank, the investment committee decided to change its vote. Just before the shareholder vote on the merger closed, DeAm recast proxies on 17 million client votes in favor of the merger. As a result, the SEC brought a settlement enforcement action against DeAm. According to the SEC, DeAm breached its fiduciary duty to its advisory clients by voting proxies on the H-P stock owned by its advisory clients without disclosing the conflict in advance.⁵⁵

On its own, such an incident might have had little traction; however, it fed into a growing suspicion that fund managers have a strong incentive to favor the interest of corporate managers

⁵⁴ While mutual funds were popular because of “their offer of expert and trustworthy management,” they “pose a substantial risk of mismanagement of assets” by those with “full discretionary powers and control over investors’ funds.” Frankel and Kirsch at page 17 and 19.

⁵⁵ Securities and Exchange Commission, “SEC Brings Settled Enforcement Action Against Deutsche Bank Investment Advisory Unit in Connection with its Voting of Client Proxies for Merger Transaction,” Press Release, August 19, 2003.

of portfolio companies over their own investors. Moreover, many fund managers were suspected of acting upon this incentive to the detriment of investors. Finally, the uber-incidents of the collapses of Enron, WorldCom and others led to a generalized concern over conflicts. Where were the accountants? Where were the investment bankers? Where were the boards of directors? Where were the institutional shareholders? And, then, where were the mutual funds?

Meanwhile, shareholder activists, including the AFL-CIO were frustrated with what they perceived as the failure of mutual fund Advisers to reign in executive pay and to act as anything more than a “rubber stamp” for corporate management. After a failed attempt in December of 2000, the AFL-CIO again approached the SEC, requesting that agency mandate that mutual funds disclose how they cast their proxy votes.⁵⁶

With these concerns in mind, the SEC enacted a rule concerning mutual fund proxy voting. The Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies (the “Fund Proxy Voting Rule”) became effective April 14, 2003 with a compliance date of August 31, 2004. This rule has three main requirements. First, mutual funds must file an annual report with the SEC “not later than August 31 of each year, containing the registrant's proxy voting record for the most recent twelve-month period ended June 30.” Second, mutual funds must make available free-of-charge to investors a description of its proxy voting policies and procedures. Third, mutual funds must inform investors how they may obtain free of charge the policies and procedures and the annual proxy voting records of the funds.⁵⁷

In the adopting release for the Fund Proxy Voting Rule, the SEC reinforced the point that an investment adviser to mutual funds is a fiduciary. The Commission affirms “This fiduciary duty extends to all functions undertaken on the fund’s behalf including voting of proxies relating to the fund’s portfolio securities. An investment adviser voting proxies on behalf of the fund, therefore, must do so in a manner consistent with the best interests of the fund and its shareholders.” The SEC recognized that on behalf of the funds, the fund board of directors or trustees “has the [voting] right and obligation” but that the board usually delegates this to the Adviser under the management agreement “subject to the board’s continuing oversight.”⁵⁸

The SEC tackled head-on, the conflict-of-interest issue in the proposing and adopting release. “[I]n some situations the interests of a fund’s shareholders may conflict with those of its investment adviser with respect to proxy voting. This may occur, for example, when a fund’s adviser also manages or seeks to manage the retirement plan assets of a company whose

⁵⁶ AFL-CIO Office of Investment, “Behind the Curtain: How the 10 Largest Mutual Fund Families Voted When Presented with 12 Opportunities to Curb CEO Pay Abuse in 2004.” September 2004 at page 3.

⁵⁷ The companion rule was the Proxy Voting by Investment Advisers (the “Adviser Proxy Voting Rule”). The rule requires Advisers (1) to “adopt policies and procedures for voting client proxies in the best interest of clients” (2) to “describe the procedures clearly; and (3) to “tell clients how they may obtain information about how the adviser has actually voted their proxies.”

⁵⁸ Similarly, in the companion Adviser Proxy Voting Rule, the SEC acknowledged that as a fiduciary, an Adviser has a duty of care and loyalty which to satisfy it “must cast the proxy vote in a manner consistent with the best interests of its client and must not subrogate client interests to its own.”

securities are held by the fund. In these situations, a fund's adviser may have an incentive to support management recommendations to further its business interest."⁵⁹

Of all the fund families included within the Corporate Library group, only one, Putnam, supported the proposal to disclose proxy voting records. Other fund Advisers actively opposed the effort through comment letters penned by their senior executives. A select group of the largest families additionally met (in person or through phone conference) with the Securities and Exchange Commission (commissioners and staff) attempting to influence the decision. Many of those fund families who were silent, were in passive support of the effort to kill this requirement. This is the case because industry trade association, the Investment Company Institute, submitted comment letters opposing this measure. In addition the ICI met or telephoned commissioners and staffers at the SEC attempting, unsuccessfully to block its adoption. Members commonly piggy-back on ICI comments. Sometimes, members choose to keep a low profile and just depend upon the ICI, either due to time or resource constraints, or the wish not to be seen out in front of an unpopular issue. Other times, members (fund Advisers) will submit separate comments to either amplify certain points or to distinguish their position.

In contrast to the mainstream fund families, funds operated and advertised as socially responsible openly supported the proposal. In addition, unions (with pension fund assets at stake) as well as public pension funds supported the proposal. Outsiders to the money management field including all living former SEC Chairmen provided supporting comment letters. Also, money managers from abroad including the UK championed the proposal. Individual shareholders and others in favor of the proposal overwhelmingly outnumbered those in opposition. The SEC counted more than 8,000 thousand supporters.⁶⁰ These letters are available for viewing at the SECs website.

IV. Conflict-of-Interest in Proxy Voting

Ironically, while the central justification for the vote disclosure requirement was to avoid conflict-of-interest influenced voting, little empirical research on the subject showing widespread abuse has appeared. While three years of voting data were available when this study was conducted only two studies looking for correlations between voting behavior and conflicting business interests were available. In this section of the paper, I will provide anecdotal evidence

⁵⁹ In the companion Adviser Proxy Voting Rule, the Commission also bluntly addresses the conflict-of-interest issue. "An adviser may have a number of conflicts that can affect how it votes proxies. For example, an adviser (or its affiliate) may manage a pension plan, administer employee benefit plans, or provide brokerage, underwriting, insurance or banking services to a company whose management is soliciting proxies. Failure to vote in favor of management may harm the adviser's relationship with the company."

⁶⁰ Securities and Exchange Commission Final Rule: "Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies," 17 CFR Parts 239, 249, 270, and 274. Release Nos. 33-8188, 34-47304, IC-25922; File No. S7-36-02, January 31, 2003.

and examples of this conflict. Next, I will describe the two studies on this subject. Finally, I will explain my research methodology and conclusions.

A. Anecdotal Evidence and Examples

Those critical of the mutual fund industry have long suspected that conflicts of interest explain why fund Advisers fail to support shareholders rights. However, a vast gulf divides generalized suspicion and empirical support. This section covers the various voices of support for the conflict of interest theory and the evidence and arguments upon which they depend.

Support for the supposition that conflicts of interest drive mutual fund Advisers to block shareholder rights initiatives is often anecdotal. Both journalists and academics regularly cite to this theory and provide examples. Even the SEC in its release for the Proxy Voting Rule, explicitly identified suspected conflicts. Some suggest that an unintended consequence of the rule has been to make mutual fund Advisers more deferential to corporate management.⁶¹

History also provides support for the contention that conflicts motivate fund Advisers to disfavor shareholders' rights. Historical evidence points to numerous examples of Advisers placing their interest over that of their fund shareholders. Indeed, the primary regulation designed to govern the entire industry in large part seeks to eliminate opportunities to benefit the Adviser over the investor. (See discussion above).

As with the US, in the UK, institutional investors are suspected to “face conflicts of interest, where they are fund managers, which deter them from the active exercise of their voting power.”⁶² In a report of the Company Law Review Steering Group, reasons for institutional investor passivity include threats by portfolio companies that they will take business away from the fund manager and fear that activism would hurt business prospects.⁶³ This resonates in the US.

Leading corporate law scholars, Bernard Black and John Coffee confirm this perception. “Thus, it is not surprising that in Britain, as in the United States, most corporate pension plans follow a variant of the golden rule: ‘Do unto other companies as you would have their pension funds do unto your company.’”⁶⁴

One columnist for the *New York Times*, Gretchen Morgenson consistently has pursued this topic since the enactment of the Fund Proxy Voting Rule. She has penned numerous columns

⁶¹ See Comments by Anne Faulk, CEO of SwingVote, at the SEC Roundtable Discussions on Proxy Voting Mechanics, May 24, 2007. “And I think anybody in the corporate governance business would tell you that one of the unintended consequences of the N-PX filings was to take a number of mutual funds who were absolutely at the forefront of good governance and engagement, and once they had to post how they voted on the shares of their clients, there was a dramatic change. And those mutual funds who were, like I say, very much engaged in the process all of a sudden became rubber stamps for management.” However, when Commissioner Atkins requested evidence, none was provided. Atkins said that he had heard different reports that mutual funds were outsourcing voting to proxy advisory services.

⁶² Adrian Cadbury, *Corporate Governance and Chairmanship: A Personal View*. (Oxford: Oxford University Press, 2002) at page 205.

⁶³ *Id.* at 205.

⁶⁴ Black and Coffee, citing James E. Heard and Howard D. Sherman, “Conflicts of Interest in the Proxy Voting System (Investor Responsibility Research Center 1987) at page 2060.

describing the failure of fund Advisers to use proxy voting as a tool to increase shareholder power. In one column, Morgenson writes: Proxy voting represents "an immensely powerful tool for change at companies run by me-first executives. Unfortunately few funds used that tool."⁶⁵ Her interviews with shareholder advocates yield affirmations of this opinion. For example, Frederick Rowe, Jr., president of Investors for Director Accountability explained, "We expect money managers to think and vote like interested owners of the shares they manage. . . . Sadly our experience is that most money managers seem to think and vote their own somewhat conflicted interests as money managers."⁶⁶

Morgenson deemed the expensing of stock options "a litmus" for honest accounting practices. She pointed to examples of when shareholders proposed non-binding resolutions that management would expense stock options. She noted that (even when corporate management opposed these resolutions), institutional investors favored them. In contrast, she found that mutual fund Advisers opposed these resolutions to expense stock options. Morgenson pointed to such a proxy vote at Intel where the majority of its shareholders supported such a resolution. In line with majority support were some large fund complexes she praised including Merrill Lynch, Citigroup, Morgan Stanley, Vanguard, Oppenheimer Funds and American Funds. In contrast, T.Rowe Price, Fidelity and MFS rejected the proposal.⁶⁷

Suggesting that a conflict-of-interest affected Fidelity's support, Morgenson noted that 3% of Intel shares were held by Fidelity for its clients. At the same time, she noted that Fidelity acts as record keeper of Intel's 401(k) plan. Eight Fidelity funds in that plan had \$1 billion in assets at the end of 2003. According to Morgenson, that could amount to at least \$7.5 million in revenue for Fidelity.⁶⁸ In its defense, according to the column, Fidelity cast shares for the family of funds it is hired to manage against the option-expensing proposal for another reason. Fidelity explained that its analysts were smart enough to determine the impact of stock options on corporate earnings without such a requirement.⁶⁹

Upon examination, this comment by Fidelity is no comfort for shareholders at large. Instead it reveals that the mutual fund Advisers may put their economic interests in collecting management fees ahead of both shareholders at large and their own shareholders. In other words their own interests ahead of direct shareholders of Corporation XYZ and ahead of shareholders of their own mutual funds. This seeming defense thus supports the theories of some academics like Black and Coffee who find that fund Advisers care about relative returns for their shareholders and not absolute returns.⁷⁰

Under this line of reasoning, if improving the disclosure for all shareholders of Intel would help Fidelity fund shareholders equally (with investors who own Intel shares directly, with investors who own Intel through some other fund or collective investment vehicle) then Fidelity (the

⁶⁵ Gretchen Morgenson, "A Door Opens, The View is Ugly," *NYT*, September 12, 2004.

⁶⁶ Gretchen Morgenson, Fair Game; Fidelity, Staunch Defender of the Status Quo, *NYT*, October 8, 2006.

⁶⁷ Gretchen Morgenson, "A Door Opens, The View is Ugly," *NYT*, September 12, 2004.

⁶⁸ Id.

⁶⁹ Id.

⁷⁰ Black and Coffee at page 2003 ("Money managers typically intervene only when doing so will improve their relative performance – when it will benefit their portfolio more than their competitors'. Conflicts of interest cause some managers to shrink from open confrontation with corporate managers.")

Adviser) would not favor the change. What is troubling about this comment is that figuring out the real impact of stock options has costs in time and research. It is not merely a matter of raw intelligence, but actual hard work and time. Moreover, given complex language and intentionally obscure language of compensation disclosures, some suggest that even a group of seasoned analysts two might not arrive at the same valuation.⁷¹

In other words, when a fund Adviser touts its intelligence as a comparative advantage and as a justification for obfuscation by corporate managers, hidden costs may be imposed on fund shareholders. In addition, such revelations undermine the hope that big institutional investors will help shift the balance of power from corporate management to shareholders and thus benefit real investors. Finally, such a revelation helps to reveal how at times the interests of fund Adviser's and fund shareholders are not aligned economically. Better disclosure would benefit fund shareholders by saving analysts time and free up labor to examine other investment strategies. However, fund Advisers would only benefit from an across the board improvement in disclosure at a particular firm if the Adviser was overweighted in that security relative to its competitors in the asset gathering field. Black and Coffee note "If one takes the logic of over- or underweighting to its logical conclusion, an underweighted fund manager may not even want to improve a portfolio company's performance."⁷²

Morgenson also tackled the topic of majority voting proposals. Pension fund activists initiated majority voting proposals in proxy materials sent to shareholders of many large corporations for the 2005 proxy season. Under majority voting, directors cannot be elected unless a majority of shareholders cast votes in favor of the candidate. Currently, for most corporations, the only option a shareholder has is either to support the management-proposed slate of directors with a vote of "yes" or withhold their votes. A director can usually be elected with a single vote. Hardly shining examples of democratic process, board elections are often compared to elections in the former Soviet Union.⁷³

In other columns, Morgenson criticized mutual funds for failing to discipline directors who are negligent or take action dilutive of shareholder value. Specifically, she challenged mutual fund Advisers for failing to withhold votes from directors of companies that had accounting fraud and granted excessive pay for underperformance. She attributes this to a conflict-of-interest, contending "investment companies are in the position of trying to serve two masters."⁷⁴

B. Review of Prior Research Studies

In the first academic study on this topic, Gerald F. Davis and E. Han Kim of the University of Michigan (the "Davis Study"),⁷⁵ asked the question of whether the "parents" of mutual fund

⁷¹ Bebchuk and Fried.

⁷² Bernard S. and Coffee, John C., Hail Britannia?: Institutional Investor Behavior Under Limited Regulation" *Michigan Law Review*, Vol. 92 at page 2064 (1994).

⁷³ Morgenson called the existing election process "an exercise in futility" and likened it to Soviet-style elections.. Gretchen Morgenson, "Who's Afraid of Shareholder Democracy?", *NYT*, October 2, 2005. Patrick McGurn of ISS called the existing model "Soviet style elections." See also, Davis, Lukomnik and Pitt-Watson at page 117.

⁷⁴ Gretchen Morgenson, "Fund Manager, It's Time to Take a Side," *NYT*, March 26, 2006.

⁷⁵ Gerald F. Davis and E. Han Kim, "Business Ties and Proxy Voting by Mutual Funds," 85 *Journal of Financial Economics* 552-570 (2007).

families would vote with management of corporations (on shareholder resolutions) when those corporations were clients of the parent for other sources of income. Specifically, they linked assets under management with pro-management votes cast by the fund family for those same corporations. Their sample included 21 mutual fund families and 2 pension funds.⁷⁶ For portfolio holdings data, they gleaned mutual fund ownership positions in 892 of the Fortune 1000 corporations from 2001 from 13F filings with the SEC. For data on fund family “parent” business ties, they used data from Form 5500, which is filed by corporate plan administrators with the Department of Labor and the Internal Revenue Service. Voting data came from N-PX filings from the 2004 proxy season, the first year this data was available.

They found that fund families were *not* more likely to vote with management when they had a relationship than when they did not.

This finding has been touted by many skeptics of the conflict-of-interest theory as evidence of fund Adviser’s absence of bias toward management.⁷⁷ Mutual fund Advisers who had insisted they did not cast proxy votes differently for portfolio companies with whom they had a client relationship were vindicated by such a study. For example, Anne Crowley of Fidelity Investments told the New York Times in 2004 that: “There is no correlation between how we vote with respect to whether someone is a 401(k) client or not.” According to the article, “Fidelity voted against management 31 percent of the time this year at companies whose 401(k) plans it serves; it opposed all 30 proposals to expense options at companies whose stock it held, whether or not 401(k) clients.”⁷⁸ In another article, Vin Loporchio, a Fidelity spokesperson stated that “The guidelines require that all voting be done without regard to any other Fidelity companies’ relationships, business or otherwise, with that company.”⁷⁹

However, the authors of the Davis Study were careful to note that the voting records they examined were from a time frame during which the mutual fund industry was under great scrutiny by the SEC and then-New York Attorney General Elliot Spitzer. Accordingly, they suggested that “A less risky strategy would be to adopt policies leading to less frequent voting against management at all firms, that is policies that favor clients’ management while appearing evenhanded.”

⁷⁶ The 21 fund families and 2 pension funds in the Davis Study sample were: AIM/Invesco, Alliance Capital Management, American Century, American Funds, Ariel, Barclays, Dreyfus, CalPERS, CREF, Fidelity, Franklin, Janus, Legg Mason, Merrill Lynch, Morgan Stanley, Oppenheimer, PIMCO, Putnam, Schroder, Scudder, State Street Global, T.Rowe Price and Vanguard.

⁷⁷ For example, University of Illinois law professor, Larry Ribstein referenced the Davis Study on his internet blog. http://busmovie.typepad.com/ideoblog/2006/04/the_mind_of_gre.html. (Ribstein wrote: “Davis & Kim offer more direct evidence on conflicts, concluding “that there is no evidence to show that mutual funds let non-fund parts of their companies influence their votes.” The authors add that “voting appears to be independent of client ties among all the fund families in our sample. In this regard, mutual funds come up clean. Their votes are explained by the policies of their parent companies, not directly by business ties.””)

⁷⁸ Gretchen Morgenson, “A Door Opens, The View is Ugly,” *NYT*, September 12, 2004.

⁷⁹ Gretchen Morgenson, “Fair Game; Fidelity, Staunch Defender of the Status Quo,” *NYT*, October 8, 2006.

In addition, importantly, fund Advisers were not completely clean of conflict-affected voting, as the Davis Study reported an additional finding. The authors examined their data to see whether the volume of business a parent has will impact the fund proxy voting record. They found that favoritism toward management proposals increased as the value of the relationships increased. They found “a positive relationship between the volume of pension business a fund company does and its propensity to vote with management.” *In other words, the greater the "business ties" the more likely the fund family will vote with management recommendations on shareholder proposals.*⁸⁰

In the other paper, Burton Rothberg and Steve Lilien of the Baruch College (the “Rothberg Study”) asked whether mutual fund “parents” with other lines of business would favor management over shareholders as compared to pure-play funds. They found that there was no difference in the voting records of funds that are part of a large financial services company and the voting records of funds that are part of a pure-play fund family. They used proxy voting data to test the hypothesis that conflicts for business at the parent level would impact voting at the fund Adviser level. Their sample included five of the large fund families and four other fund families that are part of a large financial services company.⁸¹

In a related study by Lauren Cohen of the Yale School of Management and Breno Schmidt of the Marshall School of Business at the University of Southern California found that Fund families tend to overweight holdings in the portfolio companies where they are also acting as trustees of 401(k) plans.⁸² While this does not address proxy voting behavior, it does show favoritism toward retirement plan clients perhaps to the detriment of fund shareholders.

C. Original Empirical Research: Methodology and Results

Notwithstanding the impressive work of the Davis and Rothberg studies, questions remain open regarding the conflict of interest explanation for mutual fund Adviser’s passivity. Given that the Fund Proxy Voting Rule specifically addressed the retirement plan channel, and given the huge dependency of mutual funds historically upon this channel for asset gathering, I chose to focus there.

I attempted to determine whether the dependency a mutual fund family has upon defined contribution (“DC”) plans for asset management business is correlated with the likelihood it will support shareholder resolutions related to corporate governance. Toward this end, I linked assets under management as of December 31, 2005 of a sample of fund family Advisers to the voting records of those Advisers for the proxy season spanning July 1, 2005 – June 30, 2006.

⁸⁰ He notes that Fidelity has "business ties" with 22.8% of the firms in its portfolio (p. 15) Compared to Putnam at 9.8%; Vanguard 9.2%; AIM/INVESCO 7.1%; American Funds 8.7%; T.Rowe 5.8% (see table 2)

⁸¹ The big five fund families were Fidelity, Vanguard, T. Rowe Price, Janus, Putnam. Of this group Putnam was part of Marsh & McLennan, an insurance brokerage firm. Three more financial service companies that also operated mutual funds were Goldman Sachs, Barclays and St. Paul Travelers.

⁸² Lauren Cohen and Breno Schmidt, “Attracting Flows by Attracting Big Clients: Conflicts of Interest and Mutual Fund Portfolio Choice,” January 9, 2007.

This approach was different from prior research in at least three aspects. First, I looked at propensity to **support shareholder**-initiated proposals on governance matters.⁸³ I used a data set that did not take into consideration whether management was in support of such proposals or not. This distinction is important because simply showing someone is not biased toward management does not show that someone is supportive of shareholders. Indeed, many in the field of corporate governance recognize this.⁸⁴ Eric D. Roiter, Senior Vice President and General Counsel for Fidelity Management & Research (FMR is the Adviser to the Fidelity family funds), in a discussion on mutual funds' concerns as shareholders of portfolio companies offered insight about the role of directors. Like Bebchuk and Fried, Roiter recognizes that being independent of a conflict does not make one dependent upon shareholders. "Independence is a neutral state. It doesn't tell you anything about whether that individual or group of individuals is going to add value or will help shareholders achieve economic returns."⁸⁵

Second, because my focus was on whether funds support shareholder empowerment, the data set included only governance proposals and not other shareholder proposals. Note that the Davis Study also focused on governance-related resolutions. By selecting a data set that focused only on key governance provisions, I hoped to eliminate the noise associated with disapproval of other resolutions that might relate to social or political issues.

Third, in the prior studies, the focus was on whether **non-fund** business with corporate managers would impact voting records. For example, in the Rothberg study, the **non-fund** business was banking, insurance, trading, and pension/retirement. In contrast, fund management was included in this study. Instead, this study considered whether all asset management including mutual fund asset management (with attendant advisory fees) impacted voting decisions.

The assets under management data came from Pension & Investments, "Money Manager Survey for Year-end 2005." The dollar amount reported was in response to question 19: "Of your total U.S. institutional, tax-exempt assets, how much was managed for defined contribution plans?" According to the instructions, "Only managed assets should be reflected; exclude assets held in custody, or in sponsoring company stock, or under record-keeping contracts."

The proxy voting data came from Beth Young and Jackie Cook's study for the Corporate Library of 29 large fund families' proxy voting records during the 2006 proxy season (the "Corporate Library Study". Though this data included 29 fund families, the P&I data was only available for 25. Accordingly, I selected the top 10 fund families (based on P&I DC asset size) from among the available 25. The largest ten fund families from among the universe of 29 large mainstream funds studied by TCL, as measured by AUM within the P&I survey data were: Fidelity,

⁸³ There is a twenty-year history of shareholder sponsored governance-related resolutions. In 1987, TIAA-CREF filed the first one at International Paper to protest the corporations use of a poison-pill takeover defense. Deemed a "milestone in new capitalist activism," the proposal lost with just 27.7% of the votes, however, this was higher than most previous (socially-related) resolutions had received. Davis, Lukomnik and Pitt-Watson at page 79.

⁸⁴ For example, Lucien Bebchuk and Jesse Fried, *Pay Without Performance*, (Cambridge, MA: Harvard University Press, 2004) at 204 ("[I]n the absence of sufficient pro-shareholder incentives, the directors will not serve shareholders either.")

⁸⁵ George S. Dallas and Hal S. Scott, "Mandating Corporate Behavior: Can One Set of Rules Fit All? Spring 2006, Based upon a Panel Discussion on the Current State of Corporate Governance in the Global Marketplace sponsored by Standard & Poor's, Program on International Financial Systems at Harvard Law School and BusinessWeek.

Vanguard, American, Barclays, T. Rowe, Merrill Lynch, Franklin/Templeton, Legg Mason, Scudder and Dreyfus. The data was culled from 1.2 million voting decisions. With respect to the 20 funds, that amounted to 62,000 voting decisions on 67 shareholder-sponsored resolutions. For the 10 fund families above, there were the following number of decisions Fidelity (21,705); Vanguard (166,126); American (20,470); Barclays (1,972); T. Rowe (75,363); Merrill Lynch (21,128); Franklin/Templeton (44,747/17,783); Legg Mason (7,534); Scudder (8,238) and Dreyfus (14,254)

In the Corporate Library Study, a fund complex is treated as having voted just one time on a particular resolution at a particular portfolio company. Accordingly if a fund family has three funds all of whom vote in favor of a shareholder resolution on cumulative voting at a particular portfolio company, then the study gives that fund family a one hundred percent (100%) score for that particular portfolio company. And, if that same fund family voted on cumulative voting proposals at 10 portfolio companies, and approved them at 5, but rejected or abstained at 5, then, the score that that fund family receives on shareholder cumulative voting resolutions would be fifty percent (50%). In this manner, each fund family received a percentage score for each of the 11 categories, and then a single, overall percentage score showing their propensity to vote for shareholder advisory resolutions. For example, Vanguard supported shareholder governance resolutions 25% of the time and T. Rowe Price supported shareholder governance resolutions 72% of the time. The only liberties taken with the data was to exclude TIAA-CREF and combine Franklin and Templeton funds into a blended percentage as asset data was only available as a single figure. TIAA-CREF was excluded given that it focuses upon the management of assets for retirement plans at academic institutions. Accordingly, unlike the other fund families, portfolio companies held within equity funds managed by TIAA-CREF would not also be clients.

The Corporate Library Study included eleven categories of shareholder resolutions that rolled up into an overall governance score. These categories were: (1) Board declassification; (2) Cumulative voting; (3) Majority voting for director elections; (4) Executive compensation generally (5) Pay for performance; (6) Poison pills (7) Political contributions; (8) Recoup unearned bonuses; (9) Separate chairman and CEO (10) Severance pay limitations; and (11) Simple majority voting.

Four of these categories relate to the election process including elections of the board of directors. Resolutions within this category seek to improve shareholder input in the selection of their representatives. Given that even Delaware justices William Chandler III and Leo Strine Jr. consider director elections “an irrelevancy”⁸⁶ and they are regularly likened to Soviet-style elections, substantial room for improvement remains. Four resolution types attempt to give shareholders more say over executive compensation, an area where the need for reform is well-documented, with many examples of pay de-linked from performance.⁸⁷ Note that research suggests that the passage of shareholder resolutions that criticize executive pay has a direct impact on total compensation. One study found that compensation declined by a “statistically significant average of \$2.7 million” during the two year period following the passage of such

⁸⁶ Davis, Lukomnik and Pitt-Watson at page 115.

⁸⁷ Lucian Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*. (Cambridge: Harvard University Press, 2004).

resolutions.⁸⁸ One category, relates to the limitation on the use of poison-pills as anti-takeover defensive measures. In terms of shareholder value, the removal of such provisions is widely supported as a best practice.⁸⁹ One, the separate chairman and CEO, a corporate governance structure common in other countries, is increasingly seen as a way to help ensure the agenda set by the board is not dictated by corporate management. And the final category, political contributions relates to disclosing corporate monies dedicated to politics, something, that would seem so clearly in the province of what true owners should decide. All of these areas are ones in which shareholders are asking for more participation. When representative democracy is broken, participation becomes more critical. Indeed, some observers have commented “For the first time in decades, American corporate governance seems to be taking on the flavor of a New England Town meeting.”⁹⁰

The overall percentages for support of shareholder proposals for governance reform and DC assets under management (in \$ Millions) for the 10 were as follows: Fidelity (12%; \$443,600); Vanguard (25%; \$241,137); American (38%; \$219,485); Barclays (38%; \$150,544); T. Rowe (72%; \$91,600); Merrill Lynch (48%; \$34,994); Franklin/Templeton (57%; \$33,074); Legg Mason (53%; \$32,862); Scudder (50%; \$33,718) and Dreyfus (59%; \$31,663).⁹¹

When linking the Corporate Library data with the Pension and Investments data, I found that the instances of support by a mutual fund family for shareholder sponsored resolutions declined as the value of assets the fund family Adviser had under management through defined contribution plans increased. When focused on the ten largest fund families, the resulting coefficient of determination (R-squared) was 74%. The sample standard deviation was 9.465 with a Y intercept of 59.7. The P value was .001. These data show that DC assets under management is a useful predictor of proxy voting on shareholder governance resolutions. Given the low P value, the probability that this randomly occurred is less than 1 percent.

When the sample size increased to all 25 fund families⁹², a negative correlation remained, but less strong. R-squared was only 18.9%. The sample standard deviation was 15.3519 with a Y intercept of 51.2. The P value was .030. The low R-squared value, in this larger sample size, suggests that for fund families with fewer DC assets, assets are no longer a reliable predictor of voting behavior.

The cause for the significant negative correlation with the ten largest fund families is not self-evident. One possibility is that corporations will direct more assets for management in defined contribution plans to those fund families that oppose shareholder resolutions. If so, corporate

⁸⁸ Id. citing Randall S. Thomas and Kenneth J. Martin, “The Effect of Shareholder Proposals on Executive Compensation,” *University of Cincinnati Law Review* 63 (1995).

⁸⁹ For example, even where opposing such a measure has a price, Pozen states that: “The adoption of most antitakeover measures tends to lower a company’s stock price. To avoid these adverse effects, the logic of cost-benefit analysis dictates that institutional investors should be prepared to devote some resources to opposing such measures.”)

⁹⁰ David Skeel, *Icarus in the Boardroom*, (New York: Oxford University Press, 2005) at page 202.

⁹² The 25 funds were AIM, Alliance, American, American Century, Ameriprise, Barclays, Dreyfus, Federated, Fidelity, Franklin, Janus, JPMorgan, Legg Mason, Lord Abbett, Merrill Lynch, MFS, Morgan Stanley, Oppenheimer, Putnam, Schwab, Scudder, T. Rowe, Templeton, TIAA-CREF and Vanguard.

managers reward the failure of mutual fund Advisers to support shareholders' rights. Thus, assets increasingly grow as Advisers decrease their support for shareholders' rights. Or, if corporate managers punish mutual fund Advisers who vote to support shareholders' rights, assets would decrease proportionately. Indeed, some historical evidence suggests that corporate managers do punish misbehaving pension fund advisers.⁹³

A problem with the interpretations above, however, is that in the DC world, such as with 401(k) plans, investments into a particular mutual fund are employee (or "participant") directed. The employee, not corporate management, makes contribution decisions. At first, such an observation would seem to undercut the above causal explanations. However, while the employee makes the selection at the fund level, the employer, i.e. corporate management makes the fund family selection. Corporate management who, acting as plan sponsor, influences which fund family and fund families will be among the investment choices. In the US, plan members (i.e. employees who invest their wages) are not required to be represented on the board of trustees for 401(k) plans. This is in contrast to the UK, Australia, South Africa and other nations which require 50% representation of plan participants on the boards.⁹⁴ Often, by selecting a fund family to act as a record keeper as well, the fund family is given tacit approval. Also, fund Advisers overwhelmingly vote proxies for all funds uniformly. Accordingly, an employee investor may have equity fund choices for investment only from mutual fund families that disfavor shareholder rights.

This is supported by recent research published by the Employee Benefit Research Institute in January. Using behavioral finance research, the study found that "many participants seem simply to accept plan defaults set by corporate plan sponsors. The path of least resistance is paved by the plan sponsor." The focus was on the impact of the Pension and Protection Act of 2006, which permits the automatic enrollment and automatic default investment contributions. The researchers ask the question of whether automatic enrollment affected the "path of least resistance." They found that by automatically enrolling employees in the 401(k) plans, participation increased from 37 to 86 percent. However, they also found that more than 70% of the automatically enrolled group left their money (the 3% of their pay default amount) invested in a money market fund. This endured for a long period of time, with more than 50% stuck there after a year and 40% after two years still at the default 3% investment rate. This was the case even though employers would match the contribution up to 6%.⁹⁵

Another possible interpretation of the results is that mutual fund Advisers are self-policing. They understand that if they have large plan sponsors as clients, serious dollars are at stake and they do not want to run the risk of offending the gatekeepers for those dollars by behaving in ways that jeopardize the financial well being of the managers. Those corporate governance advocates who strongly supported confidential voting should not be surprised that the new Proxy Rule may have resulted in more disfavoring of shareholders resolutions for reform.

⁹³ Cite to Armstrong Industries example set forth in the Davis Study.

⁹⁴ Davis, Lukomnik and Pitt-Watson at page 75.

⁹⁵ Jodi Di Cenzo, Behavioral Research Associates, Employee Benefit Research Institute, "Behavioral Finance and Retirement Plan Contributions: How Participants Behave, and Prescriptive Solutions." *Issue Brief, No. 301*. January 2007.

Behind the numbers, the concept is that the distribution of assets is very top heavy. That is to say, 75.4% of all corporate pension plan assets is concentrated at just 516 or 1.1 % of corporate plan sponsors.⁹⁶ Not surprisingly, the retirement plan sponsor business divides into “markets” subdivisions of this larger market. Losing (or gaining) access to one of these plan sponsors is very meaningful, not just when one acts as a record keeper (thus ensuring that employee investors have your funds on the menu), but also just being on the menu even when a rival is the record keeper.

Another equally worrisome thought to consider: the correlation randomly occurred. This raises the same issue as discussed when looking at the individual classifications of proposals where there is tremendous variance across firms. In addition to supporting management-sponsored proposals involved much less variance. Certainly, dependence toward shareholders does not exist, something that mutual fund industry leaders themselves expect of corporate management. Yet, with the voting process, they speak at worse in harmony against shareholder empowerment based upon assets and at best in discord without favoritism of shareholders.

V. Other Explanations

When mutual funds Advisers (and their supporters) are confronted with their passivity in matters of shareholder governance, they often resort to a number of explanations meant to be legitimate alternatives to conflict-of-interest. In this section of the paper, I will identify such explanations and then examine them in light of the research results.

A. Wall Street Rule

The most common defense given by passive institutional investors, including mutual fund Advisers for not actively participating in corporate governance reform efforts is that they “vote with their feet” or sell their shares if they do not like what management is doing. Many think of this “Wall Street Rule” as the best method for shareholder democracy. However, in general, it is not a very valid excuse. Some consider mutual funds to be short-term investors, the so-called “one-night stands of institutional investment,”⁹⁷ due to their need to stand ready to pay mutual fund shareholders in cash upon redemption. However, even actively managed funds seem to manage toward indices, so that to sell off a position simply because the corporate managers behave in such a way to dilute the value of the shares is not often cost-efficient. In fact, mutual funds disclose that they will not object to an aspect of a stock option or stock grant plan unless it is dilutive of share value by up to 15 percent.⁹⁸

⁹⁶ Pie Chart “2007 Money Markets Directory Database,” McGraw Hill.

⁹⁷ Robert A. G. Monks and Nell Minow, *Corporate Governance*. 2nd ed. (Cornwall: Blackwell Publishers, 2001) at page 112.

⁹⁸ Morgenson, “When Funds Have to Show Their Hand,”. According to the article, regarding stock options and restricted stock grants, Putnam has a cap of 1.67% annual dilution and Vanguard 2%. In contrast Morgan Stanley 5 - 10% and Fidelity 10 - 15%.

With regard to voting proxies in favor of shareholder-initiated governance reforms, however, the Wall Street Rule should not apply. Unlike a costly or drawn-out proxy fight, voting is routine and required and is not something that is engaged in only if one is a long-term holder. Regardless of portfolio turnover, the fiduciary duty to vote in the interest of one's fund shareholders endures.

B. Alignment of Economic Interests

Another popular defense for failure to advocate for shareholders is the claim that given the alignment of economic interests between mutual fund shareholders and Advisers, voting choices made by the fund Advisers, would logically be in the best interests of fund shareholders. However, in many instances the Adviser's interests and fund shareholders' interests are in conflict. Moreover, these instances are not just historical relics that were "cured" by the provisions of the 1940 Act and the Advisers Act. These prevail today and are well documented by industry veteran, John C. Bogle, founder of the Vanguard Group.⁹⁹ He provides five examples where the goals of the fund Adviser conflict with the interest of fund shareholders. First, is fund size. The larger the fund grows in terms of assets, the more fees the fund generates for the Adviser who is paid a percentage of assets under management. Because fund Adviser's "profits normally rise faster than their fees, and the inflow of new cash to manage can leverage that profit many times over", they gain from the economies of scale.¹⁰⁰ However, high transaction fees and limited investment choices increase with size. Second, the most obvious, is the size of (in percentage terms) management fee itself; the higher it is the more the fund Adviser profits, yet the lower the (net of fees) return is to the fund. Third is fund choice, fourth, marketing costs (which I have discussed above) and fifth is paying for research and distribution with "soft dollars" (which I have discussed above).

Of these conflicts, the significant one to consider in the context of shareholder activism is the tension between asset-gathering and asset performance. Bogle notes that he witnessed "the field move from being primarily a profession of investment management to becoming largely a business of product marketing."¹⁰¹ Fund Advisers would have us believe that their proxy voting (even in the case of shareholder resolutions) is done in the economic best interests of fund shareholders. They would argue that both the Adviser and the fund shareholder have equal interest in the performance of the portfolio company. If the stock price goes up or down, we are meant to believe, this helps or harm the fund Adviser, just as it helps or harms the fund shareholder. However, this is not the case. If given the choice, a fund Adviser to profit well needs to gather assets. If an unhappy gatekeeper of a huge portion of assets could disappear, then the Adviser has an incentive to curry favor with such a gatekeeper, even at the expense of the fund shareholders. This is the case, even if the gatekeeper is the management of a portfolio company.

Incentive and opportunity are different from action. Even if we reject the alignment of interest theory and believe that fund Advisers wish to and have the opportunity to act in their own self-

⁹⁹ Bogle at page 170.

¹⁰⁰ Id. at page 171.

¹⁰¹ Id at page 176.

interest in proxy voting, the next step is showing evidence. Given the Davis study and the research done for this paper, where the stakes are very high, they appear to do so.

C. Legal and Political Obstacles

A common defense that fund Advisers have given for their reluctance to support corporate governance efforts of shareholders is that they are prevented due to existing laws and regulations from doing so. In this case, no political or legal obstacle exists. To the contrary, the federal securities laws mandate voting.¹⁰²

Legal obstacles restrict the ability of funds to put an insider on the board of a portfolio company. To do so could implicate insider trading laws, impacting the ability for trading in that security.¹⁰³ None of the 11 categories of shareholder resolutions touched on this issue.

Another legal obstacles using referenced by “reluctant activist” are diversification requirements under securities laws and tax laws. These rules impose limitations on how much of a corporation’s equity an individual fund may own. As observed by Mark Roe, “no mutual fund could ever threaten a portfolio company that it would devote more than a quarter of its assets to obtaining a majority of the portfolio company’s stock in order to oust management.”¹⁰⁴ Roe contends that mutual funds “could have been a conduit of shareholder power” but for regulations and restrictions.¹⁰⁵ In addition, these rules impose limitations on how much of a fund can be comprised of a single corporation.¹⁰⁶ None of the 11 categories of shareholder resolutions related to this either.

Indeed, nothing in the 11 key shareholder governance resolutions would be illegal for mutual funds to approve. To begin, the vote was advisory. Thus, if a majority of shareholders vote it would not cause the proposal to go into effect. A further step by corporate management would be required to make even approved changes. In addition, even if the steps were taken by corporate management to adopt the empowering resolutions, mutual funds would not be required to take actions legally prohibited.

D. Cost-benefit and the Free Rider Problem

¹⁰² The rare exception to the obligation that funds vote shares include where it is not cost-effective to do so, the example usually given is in the case of securities held on certain foreign exchanges.

¹⁰³ However, this obstacle would not prevent a fund adviser from backing a pro-shareholder candidate who is not an insider at the fund complex.

¹⁰⁴ Mark J. Roe, “Political Elements in the Creation of a Mutual Fund Industry, 139 *U. Pa. L. Rev* 169 (1991) quoted in Frankel and Kirsch at page 53.

¹⁰⁵ Id. quoted at page 303 and 304.

¹⁰⁶ Accordingly, it is said that fund advisers are limited in the effectiveness of their efforts. If corporate management knows the fund must stop at a certain threshold, the fear of being replaced would not exist. And, it is thought that without the fear of losing control, the corporate management will not accede to changes that are often pushed through by private equity funds that have the ability to take over.

Another popular and moderately convincing explanation is that supporting shareholders rights is not cost-effective. Those who explain or defend institutional investor passivity, often articulate this as the “free-rider” problem.

For example, Roberta Romano writes that private sector funds “are faced with the free-rider dilemma. If they incur the costs in time and resources to undertake effective activism, they do not receive benefits distinct from other shareholders. The fact that most public corporations in the US are widely held, with average voting blocks of less than 5 percent, only heightens the problem.”¹⁰⁷ This presupposes that the costs to activism are high and that they would be borne by the fund (and thus its shareholders) as opposed to low costs or costs borne by the Adviser. In the case of launching proxy contests for control, such an explanation makes sense, in the case of merely casting votes on shareholder-sponsored corporate governance resolutions, it does not.

This cost-benefit theory has two different branches. One, is that costs to fund investors outweigh any benefits to activism and advocacy. I’ll deem this the Too Costly for Fund Investors Theory. The other branch of the theory is that costs to fund Advisers outweigh any benefits that would accrue to fund Advisers. I will call this the Too Costly for Fund Advisers Theory. I will separately examine both branches.

Under the too Costly for Fund Investors Theory, one looks for economic benefits that would pass to the fund investors resulting from activism. Only those activities with proven benefits usually in terms of dollars per share are worth pursuing, according to many who espouse this theory.¹⁰⁸ While some studies show that institutional activism “has no appreciable effect on firm performance”¹⁰⁹ other more recent studies show that certain activities really matter. For example, “vote no” campaigns were found to be effective methods to force CEO turnover, particularly when large pension funds were involved.¹¹⁰

Even assuming no regulatory obstacles, activities like soliciting other shareholders in order to get one’s own board candidate on the ballot are extremely costly. If a fund fails in winning and thus does not have its expenses reimbursed (or cannot get contribution from other institutional investors), then no benefit is thought to have occurred. (While the contest itself might result in board turnover and possibly improved corporate governance, this is not assumed.) Moreover, even if the battle is won and a candidate is placed on the board (or even more rare, if an entire new slate of directors is placed on the board – still a small number on a staggered board), then a question as to what economic benefit will accrue remains – While the costs would be reimbursed.

¹⁰⁷ Roberta Romano, “Institutional Shareholders and Corporate Governance in the US,” from Geoffrey Owen, Tom Kirchmaier and Jeremy Grant, *Corporate Governance in the US and Europe*. (New York: Palgrave Macmillan, 2006) at page 55.

¹⁰⁸ These include objecting to poison pills, advocating for a greater price for a corporate takeover for example.

¹⁰⁹ “Management Focus: Not Awakening the Dead,” *The Economist*, August 10, 1996, citing to a study done by Purdue University professor Catherine Daily and three other professors as excerpted in Pozen at page 569.

¹¹⁰ Diane Del Guercio, Laura Wallis and Tracie Woidtke, “Do Boards Pay Attention when Institutional Investors ‘Just Vote No’?: CEO and Director Turnover Associated with Shareholder Activism,” *Working Paper*, June 2006. However, the authors did not find a positive valuation change through the use of proxy proposals.

This theory, though does not apply to voting on these shareholder resolutions. Pointing to cost-benefit to dismiss voting for such resolutions would be a mistake. Indeed, even submitting one's own pro-shareholder governance resolution is considered by some to be cost-effective. In an oft-cited *Harvard Business Review* article, Robert Pozen admitted that activities like introducing shareholder proposals are very inexpensive. Certainly merely voting in favor of ones to enhance shareholder rights would be even less. In reference to the cost to sponsor a shareholder resolution (at \$10,000 in 1987), Pozen remarked, "At this price, a shareholder resolution could meet the cost-benefit test even if the benefits cannot be guaranteed."¹¹¹

Under the too Costly for Fund Advisers Theory, the analysis is similar, but the emphasis is upon costs and benefits to fund Advisers. At the heart of this theory is the assumption that fund Advisers care more about relative performance of their funds more than absolute performance. In other words, even if the costs of any action were fully paid up and benefits inure to corporate shareholders in proportion to their ownership, unless the fund in question was outweighed in a particular stock, it is not going to do better compared to its benchmark than a competitor fund. Another piece to the too costly for Fund Advisers Theory assumes that fund Advisers care more about gathering assets than asset performance.¹¹² Included in the cost to the funds for any pro-shareholder activity would be the potential loss of existing access or future access to employees, particularly of large plan sponsors. Thus the conflict of interest piece gets embedded in this analysis. Given the animus many corporate managers feel toward interfering gad-flies, erring on the conservative side appears to be favored.

E. More effective behind-the-scenes

Another rationalization offered regularly by leading fund families, for failing to support shareholders' rights, is that they are more effective in behind-the-scenes negotiation. This is a familiar approach for the "significantly more active" British institutional investors.¹¹³ As for the US, Bernard Black noted "To date, many shareholder successes have come through negotiations with managers, in which the managers 'voluntarily' adopt all or part of a shareholder proposal."¹¹⁴ Proponents contend that given egos, reputations and the like, corporate executives are more likely to compromise when not in the public eye.

The weakness of this notion as a defense to passivity is that it does not need to be the only method for advocacy. Other large managers of funds meet behind closed doors with executives yet also use other tactics for achieving change. Other problems with this are that by nature the success of these techniques is impossible to measure. It is a "trust us" defense, which, given the industry's record, cannot be accepted on face value.

F. Fiduciary Duty

¹¹¹ Pozen's HBR article cited within his textbook at page 577.

¹¹² Davis, Lukomink and Pitt-Watson at 69.

¹¹³ Black and Coffee at page 2003.

¹¹⁴ Bernard S. Black, "Agents Watching Agents: The Promise of Institutional Investor Voice," 39 *UCLA L. Rev.* 811 (1992).

When confronted with their failure to support shareholder rights initiatives, Advisers often claim that their fiduciary duties to fund investors bars them from such activities. This claim is based upon a corporate governance perspective that is shareholder-centric. However, as noted above, being shareholder-centric does not mean one must only support those rules and practices that are shown to create long-term shareholder wealth. There is another view within the shareholder-centric camp that would say shareholder democracy is important. Under such a view, the majority of the owners of a corporation have a right to make certain decisions. For example, the owners of small closely-held corporation might choose a more costly manufacturing process that is less harmful to the environment. Even if this process were to sacrifice profits, this is up to the owners. Similarly, if the majority of owners of a publicly-traded corporation are willing to forgo some profit in the name of another principle, that should be their choice.

When mutual fund Advisers' claim that they must put their fiduciary duties to their own fund shareholders first, they ignore some of their own behavior. They would be more convincing if they were not often using fund investor assets toward all sorts of activities that produce little if any proven benefit to the shareholders. For example, fund Advisers use fund assets to support advertising to bring in more shareholders. Bringing in more shareholders benefits fund Advisers, but once economies of scale are exhausted, does not benefit existing shareholders at the same level.

In addition, it is not clear why their fiduciary duties should prevent them from supporting many of the governance resolutions put forth by shareholders that have been shown to directly affect firms' valuations.

G. Contract

Advisers claim that as institutional investors, they must follow the mandate included in their contracts.¹¹⁵ Yet, a mutual fund Adviser negotiates a contract with a mutual fund not real people. The mutual fund itself has no employees. The fund trustees or directors are on the opposite side of the table from the fund Adviser. Yet, this is not truly arms-length bargaining. Mutual funds are often created by and captive to their Advisers. Fund directors are intended to look out for the interest of fund shareholders. However, fund Adviser essentially selects directors at many fund families. The advisory contract is not something mutual fund shareholders see before investing, nor do they actively negotiate. When it comes to proxy voting, the contract defense is no excuse. By law, the fund board has the “right and obligation to vote proxies relating to the fund’s portfolio securities.”¹¹⁶ If the board delegates that responsibility to the Adviser, nothing in the advisory agreement should require the Adviser to oppose shareholder initiated proposal for corporate governance reforms. Given that the cost of voting yes is no greater than the cost of voting no, the question of benefit to shareholders should be the only issue.

¹¹⁵ Robert C. Pozen, “Institutional Investors: The Reluctant Activists,” Harvard Business Review, January – February 1994 (“Most advisory contracts require money managers to perform normal proxy activity: reading proxy statements, making careful voting decisions, and sending reports to an oversight board. These contracts typically do not address the question of who pays for proxy activism undertaken by the institutional investor on behalf of his clients.”)

¹¹⁶ Adopting release for Fund Proxy Voting Rule.

As part of the contract defense, Advisers turn to the prospectus, noting that they must follow the investment strategies laid out in the prospectus to make its investment choices and that if it were to take certain activist actions it could be in violation of the prospectus and subject them to legal liability. Such an argument does not apply to voting for shareholder governance resolutions. First, these votes would not affect investment strategy. Second, even if they did relate to investment strategy changing the fund prospectus can be done with shareholder approval. Indeed, when it is to their advantage, fund Advisers are not shy about seeking shareholder approval for prospectus changes, even when numerous of shareholder meetings must be convened.

H. No shareholder demand

Another explanation given for Adviser inactivity in corporate governance matters is the absence of shareholder demand. For example, when discussing the approximately 8,000 comment letters sent to the SEC in support of the Proxy Voting rules, an SEC Commissioner and some in the fund industry dismiss the significance of public support given the small percentage of all fund shareholders commenting.

Some might attempt to apply this explanation to why Adviser's vote no on shareholder-initiated corporate governance resolutions. The best evidence to support such an argument would be to point to voting behavior of individual shareholders. According to JP Chase, it has 3.5 billion shares outstanding with 1 million different holders. Of those 65-70% is institutions, and 100% of these institutions vote their proxies. In contrast, of the approximately 30% of individual investors in JPChase shares, only 50% cast proxy votes.¹¹⁷ When mutual funds (as issuers) send out proxies only 32% of mutual fund shares held in street name are voted.¹¹⁸

While these data suggest trouble in reaching a quorum, and lack of shareholder education on the importance of voting, it hardly suggests unimportant levels of participation. Moreover, our standard for protecting investors cannot be based upon protecting investors only to the extent they are educated enough, are aware of the comment process and take the time to write a letter. Finally, there is reluctance by smaller shareholders to vote when ones vote is merely advisory and may have little impact on corporate behavior.

I. Lack of Confidentiality

In explaining the general passivity of mutual funds in matters of corporate governance, some argue that mutual fund Advisers need to choose their battles because activities (including proxy voting) that are not confidential could lead to retaliation from corporate managers.

While this argument carries some intuitive weight, some research would help to discredit it. For example, Roberta Romano's research on confidential voting showed no measurable benefit to

¹¹⁷Transcript from SEC Roundtable Discussion on Proxy Voting Mechanics, May 24, 2007.

¹¹⁸Statement of Paul Schott Stevens, President and CEO, Investment Company Institute, Proxy Voting Roundtable on Broker Proxy Voting, Submitted to the U.S. Securities and Exchange Commission, May 24, 2007.

shareholders for keeping voting secret.¹¹⁹ Moreover, with rules like Regulation F-D, in theory, large shareholders are not entitled to favorable treatment by corporate managers; in that material information cannot be selectively disclosed. Finally, although retaliation for voting to increase shareholder power vis-à-vis managers may occur, admitting to that as a justification for failing to do so, is the definition of conflict of interest and possibly a violation of the antifraud provisions of the Advisers Act. Interestingly, upon hearing this suggested during a public roundtable, Commissioner Atkins asked for evidence and received none.

If anything, then, lack of confidentiality, does indeed support the results in this study and the likelihood that potential or actual retaliation is the cause for the significant negative correlation between DC assets under management and proxy votes for shareholder-initiated governance proposals. However, it is not clear whether the identity of large voting blocs was a secret prior to the Proxy Voting Rule. Anecdotally, vote solicitors have been able to track the identity of large investors as votes come in.

J. Special-Interest Agenda

Another reason cited for lack of support for shareholder rights is the supposition that special-interest groups or supporters of a particular political agenda sponsor many of the shareholder resolutions. This observation, true or not, does not end the discussion. Those who make the observation, then argue that the fund Adviser should not support political agendas because either (a) the fund shareholders don't want this; (b) it runs counter to their fiduciary duties; and/or (c) the political, not the commercial arena is the place to address such issues.

Each of these rationales can be challenged. Whether fund customers support or do not support particular special interest votes is pure speculation. Other than for socially responsible investment ("SRI") funds, fund Advisers would have little or no knowledge regarding the interests of fund shareholders. If some proposals, such as environmental ones received a greater percent of overall shareholder support, then mutual fund Adviser support,¹²⁰ for the fund Advisers disproportionately to oppose such proposals must not represent the general population.

Outside of the interest-specific votes, in terms of shareholder governance proposals, why fund Advisers would assume that fund shareholders would want to limit shareholder power vis-à-vis management is difficult to understand. Mainstream fund Advisers typically do not seek out customer views on matters like executive compensation, majority voting and the like.

Finally, the argument that matters of public policy ought to be resolved in the political sphere through democratic institutions is weak.¹²¹ Its weakness can be illustrated by first starting with the example of a closely-held corporation. The owner of such a small company makes choices about whether to engage in particular activities from selecting suppliers to distributing finished

¹¹⁹ Roberta Romano, Does Confidential Proxy Voting Matter, 32(2) The Journal of Legal Studies 465 (2003)

¹²⁰ Douglas G. Cogan, "Unexamined Risk: How Mutual Funds Vote on Climate Change Shareholder Resolutions," *Investor Responsibility Research Center*. Commissioned by Ceres, January 2006.

¹²¹ In the HBR article, Bob Pozen contended that shareholders should not bother the board of directors, and indeed the board of directors should not get involved with questions like song lyrics that might incite violence.

goods or services. A company may choose, for example, not to do business where proceeds of transactions would further genocide.

However, fund Advisers routinely argue that they act on behalf of their shareholders who expect them to put profit over principle and that the governments of the world are responsible for ending the violence. For example, in response to protests over the investment by its family of funds in portfolio companies profiting from business in Darfur, Fidelity spokesperson, Anne Crowley responded, "Our funds have a fiduciary responsibility to act in the financial interests of their investors, in keeping with the investment policies for each fund. This is not Fidelity investing its own money; this is Fidelity investing the money of millions of people." While fund Advisers mouth these arguments, their actions speak louder than words when they divest directly after public protest.¹²²

Given that more than 77 million people in the US invest through mutual funds, a certain percentage of them no doubt are aware of genocide either through their places of worship, television or print media or other sources and who wish it to end, would also want to avoid profiting from such violence and murder. Why do fund Advisers wish to shield themselves? Clearly, fund Advisers must be afraid of opening a Pandora's box. If they are not going to act as an SRI, then they will stay out of this arena.

That said, support of shareholder rights does not further any particular "outsider" special interest group. One need not hold a stakeholder view of corporate governance to vote in support of these resolutions. The eleven categories included in the data set from the Corporate Library deal mainly with the shareholder's ability to reign in executive compensation, to have more control over who is elected to the board of directors to represent them and similar mechanical matters of governance.¹²³ It should make no difference whether a proposal to require majority voting for directors was initiated by a alleged special-interest group or a purportedly neutral investor. The substance and the result are the same. Thus, the special-interest argument falls flat.

K. Lack of Expertise

Advisers, hired to manage assets, might claim that their expertise is not in matters of shareholder governance. Moreover, they might argue that it is too expensive to become expert. If this is true, it supports the need for reform. If there is bias or negligence in voting due to lack of expertise, certainly, the Advisers should find a cost-effective way to delegate this responsibility to someone who can look out for their shareholders.

VI. Range of Reforms

¹²² Ross Kerber, "Fidelity says it did not divest for Darfur: Firm says decisions based on returns, not pressure by activists," *Globe Staff*, May 17, 2007.

¹²³ The categories were: (1) Board declassification; (2) Cumulative voting; (3) Majority voting for director elections; (4) Executive compensation generally (5) Pay for performance; (6) Poison pills (7) Political contributions; (8) Recoup unearned bonuses; (9) Separate chairman and CEO (10) Severance pay limitations; and (11) Simple majority voting.

The research results show that for large mutual fund families, the greater amount of DC assets under management, the less likely they will support shareholder-initiated governance resolution. Coupled with the Davis research showing “a positive relationship between the volume of pension business a fund company does and its propensity to vote with management”, there is cause for concern. The Fund Proxy Voting Rule and its companion Adviser Proxy Voting Rule were designed to shine light on potential conflicted voting behavior and to help deter such behavior. At this point, evidence suggests that the transparency creates useful data, but more needs to be done to deal with what may amount to breaches of fiduciary duties by fund Advisers. A list of possible reforms and a brief analysis of their potential efficacy follows.

A. Separation of Money Management from Retirement Plan Record Keeping

A very extreme reform would be to mandate the separation of fund Advisers from retirement plan record keeping. The intent of such a step would be to eliminate the incentive for fund Advisers to support management and not shareholders in the corporate governance matters. However, for reasons described below, this measure would seem to more draconian than effective.

First, even if fund affiliates were forbidden from acting as record keepers or having direct relationships with corporate managers, they would still wish for their funds to be included within retirement plans. Accordingly, they may still have an incentive to act in management-friendly ways, and perhaps even more so. Second, someone with expertise will need to act as a record keeper and that institution or another will need to help winnow the number of possible fund choices down to a manageable selection. If we are to believe that the existing selection process might be biased so that corporations are more likely to select pro-management/anti-shareholder mutual funds to include within their offerings that is not likely to change.

This type of arrangement has an appeal due to its simplicity and precedent. The separation of the audit function from consulting is one previous example. Another example is the separation of stock recommendations from underwriting. However the problems set out to be solved in the accounting field and investment banking business were different. Moreover, what has now become an important point made in the corporate governance field is that not being biased toward management is not the same thing as being in favor of shareholders.

B. Separation of Voting from Money Management

Another possible reform focused on the fund Adviser would be to mandate a separation between proxy voting and money management. Currently, fund boards oversee proxy voting and often delegate that function to Advisers. However, that they are largely beholden to the fund Adviser for continuing employment. Perhaps fund Advisers should be required to assign voting to an independent third party proxy voting service. Currently, one such enterprise, Institutional Shareholder Services (ISS), advises institutional investors including mutual funds as to how they

should vote at thousands of annual meetings. As of 2000, ISS is estimated to have influenced 20% of all votes at US corporate meetings.¹²⁴

Such a separation and delegation to an outside service has limits. Part of the fiduciary duties of the mutual fund itself (through its board of directors) is carefully to consider the impact of each voting decision on the fund and its shareholders. A blanket delegation to the outside service is a one-size-fits all approach. Moreover, given the growth in proxy advisory services, some questions about their own independence from corporate interests may be questioned. Similar to the large rating agencies, these services depend, though to a lesser degree, upon corporations for income. Another limitation would be that if this were mandated, undoubtedly, certain proxy voting services would arise and be more pro-management or anti-shareholder who could cater to this new business.

Finally, it would limit the ability for the underlying investor to have a voice in the corporate governance debates.

C. Pass-through voting and proxy assignments

Another option might be pass-through voting, whereby the fund Adviser would have to obtain instructions from fund shareholders for every single vote held at each portfolio company. Clearly, this would not just be expensive and unmanageable, but also likely ineffective. Equivalent to having a referendum on every issue before our legislatures, it sounds like democracy in theory, but would be too cumbersome to result in real input from the governed.

Evidence suggests that very few mutual fund customers would vote. First, the percentage of direct shareholders (other than large institutional shareholders) who vote is low.. This has led to “broker voting” whereby brokerage firms vote on routine matters “for management” on behalf of their customers who are silent. The passivity of individual mutual fund customers on voting related to fund activities is also well documented. Indeed, funds as issuers often have trouble reaching a quorum.¹²⁵

However, another option would be optional pass-through voting, where fund Advisers would have to take proxy assignments from retail fund shareholders who wish to vote from time to time on contentious matters at portfolio companies. This concept, suggested by James McRitchie, Publisher of *Corporate Governance*, has not been accepted by funds

D. Default Proxy Assignments

Another option might be to create default proxy voting assignments. This would also be a useful solution to the broker voting issues. Under the default proxy assignment, mutual fund shareholders would be automatically assigned to a pro-shareholder proxy voting advisory service. They would also be given an option to change that default position to other services (and

¹²⁴ Davis, Lukomnik and Pitt-Watson at page 136.

¹²⁵ Judith Burns, “Funds Seek Proxy-Plan Exemption: Group Argues Barring Votes By Brokers on Routine Items Would Drive Up Expenses,” *WSJ*, December 22, 2006; C5.

even to the fund advisor) if clear, conspicuous and meaningful disclosure were given about the voting policies of the other services.

In order to create a fair playing field, some limitations on the ability for fund Advisers to “sneak in” consent to change the voting back to them might be needed. For example, electronic delivery or click-wrap might be prohibited. This suggestion has been implemented in part by Lord Abbot, who, according to the *Wall Street Journal* outsources votes to an independent proxy service when in conflict.

E. Best practices for proxy voting and “comply or explain”

Another, less intrusive solution would be to create best practices standards for proxy voting. An independent advisory service could be the standard bearer. Or, better yet, federal best practices like the Combined Code could be created either by Congress or the stock exchanges. Corporate managers would be subject to the British-style comply-or-explain. In addition, fund Advisers would also be required to explain why they did not support shareholder efforts on various corporate governance matters.

For example, assume that one best practice were majority voting for directors. Assume that a corporation failed to institute this practice and disclosed as much in its annual report. Then, assume that a shareholder resolution were proposed to demand that a corporation institute majority voting. Under the best practices, a fund Adviser should vote in favor of this majority voting resolution. If the Adviser failed to do so, it would need to disclose this to fund shareholders and explain its reasoning. This annual disclosure could easily be added to the N-PX filing process.

This information would be useful for shareholders, journalists and academics who could more easily track in which companies and why a fund family is taking an anti-shareholder stance. Those firms that might find this onerous could easily use software to compare their own votes to that of an independent advisory service and show how it departed from the baseline. Ideally, one baseline would exist against which even the independent advisory services measured their own voting patterns.

This suggestion is a variation on what was part of the Proxy Voting Rule proposal, but did not make it into the final rule. Under the original rule proposal, funds would explain to shareholders when their actual proxy votes casts departed from their stated policies and procedures. Opponents of this approach noted that this would only encourage funds to have very generalized policies and procedures that would rarely if ever be violated regardless of the vote. Policies and procedures could easily be crafted that would say what the general position was and state that exceptions occur. Such language might make finding an instance of a policy departure impossible.

The original proposal would just lead to more disclosure that would be hard to decipher for the extra effort. In contrast, a uniform set of best practices – such as to always favor majority voting

proposals for director elections, would cause a fund voting against a majority voting proposal to provide an explanation as part of the N-PX filing. The uniformity of the standard would make it enable an easy determination of which fund families tend to deviate from the standard. This percentage could be compared across funds and facilitate explorations correlations between departure from the best practice and, for example assets under management. The explanation would provide some flexibility by allowing shareholders to read why their fund firm, unlike others, deviated from the norm.

F. Uniform disclosure “product label” for voting procedures

Building upon the last reform, fund Advisers might be required to include a “product label” for voting procedures and actual votes so that investors might compare across fund families. Currently, funds disclose their investment performance as compared to benchmarks over required periods. A best practices benchmark could be used to show how far off that shareholder governance benchmark the fund was. In the absence of such a benchmark, one could use just the absolute support figures. Though, these data are less useful than a thoughtful baseline.

Such a label could be included not just in the prospectus (and annual reports), but also at the initial point of sale for first time fund investor. Determining the appropriate place for disclosure is particularly important for retirement plan investors who receive less disclosure than direct investors due to some very “literal” and narrow reading of the securities laws.

G. Choice at the point of sale

A more intrusive measure focused on the fund investor behavior would be to provide more choice at the point of sale and to default to an SRI fund for auto-enrollments or when investors fail to designate an investment option. While this proposal may seem radical, what the industry is currently proposing is indeed just as extreme. As a result of recent legal changes, employers may automatically enroll employees into defined contribution plans and automatically deduct money from their paychecks. This auto enrollment was intended to combat what employers (and government) saw as mere inertia (and not lack of interest) of employees when faced with the opportunity to set aside part of their paychecks in a tax deferred savings plan.

Under auto-enrollment, the employee may opt out after the fact. However, given data concerning investor behavior put forth by the EBRI, many employees not only stay, but also, stick with default configurations. If one looks to the suggested models for the active enrollees, this is the case. Little shuffling of investment choices occurs.

Because this automatic enrollment option exists, employers must make an investment selection for the employees. This selection is made even though the employee does not have an opportunity actively to consent or even review a prospectus.

Eager to give employees better options (or make more money on management fees, perhaps), the industry has been pushing to allow enrollment in more risky mutual funds. Given this, it seems that the industry would not object to some mix of the default investments being in domestic

equity. So, the only new piece of this proposal would be having the domestic equity default investment be in an SRI/pro-shareholder governance fund.

These employees could always change their investment mix and move to a non-SRI fund, but if they are going to be placed blindly into an equity fund, one that is most likely to put their interests before that of the fund Adviser, seems a fair choice.

The result of this might be that mainstream Advisers begin to compete in the SRI market, or that they begin to have their mainstream flagship funds more attuned and more aligned to shareholder interests. Depending upon the dollars associated with this new category of auto-enrollees, it seems that this could be a very powerful incentive. Since we know that DC assets are a predictor of pro-shareholder votes, to the extent that some of these DC assets can be wrest from dependency on corporate managers could have a positive result.

H. Suitability requirement that includes investment objectives and governance topics

Another reform might be the imposition of a suitability requirement for broker-dealers (including fund underwriters). Under this requirement, those who offer mutual funds to investors and those in retirement plans that offer funds to employees must gather from such investors, information to enable them judge their suitability for a particular fund. Specifically, the questions would tie to governance topics.

This proposal raises many shortcomings. First, gathering information from existing customers would be costly. Moreover, to the extent the gathering of such information would then dictate a change in investments; this could be very disruptive and costly. To the extent that the proposal only applied to new investments how to impose change without pro-shareholder governance fund options available to all is far from clear. Accordingly, such a reform would probably best work alongside a strategy to offer at least one SRI/pro-shareholder fund at the point-of-sale, particular within retirement plans.

VII. Broader Perspective

Seventy five years after Berle and Means, we still examine corporate governance problems within their agency framework. Specifically, we see shareowners at the mercy of distant managers. Yet, the mutual fund example should show us at least one more layer. Presently, the real investors are no longer the corporate shareholders. The shareholders are now often middle men and women. And, the true investors are now at the mercy of those intermediaries to advocate on their behalf. Given that mutual funds own nearly 25 percent of the US equity markets, this is no small matter.

While this topic affects more than 77 million individuals, its impact is actually broader. For those with a shareholder-centric view of corporate governance, whether efforts to empower shareholders can be effective when institutional shareholders have conflicts that inhibit their willingness to pressure management. As the research shows, mutual fund Advisers do not exercise their existing rights in such a way that would empower shareholders at large.

As a result of this research, I suggest that corporate governance scholars and reformers use the mutual fund case to reexamine the prevailing framework. Specifically, we should shift our focus from empowerment of direct shareholders to the empowerment of the true equity investors. More than just a semantic distinction, this new framework would recognize that institutional shareholders cannot be expected to wrest power from or demand accountability from corporate managers. It also recognizes that after the “managerial” revolution whereby ownership was separated from control, a further “intermediation” revolution has further divided ownership, separating risk-taking from legal title and pushing the risk-takers further away from the decision-makers.

Taking an even broader perspective, what I find most useful about looking at the investor behind the institutional shareholders is that it ends the shell game I often see played around issues of social responsibility. Proponents of various causes are often told that corporations cannot address social issues because corporate managers have a duty to maximize long-term shareholder value and may not consider stakeholders. Then, when one looks to the legal shareholders, for example, the mutual funds, their Advisers say, we cannot address social issues, after all, we are beholden to our investors. Then, when we look to these underlying investors, they say overwhelmingly (in their capacities as citizens, neighbors, people of faith and so on) that they do not want to support genocide or environmental damage or poor labor standards. But, they actually have no idea that their own money is furthering such causes. And, even if they were informed, they have no real choices, no opportunities to make the corporations at the other end of this long intermediation chain accountable. These underlying investors, as real owners, should have a voice. In the majority, they should have the right to instruct the corporate managers who work for them how to handle large compensation packages as well as large social issues. Like owners of closely held company, the real owners of publicly-trade institutions should have the right to forgo profit in the short or long-term in the interest of other principles. Giving the true investors a voice on shareholder resolutions, governance or otherwise is a step in that direction.

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