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In the Shareholders' Interest: Funds and Proxy Voting

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Remarks of Paul Schott Stevens

President & CEO

Investment Company Institute

At the American Enterprise Institute Forum: How Do Mutual Funds Vote Their Proxies?

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Thank you, Peter [Wallison], and many thanks to AEI for hosting this forum. Thanks also to Marty Lybecker, Mike Ryan, and Heidi Schooner for the insights they will provide about our research and the issue of proxy voting.

For any shareholder, the corporate franchise is part of the value of stock ownership. To secure that value, advisers to mutual funds and other investment companies, as fiduciaries, must vote proxies in a way that best serves the interests of fund shareholders. Funds also must disclose each and every vote they cast, as well the policies that guide their voting and the procedures they use to avoid potential conflicts of interest. Because funds hold almost 30 percent of the shares of US companies on behalf of 90 million shareholders, how they vote corporate proxies is a matter of no small interest and public commentary.

Much of this commentary, however, seems designed simply to promote the notions that "companies care little about their shareholders"; that the "investors who own American companies and the hired

hands who run them" are arrayed as "combatants" against each other in proxy proposals; that funds are AWOL in this fight and "rubber-stamp" virtually all management proposals; that funds should not "vote with their feet" by selling their shares but instead should "pursue actions" to reform their portfolio companies.)[1] Some of these critics believe funds allow their votes to be swayed by other business interests—such as the desire to run portfolio companies' 401(k) plans.

In the public dialogue, these and similar propositions have become altogether acceptable and predictable. They embody all the characteristics of what John Kenneth Galbraith, in his book The Affluent Society, termed "the Conventional Wisdom." As Galbraith observed, in the "never-ending competition" of ideas, the Conventional Wisdom has all the tactical advantage—including supporters who buy ink by the barrel. What is right, what exists—put differently, the facts—have at best a strategic advantage.

To test the Conventional Wisdom about how mutual funds actually use the corporate franchise, ICI thought to conduct a detailed, factual analysis of proxy proposals, and the votes cast by the largest fund complexes, last year. The reality of their voting practices and procedures, as you will see, paints a quite different picture.

There are layers of irony, of course, about our very ability to conduct this research. Yes, the fund industry was strongly opposed to the 2003 SEC regulations that require registered investment companies to disclose their proxy votes. Other institutional investors do not do so, including many that deplore funds as not "activist" enough. Five years on, we have made peace with our disclosure obligations in this area and all the public scrutiny that implies. And we have recommended that Congress require other fiduciaries to play their cards face up as well.

Before reporting on our research, let me make one additional point. We can all agree that proxy voting is very important. But surely it is not the only way that funds—or other institutional investors—influence a portfolio company's management or policies. Corporations have every incentive to attract and retain funds as stockholders. Funds have every incentive to seek out corporations that are well governed and successful—and to avoid those that are not. And if a portfolio company goes off the rails, funds can and do engage with its management directly, quite apart from the annual shareholders' meeting. Funds also may simply sell their shares of the company.

Each of these actions—buying shares, engaging directly with management, voting proxies, and selling shares—plays an important role in how funds influence corporate conduct.

The focus today is limited to funds' proxy voting behavior. So, let me briefly describe our study)[2] and its findings.

To our knowledge, this is the broadest study of funds' proxy votes ever undertaken. It covers more than 3.5 million proxy votes cast by 160 of the largest fund families in 2007.

It also reflects the operation of proxy voting policies developed by each of these fund complexes under the direction of their respective boards of directors or trustees. That process of board oversight is the focus of a separate report that the Independent Directors Council and ICI are also jointly releasing today.)[3]

As you can see from Figure 1, most proxy votes that funds cast concerned either the election of directors who are running unopposed or ratification of the company's choice of audit firm. In 2007 these matters, largely uncontroversial, accounted for more than 80 percent of the items voted on.

It is often asserted that funds tend to vote in favor of management proposals and against shareholder proposals. And in raw numbers, that's true.

As Figure 2 shows, funds almost always voted in favor of management proposals.

Does this level of support for management signify a rubber-stamp? No, because simple vote tallies don't tell the full story.

Remember, Figure 1 showed that 80 percent of funds' proxy votes were on matters that are usually dubbed "routine"—the unopposed election of directors or selection of an audit firm

Funds' voting policies often provide that funds will vote for unopposed director nominees, but will withhold votes from directors who failed to exercise good judgment or took actions contrary to the interests of company shareholders. And funds do apply this standard. In 2007, the majority of funds withheld votes from one or more director nominees at more than 10 percent of the companies they owned.)[4]

As Figure 3 demonstrates, others have pretty much the same view of these proposals that funds do. We compared funds' voting patterns with the recommendations of two major proxy advisory firms, Institutional Shareholder Services and Glass Lewis, who supported approximately 80 to 90 percent of these same proposals. And, vote outcomes suggest that other institutions and individual shareholders may have voted along the same lines.

Figure 4 depicts the roughly 9 percent of the total votes cast on [QUOTE] “other management proposals”—for example, measures related to shareholder rights, firms’ capital structure, the makeup of corporate boards, and mergers. Here, too, funds’ votes don’t appear to be outliers. Funds are more likely than other shareholders to support measures that dismantle corporate takeover defenses, and somewhat less likely than others to support management on compensation proposals.

What about shareholder proposals? Critics contend that funds almost never vote for shareholder-sponsored proxy proposals. That is clearly false. Earlier, you saw that funds voted for shareholder proposals almost 40 percent of the time in 2007. Figure 5 shows that this was almost always over management’s objections.

Again, we compared our votes to those recommended by the proxy advisory firms. As you can see in Figure 6, funds favored certain types of proposals about as frequently as these firms did, and other proposals less so. The point I want to emphasize, though, is that by any measure support for shareholder proposals depends on the type of proposal. This underscores my point that simple vote tallies present, at best, an incomplete picture.

Now—if you’ll bear with me—I’d like to delve a little deeper into three specific areas: executive compensation, governance provisions that tend to entrench management, and social and environmental proposals. My purpose is to illustrate the approach that funds take in this context, consistent with their duty to serve the interests of their shareholders.

We examined the published proxy voting guidelines of 35 large fund families on various issues. Figure 7 summarizes those families’ policies on voting on proposals pertaining to executive compensation. Funds generally favor proposals that align the interests of company employees with company shareholders and compensation packages that are consistent with industry standards. Funds will usually vote against pay packages that are excessive or that unduly dilute their investments in companies.

In 2007, corporate ballots of companies in the Russell 3000 included 175 shareholder proposals related to executive compensation. These comprised less than 1 percent of all proxy proposals—but they had a visibility out of all proportion to their number. Displaying a talent for both assonance and alliteration, AFSCME and the Corporate Library in two recent reports labeled funds “Enablers of

Excess" and "Failed Fiduciaries" for their proxy votes on executive compensation. Do the details bear this out?

In fact, as we saw earlier, funds voted in favor of shareholder proposals related to executive compensation 38 percent of the time. Figure 8 breaks down those votes and shows that the extent of funds' support varied depending upon the specific proposal—with the strongest support shown for advisory votes on executive compensation [53 percent], performance criteria for stock awards [45 percent], and establishment of policies on SERPs [45 percent]. The evidence suggests that funds weigh the merits of different proposals in this area, and don't reflexively vote yes or no.

As Figure 8 shows, funds tended to favor advisory votes on executive pay—the so-called "say-on-pay" proposals—more than 50 percent of the time, but were less favorably inclined toward proposals to limit executive compensation or increase disclosure of that compensation.

In this context, it bears emphasizing that funds and other shareholders may agree with the general philosophical premise behind a specific proposal—linkage between pay and performance for example—but they may not vote for a proposal that is either too narrowly drafted or too inclusive. One should not infer from this figure that the majority of funds oppose the idea of pay for performance; rather, it simply shows that the proposals that invoked this philosophical premise were not, in the view of those analyzing them, worthy of support. Funds engage these issues on a balanced, nuanced basis that stands in sharp contrast to the blunt approach that activists may favor.

Funds' voting policies indicate that they focus on the economic interests of fund shareholders. As Figure 9 demonstrates, that means, among other things, keeping the market for corporate control open, and opposing strategies that management might use to entrench itself, limit shareholder rights, or erect barriers to takeovers. A majority of fund families say they vote against measures of this kind. Indeed, as we saw in Figure 5, funds voted in favor of shareholder proposals to weaken anti-takeover devices 78 percent of the time during 2007. They also supported about half of shareholder proposals to change board structures and election processes.

The point of these proxy-voting policies is not lost on corporate management. As Figure 10 shows, companies and their boards are offering more and more proposals to dismantle takeover defenses, such as classified boards and supermajority voting requirements. In 2007, as shown before, funds

supported management proposals in these areas more than 90 percent of the time, because these proposals advance true shareholder interests.

What standard, you might ask, do funds use to determine shareholder interests? As I have said, the majority of funds think in economic terms—that is, they vote in a way that they believe will maximize the fund's financial returns. This is in keeping with the "social contract" between a fund and its investors embodied in the fund's prospectus, which declares its fundamental investment objectives and policies; they can be altered only by a shareholder vote. The prospectus for one of the funds offered by a major fund family explains it simply and clearly: [QUOTE] "The fund seeks to provide capital growth, current income and preservation of capital through a portfolio of stocks and fixed-income securities."

Of course, there are many funds with broader investment purposes—including about 260 that pursue financial returns in tandem with social, environmental or other objectives, and whose advisers manage with these additional objectives in mind.

This is an important distinction, and it conditions how funds use the corporate franchise. Funds exclusively seeking to maximize financial returns do not have a mandate from their investors to engage portfolio companies on social, environmental or similar issues—valid as these may be. Absent such a mandate, they neither can nor should vote proxies simply on the basis of these considerations.

Nor should we want them to, because that would be to exceed the role for which they are well-equipped—that of investor and fiduciary—and add the role of corporate manager or social reformer, for which they are not.

As a result, on such issues, most funds are likely to defer to management's judgment, vote against such shareholder proposals, or simply abstain. That's reflected in funds' voting guidelines, and in their votes, as you see in Figure 11.

As I said, our research sought to take into account both what funds were called to vote upon and how they voted. Let me touch for just a moment upon the shareholder proposals at annual meetings last year.

In Figure 12, you see that in 2007, individual shareholders sponsored some 239 proposals that made it to the ballot at annual meetings of the largest publicly traded U.S. companies. Five individuals accounted for more than half of these proposals. During the same proxy season, labor unions sponsored 186 proposals in total—with three unions responsible for 94 of them. Taking into account shareholder proposals by all sponsors that year, five people and three organizations advanced more

than a third.

You might think it odd that hundreds of different fund complexes serving 90 million investors should be taken to task for often having views of proxy voting that differ from those of a concentrated a group of shareholder advocates. Equally odd is that the special interests of the advocates go largely unquestioned, while the pages of the New York Times level charges without evidence that fund advisers vote proxies on the basis of their own business interests.

As for the facts: Our economists scoured the available literature on this topic and found zero evidence to support the charge of a connection between fund proxy voting and business ties. In fact, two independent studies published in 2005 pretty well disproved it.)[5]

Figure 13 summarizes their findings. It's interesting that both studies were released before the New York Times published its articles suggesting that there was a connection.

Well, as Humphrey Bogart said in the film Deadline USA, [QUOTE] "That's the press, baby … And there's nothing you can do about it."

Again, funds' votes are guided by policies explicitly designed to avoid or address potential conflicts. And as a practical matter, the people who cast a fund company's proxy votes usually have little or no contact with the people who run the company's other business lines.

I don't expect this research to end the debate about how proxies should be voted by institutional investors, or how the interests of fund shareholders are best served in this context.

Funds, as investors, will continue to wrestle with proxy voting, guided by their shareholders' interests, their funds' objectives, and the nature of their role as portfolio investors. How they come down on specific issues may not always suit those with a different agenda. And as Galbraith said, the competition of ideas never ends. One would hope, though, that facts will dominate the debate. We might also advance the quality of the debate by broadening the transparency of proxy voting.

I acknowledged at the outset that funds opposed the unique disclosure obligation that they SEC adopted for them in 2004. The annual disclosures we now make may allow our detractors to misinterpret our voting behavior, but it also demonstrates how we put our shareholders' interests first, just as the law requires.

So, our policy is not to complain about being singled out, but to say to other institutional investors: come on in, the water's fine. Let's see how you vote your shares. Whether compelled or voluntary, broader proxy vote disclosure could only result in a better informed view of how the corporate franchise is used.

Thank you.

Endnotes

[1]See Gretchen Morgenson, New York Times: “Can a For-Profit College Learn a Lesson?”; May 7, 2006; “Belated Apologies in Proxy Land,” August 20, 2006; “The Owners Who Can’t Hire or Fire,” October 14, 2007.

[2]Investment Company Institute, Proxy Voting by Registered Investment Companies: Promoting the Interests of Fund Shareholders, July 2008, http://www.ici.org/pdf/per14-01.pdf

[3]Oversight of Fund Proxy Voting, Independent Directors Council and Investment Company Institute, July 2008, http://www.ici.org/pdf/ppr_08_proxy_voting.pdf.

[4]Investment Company Institute, Proxy Voting by Registered Investment Companies: Promoting the Interests of Fund Shareholders, July 2008, http://www.ici.org/pdf/per14-01.pdf, pg. 18.

[5]Gerald F. Davis and E. Han Kim, “Business Ties and Proxy Voting by Funds,” Journal of Financial Economics, Vol. 85, No. 2, August 2007, 552–570; and Burton Rothberg and Steven Lilien, “Funds and Proxy Voting: New Evidence on Corporate Governance,” working paper, Zicklin School of Business, Baruch College, February 2005, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=669161.

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