

Proxy Voting by Registered Investment Companies: Promoting the Interests of Fund Shareholders

KEY FINDINGS

- **Registered investment companies (“funds”) play an important role in corporate governance.** Funds are major shareholders in public companies and stewards of their investors’ savings. Proxy voting is one of several ways that funds promote stronger governance and better management, and in turn promote shareholder value. By law, funds must vote proxies in the best interests of funds and their shareholders.
- **Proxy proposals cover a wide range of governance and other issues.** Proxy proposals can be initiated by company boards of directors (“management proposals”) or company shareholders (“shareholder proposals”). More than 80 percent of management proposals relate to election of company boards and ratification of company audit firms; most of the remainder concern fundamental changes that must be approved by company shareholders. Shareholder proposals cover a range of issues but tend to be sponsored by a small number of individuals and organizations. One-third of the more than 600 shareholder proposals that came to a vote in the year ending June 30, 2007, were sponsored by five individuals and three labor unions.
- **Funds and their advisers devote substantial resources to proxy voting.** As part of this effort, they adopt and publish proxy voting guidelines. The guidelines of 35 of the largest fund families indicate that their funds generally support management or shareholder proposals that align the interests of company employees with those of shareholders or that bolster shareholders’ rights, including proposals to remove antitakeover devices such as poison pills or classified boards. Funds’ guidelines are often silent on, or indicate that funds will vote against, proposals on social and environmental issues.
- **Funds’ votes follow the priorities set forth in their guidelines.** This study examines more than 3.5 million proxy votes cast by funds in 160 of the largest fund families in the 12 months ending June 30, 2007. Funds supported the majority of management proposals and voted in favor of shareholder proposals about 40 percent of the time, giving especially strong support to shareholder proposals calling for elimination of antitakeover provisions.
- **Funds’ votes are not outliers.** In many areas funds’ votes mirrored the vote recommendations of proxy advisory firms.
- **Funds establish procedures to manage potential conflicts of interest in proxy voting.** Academic research indicates that funds’ proxy votes are not influenced by the business interests of fund advisers. Funds’ votes are not swayed, for example, by their advisers’ management of 401(k) plans.

INTRODUCTION

The vast majority of fund investors have as their main goal long-term saving, whether for retirement, their children's education, or other purposes. Funds help investors achieve this goal by trying to earn the highest possible return, subject to market conditions and funds' investment policies. Toward this end, funds support effective management and good corporate governance for the companies in which they invest.

The primary and most direct way a fund does this is by deciding whether to buy or continue to hold a company's stock. Among other things, a fund may assess the quality and depth of a company's management before deciding to buy that company's stock. If a company turns out to be ineffectively managed, a fund may sell its investment. Buying and selling stocks with a view to how effectively companies are managed—sometimes called "voting with your feet" or "the Wall Street walk"—can send powerful market-based signals to a company's board of directors and senior executives on how well they are doing their jobs.¹

Funds also take intermediate steps, notably engaging in direct discussions with the boards of directors of the companies in which they invest. Discussions can be a very effective, non-confrontational way to promote substantive changes that may add value to a fund's investments.² Funds may talk with companies, sometimes over a number of years, about a range of governance and management considerations that may increase shareholder value. Companies may respond by instituting changes or putting certain measures before company shareholders for their approval.

Proxy voting is another element in a fund's effort to encourage companies to make value-enhancing changes. As shareholders in publicly traded companies, funds are entitled to vote on proposals—called "proxy proposals"—put forth by a company's board or its shareholders. As this article discusses, funds and their advisers are legally obligated to cast votes on these proposals—called "proxy votes"—in the best interests of funds and their shareholders. Funds usually interpret this to mean that they should support proposals, whether initiated by a company or its shareholders, that are likely to increase the

value of funds' investments in companies. Nevertheless, critics sometimes assert that funds do not vote proxies in the interests of fund shareholders and just reflexively follow the vote recommendations of companies.³

This issue of *Perspective* examines the proxy voting record of funds. As this article discusses, proxy voting and corporate governance are complex matters. There are no simple rules for judging whether a particular proxy proposal is "good" or "bad" for fund shareholders. Reasonable people differ about the merits of various kinds of proxy proposals. Two proxy proposals ostensibly addressing the same issue (such as executive compensation) can differ in crucial respects. A proxy proposal that is appropriate for a poorly managed company may be inappropriate for a well-managed company. And company shareholders who sponsor proxy proposals may be motivated by interests not shared by fund shareholders.

The proxy voting process can be susceptible to conflicts of interest. The article discusses steps that funds, their boards, and their advisers take to help ensure that conflicts of interest do not sway the proxy votes that funds cast, such as: establishing proxy voting policies and procedures, which typically include voting guidelines that help ensure that proxies are voted consistently; consulting the vote recommendations of proxy advisory firms; and seeking guidance from the board or a committee on how to vote proxies if potential conflicts arise.

As the article also discusses, how funds vote on a proxy proposal ultimately depends on the proposal's specifics, the quality of the company's management, the company's performance, the weight each fund places on various elements of governance, and other factors. Thus, a fund may vote for a proxy proposal at one company and against a similar or identical proposal at a different company. Similarly, two funds may vote differently from one another on the same proposal.

Nevertheless, the article finds some important common features in funds' votes. We examined more than 3.5 million proxy votes cast by funds for the most recent 12-month reporting period, ending on June 30, 2007. The vast majority of fund votes are for the uncontested election of boards of directors and ratification of audit firms selected by companies. On these matters, funds typically

support the recommendations of companies' boards of directors, as do proxy advisory firms. In fact, director nominees in uncontested elections garnered on average 95 percent of the votes cast by all shareholders in the 12 months ended June 30, 2007. However, funds do express dissatisfaction when circumstances warrant, such as by withholding proxy votes for director nominees who do not meet certain standards or who act contrary to the interests of funds and their shareholders.⁴

Other proxy proposals cover a wide range of issues, such as executive compensation, the structure and election of boards of directors, antitakeover provisions, and social and environmental issues. We find that funds favor proposals that help align the interests of company management with those of company shareholders, or promote the accountability of management to shareholders. For example, funds strongly support proxy proposals, whether sponsored by companies or shareholders, that remove, or call for shareholders to vote on, provisions that could prevent value-enhancing takeover attempts. On the other hand, funds tend to vote against, or abstain from voting on, proposals that could interfere in companies' day-to-day operations. Taken as a whole, this examination indicates that funds vote proxies in the interests of fund shareholders.

WHAT KINDS OF PROXY PROPOSALS ARE THERE AND WHO OFFERS THEM?

Companies hold annual (and sometimes special) meetings at which shareholders vote on various issues. Before its annual meeting, a company's board of directors compiles a

list of proxy proposals on which shareholders will vote. The company sends its shareholders a list of these proposals, called a proxy statement, along with a ballot, called a proxy card. Shareholders usually place their proxy votes by telephone, mail, or the Internet, rather than in person at the annual meetings. Proxy proposals fall into two broad categories: management proposals and shareholder proposals.

Management Proposals

Management proposals are those initiated by a company's board of directors. The vast majority of proxy proposals are management proposals, most of which concern the election of boards of directors. Under state laws, a company's shareholders annually elect (or re-elect) a board of directors. Directors are virtually always nominated by the incumbent board of directors and run unopposed.⁵ Because each of the thousands of publicly traded companies typically has several board candidates, each of whom is treated as a separate proxy proposal, proxy statements contain thousands of management proposals relating to director nominees. For example, for the 12 months ending June 30, 2007,⁶ director elections accounted for about 75 percent of the nearly 20,000 proxy proposals of the companies in the Russell 3000 (Figure 1). Although they are not required to do so, most companies also place a proposal on their proxy statements asking shareholders to ratify the company's choice of an audit firm. In 2007, audit firm ratification accounted for 11 percent of the proxy proposals of companies in the Russell 3000.

FIGURE 1

PROXY PROPOSALS FOR THE LARGEST PUBLICLY TRADED U.S. COMPANIES, 2007*

| Type of Proposal | Number of Proposals | Percent of Proposals |
|----------------------------|---------------------|----------------------|
| Management Proposals | 19,358 | 96.8% |
| Of which: | | |
| Election of directors | 15,263 | 76.4% |
| Ratification of audit firm | 2,183 | 10.9% |
| Other management proposals | 1,912 | 9.6% |
| Shareholder Proposals | 632 | 3.2% |
| Totals | 19,990 | 100.0% |

*Proxy proposals for companies in the Russell 3000 with shareholder meetings from July 1, 2006, to June 30, 2007.
Source: ISS Governance Services/RiskMetrics; ICI calculations

Under state laws or stock exchange rules, companies typically must seek shareholder approval through proxy voting for fundamental changes, such as altering voting rights (e.g., offering classes of stock with different voting rights), altering a company's capital structure (e.g., increasing the number of shares of common stock outstanding), instituting or renewing equity incentive plans for company employees, changing a company's governance structure (e.g., approving changes to company articles of incorporation that fix the number of board members), or approving mergers or company reorganizations. These kinds of management proposals (labeled "Other management proposals" in Figure 1) accounted for about 10 percent of all proxy proposals in 2007. Almost two-thirds of these were compensation-related proposals seeking shareholder approval to institute or renew equity-based incentive plans (Figure 2).

Shareholder Proposals

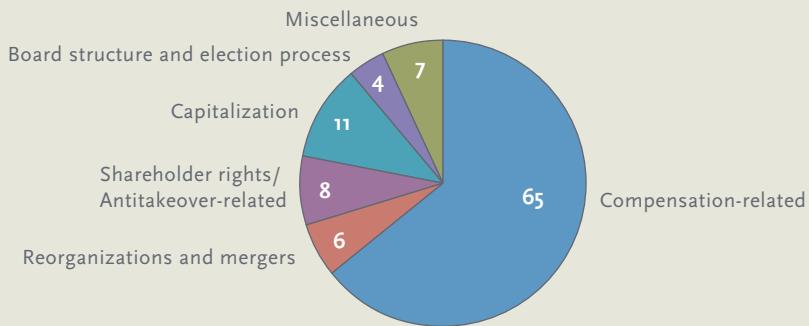
Individual or institutional shareholders may also propose matters to be voted on at shareholder meetings. Securities and Exchange Commission (SEC) Rule 14a-8, promulgated under the Securities Exchange Act of 1934, allows a shareholder who has continuously held \$2,000 in a company's stock in the last 12 months to submit a proxy proposal to be considered and voted on at the company's annual meeting. Shareholder proposals are usually non-binding: They recommend, rather than require, that a company's board of directors take some kind of action. Nevertheless, boards treat shareholder proposals that pass as strongly indicating shareholder preferences and often act on them.

SEC Rule 14a-8 is designed to allow investors to voice their concerns with company boards of directors and to propose alternative courses of corporate action. But the rule may also allow shareholders with a very limited

FIGURE 2

OTHER MANAGEMENT PROXY PROPOSALS, 2007*

(percent of management proposals other than director elections and audit firm ratification)



*Based on 1,912 "other management proposals" at companies in the Russell 3000 with shareholder meetings from July 1, 2006, to June 30, 2007.
Percentages may not add up to 100 percent due to rounding.

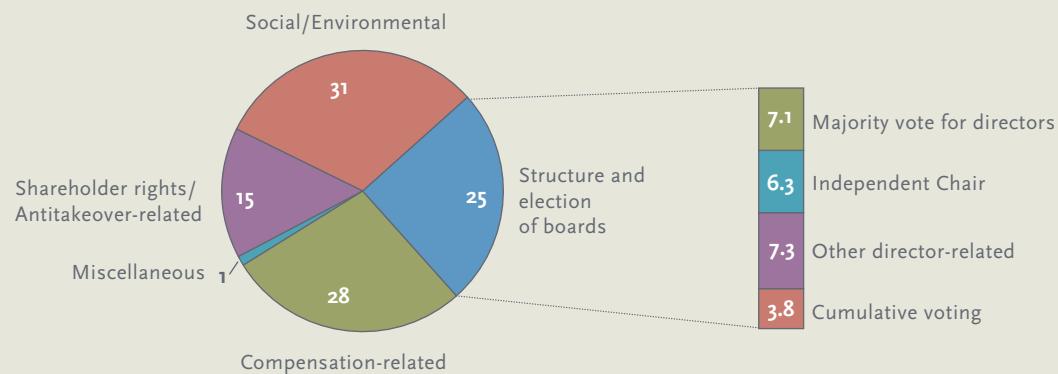
Source: ISS Governance Services/RiskMetrics; ICI calculations

financial interest in a company to exert disproportionate influence. Under Rule 14a-8, a company may under certain conditions seek to omit a shareholder proposal from its proxy statement, but such omissions are infrequent: Only about 14 percent of shareholder proposals are omitted.⁷ Another 25 percent of shareholder proposals are withdrawn by their sponsors before coming to a vote, often because the company has agreed to make the requested changes. If a shareholder proposal is not omitted or withdrawn, it must be included on the company's proxy statement along with the proponent's supporting discussion. A company's board of directors normally offers its own discussion and its vote recommendation to shareholders. Most often, the board recommends voting against shareholder proposals, often on the grounds that they are unnecessary, costly, or already reflected in company practices.⁸

Shareholder proposals comprise a small fraction of all proxy proposals—just 3.2 percent in 2007. They vary widely in substance, covering issues such as executive compensation, shareholder voting rights, the structure and election of the corporation's board of directors, corporate antitakeover provisions, and a range of social and environmental matters, such as human rights, animal welfare, global warming, and requests for information about political contributions (Figure 3 and “What Are Some Common Proxy Proposals?” on page 10). In 2007, two categories—compensation issues and social and environmental issues—each accounted for about 30 percent of shareholder proposals; proposals related to the structure and election of boards made up 25 percent of the total.

FIGURE 3

SHAREHOLDER PROXY PROPOSALS, 2007*
(percent of proxy proposals sponsored by shareholders)



*Based on 632 shareholder proxy proposals at companies in the Russell 3000 with shareholder meetings from July 1, 2006, to June 30, 2007. Percentages in bar do not add up to 25 percent due to rounding.

Source: ISS Governance Services/RiskMetrics; ICI calculations

FIGURE 4**SPONSORSHIP OF SHAREHOLDER PROPOSALS BY SHAREHOLDER TYPE, 2007***

(percent of proxy proposals sponsored by various types of shareholders)

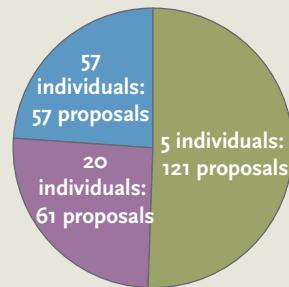


*Based on shareholder proxy proposals at companies with shareholder meetings from July 1, 2006, to June 30, 2007. Some proposals are co-sponsored; each sponsor is counted separately.

Source: ISS Governance Services/RiskMetrics; ICI calculations

Who Offers Shareholder Proposals and Why?

Proxy proposals are offered by individuals, labor unions that manage large pension plans, state and local defined benefit pension funds, religious organizations, and others, including registered investment companies (Figure 4). Sponsorship of shareholder proposals is fairly concentrated, however. In 2007, individuals and labor unions sponsored 61 percent of the shareholder proposals on companies' proxy statements. Sponsorship is also highly concentrated within these shareholder categories. For example, 82 individuals sponsored a total of 239 shareholder proposals in 2007, but half of those proposals were sponsored by just five individuals (Figure 5, top panel). Similarly, while 19 labor unions submitted 186 shareholder proposals in 2007, three unions accounted for half of these (Figure 5, bottom panel). Thus, although diverse groups and individuals offer shareholder proposals, the majority of proposals are offered by a limited number of individuals and institutions whose interests do not necessarily represent those of all of a company's shareholders.

FIGURE 5**SPONSORSHIP OF SHAREHOLDER PROPOSALS BY INDIVIDUALS AND UNIONS, 2007*****Proposals Sponsored by Individuals**

Total proposals sponsored by individuals = 239

Proposals Sponsored by Unions

Total proposals sponsored by labor unions = 186

*Based on shareholder proxy proposals at companies with shareholder meetings from July 1, 2006, to June 30, 2007. Some proposals are co-sponsored; each sponsor is counted separately.

Source: ISS Governance Services/RiskMetrics; ICI calculations

Most sponsors of shareholder proposals are undoubtedly motivated by a desire to foster good corporate governance and strong shareholder rights. However, research has indicated that shareholders who offer proxy proposals may be motivated by other interests as well, such as the personal preferences of individuals,⁹ the political interests of state and local defined benefit pension plans,¹⁰ or the collective-bargaining goals of labor unions.¹¹ Perhaps as a result of these diverse

interests, different groups of shareholders tend to focus on different types of proposals. As Figure 6 shows, in 2007, shareholder proposals sponsored by individuals covered a broad spectrum of issues. In contrast, labor unions mainly sponsored proxy proposals relating to board structure or executive compensation. State and local defined benefit pension plans, religious organizations, activist associations, funds, and socially responsible investors focused more heavily on social and environmental issues.

FIGURE 6

SPONSORSHIP OF SHAREHOLDER PROPOSALS BY TYPE OF PROPOSAL AND PROONENT, 2007*

| Proponent | Total | Shareholder Proposals Related to: | | | | |
|---|------------|-------------------------------------|--|--------------|----------------------------------|-----------|
| | | Shareholder-rights/ Antitakeover | Board Struc- ture and Elec- tion Process | Compensation | Social and Environmen- tal | Other |
| Individuals | 239 | 54 | 87 | 68 | 22 | 8 |
| Unions | 186 | 1 | 66 | 96 | 14 | 9 |
| Religious organizations | 77 | 0 | 7 | 11 | 59 | 0 |
| State and local defined benefit pension funds | 69 | 2 | 14 | 13 | 37 | 3 |
| Activist associations | 48 | 0 | 2 | 1 | 45 | 0 |
| SRI investors | 18 | 0 | 0 | 1 | 17 | 0 |
| Registered investment companies ("funds") | 15 | 0 | 1 | 1 | 13 | 0 |
| All others | 42 | 3 | 5 | 8 | 19 | 7 |
| Total | 694 | 60 | 182 | 199 | 226 | 27 |

*Based on sponsorship of shareholder proxy proposals at companies with shareholder meetings from July 1, 2006, to June 30, 2007. Excludes omitted or withdrawn proposals. Some proposals are co-sponsored; each sponsor is counted separately. Because some proposals have multiple sponsors, the total number of sponsorships may not equal the total number of shareholder proposals in Figure 1.

Source: ISS Governance Services/Risk Metrics; ICI calculations

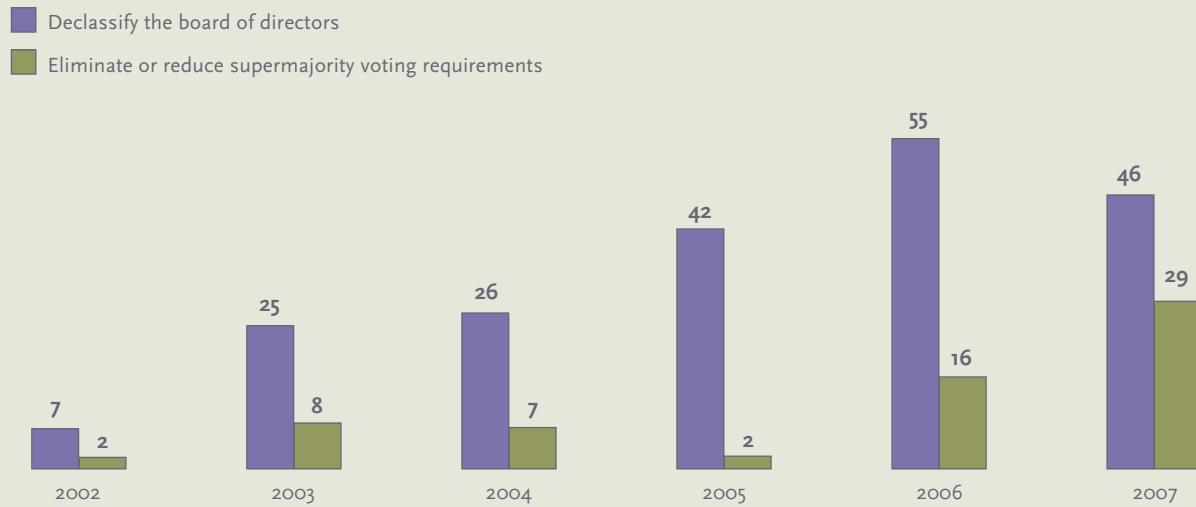
Registered investment companies infrequently sponsor shareholder proposals. In 2007, funds sponsored only 15 shareholder proposals. One reason is that most funds do not have social and environmental considerations as part of the investment objectives stated in their prospectuses. Some funds, known as socially responsible funds, are allowed by prospectus to delve into such issues. Investors generally choose these funds because they want their investment dollars to advance social and environmental causes. These funds design their portfolios to promote specific, stated objectives in these areas and often sponsor shareholder proposals related to such issues.

All 15 shareholder proposals attributable to registered investment companies in 2007 were sponsored by socially responsible funds.

Another reason funds seldom sponsor shareholder proposals is that funds have traditionally relied on direct discussions with company boards to air their concerns. In addition, company boards have increasingly offered management proposals that address shareholder concerns. In recent years, for instance, company boards have sharply increased the number of management proposals that ask shareholders to vote on the elimination of two kinds of antitakeover devices, classified boards and supermajority voting requirements (Figure 7).

FIGURE 7

MANAGEMENT PROPOSALS TO DECLASSIFY BOARDS OR ELIMINATE SUPERMAJORITY VOTING, 2002–2007*



*Management proposals offered at companies in the Russell 3000 with shareholder meetings held in the 12 months prior to June 30 of each year.
Source: ISS Governance Services/RiskMetrics; ICI calculations

THE PROXY VOTING PROCESS FOR FUNDS

A fund's board of trustees, acting on the fund's behalf, has the right and obligation to vote proxies relating to the fund's portfolio securities. While a fund board normally delegates the responsibility to cast proxy votes to the fund's adviser, the board has the responsibility to continue to oversee proxy voting. The board's oversight includes, for example, establishing fund proxy voting policies, including safeguards to help limit conflicts of interest, and receiving periodic reports on the fund's proxy votes.¹²

Fund boards delegate responsibility for casting proxy votes to fund advisers for a number of reasons. First, funds normally have no employees of their own and rely on their advisers to provide many services needed to operate, including proxy voting. Second, funds view proxy voting as an integral part of the investment advisory process, which normally is managed by the fund adviser.¹³ Third, portfolio managers and analysts who work for the adviser have expert knowledge about the companies in which their funds invest, knowledge that may be applicable to proxy voting. For instance, an analyst may be best placed to judge whether a proposed merger of two companies is in the interests of fund shareholders.

Advisers Must Vote Proxies in the Best Interests of Funds and Their Shareholders

Federal law imposes a fiduciary duty, which extends to proxy voting, on a fund's adviser. An adviser that votes a fund's proxies therefore must do so in the best interests of the fund and its shareholders and without regard to the adviser's own business interests.¹⁴ Funds usually interpret this to mean that they should support proxy proposals likely to bolster the value of funds' investments.¹⁵ SEC rules also require funds to describe in SEC filings and make available to shareholders the policies and procedures that govern how fund proxies are voted.¹⁶ Among other things, funds must describe the procedures they use to ensure that proxies are voted in the best interests of the fund and its shareholders when a vote presents a conflict between shareholders' interests and those of the fund's adviser.

Despite these legal obligations, critics have asserted that advisers cast proxy votes for funds in ways intended to attract or retain 401(k) clients.¹⁷ However, recent studies

offer no compelling evidence that that is the case (see "Do Business Arrangements Influence Fund Proxy Votes? What Does Academic Research Show?" page 12).

How Do Funds and Advisers Address Potential Conflicts of Interest?

Funds and advisers use a variety of methods to protect against potential conflicts. Most funds follow pre-determined voting guidelines, thus limiting discretion with respect to individual votes. Another method is to vote in accordance with the recommendations of a third party, such as a proxy advisory firm. Additionally, a fund's board or a proxy voting committee that includes one or more trustees may review or resolve potential conflicts. Finally, many advisers use organizational barriers to protect the proxy voting process from conflicts. They place physical or information barriers between employees responsible for proxy voting and other employees, or between the adviser's employees and employees of the adviser's affiliates. Advisers commonly exclude from proxy voting employees whose primary duties are in sales, marketing, or external client relationships, such as managing 401(k) plan business. Advisers also may require employees who are involved in the proxy voting process to recuse themselves from voting decisions where they may have a personal conflict of interest, such as if an employee is related to an executive officer of a company whose proxy is being voted.

What Are Proxy Voting Guidelines?

Proxy voting policies and procedures include guidelines specifying how funds will vote on various kinds of proxy proposals. Proposals fitting within guidelines are normally voted as the guidelines indicate, which helps ensure that proxies are voted consistently and are not swayed by conflicts of interest. A guideline might say, for instance, that a fund will "withhold" votes for directors who fail to attend 75 percent of board meetings. Funds in a given family typically adopt a common set of guidelines.¹⁸

Proxy voting guidelines, though often quite detailed, cannot cover all circumstances. Voting guidelines sometimes specify that for certain types of proposals (such as those relating to mergers), each proposal should

WHAT ARE SOME COMMON PROXY PROPOSALS?

Management and shareholder proposals fall into several categories. Except where noted, either boards of directors or shareholders may offer each kind of proposal. In recent years, some of the more common proposals in each category have been:

Antitakeover and Shareholder Rights Proposals

- **Eliminate supermajority voting provisions.** Supermajority voting provisions set a high bar—usually two-thirds of a company’s outstanding shares—for approval of fundamental changes, such as mergers. These proposals call for the repeal of such provisions.
- **Eliminate classified board structures.** For most companies, the entire board of directors stands for election or re-election each year. However, some companies have “classified” boards on which a fraction (typically one-third) of directors is elected each year. This structure makes it more difficult for a takeover group or dissatisfied shareholders to replace a company’s directors en masse. These proposals call for elimination of a classified board structure.
- **Eliminate poison pills or put them to a shareholder vote.** A poison pill makes a takeover by a hostile company more costly. For example, it might allow pre-existing shareholders to purchase shares at a deep discount to market price in the event of a takeover attempt, significantly diluting the shares and voting power of any challenger. Under state law, a company’s board may be able to institute a poison pill without prior shareholder approval. These proposals call for a company’s board to either rescind or seek shareholder approval for any poison pill.

Board Structure and Election Process Proposals

- **Establish majority voting for directors.** Most companies allow director nominees to be elected or re-elected if they receive a plurality of the proxy votes cast. Majority voting requires a candidate to receive support from a majority of the votes cast. These proposals call for the board of directors to be elected by a majority vote.

be considered individually to determine how it might affect the value of the funds’ investments. In addition, proxy proposals sometimes fall into gray areas of voting guidelines, requiring advisers to evaluate those proposals on a case-by-case basis.

When voting case-by-case, advisers may consider a number of factors, such as the proposal’s specific terms, the magnitude of the proposal’s effect on shareholder value, the certainty of that effect, and other actions taken by the company that may achieve the same ends or

WHAT ARE SOME COMMON PROXY PROPOSALS? *continued*

- **Establish cumulative voting for directors.** With cumulative voting, each shareholder is given a number of votes per share equal to the number of directors standing for election. The shareholder may split those votes among nominees (for example, casting all of those votes for a single director). This makes it easier for challengers to gain a board seat, which may be beneficial if a company's board has become ineffective. On the other hand, cumulative voting may allow shareholders with special interests to elect board members. These proposals call for directors to be elected by cumulative voting.
- **Require an independent board chair.** Traditionally, most companies have had a chief executive officer who is also chair of the company's board. These proposals call for the chair to be someone who is independent (i.e., not a company employee). Evidence is generally inconclusive on whether an independent chair leads to better corporate governance.

Compensation Proposals

- **Approve equity-based compensation plans.** Companies must seek shareholder approval to create or renew plans that allocate shares of company stock or stock options to be awarded to company executives or other employees. Apart from director nominations and audit firm ratification, these are the most common type of management proposals.
- **Tie executive stock awards to company performance.** These are shareholder proposals that ask the board to tie executive stock awards to company performance, often to a highly specific measure of performance relative to a peer group of companies.

Social and Environmental Proposals

- **Disclose political contributions.** These are shareholder proposals asking companies to report on political contributions, such as employee contributions to political action committees, contributions to campaigns at the state and local level, and other items.
- **Take action on climate change.** These are shareholder proposals asking companies to report on or reduce the effect of company actions on greenhouse-gas emissions and global warming.
- **Take action on animal welfare.** These are shareholder proposals asking companies to report on or adopt animal-rights or animal-welfare policies.

address the same issue. Advisers may give considerable weight to companies' recommendations on how to vote. Advisers may seek guidance from fund portfolio managers or the analysts responsible for monitoring the company. These individuals often have the most up-to-date and complete information about a company's management

and operations.¹⁹ Advisers may also consult the vote recommendations of proxy advisory firms; these firms are specialists in corporate governance and proxy issues and their recommendations can provide a valuable point of reference for advisers (see "Proxy Administrators and Proxy Advisory Firms: Who Are They and What Do They Do?" page 16).²⁰

DO BUSINESS ARRANGEMENTS INFLUENCE FUND PROXY VOTES? WHAT DOES ACADEMIC RESEARCH SHOW?

Fund advisers or their parent firms often engage in other lines of business, such as investment banking, insurance, broker/dealer operations, administration of 401(k) plans for corporations, or offering hedge funds or separate accounts. This could create conflicts of interest when an adviser casts proxy votes on behalf of a fund.

Suppose, for instance, that an adviser manages or provides services to a 401(k) plan for XYZ Company. If the adviser's funds own stock in XYZ, the adviser will be called on to vote on XYZ's proxy proposals. In theory, the management of XYZ could threaten to take its 401(k) business elsewhere if the adviser does not follow the XYZ board's recommendations on proxy proposals.

Legally, the adviser is obligated to cast proxy votes in the best interests of a fund and its shareholders and without regard to the adviser's other business interests. This legal obligation notwithstanding, it has been asserted in the media and elsewhere that advisers are swayed by their other business interests when voting proxies for funds.

Until recently, it was difficult to determine whether these assertions had any merit. Since 2004, however, SEC rules have required funds to disclose how they voted on proxy proposals.¹ Using these data, recent studies have found no compelling evidence that fund votes are influenced by advisers' other lines of business.

The earliest such study, by Gerald F. Davis and E. Han Kim in the *Journal of Financial Economics*, finds "no evidence that proxy voting depends on whether a firm is a [401(k)] client or not."² They instead conclude that advisers "follow relatively automatic policies in determining how to vote across firms, independent of client ties." Curiously, Davis and Kim find that the more 401(k) clients an adviser has, the more likely it is to vote against the shareholder proposals of all companies, even of companies that are not 401(k) clients. They argue that this is evidence of conflicted voting: Advisers supposedly vote against all shareholder proposals in order to favor the management of 401(k) client companies while appearing to be even-handed. This is contradicted by their own evidence, however. As Davis and Kim show, advisers with significant 401(k) business strongly favor certain kinds of shareholder proposals, such as proposals to eliminate classified boards or to require shareholder votes on poison pills.

Another example is a study by Burton Rothberg and Steven Lilien, both of the Zicklin School of Business at Baruch College.³ Their study examines whether the business lines of funds' advisers affect funds' proxy votes. They separated funds into two groups: those with advisers whose primary business is management of funds, and those whose advisers are part of firms whose primary business is investment banking, proprietary trading, or insurance. Presumably, if fund votes are influenced by their advisers' own interests, these two groups of advisers should vote differently. In fact, Rothberg and Lilien find that the two groups of funds voted similarly. Thus, as the authors put it, there is "no evidence that funds are allowing non-fund considerations to affect their proxy voting decisions."

¹*Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, SEC Release No. IC-25922 (Jan. 31, 2003), 68 Fed. Reg. 6564 (Feb. 7, 2003).

²Gerald 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.

³Burton 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.

What Do Proxy Voting Guidelines Say About How Funds Will Vote?

There is no one “right” set of voting guidelines. Voting guidelines can vary considerably from one fund family to another, reflecting differences in the views that advisers may hold about the value and potential effectiveness of certain kinds of proxy proposals, the degree of trust advisers place in the management of the companies in which their funds invest, the challenge of designing guidelines that are general enough to be widely applicable yet specific enough to be meaningful, the fact that funds and their shareholders are not all alike, and other factors.

Nevertheless, some common principles and themes emerge from funds’ proxy voting guidelines. For this article, we examine the proxy voting guidelines of 35 of the largest fund families, which operated 2,014 equity funds whose assets totaled \$4.9 trillion in August 2007. These families cast a very significant proportion of all votes by funds. Generally speaking, the voting guidelines of these fund families suggest that funds will vote:

- for competent boards of directors and impartial and highly regarded audit firms;
- for proposals that increase funds’ rights as shareholders in portfolio companies;
- for proposals that make it more difficult for company management to become entrenched;
- against proposals that make takeovers more difficult;
- for proposals that align the interests of company employees with those of company stockholders;
- against proposals that excessively dilute the value of funds’ investments in companies; and
- case by case on the merits on many other kinds of proposals, based on an assessment of whether such proposals are likely to benefit funds and their shareholders.

How do these principles play out in fund proxy guidelines for specific issues? What follows is a discussion of how guidelines address some of the most common categories of management and shareholder proxy proposals. (For definitions and discussion of these proposals, see “What Are Some Common Proxy Proposals?” page 10.)

Board Nominees and Auditor Ratification: Funds often specify that they will support board-nominated director candidates who are running unopposed, but may withhold votes from directors who failed to exercise good judgment, did not attend at least 75 percent of board or committee meetings, or took actions considered contrary to the interests of company shareholders (e.g., enacting a poison pill without shareholder approval). Guidelines for ratifying auditors are similar: They typically indicate that funds will support the auditor selected by the company board, but may vote against an auditor that has a material conflict of interest, has contributed to accounting irregularities, or has been negligent in its professional capacity.

Shareholder Rights and Antitakeover Provisions: These measures limit the ability of company shareholders to vote for changes to a company’s structure and may reduce the likelihood of takeovers by outsiders. There can be valid reasons for such provisions. For instance, such provisions may force a hostile acquirer to negotiate with the incumbent board, which may thus obtain a higher purchase price for company stockholders. There is a risk, however, that such provisions will serve only to protect ineffective executives from losing their jobs in an unfriendly takeover.

Figure 8 summarizes the voting guidelines of the 35 large fund families regarding four types of antitakeover provisions: supermajority voting, dual-class stock, classified boards, and poison pills. Not all of the 35 fund families state how they will vote on these kinds of provisions. Of those that do, most state that they will oppose such provisions. For example, 24 out of 25 fund families would oppose proposals to institute a supermajority voting standard; 22 out of 23 are opposed to dual-class stock structures; 28 out of 31 would oppose classified boards; 23 fund families either oppose, or oppose without prior shareholder approval, poison pill provisions. By the same token, these fund families would likely support shareholder proposals to eliminate supermajority voting requirements, dual-class stock, or classified boards, or that call on company boards to rescind a poison pill or put it to

a shareholder vote. Remaining fund families, if they state a position, in nearly all cases consider such proposals on a case-by-case basis.

Board Structure and Election Process: On these issues, funds' policies are more mixed, reflecting serious differences of opinion on the benefits of measures such as cumulative voting and requiring an independent board chair. Among the 25 large fund families that state a position on cumulative voting, 10 generally favor cumulative voting, eight are opposed, and seven consider such proposals on a case-by-case basis. Fund families also have mixed views on how they will vote on proxy proposals calling for an independent chair: Of those that state a position, 10 are in favor, four are opposed, two will consider such proposals on a case-by-case basis, and four feel it is a business decision best left to a company's board of directors.

FIGURE 8

VOTING GUIDELINES OF 35 LARGE FUND FAMILIES FOR SELECTED PROXY PROPOSALS

(number of fund families stating how they will vote on selected types of proxy proposals)

| | For | Against | Against Without Shareholder Approval | Abstain | Case-by- Case | Vote According to Company Board Recommendation | Unstated |
|--|-----|---------|---|---------|------------------|---|----------|
| Shareholder Rights/Antitakeover-Related | | | | | | | |
| Supermajority vote provisions | | 24 | | | 1 | | 10 |
| Dual-class stock | | 22 | | | 1 | | 12 |
| Classified boards | | 28 | | | 3 | | 4 |
| Poison pills | 1 | 12 | 11 | | 11 | | 0 |
| Board Structure and Election Process | | | | | | | |
| Independent chair of board | 10 | 4 | | | 2 | 4 | 15 |
| Cumulative voting | 10 | 8 | | | 7 | | 10 |
| Social/Environmental Issues | | | | | | | |
| | | 3 | | 4 | 14 | 13 | 1 |

Source: ICI tabulations of fund documents as of October 2006

Social and Environmental Proposals: As discussed earlier, most funds—with the notable exception of socially responsible funds—do not have a mandate from their investors to engage companies on social and environmental issues. This is reflected in the voting guidelines of the 35 large fund families: No fund family states unequivocally that it will vote for such proposals. Fund families that state a position will either abstain, accept the company board's recommendation, vote against such proposals, or vote case-by-case after considering factors such as the impact of the proposal on company shareholders, the specifics of the proposal, and the company's current policies, circumstances, and responsiveness to shareholders.

Compensation-Related Proposals: Either company boards or shareholders may offer proxy proposals related to compensation. Most management proposals ask shareholders to approve “omnibus stock plans,” which allocate a certain number of shares that can be awarded to senior executives or other employees.²¹ A fund voting on

such a proposal must weigh the benefits of using stock-based compensation to align the interests of company executives with those of stockholders against the risk of diluting a fund's investment in the stock of that company.

Figure 9 summarizes the voting guidelines of the 35 large fund families regarding executive compensation proposals. These fund families are likely to favor proxy proposals that align the interests of company executives and other employees with company shareholders (11 families mention this) or that are consistent with industry standards (nine families). They would vote against proposals that are highly dilutive (16 families) or are “excessive” (11 families). Additionally, some funds state that they may not support the election of certain directors, such as those who sit on board compensation committees, if they feel that executive compensation has been excessive.

As the next section makes clear, funds generally cast proxy votes consistent with the guidelines described in this section.

FIGURE 9

VOTING GUIDELINES OF 35 LARGE FUND FAMILIES ON EXECUTIVE COMPENSATION*



*Number of fund families that mention these (or very similar) phrases in their proxy voting guidelines for proposals related to executive compensation. Multiple mentions per fund family are possible.

Source: ICI compilation of fund documents as of October 2006

PROXY ADMINISTRATORS AND PROXY ADVISORY FIRMS: WHO ARE THEY AND WHAT DO THEY DO?

In voting fund proxies, fund advisers often use the services of proxy administrators and proxy advisory firms. In the United States, these services are provided by a small number of firms, including ISS Governance Services/RiskMetrics (ISS), Glass Lewis, Broadridge, and Proxy Governance.

Proxy administrators provide a number of services to funds. They maintain detailed records of the securities that funds hold, notify advisers of upcoming shareholder meetings, collect proxy statements and ballots for those meetings, and provide fund advisers with online access to proxy materials and online platforms to cast proxy votes. Funds may instruct proxy administrators to vote a fund's shares automatically if a given proxy proposal clearly meets the fund's voting guidelines. Proxy administrators may also help funds and their advisers comply with the SEC rule that funds must disclose their proxy votes, providing computer systems that prepare reports of these votes and transmit them to both fund websites and the SEC.

Some proxy administrators are also proxy advisory firms—for-profit consultants specializing in proxy voting and corporate governance. These firms provide in-depth research, analysis, and vote recommendations on the proxy proposals of thousands of publicly traded companies. Like funds, proxy advisory firms adopt detailed guidelines describing votes they are likely to recommend on various proxy proposals.

Funds and their advisers use the services of proxy advisory firms to varying degrees. Some funds subscribe to proxy advisory firms to follow trends in proxy proposals and voting patterns. Others may use vote recommendations of proxy advisory firms to help them decide how to vote on particular proxy proposals, such as those that are not clearly resolved by funds' voting guidelines or that raise conflicts of interest. For example, a fund might specify that proxies should be voted according to a proxy advisory firm's recommendation if its adviser manages a 401(k) plan or defined benefit plan for the company whose proxies are being voted. Still other funds—such as those that are part of smaller fund families with more limited resources—may rely more heavily on proxy advisory firms to guide their votes.

WHAT DOES THE PROXY VOTING RECORD FOR FUNDS SHOW?

This section examines how funds actually vote on proxy proposals. This analysis is possible because the SEC since 2004 has required funds to report annually, on SEC Form N-PX, the proxy votes they cast during a 12-month period ending June 30. The analysis is based on more than 3.5 million proxy votes cast by 2,973 funds in 160 of the largest fund families for the most recent N-PX reporting year, July 1, 2006, to June 30, 2007. The analysis is limited to the proxy votes that these funds cast for companies in the Russell 3000. The analysis includes votes cast by U.S. registered open-end and closed-end mutual funds, exchange-traded funds, and mutual funds underlying variable annuities, but excludes votes cast by U.S. registered investment companies with an international, world, or emerging markets focus. Fund votes are tallied

by whether funds voted “for,” “withhold,” “against,” “abstain,” or “did not vote” for particular proxy proposals, rather than by the number of shares these funds voted. Data on the number of shares that funds voted is not publicly available.²²

More than 80 percent of these 3.5 million votes concerned the uncontested election of directors and ratification of audit firms (Figure 10). Remaining votes were cast on other management proposals (8.8 percent) and shareholder proposals (8.1 percent). Multiple funds in a given family may hold some of the same stocks in their portfolios and thus may vote proxies for the same company. Nonetheless, the number of unique proxy proposals on which fund families vote in a given year is large: In 2007 funds in the average fund family voted on 512 unique “other management proposals” and 324 unique shareholder proposals.

FIGURE 10

PROXY PROPOSALS VOTED ON BY REGISTERED INVESTMENT COMPANIES, 2007*

| Type of Proposal | Number of Proxy Votes Cast ¹ | Percent of All Proxy Votes Cast | Average Number of Unique Proposals per Fund Family ² |
|----------------------------|---|---------------------------------|---|
| Management Proposals | 3,241,083 | 91.9% | 5,199 |
| Of which: | | | |
| Election of directors | 2,583,730 | 73.3% | 4,141 |
| Ratification of audit firm | 347,657 | 9.9% | 583 |
| Other management proposals | 309,696 | 8.8% | 512 |
| Shareholder Proposals | 284,802 | 8.1% | 324 |
| All Types | 3,525,885 | 100.0% | 5,499 |

*Votes cast by 2,973 registered investment companies in 160 of the largest fund families on proposals at companies in the Russell 3000 during the 2007 N-PX reporting year (July 1, 2006, through June 30, 2007). Excludes registered investment companies with an international, world, or emerging markets focus. Percentages may not add up to 100 percent due to rounding.

¹Proxy votes cast are tallied by the number of times funds voted on particular proxy proposals, not by the number of shares that funds voted. The average fund voted on about 1,186 ballot items across all of its portfolio companies.

²Fund families differ in the companies that their funds own. The proxy proposals on which families must vote therefore differ, and not all families are called upon to vote on the same array of issues in each category. Thus, the average for “All Types” is not the sum of the averages for the separate types of proposals. Source: ISS Governance Services/RiskMetrics; ICI calculations

Figure 11 summarizes the percentage of the time that funds voted in 2007 “for” management or shareholder proposals (including the subcategories shown in Figures 2 and 3).²³ To put these voting patterns into perspective, it would be helpful to compare them with the proxy votes cast by other institutional investors such as labor unions, defined benefit pension funds, hedge funds, and endowments, as well as individual stockholders. That is not possible because stockholders other than funds do not generally disclose their proxy votes. It is possible, however, to compare fund votes with the vote recommendations of company boards and of proxy advisory firms. The recommendations of company boards and of two major proxy advisory firms—ISS Governance Services/Risk Metrics (ISS) and Glass Lewis & Co.—are summarized in Figure 11, along with the percentage of proxy proposals that actually passed.

How Do Funds Vote Regarding Director Nominees and Audit Firms?

Funds gave high approval rates to slates of directors and audit firms proposed by company boards (Figure 11, Column 1). Director elections are usually not contentious. As a result, in keeping with their voting guidelines, funds on average voted 92 percent of the time in support of nominees on boards’ proposed slates of directors. Funds also strongly supported the audit firms that companies had selected, voting to ratify 98 percent of the time. As would be expected, company boards always recommend that stockholders vote for the boards’ director nominees (Column 2). Directors nominated and audit firms selected by company boards also typically receive high approval rates from proxy advisory firms (Columns 3 and 4). In 2007, the vast majority of board-nominated directors (96 percent) were elected and nearly all audit firms selected by companies (97 percent) were confirmed (Column 5).

Funds do, however, express dissatisfaction with board-nominees when circumstances warrant. A fund might, for instance, withhold votes for an independent director whom the fund feels does not meet the standards for independence from the company. Similarly, if a fund believes that a company’s executives receive excessive compensation, it may withhold votes from directors on the company’s compensation committee. Voting data indicate that in 2007, the majority of funds withheld votes on at

least one director nominee for 10 percent or more of the companies they owned.

How Do Funds Vote on “Other Management Proposals”?

Funds also gave high, though more moderate, support for “other management proposals,” voting in favor of such proposals 85 percent of the time in 2007. Other management proposals typically also receive strong support from proxy advisory firms and normally pass. For example, in 2007 ISS recommended voting for 82 percent of other management proposals and Glass Lewis recommended voting in favor on 84 percent of such proposals; 92 percent of these proposals passed.

One area of note was how funds voted on shareholder rights/antitakeover provisions. Funds voted 93 percent of the time in favor of management-sponsored shareholder rights/antitakeover-related proposals. The majority of these proposals were to eliminate antitakeover devices such as classified boards and supermajority voting provisions. Thus, funds appear to have voted in keeping with their guidelines, which generally favor elimination of antitakeover devices.

Compensation-related proposals are also interesting because some critics have suggested that voting in favor of a management compensation proposal is contrary to the interests of a company’s stockholders, including, by implication, fund shareholders.²⁴ Funds give considerable support to such proposals, voting in favor of them 84 percent of the time in 2007, support which is about in line with the recommendations of the two proxy advisory firms. ISS, for example, recommended voting for 82 percent of management compensation proposals.

How Do Funds Vote on Shareholder Proposals?

Funds voted for shareholder proposals nearly 40 percent of the time in 2007 and abstained (not shown) another 6 percent of the time. By comparison, ISS recommended voting for about 60 percent of shareholder proposals, while Glass Lewis favored nearly half of such proposals. Company boards rarely recommend voting in favor of shareholder proposals, supporting fewer than 1 percent of such measures in 2007. Only about one in six shareholder proposals (18 percent) passed in 2007.

FIGURE 11

PROXY VOTES CAST BY REGISTERED INVESTMENT COMPANIES COMPARED WITH VOTE RECOMMENDATIONS OF COMPANY BOARDS AND PROXY ADVISORY FIRMS, 2007*

| Type of Proposal | Percent of Proposals Favored by: | | | | Proposals Passing % (5) |
|---|----------------------------------|------------------------------------|-------------------------|---------------------------------|----------------------------|
| | Funds ¹ (1) | Company boards ² (2) | ISS ² (3) | Glass Lewis ² (4) | |
| Management Proposals | 92.2 | 100.0 | 90.1 | 81.6 | 95.9 |
| <i>Of which:</i> | | | | | |
| Election of directors | 92.3 | 100.0 | 89.7 | 79.0 | 96.4 |
| Ratification of audit firm | 98.0 | 100.0 | 99.6 | 97.7 | 96.5 |
| Other management proposals | 85.0 | 100.0 | 81.5 | 84.0 | 91.5 |
| <i>Of which:</i> | | | | | |
| Shareholder rights/Antitakeover-related | 92.5 | 100.0 | 87.4 | 89.6 | 76.3 |
| Capitalization | 80.2 | 100.0 | 87.7 | 80.9 | 95.7 |
| Board structure and election processs | 93.9 | 100.0 | 95.2 | 96.8 | 96.8 |
| Compensation-related | 83.8 | 100.0 | 81.5 | 85.3 | 95.8 |
| Mergers and reorganizations | 95.3 | 100.0 | 93.5 | 96.7 | 94.6 |
| Miscellaneous | 71.2 | 100.0 | 43.8 | 45.8 | 49.0 |
| Shareholder Proposals | 38.1 | 0.7 | 63.8 | 46.8 | 17.5 |
| <i>Of which:</i> | | | | | |
| Antitakeover-related | 78.0 | 1.3 | 90.9 | 88.3 | 57.1 |
| Social/Environmental | 15.3 | 0.8 | 36.6 | 5.2 | 3.0 |
| Board structure and election process ³ | 49.1 | 0.9 | 77.2 | 83.3 | 22.8 |
| Compensation-related | 37.6 | 0.0 | 66.7 | 33.3 | 3.4 |
| Miscellaneous | 1.9 | 0.0 | 0.0 | 0.0 | 0.0 |
| All Types | 89.0 | 97.6 | 89.4 | 80.8 | 94.0 |

*Votes cast by 2,973 registered investment companies in 160 of the largest fund families on proposals at companies in the Russell 3000 during the 2007 N-PX reporting year (July 1, 2006, through June 30, 2007). Excludes registered investment companies with an international, world, or emerging markets focus.

¹Measured as the number of funds recording a "for" vote for proposals in a given category, divided by the sum of "for," "against," and "withhold" votes and absences.

²Measured as the number of "for" recommendations for proposals in a given category, divided by the total number of recommendations made.

³Shareholder proposals calling for, or related to, declassifying boards are included in "Antitakeover-related" shareholder proposals.

Source: ISS Governance Services/RiskMetrics; Glass Lewis; ICI calculations

It has sometimes been suggested that funds reflexively accept the vote recommendations of company boards when voting on shareholder proposals. This is clearly not the case: Companies almost always recommend voting against all shareholder proposals, but funds nevertheless voted in favor of such proposals nearly 40 percent of the time. Still, it is true that funds gave less overall support to shareholder proposals than to management proposals. To understand why, it is necessary to look beyond raw vote totals.

How funds vote on shareholder proposals depends importantly on the type of proposal. For example, as would be expected from the voting guidelines of the 35 large fund families, funds offer generous support for shareholder proposals calling for elimination of antitakeover provisions, even though company boards almost never favor such proposals. As Figure 11 shows, in 2007 funds voted in favor of these shareholder proposals 78 percent of the time; most of these proposals asked company boards to eliminate or put to a shareholder vote classified boards or poison pills.

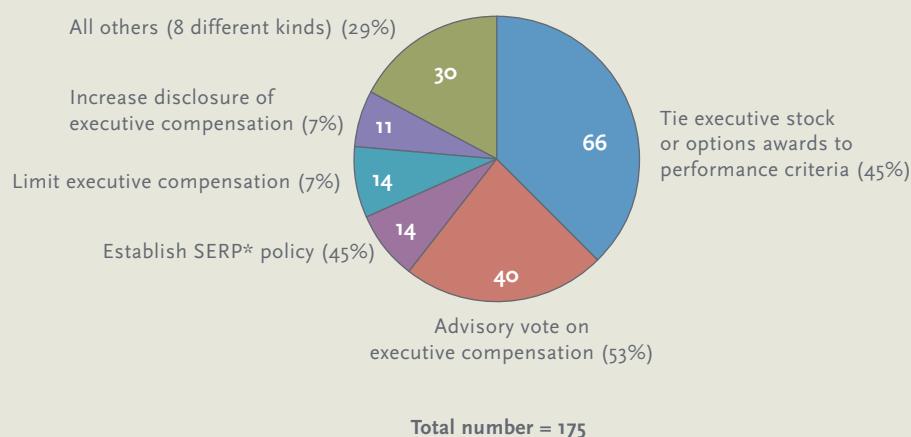
In contrast, as the voting guidelines of the 35 large fund families suggest, funds tend to vote more in line with board recommendations, or to abstain from voting, on social and environmental proposals. In 2007, all funds voted for social and environmental proposals only 15 percent of the time and abstained 17 percent of the time (votes to abstain are not shown). Socially responsible funds—those funds with a mandate from their shareholders to engage companies on social and environmental issues—voted in favor of such proposals considerably more often, an estimated 50 percent of the time or more.²⁵

Shareholder proposals related to board structure and executive compensation have in the past few years received much attention in the media and elsewhere.²⁶ For this reason, it is worth considering at greater length how funds voted on such proposals and why. As will be seen, funds' votes on these proposals depend on funds' voting guidelines, the specifics of the individual proposals, and whether funds view the proposals as likely to add shareholder value.

FIGURE 12

SHAREHOLDER PROPOSALS RELATED TO EXECUTIVE COMPENSATION AND HOW FUNDS VOTED, 2007*

(number of unique proposals by type; in parentheses: percent of times funds voted in favor of proposal)



*Number of proposals at companies in the Russell 3000, by category, voted upon by registered investment companies in 160 of the largest fund families during the 2007 N-PX reporting year (July 1, 2006, through June 30, 2007). Figures in parentheses are the percentages of times funds voted in favor of such proposals. SERP stands for supplemental executive retirement plan.

Source: ISS Governance Services/RiskMetrics; ICI calculations

How Do Funds Vote on Shareholder Proposals Related to Company Boards?

Funds offered mixed support for shareholder proposals regarding the structure and election of boards, voting for such proposals almost 50 percent of the time in 2007. These kinds of shareholder proposals received higher approval rates (about 80 percent) from both ISS and Glass Lewis.

As Figure 3 indicates, shareholder proposals regarding board structure and elections accounted for one-quarter of all shareholder proposals in 2007. A significant fraction of these shareholder proposals—most of which were sponsored by a single labor union—called for directors to be elected by a majority vote, rather than a plurality.²⁷ Funds gave substantial, though not universal, support to these proposals in 2007, voting for them 65 percent of the time. That outcome in part reflects difficult legal and business issues surrounding majority voting. For example, majority election systems risk the possibility of a failed election, in which no nominee receives a majority of votes cast. In such cases, under the laws of certain states incumbent directors would continue to serve on the board until the next annual meeting, an awkward result given the intent of majority voting provisions. Some companies, recognizing the value of majority voting but wishing to avoid difficult legal and business issues, have adopted procedures whereby a nominee who receives more “withhold” votes than “for” votes is required to tender his or her resignation for consideration by remaining board members. When companies adopt such policies, there is arguably less reason for a fund to vote in favor of a shareholder proposal calling for a majority vote standard.

As Figure 3 indicates, shareholders sponsored two other main types of proposals related to board structure and elections in 2007: calling upon companies to provide for or restore cumulative voting for directors, and calling for the board chair to be independent (not an executive officer of the company). As noted earlier, the value and effectiveness of these kinds of proposals have not been clearly established, an uncertainty mirrored in the mix of

funds’ voting guidelines. In 2007, funds voted in favor of shareholder proposals calling for cumulative voting 43 percent of the time and in favor of independent chair proposals 32 percent of the time.

How Do Funds Vote on Shareholder Proposals on Executive Compensation?

In 2007, funds voted in favor of shareholder proposals related to executive compensation nearly 38 percent of the time, as compared to 67 percent support by ISS and 33 percent support by Glass Lewis. Figure 12 provides more detail. Nearly 40 percent of these proposals (66 out of 175) asked companies to adopt measures linking executive compensation to company performance. Funds gave moderate support to such proposals, voting in favor of them 45 percent of the time.

Judging by their voting guidelines, funds would presumably favor proposals that help align the interests of company executives with those of company stockholders. The details of these 66 shareholder proposals suggest concerns, however. Many of these proposals were sponsored by unions and were identical: They asked companies to award performance-based compensation to executives only if company performance exceeded the average performance of a peer group of companies. However, targeted companies noted in their proxy statements that they were already tying executive compensation to company performance, most often to specific—albeit different—criteria. Targeted companies also noted technical difficulties. For example, under the provisions of this particular shareholder proposal, a chief executive officer hired to turn around a company would not necessarily earn any performance-based compensation, even if the company’s performance improved vastly.²⁸ In addition, as indicated earlier, some funds may feel that a more appropriate mechanism for ensuring that executive compensation is aligned with the interests of company shareholders is to withhold votes from the directors on a company’s compensation committee, rather than to vote for shareholder-proposed plans that may limit the flexibility of board compensation committees to design packages needed to attract superior talent.

CONCLUSION

Proxy voting is one of the many functions that advisers may undertake on behalf of the funds that they manage. As this study shows, simple tallies of fund votes—counting whether funds voted “for” or “against” management or shareholder proposals—mask the complexity of the issues that fund advisers weigh when determining which proposals are most likely to lead to value-enhancing changes at a portfolio company.

This study examined more than 3.5 million votes cast by funds in the year ended June 30, 2007. The vast majority of proxy votes that funds cast involved such routine matters as the uncontested election of directors and ratification of audit firms. Funds’ support of these proposals was high and about in line with the recommendations of proxy advisory firms.

Apart from these issues, management and shareholder proposals cover a wide range of matters, from company corporate structure and governance to employee compensation to social and environmental issues. Funds’ votes on these matters present a more nuanced picture, reflecting the judgments of funds’ boards and advisers on what measures will improve companies’ governance and value. Funds strongly favor proposals, whether initiated by management or shareholders, that improve shareholder rights or weaken antitakeover provisions. Funds also tend to vote for specific types of proposals affecting board structure and the election process such as those calling for the elimination of classified boards. In contrast, most funds tend not to support social or environmental proposals; the exceptions are primarily funds that have a mandate from their shareholders to engage in those issues.

Taken as a whole, this study portrays the extent and complexity of the efforts that funds make to ensure that proxies are voted in the best interests of funds and their shareholders.

NOTES

- ¹ Not all funds have the option of buying or selling shares of stock in companies on the basis of how well they are thought to be managed. For example, the portfolio manager of an index fund is not generally at liberty to buy or sell shares of stock except to bring the fund’s portfolio into line with the fund’s target index. In such cases, advisers may turn to other approaches, such as direct discussions with the management of companies in which their funds invest.
- ² See for instance the discussion on the relative merits of proxy voting versus discussions with management in *As You Sow Foundation Proxy Season Preview*, Spring 2006, which states that “A shareholder dialogue [with a company] can lead to substantive change just as, or even more effectively as a shareholder proposal,” available at http://www.asyousow.org/publications/2006_proxy_preview.pdf.
- ³ See, for example, Gretchen Morgenson, “A Door Opens. The View Is Ugly,” *New York Times*, Sept. 12, 2004.
- ⁴ With respect to uncontested director elections, shareholders may either vote “for” a director or vote “withhold.” Proxy statements do not generally allow shareholders to vote “against” directors in uncontested elections.
- ⁵ Only a tiny proportion of director elections are contested. For example, of the companies in the Russell 3000, for the 12 months ending June 30, 2007, data compiled by ISS Governance Services/RiskMetrics indicate that only 0.8% of all director seats voted on among Russell 3000 companies were contested.
- ⁶ Throughout this article, a “year” is defined as a 12-month period ending June 30. For example, the year “2007” means the 12-month period running from July 1, 2006, to June 30, 2007. This maintains consistency with cycle that the SEC requires funds to follow in disclosing their proxy votes on SEC Form N-PX.
- ⁷ Under SEC rules, a company may seek to omit a shareholder proposal from its proxy statement for various reasons: for example: the sponsor is not a qualified shareholder; the proposal is improper under state law; the proposal would require the company to violate laws or other regulations; the proposal relates to the ordinary conduct of company business; the company has already substantially implemented the proposal; or a similar proposal has been introduced in recent years but failed to gain a prescribed level of shareholder support. Data from ISS Governance Services/RiskMetrics indicate that in recent years only about 14 percent of shareholder proposals were omitted from corporate proxy statements. The most common reasons for omission were that the sponsors were ineligible to offer the proposals (failing to meet, or to verify that they met, the SEC’s stock ownership requirements) or that the proposals related to the ordinary conduct of company business, were already substantially implemented by companies, or contained false or misleading statements.

⁸ For example, the board of directors of a restaurant chain might oppose a shareholder proposal urging the chain to label any food items that contain genetically engineered ingredients because it views the proposal's provisions as vague and scientifically infeasible. See SEC Schedule 14a; *Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934*, for Wendy's International, March 7, 2006.

⁹ See Paula Tkac, "One Proxy at a Time: Pursuing Social Change through Shareholder Proposals," *Federal Reserve Bank of Atlanta Economic Review*, 3rd Quarter 2006. Tkac finds that 14 percent of "socially responsible" shareholder proposals offered by individuals over the period 1992 to 2002 were sponsored by a single individual, Evelyn Davis. Tkac notes that "[a]mong these activists, the motivation to pursue shareholder activism stems from personal preferences."

¹⁰ See, for example, Roberta Romano, "Less Is More: Making Shareholder Activism a Valuable Mechanism of Corporate Governance," *Yale Journal on Regulation*, 18(2), 174-251, 2001. See also Paula Tkac, "One Proxy at a Time: Pursuing Social Change through Shareholder Proposals," *Federal Reserve Bank of Atlanta Economic Review*, 3rd Quarter 2006.

¹¹ See Stewart J. Schwab and Randall S. Thomas, "Realigning Corporate Governance: Shareholder Activism by Labor Unions," 96, *Michigan Law Review*, 1018, 1998, who note that "Union shareholder activity sometimes serves old union goals. Often shareholder activity is part of a corporate campaign, used along with other tactics, to strengthen a union's collective-bargaining position." See also Paula Tkac, "One Proxy at a Time: Pursuing Social Change through Shareholder Proposals," *Federal Reserve Bank of Atlanta Economic Review*, 3rd Quarter 2006, who notes that "While union pensions have the same goal as public and private pensions (to meet beneficiary obligations), unions also have another well-defined motive—benefiting union workers, particularly members of their union. Union pension funds pursue social shareholder activism most strongly among the firms that employ their members." Also see Ashwini K. Agrawal, "Corporate Governance Objectives of Labor Union Shareholders," University of Chicago, Dec. 11, 2007. Agrawal's research finds that some union-affiliated pension funds "are more likely to vote against directors of firms in which there is a greater tendency of ... conflict between labor unions and management during collective bargaining and union member recruiting ... [which indicates that labor unions] vote against directors partly to support workers rather than to increase shareholder value alone."

¹² For a discussion of fund proxy voting responsibilities and the oversight function of fund boards, see *Fund Proxy Voting*, Independent Directors Council and Investment Company Institute, July 2008.

¹³ Some funds are "subadvised" by an independent third-party investment manager (a "subadviser"). In such cases, proxy voting responsibility may be delegated to the subadviser.

¹⁴ *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, SEC Release No. IC-25922, 68 Fed. Reg. 6564 (Feb. 7, 2003).

¹⁵ However, socially responsible funds may also take into account the preferences of their fund shareholders for engaging companies regarding social, environmental, or governance issues.

¹⁶ See *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, SEC Release No. IC-25922, 68 Fed. Reg. 6564 (Feb. 7, 2003). See also *Proxy Voting by Investment Advisers*, SEC Release No. IA-2016, 68 Fed. Reg. 6585 (Feb. 7, 2003). Oversight by a fund's board of trustees helps ensure that these policies and procedures are observed. A fund's board is required to review the adequacy of the fund's proxy voting policies and procedures at least annually. This is typically accomplished through the annual review of fund compliance policies conducted by a fund's chief compliance officer, who must report to the board at least annually and must inform the board about any material changes, weaknesses, or breaches in the fund's proxy voting policies and procedures. See Rule 38a-1 under the Investment Company Act of 1940.

¹⁷ See, for example, Gretchen Morgenson, "How to Find a Fund's True Colors," *New York Times*, Sept. 10, 2006; Roben Farzad, "Fidelity's Divided Loyalties," *Business Week*, Oct. 16, 2006; see also the discussions in Tom Lauricella and Kaja Whitehouse, "No Secrets: How Funds Vote Your Shares," *Wall Street Journal*, Oct. 3 2006, and Kaja Whitehouse and Tom Lauricella, "Whose Idea Was That? Some Funds Seem to Favor Management Proposals," *Wall Street Journal*, Nov. 17, 2006.

¹⁸ That is not always the case. Funds that are subadvised may adopt voting guidelines written by their subadvisers. Thus, if some funds within a given fund family are subadvised, their voting guidelines can differ from those of other funds in the same family.

¹⁹ Portfolio managers in the same fund family, however, may at times have different opinions about the same portfolio company, or may represent funds with differing investment objectives. As a result, funds in a given family sometimes vote differently on the same proxy proposal at the same company.

²⁰ For a discussion of conflicts that may arise regarding proxy advisory firms, see United States Government Accountability Office, "Issues Relating to Firms that Advise Institutional Investors on Proxy Voting," GAO-07-765, June 2007.

²¹ Shareholders do not vote on individual stock grants to executives. Once a stock plan is approved by shareholders, distribution of the stock under that plan is at the company's discretion.

²² SEC Form N-PX requires funds to report how they voted on particular proposals, but does not require them to disclose the number of shares voted.

²³ In Figure 11, if multiple funds in a given family each vote on the same proxy proposal, each fund's vote is counted as a separate vote.

²⁴ See Corporate Library, "Enablers of Excess: Mutual Funds & the Overpaid American CEO," March 2006, which states that "For management-sponsored proposals to approve management compensation ... [t]his report considers an 'against' vote to be more likely to serve shareholder interests."

²⁵ As is true of other kinds of funds, the degree of support that socially responsible funds offer for social and environmental proposals depends importantly on a number of factors, such as the type of proposal, the sponsor of the proposal, and the responsiveness of a particular company's management. For example, in 2007, the sample of socially responsible funds available for this study voted for shareholder proposals related to sustainability or equal opportunity nearly 80 percent of the time.

²⁶ See, for example, Corporate Library, "Enablers of Excess: Mutual Funds & the Overpaid American CEO," March 2006; Corporate Library, "Failed Fiduciaries: Mutual Fund Proxy Votes on CEO Compensation," Gretchen Morgenson, "A Door Opens. The View Is Ugly," *New York Times*, Sept. 12, 2004; Gretchen Morgenson, "Fidelity, Staunch Defender of the Status Quo," *New York Times*, Oct. 8, 2006.

²⁷ Traditionally, most large companies have adopted a plurality standard, which is the default option under corporate law in Delaware, where many companies are incorporated. Under a plurality vote standard, a director who garners a single proxy vote—out of potentially millions of votes—is elected. In recent years, an increasing number of shareholder proposals have called for amending companies' articles of incorporation or bylaws to require nominees to gain at least 50 percent of proxy votes cast to be elected. For the 2007 proxy season, shareholders sponsored at least 45 proposals calling for directors to be elected by a majority vote. Almost all of these were sponsored by labor unions, with one union alone accounting for more than half of such proposals.

²⁸ Another issue that some company boards cited with respect to this shareholder proposal was that it was too rigid to apply to certain corporate structures. For instance, one company noted in its proxy statement that its senior executives supervised separate regions of the country more or less independently of one another. The company's policy was to award compensation based on performance in each executive's supervisory region, rather than on company performance across the entire country. This shareholder proposal, if adopted, would rule out such an arrangement.

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