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James Cotter

Alan Palmiter

Randall Thomas

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## Symposium Articles

### ISS RECOMMENDATIONS AND MUTUAL FUND VOTING ON PROXY PROPOSALS

JAMES COTTER, ALAN PALMITER, & RANDALL THOMAS\*

**T**HIS Article analyzes mutual fund voting data from 2003-2008, the first five proxy seasons for which this data is available, and seeks to identify the extent to which mutual funds vote consistently with the voting recommendations of RiskMetrics' ISS Corporate Governance Services (ISS).<sup>1</sup> We compare voting by mutual funds to voting by all shareholders during this time period and then focus on mutual fund voting on non-election and non-routine proxy proposals—both those submitted by management and by shareholders.<sup>2</sup>

The questions we examine are: (1) Over the past five voting seasons, have mutual funds (and shareholders generally) voted on proxy proposals more consistently with ISS voting recommendations, compared to management voting recommendations? and (2) Over this same period, does mutual fund voting deviate from ISS voting recommendations depending on whether the proposal is submitted by management or shareholders, or on the topic of the proposal, such as those relating to anti-takeover issues or salient corporate governance issues?

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\* James Cotter is an Associate Professor of Finance at the Wake Forest Schools of Business; Alan Palmiter is a Professor of Law at the Wake Forest School of Law; Randall Thomas is the John S. Beasley II Professor of Law and Business at the Vanderbilt School of Law and a Professor of Management at the Owen Graduate School of Management. We thank Carol Bowie, Stephen Choi, Fabrizio Ferri, and the participants of the Villanova Securities Symposium and the Italian Law and Economics 2009 Annual Meeting for helpful comments on this Article.

1. ISS Governance Services is a subsidiary of RISKMETRICS Group, 1 Chase Manhattan Plaza, New York, NY 10005, (212) 981-7475. We use the terms ISS and RiskMetrics interchangeably as they are frequently used by most market participants. We do not look at recommendations of other proxy voting advisors, such as Glass Lewis, because of data limitations in our sample.

2. We generally exclude from our analysis fund voting in: (1) routine board elections and those elections involving "withhold" campaigns against specific directors; (2) shareholder ratifications of the company auditors; and (3) adjournments of shareholder meetings.

(1)

Mutual funds represent the largest shareholder voting bloc in U.S. corporate governance, and ISS is the most important proxy voting advisory firm. Although mutual funds historically followed the “Wall Street rule,” selling their shares in underperforming portfolio companies rather than engaging in shareholder activism, the landscape may be changing. Both anecdotal evidence and data on actual mutual fund voting suggest that mutual funds have become more activist, both by voting against management and by siding with other shareholder activists.

We begin our study with an overview of mutual fund voting, describing the position of mutual funds in U.S. corporate governance and their historical inactivism. We next summarize a rich array of studies on mutual fund voting, including studies fueled by the SEC rule in 2003 requiring mutual funds to disclose their actual voting in portfolio companies. We then look at the consistency of ISS voting recommendations and mutual fund voting decisions (as well as voting by shareholders generally) over the past five proxy seasons, analyzing when mutual fund voting has been consistent with management and ISS voting recommendations, and when mutual funds have gone their own way.

We find that mutual funds tend to vote in line with ISS recommendations across the board. First, mutual funds vote consistently with ISS recommendations more often than do all shareholders. Second, mutual funds vote consistently with ISS recommendations more often than with management recommendations, both on non-routine management proposals and shareholder proposals, and on specific types of anti-takeover and corporate governance proposals.

In short, ISS recommendations and mutual fund voting appear to be highly consistent. Whether this is because mutual funds follow ISS recommendations or because ISS tailors its recommendations to track mutual fund voting preferences is difficult to say. While our results indicate a strong correlation, they do not allow us to clearly map out the causal relationships.

Part I of this Article offers an overview of mutual fund voting in U.S. public corporations, including disclosures of voting by mutual funds, the nature of proxy proposals in U.S. public corporations, the role of ISS in proxy voting, and the growing voting activism of mutual funds. Next, Part II reviews the academic and other literature on the voting practices by mutual funds since 2003 when the SEC required disclosure of such practices, including studies that look at conflicts mutual funds face when voting proxies in portfolio companies, test the existence of a pro-management bias among mutual funds, consider the extent of mutual fund voting activism, identify differences in voting patterns in different mutual fund groups, review the consistency of mutual fund voting and trading behavior, and consider the voting guidelines and procedures disclosed by mutual funds.

Part III describes the data we gathered on mutual fund voting during the five proxy seasons from 2003-2008. Part IV provides a univariate analysis of the data, comparing proxy voting by shareholders generally to mutual funds and then the extent to which this voting is consistent with management and ISS voting recommendations. Using a series of tables, we look specifically at proxy voting by all shareholders and mutual funds on non-routine management proposals and shareholder proposals, including specifically proposals dealing with the most salient corporate governance topics during the 2003-2008 period: declassification of boards, shareholder voting on poison pills, majority election of directors, and separation of chair/CEO positions. We then cut this data to identify the extent to which voting by shareholders and mutual funds is consistent with management and ISS recommendations—when those recommendations agree and especially when they disagree.

Finally, Part V provides a multivariate analysis of the data, testing (and confirming) our conclusion from the univariate analysis that mutual funds vote consistently with ISS recommendations more than do shareholders generally and that, when management and ISS recommendations diverge, mutual funds tend to vote consistently with ISS recommendations far more than they do with management recommendations.

## I. OVERVIEW OF MUTUAL FUND VOTING

Mutual funds constitute the largest shareholder category in U.S. public markets, today holding 28.9% of all public-traded equity securities.<sup>3</sup> Mutual funds have grown steadily over the past twenty-five years. In 1970, they held a total of \$47 billion in assets.<sup>4</sup> By the end of 2007, they held nearly \$13 trillion in assets, most (nearly 93%) in open-end mutual funds.<sup>5</sup> As retirement assets continue to transition from defined-benefit plans to defined-contribution plans, mutual fund growth is likely to continue given their widespread use in IRA and 401(k) plans.<sup>6</sup>

The mutual fund industry is also concentrated. As of 2003, the largest twenty-five fund groups controlled 72%, and the largest ten 48%, of all

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3. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., *FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDINGS, SECOND QUARTER 2008* 89-90 (2008).

4. See INVESTMENT COMPANY INSTITUTE, *2008 INVESTMENT COMPANY FACTBOOK* 110 (2008).

5. See *id.* at 9.

6. See Investment Company Institute, *The U.S. Retirement Market, 2007*, 17 RESEARCH FUNDAMENTALS, July 2008 at 10, <http://www.ici.org/pdf/fm-v17n3.pdf>. Defined contribution and IRA assets, which now comprise more than half of the total retirement assets in the United States, are heavily invested in mutual funds. At the close of 2007, 47% of IRA assets were held in mutual funds, compared to 38% held in securities brokerage accounts. See *id.* at 5. Similarly, mutual funds manage 54% of total assets in 401(k) and 403(b) retirement plans. See *id.* at 10.

mutual fund assets.<sup>7</sup> Thus, the largest ten mutual funds control about one-sixth of voting in U.S. public companies—essentially a controlling position under the SEC rule of thumb that a 20% voting bloc in a public company with dispersed ownership wields effective voting control.<sup>8</sup>

#### A. Voting Disclosure Rules

In April 2003, the SEC promulgated a rule requiring disclosure of proxy voting by registered mutual funds.<sup>9</sup> The rule requires disclosure of each fund's policies and procedures used to vote proxies of portfolio securities—in the fund's statement of additional information (SAI) filed with the SEC<sup>10</sup> and actual voting record—on Form N-PX filed with the SEC, available on the fund's website or upon request by fund investors.<sup>11</sup>

The SEC identified three purposes for the rule: (1) maximizing “shareholder value” through greater fund involvement in corporate governance, thus benefiting “all investors not just fund shareholders;” (2) illuminating potential conflicts of interest and discouraging voting inconsistent with the interests of fund investors; and (3) disclosing to fund investors their fund's voting policies and practices (which the SEC characterized as a “fundamental right”).<sup>12</sup>

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7. See INVESTMENT COMPANY INSTITUTE, 2004 MUTUAL FUND FACTBOOK 41 (2004).

8. See Amendments to Beneficial Ownership Reporting Requirements, Exchange Act Release No. 39,538, 63 Fed. Reg. 15,286 (Mar. 31, 1998) (using 20% cut-off to distinguish passive and potentially controlling investors).

9. See Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities Act Release No. 8188, Exchange Act Release No. 47,304, Investment Company Act Release No. 25,922 (Jan. 31, 2003) [hereinafter Adopting Release]. The rule, effective July 1, 2003, applies to registered open-end and closed-end funds, as well as insurance company variable annuities with separate accounts organized as investment companies.

10. See *id.* at Form N-1A, Item 13(f). SAI is part of registration statement and contains information not in prospectus; SAI is available to investors on request or on EDGAR. Notice to fund investors is minimal. Shareholder reports need only state that a full description of the fund's voting policies and procedures is available by calling a toll-free number, visiting the fund's website, or going to the SEC's website. See Adopting Release, *supra* note 9, at n.29, Form N-1A, Items 22(b)(7) and 22(c)(5).

11. See *id.* at 10-11 (reporting proxy voting records on Form N-PX became effective August 31, 2004). Form N-PX, filed electronically on EDGAR, must detail each fund's complete voting record for the 12-month period ending June 30th of the reporting year. See *id.* Form N-PX calls for specific information on each matter considered at any shareholder meeting held during the reporting period on which the fund was entitled to vote: (1) the name of the issuer of the portfolio security; (2) the exchange ticker symbol of the security; (3) the security's CUSIP number; (4) the shareholder meeting date; (5) a brief identification of the matter voted on; (6) whether the matter was proposed by management or a shareholder; (7) whether the fund cast its vote on the matter; (8) how the fund voted; and (9) whether the fund voted for or against management. See *id.*

12. See *id.* at 4 (explaining purpose of voting disclosure rule).

The rule does not require, as some commentators urged the agency to do, disclosure using a uniform, web-accessible, downloadable format—such as a spreadsheet—but does require complete information on each matter presented for shareholder vote and how the fund voted.<sup>13</sup>

### B. *Proxy Voting in Public Companies*

Shareholders of public companies vote annually on board elections, management proposals, and shareholder proposals. The company's proxy statement and proxy card (ballot) must disclose all proposals anticipated to come before the shareholders at their annual meeting. Director nominees, with rare exceptions, are nominated by the incumbent board. Any insurgent proposing its own slate of directors must bear all election-related expenses, subject to reimbursement only if the insurgency is successful.<sup>14</sup>

Activist shareholders have recently sought to amend corporate by-laws to require company reimbursement of reasonable election-related expenses by a successful "short slate." The Delaware Supreme Court has held that such a by-law amendment is proper for shareholders of a Delaware corporation, but must ensure the board of directors can exercise its fiduciary duties by rejecting payment to nominees whose presence on the board would be inimical to the corporation's interests.<sup>15</sup> The Delaware legislature has amended the state's corporation law to permit shareholders to approve such by-laws.<sup>16</sup>

Management proposals involve requests for shareholders to take action at the annual meeting. Routine proposals include voting to elect uncontested slates of directors and to approve the selection of the company's auditors. Some other proposals involve matters requiring shareholder approval: authorization of new shares, classifying the board, and stock option plans. Other proposals ensure favorable tax treatment: approval of incentive compensation plans and stock option plans. Other proposals are meant to insulate management decisions from shareholder challenge: approval of interested director transactions and stock option plans for executives or rank and file employees. Most management proposals need only

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13. *See id.* at 11. The Form N-PX report has serious weaknesses. Despite comments urging a uniform, web-accessible, downloadable format, the SEC permits each fund to choose its disclosure format. *See id.*; *see also* Burton G. Rothberg & Steven B. Lilien, *Mutual Fund Proxy Votes* (February 2005) (unpublished working paper), available at <http://ssrn.com/abstract=669161> (explaining that SEC urged funds to make their voting records accessible in "user-friendly format," but researchers have difficulty collating data, which funds present in text format). Researchers must parse the text and create a data table, often writing different programs for each fund's different text format. *See* Rothberg & Lillien, *supra*.

14. *See* *Rosenfeld v. Fairchild Engine & Airplane Corp.*, 128 N.E.2d 291, 293 (N.Y. 1955) (noting only reasonable and bona fide expenses can be reimbursed).

15. *See* *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227, 240 (Del. 2008).

16. *See* DEL. CODE ANN. tit. 8, § 113 (2009).

receive a majority of votes cast on an issue (a simple majority) to be deemed “passed,” although for certain extraordinary matters, such as mergers, management must succeed in attracting a majority of votes from the total number of shares outstanding (an absolute majority) for the transaction to be approved.

Shareholder proposals arise almost exclusively under Rule 14a-8, the SEC’s shareholder proposal rule. Rule 14a-8 permits shareholders of public companies to submit “proper” proposals for inclusion in the company’s proxy materials.<sup>17</sup> If included on the ballot, the company’s shareholders (typically by proxy) vote on the proposal, which generally must be approved by simple majority.<sup>18</sup> If the proposal is precatory (and almost all 14a-8 proposals are precatory), it only recommends action by the company, and the company’s board has the discretion whether to take action. If the proposal is mandatory, such as one calling for an amendment to the company’s by-laws, the company’s management is bound to act.

For the first fifty years of the shareholder proposal rule, shareholder proposals (unless also supported by management) almost never received majority support.<sup>19</sup> Things changed, however, during the 1990s, first with proposals calling for director ownership of company shares and then for a broad range of governance reforms. From 2002 to 2004, for example, majority votes had become common for shareholder proposals to declassify a firm’s board of directors and to remove a firm’s poison pill.<sup>20</sup>

### C. *ISS/RiskMetrics: The Role of Third Party Voting Advisors*

Proxy advisory firms, such as ISS/RiskMetrics (ISS), give recommendations on proxy voting issues, such as withholding votes for individual directors or voting for or against management and shareholder proposals.<sup>21</sup> The proxy advisory firms obtain input from their institutional share-

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17. See 17 C.F.R. § 240.14a-8 (2009) (explaining shareholder proponents must have held at least \$2000 in company stock for twelve months).

18. See DEL. CODE ANN. tit. 8, § 216(2).

19. See Jonathan Macey, *Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall*, 33 EMORY L.J. 1, 17 (1984) (quoting May, 4, 1982 speech by Bevis Longstreth, Commissioner, Sec. & Exch. Comm’n, Current Issues Facing the Securities Industry and the SEC, Remarks to the Securities Industry Association).

20. See Randall S. Thomas & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction*, 13 J. CORP. FIN. 368, 369 (2007) (explaining that increased majority shareholder support has resulted in directors implementing more shareholder proposals).

21. The four leading firms are Institutional Shareholder Services, Proxy Governance, Glass Lewis, and Egan Jones. See Stephen J. Choi, Jill E. Fisch & Marcel Kahan, *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 650 (2009). Proxy advisory firms also provide logistical voting services to shareholders, either casting votes on behalf of shareholders pursuant to their instructions or in conformity with firm’s voting guideline. See Albert Verdam, *An Exploration of the Role of Proxy Advisors in Proxy Voting* (unpublished working paper, 2006), available at <http://ssrn.com/abstract=978835>. Some proxy advisory firms also advise manage-

holder clients and analyze the merits of voting proposals, often publishing general guidelines on types of proposals and corporate governance issues. The firms also analyze voting proposals at specific companies, making case-by-case recommendations based on the company's specific situation.<sup>22</sup> Institutional clients usually pay for this service, though the recommendations are often publicly available to all shareholders.<sup>23</sup>

ISS is the leading proxy advisory firm in both the United States and the world.<sup>24</sup> Among its clients are forty-three of the largest fifty mutual fund groups.<sup>25</sup> Voting recommendations by ISS are viewed as influential, if not determinative, in proxy contests.<sup>26</sup> For example, companies involved in voting contests will often issue press releases pointing to favorable ISS voting recommendations. Given the dominance of ISS and the market concentration in proxy advisory services, many have criticized the "virtual monopoly" of the ISS.<sup>27</sup>

There is some question whether proxy advisory firms actually provide additional information to institutional shareholders in making their voting decisions. In a recent study of the influence of the four leading proxy advisory firms on director elections, Choi, Fisch, and Kahan conclude that

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ment on the likely outcome of shareholder votes, creating a potential conflict with their role as advisor to shareholders. *See id.*

22. *See* Choi, *supra* note 21, at 650 (criticizing ISS case-by-case process as "black box" and urging greater transparency).

23. *See* Press Release, Sullivan & Cromwell LLP, Corporate Governance, ISS Issues U.S. Corporate Governance Policy Updates for 2008 (Dec. 19 2007), *available at* <http://www.adrbnymellon.com/files/SO21606.pdf>. *See generally* Riskmetrics Group, *2008 U.S. Proxy Voting Guidelines Summary* (2007), <http://www.riskmetrics.com/default/files/2008PolicyUSSummaryGuidelines.pdf>.

24. *See* RiskMetrics Group, *Company History*, <http://www.riskmetrics.com/history> (last visited June 18, 2009) [hereinafter *Company History*] (discussing origins of RiskMetrics). ISS, founded in 1985 by Robert Monks to promote good corporate governance and foster responsible proxy voting by institutional investors, was acquired by the RiskMetrics Group in January 2007. *See* RiskMetrics Group, *Corporate Profile*, <http://www.riskmetrics.com> (follow "Corporate Profile" hyperlink under "Our Company" and "Investor Relations") (last visited June 18, 2009). RiskMetrics is a publicly-traded company that provides advice to institutional shareholders on risk management, corporate governance, and financial research analysis—to "help investors assess risk in one form or another." *See* RiskMetrics Group, *Stock Information*, <http://www.riskmetrics.com> (follow "Stock Information" hyperlink under "Our Company" and "Investor Relations") (last visited June 18, 2009) (providing summary of stock information).

25. *See Company History*, *supra* note 24 (identifying groups served by RiskMetrics).

26. *See* Dennis K. Berman & Joann S. Lublin, *Advisor ISS Puts Itself on Sale Could Fetch Up to \$500 Million*, *WALL ST. J.*, Sept. 6, 2006, at C4 ("ISS . . . exerts tremendous clout in guiding institutional investors about how to vote on proxy fights, director re-elections and resolutions put before shareholders.").

27. *See* Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 *YALE L.J.* 269, 296-97 (2003) (citing problems of limited competition in proxy advisory services).



the influence of the proxy advisors may be overstated.<sup>28</sup> The proxy advisory firms, rather than “lead” institutional voting, simply aggregate voting factors that institutional shareholders already consider important and thus “follow” existing institutional voting attitudes. This finding is consistent with the approach that many institutional shareholders take for investment decision making—namely, to simply seek to match the performance of peers. That is, institutional shareholders may measure voting results (like investment success) on a relative, not absolute, scale—and view proxy advisory recommendations accordingly.

#### D. *Mutual Fund Shareholder (In)Activism*

In the early 1990s, as corporate governance shifted from takeover “exit” to voting “voice,” attention turned to the role of institutional shareholders.<sup>29</sup> The picture was bleak. Institutional shareholders—pension funds, mutual funds, insurance companies, banks, and endowments—seemed even less accountable to their “owners” than corporate managements to their shareholders.<sup>30</sup>

Mutual funds and other institutional shareholders were largely passive investors. The explanations for institutional passivity were many. Like individual shareholders, institutions seemed to find that the costs of governance activities (monitoring and voting) exceeded the benefits.<sup>31</sup>

Mutual funds, it has been said, are particularly reluctant as shareholder activists.<sup>32</sup> Three prevalent explanations have been given for their lethargy: one benign, one troublesome, and one legal. The benign explanation is that the mutual fund industry perceives its governance role as arising from its traditional function of portfolio selection. In other words, the “Wall Street rule” is a more credible disciplining device than long-shot proxy fights or even voting on shareholder proposals.<sup>33</sup> To the extent

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28. See Choi, *supra* note 21, at 696-97 (concluding that proxy advisory services make recommendations based on factors that should matter to investors).

29. See Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. APPLIED CORP. FIN. 55, 59 (2007) (discussing increased importance of institutional investors in response to decline in takeover market and regulatory changes enhancing shareholder voice).

30. See John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1283 (1991) (explaining that traditional mechanisms of corporate accountability are not generally available at institutional level).

31. See generally Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 520-26 (1990) (discussing passivity of institutional investors).

32. See Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 876 (2005) (noting mutual fund reluctance to take control of corporate governance issues). See generally Robert C. Pozen, *Institutional Investors: The Reluctant Activists*, HARV. BUS. REV., Jan.-Feb. 1994, at 140 (“Most institutional investors do not set out to become activists or to micromanage companies.”).

33. See Anat R. Admati & Paul C. Pfleiderer, *The “Wall Street Walk” as a Form of Shareholder Activism*, 22 REV. FIN. STUD. 2 (2009) (presenting study demonstrating efficacy of “Wall Street Rule” in various hypothetical factual settings). But others

funds pursue investment strategies that use corporate governance practices at portfolio firms as predictive of future performance, reform of governance practices is accelerated. Admati and Pfleiderer conclude that funds with informational advantages and a credible threat of walking can, in some circumstances, motivate corporate management reforms.<sup>34</sup>

A second explanation for mutual fund passivity is more troublesome. A large (and growing) segment of the industry is now devoted to employer-based thrift plans. Thus, the industry's true customers are not individual investors, but rather portfolio companies that can decide how to allocate their employee-thrift business. Some have argued that the industry is conflicted and avoids shareholder activism, including proxy voting for value-producing shareholder proposals.<sup>35</sup> Conflicts of interest in voting, it has been argued, are exacerbated when mutual funds are part of financial conglomerates that may be actively seeking other types of business from portfolio firms.<sup>36</sup> Fund managers worry both that activism may drive away employee-thrift business and that it will drive away corporate investment banking and corporate lending business.<sup>37</sup>

The third explanation for mutual fund passivity is the complex web of legal rules that discourage institutional activism in general and mutual

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find little evidence that institutional investors vote with their feet. See Robert Parrino, Richard W. Sias & Laura T. Starks, *Voting with their Feet: Institutional Ownership Changes around Forced CEO Turnover*, 68 J. FIN. ECON. 3, 42 (2003) (challenging claims that institutional investors vote with their feet).

34. See Admati & Pfleiderer, *supra* note 33, at 2 (concluding that ability of large shareholders to walk can align management decisions with shareholder preferences). The study finds that the effectiveness of the act (or threat) of walking depends on the precise type of perceived management problem and on the type of information the large shareholder has. See *id.* (discussing factual variations that affect effectiveness of walking). Management is more willing to respond to large shareholders selling when it involves taking "good action" (like introducing a new product line) compared to desisting from "bad action" (like selling a lavish corporate jet). See *id.* at 31 (summarizing findings of when walking is most effective).

35. A recurring and illustrative story of this mutual fund conflict was the opposition by Fidelity Investments to a proxy proposal at Tyco International (during the tenure of Dennis Kozlowski) for a majority independent board. See *Our Money, Our Votes*, WASH. POST, Jan. 21, 2003, at A16 (discussing potential conflicts of interest in mutual funds' proxy voting). Whether or not Fidelity's opposition to the proposal was related to the \$2 million it earned for administering Tyco's employee benefit plans, the appearance of conflict was unavoidable.

36. See Geoffrey H. Bobroff & Thomas H. Mack, *Assessing the Significance of Mutual Fund Board Independent Chairs*, (Mar. 10, 2004) (unpublished study on file with SEC), in Letter from Eric D. Roiter, Senior Vice President & Gen. Counsel, Fid. Mgmt. and Research Co., to Nancy M. Morris, Sec'y, Sec. Exchange Commission (Mar. 2, 2007), available at [http://404.gov/rules/proposed/s70304/fidelity031004.htm#P88\\_13929](http://404.gov/rules/proposed/s70304/fidelity031004.htm#P88_13929) (citing unpublished study, on file with SEC, by Geoffrey H. Bobroff & Thomas H. Mack, calculating that nine of twenty largest mutual fund families have investment banking or insurance affiliations).

37. The problem is universal. See Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2059-60 (1994) (discussing problem in Britain).

fund activism specifically.<sup>38</sup> Institutions are discouraged from communicating among themselves under SEC proxy rules, while Regulation FD discourages back-room communications with corporate insiders. Moreover, institutions (alone or as a group) cannot own more than 5% of a portfolio company's shares without being subject to reporting under the Williams Act. Institutions (alone or as a group) cannot own more than 10% of a portfolio company's shares, or place their nominee(s) on a portfolio company's board, without risking becoming subject to the short-swing disgorgement rules under section 16 of the 1934 Exchange Act.

Additional specific legal restrictions apply to mutual funds. Mutual funds must meet diversification rules to obtain flow-through tax treatment; thus, no more than 5% of a fund's assets can be invested in any one company, and no fund may hold more than 10% of any company's shares.<sup>39</sup> Mutual funds that advertise themselves as "diversified" must meet these diversification limits as to 75% of the fund's portfolio.<sup>40</sup> Open-end mutual funds (the most prevalent kind) must also maintain liquid assets, thus limiting the ability to take control positions that may be difficult to sell quickly.<sup>41</sup>

Institutional inaction may be changing. In the past decade, shareholder activism has come to define corporate governance. Perhaps stimulated by increased hedge fund shareholder activism,<sup>42</sup> more corporate managements appear to be taking institutions' concerns about their corporate governance structures more seriously. In 2007, looking back at the recently concluded proxy season, ISS reported that "most U.S. companies are responding to investor concerns," even as it recommended in favor of 58% of shareholder proposals and against 38% of management pay plan proposals (up from 30% the year before).<sup>43</sup> ISS observed both "accounta-

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38. See generally Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 520 (1990) (noting that shareholder voting has historically been passive); John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 906 (1994) (noting that institutional investors have historically been passive investors); David C. Donald, *Shareholder Voice and Its Opponents*, 5 J. CORP. L. STUD. 305 (2005) (analyzing US law and finding federal proxy rules block exercise of shareholders' rights under state law, though steady increase in institutional ownership has led to adoption of measures facilitating shareholder voice).

39. See Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 CARDOZO L. REV. 1419, 1448 (2002) (explaining Investment Company Act of 1940); Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469, 1474-75 (1991) (discussing Investment Company Act of 1940).

40. See Palmiter, *supra* note 39, at 1449 (discussing combined effect of statutory rules on mutual funds). These constraints, however, do not apply across mutual fund families.

41. See Alan R. Palmiter, *Staying Public: Institutional Investors in U.S. Capital Markets*, 3 BROOKLYN J. CORP. FIN. & COMM. LAW 245, 263-66 (2009).

42. See Alon Brav et al., *Hedge Fund Activism, Corporate Governance and Firm Performance*, 63 J. FIN. 1729, 1730 (2008) (discussing increased shareholder activism by hedge funds).

43. See RiskMetrics Group, *2007 Postseason Report: A Closer Look at Accountability and Engagement*, 5 (Oct. 2007), available at <http://www.RiskMetrics.com/node/>

bility and engagement” as shareholders strongly supported proposals seeking greater board accountability, such as “say on pay,” majority voting in director elections, board declassification, and the right to call special meetings. At the same time, shareholders withdrew more than half of their proposals on majority voting, stock option reforms, and sustainability reports after negotiations with companies, indicating management’s increased willingness to engage with shareholders on some issues.

ISS also noted greater activism among mutual fund groups:

Another development this year was the greater activism by large mutual fund companies, which historically have taken a passive role. For instance, Oppenheimer Funds helped lead a successful investor revolt in March at videogame maker Take-Two Interactive, where the company’s former CEO had pleaded guilty to stock option backdating. Fidelity opposed the Clear Channel buyout, while T. Rowe Price made 13D filings to challenge Laureate Education’s buyout and Diversa’s going-private transaction.<sup>44</sup>

Mutual funds may increasingly be playing a central role in corporate governance, as company management finds it advantageous to pay attention to their collective voice. Gine and Moussawi examined how management responded to shareholder proposals on poison pills.<sup>45</sup> In companies classified by those authors as “dictatorships,” mutual funds and pension funds play a leading role in supporting such proposals. In contrast, shareholders in “democracies” are not as forceful in expressing their voice. Among all institutional shareholders, the study concludes, management seems to respond to pressure from mutual funds and pension funds. Management in “dictatorships” is less likely to respond favorably to shareholder initiatives, a strategy that appears to be increasingly costly.

Some commentators claim that shareholder activism tapered off in 2008, as the financial crisis worsened, hedge fund activism waned, and business stability loomed on the minds of shareholders.<sup>46</sup> Shareholders appeared less concerned with governance issues and more focused on

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135682 [hereinafter *2007 Report*] (summarizing key developments in 2007 regarding increased influence of lawmakers on corporate governance issues). Support for shareholder proposals declined in 2008, perhaps due to greater concerns about the financial viability of companies. See Memorandum by David A. Katz & Laura A. McIntosh, *Corporate Governance Update: Shareholders Focused on Stability in Proxy Votes 1-2* (Oct. 30, 2008) available at <http://blogs.law.harvard.edu/corpgov/files/2008/11/shareholders-focused-on-stability-in-proxy-votes.pdf> (discussing shareholder focus on stability in proxy voting in 2008).

44. *2007 Report*, *supra* note 43, at 22.

45. See Mireia Gine & Rabih Moussawi, *Governance Mechanisms and Effective Activism: Evidence from Shareholder Proposals on Poison Pills* (EFA 2007 Ljubljana Meetings Paper, Jan. 16, 2006), available at <http://ssrn.com/abstract=968425> (examining relationship between management decisions, governance regimes, and shareholder activism).

46. See Katz & McIntosh, *supra* note 43, at 1 (discussing shareholder focus on stability during credit crisis).

corporate stability: directors were reelected with more than 90% support, backing for many governance proposals fell from 2007 levels, and shareholders voted on fewer governance proposals. Nonetheless, shareholder proposals on non-compensation governance reforms (declassify board, rescind supermajority voting, redeem poison pills, allow cumulative voting) fared relatively well in the 2008 proxy season compared with 2007, though the number of resolutions that came to a vote dropped for most topics.<sup>47</sup> The declining number of shareholder proposals brought to a vote may have also reflected improved communication between management and shareholders, with negotiated changes in corporate governance practices becoming more common.

## II. PRIOR STUDIES ON MUTUAL FUND VOTING

There is an extensive and rapidly growing literature that examines mutual fund voting using the now publicly available data on the subject. The following review of the literature attempts to group the existing studies according to the topics that they have examined.<sup>48</sup>

### A. *Conflicts of Interest: Fund Voting in Portfolio Companies with Business Connections*

Fund groups, besides sponsoring and managing mutual funds, engage in other lines of business: investment banking, insurance, broker-dealer operations, and administration of 401(k) thrift plans for corporations. One reason for disclosure of proxy voting by mutual funds was to provide transparency about potential conflicts when fund managers cast votes that may affect their other business interests.<sup>49</sup> As a result, a number of studies have focused on whether potential conflicts of interest have affected mutual fund voting patterns.

Davis and Kim examined the effects on mutual fund voting of business ties between funds and public companies in their portfolios.<sup>50</sup> They looked at the voting at the six largest fund groups that provided services to the pension plans of 878 public companies (as reported on IRS Form 5500): Fidelity, Putnam, Vanguard, AIM/Invesco, T. Rowe Price, and

47. See RiskMetrics Group, *2008 Postseason Report Summary: Weathering the Storm: Investors Respond to the Global Credit Crisis*, Oct. 2008, at 2 available at [http://www.riskmetrics.com/docs/2008postseason\\_review\\_summary](http://www.riskmetrics.com/docs/2008postseason_review_summary) (summarizing 2008 proxy season).

48. This is a constantly evolving area of research. While we have tried to be comprehensive, we have undoubtedly overlooked some newer studies that have yet to be posted on the Social Science Research Network or other public access databases.

49. See Investment Company Institute, *Proxy Voting by Registered Investment Companies: Promoting the Interests of Fund Shareholders*, 14 RESEARCH PERSPECTIVE July 2008 at 12, [www.ici.org/pdf/per14-01.pdf](http://www.ici.org/pdf/per14-01.pdf) [hereinafter *Proxy Voting by Registered Investment Companies*].

50. See generally Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. FIN. ECON. 552 (Aug. 2007).

American Funds.<sup>51</sup> These six fund groups derived significant amounts providing pension services (estimates ranging from \$87 million to \$14 million in annual fees).<sup>52</sup>

The study found that the six funds tended to distinguish between value-producing proposals and those that are not. Looking at shareholder proposals identified as potentially producing shareholder value (eliminating classified boards, poison pills, and golden parachutes), the study found greater fund support for these proposals than for others not seen as value-producing (adding independent chair, expensing options, and allowing cumulative voting).<sup>53</sup> For example, while Putnam voted 92%, 94%, and 80% for proposals in the value-producing set, it voted 0%, 22%, and 0% for proposals in the non-value-producing set.

The study also found no statistically significant relationship between how each fund votes and (1) whether the portfolio company is a client or (2) the size of the fund's stake in the company in percentage or dollar value terms. Instead, the six fund groups, faced with hundreds and thousands of voting decisions on shareholder proposals, "followed relatively automatic policies in determining how to vote across firms independent of client ties or the relative size of their holdings."

Nonetheless, Davis and Kim found some evidence that business ties affect fund voting. Using a regression analysis, the study found that the number of clients serviced by a fund group "has a significant and negative influence on the propensity to vote in favor of shareholder proposals." Comparing votes on value-producing proposals (classified boards, poison pills, golden parachutes) and those on non-value-producing proposals (independent chair, expensing options, cumulative voting), the study concluded "funds are less willing to vote against proposals that are considered to be good for shareholder value than proposals that are in a gray area."

Rothberg and Lilien in a major, early study of mutual fund voting examined the proxy voting procedures and the voting behavior of the ten largest fund families in 2003-2004. They detailed the guidelines and policies of the ten largest mutual fund families by the type of proposal being considered.<sup>54</sup> They found that the ten mutual funds vote most of their proxies (98%) and vote for management proposals (82%) more often

51. See Davis, *supra* note 50, at 556. A total of 892 companies on the 2001 list of Fortune 1000 corporations were both publicly-traded and had institutional ownership. Of these, 878 companies paid for pension services by at least one outside provider. The six mutual fund groups were selected from the ten largest fund groups that did business, according to Form 5500, with at least 30 of the selected companies. See *id.*

52. See *id.* at 557. The study found no statistically significant link between the composition of the funds' portfolios and client relationships. See *id.* at 560.

53. See *id.* The study relied on Bebchuk, Cohen, and Ferrell (2004) to identify value-producing and non-value-producing proposals. See *id.* at 560.

54. See Rothberg & Lilien, *supra* note 13 (including in study Fidelity, Vanguard, American Funds, Putnam, Janus, Franklin-Templeton, AIM/Invesco, T. Rowe Price, Morgan Stanley Dean Witter, and Oppenheimer Funds).

than for shareholder proposals (24%). When looking at proposal type, they found that the mutual funds vote against managers when they propose executive severance packages, and when they vote to include poison pills and classified boards. They found no difference in voting patterns of indexed versus more actively managed funds in the five largest fund families.

Their study found that each of the top five fund groups tended to vote collectively as a group, not as individual funds. They found no "simple global rules" for voting by fund groups, but instead found that they were voting on individual proposals on a case-by-case basis. They found substantial variation among the five funds about how they voted on different issues. For example, while Vanguard was generally the least likely to vote for management's slate of directors (29%) and T. Rowe Price the most likely to vote for management's slate (91%), their voting positions were reversed on shareholder proposals, which T. Rowe Price (31%) supported more often than Vanguard (19%).

Rothberg and Lilien found that mutual fund voting in favor of shareholder proposals (opposed by management) varies according to type of proposal so that, for example, anti-takeover proposals gained 59% approval, executive pay received 34% positive votes, but social/political topics garnered only 5% approval. They also found substantial variance within these broad categories, with funds voting more strongly against management on particular subtopics: redeeming poison pills (70%), executive severance pay (69%), removal of classified boards (61%), and sex bias policies (29%).

More generally, the study found that actively managed funds (stock pickers) tend to vote slightly more with management than large fund groups (95% for stock pickers and 81% for large funds). But there was no significant difference in the voting records of independent fund groups (such as Fidelity and Vanguard) compared to fund groups that are part of larger financial conglomerates (such as AIM/Invesco and Morgan Stanley Dean Witter). The study concluded there is "no evidence that funds are allowing non-fund consideration to affect their proxy voting decisions." We note, however, that this study was based on a single year of voting data and looked only at ten mutual fund families.

A more recent study by the Investment Company Institute (ICI), the mutual fund industry's main trade group, cited to Davis, Kim, Rothberg, and Lilien for their conclusion that "recent studies have found no compelling evidence that fund votes are influenced by advisers' other lines of business," although without independently testing whether other lines of business have an effect on fund voting.<sup>55</sup> The ICI study attempted to discredit Davis and Kim's conclusions that fund groups with more 401(k) clients tend to vote against management-opposed shareholder proposals. The ICI study argued that fund groups with significant 401(k) business

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55. See *Proxy Voting by Registered Investment Companies*, *supra* note 49, at 2.

“strongly support certain kinds of shareholder proposals, such as proposals to eliminate classified boards or to require shareholder votes on poison pills.” -

### B. *Pro-Management Bias: Fund Voting on Management Proposals*

Prior to the promulgation of the SEC’s disclosure rule, many commentators believed that mutual funds voted almost always with management—or they sold their holdings. Recent studies show that funds generally support management proposals, but also exhibit some independence and activism on specific types of management proposals.

ICI examined proxy votes at the top 160 mutual groups in Russell 3000 companies during the single 2006-2007 proxy season.<sup>56</sup> The study, which looked primarily at fund voting on management and shareholder proposals, found that most management proposals related to the election of directors (76.4% of all proposals) and ratification of auditors (10.9% of all proposals). Other management proposals (totaling 1,912, or 9.6% of all proposals) related mostly to compensation-related matters (65%), capitalization (11%), anti-takeover-related matters (8%), reorganizations and mergers (6%), board structure and election process (4%), and miscellaneous matters (7%). Shareholder proposals represented only 3.2% of proxy proposals at the sampled companies.

The ICI study found that mutual funds favored management’s slate of directors 92.3% of the time and voted in favor of ratification of the audit firm 98% of the time.<sup>57</sup> Management proposals on specific topics also garnered relatively strong support by mutual funds: compensation-related matters (83.8%), capitalization issues (80.2%), anti-takeover-related matters (92.5%), reorganizations and mergers (95.3%), board structure and election process (93.9%), and miscellaneous matters (71.2%).

The ICI study compared mutual funds to all other shareholder groups and suggested that mutual funds, on balance, may be more activist. Overall, mutual funds voted “for” management proposals 85% of the time, compared to an overall “success” rate for such proposals of 91.5% (proposals passing with a majority vote). If a proposal’s “success” rate indirectly indicates overall shareholder support, the ICI data suggested funds are voting for management proposals less frequently than other shareholders. The ICI data were mixed on this point. On some management proposals, mutual funds’ “for” votes exceeded proposal “success” rates: anti-takeover-related matters (92.5% vs. 76.3%), reorganizations and mergers (95.3% vs. 94.6%), and miscellaneous matters (71.2% vs. 49.0%). Yet, on other management proposals, mutual funds were more activist than other shareholders: compensation-related matters (83.8% vs. 95.8%), capitalization

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56. *See id.* at 2. The study was limited to the top 160 fund groups and votes cast at shareholder meetings from July 1, 2006 to June 30, 2007 for companies in the Russell 3000. *See id.* at 17.

57. *See id.* at 19.



(80.2% vs. 95.7%), and board structure and election process (93.9% vs. 96.8%).

The ICI study found that fund voting generally tracked the recommendations by the proxy advisory firms, with overall support of management proposals by funds (85%) generally consistent with the overall voting recommendations of ISS (81.5%) and Glass-Lewis (84%). On specific topics, however, mutual fund voting deviated somewhat from the recommendations of the proxy advisory firms: anti-takeover-related matters (funds 92.5% vs. advisory firms 87.4% / 89.6%), capitalization (funds 80.2% vs. advisory firms 87.7% / 80.9%) and miscellaneous matters (funds 71.2% vs. advisory firms 43.8% / 45.8%).

Cremers and Romano critically examined the impact of the 2003 mutual fund voting disclosure rule on management and shareholder proposals by using a matched pair sample of proposals submitted prior to the voting disclosure rule with similar proposals submitted after the passage of the disclosure rules.<sup>58</sup> They found that support of management proposals declined, especially for compensation related proposals, although the level of support for management proposals generally still exceeded 75%. Over this same period, they found that support of shareholder proposals had increased, especially for proposals limiting takeover defenses and executive compensation. Support for takeover defenses proposals increased from 54.9% before to 59.9% after the disclosure requirements, and proposals to limit executive compensation increased from 28.6% before to 36.9% after the disclosure requirements.

Ye examined whether mutual funds with large holdings in a portfolio company vote “responsibly.”<sup>59</sup> The study found that funds with large holdings are more likely to follow management voting recommendations, such as for management-sponsored proposals on board elections and management compensation and against shareholder-sponsored proposals to eliminate poison pills and declassify boards. The study, however, concluded that voting by funds with large holdings is strategic to enhance the fund’s private monitoring. Such funds, the study found, can use their position to reduce potentially detrimental management-sponsored proposals.

Duan examined the voting records of the 100 largest mutual fund groups on governance-related proposals for three proxy seasons from 2003 to 2006 to test whether funds exercise exit or voice when dissatisfied

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58. See Martijn Cremers & Roberta Romano, *Institutional Investors and Proxy Voting: The Impact of the 2003 Mutual Fund Voting Disclosure Regulation*, (Yale Sch. of Mgmt. and Yale Law Sch., ICF Working Paper No. 07-10, 2007), available at <http://ssrn.com/abstract=982493>.

59. Pengfei Ye, *On Investors’ Ownership and Voting Decisions: Evidence from Mutual Funds* (Feb. 2008) (unpublished working paper), available at <http://ssrn.com/abstract=1100362>.

with management.<sup>60</sup> The study found that funds are more likely to vote against management rather than exit when management's recommendations conflict with those of ISS (using ISS recommendations as reflecting voting value). In particular, funds vote against management rather than exit at poorly governed firms.

Rothberg and Lilien, discussed earlier in this review, examined voting at the largest fund groups during the 2003-2004 proxy season, comparing these mutual funds' support for management and shareholder proposals. At five large fund groups (Fidelity, Vanguard, T. Rowe Price, Janus, and Putnam), they found overall support for management proposals of 82%, while the same funds only supported shareholder proposals 24% of the time. Fund groups varied in their support levels, with T. Rowe Price being the most supportive of management proposals (90% of the time) and Vanguard being the least supportive (71% of the time). For shareholder proposals, however, T. Rowe Price was the most supportive (31%), whereas Vanguard was the second least supportive (19%). The study, which did not provide a breakdown of different proposal types, found relatively high abstention rates. The sampled mutual funds abstained from management proposals at a 2% rate and from shareholder proposals at a 12% rate, with Vanguard abstaining 29% of the time.

The Corporate Library looked at voting in the twenty-six largest mutual fund groups on pay-related proposals during the two proxy seasons 2006-2008, and concluded that "mutual funds contributed to excessive executive compensation" by voting for management proposals seeking to increase executive pay and against shareholder proposals seeking to "align pay with performance."<sup>61</sup> The report found a "steady increase" in support for management-initiated pay proposals, which rose from 75.8% in 2006 (based on an earlier Corporate Library report) to 82% in 2007, to 84% in 2008. Meanwhile, the report found a "significant decrease" in support for shareholder-initiated pay proposals, falling from 46.5% in 2006, to 42% in 2007, to 40% in 2008.

While finding less mutual fund activism on pay proposals, the report found that mutual funds were more willing to withhold votes from directors over compensation issues. For selected director nominees who had supported pay increases, the report found "withheld" votes increased from 42% in 2007 to 52% in 2008. This compared to a 32% withhold vote by shareholders generally, indicating that mutual funds were more likely to

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60. See Ying Duan, *The Role of Mutual Funds in Corporate Governance: Evidence from Mutual Funds' Proxy Voting and Trading Behavior*, (Boston College, Working Paper, Jan. 2008), available at <http://ssrn.com/abstract=1028367>.

61. The Corporate Library et al., *Compensation Accomplices: Mutual Funds and the Overpaid American CEO* (2009), [http://www.afscme.org/docs/mutual\\_fund\\_full\\_report.pdf](http://www.afscme.org/docs/mutual_fund_full_report.pdf) [hereinafter *Compensation Accomplices*]. Besides looking at voting at the largest twenty-six mutual fund groups, the report identified those fund groups that were the worst "pay enablers" and those that were the best "pay constrainers." *Id.* at 9.

withhold votes from directors over compensation concerns than were other shareholders.

C. *Shareholder Activism: Fund Voting on Shareholder Proposals*

Shareholder proposals, while almost uniformly opposed by management, have become increasingly important in recent years. The studies summarized below generally show that shareholders (and mutual funds) support proposals by fellow shareholders less frequently than management proposals, with support for shareholder proposals below 50%, compared to support for management proposals usually above 80%. Nonetheless, certain shareholder proposals regularly receive greater than majority support from shareholders, including proposals for majority, rather than plurality, voting for directors and several types of anti-takeover proposals. Importantly for our purposes, mutual funds tend to be more activist and supportive of shareholder proposals than shareholders overall.

Along the above lines, ICI's study of proxy votes by mutual funds during the 2006-2007 proxy season found less support for shareholder proposals (38.1%) than for management proposals (85%).<sup>62</sup> Shareholder proposals, representing 632 of the 19,990 proxy matters (3.2%) for the year, focused on social and environmental issues (31%), executive compensation (28%), board structure and election (25%), and shareholder rights and anti-takeover measures (15%).<sup>63</sup>

The ICI study found that mutual fund voting for shareholder proposals varies significantly depending on the type of proposal: anti-takeover-related proposals (78.0%), board structure and election process (49.1%), compensation-related (37.6%), and social/environment (15.3%).<sup>64</sup> In fact, mutual funds appear to be more activist than other shareholders, with "success" rates (proposals actually passed) lagging the rate of mutual fund support: anti-takeover-related proposals (57.1%), board structure and election process (22.8%), compensation-related (3.4%), and social/environment (3.0%). That is, while mutual fund voting, which represents about one-fourth of all proxy voting in public companies, suggests a

62. See *Proxy Voting by Registered Investment Companies*, *supra* note 49, at 18-20, fig.11. The study was limited to the top 160 fund groups and votes cast for companies in the Russell 3000. See *id.* at 17.

63. See *id.* at 5. The ICI study finds that shareholder proposals come primarily from individual investors (34%), labor unions (27%), and public pension funds (10%). See *id.* at 6. The ICI finds concentration in submitters: of the 239 proposals from individuals, 121 came from five individuals, and of the 186 proposals from labor unions, ninety-four came from three unions.

64. See *id.* In particular, the ICI study finds that mutual funds vote "for" majority-voting proposals (calling on directors to be elected by majority vote, rather than a plurality) approximately 65% of the time. The ICI study identifies the following categories of shareholder proposals: social/environmental (31%), compensation related (28%), board elections/structure (25%), and shareholder rights/antitakeover (15%). The ICI breaks down board elections/structure into majority voting (7.1%), independent chair (6.3%), director stuff (7.3%), and cumulative voting (3.8%).

higher passage rate, other shareholder voters appeared to create a drag on shareholder voting activism.

The ICI study found that mutual funds support shareholder proposals less often than recommended by the leading proxy advisory firms, ISS and Glass Lewis. While mutual funds vote “for” shareholder proposals 38.1% of the time, the ISS “for” recommendations on the same proposals was 63.8% and Glass-Lewis was 46.8%. For example, the study noted that mutual funds voted for shareholder proposals related to executive compensation 38% of the time, as compared to ISS support of 67% and Glass-Lewis support of 33%. The study did not attempt to explain why funds are not following the recommendations of the proxy advisory firms, particularly those fund groups that are paying for the service.<sup>65</sup>

The ICI study concluded that mutual funds, sensitive to the value and effectiveness of different proposal types, are discerning and distinguish between such board-related proposals as majority voting (65% support), cumulative voting (43% support), and independent board chair (32% support). The ICI study, however, was limited in some respects. Perhaps not to highlight differences among its members, the study did not look at voting by individual fund groups, instead separating out only the voting record of so-called “socially responsible interested” funds.<sup>66</sup> The study thus did not investigate the relationship between fund voting and the fund sponsor’s 401(k) business. Nor did the ICI study look at such variables as voting within fund groups, fund group size, source of fund investments (broker-directed, thrift plans), and fund group ownership.

Morgan, Poulsen, Wolf, and Yang examined shareholder proposals voted on by ninety-four fund groups (1,794 funds) during the two proxy seasons 2003-2005 to determine whether funds are effective monitors of portfolio companies.<sup>67</sup> Looking at 212,620 voting decisions on 1,047 shareholder proposals, they found that mutual funds support ISS-recommended proposals (which the authors assume are wealth-increasing) at significantly higher rates than other shareholders. Additionally, they found that voting within fund groups is not always consistent and varies according to the fund’s characteristics. Funds also support proposals targeting firms with weak governance. Finally, they found that fund support significantly affects whether a proposal passes.

The Corporate Library examined a non-random sample of forty-five mutual fund groups (440 funds in 2003-2004 and 434 funds in 2004-2005),

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65. See ProxyDemocracy, *ICI Study of Mutual Fund Votes*, Jul. 24, 2008, <http://proxydemocracy.wordpress.com/2008/07/24/ici-study-of-mutual-fund-votes/> (stating “the report shows clearly that mutual funds are more opposed to shareholder proposals than are the proxy advisers they hire [and] does little to account for this discrepancy”).

66. *Id.*

67. See Angela Morgan, Annette Poulsen, Jack Wolf & Tina Yang, *Mutual Funds as Monitors: Evidence From Mutual Fund Voting 1* (2009) (unpublished working paper), available at <http://ssrn.com/abstract=1431072>.

consisting of thirty-six “mainstream” funds and nine “socially responsible interested or SRI” funds.<sup>68</sup> The study found that overall the sampled funds increased (slightly) their support for management proposals—from 86.9% in 2003-2004 to 88.2% in 2004-2005. The study found that funds also increased their support for shareholder proposals dealing with corporate governance (declassified boards, poison pills, pay-for-performance, stock options expensing, and board stock compensation) from 47.8% in 2003-2004 to 52.8% in 2004-2005.

The Corporate Library study compared SRI funds and mainstream funds in the sample and found that SRI support of management proposals dropped from 88.3% to 70.8% during the two periods, while mainstream support remained steady at 90.8% and 92.0%. On shareholder “governance” proposals, SRI support increased from 73.1% to 78.2%, while mainstream support increased from 42.3% to 47.4%—that is, both about 5%. The significant difference between the two types of funds, as might be expected, was support for shareholder “social responsibility” proposals, which held steady for SRI funds at 88.1% and 87.7%, while mainstream funds voted for such proposals only 10.5% and 8.4% of the time.

The study thus found that SRI funds are more activist than mainstream funds. But the study may have given a distorted picture of overall mutual fund voting. First, it aggregated fund voting across fund groups (regardless of the size of assets under management). Thus, support for a resolution by Fidelity Investments (a \$1 trillion “mainstream” fund group) was counted the same as support by Domini Investments (a \$1.8 billion SRI fund group).<sup>69</sup> Second, SRI funds (nine of forty-five) were significantly over-represented in the sample. While SRI funds constituted during the relevant periods only \$20 billion of the \$8 trillion mutual fund industry—a mere 0.25% of the overall industry—they represented 20% of the study’s aggregated results.<sup>70</sup>

The Corporate Library study, however, offers a glimpse into mutual fund voting trends, particularly for mainstream funds. It showed during

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68. See Jackie Cook, *Analysis of Fund Voting Results for 2004-2005: Focus on Shareholder-Sponsored Resolutions 2* (The Corporate Library 2006), available at [http://www.boardanalyst.com/tcl-research/FundVotesReport\\_20060110.pdf](http://www.boardanalyst.com/tcl-research/FundVotesReport_20060110.pdf) [hereinafter Cook, *Analysis of Fund Voting Results for 2004-2005*]. A more recent study suggests that mainstream fund opposition to “corporate social responsibility” proposals has declined “decidedly and consistently” over the past five years for which mutual fund voting data is available. Jackie Cook, *Fund Votes Survey* (Sep. 2008), available at [http://www.fundvotes.com/downloads/Mutual\\_Fund\\_Proxy\\_Voting\\_2004-2008\\_sept.pdf](http://www.fundvotes.com/downloads/Mutual_Fund_Proxy_Voting_2004-2008_sept.pdf) (finding that support by mainstream funds for social and environmental resolutions averaged 11.5% in 2008, about double of 5.7% support in 2004).

69. See Cook, *Analysis of Fund Voting for 2004-2005*, *supra* note 68, at 8. Among the twenty-nine “mainstream” funds were the ten largest, which account for more than two-thirds of mutual fund assets. See *id.*

70. Social Funds, *Mutual Funds Center: General Fund Information*, <http://www.socialfunds.com/funds/chart.cgi?sfChartId=General+Information> (last visited Oct. 23, 2009).

the 2003-2005 proxy seasons generally low and declining interest among mainstream funds in “social responsibility” proposals, perhaps reflecting a perception that such proposals do not contribute to financial returns and most fund shareholders are indifferent to them. It also showed a 5.1% increase among mainstream funds in support for “governance” proposals from 42.3% to 47.4%, perhaps reflecting the perception that governance reforms can make a difference in financial performance, particularly in light of greater rates of corporate implementation of majority-supported proposals.<sup>71</sup>

The Corporate Library study also found increasing (and majority) support among the sampled funds, across both years, for shareholder “governance” proposals seeking declassified boards, limits on takeover defenses, and greater shareholder voting rights.<sup>72</sup> There was also a surge in support for proposals dealing with board elections (particularly majority voting for directors) from 21% to 60%.<sup>73</sup> At the same time there was markedly less support for proposals dealing with auditor independence and board structure/committees—perhaps because many boards, prompted by Sarbanes-Oxley, have addressed these issues. Thus, the study revealed a “flavor of the year” aspect to fund voting as some topics fall out of grace and others become the new star.

Comparing voting on shareholder proposals for all shareholders (ISS study, 2005) to the voting results for “mainstream” mutual funds (Corporate Library, 2006), mutual funds seem to be more activist than shareholders generally. While shareholders generally voted for shareholder proposals about 44% of the time during the 2003-2005 proxy seasons, the thirty-six mainstream funds voted for shareholder proposals 54% of the time. For example, while overall support for proposals on shareholder voting rights was a bare majority of 52%, mainstream mutual funds (which hold about one-fifth of all U.S. public company shares) gave 60% support to the proposals—thus, representing the margin of victory.

Cook found that larger mutual funds are increasingly abstaining on shareholder “corporate social responsibility” proposals, effectively deferring to other shareholders to decide the issue. Among “mainstream” funds (consisting of a sample of thirty-six fund groups, including the ten largest) votes against CSR proposals have fallen, while abstentions have

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71. An ISS study on corporate implementation of shareholder proposals found more companies redeeming their poison pills, submitting them to shareholder approval, or moderating their features. See INSTITUTIONAL SHAREHOLDER SERVICES, 2005 POSTSEASON REPORT: CORPORATE GOVERNANCE AT A CROSSROADS 5 (2005), <http://www.issproxy.com/pdf/2005PostSeasonReportFINAL.pdf>.

72. See Cook, *Analysis of Fund Voting for 2004-2005*, *supra* note 68, at 6. The study found that proposals dealing with stock option expensing and poison pills continued to receive overwhelming support from “mainstream” funds of between 79% and 86% across the two years. See *id.*

73. The study found that the number of majority voting proposals increased from 12 in 2004 to 57 in 2005, with “mainstream” fund support growing from 0% to 60%. See *id.* at 8.

risen. During the 2003-2008 period, votes against CSR proposals fell by 13% from 85% against in 2003-2004 to 72% against in 2007-2008. During the same period, mainstream funds increased their abstentions on CSR proposals from 10% in 2003-2004 to 16% in 2007-2008.<sup>74</sup>

D. *Governance Role of Mutual Funds: Relationship of Fund Voting and Fund Trading*

The prevailing view, before the SEC proxy voting disclosure rule, was that mutual funds voted with their feet. A fund dissatisfied with management at a portfolio company would simply sell rather than engage in voting activism. The studies make clear that whether this once was true, it is no longer the case. They show that funds first engage in voting activism (that is, voting against management proposals and for shareholder proposals) and then turn to selling only if the activism fails.

Duan examined the relationship between fund trading and voting for the 2003-2004 proxy season.<sup>75</sup> The study looked at voting in seventy-two fund groups (with a total of 769 funds) that cast about 30,000 votes in 308 portfolio companies. The study compared ISS recommendations with management recommendations on sixteen groups of governance-related proposals. The study found that, when ISS recommends against management proposals, mutual funds are more likely to seek to influence management through voting rather than by selling. The study found that mutual funds with a long-term investment horizon “are less likely to exit or vote against management when they should.”<sup>76</sup> Furthermore, “mutual funds are more likely to vote against management rather than support management in poorly governed firms.”<sup>77</sup>

Ashraf and Jayaraman examined the factors influencing fund voting, the incentives for fund activism, and fund trading near the meeting date and release of voting results.<sup>78</sup> Their sample included 216 funds at the top twenty-four fund groups, which resulted in 29,795 votes on shareholder proposals at 528 portfolio companies during the 2003-2004 proxy season. They found that bigger mutual fund families are less activist (vote against shareholder proposals), particularly at companies with higher visibility. Further, funds with larger ownership stakes are less activist, while

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74. For example, support by mainstream funds for climate-related proposals has increased from 11% in 2003-2004 to 17% in 2007-2008. Meanwhile, climate-related proposals have garnered increasing shareholder support, up from 12.5% to 19.4% over the same period.

75. See Duan, *supra* note 60 (examining trading and voting for 2003-2004 proxy season).

76. See *id.* at 15.

77. See *id.*

78. See Rasha Ashraf & Narayanan Jayaraman, *Determinants and Consequences of Proxy Voting by Mutual Funds on Shareholder Proposals 2* (Feb. 2007) (unpublished working paper), available at <http://ssrn.com/abstract=962126> (studying 216 funds that voted proxies, drawn from top ten funds within each fund group, provided fund had at least \$1 billion in total assets).

funds with a longer investment horizon are more activist (vote for shareholder proposals).

Ashraf and Jayaraman determined that mutual funds are more activist in portfolio companies “with higher market dissatisfaction and higher possibilities of improving governance structure.”<sup>79</sup> Mutual funds vote for value-enhancing proposals, such as anti-takeover proposals, but not compensation-related proposals, unless the portfolio company is performing poorly. They found that mutual funds engage in a two-step strategy with low-performing companies. First they vote for shareholder governance proposals, and then they reduce their holdings if they disapprove of management. Mutual funds are more likely to vote for shareholder proposals when they have a long-term investment goal and when they are likely to influence the portfolio company (smaller companies, non-dual stock companies, and companies with higher blockholder ownership). Interestingly, the study finds a correlation between mutual funds with higher levels of support for shareholder proposals and increases in asset flow.

#### E. *Voting by Mutual Fund Industry: Differences Among Fund Groups*

A prevailing assumption has been that different institutional shareholder categories, including mutual funds, tend to each vote as a group. The 2003 voting disclosure rule allowed researchers to look inside the mutual fund industry.

Chou, Ng, and Wang examined the governance structure of fund companies to determine if fund companies with stronger governance structures themselves tend to support wealth-maximizing shareholder and management proposals.<sup>80</sup> They found fund companies with a good governance rating from Morningstar are more likely to vote in favor of ISS-recommended proposals than funds with a bad governance rating, especially when management recommendations are contrary to ISS recommendations.

Rothberg and Lilien in their examination of fund voting in 2003-2004 found variability among five large mutual fund groups with respect to “withhold” votes on company directors. Although the average for withhold votes was 13%, it varied from a high of 27% for Vanguard to a low of 4% for Fidelity. Vanguard, for example, which before the rule had typically rubber-stamped nine of ten management slates, ratified only 29% of the slates in 2003-2004, withholding votes from at least one nominee in 71% of all portfolio companies.<sup>81</sup>

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79. *See id.* at 5.

80. *See* Wen-Hsiu Chou, Lilian Ng & Qinghai Wang, *Do Governance Mechanisms Matter for Mutual Funds?* 1 (Mar. 2007) (unpublished working paper), available at <http://ssrn.com/abstract=972235> (examining government mechanisms and mutual fund voting).

81. *See* David Henry, *Tossing Out the Rubber Stamp Under SEC Pressure, Mutual Funds Are Making Waves in Their Proxy Voting*, BUSINESS WEEK, Nov. 17, 2003, at 124.



A Corporate Library/AFSCME study examined fund voting on pay issues during the 2004-2005 proxy season, finding significant variance among different fund groups.<sup>82</sup>

MUTUAL FUND VOTING ON EXECUTIVE COMPENSATION PROPOSALS					
	MANAGEMENT PROPOSALS	SHAREHOLDER PROPOSALS			
		Cap Severance Pay	Performance-Based Options	Expense Stock Options	All Pay Proposals
FIDELITY	66.5%	3%	0%	5.3%	2.2%
VANGUARD	64.6%	95.2%	0%	100%	23.4%
AMERICAN	86.5%	81.3%	0%	100%	25.4%
T ROWE PRICE	87.6%	92.3%	35.0%	23.1%	28.1%
FRANKLIN TEMPLETON	80.8%	69.2%	67.6%	67.4%	35.3%

Davis and Kim in their examination of the relationship of fund voting and business ties found some fund groups (Fidelity, Vanguard, Putnam, American Funds, Morgan Stanley, and Oppenheimer) vote consistently across funds, while others (T. Rowe Price, AIM/Invesco, Janus, and Franklin) let fund managers vote on their own. Nevertheless, they found that several fund groups did not practice what they preached, comparing their stated voting guidelines with their actual voting on poison pills, golden parachutes, classified boards, and cumulative voting.

F. *Voting Guidelines and the Use of Proxy Advisory Firms: Prevalence Among Mutual Funds*

A joint report by the ICI and the Independent Directors Council describes "best practices" for fund boards charged with voting proxies.<sup>83</sup> Among other things, it explained the role of investment advisers in proxy voting and their duty, when delegated to them, to vote proxies as part of their investment management function. Investment advisers with delegated proxy voting authority are bound by general fiduciary duties and the SEC's regulations to vote proxies in the best interests of the fund and its shareholders.<sup>84</sup> The guidelines mention that proxy voting authority can be delegated to portfolio managers, non-portfolio management personnel, or a proxy voting committee comprised of adviser personnel. "Another approach adopted by some investment advisers is the use of

82. See *Compensation Accomplices*, *supra* note 61, at 16; see also Jennifer Levitz, *Do Mutual Funds Back CEO Pay?*, WALL ST. J., Mar. 28, 2006, at C1.

83. See Investment Company Institute, *Oversight of Fund Proxy Voting* 3-5 (July 2008), [http://www.ici.org/pdf/ppr\\_08\\_proxy\\_voting.pdf](http://www.ici.org/pdf/ppr_08_proxy_voting.pdf) (describing best practices for fund boards).

84. See Macey, *supra* note 19.

unaffiliated third-party proxy voting services.”<sup>85</sup> Besides indicating that the recommendations of proxy advisory firms need not be followed and that proxy voting may be different within the fund group, the guidelines do not specify how proxy advisory recommendations should be used.

Rothberg and Lilien in their examination of voting by the ten largest US mutual fund families during the 2003-2004 proxy season looked at proxy voting policies disclosed in the funds’ SAI. They found that most fund groups (eight of ten) had a proxy committee composed of senior fund managers and independent directors to adopt and revise voting guidelines for the fund group. Further, proxy voting within each fund family was as a block, with only one group permitting fund-level voting decisions.

The study found that on routine matters where the fund family’s guidelines were clear, actual voting occurred at a lower level or was outsourced to an independent proxy advisory firm (often ISS with responsibility to vote proxies and keep all records). As to specific voting topics, the funds showed uniformity in describing their voting policies.<sup>86</sup> As to anti-takeover measures, most fund groups stated a policy to oppose such measures as poison pills, supermajority voting, dual-class stock, and staggered boards. As to board composition, half the fund groups stated a policy for all-independent directors on the compensation, audit, and nominating committees of the board. As for executive compensation, none supported strict caps on executive pay, but most (seven of ten) opposed the re-pricing of stock options, and some (four of ten) had guidelines on how much dilution was acceptable from executive stock grants and option plans (ranging from 1.67% to 15%). As to social/political proposals, none showed interest in the topic, with (four of ten) saying they would vote with management or abstain and others saying they would pass the issue to the ISS.

Jones and Capellas examined the disclosed voting guidelines of the top twenty-five fund groups.<sup>87</sup> They found that more than half of the twenty-five top fund groups reported the use of a proxy voting consultant, with nine disclosing that they use ISS.<sup>88</sup> They also found that use of outside consultants was the most changed proxy voting policy from 2004

85. *See id.*

86. As to conflicts of interest, the study found that some of the fund groups (four of ten) described how the group would deal with conflicts when voting on matters involving portfolio companies that are also fund customers. But a remarkable six of ten failed to address this issue, despite the SEC rule’s mandate.

87. *See* Meredith Jones & Andrea Capellas, “Transparent” Seems Translucent: What Mutual Fund Families are Actually Disclosing About Their Proxy Voting Policies and Procedures 1 (empirical study, on file with Wake Forest Law Review), available at <http://lawreview.law.wfu.edu/documents/working.2008.capellas.jones.pdf> (studying top twenty-five mutual fund families).

88. *See id.* ISS claims to advise “24 of the top 25” and “81 of the top 100” mutual funds, all “25 of the top 25” asset managers, and “17 of the top 25” public pension funds. *Id.*

to 2008. The study concluded, “[t]here is no evidence that any of the fund families communicate amongst each other or that there exists intra-proxy committee communications, and what few similarities there are in voting patterns may be partly explained away by use of the same outside consultants.”<sup>89</sup>

Choi, Fisch, and Kahan examined the consistency of mutual fund voting in uncontested director elections with voting recommendations by proxy advisory firms from 2005 and 2006 at S&P 1500 companies.<sup>90</sup> They studied recommendations by ISS, Proxy Governance, Glass Lewis, and Egan Jones, concluding that ISS has the largest market share and is the most influential. They found substantial differences among the four advisory firms both in recommending “withhold” votes and in the factors affecting their recommendation.

They determined that these differences (and their bases) may not be transparent to the institutions that purchase proxy advisory services. By aggregating information on the voting attitudes of institutional shareholders, the proxy advisory firms (particularly ISS) simply provide institutional clients with a consensus view, potentially undermining the effectiveness of the institutional shareholders’ franchise. They concluded that proxy advisory firms should signal the factors underlying their recommendations, allowing clients to choose firms based on the relevance of these factors to the clients.

### III. DATA DESCRIPTION OF VOTING ON PROXY PROPOSALS

We purchased the data used in this Article from ISS, which routinely compiles this information as part of its services to clients. The data set includes all management and shareholder proposals for public companies in the Russell 3000 disclosed in their 2003-2008 proxy statements (five proxy seasons).<sup>91</sup>

The data set contains the following information about each proposal:

1. A short description of every management or shareholder proposal;

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89. See Jones & Cappelas, *supra* note 87, at 21.

90. See generally Choi, *supra* note 21 (examining consistency of mutual fund voting).

91. Besides limiting its data to companies in the Russell 2000, the ISS does not include data from firms with incomplete filings or data for companies that they believe are incorrect. The ISS informed us that they do not believe that this results in the loss of many observations from the data set. The data set comes from the companies’ Form N-PXs filed from mid-2003 to 2008. The SEC required mutual funds to begin filing N-PX forms in 2004 covering meetings that were held in the second half of 2003 and, as a result, proposals in the first half of 2003 do not have mutual fund voting results. For this reason, our dataset with company and mutual fund voting data begins in July of 2003.

2. The type of proposal categorized using ISS's system for such categories (e.g. Management routine business, Management director, Capitalization, Merger or reorganization, Management Non-salary Compensation, Anti-takeover, Shareholder routine business, Shareholder director, Shareholder governance, Shareholder social proposal, Shareholder compensation, and Shareholder health or environmental);
3. Whether management and/or ISS supported the proposal;
4. The minimum proportion of votes that were needed for passage of the proposal;
5. The method used by the company in calculating the proportion of votes in favor of the proposal. Here the numerator is always the number of votes in favor of the proposal. The denominator is either: (A) the number of shares cast in favor or opposed to the proposal; (B) the number of shares cast in favor of, opposed to, or abstaining to the proposal; or (C) the number of shares outstanding. There are variations in the way that companies compile the percentages of votes in favor that reflect differences in state law, corporate bylaws and charters, and other factors;
6. Whether the proposal passed; and
7. The shareholder votes in favor of the proposal, against the proposal, abstaining from voting, and the number of shares that did not vote. For mutual funds, the data only reflect the number of funds that vote in a particular direction and are not weighted by the size of the funds' holdings in any company.

There are several important caveats that need to be mentioned with respect to this data. First, we use the proposal categories that ISS attaches to the proposals for our analysis. These categories will aggregate proposals concerning similar issues, but the proposals themselves may be seeking very different things. For example, shareholder-sponsored compensation proposals may ask for a report on compensation, or seek to tie compensation to performance, or request a shareholder vote on compensation. Each of these proposals may receive very different levels of support, yet we treat them (and ISS treats them) as a single category.

Second, the ISS data do not asset weight the mutual fund voting data. This means that large funds and small funds are treated as equally important in this part of the data. This could create some biases in our analysis. For example, if large funds are much more likely to vote consistently with ISS recommendations than small funds, we will be less likely to detect this using the ISS data. We should note that mutual funds are not required to disclose the number of shares that they vote in favor of a proposal so there is no practical way to correct for this potential bias.

Third, we use the ISS vote recommendation data that ISS provides us. This data, however only reflects their general recommendations. Some ISS clients receive custom recommendations that are specifically tailored to their policies or portfolio. We do not have information about these types of recommendations because they are not publicly available. Without it, we cannot correct for potential biases in our recommendation variable.

Finally, ISS talks with its clients about how they want to vote on different types of proposals. As a result, ISS's voting recommendations reflect both its independent assessment of the merits of these proposals as well as its understanding of its clients' voting preferences. In other words, ISS takes into account its clients' voting preferences in determining what recommendation it will issue. We cannot observe this process nor determine how important it is in the final ISS recommendation data that we have. If client preferences, however, are an important influence on ISS's voting recommendations, what we may be observing is not ISS voting recommendations influencing shareholder and mutual fund voting, but rather the reverse. Again, we cannot correct for this problem given the data that we have available to us.

#### IV. UNI-VARIATE ANALYSIS OF VOTING ON PROXY PROPOSALS

To better understand the role of ISS voting recommendations, we unpack their effects on the different types of proposals. We look at voting by all shareholders (actual votes) on proxy proposals during the 2003-2008 proxy seasons and voting by mutual funds (voting decisions) on the same proposals according to whether voting was consistent with management and ISS recommendations. Obviously this greatly simplifies the factors that influence shareholders in general, and mutual funds in particular, in voting their shares.<sup>92</sup> We believe, however, and industry sources confirm, that management and ISS voting recommendations are the *most* important factors that influence how shareholders and mutual funds vote, so we think that our assumption is (as a first approximation) a reasonable one.

We structure our analysis in two stages: first, we describe the data and calculate some univariate voting statistics for several important categories of proposals; and second, we conclude with a multi-variate regression analysis of the determinants of mutual fund voting.

##### A. *Descriptive Statistics*

###### 1. *Broad Comparison of Shareholder and Mutual Fund Voting*

We begin by examining the overall voting patterns on all types of proposals brought before shareholders' meetings. We partition the data in

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92. For example, individual mutual funds may have voting policies that determine how they vote their shares irrespective of management and ISS' recommendations. There are also several additional third party voting advisors besides ISS, whose voting recommendations may differ from ISS and influence shareholders.

this initial cut to compare voting by shareholders and mutual funds on the broad categories of management proposals and shareholder proposals. Each cell in the table reports the percentage of votes cast “for” the proposal being voted on. The units of measurement differ, however, in the two rows so there are some differences in interpretation between them.

Beginning with the first row of Table 1, the units of measurement for the “All Shareholders” category are the total number of proposals that were voted on by the shareholders of the company. Thus, a total of 92,215 proposals of all kinds are included in our data set. Moving across the top row of the data, we see that there are many more management proposals (89,350) voted on than there are shareholder proposals (2,865) and that management proposals on average receive a much greater percentage of “for” votes (93.9% in favor) than shareholder proposals (27.7% in favor). This wide difference in the number of votes in favor reflects a broad variety of differences between the natures of the two groups of proposals, including the routine nature of many management proposals such as the election of directors in uncontested elections (69,908 proposals).

In the second row of Table 1, we record the percentage of times in which each individual mutual fund within a family of mutual funds voted “for” proposals of that specific type—thus, showing “voting decisions” rather than actual votes cast. The units of measurement reported are the total number of times that individual mutual funds voted on any proposal. For example, if individual mutual fund A held stock in Company B, and there were five proposals on Company B’s ballot in 2005, then we would count individual mutual fund A as having voted five times at Company B in 2005. If individual mutual fund A voted in favor of four of these proposals and against one, then its percentage of votes “for” would be 80%. We further subdivide these votes under the management and shareholder proposal columns. It is important to note that these observations are by individual fund and are not weighted by the number of shares held by each fund. While it would be preferable to weight the funds by their holdings, we do not have accurate data on the number of shares held (and voted) by each fund as the SEC does not require the funds to disclose this information.

Bearing in mind that this second row is reporting the percentage of the time a mutual fund voted in favor of a proposal, and not reporting by the number of shares voted by each mutual fund on each proposal, we can interpret the statistics that are in that row: on average, mutual funds decided to vote in favor of all proposals 86.5% of the time that they voted on a proposal. As with the “All Shareholders” category, however, mutual funds voted in favor of management proposals with greater frequency (91.8% of the time) than for shareholder proposals (30.5% of the time).

TABLE 1—VOTING DESCRIPTIVE STATISTICS; PERCENTAGE “FOR” PROPOSAL

	All Proposals	Management Proposals	Shareholder Proposals
All Shareholders (# Proposals Voted on)	91.8% 92,215	93.9% 89,350	27.7% 2,865
Mutual Funds (# Times Funds Voted on Proposals)	86.5% 11,158,140	91.8% 10,200,213	30.5% 957,927

Two general points to take away from this table are: (1) there are many more management proposals than shareholder proposals (over thirty times as many); and (2) management proposals on average attract much stronger shareholder support than shareholder proposals. Conversely, it does appear that mutual funds are slightly less likely to support management and somewhat more likely to support shareholder proposals than shareholders generally.<sup>93</sup>

## 2. All Proposals: Effects of Management and ISS Recommendations

We next turn to a comparison of shareholder and mutual fund voting on management and shareholder proposals, and the effect of management and ISS recommendations. The data reveal large variations depending on the nature of the proposal. In Table 2 we look at the importance of management and ISS recommendations on voting outcomes for proposals, which are identical in both the shareholders voting data and the mutual fund voting data. Panel A provides the data on all proposals, while Panel B focuses on management proposals only, and Panel C looks solely at shareholder proposals. In each panel, we report two different sets of figures: the first two rows show the percentage of all shareholder votes cast in favor of the proposal (labeled “All Shareholders”), while the third and fourth rows show the percentage of mutual funds that voted in favor of the proposal (labeled “Mutual Funds”).

Turning first to Table 2, Panel A, we see a large difference in voting support when management makes a voting recommendation contrary to the recommendation by ISS. Reading across the top row, for all shareholders, the effect of management’s negative recommendation on a proposal supported by ISS is accompanied by a reduction of the “for” vote percentage by 52.8%.<sup>94</sup> Similarly, looking across row two, when manage-

93. One explanation for the greater activism of mutual funds compared to shareholders generally is that “all shareholders” includes insiders (directors, officers and family members), who in many public companies hold a significant proportion of outstanding shares. Insiders predictably vote more frequently with management.

94. This difference is significant with a p-value of less than 0.01.

ment changes its recommendation from “for” to “against” on a proposal not supported by ISS, the “for” vote by shareholders is reduced by 57.3%.<sup>95</sup> Similar, though less pronounced, effects are seen for mutual funds’ voting—negative management recommendations are associated with higher negative votes by funds.

If we shift our perspective to look at the effect of an ISS voting recommendation, we need to look down the first two columns. From column 1, we see that with a proposal that management recommends to shareholders, a negative ISS recommendation seems to reduce the number of all shareholder “for” votes by 28.8%.<sup>96</sup> Column 2 illustrates that when management is opposed to a proposal, a negative ISS recommendation appears to lead to another 33.3% drop in all shareholder voting support.<sup>97</sup> These effects are substantially stronger for mutual fund voting: when management recommends a proposal but ISS does not, mutual fund support drops 63.8%; and when management does not support a proposal, and ISS moves to a negative recommendation, mutual fund support falls 53.1%.<sup>98</sup> This indicates that ISS’s voting recommendations appear to have an especially big effect on mutual fund support, even stronger than management recommendations.

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95. This difference is significant with a p-value of less than 0.01.

96. This difference is significant with a p-value of less than 0.01.

97. This difference is significant with a p-value of less than 0.01.

98. These differences are significant with p-values of less than 0.01.



TABLE 2: EFFECT OF ISS VOTING RECOMMENDATIONS ON SHAREHOLDER AND MUTUAL FUND VOTING<sup>99</sup>  
TABLE 2, PANEL A—ALL PROPOSALS; PERCENTAGE “FOR” PROPOSAL

	Management For Recommendation	Management Against Recommendation	Net Effect of Change of Mgt Recommendation	Other Management Recommendation	Totals
All Shareholders: ISS For Recommendation	95.50% 78,329	42.70% 1,499	-52.80%***	72.90% 26	94.50% 79,854
All Shareholders: ISS Against Recommendation	66.70% 1,781	9.40% 1,317	-57.30%***	37.70% 4	42.30% 3,102
Net Effect of Change of ISS Recommendation	-28.8%***	-33.3%***		-35.2%***	-52.2%***
Mutual Funds: ISS For Recommendation	95.50% 9,442,783	57.30% 463,418	-38.20%***	80.40% 3,930	93.70% 9,910,131
Mutual Funds: ISS Against Recommendation	31.70% 138,024	4.20% 484,624	-27.50%***	7.90% 378	10.30% 623,026
Net Effect of Change of ISS Recommendation	-63.8%***	-53.1%***		-72.5%***	-83.4%***

\*\*\*The p-value is significant at less than 0.01 level of significance.

99. In Tables 2 through 4, for ease of exposition, we have deleted information about ISS withhold recommendations and other ISS recommendations. We recognize that ISS issues a variety of recommendations besides those contained in Tables but we wish to focus the reader's attention on the most significant categories. The omitted observations are relatively small in number compared to those included in the tables.

In Panel B, we focus exclusively on management proposals to see if that affects the patterns observed above. Beginning with the all shareholder voting data, there are two things to note: (1) ISS issues relatively few negative recommendations on management proposals, only 1,775 out of 89,758 total management proposals or less than 2%; (2) for all shareholders, a negative ISS recommendation is associated with a 28.7% decrease in voting support for a management proposal that is supported by management, and there are almost no management proposals that are not supported by management. For mutual funds, the effect of a negative ISS recommendation seems much larger with a 63.8% drop<sup>100</sup> in the number of funds voting in favor of a proposal that management supports when ISS does not. Thus, it appears that for the small minority of management proposals that ISS opposes, its negative recommendation correlates with mutual fund voting.

Finally, in Panel C, we examine only shareholder proposals. Management opposes the vast majority of shareholder proposals (97.9%), which may reflect the fact that it can adopt any shareholder proposal that it wants to accept without the necessity of a shareholder vote. Thus, privately negotiated compromises, or adoptions, may account for a substantial number of proposals that never go to a shareholder vote.<sup>101</sup> For all shareholders, of those proposals that do get voted on where management states its opposition, a positive ISS recommendation is associated with an additional 33.3% “for” votes.<sup>102</sup> This effect is even more pronounced with mutual funds, as a positive ISS recommendation appears to increase by 53.1%<sup>103</sup> the number of mutual funds voting in favor of the shareholder proposal.<sup>104</sup>

Taking panels A, B, and C of Table 2 together, it appears that a switch from a negative to a positive ISS recommendation has a substantial correlation with on the proportion of “for” votes that are cast by all sharehold-

100. This difference is significant at the 0.01 level of significance.

101. One interesting question is why there are ever any shareholder proposals that management recommends in favor of.

102. This increase is significant at the 0.01 level of significance.

103. This increase is significant at the 0.01 level of significance.

104. There is, of course, a potential selection bias in our data. It is possible that shareholder proposals that go to a vote (those in our sample) are those that shareholder proponents believe have a chance of success, despite management opposition. Perhaps those shareholder proposals for which management opposition would doom the proposal are not submitted in the first place.

The history of shareholder proposals, however, belies this selection story. Shareholder proponents often submit proposals in the face of unified management opposition and widespread shareholder indifference. Over time, some proposals gain strength—such as those calling for director majority voting—while other proposals lose strength—such as those calling for the separation of the chair/CEO positions. And some proposals on social policy topics are resubmitted, despite consistently weak support. Because submitting a shareholder proposal is essentially cost-free, both financially and from a reputational standpoint, there is little reason to believe that only shareholder proposals that proponents believe have a strong chance of garnering significant shareholder support are submitted.

TABLE 2, PANEL B—MANAGEMENT PROPOSALS; PERCENTAGE “FOR” PROPOSAL

	Management For Recommendation	Management Against Recommendation	Net Effect of Change of Mgt Recommendation	No Recommendation	Average
All Shareholders: ISS For Recommendation	95.50% 78,298	48.50% 6	-47.00%***	84.50% 12	95.50% 78,316
All Shareholders: ISS Against Recommendation	66.80% 1,775	41.30% 3	-25.50%*	0% 0	66.80% 1,778
Net Effect of Change in ISS recommendation	-28.7%***	-7.2%^		N/A	-28.7%***
Mutual Funds: ISS For Recommendation	95.50% 9,438,004	89.10% 768	-6.40%***	79.80% 1,224	95.50% 9,439,996
Mutual Funds: ISS Against Recommendation	31.70% 137,968	0% 0	-31.70% N/A	0% 0	31.70% 137,968
Effect of ISS Recommendation	-63.8%*	N/A		N/A	-63.8%*

\*\*\*The p-value is significant at the 0.01 level.

\*The p-value is significant at the 0.1 level.

^The p-value is insignificant.

TABLE 2, PANEL C—ALL SHAREHOLDER PROPOSALS; PERCENTAGE “FOR” PROPOSAL

	Management For Recommendation	Management Against Recommendation	Net Effect of Change of Mgt Recommendation	No. Recommendation	Average
All Shareholders: ISS For Recommendation	76.10% 31	42.60% 1,493	-33.50%***	63.10% 14	43.50% 1,538
All Shareholders: ISS Against Recommendation	25.20% 6	9.30% 1,314	-15.90% <sup>^</sup> None	37.70% 4	9.50% 1,324
Net Effect of Change of ISS Recommendation	-50.9%***	-33.3%***		-25.4% <sup>^</sup>	-34.0%***
Mutual Funds: ISS For Recommendation	83.80% 4,779	57.30% 462,650	-26.50%***	80.70% 2,706	57.60% 470,135
Mutual Funds: ISS Against Recommendation	21.40% 56	4.20% 484,624	-17.20%***	7.90% 378	4.20% 485,058
Net Effect of Change of ISS Recommendation	-62.4%***	-53.1%***		-72.8%***	-53.4%***

\*\*\*The p-value is significant at the 0.01 level.

<sup>^</sup>The p-value is insignificant.

ers for a proposal of any type, ranging from a low of 28.7% to a high of 33.3%. These effects are even more pronounced with mutual funds. This effect is remarkably consistent across the different permutations of proposal type and management recommendation type. We also note that management almost always recommends for management proposals and against shareholder proposals, so that the large apparent effect of a management recommendation we saw in Panel A that includes all proposals, almost completely disappears once we break the data into separate management and shareholder categories.

Finally, in Panel D of Table 2, we look at management proposals but without all “routine” proposals that relate to uncontested elections of directors, motions to adjourn the meeting, and votes to ratify the appointment of the company’s auditors. We exclude these types of votes because they are events where shareholders are being asked to rubberstamp management’s actions, and not to make significant choices. We are interested to see if excluding them from the analysis will reveal any important differences in shareholder voting patterns and the effects of management and ISS voting recommendations. For all shareholders, we see a 12.5% drop in support for management proposals that are supported by both ISS and management but with support levels remaining comfortably above the required levels for the approval of the proposal. In all other categories of “All Shareholder” voting, there seems to be little difference. For mutual fund voting, we also see a 5.9% drop in support for management proposals that are supported by both ISS and management, as well as a 1.6% drop in support for those proposals supported by management but not by ISS. Although these changes do not alter whether mutual fund support falls above or below the required levels for approval of the proposal, they reflect lower overall support by mutual funds for non-routine management proposals.

### 3. *Board Declassification Proposals: Effects of Management and ISS Recommendations*

We next look at voting on the proposal categories that received the most submissions during the 2003-2008 proxy seasons, thus to see how subject matter affects the importance of management and ISS recommendations. The first two categories deal with corporate governance proposals submitted both by management and by shareholders: proposals to declassify the board (Table 3) and proposals to have a majority vote in board elections (Table 4). The second two categories deal with reform proposals submitted only by shareholders: proposals to submit rights plans to shareholder vote (Table 5, Panel A) and proposals to separate chair and CEO positions (Table 5, Panel B).

We begin with board declassification proposals. Table 3, Panel A presents data on management (binding) proposals to declassify and Panel B looks at shareholder (precatory) de-staggering proposals. In all panels,

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TABLE 2, PANEL D – NON-ROUTINE MANAGEMENT PROPOSALS (WITHOUT ELECTION OF DIRECTOR, ADJOURN MEETING, AND RATIFY AUDITOR PROPOSALS); PERCENTAGE “FOR” PROPOSAL

	Management For Recommendation	Management Against Recommendation	Net Effect of Change of Mgt Recommendation	No Recommendation	Average
All Shareholders:	83.00%	48.50%	-34.50%***	74.40%	82.90%
ISS For Recommendation	7,949	6		7	7,962
All Shareholders: ISS Against Recommendation	65.20% 1,513	41.30% 3	-23.90%*	0% 0	65.10% 1,516
Net Effect of Change of ISS Recommendation	-17.8%***	-7.2%***			-27.8%***
Mutual Funds: ISS For Recommendation	89.60% 989,195	89.10% 768	-0.50%***	71% 1,311	89.60% 991,274
Mutual Funds: ISS Against Recommendation	28.20% 107,128	0% 0	-28.20% N/A	0% 0	28.20% 107,128
Net Effect of Change of ISS Recommendation	-61.4%***	N/A		N/A	-61.4%***

\*\*\*The p-value is significant at the 0.01 level.

\*The p-value is significant at the 0.1 level.

we see that board declassification proposals attract more than 50% “for” votes and therefore on average cross the necessary percentage threshold to be considered “passed.”

The first thing to note is that ISS virtually always recommends in favor of declassification. In only two out of 422 proposals did ISS recommend voting against one of these proposals. This means that the only variation is what type of recommendation management issues. As we see in Panels A and B, there is very little variation—management almost uniformly recommends in favor of its own proposals, and against shareholder proposals. For all shareholders, while we see that a management against recommendation on a management proposal has a strong adverse effect (33.3% reduction) on the “for” vote, there are only four instances where this occurs. Similarly, for all shareholders voting on shareholder proposals, management only recommends in favor of a declassification proposal eight times, so the relatively weak effect of this recommendation on “for” votes (18.6% decline) is not widespread enough to make a large effect overall. Mutual fund voting on board declassification proposals is almost universally in favor of them: 97.2% on average support management proposals to declassify the board, while 87.4% support shareholder proposals to declassify (with the exception being when ISS recommends (very rarely) against the proposal).

#### 4. *Proposals on Director Majority Elections: Effects of Management and ISS Recommendations*

Next, we look at proposals that would require directors to receive a majority of the votes cast at an annual meeting of directors to be elected to the board (“majority vote” proposals). Table 4 is divided into two panels: Panel A is for management majority vote proposals, while Panel B reflects shareholder majority vote proposals. In Panel A, the first column shows management always recommends that shareholders vote for these proposals, while an ISS “for” recommendation on a management proposal increases by 20% the number of all shareholder votes cast in favor of the proposal. For mutual funds, a negative ISS recommendation has a very strong effect—60.3% lower than with a positive ISS recommendation—well below what would be needed for passage.<sup>105</sup>

Panel B shows that management virtually always recommends a negative vote on shareholders proposals for a majority vote requirement, whereas ISS is just as consistent in issuing a positive voting recommendation. The most remarkable feature of the data in this panel is that for the vast bulk of the proposals, those where management recommends against the proposal and ISS recommends in favor of it, mutual funds exhibit substantially higher support levels than the general shareholder body.

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105. The p-value for this difference is significant at the 0.01 level.

TABLE 3—EFFECT OF ISS ON BOARD DECLASSIFICATION VOTES  
 TABLE 3, PANEL A—MANAGEMENT PROPOSALS TO DECLASSIFY THE BOARD; PERCENTAGE “FOR” PROPOSAL

	Management For Recommendation	Management Against Recommendation	Net Effect of Change of Mgt Recommendation	No. Recommendation	Average
All Shareholders: ISS For Recommendation	86.60% 209	53.30% 4	-33.30%***	67.50% 4	85.70% 217
All Shareholders: ISS Against Recommendation	0% 0	0% 0	0.00% N/A	0% 0	0% 0
Net Effect of Change of ISS Recommendation	N/A	N/A		N/A	N/A
Mutual Funds: ISS For Recommendation	97.40% 41,838	89.10% 768	-8.30%***	95.50% 745	97.20% 43,351
Mutual Funds: ISS Against Recommendation	0% 0	0% 0	0.00% N/A	0% 0	0% 0
Net Effect of Change of ISS Recommendation	N/A	N/A		N/A	N/A

\*\*\*The p-value is significant at the 0.01 level.



TABLE 3, PANEL B—SHAREHOLDER PROPOSALS TO DECLASSIFY THE BOARD; PERCENTAGE “FOR” PROPOSAL

	Management For Recommendation	Management Against Recommendation	Net Effect of Change of Mgt Recommendation	No Recommendation	Average
All Shareholders: ISS For Recommendation	79.10% 8	60.50% 189	-18.60%***	75.60% 6	61.70% 203
All Shareholders: ISS Against Recommendation	0% 0	20.60% 2	20.60% N/A	0% 0	20.60% 2
Net Effect of Change of ISS Recommendation	N/A	-39.9%^		N/A	-41.1%^
Mutual Funds: ISS For Recommendation	91.30% 776	87.10% 37,031	-4.20%***	91.70% 1,249	87.40% 39,056
Mutual Funds: ISS Against Recommendation	0% 0	24.80% 362	24.80% N/A	0% 0	24.80% 362
Net Effect of Change of ISS Recommendation	N/A	-62.3%***		N/A	-62.6%***

\*\*\*The p-value is significant at the 0.01 level.

^The p-value is insignificant.

TABLE 4—EFFECT OF ISS ON MAJORITY VOTE PROPOSALS  
 TABLE 4, PANEL A—MANAGEMENT PROPOSALS TO REQUIRE MAJORITY VOTE FOR ELECTION  
 OF DIRECTORS; PERCENTAGE “FOR” PROPOSAL.

	Management For Recommendation	Management Against Recommendation	Net Effect of Change of Mgt Recommendation	No Recommendation	Average
All Shareholders: ISS For Recommendation	87.70% 47	0% 0	-87.70% N/A	0% 0	87.70% 47
All Shareholders: ISS Against Recommendation	67.70% 10	0% 0	-67.70% N/A	0% 0	67.70% 10
Net Effect of Change of ISS Recommendation	-20.0%^	N/A		N/A	-20.0%^
Mutual Funds: ISS For Recommendation	95.10% 11,811	0% 0	-95.10% N/A	0% 0	95.10% 11,811
Mutual Funds: ISS Against Recommendation	34.80% 1,251	0% 0	-34.80% N/A	0% 0	34.80% 1,251
Net Effect of Change of ISS Recommendation	-60.3%***	N/A		N/A	-60.3%***

\*\*\*The p-value is significant at the 0.01 level of significance.

^The p-value is insignificant.

TABLE 4, PANEL B—SHAREHOLDER PROPOSALS TO REQUIRE MAJORITY VOTE FOR ELECTION OF DIRECTORS; PERCENTAGE “FOR” PROPOSAL

	Management For Recommendation	Management Against Recommendation	Net Effect of Change of Mgt Recommendation	No Recommendation	Average
All Shareholders: ISS For Recommendation	92.50% 3	43.80% 176	-48.70%**	53.70% 2	44.80% 181
All Shareholders: ISS Against Recommendation	0% 0	21.10% 4	21.10% N/A	0% 0	21.10% 4
Net Effect of Change of ISS Recommendation	N/A	-22.7%^		N/A	-23.7%^
Mutual Funds: ISS For Recommendation	88.80% 814	59.60% 66,157	-29.20%***	72.50% 510	60.10% 67,481
Mutual Funds: ISS Against Recommendation	0% 0	16.80% 1,871	16.80% N/A	0% 0	16.80% 1,871
Net Effect of Change of ISS Recommendation	N/A	-40.8%***		N/A	-43.3%***

\*\*\*The p-value is significant at the 0.01 level of significance.

\*\*The p-value is significant at the 0.05 level of significance.

^The p-value is insignificant.

5. *Proposals to Submit Rights Plan to Shareholder Vote and Proposals to Separate CEO-Chair Position: Effects of Management and ISS Recommendations*

In Table 5, we examine two other important types of shareholder proposals: (1) proposals to submit a poison pill to a shareholder vote (Panel A); and (2) proposals to separate the Chairman and CEO positions (Panel B). Institutional shareholders generally consider both to be important corporate governance issues. Furthermore, ISS generally issues voting recommendations in favor of these proposals.

Beginning with Panel A, we note that about 10% of the time, management recommends in favor of submitting the rights plan to a shareholder vote, a surprisingly high number given the board's ability to take such action at any time it wants. Overall, almost all of these shareholder proposals will be deemed "passed." In terms of the effect of an ISS recommendation, when management recommends in favor of the proposal and ISS recommends in favor of the proposal as well, the ISS recommendation is associated with an 18.6% increase in the all shareholders "for" vote as compared to what it would be if ISS recommended against the proposal. If management recommends against the proposal, but ISS recommends in favor, then the increase in the all shareholders "for" vote is 32.3%.<sup>106</sup> For mutual funds, a positive ISS recommendation is associated with extremely high levels of support, between 85% and 90% of all funds. Conversely, a negative ISS recommendation is associated with a dramatic decline in mutual fund support, lowering it to the 15% to 22% level.<sup>107</sup>

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106. This difference is significant at the 0.01 level of significance.

107. These declines are significant at the 0.01 level of significance.

TABLE 5 – EFFECT OF ISS ON SELECTED CORPORATE GOVERNANCE SHAREHOLDER PROPOSALS  
 TABLE 5, PANEL A – SHAREHOLDER PROPOSALS TO SUBMIT SHAREHOLDER RIGHTS PLAN TO A SHAREHOLDER VOTE;  
 PERCENTAGE “FOR” PROPOSAL

	Management For Recommendation	Management Against Recommendation	Net Effect of Change of Mgt Recommendation	No Recommendation	Average
All Shareholders: ISS For Recommendation	78.10% 13	57.70% 139	-20.40%***	53.70% 2	59.60% 154
All Shareholders: ISS Against Recommendation	59.50% 5	25.40% 28	-34.10%*	47.70% 1	31.00% 34
Net Effect of Change of ISS Recommendation	-18.6%^	-32.3%**		-6.0%^	-28.6%***
Mutual Funds: ISS For Recommendation	85.30% 1,743	89.80% 19,639	4.50%***	92.70% 317	89.50% 21,699
Mutual Funds: ISS Against Recommendation	15.30% 176	22.00% 9,694	6.70%***	0% 0	21.90% 9,870
Net Effect of Change of ISS Recommendation	-70.0%***	-67.8%***		N/A	-67.6%***

\*\*\*The p-value is significant at the 0.01 level of significance.

^The p-value is insignificant.

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TABLE 5, PANEL B – SHAREHOLDER PROPOSALS TO SEPARATE CHAIRMAN AND CEO POSITIONS; PERCENTAGE “FOR” PROPOSAL.<sup>108</sup>

	Management For Recommendation	Management Against Recommendation	Net Effect of Change of Mgt Recommendation	No Recommendation	Average
All Shareholders: ISS For Recommendation	83.20% 1	30.80% 113	-52.40%^	0% 0	31.30% 114
All Shareholders: ISS Against Recommendation	0% 0	16.20% 53	16.20% N/A	0% 0	16.20% 53
Net Effect of Change of ISS Recommendation	N/A	-14.6%**		N/A	-15.1%***
Mutual Funds: ISS For Recommendation	96.40% 55	43.90% 40,696	-52.50%***	0% 0	43.90% 40,751
Mutual Funds: ISS Against Recommendation	0% 0	11.60% 21,756	11.60% N/A	0% 0	11.60% 21,756
Net Effect of Change of ISS Recommendation	N/A	-32.3%***		N/A	-32.3%***

\*\*\*The p-value is significant at the 0.01 level of significance.

108. There was only one management-sponsored proposal to separate the Chairman and CEO. All others were shareholder sponsored.

The picture is quite different in Panel B. Proposals to separate the Chairman and CEO positions are much less popular with shareholders. When management recommends against the proposal, as it typically does, then even a positive ISS recommendation does not lead to a majority of all shareholder “for” votes cast in favor of the proposal, although it is associated with a 14.6% increase in the “for” vote total. For mutual funds, ISS seems to be more influential as a shift from a negative to a positive recommendation corresponds to a nearly 32% increase in the vote by the individual mutual funds.<sup>109</sup> Nevertheless, this is not enough to lead to passage of the proposal and relatively small when compared to what we saw for the poison pill and board declassification proposals.

6. *Summary: Effect of ISS Recommendations on Mutual Fund Voting*

To summarize, we see that mutual funds voted consistently with ISS voting recommendations more than all shareholders. Given that we cannot break out the mutual funds’ actual votes from the total vote captured in the all shareholder vote, this effect is likely to be even larger than what we are measuring with the currently available data.

Our univariate analysis, however, does not answer a key underlying question: when does our data indicate that shareholders were voting *inconsistently* with ISS and management recommendations, thus either voting on their own or following someone else’s recommendations? To answer this question, we need to cut the data in a different manner, which we do next.

B. *Disentangling Effect of Management and ISS Recommendations on Mutual Fund Voting*

To identify the extent to which mutual fund voting has been consistent with ISS recommendations, we first compiled a matrix for different categories of proposals (such as majority voting in director elections) that showed management and ISS recommendations on various proposals and how mutual funds had voted on the proposals. The two-by-three matrix, which we created by matching for/against/none recommendations by the ISS with for/against recommendations by management, showed for each cell the number of proposals presented for shareholder vote and the percentage of favorable mutual fund votes on the proposals.

PROPOSAL CATEGORY		Management Management Management		
		For	Against	Other
ISS	For	(A)	(B)	
	Against	(C)	(D)	

109. This increase is statistically significant at the 0.01 level of significance.

Looking at the matrix, we then sought to identify the extent to which mutual fund voting was consistent with management and ISS recommendations. We focused on cells, (A)-(D), where management and the ISS had actually given recommendations on proposals (either “for” or “against”), and disregarded the relatively few cases where management made some other statement about the proposal.

In evaluating these results, we decided it was not enough to simply notice, for example, that in cell (A) mutual fund voting tended to be favorable when both management and ISS were “for” the proposals, because any non-favorable votes in cell (A) indicated funds were voting contrary to both management and ISS recommendations. To capture the extent to which funds were voting consistently with management and ISS recommendations, we looked at all the permutations to identify the proportion of mutual fund voting decisions that were consistent or inconsistent with management and ISS recommendations, breaking down mutual fund voting into four categories:<sup>110</sup>

- (1) Voting that was consistent with *both* management and ISS recommendations—“for” votes in cell (A) and “against” votes in cell (D);
- (2) Voting that was consistent with *only management*, but not ISS, recommendations—“against” votes in cell (B) and “for” votes in cell (C);
- (3) Voting that was consistent with *only ISS*, but not management, recommendations—“for” votes in cell (B) and “against” votes in cell (C); and
- (4) Voting that was consistent with *neither* ISS nor management recommendations (which we have referred to as following one’s “own muse”)—“against” votes in cell (A) and “for” votes in cell (D).

In this way, we identified how often mutual fund voting voted consistently with (1) joint recommendations by management and ISS, (2) management-only recommendations, (3) ISS-only recommendations, and (4) the funds’ “own muse.”

To give an example from Table 2, Panel A, we calculate the percentage of all shareholders voting consistently with both ISS and management recommendation.<sup>111</sup> Using the values in Table 2, Panel A, we take all

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110. We made the assumption that votes by mutual funds that were not “for” a proposal were “against” it, thus treating any abstentions or other equivocal votes as “against” votes. Generally, this reflects the standard corporate law rule that proposals must pass by a simple majority of the shares present at a meeting. Thus, a share that is present but not voted at a meeting effectively operates as an “against” vote on a proposal that must garner majority support.

111. The same procedure is used to calculate each of the four possible combinations of voting behavior.



shareholders voting consistently with ISS and management's recommendation in favor of proposals multiplied by the number of proposals on which they voted in this manner ( $0.955 \times 78,329$  proposals), plus all shareholders voting consistently with ISS and management's recommendation against a proposal, multiplied by the number of proposals on which they voted in this manner ( $(1-0.094) \times 1,317$  proposals), and then divided that sum by the total number of all proposals voted on by shareholders ( $79,854 + 3,102$ ). This fraction equals 0.916 or 91.6%. In other words, 91.6% of all shareholders voted consistently with the joint recommendation of ISS and management for all proposals included in our data set.

The same type of calculation can be done for mutual fund votes. Again using the values in Table 2, Panel A, we can calculate all mutual funds that act in accordance with ISS and management's recommendations in favor of proposals weighted by the number of proposals on which they acted in this manner ( $0.955 \times 9,442,783$  fund votes), plus all mutual funds voting consistently with ISS and management's recommendation against a proposal weighted by the number of proposals they voted on ( $(1-0.042) \times 484,624$  fund votes), divided by the total number of fund votes on all proposals ( $9,910,131 + 623,026$ ). This fraction equals 0.901 or 90.1%, so slightly more than 90% of fund voting decisions were consistent with the joint recommendation of ISS and management for all voting decisions on all proposals.

To give the reader a flavor of the differences between how all shareholders seemed to react to ISS and management recommendations, we provide Table 6, which shows selected values for these statistics on the consistency of shareholder voting with different recommendations. In each row we report results calculated from tables presented earlier.<sup>112</sup> Panel A describes selected data for all shareholders while Panel B gives similar information for mutual fund voting.

There are several interesting results in this panel. First, for the all proposal data, we see that shareholders generally voted consistently with ISS and management recommendations when they agree, but when they disagreed, then all shareholders were most likely not to vote consistently with either one's recommendation. This is also true for non-routine management proposals, where 14.3% of shareholders voted according to their "own muse," rather than vote as recommended by either ISS or management when these two disagreed.

The evidence is more mixed for voting by all shareholders on specific proxy proposals. For the four leading categories of proxy proposals generally, as well as proposals specifically seeking the majority vote for election of directors and to separate Chair and CEO positions, more shareholders

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112. The calculations in each row add to 100%, reflecting that each row captures all the voting permutations—whether consistent with both management and ISS recommendations, management-only recommendations, ISS-only recommendations or neither management nor ISS recommendations.

TABLE 6—EFFECT OF MANAGEMENT AND ISS RECOMMENDATIONS ON VOTING BY ALL SHAREHOLDERS  
 TABLE 6, PANEL A—ALL SHAREHOLDERS; PERCENTAGE OF VOTES CONSISTENT WITH RECOMMENDATION

	ISS and Management Recommendation	Management Only Recommendation	ISS Only Recommendation	Neither Recommendation
Table 2, Panel A: All Proposals	91.6%	2.5%	1.5%	4.4%
Table 2, Panel C: All Shareholder Proposals	42.7%	30.2%	22.5%	4.6%
Table 2, Panel D: All Non-routine Management Proposals	69.7%	10.4%	5.6%	14.3%
Categories of Shareholder Proposals				
Table 3, Panel C: Shareholder Proposals to De-classify the Board	8.0%	35.5%	54.4%	2.1%
Table 5, Panel A: Shareholder Proposals to Submit Rights Plan to Shareholder Vote	16.8%	33.4%	44.4%	5.4%
Table 4, Panel B: Shareholder Proposals to Require Majority Vote of Election of Directors	3.2%	54.1%	42.1%	0.6%
Table 5, Panel B: Shareholder Proposals to Separate Chair and CEO Positions	27.1%	46.8%	20.8%	5.2%

voted consistently with management recommendations than ISS recommendations when the two disagreed. If we examine proxy proposals seeking board declassification and those seeking shareholder votes on poison pills, however, the opposite is true. Interestingly, only a comparatively small percentage of all shareholders followed their “own muse” when voting on these specific proxy proposals.

Overall, when management and the ISS disagreed, management recommendations on non-routine management proposals carried more weight for all shareholders compared to ISS recommendations. The exceptions were for board de-classification and poison pill resolutions. We turn next to the differential impact of these recommendations on mutual fund voting.

As Table 6B makes clear, most mutual fund voting decisions were consistent with management and ISS recommendations when those recommendations were in harmony. But when they disagreed, mutual funds tended to vote more along the lines of the ISS recommendations than the management recommendations. Looking at voting on all shareholder proposals, when management and ISS recommendations conflicted, mutual funds voted more consistently with ISS recommendations (27.8% with ISS, compared to 20.8% with management) than did shareholders generally as we saw in Table 6A (22.5% with ISS, compared to 30.2% with management). And looking at non-routine management proposals, when management and ISS recommendations disagreed, mutual fund voting was more consistent with ISS recommendations than management recommendations (7.1% with ISS, compared to 2.7% with management)—though most often when the two disagreed on these proposals, mutual funds voted according to their “own muse” (9.4% of the time).

The same tendency of mutual funds to vote consistently with ISS recommendations, rather than contrary to management recommendations, also arose for specific categories of shareholder-submitted proxy proposals. When ISS and management recommendations disagreed, mutual funds were generally more likely to vote consistently with ISS recommendations,<sup>113</sup> especially for board declassification proposals and rights plan proposals.

These results suggest that for non-routine management proposals, both shareholders and mutual funds were somewhat skeptical of ISS and management recommendations when they disagreed, and therefore in that situation were more likely not to vote consistently with either recommendation. On the other hand, the results for shareholder proposals indicate that mutual funds (by a 27.8%/20.8%, or approximately 4:3, margin) voted consistently with ISS recommendations when management and ISS recommendations disagreed. The margin of consistency of mutual fund voting with ISS recommendations rose dramatically for proxy

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113. The one exception is shareholder proposals to separate the Chair and the CEO.

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TABLE 6, PANEL B—MUTUAL FUNDS; PERCENTAGE OF VOTING DECISIONS CONSISTENT WITH RECOMMENDATION

	ISS and Management Recommendation	Management Only Recommendation	ISS Only Recommendation	Neither Recommendation
Table 2, Panel A: All Proposals	90.1%	2.3%	3.4%	4.2%
Table 2, Panel C: All Shareholder Proposals	49.2%	20.8%	27.8%	2.2%
Table 2, Panel D: All Management Non-Routine Proposals	80.8%	2.7%	7.1%	9.4%
Categories of Shareholder Proposals				
Table 3, Panel B: Shareholder Proposals to De-classify the Board	2.6%	12.5%	84.5%	0.4%
Table 5, Panel A: Shareholder Proposals to Submit Rights Plan to Shareholder Vote	29.0%	6.5%	56.9%	7.6%
Table 4, Panel A: Shareholder Proposals to Require Majority Vote of Election of Directors	3.3%	38.8%	57.3%	0.6%
Table 5, Panel B: Shareholder Proposals to Separate Chair and CEO Positions	30.9%	36.5%	28.6%	4.0%

proposals to declassify the board (a 7:1 margin) and to require voting on poison pills (a 9:1 margin)—both proposals seeking to reduce impediments to takeovers.

In short, while shareholders generally voted consistently with management recommendations compared to ISS recommendations, the opposite is the case for mutual funds. Voting by mutual funds—both on non-routine management proposals and shareholder proposals—was much more consistent with ISS recommendations than with management recommendations when the two disagreed.

#### V. MULTIVARIATE ANALYSIS OF VOTING ON PROXY PROPOSALS

In this Part, we attempt on a selective basis to unpack the differing effects of management and ISS recommendations on shareholder and non-routine management proposals. To do this, we use a multivariate logistic regression where the dependent variable is a dummy variable that is “one” when the mutual fund voted in favor of the shareholder proposal and “zero” when it voted against the shareholder proposal.

We seek to explain the mutual fund’s vote as a function of six different independent explanatory variables about the type of recommendations made to mutual funds: (1) management supported the proposal (Management Support Proposal); (2) ISS supported the proposal (ISS Support Proposal); (3) Management and ISS Support Proposal; (4) Management and ISS do not support proposal; (5) Management supports proposal and ISS does not support proposal; and (6) ISS supports proposal and management does not support proposal.

In Table 7, we include different configurations of these possibilities in the four separate regressions in Panels A and B below, where the regressions in Panel A are for shareholder proposals only and those in Panel B are for non-routine management proposals only. Given the changes in the recommendation variables used in each equation, the default value for the recommendation varies in them. For example, in the last regression shown, we include variables for ISS supporting the proposal with management opposed, and for management supporting the proposal with ISS opposed. This means that the coefficients on each of these two recommendation variables show whether that particular recommendation variable makes it more (positive coefficient) or less (negative coefficient) likely that a mutual fund will vote in favor of the proposal as compared to all other possible recommendations. The coefficients on the independent variables can therefore be interpreted as indicating a greater (+) or lesser (-) likelihood of a positive vote as compared to management and ISS supporting the proposal, or management and ISS opposing the proposal.

For the shareholder proposals in Panel A, we include as a control variable a dummy variable that is one when the proposal is an anti-takeover proposal and zero otherwise because we hypothesize that shareholders vote in favor of anti-takeover proposals much more frequently than

other types of shareholder proposals. We also include in Panel A an interaction dummy variable for anti-takeover proposals that are only supported by ISS (and not management) for similar reasons.

TABLE 7 MULTIVARIATE LOGISTIC REGRESSION WHERE THE DEPENDENT VARIABLE IS ONE IF THE VOTE IS IN FAVOR OF THE PROPOSAL.

Panel A Shareholder Proposals Only				
	(1)	(2)	(3)	(4)
Intercept	-3.19***	-3.19***	-3.19***	-3.01***
Anti-Takeover Dummy	1.96***	1.96***	1.96***	1.77***
Anti-Takeover ISS Support Interaction Dummy	-0.08***	-0.08***	-0.08***	0.23***
Management and ISS Support Proposal	0.69**			
Management Support Proposal	0.62**		1.29***	
ISS Support Proposal	3.32***	2.71***	3.32***	
Management and ISS Do Not Support Proposal		.62**		
Management Supports Proposal and ISS Does Not Support Proposal				0.43
ISS Supports Proposal and Management Does Not Support Proposal				3.12***
Number of Observations	957,653	957,653	957,653	957,653
Number in Favor of Proposal	292,192	292,192	292,192	292,192
Number Not in Favor	665,461	665,461	665,461	665,461
R Squared	34.1%	34.0%	34.1%	32.0%
Panel B Non-Routine Management Proposals Only				
	(1)	(2)	(3)	(4)
Intercept	-11.47	-11.47	-1.38	2.14***
Management and ISS Support Proposal	-10.22			
Management Support Proposal	10.67	0.46***	0.59***	
ISS Support Proposal	13.16	2.48***	2.94***	
Management and ISS Do Not Support Proposal		10.67		
Management Supports Proposal and ISS Does Not Support Proposal				-2.94***
ISS Supports Proposal and Management Does Not Support Proposal				-0.46***
Number of Observations (x000)	1,107x	1,107x	1,107x	1,107x
Number in Favor of Proposal	182,330	182,330	182,330	182,330
Number Not in Favor	924,998	924,998	924,998	924,998
R Squared	15.2%	15.2%	15.2%	15.1%

\*\*\*, \*\*, and \* represent a test of significance that the parameter estimate is different from zero at the 1%, 5%, and 10% level of significance.

Beginning with Panel A, the most important results are shown in regressions 3 and 4. Regression 3 shows that if we focus solely on the effect

of the recommendation of management, or of ISS, then it appears as if each of them has a significant positive effect on the likelihood of a favorable vote for a shareholder proposal with the coefficient on the ISS Support Proposal variable being almost three times as big as the Management Support Proposal. This does not take into account, however, that in some situations both management and ISS will issue favorable recommendations on a shareholder proposal. Regression 4 focuses on those cases where only management or only ISS makes a favorable recommendation on a shareholder proposal. The results here show that management's recommendation is associated with an insignificant effect on the likelihood of a favorable vote by a mutual fund, whereas ISS's recommendation has a strong and significant positive coefficient. We interpret these findings as showing that ISS's recommendations have the strongest correlations with mutual fund voting on shareholder proposals. The two anti-takeover proposal control variables are highly significant in all of these equations, although the interaction variable, Anti-Takeover ISS Support Interaction Dummy, has a small negative coefficient in three of the equations.

Overall, we interpret our results in Panel A as supporting a claim that mutual funds are more likely to vote consistently with ISS recommendations in favor of shareholder proposals, even when management recommends against the proposal. On the other hand, management's recommendations on shareholder proposals do not have a statistically significant correlation with mutual fund voting when ISS does not also recommend voting in the same way. This is consistent with the conclusion that ISS voting recommendations are more important than management recommendations to mutual funds.

In Panel B, regression 3 shows results for non-routine management proposals. The coefficients on both management and ISS recommendations are positive and significant, indicating that their favorable recommendations both correlate with higher mutual fund votes, although the ISS support coefficient is much larger than that for the management support variable. This is quite similar to the results in Panel A.

Regression 4, however, shows negative and significant coefficients for the variables that indicate only management, or only ISS, have made a favorable recommendation on a non-routine management proposal. One way of interpreting these results is that when ISS and management disagree about a management proposal, the party against the proposal carries the day. This is most apparent in situations where ISS supports a proposal, but management recommends *against its own proposal*. In other words, mutual funds vote against management proposals that management itself rejects, even if ISS recommends the opposite vote. In these relatively rare events, it would seem that management is putting the proposal on the ballot only because of shareholder pressure, and mutual funds are responsive to its wishes. If, however, management recommends in favor of its

proposal and ISS recommends against it, then there is a larger negative effect on mutual fund voting.

Overall, the results in Panel B suggest that for non-routine management proposals, mutual funds vote more consistently with ISS recommendations than with management recommendations, although these results are weaker than the results for voting on shareholder proposals.

## VI. CONCLUSION

Voting data from the last five proxy seasons show that mutual funds voted consistently with ISS recommendations on both management-submitted and shareholder-submitted proposals.<sup>114</sup> By comparison, the data show that all shareholders voted in the same direction as management recommendations, on both non-routine management and shareholder proposals, more often than with ISS recommendations.

While mutual funds sometimes voted on their own—following neither the recommendations of management nor the ISS—they did so less frequently than did shareholders generally.<sup>115</sup> This was true for both non-routine management proposals and for shareholder proposals, as well as all the various shareholder proposal types we studied (the sole exception being proposals to submit rights plans to shareholder vote). Moreover, the data show that all shareholders (which, of course, includes mutual funds) followed neither the recommendations of management nor the ISS at a rate nearly double that of mutual funds.

In looking at voting on particular proposal types, such as proposals to declassify the board, to submit rights plans to shareholder vote, and to require majority voting of directors, mutual funds voted in line with ISS recommendations much more frequently than with contrary management recommendations. (The exception arose with proposals to separate the chair and CEO positions, where mutual funds voted consistently with management recommendations slightly more than ISS recommendations.)

The results of our univariate analysis are confirmed by multivariate testing. We find that although favorable management recommendations seem to carry some weight with mutual funds, favorable ISS recommendations uniformly were more strongly correlated with mutual fund voting patterns. In fact, for shareholder proposals, mutual funds seemed to vote

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114. Selection bias may exist because management can always implement proposed reforms and thus avoid a vote on proposals it favors. Thus, the proposals submitted by shareholders that go to a vote are generally only those opposed by management. This may explain why management recommendations carry less weight than ISS recommendations—on proposals seeking reforms that management has chosen not to implement.

115. It may be that mutual funds that vote differently from both management and ISS recommendations are actually following the advice, or voting consistently with, the recommendations of other proxy advisory firms other than ISS. For example, Glass Lewis has a reputation for being more “anti-management” than the ISS.



consistently with a favorable ISS recommendation more than with an unfavorable management recommendation. We find the same results for non-routine management proposals, with ISS recommendations being more strongly correlated with mutual fund voting than management recommendations.

What accounts for this association between ISS recommendations and mutual fund voting decisions? The voting data do not offer an easy answer. But some potential theories are suggested by the dynamics of mutual fund voting. One explanation may be that mutual funds, which tend to be significant customers of ISS advisory services, believe that ISS is able to identify value-producing voting choices: ISS has earned its pay among these important customers.

Another potential explanation is that ISS methodology for making recommendations tends to anticipate the voting predilections of institutional clients, including mutual funds; ISS recommendations simply reflect what mutual funds are already thinking and planning to do. In addition, mutual funds knowing they must disclose their actual votes may tend to herd, on the theory that only voting outliers can be subject to criticism. That is, ISS serves to organize “proper” voting by mutual funds, whether or not it is value-enhancing or reflects how mutual funds would have voted on their own. We leave for further research the question of identifying which of these theories will most likely be correct.