

## The \$7 Trillion Question: Mutual Funds & Investor Welfare - Mutual Funds & Corporate Governance

Lucien Bebchuk

Timothy Forde

Michael Garland

Henry Hopkins

Follow this and additional works at: <http://digitalcommons.law.umaryland.edu/jbtl>

 Part of the [Banking and Finance Law Commons](#)

---

### Recommended Citation

Lucien Bebchuk, Timothy Forde, Michael Garland, & Henry Hopkins, *The \$7 Trillion Question: Mutual Funds & Investor Welfare - Mutual Funds & Corporate Governance*, 1 J. Bus. & Tech. L. 55 (2006)

Available at: <http://digitalcommons.law.umaryland.edu/jbtl/vol1/iss1/7>

This Conference is brought to you for free and open access by the Academic Journals at DigitalCommons@UM Carey Law. It has been accepted for inclusion in Journal of Business & Technology Law by an authorized editor of DigitalCommons@UM Carey Law. For more information, please contact [smccarty@law.umaryland.edu](mailto:smccarty@law.umaryland.edu).

LUCIAN BEBCHUK, TIMOTHY FORDE, MICHAEL GARLAND, HENRY HOPKINS,  
PATRICK MCGURN, AND JOHN OLSON

## The \$7 Trillion Question: Mutual Funds & Investor Welfare

### MUTUAL FUNDS & CORPORATE GOVERNANCE

RICHARD BOOTH: This first afternoon panel is moderated by John Olson of Gibson Dunn in Washington. The title is "Institutional Investors and Corporate Governance." We are going to talk about what mutual funds can do to help run corporations, why they did not see Enron coming, and the like. John, take it away.

JOHN OLSON: Thank you very much, Richard. It's great to be here. I need to offer a personal disclaimer at the outset. As some of you know, my firm is currently suing the Securities and Exchange Commission [SEC] on behalf of the U.S. Chamber of Commerce (and I am on the briefs and papers), claiming that the SEC exceeded its authority in mandating a nonexecutive chairman and a seventy-five percent majority of independent directors on mutual fund boards. Anything I say here today does not necessarily reflect the views of my colleagues at Gibson, Dunn & Crutcher, and it certainly does not necessarily reflect the views of the Chamber of Commerce. Fortunately, we are going to talk about mutual funds as an engine for affecting corporate governance within investee corporations. I should also disclose, however, that I do work for the Business Roundtable, which has opposed the shareholder-access rule<sup>1</sup> that Jack Bogle was extolling. But that will not stop me from expressing my own views.

Let me introduce my fellow panelists. At my far left is Pat McGurn, who is a very thoughtful and knowledgeable person. He is one of the top folks at Institutional Shareholder Services [ISS] and has been there for a number of years. As you know, ISS is the leading proxy advisory firm. Next to Pat is a Baltimorean, Henry Hopkins of T. Rowe Price. Henry has been with Price for over thirty-two years and currently serves as its chief legal counsel. He brings to this panel the perspective of someone who manages funds and makes voting decisions on behalf of funds. Next to Henry is Lucian Bebchuk, the William J. Friedman and Alicia Townsend Friedman Profes-

---

1. Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities Act Release No. 8818, Exchange Act Release No. 47,304, Investment Company Act Release No. 25,922, 68 Fed. Reg. 6564 (Feb. 7, 2003).

## MUTUAL FUNDS & CORPORATE GOVERNANCE

sor of Law, Economics, and Finance at Harvard Law School. Lucian is a well-known writer on topics of corporate governance and teaches similar subjects at Harvard. On my far right is Tim Forde from the Investment Company Institute [ICI]. Tim is in charge of strategic planning and research at the ICI, and is a good student of what the trends are with respect to the mutual fund industry. He also had a career on Capitol Hill before that and is a well-known person in Washington. Next to Tim is Mike Garland, the corporate transactions coordinator for the AFL-CIO [American Federation of Labor-Congress of Industrial Organizations]. He advises them as to their investments and as to the positions they take on corporate-governance issues.

Our plan of attack for the next few minutes is to start with Mike. He will review the shareholder vote-reporting rule<sup>2</sup> and some research by the AFL-CIO regarding the initial reports by mutual fund complexes on their voting policies and the actual votes they have cast. Then we will turn the program over for a dialogue between Henry Hopkins and Pat McGurn as to how people in the real world actually make voting decisions, how fund managers vote, and how the leading advisory service decides to make advice. What kinds of principles do they apply? What kinds of criteria? What are they looking for, what are they thinking about, and what do they think their effect ought to be? After that we will let Tim make some observations about where the industry is going. Finally, Lucian will share with us some research and writing he has done in the field—what this all means, does good governance really have an effect, and does it make a difference? After that we will open it up to questions and comments from the floor.

This has been a very active year with respect to corporate governance, as you know. It has been active specifically with respect to mutual funds, both as to internal governance and as to the external responsibilities of funds. We now have in place the reporting rule<sup>3</sup> that Mike will discuss, and we are seeing its initial results. That puts mutual fund voting in the sunlight. It is interesting to me that the rule was pushed very, very hard by former SEC Chairman Harvey Pitt against strong opposition even within the Commission and from the industry. I am interested in whether you have any observations as to whether Harvey was right or Harvey was wrong. I happen to be a fan of Harvey's in many ways. He did a lot of things right, because of which we are now seeing the benefits even though he is no longer at the SEC. There is also, of course, a tremendous amount of emphasis being placed on the mutual fund industry because of the various investigations that have been conducted relating to trading practices and the like. And although that does not directly affect the funds as participants in the corporate-governance process, it may have an effect on their credibility as champions of corporate governance, sort of

---

2. Proxy Voting by Investment Advisers, Investment Adviser Act Release No. 2106, 68 Fed. Reg. 6585 (Jan. 31, 2003).

3. *Id.*

## THE \$7 TRILLION QUESTION

“Physician, heal thyself.”<sup>4</sup> The SEC has proposed and, to some extent, adopted a number of reforms. Among those is the rule I just mentioned that is being challenged by the Chamber of Commerce and additional disclosure standards of various kinds.

One of the questions we will want to think about is what kind of regulatory change is going to put the “white hat” back on the mutual fund complexes and the managers of those funds so that they again become credible advocates for good governance for others. One of the problems that CalPERS [California Public Employees’ Retirement System] has had in recent years as a governance advocate is that its own governance credentials are suspect. The *Wall Street Journal*, which is suspicious of anything that changes the natural order of things, as determined by markets, in their view, has run a number of editorials attacking CalPERS for not taking care of its own problems before telling the rest of the world how to discharge responsibilities.<sup>5</sup> Is that a problem for a mutual fund industry under siege, or is part of the solution for the fund industry to act responsibly as an engine of good governance? I think that the shareholder-access rule is probably not going anywhere until after the makeup of the SEC is resolved after the election. Nonetheless, the mere fact that it has been proposed is already affecting behavior.

Mike, let’s talk about a rule that went into effect in August, this vote-reporting rule, and what you think its effect has been.

MICHAEL GARLAND: Thank you, John. I appreciate the opportunity to share the labor movement’s perspective on mutual fund reform. For those of you who do not know, the AFL-CIO is the federation of America’s labor unions, and we represent sixty national and international unions and their membership of thirteen million working women and men. Union members invest both individually and through a variety of benefit plans with over \$5 trillion in assets, including \$400 billion in union-sponsored pension plans. While defined-benefit plans constitute the bulk of these assets, more than six million union members invest in mutual funds, through their defined contribution plans and as individual investors. So both the employment security and the retirement security of our members are very much dependent on the integrity of the capital markets. Our funds are truly long-term investors, particularly the pension funds, because of their actuarial time horizons and because more and more of the pension funds are invested in index funds. They see exercising their rights as owners as the only way to influence long-term corporate performance.

The mission of the Office of Investment, where I work, is to promote the interest of worker beneficiaries in the capital markets by supporting worker fund initiatives to enhance corporate performance and governance and by advocating for effective

---

4. *Luke 4:23* (King James).

5. See, e.g., Editorial, *Calpers and Cronyism*, WALL ST. J., Oct. 18, 2004, at A18, and Editorial, *Conflicted in California*, WALL ST. J., May 11, 2004, at A18.

regulatory reform. One of the most significant reforms we fought for in the face of intense fund industry opposition was the SEC rules adopted in January 2003, which require mutual funds to disclose their proxy votes.<sup>6</sup> We first petitioned the SEC for these rules back in December 2000. In July 2002, after corporate scandals at Enron, WorldCom, and Tyco revealed how unregulated conflicts of interest can compromise the independence of the very people entrusted to protect investors, we again called on the SEC to require mutual funds to disclose their proxy votes.

Where Sarbanes-Oxley<sup>7</sup> sought to rein in the conflicts of interest that compromise the independence of outside auditors and corporate directors, and Eliot Spitzer's global settlement sought to rein in the conflicts that drove investment analysts to issue buy ratings on stocks that they thought were junk, we hoped that the SEC would address the conflict that has led mutual fund companies to use their enormous proxy voting power to act as rubber stamps for corporate management rather than to promote the best interest of their mutual fund shareholders.

Mutual funds own twenty-three percent of U.S. corporate equity, so their proxy votes on such issues as executive pay and board of director accountability can be decisive. While mutual funds have a fiduciary duty to cast these votes in the best interests of investors, they can also have an economic interest in voting with management, even if those votes are not in the interest of their investors. This conflict, as John Bogle described, stems from the mutual fund companies' interest in selling 401(k) management services and other financial services to their portfolio companies, the same companies at which they are voting proxies on behalf of their investors. Fidelity [Investments], for example, earns half its operating income selling fee-based services to corporate America.

The result is that mutual funds have wielded their enormous proxy-voting power to ratify conflicted auditors and reelect entrenched boards of directors. Perhaps the consequences of mutual funds' conflicted voting practices are most apparent, however, in the skyrocketing CEO pay over the past two decades. In 1980, CEO pay stood at about forty-two times the average worker's pay. In 2003, CEO pay reached 301 times the average worker's pay. If you look back about two years ago, it peaked at about 500 times. Thanks to the proxy-voting disclosure rule the SEC adopted in January 2003, mutual fund companies must now do what investment firms that manage private pension plans have long been required to do by the Department of Labor [DOL]: tell their clients how they cast proxy votes on their clients' behalf. The DOL requirement has allowed us to publish the *AFL-CIO Key Votes Survey*<sup>8</sup> every year since 1997. We believe this is the first and only systematic review of how investment managers cast their proxy votes. Last year's issue had over 150 invest-

---

6. 17 C.F.R. §§ 240.14a-101, 275.206(4)-6(b) (2005).

7. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

8. AFL-CIO OFFICE OF INVESTMENT, *AFL-CIO KEY VOTES SURVEY: HOW INVESTMENT MANAGERS VOTED IN THE 2005 PROXY SEASON* (2005), available at <http://www.aflcio.org/proxyvotes>.

## THE \$7 TRILLION QUESTION

ment managers who we surveyed on about two dozen proxy votes. Conspicuously absent, however, have been the mutual fund companies, because they did not have to disclose how they voted.

To mark the first annual release of the mutual fund proxy votes on August 30, as required by the new SEC rule, and to enable investors to evaluate and interpret their fund's voting practices more easily, we prepared a special report evaluating the 2004 proxy votes of the ten largest mutual fund families.<sup>9</sup> Specifically, we looked at how these funds voted when presented with opportunities to curb pay abuses at twelve S&P 500 companies with clearly excessive CEO pay and poor performance. The report includes eight shareholder proposals, covering such issues as options expensing, golden parachutes, and performance-based pay. We also looked at four management proposals seeking approval for excessive pay packages.

JOHN OLSON: Did our friends at T. Rowe Price get a passing grade?

MICHAEL GARLAND: I believe they received a fifty-eight percent.

JOHN OLSON: That's pretty good, huh?

MICHAEL GARLAND: They are actually the AFL-CIO's 401(k) managers. [laughter] We intend to talk to them about that fifty-eight percent at some point. We chose executive compensation as our benchmark because, in the words of billionaire investor Warren Buffett, "The acid test for reform will be CEO compensation."<sup>10</sup> The report, titled *Behind the Curtain*,<sup>11</sup> also highlights business relationships between mutual fund firms and the twelve companies we looked at.

I will quickly summarize some of our findings. The most obvious and, in some ways, surprising finding was the variation we found among the twelve fund families. The scores in the survey range from a high of 100% for American Century [Investments] to a low of twenty percent for Putnam [Investments]. The other eight funds or families are distributed relatively evenly between that twenty percent and 100%.<sup>12</sup> Fidelity, the nation's largest fund family, and the most vocal opponent to proxy-vote disclosure, ranked ninth out of ten with a twenty-five percent score. Fidelity voted against all eight of the shareholder proposals in which shareholders sought to put in place reforms to rein in runaway pay. Fidelity also voted against management on three of the four management plans, however. I think that had to do with some of their guidelines with respect to dilution. Vanguard [Group], the other leading opponent to proxy-vote disclosure ranked second in the survey with a seventy-five-percent score. Vanguard was one of only two mutual fund families that voted against all four management proposals seeking excessive executive compensation.

JOHN OLSON: How do you decide what is excessive, Mike?

---

9. AFL-CIO OFFICE OF INVESTMENT, *BEHIND THE CURTAIN* (2004), available at <http://www.aflcio.org/corporatewatch/capital/upload/BehindtheCurtain.pdf>.

10. BERKSHIRE HATHAWAY INC., 2002 ANNUAL REPORT 18 (2003).

11. See *supra* note 9.

12. *Id.* at 6.

MICHAEL GARLAND: We have picked our companies by collecting research from Institutional Shareholder Services [ISS], an independent proxy-voting service, and Glass Lewis. Glass Lewis, in particular, issues grades for pay performance. The grades pay for performance. So we collected research in advance of some of the most egregious examples cited by these independent proxy-research firms. We wanted to pick firms that were widely held, so we focused only on S&P 500 companies. We wanted to cover a range of issues that shareholder proposals seek to address, including options expensing, performance-based pay, and shareholder approval of golden parachutes. We also included some management proposals seeking shareholder approval for equity-compensation plans. In the report we include a write-up of each company, cite the independent research with respect to why the particular issue the shareholders are voting on was important, and why we believe (and why we believe most shareholders would agree) that there was an opportunity to rein in what was excessive pay de-linked from performance. We were not just going after big pay packages. We wanted to link it to companies where there was high pay despite poor performance. In many cases these are the bottom quartile or bottom quintile of the S&P 500 based on *BusinessWeek* rankings.<sup>13</sup>

One shortcoming of the SEC rule is that it does not require mutual funds to disclose their business relationships with portfolio companies. So in the report we independently researched those relationships and found that, of the 104 proxy-voting decisions actually reported in the survey, twenty-five involved a mutual fund adviser that had a business relationship with the portfolio company. Fidelity maintained the most business relationships (with eight of the twelve companies), followed by Capital Research and Management (which advises the American Funds and had five), and Vanguard (which had four). We believe the widespread conflicts of interest point to the need to enhance the SEC rule to require fund companies to disclose business relationships with portfolio companies. We originally sought that in the rule and were not successful.

There is reason to believe that at least one fund company, in an effort to restore its reputation and establish best practice, may be moving in this direction. Shortly after we released the report in the first week of September, the California treasurer, Phil Angelides, CalPERS, and the California State Teachers' Retirement System [CalSTRS] were in discussions with Putnam Investments. I believe that both CalPERS and CalSTRS had fired Putnam in the wake of scandals at the firm. They were in discussions with Putnam, which was interested in adopting a set of reforms and disclosures that would help better protect mutual fund investors and help Putnam restore its reputation. As a result of issues raised in our report, Putnam, Angelides, CalPERS and CalSTRS issued a joint press release on September 23 reporting that

---

13. Business Week Online S&P 500 Scoreboard, <http://research.businessweek.com/scoreboard.asp> (last visited Apr. 7, 2006).

## THE \$7 TRILLION QUESTION

*Putnam also has agreed to undertake a special review of mutual fund proxy policies and procedures regarding executive compensation, to be completed prior to the 2005 proxy season. Putnam will consider as part of its review the possibility of disclosing potential conflicts of interests at companies with which it has a business relationship.*<sup>14</sup>

The release also notes that Putnam's announced review came in the wake of our study.<sup>15</sup> We hope that this will set a pattern in the industry. Additionally, we will also be including mutual funds in our annual survey that already includes the investment managers of pension funds. I think it is an important start.

JOHN OLSON: Mike, this is a great start for us. Let's now turn the microphone over to Pat McGurn and Henry Hopkins. They are going to talk about how voting decisions are actually made in this new fishbowl environment. Voting policies and voting decisions have to be reported. Public employee and labor union pension funds and others are paying attention to how funds vote, and perhaps even making decisions about who to use as a manager for their retirement plans, based at least in part on the policies fund managers follow in voting shares of investee companies.

PAT MCGURN: I want to give you the 20,000-foot view of corporate-governance activism or corporate-governance and proxy-voting activity by mutual funds. I think it is good to break it down into "before vote disclosure" and "after vote disclosure." I think there is a myth out there that somehow mutual funds were not voting their proxies or were not taking corporate-governance matters seriously before the vote-disclosure rules came into play. I can tell you, based upon twenty years of experience working in this industry, first at IRRC and now at ISS, that mutual funds were some of the initial clients of our services. They came in and got this research, analysis, and in the case of ISS, recommendations, long before a lot of other fiduciaries came into play. It was not until the sudden foisting upon them of fiduciary standards by the SEC, as part of this vote-disclosure package, that they began to take proxy voting seriously.

I think the best way you can give an overall view of mutual fund activism is to use Bob Pozen's words. He wrote a fairly famous new piece in the *Harvard Business Review* a number of years ago where he called mutual funds "The Reluctant Activists."<sup>16</sup> I think the title actually works well when you look at mutual funds as a category of institutional activists, from our experience. By and large, there has been activism by mutual funds, you just haven't seen it in public, for the most part, and you haven't heard about it. It tends to take place behind closed doors, and it tends to have a significant amount of influence.

---

14. Press Release, California State Treasurer Phil Angelides, California Treasurer Angelides, CalPERS, CalSTRS Join CEO of Putnam Investments to Announce Putnam's Commitment to Broad, New Array of Protections and Disclosures for Mutual Fund Investors, Financial Advisors 2 (Sept. 23, 2004), [http://www.treasurer.ca.gov/news/releases/2004/092304\\_putnam.pdf](http://www.treasurer.ca.gov/news/releases/2004/092304_putnam.pdf).

15. *Id.*

16. Robert C. Pozen, *Institutional Investors: The Reluctant Activists*, HARV. BUS. REV. 140 (Jan.–Feb. 1994).



## MUTUAL FUNDS & CORPORATE GOVERNANCE

Here are a couple basic things that have come up in earlier panels but need to be taken into consideration here. Mutual funds do view exit as a corporate-governance strategy by denying capital. Especially if you have a large stake, pulling it out of a company when you do not like the performance can change the governance structure. You may end up costing a CEO's job, or you may cost the company a great deal of marketing as a result of those large shifts in capital. I think that continues today. Although used less than in the past, some of the funds continue to view the Wall Street walk as a way to change behavior, more so than other investors do today. While I think that is changing a little bit, it is still active today.

Mutual funds were the pioneers of what today are called "just vote no" strategies. These are the efforts by institutional investors to withhold voting authority for members of boards of directors. I know mutual fund managers who were using their votes on the board as means of communication of their displeasure, particularly on performance issues, long before the public funds, the labor funds, and the others even thought about doing so. You did not see this coming into public play, first of all, because vote results were not made public before the early '90s when the SEC changed the disclosure rules. Even for the first couple of years when those rules were in play as to vote disclosure, you started seeing some numbers trickling in at companies where there were no active issues or other solicitations going on for "no vote" campaigns. Quite often these were individual managers exercising their right to indicate their displeasure with performance or other issues through their votes on boards of directors. Those votes typically were followed up by behind-the-scenes communications in which the manager and others would use the high levels of access that their stake provided to push for change.

JOHN OLSON: I can remember a situation about twenty years ago when a client of mine saw first hand that kind of activism. The client's CEO got a call from no less than Ned Johnson, the chairman of Fidelity, who said, "We are not very happy with your company's performance. We think you ought to consider a change-of-control transaction. Here are some people you ought to talk to. Let me know when you have retained an investment banker." Lo and behold, within six months the company had been sold at a very substantial premium over market. That was real shareholder activism.

PAT MCGURN: It is the purest form of shareholder activism in that it was based upon trying to improve performance directly; that sort of activism has been going on forever. You do not hear about it because they typically do not run out in the street at that point in time and say, "We were the institution that went after this particular management team or after this particular board." As a result, it is very hard to quantify, and it is impossible, frankly, for people like Lucian to see that going on because you are not going to see it reflected in that activity. They are less likely, and have traditionally been less likely, to support shareholder resolutions on a broad panoply of topics.

## THE \$7 TRILLION QUESTION

I think that has changed in the vote disclosure regime. They have generally been much more likely to support management and, in particular, active mutual fund management. We have heard this refrain for years when we have talked with mutual funds about their guidelines. They tend to make a conscious decision to invest in a company where they like the board, where they like the management, where they like the strategy of the company's following. When they do not like the direction, they tend to sell out of the security and exercise the option to exit. They are much more likely than other institutions to act with the general intention of supporting management because they believe in what they are doing.

To give you some physical descriptions of how they operate, we have more than 1,000 institutional clients today, and a significant number of them are long-term clients as mutual fund complexes. We followed these firms through their evolution, in many instances from being privately owned now to being publicly owned or acquired by larger financial services conglomerates. I can tell you that by and large, their activities and the structures they have in this area have tended to be fairly consistent throughout that evolutionary process, at least as far as we can see it. They tend to be the same in the way that all cars are the same—in other words, they are not. There are certain similarities and activities, but by and large, it is not surprising to see the high level of fluctuation in Mike's study on those votes because that reflects the broader community of what we have seen. Most of them do have proxy committees, but most of these proxy committees typically have been in the investment adviser area. It has been only over the last couple of years that we have seen the mutual fund boards themselves getting much more involved in the process of coming up with what the policies were going to be as far as proxy voting for those funds. I think that is an evolution we are going to see more and more of now that the process has to be disclosed in the public marketplace. I think that has gotten more boards asking about this process.

Individual portfolio managers—read fund managers—are much more participatory in the voting process than a lot of other institutional clients, and in a lot of other areas. Money-management firms, for example, tend to take all the proxy-voting activities and centralize them. Some mutual fund complexes do that as well, but a lot of them still basically maintain different policies that reflect the investment policies at the various firms within their complex. They have traditionally been the institutional group most likely to vote outside their proxy-voting guidelines. They have been more willing, after going through discussions with corporate managements, to end up changing their votes. Where their guidelines would have said they would not support management, they would change to supporting management after those discussions.

I have been involved behind the scenes in a lot of those discussions, and they are not typically driven by anything even close to a conflict of interest. Quite often they were able to get not only additional information, but also further concessions out of corporate managements and out of boards, which gave them a higher degree of

comfort in voting outside their guidelines in supporting management. There is a phenomenon known as "side letters," and these are letters that corporate boards of directors and/or corporate managements, CEOs in particular, provide to these funds. They spell out the reforms they have agreed to make to their stock plans, to their board independence, to other issues, and to their corporate strategy, which they deliver directly to those institutions. Typically those are not made public. We tend to track them indirectly because we know the MOs of various mutual fund complexes, so we can see when their fingers are on a particular reform that a company has adopted. It has been an interesting phenomenon.

That last thing I talked about is gone today; we do not see mutual funds voting outside the four corners of their guidelines anymore. It used to be that they were the most likely to do it. I would say that two or three years from now they are going to be the least likely to do it because of the scrutiny they get if they vote outside their guidelines in this vote-disclosure regime. I think the reluctance side of the activism, because of vote disclosure, is going to be over. There is going to be more pressure on mutual fund complexes to get much more involved in these issues. There is going to be much greater oversight. And I think a marketing element will come into play as well, as to whether they are supporting the interests of the investors and their funds. Some mutual funds, especially some of those involved in the scandals over the last twelve months, appear to be getting much more aggressive in their corporate-governance policies. We have sat down with a number of them and helped them revise their proxy-voting policies that we apply for them quite often by our agency-voting business. They are getting much more aggressive in this vote-disclosure environment than they ever have been before.

JOHN OLSON: One of the services you offer your issuer clients, your company clients, is for them to come in and pay you to analyze their proposal, tell them what kind of support it will get, and whether it meets your guidelines.

PAT MCGURN: Actually, we do not tell them. We just tell them the tools that allow them to figure out whether it is going to pass muster under our guidelines. We do not tell them whether our clients are likely to support it or not.

JOHN OLSON: Do you think we are going to see more consultation, in advance of proposals being made by company managements, with mutual funds that are large investors in the company?

PAT MCGURN: The votes are closer, John, and so we are seeing people going out on road shows in advance of putting a controversial proposal in place. Much more often they test the waters; that is something they can do under the federal proxy rules. I think we are seeing more of it, and we will see more of it in the future. We are also seeing greater numbers of road shows where people have to go out and sell their proposals retail. It is just more difficult getting people to buy off on them at that point.

HENRY HOPKINS: You indicated that there is less overriding of the guidelines adopted by the committees. Presumably that is because they simply do not want to

## THE \$7 TRILLION QUESTION

have to then justify the overriding, because now it is public. One could argue that what is happening is that portfolio managers are being dissuaded from exercising their best judgment because of the ramifications if they were to go against the guidelines; specifically, they would be subject to criticism. That is not necessarily a positive outcome.

**PAT MCGURN:** I think there has been a beneficial effect of the types of mutual fund activism we have seen in the past, the behind-the-scenes activities, the side letters, and so forth. I think the benefits that were provided by those activities are going to dissipate over time. I think it is being replaced, frankly, by simply a greater knowledge in corporate boardrooms that mutual funds are unlikely to vote outside their guidelines. So they have to go out in advance and find out what those policies are, how they are likely to support a program, and design the program up front to meet those concerns.

**JOHN OLSON:** That is certainly what I am seeing in my practice.

**PAT MCGURN:** It is a tradeoff. I think you are right that in some instances. Unfortunately, portfolio managers have been clearly dissuaded from doing things they might have felt were the right things to do because they were concerned that, in hindsight, somebody would look at those votes and say, "Oh, conflict of interest." Look, you run their 401(k) plan, your guidelines said this, you voted that way, and so, it is sad.

**JOHN OLSON:** Let me just ask a question of Henry, both because I want to give him a chance to say some things and also I want to learn this. Henry is the chief legal counsel, the person who coordinates this process for T. Rowe Price. How do you develop your guidelines? Who gets to decide, and how do you make changes from time to time?

**HENRY HOPKINS:** At T. Rowe Price there is a proxy committee. It is composed of a broad cross-section of professionals. It includes a representative of a legal department, Darrell Braman, but its investment personnel established the general policies. We have had this process in place virtually ever since I have been at the firm, which is quite a few years. The committee has evolved and changed over time, but basically it is pretty much the same structure.

**JOHN OLSON:** Is it the same set of guidelines for every fund no matter whether they are a sector fund or a growth fund or a value fund?

**HENRY HOPKINS:** We have basically firm guidelines, which go across the board.

**JOHN OLSON:** Can a manager come in and say, "Gee, those guidelines just don't make sense for my fund because everybody in my industry is doing such and such?"

**HENRY HOPKINS:** Bottom line, we place the full responsibility of voting individual separate accounts and mutual funds on the portfolio manager who is primarily responsible for that fund or account. The buck stops with them, and the reason is that they are responsible for the performance of that fund. Every mutual fund has an advisory committee, which is responsible for the management of that fund as well as the voting of the proxies for all the portfolio companies within that fund's

## MUTUAL FUNDS & CORPORATE GOVERNANCE

list of holdings. That portfolio manager can override and vote contrary to the firm's general policy. But they must document the reasons for their vote, and the committee reviews all such circumstances where a policy has been overridden by the portfolio manager.

JOHN OLSON: Do the folks who provide retirement-plan management services, T. Rowe Price Trust Company, have any role in making these decisions?

HENRY HOPKINS: That is a very important point, which I believe deserves a full airing. A statement was made earlier that mutual funds act as rubber stamps of corporate America. Now, I do not know what basis there is to justify and substantiate such a statement. I think it is a wholly erroneous statement. The facts are very clear: If you analyze every account at T. Rowe Price and virtually every other account at other federal advisers, there is a portfolio manager who is responsible for that account. That person's compensation is going to depend on the performance of the accounts he or she manages. Our portfolio managers certainly do not act as a rubber stamp for anyone, whether it be corporate America or whether it be trying to protect our 401(k) recordkeeping relationship at that firm. The portfolio manager has his or her self-interest at heart. They want to get the best performance out of their fund, and they are going to do everything they can within legal constraints to achieve and earn good performance. There is absolutely no interconnection between our 401(k) business recordkeeping or, for that matter, our investment advisory business, and the voting of portfolio proxies.

It was mentioned earlier that we scored only fifty-eight percent and that we were going to be contacted about, I presume, our low score. Let me make this very clear: We would not entertain any change in our policy because of pressure from a client wanting us to change our policy to conform to their own policy. What you are proposing is exactly what we are worried about, namely, attempts by special interests to influence our investment personnel to change their votes for other than pure investment reasons.

JOHN OLSON: Do you want to respond to Mike?

HENRY HOPKINS: For the fiduciaries of 401(k) plans, as with defined-benefit pension plans, there is a duty to monitor the performance of their investment managers. Proxy votes are considered plan assets. As part of that review, it is appropriate and consistent with their duties to discuss the proxy-voting performance with their investment managers. It is one of the factors that they may take into consideration in evaluating that relationship. I think it is appropriate for the trustees of such funds to talk about that with T. Rowe Price and other managers.

JOHN OLSON: But be careful, because there are fiduciaries all over the place. One of the problems ERISA [Employee Retirement Income Security Act]<sup>17</sup> fiduciaries have is that they have to be careful that they are not using the assets of their pen-

---

17. Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1101-1461 (2000)).

## THE \$7 TRILLION QUESTION

sioners and prospective pensioners to promote a noninvestment agenda. This criticism was made of the campaign against Safeway, which was thought by some commentators to be related to a labor-organizing effort as much as to investment objectives. There are interesting conflicts all over the place. When we talk about a mutual fund complex, when we talk about corporate or union pension funds, there may be conflicts of policy between investment objectives and other objectives.

HENRY HOPKINS: I would like to make another distinction: between clients and shareholders. At T. Rowe Price, ever since I can remember, we have annually provided a full report of our specific voting on all portfolio companies to the price funds. That report is made to the boards. The boards are, in fact, our client, not the funds' shareholders. It is interesting to note that now, through the SEC rule, which we were very much opposed to, we will now have to make the report not only to the board, but also to all shareholders. The stated reason for this new disclosure rule is that, in the SEC's view, shareholders should be able to understand and evaluate a mutual fund's investment advisory voting record in order to determine whether they wish to purchase the fund or to continue as a shareholder. I will say that the interests of shareholders in this area have been and continue to be so minute that you have to question the cost benefit. We have monitored very carefully the inquiries we receive, and they are few and far between.

JOHN OLSON: It might be different for closed-end funds. Does T. Rowe Price manage any closed-end funds?

HENRY HOPKINS: No, we don't.

JOHN OLSON: OK, so if you have an open-end, widely-held liquid fund, I suppose the Wall Street rule really does work: if you do not like what they are doing, you just buy a different fund.

HENRY HOPKINS: I might also say that the fifty-eight-percent score would indicate that Price was not at the level we would want. Nevertheless, suppose I am a shareholder and someone says, "We're going to give you two ratings: One is the investment performance; the other is the voting performance." I think the more important gauge is performance, not your voting record. I can tell you that it is very difficult for most shareholders to fully understand all the intricacies of voting and all the issues. That does not mean that if they want to study our record they should not be allowed to do so. From my perspective, however, I think the disclosure of votes annually has been a very significant and costly exercise, which is not going to attain what the SEC has assumed would be achieved. The fact is that the boards are the ones that should be evaluating the advisers' ability to vote the fund shares. Shareholders are not the governance body for the fund; the board is.

JOHN OLSON: It goes to the theory of what a fund is: Is it an investment, like a business corporation? Or is it really a product produced by a manager, which you can buy and sell and market?

HENRY HOPKINS: You just asked the right question, and I think it is one that has been completely obfuscated during many of the discussions today. When a person

buys a T. Rowe Price fund, are they buying a T. Rowe Price fund or a fund on whose board serve specific independent directors? I believe that there is little question that they are buying the fund because it is managed by T. Rowe Price and do not give any consideration to who the independent directors are. Investors buy our funds and expect T. Rowe Price to manage the product and provide consistent and long-term good performance.

JOHN OLSON: That is really an issue for another day. It is a very interesting issue to me and to the scholars. Does our whole system of 1940 Act<sup>18</sup> regulation make any sense when we are talking about what is really a financial product that competes with various kinds of insurance products and other sorts of retirement products? The '40 Act is there, though, and it says that the fund directors are fiduciaries for the people that buy and sell this product.<sup>19</sup> Have any of your independent fund directors, the fiduciaries for this "product," ever pushed back when they got a report and said, "We don't like this" or "You ought to change that," as far as you can recall?

HENRY HOPKINS: I think we have had very in-depth discussions on various issues. I do not remember an instance where the board decided to instruct us to vote in a manner different than we have. You have to understand that the board has selected the adviser not only to make the investments and to monitor the investments, but also to vote proxies in a manner we deem to be in the best interest of the fund. If directors start second-guessing or overriding the investment adviser, it is self-defeating. I think whenever you get a board, whether it be a board of a school or college that begins to get involved in the daily management of the organization, you have a problem, because the management should be the responsibility of management and not the board. If the board does not feel that management is doing an adequate job, then it may be time for the board to change management, but not take over the management itself. I feel that many of the changes that have taken place recently are, unfortunately, forcing boards into making management decisions to a greater extent than is healthy.

JOHN OLSON: How should these financial products be managed?

PAT MCGURN: I guess the scrutiny of the voting-disclosure voting data has just begun. In demand from, frankly, a lot of our mutual fund clients, we have put together a new product for them where we have databased the N-PX filings.<sup>20</sup> We are aiming toward the top 200 complexes, and we have already got about two million votes in that database—two million distinct votes that have not been cast. The interesting thing about that product is that it has been mutual fund advisers themselves who are buying it, not the boards of the mutual funds. For the first time I think they are looking at this as a competitive issue: What are other funds doing in

---

18. Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (codified at 15 U.S.C. §§ 80a-1-80a-64 (2000)).

19. *Id.* § 80a-35.

20. 17 C.F.R. 274.129 (2005).

## THE \$7 TRILLION QUESTION

this regard? How do we act vis-à-vis that? What is the perception of the marketplace going to be? It is interesting, because people have said we have not had many requests from our own holders for this information. I think the primary users of this information right now are some of the mutual fund management firms themselves, which are benchmarking themselves against peers on that basis for the first time.

HENRY HOPKINS: Can I just give a broad perspective on one issue? When I entered into the mutual fund business in 1972, we generally did not vote the securities of our separate accounts; they were voted by the clients themselves. Subsequently, the Department of Labor and the SEC came out with new pronouncements that said the voting of proxies is part of the investment process. Consequently, advisers were pressured to take over that function. At one time the fund officers voted our fund proxies, not the adviser, but again, that has now been switched to the adviser.

Mutual funds, by and large, have been passive investors. It is not in the interest of the funds and their shareholders for portfolio managers and security analysts to start trying to manage or influence their portfolio companies. When that occurs they lose their objectivity. Losing objectivity leads to bad investment decisions. I think there is a double-edged sword. We have to perform our corporate and shareholder duty to vote proxies, as any good corporate citizen. At the same time, I caution fund groups trying to encourage their portfolio managers to get involved in the management of their portfolio companies, because if they do that, they will not have time to make investment decisions.

JOHN OLSON: If they go too far, they will be business-development companies. [laughter]

TIM FORDE: Michael said something earlier in connection with Henry that I thought was very interesting. He very thoughtfully described the responsibilities that the AFL-CIO has in connection with its relationship with T. Rowe and other investment managers and its defined-benefit plan. I am not a pension lawyer, but as I understand the duties and responsibilities there, I thought that was a highly accurate description of what the various duties and responsibilities are in that relationship. That said, a report from T. Rowe Price or any other investment manager to the Office of Investment at the AFL-CIO or the board or senior management at the AFL-CIO, is very different from a report card issued publicly, with ten self-selected items, and public grades for whether or not major investment managers are taking significant actions in support of their shareholders' interest in progressive governance practices at portfolio companies. Those are, to me, completely different things.

Look at the grading system the AFL-CIO has developed, just look at one particular issue: expensing of stock options. I am a very strong supporter of expensing stock options. I got my head handed to me by John and a number of other people when I was on the Hill in 1994 and 1995 and was on the House side. Along with [Congressman Edward] Markey, [Congressman] John Dingell, and [former SEC



Chairman] Arthur Levitt, we worked hundreds of hours on what we thought was very clever correspondence trying to find a way for the SEC to support the FASB [Financial Accounting Standards Board] and not let them get run over at the time, and it did not work. They did get run over, but that issue came back. I personally feel very strongly about it, and I think it is a wonderful thing. I am very proud that the Investment Company Institute endorsed expensing of stock options two years ago, and we have written very strong follow-up letters after that.

Not every one of our members agrees with that. I say that because the AFL-CIO has listed this as an unarguable proposition. The expensing of stock options is simply not subject to debate. Your position with respect to a shareholder proposal at a particular company is a litmus test: Whatever the percentage is, it will be determined, at least according to this report, on the basis of your view on that issue. I think this is a distressing tendency in Washington that we have seen grow year by year where special-interest groups of every stripe, every place in the political spectrum, are defining their own ways of evaluating political conduct in Washington. Then they are defining the standards and issuing the grades. They are the prosecutor, the judge, and the jury, and then they go and push it out to the media. I do not think this is really ultimately beneficial. I certainly respect and understand the need to simplify complicated issues in a whole range of places in our life, but I do not necessarily think this is a way to do that.

I think Pat gave a compelling description of the year's worth of actions, very quiet actions that not a whole lot of people know about, in which mutual fund companies and leaders were in very prominent positions that protected and advanced shareholder interest. By no means am I saying all mutual fund leaders have done that; I am not saying that there are not fund companies and fund leaders that are not doing as good a job as they could be and should be. I am questioning the standards that are used to reach that determination and the instances in which it is being done.

That said, stepping back, two of the areas in the world of mutual funds that I am most excited about over the long term are corporate governance and market-structure reform (stock exchange trading systems reforms). These are two areas where we might not agree on how we define the issues and the resolution of all of those issues, but they are two extremely important areas where the interests of funds, fund advisers, and their shareholders can and should line up very well. It is an opportunity, either by reducing trading cost and creating more transparent, more efficient, more effective trading systems, or on the corporate-governance side, by supporting and promoting policies that we think have a reasonable probability of producing and adding value to companies in which fund managers choose to invest. Those are marvelous things, they both serve mutual fund shareholder interest tremendously. I think it is a very exciting thing and obviously we have a lot of issues within mutual funds, within the operation and management of mutual funds

## THE \$7 TRILLION QUESTION

and the fund companies that we are focused on right now, but these are exciting possibilities for us in the future.

JOHN OLSON: While you have the floor, Tim, what is the ICI's view of additional regulatory initiatives, additional efforts encouraging activism by mutual funds in this area? Do you think we have enough for now? Do you think the shareholder-access rule is a good idea or a bad idea? Do you have a position on whether more ought to be done?

TIM FORDE: That is a good question. The Institute has expressed support for the shareholder-access rule, although it was modest support. Obviously there is a lot of work that has gone on at the Commission to try to develop a compromise that the business community thinks it could live with. I have not been following that day by day; we have a lot of things going on inside of funds that have kept us busy recently. I do not see, quite frankly, a list of essential regulatory proposals in front of me that I think are necessary in order to strengthen the hands of institutional investors, not now. Since Enron, we have all sorts of accounting proposals. We strongly supported many of them and thought they were marvelous things. We regret that it took Enron and WorldCom and others to produce benefits in one year after being fought for for more than ten. It was a very good thing. I do not see anything immediately on the horizon that I think is the next big battle for us. Obviously you guys have your hands full with [SEC Chairman William H.] Donaldson's proposal, so I guess I will leave it there.

MICHAEL GARLAND: I am not surprised that representatives of the industry that fought the rule are now concerned about people taking the information that is now available and trying to help shareholders interpret it. It would be unfair to say that we are holding ourselves up as judge and jury. We looked at twelve votes. What we did was very transparent. A lot of other groups are going to be looking at these votes as well. Mutual fund shareholders and trustees of funds can interpret the information as they will, so we see this as an important tool.

With respect to the comment earlier about rubber stamps, before the disclosure rule requiring guidelines and votes to be disclosed, we were able to collect guidelines from some mutual fund complexes. Most of those guidelines said, "The fund votes with management in all cases except . . ." and then there were some delineated exceptions. Some were significant, but generally it was embedded in the guidelines that the fund would support management. In addition, since disclosure, you have seen more elaborate guidelines. Funds have to disclose their guidelines, and more importantly, you have seen an upward trend in the votes on proposals; there have been more majority votes. I do think that sunlight has proved to be a disinfectant, and I would hope that other investor groups also will be using this information.

JOHN OLSON: We can go back and forth on this. I suspect that part of Henry's answer would be that what fund managers do is pick good management, and that is why they tend to want to back them; otherwise they ought not to make the investment. But I am not going to give him a chance to say that. [laughter]

## MUTUAL FUNDS & CORPORATE GOVERNANCE

MICHAEL GARLAND: Voting against management on a specific proposal with respect to expensing options or something else is not an indictment of that management. Also, the Wall Street walk (i.e., selling companies with poor management) is not a viable option for many investors, including the many pension funds that invest through low-cost, broadly diversified index funds.

TIM FORDE: I have thought of one thing on the horizon that I think we support. First of all, we are committed to implementing the letter and the spirit of the proxy-vote disclosure rule. We are not fighting it, and we are not resisting it, and we are trying to help our members with it.

I agree with Michael; others are going to do these kinds of things. I think that self-selection is what it is. The GAO recently issued a report saying that proxy-vote disclosure should be extended to other institutional investors.<sup>21</sup> And Senator [Edward M.] Kennedy has picked up on that report and sent it to the Labor Department, I believe, and a couple of others. Our having made peace with where we are and what our members are being required to do, one of our major objections was that we lost confidential voting. We are the only institutional investor now that has lost the value of confidential voting. The AFL-CIO has, in numerous instances, put shareholder proposals on the ballot to get confidential voting.

MICHAEL GARLAND: That is an inaccurate representation of what confidential voting is. Confidential voting is the disclosure of a vote before the meeting.

JOHN OLSON: Well, that will be interesting. There is also a Business Roundtable petition to get the SEC to look at the whole question of how shareholders are communicated through street name holders and the like.

HENRY HOPKINS: Is there anything the Roundtable is not petitioning these days, John? [laughter]

JOHN OLSON: That is the only one I know of that is pending from the Roundtable. Now we are going to hear from someone who has done vigorous academic research in this area. We have the pleasure of having Lucian Bebchuk share some of his conclusions with us.

LUCIAN BEBCHUK: As I see it, when we think about the effect of mutual funds and corporate governance there are two questions. One question is whether they have proper incentives. I think Jack Bogle was quite right today in stressing that we have problems on that front. Michael continued on that line. I think that fundamental reform for corporate governance would have to go in that direction. Taking the existing systems of incentives as given, the question is, Can we improve? Are there any things we can do? What kind of tools do they have when institutional investors do take an interest in how much of an effect they can have on management?

---

21. U.S. GEN. ACCOUNTING OFFICE, PENSION PLANS: ADDITIONAL TRANSPARENCY AND OTHER ACTIONS NEEDED IN CONNECTION WITH PROXY VOTING 14–15, 28–29, 31 (2004).

## THE \$7 TRILLION QUESTION

The institutions are reluctant activists, but sometimes they do vote against management to overcome some tendency they have to go alone. On some issues where they think the position is very clear and the stakes are significant, they do vote systematically against management. What I want to do is to show you some evidence as to how much effect this has.

To start, I think it is time for us to recognize that, as an instrument of corporate governance, the Wall Street rule is far overrated. Why? Because in the basic problems of corporate governance the Wall Street rule cannot really have any effect. Suppose that you have a company where, with good governance, the share price would be \$150. Right now management is underperforming, everybody recognizes it, and the market price is \$100. If a mutual fund sells on the market, takes the Wall Street rule, it is not going to get the \$150. It is unhappy about having \$100 rather than \$150. It can sell on the market to somebody else who will pay \$100, who will have \$100, and it will be passing along the company with, unfortunately, too low a price to somebody else. This would not allow either institutional investors or the corporate economy to capture the extra fifty dollars we could have with better governance. We need something other than the Wall Street rule.

Now, the example I wanted to look at is staggered boards. Why are staggered boards instructive? Because they are an issue about which institutional investors, across the board, have a very clearly registered view.<sup>22</sup> As you know, mutual funds are reluctant to vote with shareholder activists on many precatory resolutions. But one type of precatory resolution that they generally vote—and increasingly vote against incumbents—is staggered boards. For several years now precatory resolutions to repeated staggered boards have been receiving majority support. If you look at the empirical evidence from studies that colleagues and I conducted, you find that staggered boards are associated with a three- to four-percent reduction in firm value, as measured by Tobin's Q.<sup>23</sup> Looking only at hostile bid targets, the presence of a staggered board doubles the likelihood of remaining independent, which turns out to be a very bad thing for shareholders. Shareholders of targets with staggered boards that remain independent suffer very large financial losses compared with the bid price, even if you look two and a half years down the road.

So, we have those resolutions, and we have this clearly registered shareholder support for getting rid of staggered boards, but what is the outcome? Documenting the outcome of precatory resolutions over the 1995 to 2003 period, 136 precatory resolutions passed with majority support to get rid of a staggered board.<sup>24</sup> Of that

---

22. See Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 835, 836, 853–61 (2005). The numbers referred to in the following paragraphs are from Prof. Bebchuk's working version of the article.

23. "Q is equal to the market value of assets divided by the book value of assets." Lucian Bebchuk et al., *What Matters in Corporate Governance?* 16 (Harvard Law School John M. Olin Center for Law, Economics, and Business, Discussion Paper No. 491, 2004), available at [http://www.law.harvard.edu/programs/olin\\_center/papers/pdf/Bebchuk\\_et%20al\\_491.pdf](http://www.law.harvard.edu/programs/olin_center/papers/pdf/Bebchuk_et%20al_491.pdf).

24. See Bebchuk, *supra* note 22, at 853.

number, ninety-five still had a staggered board in place as of fall 2004. Perhaps those were expressions of short-term sentiments and the board was proven correct after a year, as was the case in some circumstances. But if we look at the situations in which there was repeat passage of such resolutions, you see that nineteen out of those twenty-four companies still have a staggered board by 2004. This is true even if you look at companies where resolutions were passed three or more times. At Eastman Kodak, for example, resolutions were passed in 1997, 1998, 1999, and 2000.<sup>25</sup> At this point people give up.

MALE SPEAKER: Sometimes people pay a price, though. I see that Federated Department Stores passed the precatory resolution three times, and they drew in excess of sixty-percent withhold vote for their entire board of directors because a number of institutions conducted a withhold campaign there this year. If the SEC's proxy-access rule were in effect for next proxy season and keyed back to last season, Federated, like Disney, would probably actually do something about it then, too.

LUCIAN BEBCHUK: What we see here is it says nine out of fifteen, so it means that there is some effect.<sup>26</sup>

MALE SPEAKER: They have not changed yet, but as Pat says, they might.

LUCIAN BEBCHUK: Right, it suggests that there is some effect because of the various channels that still exist. I think the numbers here are larger than most people would expect. They are actually larger than we expected when we started putting them together. We did not expect these results in the face of such stable repeated expression of shorter sentiment that exists.

A staggered-board situation is also a good test of the installation of boards based primarily on shareholder desire and sentiment. This afternoon there was discussion of the possibility that there may be some back channels, that there may be some informal shareholder discussions. Sometimes we have shareholders getting their way, not through a precatory resolution being implemented, but by making those informal codes. That does not present a problem for analyzing the staggered-board studies simply because we know all the cases in which companies repealed staggered boards from 1995 to 2003, and there are very few instances. Thus, when we put things together, we see that shareholder votes against staggered boards did not have an effect. It is having a slightly larger effect in 2004 because of the changed climate.

PAT MCGURN: There is a larger picture, though. We have seen more than sixty companies repeal their classified board structures during this year alone. There is a collateral effect you see when companies fear that they are going to get a majority vote; they end up taking action or they fear the possibility that something might trigger ballot access down the line. I think you do have to look at the broader picture a little bit.

---

25. *Id.* at 855.

26. *Id.*

## THE \$7 TRILLION QUESTION

LUCIAN BEBCHUK: After 2003, what I showed you is the full picture. There is a question of whether what is happening is going to suggest a complete sea change. Until 2003, however, there was not a large number of companies that were responding to informal pressure in repeating staggered boards, outside of those in the table.<sup>27</sup> After 2003, what we had was very clearly registered shareholder opposition to staggered boards.

PAT MCGURN: What we had was the specter of ballot acts coming into play. Boards feared that there would be substantial withhold votes in response to the majority votes, which would potentially result in being displaced from the board of directors. That is what has changed since 2003.

JOHN OLSON: What do you conclude, Lucian?

LUCIAN BEBCHUK: In order to make boards more accountable, one might want to influence boards less and give shareholders more power. Part is conjecture, just the specter of shareholder access and, perhaps, the new instrument of withhold vote is going to have an effect. I think that withhold votes are not as consequential as many of us would hope. Think about the Disney example, the most celebrated case of a withhold campaign. We had more than forty percent of the shareholders withhold their votes from Eisner, and Eisner is still around. He is saying that he will leave in 2006, but two and a half more years is not something that people take for granted in many systems.

PAT MCGURN: The vote was about the chairmanship, and he gave up the chairmanship immediately. The board stripped him of that title, and that is what a lot of investors voted on. How could you say that did not have an effect?

LUCIAN BEBCHUK: I think that it would be fair to say that the effect was somewhat limited. I think that if you read what the papers said after that, it was clearly understood as a powerful no-confidence vote against Eisner. It was viewed as an unprecedented, massive revolt of shareholders against the existing team at Disney, which was the result of a combination of circumstances in the face of very substantial impediments. This massive revolt occurred, and the consequences are limited. Having George J. Mitchell become chairman after facing a twenty-four-percent withhold vote himself also emphasizes that this is not a great example of a board's complete responsiveness to shareholders.

I think that there are generally two things that give shareholders somewhat weaker rights. One is the power shareholders have to replace the board. This is something that has received a lot of attention in connection with shareholder access and related reforms that I support. Second, shareholders do not have the power to adopt changes to basic governance arrangements, regardless of how long-standing, stable, and strong shareholder support might be. Shareholders do not have the power to initiate a charter amendment or a change in the state of incorporation. Management has a monopoly over anything that changes corporate governance.

---

27. *Id.*

This suggests to me that we have a problem with the evolution of corporate-governance arrangements.

The one place where shareholders obviously have power is at the IPO stage. If you look at when companies went public, however, you will find that a majority of U.S. stock market capitalization went public before 1980, with more than one-third doing so before 1950. If the initial charter was adopted way back, basically any change in governance arrangements since that point could have taken place only if management was in its favor.

One reform that I advocate would give shareholders the power to initiate, and adopt by vote, changes in some constitutional arrangements under some circumstances. Additionally, this reform would invigorate elections. If one is concerned about shareholders' acting as a result of short-term circumstances and not having a sufficient long-term horizon, one could have a rule under which shareholders would be able to change the rules only if there were a vote in favor in two successive annual meetings. In a situation like the one we had in Eastman Kodak, for example, if shareholders prefer to change the rules of the game over four annual meetings, they would be able to do so. This one reform would be able, in one stroke, to improve governance arrangements on many other issues. We would then be able to have shareholders themselves adopt improvements to governance arrangements, rather than accepting changes in a one-size-fits-all manner. Shareholders would be able to adopt a charter amendment that requires option expensing or takes this or that position. The potential benefits from better governance arrangements are significant.

In a forthcoming paper titled *What Matters in Corporate Governance?*,<sup>28</sup> we find that one can identify six corporate-governance provisions that, both individually and in the aggregate, correlate with lower firm value, as measured by Tobin's Q, and with lower returns over a long period of time. Those six bedfellows are (i) staggered boards, (ii) limits on charter amendments, (iii) supermajority provisions for mergers, (iv) supermajority provisions for charter amendments, (v) golden parachutes, and (vi) poison pills. All six are associated with a higher level of entrenchment for a company, and that is why we put them together in the form of an entrenchment index. When we run regressions, we find that even when we control for many other governance provisions, there are six provisions that have very strong negative correlations; other things matter little. Moreover, if you take this entrenchment index and you look at the firm that is called "the best," you can see that over the thirteen-year period from 1990 to 2003 the best firms had lower levels of entrenchment and risk adjustment. Even if you just compare the top half versus the bottom half, there is still an excess return of more than 2.5% a year.

JOHN OLSON: Thank you very much, Lucian. Let's thank our speakers, and we will take a break.

---

28. See Bebchuk, *supra* note 23.