

Reflections on Roberta Romano's
“Institutional Investors and Proxy Voting:
The Impact of the 2003 Mutual Fund Voting
Disclosure Regulation”



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Summary

- In a 2007 dated version of “Institutional Investors and Proxy Voting: The Impact of the 2003 Mutual Fund Voting Disclosure Regulation.” Professors Romano (Yale Law School) and Cremers (Yale School of Management) examine the impact on shareholder voting of the SEC mutual fund voting disclosure regulation adopted in 2003 (rule’s official date was April 14, 2003, but really effective July 1).
- Methodology involves examining paired sets of similar proposals for firms before and after the rule change, with emphasis on Executive Equity Incentive Compensation (EEIC) plans.
- Presumption: Once mutual fund voting becomes more transparent, there will be less support for management (i.e., after the rule change is enacted).
- Dependent variable is “transformed” vote in support of management.

Empirical Analysis

- A very thoughtful, comprehensive study.
- Account for a large number of potentially relevant factors:
past performance (return), net profit margin, return on assets, beta, market returns, market capitalization, stock turnover, institutional ownership (mutual funds, banks, insurance companies, individual investment advisors, other institutions), board size, composition (degree of board independence, extent of board independence), and characteristics (staggered), poison pills, shareholder meeting restrictions, a few dilution measures,... [30 independent (explanatory) variables in all.]
- Examined for the full sample, for management proposals, and for shareholder proposals.
- Examined before the rule change and after the rule change.
- Even univariate relationships between the independent variables are examined.

Conclusions

- Over the last decade, voting support for management has declined; mutual funds appear to support management less than other investors.
- That said, taking relevant factors into account, it appears that mutual funds (especially with respect to EEIC proposals) have increased their support for management over time (more precisely, since the proxy voting disclosure requirement implementation).
- Greater ownership by mutual funds and the magnitude of independent directors' shareholdings are positively related to management support after the rule change.
- The analysis of the impact of takeover defenses is ambiguous, but it does suggest a more involved thought process (relative to the conventional wisdom that perceives management as blindly resistant to any acquisition, independent of shareholder value).

Caveats

- Some data is missing/unavailable.
- An issue (noted) is ownership rights due to short stock trading (especially given the explosion of hedge fund activity).
- One consideration for which there should be allowance:
Example:
Pre-2003 support of management compensation (approved)
Post-2003 lack of support for new management compensation.
- Possible misspecification (the fitted regressions do not contain all of the relevant characteristics of mutual fund voting) and potential lack of stability (that the relationships between the aforementioned characteristics and voting behavior changed over time). (Also noted.)

Mutual Fund Objectives

- **Fidelity's Approach to Corporate Governance**
“We manage our mutual funds with one overriding goal: to provide the greatest possible return to shareholders consistent with governing laws and the investment policies of each fund.”
- Moreover, “When we believe that a company is not being run well, we have the option to sell our shares and, in fact, we’re buying and selling shares of companies every day in the market.”
- Milton Friedman became the target of severe criticism when he wrote “The Social Responsibility of Business is to Increase its Profits” in The New York Times (1970).
- “Any honest Democrat will admit that we are now all Friedmanites.”
-- Lawrence H. Summers

Conflicts of Interest

- This is one area that remains “fuzzy” (as it was, at least arguably on the face of it, to the Investment Company Institute in their response to the proposal that preceded this legislation):
 - the exact nature of the conflicts of interest that might arise between mutual fund companies engaging in proxy voting and the management of those companies whose stocks make up the holdings of the respective mutual fund portfolio managers.
- Is the fear that mutual fund managers might vote in support of management (without regard to future corporate performance) in order to secure Super Bowl tickets?
- There were also other safeguards in place (like Reg FD – 2000) to preclude improper interaction between funds and management.
- One potential source of conflict arises when mutual funds companies are engaging in other business activities with corporates.
- One would think that if a mutual fund could attract more funds because of their stance (e.g., based on the environmental concerns of the companies whose stocks they hold), and that is how they are compensated (based on assets under management), laissez faire!

Who are the Beneficiaries?

- For whom? (Remember pursuant to corporate governance scandals.)

The individual mutual fund investor?

To address the bifurcation of the mechanism for influencing corporate governance and the economic exposure to that company? (We'll return to this in a minute.)

The activist institutional investor?

To identify the other stakeholders and their views?

The funds of labor unions and other investor groups?

To monitor whether mutual fund voting aligned with their goals?

The regulator?

To more clearly identify conflicted interests?

- Where's the "regulatory capture"?



Some Facts About Mutual Funds

- According to ICI (Investment Company Institute), 44% of households in the U.S. own mutual funds (2007).
- 2/3 of those households owning mutual funds are headed by an individual between age 35 and 64.
- About 60% of mutual fund owners are employed and have incomes between \$25,000 and \$99,999.
- Educational achievement is equally represented in fund investors.
- Of households with mutual funds, 80% hold more than one fund.
- More than half of mutual fund investors own no individual stocks.
- 80% of mutual fund ownership is in equity funds.
- Well over half (64%) of mutual-fund-investing households have the majority of their financial assets in mutual funds.
- 2/3 of mutual fund-investing households first participated in mutual funds through employee-sponsored retirement plans.

Source: “Characteristics of Mutual Fund Investors, 2007”

ICI Research Fundamentals Vol.17 No.2 (April 2008)

Summary of Mutual Fund Facts and Inference

- **About half the households in the U.S. own mutual funds.**
- **Educational achievement is equally represented.**
- **2/3 of all mutual fund owners initially participated via work.**
- **Over half of fund investors own no individual stocks.**
- **Well over half of mutual-fund-investing households have the majority of their financial assets in mutual funds.**

Inference

A great many investors seem to have (initially) happened upon their mutual fund ownership; many are not particularly sophisticated investors (independent of academic degrees); many would likely not feel comfortable actively managing their own active portfolio; and many have overwhelmingly chosen this investment vehicle as their wealth management instrument of choice (i.e., they have delegated their direct investment responsibilities to mutual fund managers).

Regulation

- Rationale for Regulation:
Market Failure (Trading Opportunity),
Externalities,
Asymmetric Information,
...
- Vote with one's "feet" (dollars)?
- If disclosure has value, even though costly, why wasn't it done?
- Although do see some strange things.
In Brazil, voting shares trade at discounts to non-voting shares.



A Better Regulation

- If this regulation is intended to improve the informational basis of the common U.S. investor, perhaps voting disclosure is good.
- Is more information always good?
- “Studies have shown that investors who tune out the majority of financial news fare better than those who subject themselves to an endless stream of information, much of it meaningless. ... ”
 - “From 1984 through 1995 the average stock mutual fund posted a yearly return of 12.3 percent, while the average bond mutual fund returned 9.7 percent a year.
From 1984 through 1995 the average investor in a stock mutual fund earned 6.3 percent, while the average investor in a bond mutual fund earned 8 percent.”
 - G. Belsky and T. Gilovich
– in Why Smart People Make Big Money Mistakes (1999)
- Maybe best to enforce mandatory financial education requirements!

Finally, in an earlier publication,...

- While unrelated to the topic at hand (the 2003 SEC Mutual Fund Proxy Voting Disclosure Requirement), Professor Romano showed (in 2003) that, “adoption of confidential (proxy) voting has no significant effect on voting outcomes.”*
- Bottom Line:
 - Once you account for other factors,
it does not seem to matter
whether fund voting is confidential or transparent.

* “Does Confidential Proxy Voting Matter?”

Journal of Legal Studies, Vol.32, No.2, pp.465-509, June 2003

