

# WHO CALLS THE SHOTS? HOW MUTUAL FUNDS VOTE ON DIRECTOR ELECTIONS

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## ABSTRACT

*Shareholder voting has become an increasingly important focus of corporate governance, and mutual funds control a substantial percentage of shareholder voting power. The manner in which mutual funds exercise that power, however, is poorly understood. Because of the economic structure of mutual funds, there are particular reasons to be concerned about the extent to which mutual funds may seek to economize on the cost of their voting decisions by employing short cuts or delegating voting decisions to proxy advisors. These concerns, if true, hamper the potential effectiveness of regulatory reforms such as proxy access and say on pay.*

*This Article analyzes mutual fund voting decisions in uncontested director elections—an area in which the likelihood that funds will employ voting short cuts is high because the information costs of informed voting are high, and the stakes are low. We find evidence that mutual funds use various cost-saving measures but that the incidence of implicitly delegating voting authority ISS is less than commonly believed, especially for larger funds. Only a small proportion of mutual funds as measured by asset size appear to vote in “blind reliance” on ISS recommendations. Although ISS recommendations are extremely important, their importance seems to take the form of identifying problematic directors, forming a focal point around which funds may consider withholding their votes. Most funds do not appear, however, to follow these recommendations automatically. To the contrary, as measured by asset size, more funds seem to blindly follow management recommendations than blindly follow ISS.*

*We examine, in more detail, the voting behavior of the three largest mutual fund families: Vanguard, Fidelity, and American Funds. Together these three families account for more than one third of total mutual fund assets. We find that with respect to uncontested director elections the funds in these families vote largely in lockstep. Voting decisions of the three fund families differ substantially both from each other and from ISS recommendations. This is strong evidence of heterogeneity in the voting behavior of mutual funds in director elections.*

*Finally, we examine the factors associated with high “withhold” votes in director elections. Although an ISS “withhold” recommendation is a key factor in triggering a high “withhold” vote, the effectiveness of the recommendation is limited unless it is combined with an additional factor. We identify four significant additional factors: a “withhold” vote by Fidelity, the director missing 25% of board meetings, the company having ignored a shareholder resolution that received majority support, and a Vanguard “withhold” vote on outside directors with business ties to the company. Our findings suggest steps that companies and directors should take to reduce the likelihood of receiving a high “withhold” vote.*

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## INTRODUCTION

Recently, the field of corporate governance has focused on increasing shareholder voting power. Regulatory developments and company-specific governance changes allow shareholders to vote on more issues and accord greater weight to their votes.<sup>1</sup> Increasingly, shareholders are approving shareholder proposals to adopt or request structural changes, such as the elimination of poison pills and staggered boards.<sup>2</sup> Shareholders at most large public companies now elect directors through majority rather than plurality voting.<sup>3</sup> Delaware<sup>4</sup> amended its state corporation law in 2009 to authorize

<sup>1</sup> The New York Stock Exchange recently amended its rules to eliminate discretionary broker voting in uncontested elections. The rule change had the effect of increasing the power of shareholders who cast a vote. See Stephen Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 873–74 (2010) (describing the rule change and its significance). As we noted in that article, had the rule been in effect in 2009, two of Citigroup’s director nominees would not have been elected. See *id.* at 874.

<sup>2</sup> See, e.g., Lucian A. Bebchuk, Alma Cohen & Charles C.Y. Wang, *Staggered Boards and the Wealth of Shareholders: Evidence from a Natural Experiment* 3 (Harv. Law Sch. John M. Olin Ctr. for Law, Econ., and Bus., Discussion Paper No. 697, 2010), available at <http://ssrn.com/abstract=1706806> (describing increasing institutional investor opposition to staggered boards and efforts to dismantle existing staggered boards); Soren Lindstrom, *Shareholder Activism Against Poison Pills: An Effective Antidote?*, 9 WALL ST. LAWYER 17, 17 (2005) (“Today shareholders increasingly are exercising their right to vote for proposals to eliminate shareholder rights plans . . .”).

<sup>3</sup> See, e.g., Sarah Johnson, *In the Minority on Majority Voting*, CFO.COM (Jan. 27, 2011), <http://www.cfo.com/article.cfm/14552148/?f=rsspage> (reporting that investors supported majority voting in over half the companies that held a vote on the issue in 2010, and that nearly 70% of S&P 500 companies currently have majority voting).

<sup>4</sup> The majority of publicly traded corporations are incorporated in Delaware. See *Division of Corporations*, STATE OF DELAWARE, <http://corp.delaware.gov/> (last visited Oct. 13, 2012).

both proxy access bylaws and bylaws permitting reimbursement of shareholders' proxy solicitation expenses.<sup>5</sup> The Dodd-Frank Act<sup>6</sup> gave shareholders the right to cast an advisory vote on executive compensation ("Say on Pay")<sup>7</sup> and authorized the Securities and Exchange Commission ("SEC") to adopt rules granting shareholders the right to have their board of director nominees for the board of directors appear in the issuer's proxy statement ("Proxy Access").<sup>8</sup>

The potential effectiveness of increasing shareholder voting power depends critically on the manner in which shareholders exercise that power. One shareholder group of particular concern is mutual funds. Mutual funds constitute the largest group of institutional investors, holding approximately 29% of the equity of U.S. public companies,<sup>9</sup> and their ownership percentage is growing.<sup>10</sup> Traditionally mutual funds were passive investors, rarely challenging management and often not even exercising the voting rights of the shares in the portfolio companies in which they invested.<sup>11</sup> In 2002, however, the Department of Labor issued a release stating that voting was a component of pension plans' fiduciary obligations to their beneficiaries.<sup>12</sup> The following year, the SEC adopted a rule that required mutual funds to disclose their voting policies and proxy voting records.<sup>13</sup> The adoption of this rule focused attention on mutual fund voting behavior.

Mutual funds have the potential to affect the outcome of most shareholder votes due to the size of their collective equity interests.<sup>14</sup> Additionally, unlike most retail investors, mutual funds have the scale and sophistication to acquire information about their portfolio companies. However, mutual funds are merely intermediaries—holders of pooled investments—and the funds' investors, those with an economic interest in the

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(stating that a majority of publicly traded corporations and 63% of Fortune 500 companies are incorporated in Delaware).

<sup>5</sup> See DEL. CODE ANN. Tit. 8, § 112 (2009) (authorizing proxy access bylaws); see *id.* § 113 (2009) (authorizing bylaws that provide for reimbursement of shareholder proxy solicitation expenses).

<sup>6</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>7</sup> See *id.* § 951.

<sup>8</sup> See *id.*, § 971. The SEC adopted a proxy access rule, SEC Rule 14a-11, 17 C.F.R. § 240.14a-11(2010), but the D.C. Circuit invalidated the rule based on the SEC's failure adequately to assess its costs and benefits. See *Bus. Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

<sup>9</sup> See INV. CO. INST., 2012 INVESTMENT COMPANY FACT BOOK, 7 (2012), available at [http://www.ici.org/pdf/2012\\_factbook.pdf](http://www.ici.org/pdf/2012_factbook.pdf).

<sup>10</sup> See *id.*

<sup>11</sup> See Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 CARDOZO L. REV. 1419, 1430-31 (2002).

<sup>12</sup> See Interpretive Bulletins Relating to the Employee Retirement Income Security Act of 1974, 29 C.F.R. § 2509.94-2 (2002) (fiduciary act of managing employee benefit plan assets consisting of equity securities includes voting of proxies appurtenant to those securities).

<sup>13</sup> See 17 C.F.R. § 275.204-2(c)(2) (2003).

<sup>14</sup> See, e.g., Palmiter, *supra* note 11 at 1421 (explaining that mutual funds have become "the swing vote in U.S. corporate governance").

underlying securities, lack voting authority.<sup>15</sup> Mutual fund voting decisions are made by agents, either by the mutual fund board or the fund officers employed by the fund's investment advisor.<sup>16</sup> Of particular significance is that the business model of a mutual fund company consists not of maximizing absolute fund performance but rather of maximizing the performance of its funds relative to a benchmark or a peer group of comparable funds.<sup>17</sup> Toward that end, a fund's voting behavior is subject to a peculiar dynamic. The costs expended by the fund in setting voting policy and making specific voting decisions reduce the fund's relative performance. Voting decisions are particularly costly because a mutual fund family may invest in hundreds or even thousands of portfolio companies.<sup>18</sup> The benefits produced by informed voting, however, accrue to the portfolio company and all funds that invest in that company, including those from competing fund families. This free rider effect creates a strong incentive for funds to economize on their voting decisions.<sup>19</sup>

Funds can economize on their voting decisions in several ways. One option is for fund families to centralize voting within a central decision maker rather than allowing each individual fund to make its own voting decisions. We would expect members of a fund family that centralizes its voting decisions to vote in lockstep. A second possibility is for funds simply to vote in favor of management. Voting with management is not just simple, but it may also be rational<sup>20</sup> in the sense that, by deciding to invest in a

<sup>15</sup> See Jennifer S. Taub, *Able but not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholder Rights*, 34 IOWA J. CORP. L. 843 (2009) (describing this intermediation).

<sup>16</sup> Both the fund's board and its investment advisor owe fiduciary duties to the fund in exercising their power to make voting decisions. See, e.g., Disclosure of Proxy Voting Policies and Proxy Voting Records By Registered Management Investment Companies, 68 Fed. Reg. 6564, 6565 (Feb. 7, 2003) (explaining that investment advisor's fiduciary duty to the fund "extends to all functions undertaken on the fund's behalf, including the voting of proxies relating to the fund's portfolio securities."); *Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418, 1426–30 (2010) (explaining role and duties of mutual fund directors).

<sup>17</sup> Researchers have identified additional goals for mutual fund sponsors such as increasing the range of funds offered and product differentiation. See, e.g., Massimo Massa, *How do family strategies affect fund performance? When performance-maximization is not the only game in town*, 67 J. FIN. ECON. 249 (2003).

<sup>18</sup> A report in 2004 stated that the average equity fund held 140 different stocks. Janice Revell, *The power of concentration, Mutual funds that buy fewer stocks and hold them longer beat the competition*, CNN MONEY (Aug. 23, 2004), [http://money.cnn.com/magazines/fortune/fortune\\_archive/2004/08/23/379390/index.htm](http://money.cnn.com/magazines/fortune/fortune_archive/2004/08/23/379390/index.htm). Fidelity currently reports offering 68 separate funds in the domestic equity category alone. *Fund Results by Category: Domestic Equity Funds*, FIDELITY, <http://fundresearch.fidelity.com/mutual-funds/category-performance-annual-total-returns/STK> (last visited May 24, 2012).

<sup>19</sup> For an early article explaining how the free rider effect reduces the incentive for institutional investors to engage in efficient levels of monitoring see Jill E. Fisch, *Relationship Investing: Will it Happen? Will it Work?*, 55 OHIO ST. L.J. 1012 (1994).

<sup>20</sup> A more sinister explanation for why funds vote with management is their desire to obtain pension-related business. See, e.g., Disclosure of Proxy Voting Policies, *supra* note 16, at 20–21 (explaining that fund's investment advisor may face a conflict of interest in voting the securities of a portfolio company when the advisor "also manages or seeks to manage the [company's] retirement plan assets.").

portfolio company, the fund has decided that it trusts the company's management.<sup>21</sup> A third way to reduce costs is to outsource the fund's voting decisions to an external advisor. In particular, critics have expressed concern over the extent to which mutual funds directly or indirectly delegate their voting judgments to Institutional Shareholder Services ("ISS"), the leading proxy advisor.<sup>22</sup> As related by Delaware's Chancellor Leo Strine, the primary concern is that some institutional investors will simply follow ISS's advice rather than do any thinking of their own.<sup>23</sup>

This Article proceeds as follows. In Part I, we situate our study within the empirical literature on mutual fund voting. In Part II, we describe our methodology and examine the extent to which mutual funds centralize their voting and employ shortcuts to minimize their costs of voting. In particular, we focus on the degree to which funds follow the recommendations of either management or ISS. We find evidence that, although funds appear to economize by centralizing their voting decisions, their use of voting shortcuts is less common than frequently assumed. In particular, we find a substantial degree of divergence from ISS recommendations, refuting the claim that most funds follow ISS blindly.

Part III expands on our analysis by examining in more detail the voting behavior of the three largest mutual fund families: Vanguard, Fidelity, and the American Funds. The rationale for focusing on these funds is clear—together, they account for more than one-third of total mutual fund assets,<sup>24</sup> making their voting behavior most important both in understanding mutual fund voting and more broadly in assessing the potential impact of institutional investors. They also reflect distinctive business models and investment approaches. We find that, with respect to uncontested director elections, the funds in these families vote largely in lockstep, but that their specific voting decisions vary substantially vis-à-vis one another and the ISS recommendations.

Finally, in Part IV, we examine the factors associated with high "withhold" votes in director elections in which directors receive 30% or more "withhold" votes as a percentage of votes cast. We find that, although an ISS "withhold" recommendation is a key factor in triggering a high "withhold" vote, the effectiveness of the recommendation is limited unless it is combined with an additional factor. By analyzing specific company and di-

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<sup>21</sup> Traditionally funds that were unhappy with management expressed their disfavor by following the so-called "Wall Street Rule" and selling their stock. See Palmiter, *supra* note 11, at 1430–34 (discussing various explanations for mutual fund passivity); see also John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1288 n. 29 (1991) (describing possible origin of the "Wall Street Rule").

<sup>22</sup> See, e.g., Stephen Choi, Jill Fisch & Marcel Kahan, *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 658 (2009) (describing concerns over the influence of ISS on institutional investor voting decisions).

<sup>23</sup> See Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 688 (2005).

<sup>24</sup> See *infra* note 98 (providing statistics on mutual fund asset holdings).

rector attributes we identify four significant additional factors: (1) a “withhold” vote by Fidelity, (2) a director who has missed 25% of board meetings, (3) a company that ignored a shareholder resolution that received majority support, and (4) Vanguard’s “withhold” vote on outside directors with business ties to the company. When an ISS “withhold” recommendation is issued in conjunction with at least one of these four factors, it is associated with a 49% probability of the director receiving a high “withhold” votes. Directors in this group account for 48% of all directors who received high “withhold” votes.

## I. BACKGROUND

As noted above, mutual funds possess several distinctive attributes.<sup>25</sup> First, a mutual fund itself is simply a pool of assets created by a financial institution known as a fund sponsor. The legal structure of the mutual fund consists of a corporation or a trust, but funds outsource their operations including administrative services and investment decisions through contracts with third parties.<sup>26</sup> The most important of these third parties is the investment advisor, which is reasonable for making investment decisions and compensated according to the terms of an advisory contract.

Fund sponsors may be independent entities or banks, brokerage companies, or insurance companies. Most fund sponsors offer multiple funds comprising a fund family<sup>27</sup> and create, merge, and close individual funds on an ongoing basis in response to investor demand.<sup>28</sup> The organization of mutual funds into families is important in that large fund families can often generate economies of scale and increased flexibility.<sup>29</sup> Researchers have documented that some fund families manage their funds as a “portfolio” rather than making operational decisions purely on an individual fund basis.<sup>30</sup> Finally, some research documents performance advantages in funds that are part of a large fund family.<sup>31</sup>

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<sup>25</sup> For a general description of the legal structure of mutual funds see generally Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 1967–75 (2010).

<sup>26</sup> See *id.* at 1967, 1968.

<sup>27</sup> Daniel Li, *Mutual Fund Family Strategies and Bayesian Alphas 1* (SSRN Working Paper, Jan. 8, 2012), available at <http://ssrn.com/abstract=1981438> (estimating that 80% of mutual funds worldwide belong to a fund family).

<sup>28</sup> See ICI FACT BOOK, *supra* note 9, at 15–16 (“fund sponsors create new funds to meet investor demand, and they merge or liquidate funds that do not attract sufficient investor interest.”).

<sup>29</sup> Li, *supra* note 27, at 2.

<sup>30</sup> See, e.g., Jose Miguel Gaspar, Massimo Massa & Pedro Matos, *Favoritism in Mutual Fund Families? Evidence on Strategic Cross-Fund Subsidization*, 61 J. FIN. 73 (2006) (demonstrating that sponsors engage in cross-fund subsidization in order to create “high-value funds.”).

<sup>31</sup> See, e.g., Ilan Guedj & Jannette Papastakaikoudi, *Can Mutual Fund Families Affect the Performance of Their Funds?* 2 (SSRN Working Paper, Oct. 2003), available at <http://ssrn.com>.

Fund vote decision making takes place at three different levels. First, the Investment Company Act requires funds to have a board of directors.<sup>32</sup> It is common for the same directors to serve on the boards of multiple funds within the fund family, a structure known as the unitary board.<sup>33</sup> A unitary board obviously has the effect of centralizing fund decision making that occurs at the board level.<sup>34</sup> In most fund families, the board of directors has some role in overseeing or approving the funds' proxy voting policies.

Second, mutual funds outsource their investment decisions to an investment advisor. Again, the advisor, although technically a separate entity, typically provides investment management services for all or a subset of the funds within a fund family. As an example, Fidelity Management & Research Company is the investment advisor to Fidelity Investment's family of mutual funds. The agreement between each fund and the advisor dictates the terms of the advisory relationship, including the advisor's fees, and must be approved by the fund board.<sup>35</sup> The advisory agreement may delegate voting decisions to the investment advisor. In turn, the investment advisor may make voting decisions at the advisory company level, often through the use of a proxy voting committee.<sup>36</sup> Third, voting decisions may be made by individual portfolio managers, who are employees of the investment advisor.<sup>37</sup>

The various levels of mutual fund decision making complicate the task of analyzing mutual fund voting behavior. Although voting rights belong to the funds themselves, each fund's sponsor and advisor may have different objectives from those of the investors, and those objectives may dominate, especially when voting decisions are made for a family of funds in a centralized manner. One such concern is conflicts of interest that may be motivated by the business ties of the fund sponsor or advisor. Proxy voting decisions also raise policy and strategic issues for the fund family, including reputa-

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com/abstract=467282 (reporting greater performance persistence for funds that are part of a large fund family).

<sup>32</sup> See 15 U.S.C. § 80a-10(a) (2006) (requiring mutual funds to have their own boards of directors or trustees whether or not they are structured as corporations).

<sup>33</sup> See *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1154 (D.C. Cir. 2011) (citing survey data showing that 81% of responding funds have a unitary board).

<sup>34</sup> See Letter from Heidi Stam, Managing Director and Gen. Counsel, Vanguard Group Inc., to Elizabeth Murphy, Sec'y, Sec. & Exch. Comm'n 2 (Aug. 18, 2009), [www.sec.gov/comments/s7-10-09/s71009-326.pdf](http://www.sec.gov/comments/s7-10-09/s71009-326.pdf) (explaining that "unitary boards are powerful and efficient bodies, better able to moderate the influence of the advisers who operate the funds day-to-day.").

<sup>35</sup> 15 U.S.C. § 80a-15(c) (2006).

<sup>36</sup> See NATIONWIDE FUND ADVISORS, SUMMARY OF PROXY VOTING GUIDELINES 1, available at <http://www.nationwide.com/pdf-mutual-funds/proxy-nationwide.pdf> (explaining that the Nationwide Funds delegate voting authority to the funds' investment advisor, Nationwide Fund Advisors which, in turn, oversees proxy voting through a "Proxy Voting Committee").

<sup>37</sup> See, e.g., *Proxy Voting Policies*, T. ROWE PRICE GROUP, INC., <http://corporate.troweprice.com/ccw/home/ourCompany/proxyVotingPolicies.do> (last visited May 24, 2012) (explaining that, although the proxy committee develops voting guidelines, "Ultimately, the portfolio managers decide how to vote on the proxy proposals of companies in their portfolios.").

tion and public perception.<sup>38</sup> As a result, the extent to which proxy voting authority is allocated among different fund decision makers and, in turn, allocated differently within different fund families, poses challenges in measuring and understanding the way funds vote their shares.<sup>39</sup>

Several empirical articles examine mutual fund voting. One notable distinction in the literature concerns the difference between director elections and issue proposals; several articles study both, but shareholder proposals and director elections present somewhat different issues. For example, a number of scholars have documented the growing shareholder opposition to takeover defenses.<sup>40</sup> This trend is reflected in statistics that measure the overall degree of shareholder voting support for management.<sup>41</sup>

In an early study of mutual fund voting in the two years following the SEC rule change, Rothberg and Lilien found that the mutual funds in their sample voted against management-nominated director candidates 14% of the time; votes against management concerning antitakeover issues, executive compensation, and issuances of preferred stock were much higher.<sup>42</sup> Another early study by Cremers and Romano used matched pairs to study the specific effect of the rule change.<sup>43</sup> Although they reported finding no evidence “that the rule altered mutual funds’ behavior,” they did find some evidence that fund support for management-sponsored proposals on executive equity incentive compensation plans increased following the rule change.<sup>44</sup> This finding suggests the possibility that required disclosure decreased fund willingness to openly oppose a management proposal. Cremers and Romano also noted that shareholder voting support for management had declined substantially from that reported in earlier studies.<sup>45</sup> Ng et al. studied mutual fund voting on a range of shareholder and management proposals, including

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<sup>38</sup> See, e.g., Laura Smitherman, *T. Rowe Price Takes Activist Role: Recent Takeover Deals Stir Mutual Fund Giant*, BALT. SUN, June 8, 2007, at 1E. (describing media attention focused on T. Rowe Price after its money managers took activist positions with respect to several corporate buyouts).

<sup>39</sup> In particular, it is unclear whether it is appropriate to treat separately funds that vote as part of a centralized family voting decision. Cf. Lilian Ng, Qinghai Wang & Nataliya Zaiats, *Firm Performance and Mutual Fund Voting*, 33 J. BANK. & FIN. 2207, 2210 (2009) (measuring “mutual fund voting based on the percentage of funds with affirmative votes relative to the total number of funds that cast votes.”). The extent to which fund votes should be considered independent of fund size is another issue that we address below.

<sup>40</sup> See, e.g., Michael Klausner, *Investor’s Choices: Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755, 757 (2003) (documenting “substantial and growing shareholder opposition to takeover defenses.”)

<sup>41</sup> See, e.g., Burton Rothberg & Steven Lilien, *Mutual Funds and Proxy Voting: New Evidence on Corporate Governance*, 1 J. BUS. & TECH. L. 157, 167 (2006) (measuring the extent to which funds supported management).

<sup>42</sup> *Id.* at 168.

<sup>43</sup> See K.J. Martijn Cremers & Roberta Romano, *Institutional Investors and Proxy Voting on Compensation Plans: The Impact of the 2003 Mutual Fund Voting Disclosure Rule*, 13 AM. L. & ECON. REV. 220 (2011).

<sup>44</sup> *Id.* at 265.

<sup>45</sup> *Id.* at 222.



director elections.<sup>46</sup> They found that mutual fund voting was related to the prior performance of the portfolio company—“Mutual funds render fewer affirmative votes for management proposals and more affirmative votes for shareholder proposals if prior firm performance has been weak.”<sup>47</sup>

Matvos and Ostrovsky focused specifically on director elections.<sup>48</sup> In a study of voting during the 2003–2005 time period, they found that the average director received a 90% “for” vote from mutual funds.<sup>49</sup> The authors also demonstrated consistency in voting patterns within fund families,<sup>50</sup> but found considerable heterogeneity among funds, observing that some funds were consistently more likely to support management than others.<sup>51</sup> Matvos and Ostrovsky also documented substantial peer effects, showing that a fund was significantly more likely to “withhold” its votes from a director candidate if its peers were expected to do so.<sup>52</sup>

Several articles look specifically at potential mutual fund conflicts of interest, hypothesizing that funds or fund families may be influenced by business concerns in their voting decisions. These studies, as noted above, concentrate on issue proposals rather than director elections. A significant number of studies have found that funds with business ties to their portfolio companies vote differently from funds that lack such ties.<sup>53</sup> Davis & Kim, for example, found that funds that derived a substantial portion of their management fees from companies in their portfolios were more likely to favor management in their voting behavior.<sup>54</sup> Taub, studying the ten largest mutual funds, found that a higher value of defined contribution plan assets under management for the funds’ advisor was correlated with reduced support for shareholder proposals.<sup>55</sup> Similarly, Ashraf et al. found that mutual funds with pension-related business were less likely to support shareholder proposals on

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<sup>46</sup> See Ng et al., *supra* note 39.

<sup>47</sup> *Id.* at 2216.

<sup>48</sup> See Gregor Matvos & Michael Ostrovsky, *Heterogeneity and Peer Effects in Mutual Fund Proxy Voting*, 98 J. FIN. ECON. 90 (2010).

<sup>49</sup> *Id.* at 95.

<sup>50</sup> *But see* Angela Morgan, Annette Poulsen, Jack Wolf, & Tina Yang, *Mutual Funds as Monitors: Evidence from Mutual Fund Voting*, 17 J. CORP. FIN. 914, 927 (2011) (finding “substantial divergence across funds within the same family with respect to voting on shareholder proposals.”)

<sup>51</sup> See Matvos & Ostrovsky, *supra* note 48, at 96–97.

<sup>52</sup> See *id.* at 97. (finding that there are “significant peer effects in fund voting behavior.”); *Cf.* at 97 (showing that “mutual funds are more likely to vote ‘for’ a director if they think other funds are more likely vote ‘for’ her as well”).

<sup>53</sup> *But see* Rothberg & Lilien, *supra* note 41, at 171 (finding found no significant difference in voting between four mutual fund companies and four other funds that are affiliated with financial services firms).

<sup>54</sup> *Cf.* Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. FIN. ECON. 552, 569 (2007) (finding that funds are less inclined to vote in favor of shareholder proposals opposed by management when the fund has substantial business ties with the company in question).

<sup>55</sup> See Taub, *supra* note 15, at 845–46.

executive compensation.<sup>56</sup> Ng et al. studied mutual funds with business ties and found differences in fund voting on some governance and compensation issues.<sup>57</sup>

Finally, a few studies examine the influence of ISS on voting decisions. Cai et al. found that a negative ISS recommendation increased “withhold” votes in director elections by approximately 20%.<sup>58</sup> By contrast, in an earlier article, we estimated that ISS swings only 6–10% of the vote in uncontested director elections.<sup>59</sup> Neither of these studies looked specifically at mutual fund voting, however, and ISS may enjoy greater influence with other shareholder groups, such as public pension funds.<sup>60</sup> Cotter et al. examined voting on shareholder proposals, and found that mutual funds voted more consistently with ISS recommendations than with management recommendations.<sup>61</sup> Ng et al. similarly found that mutual fund voting correlates with ISS recommendations.<sup>62</sup>

The Investment Company Institute has also published various statistical analyses of mutual fund voting.<sup>63</sup> One recent report reveals that, although mutual funds consistently supported management and management proposals, by voting in favor of director nominees more than 90% of the time during 2007–2009, this support has declined over the same period, largely due to fund concerns about executive compensation, which have led to increased “withhold” votes for directors on board compensation committees.<sup>64</sup>

<sup>56</sup> See Rasha Ashraf, Narayanan Jayaraman, & Harley E. Ryan, Jr., *Conflicts of Interest and Mutual Fund Proxy Voting: Evidence from Shareholder Proposals on Executive Compensation 5* (October 9, 2009), available at [http://www.researchgate.net/publication/228811339\\_Conflicts\\_of\\_interest\\_and\\_mutual\\_fund\\_proxy\\_voting\\_Evidence\\_from\\_shareholder\\_proposals\\_on\\_executive\\_compensation](http://www.researchgate.net/publication/228811339_Conflicts_of_interest_and_mutual_fund_proxy_voting_Evidence_from_shareholder_proposals_on_executive_compensation); see also Rasha Ashraf, Narayanan Jayaraman & Harley E. Ryan, *Do Pension-Related Business Ties Influence Mutual Fund Proxy Voting? Evidence from Shareholder Proposals on Executive Compensation*, 47 J. FIN. & QUANTITATIVE ANALYSIS 567, 587 (2012) (finding that this effect exists at both client and non-client portfolio companies).

<sup>57</sup> Ng et al. defined a mutual fund with business ties as “one that has banking, insurance, brokerage, or investment banking parent, or a large 401(k) business”). Ng et al., *supra* note 39, at 2216.

<sup>58</sup> See Jie Cai, Jacqueline Garner & Ralph A. Walkling, *Electing Directors*, 64 J. FIN. 2389, 2391 (2009).

<sup>59</sup> See Choi et al., *supra* note 1, at 906.

<sup>60</sup> See generally, Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315, 342 (2008) (describing delegation by public pension funds of voting authority and the preparation of voting guidelines).

<sup>61</sup> See James Cotter, Alan Palmiter & Randall Thomas, *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 55 VILL. L. REV. 1 (2010).

<sup>62</sup> See Ng et al., *supra* note 39, at 2213–14.

<sup>63</sup> The Investment Company Institute, a membership organization, is the national association of U.S. investment companies, which includes mutual funds as well as ETFs, closed-end funds and unit investment trusts. See *About ICI*, INVESTMENT COMPANY INSTITUTE, [http://www.ici.org/about\\_ici](http://www.ici.org/about_ici) (last visited Oct. 15, 2012).

<sup>64</sup> See Sean S. Collins, *Trends In Proxy Voting By Registered Investment Companies, 2007–2009*, INVESTMENT COMPANY INSTITUTE RESEARCH PERSPECTIVE, Nov. 2010, at 12 fig. 8.

## II. ECONOMIZING ON VOTING

### A. Methodology and Sample Construction

Our study focuses specifically on uncontested director elections. Director elections differ significantly from votes on shareholder proposals because they are much more information intensive. Many funds have developed guidelines on how to vote on certain issue proposals, such as proposals to declassify the boards of directors or to split the chairman and CEO positions.<sup>65</sup> These guidelines will determine most of the funds' votes on these types of proposals. In contrast, director votes are issuer- and director-specific. As such, director elections present a greater need for funds to economize on research costs. To the extent a fund relies on ISS for its research, it is potentially more dependent on the information supplied by ISS with respect to director elections. We expect that these information challenges are likely to affect funds differentially—larger fund families with centralized voting can spread the costs of their research across a number of funds.

We consider only uncontested director elections because contested elections are typically associated with a related strategic or economic event, such as the proposed sale of a company, a merger, or a restructuring.<sup>66</sup> We hypothesize that shareholder voting in such elections reflects, to a substantial degree, the merits of the proposed transaction rather than the characteristics of the particular director nominees. In addition, the voting behavior of mutual funds in uncontested elections offers, more than any other area, insight into the extent to which mutual funds are engaging in ongoing governance oversight.

To construct the data sample for this study, we obtained a list of 348 mutual fund families from the Investment Company Institute. The list identified the quantity of assets under management for each fund family, broken down between short-term and long-term assets as of March 31, 2007.<sup>67</sup> We sorted this list by the amount of long-term assets.<sup>68</sup>

We then selected a total sample of 60 fund families, 20 drawn from each of three size categories: large, medium, and small. For the category of large funds, we chose the 20 fund families with the largest amount of long-

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<sup>65</sup> See, e.g., *Vanguard Web Site, Vanguard's Proxy Voting Guidelines*, THE VANGUARD GROUP, INC., <https://personal.vanguard.com/us/content/Home/WhyVanguard/AboutVanguardProxyVotingGuidelinesContent.jsp> (last visited Oct. May 24, 2012) (Vanguard proxy voting guidelines which state, among others, that Vanguard funds "will generally support proposals to declassify existing boards (whether proposed by management or shareholders) and will block efforts by companies to adopt classified board structures, in which only part of the board is elected each year.")

<sup>66</sup> See, e.g., *Air Products & Chemicals, Inc. v. Airgas, Inc.*, 16 A.3d 48, 71, 102–03 (Del. Ch. 2011) (describing election contest conducted by Air Products as part of takeover battle).

<sup>67</sup> See e-mail from Erin Short to Marcel Kahan (on file with authors).

<sup>68</sup> We hypothesized that the quantity of long term assets served as a rough proxy for the fund family's equity holdings. We thereby sought to reduce the effect of a family's short term fixed income funds, such as money market funds, on our classification.

term assets.<sup>69</sup> The families in this group held long-term assets ranging in amount from \$88 billion to \$1.115 trillion, with an average of \$275 billion and a median of \$136 billion. For medium-size families, we chose the 20 families with the largest amount of long-term assets below \$40 billion. Funds in this group held long-term assets ranging from \$18 billion to \$39 billion with an average of \$27 billion and a median of \$26 billion. For small families, we chose the 20 families holding the largest amount of long-term assets below \$10 billion. The families in this group held long-term assets ranging from \$5 billion to \$10 billion with an average and median of \$7 billion.<sup>70</sup>

For each fund family, we examined Form N-PX filings with the SEC and tabulated the votes by domestic equity funds of the sample families in uncontested director elections in 2005 and 2006.<sup>71</sup> We examined only elections at S&P 1500 companies, and we eliminated any fund that cast less than 100 votes in these elections, leaving us with 719 funds across the different fund families. Of the sixty families initially selected, we had to eliminate four because they had no funds that satisfied these criteria.

For each director vote, we collected data<sup>72</sup> from SEC filings and the IRRC Governance database on firm- and director-specific characteristics that might influence the likelihood of a “withhold” vote.<sup>73</sup> Using the methodology developed in our prior work,<sup>74</sup> we determined: (1) whether the director was the CEO (CEO), an employee of the company other than the CEO (Empl\_Dir), an outside directors with certain links to the company (OutDir-Link), or a new Director (New Director); (2) whether the director was a member of the audit (AuditMbr), the compensation committee (CompMbr),

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<sup>69</sup> Because the fund industry is heavily concentrated in the largest fund families, this methodology has the effect of causing our sample to include approximately 50% of the domestic equities held by mutual funds.

<sup>70</sup> Families for which no data were available on CRSP, who had no domestic funds, or who were affiliated with a larger fund family were eliminated and the family with the next lower long-term assets was chosen instead.

<sup>71</sup> This article is the third in a sequence of papers that examine proxy advisory firm recommendations and mutual fund voting. See Choi et al., *supra* note 1; Choi et al., *supra* note 22. The dataset used in all three of the articles derives from fund voting and proxy advisory firm recommendations from 2005 to 2006, the first years mutual fund voting data was publicly available, and does not encompass more current data as of the date of this third article. Nonetheless, we believe that the relationship between proxy advisory firm recommendations and mutual fund voting behavior remains largely the same in 2012 as compared with the 2005 to 2006 period. For example, in 2005, 445 directors at 228 S&P 1500 companies had withhold votes of 15% or greater. See GEORGESON, 2008 ANNUAL CORPORATE GOVERNANCE REVIEW 7 (2008). The financial crisis did correspond with an increase in directors receiving high levels of withhold votes. In 2009, 1,027 directors at 378 S&P 1500 companies had withhold votes of 15% or greater. See GEORGESON, 2011 ANNUAL CORPORATE GOVERNANCE REVIEW 5 (2011). But the effect of the financial crisis appears to be temporary. By 2011, 549 directors at 254 S&P 1500 companies had withhold votes of 15% or greater—similar to the 2005 level. *Id.*

<sup>72</sup> For a definition of these and other variables, see the Appendix.

<sup>73</sup> See Choi et al., *supra* note 1, at 662–63 (explaining the rationale for this methodology and the basis for selecting these particular characteristics).

<sup>74</sup> See Choi et al., *supra* note 1, at 888–89; Choi et al., *supra* note 22, at 661–63.

or the nominating committee (NomMbr); and (3) whether the director was a member of at least three other “major” company boards during the year prior to the annual meeting date (ManyBds),<sup>75</sup> whether the director attended less than 75% of the director meetings (Attendance), whether the director was an Interlocking director (Interlock), and whether the director was 75 years or older (Age75). In addition, for each company in the sample and each year, we collected data from SEC filings, press releases, the IRRC Governance database, the Georgeson Annual Corporate Governance Reviews, and CRSP on (1) whether the first public report of a restatement to a company’s financial statement occurred within two years prior to the annual meeting (Prior Restat), whether the first public statement of an SEC investigation or enforcement action occurred within two years prior to the annual meeting (Prior SEC), and whether the company rejected an issue proposal that had received majority shareholder support in the last year (IP No); (2) whether the company had a classified board (ClassBd), a poison pill (Poison Pill), cumulative voting (CumVote), or golden parachutes (Golden Parachute); (3) whether the company was in the top or bottom 5% of the companies ranked based on the abnormal holding period return for the three-year period prior to the meeting date for the year of the recommendation (Top5AbRet, Bot5Abret);<sup>76</sup> and (4) whether the CEO for the company was in the top 5% total excess compensation (Top5AbComp).<sup>77</sup> We obtained data on ISS’s voting recommendation for each director who was subject to election during our sample period directly from ISS or from LEXIS (VoteISS = 1 for a “withhold” recommendation and 0 for a “for” recommendation).

### B. Centralization

As noted above, both the research and the mechanics of proxy voting are costly. To reduce these costs, a fund family may centralize the voting decisions across some or all of the funds in the family. Centralization also enables a family to monitor strategic or business concerns associated with its voting behavior. Prior studies have disagreed about the extent to which funds within a family vote differently, and the degree of centralization is critical in determining whether voting decisions should be analyzed at the family level or at the level of the individual fund. We therefore begin by examining the extent to which fund votes within a single fund family deviate from each other.

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<sup>75</sup> We use the IRRC data on other “major” company boards held by directors for the year prior to the annual meeting.

<sup>76</sup> We define the abnormal holding period return for the three year period prior to the meeting date for the year of the recommendation as the holding period return for the specific company minus the holding period return of the CRSP value-weighted market index for the same period.

<sup>77</sup> See Choi et al., *supra* note 22, at 662; Choi et al., *supra* note 1, at 889.

Within each fund family, we are able to identify separate clusters of funds that vote largely in lockstep with one another. We treat funds in the same fund family as voting in lockstep with one another if there are no or only a trivial number of deviations in the votes on the same nominees for the same company. Using these clusters, we are able to characterize the extent to which each fund family's voting is centralized. We classify a fund family as fully centralized if all funds in that family belong to a single voting cluster. We classify a family as substantially centralized if a substantial block of the family's funds vote in lockstep, forming a single cluster. A substantial block is defined as funds accounting for at least 70% (but less than 100%) of the aggregate fund family assets.<sup>78</sup> We characterize a fund family as non-substantially centralized if it lacks a single such dominant cluster. In total, the 719 funds of the 56 families formed 127 different clusters.

In total, of the 56 families in our sample, we were able to classify 38 families.<sup>79</sup> Of these families, we find that 21 were fully centralized and another 12 were substantially centralized; only 5 were classified as non-substantially centralized. We had hypothesized that centralization was one way in which funds could economize on voting costs. Our findings are consistent with this hypothesis.

While we find that fund voting is often highly centralized, the degree of centralization varies by fund family.<sup>80</sup> Centralization is substantially more common among smaller fund families. As Table 1 shows, 83% of the small funds are fully centralized, while only 40% of the medium-sized and 44% of the large funds are fully centralized. In chi-square tests, the difference in centralization between large and small funds is statistically significant (Pearson  $\chi^2(2) = 5.0613$ ,  $Pr = 0.080$ ).<sup>81</sup>

We note that even in fund families that were classified as non-substantially centralized, some of the funds voted in lockstep. For example, we classified the BlackRock fund family as non-substantially centralized. The ten BlackRock funds in our sample formed three clusters: five funds voted in lockstep with each other, four others voted in lockstep with each other (and not in lockstep with the first cluster) and the last fund voted out of lockstep with the other two clusters, forming a third cluster. Also, in some instances, lack of overlap among the votes cast by different funds due to the variation

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<sup>78</sup> If instead a 60% (80%) threshold is used to classify fund families as substantially centralized, the percentage of sample assets held in substantially centralized funds increases by 2% (decreases by 3.5%).

<sup>79</sup> Several fund families could not be classified because the family consisted of a single fund or because the funds within that family had insufficient overlap in holdings to determine whether these funds voted in lockstep and the funds at issue accounted for a material portion of the aggregate fund family assets.

<sup>80</sup> Notably our findings differ from those of Rothberg and Lilien who found that "proxies could be are voted as a block across all the funds of the manager." Rothberg & Lilien, *supra* note 41, at 162.

<sup>81</sup> We also test the difference across all three types of funds and find that the difference is insignificant (Pearson  $\chi^2(4) = 6.0785$ ;  $Pr = 0.193$ ).

TABLE 1: FUND FAMILY SIZE AND CENTRALIZATION

	Non- Substantially Centralized	Substantially Centralized	Fully Centralized	Total
Large	3	6	7	16
Medium	2	4	4	10
Small	0	2	10	12

in fund holdings prevented us from determining whether the funds voted in lockstep. These funds may, in fact, vote in lockstep with each other, but we lacked sufficient observations to determine so with confidence.

Although we cannot explain the reasons for the difference in degree of centralization in every case, in some, the reasons are apparent. For example, the current Franklin Templeton family consists of the (old) Franklin Templeton funds and the Mutual series of funds, formerly owned by Heine Securities Corporation, which merged into Franklin Templeton in 1996.<sup>82</sup> The funds that were formerly part of the Mutual series vote out of lockstep with the other Franklin Templeton funds, but in lockstep with each other. To the extent that large families are more likely to have incorporated predecessor funds and retained multiple decision making bodies within the overall fund family, we should expect to see a lesser degree of centralization for reasons that are independent of the desire to economize.

In the case of Fidelity, variation in fund voting has a different explanation. Fidelity separated the advisory services for its index funds in order to avoid having their holdings aggregated with the holdings of other Fidelity funds for purposes of Section 13(d) of the Securities Exchange Act of 1934.<sup>83</sup> Fidelity's index funds are therefore sub-advised by Geode Capital Management LLC, and Geode independently makes the voting decisions for those index funds.<sup>84</sup> Our study confirms that Fidelity's index funds vote out of lockstep with the other Fidelity funds.

In many other instances, however, no ready explanations for the degree of centralization or lack thereof are apparent. Differences may be due to the location within the fund complex at which voting decisions are made. For example, the voting decisions of a fund family in which the portfolio managers of individual funds exercise greater control of voting are unlikely to be

<sup>82</sup> See Press Release, Franklin Resources, Inc., Franklin Resources, Inc. Merges with Heine Securities Corporation (Nov. 1, 1996), available at [https://www.franklintempleton.com/retail/pages/corp/press/1996/heine\\_110196.jsf?archived=true](https://www.franklintempleton.com/retail/pages/corp/press/1996/heine_110196.jsf?archived=true). (describing the merger).

<sup>83</sup> See 15 U.S.C. § 78m(d) (2006) (requiring certain registered entities to publically disseminate the security-based swap transaction and pricing data required to be reported).

<sup>84</sup> See Robern Farzad, *Special Report: Fidelity's Divided Loyalties*, BLOOMBERG BUSINESSWEEK (Oct. 15, 2006), <http://www.businessweek.com/stories/2006-10-15/fidelitys-divided-loyalties> (describing separate voting by Fidelity index funds); *Overview of Proxy Voting*, FIDELITY, <http://personal.fidelity.com/myfidelity/InsideFidelity/InvestExpertise/ProxyVoting/ProxyVotingOverview.shtml> (last visited Dec. 18, 2012) (stating that Fidelity index funds are subadvised by Geode Capital Management, LLC, which votes the proxies of those funds).

centralized. Similarly, decentralization may be more common in fund families that do not use a unitary board. We do not explore all potential reasons in this article.

We do, however, employ our findings about centralization to refine the manner in which we count fund votes. For the remainder of our analysis, we treat the funds comprising a cluster as a single fund, reflecting our determination that the lockstep vote by a cluster represents a single voting decision. Similarly, when multiple funds in a cluster cast votes on the same director-nominee, we treat that vote as a single observation and aggregate the assets of the funds in the cluster.

### C. Shortcuts

We next examine the extent to which funds economize on the costs of voting by relying on short cuts. Commentators have identified two possible short cuts that mutual funds may use: (1) virtually always following the voting recommendations by the ISS<sup>85</sup> and (2) virtually always following the voting recommendations of the board of directors (which means, in effect, voting “for” the board nominees).<sup>86</sup> The concern about both is that, by relying on a short cut, a fund may be neither engaged in independent thinking nor, necessarily, using its voting power to attempt to maximize the profitability of its portfolio companies. Extensive reliance by mutual funds on short cuts may frustrate the role of shareholder voting as a corporate governance mechanism. This concern is of particular significance in the context of director elections because shareholders’ ability to elect the board is perhaps their most important protection against improper management behavior.<sup>87</sup>

The possibility that funds routinely follow management recommendations suggests the risk that shareholders are not using their voting power to elect a board capable of exercising effective management oversight. Funds’ reluctance to challenge management may be the product of (1) a judgment that the costs of an informed voting decision outweigh the benefits to fund investors, (2) an effort by funds to free ride on the informed voting by other shareholders, or (3) a desire not to antagonize management of portfolio companies (e.g., in order not to jeopardize relationships between fund analysts and those managers or other business relationships between the fund man-

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<sup>85</sup> See, e.g., Lynn A. Stout, *Why Should ISS Be The New Master Of The Corporate Governance Universe?* CORP. GOVERNANCE, Jan. 4, 2006, at 14–15 (describing how SEC regulation of mutual fund voting has driven mutual funds “into the arms of ISS”); Tamara C. Belinfanti, *The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control*, 14 STAN. J.L. BUS. & FIN. 384, 386 (2009) (stating that “15–20% of mutual funds have even authorized ISS to automatically vote their shares however it sees fit . . . .”).

<sup>86</sup> See, e.g., Palmiter, *supra* note 11.

<sup>87</sup> See, e.g., *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988) (“matters involving the integrity of the shareholder voting process involve consideration not present in any other context in which directors exercise delegated power.”).



agement company and the portfolio company). Depending on the reason, such voting may or may not be in the interest of fund investors. In contrast, we do not believe that this voting pattern simply reflects the same confidence in management that motivated the funds' investment decision. After all, funds sometimes decide to sell stock when they decide that they no longer have such confidence.<sup>88</sup> If they are in the process of divesting themselves, they should not automatically vote in accordance with management recommendations.

The possibility that funds routinely follow ISS recommendations raises different issues. Many commentators have expressed concerns about the potential influence that ISS exercises over corporate elections, a concern that we will explore in more detail below.<sup>89</sup> The potential effect of an ISS short cut is to grant substantial power over voting results to an unregulated entity with no equity stake in the portfolio companies that it analyzes.

We approach the analysis of short cuts with caution. The vast majority of mutual fund votes, more than 90%, are cast "for" the director nominee. During the period of our study, ISS recommended a "for" vote for 93.2% of the directors in our sample. As a result, there is likely to be a substantial correlation between mutual fund votes, management recommendations and ISS recommendations. In addition, we note that our tests measure correlation, not causation. To the extent that ISS attempts to formulate its voting policies to incorporate the preferences of its institutional investor subscribers,<sup>90</sup> its recommendations will naturally correlate substantially with, but not necessarily cause, voting decisions that are the result of those underlying preferences.<sup>91</sup>

We first consider the extent to which fund clusters employ an ISS short cut. We view a fund as employing an ISS short cut if the fund votes in accordance with the ISS recommendation in 99.5% or more of its votes. Given the high correlation between ISS "for" recommendations and fund "for" votes due to factors other than the influence of ISS, we utilize a 99.5% threshold to measure whether a fund cluster in fact is using ISS as a short cut in voting. Of the 127 clusters in our sample, we find that 10 virtually always follow ISS, voting in accordance with the ISS recommendation in 99.5% or

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<sup>88</sup> See, e.g., Tara Siegel Bernard, *Mutual Funds: What You Need to Know*, N.Y. Times (Dec. 16, 2008), <http://www.nytimes.com/2008/12/16/your-money/mutual-funds-and-etfs/pri-mermutualfunds.html?pagewanted=all> (explaining that "kicking the tires" by meeting with management is one of the ways that portfolio managers choose which companies to invest in).

<sup>89</sup> See, e.g., Belinfanti, *supra* note 85, at 387, 438.

<sup>90</sup> See *Policy Formulation and Application*, INSTITUTIONAL SHAREHOLDERS SERVICE, <http://www.issgovernance.com/policy/process> (last visited Aug. 15, 2011) (explaining that annual survey of institutional investors is part of the process by which ISS formulates its voting policies).

<sup>91</sup> See Choi et al., *supra* note 1, at 882–85 (discussing possible explanations for correlation between ISS recommendations and voting outcomes).

more of their votes, and that another 26 appear to follow ISS to a lesser degree.<sup>92</sup>

We then study the propensity of funds to employ a management short cut. Because many factors can lead a fund to vote “for” in addition to the management’s recommendation to vote “for”, we focus on situations where ISS recommends “withhold” as a proxy for a situation where other factors may cause a fund to vote “withhold”. We treat a fund that continues to follow management’s recommendation to vote “for” even in these circumstances as following a management short cut. To gauge the strength with which a fund follows management, we compare a fund cluster’s actual “withhold” rate to the frequency of an ISS “withhold” recommendation for directors. We term this frequency the “relative ‘withhold’ rate.” Focusing in particular on very low relative “withhold” rates, we find that 13 fund clusters have a relative “withhold” rate of less than 0.1, which translates roughly into an absolute “withhold” rate of 0.6% or less. Another 5 fund clusters have a relative “withhold” rate of less than 0.2. In total, 54 of the 127 clusters appear to follow some sort of short cut.<sup>93</sup>

Next we consider separately the largest cluster in each fund family as measured by asset size (termed the “dominant” cluster). Within this group of 56 dominant clusters, we find that seven clusters vote in accordance with the ISS recommendation more than 99.5% of the time and an additional eight vote in accordance with ISS recommendations to a lesser degree.<sup>94</sup> Eight dominant clusters have a relative “withhold” rate of less than 0.1 and four more have a relative “withhold” rate below 0.2. Overall 27 of 56 dominant clusters appear to utilize some type of short cut.

To the extent that short cuts are a means of economizing on the cost of voting, we would expect to see greater use of short cuts within smaller fund families. We confirm this hypothesis with our data on dominant clusters. Among small fund families, 12 of 18 used a short cut, among medium sized of 10 of 19, but among large only 5 of 19. The difference in the proclivity to

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<sup>92</sup> These funds either follow ISS “for” recommendations in at least 99.95% of the votes (but not ISS “withhold” vote recommendations to the same degree), follow ISS “withhold” recommendations in at least 99.95% of the votes (but not ISS “withhold” vote recommendations to the same degree), or vote in accordance with ISS recommendations more than 99% of the time.

<sup>93</sup> In unreported tests we examined whether business ties or conflicts of interest are associated with use of shortcuts. Of the 56 fund families in our sample, 28 are affiliated with other financial firms such as commercial and investment banks or insurance companies; 28 are independent. We studied the “withhold” rates as well as the use of shortcuts, both for dominant clusters and for all funds. We found no statistically significant difference in the voting behavior of affiliated versus independent firms.

<sup>94</sup> Five dominant fund clusters follow ISS “for” vote recommendations in at least 99.95% of the votes (but not ISS “withhold” vote recommendations to the same degree); 1 follows ISS “withhold” vote recommendations in at least 99.95% of the votes (but not ISS “for” vote recommendations to the same degree); and 2 more funds vote according to the ISS recommendation in over 99% of the votes.

use short cuts for fund families of different sizes is statistically significant (Pearson  $\chi^2(2) = 4.9350$ ;  $Pr = 0.085$ ).

Our finding that smaller fund families rely more heavily on short cuts suggested an alternative way to measure the influence of ISS. Rather than examining the percentage of funds that vote in accordance with an ISS recommendation, we considered the percentage of underlying assets in our sample reflected in the vote. Table 2 gives some information on the assets and the percentage of the aggregate sample assets for funds that vote in accordance with ISS recommendations.

TABLE 2: FUND VOTING AND ISS RECOMMENDATIONS

Fund Cluster Category	Assets (\$ millions)	Percentage of Assets in Sample
Fund votes that follow ISS > .99	76,632	3.04%
Fund votes that follow ISS > .975	255,874	10.16%
Fund votes that follow ISS > .95	478,701	19.00%
Fund WH votes conditional on ISS WH rec. > .90	80,664	3.20%
Fund WH votes conditional on ISS WH rec. > .80	203,345	8.07%
Fund WH votes conditional on ISS WH rec. > .70	208,719	8.28%
Fund WH votes that follow ISS/total fund WH votes > .90	177,764	7.06%
Fund WH votes that follow ISS/total fund WH votes > .80	334,244	13.27%

Fund clusters that follow ISS with respect to more than 99% of all ISS recommendations account for a mere 3.04% of the sample assets. Funds that follow ISS with respect to 97.5% of all ISS recommendations account for only 10.16% of the sample assets. Two caveats are important. First, we are measuring overlap, not causation. Second, because most ISS recommendations are in favor of the director nominees and most votes are cast in favor of the director nominees, the degree of correlation is less significant than it initially appears. A fund that always voted “for” would vote in accordance with the ISS recommendations in about 94% of all cases, even though such a fund’s votes would presumably be completely independent of the ISS recommendation.

Because of the large percentage of ISS “for” recommendations and fund “for” votes, it is perhaps more valuable to examine the relationship between “withhold” recommendations and votes. As reported in Table 2, we find that fund clusters that vote “withhold” at least 90% of the time in circumstances where ISS recommended a “withhold” vote account for 3.20% of the sample assets. For fund clusters accounting for 8.07% of the sample assets, the corresponding probability is at least 80%; for fund clusters accounting for 8.28% of the sample assets, the corresponding probability is at least 70%.

Lastly, we look at how important “withhold” votes that correlate with an ISS “withhold” recommendation are relative to the total number of

“withhold” votes cast by a particular fund cluster. If ISS is influential to the voting of a particular fund cluster, we expect that this ratio will be high. Conversely, a fund that casts “withhold” votes frequently when ISS does not recommend “withhold” will have a low ratio. As reported in Table 2, we find 7.06% of total sample assets are in the category of fund clusters where the “withhold” votes that correlate with ISS “withhold” recommendations correspond to 90% or more of the total “withhold” votes. Likewise, we find that 13.27% of total sample assets are in the category of fund clusters where the “withhold” votes that correlate with ISS “withhold” recommendations correspond to 80% or more of the total “withhold” votes.

Table 3 summarizes the relative difference in importance between ISS “for” recommendations and “withhold” recommendations, a difference that highlights the extent to which data showing the degree of overlap between “for” recommendations and “for” votes may overstate the influence of ISS. We note that both the average and asset-weighted correspondence between mutual fund votes and ISS recommendations is much higher for the “for” votes which, in turn, represents the vast majority of director elections. Turning to “withhold” votes, ISS recommends “withhold” for only 6.8% of director candidates and, on an asset-weighted basis, those recommendations are followed by only 26.5% of all mutual funds. Thus when ISS recommends withholding a vote for a particular director an average of 73.5% of mutual fund votes are cast in opposition to that recommendation.

TABLE 3: CORRESPONDENCE OF “FOR” AND “WITHHOLD” VOTES

	Average	Asset-weighted
Fund “for” and ISS “for”	94%	95.6%
Fund WH and ISS WH	47%	26.5%

(Overall ISS recommendations are 93.2% “for” and 6.8% “withhold”)

Although our data do not support the claim that most mutual funds blindly follow an ISS recommendation, they do suggest that ISS has the effect of focusing funds on potentially problematic elections. To measure this focal point effect, we calculated the correlation in voting among ISS and the dominant clusters of the 19 large fund families in our sample. The correlation was significant and positive between ISS and 17 of the clusters. In comparison the average number of significant correlations between any one cluster and the 18 other clusters was 11.4. The average correlation between ISS and the dominant clusters of only large fund families was also significantly higher than the average correlation among the clusters.<sup>95</sup> These results

<sup>95</sup> This being said, four clusters had a higher average correlation with the other clusters than with ISS—the families were Alliance Bernstein, Hartford, Morgan Stanley and T. Rowe Price—and one family (T. Rowe Price) had a number of significant correlations equivalent to ISS. These four clusters generally voted similarly, but only two of them were characterized as following an ISS shortcut. The other two families—T. Rowe Price and Morgan Stanley—had a

show that, although funds often vote heterogeneously on any particular director candidate, in those circumstances in which many large funds are voting the same way, that vote generally corresponds with the ISS recommendation. We return to the focal point effect of an ISS “withhold” recommendation in Part IV below.

To put ISS’s influence further in perspective, we compare the assets held by funds that have a strong tendency of following ISS with the assets held by funds that have adopted a “follow management” short cut. Funds that have a relative “withhold” rate of less than 0.1 (our measurement of a “follow management” short cut), which translates roughly into an absolute “withhold” rate of 0.6% or less, account for 24% of the sample’s aggregate assets, and funds with a relative “withhold” rate of less than 0.2% account for 27% of the aggregate assets. Compare this with the 3.04% of the sample’s aggregate assets that follow ISS recommendations more than 99% or 10.16% of assets that follow ISS recommendations more than 97.5% of the time as reported in Table 2. From the perspective of economic significance, blindly following ISS appears to be less of a concern for the funds in our sample than blindly following management.<sup>96</sup>

### III. HOW THE LARGEST FUNDS VOTE

Three mutual fund complexes—Vanguard, Fidelity, and American funds—tower over all other funds in terms of assets under management.<sup>97</sup> Each of them had more than \$1 trillion under management during 2005–2006, accounting for about 20% of the total assets in our sample.<sup>98</sup> Together, these three families accounted for 34% of aggregate mutual fund assets during our sample period. Thus, as far as mutual funds are concerned, these three major families control at least as many votes, and probably more, than those that strictly follow ISS.

The factors that influence the voting decisions of these three fund complexes are thus of particular interest. Notably, all Vanguard and American funds vote fully or virtually fully in lockstep, as does the dominant cluster of Fidelity funds (the non-index funds), which accounts for 90% of Fidelity’s aggregate assets.

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similar overall “withhold” rate as did ISS, but declined to follow ISS “withhold” recommendations in, respectively, 16% and 37% of all cases and their “withhold” votes that did not follow ISS accounted for, respectively, 12% and 22% of their total “withhold” votes.

<sup>96</sup> Indeed, we note that the fifth largest fund family in our sample, Dodge & Cox, had a “withhold” rate of zero.

<sup>97</sup> By comparison, the next largest fund family, Franklin Templeton, is roughly one-third the size of these three, and its dominant cluster accounts for only 72% of its assets.

<sup>98</sup> Data on mutual fund asset holdings as of March 31, 2007, provided by Mr. Erin H. Short, Senior Research Associate, Statistical Research, Investment Company Institute. For more information on our methodology, see *supra* note 68. Total US mutual fund assets as of Dec. 31, 2006 were approximately \$10.4 trillion. INV. CO. INST., INVESTMENT COMPANY INSTITUTE 2007 FACT BOOK, Section 1, Table 3, available at [http://www.icifactbook.org/2007/data/07\\_fb\\_table03.xls](http://www.icifactbook.org/2007/data/07_fb_table03.xls).

To see how specific director and company attributes<sup>99</sup> related to the probability of a “withhold” vote, we tabulated the fund complexes’ votes for directors along several attributes identified in our prior research, such as being a new director, being a director candidate over the age of 75 or being a director at a company that pays abnormally high executive compensation.<sup>100</sup> We then calculated whether the probability that a director with a certain attribute received a “withhold” vote from a certain fund complex (e.g., Vanguard) was significantly higher or lower than the average probability of a “withhold” vote for that specific complex. Tables A1 to A3 in the Appendix report the summary statistics.

We divided the attributes into several categories and subcategories as follows: audit/disclosure-related attributes (AuditMbr, Prior Restat, Prior SEC); compensation-related attributes (CompMbr, Top5AbComp); board-related attributes with the following subcategories: board effectiveness (Attendance, ManyBds, Age75); board composition (NomMbr), board independence (Empl\_Dir, OutDirLink, Interlock), and board responsiveness (IP No – shareholder proposal ignored); takeover related attributes (ClassBd, CumVote, Poison Pill, and Golden Parachute); performance related attributes (Top5AbRet and Bot5Abret); and uncategorized attributes (New Director, CEO, and ISS recommendation).<sup>101</sup>

We then ran logistic regressions for the Vanguard, American, and Fidelity non-index fund clusters using company-director-year level data (e.g., how the Vanguard funds voted for a specific director at a specific company in a particular year form one data point in the Vanguard fund cluster logistic model). The dependent variable in the models is the specific fund cluster’s voting decision (either “for” = 1 or “withhold” = 0). In each logistic regression model, we included the above attributes and other factors as independent variables. Errors are clustered by company in the models. The results are shown in Tables A4 to A6 in the appendix.

### A. Vanguard

Vanguard cast “withhold” votes for about 10% of the director candidates on which it voted. The summary statistics (see Appendix, Table A1) indicate that Vanguard was significantly more likely to “withhold” its vote from members of compensation or nominating committees and significantly less likely to “withhold” its vote from CEOs, other directors who are company employees, non-executive chairmen, and new directors.<sup>102</sup>

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<sup>99</sup> See the Appendix for definitions of the attributes.

<sup>100</sup> In prior research, we have shown that most of the attributes affect the voting recommendations of proxy advisors and the shareholder vote. See Choi et al., *supra* note 22, at 669–70.

<sup>101</sup> See the Appendix for definitions of the variables.

<sup>102</sup> We caution, however, that these variables are correlated (e.g., the CEO is ordinarily not a member of the compensation committee).

Of 1,435 Vanguard “withhold” votes, 1,087 (over 75%) were cast against members of a company’s compensation committee even though such directors account for only 39% of the nominee pool. This strongly suggests that a large fraction of Vanguard’s “withhold” votes are driven by compensation-related matters for which Vanguard holds members of the compensation committee responsible. Consistent with this focus on compensation, Vanguard is also significantly more likely to cast a “withhold” vote against board members of companies that paid abnormally high compensation, and even more likely to cast a “withhold” vote against the members of the compensation committees of such companies.

Other factors that are associated with a Vanguard “withhold” vote in the univariate analysis are failure to attend at least 75% of the board meetings, being an outside-linked director, and bottom 5% abnormal return. By contrast, membership on many boards, ignoring shareholder proposals, and having a poison pill or a golden parachute are associated with a *reduction* in the probability of a Vanguard “withhold” vote.

Although we classified Vanguard as voting independently, Vanguard’s votes are significantly correlated with the ISS recommendations. Vanguard followed 91% of the ISS “for” recommendations and 40% of the ISS “withhold” recommendations. We note that this degree of correlation does not mean that Vanguard follows an ISS shortcut. Indeed, Vanguard rejected a majority (60%) of ISS’s “withhold” recommendations. Perhaps more significantly, Vanguard reached an independent decision with respect to three-quarters of its “withhold” votes—76% of Vanguard’s “withhold” votes were cast on directors for whom ISS recommended a “for” vote. Vanguard thus does not follow ISS blindly, or even usually, but instead regularly departs from ISS recommendations.

The company-director-year vote logistic regressions using the Vanguard vote as the dependent variable (see Appendix, Table A4) confirm the importance of compensation-related factors for Vanguard’s voting decisions. We first consider model (1), which includes the variables from the univariate analysis of Appendix Table A1 as independent variables, except that it does not include the ISS recommendation as an independent variable. The variables for CompMbr and Top5AbComp are significant, at the 1% and 5% levels, respectively, and of large absolute magnitude. At the mean level for the other variables, membership on the compensation committee and high compensation are estimated to increase the probability of a Vanguard “withhold” vote by, respectively, 16% and 6%. The large coefficient estimate for membership on a compensation committee is of particular interest since there is nothing per se problematic about such membership. (In contrast, other variables, such as non-attendance at board meetings, prior restatement, and even an ISS “withhold” recommendation, are per se indicators of some problem.) The large coefficient estimate indicates not only that compensation-related factors are important for Vanguard, but also that a large percent-

age of compensation committee members do not live up to Vanguard's standards.

Other variables that are associated with an increased probability of a Vanguard "withhold" vote are *OutDirLink*, *Empl\_Dir*, and *Attendance*, each at the 1% level. At the mean level for the other variables, these factors are estimated to increase the probability of a "withhold" vote by, respectively, 22%, 11% and 62%. Being a member of the nominating or audit committee is also associated with an increased probability of a "withhold" vote, but the later are significant only at the 10% level, and they have only a marginal quantitative effect on the probability of a Vanguard "withhold" vote. In contrast, *New Director*, *Chairman Only*, and *Top5AbRet* significantly reduce the probability of a "withhold" vote (at the 1%, 5%, and 10% levels, respectively). Of the takeover-related attributes, having a classified board increases, but having a poison pill reduces, the probability of a "withhold" vote.

In model (2), the added variable for the ISS recommendation is highly significant, reflecting, as noted above, the correlation between Vanguard votes and ISS recommendations. The quantitative impact, while important, is not overwhelming. At the mean level for the other variables, an ISS "withhold" recommendation increases the probability of a Vanguard "withhold" vote by 14% (compared to 51% for failure to attend at least 75% of the board meetings, 16% for being an outside-linked director, and 15% for being a member on the compensation committee (all from model (2))). The inclusion of the ISS variable has little effect on the significance of the other variables except that *Top5AbRet*, which was borderline significant in model (1), is now borderline insignificant and *IP No* is now associated with a significant (at the 5% level) *reduction* in the probability of a "withhold" vote.<sup>103</sup>

In sum, our analysis demonstrates the substantial degree to which Vanguard makes its voting decisions independently. Compensation is a critical factor in Vanguard's analysis, and Vanguard does not appear to withhold votes based primarily on an issuer's corporate governance characteristics.

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<sup>103</sup> In our assessment, this does not signify that Vanguard prefers directors who ignore shareholder proposals that receive majority support, but rather reflects Vanguard's selective approach to ISS "withhold" recommendations. As we have shown elsewhere, *IP No* is a powerful factor in explaining ISS "withhold" recommendations. However, the summary statistics and the regression in model (1) indicate that *IP No* does not explain Vanguard "withhold" votes. Likewise, while Vanguard may heed ISS "withhold" recommendations (or independently arrive at the same conclusions as ISS) with respect to some reasons for "withhold" votes, Vanguard does not follow ISS "withhold" recommendations that are based on the company's ignoring a shareholder proposal. In model (2), this is reflected in the significant negative coefficient for the ISS recommendation and the significant positive coefficient (or similar magnitude) for *IP No*, which balance each other out for ISS "withhold" recommendations issued because the director ignored a shareholder proposal.



*B. The American Funds*

The American Funds group was classified above as employing a management shortcut. The American Funds cast “withhold” votes in a mere 16 of over 4,000 director elections, a “withhold” rate of 0.4%.<sup>104</sup> A substantial number of the very rare “withhold” votes by American are with respect to directors on companies that restated their financial statements. As shown in the summary statistics, over half (9 of 16) of the “withhold” votes relate to directors at such companies, even though these directors account for only 10% of the director nominees on which American cast a vote. If a company restated its financials, a director’s membership on the audit committee did not further increase the probability of a “withhold” vote.

The summary statistics point to no other identifiable explanatory factor for the American Funds’ “withhold” votes. Notably, neither Attendance nor OutDirLink—which we have shown elsewhere are important factors in explaining both “withhold” recommendations by ISS and shareholder voting overall<sup>105</sup>—appears to affect the voting of the American Fund complex.<sup>106</sup> In addition, in the univariate analysis, the ISS recommendation has no impact on the vote by the American Funds.

In the company-director-year vote logistic regressions using the American Funds vote as the dependent variable (see Appendix, Table A5), as one would expect, the coefficient for Prior Restat is highly significant and, in absolute magnitude, dwarfs all of the other coefficient estimates. While the interaction variable Prior Restat x AuditMbr is significant and negative, the variable for AuditMbr is of similar magnitude and significantly positive. This means that, given a restatement, being a member of the audit committee does not further increase the probability of a “withhold” vote. In addition, and somewhat counterintuitively, being a new director increases the probability of a “withhold” vote.<sup>107</sup> Albeit statistically significant in absolute terms, the effects of being a member of the audit committee and being a new director are trivial. When we add the variable for the ISS recommendation,<sup>108</sup> the significance levels of these other variables do not change, and the ISS variable itself is insignificant.

In sum, our analysis demonstrates that the American Funds rarely choose to withhold their votes in director elections. The presence of a prior restatement is a critical factor in the few instances where the American Funds do vote “Withhold”.

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<sup>104</sup> See Appendix, Table A2.

<sup>105</sup> See Choi et al., *supra* note 22 at 674–75.

<sup>106</sup> These factors, as shown above, also have a significant impact on Vanguard’s voting.

<sup>107</sup> We document elsewhere that new directors are substantially less likely to receive “withhold” recommendations from ISS. See Choi et al., *supra* note 22, at 673.

<sup>108</sup> See Appendix, Table A5 model (2).

*C. Fidelity*

As noted above, Fidelity funds vote in two separate clusters. Most Fidelity funds, other than the index funds, vote in lockstep with each other and form the dominant Fidelity cluster. Collectively, these funds represent 90% of the equity assets under management by the Fidelity group. The second cluster consists of the Fidelity index funds, which also vote in lockstep with each other, but differently from the dominant Fidelity cluster. This cluster comprises the remaining 10% of equity assets under management by the Fidelity group.

Our analysis here concerns only the dominant Fidelity cluster (the non-index funds). Fidelity's "withhold" rate for that cluster was about 3%. In the summary statistics,<sup>109</sup> factors associated with an increased probability of a "withhold" vote included audit-related factors (Prior Restat, Prior SEC, as well as the interaction variables Prior Restat x AuditMbr and Prior SEC x AuditMbr), Empl\_Dir, Age75, and three takeover-related factors (ClassBd, Poison Pill, and Golden Parachute). Curiously, our variable for low abnormal return (Bot5AbRet) was associated with a reduced probability of a "withhold" vote. Fidelity funds were also slightly more likely to "withhold" their vote on directors when ISS recommended a "withhold" vote (4.4%) than when ISS recommended a "for" vote (2.9%).

As to the company-director-year vote logistic regression, using the Fidelity non-index fund vote as the dependent variable, our explanatory variables do a relatively poor job in explaining Fidelity's voting behavior (see Appendix, Table A6). This is reflected, for one, in the low pseudo r-squared of the logistic regressions (0.082 and 0.084 depending on the model).<sup>110</sup> For comparison, the respective pseudo r-squares are 0.243 and 0.270 for Vanguard and 0.277 and 0.282 for American. This suggests that Fidelity's voting decisions, to a substantially greater extent than Vanguard's and American's, are affected by factors not accounted for in our analysis.

Taking a closer look at the independent variables, in model (1) (without the ISS variable) prior restatements increase the probability of a Fidelity "withhold" vote for members of the audit committee, as does being an employee director. In addition, one takeover-related factor (Golden Parachute) increases the probability of a "withhold" vote. As with the American Funds, Attendance, IP No and OutDirLink are not significant. Model (2) yields equivalent results, and the ISS recommendation is insignificant. We conclude that Fidelity's voting decisions are independent, but eclectic.

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<sup>109</sup> See Appendix, Table A3.

<sup>110</sup> R-squared is a variable that measures the fraction of the variation in the dependent variable—i.e. Fidelity voting decision—that is explained by the independent variables.

*D. Comparison of Large Fund Voting with Overall Shareholder Voting and ISS Recommendations*

In our earlier articles, we examined the factors that determine the overall percentage “for” vote directors received in election as well as the factors that determine the ISS voting recommendations. Our analysis here of the voting by the Vanguard, American and Fidelity fund complexes enables us to compare the voting behavior of these large institutional investors with each other as well as with the votes of shareholders overall and the ISS recommendations.

Table 4 below summarizes how these factors affect the voting decision. Two results stand out. First, the three large mutual fund families differ from each other not only in the overall “withhold” rate, but also in the factors that determine “withhold” votes. Second, the factors that affect overall voting outcomes correspond more closely to the factors that affect the ISS recommendation than to the factors that affect the voting decisions by Vanguard, American and Fidelity. This is true even if we control for the ISS recommendation itself in examining the factors that affect the voting outcome. The latter finding supports the conclusion in our earlier article that ISS is more in tune with voter sentiments at large than other market participants.<sup>111</sup>

Looking at the three large fund families individually, the factors that affect Vanguard’s vote are very similar to the factors that affect ISS recommendations and, to a lesser extent, the factors that affect voting decisions. The most important difference is the dramatic effect of compensation-related matters on Vanguard’s vote. For Vanguard, being a member of the compensation committee raises the probability of a “withhold” vote by 16%, from roughly 5% to 21%. For ISS, the corresponding increase is a mere 2%. Importantly, 39% of all nominees for which Vanguard cast a vote were members of a compensation committee. Because the number of nominees who serve on a compensation committee is so high, such membership has a much larger effect on Vanguard’s vote than the (relatively) larger increase in “withhold” vote probability for the few (0.7% of director pool) directors who missed more than 25% of the board meetings.

A second notable difference is that Vanguard did not hold it against board members if they ignored a shareholder proposal that received majority support. In contrast, ignoring a shareholder proposal vastly increases the probability of an ISS “withhold” recommendation (by 42%) and is also associated with an approximately 2% decline in the overall “for” vote *beyond* the average effect of an ISS recommendation. This factor, however, affects only about 1% of the director nominees in the sample.

The American Funds complex differs from both ISS and voters at large (and, for that matter, from Vanguard and Fidelity) in its level of support for the company’s nominees. Even in the rare cases where the American Funds

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<sup>111</sup> See, e.g., Choi et al., *supra* note 1, at 906.

TABLE 4: COMPARISON OF FACTORS AFFECTING VOTES AND ISS RECOMMENDATION

Factor	Category	ISS Rec.	Aggregate Vote Outcome Exc. ISS	Aggregate Vote Outcome Inc. ISS	Vanguard Vote Exc. ISS	Vanguard Vote Inc. ISS	American Vote Exc. ISS	American Vote Inc. ISS	Fidelity Vote Exc. ISS	Fidelity Vote Inc. ISS
CEO		***	***	***						
New Dir.		***	***	***	**	**				
Audit	Audit		***	***	*	*				
PriorRestat	Audit						***	***		
PriorSEC	Audit		***	***						
CompMbr	Comp.	***	***	***	***	***				
Top5Ab Comp	Comp.	*			*	*				
Attendance	Board – Effect.	***	***	***	***	***				
ManyBds	Board – Effect.	***	***	***						
Age75	Board – Effect.		***	***						
NomMbr	Board – Comp.	***	***	***	***					
Empl_Dir	Board – Indep.	***	***	***	***	***			*	*
OutDirLink	Board – Indep.	***	***	***	***	***		**		
Chairman Only		**			**	**				
IP No	Board – Respon.	***	***	***		**				
ClassBd	Takeover	*	***	***	*	*				
Poison Pill	Takeover				**	**				
CumVote	Takeover	*								
Golden Parachute	Takeover	***							*	*
Top5AbRet	Performance		**	**	*					
Bot5AbRet	Performance		*	***						

\*, \*\*, \*\*\* signify statistical significance of the factor at the 10%, 5%, and 1% levels, respectively.

“ISS Rec.” is from a model with the ISS recommendation (For or WH) as the dependent variable. See Choi et al., *supra* (USC Paper). “Aggregate Vote Outcome Exc. ISS” is from a model with the log odds of the total “for” vote as a fraction of all votes cast as the dependent variable without VoteISS (the ISS recommendation) as an independent variable. “Aggregate Vote Outcome Inc. ISS” is the same as “Aggregate Vote Outcome Exc. ISS” but including VoteISS as an independent variable. See Choi et al., *supra* (Emory). The Vanguard, American, and Fidelity regressions use the respective fund’s vote as the dependent variable and are reported in Appendix Tables A4 to A6.

+, - signify direction. ++, — signify a larger quantitative impact. In the non-outcome regressions, we considered an impact large if it was statistically significant and our quantitative estimate at the median for other factors was either (i) at least 10% or (ii) at least 5% and the factor was present for at least 10% of the nominees. Statistically significant factors with a quantitative impact of less than 1% are omitted. In the outcome regressions, we treated an impact as large if it was associated with a coefficient of greater than 1.

“withhold” their vote from a nominee, the factor we identify is distinctive in that the presence of a prior restatement neither affects the ISS recommendation nor the voting outcome at large.

As to Fidelity, the most notable observation is that its analysis is persistently independent. Factors related to compensation, board governance, and performance—important to ISS, Vanguard, and voters at large—have

little or no impact on Fidelity. For that matter, none of the other factors we identify have a large effect on Fidelity's voting. We conclude that factors that we did not include in our analysis affect Fidelity's voting decision. Although we cannot pinpoint Fidelity's analysis from the factors we consider here, as we observe in the next Part, that analysis contains an important element that appears to contain substantial power, beyond the ISS recommendation, in explaining high numbers of "withhold" votes.

#### IV. WHAT ACCOUNTS FOR HIGH "WITHHOLD" VOTES?

Although particular investors may withhold votes for a variety of reasons, high "withhold" votes are of particular concern because they signal widespread investor concern about the company.<sup>112</sup> The data that we have collected enables us to look more carefully at directors who receive high "withhold" votes and the factors associated with those votes. For purposes of this examination, we define a high "withhold" vote as a "withhold" vote of 30% or more of the votes cast.<sup>113</sup> During 2005–2006, 276 directors in our sample received high "withhold" votes.<sup>114</sup> Table 5 below provides information about directors who received a high "withhold" vote.

For the entire set of directors in our sample, the probability of getting a high "withhold" vote is 2% (High WH Vote/Pool Column (1)). For directors who received an ISS "withhold" recommendation, the probability of a high "withhold" vote jumps to 30% (High WH Vote/Pool Column (2)). More significantly, directors who received an ISS "withhold" recommendation account for 95% of the directors who received a high "withhold" vote (High WH Vote for Specific Category/Total High WH Vote for All Directors Column (2)). Correspondingly, for directors who did not receive an ISS "withhold" recommendation, the probability of a high "withhold" vote drops to 0.1%. The data strongly supports our previously discussed hypothesis that ISS recommendations have the effect of focusing investors on potentially problematic directors or companies.

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<sup>112</sup> See, e.g., WILKIE, FARR & GALLAGHER, "JUST VOTE NO" CAMPAIGNS IN UNCONTESTED DIRECTOR ELECTIONS—RENEWED VITALITY FOR THE 2010 PROXY SEASON 1 (2009), available at [http://www.willkie.com/files/tbl\\_s29Publications%5CFileUpload5686%5C3113%5CJust%20Vote%20No%20Campaigns.pdf](http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C3113%5CJust%20Vote%20No%20Campaigns.pdf) ("By achieving a compelling 'withhold' vote . . . the campaign seeks to send a strong message to the company's board of directors that shareholders are dissatisfied with some aspect of governance, management or corporate strategy.").

<sup>113</sup> Cf. QUINTON HUCKEY, ELECTIONS THAT MATTER: A REVIEW OF DIRECTOR VOTES IN 2008 1 (2008), available at <http://www.directorsandboards.com/DBEBRIEFING/November2008/AReviewofDirectorVotesin2008FINAL.pdf>; (defining as "high" a "withhold" vote of 20% or more); Diane Del Guercio, Laura Seery & Tracie Woidtke, *Do Boards Pay Attention When Institutional Investor Activists "Just Vote No"?*, 90 J. FIN. ECON. 84, 89 (2008) (describing "withhold" votes of more than 20% as "substantial").

<sup>114</sup> We note that high "withhold" votes are increasing in frequency. See, e.g., HUCKEY, *supra* note 113, at 1 (stating that 5–6% of directors received a "withhold" vote of 20% or more in 2007).

TABLE 5: OVER 30% “WITHHOLD” VOTES

	(1) All Directors	(2) ISS WH	(3) ISS WH + Fidelity WH	(4) ISS WH + Attendance	(5) ISS WH + Share- holder Resolution	(6) ISS + Vangd. WH + Outside- Linked Director	(3)-(6) Combined
Number of Directors (Pool)	13,159	887	29	40	52	174	281
High WH Vote	276	262	23	24	18	69	134
High WH Vote / Pool	0.02	0.30	0.79	0.60	0.35	0.40	0.48
High WH Vote for the Specific Category / Total High WH Vote for All Directors	1.00	0.95	0.08	0.09	0.06	0.25	0.49

High WH Vote tabulates the number of directors that received a “withhold” vote of 30% or more of the votes cast. High WH Votes for the Specific Category is the number of directors that received a “withhold” vote of 30% or more of the votes cast for a specific category (such as Column (2) in the table) and Total High WH Vote for All Directors is the number of all directors that received a “withhold” vote of 30% or more of the votes cast. The (3)-(6) combined column includes directors who meet the criteria of at least one of columns (3) through (6).

Although an ISS “withhold” recommendation is a significant factor in predicting a high “withhold” vote, it is not as powerful as the commentary about ISS might suggest. Note that even those directors who receive an ISS “withhold” recommendation have a 70% probability of not receiving a high “withhold” vote (or  $1 - \text{High WH Vote/Pool Column (2)}$ ). What else matters? We analyze specific company and director attributes to identify four additional factors that significantly enhance our power to predict the incidence of a high “withhold” vote.

Combining an ISS “withhold” recommendation with at least one of four factors raises the probability of a high “withhold” vote to 49%. Those factors are (1) a Fidelity “withhold” vote with respect to that director (which together with a ISS “withhold” recommendation is associated with a 79% probability of receiving a high “withhold” vote); (2) a director who did not attend at least 75% of the board meetings (60% probability); (3) being a director at a company that ignored a shareholder resolution that received majority support (35% probability); and (4) an outside-linked director for whom Vanguard cast a “withhold” vote (40% probability).<sup>115</sup>

Overall, directors in one (or more) of these four groups account for 48% of the directors who received a high “withhold” vote. Directors who, in addition to receiving an ISS “withhold” recommendation, fall in any one of the four groups have a 49% probability of receiving a high “withhold” vote. In comparison, a director who receives an ISS “withhold” recommendation

<sup>115</sup> Outside this group, a Vanguard “withhold” vote did not make much difference. Directors who received an ISS “withhold” recommendation and for whom Vanguard cast a “withhold” vote but who are not in one of the four groups had a 18% probability of receiving a high “withhold” vote, slightly less than the respective directors for whom Vanguard did not cast a “withhold” vote.

but is *not* in one of these groups only has a 21% probability of receiving a high “withhold” vote. Although this figure is still reasonably high, it is substantially less than that for a director who combines an ISS “withhold” recommendation with one of our four additional factors.

If we define a high “withhold” vote more narrowly, as directors receiving more than 40% or more than 50% “withhold” votes, the pattern becomes even stronger, as indicated in Table 6 below.

TABLE 6: PROBABILITY OF HIGH “WITHHOLD” VOTE

	ISS WH only	ISS WH plus at least one of four factors
WH vote > 30%	21.0%	48.0%
WH vote > 40%	7.0%	19.0%
WH vote > 50%	0.5%	5.0%

Directors who receive an ISS “withhold” recommendation and who are in at least one of the four groups account, respectively, for 56% and 81% of the pool of directors who received in excess of 40% or in excess of 50% “withhold” votes. For directors who are within one of the groups, the probability of receiving a 40% or more or 50% or more “withhold” vote is, respectively, 19% and 5%. For directors who receive an ISS “withhold” recommendation but who are not in one of the groups, the probability of receiving such a high “withhold” vote is significantly lower (7% and 0.5%, respectively).

Our findings indicate that the four factors we have identified, in conjunction with ISS recommendations, have substantial explanatory power in predicting whether a director receives a high “withhold” vote. An adverse ISS recommendation that is not combined with one of the factors increases the probability of receiving a high “withhold” vote by a factor of 5 to 10. The presence of one of the factors on top of the ISS recommendation increases the probability of a high “withhold” vote by a further factor of 2.5 to 10.

The higher the definition of what constitutes a high “withhold” vote, the less important the ISS recommendation is on its own and the more important is the presence of one of the additional factors. This finding reinforces the suggestion in our prior research that ISS’s recommendations are influential because they focus shareholder attention, but not because shareholders follow those recommendations blindly.

It is worth highlighting the fact that the combination of an ISS “withhold” recommendation and a Fidelity “withhold” vote (a combination which is associated with a 79% probability of a high “withhold” vote) is particularly problematic for directors—much more so than the combination of an ISS “withhold” recommendation and a Vanguard “withhold” vote (which is associated with only a 36% probability of a high “withhold” vote).

As we have discussed earlier, the factors in our model do not explain Fidelity's voting behavior well, and the correlation between Fidelity's voting and ISS recommendation is much lower than the equivalent correlation between Vanguard and ISS. Thus, ironically, while Fidelity's voting appears largely independent from ISS, in the relatively infrequent instances where Fidelity and ISS agree, the director is in trouble.

Less surprisingly, lack of regular attendance at board meetings is highly significant in explaining high "withhold" votes. For the >40% and >50% thresholds for a high "withhold" vote, the combination of an ISS "withhold" recommendation and lack of regular attendance was the best predictor we found for directors receiving a high "withhold" vote.<sup>116</sup> Specifically, this combination raised the background probability of receiving a majority "withhold" vote by a factor of 100.

Our prior findings and those of other scholars suggested that attendance is an important factor in explaining both voting outcomes and the recommendations of proxy advisors.<sup>117</sup> Importantly, however, lack of attendance is also relatively easy for shareholders to observe directly because SEC rules require companies to identify specifically, in the proxy statement itself, any director who did not attend at least 75% of the board meetings.<sup>118</sup> Thus director attendance is likely a characteristic for which the information provided by ISS is of limited value.

The two other factors—ignoring a shareholder resolution (IP No) and the combination of a Vanguard "withhold" vote and being an outside-linked director (OutDirLink)—are less strongly associated with a high "withhold" vote. In our prior studies, we found that ignoring a shareholder resolution is a strong predictor of an ISS "withhold" recommendation (in fact, a stronger predictor than lack of attendance)<sup>119</sup> and a significant factor in explaining the vote outcome (though less important than attendance, being an employee director, or being an outside-linked director).<sup>120</sup> Unlike director attendance, shareholders cannot readily observe whether directors have ignored a prior shareholder resolution by reviewing the current proxy statement, because the SEC does not require explicit disclosure of that fact, making the reliance of ISS on this factor particularly important in its ability to convey new information to shareholders.<sup>121</sup>

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<sup>116</sup> Lack of regular attendance is also a strong predictor of getting an ISS "withhold" recommendation. See Choi et al., *supra* note 22.

<sup>117</sup> See Choi et al., *supra* note 1, at 888–95, 909–912; Choi et al., *supra* note 22, at 665–75; Cai et al., *supra* note 58, at 2402–04.

<sup>118</sup> SEC rules require issuers to disclose the name of each director who attended fewer than 75% of the meetings of the board and of committees on which he or she sat. 17 C.F.R. § 229.407(b) (2012).

<sup>119</sup> See Choi et al., *supra* note 1, at 888–95, 909–12; Choi et al., *supra* note 22, at 665–75.

<sup>120</sup> See *id.*

<sup>121</sup> In our prior work, we found that ignoring a prior shareholder resolution is less of a factor in explaining voting recommendations of other proxy advisors (in particular for PROXY Governance Inc. and Glass, Lewis & Company). See Choi et al., *supra* note 22, at 670–75. We also find that ignoring a prior shareholder resolution is generally not relevant in explaining the



The combination of an ISS “withhold” recommendation, a Vanguard “withhold” vote and being an outside-linked director is associated with a surprisingly high probability of a high “withhold” vote—higher than would seem to be predicted from the separate effects of these factors. Although we cannot explain this result with our existing data, we surmise that the combination of these factors is associated with additional factors that we have not separately identified and that make these directors particularly objectionable to shareholders.

#### CONCLUSION

This paper addresses an increasingly important question: what factors explain the voting of mutual funds? Unlike prior studies, we focus specifically on uncontested director elections as a particularly clean test of fund voting behavior. Mindful of the economic and structural realities of mutual funds, we examine their voting mechanisms as well as their actual voting decisions, identifying both the degree to which fund families centralize their voting and the extent to which they employ short cuts to economize on voting costs.

We find that, although a substantial number of funds employ short cuts, appearing to presumptively follow the voting recommendations of either management or ISS, these strategies are more common in smaller fund families. On an asset-weighted basis, reliance on management appears to be more significant than reliance on ISS, and a very small percentage of fund assets appear to be voted automatically in accordance with ISS recommendations. Perhaps more importantly, ISS recommendations appear to be most significant in focusing investor attention on potentially problematic directors.

We find substantial heterogeneity in mutual fund voting. Although each of the three largest fund families—Vanguard, Fidelity, and the American Funds—vote substantially in lockstep, they exhibit significantly different voting patterns from each other, both in terms of their overall proclivity to cast “withhold” votes and in terms of the factors explaining these votes. Finally, we identify four factors that, in conjunction with an ISS “withhold” recommendation, explain which directors are likely to receive “withhold” votes in excess of 30%. These findings are of special import for companies and directors who want to avoid such embarrassingly high “withhold” votes.

Our research documents the use by funds of their increasing voting power. We are hopeful that, as funds become more experienced and sophisticated participants in the election process, they will increase their attempts to hold directors accountable beyond the efforts that we find here.<sup>122</sup> Although

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votes of Vanguard or Fidelity. See Appendix, Tables A4 (Vanguard) and A6 (Fidelity Non-Index Funds).

<sup>122</sup> See, e.g., Yonca Ertimur, Fabrizio Ferri & David A. Maber, *Reputation Penalties for Poor Monitoring of Executive Pay: Evidence from Option Backdating*, 104 J. FIN. ECON. 109 (2012) (finding that, although investors withheld votes from directors at firms involved in

some scholars have questioned the ability of institutional investors to improve issuer performance through shareholder activism,<sup>123</sup> it is nonetheless true that intelligent voting by those shareholders with a meaningful economic interest offers a promising mechanism for increasing board accountability.

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options backdating scandals, they did not “withhold” votes from those same directors at firms not involved in the scandals).

<sup>123</sup> See, e.g., Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. REG. 174 (2001) (finding that institutional activism through shareholder proposals does not improve, and in some cases damages, firm performance).

APPENDIX  
VARIABLE DEFINITIONS

Variable	Definition
CEO	Indicator variable equal to 1 if the director is the CEO of the company in question and 0 otherwise.
New Director	Indicator variable equal to 1 if the director has been on the board for less than 2 years and 0 otherwise.
AuditMbr	Indicator variable equal to 1 if the director is a member of the audit committee and 0 otherwise.
Prior Restat	Indicator variable equal to 1 if news relating to a financial restatement was first made public within 2 years prior to the meeting date (either in a SEC filing or through a public press release) and 0 otherwise.
Prior SEC	Indicator variable equal to 1 if news relating to an SEC investigation or enforcement action was first made public within two years prior to the meeting date (either in a SEC filing or through a public press release) and 0 otherwise.
CompMbr	Indicator variable equal to 1 if the director is a member of the compensation committee and 0 otherwise.
Top5AbComp	Indicator variable equal to 1 if the total excess compensation for the CEO for the company in question is in the top 5% of the sample and 0 otherwise. We define total excess CEO compensation as the difference between the total CEO compensation for the year prior to the meeting date (as provided by the Compustat Executive Compensation database) minus the expected total CEO compensation. We calculate the expected total CEO compensation by (1) estimating an OLS model for Total CEO compensation = $a + b_1\text{market\_capitalization} + b_2\text{One\_Year\_Abnormal\_Holding\_Period\_Return} + b_3\text{Year\_2006} + e$ . (2) Using the predicted Total CEO compensation based on this model as the expected Total CEO compensation.
Attendance	Indicator Variable equal to 1 if director attended less than 75% of the meetings and 0 otherwise (as tracked by IRRC for the year prior to the annual meeting date).
ManyBds	Indicator variable equal to 1 if the director is a member of at least three other “major” company boards (as followed by IRRC for the year prior to the annual meeting date) and 0 otherwise.

Age75	Indicator variable equal to 1 if the director is 75 years or older and 0 otherwise.
NomMbr	Indicator variable equal to 1 if the director is a member of the nominating committee and 0 otherwise.
Empl_Dir	Indicator variable equal to 1 if the director is an employee of the company in question (but not the CEO) and 0 otherwise.
OutDirLink	Indicator variable equal to 1 if the director is an outside director of the company in question with affiliated links with the company and 0 otherwise. IRRC treats as linked a director: “who is a former employee; is an employee of or is a service provider, supplier, customer; is a recipient of charitable funds; is considered an Interlocking or designated director; or is a family member of a director or executive.” See “Definitions for RiskMetrics’ Directors Dataset” available at <a href="http://wrds.wharton.upenn.edu/ds/riskmetrics/dir_doc.shtml">http://wrds.wharton.upenn.edu/ds/riskmetrics/dir_doc.shtml</a> .
TotDirSH	The percentage of the votes in the company in question held by all board members.
Interlock	Indicator Variable equal to 1 if director met the IRRC criteria for an Interlocking director in the year prior to the annual meeting date and 0 otherwise. IRRC defines an Interlocking directorship as follows: “whereby a director and executive of the company sits on a board of another company that has an executive and director who also sit[s] on the original company’s board.” See “Definitions for RiskMetrics’ Directors Dataset” available at <a href="http://wrds.wharton.upenn.edu/ds/riskmetrics/dir_doc.shtml">http://wrds.wharton.upenn.edu/ds/riskmetrics/dir_doc.shtml</a> .
Chairman Only	Indicator variable equal to 1 if the director is the chairman of the board of the company in question but not an employee and 0 otherwise.
IP No	Indicator variable equal to 1 if the company in question faced a proxy issue proposal that received a majority “for” vote in the year prior to the director vote in question and failed to implement the recommendations of the proxy issue proposal and 0 otherwise.
ClassBd	Indicator variable equal to 1 if the director sits on a classified board for the company in question (as measured by IRRC for the year prior to the annual meeting date) and 0 otherwise.

Poison Pill	Indicator variable equal to 1 if a poison pill exists for the company in question (as measured by IRRC for the year prior to the annual meeting date) and 0 otherwise.
CumVote	Indicator variable equal to 1 if the company in question uses cumulative voting to elect directors (as measured by IRRC for the year prior to the annual meeting date) and 0 otherwise.
Golden Parachute	Indicator variable equal to 1 if the company in question uses golden parachute agreements (as measured by IRRC for the year prior to the annual meeting date) and 0 otherwise.
Top5AbRet	Indicator variable equal to 1 if the abnormal return for the three-year period prior to the annual meeting date for the company in question is in the top 5% of the sample and 0 otherwise. The abnormal return is defined as the three-year holding period return for the company in question minus the three-year holding period return for the CRSP value weighted market index.
Bot5AbRet	Indicator variable equal to 1 if the abnormal return for the three-year period prior to the annual meeting date for the company in question is in the bottom 5% of the sample and 0 otherwise. The abnormal return is defined as the three-year holding period return for the company in question minus the three-year holding period return for the CRSP value weighted market index.
Sdret	Standard deviation of returns for the company in question for the one-year period prior to the annual meeting date.
ln(Mktcap)	Log of the market capitalization (in \$ millions) of the company in question.
InstHold	Percentage of shares of the company in question held by institutional investors.
Year06	Indicator variable equal to 1 if the director recommendation is for 2006 and 0 otherwise (for 2005).
VoteISS	Indicator variable equal to 1 if ISS recommends a “withhold” vote for the director in question and 0 otherwise.

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APPENDIX TABLE A1: VANGUARD VOTE SUMMARY STATISTICS

	=0		=1		Chi-Squared p-value				
Total Votes	N	FOR	WH	ForVote	N	FOR	WH	ForVote	p-value
All	13,427				13,427	11,992	1,435	89.3%	0.000
ISS REC (1=WH)	13,424	12,566	11,476	1,090	858	513	345	59.8%	0.000
CEO	13,483	12,057	10,649	1,408	1,426	1,393	33	97.7%	0.000
New Director	13,483	11,332	10,012	1,320	2,151	2,030	121	94.4%	0.000
AuditMbr	13,483	8,098	7,228	870	5,385	4,814	571	89.4%	0.797
Prior Restat	13,483	11,861	10,596	1,265	1,622	1,446	176	89.1%	0.820
Prior SEC	13,483	12,562	11,212	1,350	921	830	91	90.1%	0.412
Prior Restat x AuditMbr	13,483	12,832	11,459	1,373	651	583	68	89.6%	0.838
Prior SEC x AuditMbr	13,483	13,147	11,459	1,688	336	300	36	89.3%	0.987
CompMbr	13,483	8,267	7,913	354	5,216	4,129	1,087	79.2%	0.000
Top5AbComp	12,885	12,248	11,004	1,244	637	525	112	82.4%	0.000
Top5AbComp x CompMbr	12,885	12,656	11,377	1,279	229	152	77	66.4%	0.000
Attendance	13,443	13,353	11,971	1,382	90	31	59	34.4%	0.000
ManyBds	12,864	11,619	10,403	1,216	1,245	1,120	125	90.0%	0.641
ManyBds x CEO	12,864	12,813	11,473	1,340	51	50	1	98.0%	0.047
Age75	13,483	13,043	11,674	1,369	440	368	72	83.6%	0.000
NomMbr	13,483	8,161	7,472	689	5,322	4,570	752	85.9%	0.000
Empl_Dir	13,483	12,642	11,257	1,385	841	785	56	93.3%	0.000
OutDirLink	13,483	12,066	10,951	1,115	1,417	1,091	326	77.0%	0.000
Interlock	13,483	13,451	12,014	1,437	32	28	4	87.5%	0.740
Chairman Only	13,483	13,184	11,761	1,423	299	281	18	94.0%	0.008
IP No	13,483	13,377	11,940	1,437	483	465	18	96.2%	0.021
ClassBd	13,290	8,558	7,654	904	106	102	4	96.2%	0.021
Poison Pill	13,290	6,362	5,650	712	4,732	4,220	512	89.2%	0.646
CumVote	13,290	11,794	10,522	1,272	6,928	6,224	704	89.8%	0.055
Golden Parachute	13,290	3,324	2,874	450	1,496	1,352	144	90.4%	0.171
Top5AbRet	13,478	12,781	11,424	1,357	9,966	9,000	966	90.3%	0.000
Bot5AbRet	13,478	12,868	11,507	1,361	697	613	84	87.9%	0.233
Top5AbRet x CEO	13,478	13,393	11,953	1,440	85	84	1	86.9%	0.047
Bot5AbRet x CEO	13,478	13,406	11,967	1,439	72	70	2	97.2%	0.029

For each variable = 0 is for director who do not meet the criteria and = 1 if for directors who do meet the criteria. (For example, CEO = 0 represents directors who are not CEOs). "FOR" is the number of directors in the = 0 or = 1 subgroup that received a "for" vote from Vanguard. "WH" is the number of directors in the = 0 or = 1 subgroup that received a "withhold" vote from Vanguard. ForVote is the "for" vote as a percentage of all "for" and "withhold" votes cast for directors in the = 0 and = 1 subgroups of directors by Vanguard funds for each criteria. The chi-squared p-value is from a chi-squared test of the difference in the relative frequencies of "for" and "withhold" votes for directors who are = 0 and = 1 for the specific criteria in the table.

APPENDIX TABLE A2: AMERICAN VOTE SUMMARY STATISTICS

	Total Votes		=0		=1		ForVote	WH	FOR	WH	ForVote	Chi-Squared p-value
	N	N	FOR	WH	N	N	ForVote	WH	FOR	WH	ForVote	
All	4,324	4,324	4,077	15	4,324	4,308	99.6%	16	4,308	16	99.6%	
ISS REC (1 = WH)	4,327	4,092	4,077	15	4,324	4,308	99.6%	16	4,308	16	99.6%	0.885
CEO	4,351	3,942	3,928	14	4,092	235	99.6%	1	234	1	99.6%	0.670
New Director	4,351	3,706	3,694	12	4,092	409	99.7%	2	407	2	99.5%	0.251
AuditMbr	4,351	2,687	2,675	12	645	641	99.6%	4	641	4	99.4%	0.275
Prior Restat	4,351	3,923	3,916	7	1,664	1,660	99.8%	4	1,660	4	99.8%	0.000
Prior SEC	4,351	3,917	3,901	16	428	419	99.6%	9	419	9	97.9%	0.182
Prior Restat x AuditMbr	4,351	4,183	4,170	13	434	434	99.7%	0	434	0	100.0%	0.002
Prior SEC x AuditMbr	4,351	4,190	4,174	16	168	165	99.6%	3	165	3	98.2%	0.432
CompMbr	4,351	2,807	2,796	11	1,544	1,539	99.6%	5	1,539	5	99.7%	0.723
Top5AbComp	4,249	3,961	3,945	16	288	288	99.6%	0	288	0	100.0%	0.280
Top5AbComp x CompMbr	4,249	4,150	4,134	16	99	99	99.6%	0	99	0	100.0%	0.536
Attendance	4,347	4,320	4,304	16	27	27	99.6%	0	27	0	100.0%	0.751
ManyBds	4,189	3,634	3,620	14	555	553	99.6%	2	553	2	99.6%	0.929
ManyBds x CEO	4,189	4,171	4,155	16	18	18	99.6%	0	18	0	100.0%	0.792
Age75	4,351	4,244	4,228	16	107	107	99.6%	0	107	0	100.0%	0.525
NomMbr	4,351	2,693	2,682	11	1,658	1,653	99.6%	5	1,653	5	99.7%	0.572
Empl_Dir	4,351	4,100	4,085	15	251	250	99.6%	1	250	1	99.6%	0.934
OutDirLink	4,351	3,881	3,866	15	470	469	99.6%	1	469	1	99.8%	0.557
Interlock	4,351	4,340	4,324	16	11	11	99.6%	0	11	0	100.0%	0.840
Chairman Only	4,351	4,259	4,243	16	92	92	99.6%	0	92	0	100.0%	0.556
IP No	4,351	4,320	4,304	16	31	31	99.6%	0	31	0	100.0%	0.734
ClassBd	4,336	3,074	3,058	16	1,262	1,262	99.5%	0	1,262	0	100.0%	0.010
Poison Pill	4,336	2,441	2,425	16	1,895	1,895	99.3%	0	1,895	0	100.0%	0.000
CumVote	4,336	3,862	3,846	16	474	474	99.6%	0	474	0	100.0%	0.160
Golden Parachute	4,336	1,147	1,140	7	3,189	3,180	99.4%	9	3,180	9	99.7%	0.116
Top5AbRet	4,346	4,254	4,238	16	92	92	99.6%	0	92	0	100.0%	0.556
Bot5AbRet	4,346	4,209	4,193	16	137	137	99.6%	0	137	0	100.0%	0.470
Top5AbRet x CEO	4,346	4,335	4,319	16	11	11	99.6%	0	11	0	100.0%	0.840
Bot5AbRet x CEO	4,346	4,331	4,315	16	15	15	99.6%	0	15	0	100.0%	0.814

For each variable = 0 is for director who do not meet the criteria and = 1 if for directors who do meet the criteria. (For example, CEO = 0 represents directors who are not CEOs). "FOR" is the number of directors in the = 0 or = 1 subgroup that received a "for" vote from American. "WH" is the number of directors in the = 0 or = 1 subgroup that received a "withhold" vote from American. ForVote is the "for" vote as a percentage of all "for" and "withhold" votes cast for directors in the = 0 and = 1 subgroups of directors by American funds for each criteria. The chi-squared p-value is from a chi-squared test of the difference in the relative frequencies of for and "withhold" votes for directors who are = 0 and = 1 for the specific criteria in the table.

APPENDIX TABLE A3: FIDELITY NON-INDEX FUND VOTE SUMMARY STATISTICS

	Total Votes	=0 N	FOR	WH	ForVote	=1 N	FOR	WH	ForVote	Chi-Squared p-value
All	10,112					10,112	9,814	298	97.1%	
ISS REC (1=WH)	10,112	9,453	9,181	272	97.1%	659	630	29	95.6%	0.026
CEO	10,150	9,088	8,815	273	97.0%	1,062	1,034	28	97.4%	0.504
New Director	10,150	8,555	8,308	247	97.1%	1,595	1,541	54	96.6%	0.281
AuditMbr	10,150	6,149	5,960	189	96.9%	4,001	3,889	112	97.2%	0.426
Prior Restat	10,150	8,990	8,758	232	97.4%	1,160	1,091	69	94.1%	0.000
Prior SEC	10,150	9,315	9,052	263	97.2%	835	797	38	95.4%	0.005
Prior Restat x AuditMbr	10,150	9,687	9,415	272	97.2%	463	434	29	93.7%	0.000
Prior SEC x AuditMbr	10,150	9,844	9,557	287	97.1%	306	292	14	95.4%	0.092
CompMbr	10,150	6,283	6,086	197	96.9%	3,867	3,763	104	97.3%	0.198
Top5AbComp	9,803	9,196	8,922	274	97.0%	607	586	21	96.5%	0.503
Top5AbComp x CompMbr	9,803	9,587	9,299	288	97.0%	216	209	7	96.8%	0.840
Attendance	10,131	10,054	9,756	298	97.0%	77	74	3	96.1%	0.631
ManyBds	9,699	8,675	8,417	258	97.0%	1,024	998	26	97.5%	0.435
ManyBds x CEO	9,699	9,659	9,375	284	97.1%	40	40	0	100.0%	0.271
Age75	10,150	9,859	9,572	287	97.1%	291	277	14	95.2%	0.060
NomMbr	10,150	6,157	5,970	187	97.0%	3,993	3,879	114	97.1%	0.597
Empl_Dir	10,150	9,532	9,257	275	97.1%	618	592	26	95.8%	0.060
OutDirLink	10,150	9,081	8,815	266	97.1%	1,069	1,034	35	96.7%	0.529
Interlock	10,150	10,130	9,830	300	97.0%	20	19	1	95.0%	0.591
Chairman Only	10,150	9,923	9,626	297	97.0%	227	223	4	98.2%	0.280
IP No	10,150	10,063	9,767	296	97.1%	87	82	5	94.3%	0.125
ClassBd	10,024	6,612	6,439	173	97.4%	3,412	3,287	125	96.3%	0.003
Poison Pill	10,024	4,792	4,690	102	97.9%	5,232	5,036	196	96.3%	0.000
CumVote	10,024	9,053	8,776	277	96.9%	971	950	21	97.8%	0.118
Golden Parachute	10,024	2,530	2,496	34	98.7%	7,494	7,230	264	96.5%	0.000
Top5AbRet	10,145	9,533	9,252	281	97.1%	612	592	20	96.7%	0.651
Bot5AbRet	10,145	9,746	9,448	298	96.9%	399	396	3	99.2%	0.008
Top5AbRet x CEO	10,145	10,071	9,772	299	97.0%	74	72	2	97.3%	0.893
Bot5AbRet x CEO	10,145	10,102	9,801	301	97.0%	43	43	0	100.0%	0.251

For each variable = 0 is for director who do not meet the criteria and = 1 for directors who do meet the criteria. (For example, CEO = 0 represents directors who are not CEOs). "FOR" is the number of directors in the = 0 or = 1 subgroup that received a "for" vote from the Fidelity Non Index funds. "WH" is the number of directors in the = 0 or = 1 subgroup that received a "withhold" vote from the Fidelity Non Index funds. ForVote is the "for" vote as a percentage of all "for" and "withhold" votes cast for directors in the = 0 and = 1 subgroups of directors by Fidelity Non Index funds for each criteria. The chi-squared p-value is from a chi-squared test of the difference in the relative frequencies of "for" and "withhold" votes for directors who are = 0 and = 1 for the specific criteria in the table.



APPENDIX TABLE A4: VANGUARD

	<b>Model (1)</b>	<b>Model (2)</b>
CEO	-0.0484 (-0.20) [-0.0023]	0.0965 (0.41) [0.0042]
New Director	0.485** (3.85) [0.0196]	0.410** (3.23) [0.0162]
AuditMbr	-0.185+ (-1.78) [-0.0088]	-0.189+ (-1.76) [-0.0086]
Prior Restat	0.116 (0.57) [0.0052]	0.116 (0.54) [0.0050]
Prior SEC	-0.0153 (-0.05) [-0.0007]	-0.0144 (-0.05) [-0.0006]
Prior Restat x AuditMbr	-0.103 (-0.41) [-0.0050]	-0.0926 (-0.36) [-0.0043]
Prior SEC x AuditMbr	-0.410 (-0.99) [-0.0229]	-0.451 (-1.13) [-0.0246]
CompMbr	-2.353** (-19.08) [-0.1594]	-2.330** (-18.98) [-0.1512]
Top5AbComp	-0.899* (-2.42) [-0.0612]	-0.876** (-2.67) [-0.0567]
Top5AbComp x CompMbr	-0.288 (-0.60) [-0.0153]	-0.265 (-0.58) [-0.0133]
Attendance	-3.667** (-10.93) [-0.6163]	-3.247** (-9.02) [-0.5084]
ManyBds	0.0981 (0.71) [0.0044]	0.234 (1.54) [0.0096]
ManyBds x CEO	-0.508 (-0.49) [-0.0299]	-0.841 (-0.81) [-0.0554]
Age75	-0.0648 (-0.36) [-0.0031]	-0.0561 (-0.32) [-0.0026]
NomMbr	-0.241** (-2.71)	-0.210* (-2.28)

	[-0.0115]	[-0.0096]
Empl_Dir	-1.331** (-5.16) [-0.1075]	-1.030** (-4.34) [-0.0707]
OutDirLink	-2.163** (-15.16) [-0.2241]	-1.825** (-12.24) [-0.1624]
TotDirSH	-1.487** (-2.68) [-0.0695]	-1.319* (-2.49) [-0.0591]
Interlock	0.837 (1.62) [0.0273]	0.592 (1.20) [0.0205]
Chairman Only	0.749* (2.36) [0.0257]	0.675* (2.14) [0.0228]
IP No	1.161 (1.31) [0.0335]	1.982* (2.22) [0.0409]
ClassBd	-0.304* (-2.38) [-0.0148]	-0.293* (-2.19) [-0.0137]
Poison Pill	0.249* (1.98) [0.0117]	0.274* (2.09) [0.0124]
CumVote	0.251 (1.32) [0.0107]	0.319 (1.60) [0.0128]
Golden Parachute	0.182 (1.30) [0.0089]	0.134 (0.92) [0.0062]
Top5AbRet	0.420+ (1.75) [0.0166]	0.389 (1.55) [0.0149]
Bot5AbRet	0.301 (1.38) [0.0124]	0.313 (1.28) [0.0124]
Top5AbRet x CEO	0.191 (0.21) [0.0082]	0.317 (0.38) [0.0123]
Bot5AbRet x CEO	-0.184 (-0.24) [-0.0093]	-0.127 (-0.15) [-0.0060]
Sdret	-49.50** (-6.42) [-2.3143]	-44.41** (-5.47) [-1.9892]
lnmktcap	0.140**	0.146**

	(2.87)	(2.87)
	[0.0066]	[0.0065]
InstHold	-1.167*	-1.210*
	(-2.14)	(-2.12)
	[-0.0546]	[-0.0542]
Year06	0.560**	0.556**
	(5.07)	(4.83)
	[0.0266]	[0.0253]
VoteISS		-1.624**
		(-8.98)
		[-0.1419]
Constant	4.446**	4.375**
	(5.92)	(5.60)
<i>N</i>	12163	12123
pseudo <i>R</i> <sup>2</sup>	0.243	0.270

*t* statistics in parentheses; +  $p < 0.10$ , \*  $p < 0.05$ , \*\*  $p < 0.01$ . Dependent variable Vote = 1 if the fund voted “for” and 0 if the fund voted “withhold” for the director in question. Errors are clustered by company. Marginal effects on the probability of a “for” vote for each coefficient are in brackets. For indicator variables, the marginal effect on the “for” vote probability is for a change from 0 to 1.

APPENDIX TABLE A5: AMERICAN

	<b>Model (1)</b>	<b>Model (2)</b>
CEO	-0.240	-0.242
	(-0.96)	(-0.98)
	[-0.0009]	[-0.0008]
New Director	-0.873**	-0.881**
	(-3.61)	(-3.89)
	[-0.0039]	[-0.0039]
AuditMbr	1.198**	1.154**
	(4.11)	(5.00)
	[0.0035]	[0.0032]
Prior Restat	-2.791*	-2.913*
	(-2.17)	(-2.15)
	[-0.0387]	[-0.0421]
Prior Restat x AuditMbr	-1.515**	-1.450**
	(-3.64)	(-4.56)
	[-0.0109]	[-0.0097]
CompMbr	0.00409	-0.00198
	(0.01)	(-0.00)
	[0.0000]	[0.0000]
ManyBds	-0.127	-0.115
	(-0.30)	(-0.23)
	[-0.0004]	[-0.0004]

NomMbr	0.152 (0.31) [0.0005]	0.224 (0.41) [0.0007]
Empl_Dir	-0.429 (-1.07) [-0.0017]	-0.471 (-1.15) [-0.0018]
OutDirLink	0.524 (0.40) [0.0014]	0.875 (1.02) [0.0020]
Sdret	-43.84 (-1.26) [-0.1406]	-51.80 (-1.42) [-0.1607]
lnmktcap	-0.546* (-1.96) [-0.0018]	-0.540+ (-1.90) [-0.0017]
InstHold	-9.279 (-1.49) [-0.0298]	-9.079 (-1.49) [-0.0282]
Year06	1.190 (0.85) [0.0045]	1.084 (0.81) [0.0039]
VoteISS		-1.476 (-1.32) [-0.0099]
Constant	16.24** (2.81)	16.33** (2.84)
<i>N</i>	1233	1224
pseudo <i>R</i> <sup>2</sup>	0.277	0.282

*z* statistics in parentheses; +*p* < 0.10, \**p* < 0.05, \*\**p* < 0.01. Dependent variable Vote = 1 if the fund voted “for” and 0 if the fund voted “withhold” for the director in question. Errors are clustered by company. Marginal effects on the probability of a “for” vote for each coefficient are in brackets. For indicator variables, the marginal effect on the “for” vote probability is for a change from 0 to 1. Note that Prior SEC, Top5AbComp, Attendance, ManyBds x CEO, Age75, Interlock, Chairman Only, IP No, ClassBd, Poison Pill, CumVote, Top5Abret, Bot5Abret = 1 all predicted Vote = 1 (“for” vote) perfectly and were dropped from the models (along with the corresponding observations). Prior SEC x AuditMbr, Top5AbComp x CompMbr, Top5Abret x CEO, and Bot5Abret x CEO were dropped due to collinearity with other independent variables.

APPENDIX TABLE A6: FIDELITY NON-INDEX FUNDS

	<b>Model (1)</b>	<b>Model (2)</b>
CEO	0.0872 (0.36) [0.002]	0.0981 (0.40) [0.0019]
New Director	-0.0578 (-0.30) [-0.0012]	-0.0785 (-0.41) [-0.0016]
AuditMbr	0.168 (1.08) [0.0033]	0.166 (1.07) [0.0033]
Prior Restat	-0.701 (-1.63) [-0.0187]	-0.687 (-1.57) [-0.0182]
Prior SEC	-0.652 (-1.43) [-0.0174]	-0.663 (-1.43) [-0.0178]
Prior Restat x AuditMbr	-0.348* (-2.12) [-0.0082]	-0.338* (-2.03) [-0.0080]
Prior SEC x AuditMbr	-0.109 (-0.70) [-0.0023]	-0.128 (-0.80) [-0.0027]
CompMbr	0.146 (1.01) [0.0029]	0.159 (1.10) [0.0032]
Top5AbComp	-0.294 (-0.45) [-0.0067]	-0.284 (-0.43) [-0.0065]
Top5AbComp x CompMbr	-0.0740 (-0.50) [-0.0016]	-0.0655 (-0.42) [-0.0014]
Attendance	-0.328 (-0.44) [-0.0078]	-0.193 (-0.25) [-0.0043]
ManyBds	0.00560 (0.03) [0.0001]	0.0227 (0.11) [0.0005]
Age75	-0.647 (-1.53) [-0.0178]	-0.640 (-1.50) [-0.0175]
NomMbr	-0.0223 (-0.18) [-0.0005]	-0.00925 (-0.07) [-0.0002]

Empl_Dir	-0.664* (-2.42) [-0.0180]	-0.633* (-2.27) [-0.0169]
OutDirLink	0.0610 (0.28) [0.0012]	0.135 (0.57) [0.0026]
TotDirSH	-0.816 (-0.87) [-0.0165]	-0.814 (-0.87) [-0.0165]
Interlock	-0.820 (-0.79) [-0.0251]	-0.886 (-0.85) [-0.0279]
Chairman Only	0.845 (1.63) [0.0119]	0.816 (1.56) [0.0116]
IP No	-0.750 (-0.71) [-0.0220]	-0.549 (-0.54) [-0.0145]
ClassBd	-0.272 (-0.72) [-0.0058]	-0.267 (-0.71) [-0.0056]
Poison Pill	-0.437 (-1.12) [-0.0088]	-0.442 (-1.12) [-0.0089]
CumVote	0.394 (0.58) [0.0069]	0.403 (0.59) [0.0070]
Golden Parachute	-1.331* (-2.46) [-0.0208]	-1.332* (-2.47) [-0.0208]
Top5AbRet	-0.422 (-0.64) [-0.0103]	-0.400 (-0.60) [-0.0096]
Bot5AbRet	1.606 (1.46) [0.0174]	1.634 (1.48) [0.0175]
Top5AbRet x CEO	0.200 (0.60) [0.0037]	0.220 (0.66) [0.0040]
Sdret	-22.84 (-0.96) [-0.4625]	-22.06 (-0.91) [-0.4462]
lnmktcap	0.121 (0.73) [0.0025]	0.119 (0.71) [0.0024]
InstHold	3.268* (2.02) [0.0662]	3.227* (1.97) [0.0653]

Year06	-0.791* (-2.25) [-0.0163]	-0.804* (-2.28) [-0.0166]
VoteISS		-0.429 (-1.08) [-0.0104]
Constant	3.121 (1.40)	3.159 (1.41)
<hr/> N	9188	9158
pseudo R <sup>2</sup>	0.082	0.084

*t* statistics in parentheses; <sup>+</sup> $p < 0.10$ , <sup>\*</sup> $p < 0.05$ , <sup>\*\*</sup> $p < 0.01$ . Dependent variable Vote = 1 if the fund voted “for” and 0 if the fund voted “withhold” for the director in question. Errors are clustered by company. Marginal effects on the probability of a “for” vote for each coefficient are in brackets. For indicator variables, the marginal effect on the “for” vote probability is for a change from 0 to 1. Note that ManyBds x CEO and Bot5Abret x CEO = 1 both predicted Vote = 1 (“for” vote) perfectly and were dropped from the models (along with the corresponding observations).

