

APRIL 5, 2010

# Critics Say Funds Should Do More to Police Corporate Pay

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By IAN SALISBURY

To the millions of Americans wondering how Wall Street's compensation culture got so brazen, one part of the answer may come as a surprise: It's your mutual fund.

Many Main Street investors have fumed at the huge bonuses paid to Wall Street executives and traders following a government bailout of the financial industry. Yet directors at companies such as [Goldman Sachs Group Inc.](#) and [Morgan Stanley](#) are mostly expected to sail to re-election in proxy voting this month and next—and among the parties casting the most votes will be fund-management companies.

### Journal Reports

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Over the past 30 years, as retirement plans such as 401(k)s replaced pension funds as the retirement engine for millions of Americans, mutual funds became the largest shareholders at most big U.S. corporations. Eighteen of the top 20 shareholders at Morgan Stanley and [Bank of America Corp.](#) are asset-management companies, as are 19 of the top 20 at Goldman Sachs, according to [FactSet Research Systems Inc.](#) That clout has given fund firms a central, if sometimes overlooked, role in overseeing public companies and policing corporate pay practices.

Not only do they and other corporate shareholders get to vote on company directors, who approve executive-compensation deals, they sometimes have a nonbinding say on pay matters as well. Because funds' annual proxy votes are cast by fund-management companies—Vanguard Group for the Vanguard funds or [BlackRock Inc.](#) for the BlackRock and iShares funds—and not individual investors, the market, at least in theory, is relying on fund firms to use their power to vote out directors who approve exorbitant pay packages. But for a range of complicated reasons—from passive-minded investment strategies to insider-trading rules to funds' own close ties to Wall Street—funds rarely muster the will to challenge corporate chiefs, critics say.

"Directors are asleep at the switch because mutual funds are asleep," says Jack Bogle, retired founder of Vanguard Group, one of the largest mutual-fund groups, and a frequent critic of Wall Street. "If mutual funds got together and said, 'We're not going to stand for it anymore,' the world would change."



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The Securities and Exchange Commission in 2003 began requiring funds to issue formal proxy-voting policies as well as to disclose their votes in individual corporate elections. The move, partly in response to that era's corporate-governance scandals, was made over objections from the fund industry, which argued disclosure could make it a target of special interests.

Individual investors can find mutual funds' votes through form "N-PX" on the SEC Web site. Watchdogs such as the Corporate Library and Web sites like [Proxydemocracy.org](#) help investors keep tabs on the behavior of individual fund families. Fund firms' proxy-voting guidelines, meanwhile, can usually be found on their Web sites.

Among the fund families the Corporate Library calls "pay enablers," consistently failing to use their voting power to rein in executive pay, are AllianceBernstein LP; Barclays Global Investors, now owned by BlackRock; and Ameriprise Financial Inc. Among those it ranks as more aggressive are [T. Rowe Price Group Inc.](#) and [Franklin Resources Inc.](#)'s Templeton Funds. BlackRock and AllianceBernstein say they strive to cast votes in shareholders' best interests. Ameriprise declined to comment.

The benefit of SEC disclosure has limits, however. Investors are confronted with so many variables when purchasing funds, it may be a reach to assume voting records will play a big role in their decisions. Further, while proxy elections are held in the spring, often in April and May, mutual funds don't disclose their votes until much later, usually August.

"By the time shareholders get a picture of what a fund is doing, it's long past the time when it's relevant," says Stephen M. Davis, executive director of Yale University's Millstein Center for Corporate Governance and Performance.

### *Red Herring?*

For its part, the Investment Company Institute, the mutual-fund industry's trade group, says the notion that mutual funds reflexively bow to management in proxy contests is false. In 2007, for example, funds voted in favor of proposals offered by shareholders almost 40% of the time, the ICI says.

Moreover, there is a long-standing argument that voting records are essentially a red herring and that market forces shape the way companies are governed because funds that don't like how a firm is managed can sell shares and invest elsewhere. But Wall Street's case is unusual. For years, these firms' shareholders overlooked lavish compensation packages on the assumption that the financial wizardry of executives and traders was what made the companies wildly profitable. Now that those profits seem largely driven by risk-taking, it may be time to strike a new bargain, some critics say.

Some observers say that although mutual funds are the largest shareholders of most big corporations, individual funds rarely amass large enough stakes to make it worth their while to lead expensive proxy battles over directors or give them power to dictate business strategy from the background.

For example, [J.P. Morgan Chase & Co.](#), the largest Wall Street firm, has a market value of about \$178 billion. BlackRock, the largest fund manager by assets, is J.P. Morgan's largest shareholder, but it owns only about 5.6% of the company.

"I've never heard of a major proposal put up by a mutual fund that had bite or substance," says Russ Wermers, a finance professor at the University of Maryland's Smith School of Business who studies mutual funds. "It isn't worth their while to stir the pot."

Size isn't the only thing that makes it difficult for fund firms to challenge company managers. SEC rules designed to guard against insider trading prevent funds from using tactics often employed by activist investors, such as demanding board seats.



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Either sitting on a company's board or amassing a stake of more than 10% triggers strict limits on when an investor can trade shares. Such limits would pose huge risks for mutual funds, which need constant flexibility to unload shares because their own investors can cash out on a single day's notice, says Glenn Booraem, Vanguard's head of proxy voting and corporate governance.

"We've tried to communicate our perspective through proxy voting," Mr. Booraem says. Still, independence on an issue like pay "is easy to assert on paper, but difficult to evaluate in real life, especially if you are not in the boardroom."

Challenging company management also doesn't mesh well with many funds' investment philosophies.

Index funds, for example, buy stocks based simply on market values. Employing platoons of analysts to research and possibly challenge management arguments—much less wage costly proxy campaigns—would undermine their main mission, which is keeping investing and trading costs as low as possible.

Indexers such as Vanguard, BlackRock and [State Street Corp.](#), which rank among the largest holders at many companies, say they work hard to fulfill governance duties despite making these trade-offs. Vanguard, for example, says it talks to hundreds of companies a year about its concerns.

### *Ties That Bind*

Mutual funds' business and cultural ties to the companies in which they invest also may make them less than ideal at policing management.

Some analysts say that because retirement plans such as 401(k)s are a key source of investment dollars for mutual funds, some fund firms may be reluctant to anger company managers by getting into disagreements with them over issues such as pay.

A frequently cited 2007 study by Gerald Davis and Han Kim at the University of Michigan concluded that mutual-fund firms with extensive 401(k) businesses tend to have the most management-friendly voting habits. "The more a fund family relies on pension-plan business, the bigger suck-ups they are," Mr. Davis says.

The finding is particularly significant because handling 401(k) plans gives some of the largest fund firms—like Fidelity Investments, Vanguard and T. Rowe Price—a lot of extra clout at the corporate ballot box.

Fidelity and T. Rowe Price say employees that handle 401(k) clients don't mix with those that cast proxy votes. Vanguard says the University of Michigan study focuses too narrowly on certain shareholder votes and overlooks areas like director elections.

Finally, although mutual-fund companies are supposed to represent the interests of millions of Americans at the corporate ballot box, they may have more in common with Wall Street than with the average investors. Portfolio managers' careers, much like those of Wall Street traders, hinge on their skill in valuing various securities. If anyone is likely to think this skill is worth millions of dollars a year, it is people whose own livelihood also depends on it.

"They all drank the same Kool-Aid," says Simon Johnson, a former chief economist of the International Monetary Fund, who has been critical of the financial-services industry's ability to police itself. "I wouldn't hold my breath for them to be the ones to weigh in on pay."

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