MUTUAL FUND VOTING OF PORTFOLIO SHARES: WHY NOT DISCLOSE?

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Over the last decade, many shareholders have shed their apathy toward corporate voting. Shareholder activism, championed by institutional investors and embraced by individuals, has revolutionized U.S. corporate governance. Investors have assumed a looming presence in corporate boardrooms, and the stories of ousted CEOs, emboldened outside directors, shareholder “target” lists, and corporate capitulations fill the financial headlines. Yet U.S. mutual funds, which control nearly one-third of U.S. equity voting power, exercise their voting/governance power in obscurity. No rules (private or public) compel disclosure of the methods, policies and practices of mutual fund voting of portfolio shares. Why not?

Mutual funds—financial intermediaries whose economies of scale make diversification, asset allocation and risk management available to individual investors—are heavily regulated. Federal substantive regulation specifies the governance structure and diversification levels of publicly-sold mutual funds. In addition, federal disclosure rules mandate that mutual funds provide investors with detailed information about fund investment policies, risk profiles, securities holdings and fees charged—now in plain English. Remarkably absent from this regulatory mix is any mandate to disclose voting of portfolio shares and funds’ other corporate governance activities.

This Article proceeds in three steps. First, I describe the evolving role of U.S. mutual funds in shareholder activism. Although less vocal than their pension fund cousins, mutual funds have lately become a quiet voting/governance behemoth. Today mutual funds, voting within fund families or in coordination with proxy service firms (principally the dominant Institutional Shareholder Services) have extraordinary sway in corporate boardrooms. They have become the swing vote in U.S. corporate governance. I consider the reasons for this new role, despite the many structural and legal impediments to mutual fund activism.
Second, I review the regulation of U.S. mutual funds in their voting of portfolio shares, which imposes various concentration limits on fund portfolios. Apparently based on the assumption that mutual funds would not play a significant governance role, federal and state regulation is largely indifferent to their voting/governance activities. In the 1970s, as trends in institutional ownership suggested the potential for a new governance dynamic, the SEC twice undertook to mandate disclosure of mutual fund voting policies and practices, but each time abandoned the project. Except when a fund seeks to exercise control of a portfolio company, no statute or rule requires disclosure of the fund’s voting processes, policies or actual practices. Today as the mutual fund industry has grown in size and importance, regulators and industry observers have urged greater attention to the fiduciary duties and oversight responsibilities of fund directors—though curiously have given only peripheral attention to the role of fund directors and managers in their corporate governance role. This regulatory indifference stands in sharp contrast to the interest in voting shown by other institutional investors, such as public and private pension funds, which are subject to more demanding regulatory regimes and which have been far more forthcoming about their voting/governance activities.

Third, I outline a proposal for the mandatory disclosure of the process, policies and practice of mutual fund voting and governance activities, as well as possible arguments against such a regime. Perhaps the existing discipline of price disclosure and redemption liquidity, combined with apparent apathy of mutual fund investors, renders voting disclosure by open-end mutual funds (the dominant investment company form) unnecessary. Moreover, it is possible that greater transparency would undermine the current effectiveness of behind-the-scenes mutual fund voting/governance activities or would create perverse incentives for mutual fund managers to politicize the voting function. But these fears are belied by the handful of activist funds that disclose their voting policies and activities. On inspection, transparency—so vociferously touted by the mutual fund industry with respect to portfolio companies—offers many potential and relatively low-cost benefits. With the possibility of electronic filing and dissemination of voting/governance information, it is difficult to imagine that the costs of disclosure could outweigh the potential benefits, as conjectural as they may be. Whether the voting issue is one of social responsibility or corporate governance, it is hard to see how fund investors are better served by opacity rather than disclosure.
In the end, however, I have no illusions. I recognize that most mutual fund investors have been indifferent to their mutual funds' corporate governance role—at least for now. Disclosure has much to offer: investors may find this information relevant and disclosure may galvanize their interest; fund managers and directors may be led to focus more on their voting task; intermediaries (such as rating services and academic researchers) may gain information to evaluate funds' governance effectiveness; and regulators may increase their monitoring of this fiduciary function. Perhaps not a complete remedy to a perceived voting/governance dysfunction in the mutual fund industry, mandatory disclosure of mutual funds' voting and governance activities has great promise as a catalyst.¹

I. MUTUAL FUND ACTIVISM

Shareholder activism, led by institutional investors, was the

¹ Recently, there has been a significant surge in interest over the question of mutual fund disclosure of proxy voting. The Council of Institutional Investors urged the SEC, as part of its review of disclosure by investment advisers to clients, to "consider extending the proxy voting... disclosure requirements to mutual funds." Letter from Sarah A.B. Teslik, Executive Director, Council of Institutional Investors, to Jonathan G. Katz, Secretary, SEC (June 12, 2000) (commenting that the SEC "should ensure that the millions of individual investors investing in mutual funds are provided the same level of disclosure as those working with investment advisers."). In addition, the American Federation of Labor and Congress of Industrial Organizations petitioned the SEC to initiate a rulemaking "designed to improve the quality and frequency of mutual fund portfolio and proxy voting disclosure." Letter from Richard Trumka, Secretary-Treasurer, AFL-CIO, to Jonathan G. Katz, Secretary, SEC (Dec. 20, 2000) (seeking rules that would require mutual funds to disclose on the Internet in "user-friendly format... the policies or guidelines they use in determining how to vote fund shares on proxy proposals" and to disclose on an annual basis "votes cast in respect of all shares held in their portfolios"). See Mercer Bullard, Are Ballots Too Secret? Fund Advisers Should Tell How They Vote Proxies, at http://www.thestreets.com/funds/mercerbullard/1240302.html (Jan. 4, 2001).

One request has come from a mutual fund group, Domini Social Investments, which wrote urging the SEC "to require mutual funds to adopt and publish proxy-voting policies and to record and publicly disclose their proxy votes." Letter from Amy Domini, Managing Principal, Domini Social Investments, LLC., to Harvey L. Pitt, Chairman, SEC (Nov. 27, 2001) (pointing out that there are "still no regulatory requirements or even industry guidelines for the disclosure of voting or governance information that would allow mutual fund investors to evaluate how mutual fund managers are discharging their proxy voting duties"), available at http://www.domini.com/about-domini/News/Press-Release-Archive/Proxy-Voting-Ltr-to-SEC-12-01.doc_cvt.htm. The Domini letter, which cites to a draft of this Article, pointed out that fund voting of proxies is a fiduciary responsibility, and there is "no other instance where the Commission countenances opacity rather than transparency in the discharge of fiduciary obligations." Id. (citing Alan R. Palmeter, Mutual Fund Voting of Portfolio Shares: Why Not Disclose? (Soc. Sci. Res. Network Working Paper, May 9, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=269337.
principal corporate governance story of the 1990s and promises to be equally central in the new millennium. Although the mechanisms and results continue to evolve, this activism has realigned and probably will continue to shape corporate incentives and behavior. As share ownership becomes more widespread and business news saturates our daily lives, shareholder activism will also increasingly represent a significant and potent method of political expression. Corporate democracy fuses into and becomes part of political democracy.

Shareholder activism is not monolithic. Institutional investors—banks, public and private pension funds, mutual funds and insurance companies—vary in their proclivity for activism. Although each performs financial intermediation for different classes of investors and each has fiduciary obligations to exercise an ownership role, the institutions have shown different appetites for the task. Institutions having business relationships with portfolio companies (such as commercial banks, insurance companies, and corporate pension plans) have been relatively

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2 Recent empirical research suggests that shareholder activism has prompted changes in firms’ governance structures, but has had negligible effects on share values and earnings. See Roberta Romano, Less Is More: Making Shareholder Activism a Valued Mechanism of Corporate Governance (Yale Int'l Ctr. for Fin., Working Paper No. 00-10, May 14, 2000), available at http://papers.ssrn.com/paper.taf?abstract_id=218650. In short, shareholder activists have been able to change board composition, poison pills and compensation structures, but Romano concludes these changes have not significantly affected firm value or operating results.

This research is belied by performance results claimed by activist investors. For example, CalPERS points to a Wilshire Associates study of the “CalPERS Effect” of corporate governance activities—namely the annual targeting of ten poorly-performing companies in the CalPERS portfolio—over a five-year period. According to CalPERS, the study showed that while the stock of these companies trailed the S&P 500 Index by 89 percent in the five-year period before CalPERS acted, the same stocks outperformed the index by 23 percent in the following five years. This, according to CalPERS, added “approximately $150 million annually in additional returns to the Fund.” CalPERS, About CalPERS: Corporate Governance Facts, at http://www.calpers.org/about/facts/ corpGovCorpGov.htm (Jan. 2002). Other activist investors—such as LENS and TIAA-CREF—make similar claims about the value of their activism. See TIAA-CREF, Principles of Sound Investing, at http://www4.tiaa-cref.org/pubs/html/psi/basics.html (last visited Jan. 28, 2002) (explaining that fund has adopted corporate governance principles and engages in voting/activist strategies “because good corporate governance will help [portfolio companies] achieve superior long-run performance”); Lens Investment Management, at http://www.lens-inc.com (last visited Jan. 28, 2002) (describing method of targeting under-performing companies and claiming above-market returns since 1992).

While their claims of above-market returns have been questioned, CalPERS and other activist shareholders continue to pursue an activist agenda, suggesting a belief in untapped value, which their early voting strategies may not yet have fully uncovered. Activist strategies may also have broad “spillover effects,” so that even though an activist strategy may not be reflected in targeted companies, it is reflected in industries and markets as a whole.
muted in exercising their governance rights. Institutions with political constituencies that face fewer of these conflicting interests (public pension funds and endowments/foundations) have been more assertive and more effective in exercising their governance role.

In this Part, I review the emergence of mutual funds as the “swing vote” in U.S. corporate governance. They are the fastest growing financial intermediaries, a trend set into motion as employers have converted “defined benefit” plans to “defined contribution” plans under which employees allocate their retirement investments, principally to mutual funds. Mutual funds are also politically up for grabs, neither captured by nor immune to pressure from the management of portfolio companies. Although mutual funds have traditionally followed a “Wall Street rule” in their voting, many mutual fund managers (particularly in larger fund complexes) have lately concluded that there is greater value in pursuing an activist governance agenda than protecting relationships with portfolio company management. Other fund managers have delegated their voting function to proxy adviser firms, primarily Institutional Shareholder Services, to coordinate voting of many funds and negotiate directly with management.

A. Growth of Mutual Fund Ownership

Mutual funds hold a growing proportion of U.S. equities, both as a proportion of institutional ownership and total U.S. equity shares.

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3 See James E. Heard & Howard D. Sherman, Conflicts of Interest in the Proxy Voting System (1987). For example, insurance companies that sell insurance policies to portfolio companies may decide that they stand to lose more in the insurance-writing business than they stand to gain in investment returns by pressuring management. See James A. Brickley et al., Ownership Structure and Voting on Antitakeover Amendments, 20 J. Fin. Econ. 267 (1988).

4 See Rahul Kochhar & Parthiban David, Institutional Investors and Firm Innovation: A Test of Competing Hypotheses, STRATEGIC MGMT. J., Jan. 1996, at 73 (finding that “pressure-resistant” institutions had a positive influence on firm innovation, while “pressure-sensitive” institutions had no effect).

5 See Aaron Lucchetti, Bogle Backs Group for Shareholder Issues, WALL ST. J., Feb. 14, 2002, at C21 (quoting John Bogle, founder of the Vanguard Group, who described mutual funds as “the 800-pound gorilla that can make all the changes” on such issues as corporate financial disclosures, auditor independence, earnings quality, and executive compensation); Christopher Brown, Rise of the Institutional Equity Funds: Implications for Managerialism, 32 J. Econ. Issues 803, 811 (1998) (finding a “demonstrable connection” between the rising strength of pension and mutual fund managers and the value-driven management practices of the 1990s).
Mutual Funds

<table>
<thead>
<tr>
<th>Holdings in U.S. Equities (in billions)</th>
<th>Percent of U.S. Institutional Ownership</th>
<th>Percent of Total U.S. Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>$122.9</td>
<td>11.9%</td>
</tr>
<tr>
<td>1990</td>
<td>$257.6</td>
<td>19.5%</td>
</tr>
<tr>
<td>1995</td>
<td>$1,354.4</td>
<td>45.0%</td>
</tr>
<tr>
<td>2000</td>
<td>$4,137.2</td>
<td>61.6%</td>
</tr>
</tbody>
</table>

Mutual funds also manage portfolios for other institutions, bringing the combined total of equity under mutual fund management to approximately one-third of all U.S. equities.⁷

For many larger U.S. firms, institutional investors (which historically prefer to invest in large-capitalization companies over smaller-capitalization companies) collectively often hold significantly more than 50 percent of a firm’s stock.⁸ Although

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⁷ See Sarah O’Brien, Activists Renew Push for Proxy Disclosures, INVESTMENT NEWS, Jan. 14, 2002, at 6 (reporting that mutual funds control nearly one-third of U.S. equity voting power); Lucchetti, supra note 5 (stating U.S. mutual fund investment in publicly-traded companies to be $7 trillion as of 2002).

⁸ See Carolyn Kay Brancato & Patrick A. Gaughan, Institutional Investors and Capital
individual mutual funds are subject to a 10 percent limit on holdings in any one portfolio company, these limits do not apply to mutual fund families (or complexes), whose funds are under common management. These families often hold collective positions in many companies at levels close to or above 10 percent through their many constituent funds. The concentration of mutual fund holdings increased with the emergence of focus funds that own stock in twenty-five or fewer companies, often with close to 10 percent of the fund’s assets concentrated in a single company’s stock.

The same picture of dramatic mutual fund growth also emerges in international markets. A 1997 study by the Organization for Economic Cooperation and Development ("OECD") of institutional investment in OECD countries found that “[i]nvestment companies’ assets have increased at a much faster pace than have the assets of other institutional investors.” Assets of investment companies in OECD countries, estimated at $5.2 trillion in 1995, showed an annual growth of 19 percent over the 1990-95 period. The total share of assets under investment fund management increased from 18 percent to 22 percent during the period of 1990 to 1995. The study attributed this “spectacular growth” in mutual fund assets in part to “technological advances in communications and information technology” and “a relaxation of regulatory constraints on cross-border activities and investments.” The study also noted that U.S. mutual funds “show a clear trend toward increased international diversification.”

Two engines drive mutual fund investment. The first is the influx of individual investors into the capital markets and their

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10 For example, as of December 31, 1999, Janus held more than 10 percent of over 15 companies (including 22 percent of UnitedGlobalCom, 12.8 percent of Univision, and 12.7 percent of Globix). Lisa Gibbs, Glory Days at Janus, MONEY, June 2000, at 122, 126.

11 See Pui-Wing Tam, Putting Index Funds in Their Place, WALL ST. J., Mar. 12, 1999, at C1.


13 Id.

14 Id.

15 Id. at 20.

16 Id.
choice of mutual funds for the diversification, asset allocation and transactional services they offer. Although the overall growth of institutional investment has leveled off in the last couple of years, individual investors continue to increase their holdings in mutual funds. As the aggregate savings and the number of savers has increased both domestically and internationally, mutual funds promise to remain a potent investment device.

The second is the movement by employers from "defined benefit" to "defined contribution" plans, which permit employees to designate their investment vehicle. Not surprisingly, mutual funds have been the vehicle of choice. For example, since their authorization in 1978, 401(k) plans have accounted for more than three-quarters of the increase in all private pension plans and 44.0 percent of 401(k) plan balances are invested in equity mutual funds. Some anticipate that investments in mutual funds will soon surpass that of pension plans.

B. Emergence of Mutual Funds as Shareholder Activists

Mutual funds are an enigmatic giant in U.S. corporate governance. We have little systematic information about their governance role, and specifically their voting methods, policies and practices. Beyond offering snippets in press interviews, fund managers have been publicly circumspect about the nature and level of their activism. Compounding this opacity, the leading proxy service firms for mutual funds, Institutional Shareholder Services and Proxy Monitor, purposefully maintain discreet

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18 See Edward B. Rock, Foxes and Hen Houses?: Personal Trading By Mutual Fund Managers, 73 WASH. U. L.Q. 1601, 1601-02 (1995); Roberta Romano, The Politics of Public Pension Funds, PUB. INTEREST, Winter 1995, at 42, 44 (recommending that state pension funds change from defined benefit to defined contribution plans, under which state employees could funnel their retirement investments into mutual funds, which would make the investment and voting decisions for shares their funds hold).
19 See John C. Bogle, Creating Shareholder Value: BY Mutual Funds... Or FOR Mutual Fund Shareholders?, Address Before the Annual Conference of Investor Responsibility Research Center (Oct. 26, 1998), in JOHN BOGLE ON INVESTING: THE FIRST 50 YEARS, at 180 (2001) [hereinafter BOGLE ON INVESTING]. The then-chair of Vanguard described the fund family's voting procedures and stated his "impression that only a minority of mutual funds follow such thorough procedures."
20 According to a comment letter to the SEC, Institutional Shareholder Services "is the world's largest provider of proxy voting and corporate governance services. Serving more than 700 institutional and corporate clients throughout North America and Europe, ISS analyzes proxy proposals and issues vote recommendations for nearly 9,000 U.S. and 9,000 non-U.S. shareholder meetings each year." Letter from Patrick S. McGurn, Vice President, Director of Corporate Programs, Institutional Shareholder Services, to
profiles.

From press accounts and industry publications, one can surmise a picture of increasing mutual fund activism. Why this activism now? There are different explanations. The growing number of larger funds whose size makes them relatively illiquid, as well as funds that have adopted an indexing strategy, must seek higher returns not through trading but by exercising their corporate franchise.22 Some mutual funds, particularly those committed to “socially responsible” investments, have adopted activist voting policies that match their investment orientation.23


The financial press occasionally reports on the ISS, but with remarkably less frequency than other high profile institutional investors like CalPERS and TIAA-CREF. See Christina Binkley, Marriott's Effort to Get Backing for New Class of Stock Faces Fire, WALL ST. J., May 4, 1998, at B4 (describing opposition to issuance of super-voting stock proposed by Marriott International, including advice by ISS to its client to vote against the provisions); Joann S. Lublin & Leslie Scism, Texaco Plan for Poison Pill Is Up for Vote, WALL ST. J., Apr. 23, 1998, at C1 (reporting ISS and Proxy Monitor urged clients to oppose proposed Texaco poison pill plan, despite its more shareholder-friendly provisions, such as a 20 percent trigger, a five-year “sunset” provision and a “chewable” feature dissolving the defense if a fully financed, all-cash tender offer were made to all shareholders); Editorial, Why Not Sack a Few Directors?, BUS. WK., Dec. 8, 1997, at 134 (reporting that ISS is urging its clients to vote against individual directors who do not show up for 25 percent of meetings); William Freedman, Rexene Proxy War Gets Uglier, CHEM. WK., Feb. 19, 1997, at 8 (reporting that ISS advised fund managers to vote in favor of Rexene management in proxy contest, despite support by Proxy Monitor for dissident shareholders).


23 See Bogle, supra note 19, at 185 (stating that “[o]nce investors adopt the market-indexing strategy, they hold stocks in the same companies, in effect, forever. So the only way to add economic value becomes the exercise of the same governance responsibility as would characterize the sole owner of a private business: the shareholder comes first”).

Many mutual funds have followed the institutional crowd, which has embraced the new governance culture in which voice displaces exit. Encouraged by the mutual fund industry's main trade group, the Investment Company Institute, many funds have recognized the importance of voting and have taken a more active role. Others have delegated voting responsibility to proxy adviser firms (primarily the ISS), which in turn have assumed an activist, and often pivotal, role in voting contests.

1. Tradition of Mutual Fund Passivity

Historically, mutual fund managers disregarded their portfolios' governance potential and followed a "Wall Street rule," voting routinely with management or, alternatively, selling portfolio shares. In its 1980 study of institutional investors, the

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24 For example, the Council of Institutional Advisers annually lists companies and directors that in its judgment are performing poorly. See James E. Heard & Patrick S. McGurn, Corporate Governance Audit for 1998, INSIGHTS, Dec. 1997, at 3; see also Let's Rumble: Frustrated Shareholders Strike Back, INV. REL. BUS., Mar. 15, 1999, available at 1999 WL 5954097 (paraphrasing Patrick McGurn, Director of Corporate Programs for Institutional Shareholder Services, that "this year's proxy season will be laced with more hostility than companies have seen in a while").


25 See Pui-Wing Tam & Gary McWilliams, H-P Garners Major Endorsement Deal—ISS Advisory Firm Backs Acquisition of Compaq, WALL ST. J., Mar. 6, 2002, at A3 (reporting that "many money-management firms take ISS's reports into account before voting in a proxy battle"); Patrick S. McGurn, Corporate Governance in a Changing Market, INSIGHTS, Dec. 1998, at 3 (describing topics slated for institutional shareholder activism during 1999 proxy season—including stock option repricing, poison pill adoptions and renewals, faithless directors, binding bylaw amendments and direct action proposals—and, by implication, how ISS would be advising its mutual fund clients to vote).

26 See Bill Barnhart, Mutual Funds Haven't Joined the Rush to Shareholder Activism, CHI. TRIB., Mar. 16, 1997, at C3 (quoting Edward Regan, former comptroller of the State of New York, who wrote in the February 1997 issue of Director's Monthly, the newsletter of the National Association of Corporate Directors: "Mutual funds have been quiet on the proxy-voting front. Their proxy votes, with some significant exceptions, appear to be cast
SEC found that mutual funds prior to the 1970s “almost universally exercised [voting authority] in accordance with the ‘Wall Street Rule.’” As recently as 1994, Professor Mark Roe in his seminal study of the politics of U.S. institutional passivity concluded that mutual funds, despite their huge financial resources, “rarely participate in corporate governance.”

Even today, conventional wisdom holds that mutual funds are passive participants in corporate governance. Under this view, mutual fund managers have not been and are unlikely to be activist—whether in proposing corporate reforms, voting against management initiatives or voting for other shareholders’ proposals. Others point out that most mutual fund managers have delegated their voting of portfolio shares to professional proxy voting services, often merely to handle the paperwork of corporate voting. Despite academic urgings for mutual funds to join the wave of shareholder activism, Professor Tamar Frankel, a leading academic commentator on mutual funds, recently concluded that “United States mutual funds did not follow the call.”

Academic writers have offered a catalogue of largely untested explanations for mutual funds’ governance passivity.

**Focus on investment function.** Mutual fund managers are short-term investors, with recent portfolio turnover above 100 percent. In their focus on short-term returns, fund managers “don’t care about corporate governance.”

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almost routinely in favor of management.”); Trudy Ring, *Mutual Fund Activism Unlikely*, PENSIONS & INV., Jan. 22, 1990, at 75 (quoting various mutual fund managers, as well as Eric Kanter, vice president-public information of Investment Company Institute: “Mutual funds have tended to ‘vote with their feet.’”).

27 DIV. OF CORP. FIN., SEC, STAFF REPORT ON CORPORATE ACCOUNTABILITY 339 (Sept. 4, 1980) (prepared for S. Comm. on Banking, Housing and Urban Affairs).


29 See Robert McGough & Pui-Wing Tam, *Bogle Urges Role in Corporate Governance*, WALL ST. J., Oct. 21, 1999, at C23 (quoting Bogle as saying funds have failed “to live up to their responsibility of corporate citizenship” and that “funds haven’t wielded their voting power to oppose management on issues such as excessive stock-option issuance, option repricing and earnings that are smoothed by accounting gimmicks”).

30 See ROE, supra note 28, at 102. Mutual funds were widely criticized in the wake of the 1998 Asian financial crisis for failing to exercise their significant clout to demand better corporate governance practices. See Krieder, supra note 9, at 446-47.


Safeguard information access. Mutual funds fear offending management of portfolio companies and losing access to valuable inside information. Because of their short-term orientation, mutual fund managers have greater interest in information that drives short-term returns than corporate change that contributes to long-term performance.34

Safeguard retirement plan business. Many mutual funds receive investments through retirement plans, such as 401(k) plans, offered by companies in which the funds also invest. This creates a conflict, as fund managers may be reluctant to vote or take other actions that risk offending company managers who steer business to them, even though these actions may be contrary to the best interests of plan participants.35 As Professor Al Conard explained, managers of portfolio companies may sometimes coerce fund managers “to oppose takeover bids, even though the bid would enhance returns if it succeeded.”36 For example, in 1990, Fidelity dropped its opposition to a Pennsylvania antitakeover bill when executives of a large Pennsylvania company threatened to switch the firm’s pension plan to Vanguard.37

Avoid unreimbursed activist costs. Mutual funds gain no relative advantage and may actually be disadvantaged by becoming activist.38 Most activism is not reimbursed and any activism-created performance gains are shared with all

34 See Bill Barnhart, Mutual Funds Haven’t Joined the Rush to Shareholder Activism, CHI. TRIB., Mar. 16, 1997, at C3 (stating view by Edward Regan, former activist comptroller for the State of New York, that a reason for mutual fund passivity is mutual funds’ short-term orientation).

35 See BOGLE, supra note 33, at 198 (“Given the drive for corporate customers, the reluctance of fund managers to risk the opprobrium of potential clients by leaping enthusiastically into the controversial areas of corporate governance is hardly astonishing, though it is discouraging.”); Richard Siklos, The Price Is Right: Fund Manager Michael Price Scares Wall Street with His Style and His Clout, FIN. POST (TORONTO), Mar. 15, 1997, at 18 (reporting comments by Michael Price, analyst of Franklin Mutual Series Funds, Inc., that “most fund managers are either reluctant to rock the boat or too reliant on the pension business of the companies they invest in to stir the pot.”).

36 Alfred F. Conard, Beyond Managerialism: Investor Capitalism?, 22 U. MICH. J.L. REFORM 117, 143 (1988); see also McGough & Tam, supra note 29, at C23 (paraphrasing Bogle’s comment that “fund companies fear that corporate activism will alienate corporate customers, who sponsor retirement plans managed by fund companies.”).


38 See BOGLE, supra note 19, at 191 (concluding that “[w]hile the costs of greater attention and thoroughness would be trivial to any but the smallest fund groups, the benefits of activism are apparently deemed too uncertain for most funds to undertake the effort”).
shareholders, including competing mutual funds.\textsuperscript{39} Motivated
to outperform industry benchmarks and competing funds,
multiple fund managers view their role as running portfolios,
not companies.\textsuperscript{40} Activism on a cost-benefit analysis may not
be worthwhile.\textsuperscript{41}

**Free-ride on other activists.** Mutual funds find value in a
“follow the leader” strategy. Mutual fund managers can free-
ride on the activism of pension and union funds, whose
managers face political and constituent pressures to be activist\textsuperscript{42}
and may be more personally comfortable with
frontational politics.\textsuperscript{43}

**Preserve liquidity.** The dominant mutual fund form, the
open-end fund, must be able to redeem investors’ shares
overnight on demand. To ensure liquidity, mutual funds do
not hold big stock blocks, thus diluting their incentive to
engage in governance activities.\textsuperscript{44}

**Abide by legal limits.** Mutual funds, legally constrained in
their ability to acquire and exercise control blocks, have no
choice but to be passive.\textsuperscript{45} Individual funds, for a variety of
legal reasons, are effectively prohibited from taking a board
seat of a portfolio company or hold more than 10 percent of
any portfolio company’s voting securities.\textsuperscript{46} As some mutual
fund managers point out, corporate management has little
reason to listen to a shareholder who lacks a credible threat of

\textsuperscript{39} See Conard, supra note 36, at 152 (noting that other institutional investors are not
deterred by this free-riding problem).

\textsuperscript{40} See Barnhart, supra note 31 (quoting Paul Stevens, general counsel of the
Investment Company Institute).

\textsuperscript{41} See Robert C. Pozen, Institutional Investors: The Reluctant Activists, HARV. BUS.
REV., Jan.-Feb. 1994, at 140, 144 (commenting that the advisory fees for mutual fund
managers “do not cover heavy intervention of the part of the money manager” and that
the new SEC rules that allow greater shareholder communications “do not solve the ‘free
rider’ problem”).

\textsuperscript{42} See Romano, supra note 18, at 42 (concluding that public pension fund managers are
subject to political pressure to accommodate investment and voting policies to local
consideration, such as increasing in-state employment).

\textsuperscript{43} See Barnhart, supra note 31 (noting that Regan says mutual fund managers tend to
be individuals who are uncomfortable with overt pressure tactics).

\textsuperscript{44} See ROE, supra note 28, at 119-20. But see McGough & Tam, supra note 29 (stating
that “Bogle said one reason why the fund industry hasn’t been active in promoting better
corporate governance is fund managers’ focus on short term trading’’’); George Melloan,
Business World: Big Funds Swing More Weight in the Proxy Wars, WALL ST. J., Apr. 18,
1999, at 1 (stating that “sheer size made it harder to invoke the Wall Street rule. . . . ‘You
can’t walk away from 600 stocks’’’); Pui-Wing Tam, Managers Put Pressure on Firms,
WALL ST. J., Nov. 15, 1999, at C1 (quoting Meyrick Panye, head of fund-consulting firm
Management Practice, that “now, many funds have grown so large and have ‘such big
positions, they can’t sell, because a sale might cause a run on the stock.’’’).

\textsuperscript{45} See ROE, supra note 28, at 122.

\textsuperscript{46} See infra Part II.A.1.
accumulating a control block.\textsuperscript{47} \\
**Avoid the unknown.** As Professor Roe has pointed out, mutual fund managers understand the financial world in which they have succeeded and “see no reason to change it.”\textsuperscript{48} Others have observed that money managers generally lack the incentives to monitor portfolio companies since the mutual fund market tends to reward high-turnover strategies that generate short-term performance compared to industry benchmarks.\textsuperscript{49} Moreover, the general passivity of shareholders with respect to proposals that management portrays as “routine,” even though they may not be, suggests that acquiescent passivity may still characterize corporate governance.\textsuperscript{50} \\
In addition to governance passivity, mutual funds have been politically quiet, as compared to other institutional investors, in pursuing and commenting on regulatory reforms to expand voting prerogatives. For example, mutual funds were noticeably absent from the 1992 SEC rulemaking to facilitate shareholder communications\textsuperscript{51} and the 1998 revisions to the shareholder proposal rule.\textsuperscript{52} Although both initiatives anticipated an expanded role for institutional investors, mutual fund managers chose not to comment on the proposals, suggesting either a natural indifference or a tactical silence.\textsuperscript{53}

\textsuperscript{47} See Leonard J. Hollie, *Activism Not Role for Firms*, PENSIONS & INV. AGE, Oct. 2, 1989, at 17, 24 (quoting John Brennan, then-president of the Vanguard Group: “We have a limitation of 10% ownership of a company. Management won’t listen to us when we own 3%.”).

\textsuperscript{48} Roe, supra note 28, at 121.

\textsuperscript{49} See John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1283, 1321-22 (1991) (arguing “the primary explanation for institutional passivity is not overregulation, but the insufficiency of existing incentives to motivate institutional money managers to monitor”). Professor Louis Lowenstein commented that mutual fund managers “exhibit a persistent emphasis on momentary stock prices. The subtleties and nuances of a particular business utterly escape them.” Louis Lowenstein, *A Governance Tool that Really Works*, DIRECTORS & BOARDS, Fall 1997, at 51.


\textsuperscript{52} See Barnhart, supra note 31, at C3.

2. Increase in Mutual Fund Activism

This story of mutual fund passivity, although perhaps once valid, is changing. In the last several years, mutual funds have become important participants in U.S. corporate governance. A catalogue gleaned mostly from the financial press reveals a powerful and growing, though still cloaked, mutual fund voting power. A recent survey of institutional investors’ views of their corporate governance role, based largely on interviews of money managers of the largest institutions, suggests a growing awareness of the potential of institutional voting power.54

Lately, mutual fund managers, in word and in deed, have been more assertive in their governance role. Some have been openly critical of portfolio companies’ management.55 The increasing rates of favorable votes for shareholder proposals evidence this unmistakable drift.56 Many fund managers increasingly stress the importance of their voting function. Some mutual fund families, including Vanguard, have kept voting in-house and review and vote proxies themselves.57 Other fund families that delegate proxy voting to outside proxy advisers claim that their funds have a proxy committee that annually sets voting policies, based on perceptions of how mutual fund investors would want their funds to vote.58 Others claim to have policy statements on corporate governance to vote against management when management’s proposal would impair shareholder rights.59

As mutual funds’ holdings have increased, an increasing

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54 See Gile R. Downes et al., Institutional Investors and Corporate Behavior 43 (1999) (finding that “all the institutional investors we interviewed expressed detailed and well-researched views on corporate governance”).

55 Some of Vanguard’s fund managers have been openly critical of management in portfolio companies. See Barnhart, supra note 34, at C3 (describing criticism by Jeff Neff, former manager of Vanguard Windsor Fund, of fund-owned companies, notably Chrysler and Citicorp).

56 See Carrick Mollenkamp, First Union Gains Support in Battle for Wachovia Corp., WALL ST. J., July 24, 2001, at 36 (describing “much anticipated report” by ISS on First Union-Wachovia merger); Randall S. Thomas & Kenneth J. Martin, The Determinants of Shareholder Voting on Stock Option Plans, 35 WAKE FOREST L. REV. 31, 50 (2000). The level of institutional ownership of portfolio companies has become a proxy for shareholder activism. Not surprisingly, companies with higher proportions of public pension fund and mutual fund ownership tend to adopt more shareholder responsive governance structures.

57 See Barnhart, supra note 31, at C3.

58 See id. (describing voting by Zurich Kemper Investments).

59 See Hollie, supra note 47 (quoting Jane Nelson, spokeswoman for T. Rowe Price Associates Inc., that the company’s twenty-nine equity funds “have a policy statement on corporate governance to vote against management in any takeover measure”) (internal quotations omitted).
number of mutual funds (particularly those of large fund families) have abandoned the "Wall Street rule." Realizing that they cannot easily sell blocks of poorly performing stock, many mutual funds, like large public pension plans, have sought to improve performance in portfolio companies. This is particularly true for the larger fund families, which through various funds under common management often own more than 5 percent (and sometimes more than 10 percent) of many larger U.S. companies. Filings by leading fund families reveal significant new (Schedule 13G) and continuing (Schedule 13G/A) portfolio holdings in excess of 5 percent of voting shares:

13G and 13G/A Filings
(Aug. 1, 1999 through July 31, 2000)

<table>
<thead>
<tr>
<th></th>
<th>13G</th>
<th>13G/A</th>
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<tbody>
<tr>
<td>Fidelity</td>
<td>61</td>
<td>138</td>
</tr>
<tr>
<td>Putnam</td>
<td>225</td>
<td>481</td>
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<tr>
<td>Vanguard</td>
<td>84</td>
<td>205</td>
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This family ownership can be expected to become more concentrated as the number of mutual fund families increases at a slower rate than overall mutual fund assets continue to grow. Moreover, many mutual funds have investment policies that compel them to concentrate investments in giant multinational firms, making exit an untenable option. Activism in selected portfolio firms promises the best way to distinguish returns from

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60 See Siklos, supra note 35 (reporting that Michael Price, analyst of $22 billion Franklin Mutual Series Funds, was "considered almost single-handedly responsible for forcing" the 1995 sale of Chase Manhattan to Chemical Bank, leading to a 165 percent rise in Chase's stock price); Ring, supra note 26, at 75 (reporting that Fidelity Investments became more activist since it could not easily liquidate holdings due to its size).


62 For example, Fidelity in 1995 controlled more than 5 percent of the stock of 104 of the Fortune 500 companies, and in many cases, Fidelity's holdings exceed 10 percent. See Kimberly Blanton, In the Fidelity Fold: An Investment by the Funds Giant Can Be a Mixed Blessing, BOSTON GLOBE, May 16, 1995, at 57, 72 (reporting that as of the end of 1994 Fidelity owned 5 percent or more of the stock of 792 publicly-traded companies, 195 of the Fortune 1000, and 104 of the Fortune 500).

63 See SEC EDGAR Database, Form Pick, at http://www.sec.gov/edgar/searchedgar/ formpick.htm (last modified June 1, 2001).

64 From 1991-2000, mutual fund assets grew from $1,393.2 billion to $6,965.2 billion, an increase of 400 percent. See ICI 2001 FACT BOOK, supra note 6, at 64. During the same period, the number of mutual funds increased by approximately 140 percent from 3,405 to 8,171, while fund families or complexes increased by only approximately 19 percent from 361 to 431. Id. at 63.

65 See Kochhar & David, supra note 4, at 73.
those of competing funds. Interestingly, the pressure to improve performance, rather than to sell, is heightened for the many funds that have adopted a strategy of partial indexation. For these funds the only way to improve the returns of the fund’s indexed portion is to improve overall market returns through voting/governance activities.

Mutual fund families, by voting the shares in their many funds under a consolidated voting strategy, can achieve impressive voting power. The leading mutual fund families—Vanguard and Fidelity—report that they seek to have individual portfolio managers vote according to family-wide voting policies. For example, when Kirk Kerkorian disclosed plans in 1995 to buy Chrysler, the 16.8 million block of shares held by the various Fidelity funds (representing the biggest single stake in the company) was viewed as essential to making or breaking the Kerkorian bid. The Vanguard Group’s open support and vote for dissident Robert Monks in his quest for a seat on the Sears board in 1991, although unsuccessful, led the company’s management to reassess its strategic plan.

Some funds, particularly the larger fund families, have also recently been active (and effective) players in behind-the-scenes governance negotiations. Rather than make proposals or vote vociferously, these funds found greater success in quiet “big stick” diplomacy. These fund families get management attention with the threat (actual or implied) of selling their holdings and driving

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66 See Hollie, supra note 47, at 24 (describing Fidelity’s Proxy Edge System, a computerized tracking system that provides updated and historical information on annual and special shareholder meetings for more than 2,500 companies); see also Downes, Jr., et al., supra note 54, at 18-22 (describing the voting processes of ten large institutional investors, including three mutual fund families, which include detailed proxy-voting guidelines that govern the mechanics of proxy voting, as well as proxy committee that administers the guidelines and consults with fund managers on “nonroutine governance issues of material significance to the [mutual fund] organization”).
67 See Blanton, supra note 62, at 57.
68 See Norton, supra note 61, at 138.
69 Institutional investors have available various “activism tools”:
- Proxy fights for control—rarely used by institutional investors, which lack the staffs or expertise to exercise control;
- Proxy campaigns against management proposals—unusual for institutions, even when opposed to such management proposals as anti-takeover measures or high-priced compensation plans;
- Shareholder resolutions—popular with some pension fund activists, because of their low cost and growing effectiveness;
- Informal jawboning—sometimes used in conjunction with shareholder proposal and often effective in inducing management changes; and
- Explanatory letters—used to explain a “no” vote, often by mutual fund families, and often effective in having company management changing its position.

See Pozen, supra note 41, at 146-47.
down the price of the targeted company. As early as 1990, Fidelity Investments was instrumental in pressuring many Pennsylvania companies to opt out of that state's heavy-handed anti-takeover legislation. 70 Recently Vanguard declared, without elaboration, that it does not need the public glare of formal shareholder proposals and proxy fights to influence corporate behavior. 71 As one corporate manager said of Fidelity, his company's largest investor, "They have the power to move markets significantly, and it's not worth [fighting them]." 72

A few diversified funds, anticipating an even broader governance role, have bucked the prevalent industry practice of self-imposed fragmentation and diversification limits on unrestricted portfolio assets 73 and have sought shareholder approval to free the fund's unrestricted portion (25 percent of the fund's assets) from any ownership limitations. 74 For a large fund, such as Fidelity's Magellan, the ability to invest up to 25 percent in one company would permit acquiring control of multi-billion-dollar firms. 75

Funds (or fund families) that lack the clout of Vanguard and Fidelity have collectivized their voice through proxy adviser firms,
primarily Institutional Shareholder Services. These advisory firms, though operating outside the limelight, have become increasingly influential. A recent study found that voting recommendations by the ISS against management proposals are usually decisive, and the firm's stated views on a voting issue will often be critical as to whether management pursues the issue. ISS, which grew from 400 to over 700 institutional clients from 1997 to 1999, has been instrumental in how companies structure their voting initiatives. For shareholder votes on stock option plans, ISS voting policies—on such issues as option repricing, dilution effects and low-cost purchase loans—have, in effect, become the "industry template" that compensation committees use to design pay packages. For example, in 1998 the American Society of Corporate Secretaries met with ISS officials to urge the firm to revise its formula for evaluating stock option plans, particularly repricing provisions, after the 1998 stock market break. Although some institutional investors claim to use ISS as a "sounding board" for their voting decisions, many mutual funds have reportedly delegated voting decisions to the firm.

Despite this picture of greater activism, influential observers continue to doubt whether the mutual fund industry is taking seriously its voting function. John Bogle recently remarked that "while the managers of most large fund groups carefully review corporate proxies, they endorse the proposals of corporate management almost without exception.... Mutual funds have

76 See Bethel & Gillan, supra note 50, at 3-4 (finding that "against" recommendations from ISS were associated with fewer affirmative votes for management proposals—from 14 percent to 21 percent depending on proposal type—and that these recommendations affected the outcome in 53 percent of the cases).


78 Compare ISS Comment Letter, supra note 20 (reporting over 700 clients as of mid-1999), with LIPIN, supra note 77 (reporting 400 clients as of late 1997).


failed to live up to their responsibility of corporate citizenship." In a recent speech, former SEC Commissioner Paul Carey called on fund directors and advisers to carry out their responsibilities as fiduciaries by opening lines of communication with portfolio company management and voting shares on such “important issues” as corporate governance, executive compensation plans, capital structure, and anti-takeover defenses.

Underlying this mixed story is the contentious question of whether shareholder activism produces value. In a recent survey of executives and managers of ten large institutional investors, most mutual fund managers that activism does not produce value while most pension fund managers believe that it does. Robert Pozen, then president of Fidelity Management & Research, pointed out in 1994:

It is difficult to prove the financial benefits of good governance structures, such as the establishment of separate audit, compensation, and nominating committees composed entirely of independent directors.... But these structures are important safety valves when crises arise, when CEO succession is an issue, or when the business begins to go downhill. It is in the interest of institutional investors to make modest efforts toward promoting good governance structures as part of long-term investment philosophy.

Although recent studies suggest that shareholder proposals fail to induce corporate performance as measured by stock price, earnings or assets, other studies suggest that other forms of activism, such as targeting under-performing firms, produce long-term returns. Moreover, higher levels of institutional ownership (primarily by mutual funds) increases the probability of takeover bids, a potent monitoring device.

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82 BOGLE, supra note 33, at 197.
83 See id. at 205 (“It is high time for funds to make their ownership muscle felt by joining the pension funds of state and local governments and TIAA-CREF in actively participating in the process of corporate governance, with a view to enhancing shareholder value.”); Carey, supra note 81 (“Advisers are fiduciaries.... [W]hen voting portfolio securities, a fund adviser must act in the best interest of the fund, and not in its own interest.”).
84 See DOWNES ET AL., supra note 54, at 43.
85 Pozen, supra note 41, at 145-46.
86 DOWNES ET AL., supra note 54, at 9 (summarizing recent empirical studies).

No rule currently requires mutual funds to disclose any aspect of their voting/governance activities, unless the fund holds shares of another investment company or controls the management of a portfolio company. Nor do Mutual funds voluntarily disclose in either SEC filings or press releases. Vanguard's prospectus for its U.S. index funds and its more-detailed "statement of additional information" is typical. Neither document mentions voting portfolio securities, except to state that each fund (as to its restricted portfolio) cannot purchase more than 10 percent of a portfolio company or invest more than 5 percent of fund assets in any one company—a restatement of the statutory fragmentation and diversification limits. No mention is made of how Vanguard coordinates voting in its family of funds or any of its governance activities.

The little voting/governance disclosure information contained in SEC filings is mostly spotty and meaningless. Some funds mention, in connection with their investment adviser agreements, that the adviser has responsibility in making voting decisions. Other funds mention a "proxy voting policy" in the investment adviser agreement and state the agreement permits the fund manager to provide shareholders a copy of the policy on request.

Funds are tight-lipped in their voluntary disclosures to the press about specific voting policies and practices. For example, in 1994 Fidelity was reported to have voted on shareholder and management proposals in 4,200 companies, but declined to name

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88 A fund that holds shares in other investment companies must disclose the arrangement and provide pass-through voting to its holders to the same extent they held shares in the underlying investment company. See Investment Company Act § 12(d)(1)(E)(iii)(aa), 15 U.S.C. 80a-12(d)(1)(E)(iii)(aa) (1994). This pass-through voting arises in hub-and-spoke arrangements where one fund owns shares in underlying funds or when an insurance company offers insurance policies that invest in separate accounts. In each situation, the investors only receive disclosure and have voting rights with respect to the underlying funds management and investment activities—but not the voting of the underlying fund's portfolio shares.

89 See infra Part II.A.3.


the twelve companies in which it was actively involved. More telling is a recent academic study of attitudes among institutional investors, including three large mutual fund families, about corporate governance, including voting guidelines followed by the different institutions. The study reported the results without attribution and noted the greater willingness of pension funds, compared to private mutual funds, to outline "their positions concerning shareholders rights and governance issues in philosophical, as well as practical, terms."

The only systematic disclosure of mutual funds' governance power is SEC mandated disclosure of funds' portfolio holdings. As noted by the SEC in its 1978 study of institutional investors, despite an increase in information on portfolio holdings by large institutional investors, "[w]hat is not so clear is the correlation between the percentage of outstanding stock held and the extent of control or influence over portfolio companies as a result of such holdings."

Voting/governance disclosure is feasible. At least one mutual fund, Domini Social Investments, voluntarily discloses its voting/governance activities. The Company posts on a Web site its planned proxy votes two weeks in advance of portfolio company meetings and all final proxy votes, as well as publishing annually its voting guidelines and screening criteria. The fund's avowed purpose is to increase awareness of corporate responsibility, challenge the mutual fund industry to disclose fund voting, and to serve as a voting resource for investors with individual holdings. But these disclosures are the rare exceptions that prove the rule.

Other institutional investors face explicit legal duties

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93 See Blanton, supra note 62, at 72.
94 See Downes et al., supra note 54, at 12, 47.
95 See infra notes 137-40.
96 SEC, INSTITUTIONAL INVESTOR STUDY, H.R. Doc. No. 92-64 (1971) [hereinafter INSTITUTIONAL INVESTOR STUDY].
97 The Domini fund group, which manages $2 billion in portfolio assets, was the first in April 1999 to provide public access to its proxy voting record. See Domini Social Investments, Domini Proxy Votes, at http://www.domini.com/shareradvocacy/Proxy-Voting/index.htm (describing proxy voting policies and containing "proxy voting guidelines" and current proxy votes) (last visited Feb. 10, 2002). The Praxis funds became the first faith-based fund family in December 2000 to post proxy votes on its Web site. See Mennonite Mutual Aid, MMA Praxis Mutual Funds—Proxy Voting Report, at http://www.mmapraxis.com/mma-praxis/index.html (describing voting philosophy and linking to last two years of votes, including current votes at least two weeks before shareholder meetings) (last visited Feb. 10, 2002). See also Bullard, supra note 1 (describing two additional fund families that plan to disclose their proxy voting online).
regarding their voting function. The Department of Labor, which regulates private pension plans under the Employee Retirement Income and Security Act ("ERISA"), has recognized that proxy votes have economic value and that pension managers have fiduciary responsibilities in voting portfolio shares. In a 1994 interpretive bulletin, the Department encouraged pension funds to exercise their share voting rights and announced that fund fiduciaries should "consider those factors that may affect the value of the plan's investment and not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives."\textsuperscript{99} In a series of advisory letters, the Department also stated that the prudent investor rule requires fund fiduciaries to develop proxy voting guidelines and to record voting decisions.\textsuperscript{100} In addition, state legislation regulating public pension funds often requires funds to keep records of their voting of portfolio shares and to make them available to beneficiaries.\textsuperscript{101} Public pension fund managers face political pressures not only to maximize fund performance but also to maintain a public profile to ensure a measure of independence from state politicians.\textsuperscript{102}

Consistent with their voting/governance duties, some private and public pension funds instituted policies of voting/governance transparency. The College Retirement Equities Fund, regulated by ERISA, has produced a detailed "Policy Statement on Corporate Governance."\textsuperscript{103} The statement, which recognizes that


\textsuperscript{100} See Letter from Alan D. Lebowitz, Dep. Ass. Secretary, Labor Dep't, to Helmuth Fandl, Chairman of the Retirement Board, Avon Products, Inc. (Feb. 23, 1988), \textit{reprinted in BNA Pension Rep.}, Feb. 29, 1988, at 391 (stating "with respect to proxy voting, . . . an investment manager or other responsible fiduciary must keep accurate records as to the voting of proxies"); Letter from Alan D. Lebowitz, Dep. Ass. Secretary, Labor Dep't, to Robert A.G. Monks, Institutional Shareholder Services, Inc. (Jan. 23, 1990), \textit{reprinted in BNA Pension Rep.}, Jan. 29, 1990, at 244, 245 (advising that records must be kept on the voting of proxies, voting procedures pursuant to which the investment manager votes proxies, and actual votes).

\textsuperscript{101} See, e.g., \textit{CAL. CORP. CODE} § 711 (West 1990). State legislation also politicizes the state pension function by specifying the investments permissible for public pension funds, including weighted state-related investments, and by mandating the composition of public pension fund boards, including gubernatorial appointees, \textit{ex officio} state officials and plan participants.

\textsuperscript{102} See Norton, \textit{supra} note 61, at 142 (describing Governor Pete Wilson's attempt in 1991 to cut state contributions to CalPERS, reduce the size of the CalPERS board, and have the state governor control a majority of board appointments). State political pressure has mostly been directed toward influencing public pension fund managers to make "economically targeted" investments in local (sometimes distressed) businesses or local housing markets. See Romano, \textit{supra} note 18, at 45-46.

\textsuperscript{103} See TIAA-CREF, \textit{Policy Statement on Corporate Governance} (Nov. 2000).
“good corporate governance” must balance shareholder rights and management prerogatives, is meant as “a basis for dialogue with senior corporate management and boards of directors with the objective of improving corporate governance practices.”104 It identifies general areas of “good governance practices” and makes specific recommendations on how portfolio companies should implement these practices with respect to the board of directors, shareholder voting, executive compensation, CEO evaluation, strategic planning, internal monitoring and social responsibility.105 The statement then sets out detailed guidelines for voting proxies on executive compensation, hoisting “red flags” for compensation plans that exceed specified dilution limits, grant reload options, permit low-priced exercise of options, limit coverage to senior employees, contain pay redundancies, or allow “underwater” repricing of options.106

Voting advisers to ERISA-regulated union funds have adopted and disclosed similar guidelines. The AFL-CIO issues “proxy voting guidelines” to assist union and public employee fund


104 Policy Statement on Corporate Governance, supra note 103.

105 The categories and specific recommendations include:

- The board of directors—majority of independent directors on the board and important committees, director stock ownership, director performance reviews and board freedom.
- Shareholder voting rights—confidential voting, one-share/one-vote, shareholder approval of increases in authorized shares and anti-takeover measures, equal treatment of shareholders, availability of appraisal rights, access by larger shareholder to the proxy statement.
- Executive compensation—“pay for performance” based on an evaluation of “excessive” pay, internal approval processes and disclosure, salary based on industry-peer groups, full and clear disclosure, and close scrutiny of stock options and other incentive plans.
- CEO performance evaluation—performance accountability, ethical behavior, and annual review process.
- Strategic planning—annual board review of strategic plan, assessment of business segment and position, technology audit, and capital planning.
- Fiduciary oversight—internal monitoring for legal compliance, audit committee responsibilities, mechanisms for major shareholders to communicate with board.
- Social responsibility—development of environmental policies, equal employment opportunities, employee communications and training, sensitivity to communities and non-shareholder constituencies.

See id.

106 See id.
managers when they face corporate governance proposals. The guidelines call for voting against repricing stock options, for linking executive compensation to long-term performance goals, and nominating, compensation and audit committees composed of all or a majority of independent directors.

CalPERS, the leader of public pension activism, publishes its Corporate Governance Principles and Proxy Voting Guidelines. CalPERS described its three core corporate governance principles as board independence and leadership, board processes and evaluation, and individual director characteristics. The CalPERS voting guidelines are classified into six major categories: board of directors; corporate governance issues; capital structure; executive compensation; proxy voting process; and social/political issues.

II. Regulation of Mutual Fund Voting of Portfolio Shares

U.S. regulation is ambivalent about mutual fund participation in corporate governance. On the one hand, long-standing diversification rules and ownership limits impose a heavy-handed regulation of mutual fund governance activities. On the other hand, the mutual fund governance function is subject only to vague, virtually unenforced fiduciary rules that mandate that fund directors and advisers act in the best interests of fund shareholders. The absence of any specific rules requiring mutual funds to disclose their regular voting of portfolio shares or other governance activities reflects a curious laissez faire.

In this Part, I review the regulatory scheme that governs mutual funds’ corporate governance activities, principally under the Investment Company Act of 1940. The Act, along with complementary provisions in the federal tax code, limits the ability of any one fund to concentrate its portfolio equity holdings. In addition, the insider-trading and anti-takeover rules generally

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108 See id.
applicable to larger shareholders further discourage a mutual fund’s governance role. Not surprisingly, on the long-standing assumption that mutual funds have been and will be passive shareholders, no explicit rules govern the substance or process of voting portfolio companies’ shares. In the 1970s, the SEC quietly abandoned two proposals to require mutual fund disclosure of voting policies and practices.

Fiduciary norms impose over-arching responsibilities on those who manage fund affairs. At a federal level, mutual fund directors are subject to explicit fiduciary rules concerning advisory arrangements and fees. At a state level, directors and advisers are subject to fiduciary duties imposed by the fund’s state of organization. Despite a handful of recent calls for greater voting responsibility, neither regime has explicitly imposed duties applicable to mutual fund voting. In practice, mutual funds have generally not felt compelled by these vague fiduciary principles to disclose their governance role.

A. Regulation of Mutual Funds’ Governance Role

Mutual fund regulation focuses on the mutual fund’s role as an investment intermediary, the strategic allocation of assets in particular categories (bonds, stocks, derivatives, real estate, cash

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112 The one exception is when an investment company holds shares issued by other investment companies. In this case, the 1940 Act compels the investment company to seek holders’ instructions and to vote the portfolio investment-company shares according to the instructions. See Investment Company Act of 1940 § 12(d)(1)(E)(iii)(aa); 15 U.S.C. § 80a-12(d)(1)(E)(iii)(aa). Such pass-through voting typically arises in hub-and-spoke funds, typically offered by banks. See House Committee on Energy and Commerce, SEC No-Action Letter (June 2, 1993), 1993 SEC No-Act. LEXIS 766 [hereinafter Energy and Commerce Comm. No-Action Letter] (responding to congressional inquiry and describing two-tiered structure authorized by SEC since 1989). In hub-and-spoke funds, pass-through voting applies only to the “hub” fund, not the underlying portfolio shares. As the SEC pointed out, “the spoke fund security holders have the same voting rights they would have as direct security holders of the hub fund.” See Energy and Commerce Comm. No-Action Letter, supra.

Pass-through voting also arises in separate accounts managed by insurance companies for directed investments by policyholders. See, e.g., Integrity Life Insurance Company, Separate Account I, Form N-4 (filed Nov. 13, 2000). Like hub-and-spoke funds, policyholders have voting rights only with respect to the separate accounts, which are registered and operate as investment companies.

113 See BOGLE, supra note 33, at 205 (“It is high time for funds to make their ownership muscle felt by joining the pension funds of state and local governments and TIAA-CREF in actively participating in the process of corporate governance, with a view to enhancing shareholder value); Carey, supra note 81 (“Advisers are fiduciaries... when voting portfolio securities, a fund adviser must act in the best interest of the fund, and not in its own interest.”).
and countries) and the tactical allocation of particular assets within those categories. The regulatory regime seeks to minimize conflicts of interest in the investment buy-sell function and to mandate disclosure of investment policies and portfolio holdings. With respect to the fund’s role as voting intermediary, federal regulation assumes mutual funds are inconsequential, passive participants in corporate governance. A federal complex of diversification and fragmentation requirements mirror and beget this passivity.

This constrained understanding of the governance role of mutual funds also exists outside the United States. A recent comprehensive study by the OECD of institutional investment in global financial markets noted:

Thus far, corporate governance guidelines have mainly concerned pension funds and insurance companies. Guidelines for mutual funds along the same lines as for pension funds, making it explicit that exercise of ownership rights, including proxy voting and evaluating more activist alternatives, must be undertaken as a part of fiduciary obligation, seem not to exist in OECD countries. For example, no provision of the United States federal securities laws nor any SEC rule thereunder specifically addresses the responsibilities of investment advisers regarding the voting of proxies or shareholder activism.

Perhaps due to the regulatory understanding that U.S. mutual funds would have limited governance powers with respect to portfolio companies, disclosure of voting policies and practices were thought superfluous. Mutual funds were expected to follow the “Wall Street rule”—vote with management or sell.

1. Statutory Limits on Mutual Fund Governance Role

From the inception of the mutual fund industry, Congress and the SEC sought to limit the governance potential of mutual funds. In his comprehensive study of the politics of U.S. corporate governance, Professor Roe describes the political motivations behind legislative restrictions meant to prevent mutual funds from

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114 See Blommestein, supra note 12, at 31 (describing fund management as a “two-stage decision-making process” involving strategic decisions on allocation of funds to different asset categories and countries, and tactical decisions on the size of specific assets within each category).

115 See ROE, supra note 28, at 109-10 (describing assumption that mutual funds would be in “business of picking stock and bonds, not of making operating decisions”).

116 See Blommestein, supra note 12, at 46-47.

117 See Roe, supra note 9, at 1484-1500 (describing political roots of rules that made it difficult for mutual funds to actively affect portfolio companies).
exercising an effective governance role. The SEC speculated that, if allowed to take large positions in portfolio companies, mutual funds would divert fund assets to faltering portfolio companies to: protect the fund’s position, manipulate portfolio company financial or capital structures to the detriment of other shareholders, extract too-high dividends to bolster fund returns, and force mergers of controlled companies on terms disadvantageous to other shareholders. Congress, in turn, feared Wall Street control of industrial companies.

Reflecting the New Deal distrust of concentrated financial power, the Investment Company Act defined the structure of U.S. mutual funds and limited any one fund’s ability to exercise governance control of its portfolio companies. First is a diversification rule: a mutual fund can advertise itself as “diversified” only if its restricted portfolio (75 percent of assets) has no more than 5 percent of fund assets in the securities of any one issuer. Second is a fragmentation requirement: a “diversified” mutual fund cannot own in its restricted portfolio more than 10 percent of the stock of any company. This requirement, not really aimed at diversification, precludes a fund from investing even a small portion of its assets in a single company if the investment would represent a 10 percent control block of that company’s stock. The avowed purpose of the fragmentation rule is to disable mutual fund control of operating companies.

What’s to keep a mutual fund from avoiding these limits by choosing not to call itself diversified or using its unrestricted portfolio (25 percent of assets) to buy control? The answer comes from the tax code, and specifically the 1936 Revenue Act, which conditions pass-through tax treatment of mutual fund income (and thus the financial viability for mutual funds as an investment instrument) on similar diversification and fragmentation

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118 See ROE, supra note 28, at 102-23; see also Roe, supra note 9.
119 See Roe, supra note 9, at 1472-74.
121 See id.
122 See ROE, supra note 28, at 104; see also Roe, supra note 9, at 1474. In addition, the Investment Company Act eviscerates any value to a mutual fund of placing a director on a portfolio company’s board or owning more than 5 percent of any portfolio company. See Investment Company Act of 1940 §§ 2(a)(3), 17(d), 15 U.S.C. §§ 80a-2(a)(3), 80a-17(d) (1994). A mutual fund that acquires more than 5 percent of a portfolio company (an “affiliate” of the fund) is effectively blocked by SEC rule from engaging in stock transactions with the portfolio company or otherwise exerting control. See id. (requiring SEC approval of all joint activities by the fund and an “affiliate” portfolio company); SEC v. Talley Indus., Inc., 399 F.2d 396 (2d Cir. 1968), cert. denied, 393 U.S. 1015 (1969) (precluding mutual fund from purchasing stock of takeover target, when purchases were coordinated with portfolio company in which fund held more than 5 percent).
requirements. Only “diversified” mutual funds (subject to a 5 percent diversification limit on all the fund’s assets and 10 percent fragmentation cap) can pass income to shareholders tax-free at the fund level. In 1942, Congress relaxed the fragmentation limits by allowing greater concentration in half of a fund’s portfolio, provided that in this other half no more than 25 percent of the fund’s assets could be invested in a single company’s stock.

The combined effect of these rules is that virtually all mutual funds call themselves “diversified” and subject themselves to this overlay of fragmentation rules under the 1940 Act and the tax code. Although the rules in theory permit a fund to use 25 percent of fund assets to buy controlling interests in portfolio companies, additional rules discourage this. If the fund were to acquire more than a 10 percent interest in a portfolio company, the short-swing profits rules of the Securities Exchange Act would limit the fund’s liquidity and subject it to reporting requirements. If the fund were to acquire a 5 percent interest in concert with other financial shareholders also acquiring 5 percent, they would all become 1940 Act affiliates. Absent an SEC exemption, such affiliates would be precluded from electing representatives to the company’s board of directors or otherwise exerting control. Even if the SEC granted an exemption and the group placed a representative on a portfolio company board, the group actors could become subject under a “deputization” theory to the short-swing profit rules, again limiting liquidity and subjecting the group to reporting requirements.

Even if a control-motivated fund kept its holdings at or below 4.9 percent and acted with other funds each holding 4.9 percent—such as in a mutual fund family under common management—this amalgamation of voting power would trigger additional problems. The funds, acting as a group, would be subject to the Williams Act disclosure rules applicable to any 5 percent shareholder group

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123 See I.R.C. § 851(b)(3) (2000). As amended in 1942, the tax code subjects only 50 percent of the fund’s portfolio to the 5 percent diversification limit and the 10 percent fragmentation rule. See id. § 851 (b)(3)(A)(ii).


125 See Securities Exchange Act of 1934 § 16(a), 15 U.S.C. § 78p(a) (1994). In addition, the fund would be limited if it sought control of companies in a related market segment. Under the tax code a mutual fund cannot invest, without becoming subject to fund-level tax, more than one-fourth of its portfolio in two or more controlled firms “engaged in the same or similar [or related] trades or business.” I.R.C. § 851(b)(4)(B), added Revenue Act of 1942, § 170(a), Pub. L. No. 77-753, 56 Stat. 798, 878 (1942); see also ROE, supra note 28, at 115-16.

contemplating the exercise of control.\textsuperscript{127} In addition, every member of the group (if the group holdings exceeded 10 percent or if the group placed a director on a portfolio company’s board) would become subject to the short-swing profit rules.\textsuperscript{128} For these reasons, mutual fund families reportedly limit aggregate holdings to no more than 10 percent of the voting shares of any one company.\textsuperscript{129}


2. Regulation of Mutual Fund Management Structure

The Investment Company Act imposes structural rules and substantive prohibitions, undergirded by disclosure mandates, with respect to the mutual fund \textit{investment function}:

- Mutual funds must adhere to stated investment policies and limitations;
- Investment policies, portfolio holdings and fund expenses must be disclosed;
- Certain types of investments are prohibited;
- Transactions with affiliates are restricted; and
- Investment advisory and distribution arrangements are regulated.

In addition, the 1940 Act specifies the composition of the board (which must include at least 40 percent independent directors) and the election of directors, capital structure, portfolio transactions, custodial arrangements, fidelity bonding, selection of accountants, valuation and pricing of shares, and portfolio liquidity.\textsuperscript{130} The fund’s board of directors (including a majority of

\textsuperscript{127} See Securities Exchange Act of 1934 § 13(d)(3), 15 U.S.C. § 78m(d)(3) (1994) ("When two or more persons act as a... group for purposes of acquiring, holding, or disposing of securities of an issuer, such... group shall be deemed a "person" for purposes of this subsection [requiring disclosure of 5 percent holdings]."). \textit{See also} Securities Exchange Act Rule 13d-5(b)(1), 17 C.F.R. § 240.13d-5(b)(1) (1999) ("When two or more persons agree to act together for the purpose of acquiring, holding, \textit{voting}, or disposing of equity securities of an issuer, the group... shall be deemed to have acquired beneficial ownership... ") (emphasis added).

\textsuperscript{128} Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (1994) (requiring disgorgement of trading profits by holders of more than 10 percent of the equity shares of a registered company). \textit{See also} Securities Exchange Act Rule 16a-1, 17 C.F.R. § 240.16(a)(1) (1999) (defining "beneficial owner" to be a person who is "deemed a beneficial owner pursuant to section 13(d) of the Act and the rules thereunder). \textsuperscript{129} E.g. Roe, \textit{supra} note 9, at 1477.

\textsuperscript{130} \textit{See} Task Force on Fund Director’s Guidebook, Federal Regulation of Securities Committee, ABA Section of Business Law, \textit{Fund Director’s Guidebook} 5, 13-14 (1996).
the board’s independent directors) is charged with annually negotiating and approving the advisory contract with the fund’s adviser. The board must request and evaluate information “as may be reasonably necessary” to evaluate the terms of the advisory contract. The SEC has recently emphasized the “watchdog role” of independent fund directors with respect to fund expenses, fund distribution and brokerage arrangements, fund disclosure of expenses and risks, and valuation of fund portfolio securities. Former SEC Chair Arthur Levitt called for greater independence of fund directors, noting that the fund director’s “responsibility for the fund’s disclosure obligations [is] an extraordinary tool with which to protect investors.”

Absent from the governance rules is any explicit regulation or even record-keeping requirement related to the mutual fund’s voting function. Although management advisory contracts typically give the fund adviser responsibility over portfolio shares, including their voting, there is no specific mention of this function in the statute, SEC rules or disclosure forms. Instead, the focus is on fund structure and investment functions: mutual funds must keep extensive records of their constitutive and internal governance documents, trading transactions, portfolio investments and positions, investment authorizations and investment advisory materials.

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132 See FUND DIRECTOR’S GUIDEBOOK, supra note 130, at 29.
134 Arthur Levitt, Mutual Fund Directors as Investor Advocates, Address Before SEC’s Second Annual Symposium for Mutual Fund Trustees and Directors (Apr. 11, 1995), in FRANKEL & KIRSCH, supra note 32, at 250.
135 The one exception is when a fund holds shares in other investment companies, triggering disclosure and pass-through voting obligations. See Investment Company Act of 1940 § 12(d)(1)(E)(iii)(aa), 15 U.S.C. § 80a-12(d)(1)(E)(iii)(aa) (1994). This pass-through voting, which arises in hub-and-spoke arrangements and insurance company separate accounts, applies only to the underlying fund’s management and investment activities—not the voting of the underlying fund’s portfolio shares.

- Corporate charters, certificates of incorporation or trust agreements, by-laws, minute books of stockholders' and directors' or trustees' meetings, minute books of directors' or trustees' committee and advisory board or advisory committee meetings;
- Journals, ledgers, records of each brokerage order, records of all other portfolio purchases or sales, records of all puts, calls, spreads, straddles, and other options in which the investment company has any direct or indirect interest;
- A record of the proof of money balances in all ledger accounts (except shareholder accounts), for each fiscal quarter;
3. Mandatory Disclosure of Mutual Fund Governance Role

No provision of federal securities law (statutory or administrative) requires that mutual funds disclose the regular voting of their portfolio shares. Only if a mutual fund “directly or indirectly” controls a portfolio company must the fund disclose this control relationship in its Statement of Additional Information filed with the SEC.

True to this regulatory indifference, the SEC’s recent comprehensive report on mutual fund regulation gives only glancing attention to the role of mutual funds in an era of shareholder activism. Instead, reform attention has been focused on investment advisory fees, disclosure on pre-tax and after-tax returns, proper naming of mutual funds to reflect the investments in their portfolio, more frequent disclosure of fund holdings, and greater independence of fund directors. Despite recent regulatory attention directed to the nature and usefulness of mutual fund disclosure, the SEC has paid no attention to the disclosure of a fund’s regular voting/governance activities.

In contrast, federal mutual fund regulation requires detailed and binding disclosure with respect to the fund’s investment function. The fund’s objectives, strategies and limitations must be disclosed in the fund’s prospectus. Investment objectives and

- A record identifying entities authorizing the purchase or sale of portfolio securities; and
- Files of all advisory materials received.

Id.

137 The one exception is the disclosure required in connection with the pass-through voting when one investment company holds shares of another investment company. See Energy and Commerce Comm. No-Action Letter, supra note 112 (responding to congressional inquiry and describing disclosure to fund investors regarding fees, investment policies of the underlying fund, and method of voting the shares in the underlying fund).


policies—arising in the fund’s articles, bylaws, board resolutions, and SEC exemptive orders—can be changed only with shareholder approval.\textsuperscript{143} In addition, semi-annual disclosure of the fund’s holdings allow investors (and regulators) to check the fund’s compliance with its stated investment policies.\textsuperscript{144} Similarly, recent disclosure reforms have been aimed at the investment function. The new “plain English” standards applicable to the mutual fund prospectus require “clear, concise and understandable” disclosure only of the fund’s investment objectives and policies, investment strategies, risk exposures, and annualized returns.\textsuperscript{145}

Despite the disclosure lacuna concerning voting/governance activities, federal securities laws compel significant information about mutual funds’ holdings. Mutual funds must disclose their portfolio holdings (but not their voting policies or practices) in a semi-annual report to shareholders,\textsuperscript{146} as well as in an annual informational filing with the SEC required of all institutional investors.\textsuperscript{147} In addition, a mutual fund that acquires (alone or as part of a group) more than 5 percent of a portfolio company’s voting stock, with a purpose to exercise control, must disclose its holdings and intentions within ten days of the acquisition.\textsuperscript{148} If the


\textsuperscript{144} With more market volatility and fund turnover, some have criticized the regulatory lag for fund disclosure of portfolio holdings. See Robert Barker, \textit{Wanted: Shareholder Rights for Mutual Funds}, BUS. WEEK, Sept. 1, 1997, at 39.

\textsuperscript{145} Securities and Exchange Commission, Registration Form Used by Open-End Management Investment Companies, Securities Act Release No. 7512 at 9-10, 63 Fed. Reg. 13,916, 13,917 (Mar. 23, 1998); see Pui-Wing Tam, \textit{Mutual-Fund Documents Are Simply Put}, WALL ST. J., June 12, 1998, at C1, C27. On the assumption that mutual fund investors only browse the prospectus, if that, the initiative requires plain English only for the cover page, summary and risk factor sections of the prospectus.


Any person who . . . is directly or indirectly the beneficial owner of more than 5 percent of such class shall . . . file with the Commission . . . (C) if the purpose of the purchases or prospective purchases is to acquire control of the business of the issuer of the securities, any plans or proposals which such persons may have to liquidate such issuer, to sell its assets to or merge it with any other persons, or to make any other major change in its business or corporate structure.
fund does not have control intentions, it can postpone disclosing its 5 percent position until year’s end.  


The issue of mutual disclosure of voting/governance activities surfaced two decades ago, but then quietly disappeared. In 1980, following an SEC report on U.S. institutional ownership, Congress toyed with the idea of mandating disclosure of institutional investors voting, but no bill was proposed and congressional interest faded.

The SEC has come closer to ruling on the disclosure of mutual fund voting/governance activities. Twice in the 1970s the SEC formally proposed rules for mandatory disclosure of mutual fund voting policies and procedures, only to withdraw them. Since then the SEC urged (and facilitated) voluntary disclosure by mutual funds and other institutional investors of how they vote their portfolio shares, though only a handful have accepted the regulatory invitation.

The SEC’s 1971 proposal. In 1971, the SEC proposed “to require investment companies registered under the [Investment Company] Act to disclose with greater specificity their policies or involvement in the affairs of their portfolio companies.”

Id. (emphasis added)) (Schedule 13D); see also SEC, Schedule 13D, available at http://www.sec.gov/divisions/corpfin/forms/13d.htm (last visited Feb. 3, 2002).

Any person who is directly or indirectly the beneficial owner of more than 5 per centum of any security of a class described in subsection (d)(1) of this section shall send to the issuer of the security and shall file with the Commission a statement setting forth, in such form and at such time as the Commission may, by rule, prescribe—(A) such person’s identity, residence, and citizenship; and (B) the number and description of the shares in which such person has an interest and the nature of such interest.


(d) Investment in companies for the purpose of exercising control or management, and any other policy with respect to involvement in the affairs of portfolio companies, including:
(1) Procedures for considering proxy materials of portfolio companies, including any procedure that may be followed whereby registrant solicits from its shareholders instructions or opinions with respect to voting of proxies.
(2) Any general policy of supporting management of portfolio companies.
Growing out of the SEC’s Institutional Investor Study Report to Congress, the 1971 proposal was part of a broader initiative to promote a role for institutional investors in U.S. corporate governance. As the SEC stated to Congress:

Consideration should be given to requiring all institutions to state their policies on involvement in corporate affairs and with more specificity than now required of investment companies, including: their procedures for considering proxy materials, any general policy regarding supporting management, any general policy of abstaining from voting, any general policy on voting for or against (or not voting on) certain types of proposals, any general policy of participating or not participating in corporate transfer situations, any policies regarding other business relationships, and informal participating or consultation with portfolio companies in corporate affairs.

The SEC saw its mutual fund rulemaking as a first step in a broader campaign to induce institutional investors to rethink their voting passivity. Specifically, the rule would have required registered investment companies to disclose voting procedures and policies, though not actual voting results or practices. The rulemaking was aimed unabashedly at the “Wall Street rule” and called on mutual funds to state the fund’s policy when the fund did not support management, such as choosing to “liquidate holdings in such company.”

Comments to the SEC proposal offered tepid support, though doubted the usefulness of a rule that would likely add boilerplate to already prolix fund prospectuses. Commentators anticipated compliance along the following lines:

The mutual fund does not solicit shareholder instruction or opinions in voting portfolio shares. Instead, the fund reserves the discretion to make decisions about voting portfolio shares in

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(3) Any general policy of abstaining from voting at annual and other meetings of portfolio companies.
(4) Any general policy on voting for or against (or not voting on) certain types of proposals at annual and other meetings of portfolio companies.
(5) Any general policy of participating or not participating in transfers of control of actual or potential portfolio companies.
(6) Any general polices or practices regarding other business relationships, personnel relationships and informal participation with portfolio companies in corporate affairs.

Id. ¶ 80,947.

151 See INSTITUTIONAL INVESTOR STUDY, supra note 96.
152 Id. at XXXI.
154 Id. (Proposed Form N-8B-1, Instructions (1)).
the best interest of fund shareholders. The fund generally acquires shares of portfolio companies because of its faith in company management, and sells when management falls out of grace.\textsuperscript{156}

Some commentators pointed out that mutual fund managers did not formulate voting policies, rather they voted on a case-by-case basis as their business conscience dictated.\textsuperscript{157} Other commentators noted that liability fears arising from charges of misleading disclosure or non-compliance with stated policies would lead funds to hedge their disclosure, rendering it useless.\textsuperscript{158} One commentator worried that mandatory disclosure would compel funds to adopt rigid voting policies without regard to the merits of the issue.\textsuperscript{159} Another criticized the idea floated by the SEC of funds' soliciting investor instructions, since fund managers are "better able to discharge [the voting function] than the fund shareholders themselves."\textsuperscript{160} Another commentator, viewing the disclosure issue as part of a larger debate, questioned whether "the investment company prospectus" was the right forum for debating the proper governance role of institutional investors.\textsuperscript{161}

One group of commentators, who identified themselves as supporting "greater social responsibility on the part of business corporations through the active participation of the shareholders," concluded the rule was ill-conceived and would only add boilerplate.\textsuperscript{162} This group, which included Professors Roy A. Schotland and Donald E. Schwartz, explained, "To understand [voting] policy requires an examination of [voting] practices."\textsuperscript{163} They recommended mutual funds (and other institutional investors) be required to describe those instances when the fund had voted against management.\textsuperscript{164}

The SEC tabled the proposal and, five years later in 1976,


\textsuperscript{157} See Letter from Arthur Fleischer, Jr., Chairman, Association of the Bar of the City of New York, to Ronald F. Hunt, Secretary, SEC, at 1-2 (Jan. 25, 1972) [hereinafter Letter from Arthur Fleischer, Jr.] (on file with author); see also Letter from David Silver, supra note 155, at 2.

\textsuperscript{158} See Letter from Arthur Fleischer, Jr., supra note 157, at 2.

\textsuperscript{159} See Letter from Neil Flanagan, Partner, Leibman, Williams, Bennett, Baird and Minow, to Ronald F. Hunt, Secretary, SEC, at 1-2 (Jan. 25, 1972) (on file with author).

\textsuperscript{160} See Letter from Kevin P. Howe, Associate Counsel, Investors Diversified Services, Inc., to SEC, at 1 (Jan. 20, 1972) (on file with author).


\textsuperscript{162} Id.

\textsuperscript{163} Id.

\textsuperscript{164} See id. at 2-3.
withdrew it. 165 In its notice of withdrawal, the SEC stated that most commentators criticized the proposal “stressing that, as a rule, investment companies do not form general policies with respect to involvement in portfolio companies.”166 The SEC suggested it might return to the issue as part of its ongoing review of investment company disclosure.167

The SEC’s 1978 proposal. In 1977, the SEC revived the idea of institutional disclosure of voting policies as part of a broad re-examination of its rules relating to corporate democracy, including rules involving shareholder communications, shareholder participation in the corporate electoral process, and corporate governance generally.168 The inquiry went beyond mutual funds, and the SEC sought comments and conducted hearings on the institutional voting process. In 1978, the SEC proposed a disclosure rule that would have required registered mutual funds and investment advisers, as well as parent holding companies of banks, insurance companies and broker-dealers:

- to disclose their voting policies and procedures (as well as those of their subsidiaries) in the company’s annual report to shareholders;
- to describe any existing procedures for consulting beneficial owners; and
- to disclose the number of times the institution (or subsidiary) had voted for or against management on contested matters.169

The proposal’s avowed purpose was “to elicit information relevant to an assessment of the governance of portfolio companies.”170 In explaining the proposal, the SEC noted the growing importance of institutional investors, which at the end of 1977 held more than 33 percent of U.S. stock, and the prevalence of a reflexive institutional adherence to the “Wall Street rule.”171

The 1978 proposal itself was remarkably restrained. It contained no shareholder consultation requirements because most commentators who addressed the issue were opposed to “a polling

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166 Id.
167 Id.
170 Staff Report on Corporate Accountability, supra note 27, at 406-07.
or pass-through voting requirement.”

It did not require disclosure of actual votes, though some commentators urged disclosure of “actual votes on certain issues, particularly shareholder proposals, contested issues and matters affecting [shareholder] rights.” Instead, the proposal mandated only a “brief” description of voting policies and procedures. According to the proposed rule’s instructions, specificity was required only with respect to voting in contested matters. In such instances, the institution needed to “indicate in the aggregate the number of times such matters were presented and the number of times [the institution] voted for or against” recommendations by management.

The SEC acknowledged that the proposal failed to cover many other institutional investors—such as banks, insurance companies and pension funds—not subject to the SEC’s proxy rules. Nevertheless, the SEC saw the proposal as a “preliminary step toward providing shareholders with better information concerning the exercise of voting power by institutions which are subject to the Commission’s proxy rules and facilitating consideration of the impact of institutional voting on corporate governance.” Curiously, the SEC proposal’s avowed focus was on disclosure to shareholders of portfolio companies, perhaps as part of its larger regulatory agenda of the 1970s to protect shareholders (and incumbent management) in takeovers.

Ultimately the SEC withdrew the 1978 proposal, apparently based on criticism that the proposal left regulatory gaps and imposed an uneven disclosure burden. The SEC also noted the criticism that the proposal failed to provide “a correlation between [an institution’s] voting record and the identity of portfolio companies,” making it difficult for shareholders of portfolio companies to assess institutional voting in contested matters. While maintaining that “there is shareholder interest in institutional voting policies and procedures,” the SEC decided its proposal was not an appropriate vehicle for promoting that

172 Id. at 33.
173 Id. at 33-34.
174 Id. at 45 (Proposed Rule 14a-3(b)(11), Instruction 3).
175 See id. at 45.
177 Id.
178 See Exchange Act Release No. 15,385, 16 SEC DOCKET 365 (Dec. 6, 1978). The SEC also noted that commentators had criticized the proposal’s “blanket approach” which disregarded that institutions hold equity securities in many different capacities, each one impacting the institution’s voting policies and procedures.
179 Id.
interest. It nonetheless commended those institutions that were voluntarily providing voting and governance information to their investors and encouraged other institutions do the same.

The SEC’s 1980 report to Congress. Mutual fund disclosure of portfolio voting has since been a quiescent issue on the regulatory agenda, receiving only incidental attention. In a 1980 staff report to Congress on institutional investor activism, the SEC returned to its theme of greater oversight and urged institutional investors to “voluntarily disclose their voting procedures and practice [since] such disclosure could be of material benefit to investors.” The agency’s purpose, however, seemed aimed as much at permitting “shareholders [of portfolio companies] to evaluate the operation of a company’s electoral process” as at informing investors on how institutions “discharge their responsibilities with respect to voting the stock they manage.”

This disclosure, according to the SEC, would “produce a better understanding of the relationships between institutional investors and the companies in which they invest,” apparently for the benefit of regulators and portfolio company management.

In their 1980 report, SEC staff specifically recommended that institutions:

a) Establish voting criteria designed to produce objective voting decisions consistent with fiduciary responsibility . . .

b) Discontinue the practice of categorizing an uncontested election of directors as a routine matter warranting an automatic vote for the entire slate of nominees, bearing in mind that more exacting judgements with respect to the election of directors may improve corporate accountability and long-term profitability.

The staff report called on the SEC to “urge all financial institutions to make information concerning their voting procedures and practices readily available to customers and the public.” But the report disappeared into a legislative/regulatory oblivion.

The SEC’s 1992 shareholder communications rules. In its 1992 shareholder communications rules, the SEC sought to encourage greater voluntary disclosure by shareholders, including institutional investors. Among other things, the rules permit a
shareholder to state, in a public forum or to persons owed a fiduciary duty, "how the security holder intends to vote and the reasons therefor." As the SEC explained, the rule allows institutional fiduciaries "to disclose to the public and their beneficiaries how the fiduciary will vote [portfolio] securities on significant issues."

The 1992 amendments have been used by Michael Price and other activist fund managers to publicly state their voting positions, particularly on extraordinary transactions, to mobilize other institutional investors. Even when a mutual fund holds a noncontrolling interest in a company, the ability to communicate with other shareholders (particularly large institutional shareholders) can put the fund manager in a position as deal broker, as happened to Price in the merger of Chase and Chemical Bank.

The Investment Company Act Amendments of 1996. In 1996 Congress amended the Investment Company Act to streamline disclosure to investors. Although neither the amendments nor their legislative history discuss the role of mutual funds in corporate governance, the SEC Director of the Division of Investment Management noted that the proposed disclosure changes would help funds include more information on fund policies, including the voting of portfolio shares.

B. Fiduciary Duties to Exercise a Governance Role

Fiduciary norms, elucidated and enforced by courts, fill the inevitable gaps of statutory and administrative regulation. Mutual

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189 See Andrew E. Serwer, Mr. Price Is on the Line, FORTUNE, Dec. 9, 1996, at 70 (describing Price's role in pressuring Chase to merge with Chemical Bank).
fund directors are subject to “tightened” fiduciary duties under the Investment Company Act, which are superimposed on traditional state fiduciary duties of care and loyalty. Operating in this two-tiered regime, fund directors are generally charged with setting fund policies, approving the fund manager’s contract and fees, monitoring the fund manager’s compliance with fund policies, and assuring that fund operations conform to the fund’s stated investment objectives.\textsuperscript{192}

The setting and monitoring by fund directors of voting/governance policies with respect to portfolio companies, however, has received only passing attention. As Professor Conard pointed out, “[t]he voting of shares . . . is not mentioned by . . . the ICA . . . among the acts to which the fiduciary duty applies, and the law of trusts has very little to say about it.”\textsuperscript{193}

In its 1980 report on corporate accountability, the SEC staff described to Congress the ambivalence of institutional investors, including mutual funds, which “are accused by some of exerting undue influence if they actively participate in corporate affairs . . . and by others of [abstaining and] not fulfilling the responsibility to their beneficiaries and to other shareholders.”\textsuperscript{194} The report pointed out, “The fiduciary principle applies to all aspects of investment management, including voting. In exercising the stock franchise, the fiduciary has a duty to vote in such a way as to promote the interests of the beneficiaries.”\textsuperscript{195} A recent survey of managers of ten large institutional investors reported that managers state “performance is the primary driver of the [corporate] monitoring process . . . some investors consider performance a critical component of their fiduciary responsibility, and in a few cases, fiduciary responsibility and performance are seen as inseparable concepts.”\textsuperscript{196}

Despite this rhetoric, no court has apparently ever mentioned (much less decided) the fiduciary responsibilities of fund directors with respect to the voting of portfolio shares.\textsuperscript{197} Instead, the

\textsuperscript{192} See Frankel & Kirsch, supra note 32, at 253-54.
\textsuperscript{193} Conard, supra note 36, at 150.
\textsuperscript{194} Staff Report on Corporate Accountability, supra note 27, at 379. Some institutional investors recognized the irresponsibility of turning over voting responsibility to others. See Pension Fund Investment Policies: Hearing Before the Senate Subcomm. On Citizens and Shareholder’s Rights and Remedies, Comm. On the Judiciary, 95th Cong. 164 (1978) (statement of Harrison V. Smithy: “To ignore the responsibility to vote where we are sole trustee, or to abstain, would be abdicating our fiduciary responsibilities.”).
\textsuperscript{195} Staff Report on Corporate Accountability, supra note 27, at 390-91.
\textsuperscript{196} Downes et al., supra note 54, at 24-25.
\textsuperscript{197} Contrast this silence with the emerging judicial supervision under ERISA of voting by ESOP trustees. See Grindstaff v. Green, 133 F.3d 416 (6th Cir. 1998) (holding that ESOP trustees did not breach fiduciary duties by refusing to allow for pass-through voting
judicial focus, paralleling the regulatory and academic focus, has been on the role of fund directors in overseeing the fund's investment function, as well as the supervision of advisory contracts and fees. For example, a recent Report of the Advisory Group on Best Practices for Fund Directors proposes significant structural reforms to ensure greater "watchdog" supervision by independent directors of the fund's adviser and other service providers, yet makes no mention of the role of fund directors with respect to the voting of portfolio securities. 198

1. Fiduciary Duties Under the 1940 Act

The 1940 Act prescribes the fiduciary duties of investment company directors in specific contexts, but none deals with voting of portfolio shares. 199 Nonetheless, it might be possible to infer disclosure duties from the existing supervisory duties of fund directors, as well as from disclosure duties imposed on other securities intermediaries operating on behalf of beneficial owners

in an uncontested board election); Newton v. Van Otterloo, 756 F. Supp. 1121 (N.D. Ind. 1991) (finding that ESOP trustees, members of corporate management, breached fiduciary duties to plan beneficiaries by not forwarding to them proxies so they could vote their shares in proxy fight); see also Brett McDonnell, ESOPs' Failures: Fiduciary Duties when Managers of Employee-Owned Companies Vote to Entrench Themselves, 2000 COLUM. BUS. L. REV. 199 (2000) (arguing that ESOP trustees should be subject to an intermediate standard of review in voting company shares).

198 See INVESTMENT COMPANY INSTITUTE, REPORT OF THE ADVISORY GROUP ON BEST PRACTICES FOR FUND DIRECTORS, ENHANCING A CULTURE OF INDEPENDENCE AND EFFECTIVENESS (1999), available at http://www.ici.org/pdf/rpt_best_practices.pdf (last visited Feb. 3, 2002). The recommendations included that mutual funds have boards composed of a super-majority of independent directors, id. at 10, that independent directors control the nominating process, id. at 14, that independent directors have qualified independent counsel and other experts, id. at 18, and that unitary boards oversee a family (or complex) of funds, id. at 27.

The Advisory Group was not without expert advice on the subject of corporate governance. Its members included Tamar Frankel (Boston University Law School), Richard Koppes (formerly General Counsel, CalPERS), Ned V. Regan (former Comptroller of New York State), Kenneth Scott (Stanford Law School), and Jean Head Cisco (former Chair, National Association of Corporate Directors).

199 See Investment Company Act of 1940 § 10(f), 15 U.S.C. §§ 80a-10(f) (1994) (mutual funds are prohibited from buying securities in an offering in which the principal underwriter is affiliated with any officer, director or investment adviser of the fund.). id. § 17(a) (mutual funds are prohibited from engaging in transactions (involving securities or other property) with affiliated persons.). id. § 17(i) (mutual funds are prohibited from indemnifying the fund's investment advisers or underwriters against willful or grossly negligent liability to fund shareholders.). id. § 36(a) (the SEC can sue mutual fund officers, directors and investment advisers for injunctive and other relief in cases of breach of fiduciary duty involving personal misconduct.). id. § 36(b) (the SEC or fund shareholders may sue the investment adviser with respect to the receipt of compensation for services, as to which the adviser owes fiduciary duties to the fund.)
in other contexts.

The centerpiece of the 1940 Act’s fiduciary regime is its regulation of advisory fees—which cover, among other functions, the provision of voting services. Section 36(b) imposes a fiduciary duty with respect to the fund’s compensation of the fund adviser, and authorizes federal lawsuits by the fund shareholders and the SEC. Given the relative weakness of market controls over adviser fees, confirmed by recent evidence of widespread investor insensitivity to the level and nature of advisory fees, judicial review is meant as an antidote to this market failure.

In fulfilling this supervisory role, independent directors are given by the 1940 Act a central role. As the Supreme Court explained:

Congress’ purpose in structuring the [1940] Act as it did is clear. It “was designed to place the unaffiliated directors in the role of ‘independent watchdogs,’” ... who would “furnish an independent check upon the management” of investment companies. . . . In short, the structure and purpose of the [1940 Act] indicate that Congress entrusted to the independent directors of investment companies, exercising the authority granted to them by state law, the primary responsibility for looking after the interests of the funds’ shareholders.

Despite the Court’s call to action, lower courts have largely deferred to independent directors’ setting of advisory fees. Under the prevailing judicial standard, fund directors violate Section 36(b) only if the adviser’s fee is “so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.” In addition, independent fund directors—particularly if advised by outside legal counsel—have significant discretion in approving fund management arrangements. Rare is the case that advisory fees fail this “business judgment” review.

Much attention, academic and journalistic, has been lavished

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202 See, e.g., Migdal v. Rowe Price-Fleming Int'l Inc., 248 F.3d 321 (4th Cir. 2001) (refusing to find that investment advisory fees were excessive or that the fund directors were not independent because of multi-board membership in a family of mutual funds); Meyer v. Oppenheimer Mgmt. Corp., 895 F.2d 861, 866-67 (2d Cir. 1990) (rejecting claim that advisory and distribution fees were unfair).
203 Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928 (2d. Cir. 1982).
on the internal supervision of adviser compensation, including:

- the allocation of common costs among funds in a fund family;
- the appropriateness of the reimbursement for promotional charges;\(^{205}\)
- the proper methodology for incentive pay; and
- the profitability of the adviser.\(^{206}\)

But the focus has invariably been on the adviser's role and fees in providing investment-related services. Lost in the furor is the adviser's role in providing voting/governance services—or, more to the point, the adviser's role in coordinating this function with other advisers of the same fund family or sub-contracting this function to a proxy service or advisory firm.

Nonetheless, the growing recognition of the value of coordinated action and supervision within a fund family suggests a model for mutual fund voting/governance activities. As mutual fund voting power has become concentrated in mutual fund families and proxy adviser firms, continuing coordination seems inevitable. Recently, Maryland (one of the leading states for mutual fund organization) explicitly authorized directors to serve on multiple fund boards within a fund family, overturning a federal court decision that such service subverts a director's independence.\(^{207}\) Following this legislative lead, other courts have uniformly rejected challenges based on multiple director service.\(^{208}\)

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\(^{205}\) The SEC permits funds to pay for marketing and promotional expenses. See Investment Company Act Rule 125-1, 17 C.F.R. § 270.12b-1 (1999). Approximately 60 percent of funds incur 12b-1 selling fees, charged either as front-end or back-end sales charges or as an ongoing charge based on a percentage of net assets.

\(^{206}\) See John P. Freeman & Stewart L. Brown, Mutual Fund Advisory Fees: The Cost of Conflicts of Interest, 26 J. CORP. L. 609 (2001) (finding that mutual fund managers systematically overprice professional investment advice); see also Tom Lauricella, This Is News? Fund Fees Are Too High, Study Says, WALL ST. J., Aug. 27, 2001, at C1 (describing study by law school and business school professors that mutual fund investors are paying "far too much" in investment-management fees, compared to public pension fund fees).


\(^{208}\) See Strougo v. BEA Assocs., 98 Civ. 3725, 1999 WL 147737 (S.D.N.Y. 1999); Verkouteren v. Blackrock Fin. Mgmt., Inc., 98 Civ. 4673, 1999 WL 511411 (S.D.N.Y. 1999); see also Migdal v. Rowe Price-Fleming Int'l Inc., 248 F.3d 321 (4th Cir. 2001) (noting that "membership on the boards of several funds within a mutual fund complex is the prevailing practice in the industry"). Indeed the SEC has stated that "a director of a fund who also is a director of another fund managed by the same adviser generally would not be viewed as an interested person of the fund under section 2(a)(19) solely as a result of this relationship." Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24,083 [1999-2000 Transfer
In fact, the Advisory Group on Best Practice for Fund Directors has recommended that "all fund complexes with any substantial number of funds generally adopt either a unitary or a cluster board structure." The Advisory Group's report describes the advantages of multiple service by independent directors: opportunity to obtain better familiarity with complex-wide fund operations; greater access to the fund's adviser; greater influence with the adviser; and the greater ease in attracting highly qualified directors to serve on multiple boards in a fund complex.

These reasons, meant to support coordinated oversight of the investment function, also apply to the governance function when a fund aggregates its voting power within a fund family or by using a proxy adviser firm. A fund family committee directing the voting of multiple funds within a family, or a proxy adviser coordinating the voting of many funds, can be expected to have greater familiarity and information about corporate governance issues, more leverage in negotiating with portfolio company management, and more possibilities of attracting personnel with governance expertise.

Despite the mounting evidence that corporate voting/governance activities can produce investment value and that coordinated voting is a potent governance tool, the scope and character of the fiduciary duties under federal law compelling fund managers to vote in the best interests of fund shareholders are at best sketchy. Although the Investment Company Act makes clear that mutual funds must be operated and managed in the interests of their shareholders, the content of this responsibility with respect to voting of portfolio shares is unclear. Recently, former SEC Commissioner Carey urged that fund directors and advisers be more conscientious about their voting responsibilities and, among other things, has suggested that fund boards should "consider whether funds should disclose voting policies or practices to fund shareholders."

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209 INVESTMENT COMPANY INSTITUTE, supra note 198, at 28. The report describes "clusters" as funds within a fund family grouped together according to investment objective, investment sector or distribution channel. See id.

210 Id.

211 Investment Company Act of 1940 § 1(b)(2), 15 U.S.C. § 80a-1(b)(2); see BOGLE, supra note 19, at 195 (commenting that this "explicit directive" of federal law imposes on fund directors "an added responsibility" not found under state corporate law).

212 See Carey, supra note 81.
One source for constructing a fiduciary duty under the Investment Company Act with respect to voting/governance matters might be the federal rules that govern the voting responsibilities of other financial intermediaries. In particular, federal law, along with the rules of the self-regulatory organizations, imposes voting and disclosure obligations on broker-dealers that hold securities in "street name" for beneficial owners and on investment advisers that have investment and voting discretion over client securities.213

2. Fiduciary Duties Under State Law

State fiduciary duties applicable to mutual fund directors, arising under trust and corporate law, are even more obscure. Although fund directors and trustees owe duties of care, loyalty and obedience—each a vague abstraction—no statute, court decision or commentary has articulated the nature of these duties in the context of the fund’s voting of portfolio shares. Instead, the leading commentaries on director duties—if they mention voting at all—view it as just another fund function deserving board supervision.

The Fund Director’s Guidebook, published by the ABA’s Section of Business, gives a full account of directors’ duties with respect to the fund’s investment function, but pays fleeting attention to the fund’s voting function.214 The Guidebook’s only elliptical reference to the duties of fund directors in overseeing the voting of portfolio shares is its call for the board to consider creating a “voting or proxy committee.”215

In her treatise on mutual fund regulation, Tamar Frankel describes the ongoing debate about whether fund directors have heightened supervisory duties given the special hazards of financial management, but the focus is on the investment

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213 Many self-regulatory organizations have rules that allow investment advisers to vote proxies and receive proxy material on behalf of the beneficial owners. See Order Approving Proposed Rule Changes by the NASD, Exchange Act Release No. 34-35,681, 60 Fed. Reg. 25,749 (May 12, 1995); Order Approving Proposed Rule Changes by the New York Stock Exchange, Exchange Act Release No. 34-34,596, 59 Fed. Reg. 45,050 (Aug. 31, 1994) (approving New York Stock Exchange rule relating to transmission of proxy materials and commenting that rule “approximately gives investors the freedom . . . to designate an investment adviser to . . . receive proxy and related issuer materials and vote the proxies”). The Securities Industry Association has noted “the growing regulatory perspective that an investment adviser’s fiduciary obligations include the voting of proxies unless otherwise directed by the clients.” Id. at 45,053.

214 See Carey, supra note 81.

215 Id.
function." Directors are called on to examine adviser practices in buying and selling portfolio securities, as well as custodial and bonding arrangements. Although Frankel points out that fund managers must ensure fund activities conform with the fund's stated investment objectives and policies, she makes no mention of the relation of a fund's voting policies to its objectives.

Lately, state courts have expanded the scope of the duties of corporate managers to disclose material information in connection with shareholder voting. The Delaware Supreme Court required "information which a reasonable shareholder 'would consider important in deciding whether to [vote]." Translated to the mutual fund context, these duties could be seen as requiring that fund managers disclose to investors how the managers will exercise the investors' valuable voting rights. That is, if corporate law treats voting rights as a shareholder prerogative that corporate managers cannot arrogate for themselves, unless they disclose, the same can be said of mutual fund managers who have been delegated the task of voting portfolio shares. Just as corporate shareholders have rights to information when they are asked to vote, fund investors arguably have rights to information when fund managers seek to attract their investment dollars on the promise (among other things) that the managers will engage in voting/governance activities on their behalf.

Even if disclosure duties arise under state law, they may create an uncomfortable fit with federal law. Under the National Securities Market Improvement Act of 1996, states can no longer specify the content of disclosure documents used in a federally registered securities offering. Whether state law could require disclosure in other documents or contexts raises preemption issues under the 1940 Act. Although Congress understood that state

219 Preemption under the 1940 Act has received only scant attention. Recently, in a case of first impression, the Third Circuit held that section 36(b) of the 1940 Act does not preempt mutual fund shareholders from bringing state fiduciary claims to challenge
fiduciary law would operate in tandem with federal duties, state law may be preempted to the extent it seeks to expand or redefine disclosure duties for mutual funds. It is unclear whether the heavily regulated mutual funds are subject to disclosure duties beyond those specified by federal securities law.²²⁰

III. WHY NOT DISCLOSE

We confront a regulatory anomaly. Mutual funds have achieved a large and growing role in U.S. corporate governance, yet no mandatory rules (or industry guidelines) compel information that would allow investors, market monitors, academic investigators or public regulators to evaluate how fund directors, managers and advisers are carrying out their role. Why not?

Perhaps mandatory disclosure of mutual funds’ governance role in portfolio companies is foolish and unnecessary. Arguably, existing incentives, weak as they are, are adequate to induce optimal voting and governance activities. To impose additional record-keeping and disclosure costs, without clear informational value to fund investors, might be contrary to the interests of fund investors. Moreover, mandatory rules might undermine the delegation by fund investors to fund managers to decide ordinary investment matters, including voting of portfolio shares.

Perhaps mandatory disclosure is naive and would have untoward consequences. Forced disclosure might discourage funds (alone or together in fund families) from being activist for fear of reprisals by portfolio companies that may withhold information or investment business. Greater transparency might dilute the growing effectiveness of mutual funds as corporate monitors by, for example, squelching secret balloting and behind-the-scenes jawboning. Or perhaps forced disclosure might overstimulate activism as funds seek, like their politically-motivated labor and public pension fund cousins, to gain notoriety. If voting power were to become concentrated in large fund families or in proxy service companies delegated voting authority,

²²⁰ See O’Malley v. Boris, No. 15,735, 24 DEL. J. CORP. L. 1189 (Del. Ch. 1999) (Chandler, Ch.) (rejecting preemption argument against state contract and fiduciary claims that mutual fund improperly switched investors’ accounts, noting that there was no “specific contemplation by the SEC” of additional disclosure of such account switching).
fund voting motivated by a private or political agenda could further divorce investor money from corporate control.

But mandatory disclosure, in the face of an apparent market failure in an industry that proclaims the virtues of financial transparency, could serve many purposes. In this Part, I consider the possible merits and demerits of a regime of mandatory disclosure of mutual fund voting of portfolio shares. The disclosure regime I imagine would focus on the “how, why and what” of the mutual fund voting/governance role.221

(1) the process by which the mutual fund makes its voting and other governance decisions—
- Who makes these decisions for the fund?
- How is this person selected and supervised?
- How does the fund gain information on portfolio governance matters?

(2) the policies under which these voting/governance decisions are made222—
- What is the fund’s attitude toward voting of portfolio shares?
- What principles guide the fund’s voting agent?
- What general and specific guidelines does the voting agent follow?

(3) the practices of the fund in voting/governance matters—
- What has been the fund’s voting record?
- What non-voting governance activities has the fund engaged in?
- What have been the results of these activities?

This disclosure would provide uniformity and comparability across mutual funds, and would be a first step toward greater uniformity in voting/governance disclosure by all institutional

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221 My proposal parallels the current SEC rules on operating companies’ disclosure of executive compensation. See 17 C.F.R. § 229.402(k) (1999) (Reg. S-K, Item 402). It is similar to guidelines proposed by former SEC Commissioner Paul Carey, who urged mutual fund boards (1) to find out whether advisers are actually voting portfolio shares, how they are deciding to vote and how they are in fact voting, and (2) to provide guidance to advisers on a fund strategy for voting, a cost/benefit analysis the adviser should engage in, and the circumstances the fund should seek to influence company policy. In particular, Commissioner Carey urged fund boards to consider how voting should occur when the adviser faces a conflict of interest. See Carey, supra note 81.

222 My proposal does not call for mandatory disclosure by proxy advisers, such as ISS. Rather it calls for mutual funds to disclose their own policies regarding whether or not to follow the advice of outside advisers. To the extent that ISS issued voting/governance guidelines to its clients, these guidelines would have to be disclosed if a fund followed them or authorized ISS to vote on its behalf under the guidelines.
investors.\textsuperscript{223}

A. Is Mandatory Disclosure of Voting/Governance Activities Warranted?

Assuming voting/governance activities add value to the investment function, would mandatory disclosure of fund voting and governance activities be worth the candle? It may be that existing market forces and legal incentives faced by mutual funds combine to encourage an adequate level of corporate governance activity. Or disclosure of voting/governance activities might well fall on deaf investor ears and add unnecessary expenses to an already weakly disciplined cost structure. Or it might be that voluntary disclosure—which already has begun with some funds—might be preferable to mandatory rules.

1. Are Market Forces Sufficient?

Some commentators justify the lack of a disclosure mandate for mutual fund voting on the ground that funds are subject to market forces that discipline and legitimize their voting of portfolio shares.\textsuperscript{224} According to the argument, mutual funds whose activism produce favorable net portfolio performance can be expected to attract more investment assets and garner higher fees. That is, the entrance-exit option for investors in open-end funds (the dominant mutual fund type) makes fund managers sufficiently answerable to investor preferences.\textsuperscript{225} What matters to investors are the results, not the disclosure, of value-producing voting or governance policies. In fact, studies show that mutual fund investors are sensitive to favorable changes in fund performance and readily shift their investments to funds that have produced superior returns.\textsuperscript{226} This investor sensitivity is borne out

\textsuperscript{223} The lack of uniformity in reporting requirements for institutional investments has been frequently noted. See INSTITUTIONAL INVESTOR STUDY, supra note 96.


\textsuperscript{225} See ROE, supra note 28, at 121, 268-69.

by the significant investment in mutual funds assets (45.6 percent as of 1999)\textsuperscript{227} by institutional investors and recent evidence of the rationality of individual investors' asset allocations.\textsuperscript{228} In sum, so long as performance results are disclosed to fund investors, disclosure of voting/governance matters would be a superfluous and costly intervention.

Moreover, voluntary disclosure is available to the extent fund managers believe they can attract more investments by disclosing voting/governance matters. For mutual funds that wish to distinguish themselves on non-performance grounds—such as "social responsibility" funds that promise an investment philosophy that goes beyond financial performance and risk measures—voting disclosure would seem a useful market tool. In fact, one such fund, Domini Social Equity Fund, now discloses its voting practices with respect to portfolio companies.\textsuperscript{229} Investors can access this information on the fund's Web site, which discloses the voting decisions for each of the 400 companies in the fund's portfolio, as well as shareholder resolutions the company has sponsored at portfolio companies.\textsuperscript{230} As the fund's manager explained, "I felt that because they are the ultimate owners of this fund, they have a right to know how we are voting."\textsuperscript{231} If this strategy is successful for particular kinds of funds, such as a "social responsibility" fund whose investors may also have a social/political agenda, one might expect emulation in the competitive mutual fund industry.

This imagined story of market responsiveness, though attractive, suffers at a number of levels. Recent studies and investor behavior suggests that fund investors' sensitivity to fund performance is uni-directional and shallow. Mutual fund investors, though they readily move into well-performing funds, fail to withdraw from funds following unfavorable fund performance\textsuperscript{232} or increases in expense ratios.\textsuperscript{233} Mutual fund


\textsuperscript{228} According to a study by the Investment Company Institute and the Employee Benefit Research Institute, 401(k) participants "appear to be engaging in reasonable asset allocation as their retirement nears." See Investment Company Institute, EBRI/IICI Study Indicates 401(k) Plan Participants Allocate Assets Appropriately (Jan. 20, 2000), at http://www.ici.org/ici_info/00_ebri_iici_newsrel.html (based on statistics derived from EBRI/IICI Participant-Directed Retirement Plan Data Collection Project). According to the study, younger participants tend to favor equity funds while older participants are more likely to invest in GICs and bond funds.

\textsuperscript{229} See Bullard, supra note 1 (describing Domini's social investment objectives).

\textsuperscript{230} See Domini Social Investments, supra note 97.

\textsuperscript{231} Domini Offers Web Access to Proxy Votes, FIN. PLANNING, May 1999, at 28 (quoting Amy Domini speaking about shareholders).

\textsuperscript{232} See Ippolito, supra note 226, at 61-62.
investors also regularly approve increased advisory fee rates even as fund assets are growing.\textsuperscript{234} Even if net performance were all that mattered to mutual fund investors, market behavior suggests investors are insufficiently sensitive to obtuse or inefficient fund governance activities. In short, funds that adopt high-cost or ineffectual voting/governance policies seem largely immune from market discipline.

While funds assiduously seek to differentiate themselves on the basis of investment policies and techniques, this differentiation is virtually nonexistent as to governance matters. For example, funds that promise low-expense indexing implicitly promise a lower level of governance activism compared to funds that promise actively-managed or industry-targeted investments. That is, as investment differentiation increases, one would expect greater governance differentiation. That funds make no disclosures in this regard suggests voting/governance activities tend toward an inefficient one-size-fits-all—and fund managers lack incentives to behave otherwise.

2. Are Non-Market Incentives Sufficient?

Despite market imperfections, perhaps current legal incentives are sufficient to induce fund voting and governance practices that maximize shareholder value and desires. As we have seen, the Investment Company Act requires that a fund’s board be composed of at least 40 percent independent directors and that advisory contracts be approved by a majority of independent directors. Giving substance to this structural requirement, fund directors are subject to fiduciary duties that increasingly are understood to encompass oversight of portfolio voting.\textsuperscript{235}

On closer inspection, however, these legal incentives may be illusory. Recent data on rising fund expenses, portfolio turnover and director pay undermine a story of effective structural

\textsuperscript{233} See Manuel Schiffres & Steven T. Goldberg, The World According to Morningstar, Kiplinger's Personal Fin. Magazine, Feb. 1997, at 89 (quoting Don Phillips, president of Morningstar, in response to an interviewer's statement that with fund assets growing so fast “You’d think that... expense ratios would decline,” “Investors aren’t voting with their feet... It has gotten to a point that the funds don’t even care anymore when Morningstar Mutual Funds writes about high expense ratios.”).

\textsuperscript{234} See Jason Zweig, Your Funds May Be Making You Rich... But You're Also Getting Robbed, Money, Feb. 1997, at 62 (listing funds where management fees and expenses, stated as a percentage of fund assets, have risen even as assets have grown significantly).

\textsuperscript{235} See Carey, supra note 81.
safeguards and legal incentives:

- Average expense ratios for equity funds have risen from 1.25 percent in 1985 to 1.53 percent in 1998, even as fund assets have quadrupled in the 1990s with resulting greater economies of scale.\(^{236}\)

- Equity funds that held stock on average for at least 5 years produced annual returns of 12.9% over a 10-year period, compared to annual returns of 11.3% for funds that held stock on average for less than one year—suggesting excessive buying and selling of portfolio assets in these low-performing funds.\(^{237}\)

- Fund expense ratios have varied directly with director compensation—that is, the more a fund pays its directors, the higher the fund’s overall expenses borne by shareholders.\(^{238}\)

If fund directors already have difficulty supervising advisory fees, turnover rates and their own fee arrangements, it seems unlikely they would have the independence, judgment or motivation to supervise fund voting practices. The SEC has recognized this problem and has recently urged greater director independence. But the problem is deeply ingrained. As John C. Bogle, ex-CEO of Vanguard Group, pointed out, “Everybody knows... that people come on fund boards because they’re friends of the CEO. So they go along with whatever he wants.”\(^{239}\)

Recent lawsuits challenging advisory fees, mostly filed as derivative claims under Section 36(a) and (b) of the Investment Company Act of 1940, far from portraying a functional supervisory regime, suggest instead that fund directors have systematically failed in their role as independent watchdogs of fund managers.\(^{240}\)

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\(^{236}\) See Geoffrey Smith, *Why Fund Fees Are So High*, BUS. WEEK, Nov. 30, 1998, at 126 (“After all, it doesn’t take twice as many people, computer, or offices to run a $2 billion fund instead of a $1 billion fund.”).


\(^{238}\) See Tyler Mathisen, *Bogle May Have Had a Transplant, But He Hasn’t Had a Change of Heart*, MONEY, Dec. 1996, at 15 (describing Morningstar study of director pay at 82 largest fund families that found expenses to be 16 percent higher in fund families where director annual pay exceeds $100,000, compared to fund families that pay directors $25,000 or less).

\(^{239}\) Id. (internal quotations omitted).

3. Would Fund Investors Use the Disclosure?

Perhaps mandatory disclosure of voting/governance matters is not the solution to this story of market and legal failure. Arguably mutual fund investors, whose focus is on obtaining low-cost diversification and asset allocation services, are rationally indifferent to portfolio voting and fund governance activities. Fund investors can be seen as having delegated this tangential matter to fund managers. The absence of a market or legal response may simply mirror investor apathy. Given the mixed results of shareholder activism, disclosure of an arguably value-neutral function would hardly seem justified. A rational fund investor might conclude that the costs of monitoring fund voting and governance activities exceed the potential gains. The perfunctory way in which many fund managers seem to treat voting and the opacity of fund disclosure may reflect this investor calculus.

The story of investor apathy, however, is undercut by growing evidence that individual investors recognize the governance value of share ownership. Beginning in the 1980s, with individual shareholder advocacy groups such as United Shareholders Association, shareholder activism has "become a force to be reckoned with in the modern corporate world." The rise and


241 See Barnhart, supra note 31 (according to John Verani, compliance officer for Putnam Investments, "rarely, if ever, does a [Putnam fund] shareholder attempt to find out" about a fund’s voting practices or policies) (internal quotations omitted). Others have argued that mutual funds’ voting of portfolio shares may not reflect the desires of fund investors. See Peter Warshall, Shareholder Activism, WHOLE EARTH, Mar. 22, 1998, at 84 (describing criticism that allowing corporate shareholders to vote on corporate charitable giving may frustrate investors’ true desires, since pension funds and mutual funds may vote against charitable giving despite the silent support of their beneficial interest holders).

242 Richard H. Koppes, Future Governance and Activism Trends, NAT’L L.J., July 3, 2000, at B13; see Now, a Gaddly Can Bite 24 Hours a Day, BUS. WK., Jan. 24, 2000, at 150 (quoting Patrick S. McGurn, “The Web will change the face of activism in the future... It promises to increase activism and to perhaps radicalize smaller investors.”); see also Feldman, supra note 24 (describing eRaider.com and other Internet activist sites for individuals); Internet Spurs Shareholder Activism, supra note 24 (quoting Patrick McGurn, “Shareholder activism on the Internet will increase in leaps and bounds in the new millennium”).

United Shareholders Association, started in 1986 by T. Boone Pickens, Jr., disbanded in 1993 having, in Pickens’s words, “started out to do something, and... got it
staying power of “social responsibility” funds reflect the emergence of a class of individual investors motivated by governance issues. Moreover, the significant and growing institutional ownership of mutual funds suggests that governance issues, even if given a short shrift in the past, will become a prominent issue for mutual funds in the future. In fact, many studies on the role of institutional investors in corporate governance conclude with a call for further research on the actual interplay between corporate managers and mutual funds, the last governance frontier.

Will fund investors respond to voting/governance information by mutual funds, if mandated? The question restates the conundrum of shareholder voting apathy, which dominated academic literature during the 1970s and 1980s: Why bother to inform and empower fund investors at a non-trivial cost if they will be indifferent to their funds’ governance role? This question, however, misses the mark. Just as voting apathy was overcome in the 1980s by intermediaries who acquired shareholder votes in tender offers, fund intermediaries promise a solution today. Already, many fund investors rely on intermediated information concerning fund performance, such as Morningstar “star” and Wall Street Journal “grade” ratings. Further, these ratings (reflecting their users’ increasing sophistication) are multivariate, with specific and comparative information on returns, risk,

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243 See Parthiban David et al., The Effect of Institutional Investors on the Level and Mix of CEO Compensation, 41 ACAD. MGMT. J. 200, 200-08 (1998) (concluding with question asking how pressure-resistant institutions gain power).


turnover and expenses. Fund activism could well become an additional criterion in measuring a fund's overall suitability, not only as a means for evaluating compliance with stated investment objectives and policies, assessing fund expense levels, and predicting financial returns, but also as a measure of the fund's attitudes toward corporate governance and social responsibility. Is TIAA-CREF more attractive to investors because of its aggressive and highly-touted governance role? Its growth and success in attracting new investors suggests a correlation. Certainly, TIAA-CREF managers, who must compete for pension investments, seem to believe their activism is a good long-term strategy.

Disclosure of fund voting/governance activities would also provide valuable information to another, highly important and greatly under-appreciated, intermediary in U.S. corporate governance—the academic researcher. Academic research has explored and guided shareholder voting on such matters as takeover defenses (whose value in corporate acquisitions is surprisingly mixed), board structures (whose effect on corporate performance seems to have been overstated) and executive compensation (which is more likely to be performance-based when the company has an institutional shareholder mix weighted toward pressure-resistant institutions, such as public pension funds, mutual funds and foundations). Lately, researchers focused on the results of institutional activism, with some important preliminary conclusions. Hidden from their view, however, has been mutual fund voting. Greater disclosure—with a premium on its uniformity and universality—would give researchers a chance to gain insights that could inform fund managers, investors and regulators about how well funds are performing in their role as voting/governance intermediaries.

Fund disclosure of voting/governance activities has the attributes of a public good, but sharing the information through a mandatory disclosure system could also benefit the mutual funds required to disclose the information. For example, a fund that identified a particularly pernicious executive compensation device and announced its discovery, along with the fund's plans to vote against it, could gain value by being able to disclose this learning through a uniform, mandatory disclosure system. Michael Price has already been a voice in the wilderness in this respect. Other

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247 At most, some studies have considered whether companies with an institutional shareholder mix weighted toward pressure-resistant institutions (public pension funds, mutual funds and foundations) exhibit pro-shareholder governance results, such as incentive-based executive compensation, compared to companies with a greater proportion of pressure-sensitive institutions (banks and insurance companies).
shareholders could use this information. The alternative, voluntary, episodic and non-universal disclosure, carries less credibility and is more difficult to interpret. Thus, all investors would benefit from greater fund transparency.

Above all, legal norms catalyze attitudes, expectations, and behavior. Although fund investors (and even some fund managers) may today seem uninterested in governance matters, mandated disclosure of funds’ voting and governance activities could well highlight the governance aspect of fund intermediation. As investors, perhaps aided by the financial press, rating services and regulators, come to view the voting function with greater sensitivity, fund managers could well respond in kind. If fund managers concluded that fund value could be enhanced more effectively through governance rather than trading activities, this strategy could be disclosed and the fund’s success compared to the results of less-active competitors. Moreover, disclosure would allow investors (and especially their many intermediaries) to monitor fund managers that promise to actively seek fund value, particularly those fund managers with concentrated ownership of portfolio companies, based not only on fund returns, but also on the manager’s voting record. As the OECD noted, “activism is a highly competitive investment strategy and, therefore, governance activities should be merged into the mainstream of asset management.”

Although it is hard to know how fund investors will use disclosure of fund voting/governance activities, the potential value of this disclosure is significant. As Professor Lowenstein has observed:

Our disclosure policies were adopted in order to make Wall Street fair and efficient. They also give substance to shareholder rights by providing the information essential to their exercise. But quite apart from these intended benefits, good disclosure has been a most efficient and effective mechanism for inducing managers to manage better.

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249 Blommestein, *supra* note 12, at 49 (describing argument based on empirical studies that institutional activism is associated with statistically significant value gains, including stock price appreciation and increased financial performance).

In addition, fund investors (aided by intermediary information processors and even financial press reporting of academic research) might consider a fund's activism or passivity as an integral part of its overall performance-risk-expense profile. Moreover, investor attention could well focus fund managers on the possibility of achieving performance gains through voting/governance activism or by attracting investors on this basis. Given that mutual fund fees must be based on assets-under-management, not fund performance, the primary incentive of fund managers is to attract and increase fund assets. A disclosure regime could open new avenues by which investors could express their attitudes, through purchase decisions and perhaps even directly through pass-through voting recommendations, on such matters as corporate charitable giving, workplace practices and other matters of corporate social responsibility—matters that today exist in a corporate political penumbra. As Robert Pozen commented, "it would be an act of hubris for an institutional investor to vote its social preference unless specifically directed to do so by its clients."

4. Are the Direct Costs of Disclosure Justifiable?

Perhaps the costs to mutual funds of identifying and disclosing their voting processes, policies and practices would be unjustifiably expensive, a common first line of defense against any new disclosure regime. The cost argument, though plausible, has little support. At least one mutual fund currently provides significant information about its voting practices, without any apparent adverse expense repercussions. Larger, low-expense transparency extends beyond the United States and has been seen as reaching beyond financial disclosure to include broadly corporate governance. See Tara Vishwanath & Daniel Kaufmann, Toward Transparency in Finance and Governance (Soc. Sci. Res. Network, Working Paper, Sep. 1999), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=258978 (reviewing literature on corporate transparency).


252 Similar arguments have been made against corporate disclosure of charitable giving. See Peter Warshall, Shareholder Activism, WHOLE EARTH, Spring, 1998, at 84 (describing backlash to proposals, including that mandatory disclosure will raise record-keeping and proxy disclosure costs, that increased administrative costs will come at expense of charitable giving, that publicity may discourage matching gifts chosen by employees, as well as politically controversial charity, and that disclosure will undermine the shareholders' delegation to corporate managers of ordinary business matters, including charitable giving).

253 Domini Social Equity expense ratio is 0.92 percent. See Domini Social Investments, Domini Social Equity Fund Profile, at http://www.domini.com/domini-funds/Domini-
pension funds, such as TIAA-CREF and CalPERS, also provide significant voting information, including online.\textsuperscript{254} Presumably, mutual funds (or their managers) already collect information on fund voting and governance activities and the only additional expense involved in voting disclosure would be standardizing this information, filing it with the SEC, and distributing or making it available to investors. Given the possibility of electronic filing and distribution, it is unlikely that this added expense would be significant.\textsuperscript{255}

Interestingly, when the SEC broached the idea of mandatory disclosure of fund voting policies and practices in the paper-intensive 1970s, the principal criticism focused on the unnecessary prolixity that would be added to fund prospectuses, not the difficulty of acquiring the information or the extra expense of distributing it. Perhaps critics of the proposals were reluctant to acknowledge that funds are lackadaisical in monitoring their own voting of portfolio shares. In which case, a mandatory disclosure regime could well improve fund management by requiring greater internal monitoring of portfolio voting.

In the end, there is a case for mandatory disclosure if the benefits, however unlikely, outweigh the minimal direct costs. Even if only some investors respond to voting/governance disclosure or if governance activities figure only slightly in fund ratings or if greater transparency improves only slightly fund managers’ voting acumen, the possibility of investor value in each case would seem to justify the expense. As Professor Joe Grundfest commented with respect to the $100 billion College Retirement Equity Fund, “for an investor of CREF’s size, the potential benefits of an activist strategy that targets poorly managed firms are quite substantial relative to the associated cost.”\textsuperscript{256} If well-focused activism has value (for which there is evidence) and disclosure would enhance focus, then mandatory disclosure is worth promoting.

\textsuperscript{254} For a description of TIAA-CREF and CalPERS voting/governance disclosure, see supra notes 103, 109-11.

\textsuperscript{255} Former SEC Commissioner Carey came to a similar conclusion: “The Internet . . . provides an easy and relatively inexpensive medium to prove voting information to shareholders.” Carey, supra note 81.

disclosure of mutual funds' voting methods, policies and practices would seem relatively inexpensive in view of the potential benefits to mutual fund investors—and ultimately to all investors and even to the body politic.

B. Will Mandatory Disclosure Distort Voting/Governance Behavior?

The more difficult question is whether the indirect costs of pushing mutual fund voting into the limelight will be worth the benefits. Perhaps disclosure will chill valuable mutual fund activism; perhaps disclosure will over-stimulate or misdirect it; and perhaps, whatever the incentive effects of disclosure, a mandatory regime will invite overly intrusive oversight and lawsuits by investors and regulators. Perhaps greater publicity would have other unforeseen, unintended consequences.

Similar arguments have been made against proposals for corporate disclosure of charitable giving.\(^{257}\) Some argue that disclosure will discourage corporate matching of gifts by employees, as well as politically controversial giving, because of fears about bad publicity. Others speculate that mandatory disclosure will lead cautious companies to simply direct their giving to well-known charities, such as United Way, which will then channel charitable dollars independently to causes the companies might not have chosen. What can we expect with respect to more mutual fund voting disclosure? In the end, we can only speculate about disclosure's effects and side-effects, in part because we know so little about mutual fund managers' incentives in connection with their voting/governance activities. Disclosure may be valuable simply in helping determine what information is worthwhile.

1. Will Disclosure Chill Mutual Fund Activism?

Greater voting/governance transparency might work against now-discreet mutual fund activism in a number of ways. First,

\(^{257}\) See Warshall, supra note 241, at 84. Congress recently considered legislation that would mandate proxy statement disclosure of company's charity for the preceding year and require shareholder approval of the distribution of corporate funds set aside for charity. See H.R. 944, 105th Cong. (1997) (proposing amendments to the Securities Exchange Act of 1934 to require improved disclosure of corporate charitable contributions and for other purposes).
mutual fund managers may be reluctant to publicly adopt an aggressive governance reputation for fear that portfolio executives will deny them access to corporate information. This reluctance fits the traditional non-confrontational personality of mutual fund managers. In an industry where access to corporate information is seen as critical to competitive success, fund managers would likely avoid any activities that would jeopardize this lifeline.\textsuperscript{258} In fact, a regime of mandatory disclosure might exacerbate this obsequiousness, as fund managers seek overtly to prove their \textit{bona fides} by voting with and disclosing their allegiance to corporate management.

Second, mutual fund managers may also fear that portfolio executives will direct their employees, whether by compulsion or persuasion, to allocate investments under their corporate “defined contribution” benefit plans to less activist mutual funds. Mutual funds, like banks and insurance companies, would come to base their voting/governance decision-making on the potential effects on business with portfolio companies—in the words of Rahul Kochhar and Parthiban David, mandatory disclosure could push mutual funds from being “pressure-resistant” to become “pressure-sensitive.”\textsuperscript{259} Furthermore, as employee retirement savings increasingly moves from “defined benefit” plans administered by corporate pension funds to “defined contribution” plans in which employees can allocate investments to mutual funds, it is likely that corporate managers will seek to control the governance activities of mutual funds just as they have for corporate pension plans. It is conceivable, even likely, that corporate executives will choose the mutual funds in which “defined contribution” employees may participate on the basis of the funds’ voting/governance acceptability. Management will prefer passive funds over activist funds.

Third, mutual fund investors themselves might (perhaps erroneously) view activism as a wasteful superfluity and move their money away from activist funds. Investors might believe that mutual fund activism would only result in unjustified higher fees, particularly in view of the low-cost alternative of free-riding on the activism of labor union funds and public pension funds. As


\textsuperscript{259} Kochhar & David, \textit{supra} note 4, at 76 (finding that such “pressure-resistant” institutions had a positive influence on firm innovation, while “pressure-sensitive” institutions had no effect).
investors become more sensitive to mutual fund expenses, particularly for indexed funds, disclosure of voting/governance activism would drive them away.

These concerns, however, fail to withstand a closer inspection. Mutual fund managers, particularly of the larger fund families, have had unparalleled access to corporate information, despite the growing mutual fund activism of the same larger fund families. Withholding corporate information from these larger investors, and risking alienation seems to be counterproductive for corporate executives whose increasingly stock-heavy compensation compels them to curry market acceptance of their company’s stock. Moreover, Regulation FD mitigates the ability of corporate management to engage in preferential, selective disclosure as a means of molding shareholder activism, a significant side-benefit of the new rule.260

In fact, there is little evidence of corporate boycotts of activist funds. The larger and more activist fund families have lately been successful in capturing larger portions of mutual fund investment. Recent data on mutual fund market concentration, in the face of increasing “defined contribution” investment, suggests that portfolio executives have accepted or chosen for their employees the market leaders, despite their greater activism.

Even if mutual fund investors made the connection between voting/governance activism and increased fund costs, there is no reason to think that investors would automatically conclude that the costs were unjustified. If well-targeted activism produces superior performance, as some research indicates, investors should be pleased to learn of funds incurring these costs.261 The increasing presence of institutional investors in mutual funds, as well as the use by individual investors of informational intermediaries such as Morningstar, suggest fund investors will be capable of a rational cost-benefit analysis. For example, the increased presence of institutional investors in closed-end mutual funds has led many of these funds to convert to open-end status or to repurchase shares at a premium.262 When fund managers realize activism’s potential,


261 See supra note 1.

262 Sara Webb & Pui-Wing Tam, Poor Returns, Big Discounts Spur Shareholders to Demand Changes, WALL ST. J., July 6, 1998, at R10 (describing increased shareholder activism as individual investors have “bailed out” and institutional investors have “moved in”).
currently hidden from view, mandatory disclosure could well mitigate this free-riding impasse. If free riding proves to be the preferable alternative, disclosure of a fund's rational voting passivity would confirm the fund's value.

One interesting question is whether greater disclosure will reduce the governance effectiveness of indexed mutual funds. At present, these fund have at best weak incentives to participate in shareholder activism since improved performance of portfolio companies redounds to the benefit of all investors and the indexed fund only matches the index. In other words, there would seem to be little competitive advantage in working to make the sea rise for all boats. Since an indexed fund improves its asset base best by keeping costs down, activism would not seem an advantageous strategy. Yet some mutual fund families, notably Vanguard, actively vote their indexed funds, creating a kind of public good. Would greater disclosure undercut this practice? Perhaps it would, perhaps not. Investors might be willing to incur higher fund expenses if overall market performance is enhanced. Although there might be a risk of free-riding by indexed funds that choose not to be activist, this free-riding is endemic to shareholder voting and might be somewhat minimized by voting disclosure. At some point, economies of scale and a sense of governance responsibility seem to produce institutional activism. When this happens, investors should know.

2. Will Disclosure Politicize or Over-Stimulate Mutual Fund Activism?

Greater transparency could undermine the governance role of mutual funds by perverting or undermining the effectiveness of fund activism. Some effects can be imagined.

First, increasing mutual funds' governance visibility might cause mutual fund managers to follow the politically activist lead of high-visibility, politicized institutional investors, namely public pension funds and labor union pension plans. Their significant governance role exposed, mutual fund managers (like their activist counterparts) might feel compelled to take on political agendas unrelated to investment returns, such as compliance with international fair-labor standards or disclosure of corporate political contributions.

This concern about governance hyperactivity resonated during the early days of mutual fund regulation. President Franklin Roosevelt, for example, said: "I am against private
socialism of concentrated economic power as thoroughly as I am against government socialism. The one is equally as dangerous as the other; and destruction of private socialism is utterly essential to avoid government socialism.\textsuperscript{263} The open embrace by mutual fund managers of a politically active role could prove unfortunate. Managers of other institutional investments, such as labor union funds and state pension funds, have assumed a markedly greater public profile, with mixed performance results for their funds. Today mutual funds, because of their low governance profile, face less political pressure to cultivate activist \textit{persona} and may as a result be more rational and effective corporate voters. For example, during the early institutional rush against poison pill plans, some mutual fund managers recognized the potential value of well-crafted pills to increase shareholder returns in a takeover.\textsuperscript{264} Mutual fund managers also pushed for time-limited poison pills subject to shareholder renewal, which recent research suggests enhance firm value.\textsuperscript{265} Anonymity may have its virtues.

Second, mutual fund managers in an environment of full disclosure might be forced to publicly wed themselves to particular positions or to confrontational approaches, thus undermining their effectiveness in behind-the-scenes negotiations. Recent experience by other activist investors suggests the usefulness of exerting non-confrontational influence. For example, studies indicate that pension fund activism has been most effective when the fund negotiates governance reforms with portfolio companies, rather than submits proxy proposals.\textsuperscript{266} As Professor Romano has pointed out, submission of a proxy proposal often reflects failure in the activist's negotiations. The College Retirement Equities Fund ("CREF") describes its stealthy \textit{modus operandi}:

TIAA-CREF has developed a corporate assessment program to monitor and evaluate the corporate practices and policies of the U.S. companies in CREF's portfolios. . . . "CREF's database includes most of the [2,000 U.S. firms in which it invests] and

\textsuperscript{263} ROE, \textit{supra} note 28, at 114 (internal quotations and emphasis omitted).

\textsuperscript{264} See Hollie, \textit{supra} note 47, at 24 (quoting Michael Ducar, director of investment research for IDS Financial Services: "We are looking very carefully at our policies and are not arbitrarily voting against poison pills. We have our portfolio managers and analysts take a look at these for a deeper meaning of the issue," and John Brennan, then president of the Vanguard Group: "We have a limitation of 10% ownership of a company. Management won't listen to us when we own 3%.").

\textsuperscript{265} See id. (referring to a statement by Robert Pozen, managing director of Fidelity Management & Research).

\textsuperscript{266} See Sunil Wahal, \textit{Pension Fund Activism and Firm Performance}, \textit{J. FIN. & QUANTITATIVE ANALYSIS}, Mar. 1996, at 1 (finding significant short-term positive wealth effects in firms subject to non-proxy targeting, but no significant abnormal returns for firms subject to takeover-related or governance related proxy proposals).
serves as a screen of 27 corporate governance parameters to
give us an indication of the conformity of each company to
good governance practices,” says Mr. West [senior consultant
for corporate governance]. . . . When a score [measuring a
company’s adherence to good governance] indicates the
company may have questionable governance, [CREF] carefully
examines documents such as the company’s proxy statement,
SEC filings and annual report to find our more information.

If this analysis reveals problems with a company’s governance
practices, TIAA-CREF will send a letter to the company’s
senior management. . . . “Generally,” [says West], “we find that
companies don’t want to disagree with us because TIAA-CREF
carries unusual weight in corporate America.”

Because TIAA-CREF prefers working with companies to
improve their practices, the vast majority of TIAA-CREF’s
shareholder resolutions usually don’t come to a vote. “When
we have a shareholder resolution, we file it with the company
and don’t make a public announcement at that point,” says
Dick Schleifer, second vice president, Corporate Governance
and Information Services, “Then, the company will negotiate
with us to come up with an accommodation. Once they’ve done
that, we will withdraw the resolution, and the public won’t even
know that we filed one.”

Third, greater publicity might exacerbate the current mutual
fund “herd mentality” of following industry practices, including
voting. Since mutual fund managers and investors generally
perceive success as dependent on beating industry benchmarks,
 fund managers understandably shun any activity that risks fund
performance falling below the benchmark, unless there are
significant commensurate rewards. This herding mentality applies
not only to stock picking, where managers systematically choose
moderate-risk over higher-risk assets, but apparently to voting
and governance activities as well. For example, many fund
managers currently delegate the voting function to proxy adviser
firms, particularly Institutional Shareholder Services, as a strategy
that assures nobody wins or loses—benchmark performance is

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267 How TIAA-CREF Works for Better Corporate Governance, supra note 256, at 11.
268 Professor Donald Schwartz imagined that disclosure of actual voting by institutional
investors would allow for greater coordination of institutional voting, overcoming the
practical inability of obtaining stockholder lists from management. See Donald E.
Rev. 421, 514 (1971).
269 See Zweig, supra note 237, at 45 (“Recent research by finance professors Josef
Lakonishok, Andrei Shleifer and Robert Vishny found that money managers place the
bulk of their assets in stocks with only middling potential for risk and return rather than in
those with higher odds of gain or loss.”).
assured. Delegating the voting function is understandable since voting/governance is a wild card about which there is currently only preliminary data demonstrating which activism produces favorable returns and which does not.270 Under a regime of mandatory disclosure, armed with even greater information on competitors’ governance policies and actual voting practices, fund managers might predictably be tempted to follow even more closely the disclosed industry norm. This “nobody wins, nobody loses” herding would be exacerbated if fund managers signaled to each other their cartel-like compliance by uniformly turning over voting discretion to a proxy adviser firm, such as Institutional Shareholder Services. Just as price disclosure facilitates price-setting, revelation of governance/voting activities would encourage voting conformism and uniformity. Whatever innovation and risk-taking that now occurs could well be squelched.

These possibilities, while troubling, are unlikely. The politicalization of mutual fund voting, though worrisome, seems unlikely given the incentive structure of fund managers and their decidedly non-political “money manager” culture. Fund managers seem principally concerned with fund returns and attracting new investors, driven by the requirement that fees be based on assets under management. Mutual funds often take a course independent of other institutional investors, for example defending performance-enhancing executive pay packages criticized by politically-motivated shareholders and politicians.271 Unlike managers of labor union funds and state pension plans, mutual fund managers face no organized constituency calling for high-profile, populist corporate governance activism. Moreover, there is little reason to believe that fund directors, also drawn from the “money manager” culture of fund managers, will exhort governance reform. To the extent that some funds assume an openly activist posture, whether to provide consistency with the fund’s “social responsibility” objectives or to improve performance, disclosure would seem to result from the choice to pursue an activist strategy. Disclosure would not necessarily cause activism. For example, the Domini Social Equity Fund, which promises an investment portfolio composed of “companies with positive records in community involvement, the environment,

270 See Romano, supra note 2.
271 See Charles Gasparino, Funds Back the Chairman in MarketSpan Controversy, WALL ST. J., July 28, 1998, at C1 (describing efforts by mutual fund families, Capital Research and Prudential Investments, to save the job of company chair criticized by state officials for excessive pay package he received when the company’s utility was sold to the state).
employee relations, product related issues, and hiring practices," requires disclosing its voting policies and decisions with respect to all 400 portfolio companies as a means to confirm and support its promised investment policies.\(^{273}\)

Moreover, mandated disclosure of a fund’s voting policies and practices might prove a useful tool by which the fund could assert an effective governance role. Today some activist institutional investors publicly describe their voting/governance policies, and even their particular voting records, purportedly to increase the credibility of their activism. For example, CalPERS now supplements its “good policies” statement with disclosure on its Web site of all the fund’s proxy votes.\(^{274}\) TIAA-CREF explained that, through its statement on corporate governance practices, the fund seeks to develop strategies to address “timely corporate governance issues, such as board independence, executive compensation and anti-takeover devices.”\(^{275}\) This visibility, according to CREF, makes it possible for CREF to produce “changes in companies’ practices and policies through constructive dialog.”\(^{276}\)

The herd mentality of fund managers may also be on the wane with respect to voting/governance matters. For example, some funds have sought approval by fund shareholders to allow the fund to hold controlling interests in portfolio companies.\(^{277}\) Far from seeking to blend into the crowd on governance issues, these funds believe there may be performance reasons (as well as marketing reasons) to have an individualized governance profile. In addition, some so-called focus funds are concentrating their investments so the fund owns stock in twenty-five or fewer companies, often with close to 10 percent of the fund’s assets in a single company’s stock.\(^{278}\) These developments, rather than arguing for


\(^{273}\) See *Domini Offers Web Access to Proxy Votes*, supra note 231, at 28 (stating that Domini’s Social Equity Fund is a “socially screened” no-load mutual fund).


\(^{275}\) How *TIAA-CREF Works for Better Corporate Governance*, supra note 256, at 10.

\(^{276}\) Id. at 11 (quoting Peter Chapman, head of TIAA-CREF’s corporate governance program).

\(^{277}\) See, e.g., *Definitive Proxy Statement, DEFA14A*, supra note 74.

\(^{278}\) See Tam, supra note 11, at C1. For example, the Berkshire Focus Fund “invests primarily in... 20-30 common stocks.” THE BERKSHIRE FUNDS, BERKSHIRE FOCUS
nondisclosure, highlight the importance of investors receiving full
disclosure of the fund’s voting processes, strategies and results.

3. Will Mandatory Disclosure Invite Heavy-Handed Oversight?

Disclosure rules, if mandatory, trigger three kinds of potential
liability, and thus regulatory and judicial intervention. First,
disclosers face liability for not complying with the rules, a
significant risk if voting processes and policies are inherently vague
and not amenable to accurate description. Second, disclosers face
liability for not disclosing the information required, even though
sometimes the information mandated might sometimes be
competitively sensitive and disclosure would cause more harm
than good. Third, disclosers face liability for disclosing falsely,
either by misstating what they know (or should know) or engaging
in behavior that renders their statements false.

The likelihood of liability, however, seems minimal. Already
mutual funds and other institutional investors such as Domini
Social Investments, TIAA-CREF, and CalPERS are finding it
feasible to describe their voting processes and policies. These
existing disclosure models could well be the basis for a mandatory
rule.

To the extent voting/governance disclosure may be sensitive,
such as in an ongoing voting contest or during governance
negotiations, the regime could provide exemptions by rule or SEC
order to alleviate disruption of desirable voting/governance
activities. Such exemptions exist with respect to competitively
sensitive corporate information, such as executive compensation
and pending merger negotiations. They could be designed for
mutual fund disclosure of voting/governance matters.

Whether mutual funds would face additional securities fraud
liability under a voting/governance disclosure regime beyond the
current liability exposure for not disclosing material information
on the voting/governance activities of mutual fund
intermediaries—the risk of inappropriate enforcement also seems
minimal. The record of shareholder and SEC enforcement of
mutual fund disclosure standards, in general, has been spotty.

\begin{itemize}
prospectus_050100.pdf} (last visited July 31, 2000); see John Waggoner, \textit{Diversified Funds Offer
Opportunity for Change}, \textit{USA Today}, Nov. 5-7, 1999, at B3 (stating that the Berkshire Focus Fund “owns 27
3, 2002).
\item See supra Part I.B.3.
\end{itemize}
Over-enforcement has not been an issue. Although voting/governance matters might raise more hackles, particularly by corporate management in a hard-fought voting contest or takeover battle, it would seem likely that a fund could avoid liability by designing its disclosure to leave enough flexibility to avoid charges it had deviated from fund voting policies. Moreover, there would be some question whether non-investor portfolio companies (and their management) would have standing to claim disclosure irregularities.

A liability scheme, however, should have some teeth. Disclosure of voting activities provides a metric for measuring the fund’s and the adviser’s contractual performance. Disclosure can also measure whether a fund’s voting/governance behavior is consistent with the fund’s stated investment objectives and policies. For example, a fund that promises an anti-tobacco investment policy should vote in a similar fashion. Disclosure would allow shareholders and regulators to monitor fund compliance.

If a fund manager believes fund value can be enhanced better through governance rather than trading activities, this strategy should be disclosed and the manager held accountable. As the OECD has noted, “activism is a highly competitive investment strategy and, therefore, governance activities should be merged into the mainstream of asset management.”

For example, a manager that promises to actively seek fund value, particularly in a fund with a concentrated portfolio, should be accountable as measured not only by the fund’s returns but by its voting record.

CONCLUSION

Mutual fund investors buy financial intermediation in the form of both investment services and voting services. The prevailing assumption, incorporated into the regulatory structure of the Investment Company Act, has been that mutual funds would not exercise a significant role in their capacity as voting/governance intermediaries. The assumption is no longer true. The emergence of large mutual fund families, with limited “exit” options and coordinated voting through proxy adviser firms has eroded if not jettisoned the notion of mutual fund passivity. With overall voting power nearing 30 percent and growing, mutual

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280 Blommestein, supra note 12, at 18 (describing argument based on empirical studies that institutional activism is associated with statistically significant value gains, including stock price appreciation and increased financial performance).
funds have become a pivotal player in U.S. corporate governance. Should we insist on transparency as mutual fund managers choose to take on or slough off this new role?

The potential benefits of disclosure would be many and the costs few. Disclosure of the voting/governance activities of mutual funds is feasible. A handful of pension plans and at least one mutual fund already provide investors a fulsome account of their voting processes, policies and even actual voting practices. Disclosure would enhance accountability and transparency, the guiding principles of all financial regulation. It would remind fund managers of their role and responsibilities as governance intermediaries for fund investors. It would enable fund investors, on their own and particularly through informational intermediaries, to evaluate and monitor fund governance activities. The gap between capital and control, the endemic challenge of our system of corporate governance, would narrow as corporate management became more answerable to investors’ wishes.

Ultimately, the question is whether disclosure of mutual fund voting presents a case of market failure, justifying regulatory intervention. If investors truly prized voting/governance activities, won’t mutual funds disclose those activities? The structural and informational regulation imposed by the Investment Company Act, whose continuing vitality has not been questioned even during this era of financial deregulation, acknowledge the inadequacies of private market forces in the mutual fund context. The protective market pressures that operate for other investors in primary and secondary capital markets, such as informationally efficient pricing mechanisms and intermediary reputational incentives, exist only weakly for mutual fund investors confronted by the risk of manager opportunism. Studies continue to confirm that mutual fund investors systematically fail to discipline underperforming funds or monitor excessive advisory fees. Disclosure, though not a panacea for aligning fund investor and fund manager interests, would be a salutary step. Even if mutual fund investors might not themselves be interested in this disclosure, the many intermediaries who act on their behalf could well be. Greater information would enable rating services, academic researchers and regulators to evaluate the currently opaque voting/governance activities of mutual fund managers.

This disclosure proposal, I should make clear, does not advocate a particular role for mutual funds in U.S. corporate governance—activist or passive, pro- or anti-management, political or apolitical, visible or behind-the-scenes. Instead, mandatory disclosure would openly raise the question and give us a view of
how the mutual fund industry is performing its *voting function*. It is time for this actor to step out from behind the curtain.