MUTUAL FUND VOTING AND FIDUCIARY OBLIGATION: WHETHER DISCLOSURE OF FAMILY LOYALTY WOULD FACILITATE EFFICIENT INVESTING

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I. INTRODUCTION

My ultimate objective in writing this commentary is to offer additional support to Professor Ann Lipton's thesis that mutual fund managers voting proxies as a family creates a conflict of interest among the individual mutual funds, which violates the mutual fund manager's ("fund manager") fiduciary duty to each individual fund.[2] This commentary offers additional support by exploring the idea that the market may not be allocating resources optimally due to investors being unaware that fund managers' centralized voting is contrary to the investors' benefit. Furthermore, this commentary examines whether the Securities and Exchange Commission ("SEC") should mandate disclosure of a fund manager's research on proxy voting to investors ("research"). Accordingly, the following two key questions arise: (1) Whether there is a benefit in fund managers disclosing to retail investors a simplified version of the fund manager's research on proxy voting, along with the current mandatory disclosures the SEC already requires; and (2) Whether disclosure of the research would cure the capital allocation deficiencies related to the conflict of interest mutual fund family voting creates.

Part II of this commentary analyzes the market efficiency argument, i.e., that fund managers will cast proxies to each mutual funds' benefit, otherwise investors will choose to allocate their resources in a different manner. Part III of this commentary examines factors other than the fund managers' research that may drive fund managers to vote a

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[2] *See* Ann M. Lipton, Family Loyalty: Mutual Fund Voting and Fiduciary Obligation, 19 TENN. J. BUS. L. 175 (2017).

specific way, which would render disclosure of the proxy voting research pointless.

II. THERE IS A BENEFIT IN PROVIDING INVESTORS WITH PROXY VOTING RESEARCH

As explained more fully herein, investors would most likely benefit from disclosures of the research fund managers conduct to determine how to vote proxies. Under current disclosure requirements, retail investors are not entitled to fund managers' proxy voting research.[3] However, disclosure of a fund manager's proxy voting research could serve as a signal to investors that the fund manager is voting for the individual mutual fund's benefit. Furthermore, due to the hardship of switching mutual funds, investors would most likely benefit from disclosure of this research before investing in a mutual fund.

A. Market Efficiency and Information Asymmetries

Financial professionals promote the theory that an efficient market will allocate resources to different mutual funds if the conflict of interest caused by centralized voting causes the fund to underperform.[4] The theory is that investors can either choose to invest in a different fund to begin with, or an investor can choose to exit their current underperforming fund. Thus, financial professionals argue that mutual fund managers have good business incentives to manage conflicts of interest so to attract and retain business.

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[3] 17 C.F.R. § 275.204-2(c)(2)(iv) (2016).

[4] Jonathan Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 Stan. L. Rev. 1059, 1076 (1990).

However, for this market theory to work, investors must be informed. A key assumption in this theory is that all retail investors have the same information about the mutual fund as the fund manager. When this assumption fails, the failure leads to market information asymmetries.[5] When there is asymmetric information "prices are distorted and do not achieve optimality in the allocation of resources."[6] Thus, when investors are uninformed, resources are not allocated optimally.[7]

B. Current Proxy Voting Required Disclosures

Currently, the SEC mandates disclosure with respect to proxy voting for mutual funds through the Investment Company Act of 1940.[8] The SEC requires mutual funds to file a report known as Form N-PX, which contains the mutual fund's complete proxy voting record for the past twelve months.[9] The Form N-PX discloses to the public whether the matter was proposed by management or a shareholder, whether the mutual fund voted on the matter, and, if so, how the mutual fund voted.[10]

Additionally, Rule 206(4)-6 requires mutual funds to adopt and disclose broad voting policies and procedures that are "reasonably designed to ensure that the adviser votes proxies in the best interest of clients."[11] While the broad policies and procedures do address general sit-

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[5] Quy-Toan Do, *Asymmetric Information*, *in* THE SOCIAL SCIENCE ENCYCLOPEDIA (Adam Kuper et al. eds., 2d ed. 2004), http://siteresources.worldbank.org/DEC/Resources/84797-1114437274304/Asymmetric_Info_Sep2003.pdf.

[6] *Id.*

[7] *Id.*

[8] LOIS YUROW ET AL., MUTUAL FUND REGULATION AND COMPLIANCE HANDBOOK §§ 12:2, 27:2 (2017).

[9] 17 C.F.R. § 270.30b1-4 (2003).

[10] *Id.*

[11] Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, SEC Release No. IC-25922 (Jan. 31, 2003) (available at https://www.sec.gov/rules/final/33-8188.htm#P40_4561) [hereinafter *Disclosure of Proxy Voting Policies & Records*].

uations, the SEC does not require disclosure specific to each matter voted on.[12]

The SEC also requires mutual fund advisers to retain a copy of any document that was material in the adviser's decision-making process to voting proxies.[13] However, these documents are not disclosed to investors.[14]

C. Nondisclosure of Mutual Fund Proxy Voting Research Puts Investors at an Informational Disadvantage

Noticeably missing from the SEC required disclosures are the research a fund manager conducts in connection to proxy votes and the material documents that the fund manager relied upon when determining how to vote the proxies. While investors have access to the mutual funds policies and procedures and actual voting record, there are no documents disclosed that connects the two or evidences the fact that the proxy vote was in fact for the benefit of the mutual fund.[15]

As a result, investors are potentially unaware that fund managers vote proxies contrary to the mutual fund's benefit by voting proxies as a fund family. Without access to this information, investors invest in mutual funds without taking that breach of fiduciary duty into consideration when determining a fair price for investing in the mutual fund. Thus, investors are at an informational disadvantage when picking a mutual fund to invest in, which could distort prices and result in the market not achieving optimality in the allocation of capital.[16]

D. Disclosure of Mutual Fund Proxy Voting Research Would Signal to Investors the Quality of the Mutual Fund

As things currently stand, investors are not privy to the research driving a fund manager's proxy voting decisions. Access to the simplified

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12 17 C.F.R. § 275.204-2(c)(2)(iv) (2016).

13 *Id.*

14 *Id.*

15 *Disclosure of Proxy Voting Policies & Records*, *supra* note 11.

16 DO, *supra* note 5.

research would serve one main purpose. Investors would have the opportunity to determine whether the mutual fund manager was in fact voting for its benefit. This would enable the market to allocate resources more efficiently because investors would be able to make an informed decision before investing in a mutual fund that was potentially breaching its fiduciary duty.

More specifically, disclosure of the proxy voting research would act as a signal. [17] Fund managers can signal the lack of conflict of interest and thus the quality of the mutual fund by offering research to verify the fund manager's proxy voting is in the best interest of each individual fund. Even if the proxy voting research shows that the proxy vote was not in the best interest of each individual fund, fund managers can demonstrate that the centralized voting benefits all mutual funds individually by keeping the management fees low.[18] Accordingly, investors could make the informed choice to opt in to the mutual fund once fund managers demonstrate that the costs of researching and voting for each fund individually would dramatically raise management cost.

E. Investors Would Benefit Most from Disclosure Prior to Investing in a Mutual Fund

Because investors have a difficult time exiting and/or switching mutual funds, fund managers should disclose research to investors prior to an investor investing in a mutual fund. Along with the reasons Professor Lipton's essay states, there are government and self-regulatory organization rules and regulations that make an investor's task of switching mutual funds difficult.[19] Therefore, if the SEC actually considers mandating this type of disclosure, investors would benefit most if fund manag-

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[17] Signaling is an activity that sellers engage in to inform buyers of the quality of the seller's product. Michael Spence, *Informational Aspects of Market Structure: An Introduction*, 90 Q. J. ECON. 591, 591–92 (1976).

[18] In a mutual fund, investors are interested in keeping costs low because investors retain all returns not expended to fund managers. John P. Freeman, *The Mutual Fund Distribution Expense Mess*, 32 J. CORP. L. 739, 749 (2007).

[19] *See* Lipton, *supra* note 2.

ers were to make past proxy voting research available prior to investors investing in its fund.

Specifically, rules regulating intermediaries like broker-dealers incentivize a broker-dealer not to recommend an investor switch mutual funds. Currently, a large number of intermediaries sell shares to investors. Likewise, investors depend on intermediaries to make recommendations and to actually buy shares. If broker-dealers were informed of a fund manager's breach of fiduciary duty, it is unclear whether a broker-dealer would recommend to an investor to exit a mutual fund in order to enter another. This is so because broker-dealers are subject to strict suitability rules.[20] Mutual fund switching is a practice regulators generally think to be unsuitable which subjects broker-dealers to higher scrutiny and forces them to defend their recommendations to regulators.[21] For this reason, there is incentive for a broker-dealer to not to recommend a mutual fund switch.

As explained more fully herein, investors would most likely benefit by a fund manager disclosing its research on proxy voting. Because retail investors are not currently entitled to any fund manager's proxy voting research, investors—at the time of investing in a mutual fund—are unaware of whether fund managers are voting proxies for the mutual fund's benefit. In the interest of signaling the quality of the mutual fund, fund managers can disclose this research to investors in an effort to ensure optimality in resource allocation.

III. FACTORS OTHER THAN PROXY VOTING RESEARCH DRIVES MUTUAL FUND VOTING

While there would most likely be a benefit in fund managers disclosing proxy voting research as a signaling device, the disclosure may not ensure the optimization of resource allocation. Studies evidence the fact that other factors drive fund managers to vote proxies a specific way, which could make disclosure of the fund managers' research on

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[20] FINRA Rule 2111 (2014).

[21] *See* In re Charles E. Marland & Co., 45 S.E.C. 632, 636, 1974 SEC LEXIS 2458, at 8–16 (1974) (explaining that recommending mutual fund-switching creates a rebuttable presumption of unsuitability).

proxy voting irrelevant. Thus, it is likely that fund managers providing research to investors would not fix any capital allocation discrepancies in the market related to the lack of research available to investors on fund managers' proxy voting.

Specifically, a recent study shows that fund managers are more inclined to vote in favor of management-sponsored proposals in locally headquartered companies.[22] The results of the study suggest that "social networks and interactions between firm executives and fund managers impact the latter's proxy voting decisions."[23] That is, "[i]f mutual fund managers enjoy good relationships with the management of the firms in their portfolios, they are more likely to vote favorably in proposals sponsored by the management" without regard to the any research performed.[24]

Another study shows that business ties between a mutual fund and a portfolio corporation influences funding.[25] For example, there are situations where a fund manager also manages the retirement plan assets of a portfolio company.[26] In this case, the fund manager is incentivized to support management recommendations to further its own business interests (i.e., gain and/or retain business from the portfolio corporation) rather than voting to maximize the wealth of the mutual fund investors.[27] Thus, "the more business ties a fund company has, the less likely it is to vote in favor of shareholder proposals that are opposed by manage-

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[22] Praveen K. Das, *Geographical Proximity and Mutual Funds' Proxy Voting Behavior*, 32 MANAGERIAL & DECISION ECON. 425 (2011).

[23] *Id.* at 426.

[24] *Id.*

[25] Dragana Cvijanovic, Amil Dasgupta, & Konstantinos Zachariadis, *Ties That Bind: How Business Connections Affect Mutual Fund Activism,* 71 J. FIN. 2933, 2934 (2016).

[26] *Id.*

[27] *Id.*

ment."[28] Regardless of the research, "[b]usiness ties affect the overall voting practices at the fund family level."[29]

Other studies show "the presence of peer effects in mutual fund voting."[30] Specifically, fund managers demonstrate herd like behavior when it comes to proxy voting.[31] A fund manager "is more likely to oppose management when other funds are more likely to oppose it as well."[32] Likewise, "fund managers are more likely to vote 'for' when their expectations about the number of 'for' votes cast by other funds are higher."[33]

These studies demonstrate that factors other than the fund manager's research on proxy voting drive the proxy voting process. Thus, disclosure of a fund manager's research would not necessarily cure all capital allocation discrepancies. While the point of disclosure is to assist an investor in comparing one mutual fund with another mutual fund to make an informed decision, disclosing research to investors on proxy voting may be ineffective if factors other than the research are driving proxy voting.

IV. CONCLUSION

The ultimate objective in writing this commentary is to offer additional support for Professor Lipton's thesis by exploring the idea that the market may not be allocating resources optimally due to investors being unaware that fund managers' centralized voting is contrary to the investors' benefit. Furthermore, this commentary examines whether the SEC should mandate disclosure of a fund manager's research on proxy voting to investors in order to cure any capital allocation deficiencies.

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[28] Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. FIN. ECON. 552, 569 (2007).

[29] *Id.*

[30] Gregor Matvos & Michael Ostrovsky, *Heterogeneity and Peer Effects in Mutual Fund Proxy Voting*, 98 J. FIN. ECON. 90, 91 (2010).

[31] *Id.*

[32] *Id.*

[33] *Id.* at 92.

Accordingly, this commentary concludes that while disclosure of the fund manager's research can serve as a signal to assist investors in comparing the fund with other funds, disclosing research to investors on proxy voting may be ineffective in ensuring optimization in the allocation of resources if factors other than the proxy voting research are driving fund managers' proxy voting. Thus, additional disclosure may not add any benefit to the investors' decision and instead serve as an added cost to investors.