

FAMILY LOYALTY: MUTUAL FUND VOTING AND FIDUCIARY OBLIGATION

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ABSTRACT

In recent years, institutional investors have increasingly come to dominate the market for publicly-traded stock. Mutual funds have become especially important, controlling trillions of dollars of corporate equity.

The United States Securities and Exchange Commission ("SEC") has made it clear that it is the fiduciary responsibility of fund administrators to vote their shares in a manner that benefits investors in the fund. Sponsoring companies have responded by creating centralized research offices that determine the voting policies across all the funds they administer. Though there may be some variation at the individual fund level, most fund families vote as a block.

The practice of centralized voting raises the question whether each fund is promoting the best interests of its investors. For example, one fund may hold stock in an acquisition target, while another holds stock in the acquirer; one fund may hold stock in a target, while another holds debt. These funds have different interests, but voting policies rarely differentiate among them.

This Essay argues that mutual fund boards should develop procedures to ensure that fund shares are voted with a view toward advancing the best interests of that particular fund. If such procedures cannot be implemented in a manner that justifies their costs, funds should refrain from voting their shares at all.

In addition to benefitting fund investors, this proposal may also have a salutary effect on portfolio firms. In recent years, commenters have expressed concern about the voting power exerted by mutual fund managers, who may pressure firms to avoid competition within an industry or who may encourage short-term financial engineering over long-term growth. Decentralization may diminish asset managers' power, thereby alleviating these effects.

I. INTRODUCTION

Mutual funds have dramatically changed the way that Americans invest. In 1998, registered investment companies controlled \$5.8 trillion in assets; today, that figure has reached nearly \$20 trillion.¹ In 1980, three percent of American households' financial assets were invested in mutual funds; today, mutual funds hold twenty-two percent of household financial assets.² Ninety-four million U.S. individual investors own mutual funds, either directly or through a retirement account, representing nearly forty-four percent of all U.S. households.³

Though there are thousands of mutual funds and investment managers registered with the SEC,⁴ the industry is in fact dominated by financial conglomerates that may each sponsor hundreds of funds, representing trillions of dollars in assets under control of a single umbrella manager.⁵ Conflicts among client funds are both inevitable and ubiquitous, resulting in a variety of regulatory responses. Chief among these are the basic fiduciary duties that each investment adviser and mutual fund board of directors owes to the fund: the duties of care and loyalty.⁶ The SEC has also promulgated a number of specific rules aimed at en-

¹ Inv. Co. Inst., 2017 Investment Company Fact Book 9 (57th ed. 2017) [hereinafter "ICI Fact Book"].

² ICI Fact Book, *supra* note 1, at 11.

³ ICI Fact Book, *supra* note 1, at 112.

⁴ Arthur B. Laby, *Fiduciary Structure of Investment Management Regulation*, in RESEARCH HANDBOOK ON MUTUAL FUNDS (John D. Morley & William A. Birdthistle, eds.) (Elgar Publishing, forthcoming) (reporting 11,500 SEC-registered investment managers as of January 2015); ICI Fact Book, *supra* note 1, at 16, 22 (reporting 850 sponsors and over 16 thousand registered investment companies as of 2016).

⁵ See, e.g., Sarah Krouse, *'Passive' Investing Frenzy Pushes Vanguard to \$4.7 Trillion in Assets*, WALL ST. J. (Oct. 10, 2017, 5:33 PM), <http://www.wsj.com/amp/articles/passive-investing-frenzy-pushes-vanguard-to-4-7-trillion-in-assets-1507671188>; see also BlackRock Annual Report (Form 10-K) (Feb. 28, 2017) (reporting \$5.1 trillion in assets under management).

⁶ See Investment Company Governance, Exchange Act Release No. IC-26520 (July 27, 2004) ("the paramount principle that must prevail, and should animate all decisions directors are called upon to make, is that a fund must be managed on behalf of its investors").

sureing that advisers develop investment policies and execute orders in a manner that advances the fund's best interests.

What has received less attention is conflicts among funds when it comes to voting. Mutual funds that hold equity investments are entitled to vote their shares, but funds may stand on opposite sides of a merger, hold investments in competing companies, or have different time horizons for their investments. As a result, they are likely to have varying preferences. Notwithstanding this fact, it is common for advisers to centralize and coordinate their voting decisions. The practice is well known and, indeed, publicized, but has attracted little regulatory attention despite the fact that in many instances, votes may be cast in a way that does not advance—and indeed may harm—individual fund interests.

The issue takes on a particular significance given the extraordinary voting power exercised by mutual fund families. As one commenter explained, “When one looks at the shareholder registry of a typical company, there are six names that come up repeatedly. These are Blackrock, Vanguard, State Street, Fidelity, BNY Mellon Investment Management and Capital Group.”⁷ The dominance of a handful of asset managers has been described as “a concentration of corporate ownership, not seen since the days of J.P. Morgan and J.D. Rockefeller.”⁸ Coordination among funds dramatically increases each asset manager's leverage, with all of the benefits to portfolio companies—as well as pitfalls—that follow.

As a result, this Essay argues that the common practice of coordinated voting among mutual fund families should be reconsidered. Fund boards should carefully examine whether funds are served by adhering to a centralized governance strategy, and, if not, insist that individual funds vote their shares separately. In some cases, fund boards may conclude that without centralization, it is not cost-effective to vote a particular fund's shares at all; if so, abstaining would be preferable to

⁷ Patrick Jahnke, *Voice versus Exit: The causes and consequence of increasing shareholder concentration* 9 (Sept. 18, 2017), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=3027058.

⁸ Jan Fichtner et al., *Hidden power of the Big Three?: Passive index funds, re-concentration of corporate ownership, and new financial risk*, 19 BUS. & POL. 298, 315 (2017).

causing the fund to cast votes that do not advance the fund's interests. These changes will improve fund administration, ensure that votes are cast in a manner that better reflects investors' interests, and potentially eliminate some of the pathologies that have resulted from the new concentration of stock ownership among a handful of asset managers.

II. MUTUAL FUNDS AND REGULATION OF CONFLICTS

Mutual funds are shell companies, usually organized as trusts under either Delaware or Massachusetts law, or as corporations under Maryland law.⁹ They have no operations or functions other than to hold a basket of securities under professional management.¹⁰ Each fund has a board of directors or board of trustees, whose main responsibility is to hire and oversee an adviser who directs the fund's investment strategy and oversees its administrative operations.¹¹ Investors buy shares in the shell, and thereby indirectly gain exposure to a pro rata share of the securities held by the fund.¹²

A fund is established by a sponsoring firm. The firm selects the initial board of directors, which is then expected to contract with the sponsor to provide the fund with the necessary investment advice and management services for a fee paid out of fund assets.¹³ These arrangements are rife with conflict and opportunity for predation; the board does not have a meaningful opportunity to select a different investment adviser,¹⁴ so there can be no serious haggling over fees and the scope of

⁹ Deborah A. DeMott, *Fiduciary Contours: perspectives on mutual funds and private funds*, in RESEARCH HANDBOOK ON MUTUAL FUNDS (William A. Birdthistle & John D. Morley eds.) (Edward Elgar Publishing, forthcoming).

¹⁰ Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights*, 34 IOWA J. CORP. L. 101, 107 (2009).

¹¹ *See id.*

¹² *See id.* at 101, 106–07 (2009).

¹³ *See* John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 93–94 (2010).

¹⁴ *Burks v. Lasker*, 441 U.S. 471, 481 (1979).

services provided.¹⁵ Moreover, fund investors are often unsophisticated, and may be steered to a particular fund by their brokers, who are compensated by the sponsor out of fund assets.¹⁶ All manner of abuse is possible, from inflated fees to an investment portfolio designed to advance the interests of the sponsor rather than the interests of fund investors.¹⁷

The legal system addresses these conflicts in various ways. First and most importantly, in 1940, Congress passed the Investment Company Act of 1940 (ICA)¹⁸ and the Investment Advisers Act of 1940 (IAA).¹⁹ In addition to imposing numerous requirements on mutual funds regarding, among other things, disclosure,²⁰ diversification,²¹ liquidity,²² valuation,²³ and related-party transactions,²⁴ these statutes and their implementing regulations mandate that the board of each fund include a majority of “independent” directors, i.e., directors who have no material relationship with the sponsoring firm.²⁵ Independent directors have

¹⁵ Alan R. Palmiter, *Mutual Fund Boards: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 161, 169 (2006).

¹⁶ Benjamin P. Edwards, *Conflicts & Capital Allocation*, 78 OHIO ST. L.J. 1 (2017). The Department of Labor’s controversial fiduciary rule was adopted to address some of these concerns. See Daisy Maxey, *Investing in Funds & ETFs: A Quarterly Analysis – The ABCs (and T’s and Z’s) of the Fiduciary Rule*, WALL ST. J., July 10, 2017, at R1.

¹⁷ Taub, *supra* note 10, at 115 (2009).

¹⁸ 15 U.S.C. §80a-1 et seq.

¹⁹ 15 U.S.C. §80b-1 et seq.

²⁰ LOIS YUROW ET AL., *MUTUAL FUNDS REGULATION AND COMPLIANCE HANDBOOK* §§ 12:2, 27:2 (2017).

²¹ John Morley, *Collective Branding and the Origins of Investment Fund Regulation*, 6 VA. L. & BUS. REV. 341 (2012).

²² YUROW, *supra* note 20, at § 16:4.

²³ YUROW, *supra* note 20, at § 14:1.

²⁴ 15 U.S.C. § 80a-17; 15 U.S.C. § 80a-10(f).

²⁵ The ICA requires only that boards be forty percent independent, see 15 U.S.C. §80a-10(a), but in 2001, the SEC promulgated a rule requiring that funds seeking certain specified regulatory exemptions maintain majority independent boards. Most funds have voluntarily chosen to take advantage of these exemptions. Thomas A. Bausch et

been described as the “cornerstone of the ICA’s effort to control conflicts of interest” who serve as “independent watchdogs” to protect the interests of fund investors.²⁶ As such, their most important responsibilities are to approve the investment adviser’s contract, including its fee,²⁷ and to evaluate the quality of the fund’s management.²⁸

Fund directors and advisors also have fiduciary duties to each fund they administer under the ICA and IAA, and the law of the organizing state, namely, the duties of care and loyalty.²⁹ The duty of care requires that the fiduciary “exercise the judgment and care that a prudent person would exercise in the management of his or her own affairs.”³⁰ The duty of loyalty requires that the fiduciary “resolve all conflicts of interest in favor of the beneficiary and to devote its full energies toward enhancing the beneficiary’s interest.”³¹ Many funds are also offered as

al., *Creating an Effective, Functioning and Legally Compliant Mutual Fund Board*, 22 THE INVESTMENT LAWYER 1 (2015); Role of Independent Directors of Investment Companies, Securities Act Release No. 33-7932 Investment Company Act Rel. No. 24816 (Jan. 2, 2001).

²⁶ *Burks v. Lasker*, 441 U.S. 471, 482–84 (1979).

²⁷ 15 U.S.C. § 80a-15(c).

²⁸ See SEC Release No. IC-26520 (July 27, 2004).

²⁹ Investment Company Act of 1940 § 36, 15 U.S.C. § 80a-35 (2006); SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963); *Morris v. Wachovia Sec., Inc.*, 277 F. Supp. 2d 622, 644 (E.D. Va. 2003); *Burks v. Lasker*, 441 U.S. 471 (1979); Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585 (Feb. 7, 2003); Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities Act Release No. 8188, Exchange Act Release No. 47,304, Investment Company Act Release No. 25,922, 2003 WL 215451 (Jan. 31, 2003); Role of Independent Directors of Investment Companies, Securities Act Release No. 33-7932 Investment Company Act Rel. No. 24816 (Jan. 2, 2001); SEC Release No. IC-26520 (July 27, 2004).

³⁰ DIV. OF CORP. FIN., U.S. SEC. & EXCH. COMM’N, STAFF REPORT ON CORPORATE ACCOUNTABILITY: A RE-EXAMINATION OF RULES RELATING TO SHAREHOLDER COMMUNICATIONS, SHAREHOLDER PARTICIPATION IN THE CORPORATE ELECTORAL PROCESS AND CORPORATE GOVERNANCE GENERALLY (Sept. 4, 1980) (printed for the use of S. Comm. on Banking, Housing, and Urban Affairs, 96th Cong., 2d Sess.) [hereinafter “STAFF REPORT”].

³¹ STAFF REPORT, *supra* note 30, at 391.

part of an ERISA-regulated retirement plan, with similar fiduciary obligations imposed.³²

Yet, despite this extensive regulatory framework, the conflicts under which funds labor remain an intractable fact of the industry. Fee structures may be exploitative.³³ Sponsors may be part of larger financial conglomerates, and their interests in promoting other lines of business may conflict with fund interests.³⁴

More fundamentally, most mutual funds exist as part of a family or complex of funds, all sponsored by a single asset manager, and each with its own investment strategy, such as a focus on achieving particular investment goals, or a focus on particular market segments. Because the largest asset managers may offer hundreds of individual funds,³⁵ conflicts are pervasive; at every level, the fund adviser must decide how to allocate resources.³⁶ As John Morley and Allen Ferrell put it, “Every time a manager assigns an employee to serve one client, decides the order in which to execute trades, . . . the manager is facing a conflict of interest. Even the allocation of computer equipment and office space involves a conflict among clients.”³⁷ In resolving these conflicts, there is strong evidence that advisers favor some funds over others by, among other

³² Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, Including Proxy Voting Policies or Guidelines, 81 FR 95879-01, 2016 WL 7453352.

³³ Edwards, *supra* note 16, at 19–20 (2017); K.J. Martijn Cremers & Quinn Curtis, *Do Mutual Fund Investors Get What They Pay For? Securities Law and Closet Index Funds*, 11 VA. L. & BUS. REV. 31 (2016).

³⁴ For example, asset managers might direct funds to buy shares in offerings by an associated underwriter. Taub, *supra* note 10, at 115–116.

³⁵ Fichtner et al., *supra* note 8, at 307 (BlackRock offers over 200 funds); John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1232 (2014) (Fidelity offers several dozen funds).

³⁶ Allen Ferrell & John Morley, *New Special Study of the Securities Markets: Intermediaries*, http://www.law.columbia.edu/sites/default/files/microsites/capital-markets/ferrell-morley-final_draft.pdf; John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1263 (2014).

³⁷ Ferrell & Morley, *supra* note 36.

things, assigning them more portfolio managers,³⁸ hot IPO allocations,³⁹ or the favorable side of market trades.⁴⁰ In so doing, sponsors may seek to boost funds that charge higher fees.⁴¹ Goosing the performance of these funds attracts greater investment to them, which more than counterbalances any losses in lower-fee funds.⁴² Moreover, investors tend to gravitate toward particular fund families, creating incentives for sponsors to artificially create “star performers” who attract investors’ attention.⁴³

These conflicts are exacerbated by the nearly universal practice of using a single board, or clusters of boards, to oversee all funds in a family.⁴⁴ Though the practice has frequently been challenged on the ground that these overboarded directors cannot devote sufficient attention to the individual funds whose interests they are obliged to protect—and high salaries compromise nominally “independent” directors⁴⁵—asset managers have long maintained that funds often face similar issues, and service on multiple boards “may actually give directors greater leverage when dealing with the common adviser.”⁴⁶ Both courts and the SEC have accepted the funds’ position, and have rejected the claim that service on multiple boards undermines directors’ independence.⁴⁷

³⁸ Ilan Guedj & Jannette Papastaikoudi, *Can Mutual Fund Families Affect the Performance of Their Funds?*

³⁹ Jose-Miguel Gaspar et al., *Favoritism in Mutual Fund Families? Evidence on Strategic Cross-Fund Subsidization*, 61 J. FIN. 73 (2006).

⁴⁰ *Id.*

⁴¹ *Id.* at 76.

⁴² *Id.* at 102.

⁴³ *Id.*

⁴⁴ *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

⁴⁵ Palmiter, *supra* note 15; James Sterngold, *On Board, at a Mutual Fund*, WALL ST. J., Sept. 3, 2014, <https://www.wsj.com/articles/on-board-at-a-mutual-fund-1409757187>; James Sterngold, *Is Your Fund's Board Watching Out for You?*, WALL ST. J., June 9, 2012, <https://www.wsj.com/articles/SB10001424052702303753904577450243418998540>; Palmiter, *supra* note 15.

⁴⁶ *Investment Company Governance*, 69 FR 3472-01, 2004 WL 101604.

⁴⁷ *See, e.g., Migdal v. Rowe Price-Fleming Intern., Inc.*, 248 F.3d 321 (4th Cir. 2001).

At the same time, the SEC is aware of the potential for interfund conflict, and has responded with regulations that target specific points of concern.⁴⁸ The landscape is very different when it comes to fund voting, however. In that context, the SEC has been slow to consider conflicts between the funds and their sponsors and has been unconcerned with—and perhaps even encouraged—conflicts among funds managed by a single adviser.

III. MUTUAL FUNDS AND REGULATION OF VOTING

For many years, mutual fund regulation focused on funds' fees, disclosure practices, and selection of investments, with little attention paid to funds' involvement in the governance of their portfolio companies.⁴⁹ Matters began to change in the late 1970s and early 1980s, as stock became increasingly concentrated in the hands of institutional investors for the ultimate benefit of other persons, such as retirees and employees. These institutions' holdings were so large that the traditional mechanism for expressing disapproval of management—exit—became impractical in many instances; at the same time, the new corporate responsibility movements, along with the popularity of shareholder proposals, complicated matters on which shareholders were expected to vote.⁵⁰

In 1980, the SEC staff issued a report on institutional involvement in corporate governance.⁵¹ Though the report did not focus on mutual funds specifically, it articulated the principle that institutional investors' fiduciary duties of care and loyalty extended to the exercise of the stockholder franchise.⁵² The staff made clear that institutions had a “duty to vote in such a way as to promote the interests of the beneficiar-

⁴⁸ 17 C.F.R. 270.17d-1 (2013); 17 C.F.R. 270.17a-7 (2005); 17 C.F.R. 270.10f-3 (2016); see also John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228 (2014) (characterizing SEC approach as “ad hoc”).

⁴⁹ Palmiter, *supra* note 15.

⁵⁰ STAFF REPORT, *supra* note 30.

⁵¹ Investment Company Governance, 69 FR 3472-01, 2004 WL 101604.

⁵² *Id.*

ies,”⁵³ and concluded that “an institutional investor which does not participate in the corporate governance process may be taking insufficient interest in the financial integrity and performance of its investment.”⁵⁴

In the years that followed, the SEC sporadically mentioned fiduciary duties in connection with institutional voting generally, and mutual fund voting in particular.⁵⁵ Finally, in 2003, the SEC promulgated rules under the ICA and IAA requiring that funds develop and publicize their policies for voting portfolio company shares.⁵⁶ In the implementing release, the SEC reiterated that “The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies. To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own.”⁵⁷

During the same period, the Department of Labor (which oversees ERISA) also became increasingly concerned about voting of stock held in ERISA-regulated benefit plans,⁵⁸ culminating in a 1994 interpretive bulletin clarifying that the “fiduciary obligations of prudence and loyalty . . . require the responsible fiduciary to vote proxies on issues that

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ Paul R. Carey, Comm’r, U.S. Sec. & Exch. Comm’n, Remarks to the Investment Company Institute Procedures Conference (Dec. 9, 1999) (transcript available at <https://www.sec.gov/news/speech/speecharchive/1999/spch335.htm>); Joann S. Lublin, *Proxy Voting Is a Fiduciary Duty, SEC Chief Says in Letter to Group*, WALL ST. J. (March 21, 2002, 12:01 AM) <https://www.wsj.com/articles/SB1016665892898975640>.

⁵⁶ 17 C.F.R. § 275.206(4)-6 (2017); 17 C.F.R. § 275.204-2 (2017); Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585 (Feb. 7, 2003); Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities Act Release No. 8188, Exchange Act Release No. 47,304, Investment Company Act Release No. 25,922, 2003 WL 215451 (Jan. 31, 2003).

⁵⁷ Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585, 6586 (Feb. 7, 2003).

⁵⁸ See Letter from Alan D. Lebowitz, Deputy Assistant Sec’y, Dep’t of Labor, to Helmuth Fandl, Chairman of the Ret. Bd., Avon Prods., Inc. (Feb. 23, 1988), in 1988 ERISA LEXIS 19, 15 Pens. Rep. (BNA) 371, 391 (Feb. 29, 1988) (explaining that “the decision[s] as to how proxies should be voted . . . are fiduciary acts of plan asset management.”); Lublin, *supra* note 55.

may affect the value of the plan's investment."⁵⁹ As a result, plans would be expected to include written statements of proxy voting policy in their overall investment policies.⁶⁰

Both agencies were apparently motivated, at least in part, by concerns that investment advisers were voting shares in their own self-interest, often to please corporate management that could direct banking or pension-related business to the adviser.⁶¹ As a result, the SEC rules place particular emphasis on conflicts between advisers and funds, requiring advisers to adopt "written policies and procedures that are reasonably designed to ensure" that securities are voted "in the best interest of clients" and "address material conflicts that may arise between" the interests of the adviser and its clients.⁶² In comments to the rule, the SEC explained further:

An adviser's policies and procedures under the rule must also address how the adviser resolves material conflicts of interest with its clients. . . . [W]e believe that an adviser that has a material conflict of interest with its clients must take other steps designed to ensure, and must be able to demonstrate that those steps resulted in, a decision to vote the proxies that was based on the clients' best interest and was not the product of the conflict.⁶³

In adopting its rules, the SEC explicitly stated that advisers may avoid conflicts by voting securities in accord with the recommendations

⁵⁹ 29 C.F.R. § 2509.94-2 (2017).

⁶⁰*Id.*; see also Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, Including Proxy Voting Policies or Guidelines, 81 FR 95879-01, 2016 WL 7453352 (providing updated guidance).

⁶¹ Lublin, *supra* note 55; Taub, *supra* note 10.

⁶² 17 CFR 275.206(4)-6(a) (2017).

⁶³ Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585, 6587 (Feb. 7, 2003).

of an independent third party.⁶⁴ Such third parties, the SEC later advised, might include certain proxy advisory firms—companies that specialize in analyzing proxy materials and advising institutions as to how to vote their shares to promote long-term value⁶⁵—so long as the firm was properly vetted for its own conflicts.⁶⁶

At the same time, both the SEC and DOL have made clear that funds need not cast votes in every election on every issue proposed by portfolio companies; instead, advisers should perform a cost-benefit analysis to determine whether the effort involved in researching the issue exceeds the potential value to the fund of casting an informed vote.⁶⁷ That said, the agencies apparently assume that for most issues involving publicly traded stock, costs are minimal. The DOL has been explicit on this point, explaining that professionalization of investment management and associated economies of scale, as well as reliance on proxy advisory firms, will make the voting process in most instances relatively inexpensive.⁶⁸ Though the SEC has not articulated its views as plainly as the DOL, it appears to operate under the same assumption. Both of the SEC's 2003 releases cited the DOL's 1994 bulletin,⁶⁹ and the SEC of-

⁶⁴ *Id.*

⁶⁵ Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 889–90 (2007); Matthew D. Cain et al., *How Corporate Governance is Made: The Case of the Golden Leash*, 164 U. PA. L. REV. 649, 672–73 (2016).

⁶⁶ Egan-Jones Proxy Services No-Action Letter (May 27, 2004), <https://www.sec.gov/divisions/investment/noaction/egan052704.htm>.

⁶⁷ Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585, 6587 (Feb. 7, 2003); 29 C.F.R. § 2509.94-2 (2017); Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, Including Proxy Voting Policies or Guidelines, 81 FR 95879-01, 2016 WL 7453352; Paul R. Carey, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks to the Investment Company Institute Procedures Conference (Dec. 9, 1999) (transcript available at <https://www.sec.gov/news/speech/speecharchive/1999/spch335.htm>).

⁶⁸ Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, Including Proxy Voting Policies or Guidelines, 81 FR 95879-01, 2016 WL 7453352.

⁶⁹ Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585, 6587 (Feb. 7, 2003); Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management

ferred the same example as the DOL—voting securities of a foreign company—as a scenario in which a vote may not be cost-justified.⁷⁰ Moreover, as described above, the SEC, like the DOL, has blessed the use of proxy advisory firms.

Partially in response to the new federal requirements, most asset managers have created centralized governance offices that handle the voting and engagement functions for all of the funds, or clusters of funds, administered by the manager.⁷¹ These offices articulate a general set of corporate governance preferences that guide all proxy voting across the funds. For example, asset managers might declare a general preference for destaggering boards,⁷² proxy access under certain conditions,⁷³ and opposition to directors who ignore successful shareholder proposals.⁷⁴ As a result, funds administered as part of a single family tend to vote their shares as a block.⁷⁵ In some cases, funds may simply

Investment Companies, Securities Act Release No. 8188, Exchange Act Release No. 47,304, Investment Company Act Release No. 25,922, 2003 WL 215451 (Jan. 31, 2003).

⁷⁰ Compare Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585, 6587 n. 18 (Feb. 7, 2003), with 29 C.F.R. § 2509.94-2 (1994), and Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, Including Proxy Voting Policies or Guidelines, 81 FR 95879-01, 2016 WL 7453352.

⁷¹ See, e.g., Vanguard, *Statement of Additional Information*, (April 27, 2017), <http://www.vanguard.com/pub/Pdf/sai040.pdf> (describing Vanguard's Proxy Oversight Committee); BlackRock, *BlackRock Investment Stewardship* (July 2017), <https://www.blackrock.com/corporate/en-be/literature/publication/blk-profile-of-blackrock-investment-stewardship-team-work.pdf> (describing Blackrock's voting procedures).

⁷² BlackRock, *Proxy voting guidelines for U.S. securities* (Feb. 2015), <https://www.blackrock.com/corporate/en-kr/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf>; Fidelity, *Fidelity Funds' Proxy Voting Guidelines* (Jan. 2017), https://www.fidelity.com/bin-public/060_www_fidelity_com/documents/Full-Proxy-Voting-Guidelines-for-Fidelity-Funds-Advised-by-FMRCo.pdf.

⁷³ BlackRock, *Proxy voting guidelines for U.S. securities* (Feb. 2015); Fidelity, *Fidelity Funds' Proxy Voting Guidelines* (Jan. 2017).

⁷⁴ BlackRock, *Proxy voting guidelines for U.S. securities* (Feb. 2015); Fidelity, *Fidelity Funds' Proxy Voting Guidelines* (Jan. 2017).

⁷⁵ Scott Hirst, *Social Responsibility Resolutions*, J. CORP. L. (forthcoming 2017) (manuscript at 11–13), <https://pcg.law.harvard.edu/wp-content/uploads/2015/11/Scott-Hirst->

outsource their voting function to proxy advisor services, like ISS, and vote in accordance with their recommendations.⁷⁶ Even when votes are handled by individual fund portfolio managers—such as transaction-

Social-Responsibility-Resolutions.pdf; Rasha Ashraf et al., *Do Pension-Related Business Ties Influence Mutual Fund Proxy Voting? Evidence from Shareholder Proposals on Executive Compensation*, 47 J. FIN. & QUANT. ANAL. 567, 578 (2012) (“In our sample, over 90% of votes by fund families exhibit unanimity among the funds within the family.”); Stephen Choi et al., *Who Calls the Shots? How Mutual Funds Vote on Director Elections*, 3 HARV. BUS. L. REV. 35 (2013) (finding it common for large fund families to vote either as a block, or in clusters, often traced to common subadvisors); Vanguard, *Statement of Additional Information*, B-47 (April 27, 2017) <http://www.vanguard.com/pub/Pdf/sai040.pdf> (“For most proxy proposals, particularly those involving corporate governance, the evaluation will result in the same position being taken across all of the funds and the funds voting as a block,” though with the caveat that some votes may require individuation.); Palmiter, *supra* note 15 (describing Fidelity and Vanguard); Burton Rothberg & Steven Lilien, *Mutual Funds and Proxy Voting: New Evidence on Corporate Governance*, 1 J. BUS. & TECH. L. 157 (2006); Angela Morgan et al., *Mutual Funds as Monitors: Evidence from Mutual Fund Voting*, 17 J. CORP. FIN. 914 (2011); Jan Fichtner et al., *Hidden Power of the Big Three? Passive Index Funds, Re-concentration of Corporate Ownership and New Financial Risk*, 19 BUS. & POL. 298 (2017); Ying Duan & Yawen Jiao, *The Role of Mutual Funds in Corporate Governance: Evidence from Mutual Funds’ Proxy Voting and Trading Behavior*, 51 J. FIN. & QUANT. ANAL. 489 (2016); Susanne Craig, *The Giant of Shareholders, Quietly Stirring*, N.Y. TIMES, May 18, 2013, at BU1 (describing how centralized governance analysts decide how to vote fund shares). There are, of course, exceptions; for example, in the recent proxy battle at P&G, some individual BlackRock funds voted differently than the rest of the family. See Sharon Terlep & David Benoit, *P&G Says Trian’s Nelson Peltz Has Lost Bid for Board Seat; He Disagrees*, WALL. ST. J. (Oct. 10, 2017, 8:57 PM), <https://www.wsj.com/articles/p-g-board-vote-comes-down-to-the-wire-1507629601>.

⁷⁶ Choi, *supra* note 75 (finding that pure reliance on an advisory service is more common among the smaller families); Duan & Jiao, *supra* note 75.

specific votes on mergers⁷⁷—funds within a family often coordinate their voting.⁷⁸

Since the rules were put in place, the SEC has continued to focus on potential conflicts of interest between the asset manager and investors in the fund. For example, the SEC settled an action against an investment adviser that voted all of its clients' shares in accord with AFL-CIO guidelines in order to win union pension business.⁷⁹ The SEC has also expressed concern about proxy advisory firms that offer conflicted advice.⁸⁰ Yet despite funds' open practice of centralizing votes, little heed has been paid to the potential for *interclient* conflicts, that is, conflicts between the interests of different funds.

⁷⁷ Patrick Jahnke, *How Institutional Investors' Ownership Concentration Affects Corporate Governance*, CLS BLUE SKY BLOG, (Sept. 22, 2017), <http://clsbluesky.law.columbia.edu/2017/09/22/how-institutional-investors-ownership-concentration-affects-corporate-governance/> (Within fund families, votes on “votes on capital increases or takeovers and other major corporate actions” may be handled by portfolio managers; other voting decisions are centralized.); *In re CNX Gas Corp. S'holders Litig.*, 4 A.3d 397 (Del. Ch. 2010) (describing fund managers' involvement with decisions regarding how to respond to a tender offer).

⁷⁸ See Andriy Bodnaruk & Marco Rossi, *Dual Ownership, Returns, and Voting in Mergers*, 120 J. FIN. ECON. 58 (2016); Hortense Bioy et al., Morningstar Manager Research, *Passive Fund Providers Take an Active Approach to Investment Stewardship* 11, 14 (Dec. 2017).

⁷⁹ *In re Intech Inv. Mgmt. LLC & David E. Hurley Respondents*, Investment Advisors Act of 1940 Release No. IA-2872, 95 SEC Docket 2265, 2009 WL 1271173 (May 7, 2009).

⁸⁰ Egan-Jones Proxy Services No-Action Letter (May 27, 2004), <https://www.sec.gov/divisions/investment/noaction/egan052704.htm>; Concept Release on the U.S. Proxy System, Exchange Act Release No. 62495, Investment Advisers Act Release No. 3052, Investment Company Act Release No. 29340, 2010 WL 2779423 (July 14, 2010). The SEC's efforts have apparently been only somewhat successful; there is, for example, substantial evidence that fund advisers who seek business administering retirement plans will vote clients' shares so as to curry favor with corporate management. Taub, *supra* note 10; Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. FIN. ECON. 552 (2007); David J. Pedersen, *All Tied Up in Knots: The Complex Relationship between Bidders and their 401(k) Trustees*, (May 22, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2972099; Choi, *supra* note 75; Ashraf, *supra* note 75.

In the most obvious examples, one fund may hold shares of a potential acquiring firm while another holds shares of the target. The funds' interests are opposed, yet evidence suggests that fund managers behave as though all of the funds are part of a single portfolio, and seek to maximize wealth across the entire fund family, rather than at a specific fund.⁸¹ Similarly, when fund families hold both equity and debt of a single firm, they may vote the stock with a view to shoring up the value of the debt, even if the stock and debt are held by different funds.⁸² There is even evidence that fund families that own stock in competing firms prefer compensation packages that reward wealth maximization across the industry, without regard for whether particular funds have more or less of an interest in specific companies.⁸³

These practices were on display in the tender offer context in *In re CNX Gas Corporation*.⁸⁴ One T. Rowe Price fund held shares in both a potential acquirer and its target company, while another held shares in the target alone. Despite the funds' differing interests, T. Rowe Price negotiated a price for the target stock on behalf of all of its funds, simultaneously.⁸⁵

Funds are often asked to vote on governance matters, such as destaggering a board or granting proxy access to shareholders.⁸⁶ Alterna-

⁸¹ Gregor Matvos & Michael Ostrovsky, *Cross-Ownership, Returns, and Voting in Mergers*, 89 J. Fin. Econ. 391 (2008) (analyzing cross-ownership at the conglomerate level); Chris Brooks et al., *Institutional Cross-ownership and Corporate Strategy: The Case of Mergers and Acquisitions*, (Dec. 21, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2747036 (same); Maria Goranova et al., *Owners on Both Sides of the Deal: Mergers and Acquisitions and Overlapping Institutional Ownership*, 31 Strat. Mgmt. J. 1114 (2010) (same).

⁸² Bodnaruk & Rossi, *supra* note 78.

⁸³ Miguel Anton et al., *Common Ownership, Competition, and Top Management Incentives* (Ross Sch. of Bus., Working Paper No. 1328, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2802332.

⁸⁴ 4 A.3d 397 (Del. Ch. 2010).

⁸⁵ *Id.* at 402.

⁸⁶ Gibson Dunn, *Shareholder Proposal Developments During the 2017 Proxy Season*, (June 29, 2017), <http://www.gibsondunn.com/publications/documents/Shareholder-Proposal-Developments-During-the-2017-Proxy-Season.pdf>.

tively, they may be asked to support or reject director nominees from a dissenting shareholder, typically advocating for immediate cost-cutting and a return of cash to shareholders.⁸⁷ These are matters on which funds may reasonably differ, depending on their investment strategies. Actively managed funds with high turnover may prefer immediate financial engineering measures that boost stock prices⁸⁸; funds that specialize in companies that expect growth, or rely on research and development, may prefer to keep antitakeover measures in place.⁸⁹ But centralized voting policies do not draw such distinctions.

Thus, the issues raised by centralized voting are not limited to the usual critique that proxy advisors or institutional investors adopt a “one-size-fits-all” approach to corporate governance that fails to allow for flexibility at individual portfolio companies.⁹⁰ Though specific compa-

⁸⁷ John C. Coffee, Jr & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 580–81 (2016).

⁸⁸ Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 579–80 (2006). Short-term investors may therefore prefer executive pay packages that reward short-term measures over longer term investment. Cf. Alex Edmans et al., *The Long-Term Consequences of Short-Term Incentives*, (Oct. 28, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3037354 (describing how CEO incentives may induce measures that result in short-term stock price increases at the expense over long-term performance).

⁸⁹ Robert Daines et al., *Can Staggered Boards Improve Value? Evidence from the Massachusetts Natural Experiment*, (March 2017) <http://ssrn.com/abstract=2836463> (concluding that staggered boards contribute to value at earlier-stage firms); Martijn Cremers et al., *Staggered Boards and Long-Term Firm Value, Revisited*, (July 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2364165 (concluding that staggered boards may add value at firms that rely on research and innovation); Martijn Cremers et al., *Shadow Pills and Long-Term Firm Value*, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3074658. But see Emiliano Catan & Michael Klausner, *Board Declassification and Firm Value: Have Shareholders and Boards Really Destroyed Billions in Value?*, (Sept. 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2994559 (concluding that board destaggering does not reduce value at firms with high research and development expenditures).

⁹⁰ See Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 906 (2007); Concept Release on the U.S. Proxy System, Exchange Act Release No. 62495, Investment Advisers Act Release No. 3052, Investment Company Act Release No. 29340, 2010 WL 2779423 (July 14, 2010).

nies might benefit from idiosyncratic governance approaches, it might still be appropriate for funds to adopt general sets of governance preferences if, on average, those preferences make sense for most companies in which it invests, and further company-specific research would not yield additional benefits. The problem, from the perspective of mutual fund investors, arises when centralized voting practices fail to draw appropriate distinctions at the fund level.

In other words, though an institutional investor (or a fund) with a variety of holdings might reasonably adopt a uniform set of preferences with respect corporate governance, the optimal set of preferences might vary from fund to fund depending on its particular investment strategy. However, the current practice within fund families is to elide these differences through centralized and coordinated voting and engagement.⁹¹

IV. DOES CENTRALIZED VOTING VIOLATE FUNDS' DUTIES TO INVESTORS?

A. Fiduciary Obligations and Conflicts of Duty

Under traditional common law, from which federal standards are drawn,⁹² fiduciaries are prohibited not only from acting out of self-interest, but also from even accepting engagements from persons whose interests conflict.⁹³ As the *Restatement (Second) of Agency* puts it, “an agent is subject to a duty not to act or to agree to act during the period of his agency for persons whose interests conflict with those of the principal in

⁹¹ Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L.J. 1870, 1913–14 (2017) (indexed funds and active funds may vote identically within a complex). *But see* Choi, *supra* note 75 (pointing out that within the Fidelity family of mutual funds, active funds and indexed funds are managed separately, and do not vote together).

⁹² Staff Report; Arthur B. Laby, *Fiduciary Structure of Investment Management Regulation*, in RESEARCH HANDBOOK ON MUTUAL FUNDS (John D. Morley & William A. Birdthistle, eds.) (Elgar Publishing, forthcoming); *see also* Jones v. Harris Assocs. L.P., 559 U.S. 335 (2010) (interpreting federal duties of mutual fund directors in light of trust principles).

⁹³ Andrew F. Tuch, *The Weakening of Fiduciary Law*, in RESEARCH HANDBOOK ON MUTUAL FUNDS (John D. Morley & William A. Birdthistle, eds.) (Elgar Publishing, forthcoming); Arthur R. Laby, *Resolving Conflicts of Duty in Fiduciary Relationships*, 54 AM. U. L. REV. 75, 81 (2005).

matters in which the agent is employed.”⁹⁴ In modern financial conglomerates, however—including the mutual fund industry—this rule has long been abandoned.⁹⁵ Courts instead have endorsed the practice of partitioning, allowing businesses to serve clients with competing interests so long as there are informational and other barriers among the agents who handle those accounts.⁹⁶ It is perhaps unsurprising, then, that the *Restatement (Third) of Agency* no longer contains the blanket prohibition of the *Restatement (Second) of Agency*.

Still, the *Restatement (Third) of Agency* continues to forbid agents from “us[ing] the property of the principal for . . . [the purposes] of a third party.”⁹⁷ Similarly, the *Restatement (Third) of Trusts* requires that trustees not “be influenced by the interest of any third person or by motives other than the accomplishment of the purposes of the trust” in administering trust assets.⁹⁸ The *Restatement (Third) of Trusts* does recognize that, in some instances, a trust has multiple beneficiaries, necessitating that the trustee balance their competing interests (while displaying impartiality among them).⁹⁹ Such a situation might be analogized to the types of resource-based conflicts encountered by fund sponsors who must decide how to allocate personnel and scarce opportunities among funds (recognizing that these conflicts exist because sponsors voluntarily assume conflicting obligations, which would be forbidden under traditional principles).¹⁰⁰ Voting, however, is not like these other conflicts, because it is not a limited resource; centralization, let alone the use of one fund’s votes to benefit holdings in another fund, is not an inescapable aspect of the business model. Thus, an application of these principles would bar

⁹⁴ *Restatement (Second) of Agency* § 394.

⁹⁵ Tuch, *supra* note 93.

⁹⁶ *Id.*

⁹⁷ *Restatement (Third) of Agency* § 8.05.

⁹⁸ *Restatement (Third) of Trusts* § 78 cmt. f.; *see also* *Restatement (Third) of Agency* § 8.05 cmt. b (trustees must exhibit “undivided loyalty” to beneficiaries, and act “solely in the interest of the beneficiary in matters of trust administration”).

⁹⁹ *Restatement (Third) of Trusts* § 90 cmt. c.

¹⁰⁰ Laby, *supra* note 93, at 92–93.

advisers from using the votes of one fund to enhance the value of a different fund.¹⁰¹

Moreover, the duty of care requires that advisers “exercise the judgment and care that a prudent person would exercise in the management of his or her own affairs.”¹⁰² Centralization may result from a kind of short-cut on governance matters that may not satisfy the needs of particular funds; that practice, as well, would seem to violate asset managers’ duties to the funds they sponsor.¹⁰³

But matters are not quite so straightforward.

First, from a regulatory standpoint, both the SEC and the DOL have appeared to approve, if not encourage, centralized voting in general, and outsourcing to proxy advisory services in particular. The SEC has explained that the use of a “pre-determined voting policy” or the “recommendations of an independent third party” are permissible mechanisms for avoiding conflicts between an adviser and its client.¹⁰⁴ To be sure, these policies and recommendations could be fund-specific—as the SEC put it, “[n]othing in the rule prevents an adviser from having differ-

¹⁰¹ Mutual funds organized as trusts differ from ordinary trusts, in that they have no donor/settlor and thus are more contractual. *See* Northstar Financial Advisors Inc. v. Schwab Investments, 779 F.3d 1036 (9th Cir. 2015). Nonetheless, the Supreme Court has held that traditional trust law provides the most appropriate analogy. *See* Jones v. Harris Assocs. L.P., 559 U.S. 335 (2010). *See also* Tuch, *supra* note 93 (investment advisers are subject to fiduciary duties of the common law of trusts); Palmiter, *supra* note 15, at 1466 (same).

¹⁰² Restatement (Third) of Trusts § 90 (“The trustee has a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust”).

¹⁰³ For example, passive investment managers that control funds with holdings of both an acquirer and target may simply vote all target shares in favor of a merger, and all acquirer shares against the merger, ignoring the needs of particular funds. As the current Chief Justice of the Delaware Supreme Court, Leo Strine, put it, “This is, of course, incoherent, stupid, and reflective of a lack of judgment being exercised by the index fund on behalf of its specific investors and their interests.” Leo E. Strine, J., *Securing Our Nation’s Economic Future: A Sensible, Nonpartisan Agenda to Increase Long-Term Investment and Job Creation in the United States*, 71 BUS. L. 1081, 1093 (2016).

¹⁰⁴ Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585 (Feb. 7, 2003).

ent policies and procedures for different clients”¹⁰⁵—but that phrasing itself suggests something of a one-size-fits-all default.

Additionally, both the SEC and the DOL have stressed that funds need not vote their shares if the costs of researching an issue outweigh the benefits to the fund of voting. Since each individual fund may only benefit from its votes to a very small degree, many votes are unlikely to be cost-justified without centralization.¹⁰⁶ This point was acknowledged by the DOL which, as described above, explicitly stated that the professionalization of investment advice, coupled with the use of proxy advisor services, renders voting inexpensive enough to justify the cost.

The SEC has also emphasized the positive externalities associated with careful voting by mutual funds due to their “increased equity holdings and accompanying voting power.” That voting power, according to the SEC, “place[s] them in a position to have enormous influence on corporate accountability. As major shareholders, mutual funds may play a vital role in monitoring the stewardship of the companies in which they invest.”¹⁰⁷ But this voting power is only present when an asset manager like BlackRock or Fidelity votes its funds in a uniform manner; viewed fund-by-fund, each institution is far less powerful and far less likely to individually assert much of an influence on governance. Thus, in this passage, the SEC once again implicitly assumes that fund shares will be voted en masse.

In sum, the SEC has sent somewhat mixed messages. Despite generally endorsing broad common law standards of fiduciary conduct, in practice, the SEC appears to tolerate something quite different.

¹⁰⁵ *Id.*

¹⁰⁶ See Usha Rodrigues, *Corporate Governance in an Age of Separation of Ownership from Ownership*, 95 MINN. L. REV. 1822, 1830–32 (2011).

¹⁰⁷ Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Investment Company Act Release No. 8188, 2003 WL 215451 (Jan. 31, 2003).

B. *The Role of Consent*

These conflicting signals might be reconciled if we view funds' voting arrangements through the lens of consent. In general, both common law and the federal regulatory scheme permit clients to consent to managerial conflicts upon full disclosure. For example, the *Restatement (Third) of Agency* permits an agent to act for more than one principal so long as the agent deals in good faith and discloses all relevant facts.¹⁰⁸ Similarly, the SEC has stated that "an adviser's policy of disclosing [any] conflict to clients and obtaining their consents before voting satisfies the requirements of the rule."¹⁰⁹ In the context of mutual funds, we may reasonably question whether retail investors can provide autonomous consent, but there is an alternative: the SEC has stated that the directors are empowered to consent to actions that might otherwise present a conflict.¹¹⁰

There are certainly plausible reasons for why a mutual fund board might consent to centralization of voting policies, despite the conflicts they present. By coordinating votes across funds, fund families increase their leverage with portfolio companies, thus enabling them to more effectively advocate for better governance.¹¹¹ This kind of cooperation among funds may ultimately represent the most profitable arrangement for investors, even if each fund occasionally makes small sacrifices on individual matters. Funds may also share the view that a single set of governance policies broadly suit the market as a whole, even if they are suboptimal in particular cases, and that therefore it benefits all of the funds to seek market-wide standardization. Standardization may also carry its own benefits, by permitting investors to focus on the substance of businesses when evaluating firms, sparing them the need to investigate and price varying governance arrangements. The resulting

¹⁰⁸ Restatement (Third) of Agency § 8.06.

¹⁰⁹ Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585 (Feb. 7, 2003)

¹¹⁰ *Id.* at n.20.

¹¹¹ Palmiter, *supra* note 15, at 1465.

reduced transaction costs and increased liquidity may counterbalance any efficiency losses at outlier firms.¹¹²

The difficulty is that this hypothetical consent remains just that. Though we may assume that fund directors are aware of—and perhaps have acquiesced—to the sponsor’s publicly announced approach to governance issues, it is not obvious that every board has evaluated centralized voting strategy with the “high degree of rigor and skeptical objectivity”¹¹³ that their role demands. Though both the full board, and the independent directors, are required to conduct an annual review of their advisory contracts,¹¹⁴ typically the focus of these reviews is on such matters as the fund’s financial performance, the size of the fee and the adviser’s profits, and adviser conflicts of interests¹¹⁵; there is little reason to believe much attention is paid to problems created by voting coordination specifically.¹¹⁶

V. PROPOSALS FOR REFORM

If fund boards and investment advisers are, in fact, neglecting their fiduciary duties by centralizing their voting and engagement without appropriate consideration, fund investors might seek to remedy the situa-

¹¹² Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 762 (1995); Ann M. Lipton, *Manufactured Consent: The Problem of Arbitration Clauses in Corporate Charters and Bylaws*, 104 GEO. L.J. 583, 619 (2016).

¹¹³ Investment Company Governance, Investment Company Act Release No. 26,520, 83 SEC Docket 1384 (July 27, 2004) (quoting Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L. J. 797, 798 (2001)).

¹¹⁴ 15 U.S.C. § 80a-15.

¹¹⁵ ABA Business Law Section, *Fund Director’s Guidebook* 45 (4th ed. 2015).

¹¹⁶ The ABA *Fund Director’s Guidebook* does not even mention proxy voting policy as an aspect of board review. *See id.* at 45–51; *see also id.* at 69–94 (describing director oversight responsibilities; no mention of voting policy). *Cf.* John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don’t Work in Mutual Funds*, 120 YALE L.J. 84, 95 (2010) (observing that advisory contracts “are generally only two or three pages long and specify very little about strategy”). Significantly, Alan Palmiter, writing in 2002—before the SEC promulgated its proxy voting rules—also observed that the then-current edition of the ABA Fund Director Guidebook did not discuss voting policy. *See* Palmiter, *supra* note 15, at 1466.

tion by filing lawsuits for breach of fiduciary duty. However, shareholders' private rights of action in the mutual fund context are quite limited.¹¹⁷ Moreover, it would be difficult if not impossible for investors to establish any concrete, tangible damages to the fund as a result of its voting policy; the most appropriate remedy would be an injunction directing fund boards and investment advisers to reform their voting practices. Given the widespread practice of voting centralization, and the SEC's expertise in developing industry-wide rules, a more promising path forward would be for the SEC to undertake a rulemaking that more precisely specifies the duties of the board and the investment advisor. Below, I outline how the SEC might approach that task.

Ordinarily, the SEC requires that contracts between funds that share an investment adviser be in the best interests of both parties. For example, according to the SEC, the duty of loyalty requires that "an investment adviser . . . not cause funds to enter into a 17a-7 transaction unless doing so would be in the *best interests of each fund* participating in the transaction."¹¹⁸ When it comes to mutual fund voting, however, such strict equivalence may not be feasible; funds may reasonably cooperate by casting votes reciprocally.

A more appropriate comparison might be drawn to joint distribution arrangements. Sponsors often use mutual funds' own assets to market shares to new investors, in a practice that is permitted—but regu-

¹¹⁷ Investors might bring claims under state law. *See* *Strougo v. Bassini*, 282 F.3d 162 (2d Cir. 2002). Alternatively, federal law offers a limited right of action for excessive fees, *see* *Jones v. Harris Assocs. L.P.*, 559 U.S. 335 (2010), or to void contracts whose formation or performance violates the Investment Advisers Act. *See* *Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 24 (1979). Frequently such actions must be brought derivatively, with all of the procedural barriers that follow. *See* Donald C. Langevoort, *Private Litigation To Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1025–26 (2005).

¹¹⁸ *Federated Municipal Funds*, SEC No-Action Letter, 2006 WL 3421853 (Nov. 20, 2006) (emphasis added). Similarly, when funds purchase joint liability insurance, the directors of each fund must determine that the contract is in its best interests. *See* 17 C.F.R. § 270.17d-1(d)(7).

lated by—the SEC.¹¹⁹ Though the SEC prohibits affiliated funds from coordinating their marketing in a single plan,¹²⁰ sponsors may apply for relief from the restriction on a case-by-case basis.¹²¹ In considering a proposed plan, the SEC does not require “absolute equality among the participants” or a precise apportionment of costs relative to the benefits for each fund,¹²² but does require that each fund board make an individualized, fund-specific determination that the arrangement falls within a “reasonable range of fairness” that will redound to the fund’s benefit.¹²³ In so concluding, the board may consider intangible benefits to the fund, such as those that flow from economies of scale, and that arise from enhancing the attractiveness of the fund complex as a whole.¹²⁴ At one point, the SEC even considered adopting a formal rule that would permit joint distribution arrangements so long as the plan was approved by independent directors who concluded that the plan both benefitted the fund, and did not place it at a disadvantage relative to other participating funds.¹²⁵

¹¹⁹ 17 C.F.R. 270.12b-1.

¹²⁰ 17 C.F.R. 270.17d-3.

¹²¹ Mutual Fund Distribution Fees; Confirmations, SEC Proposed Rule, 2010 WL 11248712 (July 21, 2010) (“any joint arrangement between funds that implicates section 17(d) and rule 17d-1 would require the funds to apply for and obtain an exemption from the Commission prior to implementing the arrangement”).

¹²² *In re* Vanguard Group, Investment Company Act Release No. 11645, 1981 WL 749192 (Feb. 25, 2011).

¹²³ Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16431, 1988 WL 1706824 (June 10, 1988).

¹²⁴ *See In re* Vanguard Group, Investment Company Act Release No. 11645, 1981 WL 749192 (Feb. 25, 2011); Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16431, 1988 WL 1706824 (June 10, 1988).

¹²⁵ *See* Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16431, 1988 WL 1706824 (June 10, 1988).

Centralized voting policies could follow a similar model. Independent directors would be expected to scrutinize such arrangements, and make fund-by-fund determinations whether, based on the fund's investment strategy as compared to the governance preferences expressed by the sponsor, participating in the arrangement would be in the fund's best interests. If they conclude that the fund's interests differ from those of other funds in the complex, they should insist that the fund vote its shares independently.

Consent to a conflict, however, is only effective if "it is specific and is given with knowledge of material facts."¹²⁶ In the context of joint distribution arrangements, for example, the SEC's proposed rule would only have granted blanket permission if the specifics of the arrangement were detailed in advance, presumably so that each fund board would be fully informed.¹²⁷ When it comes to voting and engagement, fund boards may be aware of the "material facts" with respect to generalized corporate governance policies, but they would need transaction-specific information to consent to coordinated voting and engagement on issues like mergers or company-specific resolutions. Presumably, the benefits and drawbacks of centralization on these types of votes are dependent on the particular factors involved, including an assessment of whether the fund is sacrificing more—in lost merger compensation, from lack of vigorous competition—than it is gaining through cooperation with sibling funds. Thus, for these matters, informed consent might require case-by-case board consideration.

In an alternative model, asset managers might alter their structure so that governance *research* is centralized, but actual voting determina-

¹²⁶ Deborah A. DeMott, *Forum-Selection Bylaws Refracted Through an Agency Lens*, 57 ARIZ. L. REV. 269, 282 (2015); see also Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585, n.21 (Feb. 7, 2003) ("An adviser seeking a client's consent must provide the client with sufficient information regarding the matter before shareholders and the nature of the adviser's conflict to enable the client to make an informed decision to consent to the adviser's vote. Boilerplate disclosure in a client brochure regarding generalized conflicts would be inadequate.").

¹²⁷ See Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16431, 1988 WL 1706824 (June 10, 1988).

tions are made at the fund level. That way, the family might avoid costly and duplicative determinations regarding the likely effects/outcomes of particular proposals, while allowing each fund to judge for itself what policies are likely to benefit that particular fund. To the extent that the actual voting decisions are not made by the board, but by portfolio managers—who are more informed than directors, but also employed by and beholden to the sponsoring company—procedures akin to those used for cross-client trades might be appropriate. Voting decisions and analysis could be documented, along with a description of how the votes impacted other related funds, and presented to each board on a quarterly basis for its review and approval by the independent directors.¹²⁸

Certainly, these proposals are far from ideal. One major issue concerns the heavy reliance placed on fund independent directors. As described above, even statutorily independent directors may serve on tens or hundreds of boards within a complex, raising questions about both their loyalties and their attention. However, nominally independent boards are central to the entire system of mutual fund compliance¹²⁹; if they are inadequate to the task, the issues go far beyond voting policy.

More fundamentally, these procedures would come with a price. Additional demands on the time and attention of fund boards might ultimately increase costs to the funds themselves, even to the point where the votes would no longer be cost-justified.¹³⁰ If so, then, as the SEC has acknowledged, the prudent course may be for funds not to vote at all. This alternative, however, would be better for fund investors than for

¹²⁸ Compare 17 CFR 270.17a-7, with 17 CFR 275.206(3)-2, and SEC Staff No Action Letter to Independent Directors Council (Nov. 2, 2010), <https://www.sec.gov/divisions/investment/noaction/2010/idc-mfdf110210.pdf> (requiring that boards conduct quarterly reviews of affiliated transactions; boards may “tap ...relevant expertise” to assist with the effort, including counsel and fund personnel).

¹²⁹ See Palmiter, *supra* note 15; Morley & Curtis, *supra* note 13.

¹³⁰ Costs may be justified for some funds in the complex, but not others. Active funds, for example, may collect more information about the securities they trade than passive funds, making it easier for directors of those funds to make informed decisions about voting policy. Cf. Dorothy Shapiro Lund, *The Case Against Passive Shareholder Voting* (forthcoming in *Journal of Corporation Law*), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2992046.

funds to cast suboptimal votes to shore up other funds—particularly as there will always be concerns that the ultimate beneficiaries of such votes will be funds that charge higher fees and thus generate more profits for the sponsor.

VI. CONCLUSION

Though the SEC has exhibited concern about investment advisers who use fund votes as currency to advance their own interests, it has paid less attention to the problems of interfund conflict. As a result, there is reason to believe that fund managers do not seek to maximize value at particular funds, but instead seek to maximize value across the entire fund complex. Though this might be a reasonable choice that benefits investors, it is not clear that the matter has received serious consideration. Whether due to regulation or on their own initiative, fund boards should make reasoned choices about the extent to which particular funds benefit from participating in a cooperative voting scheme with their sibling funds.

More focused attention to conflicts in voting policy—both at the regulatory level, and the fund board level—may also have a salutary effect on portfolio company management. In recent years, scholars have raised concerns that mutual funds' voting power distorts corporate policy. For example, mutual fund managers may pressure portfolio companies to achieve short-term stock price boosts at the expense of investments that would yield longer-term gains.¹³¹ Index fund managers may be relatively uninformed about portfolio companies and make poor governance decisions when voting or engaging with management.¹³² In one of the more explosive charges, it has been suggested that because fund families hold stock in multiple competing firms across their portfolios, they may encourage firms within an industry to cooperate with each other rather than compete, potentially running afoul of the spirit, and possibly the letter, of antitrust laws.¹³³ These and many other concerns about

¹³¹ See David Millon, *Looking Back, Looking Forward: Personal Reflections on a Scholarly Career*, 74 WASH. & LEE L. REV. 699, 729 (2017).

¹³² See Shapiro Lund, *supra* note 130.

¹³³ See José Azar et al., *Anti-Competitive Effects of Common Ownership*, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2427345; Einer Elhauge, *Horizontal Shareholding*, 129

the power of mutual funds have led to a variety of proposals for dramatic corporate governance reforms, including eliminating voting rights for passive investors,¹³⁴ and regulating the investment policies of mutual fund families.¹³⁵ Assuming these scholars are correct, the premise of the argument is that fund families act as a block. If a more precise articulation of fiduciary duties forced less coordination within the family itself, some of these concerns might be alleviated, without the need for upheavals of other aspects of the corporate legal regime.

HARV. L. REV. 1267 (2016); Eric A. Posner, et al., *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, <https://ssrn.com/abstract=2872754>; Fiona M. Scott Morton & Herbert J. Hovenkamp, *Horizontal Shareholding and Antitrust Policy*, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3046203.

¹³⁴ See Shapiro Lund, *supra* note 130.

¹³⁵ See Posner, *supra* note 133.