

impact on the financial fortunes of American investors, funds have been reluctant to disclose how they exercise their proxy voting power with respect to portfolio securities.¹⁰ We believe that the time has come to increase the transparency of proxy voting by mutual funds. This increased transparency will enable fund shareholders to monitor their funds' involvement in the governance activities of portfolio companies, which may have a dramatic impact on shareholder value.

Mutual funds are formed as corporations or business trusts under state law and, as in the case of other corporations and trusts, must be operated for the benefit of their shareholders.¹¹ Because a mutual fund is the beneficial owner of its portfolio securities, the fund's board of directors, acting on the fund's behalf, has the right and the obligation to vote proxies relating to the fund's portfolio securities. As a practical matter, however, the board typically delegates this function to the fund's investment adviser as part of the adviser's general management of fund assets, subject to the board's continuing oversight. The investment adviser to a mutual fund is a fiduciary that owes the fund a duty of "utmost good faith, and full and fair disclosure."¹² This fiduciary duty extends to all functions undertaken on the fund's behalf, including the voting of proxies relating to the fund's portfolio securities. An investment adviser voting proxies on behalf of a fund, therefore, must do so in a manner consistent with the best interests of the fund and its shareholders.¹³

¹⁰ See John Wasik, *Speak Loudly—Or Lose Your Big Stick*, The Financial Times, July 24, 2002, at 26 (only eight retail mutual fund groups openly disclose how they vote on proxies). We have previously prepared reports commenting on the role of institutional investors in the corporate accountability process and their impact on portfolio companies. See Division of Corporation Finance, SEC, Staff Report on Corporate Accountability (Sept. 4, 1980) (printed for the use of Senate Comm. on Banking, Housing and Urban Affairs, 96th Cong., 2d Sess.) [hereinafter SEC, Staff Report on Corporate Accountability]; SEC, Institutional Investor Study Report (Mar. 10, 1971) (printed for the use of House Comm. on Interstate and Foreign Commerce, 92nd Cong., 1st Sess.) [hereinafter SEC, Institutional Investor Study Report].

¹¹ See generally James M. Storey & Thomas M. Clyde, *Mutual Fund Law Handbook* § 7.2 (1998); Allan S. Mostoff & Olivia P. Adler, *Organizing an Investment Company—Structural Considerations* § 2.4 in *The Investment Company Regulation Deskbook* (Amy L. Goodman ed., 1997).

¹² SEC v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (interpreting Section 206 of the Investment Advisers Act of 1940). Cf. Section 36(b) of the Investment Company Act [15 U.S.C. 80a–35] (investment adviser of a fund has a fiduciary duty with respect to the receipt of compensation paid by the fund).

¹³ See Investment Advisers Act Release No. 2106, *supra* note 5. See also SEC, Staff Report on

Traditionally, mutual funds have been viewed as largely passive investors, reluctant to challenge corporate management on issues such as corporate governance.¹⁴ Funds have often followed the so-called "Wall Street rule," according to which an investor should either vote as management recommends or, if dissatisfied with management, sell the stock.¹⁵ In recent years, however, some funds, along with other institutional investors, have become more assertive in exercising their proxy voting responsibilities.¹⁶ The increased assertiveness by mutual funds in the voting of proxies may have a number of causes. In some instances, funds have come to hold such large positions in a particular portfolio company that they cannot easily sell the company's stock if the company's management is performing poorly.¹⁷ The investment policies of index funds typically do not permit them to sell poorly performing investments, and thus these funds may become active in corporate governance in order to maximize value for their shareholders.¹⁸

Recent corporate scandals have created renewed investor interest in issues of corporate governance and have

Corporate Accountability, *supra* note 10, at 391 (fiduciary principle applies to all aspects of investment management, including voting). Cf. Dep't of Labor, Interpretive Bulletins Relating to the Employee Retirement Income Security Act of 1974, 29 CFR 2509.94–2 (2002) (fiduciary act of managing employee benefit plan assets consisting of equity securities includes voting of proxies appurtenant to those securities).

¹⁴ See, e.g., SEC, Staff Report on Corporate Accountability, *supra* note 10, at 404 (investment managers have routinely supported management slates of director nominees); Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 Cardozo L. Rev. 1419, 1430–31 (2002) (discussing mutual fund passivity in corporate governance). See generally John C. Coffee, Jr., *The SEC and The Institutional Investor: A Half-Time Report*, 15 Cardozo L. Rev. 837 (1994) (institutional investors have historically been passive investors); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520 (1990) (shareholder voting has historically been passive).

¹⁵ See SEC, Staff Report on Corporate Accountability, *supra* note 10, at 392 (describing "Wall Street Rule").

¹⁶ See, e.g., Aaron Lucchetti, *A Mutual-Fund Giant Is Stalking Excessive Pay*, Wall Street Journal, June 12, 2002, at C1 (Fidelity has voted against management recommendations involving stock-option plans); Kathleen Day, *Prodding For Disclosure of Funds' Proxy Votes*, Washington Post, Apr. 8, 2001, at H1 (Domini Social Equity Fund voted against management proposal to issue additional stock options for directors).

¹⁷ See Palmiter, *supra* note 14, at 1435–36 (as holdings have increased, mutual funds have realized that they cannot easily sell blocks of poorly performing stock).

¹⁸ See Kathleen Pender, *The Influence of Indexing on the Markets*, San Francisco Chronicle, June 23, 2002, at G1 (some index funds are more likely to vote proxies because they generally cannot sell portfolio securities consistent with their investment policies).

underscored the need for mutual funds and other institutional investors to focus on corporate governance.¹⁹ The increased equity holdings and accompanying voting power of mutual funds place 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.

Moreover, in some situations the interests of a mutual fund's shareholders may conflict with those of its investment adviser with respect to proxy voting.²⁰ This may occur, for example, when a fund's adviser also manages or seeks to manage the retirement plan assets of a company whose securities are held by the fund.²¹ In these situations, a fund's adviser may have an incentive to support management recommendations to further its business interests.

Yet, in spite of the substantial institutional voting power held by mutual funds, the increasing importance of the exercise of that power to fund shareholders, and the potential for conflicts of interest with respect to the exercise of fund proxy voting power, limited information is available regarding how funds vote their proxies. At present, the Commission's rules do not require mutual funds to disclose either their proxy voting policies and procedures or their proxy voting records.²² Several mutual fund complexes voluntarily provide

¹⁹ See, e.g., Josh Friedman, *Vanguard to Turn More Activist in Proxy Voting*, Los Angeles Times, Aug. 22, 2002, at B3 (Vanguard imposing stricter corporate governance guidelines in light of recent events); Tom Hamburger, *Union Targets Corporate Change*, Wall Street Journal, July 30, 2002, at A2 (workers should use pension funds and votes to compel changes in corporate behavior); Beth Healy, *Big Investors Assuming a More Activist Stance*, Boston Globe, July 11, 2002, at C1 (big investors say they are taking a more activist stance after financial scandals at Enron, Global Crossing, and WorldCom); Russ Wiles, *Funds May Have More to Say on Governance*, Chicago Sun-Times, June 3, 2002, at F53 (investors taking a closer look at corporate governance issues as a result of Enron).

²⁰ See, e.g., Aaron Bernstein & Geoffrey Smith, *Can You Trust Your Fund Company?*, BusinessWeek Online, Aug. 8, 2002 (AFL–CIO argues that conflicts of interest lead mutual funds to vote with management).

²¹ For additional examples of potential conflicts of interest involving investment advisers, See Investment Advisers Act Release No. 2106, *supra* note 5, at Section I., "Background."

²² In general, investment companies are organized either as business trusts in Delaware or Massachusetts, or as corporations in Maryland. The applicable state statutes do not specifically permit shareholders to inspect books and records relating to proxy voting by funds with respect to portfolio securities. See Del. Code Ann. tit. 12, § 3801–3824 (2001); Mass. Gen. Laws. Ann. ch. 182, § 1–14 (2002); Md. Code Ann., Corporations § 2–512 (2001).