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## Securities Law: Proxies Pull Mutual Funds into the Sunlight: Mandatory Disclosure of Proxy Voting Records

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# Securities Law: Proxies Pull Mutual Funds into the Sunlight: Mandatory Disclosure of Proxy Voting Records\*

## I. Introduction

In August 2003, the Securities and Exchange Commission (SEC) imposed a \$750,000 fine on Deutsche Bank, an investment bank, for failing to disclose to its mutual fund investors a material conflict of interest relating to its vote on the proposed merger between Hewlett Packard (HP) and Compaq.<sup>1</sup> Deutsche Bank had seventeen million proxies to vote on behalf of individuals who had invested in its mutual funds that held HP stock.<sup>2</sup> A majority vote of HP shareholders, of whom 57% are institutional investors,<sup>3</sup> was required for the merger to succeed.

The shareholder vote became contentious as HP's Chief Executive Officer, Carly Fiorina, and HP board member and son of HP's co-founder, Walter Hewlett (Hewlett), publicly battled for shareholder support of their positions.<sup>4</sup> Both Fiorina and Hewlett lobbied large shareholders, especially institutional

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\* The author would like to thank Professor Steven J. Cleveland for his assistance with the preparation of this note.

1. Ina Fried, *Deutsche Bank Resolves HP Merger Issue* (Aug. 19, 2003), at [http://news.com.com/2100-1014\\_3-5065555.html](http://news.com.com/2100-1014_3-5065555.html); see also *SEC Brings Settled Enforcement Action Against Deutsche Bank Investment Advisory Unit in Connection with Its Voting of Client Proxies for Merger Transaction; Imposes \$750,000 Penalty* (Aug. 19, 2003), at <http://www.sec.gov/news/press/2003-100.htm> [hereinafter *SEC Brings Settled Enforcement Action*].

2. *SEC Brings Settled Enforcement Action*, *supra* note 1. As discussed later in detail, shareholders of public companies have the right to vote on matters affecting the corporation. When an individual invests in a mutual fund managed by an investment company, the duty to vote is delegated to the mutual fund, whose management serves as the "proxy" for the true owner of the shares. The term "proxy" is defined in federal securities laws as a "consent"; the term is also used to describe the permission to vote on another's behalf, as well as the statement discussing shareholder proposals issued by the corporation in preparation for the shareholders' meeting. See General Rules and Regulations, Securities and Exchange Act of 1934, 17 C.F.R. § 240.14a-1(f) (2003).

3. Louise Kehoe & Scott Morrison, *Fiorina Comes a Step Closer to Making the Connection: Shareholders Face Big Decision on Deal*, *FIN. TIMES*, Mar. 7, 2002, at 26. The term "institutional investor" typically refers to mutual funds or pension funds, which are corporate entities that trade securities in large volumes on behalf of others.

4. Fiorina forecasted that the merger would be the key to HP's long-term growth. Hewlett opposed the merger, arguing that the move would reduce HP's stock price. Hewlett acted on behalf of the William and Flora Hewlett Foundation and the William R. Hewlett Revocable Trust, which together own more than 18% of HP's stock. Kehoe & Morrison, *supra* note 3.

investors, for support.<sup>5</sup> Ultimately, shareholders approved the merger, by a vote of 51% to 49%, with a margin of only forty-five million votes.<sup>6</sup>

The SEC initiated an investigation into Deutsche Bank's vote after a California newspaper leaked a voicemail from Fiorina.<sup>7</sup> In her message to HP Chief Financial Officer Bob Wayman, Fiorina stated that HP might "have to do something extraordinary" to capture the votes of the shares held by Deutsche Bank.<sup>8</sup> Deutsche Bank's investment banking arm was already working with HP on financing related to the merger and earning fees for this effort.<sup>9</sup> Further, a lawsuit filed by Hewlett immediately after the shareholder vote alleged that Deutsche Bank had already voted its shares against the merger when individuals from its commercial banking division intervened and initiated a meeting between HP management and the individuals responsible for voting the proxies.<sup>10</sup> Subsequently, Deutsche Bank changed its votes to support the merger.<sup>11</sup>

Although the SEC's investigation did not determine that Deutsche Bank's relationship with HP affected its vote for the merger,<sup>12</sup> and the Hewlett lawsuit

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5. *Id.* Both Fiorina and Hewlett lobbied Institutional Shareholder Services (ISS), the third-party proxy research firm, for its recommendation; clients of ISS owned 23% of HP's stock. *Id.* One such client was Barclays Global Investors, which had pledged to vote its sixty million shares in accordance with the ISS recommendation. *Hewlett v. Hewlett-Packard Co.*, No. 19513-NC, 2002 Del. Ch. LEXIS 35, at \*34 (Del. Ch. Apr. 30, 2002). Fiorina and Hewlett each made two visits to ISS analyst Ram Kumar, who was responsible for determining ISS's recommendation. John Haberstroh, *Activist Institutional Investors, Shareholder Primacy, and the HP-Compaq Merger*, 24 *HAMLIN J. PUB. L & POL'Y* 65, 87-88 (2002).

6. Ariana Eunjung Cha, *Deutsche Bank Pays \$750,000 in SEC Settlement*, *WASH. POST*, Aug. 20, 2003, at E1.

7. John Markoff, *U.S. Agencies Looking into Hewlett Vote*, *N.Y. TIMES*, Apr. 16, 2002, at C1.

8. *Id.*

9. See Cha, *supra* note 6 (reporting that the SEC had found that Deutsche Bank received \$1 million for "market intelligence" relating to the merger, and was to receive an additional \$1 million at the successful completion of the transaction); see also *SEC Brings Settled Enforcement Action*, *supra* note 1.

10. See *Hewlett*, 2002 Del. Ch. LEXIS 35, at \*\*2-3.

11. See *id.* The SEC, in its administrative proceeding, found that after Deutsche Bank had voted its proxies, two members of the investment banking side of the bank had intervened on HP's behalf. The SEC stated that "[a] reasonable advisory client would want to know that its fiduciary, which was called upon to vote client proxies on a merger, had been contacted by officials of its affiliated investment bank in connection with an engagement directly related to the subject of the proxy vote." *Deutsche Asset Management, Investment Advisers Act of 1940*, Release No. 2160, 2003 SEC LEXIS 1977, at \*\*10-11. Based on Deutsche Bank's failure to disclose, the SEC found that Deutsche Bank had "willfully violated Section 206(2) of the Investment Advisers Act." *Id.* at \*11.

12. *Deutsche Asset Management*, 2003 SEC LEXIS 1977, at \*11. The SEC determined that Deutsche Bank should have disclosed its conflict of interest to shareholders on whose behalf

was dismissed,<sup>13</sup> the conflict of interest identified by the SEC in this case illustrates the types of conflicts that have given rise to new SEC regulations. Two of these regulations specifically address the process and procedure for voting client proxies. The first clarifies the fiduciary obligation of voting proxies in the best interests of an investment adviser's clients. The second regulation requires mutual funds to disclose their proxy voting policies and procedures, as well as their actual votes on specific proposals.<sup>14</sup> The SEC described its rationale for the new regulations as the ongoing quest for greater transparency and as a means "to prevent material conflicts of interest from affecting the manner in which advisers vote clients' proxies."<sup>15</sup>

This note discusses the new proxy disclosure rules as proposed and adopted by the SEC in early 2003, and ultimately argues that the rules are a relatively cost-effective means to combat conflicts of interest in the mutual fund industry. Part II examines the changing nature of institutional investors and how the rise of such investment, along with the structure of mutual funds, have caused the SEC to conclude that the current regulations fail to protect individual investors. Part III reviews the labyrinth of securities and proxy regulation at the state and federal levels. In addition, Part III examines the new proxy disclosure regulations in greater detail, as well as the comments that these regulations generated from the financial services industry. Part IV argues that the proxy disclosure regulations will do little to benefit the individual shareholder, but dismissing these regulations on this basis alone would be premature. Further, Part IV briefly looks at these regulations in light of long-held and emerging beliefs about law and economics, and concludes

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Deutsche Bank voted by proxy, but stated that there was no requirement to show client harm to establish a violation of the Advisers Act. *Id.* at \*10. Consequently, the SEC did not opine whether the votes were made in the best interest of Deutsche Bank's clients. *Id.* at \*11. The lack of disclosure alone creates the violation because, without it, clients cannot decide whether to retain the adviser or use other means to protect their interests. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 196 (1963).

13. The Delaware Chancery Court was disconcerted by the fact that Deutsche's investment banking division initiated the meeting between the Proxy Working Group and HP management and found this to "raise[] clear questions about the integrity of the internal ethical wall that purportedly separates Deutsche Bank's asset management division from its commercial division." *Hewlett*, 2002 Del. Ch. LEXIS 35, at \*\*59-60. Despite this concern, the court found that the evidence indicated the group's intent to vote in the best interest of individual investors. *Id.*

14. Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585 (Feb. 7, 2003) [hereinafter Proxy Voting by Investment Advisers]; Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 68 Fed. Reg. 6564 (Feb. 7, 2003) [hereinafter Disclosure of Proxy Voting].

15. Proxy Voting by Investment Advisers, *supra* note 14, at 6585-86.

that proxy disclosure is a relatively simple and cost-efficient way to deter mutual fund advisers from voting against the clients' best interests.

## II. Prelude to Mandatory Disclosure

### A. The Changing Nature of Investors and Institutions

The image of individual shareholders in publicly held companies has slowly faded away during recent decades as mutual funds have begun to play a dominant role in individuals' investment strategies.<sup>16</sup> Traditionally, individual investors were passive investors, employing a "hold or trade" policy.<sup>17</sup> If shareholders disagreed with management, they would sell their shares.<sup>18</sup> In contrast, if shareholders agreed with management decisions, they would continue to hold their shares.<sup>19</sup> The individual shareholder did not actively participate in the governance of the corporation because of the significant informational costs; a single shareholder would need to invest considerable time and effort to learn about and monitor the corporation. Despite the investment of time and effort, there was little chance that a single informed shareholder, acting alone, could influence the corporation.<sup>20</sup>

Mutual funds have the potential to change that dynamic. Mutual funds hold about \$2 trillion in publicly traded corporate equity,<sup>21</sup> representing the

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16. Stuart L. Gillan & Laura T. Starks, *Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors*, 57 J. FIN. ECON. 275, 278 (2000) [hereinafter Gillan & Starks, *Corporate Governance*].

17. Stuart L. Gillan & Laura T. Starks, *A Survey of Shareholder Activism: Motivation and Empirical Evidence*, CONTEMP. FIN. DIG., Autumn 1998, at 10.

18. *Id.*

19. *Id.*

20. Gillan & Starks, *Corporate Governance*, *supra* note 16, at 279. Adolf A. Berle and Gardiner C. Means were the original theorists behind the "atomization" of ownership; they hypothesized that individual shareholders were scattered geographically and could not easily organize themselves to form a voting block. Accordingly, "no individual shareholders were willing to invest the necessary time and effort to monitor management because their interest was small and, if they did so, other shareholders would 'free ride' on their efforts." Robert W. Hamilton, *Corporate Governance in America 1950-2000: Major Changes but Uncertain Benefits*, 25 J. CORP. L. 349, 350 (2000). Further, dissatisfied shareholders used the trade policy and sold their stock, leaving only those shareholders who were supportive of management. Consequently, "management was assured that shareholders would routinely approve management proposals, and that as a practical matter, the power of shareholders to select directors was purely theoretical." *Id.*

21. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., *FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES* 90 (Dec. 5, 2002), available at <http://www.federalreserve.gov/releases/z1/20021205/z1.pdf> (estimating \$2.005 trillion market value of mutual fund corporate equity holdings and \$10.960 trillion market value of all corporate equity issued at the end of the third quarter of 2002). The Investment Company Institute found that equity fund assets totaled

investment of more than ninety-five million individual investors.<sup>22</sup> These institutional shareholders have such immense holdings that they cannot maintain a “hold or trade” policy; if a fund attempted to sell significant numbers of shares on the market, the share price would drop in response.<sup>23</sup> Because they cannot liquidate their holdings without suffering significant financial losses, institutional investors are incentivized to monitor their portfolio companies.

These monitoring activities typically focus on the governance of the corporation as a mechanism to increase value and decrease risk.<sup>24</sup> As with individual shareholders, institutional investors use their proxy votes as the principal way to influence the governance activities of a publicly traded corporation.<sup>25</sup> The growing recognition of the power of institutional investors is illustrated by the shift of assets to mutual funds that encourage shareholder activism.<sup>26</sup> The number of regulations adopted by the SEC that attempt to

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\$2.667 trillion on December 31, 2002. INVESTMENT CO. INST., MUTUAL FUND FACT BOOK 23 (2003), available at [http://www.ici.org/stats/mf/2003\\_factbook.pdf](http://www.ici.org/stats/mf/2003_factbook.pdf) [hereinafter MUTUAL FUND FACT BOOK].

22. MUTUAL FUND FACT BOOK, *supra* note 21, at 41.

23. Gillan & Starks, *Corporate Governance*, *supra* note 16, at 278.

24. See Roberto Newell & Gregory Wilson, *A Premium for Good Governance*, MCKINSEY Q., Summer 2002, at 20 (finding that institutional investors are, on average, willing to spend more to acquire a stake in a company with strong governance values and practices). The extent of an institution's involvement in governance activities varies. For example, pension funds, such as CalPERS (California Public Employees' Retirement System), are better known for their activism than corporate funds. See Douglas M. Branson, *Corporate Governance "Reform" and the New Corporate Social Responsibility*, 62 U. PITT L. REV. 605, 633 (2001).

25. E-mail from Diane Tod South, Director of Social Research, Citizens Funds, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 3, 2002), at <http://www.sec.gov/rules/proposed/s73602/dtsouth1.txt> (observing that “proxy voting . . . is the primary forum through which shareowners participate in the governance of a corporation, and through which corporate management seeks affirmation and approval from shareowners”).

26. See, e.g., Jerry Guidera, *Shareholder Activists Win Two Big Ones*, WALL ST. J., May 9, 2002, at C1; Alison Maitland, *Social Concerns Edge into the Mainstream*, FIN. TIMES, Sept. 29, 2003, at 2. In addition, the Social Investment Forum (SIF), a membership organization for socially responsible investment funds or funds that maintain a greater focus on shareholder advocacy, found in its 2001 survey that assets managed by such funds exceeded \$2 trillion, a 36% increase from its last biennial survey. In its 2003 survey, funds under management by socially responsible investment entities increased by 7% while, on average, funds under management decreased by 4% overall. SIF also tracked a 15% increase in shareholder proxies, another indicator of shareholder activism. Finally, SIF documented that assets involved in socially responsible investing, including shareholder advocacy, have increased 40% faster than all assets under professional management between 1995 and 2003. SIF, 2003 REPORT ON SOCIALLY RESPONSIBLE INVESTING TRENDS IN THE UNITED STATES i-ii, available at [http://www.socialinvest.org/areas/research/~trends/sri\\_trends\\_report\\_2003.pdf](http://www.socialinvest.org/areas/research/~trends/sri_trends_report_2003.pdf) (last updated Dec. 2003).

combine the financial benefits of mutual funds with their increasing authority in matters of corporate governance further demonstrate the potential mutual funds hold for increased shareholder value.<sup>27</sup>

### *B. The Structure of Mutual Funds*

Mutual funds have grown in importance as investment vehicles for individuals who have entered the financial markets.<sup>28</sup> Mutual funds invest in diverse securities to offer investors a reduction in risk without a significant reduction in their return on investment.<sup>29</sup> When individuals invest in mutual funds, they use one vehicle to acquire a stake in potentially hundreds of different companies depending on the diversity of the particular fund's holdings.<sup>30</sup> Individuals receive a pro rata stake in the individual holdings of the fund based on the amount of their investment in the fund and receive the benefit of a professional investment manager for a fee.<sup>31</sup>

A portfolio with holdings in a large number of companies in different industries decreases the risk of investment because companies are affected differently by changes in the economy. During the recent period of "irrational exuberance" in the stock market,<sup>32</sup> an individual who had invested solely in a

27. See Matthew R. Morey, Testimony Before the House Subcommittee on Government Efficiency and Financial Management (Apr. 20, 2004), at <http://reform.house.gov/UploadedFiles/Morey%20Testimony%20-%20April%2020,%202004.pdf> (encouraging greater funding for SEC enforcement and more regulations on the frequency and form of disclosure, and stating that SEC funding "does not take into consideration that the importance of funds has dramatically increased since 1990").

28. Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 CARDOZO L. REV. 1419, 1427 (2002).

29. MUTUAL FUND FACT BOOK, *supra* note 21, at 3.

30. For example, the Growth Fund of America (the Growth Fund), managed by the American Funds, held equity in 189 companies as of June 30, 2003. See GROWTH FUND OF AMERICA PROSPECTUS (Nov. 1, 2003), available at [http://www.americanfunds.com/pdf/shareholder/gfa-010\\_gfap.pdf](http://www.americanfunds.com/pdf/shareholder/gfa-010_gfap.pdf). The prospectus is also available through the SEC's Electronic Data Gathering, Analysis, and Retrieval System (EDGAR), at <http://www.sec.gov/Archives/edgar/data/44201/00004420103000005/gfa485b.txt> [hereinafter GROWTH FUND OF AMERICA PROSPECTUS].

31. An investor pays an annual fee to invest in a mutual fund. This fee covers the costs of managing the fund and other administrative costs, such as accounting, clerical, and filing costs. The amount of the fee is typically assessed as a percentage of the total assets held by the fund. MUTUAL FUND FACT BOOK, *supra* note 21, at 3, 15.

32. Alan Greenspan, Chairman of the Federal Reserve, coined this phrase during a speech at the American Enterprise Institute to describe the overvaluation of the stock market. Greenspan asked, "[H]ow do we know when irrational exuberance has unduly escalated asset values . . . ?" Alan Greenspan, Remarks at the Annual Dinner and Francis Boyer Lecture of the American Enterprise Institute for Public Policy Research (Dec. 5, 1996), at <http://www.federalreserve.gov/boarddocs/speeches/1996/19961205.htm>.

technology fund suffered significantly greater losses than an investor who had invested in a fund that held other stock along with its technology shares.<sup>33</sup> In this way, diversification protects an individual investor from downturns in any one industry. Also, by placing an investment in a fund with thousands or millions of other investors, individuals are able to acquire a small stake in a large number of companies, which effectively shelters their investment from some market fluctuation.<sup>34</sup> In addition, an investor may reduce risk by investing in a number of different funds, as various funds have different investment strategies and invest in different types of securities. There are funds that invest solely in bonds, those that seek aggressive growth, and others that focus on regular dividends.<sup>35</sup> The variety of mutual fund offerings, all using the principle of diversification, is another advantage mutual funds offer investors.

### C. Conflicts of Interest

The effectiveness of mutual funds in reducing risk has caused them to become one of the principal ways in which investors participate in financial markets.<sup>36</sup> As the amount of money under management at mutual funds continues to grow, commentators and investment professionals warn investors

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33. A brief look at the performance history of funds offered by Fidelity demonstrates that risk can be reduced if an investment is spread among a variety of companies and industries. The Oppenheimer Emerging Technologies Fund, which invests solely in the technology sector, shows a one-year average return of 59%, while the average return over the life of the fund is a negative 31.4%. In contrast, Fidelity's Value Fund, which invests in more than 280 companies across ten major market sectors, has a one-year return on investment of 18% and a ten-year average of 11.3%. Another way of comparing risk is to look at a fund's "beta" value, a measure of the fund's volatility compared to the market as a whole. A beta of 1.0 indicates that a fund tracks the changes in the market overall — when the market goes up, the fund goes up. As of August 31, 2003, Oppenheimer's Emerging Technology Fund had a beta of 2.06, indicating extreme volatility, while Fidelity's Value Fund had a beta of 0.75, indicating less sensitivity to market changes. See Fidelity Investments, at <http://www.fidelity.com> (last visited Nov. 23, 2004).

34. For example, the Growth Fund has over 2.6 million investors and holdings in almost 200 companies. The Growth Fund's largest holdings are in the semiconductor and media industries, in which it invests 19.6% and 9.8%, respectively, of the fund's assets. Within each industry, however, the Growth Fund holds the stock of numerous companies. For example, within the media industry, the Growth Fund invests 3.3% of its assets in AOL Time Warner, 1.8% in Viacom, and 0.53% in Fox Entertainment Group. GROWTH FUND OF AMERICA PROSPECTUS, *supra* note 30.

35. SECTION OF BUS. LAW, AM. BAR ASS'N, A FIDUCIARY'S GUIDE TO FEDERAL SECURITIES LAWS 254-55 (1994).

36. See Christopher B. Bernard, *Toward an International Market in Mutual Funds*, 36 VA. J. INT'L L. 467, 468 (discussing diversification and risk reduction as primary motivators for mutual fund investment).



of the potential weaknesses of mutual fund accountability.<sup>37</sup> As the example of Deutsche Bank illustrates, the organization of a mutual fund may incentivize fund boards or advisers to act in ways that do not promote shareholder value.

A mutual fund is registered as either a corporation or a trust,<sup>38</sup> but differs from these entities because it is “organized and operated by people whose primary loyalty and pecuniary interest lies outside the enterprise.”<sup>39</sup> Technically, a mutual fund has no employees of its own, but instead is organized and managed by a separate “sponsor,” which, along with independent contractors, provides all services necessary for the fund’s operation.<sup>40</sup> The sponsor may be a bank, insurance firm, financial services firm, or securities broker.<sup>41</sup> The sponsor employs and compensates any and all officers of the fund, including the board of directors.<sup>42</sup>

This structure may result in significant conflicts of interest, most notably where the fund’s sponsor has business relationships with the companies held in the fund’s portfolio.<sup>43</sup> In the case of the HP-Compaq merger, Deutsche Bank’s investment banking division had a contract with HP for merger-related services and would earn an additional \$1 million upon the merger’s completion.<sup>44</sup> At the same time, Deutsche Asset Management was earning fees from investors for managing shares of HP stock in its mutual fund holdings, shares that had voting rights that Deutsche exercised in support of the merger.<sup>45</sup>

A mutual fund’s management of the retirement plan assets of a company whose stock is also held in that mutual fund is another example of an inherent conflict. For example, Fidelity Investments voted against a shareholder proposal requesting that Tyco International maintain a majority of

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37. See, e.g., Sara Hansard, *Conference Call — Bogle: Big Investor Should Use Clout to Curb Fund Abuses*, INVESTMENT NEWS, May 13, 2002, at 18; Palmiter, *supra* note 28, at 1468-69.

38. MUTUAL FUND FACT BOOK, *supra* note 21, at 1.

39. DIV. OF INVESTMENT MGMT., U.S. SEC. PROTECTING INVESTORS: A HALF-CENTURY OF INVESTMENT COMPANY REGULATION 251 (1992).

40. *Id.* at 251 n.3.

41. *Id.*

42. *Id.*

43. *Id.* The classic example, as with Deutsche Bank, is a mutual fund managed by an investment bank that also provides services to portfolio companies. Investment banking fees can be much more lucrative than investment advisory fees. Congress recognized these conflicts when it passed the Investment Company Act of 1940 and created a system of “corporate democracy” to combat the abuses arising from conflicts of interest. *Id.* at 251-52.

44. Deutsche Asset Management, Investment Advisers Act of 1940, Release No. 2160, 2003 SEC LEXIS 1977, at \*4.

45. See Cha, *supra* note 6.

independent board members.<sup>46</sup> At the time of the vote, Fidelity was managing Tyco's employment benefit plan and was earning millions of dollars in fees for this service.<sup>47</sup> In the aftermath of the corporate scandal at Tyco,<sup>48</sup> Fidelity's vote may lend credence to the assertion that mutual funds have inherent conflicts of interests that must be mitigated through regulation or other mechanisms.

### *III. Mutual Fund Regulation and Regulation of Proxy Voting: Old and New*

These conflicts illustrate the source of increased concern about the sufficiency of mutual fund regulation. Currently, mutual funds are subject to two layers of regulation, state and federal.

#### *A. Proxy Voting Under State Law*

State law governs shareholder voting rights and the prescribed method of exercising shareholder franchise.<sup>49</sup> The general rule governing the voting of shares provides for one vote for each outstanding share on each matter before the shareholders.<sup>50</sup> By default, shareholders vote on significant matters, such as those decisions outside of the ordinary course of business, including mergers,<sup>51</sup> sales of significant assets,<sup>52</sup> and dissolution.<sup>53</sup> In addition, shareholders vote annually to elect directors — their representatives within the organization — who in turn select the officers of the corporation.<sup>54</sup>

In addition to establishing the items on which a shareholder is entitled to vote, state law typically dictates the mechanics of a shareholder vote. State law allows for individuals to delegate their voting rights to another by proxy.<sup>55</sup> In the case of mutual funds or other intermediaries, individual investors

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46. Matthew Benjamin, *Leaving the Little Guy Behind*, U.S. NEWS & WORLD REP., Oct. 21, 2002, at 50.

47. *Id.*

48. Former CEO Dennis Kozlowski has been indicted on securities fraud charges and is accused of looting the company of more than \$600 million. Carrie Johnson, *Judge Dismisses Charge Against Ex-Tyco CEO; Fraud, Evasion Counts To Be Tried Separately*, WASH. POST, Nov. 3, 2004, at E1.

49. Under Delaware General Corporation Law, a corporation may determine the voting powers for each class of stock it issues. DEL. CODE ANN. tit. 8, § 151(a) (2003). This flexibility is one attractive aspect of Delaware's corporate law. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 213 (1991).

50. DEL. CODE ANN. tit. 8, § 212(a) (2001).

51. *Id.* § 251.

52. *Id.* § 271.

53. *Id.* § 275.

54. *Id.* § 141.

55. *Id.* § 212.

implicitly or explicitly delegate voting rights to the fund itself.<sup>56</sup> A representative from the fund, typically the investment manager, votes the proxies on behalf of the individuals invested in the fund.<sup>57</sup>

### *B. Proxy Voting Under Federal Law*

Although state law and corporate charters detail shareholder rights in voting, securities law and the regulation of proxies remains federal law. Congress passed most of the securities laws in the 1930s and 1940s in reaction to the stock market crash in 1929.<sup>58</sup> While federal securities law historically has focused on disclosure, until the 2003 proxy voting and disclosure regulations there was no mandatory disclosure of voting or other governance activities.<sup>59</sup> The Investment Company Act,<sup>60</sup> which governs mutual funds, and the Investment Advisers Act,<sup>61</sup> which governs mutual funds and the individual advisers within a fund, offered no guidance to either advisers or mutual funds voting on behalf of individual shareholders.<sup>62</sup>

In contrast to federal securities law's lack of regulation concerning proxy voting, the Employee Retirement Income Security Act of 1974 (ERISA),<sup>63</sup> which governs employee benefit plans in the private sector, provides detailed guidance on the fulfillment of fiduciary duties relating to proxies. ERISA provides requirements as to voting, documenting votes, and monitoring requirements for the mutual funds subject to the statute.<sup>64</sup> Indeed, one

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56. Indeed, this is one of the benefits of investing in a mutual fund, as the informational costs discussed above are borne by the mutual fund in exchange for the annual advisory fee. See *supra* note 20 and accompanying text.

57. THOMAS P. LEMKE & GERALD T. LINS, REGULATION OF INVESTMENT ADVISERS § 2.02[16] (2001).

58. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963). In *SEC v. Capital Gains Research*, the U.S. Supreme Court stated that a "fundamental purpose [of] these statutes, was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* [let the buyer beware] . . ." *Id.* at 186. Each state also has its own securities laws, which focus largely on sales practices and the prevention of fraud, as well as licensing issues. See Stefania A. Di Trolio, *Public Choice Theory, Federalism, and the Sunny Side to Blue-Sky Laws*, 30 WM. MITCHELL L. REV. 1279, 1283-87 (2004).

59. Palmiter, *supra* note 28, at 1441.

60. 15 U.S.C. § 80a (2000).

61. *Id.* § 80b.

62. Until these new rules, guidance for investment advisers was limited to the SEC staff's informal interpretation of the antifraud section of the Investment Advisers Act of 1940. LEMKE & LINS, *supra* note 57, § 2.02[a]; see also *Proxy Voting by Investment Advisers*, *supra* note 14, at 6585.

63. 29 U.S.C. §§ 1001-1461 (2000).

64. The Department of Labor issued an Interpretive Bulletin stating that the fiduciary duty of managing assets under retirement plans includes the voting of proxies, and that fund

challenge for mutual funds governed by both securities law and ERISA was the different standard applied by each. The new regulations bring federal securities law in line with the ERISA standards.<sup>65</sup> The mandatory public disclosure of individual proxy votes made by investment companies emphasizes that voting client proxies and subsequently disclosing those votes is a duty owed to individual investors.<sup>66</sup>

### C. *The New Regulations*

In January 2003, the SEC adopted regulations governing (1) proxy voting by registered investment advisers, and (2) the disclosure of voting policies and actual votes cast by mutual funds.<sup>67</sup> These changes affect three seminal bodies of law for securities regulation: the Securities Act of 1933,<sup>68</sup> the Securities Exchange Act of 1934,<sup>69</sup> and the Investment Company Act of 1940.<sup>70</sup> By

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managers are obligated to vote proxies on items that will affect the value of the plan. Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974, 29 C.F.R. § 2509.94-2 (2003). Fiduciaries may delegate the duty of voting to a third party, but that act alone does not relieve fiduciaries of their duty. *Id.* Rather, the fiduciary naming the investment manager for the plan is required to monitor the performance of the manager, including the manager's voting of client proxies. *Id.* Further, fulfillment of this monitoring requirement mandates the appropriate documentation of proxy voting records. *Id.* Finally, the Interpretive Bulletin stated that active monitoring and communication with corporate management is "consistent with a fiduciary's obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such [activities] . . . [are] likely to enhance the value of the plan's investment . . . ." *Id.* Such expectations are reasonable when investments are held for long-term growth, or when the size of a fund's holdings would make the sale of the investment difficult. With some types of investments, such as index funds, the Department of Labor stated that the "prudent exercise of proxy voting rights or other forms of corporate monitoring . . . may be the only method available for attempting to enhance the value of the portfolio." *Id.*

65. The SEC's rule on the voting of client proxies does not require plan fiduciaries to be "activist," in contrast to the standard required by ERISA. *See* Proxy Voting by Investment Advisers, *supra* note 14, at 6585, 6587.

66. Curiously, though, the regulation addressing disclosure is very similar to regulations proposed by the SEC in 1978. *See* Proposed Rules Relating to Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance, Securities Exchange Act Release No. 14,970, 1978 SEC LEXIS 1127 (July 18, 1978). The 1978 proposal did not require disclosure of actual votes, contrary to the urging of several commentators, but did require that funds disclose the number of times they voted for and against management. *Id.*

67. Proxy Voting by Investment Advisers, 17 C.F.R. § 275.206(4)-6 (2003); Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 17 C.F.R. § 270.30b1-4.

68. 15 U.S.C. § 77a (2000).

69. *Id.* § 78a.

70. *Id.* § 80a.

enacting these changes, the SEC now places the voting of proxies within an adviser's duties of care and loyalty and requires greater disclosure on the part of institutional investors.<sup>71</sup> The SEC stated that the amendments were necessary to increase transparency in the market, which will instill confidence in investors and may lead to an increase in shareholder value.<sup>72</sup>

### *1. Regulation Governing Proxy Voting*

The first of the two SEC regulations addresses the voting of client proxies by investment advisers registered with the SEC.<sup>73</sup> In this regulation, the SEC clarifies the previous informal interpretation of the antifraud provisions of the Advisers Act by expressly affirming that voting client proxies is indeed an exercise of the investment adviser's fiduciary duty.<sup>74</sup> The duty of care mandates that advisers vote when their monitoring of corporate events dictates action or when the benefits of voting outweigh the costs.<sup>75</sup> The duty of loyalty requires advisers to vote proxies to maximize shareholder value, which is considered to be in the clients' best interests.<sup>76</sup>

In addition to the confirmation of voting as a fiduciary duty, the regulation requires each investment adviser to develop policies and procedures relating to the voting of client proxies, particularly the steps the investment adviser

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71. Proxy Voting by Investment Advisers, *supra* note 14, at 6585.

72. *Id.*

73. The new rule mandating the creation of proxy voting policies and procedures may be found at Proxy Voting by Investment Advisers, 17 C.F.R. § 275.206(4)-6. The amendments to Rule 204-2, which describes the record-keeping requirements, may be found at Records to be Maintained by Investment Advisers, 17 C.F.R. § 275.204-2. Both are amendments to the Investment Advisers Act of 1940, 15 U.S.C. § 80b.

74. Proxy Voting by Investment Advisers, *supra* note 14, at 6585. In *SEC v. Capital Gains Research*, the U.S. Supreme Court found that all investment advisers owe fiduciary duties to their clients as a matter of law. The Court stated, "Courts have imposed upon a fiduciary an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts . . .'" *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (quoting WILLIAM L. PROSSER, *LAW OF TORTS* 534-35 (2d ed. 1955)). This fiduciary duty did not extend to the voting of client proxies until the SEC released the new regulations in January 2003. Proxy Voting by Investment Advisers, *supra* note 14, at 6585.

75. Proxy Voting by Investment Advisers, *supra* note 14, at 6585. The SEC clarifies that in every instance a failure to vote would not constitute a violation of the adviser's fiduciary duty. The agency further states that in some situations, the costs of voting a client's proxies, as in the instance of foreign securities that might require travel or the expense of a translator to vote, would outweigh the benefits of voting. *Id.* at 6587. The duty imposed under this rule differs from ERISA, which seems to require the active solicitation of, support of, or opposition to items up for shareholder votes. *Id.*

76. *Id.*

should take in cases where there is a material conflict of interest.<sup>77</sup> As mentioned previously, these conflicts can arise where a financial services firm earns revenue from both investment banking and mutual fund fees or where an adviser is selected by management to oversee employer pension plans.<sup>78</sup> The SEC does not provide approved methods to resolve conflicts but states that following a predetermined policy of voting or relying on an independent third party to vote are both appropriate means to insulate a voting decision from the adviser's conflict of interest.<sup>79</sup>

In addition to the development of voting policies and the voting of proxies in the best interests of an adviser's clients, an adviser must provide requesting clients with a copy of the adviser's actual proxy votes.<sup>80</sup> In contrast, the regulation for investment companies, discussed in the following section, mandates public disclosure of votes as a means to inform shareholders.<sup>81</sup>

## 2. Regulation Requiring the Disclosure of Proxy Votes

In addition to the regulation regarding proxy voting by investment advisers, the SEC concurrently released a regulation specifically directed at investment companies.<sup>82</sup> Similar to the requirements for investment advisers, the SEC now requires investment companies to develop and adopt proxy voting policies, including the procedures that the fund will follow to reach a decision

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77. 17 C.F.R. § 275.206(4)-6. The regulations require advisers to provide clients with a summary of the policy and to furnish a copy of the policy to clients upon request. *Id.* The final rule also mandates record keeping of proxy materials. *See* Records to be Maintained by Investment Advisers, 17 C.F.R. § 275.204-2.

78. *See supra* Part II.C.

79. Proxy Voting by Investment Advisers, *supra* note 14, at 6585. The SEC recognizes that many funds will retain or continue to retain third-party proxy services to comply with these regulations. *Id.* at 6591.

80. 17 C.F.R. § 275.206(4)-6. The SEC anticipates that this disclosure will be included in the adviser's written brochure required under Rule 204-3 of the Investment Advisers Act of 1940. Proxy Voting by Investment Advisers, *supra* note 14, at 6585, 6590.

81. *See infra* notes 82-89 and accompanying text. The SEC imposed the rule regarding proxy voting on all advisers registered with the fund. For those with a comparatively small number of clients, responding to client requests for specific votes will not present a significant logistical challenge. For investment companies, the public posting of proxy votes is a more efficient use of resources. Further, as stated in the release discussing the new regulations, the SEC was concerned that requiring public disclosure of adviser votes would reveal client holdings. Proxy Voting by Investment Advisers, *supra* note 14, at 6585, 6590.

82. Disclosure of Proxy Voting, *supra* note 14, at 6564. Although the regulations will also apply to other registered investment companies, such as closed-end investment companies and insurance company accounts organized as investment companies, the regulations focused on mutual funds, also known as open-end management investment companies. *See* Investment Company Act, 15 U.S.C. §§ 80a-4, 80a-5(a)(1) (2000).

on a shareholder resolution.<sup>83</sup> Mutual funds must disclose the policy to the fund's shareholders, as well as the steps the mutual fund will take in cases where a conflict of interest exists.<sup>84</sup> Most controversially, the SEC regulation requires mutual funds to disclose the fund's vote on each resolution for all publicly traded companies held in the fund's portfolio. In conjunction with these regulations, the SEC adopted a new form for annual reporting of the complete proxy voting record, which must be filed with the agency.<sup>85</sup>

As for the disclosure of a fund's votes on specific resolutions, the SEC allows a fund to either post this information on its website or to furnish the information to interested persons upon request.<sup>86</sup> The SEC requires the company to disclose the following: the company name, the shareholder meeting date, a brief description of each resolution, whether the resolution was proposed by shareholders or management, whether the fund voted for or against the resolution, and whether the fund voted with or against management.<sup>87</sup> Finally, the SEC requires mutual funds to tell shareholders in their annual and semiannual reports how shareholders can access a fund's voting record.<sup>88</sup> In contrast to its proposed rule, the SEC elected not to require funds to disclose and explain their rationale when the funds vote contrary to their stated policies.<sup>89</sup>

#### *D. Industry Response to the Proposed Regulations*

After new rules are proposed, the SEC allows a public comment period during which the agency accepts comments on and suggestions for the proposed regulations. During the eleven-week period that the SEC provided

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83. Disclosure of Proxy Voting, *supra* note 14, at 6564. The regulations require a fund's initial registration statement, specifically the Statement of Additional Information (SAI), to disclose a fund's proxy voting policies, and funds will file an annual report disclosing the actual proxy votes. *Id.*

84. *Id.*

85. *Id.* Form N-PX is the new, adopted form, and funds must provide a complete voting record for the twelve-month period ending June 30 of each year. *Id.*

86. *Id.* The proposed rule would have required mutual funds to provide individuals with a copy of voting records upon request. Disclosure of Proxy Voting, Policies and Proxy Voting Record by Registered Management Investment Companies, 67 Fed. Reg. 60,828 (Sept. 26, 2002) [hereinafter Policies and Proxy Voting Record]. Thus, this initial proposal was identical to the one provided for investment advisers. See *supra* notes 67-74 and accompanying text. Individuals commenting on the proposed regulation were concerned about the bulk of material that mutual funds would be required to mail to individuals requesting the record. Consequently, the SEC offered funds the choice of means to comply with the disclosure requirements. Policies and Proxy Voting Record, *supra*.

87. Policies and Proxy Voting Record, *supra* note 86.

88. *Id.*

89. *Id.*

for comment on the proxy voting and voting disclosure regulations, the SEC received approximately eight thousand letters and e-mails from individuals and institutions.<sup>90</sup> While the SEC characterized the response to the regulations as “extraordinary,” others were quick to point out that the number of comments represented less than one percent of individual shareholders in the United States.<sup>91</sup>

The SEC received few comments on the proposal to expressly define the voting of client proxies as a fiduciary duty; the majority of comments involved the disclosure requirement.<sup>92</sup> Further, the proposed rule would have required mutual funds to disclose any conflict that existed between their votes and their voting policies, a requirement vociferously opposed by the investment companies and trustees who submitted comments.<sup>93</sup> That requirement was deleted from the proposal when the SEC adopted the final regulation, but the disclosure requirement remained.<sup>94</sup>

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90. *Id.* From the samples of letters provided by the SEC, more than 90% of the eight thousand letters were form letters or variations thereof in support of the regulations. See Comments on Proposed Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, at <http://www.sec.gov/rules/proposed/s73602.shtml> (last visited Aug. 20, 2004) [hereinafter Comments on Proposed Rule].

91. Comments on Proposed Rule, *supra* note 90.

92. *Id.*

93. *Id.*; see, e.g., Comment Letter of John E. Pelletier, Senior Vice President/General Counsel, CDC IXIS Asset Management Advisers, L.P.; Executive Vice President/General Counsel, CDC IXIS Asset Management Services, Inc., to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 6, 2002), at <http://www.sec.gov/rules/proposed/s73602/jepelletier1.htm> (“Disclosure of the fund’s actual voting record will be harmful to the fund and its shareholders. Disclosure of a fund’s voting record would subject the proxy voting process for funds to outside pressures from, among others, company management and special interest groups.”); see also Comment Letter of Domenick Pugliese, Senior Vice President, Alliance Fund Distributors, Inc., to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 5, 2002), at <http://www.sec.gov/rules/proposed/s73602/dpugliese1.htm> (“[I]t is unclear to us how disclosure of the rationale for votes which are submitted contrary to the voting policy would achieve the SEC’s stated objective of controlling conflicts of interest. In fact, we believe it will have unintended negative consequences. We further believe that this disclosure will result in additional costs to fund shareholders, again with little or no benefit to shareholders.”); Comment Letter of Brian T. Zino, President, J. & W. Seligman & Co. and Seligman Funds, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 6, 2002), at <http://www.sec.gov/rules/proposed/s73602/btzino1.htm> (“[W]e disagree with those portions of the Commission’s proposal that would require a fund to disclose publicly information regarding how the fund voted each of its individual proxies, and to disclose publicly those specific instances in which an actual vote differs from the fund’s policies and the reason thereof. These proposals, in our opinion, reflect an attempt to solve a problem which does not exist.”).

94. Disclosure of Proxy Voting, *supra* note 14, at 6566-67.



### 1. *Those in Favor*

The impetus behind these new regulations came from management companies that advocate for shareholder activism. Domini Social Investments (Domini), an investment company with more than \$1.3 billion under management, was one of the first companies to publicly disclose its proxy voting policies, as well as the actual votes cast during the proxy season.<sup>95</sup> Domini, in fact, initiated the rulemaking petition with the SEC that resulted in these new regulations.<sup>96</sup> Domini's comments represented the sentiment of those writing in favor of the regulations. Primarily, Domini and other supporters stressed the fiduciary obligation of voting proxies and asserted that the discharge of the fiduciary duty must be "disclosed to the person(s) to whom the duty is owed."<sup>97</sup> Domini argued that the law supports transparency in the discharge of fiduciary duties in other contexts and that the regulations align the duties of private mutual fund managers with those subject to ERISA.<sup>98</sup>

Proponents of disclosure further argued that disclosure of the proxy votes will mitigate the conflict of interest present when a mutual fund votes proxies for a company for whom it also manages retirement assets.<sup>99</sup> Disclosure will increase the seriousness with which fund managers vote and will deter managers from unilaterally "rubber stamping" management decisions.<sup>100</sup> In addition, proponents of the regulations argued that disclosure would allow individuals to effectively evaluate the performance of their management company and would support greater corporate governance by increasing a corporation's responsiveness to institutional investor concerns.<sup>101</sup>

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95. Through Domini's website, investors and members of the general public can review upcoming and recently attended shareholder meetings, as well as Domini's votes on each of the shareholder resolutions. DOMINI SOCIAL INVESTMENTS, at <http://www.domini.com/shareholder-advocacy/Proxy-Voting/index.htm> (last visited Aug. 20, 2004).

96. Comment Letter from Amy L. Domini, Founder and CEO, Domini Social Investments LLC, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Nov. 1, 2002), at <http://www.sec.gov/rules/proposed/s73602/aldomini1.htm> [hereinafter Comment Letter of Domini].

97. *Id.*

98. *Id.*; see also Comment Letter from Thomas W. Grant, President, and Laurence A. Shadek, Chairman, Pax World Management Corp., to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Nov. 26, 2002), at <http://www.sec.gov/rules/proposed/s73602/twgrant1.htm> [hereinafter Comment Letter of Grant & Shadek].

99. Comment Letter of Domini, *supra* note 96.

100. *Id.*; see also Comment Letter of Grant & Shadek, *supra* note 98. *But see infra* Part IV.A (arguing that without additional detail on the proxy voting record, the final regulation requires information insufficient to judge whether management's decisions have been "rubber-stamped").

101. Comment Letter of Domini, *supra* note 96.

## 2. *Those Against*

A number of organizations countered the proponents' statements by arguing against the disclosure of actual votes on shareholder proposals. The Investment Company Institute (ICI), an association of investment companies with approximately nine thousand mutual funds as members, provided comments on the proposed regulations that are representative of many of the mutual funds arguing against disclosure.<sup>102</sup> While ICI supported the requirement that mutual funds adopt policies and procedures for conducting their proxy voting, it strenuously opposed the requirement that mutual funds disclose their actual votes on each proposal.<sup>103</sup>

Those opposing disclosure, including ICI, raised two main points. The first focused on shareholder demand; several funds stated that no client had ever requested the funds' actual voting history.<sup>104</sup> Without shareholder demand for

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102. Comment Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 6, 2002), at <http://www.sec.gov/rules/proposed/s73602/cstyle1.htm>. There were a number of mutual funds and related organizations providing comments that supported the disclosure requirements. See Comments of Deborah A. Lamb, Chair, U.S. Advocacy Committee, and Linda L. Rittenhouse, Staff, AIMR Advocacy, Association for Investment Management and Research, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 13, 2002), at <http://www.sec.gov/rules/proposed/s73602/dalamb1.htm> (stating AIMR's support for disclosure provided that "there is no specific requirement to reveal, prior to the completion of the proxy voting process, how the fund manager intends to vote on particular issues"); see also Comment Letter from John A. Hill, Chairman, The Putnam Funds, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Oct. 24, 2002), at <http://www.sec.gov/rules/proposed/s73602/jahill1.htm>. Many of those in favor of the requirement already provided proxy vote information to their clients. TIAA-CREF, the retirement system for the education and academic community, is known for its strong governance practices and extensive disclosure. Comment Letter from Peter C. Clapman, Senior Vice President and Chief Counsel, Corporate Governance, Teachers Insurance and Annuity Association of America/College Retirement and Equities Fund, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 6, 2002), at <http://www.sec.gov/rules/proposed/s73602/pcclapman1.htm> [hereinafter Comment Letter of Clapman]. TIAA-CREF argued against disclosure of actual votes, however, because of the concern that disclosure may jeopardize its use of the vote to negotiate with the management of portfolio companies. *Id.* Instead, TIAA-CREF proposed a summary disclosure that would group votes by type and report in the aggregate. *Id.*

103. Comment Letter of Clapman, *supra* note 102.

104. See, e.g., Comment Letter from Karl J. Ege, General Counsel and Secretary, Frank Russell Investment Co. and Russell Insurance Funds, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 5, 2002), at <http://www.sec.gov/rules/proposed/s73602/kjege1.htm> [hereinafter Comment Letter of Ege]; see also Comment Letter from Dechert, Inc., to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 9, 2002), at <http://www.sec.gov/rules/proposed/s73602/dechert1.htm>; Comment Letter from Robert D. Neary, Chairman of the Board and Independent Trustee, Armada Funds, to Jonathan

this information, shareholders would be penalized, in the form of higher administrative costs, for the costs involved in complying with the disclosure requirement.<sup>105</sup> Goldman Sachs commented that shareholders would gain little by having the actual voting records and that individual investors are in a poor position to monitor funds using only this limited information.<sup>106</sup>

The second primary argument from the financial services industry focused on the role of the funds' boards of directors. Many opponents believed that the boards should continue to be the appropriate overseers of the investment advisers' fiduciary duties.<sup>107</sup> Several commentators argued that the new regulations would undermine the existing oversight function of the funds' boards.<sup>108</sup> Similarly, opponents raised concerns that disclosure would serve only "special interest" groups who might target funds or their boards for pressure tactics<sup>109</sup> based on their vote. Several funds argued that disclosure would negatively impact the "quiet negotiations" used by mutual funds when interacting with management on governance issues.<sup>110</sup>

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G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 4, 2002), at <http://www.sec.gov/rules/proposed/s73602/rdneary1.htm>.

105. Although some may disagree with the SEC's final decision, the SEC was cognizant of costs to funds and shareholders and considered concerns about costs in shaping its requirements. See Disclosure of Proxy Voting, *supra* note 14, at 6564, 6568. Arguably, if all mutual funds are subjected to the same requirement, all funds will be equally penalized.

106. Comment Letter from Kaysie Uniacke, Managing Director, Investment Management Division, Goldman, Sachs & Co., to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 6, 2002), at <http://www.sec.gov/rules/proposed/s73602/kuniacke1.htm>.

107. See, e.g., Comment Letter from Paul G. Haaga, Jr., Executive Vice President, Capital Research and Management Co., to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 6, 2002), at <http://www.sec.gov/rules/proposed/s73602/pghaaga1.htm>.

108. Both those submitting comments and the SEC recognized that the funds' boards owe investors fiduciary duties, which are then delegated to a fund's investment adviser or the fund manager. The SEC further stated that the new regulations would work in tandem with the existing role of the funds' boards. Disclosure of Proxy Voting, *supra* note 14, at 6568.

109. A number of funds were concerned about proxy voting becoming politicized. See, e.g., Comment Letter of Pelletier, *supra* note 91. The SEC recognized that politicization of voting records or the targeting of firms for social campaigns based on votes for nonfinancial resolutions were real concerns. Disclosure of Proxy Voting, *supra* note 14, at 6568. The SEC requested its staff to report back to the agency about any "unintended consequences" of the regulation before December 31, 2005. *Id.*

110. TIAA-CREF, with more than \$249 billion under management and holdings in more than five thousand companies, was concerned that "requiring complete vote by vote disclosure could unintentionally undermine the effectiveness of fund fiduciaries in voting proxies by discouraging nuanced voting and hampering productive private communications with portfolio companies." Comment Letter of Clapman, *supra* note 102. This is certainly a legitimate concern, but Domini uses shareholder proposals and negotiation without hindrance by the disclosure of its efforts. See DOMINI SOC. INVESTMENTS, PROXY VOTING GUIDELINES AND SHAREHOLDER ACTIVISM (2003), available at <http://www.domini.com/common/pdf/Proxy>

#### *IV. Evaluation of the New Proxy Voting and Disclosure Rules*

The SEC oversees a disclosure-based system of regulation, and the new proxy voting regulations fit squarely within this framework.<sup>111</sup> For this reason, the argument that proxy voting disclosure will not benefit individual shareholders, while true, is not an indication that the regulations will be ineffectual. The SEC has realized that mutual funds and other investment companies can no longer rely on market forces to determine the correct level of disclosure and has imposed these new regulations in recognition of this market failure.<sup>112</sup>

##### *A. Impact on Shareholders*

The commentators who opposed disclosure focused on the benefit conferred on individual investors; they argued that investors do not want the information, have not requested the information in the past, and would not know what to do with the disclosed information.<sup>113</sup> These arguments may be correct. Individuals invest in mutual funds because they recognize that they lack the time, expertise, or willingness to research individual stocks and actively manage a portfolio of investments. These individuals may have already determined that, rather than review voting records, they would prefer to pay the advisory fee as a more effective use of resources. A number of funds currently disclose their proxy voting records and other governance activities, and if this disclosure were valued, investors would select these

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VotingGuide2003.pdf.

111. See *supra* note 58; 15 U.S.C. § 80a (2000).

112. Palmiter, *supra* note 28, at 1469 (arguing that “mandatory disclosure, in the face of an apparent market failure in an industry that proclaims the virtues of financial transparency, could serve many purposes”).

113. See, e.g., Comment Letter of Paul Doherty, Esq., et al., Independent Trustees and Directors of the GCG Trust and the ING Funds, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Nov. 19, 2002), at <http://www.sec.gov/rules/proposed/s73602/pdoherty1.htm> (The “costs [of compliance] are unwarranted in the absence of, among other evidence, a meaningful investor demand for this type of information . . . [W]e are advised by management of our funds that very few, if any, actual shareholders or investors have sought this type of information.”); Comment Letter of Robert G. Zack, Senior Vice President and General Counsel, OppenheimerFunds, Inc., to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 2, 2002), at <http://www.sec.gov/rules/proposed/s73602/rgzack1.htm> [hereinafter Comment Letter of Zack] (“As the Commission knows, this proposal was not the result of demands by shareholders of investment companies. We believe that shareholders of funds have little interest in such information and note that over the last three years, our records show that we have received *one* request by a shareholder about portfolio proxy voting . . .”).

funds for their initial investment.<sup>114</sup> In cases where investors are not aware of or do not value disclosure, mutual funds could view the costs of compliance as a penalty.<sup>115</sup>

Shareholder demand, however, is not a principal driver of securities regulation; one look at the expanse of forms and disclosures demonstrates that investor demand is not the impetus behind most securities law.<sup>116</sup> If shareholder demand motivated the SEC to enact these regulations, the regulations would certainly fail to meet investor expectations. Individuals are rational beings who consider relevant information in making decisions that maximize their wealth.<sup>117</sup> At some point, however, there is too much information for an individual to incorporate into making a rational decision.<sup>118</sup>

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114. A few examples include Domini Social Investments, Walden Asset Management, Pax World Funds, and Trillium Asset Management.

115. Before these regulations, the SEC had informally confirmed that the voting of proxies in the clients' interests fell under the antifraud provisions of the Investment Advisers Act of 1940. *See supra* note 62 and accompanying text. As a matter of good business practice, mutual funds would likely maintain a record of proxy votes. In the age of technology, compiling this information may not impose as great of a cost as some funds have argued. In addition, as with other advisory and management fees, such costs would be shared among millions of investors. Funds that currently disclose their proxy voting records do not have higher expense ratios than those that do not. *See* Comment Letter from Adam Kanzer, General Counsel, Domini Social Investments, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Mar. 31, 2003), at <http://www.sec.gov/rules/proposed/s73602/akanzer1.htm>; *see also* Comment Letter from Mercer Bullard, Founder and President, Fund Democracy, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Oct. 21, 2002), at <http://www.sec.gov/rules/proposed/s73602/mbullard.htm>.

116. *See Mutual Fund Regulation in the Next Millennium Symposium Panels*, 44 N.Y.L. SCH. L. REV. 463, 464 (2001) (quoting a symposium participant who explained that the history of securities law demonstrates that individual investors were not seen as the beneficiaries of disclosed information: "William O. Douglas, who later went on to become SEC chairman. . . . wrote that the point wasn't to make prospectuses something the average investor could understand. It was, instead, to put a body of information into the marketplace through which experienced professionals . . . could distill and provide to investors.").

117. Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L. J. 1397, 1413 (2002) [hereinafter Prentice, *Behavioral Observations*]; *see also* W. Kip Viscusi, *Individual Rationality, Hazard Warnings, and the Foundations of Tort Law*, 48 RUTGERS L. REV. 625, 636 (1996) ("The foundation of economic analysis of choice is based on the rationality of individual decision making.").

118. For a discussion of the evidence supporting and refuting individual rationality in the marketplace, *see* Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 133, 139-81 (2000). For additional reading on the impact of irrational investing on securities litigation, *see* Peter H. Huang, *Moody Investing and the Supreme Court: Rethinking Materiality of Information and Reasonableness of Investors*, University of Pennsylvania, Institute for Law and Economics Research Paper 03-36 (Dec. 10, 2003), at [http://ssrn.com/abstract\\_id=478421](http://ssrn.com/abstract_id=478421).

Reviewing a fund's votes on hundreds of resolutions and board elections would qualify as "information overload."<sup>119</sup> Individuals will decide to exclude certain information when making a decision because, after a certain point, additional information renders decision making more difficult and time-consuming.<sup>120</sup>

The market provides investors with a tremendous amount of information; mutual funds provide performance histories, investment policies, and descriptions of the fund's management.<sup>121</sup> Mutual funds collect the information they provide investors along with market information about companies in the funds' portfolios and information about the fund from financial news or rating sources. Proxy voting records are unlikely to assist investors in assessing the fund's management. According to the regulations, the fund must disclose the name of the company, identify information on the security voted, provide a brief description of the matter voted on and the proposing party, state whether the fund voted on the matter, disclose how the fund voted, and detail whether this vote was in favor of, or against, management's position.<sup>122</sup>

The information required by the new regulations adds very little to an investor's resources for making an informed decision about the quality of fund

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119. Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 418-19 (2003) (arguing that there are two keys to effective federal securities law: (1) disclosure, and (2) the effective use of disclosed information; too much disclosure can be counterproductive if individuals cannot use the information to make better decisions). Mutual funds can vote on thousands of resolutions annually. For example, in its comments against disclosure of actual votes, Fidelity Funds stated that the new regulations would require 180 funds to disclose 330,000 items on each disclosure statement. Comment Letter of Eric D. Roiter, Senior Vice President and General Counsel, Fidelity Management & Research Co., to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 6, 2002), at <http://www.sec.gov/rules/proposed/s73602/edroiter1.htm> [hereinafter Comment Letter of Roiter].

120. Herbert Simon pioneered the concept of "bounded rationality" half a century ago. He postulated that cognitive resources are scarce, and to cope with making complex choices, individuals will work with an amount of information that leads to a satisfactory decision, even though it may not be the best decision. Individuals accept a satisfactory decision over the optimal one as a trade off for investing fewer cognitive resources in decision making. See Paredes, *supra* note 119, at 418-19.

121. The fund may provide these items voluntarily or as required disclosures. See, e.g., Form N-1A, the registration form for mutual funds promulgated under the Investment Company Act, at <http://www.sec.gov/about/forms/formn-1a.pdf> (last visited Nov. 8, 2004).

122. Disclosure of Proxy Voting, *supra* note 14, at 6564, 6569. As mentioned previously, the SEC elected not to require a fund to disclose when its vote was inconsistent with its stated policies. *Id.* Interestingly, TIAA-CREF, a large pension fund-insurance company, commented that individual investors would find this information more valuable than the disclosure of the individual votes. Comment Letter of Clapman, *supra* note 102.

management. For example, a yea or nay vote on a resolution nominating an individual to a company's board of directors sheds little light on *why* a fund voted that way. Investors would need to understand the industry, the competitive environment of the industry, and trends within the industry to begin to decipher the rationale for a specific vote. Unless an evaluation consisted solely of reviewing whether a fund voted, or if investors were to assume that all votes in favor of management are bad, this data is of little help to investors. Such an evaluation would be ineffective and naïve given the strategic reasons for a fund to withhold its vote or vote a certain way on a resolution that would not be apparent from a cursory review of a voting record. Further, the SEC has recognized that there are cases where the costs of voting would outweigh the benefits and explicitly stated that the failure to vote would not constitute a breach of the adviser's fiduciary duty.<sup>123</sup>

### *B. Impact on Mutual Funds*

Although the disclosure of proxy voting records may not directly benefit individual investors, investors will benefit from the regulations' impact on mutual funds. Conflicts of interest within the financial services industry present a real challenge to regulators, particularly where no disclosure rules exist to police unethical and illegal behavior. Arguably, the market has not dictated the necessary levels of disclosure, perhaps because mutual funds are less vulnerable to market forces. As a result of the market's inability to police mutual funds, the SEC has turned to regulation to force disclosure.

Conflicts of interest within mutual funds exist, and there are circumstances where mutual fund advisers or directors have incentives to act in the financial interests of the fund or the fund's sponsor. Where the largest mutual fund company earned half of its \$9.8 billion revenue through fees for managing corporate retirement plans, a real conflict exists for mutual fund managers who are evaluating proxy solicitations.<sup>124</sup> As the founder of the Vanguard Group stated, "These corporations whose shares we're voting are also the source of our 401(k) and pension business. We don't want to offend the corporations we own."<sup>125</sup> Without required disclosure of the voting record, a mutual fund has no economic incentive to vote in the best interests of the client because the mutual fund cannot be held accountable to shareholders.

Before the proxy disclosure rules, financial markets relied on competitive forces to determine "optimal" levels of disclosure; theorists postulated that "if

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123. See Disclosure of Proxy Voting, *supra* note 14, at 6575.

124. AFL-CIO, *Five Excuses About Mutual Fund Proxy Voting Disclosure*, at <http://www.funddemocracy.com/mutual%20Fund%20Excuses.htm> (last visited Aug. 20, 2004) (discussing conflicts of interest, using Fidelity as an example and revenue figures from 2001).

125. Hansard, *supra* note 37, at 18.

disclosure is worthwhile to investors, the firm can profit by providing it.”<sup>126</sup> This conclusion depends on an efficient market, one where stock prices reflect all known information relating to the stock.<sup>127</sup> The assumption of efficient capital markets, however, may no longer be sacrosanct; several commentators have argued that the market may not operate efficiently with regard to mutual funds.<sup>128</sup> For example, investors do not withdraw from funds that are underperforming,<sup>129</sup> continue to buy shares in funds with high expense ratios,<sup>130</sup> and approve increases in advisory fees when a fund’s assets are increasing even though the fee should decrease based on economies of scale.<sup>131</sup> Even if the market operates efficiently and mutual funds are rational actors, organizations may find that gains from a failure to disclose or from a failure to vote proxies in clients’ best interests outweigh any potential loss of revenue or reputation, especially when mutual funds face little chance of being caught.<sup>132</sup>

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126. EASTERBROOK & FISCHER, *supra* note 49, at 288. Disclosure alone, however, does not create value but is merely a means to an end. Disclosure encourages governance activities, and good governance creates value. See Newell & Wilson, *supra* note 24, at 20.

127. Howell E. Jackson, *Symposium: Revisiting the Mechanisms of Market Efficiency: To What Extent Should Individual Investors Rely on the Mechanisms of Market Efficiency: A Preliminary Investigation of Dispersion in Investor Returns*, 28 J. CORP. L. 671, 672 (2003) (explaining that “[u]nder [one] version of the efficient markets hypothesis, the market price of securities that trade in liquid markets and are well-followed by investment analysts will reflect all publicly available information on the securities”).

128. See Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 853-54 (1992); Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 648-50 (1995) (reporting skepticism on the part of financial economists on the validity of the efficient market hypothesis). *But see* Mark Klock, *Are Wastefulness and Flamboyance Really Virtues? Use and Abuse of Economic Analysis*, 71 U. CIN. L. REV. 181, 194-218 (2002) (illustrating the numerous ways in which legal scholars have misinterpreted or misunderstood the efficient capital market hypothesis).

129. John B. Carlson et al., *Mutual Funds, Fee Transparency, and Competition*, FED. RES. BANK OF CLEVELAND ECON. COMMENT. SERIES, 2004, at 1 (finding that “[a]lthough it is easy to identify which S&P 500 funds have high costs and are thus likely to exhibit poor performance, the high-cost funds persist and even grow — an outcome not consistent with the competitive market paradigm”); see also Richard A. Ippolito, *Consumer Reaction to Measures of Poor Quality: Evidence from the Mutual Fund Industry*, 35 J. L. & ECON. 45, 61-62 (1992).

130. Hank Ezell, *The Inside Scoop on Mutual Funds; Costs Can Be Draining, High Sales Fees, Expenses Represent a Trap for the Unwary*, ATLANTA J. & CONST., May 17, 1998, at 3R; Steven D. Kaye, *Bailing Out of a Biggie*, U.S. NEWS & WORLD REP., Feb. 7, 1997, at 66.

131. Samuel S. Kim, *Mutual Funds: Solving the Shortcomings of the Independent Director Response to Advisory Self-Dealing Through the Use of the Undue Influence Standard*, 98 COLUM. L. REV. 474, 478 (1998).

132. See Prentice, *Behavioral Observations*, *supra* note 117, at 1414-15 (urging commentators to examine the assumption that “it is irrational for [investment] managers and



The market may not discipline mutual funds, but the SEC can use its regulatory authority to enact regulations that will protect individual investors. Mandatory disclosure will elicit the fiduciary behavior that voluntary actions and market forces cannot. Given the new regulations, mutual funds should expect that intermediaries will monitor their votes and publicize any misdeeds.<sup>133</sup> Voting contrary to their clients' interests, then, should lead to a certain economic loss.<sup>134</sup> The recognition that wrongdoing will result in financial losses and tarnished reputation should cause funds to modify their behavior by taking more seriously their fiduciary duties of care and loyalty.

Industry-wide regulations should mitigate conflicts and deter wrongdoing without sacrificing any one fund's performance. Previously, mutual funds were likely reluctant to disclose because other funds could benefit from the information without incurring the costs of disclosure.<sup>135</sup> Further, mandatory disclosure should have a salutary effect on mutual funds industry-wide by lessening the likelihood that the mutual fund industry could capture regulatory interests.<sup>136</sup> Public disclosure removes some of the onus from the SEC to be

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issuers to do anything other than make full and accurate financial disclosure to the market"). Professor Merritt Fox's study found that "[i]ssuer choice would lead U.S. issuers to disclose at a level significantly below . . . [the] social optimum." *Id.* at 1416-17 n.90 (quoting Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1390 (1999)). Fox further states that economists recognize the incentive to fail to disclose sufficient information for the successful operation of the financial industry, and consequently, side with government-imposed disclosure. *Id.*

133. See *infra* Part IV.C (discussing the importance of market intermediaries).

134. Although investors may not withdraw from a fund for higher fees or lesser performance, recent scandals in the mutual fund industry indicate that individuals will withdraw from funds because of the fund's failure to serve as a fiduciary of investor funds. Josh Friedman, *Fund Firms in Scandal Feel Loss; Companies had Average of \$10.7 Billion in Investor Withdrawals in Last Months of '03*, L.A. TIMES, Apr. 12, 2004, at C1.

135. EASTERBROOK & FISCHER, *supra* note 49, at 290.

136. Palmiter, *supra* note 28, at 1425 (describing mutual funds as "politically up for grabs, neither captured by nor immune to pressure from the management of portfolio companies"); see also John P. Freeman, Statement Before the Senate Governmental Affairs Subcommittee on Financial Management, the Budget, and International Security (Jan. 27, 2004), at [http://govt-aff.senate.gov/\\_files/012704freeman.pdf](http://govt-aff.senate.gov/_files/012704freeman.pdf) ("The SEC's Division of Investment Management ('DIM') presents a classic case of 'regulatory capture . . . .' What we almost always find when SEC staffers move on are the SEC-honed skills being put to work protecting the wealth of mutual fund managers . . . . My analysis of SEC personnel movements . . . shows that most of the SEC's senior personnel who leave the DIM go to work for mutual funds as officers or directors, for the [Investment Company Institute], or for service suppliers (law firms or accounting firms) who advise fund sponsors . . . . When I was working with the SEC in DIM years ago, I was told by a fellow staff lawyer: 'Let's face it. In five years, we'll all be working for these guys.'").

the sole investigator of wrongdoing, and provides the market with sufficient information to regulate mutual funds.

### *C. Proxy Disclosure Within Securities Regulation*

In light of the conflicts of interest and the potential market failure within the mutual fund industry, the SEC clearly needed to realign the incentives for mutual funds to maintain their duty of loyalty to their clients. The disclosure of proxy policies and the disclosure of specific votes, as required by the new regulations, provides the correct incentives at a reasonable cost.<sup>137</sup> Several fund companies already disclose this information and prove, through comparable expense ratios, that making such information available is neither impossible nor cost prohibitive.<sup>138</sup>

As previously discussed,<sup>139</sup> many mutual funds argued against mandatory disclosure and in support of the role of the mutual fund's board of directors in complying with fiduciary duties.<sup>140</sup> These opponents argued that the directors would approve the proxy voting policy and monitor proxy voting in conflict of interest situations.<sup>141</sup> In contrast to required disclosures, such an

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137. See Comment Letter of Grant & Shadek, *supra* note 98.

138. *Id.*

139. See *supra* notes 102-110 and accompanying text.

140. See, e.g., Comment Letter of Ronald Feiman, Mayer, Brown, Rowe & Maw, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 6, 2002), at <http://www.sec.gov/rules/proposed/s73602/rfeiman1.htm> ("The Independent Board Members we represent believe that . . . they are capable of discharging all necessary oversight, without politicizing the process through disclosing every single proxy vote and every deviation from policy, thereby encouraging special interest groups to lobby regarding particular votes."); Comment Letter of Zack, *supra* note 113 ("The proposal's approach to this issue [of proxy vote disclosure] may be read to imply that boards are not capable of dealing with this type of potential conflict, or that boards have somehow failed to do so, without citing any evidence to support those contentions. We believe that this approach undermines the role of the independent directors in overseeing fund policies and is unwarranted."); Comment Letter of Roiter, *supra* note 119 ("[A] fund's independent directors are far better positioned to carry out close and sustained monitoring of any potential conflicts of interests. Fund directors need not depend solely upon reports of proxy voting activity received from a fund's adviser and need not personally pore over proxy voting records in order to carry out their oversight duties."); Comment Letter of R. Gregory Barton, Managing Director and General Counsel, Vanguard Group, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 5, 2002), at <http://www.sec.gov/rules/proposed/s73602/rgbarton1.htm> ("In Vanguard's view, enhancing board of directors oversight over proxy voting decision-making would be a far more appropriate and effective means of achieving the Commission's objectives than publicizing funds' proxy voting records.").

141. See, e.g., Comment Letter of Roiter, *supra* note 119; Comment Letter of Ege, *supra* note 104.

alternative may address conflicts of interest,<sup>142</sup> but provides no incentive for the mutual fund to maintain its loyalty to the individual investor.

The SEC's disclosure requirements pull the monitoring function out of the mutual funds and its sponsor and rely on disclosure to correct the market's failure to discipline mutual funds. These regulations, like the majority of the SEC's regulations, are predicated on the expectation that the market has independent "filters" to digest and interpret the data disclosed under federal securities laws.<sup>143</sup> The proxy disclosure requirement is no different; the SEC must have envisioned financial intermediaries as the primary recipients for the raw data on proxy voting.<sup>144</sup> Few individual investors would have sufficient information about each company within a portfolio and the necessary background data to evaluate a fund's vote. With the cooperation of these independent filters, the new regulations have the potential to pull mutual funds into the sunlight.<sup>145</sup>

### V. Conclusion

The new proxy disclosure regulations are products of a financial market where mutual funds wield more economic power and impact more individual investors than the drafters of the financial legislation of the 1930s and 1940s could have anticipated. The growth of mutual funds, coupled with the

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142. Recent statements by the SEC indicate that the agency is no longer as confident with the role of the independent director as the mutual fund monitor. See Arthur Levitt, *Keeping Faith with the Shareholder Interest: Strengthening the Role of Independent Directors of Mutual Funds*, Speech at the Mutual Funds and Investment Management Conference (Mar. 22, 1999), at <http://www.sec.gov/news/speech/speecharchive/1999/spch259.htm> (indicating that the law's current requirement that 60% of a mutual fund's board consists of independent directors may no longer be sufficient to assure investors that their funds are being managed in their best interests); see also Commissioner Harvey J. Goldschmid, *Mutual Fund Regulation: A Time for Healing and Reform*, Speech At ICI 2003 Securities Law Developments Conference (Dec. 4, 2003), at <http://www.sec.gov/news/speech/spch120403hjg.htm> (stating that "[m]aking the mutual fund board truly independent and effective is where a great deal of the pay dirt lies").

143. Paredes, *supra* note 119, at 432 ("As a practical matter, a company's disclosures are largely 'filtered' through experts — various securities professionals and financial intermediaries — who research and process the information and whose trades and recommendations ultimately set securities prices.").

144. See *supra* note 116 and accompanying text.

145. In support of the passage of the Securities Act of 1933, Louis Brandeis said, "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." LOUIS D. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT* 92 (1914); see also Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What You Measure*, 96 COLUM. L. REV. 1335, 1344 (1996) (explaining that "[t]he principle of sunlight — reflected in the mandated disclosure under SEC rules — works particularly well with respect to various conflict-of-interest transactions").

conflicts of interest inherent in their structure, has an impact on individual investors who delegate their voting rights to mutual funds. Although these new regulations will have little direct benefit for the individual shareholder, they will nevertheless mitigate conflicts that may negatively impact shareholder wealth, and consequently, limit capital expansion.

Disclosure is a relatively simple and cost-efficient way to deter mutual funds from acting in their own interests, particularly where financial intermediaries will monitor mutual fund voting on behalf of individual shareholders. In this way, disclosure will effectively deter mutual funds from pursuing their own economic benefit when voting client proxies, and instead will provide them with incentives to vote in the best interests of their investors.

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