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# THE PROPER ROLE OF A MUTUAL FUND AS CORPORATE MONITOR

11 "Institutions Hold Stock Reins", Pensions & Investment, September 30, 1991 22 Id. January 16, 1992 TO: INVESTMENT ISSUES COMMITTEE NO. 2-92 RE: THE PROPER ROLE OF A MUTUAL FUND AS CORPORATE MONITOR

_____ According to a recent study sponsored by the Columbia University Center for Law and Economic Studies Institutional Investor Project entitled "Institutional Investors and Capital Markets: 1991 Update", institutional investors owned more than half of all outstanding public and private equities in 1990. 11 The Columbia Study also found that institutional asset holdings grew in 1990 to $6.52 trillion, up from $6.25 trillion in 1989. 22 Yet despite the absolute size and growth of these holdings, institutional investors and particularly mutual funds rarely participate in corporate governance or serve as a corporate monitor of the companies in which they have made significant investments. Similarly, there have been virtually no efforts by mutual funds and other institutional investors to coordinate the voting of proxies so as to enhance their overall ability to influence the affairs of portfolio companies by acting in concert. In recent years, there has been increasing debate whether institutional investors, including mutual funds, should become more actively involved in monitoring and, where appropriate, opposing proposals of or actions taken by the managements of their portfolio companies. Accordingly, it is appropriate to focus on the legal and political forces which over the years have largely restrained mutual funds from assuming an active role in influencing corporate affairs. I. THE 1940 ACT RESTRICTIONS A. Power of Control According to Professor Mark Roe in a recent article in the University of Pennsylvania Law Review, Congress was highly suspicious of the power of mutual funds to control companies when the federal securities laws were originally enacted in the 1930's and early 1940's, and the provisions of the various federal 33 Mark J. Roe. Political Elements in the Creation of a Mutual Fund Industry, 139 University of Pennsylvania Law Review 6 (1991) (Hereinafter Roe, Political Elements) 44 See Stock Exchange Practices: Report of the Commission on Banking and Currency S. Rep., No 1455, 73rd Congress, 2nd Session 333-334 (1934). 55 Id. at 393 66 Investment Trusts and Investment Companies: Hearing on S 3580 Before Subcommittee of the Commission on Banking and Currency, 76th Congress, 3rd Session, note 10, pt.2 at 434. 77 A. Berle and G. Means. The Modern Corporation and Private Property 153-88 (1932) securities laws amply reflect that suspicion. 33 According to Professor Roe, a 1934 Senate securities report identified two functions for mutual funds: investment and control of management. The report asserted the control function was highly improper for mutual funds. The report concluded that mutual funds should only passively invest.44 Similarly, another Congressional report in that era noted that "The investment company has become the instrumentality of financiers and industrialists to facilitate acquisition of concentrated

control of wealth and industries of the country." The report asserted that as a consequence, Congress must "prevent the diversion of these [investment] trusts from their normal channels of diversified investment to the abnormal avenues of control of industry". 55 In a similar expression of suspicion about the voting power of institutional investors, the SEC declared in its proposed bill that ultimately led to the 1940 Act that "the national public interest...is adversely affected...when investment companies have great size... and have excessive influence on the national economy".66 This country historically has supported a strong separation between ownership and control of the typical American corporation as originally characterized by Berle and Means, 77 and this strong separation has been amply protected by various provisions in securities and tax law according to Professor Roe. B. Diversification Standards Under the 1940 Act Congress manifested those strong reservations against mutual fund control or influence by providing that under the Investment Company Act of 1940, a mutual fund cannot advertise itself as "diversified" if it owns in the regulated part of the portfolio more than 10% of the voting stock of any company. Three quarters of the portfolio is subject to this fragmentation rule, even if that influential block of stock is only a small portion of the fund's entire portfolio. The SEC wanted that restriction to disable mutual fund control of portfolio 88 Roe, Political Elements at 1474 99 Id. 1010 Roe, Political Elements at 1476 companies. According to Professor Roe, some mutual funds might have attempted to act as monitors of their portfolio companies by owning large blocks of stock. That prospect was severely limited for diversified investment companies. Today, virtually all mutual funds call themselves diversified: they do not control public firms.88 In addition, several states have imposed even more severe restrictions: to sell mutual fund shares to their residents, the fund cannot own more than 10% of any portfolio company. As a result, many mutual funds have adopted an investment policy of not permitting themselves to use even the limited portfolio concentration that the 1940 Act permits. 99 The 1940 Act also requires that mutual funds calling themselves diversified have no more that 5% of the mutual fund's regulated assets in the securities of any one issuer. The effect of this limitation tends to prevent a mutual fund from controlling a portfolio company, although with the growth of mutual funds in recent years, the 5% limitation is becoming less meaningful as a control limitation. Similarly, Guide 16 to Form N-1A requires that if one of the registrant's significant investment policies is to invest in companies for the purpose of exercising control, the registrant must explain in the prospectus the extent to which and the circumstances under which, such investments will be made. Most mutual funds respond to this disclosure item by disclaiming any intent to invest for the purpose of exercising control. C. Networks and Affiliates If a mutual fund owned 5% of the stock of a portfolio company's stock and acted in concert with a group of other institutions owning 5% of the stock of the portfolio company, all would become 1940 Act affiliates under the affiliation definition contained in the 1940 Act. Section 17(d) of the 1940 Act would prohibit the mutual fund from acting jointly with an affiliated financial institution to join a portfolio company's board of directors, or be otherwise jointly asserting influence. Hence, the 1940 Act by defining affiliates and prohibiting joint transactions, effectively further operates to limit mutual funds from asserting influence over the corporate affairs of portfolio companies.1010 II. RESTRICTIONS UNDER TAX LAW A. Subchapter M of the Internal Revenue Code If a mutual fund were to deploy most of its portfolio in 1111 Id. at 1478 1212 Coffee, John C. Jr., Liquidity Versus Control: The Ins tit uti ona l Inv est or as large influential blocks, it would be taxed unfavorably on its entire portfolio, because Subchapter M of the Internal Revenue Code allows only diversified RICs to avoid income tax at the fund level. Under the Code's diversification requirement, investments in companies could constitute no more than 5% of the portfolio and constituting no more than 10% of the portfolio company's outstanding stock. According to Professor Roe, witnesses at the Congressional hearings considering the Investment

Company Act suggested that the principal basis for the distinction between diversified an nondiversified companies was not tax policy. The distinction was to establish "good" mutual funds-- those that did not exert control--which would be favorably taxed, and all other mutual funds, which would be unfavorably taxed. 1111 Congress liberalized the portfolio fragmentation requirements of Subchapter M in 1942, but left in place restrictions on mutual fund control of portfolio companies. No more than 25% of the mutual fund's portfolio could go into the stock of a single company. Nor could more than 25% go into stock of two or more controlled companies "engaged in the same or similar trades or businesses or related trades or businesses". The fund could put all of its assets into a single industry and get pass-through tax status and diversified status under the 1940 Act. But it could not control companies in the single industry. With this strong Congressional bias against mutual funds exercising control, to the extent that mutual funds would become active in influencing corporate affairs there is the fear whether real or exaggerated that Congress might repeal or severely cut back the favorable tax attributes Subchapter M status confers on mutual funds. III. PRACTICAL LIMITATIONS UPON MUTUAL FUNDS EXERCISING CONTROL In addition to the statutory restraints described above, there are numerous practical limitations upon mutual funds desiring to exercise institutional activism in the affairs of portfolio companies which are discussed in an October 1991 Columbia Law Review article by Professor John C. Coffee, Jr. 1212 Cor por ate Mon ito r, 91 Col umb ia Law Rev iew 6 (19 91) (he rea fte r Cof fee , Liq uid ity ) Initially, the need for liquidity in the mutual fund portfolio can operate as an effective limitation upon the ability of a mutual fund to accumulate the large block of securities necessary to exert influence over a portfolio company since large blocks of securities are often illiquid. Such illiquid positions can be 1313 Roe, Political Elements at 490-92 difficult to value and can run afoul of SEC restrictions limiting such investments. Also, there is the fear of conflicts of interest between an activist mutual fund and a portfolio company and the possibility that a portfolio company may retaliate through litigation or through complaints to Congress and regulators if a mutual fund attempted to exercise influence upon portfolio companies. Similarly, the fear of political retaliation is ever present if mutual funds and other institutional investors would band together to exercise influence upon portfolio companies, with all the attendant concentration of economic power in the hands of fund managers. Given the political and legal barriers already engrafted into the federal securities and tax laws against individual mutual funds exercising a controlling influence upon portfolio companies, the prospect of mutual funds acting in concert to effect control of portfolio companies could provoke a decidedly negative response on the political and regulatory arena.1313 Another practical concern is that portfolio companies could cut mutual funds off from helpful financial and investment information the fund needs to monitor its investment in the portfolio company if activism by the mutual fund alienates the management of the portfolio company. Moreover, the fact that some mutual funds have near term profit orientations in making an investment in a portfolio company often lessens the ability to exercise any meaningful influence in the affairs of portfolio companies because the mutual fund is not an investor sufficiently long enough in a particular company to effect meaningful change. In addition, the costs to a mutual fund in monitoring and changing corporate policies in the portfolio companies often is not adequately compensated by the fairly narrow margins inherent in investment advisory fees of the 50 basis point range or less. There is also the concern that mutual funds may simply not have the sufficient expertise resident on staff to monitor and exercise influence over the affairs of portfolio companies. Finally, a mutual fund is accorded certain relief from detailed federal filing and disclosure requirements if securities are acquired in the ordinary course of business and not with the purpose of changing or influencing control of the issuer under Section 13(d) of the Exchange Act or if securities are acquired solely for the purpose of investment under the premerger filing requirements of the Hart-Scott-

Rodino Act. All these practical limitations upon the ability or desire of mutual funds to exercise control or influence in the management of portfolio companies operate individually or in combination to restrict active investing by mutual funds. 1414 "Institutions May Use Negotiation More in 1992 to Change Corporate Governance", Federal Securities and Law Report, January 3, 1992, p. 13. IV. LIMITED INSTANCES WHERE MUTUAL FUNDS HAVE INFLUENCED CORPORATE AFFAIRS While much has been said about the various political, legal, and practical limitations upon active investing by mutual funds, it is important to acknowledge that there are limited instances where mutual funds historically have influenced corporate affairs in their portfolio companies. Initially, mutual funds as well as other institutional investors have used the proxy voting process to oppose corporate actions by their portfolio companies which would have adverse economic impact upon the securities held by the mutual fund, namely proxy proposals (1) to adopt "poison pills" and other anti-takeover devices which could deprive a mutual fund from receiving the price appreciation realized in tender offer or corporate merger proposals, (2) seeking approval of executive compensation and stock packages which are excessive, and (3) to limit liability of corporate officers and directors for mismanagement. In such instances, mutual funds, often working under guidelines from their boards of directors will oppose the adoption of such proposals with varying degrees of success. Some institutional investors such as the California Public Employee's Retirement System have increased their use of private negotiations to obtain changes in corporate governance, rather than rely on shareholder proposals. 1414 A second major area where mutual funds attempt to influence the activities of portfolio companies arises where the portfolio company becomes financially distressed and a work-out or restructuring effort is necessary. In such instances, many mutual funds will use all available legal remedies to protect the interests of the class or classes of securities held in the distressed portfolio company to ensure that mutual fund shareholders are protected in any restructuring, even if that translates into intervening in corporate affairs. A third area of mutual fund activism occurs when mutual funds vote upon shareholder proposals involving social issues, e.g. investment in South Africa, limits upon charitable contributions, participation in defense research, etc. While many funds have adopted policies of abstaining from voting on proxy proposals involving social issues, a limited although possibly increasing number of fund groups evaluate and vote proxy proposals involving social issues. V. RECENT DEVELOPMENTS IN MUTUAL FUND ACTIVISM Fidelity Investments recently amended the investment restrictions of certain of its funds to remove the restriction that the fund not invest "for the purposes of exercising control or management". However, spokesmen for Fidelity have repeatedly asserted that Fidelity has no intent to becoming involved in a company's day to day operations, but wants to be able to express its views to management or others, without being accused of violating the investment policies of the funds it manages. The intent of removing the restriction by Fidelity is to give its funds the power to give or withhold consent to a proposed action by the management of an authority or agency or the issuer of portfolio securities, to solicit support from other holders of the same or similar securities, or take other action, including instituting litigation when Fidelity believes such action may be appropriate in order to protect the value of the portfolio's investments. Representatives of other major fund groups have asserted that maintaining the investment restriction of not investing for the purposes of exercising control of management in no way restricts their ability to accomplish the stated goals of protecting the value of the portfolio's investments by taking such actions as are necessary in voting proxies or initiating litigation against portfolio companies, where appropriate. Of additional interest is the fact that the SEC recently proposed major revisions to its proxy rules which, among other things, would have greatly enhanced the ability of institutional investors to communicate among themselves for the purposes of deciding how to vote proxies and for purposes of influencing corporate governance. Major corporations

and The Business Roundtable expressed considerable reservations to allowing institutions to communicate among themselves in the proxy voting process without going through the presently required routine of filing a proxy statement with the SEC. According to the comment letter filed with the SEC by The Business Roundtable, the SEC's proposed changes in the proxy rules "would plunge the proxy process into the secret back-room dealings among powerful institutional investors with billions of dollars of assets, rely on expensive, after the fact, private litigation... and would place the fate of the corporations in the hands of many of the same financial intermediaries who were the driving force behind the excessive take-overs of the 1980's". Not only did business groups resist the SEC's proposal to loosen the proxy rules for communications among institutional investors, but in some instances, argued for tightening the existing rules. In particular, the business groups argue that the current exemption permitting up to 10 shareholders to talk to each other should be replaced by a new threshold exempting only investors whose total shares amount to no more than 5% of a company's outstanding stock to communicate with each other without the need to file a proxy statement. (The Institute's comment letter on the proposal recommended that the exemption be limited to communication among institutional investors, defined as those entities permitted to file ownership reports on Schedule 13G.) 1515 Roe, Political Elements 1508-1509 1616 Coffee, Liquidity at 1367 Due to an unprecedented volume of public comment opposing the proposed revisions, the SEC has postponed final adoption of the proposed liberalizations pending further study. While it would be speculative to suggest the SEC will ultimately back away from liberalizing proxy rules vis a vis institutional investors, the fact that the SEC has delayed adopting the proposed liberalizations in the face of strong opposition from major public companies and groups representing such companies means that institutional investors will continue to have significant restrictions upon their ability to communicate with each other without running afoul of the proxy solicitation rules of the SEC. VI. OUTLOOK FOR THE FUTURE While there has been increasing discussion of mutual funds becoming more active in monitoring and influencing corporate activities, to date there has been but modest experimentation in paving the way for increased activism rather than such activism being implemented in its own right. Moreover, the same political and legal constraints which have effectively worked to restrict mutual fund activism continue to remain in effect and without a significant change in the political environment will likely remain in effect for the foreseeable future. Also, many mutual fund managers strongly believe that mutual funds must not engage in controlling or attempting to control corporate affairs of their portfolio companies and will act accordingly in avoiding any such intervention. The net result may well be that any increased activism by mutual funds will occur by a relatively limited number of mutual funds in highly specific fact situations such as work-outs of distressed investments, litigation, and proxy and control battles where mutual funds are forced to take sides in battles waged by outside parties. Nevertheless, it is important to acknowledge that law review commentators are increasingly suggesting substantive modifications to the very stringent barriers against mutual funds exercising influence in corporate affairs. Professor Roe argues that some restrictions should be lifted for mutual funds and other institutional investors as long as the financial entities do not sell their products to the portfolio company. 1515 Similarly, Professor Coffee argues that public policy should encourage some institutional investors such as pension funds and closed-end mutual funds to assume a monitoring role. 1616 To the extent that the academic literature continues to argue for limited modifications to the barriers and to the extent that certain mutual funds continue to experiment with reserving the right to exercise influence whenever it is in the interest of fund shareholders, it is likely that there will be continuing developments and debate concerning the proper role of a mutual fund as a corporate monitor. The Institute will keep you informed of ongoing developments. Lawrence A. Rogers General Counsel