

WHY GOVERNANCE MIGHT WORK IN MUTUAL FUNDS[†]

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The Supreme Court's recent decision in Jones v. Harris Associates L.P. has highlighted the potential for agency conflicts in mutual funds, whose advisors have the de facto power to award themselves high fees. While the surrounding debate has focused on the extent to which market competition replaces the need for fee litigation, there appears to be a growing consensus that fund governance, through the use of voice, is unlikely to be effective. The use of voice is commonly said to be hampered by collective action problems. More recently, scholars have argued that it is further weakened by the easy availability of exit. Yet while the easy availability of exit may discourage the use of voice, the easy availability of exit may also encourage voice. This Essay explains how the easy availability of exit from mutual funds encourages shareholder voice, at least in theory. By analyzing the responsibility of 401(k) plan fiduciaries to prudently select investment options that plan participants can choose from, this Essay also explains why mutual fund governance might work in practice.

I. INTRODUCTION

Nearly half a century ago, Congress adopted the Investment Company Act because of its concern with the potential for agency conflicts in investment funds, including mutual funds. The Act gave shareholders the right to vote on adviser fees and directors, thereby opening the door to governance through the use of voice. Shareholder activism in mutual funds nevertheless remains uncommon, which is widely attributed to collective action problems. Because shareholders in mutual funds are typically household investors, their stakes are said to be too small to make activism worthwhile. In a recent article, John Morley and Quinn Curtis offer a deeper explanation for fund shareholders' passivity, arguing that the use of voice is discouraged by the easy availability of exit—the ability to redeem one's shares in the

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fund.¹ This argument is based on Albert Hirschman's influential book, *Exit, Voice and Loyalty*,² yet it fails to fully capture the subtle implications of Hirschman's work. After all, the easy availability of exit may also *encourage* voice. This Essay explains how the easy availability of exit from mutual funds encourages shareholder voice, at least in theory. By analyzing the responsibility of 401(k) plan fiduciaries to prudently select investment options that plan participants can choose from, this Essay also explains why mutual fund governance might work in practice.

Before getting to the heart of the matter, it is useful to clarify the meaning of "voice" in the context of fund governance. Hirschman defined voice as any attempt "to change, rather than to escape from, an objectionable state of affairs, whether through individual or collective petition to the management directly in charge, through appeal to a higher authority with the intention of forcing a change in management, or through various types of actions and protests."³ Morley and Curtis apply a similarly broad definition that encompasses both voting to lower fees or change managers, as well as putting pressure on the fund's directors ("lobbying"). Their analysis focuses on voting, and shows that mutual fund shareholders can be expected to consistently prefer exit to voting. By contrast, the act of putting pressure on the fund's directors—or directly on the fund adviser—features less prominently in the analysis. As we will see, it is this informal use of voice that holds promise as a tool of fund governance.

II. THE INTERACTION BETWEEN EXIT AND VOICE

Clearly, the easy availability of exit may discourage voice: If one can easily exit, why bother to use voice? The notion that the easy availability of exit may *encourage* voice therefore seems counterintuitive at first. However, as Hirschman explains, "The chances for voice to function effectively as a recuperation mechanism are appreciably strengthened if voice is backed up by the threat of exit, whether it is made openly or whether the possibility of exit is merely well understood to be an element in the situation by all concerned." As a result, while "the willingness to develop and use the voice mechanism is reduced by exit, [the] *ability to use it with effect is increased by it.*" The probability that the use of voice will be effective obviously plays an important role in deciding whether to exit or use voice. If exit is easily available, this makes the threat of exit more credible; this in turn results in a higher probability that the use of voice will be effective. Viewed this way, easy availability of exit makes voice more attractive.

As an example of this peculiar interaction between exit and voice, consider the dilemma faced by a corporate shareholder who is dissatisfied with

1. John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 106 (2010).

2. ALBERT O. HIRSCHMAN, *EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES* (1970).

3. *Id.* at 30.

the way her portfolio firm compensates its executives. Such a shareholder can either exit or use voice. The formal way to use voice is by voting; the recent Dodd-Frank Act grants shareholders say-on-pay, albeit the outcome of the vote is not legally binding. The informal way to use voice is by communicating concerns directly to management, a real option to institutional shareholders: studies have found that as many as 55 percent of institutional investors are willing to engage directly in discussions with the firm's executives.⁴ In both cases, management will have discretion in deciding whether or not to take measures alleviating the shareholder's concerns. The probability that management will do so, that is the probability that the use of voice will be effective, depends in part on how credible the threat of exit is. Management will generally want to prevent dissatisfied shareholders from exiting, given the downward pressure on the share price this may cause. A decrease in the share price, after all, negatively affects the variable compensation many executives receive.⁵ Moreover, a decrease in the share price increases the probability of a hostile takeover.⁶

At first glance, the threat of exit appears credible given how easily investors can sell their corporate shares in liquid markets. However, a significant downside to exiting (or "switching" from one portfolio firm to another) is that the cash amount that a shareholder receives for selling her shares in the market may not suffice, and is indeed unlikely to suffice, to purchase a substitute share that is expected to yield higher returns. This mitigates the threat of exit and therefore makes it easier for management to ignore the shareholder's concerns. The fact that sale prices in corporations reflect expected returns thus lowers the probability that the use of voice will be effective and, all else being equal, makes voice less attractive.

III. THE THREAT OF EXIT IN MUTUAL FUNDS

Sale prices in mutual funds, by contrast, do *not* reflect expected returns. Rather than selling their shares on the market, shareholders in mutual funds who are dissatisfied with the fund advisor's compensation level can redeem their shares and receive a cash amount equal to a pro rata share of the fund's assets (after debts and liabilities), which is called the net asset value per share ("NAV"). This cash amount *should* suffice to buy a substitute share in a different mutual fund with the same NAV but with higher expected returns

4. See Joseph A. McCahery, Laura T. Starks & Zacharias Sautner, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, at 13 (2010). AFA 2011 Denver Meetings Paper, available at <http://ssrn.com/abstract=1571046>.

5. See Anat R. Admati & Paul Pfleiderer, *The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice*, 22 REV. FIN. STUD. 2245 (2009) (developing a theoretical model that shows that the threat of exit by a large shareholder, via its potential negative effect on executive compensation, generally discourages executives from taking actions that are undesirable from the shareholders' perspective).

6. See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965) (discussing the market for corporate control); Radhakrishnan Gopalan, *Institutional Stock Sales and Takeovers: The Disciplinary Role of Voting with Your Feet* (2008) (finding that block sales increase the probability of a takeover).

because of lower fees. As a result, shareholders whose concerns are ignored do not face a similar barrier to exiting as shareholders in corporations do, and the threat of exit is very credible. Fund advisors will generally want to prevent dissatisfied shareholders from exiting, as their compensation is usually tied to the amount of assets under management. All else being equal, this should make fund advisors more responsive to shareholders' concerns, and this, in turn, makes voice more attractive.

Importantly, the significance of a dissatisfied shareholder's threat of exit depends not only on how credible the threat is, but also on the number of shares that the shareholder would redeem. Given that shareholders in mutual funds are typically household investors, this number is generally low. The fund advisor, therefore, would not need to bother when a shareholder informally voices concerns, unless of course there is reason to believe that the concerns are tacitly shared by a wider group of shareholders. Thus, share-ownership dispersion acts as a double-edged sword: it discourages voice not only by creating collective action problems, but also by diluting the threat of exit and hence the likelihood that voice will be effective.

IV. WHY GOVERNANCE MIGHT WORK IN MUTUAL FUNDS

Even if fund managers may be inclined to ignore the voice of individual investors, they can be expected to heed the voice of 401(k) plan fiduciaries. By 2009, no less than 68 percent of mutual fund investors owned funds inside an employer-sponsored pension plan.⁷ The employer typically appoints a fiduciary who has a duty under the Employee Retirement Income Security Act of 1974 "to prudently select and monitor" investment options that participants in the plan can choose from. Under existing law, this duty does not require fiduciaries to minimize fees associated with investment options.⁸ However, the issue is high on the agenda of the U.S. Department of Labor, which has repeatedly stated that fiduciaries should monitor fees⁹ and has recently adopted a rule requiring fiduciaries to disclose information regarding fees.¹⁰ While these disclosures are intended to enable plan participants to make their own investment decisions, they are likely to increase scrutiny of

7. INVESTMENT COMPANY FACT BOOK 84 (2010).

8. See *Hecker v. Deere & Co.*, 556 F.3d 575, 578-79 (7th Cir. 2009) (stating that "nothing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund"); see also John M. Vine, *Prudent Investing*, 38 TAX MGMT. COMP. PLANNING J. 1, 5 (2010) (stating that "ERISA does not require a fiduciary to make the best or most profitable investment decisions"); Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 1985 (2010) (stating that "[e]xisting law does not require an employer or plan provider to maximize returns or minimize fees").

9. See U.S. DEPT. OF LABOR, UNDERSTANDING RETIREMENT PLAN FEES AND EXPENSES 2 (2004) (stating that "evaluating plan fees and expenses associated with . . . investment options . . . are an important part of a fiduciary's responsibility" and that this responsibility is ongoing); *id.* at 3 (stating that "employers should pay attention to [fees for investment managers, such as mutual fund managers]"); see also U.S. DEPT. OF LABOR, A LOOK AT 401(K) PLAN FEES 3 (2010) (stating that employers must "monitor investment alternatives . . . once selected to see that they continue to be appropriate choices").

10. 29 CFR § 2550.404a-5(d)(1)(iv).

plan fiduciaries' selection of investment options.¹¹ This may cause plan fiduciaries to pay more attention to fees and to oppose fee increases through the informal use of voice, backed by the significant threat of removing the fund from the plan's menu of investment options and replacing it with another mutual fund or a different type of fund altogether.¹²

In fact, 401(k) plan fiduciaries may *already* be opposing fee increases through the informal use of voice—we simply don't know. After all, when plan fiduciaries voice their concerns by communicating directly with the fund's directors or with the fund adviser, their activism remains unknown to the public. "Behind the scenes" activism by plan fiduciaries thus is an interesting avenue for future research, especially in light of mounting evidence of behind the scenes activism by corporate shareholders.¹³

V. CONCLUSION

As the Supreme Court's recent decision in *Jones v. Harris Associates L.P.* reminds us, agency conflicts in mutual funds are potentially significant.¹⁴ The question of whether fund governance through the use of voice works therefore is an important one. Activism in mutual funds appears to be uncommon, which scholars have sought to explain by pointing to collective action problems and the easy availability of exit. However, as the preceding analysis has shown, the easy availability of exit may actually *encourage* voice, at least when it is expressed through informal channels. To complete the explanation of shareholders' passivity, one needs to take into account the fact that the high degree of fund-ownership dispersion discourages shareholder voice not only by creating collective action problems but also by diluting the threat of exit and, consequently, the likelihood that the use of voice will be effective.

By focusing on the threat of exit, it also becomes clear that whereas the use of voice by individual shareholders is unlikely to be effective, the use of voice by 401(k) plan fiduciaries is much more likely to be effective. While such fiduciaries do not hold shares themselves (and therefore are not entitled

11. See John F. Wasik, *Pump Up a 401(k) by Lowering the Fees*, N.Y. TIMES (Sept. 15, 2010) (suggesting that the Department of Labor's new rules should enable plan participants to compare fees and hold employers accountable for their selection of investment options).

12. See Jane Hodges, *Cheaper Choice in 401(k)s*, WALL ST. J. (Aug. 2, 2010) (describing how plans are increasingly offering collective trust funds, which typically have lower expenses than mutual funds); see also DELOITTE CONSULTING LLP & THE INTERNATIONAL SOCIETY OF CERTIFIED EMPLOYEE BENEFIT SPECIALISTS, 401 (K) BENCHMARKING SURVEY 28 (2009) (finding that 72 percent of plan sponsors who responded to the survey handle underperforming funds by replacing them and that 39 percent replaced a fund due to poor performance within the last year).

13. See e.g., Joseph A. McCahery, Laura T. Starks & Zacharias Sautner, *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors* (2010); AFA 2011 Denver Meetings Paper, available at <http://ssrn.com/abstract=1571046>; INSTITUTIONAL SHAREHOLDER SERVICES, THE STATE OF ENGAGEMENT BETWEEN U.S. CORPORATIONS AND SHAREHOLDERS (2011); M. Weisbach, W. Carleton & J. Nelson, *The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA-CREF*, 53 J. FIN. 1335 (1998).

14. *Jones v. Harris Assocs.*, 130 S. Ct. 1418 (2010) (addressing the issue of fund advisors' liability for charging excessive fees).

to vote), they are responsible for selecting investment options that plan participants can choose from, and for doing so in a prudent manner. This means they have the ability to, and may even be obliged to, remove from their menu of investment options any mutual fund whose advisor ignores concerns about excessive fees. The implicit or explicit threat of such removal is what makes the informal use of voice by plan fiduciaries a powerful governance mechanism, the full potential of which is yet to be unleashed. Governance in mutual funds, then, might work after all.