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Mutual Fund Boards and Shareholder Action
David J. Carter

The Investment Company Act of 1940\(^1\) (the “Investment Company Act”) imposes on mutual funds a structure of governance similar to that of traditional corporations. A board of directors sits atop each mutual fund and is responsible for overseeing the fund’s operations. However, due to the potential for abuse inherent in the operation of mutual funds, the Investment Company Act requires that a portion of a fund’s directors be independent of the fund’s investment adviser.\(^2\) In addition, the Act, and the rules thereunder, assign certain additional responsibilities to the independent directors. Some claim that, because of these additional tasks, independent directors serve as “watchdogs” protecting the interests of mutual fund shareholders.\(^3\) Others argue that the interests of independent directors are more closely aligned with those of mutual fund investment advisers than with those of fund shareholders.\(^4\)

Figures One and Two present two modes of thinking about the structure of the mutual fund industry. Figure One represents the structure as envisioned by the draftsmen of the Investment Company Act and the rules thereunder. The board of directors, whose interests are aligned with shareholders, polices the investment adviser for the benefit of the shareholders. Within the board itself, the Act and rules assign certain responsibilities to the independent directors, who serve as checks on the behavior of the interested directors and adviser. Figure Two represents the structure of the industry if its critics are

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\(^2\) See Investment Company Act of 1940 § 10(a), 15 U.S.C. § 80a-10(a) (1998) (“No registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company”).


\(^4\) See Paul J. Lim, Your Money Funds and 401(K)’s: Despite Plan to Fortify Independent Directors, Shareholders Must Be Their Own Watchdogs, L.A. TIMES, Mar. 28, 1999, at C3 (stating that independent directors “often just rubber-stamp management’s decisions”); Charles A. Jaffe, Investing in Mutual Funds: Don’t Depend on Directors for Protection, CHI. TR., Feb. 28, 1999, at C3 (believing that independent directors are about as “independent as indentured servants”).
to be believed. The interests of the board of directors are aligned with the interests of the investment adviser rather than with those of shareholders, and the interests of the independent and interested directors are the same. As a result, the board of directors does not police management and the independent directors do not police the interested directors.

Rather than passing judgment on the effectiveness of independent directors, this article asks an antecedent question. Assuming for the sake of argument that the industry’s critics are correct, can and do shareholders use the tools available to them to protect themselves? If the interests of shareholders are protected by actions that shareholders can take, then there is less reason to be concerned about the alleged alignment of the independent directors with management. The following sections, then, seek to gauge the weight or thickness of the arrow from the Shareholder box to the Board of Directors box in Figure Two. If the actions that the shareholders can take provide a sufficient check on the board and the investment adviser (the solid arrow in Figure Two), then there should be less concern with the board’s possible alignment with management. Alternatively, if the policing effect of shareholders is minimal (represented by the dotted arrow in Figure Two), then the current structure of the industry may leave shareholders unprotected.

After describing characteristics of a mutual fund’s “typical” investor in Section I and constraints that may prevent such investors from taking any action to affect the activities of a mutual fund board of directors or its investment adviser in Section II, this article addresses three possible actions that mutual fund investors, singly or collectively, could take to police the activities of a mutual fund board or its investment adviser. The ability of shareholders to redeem their shares when the board takes actions that shareholders dislike is discussed in Section III as well as the efficacy of such actions. Section IV addresses whether shareholder voting serves as a limit on board behavior. In Section V the effectiveness of recent shareholder derivative suits is examined.

Analysis of these three possible actions by mutual fund shareholders should provide some sense of the weight that shareholders retain vis-à-vis the board of directors. In other words, the analysis should help to gauge the extent to which the interests of shareholders are protected even though the interests of independent mutual fund directors may be more closely aligned with those of interested directors and the fund’s investment adviser than the draftsmen of the Investment Company Act and the rules thereunder envisioned.

I conclude that, among the three possible actions, the ability to redeem provides the greatest level of protection to shareholders. However, the ability to redeem does not protect shareholders in a manner equivalent to the protection that the board of directors and the independent directors are supposed to provide under the Investment Company Act.
I. THE “TYPICAL” INVESTOR

Before addressing the actions that shareholders may take or their willingness to take them, it is helpful to have a picture of the “typical” fund shareholder. The average mutual fund investor, according to research done by the Investment Company Institute (Institute), is 44 years old, middle class, married, employed, with a median household income of $55,000 and financial assets of $80,000 excluding his primary residence.\(^5\) Of these assets, mutual fund investments account for roughly $25,000 or 31 percent.\(^6\) In 54 percent of households owning funds, men and women share investment decision-making. Men are the sole decision-makers in 24 percent of households and women are the sole decision-makers in 22 percent.\(^7\)

The average fund investor owns four mutual funds with equity funds accounting for the largest type of fund held. Among fund-investing households, 88 percent hold equity funds, 48 percent hold money market funds, 42 percent hold bond funds and 35 percent hold hybrid funds (that is those investing in both stocks and bonds).\(^8\)

Fifty-one percent of mutual fund shareholders were born between 1946 and 1964; 22 percent were born after 1964; 27 percent were born prior to 1946.\(^9\) Additionally, more than 80 percent of mutual-fund owning households are headed by persons in their primary income-earning years (ages 25 to 64), with the heaviest concentration between the ages of 35 and 44.\(^10\) A mere 17 percent of mutual fund owners are retired.\(^11\) Fifty percent of fund shareholders have a four-year college degree while 30 percent have an associate degree or have attended college.\(^12\)

Nearly all mutual fund investors consider their investments long-term. Ninety-eight percent of shareholders say their investments constitute long-term savings and 86

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\(^7\) See id.


\(^9\) See FAQ, supra note 6.

\(^10\) See 1999 FACT BOOK, supra note 5, at 44.

\(^11\) See id.

\(^12\) See 1998 Profile, supra note 8, at 1.
percent claim not to be concerned about short-term fluctuations. Additionally, 77 percent cite retirement savings as their primary financial goal.\(^\text{13}\)

Consistent with these investment purposes, employer-sponsored retirement plans are an important aspect of mutual fund ownership. As of the end of 1998, retirement plans accounted for 35 percent of all mutual fund assets.\(^\text{14}\) Of the $1.9 trillion in mutual fund assets arising through retirement plans, half were held in Individual Retirement Accounts (IRAs) and half were held by employer-sponsored accounts such as 401(k) plans.\(^\text{15}\) Fifty percent of mutual fund shareholders claim that their primary channel for purchasing mutual funds is an employer-sponsored retirement plan.\(^\text{16}\) Among all fund shareholders, only 28 percent own funds solely outside of these plans; 38 percent own funds solely through these plans; and 34 percent own funds both inside and outside of employer-sponsored retirement plans.\(^\text{17}\) However, nearly fifty percent of all fund shareholders indicate that their first fund purchase was through their employer-sponsored retirement plan.\(^\text{18}\)

The amount of assets invested in mutual funds has grown significantly over the last thirty years. The total amount of fund assets rose from $47.6 billion in 1970 to $495.4 billion in 1985. By 1998, that amount had grown to $5.5 trillion.\(^\text{19}\) In 1998 alone, the level of assets in mutual funds increased by 24 percent, representing the fourth consecutive year in which growth exceeded 20 percent.\(^\text{20}\) Between 1979 and 1998, the number of funds rose from 524 to 7,314\(^\text{21}\) and the number of mutual fund complexes grew from 119 to 419.\(^\text{22}\)

\(^\text{13}\) See id. at 6.

\(^\text{14}\) See 1999 FACT BOOK, supra note 5, at 47.

\(^\text{15}\) See id. at 49. A 401(k) plan, generally, is a qualified plan in which a participant is allowed to elect whether to receive part of his or her pay in cash or to defer the pay in the plan on a deductible basis. See Internal Revenue Code § 401(k), 26 U.S.C. § 401(k) (2000); JOHN MICHAEL MAIER, ET AL., PARTICIPANT DIRECTED INVESTMENT ANSWER BOOK 2-8 (1998) (providing basic characteristics of 401(k) plans).

\(^\text{16}\) See FAQ, supra note 6.

\(^\text{17}\) See 1998 Profile, supra note 8, at 7.

\(^\text{18}\) See FAQ, supra note 6.

\(^\text{19}\) See 1999 FACT BOOK, supra note 5, at 67. Of the $5.5 trillion invested in mutual funds in 1998, $2,978.2 billion was invested in equity funds, $830.6 billion was invested in bond funds, $1,163.2 billion was invested in taxable money market funds, $188.5 billion was invested in tax-exempt money market funds, and $364.7 billion was invested in hybrid funds (those investing in both stocks and bonds).


\(^\text{21}\) See 1999 FACT BOOK, supra note 5, at 69. As of 1999, the total number of funds rose to 7,791. See 2000 FACT BOOK, supra note 20, at 71.
As of June 1999, 82.8 million individuals in 48.4 million (or 47.4 percent of) households in the United States invested in mutual funds. In 1980, 4.6 million (or 5.7 percent of) U.S. households owned mutual fund shares. As of the end of 1998, individuals held 78 percent of mutual fund assets, fiduciaries held 12 percent and other institutional investors held 10 percent.

II. CONSTRAINTS ON MUTUAL FUND INVESTORS

Mutual fund investors may be unable or ill inclined to police the actions of mutual fund boards of directors and investment advisers whether or not they have the tools to do so. Two factors that may constrain the behavior of fund investors are the nature of the mutual fund investment and the level of knowledge possessed by some investors.

A. THE NATURE OF THE MUTUAL FUND INVESTMENT

One reason why shareholder action may not replace the role to be played by independent directors concerns the nature of the mutual fund investment. It has been argued that the nature of ownership of mutual fund shares is different from ownership of shares in a traditional corporation. If an individual invests in the stock of Dell Computer Corporation, then the shareholder is purchasing a portion of the ownership of Dell and the rights and duties commensurate therewith. In a mutual fund, the investor may, in fact, be purchasing an equity ownership in the fund. However, because the fund is really merely a pool of assets, the investor may primarily view the purchase as a means for obtaining management of his assets. In this regard, the mutual fund shareholder is essentially a customer of the fund’s management.

22 See 1999 FACT BOOK, supra note 5, at 38. The number of mutual fund complexes grew to 433 in 1999. See 2000 FACT BOOK, supra note 20, at 38.


24 See Household Ownership, supra note 23, at 1.

25 See 1999 FACT BOOK, supra note 5, at 41. Fiduciaries are defined to include banks and individuals serving as trustees, guardians or administrators. There has not been much movement in these percentages in the last few years. In 1990, households accounted for 74 percent of fund ownership, fiduciaries accounted for 16 percent and other institutional investors accounted for 10 percent.

26 See Richard M. Phillips, Deregulation Under the Investment Company Act — A Reevaluation of the Corporate Paraphernalia of Shareholder Voting and Boards of Directors, 37 BUS. LAW. 903, 908 (1982) (stating mutual fund share ownership to be more widely dispersed and mutual fund shareholders to have different investment reasons for buying into mutual funds).

27 See id. at 908 (arguing this view makes mutual fund shareholders lose their “identity” within mutual fund, unlike shareholders who purchase equity ownership of ongoing corporations).

If the shareholder wished to accept the obligation to track the decisions of a corporate board, then he could have selected individual stocks (assuming that he could have afforded to diversify his investments outside of an investment company vehicle and that his purchase decisions were not limited by the provisions of his employer-sponsored retirement plan). Rather, the mutual fund investment can be viewed, in part, as an attempt to avoid those responsibilities by hiring the services of the investment adviser. The mutual fund investor is purchasing, among other things, the ability to ignore the actions of a corporate board except, possibly, in extreme circumstances.  

B. UNINFORMED SHAREHOLDERS

If shareholders are to protect their interests themselves rather than being protected by the board of directors, then shareholders must be fully informed. This means that they must not only be made aware of the decisions of the board and the investment adviser, but they must also be able to appreciate the significance of those decisions. As one commentator noted, “In the case of an open-end fund, with investors able to exit at will if they detect misbehavior, agency problems are not onerous.” However, some mutual fund shareholders may not possess a sufficient level of knowledge to detect misbehavior. This lack of knowledge may be the most significant constraint on the ability of shareholders to police board behavior.

It is quite easy for a shareholder to determine a mutual fund’s recent investment performance or fee structure. Data of this sort is readily available in the financial press. In addition to the coverage provided by the Wall Street Journal, services such as Morningstar and Moody’s can provide a shareholder with a plethora of information on their funds. Shareholders can compare the performance of their fund with that of a myriad of other funds. A fund’s prospectus and shareholder reports are an additional source of information.

However, if shareholder action is to be effective in reining in the behavior of a mutual fund board of directors, then shareholders must know more than just the fund’s

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29 Navellier and Yacktman, discussed in Section IV, infra, are examples where the circumstances were sufficiently extreme that shareholders reacted.


32 Among those shareholders who actively seek information on their funds, it is likely that they turn to the financial press and services before (or perhaps instead of) turning to the information provided by the fund itself in its prospectus and other disclosure documents. See Bevis Longstreth, The Profile: Designer Disclosure for Mutual Funds, 64 BROOK. L. REV. 1019, 1031 (1998) (believing investors rely on “magazines, mutual fund reviews, employer screens and word of mouth” when selecting mutual funds).
performance. Shareholders must be made aware of the decisions of the board and the investment adviser and then must be able to appreciate the significance of those decisions.

One study has found that shareholders know little about the mutual funds in which they invest. Using a random telephone survey of mutual fund customers, Noel Capon and others found that 39.3 percent of those surveyed did not know whether their funds were load or no-load funds; “72.3 percent did not know whether their funds focused on domestic or international investments”; and 75.0 percent did not know whether their funds were equity or fixed income. Even if shareholders are made aware of a board decision, it is unlikely that many shareholders could appreciate the significance of the decision given that such basic information about the fund is not known. The significance of terms in the advisory and underwriting contracts or the importance of the adviser’s investment decisions would likely escape recognition by many shareholders. This lack of information by many shareholders reduces the extent to which shareholders can protect themselves. On the other hand, the existence of the financial press and services noted above suggests that there is at least some demand for the information provided therein.

In regard to information about mutual fund directors themselves, the Securities and Exchange Commission (Commission) recently adopted increased disclosure requirements in an effort to enhance the role of independent directors. The new requirements call for the release of information on the director’s holdings of equity securities of funds in the fund complex, positions held by the director with the fund and with related persons, securities holdings in entities related to the funds, and transactions with the fund and related persons. The Commission adopted changes to help “a mutual fund shareholder to evaluate whether the independent directors can, in fact, act as an independent, vigorous, and effective force in overseeing fund operations.” To the extent that shareholders need this information to assess the degree of protection offered by the board, then the new disclosures should empower shareholders.

The preceding discussion suggests that a shareholder’s lack of information may be more a consequence of the characteristics of the shareholder himself rather than any bar to the distribution of such information. If shareholders view the investment decision as the purchase of investment management services rather than the purchase of an equity stake in an operating business, then maybe we should not expect them to monitor every decision that the board of directors makes. This may be particularly true if the reason the

33 See Noel Capon, et al., An Individual Level Analysis of the Mutual Fund Investment Decision, 10 J. FIN. SERVICES RES. 59, 68 (1996) (concluding that mutual funds investors were “generally uninformed about their mutual fund investments”).


35 Id. at 3740.
shareholder purchased the investment management services is because the shareholder does not believe that he has the expertise to invest on his own.

III. REDEMPTIONS

One of the primary differences between an open-end management company (a mutual fund) and a closed-end management company is the ability to redeem shares in the former at the shareholder’s election. While shares in closed-end funds are traded like traditional stock, mutual fund shares may be redeemed at the will of the shareholder. This option to redeem is a powerful tool in the shareholder’s hands. The following section discusses whether this power can substitute for the watchdog role that the independent directors are expected to provide. It begins with a description of how the redemption option could be used to police the actions of the board. The remainder of the section analyzes the limitations of this theory.

A. A THEORY OF REDEMPTIONS

Theoretically, the ability of shareholders to redeem their shares in a mutual fund should provide a check on the activities of its board of directors and investment adviser. Since the investment adviser’s fee is ordinarily related to the level of assets in the fund, the adviser has an incentive to prevent declines in the level of fund assets. The higher the level of assets controlled by the fund, the higher the fee paid to the adviser. Additionally, in the world of the fund complex, negative publicity about extraordinary redemptions from one fund might deter potential shareholders from investing in other funds offered by the same complex. If the interests of the mutual fund’s board of directors are aligned with those of the adviser, then the board similarly will wish to prevent extraordinary redemptions from the fund.

If shareholders were perfectly informed about the decisions made by the board of directors and the investment adviser, then shareholders would know when the board and the adviser took positions contrary to their interests. For example, if shareholders could adequately gauge the “appropriate” fee that should be paid to the adviser, then any fee greater than that amount should face shareholder disapproval. One of the primary ways in which shareholders can voice their disapproval is to redeem their shares. If the board views this threat as credible, then the ability of shareholders to redeem should prevent the

36 See Investment Company Act of 1940 § 5(a), 15 U.S.C. § 80a-5(a) (1998) (defining “open-end company” to mean “a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer” and “closed-end company” to mean “any management company other than an open-end company”).

37 See e.g., Strougo v. Scudder, Stevens & Clark, 964 F. Supp. 783, 789 (S.D.N.Y. 1997) (outlining shareholders claim against mutual fund in which plaintiff alleged that fund attempted to raise capital in order to increase fund assets solely to increase adviser’s fee).

38 A fund complex is a group of mutual funds, each with a separate investment objective, marketed together and providing exchange privileges between the funds. Generally, funds in a complex are advised by the same or affiliated investment advisers and have overlapping or identical boards of directors.
board from acting contrary to shareholder interests and should prompt the board to police the actions of the investment adviser so that its actions also are not inconsistent with shareholder interests.

**B. THE REALITY OF REDEMPTIONS**

One argument in support of the preceding view is the sheer size of the mutual fund industry. Currently there are 7,791 funds available and 433 different fund complexes controlling assets of $6.84 trillion. An investor unsatisfied with her investment in funds for which Fidelity Management & Research serves as the investment adviser literally can walk across the street and invest her money in funds for which Putnam Investments serves as the adviser.

At least one study (by Erik Sirri and Peter Tufano) has found that, while shareholders tend to base their mutual fund investment decisions on past performance, they do so asymmetrically. Investors tend to purchase shares of funds that have experienced high returns in the recent past. However, poor performing funds do not experience a wave of redemptions. While investors willingly buy the shares of funds that have performed well recently, they do not freely redeem in the face of poor performance.

This is not meant to imply that redemptions occur only infrequently. Each year, a significant number of mutual fund assets are redeemed. In 1999, a total of $743 billion was redeemed from equity funds, an increase from $534 billion in 1998 and $172 billion in 1995. Additionally, another study found that the average mutual fund experiences a large volume of both purchases and redemptions in any one year. Examining data from 1985 to 1990, the study found that, in any one year, one-half of the average fund’s assets were redeemed and two-thirds of the average fund’s assets constituted new inflows.

While the Sirri and Tufano research suggests that poor-performing mutual funds do not experience more redemptions than high-performing mutual funds, recent experience suggests that shareholders may redeem en masse in order to move their investments into individual stocks. Over the last few years, demand for computer technology stocks pushed shareholders away from the lower-performing mutual fund

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39 See 2000 FACT BOOK, supra note 20, at 38, 69, 71.

40 See Sirri & Tufano, supra note 28, at 1619 (finding that investors of consumer funds “disproportionately flock to high performing funds while failing to flee lower performing funds at the same rate”). However, more recent data suggests that mutual fund investors will redeem shares of funds in poorly performing sectors. Bob Adler of AMG Data Services reported “in February [2001] investors pulled a net $3.5 billion out of mutual funds...[and that] the bulk of those redemption were from non-domestic funds and technology.” Albert B. Crenshaw, Fund Investors Not Bailing Out, WASH. POST, Mar. 14, 2001, at E1.


42 See Edelen, supra note 30, at 447-48 (finding significant inflow and outflow in average open-end mutual fund).
industry. The example of the Oakmark Fund is illustrative. The investment adviser refused to move into high technology stocks resulting in a mere 3.7 percent gain in the fund in 1998 as compared with a 28.6 percent gain in the S & P 500. In response, investors quickly redeemed, lowering the fund’s assets by half. Thus, while there is some evidence to suggest that shareholders do not redeem when mutual funds underperform relative to other mutual funds, there is also evidence to suggest that, at least recently, fund shareholders redeem when individual stocks provide significantly higher returns.

While numerous papers analyzing the purchasing decisions of mutual fund investors have been published, far less research has been done on the motives for redemptions. The Investment Company Institute has published a few studies dealing with redemptions. In 1993, the Institute released survey results of shareholders who had either fully or partially redeemed in the recent past. Data from this survey is incorporated below. In addition, the Institute has released a study analyzing the correlation between mutual fund redemptions and stock market cycles over the period from 1944 to 1995. The Institute found that mutual fund shareholders have not redeemed in the face of sudden and sharp downturns in the market. However, over a longer horizon shareholders are sensitive to movements in stock prices with the net flow of new cash to funds increasing and decreasing as stock prices rise and decline, respectively.

For purposes of this paper, the most helpful research would be an analysis of the correlation between director actions and redemptions. Some evidence of this correlation can be gleaned from the Navellier and Yacktman proxy battles discussed in Section IV. In both cases, battles between the investment adviser and the independent directors resulted in a large volume of redemptions as shareholders chose to sell their shares rather

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43 See Bill Barnhart, Redemptions Aren’t Easy to Combat, CHI. TRIB., May 9, 1999, at C3 (noting industry trend of redeeming mutual fund shares in order to buy shares of “hot technology” stocks directly).

44 See Pui-Wing Tam, A Fund Manager Sticks to His Values, Loses Customers, WALL ST. J., Jan. 3, 2000, at C1 (stating that at one point investors were withdrawing up to $20 million per day).


47 See id. at 1, 2 (finding investor response to stock movements tend to be spread over time). The authors define net flow of cash to stock funds as “sales less redemptions, expressed as a percent of assets.” Id.


49 For a further discussion on the proxy battle involving Yacktman, see infra, notes 106-11 and accompanying text.
than take sides. However, research directly addressing this issue does not seem to be available.

1. The Initial Investment Decision

The following section briefly describes the selection of a mutual fund. Most studies of mutual fund investor behavior focus on the purchase decision rather than on actions by the shareholder post-purchase (such as a decision to redeem). The general conclusion reached is that shareholders tend to select funds based on recent performance, even though such performance is only one aspect of the mutual fund investment.

As described more fully below, a mutual fund offers shareholders the opportunity to obtain professional management of their assets. Rather than expending the effort needed to select individual stocks, mutual fund shareholders rely on the investment decisions of others, even though there is evidence to suggest that mutual funds underperform relative to the market as a whole. The professional management offered by the fund can be thought of as a basket of goods and services that the shareholder is purchasing. Included in the basket are three items: the services afforded by the investment adviser for a fee, diversification and a combination of risk and return.

The investment adviser’s services include not only investment advice, but also the panoply of customer service options that mutual fund complexes now provide. For example, a fund complex may offer on-line account access or the ability to transfer funds from a bank account without the need to write a check. The cost of such services is included in the fee paid to the adviser, which is provided for in the investment advisory contract.

One of the principal reasons to invest in a mutual fund is to obtain the benefits of diversification. Investing in companies whose fortunes are not necessarily correlated with each other allows an investor to decrease the variance of his portfolio’s expected return. Although an individual stockholder could create a sufficiently diversified portfolio, doing so may involve considerable effort and require significantly more money than the shareholder has to invest. Mutual funds offer the ability to diversify without the need to research, select, and purchase a number of different individual stocks.

50 See e.g., Lu Zheng, Is Money Smart? A Study of Mutual Fund Investors’ Fund Selection Ability, 54 J. Fin. 901, 902 (1999) (stating that most studies of mutual fund managers' performance find that they on average underperform).

Lastly, a mutual fund offers some combination of risk and return. Funds vary in the degree of risk represented by the shares that the fund purchases. Some funds, such as income funds, are geared toward providing more stable, though lower, returns. Other high-growth funds aim at providing greater returns, subject to greater risk. Share-holders can select their funds on the basis of a suitable risk-return combination.

Although a mutual fund offers several different goods and services, studies have shown that shareholders tend to focus primarily on recent returns. Sirri and Tufano found that investors “disproportionately flock to high performing funds,” although shareholders do not flee under-performing funds at an equivalent rate. One explanation for this phenomenon is advertising, which tends to stress recent returns. Sirri and Tufano also found some evidence of other factors in the selection process. For example, membership of a fund in a fund complex was a determinant of flows into the fund. While acknowledging that more research is needed, the authors suggest that this may be related to the services provided by fund-complex funds. Using data from 1965 to 1984, Richard Ippolito found that investors move money toward funds whose recent performance has been good and away from funds whose recent performance has been poor. Andrew Metrick and Richard Zeckhauser, while stating that the correlation between past and future returns is an open question, admit that many shareholders look to recent returns when purchasing funds.

Consistent with this notion, the Securities and Exchange Commission has attempted to educate investors about the risks of focusing purely on recent returns. In a set of “tips” for mutual fund investors, the Commission emphasized that short-term gains are only one factor to examine when selecting a fund. In its release, the Commission suggested that shareholders watch fees closely, given that “a one percent higher annual fee will reduce a fund’s ending balance by 18 percent after 20 years.” Additionally,

52 For a list of studies showing that investors tend to chase recent returns, see Zheng, supra note 50, at 902 n.1.

53 See Sirri & Tufano, supra note 28, at 1619 (studying determining factors in mutual fund shareholders’ decision to invest money in and take money out of mutual funds).

54 See id. at 1620 (noting that marketing and media tend to spotlight higher performing funds while poorer performers receive little attention).


56 See Andrew Metrick & Richard Zeckhauser, Price Versus Quantity: Market-Clearing Mechanisms When Consumers are Uncertain About Quality, 17 J. RISK & UNCERTAINTY 215, 217 (1999) (stating “it is clear that some consumers pay great attention” to ratings given to mutual funds by financial press).

investors were urged to consider the fund’s size, risk and volatility and any tax implications of the investment decision.

One possible explanation for why mutual fund investors focus on recent performance may be that it is the most transparent of the factors to consider. A mutual fund investor can easily distinguish between the returns one fund has had relative to another. Although past performance may not be an indication of future performance, some shareholders may view past performance as a reflection of the investment adviser’s ability to pick winners. It is more difficult for a shareholder to determine the appropriate fees to be charged for the services offered by management. Additionally, a lack of knowledge may prevent shareholders from adequately assessing the risk that investment in a mutual fund entails. If a fund invests in a certain sector, then failing to understand the risks associated with that sector would impede the shareholder from understanding the risks involved with investing in the fund.

2. The Redemption Decision

For the redemption option to substitute for the watchdog role of the independent directors, the option must be freely exercisable. Each shareholder must have the freedom to redeem if the board of directors moves against the shareholder’s interests. If there is reason to believe that shareholders cannot redeem at will, then the level of protection that the option provides is necessarily lower.

For some investors, the ability to redeem may be constrained for one of two reasons. First, redemption is considered a taxable event in which the shareholder’s gains are both realized and recognized. If the shareholder is not willing to accept the tax liability at that time, then the shareholder may be willing to remain in the mutual fund, even though the board has taken actions contrary to the shareholder’s interests. Second, if a shareholder’s channel for purchasing the fund shares is through a 401(k) plan, then the shareholder’s range of options may be limited. To the extent that the redemption option is limited, a shareholder may be constrained in her ability to use redemption as a policing mechanism against the board.

a. Taxes

Although the tax consequences of redeeming shares of mutual funds may differ depending on the type of mutual fund involved, in general, a redemption of mutual fund shares constitutes a taxable event. Much like a sale of stock in a traditional corporation, redeeming mutual fund shareholders have realized capital gains (or losses) on any appreciation (depreciation) in the value of their shares.\(^\text{58}\) If the shareholder either does not wish to pay tax at that time or is constrained in her ability to do so, then the

shareholder may be deterred from redeeming.\textsuperscript{59} One may suspect that the opposite holds true where the mutual fund’s shares have declined in value: capital losses should encourage redemptions. While in general this may be true, it is important to point out two limits on the strategic use of capital losses. First, capital losses can be recognized only to the extent of capital gains plus (at most) $3000.\textsuperscript{60} Second, the tax code disallows a capital loss altogether on the redemption of fund shares if shares in the same fund are purchased within 30 days before or after the redemption.\textsuperscript{61}

While the exact link is not known, one can surmise that tax consequences deter some shareholders from disposing of their shares. If so, then the shareholder’s option is not freely exercisable and it has less significance in policing the activities of the board then if taxes did not have a deterrent effect.

b. Employer-sponsored retirement plans

A substantial portion of mutual fund shareholders invest in funds through 401(k) plans. Seventy-two percent of households owning mutual funds buy shares through an employer-sponsored retirement plan and 38 percent of households own fund shares solely through these plans.\textsuperscript{62} Among households owning mutual fund shares solely through an employer-sponsored plan, 82 percent of households are in 401(k) plans and 11 percent are in 403(b) plans.\textsuperscript{63} In households owning shares both inside and outside of employer plans, 77 percent of the households are in 401(k) plans and 17 percent are in 403(b) plans.\textsuperscript{64} Assets in employer-sponsored accounts totaled $975 billion or 18 percent of total mutual fund assets as of the end of 1998.\textsuperscript{65}

\textsuperscript{59} See Jeff Brown, Shareholders Key to Reform of Mutual Fund Industry, DES MOINES REG., July 5, 1999, at 7 (noting “high cost” associated with changing funds).

\textsuperscript{60} See Internal Revenue Code § 1211(b), 26 U.S.C. § 1211(b) (2000) (stating limitations on capital losses for taxpayers other than corporation).

\textsuperscript{61} See id. at § 1091(a) (noting disallowance of loss deduction from “wash sales” of stock or securities); see also LEMKE, ET AL., supra note 58, § 11.02[3][c], at 11-8 (noting that purpose of “wash sale” rule is to discourage transactions that generate tax losses).

\textsuperscript{62} See 1998 Profile, supra note 8, at 7 (charting percentage of mutual fund shareholders both inside and outside employer-sponsored retirement plans).

\textsuperscript{63} See id. at 9 (charting characteristics of mutual fund ownership by source). 403(b) plans are an option for tax-exempt organizations, which allow an employees to “exclude amounts from taxable income that are either premiums paid on an insurance contract or amounts paid to a custodian of a mutual fund,” and involve minimal employer involvement. MAIER, ET AL., supra note 15, at 2-11.

\textsuperscript{64} See 1998 Profile, supra note 8, at 9 (charting mutual fund ownership by source).

\textsuperscript{65} See 2000 FACT BOOK, supra note 20, at 50 (defining “employer-sponsored accounts” to include “private defined-contribution plans (401(k), 403(b), and others), state and local government employee retirement funds (and 457 plans), and private defined-benefit plans”).
In its study of the decision to redeem, the Investment Company Institute found that of the shareholders surveyed who fully redeemed their fund shares, only two percent were part of an employer-sponsored retirement plan. The percentage was the same for those shareholders who partially redeemed. This data seems to point to a relatively low propensity to redeem by shareholders in employer-sponsored retirement plans. One possible explanation is that shareholders who purchase their shares through employer-sponsored plans view their investments as long-term and, thus, are more willing to withstand short-term fluctuations than those who purchase shares through other channels. The problem with this explanation is that the vast majority of mutual fund shareholders consider their investments to be long-term. As mentioned above, 98 percent of shareholders claim to invest for the long-term and 86 percent claim not to be concerned with short-term fluctuations.

However, the primary reason cited for redeeming shares is not performance-based. Rather, among full redeemers, 80 percent cite an investment-strategy related reason such as wanting to invest within a different fund complex or concern about economic conditions. Fifty-five percent of full redeemers cited a fund-related reason such as low performance. Among partial redeemers, only 16 percent cite a fund-related reason, while 49 percent cite an investment-strategy reason, and 75 percent cite a need for the money. This leads to the conclusion that the difference in the rate of redemptions between employment plan shareholders and non-employment plan shareholders cannot

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66 See Redemption Decisions, supra note 45, at 21 (noting that only two percent of full redemptions were of shares held in employer-sponsored retirement plan).

67 Id. at 45 (noting that only two percent of partial redemptions were of shares held in employer-sponsored retirement plan).

68 Id. (comparing redemption characteristics for different types of funds). The survey methodology used by the Institute could be viewed as suspect because the Institute excluded from the survey those shareholders who switched between funds in the same complex, which the Institute considers to be “exchanges” rather than redemptions. See id. at 77. However, for purposes of this article, the Institute’s methodology is useful because it highlights those redemptions that could possibly affect the behavior of directors or investment advisers. Redemptions viewed as “exchanges” by the Institute are not likely to affect the behavior of directors or advisers because the boards and advisers of the funds between which shares are exchanged are often identical.

69 See 1998 Profile, supra note 8, at 6 (surveying views on mutual fund investing). When surveying shareholders views on investing the Institute allowed for multiple responses. Id. This may be a function of the form of the survey. Employment plan shareholders and non-employment plan shareholders may have different lengths of time in mind when they categorize their investments as “long-term.” If so, then employment plan shareholders may be less willing to redeem for fund-performance reasons than non-employment plan shareholders.

70 See Redemption Decisions, supra note 45, at 15 (noting reasons for redemption of those investors who fully redeemed their mutual fund shares). Again, multiple responses are included in the calculation.

71 See id. at 39 (charting reasons for redemption of those investors who partially redeemed their mutual fund shares). Again, multiple responses are included.
be explained by the formers’ conscious willingness to remain with funds that underperform in the short run.

There are two other possible reasons, which are not necessarily independent of each other, for why employment plan redemptions may constitute a small fraction of total redemptions. First, some plan shareholders may not follow their employment plan investments as closely as non-plan shareholders follow their investments. Second, limits on the redemption option on shares held through employer-sponsored plans may affect the rate of redemptions from such plans.

Some employment plan shareholders may not monitor their investments as closely as non-employment plan investments are monitored. There is some evidence that shareholders who invest in mutual funds solely through employer-sponsored plans are less knowledgeable than other fund investors. However, that evidence is far from convincing. According to an Institute survey of fund shareholders, only 13 percent of individuals who own shares solely within an employment plan claim to have a “comprehensive” understanding of mutual fund investing, while 29 percent of individuals owning shares both inside and outside of employment plans claim to have a “comprehensive” understanding. While 58 percent of individuals investing in fund shares solely through employer-sponsored plans claim to have a “basic” understanding of mutual fund investing, a not-insubstantial 29 percent claim to have limited or no understanding. Other evidence suggests that, in regard to fees, the lack of knowledge of plan shareholders is similar to that of all mutual fund investors. Less than 20 percent of plan shareholders know the fees charged by their largest funds.

The second reason for why redemptions by those in employer-sponsored plans represent a small fraction of total redemptions may be the limits on the redemption option in the context of such plans. If a mutual fund shareholder is limited in his ability to redeem, yet wishes to take advantage of his employer’s matching contribution to a plan, then the employee will invest in the plan but have little incentive to pay attention to the activities of the mutual fund that is the funding vehicle for the plan.

Although there are several different types of retirement plans that an employer can provide, the following discussion focuses on 401(k) plans, the type of plan adopted by the majority of employers over the past 20 years. In a 401(k) plan, the employee contributes a portion of her pre-tax compensation to the plan with matching contributions

72 See 1998 Profile, supra note 8, at 11 (noting “self-assessed understanding of mutual fund investing”).


74 See Karin Rettger, Considerations Before Implementing a 401(k) Plan, in 401(k) PLANS 4, 4 (Laurel A. Nicholson, ed. 1995) (noting range from 46 percent for small employers to 87 percent for large employers who implemented 401(k) plans).
made by the employer. The money in the fund is then invested in various assets, subject to the requirement that the plan offer at least three investment alternatives with different risk and return characteristics. As of year-end 1999, an estimated 45 percent of 401(k) assets were invested in mutual funds, up from 9 percent in 1990.

A majority of employers offer a "menu of investment options" in which an employee can choose to invest her contributions. A few employers offer self-directed plans in which the participants' investment options are unlimited. Such plans are less common for two reasons. First, the menu option is considered sufficient for most employees. Second, the cost of administering a plan that allows for unlimited investment options is thought to be prohibitively high.

The menu of investment options can restrict the shareholder's ability to move between different mutual funds in the plan. If the menu is sufficiently small, then the employee may decide not to switch investments because the other investments are equally unattractive. If the list of options is sufficiently large, then such restrictions do not exist. If the menu is prohibitively small, then the employee has no incentive to track the performance of the funds. As long as the employee wishes to remain in the fund to garner the employer's matching contributions, the shareholder may decide not to pay attention to the funds if the range of options does not provide acceptable alternatives.

The preceding discussion has important consequences for the shareholder's ability to use the redemption option as a policing mechanism against the board of directors. Plan shareholders can be divided into two groups. The first group includes those shareholders who pay less attention to their employment plan investments than to their non-

75 See Norman T. Fowlkes, III, Plan Design, in 401(K) PLANS, supra note 74, at 12, 22-23 (stating that matching contributions have become commonplace in 401(k) plans). The term "matching contribution" is defined as "any employer contribution made to the plan on behalf of an employee on account of an employee contribution made by such employee." Internal Revenue Code § 401(m)(4)(A), 26 U.S.C. § 401(m)(4)(A) (2000).

76 See Elizabeth Weiner-Schulman et al., Investment Management and Fiduciary Responsibility, in 401(K) PLANS, supra note 74, at 39, 45 (stating that 401(k) plans must comply with Code section 404(c), which requires 401(k) plans to "offer at least three investment alternatives with different risk or return characteristics").


78 See MAIER, ET AL., supra note 15, at 4-70 (stating most employers find that limiting investment options is adequate for most of its employees).

79 See id. at 4-70 - 4-73 (outlining costs and benefits of self-directed option plans).

80 See id. at 1-2 (stating employer has ability to limit investment options of employee); see e.g., Hicks, supra note 51, at 32 (discussing lack of investment choices in relation to high fees because of possible lack of competitive price pressures between funds).
employment investments. The second group includes those shareholders who view their ability to redeem as limited because of a lack of sufficient investment alternatives. The first group is based on the characteristics of the plan shareholder and the second on the characteristics of the plan investment.

Neither group can effectively use the redemption option to police the board of directors and the investment adviser. The members of the first group may not be aware of board and adviser behavior that, in actuality, runs counter to their interests. If the members of this group do not follow the performance of their funds, they are unlikely to follow the decisions made by the board. Even if they were aware of the behavior, they might not consider it significant. In other words, they might not perceive such behavior as running counter to their interests even if they were informed of the board decision. In either case, shareholders would not necessarily redeem if the board acted in a way that opposed shareholder interests.

The members of the second group may be fully aware of the board of director’s decisions and may accurately recognize the harm they cause, but may be unable to redeem. If the menu of investment options is too small, then the shareholder has few alternatives. It is not likely that a shareholder will direct the plan to redeem his shares in one mutual fund and invest the proceeds in another if the range of other funds is not sufficiently attractive. This is particularly true if the other funds on the menu are part of the same fund complex as the fund from which the shareholder wishes to redeem. An attempt to police the actions of the board of directors would not be particularly effective if the fund from which a shareholder redeems and the fund into which the shareholder switches his investment have the same or a very similar board of directors and the same investment adviser. Additionally, a shareholder without sufficient options faces the decision of whether to discontinue investing in the 401(k) plan altogether in the face of harmful board behavior. Some such shareholders may decide to roll over their 401(k) assets into an Individual Retirement Account. However, if the employee does not wish to lose the employer’s matching contributions, then such a move is unlikely. Moreover, it is equally unlikely that the employee will cash out altogether. First, such a move removes the participant’s retirement savings from active investment. Second, cashing out would subject the participant to early withdrawal penalties in addition to any applicable capital gains taxes. Thus, for a variety of reasons, participants in 401(k)’s are unlikely to use the redemption option as a way to police the actions of the board, even if they are aware of harmful board behavior.

In conclusion, there is little reason to believe that the shareholder’s option to redeem can fully replace the protections that should be provided by the independent directors. While some shareholders face limits on their ability to redeem, others view

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81 The exchange may actually reward the investment adviser for its actions or those of the board of directors if the fee structure of the second fund is more favorable to the adviser than the fee structure of the first.

82 See MAIER, ET AL., supra note 15, at 7-30 (listing penalties for premature distributions); Cundiff, supra note 51, at 17 n.49 (noting that early withdrawals are subject to penalties unless plan contributor meets age requirement or is totally disabled).
their investments as a means of purchasing management of their assets. Thus, shareholders cannot or do not protect themselves sufficiently by redeeming. However, this does not mean that the redemption option has no force. In instances in which the actions of the board of directors and investment adviser and the significance thereof are apparent to the shareholders, then shareholders may choose to redeem. This is the lesson of the Navellier and Yacktman proxy battles discussed below. Thus, while the ability to redeem can provide some protection to shareholders, it is not equivalent to that which would be provided by independent directors not aligned with the investment adviser.

IV. SHAREHOLDER VOTING

This section discusses the ability of shareholders to police the actions of the board of directors by exercising their voting rights. While, in theory, shareholder voting could make the directors responsive to the wishes of the shareholders, there is little evidence to suggest that it does. Voting has long been considered ineffective in the context of mutual funds. The explanations given for this weakness as well as the history of two recent proxy battles are described below.

A. SHAREHOLDER VOTING IN GENERAL

The Investment Company Act assigns shareholders certain specific voting rights. Shareholders must approve the investment advisory and may approve, principal underwriting contracts, which include the level of fees paid to the investment adviser and principal underwriter; must approve changes to the mutual fund’s fundamental investment policies; and must elect the directors. As in the case of a traditional corporation, the board solicits the votes of shareholders through the use a proxy, which is subject to the proxy rules under the Securities Exchange Act of 1934.

The ability of shareholders to vote should theoretically make the board of directors receptive to the interests of the shareholders. For example, shareholder election of directors could provide some oversight of the board by the shareholders. The need to seek shareholder approval of a director-candidate should lead to the nomination of

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84 See id. at § 80a-15(b)(1) (stating that principal underwriting contract must either be approved annually by board of directors, or by majority vote of voting shareholders).

85 See id. at § 80a-13(a)(3) (stating that majority vote of voting shareholders must approve any deviation “from its policy in respect of concentration of investments...as recited in its registration statement”).

86 See id. at § 80a-16(a) (providing for investment company directors to be elected by voting shareholders).

candidates whom shareholders are likely to approve. If shareholders believe that a candidate would not act in their best interests, then they are free to reject the candidate.

While shareholders retain the power to reject candidates for the board of directors, it is rarely exercised. In practice, shareholders simply approve the proposed slate of directors without objection. The shareholder vote is considered “nothing more than a ritualistic ratification of nominees selected either by the external manager or the incumbent independent directors.”

Likewise, one can imagine that the requirement of shareholder approval of the investment advisory contract could serve to make the board of directors accountable to shareholders for the level of fees paid to the adviser. The requirement of shareholder approval should keep advisory fees to a level considered appropriate by shareholders. However, shareholder ratification of the advisory contract is considered equally ineffective. In its 1966 study, the Securities and Exchange Commission found that mutual fund shareholders do not act to police the level of fees paid to the adviser. First, shareholders can only accept or reject the proposed contract. Shareholders cannot create a new contract or set a new level of fees. If shareholders reject the contract proposal, then the fund may be without an advisory contract. If that happens, then the fund cannot conduct business because section 15(a) of the Investment Company Act makes it unlawful for any investment adviser to serve as adviser to a mutual fund except pursuant to an advisory contract. In its report, the Commission concluded that while “shareholder voting can serve as an important method of communication with management,” it “cannot be used effectively to obtain departures from traditional fees...or with respect to other matters that affect so crucially the interests of the adviser and those who are affiliated with it.” In addition, any policing effect that shareholders may have over the investment advisory contract is limited to the contract’s initial approval. Under section 15(a), the advisory contract approved by shareholders remains in effect for two years. The contract may continue in effect after the two-year time period if two conditions are satisfied: the contract is renewed annually by a majority vote

88 Phillips, supra note 26, at 909-10.


90 See SEC Report, supra note 89, at 129 (outlining reasons for concluding that shareholders have limited meaningful alternatives); Frankel & Kirsch, supra note 51, at 221 (same).


92 SEC Report, supra note 89, at 130; Frankel & Kirsch, supra note 51, at 222.

93 See 15 U.S.C. § 80a-15(a)(2) (stating that advisory contract shall not continue in effect for more than two years from date of execution).
of the independent directors and it is renewed annually either by a majority of the directors as a whole or by a majority of the shareholders. This would seem to open up the advisory contract to shareholder review after the initial approval. However, it is unlikely that a fund would seek shareholder renewal instead of seeking renewal by the board. To the extent that a mutual fund must seek renewal by the independent directors, it is unlikely that the fund would then go outside the board in order to seek shareholder approval.

The Commission’s conclusions are consistent with the available facts and the views of other commentators. The 1962 report entitled Study of Mutual Funds (the “Wharton Report”) by the Wharton School of Finance referred to shareholder voting as a “ritualistic anachronism.” Attendance at shareholder meetings and return of proxies is sparse, making it difficult to achieve a quorum. When votes are cast, they always result in approval of the proposed contract. Additionally, mutual fund shareholders, in general, participate in the voting process less often than shareholders of traditional corporations. As one commentator noted, “The paucity of shareholder activism is noteworthy even in comparison to corporations other than funds, in which significant difficulties with managerial monitoring have been identified.”

Given the lack of shareholder involvement, one can question whether shareholder voting even serves as the communication device to which the 1966 Commission report gave some credence. Regardless, it does not appear that shareholder voting can serve as an effective check on the activities of the board.

The lack of shareholder participation in the voting process and, thus, the ineffectiveness of shareholder voting in policing the board, can be explained by three factors. First, mutual fund shares are widely dispersed. Unlike traditional corporations, there are no large blocks of mutual fund shares in the hands of individual investors.

94 See id. at § 80a-15(c) (requiring approval of majority vote of non-interested directors to enter into and renew advisory contract).

95 See id. at § 80a-15(a)(2) (allows continuation of advisory contract past two years if either condition is satisfied).

96 Shareholders do have an opportunity to review and reject the investment advisory contract again if there is a material change to the contract or the adviser changes. See id. at § 80a-15(a)(4) (providing that advisory contracts must provide for their automatic termination upon assignment, unless section 15(f) is satisfied); LEMKE, ET AL., supra note 58, § 7.11[1][b], at 7-56 (stating that generally material changes to advisory contracts must be approved in accordance with section 15(a)).

97 See Roger M. Klein, Who Will Manage the Managers?: The Investment Company Act’s Antipyramiding Provision and its Effect on the Mutual Fund Industry, 59 OHIO ST. L.J. 507, 539 (1998) (discussing shareholder monitoring of fund manager through corporate governance process); see also SEC REPORT, supra note 89, at 67 (“open-end investment companies are typically legal shells without genuine autonomy, controlled by external management interests”).

98 Klein, supra note 97, at 539 (citing Edward B. Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 GEO. L.J. 445, 450-51 (1991)).
Rather, a fund may have thousands of shareholders, each holding only a small fraction of the total number of shares.\textsuperscript{99} Compared to a body of shareholders that includes particular individuals holding large fractions of the stock, it is more difficult to get the requisite number of shareholders voting for or against a proposal. Second, voting is ineffective because of the nature of the investment in a mutual fund.\textsuperscript{100} As described in Section II above, the shareholder in a mutual fund is primarily a customer. Rather than purchasing an equity ownership of an on-going business, the shareholder primarily is purchasing a basket of investment management services offered by the fund. One of these services may be the ability to invest in the stock market without the need to follow management decisions too closely. Although shareholder voting could serve as an effective tool for regulating the actions of the board, the shareholder-customer simply does not wish to expend the energy necessary to participate in the voting process. Third, voting rights may be ineffective because the shareholder has the ability to redeem.\textsuperscript{101} If a shareholder is not satisfied with the performance of the fund, the shareholder can, subject to the limitations described above, redeem the shares rather than expend the effort necessary to challenge management. In the Wharton Report, voting rights of mutual fund shareholders were found to be ineffective because “the redemption feature...facilitates [the] exit from the fund” for shareholders who are “dissatisfied with management[’s] performance.”\textsuperscript{102}

\textbf{B. PROXY BATTLES}

The connection between the ability to redeem and the ineffectiveness of voting is highlighted by the examples of two recent proxy battles. In both cases, many of the shareholders elected to vote “with their feet” by redeeming their shares rather than choosing sides in the proxy battles.\textsuperscript{103} In each case, the dispute was between the investment adviser and the independent directors, and in neither case was the proxy battle initiated by the shareholders. After analyzing these cases, this section concludes with a

\textsuperscript{99} See Phillips, supra note 26, at 908 (discussing reasons why compliance with shareholder voting requirements of 1940 Act has “proved extremely troublesome to mutual fund managers and very costly to mutual fund investors”).

\textsuperscript{100} See id. at 908 (stating that shareholders “view their purchase of fund shares as a vehicle for obtaining management of their investment capital rather than equity ownership of an operating business”); FRANKEL & KIRSCH, supra note 51, at 257 (same).

\textsuperscript{101} See Phillips, supra note 26, at 908 (noting that dissatisfied shareholders may exercise their alternative right of redemption).

\textsuperscript{102} SEC REPORT, supra note 89, at 64.

\textsuperscript{103} See David A. Sturms, Enhancing the Effectiveness of Independent Directors: Is the System Broken, Creaking or Working?, 1 VILL. J.L. & INV. MGMT. 103, 111 (1999) (discussing situation in which 64 percent of mutual fund shareholders redeemed their mutual fund shares during proxy battle between investment advisor and independent directors); Edward Wyatt, When Empty Suits Fill the Board Room: Under Fire, Mutual Fund Directors Seem Increasingly Hamstrung, N.Y. TIMES, June 7, 1998, § 3, at 1 (stating that many shareholders unable to decide what is in their best interests choose to redeem and flee).
discussion of why shareholder-initiated proxy battles, in which the shareholders voluntarily decide to oppose the fund management, are also ineffective.

1. Navellier

Navellier Management, Inc. sought to merge the Navellier Series Fund – Aggressive Stock Portfolio into another fund with a similar investment objective it managed. The independent directors of the Navellier Series Fund sought to replace Navellier with a different investment adviser, Massachusetts Financial Services (MFS). Navellier waged a proxy contest to prevent shareholder approval of MFS’s investment advisory contract with the fund. At the share-holder meeting, MFS did not receive a sufficient number of votes and, ultimately, Navellier Management was reinstated as the investment adviser.104

The battle between the independent directors and Navellier caused a wave of redemptions. Before the dispute began, the fund was valued at $250 million. By the time it ended, the fund’s assets had decreased to $60 million.105 Rather than become involved in the dispute, shareholders simply moved their money elsewhere. Note, however, that this wave of redemptions occurred in response to a situation where the interests of the independent directors were clearly not aligned with those of the investment adviser. Redemptions in this situation probably did not reflect a judgment on the part of shareholders as to whether shareholder interests were more closely aligned with those of the independent directors or of the investment adviser.

2. Yacktman

As a result of disputes between Don Yacktman, investment adviser to the Yacktman Fund and the board of directors of that fund over investment strategy and other matters, Yacktman threatened to file a proxy statement seeking to replace the independent directors if they did not resign voluntarily.106 When the independent directors refused to resign, the president of the mutual fund called a special meeting of shareholders to remove the independent directors. The board responded by firing the president and canceling the shareholder meeting.107 After the investment adviser brought suit against the fund seeking to force the shareholder’s meeting, a bitter campaign

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104 For a more complete description of the events leading up to the proxy battle involving the Navellier Series Fund, see Sturms, supra note 103, at 106-07 (outlining background of proxy battle between investment adviser and independent directors); Wyatt, supra note 103 (same); Pui-Wing Tam, Jury Give Boost to Independent Directors, WALL ST. J., July 26, 1999, C19 (same).

105 See Wyatt, supra note 103 (noting that most shareholders simply moved their money out of fund during proxy battle).

106 See Pat Regnier, Don Yacktman’s Lonely Crusade, MONEY, Apr. 1, 1999, at 120 (outlining Yacktman’s battle with independent directors); Sturms, supra note 103, at 110 (same).

107 See Sturms, supra note 103, at 110.
ensued. Shareholders received letters from both Yacktman and the independent directors accusing the others of acting inappropriately.\textsuperscript{108}

At the same time, the battle within management was causing “startled investors” to redeem their shares in the fund.\textsuperscript{109} In 1997, the Yacktman Fund had assets of $1.2 billion. By April 1999, that amount had declined to $280 million.\textsuperscript{110} The holders of 64 percent of the shares chose to redeem their investments during the dispute.\textsuperscript{111} When the shareholder vote was finally held, the remaining shareholders supported Yacktman. While Yacktman continues to serve as the investment adviser, the independent directors of the fund have been replaced.

3. Shareholder-Initiated Proxy Fights

In the Yacktman and Navellier proxy contests, the proxy battles were between a mutual fund’s investment adviser and its independent directors. However, shareholders themselves can also seek to solicit the proxies of other shareholders in an attempt to replace, or oppose actions of, the fund’s board of directors. If the shareholders wished to elect a slate of directors different from the one nominated by management, they could engage in a proxy fight. However, for reasons previously discussed, such shareholder-initiated proxy battles are unlikely to succeed. In its 1966 report,\textsuperscript{112} the Securities and Exchange Commission cited two reasons for the ineffectiveness of shareholder proxy battles. First, the wide dispersion of fund shares makes it difficult for a shareholder to obtain the support of a sufficient number of other shareholders in opposing management. Second, as the Navellier and Yacktman proxy contests suggest, shareholders opposed to management may be more likely to redeem than to stay for the fight.\textsuperscript{113}

While the shareholder’s option to redeem may have some influence on director behavior, the exercise of voting rights does not. In routine cases, shareholders automatically accept management’s proposals. In more extreme cases (such as a proxy fight), there is evidence to suggest that shareholders redeem. Thus, shareholders must

\textsuperscript{108} See Regnier, supra note 106, at 130.

\textsuperscript{109} See id. (stating that one investor said “[t]hey were shooting howitzer shells at each other” as reason for withdrawing $1 million from fund).

\textsuperscript{110} See id. at 122.

\textsuperscript{111} See Sturms, supra note 103, at 111 (describing shareholder action as “vot[ing] with their feet”).

\textsuperscript{112} See SEC REPORT, supra note 89.

\textsuperscript{113} See SEC REPORT, supra note 89, at 129-30 (discussing reason why there is little likelihood of shareholder-initiated opposition to management of mutual fund). One can view the ability of shareholders to redeem in the face of a proxy fight as providing the board of directors with leverage over the investment adviser, even though redemption is a shareholder move. Even if an adviser believed that it could survive a proxy battle with the board over renewal of its investment advisory contract, the adviser might not want to risk a battle and watch the assets of the fund dissipate through a wave of redemptions. Of course this leverage would only be useful for a board already inclined to oppose the investment adviser.
seek protection through mechanisms other than voting if they are to succeed in protecting themselves.

V. SHAREHOLDER SUITS

The third manner in which shareholders can seek to safeguard their interests in a mutual fund is by filing suit against the board of directors. The following section briefly describes the two types of suits that can be brought (derivative and direct), and then discusses a line of notable recent cases involving closed-end funds that had the potential to alter the current system of clustered boards of directors.\(^\text{114}\) Since the litigation, in the end, proved fruitless, there is little reason to suspect that a shareholder would be able to challenge successfully the independent directors in a fund complex based on a breach of fiduciary duty arising solely from their service on other boards in the fund complex. However, if a shareholder could make out a claim for breach of fiduciary duty against a director for an action that the director took, based not on the degree of his independence but rather on the propriety under state law of the action he took, then the suit should provide the shareholder with some relief.

In the setting of a traditional corporation, there are two ways in which a shareholder can sue the directors. If the alleged harm was done to the shareholder as such, the shareholder could bring a direct suit and collect damages herself. If the harm was done to the corporation, the shareholder could bring a derivative suit on behalf of the corporation with any damages being paid to the corporation.\(^\text{115}\) Thus, the shareholder has an incentive to characterize the harm as individual in nature. The answer to whether a certain action inflicted harm on the individual or on the corporation likely would depend on how courts in the relevant jurisdiction have interpreted the issue. It is generally accepted that lawsuits based on a breach of a fiduciary duty are derivative in nature.\(^\text{116}\)

A. Stroouga v. Scudder, Stevens & Clark, Inc.

The recent debate surrounding the independence of independent directors received additional attention as a result of a shareholder’s derivative suit against an investment adviser and various board members of a closed-end fund.\(^\text{117}\) Since the

\(^{114}\) Clustered boards of directors are boards of related funds that share directors. All of the directors may be the same or the directors may significantly overlap.

\(^{115}\) See Robert C. Clark, Corporate Law § 15.1, at 639 (1986) (stating that shareholder derivative suits are “one of the most interesting and ingenious of accountability mechanisms for large formal organizations”).


\(^{117}\) Although Stroouga involved a closed-end fund, the same arguments about director independence could be made in the context of an open-end fund.
directors of investment companies are subject to fiduciary duties imposed by state law, a shareholder can bring a derivative suit against a director to redress a violation of a fiduciary duty. In Strougo v. Scudder, Stevens & Clark, Inc., the plaintiff (Strougo) alleged a violation of the duty of loyalty by the directors of the Brazil Fund because of their decision to offer to existing shareholders the rights to purchase additional shares of newly issued stock in the fund. The Brazil Fund was a closed-end investment company incorporated under Maryland law that invested exclusively in securities of Brazilian companies. The interested members of the board of the Brazil Fund were also executive officers of the investment adviser, Scudder, Stevens & Clark, Inc. (“Scudder”). As is common in fund complexes, the other members of the board served as directors of other funds in the Scudder family of funds. Of the seven directors on the Brazil Fund board, six served on other boards for which Scudder was the investment adviser. The fee paid to Scudder was equal to a percentage of the fund’s net assets. Strougo claimed that the board chose to pursue the rights offerings in order to raise additional capital after the fund’s net assets declined dramatically between December 1994 and November 1995, presumably because of the Tequila Effect in Brazil. The increased capital would raise the fund’s net assets and, thus, Scudder’s fee. Strougo claimed that the rights offerings caused harm because they “dilute the pro rata holdings of...stock held by the fund allocable to existing shares [and] because investment banking fees and other transactional costs are incurred by the closed-end fund.”

Under Maryland law, a derivative suit will not be entertained unless the plaintiff first makes a demand on the corporation to take remedial action itself. Such demand is to be made first against the board of directors and then against the shareholders. When

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120 See id. at 788.

121 See id.

122 See id.

123 See id.


125 See Strougo, 964 F. Supp. at 788-89.

126 See id. at 789.

127 See id. at 793 (citing Parish v. Maryland & Virginia Milk Producers Ass’n, Inc., 242 A.2d 512, 544 (Md. 1968)).
demand is made on the board, the board is to appoint a committee (the “litigation committee”) comprised of a minimum of two sufficiently disinterested directors to consider a shareholder’s demand. The demand requirement is excused when it would be futile. Strougo argued that the system of clustered boards in the Scudder family made demand on the board futile. Since six of the seven Brazil Fund directors served on other boards for which Scudder was the investment adviser, Strougo claimed that the directors “could not impartially consider a demand or impartially prosecute this action against Scudder or themselves.”

The court agreed with Strougo, ruling that demand was excused because the directors held positions on the boards of other Scudder funds. Only one of the seven Brazil Fund directors did not serve on other boards. The remaining six were considered interested because of their membership on other Scudder boards and, thus, unable to serve on the litigation committee. Since the board did not have two disinterested directors, the board could not appoint a litigation committee with a sufficient number of disinterested directors to consider the demand. Therefore, the court held that demand was excused as futile.

The litigation continued for quite some time. After the court denied re-argument, the Brazil Fund elected an additional director who was considered disinterested under the court’s ruling and, thus, able to serve on the litigation committee with the existing disinterested director. The court granted a stay for three months to allow the litigation committee to consider whether the derivative suit was in the best interest of the corporation. Finally, the court determined that the litigation committee

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128 See id. at 795 (citing JAMES J. HANKS, JR., MARYLAND CORPORATION LAW § 7.21(c), at 269 n.173 (1994 & Supp. 1)).

129 See Parish, 242 A.2d at 544-45 (stating that futility exception should be sensibly applied).

130 Strougo, 964 F. Supp. at 793.

131 See id. at 795 (applying Maryland state law that requires at minimum two non-interested directors to form litigation committee).


134 See Strougo v. Padegs, 986 F. Supp. 812, 815 (S.D.N.Y. 1997) (stating that three month stay was reasonable “[c]onsidering the complexity and seriousness of the allegations”).
acted appropriately in deciding not to pursue the derivative suit and granted the defendant’s motion to dismiss.\footnote{135}{Strougo v. Padegs, 27 F. Supp. 2d 442, 448-56 (S.D.N.Y. 1998) (finding that litigation committee conducted “a reasonable investigation in good faith” and “exercised sound business judgment” when recommending termination of derivative action). After the original Strougo ruling but before the case was dismissed, the same law firm filed another suit in the same court alleging the same violations of Maryland law. See Strougo on Behalf of Brazilian Equity v. Bassini, 1 F. Supp. 2d 268 (S.D.N.Y. 1998). This litigation (Strougo II) proceeded on much the same path as the original Strougo litigation resulting in the granting of a motion to dismiss in April 1999. See Strougo on Behalf of Brazilian Equity v. Bassini, 1999 U.S. Dist. LEXIS 5951 (S.D.N.Y. 1999).}}

While the original ruling was limited to the holding that demand is excused when directors serve on multiple boards for the same investment adviser, the effect was potentially significant. The ruling would have required that all funds incorporated in Maryland have at least two directors that do not serve on other boards. For a fund complex with, for example, 100 funds -- each with the same board, the changes imposed by the ruling would have been drastic. However, the court itself did not view its holding as that significant. In responding to the contention that the ruling is inconsistent with the Investment Company Act since the Act does not prohibit clustered boards, the court stated,

Although multiple directorships are not necessarily determinative of a director’s independence, either under the Investment Company Act or the SEC’s interpretations, where, as here, a director’s actions are alleged to establish that he or she may be acting in the interests of the advisor, the receipt of substantial remuneration from a fund complex does call into question the director’s independence from the manager of that complex. Moreover, the rule would not eliminate multiple directorships. It would require only that a sufficient number of directors without such multiple directorships serve on a board so that a litigation committee could be convened to consider proposed litigation.\footnote{136}{Strougo, 964 F. Supp. at 795.}

The above analysis highlights what is perhaps the most important potential consequence of the ruling. It appears to open the door to derivative litigation challenging the independence of the independent directors. For example, directors serving on multiple boards could face scrutiny under the standard of care of directors of Maryland corporations.\footnote{137}{See Hanks, supra note 133, at 21-22 (stating that directors could violate the duty to act in the best interest of corporation).} Additionally, while Strougo did not hold that the Investment Company Act was violated, one can read the court’s statement as implying that the court would be sympathetic to the argument that clustered boards whose members receive “substantial remuneration” violate section 10(a) of the Investment Company Act.
While the case had the potential to open up the entire management investment company industry to challenge, Strougo has not had that effect. No subsequent decisions have found violations of state law or the Investment Company Act based on an independent director’s service on multiple boards in the same fund complex. Additionally, at least one court has refused to rule that the mere existence of clustered boards calls into question the independence of the independent directors. After Strougo, the same law firm that represented Strougo represented another plaintiff in suing his board, this time alleging violations of the investment Company Act. In Verkouteren v. Blackrock Financial Management, the plaintiff claimed violations of sections 10(a) and 15(c) of the Investment Company Act. The crux of the argument was that the directors’ service on other boards in the Blackrock family made all of the directors interested. As a result, the plaintiff argued that the fund was in violation of section 10(a) because the board failed to meet the 40 percent requirement, and that approval of the advisory contract violated section 15(c) because it was not approved by a majority of disinterested directors.

The court granted the defendant’s motion to dismiss for failure to state a claim. The plaintiff’s claim came down to the proposition that the independent directors were controlled by the investment adviser and, thus, not truly independent. The court rejected the plaintiff’s claim, citing the Investment Company Act’s presumption that natural persons are not controlled by a company and finding that the plaintiff’s complaint failed to set forth sufficient facts to support a finding of control by the adviser. Most significantly, the court rejected the plaintiff’s oral arguments concerning the lack of shareholder protection in the world of investment company complexes. The court stated,


139 Investment Company Act of 1940 § 10(a), 15 U.S.C. § 80a-10(a) (1998) (providing that registered investment company shall not have board of directors consisting of “more than 60 per centum of the members of which are persons who are interested persons of such registered company”).

140 Id. at § 80a-15(c) (requiring approval of majority vote of non-interested directors to enter into and renew advisory contract).

141 See Verkouteren, 37 F. Supp. 2d at 257 (stating that plaintiff was arguing that because all directors were “interested” that section 10(a) of Act was violated because no board can consist of more than 60 percent interested directors). In turn, the plaintiff argued that because the board was 100 percent interested there was a section 15(c) violation. See id. (noting requirement that advisory contract must be approved by majority of non-interested directors).


143 See 15 U.S.C. § 80a-2(9) (“A natural person shall be presumed not to be a controlled person”); Verkouteren, 37 F. Supp. 2d at 258 (same).

144 See Verkouteren II, supra note 142, at 92,690 (granting defendant’s motion to dismiss).
Several times during oral argument, plaintiff’s counsel decried the inadequate level of oversight over investment advisers provided by independent directors in today’s mutual fund industry. It seems to us that plaintiff’s complaints are better posed to Congress or the regulatory bodies supervising the industry – we are constrained to apply the laws as written and cannot take action where Congress and the SEC have not done so.145

Thus, despite the original ruling in Strougo, it is unlikely that a shareholder will be successful in bringing suit against a board of directors on the theory that the directors are not independent because of their service on multiple boards. Absent action by Congress or the Securities and Exchange Commission, it is unlikely that courts alone will deem the general structure of the mutual fund industry to be in violation of relevant statutes.

In addition, the implication of the Strougo ruling that all investment company boards of directors must include at least two board members who do not serve on other boards available to serve on litigation committees has not altered the mutual fund landscape. In response to the Strougo ruling, the state of Maryland enacted a statute effectively overruling Strougo. The law states that,

A director of a corporation who with respect to the corporation is not an interested person, as defined by the Investment Company Act of 1940, shall be deemed to be independent and disinterested when making any determination or taking any action as a director.146

Under the statute, the disinterested directors of the fund as defined by the Investment Company Act would be considered disinterested under Maryland law. In the context of the Strougo facts, demand would not have been futile because those directors serving on multiple boards who were considered independent under the Investment Company Act could serve on the litigation committee. The mere fact of their service on multiple boards would not have called into question their independence under Maryland law. In 1998, Massachusetts passed a similar law using language almost identical to the Maryland statute.147 Because Maryland and Massachusetts are, along with Delaware, the most

145 Id.

146 Md. Code Ann. Corps. & Ass’ns § 2-405.3 (1998). The section applies to “a corporation that is an investment company, as defined by the Investment Company Act of 1940.” Id.


This section shall apply to a trust that is an investment company, as defined in the Investment Company Act of 1940, and that is registered thereunder with the United States Securities and Exchange Commission. A trustee of a trust who with respect to the trust is not an interested person, as defined in said Investment Company Act of 1940, shall be deemed to be independent and disinterested when making any determination or taking any action as a trustee.

Id.
popular states in which to organize mutual funds, the ruling in Strougo has been effectively overturned and the line of cases is unlikely to engender changes in the structure of the mutual fund industry.

B. OTHER SUITS

Although derivative suits based purely on the independence of directors in mutual fund complexes are unlikely to succeed, shareholders may still bring traditional suits, either direct or derivative, based on violations of state-law duties or of the Investment Company Act. Strougo was unique in that the litigation centered on the degree of independence of the directors. However, if a plaintiff can show that actions by fund directors violate the directors’ duties under federal or state law, then the plaintiffs or the mutual fund may be able to recover damages.

A shareholder can bring a direct or derivative suit either for a violation of the Investment Company Act or for a violation of state law. Section 36(a) of the Investment Company Act allows for suits based on personal misconduct by officers, directors, investment advisers and others. Courts have held that a private right of action exists under section 36(a). Professor Tamar Frankel has argued that, although a private right of action exists under section 36(a), such actions are not well suited to deterring board members from taking actions that they might otherwise take. While the amount of damages involved in section 36(a) suits are large, “the damages are not necessarily related to the individual managers’ gains or to the individual investors’ injuries or to the gravity of the violations; but mainly to the fortuitous number of investors involved.” As a result, the deterrent effect is reduced. If the amount of damages was not as arbitrary, then the deterrent effect would be greater.

In 1970, Congress adopted section 36(b) of the Investment Company Act, which imposes on the investment adviser, as a matter of federal law, a fiduciary duty with respect to the amount of compensation received. The provision is unique in that it imposes a fiduciary duty with respect to compensation rather than the performance of

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152 See 15 U.S.C. § 80a-35(b) (stating “the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof”).
services.\textsuperscript{153} By the terms of the statute itself, suits may be brought against the investment adviser either by the Securities and Exchange Commission or by a shareholder on behalf of the fund. While most section 36(b) suits have been settled, a few cases have held that the adviser’s fees must be “within the range of what would have been negotiated at arm’s length in the light of all of the surrounding circumstances.”\textsuperscript{154}

It is important to note that many of the issues discussed above are applicable here as well. To the extent that shareholders are generally uninformed or view their shares as the means for purchasing professional asset management, then it is possible that potentially actionable behavior by the board of directors or investment adviser may go undetected. However, these concerns should be less significant in the context of shareholder suits than in the case of redemptions. Since mutual fund shares are widely dispersed, the power of the redemption option in policing the board turns on having a sufficient number of shareholders informed and willing to redeem. If shareholders generally are uninformed, then there is reason to doubt the effectiveness of the redemption option. Shareholder suits only require that one shareholder be sufficiently informed and willing to file suit. This at least increases the chances that actionable behavior will be noticed and that remedies will be sought.

As with shareholder voting, the ability to redeem shares in the mutual fund may decrease the significance of shareholder suits. If a shareholder detects behavior by the board that could be the subject of a suit, either direct or derivative, a mutual fund shareholder (unlike the closed-end fund shareholder-plaintiff in \textit{Strougo}) faces a choice: either bring suit or redeem. If it is assumed that the costs of litigation will be paid by the shareholder, then the shareholder would file suit if the expected value of the recovery is greater than the costs of the litigation. In order to determine the expected value of filing suit, the shareholder must assess the probability that the case will succeed, either through a favorable ruling or through a sufficiently large settlement. This calculation ignores the higher return that another fund may offer, since that factor is not unique to the situation of the shareholder deciding whether or not to file suit. If there are no limitations on the ability to redeem, the shareholder always faces the possibility of higher returns in another fund.

It is important to distinguish between the various “costs” that a shareholder suit entails. The total costs can be thought to include the actual dollar amount necessary to bring suit (such as attorney’s fees and court fees) plus the intangible costs to the shareholder. In regards to the latter, many shareholders may decide that the hassle of bringing suit is not worth the gain given the option to redeem. Compared with a decision where the option to redeem does not exist, a shareholder may give greater value to these hassle costs given the relative ease with which shares may be redeemed. Alternatively, if

\textsuperscript{153} See \textit{Lemke, et al.}, supra note 58, at \S\ 9.08[2][b] (stating that provision’s “sole purpose is to specify an adviser’s fiduciary duty with respect to the receipt of compensation”).

\textsuperscript{154} Gartenburg v. Merrill Lynch Asset Mgmt, Inc., 694 F.2d 923, 928 (2\textsuperscript{nd} Cir. 1982); see generally \textit{Schuyt v. Rowe Price Prime Reserve Fund, Inc.}, 835 F.2d 45 (2\textsuperscript{nd} Cir. 1987) (affirming lower court’s decision in which it applied \textit{Gartenburg} to facts of case).
it is assumed that the hassle costs are the same in both instances, then the redemption option affects the decision in a different way. The ability to redeem would affect the size of the payout needed to justify suit. Instead of electing to file suit when the net expected value is merely positive, the shareholder would file suit only when the expected payout is sufficiently greater than the costs to the litigation given the relative ease with which the shareholder can redeem. 155

VI. CONCLUSION

Among the three actions available to shareholders for policing the behavior of mutual fund boards of directors, the exercise of voting rights presents little opportunity to serve as an effective regulator of board behavior. The use of lawsuits can provide some degree of protection, although a shareholder must be willing to accept the associated costs. The value of both of these options is lessened by the existence of the third option—the ability to redeem. The redemption option presents shareholders with the greatest protection against misbehavior by the board. Although some people are limited in their ability to redeem, the option remains an important tool for shareholders.

Thus, while shareholders have some power to protect themselves, the safeguards are not sufficient to render the possible alignment of the board of directors with the investment adviser a non-issue. There are too many impediments to shareholders protecting themselves without the additional layer of protection that should be provided by independent directors. If criticisms by the press are true, then there is reason to believe that the interests of shareholders are not being adequately safeguarded.

155 There is a complete body of literature on the value that shareholder suits play in the context of traditional corporations. For a good discussion, see Daniel R. Fischel & Michael Bradley, The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis, 71 CORNELL L. REV. 261 (1986), and the commentaries that follow. However, I have been unable to find similar studies in the mutual fund context. This lack of scholarly literature on the topic may imply that there is room for work of this sort. Alternatively, it could suggest that there is not a clear answer to the question of whether, on net, shareholder suits in the mutual fund context encourage greater oversight of the fund’s operations by the board of directors.
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