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# Capital gains lock-in and governance choices☆

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ABSTRACT

Differences in accrued gains and investors' tax-sensitivity induce variation in a capital gains lock-in effect across mutual funds even for the *same* stock at the *same* time. Exploiting this variation, we show this effect influences funds' governance decisions: higher capital gains decrease the likelihood a fund exits prior to contentious votes and increase the likelihood a fund votes against management. Consistent with tax motivation, these findings are concentrated among funds with tax-sensitive investors. Further, high *aggregate* capital gains across funds holding a stock predict a higher likelihood management loses a vote and a lower likelihood a contentious vote is proposed.



## 1. Introduction

Mutual funds face a dilemma when voting on contentious proposals in which the fund believes that opposing management will increase shareholder value. In this situation, a mutual fund must weigh the potential value created by opposing the firm's management against the potential costs. Prior studies suggest that, upon anticipating an imminent conflict with a company's management, a fund generally prefers to exist a position rather than fight (i.e., directly oppose management).[1] Economic incentives

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[1] See Parrino, Sias, and Starks (2003) and McCahery, Sautner, and Starks (2016).

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for this preference are clear: voting against management can reduce both the likelihood the mutual fund will be included in corporate defined contribution plans (Davis and Kim, 2007; Ashraf, Jayaraman, and Ryan, 2012) and access to information from management (Butler and Gurun, 2012).[2] Also, Roe (1990) argues that political and legal constraints encourage mutual funds to exit rather than directly oppose management.

For mutual funds with tax-sensitive investors and a capital gain on a stock, exiting a position, rather than "staying and fighting" the firm's management, imposes tax costs on the funds' investors. Therefore, to some extent, a mutual fund with a largely taxable clientele is locked into a stock position with an unrealized capital gain. Prior research shows that the capital gains lock-in effect influences mutual funds' trading decisions (Huddart and Narayanan, 2002; Cici, 2012; Sialm and Starks, 2012). Bergstresser and Poterba (2002) show that ignoring tax incentives is costly for fund managers because tax efficiency affects investment flows. Accordingly, because of this capital gains lock-in effect, the cost of exiting a position will differ across mutual funds even for the *same* stock at any given time, depending on the tax status of the funds' investors and the accrued capital gains (or losses) in that stock. Thus, for a position with an unrealized capital gain, mutual funds with taxable clientele must trade off these countervailing forces.

In this paper, we study the relation between funds' willingness to oppose management on contentious proposals and the capital gains lock-in effect. A mutual fund locked-in to a position for tax reasons may be more likely to oppose management because of the tax incentive to hold that position even if the fund disagrees with the firm's management on a particular vote. There are two related reasons for this. First, because realizing a capital gain is more costly for funds with tax-sensitive investors, the fund has a longer investment horizon and can benefit from the long-term value created by their voting. Second, funds that are not locked-in and that continue to hold the position are more likely aligned with management. In contrast, funds with a larger accrued gain in a stock and with tax-sensitive clientele may be more likely to oppose management on contentious votes because the capital gains lock-in effect, rather than an affinity for management, causes them to continue holding the stock. For funds locked into a holding for tax reasons, a pragmatic alternative to sale is actively monitoring the firm. Indeed, Bhide (1993, p. 42) explicitly mentions that the capital gains lock-in effect encourages active governance by reducing an investor's willingness to sell shares.

We test whether a higher accrued gain, by making exit less attractive because of the tax consequences, increases the likelihood that a mutual fund will oppose management. We first confirm, consistent with prior studies, a negative relation between the probability a fund sells a stock and the accrued capital gain[3] on that stock. We also confirm that this relation is stronger for funds with tax-sensitive clientele. We then test how the accrued gain affects the decision whether to oppose management, conditional on staying. For these tests, we focus on contentious votes, for which opposing management is potentially value-increasing. McCahery, Sautner, and Starks (2016) survey institutional investors, including mutual funds, and report that "most investors use proxy advisors and believe that their information improves their own voting decisions." Accordingly, in our main results we limit the sample to "contentious" votes for which Institutional Shareholder Services (ISS) recommends voting against management.[4] In robustness tests, we show that our results also hold in the full sample of all votes.

In our *Oppose Management* regressions, we obtain identification by including two sets of fixed effects: one set for each vote and one set for each mutual fund-quarter combination. First, for a given vote, the accrued capital gain since purchase varies across the different funds holding the company's stock, as does the tax status of those funds' investors. This variation allows us to include vote fixed effects in our specifications. These fixed effects eliminate many potential sources of confounding variation, such as the issue voted upon, as well as the company's finances, governance, and past performance. For example, past performance of the stock could certainly affect whether a fund opposes management (i.e., opposition to management may be lower following good performance). Our vote fixed effects control for any relation between opposition to management on a particular vote and past stock returns over any horizon because the stock return over a given past horizon is the same for all investors. We identify the effect of the capital gains lock-in effect on governance by exploiting the differences across funds in their accrued capital gain in *the same stock at a given time*, as well as differences across funds in the tax status of their investors. In particular, different funds will have different accrued capital gains if they established their positions in a stock at different times at different prices. For funds with taxable investors, it is this accrued capital gain that is relevant for tax-motivated decisions.

Second, for a fixed fund-quarter combination, the accrued capital gains vary across the different stocks held by the fund at that point in time. This variation allows us to include fund-quarter fixed effects in our specifications. These fixed effects eliminate many other potential

[2] For example, a mutual fund company's statement to the U.S. Securities and Exchange Commission (SEC) regarding vote disclosure rules states that "… retaliation [from the firm] could be in the form of denial of access to company management in the course of our investment research on behalf of our shareholders." See http://www.sec.gov/rules/proposed/s73602/rmason1.txt.

[3] For expositional simplicity, we use the term "capital gain" to refer to the percent change in a stock holding's price since the time of purchase. Therefore, "capital gain" can refer to either a gain or a loss in a stock position.

[4] Numerous prior studies use ISS recommendations as a proxy for value-increasing voting recommendations (Bethel and Gillian, 2002; Morgan, Poulsen, and Wolf, 2006; Cotter, Palmiter, and Thomas, 2010; Morgan, Poulsen, Wolf, and Yang, 2011). Alexander, Chen, Seppi, and Spatt (2010) examine stock-price reactions to ISS announcements of voting recommendations that oppose management and show that ISS voting recommendations are generally value-enhancing, thus justifying this proxy. Although Iliev and Lowry (2015) argue that ISS recommendations are not always value-enhancing, at a minimum, proposals for which ISS and management disagree are contentious, with support for management not clearly in shareholders' best interests.