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Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry

William A. Birdthistle

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Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry

William A. Birdthistle*

Recent allegations of malfeasance in the investment management industry—market-timing, late-trading, revenue-sharing, and several others—involve a broad range of mutual fund operations. This Article seeks to explain the common source of these irregularities by focusing upon a trait they share: the practice of investment advisers’ capitalizing upon their managerial influence to increase assets under management in order to generate greater fees from those assets. This Article extends theories of executive compensation into the context of investment management to understand the extraction of rents by mutual fund advisers. Investment advisers, as collective groups of portfolio managers, interact with the boards of trustees of mutual funds in ways analogous to the dealings of business executives with corporate boards of directors. In this setting, the managerial power hypothesis of executive compensation provides a useful paradigm for understanding distortions in arm’s-length bargaining between investment advisers and fund boards, as well as limitations of the market’s ability to ensure optimal contracting between those parties.

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* Associate, Ropes & Gray LLP. J.D. 1999, Harvard Law School; B.A. 1995, Duke University. The author thanks Victor Fleischer, Christine Hurt, Kate Litvak, Jeremy Paul, Larry Ribstein, David Shapiro, Guhan Subramanian, David Walker, and Alison LaCroix for their comments on earlier drafts of this Article.

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I. INTRODUCTION

In the wake of the heaviest outpouring of criticism in its history, the investment management industry has been punished with handsome profits and proposals for a lucrative future stream of Social Security revenues. The year following New York Attorney General Eliot Spitzer's September 2003 accusation of malfeasance in mutual funds was truly an *annus horribilis* for those funds and the financial

houses that invest the funds' money.¹ Prior to Spitzer's announcement, investment advisers²—firms of professional money managers who collectively manage more than \$7 trillion in assets and advise more than 8000 mutual funds³—had enjoyed general approbation for the way in which they ran their businesses.⁴ Indeed, while much of corporate America suffered through its own outbreak of accounting malfeasance, commentators hailed mutual funds (owned by ninety-one million investors living in nearly half of all U.S. households⁵) and their unique structure as models of corporate governance.⁶ Spitzer's press conference, however, triggered an unceasing tide of opprobrium, which has flowed over the investment management industry and befouled its reputation.

But as the market has recuperated since then, the indignation has ebbed. Shareholders seem to have forgiven any enormities and returned to invest anew and to share in the funds' success.⁷ Yet structural flaws in the industry remain. And with the tremendous amount of assets invested in mutual funds, spiced with the possibility that Social Security reform might some day direct an additional \$65 billion into personal fund accounts each year,⁸ the late transgressions

1. See Press Release, Office of N.Y. State Att'y Gen. Eliot Spitzer, State Investigation Reveals Mutual Fund Fraud (Sept. 3, 2003) [hereinafter Press Release, Eliot Spitzer], available at http://www.oag.state.ny.us/press/2003/sep/sep03a_03.html.

2. Although the term "investment adviser" may be understood colloquially to refer to an individual who manages money, the term as used in the mutual fund industry and this Article refers to a professional business organization staffed by such individuals. The Investment Advisers Act of 1940 (Advisers Act) defines "investment adviser" to mean "any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities" and "person" to mean "a natural person or a company." Investment Advisers Act of 1940, Pub. L. No. 768, §§ 202(a)(11), (16), 54 Stat. 847 (1940) (codified at 15 U.S.C. § 80b-2(11), (16) (2000)). It is in the latter sense of a company that this Article uses the term "investment adviser."

3. See INV. CO. INST., 2004 MUTUAL FUND FACT BOOK 1, 13 (44th ed. 2004).

4. See Richard M. Phillips, *Mutual Fund Independent Directors: A Model for Corporate America?*, PERSPECTIVES, Aug. 2003, at 2, 12.

5. See INV. CO. INST., *supra* note 3, at 79-80.

6. See Phillips, *supra* note 4, at 2, 12.

7. See, e.g., Laura Johannes, *Strong Performers Suffer Less in Mutual-Fund Scandals*, WALL ST. J., Jan. 24, 2005, at C1; David Serchuk, *Fund Companies: After the Fall*, FORBES, Jan. 14, 2005, available at http://www.forbes.com/strategies/2005/01/14/cz_ds_0114sf.html ("More than a year after the mutual fund industry got into trouble for late-trading and market-timing practices, shares of some of the offending fund companies have bounced back nicely.")

8. See Tom Lauricella, *In Bush Plan, Who Will Do the Managing?*, WALL ST. J., Feb. 4, 2005, at C1 ("Robert Pozen, chairman of MFS Funds and a member of the presidential commission that backed private accounts, estimates that about \$65 billion will flow into the accounts every year."). Of course, until any Social Security plan is successfully adopted,

compel a serious appraisal of the industry's architectural vulnerabilities.

After presenting an introduction to the charges against mutual funds, the unique structures of these funds, and the dynamics at work in the alleged malfeasance, this Article in Part II provides background on the components and organization of the investment management industry, beginning with a brief history of its development in the United States and a discussion of the rationales that encourage investment in pooled vehicles. Part III argues that the relationship between mutual fund boards of trustees and the investment advisers that those boards hire can best be understood within the paradigm of executive compensation. Part III then considers what the prevailing model of executive compensation, the optimal contracting approach, might predict when deployed in the investment advisory context. Part IV explores the limitations of the optimal contracting approach and, finding that theory wanting, suggests that another theoretical approach, the managerial power hypothesis, which has heretofore been confined to the operating company⁹ context, might apply with equal or greater force in the mutual fund setting. Part V examines the malfeasance exposed by the recent industry investigations and argues that the behavior in question can best be understood as camouflaged extraction of compensation from fund shareholders. The Article concludes that recently proposed and adopted regulatory reforms are, and will continue to be, inadequate to the task of vitiating the influence of investment advisers and the conflicts of interest that currently pervert those advisers' incentives to the detriment of shareholders.

industry executives have an incentive to diminish estimates of potential inflows to avoid appearing rapacious. Conversely, opponents of Social Security reform have an incentive to inflate the figures to suggest that reforms involving personal accounts are driven by the financial industry's desire for profit. Other estimates suggest that \$75 billion or more would flow into personal accounts. See Peter Bucci, *Bush Plan Could Add \$75B to Funds Annually*, IGNITES, Nov. 8, 2004, http://www.ignites.com/articles/print/20041108/bushplan_could-funds.annually ("Ken Worthington, an analyst at CIBC World Markets, expects 100 million of 130 million taxpayers to invest some of their Social Security money in private accounts. Contributions will likely average \$750 a year, assuming an annual cap of \$1,000. In comparison, he says, the fund industry took in some \$200 billion annually from 1996 to 2003.").

9. The term "operating company" is used in the investment management industry—and this Article—to refer to a typical company other than an investment company or mutual fund; that is, a company outside the investment management business whose primary purpose is the provision of goods or services and not simply the investment of assets. Cf. Investment Company Act of 1940, § 3(a)(1), 15 U.S.C. § 80a-3(a)(1) (2000) (setting forth the definition of "investment company" under the 1940 Act).

In the past two and a half years, federal and state investigators have alleged that investment advisers—including many of the most well-respected firms in the business, such as Putnam Investments (Putnam), Alliance Capital (Alliance), and Massachusetts Financial Services (MFS), to name but a few—have indulged in a feast of abuses, including illicitly abetting private investors in arbitraging mutual funds to the detriment of other fund shareholders;¹⁰ failing to “fair value” the worth of assets under their management;¹¹ permitting favored shareholders to buy and sell fund shares illegally after the daily trading deadline;¹² selectively disclosing the holdings of securities in their funds’ portfolios to preferred clients;¹³ appropriating shareholder assets to boost fund sales and, in turn, their own advisory fees;¹⁴ and, perhaps not surprisingly, destroying evidence of the aforementioned abuses.¹⁵

Spitzer sounded the first ominous note on September 3, 2003, when he held a press conference to announce a complaint alleging the

10. See, e.g., Investment Advisers Act Release No. 2213, Mass. Fin. Servs. Co., Investment Company Act Release No. 26,347, 82 SEC Docket 341 (Feb. 5, 2004), available at <http://www.sec.gov/litigation/admin/ia-2213.htm>.

11. See, e.g., Alison Sahoo, *SEC Probe: Pricing Problems Widespread*, IGNITES, Mar. 24, 2004, http://www.ignites.com/articles/print/20040324/probe_pricing_problems_widespread (“More than half of the 961 global funds and 219 complexes that responded to an SEC inquiry letter used fair-valuation procedures less than five times in the past 20 months. Another 277 funds, or 31% of the respondents, didn’t use fair valuation at all during that time.”).

12. See, e.g., Riva D. Atlas & Diana B. Henriques, *U.S. Closes Mutual Fund Intermediary*, N.Y. TIMES, Nov. 26, 2003, at C1 (“The regulators in the Office of the Comptroller of the Currency coordinated their decision to close Security Trust with Mr. Spitzer’s office and the Securities and Exchange Commission, which both announced their own actions yesterday. The S.E.C. accused the company and three former executives of facilitating hundreds of illegal trades by hedge funds managed by Edward J. Stern, who reached a settlement with Mr. Spitzer in early September.”).

13. See, e.g., Paul F. Roye, Dir., Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm’n, Remarks Before the ICI General Membership Meeting (May 20, 2004), available at <http://www.sec.gov/news/speech/spch052004pfr.htm> (“In addition, as the fund industry was resisting efforts to require more frequent disclosure of mutual fund portfolio holdings, some management firm personnel allegedly were selectively disclosing portfolio information that was later used to trade against their funds and harm their investors.”); Deborah Brewster, *SEC Hits Out at Mutual Funds’ Credibility Gap*, FIN. TIMES (London), May 21, 2004, at 19 (reporting on Paul Roye’s announcement that some firms “were selectively disclosing portfolio holdings”).

14. See, e.g., Press Release, U.S. Sec. & Exch. Comm’n, Fifteen Firms To Pay over \$21.5 Million in Penalties To Settle SEC and NASD Breakpoints Charges (Feb. 12, 2004) [hereinafter Press Release, SEC], available at <http://www.sec.gov/news/press/2004-17.htm>.

15. See, e.g., Gregory Zuckerman, Tom Lauricella & John Hechinger, *Former Fred Alger Official Pleads Guilty*, WALL ST. J., Oct. 17, 2003, at C1 (“But on Sept. 4, Mr. Connelly allegedly told a subordinate to ‘delete certain e-mails,’ and directed her to instruct three other Alger people who reported to Mr. Connelly to delete e-mails about the [late] trading.”).

complicity of several major fund groups in illegal market-timing and late-trading.¹⁶ In the year following that dramatic press conference, barely a week passed during which the industry escaped accusations of yet more transgressions.¹⁷

Within days of Spitzer's announcement, a pack of governing agencies had loosed investigations of their own upon the investment advisory business.¹⁸ Indeed, within just a matter of months, the Securities and Exchange Commission (SEC) had issued Wells notices,¹⁹ conducted depositions, and even reached settlements in several of its investigations.²⁰ The aggregated penalties, fines, and fee reductions levied against the investment advisers in just two of those early settlements amounted to almost \$1 billion.²¹ Since then, other federal regulators and a posse of state agencies have joined the SEC in conducting investigations into dozens of fund complexes, and the aggregate amount paid to settle investigations has climbed to many billions of dollars.²²

In addition, the SEC quickly proposed and adopted a litany of new rules aimed at patching the industry's ethical leaks. These regulations call for broader disclosure with respect to pricing

16. See Press Release, Eliot Spitzer, *supra* note 1.

17. Until September 2005, the industry publication, *Ignites*, maintained on its Web site a "Scandal Timeline," which in the first year following Spitzer's press conference, from September 3, 2003, to September 3, 2004, listed 204 separate entries. E-mail from Chris Frankie, Managing Editor, *Ignites*, to Hannah Campbell, *Tulane Law Review*, in New Orleans, La. (Jan. 25, 2006) (on file with the *Tulane Law Review*).

18. See Brooke A. Masters, *Mutual Fund Abuses Alleged in Two Cases*, WASH. POST, Sept. 17, 2003, at E1.

19. After conducting an investigation into alleged wrongdoing, but prior to recommending that the Commission approve an enforcement action, the staff of the SEC will (in a Wells notice) typically provide defendants with one final opportunity (through a Wells submission) to persuade the staff to change its recommendation. The process derives its popular name from John Wells, the Chair of an Advisory Committee on Enforcement Policies and Practices that published a report in 1972 recommending this procedure. See LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 1481-84 (5th ed. 2004).

20. See Press Release, SEC, *supra* note 14.

21. The settlement orders, formalized as SEC releases, set forth the underlying allegations and any penalties or fines to which investment advisers have agreed. See Alliance Capital Mgmt., L.P., Investment Advisers Act Release No. 2205A, Investment Company Act Release No. 26,312A, 81 SEC Docket 3401 (Jan. 15, 2004), available at <http://www.sec.gov/litigation/admin/ia-2205a.htm> (setting forth a penalty of \$250 million, excluding additional fee reductions and settlements aggregating to \$600 million); Mass. Fin. Servs. Co., Investment Advisers Act Release No. 2213, Investment Company Act Release No. 26347 (Feb. 5, 2004), available at <http://www.sec.gov/litigation/admin/ia-2213.htm> (setting forth a total settlement of \$225 million).

22. Hank Ezell, *Mutual Fund Cleanup Gets Good Reviews*, ATL. J. CONST., Aug. 29, 2004, at 4Q.

discounts,²³ codes of ethics,²⁴ investment company governance,²⁵ and new compliance programs,²⁶ among almost a score of topics. The self-regulating organizations have also sharpened their pencils, with the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) issuing new corporate governance rules to their members.²⁷ Congress, too, stoked the legislative machinery, holding numerous committee hearings on the matter and voting on bills aimed at addressing the growing list of complaints.²⁸

Of course, the civil bar never long remains ignorant of plumes of smoke emanating from regulatory investigations; plaintiffs' attorneys have commenced an eager hunt for fire of their own. They have already filed more than one hundred civil law suits—both class actions and derivative suits—against dozens of investment advisers, funds, and trustees.²⁹

What has been remarkable about this decline and fall is not so much its speed but the pedigree of its tragic hero: the mutual fund industry boasted a largely celebrated history reaching back eighty years. Ostensibly, the investment management business benefits from many of the textbook safeguards designed to guarantee the integrity of any financial industry and to permit optimal contracting amongst all parties.

First, mutual fund boards boast high percentages of independent trustees, who are charged with bargaining at arm's length with investment advisers on behalf of fund shareholders.³⁰ Second, the industry comprises more than 8000 different funds, and competition

23. See Disclosure of Breakpoint Discounts by Mutual Funds, Investment Company Act Release No. 26,464, 69 Fed. Reg. 33,262, 33,263-65 (June 14, 2004).

24. See Investment Adviser Codes of Ethics, Investment Advisers Act Release No. 2256, Investment Company Act Release No. 26492, 69 Fed. Reg. 41,696, 41,696 (July 9, 2004).

25. See Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378, 46,378 (Aug. 2, 2004).

26. See Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, Investment Company Act Release No. 26,299, 68 Fed. Reg. 74,714, 74,715-23 (Dec. 24, 2003).

27. See Phillips, *supra* note 4, at 1.

28. See Stephen Labaton, *House Backs Bill To Overhaul Mutual Funds*, N.Y. TIMES, Nov. 20, 2003, at C1 (reporting the U.S. House of Representatives' vote of 418-2 to approve legislation "aimed at deterring trading abuses and fund mismanagement, improving the disclosure of fee information and increasing the independence of fund boards").

29. See, e.g., Complaint, *Hammerslough v. Mass. Fin. Servs. Co.*, No. 04-CV-1185 (S.D.N.Y. Feb. 13, 2004) (a derivative action consolidated as part of the multidistrict litigation of market timing and related claims involving several fund complexes, such as Alger, Columbia, Janus, MFS, One Group, Putnam, and Allianz Dresdner).

30. See INV. CO. INST., *supra* note 3, at 8, 27.

for the 91 million investing shareholders would appear to be robust.³¹ With scores of investment advisers competing for more than \$7 trillion in assets,³² one would be hard pressed to imagine a more vigorous marketplace. Third, both investment advisers and investment companies are heavily regulated by several important federal regulations, including not only the Securities Act of 1933³³ (the Securities Act) and the Securities Exchange Act of 1934³⁴ (the Exchange Act) but also the Investment Advisers Act of 1940³⁵ (the Advisers Act), the Investment Company Act of 1940 (the 1940 Act),³⁶ and the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley).³⁷ Furthermore, the industry is also governed by specific provisions of the Internal Revenue Code³⁸ (the Code) and the Employee Retirement Income Security Act of 1974 (ERISA).³⁹ Largely as a consequence of the stringency of these regulations, the industry is obliged to disclose vast quantities of information about mutual funds and their advisers. In annual reports, semi-annual reports, prospectuses, statements of additional information, certified shareholder reports, and several other regularly required disclosure documents, advisers must, in extensive detail, lay bare the fees, performance histories, investment strategies, and risks of the funds they manage. For any given mutual fund, the disclosure documents filed with the SEC annually may easily amount to several hundred pages. Fourth, many of the shareholders in these funds are not simply passive retirees; they are sophisticated and powerful governmental pension plans, university endowments, and frequently other mutual funds, each aggressively pursuing its own interest with a full-time staff of highly educated and well-informed managers. Finally, shareholders of mutual funds, like any other

31. *See id.* at 13, 79-80.

32. *See id.* at 79.

33. Pub. L. No. 22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (2000)).

34. Pub. L. No. 291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78mm).

35. Pub. L. No. 768, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1 to 80b-21).

36. Pub. L. No. 768, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-64). The Investment Company Act is often colloquially referred to as either the Company Act or, with apparent disregard for the fact that the Advisers Act was passed in the same year, the 1940 Act.

37. Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.A. (West 2005)).

38. 26 U.S.C. § 4982(a)-(f) (2000).

39. Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended in scattered sections of 5, 18, 26, 29, and 31 U.S.C. (2000)).

investors, have access to the courts to pursue legal remedies to void any advisory agreements that are adverse to their pecuniary interests.

With such an arsenal of structural protections, the investment management industry should have proven largely immune to inept governance and distortions in optimal contracting amongst its constituent parties. Then whence, one must ask, came this collapse?

While the soothing effects of a market rebound appear to have cooled the interest of some investors in seeking an answer to that question, the amounts of money at stake are simply too significant to ignore. Settlements and fines in the first year of investigations alone amounted to many billions of dollars, and those amounts are very likely to grow significantly through civil litigation.⁴⁰ Moreover, those sums could be dwarfed by the billions and even trillions of dollars in revenues that some analysts believe Social Security reform would bring to the industry.⁴¹ If mutual funds are truly as susceptible to malfeasance as the broad array of regulatory investigations would suggest, surely the time to understand those vulnerabilities is now, prior to the emergence of new irregularities and before the arrival of substantial inflows of money magnifies the problem.

This Article argues that the industry's faults can be found in the idiosyncratic structure of mutual funds, a structure that exacerbates the ability of managers to wield substantial power and to use that power to extract rents both overtly and surreptitiously from shareholders.⁴²

The very structure of mutual funds lays them open to such abuses. The typical mutual fund is a rudimentary legal vessel into which shareholders contribute money and over which a board of trustees governs; the fund has no offices, no equipment, and no employees.⁴³ Instead, all the functions that a fund needs to perform in order to achieve its basic mission—which is, essentially, to increase the value of each shareholder's investment—are performed by third parties.⁴⁴ The most important of these service providers is the entity that manages the fund's investment portfolio, the investment adviser.

The investment adviser enters into an advisory agreement with the fund, represented by the fund's board of trustees, pursuant to which the adviser agrees to manage the fund's money in exchange for a fee

40. See Ezell, *supra* note 22.

41. See Lauricella, *supra* note 8; Bucci, *supra* note 8.

42. See generally Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. ECON. PERSP. 161 (2004) (describing the structure of mutual funds and the incentives and conflicts facing managers and brokers).

43. See INV. CO. INST., *supra* note 3, at 2.

44. See *id.*

calculated as a percentage of the assets under management. In essence, the investment adviser serves as the entire management and all the personnel of the fund. If a fund—that is, its board of trustees—is unhappy with the investment adviser’s performance, there is but one contractual recourse: to terminate the advisory agreement. The board is heavily constrained from hiring or firing particular executives or portfolio managers who work for the investment adviser because those individuals report directly only to their own company’s board of directors.

Termination of an advisory agreement, however, would have a devastating effect on the fund. To change the investment adviser of a fund would be to change the very nature of the fund and to nullify an essential reason many shareholders have invested in the fund: namely, to obtain the services of a particular investment adviser. When thousands of shareholders flocked to the Magellan Fund in its heyday—the period during which it rose 2700% between 1977 and 1990⁴⁵—many of them were not merely hoping to aggregate their monies with other shareholders; rather, they were specifically seeking the wisdom of Peter Lynch, the celebrated portfolio manager who had won superlative returns on shareholder investments. Magellan’s board might have believed, therefore, that to replace Lynch and Fidelity Investments with another adviser would have been to convert the fund into a completely different investment choice. Rather, the board might conclude that, if shareholders are unhappy with their investment adviser, they do not need to wait for the fund’s board to provide a remedy; the shareholders have a remedy of their own at their ready disposal: they can simply redeem their shares and leave the fund. Of course, the ability to redeem is useful to shareholders only if they know when to do so. Many shareholders, however, may not be paying close attention to whether their adviser is extracting insupportable fees, either because they are unwilling or unable to monitor the situation or because they are receiving sufficiently large returns from the fund not to mind losing out on additional gains. Either way, many shareholders may not exit a fund even when it may be in their interest to do so. In any event, the termination of advisory agreements is so rare as to be practically nonexistent. This limitation severely restricts the ability of

45. See Stephen Schurr, *A Little Knowledge Can Often Be a Dangerous Thing*, FIN. TIMES (London), Dec. 14, 2004, at 12 (“I am awestruck by [Lynch’s] genius as a money manager, as evidenced by the 2,700 per cent return of the Magellan fund from 1977 to 1990.”).

a fund's board to control the management of the fund. Investment advisers are well aware of this limitation.

Typically, the only recourse open to a board is for its members to make their displeasure known publicly, in an attempt to embarrass an uncooperative investment adviser or to invite the possibility of SEC scrutiny of the adviser. Particularly in the current climate of heightened regulatory oversight, the threat of such action by a board certainly can restore some balance of power with the investment adviser. Advisers are therefore not completely free to impose their unchecked will in the annual negotiations with a fund board. Accordingly, if an adviser wishes to extract rents without triggering board outrage, it may have to camouflage its behavior—that is, an investment adviser may attempt to obtain greater-than-optimal value from shareholders without being detected.

In the unique structure of investment companies, advisers are essentially surrogate executives to mutual funds, and advisory agreements govern their compensation. And, as has been argued in the study of executive compensation,⁴⁶ though not before in the mutual fund context, a substantial degree of managerial power may distort optimal contracting and permit managers to extract rents. In this setting, advisers wield a great deal of managerial power and often use that power to extract value from shareholders beyond what has been negotiated in the advisory contract. Indeed, this novel application of the managerial power hypothesis demonstrates that the alleged transgressions are best understood as camouflaged attempts by advisers to mine rents from fund shareholders.

II. THE INVESTMENT ADVISORY INDUSTRY

A. *A Brief History of Mutual Funds*

The notion of pooling money into a common investment fund is not a new one. Indeed, European financiers have been investing in mutual funds or their antecedents for hundreds of years.⁴⁷ In Britain,

46. See, e.g., Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 843-49 (2005); Lucian Arye Bebchuk, Jesse M. Fried & David L. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 785 (2002); cf. Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 857-69 (2002) (arguing that managers extract greater compensation through the undervalued “perceived cost” of stock option incentives as opposed to managerial power).

47. Dustin Woodard, *The History of Mutual Funds*, http://mutualfunds.about.com/cs/history/a/fund_history.htm (last visited Mar. 28, 2006).

Parliament authorized the earliest formal authority in the Anglo-American legal tradition for such vehicles when it passed the Joint Stock Companies Acts of 1862 and 1867.⁴⁸ These two laws created the first opportunity for investors, “to share in the profits of an investment enterprise” while “limit[ing] investor liability to the amount of investment capital devoted to the enterprise.”⁴⁹

Soon thereafter, in 1868, London witnessed the founding of the Foreign and Colonial Government Trust, which proclaimed its ability to offer “the investor of moderate means the same advantages as the large capitalist . . . by spreading the investment over a number of different stocks.”⁵⁰ More than fifty years later, on March 21, 1924, three Boston financiers at last gave America its first mutual fund: Massachusetts Investors Trust.⁵¹ In its inaugural year, the trust grew from \$50,000 to \$392,000 in assets.⁵² Now, eighty years later, Massachusetts Investors Trust is a \$5.3 billion fund.⁵³

Despite the dramatic growth of the first American trust in its debut year, this novel investment approach was not immediately celebrated: by the close of 1929, the entire industry amounted to no more than \$140 million.⁵⁴ The stock market crash of 1929 and ensuing Great Depression continued to inhibit growth of mutual funds. In the course of the next decade, however, the passage of a series of foundational securities laws helped to restore the confidence of investors: first came the Securities Act in 1933,⁵⁵ then the Exchange

48. See The Companies Act, 1862, 25 & 26 Vict., c. 89 (Eng.); The Companies Act, 1867, 30 & 31 Vict., c. 131 (Eng.); see also INV. CO. INST., *supra* note 3, at 4 (describing a brief history of mutual funds).

49. INV. CO. INST., *supra* note 3, at 4.

50. *Id.*

51. See Mass. Investors Trust, Registration Statement Under the Securities Act of 1933 (Form N-1A), pt. IV (Feb. 27, 2004), available at <http://www.sec.gov/Archives/edgar/data/63091/000095015604000074/d604691.txt> (“MFS is America’s oldest mutual fund organization. MFS and its predecessor organizations have a history of money management dating from the founding of this fund in 1924.”).

52. Woodard, *supra* note 47.

53. See MFS Investment Management Home Page, www.mfs.com (follow “Products and Performance” hyperlink; then follow “Mutual Funds” hyperlink; then follow “Massachusetts Investors Trust” hyperlink) (last visited Mar. 28, 2006). Massachusetts Investors Trust is also centrally involved in the recent industry investigations, having been named as one of ten funds advised by MFS that the SEC believes were market-timed. See Mass. Fin. Servs. Co., Investment Advisers Act Release No. 2213 (Feb. 5, 2004), Investment Company Act Release No. 26347, available at <http://www.sec.gov/litigation/admin/ia-2213.htm>.

54. See INV. CO. INST., *supra* note 3, at 5.

55. Pub. L. No. 22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (2000)).

Act in 1934,⁵⁶ then, in 1940, both the Advisers Act⁵⁷ and the Investment Company Act.⁵⁸

Ten years later, in 1951, the total number of funds exceeded one hundred, and the number of shareholder accounts exceeded one million.⁵⁹ In 1954, the stock market finally rose above its 1929 peak, and by the end of that decade, the industry comprised 155 mutual funds with \$4.3 million in shareholder accounts.⁶⁰ Over the next five decades, the investment advisory industry enjoyed a sustained boom in the growth of mutual funds, spurred by the advent of index funds, which allowed investors to replicate in one security the entire breadth of a market metric (such as the Dow Jones Industrial Average or the Standard & Poors 500 Stock Index);⁶¹ the emergence of 401(k) accounts in the 1970s, which encouraged employees to funnel tax-free savings to a limited buffet of investment options (frequently mutual funds) selected by their plan administrator;⁶² and the creation of

56. Pub. L. No. 291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78mm).

57. Pub. L. No. 768, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80b-1 to 80b-21).

58. Pub. L. No. 768, 54 Stat. 789 (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-64).

59. See INV. INST. CO., *supra* note 3, at inside front cover.

60. INV. INST. CO., MUTUAL FUND FACT BOOK, inside front cover (41st ed. 2001).

61. See JOHN C. BOGLE, COMMON SENSE ON MUTUAL FUNDS: NEW IMPERATIVES FOR THE INTELLIGENT INVESTOR 114-17 (1999).

62. One account of the origin of the 401(k) describes it as follows:

In 1974, the first individual retirement accounts . . . were introduced, but the standards for qualification were strict, and they didn't really catch on. In the Tax Reform Act of 1978, legislators loosened things up a bit by allowing workers to contribute their cash bonuses to retirement savings accounts on a tax-deferred basis. The wording of this clause, No. 401(k), was vague, and it attracted the attention of R. Theodore Benna, an employee-benefits consultant in Langhorne, Pennsylvania.

One Saturday afternoon in 1980, Benna, who was then thirty-nine years old, was helping one of his clients, a local bank, to redesign its employee pension plan when he had a thought. If cash bonuses could be sheltered from tax under clause 401(k), why couldn't regular income be sheltered in the same way? There didn't appear to be anything in the statute that specifically ruled it out. "My approach was that if the code doesn't say, 'Thou shalt not,' then thou should be able to" He designed a retirement plan that would allow employees to contribute a portion of their paychecks to a savings account on a pretax basis. A few months later, Benna's own firm, the Johnson Companies, launched the first 401(k) plan. In November, 1981, the Internal Revenue Service gave Benna's creation its official blessing. With legal approval, the new savings plans spread rapidly, and by 1985 more than ten million employees had one.

Deborah A. Geier, *Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income*, 22 VA. TAX REV. 1, 52 n.151 (2002) (quoting John Cassidy, *Striking It Rich*, NEW YORKER, Jan. 14, 2002, at 63, 63-64).

Individual Retirement Accounts in the 1980s,⁶³ which prompted yet more personal investing.

Today, there are more than 8000 U.S. mutual funds,⁶⁴ which hold an aggregate of more than \$7.4 trillion in assets.⁶⁵ By way of comparison, the entire value of the outstanding equity of U.S. companies is \$14 trillion.⁶⁶ Approximately ninety-one million individuals residing in over fifty-three million households⁶⁷ (that is, almost half of all U.S. households) and almost a fifth of all U.S. household assets⁶⁸ are invested in mutual funds.

B. Rationales for Investing in Pooled Vehicles

In just eighty years, mutual funds have thoroughly saturated the investment landscape, insinuating themselves into the entire spectrum of American portfolios. What accounts for this broad appeal? Advocates of mutual funds⁶⁹ typically point to three principal reasons for the allure of modern mutual funds to such a broad and deep segment of the U.S. population: diversification of investments, professional asset management, and redemption upon demand.⁷⁰

1. Diversification of Investments

Financial advisers have long appreciated the salutary effects of diversification upon an investment portfolio.⁷¹ By spreading investments across a broad range of ventures, an investor can protect against the risk of any single one of those ventures failing.⁷² While such an approach may limit the possibility of fully enjoying the rewards of any single venture succeeding wildly, over the long term,

63. See Sarah Holden et al., *The Individual Retirement Account at Age 30: A Retrospective*, PERSPECTIVE (Inv. Co. Inst., Wash., D.C.), Feb. 2005, at 1 (noting that “[i]ndividuals had \$3.0 trillion in IRAs by the end of 2003”).

64. According to the Investment Company Institute (ICI), “[a]t the end of 2003, investors could choose from 8,126 U.S. mutual funds.” INV. CO. INST., *supra* note 3, at 13.

65. *Id.* The total amount of assets in mutual funds at the end of 2003, according to the ICI, was \$7.414 trillion. *Id.*

66. See *id.* at 59.

67. See *id.* at 80 (“Household mutual fund owners represented 47.9 percent of all U.S. households in July 2003, down from 49.6 percent in 2002.”).

68. See *id.*

69. In this Article, references to the activities of “mutual funds” and “investment companies” are generally to open-end investment companies and not, unless stated otherwise, to closed-end funds, exchange-traded funds, or unit investment trusts.

70. INV. CO. INST., *supra* note 3, at 13-19.

71. See *id.* at 10.

72. See *id.*

diversification dampens the effects of outlying highs and lows, allowing investors to benefit from the seemingly ineluctable longer-term trend toward economic appreciation. Over the past fifty years, all the established financial benchmarks of the overall U.S. economy—such as the Dow Jones Industrial Average, S & P 500 Index, Russell 2000, and Wilshire 5000—have registered a steady increase in value.⁷³

For the lone investor of modest means, however, achieving diversification without the assistance of mutual funds or similar pooled investment vehicles might prove impossible. With only a few hundred dollars to invest, such an individual might be able to purchase single shares of just a few companies—certainly nothing like the well-balanced portfolio contemplated by advocates of prudent diversification. Investors who coordinate their efforts, however, can use the combined fund of millions or even billions of dollars to build a highly diversified set of investments, with each investor owning a pro rata share of the total fund.⁷⁴ This approach is the fundamental technique of a mutual fund and is not limited merely to stocks but also encompasses bonds, foreign securities, derivatives, foreign currencies, short sales, swaps, shares of other funds, and a panoply of other investment strategies.⁷⁵ Thus, one can use funds to diversify ownership not only of particular issuers or transactions but also of substantially different investment techniques.

2. Professional Asset Management

Informal pools, formed by friends and acquaintances, may allow all participants to discuss and determine their investment decisions by

73. See Dow Jones Averages, <http://www.djindexes.com/mdsidx/?event=showAverages>; Standard and Poors 500 Index Gains and Losses, <http://www.efmoody.com/investments/returns.html>; Russell 200 Historical Index, http://www.russell.com/common/indexes/csvs/russell2000index_hist.csv; Wilshire Total Market (5000) Stock Index, <http://www.neatideas.com/data/data/w5000M.htm>.

74. Since the earliest British joint stock companies and before, investors have long appreciated that the freedom to amalgamate funds creates economies of scale and allows individual investors to purchase fractions of items that might not otherwise be divisible. See *Inv. Co. INST. supra* note 3, at 4. A whaling ship, for instance, might have been a lucrative investment but surely also an expensive one. Having a quarter of the necessary money would be worth nothing, for a quarter of a boat would bring home nothing. With three likeminded patrons, however, one could venture to own a quarter of all the oil, baleen, spermaceti, and ambergris the ship might carry.

75. As just one example, the MFS fund complex offers more than sixty-five funds, among which are the MFS West Virginia Municipal Bond Fund, the MFS International Diversification Fund, and the MFS Utilities Fund. See MSF Investment Management, <http://www.mfs.com> (follow “Products & Performance” hyperlink; then follow “Mutual Funds” hyperlink) (last visited Mar. 22, 2002).

consensus, but that approach would be impossible for a formal mutual fund. In order for such a complex organism to function effectively, its shareholders must delegate the full-time business of making investment decisions to an individual or a team of specialists. In the case of investment companies, the portfolio managers of a professional investment adviser research and choose when to buy and sell securities on behalf of the entire fund. This professional management is frequently touted as one of the paramount advantages of an actively managed mutual fund.⁷⁶

By purchasing shares of a mutual fund and agreeing to pay administrative fees associated with those shares, investors essentially hire professional money managers to invest their money. For investors who have neither the time, the expertise, nor the inclination to manage their own funds, the attraction of such an approach is considerable. And with a modicum of research, any shareholder can determine the track record of a particular investment adviser—or even of an individual portfolio manager who works for that adviser—with respect to any of the mutual funds that the adviser or portfolio manager oversees.⁷⁷ Of course, as we are constantly reminded, past performance is no guarantee of future results, but millions of investors nevertheless express their confidence by investing with money managers who have established successful track records.

3. Redemption upon Demand

As important as the decision of which investment to put money into is the ability to get money out, preferably with profits in tow. The exit strategy is a serious consideration with any investment, and investors frequently must pay a premium for the ability to extricate themselves with the minimum of bother or delay. Liquidity—that is,

76. See INV. CO. INST., *supra* note 3, at 9. An “actively managed” mutual fund is one in which portfolio managers personally research, select, and monitor the fund’s investments; this type of fund is far more expensive to operate than, for instance, an index fund, whose investment decisions are made by a computer algorithm programmed simply to track the holdings of a market index, such as the S & P 500. Because no ongoing human involvement is required to manage the latter, such funds typically bear lower advisory fees. See *id.*

77. Investors can purchase information on specific funds from commercial third-party information purveyors, such as Morningstar, <http://www.morningstar.com> and Lipper, <http://www.lipperweb.com>, but can also use free, publicly available sources, such as the SEC’s Web site, which includes links to all filings made on the Electronic Data Gathering, Analysis, and Retrieval system (EDGAR). EDGAR includes all mutual fund prospectuses and SAIs, which include large quantities of data on each registered fund. See SEC Filings & Forms, <http://www.sec.gov/edgar.shtml> (last visited Mar. 28, 2006).

the ability to exit from an investment upon relatively short notice—is influenced by a number of factors.⁷⁸

Often, issuers of securities will offer an enhanced return in exchange for an investor's agreeing to leave his or her money untouched for longer periods of time. Certificates of deposit and treasury bills reflect this premium by offering higher interest rates commensurate with longer term notes. Hedge funds, too, will frequently reward investors who agree to lock up their funds for years by charging those investors lower management or performance fees.⁷⁹ Securities regulations also impose time restrictions upon the resale of certain securities or, alternatively, condition the resale of securities upon registration with the SEC, a process that adds not only time but significant expense. Outside the realm of securities transactions, one can easily appreciate the illiquidity of certain investments, such as purchasing a house. If an owner wishes to flip a property as soon as possible, nothing will guarantee the immediate appearance of a ready buyer willing to purchase the property for an amount at which the owner values it.

Mutual funds offer investors a highly liquid investment vehicle by guaranteeing the redemption of shares upon demand. Subject to a few limitations,⁸⁰ mutual funds guarantee their shareholders, on any given business day, the right to put shares back in the fund and to receive cash in exchange for them.⁸¹ Thus, fund shareholders are never locked into an investment from which they cannot readily extricate themselves on short notice.

C. *The Structure of a Mutual Fund Complex*

For such a ubiquitous investment option, mutual funds suffer from a great deal of misunderstanding. Perhaps the most common misconception reflects a fundamental confusion about the architecture of mutual funds: many people erroneously conflate the acquisition of

78. *Black's Law Dictionary* defines liquidity as the "quality or state of being readily convertible to cash" or "[t]he characteristic of having enough units in the market that large transactions can occur without substantial price variations." BLACK'S LAW DICTIONARY 950 (8th ed. 2004).

79. See Alexander M. Ineichen, *Funds of Hedge Funds: Industry Overview*, 4 J. WEALTH MGMT., Mar. 22, 2002, at 47, 47-48; Ron S. Geffner, *Deals on the Side*, HEDGE FUND MANAGER, U.S. EAST COAST 2005, at 26-27.

80. For example, many mutual funds charge investors a fee to redeem their shares if those shares have been held for less than some minimum period. See Mandatory Redemption Fees for Redeemable Fund Securities, Investment Company Act Release No. 26,375A, 69 Fed. Reg. 11,762, 11,763-64 (proposed Mar. 11, 2004).

81. See INV. CO. INST., *supra* note 3, at 16.

shares of a mutual fund with an investment in the equity of an investment adviser. In fact, mutual funds and their investment advisers are almost always two entirely separate legal entities. Thus, a purchase of shares of Fidelity's Magellan Fund is not a purchase of equity in Fidelity Investments.⁸² Indeed, investment advisers are frequently subsidiaries of large financial conglomerates and therefore closed to direct public investment. Mutual funds are unique business organizations, and that fact accounts for the somewhat curious structure of the investment management industry.

1. Investment Companies

At the heart of the industry's structure lies the mutual fund or, as it is known more formally, the investment company.⁸³ Investment companies are rather Spartan business organizations, consisting of little more than shareholders, cash, fund shares, a portfolio of investment securities, and trustees. Shareholders contribute cash—which is then used to acquire a portfolio of investment securities—in exchange for shares of the investment company, and trustees represent the interests of those shareholders.⁸⁴ Typically, a company has no employees and no physical plant, property, or equipment. Broadly speaking, the goal of every investment company is to try to increase the value of each shareholder's investment. In order to accomplish that

82. The confusion surrounding this topic was at the heart of an issue raised during the Senate confirmation hearings for Supreme Court Justice Samuel A. Alito, Jr. At the time that he was a member of the Third Circuit Court of Appeals, then-Judge Alito, who owned shares in Vanguard mutual funds, sat on a case in which the investment manager, Vanguard, appeared as a defendant. During the confirmation hearings, some critics—who mistakenly assumed that a financial interest in a mutual fund is the same as a financial interest in that fund's adviser—contended that Alito should have recused himself from the case. Mutual funds and their advisers, however, are almost never the same entity.

Vanguard, however, is a rare exception to that rule, inasmuch as Vanguard, the investment adviser, is wholly owned by the Vanguard funds. Thus, an owner of shares of Vanguard funds, such as Judge Alito, would in fact indirectly own a portion of Vanguard, the investment adviser. Several ethics experts, however, argued that the size of Judge Alito's ultimate ownership of the defendant in this instance was insignificant. *See, generally*, Sheryl Gay Stolberg, *Democrats Press Court Designee Over Mutual Fund Case*, N.Y. TIMES, Nov. 10, 2005, at A22.

83. The 1940 Act definition of an "investment company" is lengthy and convoluted but covers, *inter alia*, "any issuer which . . . is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities." 15 U.S.C. § 80a-3(a)(1)(A) (2000).

84. The shares that an investor purchases to participate in the mutual fund are typically referred to as "fund shares," whereas the securities in which the fund then invests using the proceeds from fund shares are known as "portfolio securities" or "underlying securities."

mission, mutual fund trustees enter into contractual arrangements on behalf of their investment companies with a retinue of third-party service providers.

The conflation of investment advisers and investment companies is not entirely accidental. Funds are almost always sponsored by investment advisers, who file the formation documents, pay the start-up costs, register the shares, seed and incubate the fund, and select the trustees. When provided the opportunity to give a name to a new investment company on a Secretary of State's forms, few advisers forgo the opportunity to incorporate their own name into the title of the new fund. Hence, there should be no mystery as to the identity of the adviser of, say, the Putnam Classic Equity Fund⁸⁵ even though, technically, that fund could be advised by any investment adviser and is not an affiliate of Putnam. Having developed a reputation from years of managing other mutual funds, however, Putnam wants to be sure future potential investors in the new fund know immediately who will be acting as its investment adviser.

Perhaps the most common business form chosen for new investment companies is the Massachusetts business trust. This choice is explained partly by the industry's heritage in Boston and partly by the rather peculiar idiosyncrasies of Massachusetts state law. The particular chapter of Massachusetts Code that provides for these trusts contains only fourteen sections⁸⁶—compared to 222 for corporations.⁸⁷ This relative dearth of regulation is one of the primary attractions of Massachusetts business trusts. Against this less burdensome regulatory backdrop, founders of trusts are at liberty to devise many of their own rules for the new organizations and to codify those preferences in the formation documents: the declaration of trust and by-laws. These governing principles are legally valid provided they do not conflict with state or federal securities regulations, though of course, ultimately, shareholders must be willing to accept them. Again, Massachusetts state law leaves the canvas largely blank for the initial shareholders of a trust.⁸⁸ And, typically, at its inception, a trust's shares are owned by only one initial shareholder: the investment

85. See Putnam Equity Fund, Registration Statement (Form N-1A), at 4-6 (Mar. 29, 2004), available at <http://www.sec.gov/Archives/edgar/data/930748/000092881604000243/cef1.txt>.

86. MASS. ANN. LAWS ch. 182, §§ 1-14 (LexisNexis 2005) (entitled "Voluntary Associations and Certain Trusts").

87. *Id.* ch. 156D, §§ 1.01-17.04 (LexisNexis 2005) (entitled "Business Corporations").

88. See generally *id.* ch. 182, §§ 1-14.

adviser. As long as the investment company's governing principles comport with state law (which is usually quite lenient) and federal securities regulation (which is somewhat less so), the investment adviser can draft them with a free hand, subject to what the market will bear.⁸⁹

Once the investment company is formed and its shares registered with the SEC, the sponsoring investment adviser will typically seed the fund with at least \$100,000 and assign a portfolio manager to manage the portfolio as though it were a public mutual fund.⁹⁰ This period of incubation allows the investment adviser to train portfolio managers and to assess the efficacy of the fund's particular investment strategy. When the adviser is ready, it will open the fund and then market the fund's shares to the investing public.

2. Fund Shareholders

Shareholders typically purchase fund shares from the investment company itself and, when they are ready to sell, put those shares back into the company.⁹¹ This approach contrasts with the manner in which shares of public operating companies are traded, where the majority of investors purchase shares not from the company itself—a transaction that occurs only in the comparatively rare event of an initial public or follow-on offering—but from current shareholders of the issuer's stock who are willing to sell. Mutual fund shares, by contrast, are not typically traded among investors on a secondary exchange.⁹² Instead, the investment company offers a perpetual stream of its shares to any investors willing to purchase them; similarly, it must be prepared to redeem each of the shares it issues.⁹³ Consequently, the registration statement for a mutual fund does not fix the number or value of shares

89. In recent settlement agreements related to the industry abuses, however, the SEC has demanded, and several investment advisers have agreed to hold, shareholder meetings on a regular basis. *See, e.g.*, Investment Advisers Act Release No. 2213, Mass. Fin. Servs., Investment Company Act Release No. 26,347, 82 SEC pocket 341 (Feb. 5, 2004), *available at* <http://www.sec.gov/litigation/admin/ia-2213.htm> ("Commencing in 2005 and not less than every fifth calendar year thereafter, each MFS Retail Fund will hold a meeting of shareholders at which the board of trustees will be elected.").

90. *See id.*

91. Investors can make these purchases and sales either directly through the fund's distributor or indirectly through retail brokerage houses. Mutual fund prospectuses regularly contain information on how prospective investors can contact the fund's distributor by telephone or the Internet.

92. Compare the shares of registered closed-end funds, which are regularly traded on stock exchanges.

93. INV. CO. INST., *supra* note 3, at 16.

it wishes to issue but rather allows for the issuance of an infinite number of shares.⁹⁴ As long as new investors pay fair value for their shares and exiting investors receive fair value for theirs, these comings and goings do not dilute or increase the value of any other shareholder's investment.

Because mutual fund shares are not traded on an exchange, their value does not turn on the subjective assessments of other investors in the marketplace. Instead, the worth of each share is a simple fraction of the total value of the net assets of the fund.⁹⁵ Shareholders purchase fund shares by paying the net asset value (NAV) per share and, in turn, receive NAV when redeeming fund shares.⁹⁶ NAV is calculated by dividing the total value of a fund's portfolio investments plus any other assets, minus any liabilities, by the total number of outstanding fund shares. Funds are required to calculate their NAV daily, and typically they do so immediately after the close of business at 4:00 p.m. Eastern time.⁹⁷

To illustrate, if a fund possessed cash in the amount of \$11 million and securities valued at \$74 million, owed liabilities of \$4 million, and had 5 million outstanding shares, its NAV would be:

$$\begin{array}{rcl}
 \text{Cash plus other assets minus liabilities} & & \\
 \$11 \text{ million} + \$74 \text{ million} - \$4 \text{ million} & \text{Fund Share Price or} & \\
 \hline
 5,000,000 & = \text{Net Asset Value} & \\
 & & \$16.20
 \end{array}$$

So with any appreciation or decline in the value of securities in a fund's portfolio, the value of the shares of that fund will rise or fall accordingly.

94. *See id.* at 16-17.

95. *See id.*

96. *Id.*

97. Rule 22c-1 of the 1940 Act sets forth the requirements for the daily pricing of mutual fund shares. 17 C.F.R. § 270.22c-1(a) (2005); *see also* Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26,288, 68 Fed. Reg. 70,388, 70,388 (proposed Dec. 17, 2003) (proposing to amend current rules to the effect that an order to redeem or purchase fund shares would receive the current day's price only if the order is received by the time the fund established for calculating its NAV). Violating the 4:00 p.m. deadline allows late traders to reap benefits at the expense of existing fund shareholders, whose gains are thereby diluted. *See* Conrad S. Ciccotello et al., *Trading at Stale Prices with Modern Technology: Policy Options for Mutual Funds in the Internet Age*, 7 VA. J.L. & TECH. 6, ¶¶ 16-20 (2002), http://www.vjolt.net/vol7/issue3/v7i3_a06-Ciccotello.pdf.

3. The Board of Trustees

Representing the interests of the fund's shareholders is the board of trustees. In a fund's earliest stages, the investment adviser, as the fund's only shareholder, is in a position to appoint the trustees. This power of appointment is not entirely unconstrained, as federal securities laws require that a majority of the members of the board be independent—that is, persons who are not affiliated with the investment adviser.⁹⁸ In the aftermath of the industry's recent upheavals, the SEC has passed new rules that allow advisers to take advantage of regulatory exemptions that have become critical to the running of a mutual fund only if the fund's board increases its percentage of independent trustees to seventy-five percent of the board.⁹⁹

Another quirk of the mutual fund industry that has no analog in the world of operating companies is that a single board of trustees may be responsible for the shareholders of many different funds. Investment advisers frequently manage the assets of multiple funds. Indeed, in some of the nation's larger fund complexes, a single adviser manages more than one hundred funds.¹⁰⁰ To be a shareholder in one fund does not necessarily mean that one is a shareholder in any other fund in a mutual fund complex; the only way to be a shareholder in each of those funds is to purchase shares in each particular fund. As a practical matter, then, the populations of shareholders in separate funds sometimes overlap and sometimes remain entirely distinct. Shareholder distribution is simply a function of the investment choices individual shareholders make. The same is not the case for the board of trustees. Frequently, a single board of trustees serves all of the funds managed by a single adviser. For the investment adviser, who wields the greatest degree of control in choosing the trustees, interacting with a single board affords great practical convenience. For their services, board members are typically paid for participation in

98. See Investment Company Act of 1940, § 15(c), 15 U.S.C. § 80a-15(c) (2000) (prohibiting an investment advisor from serving a mutual fund except pursuant to a contract that has been approved by a majority of trustees who are independent).

99. See Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378, 46,381 (Aug. 2, 2004).

100. MFS, for instance, oversees a family of 71 funds, and Fidelity manages more than 200 funds. See MFS Investment Management, <http://www.mfs.com> (last visited Feb. 14, 2006); Fidelity Investments, <http://www.fidelity.com> (last visited Mar. 28, 2006).

board and committee meetings, and those costs are spread across all the funds in the complex represented by that board.¹⁰¹

The primary service that a board of trustees provides for the shareholders of a fund is overseeing the contractual arrangements between the funds governed by the board and the third parties that provide services to those funds.¹⁰² Specifically, a board will regularly monitor the performance of the service providers, meet annually to review their mutual funds' contracts, and then negotiate to renew contracts with the service providers.¹⁰³

4. Service Providers to the Funds

As with practically all serious business enterprises, mutual funds hire external contractors to perform specialized tasks on their behalf. These service providers include the usual suspects, such as law firms and accounting firms and, when times are trying, public relations agencies. Mutual funds also retain the services of a specialized group of four entities that perform the operations unique to the investment advisory business: the investment adviser, the distributor, the transfer agent, and the custodian.¹⁰⁴

a. The Investment Adviser

The single most important service provider to a mutual fund is the company that serves as its investment adviser. Indeed, as has been discussed,¹⁰⁵ funds almost always owe their very existence to investment advisers, which create the funds and shepherd them through their formation and incubation. Then, once a fund is fully operational, the adviser's portfolio managers continue to make the critical investment decisions that determine whether shareholders realize a profit or loss on their fund shares. In addition, advisers provide most of the personnel and administrative support the fund needs to conduct its business, from paying the fund's bills, to compiling board materials and data that trustees need for their deliberations, to drafting regulatory filings in compliance with federal

101. See Bonnie Bauman, *'More Time, More Money' for Directors in 2004*, BOARDIQ, May 3, 2005, http://www.boardiq.com/articles/print/20050503/more_time_more_money_directors (subscription required).

102. INV. CO. INST. *supra* note 3, at 7-8.

103. See *id.* at 8-9.

104. See *id.* at 7 (but referring to a "distributor" as a "principal underwriter").

105. See *supra* text accompanying note 91.

securities laws.¹⁰⁶ In essence, advisers provide life support to otherwise inert funds.

At the core of the adviser's team of employees is a staff of senior portfolio managers, who are the professional money managers charged with investing the millions and sometimes billions of dollars pooled in the funds.¹⁰⁷ At times, one portfolio manager will take ultimate responsibility for each fund; at others, a team of managers takes joint responsibility for the investment decisions. Regardless of the strategy, portfolio managers are the stars of investment advisers, and are compensated accordingly.

The advisory agreements pursuant to which advisers provide their services to mutual funds and mutual funds pay those advisers are limited by law to one-year terms.¹⁰⁸ Each year, then, the trustees must decide whether to renew a fund's contract with its adviser.¹⁰⁹ Although boards almost always renew these agreements, trustees must still undertake a process to review important contractual terms.¹¹⁰ One of the key provisions of every advisory agreement is the fee that the adviser will receive for rendering its services to the fund. Federal regulations severely constrict the ability of advisers of mutual funds to earn compensation based on the performance of the funds they manage for fear of providing advisers with too strong an incentive to pursue aggressive investment strategies with the investments of shareholders insufficiently sophisticated to appreciate the risks.¹¹¹ Unlike hedge fund managers or venture capital firms, therefore, a mutual fund investment adviser does not receive a sizeable percentage of profits earned. Instead, the adviser receives an advisory fee computed as a percentage of assets under management.¹¹² Typically, advisory fees range from 20 to 200 basis points,¹¹³ depending on whether the fund is actively managed by investment personnel or governed by an automatic, computer-driven investment program, as

106. See INV. CO. INST., *supra* note 3, at 8-10.

107. See Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, Investment Company Act Release No. 26,533, 69 Fed. Reg. 52,788, 52,788-89 (Aug. 27, 2004).

108. See Investment Company Act of 1940, § 15(a), (c), 15 U.S.C. § 80a-15(a), (c) (2000).

109. *Id.*

110. See Investment Company Act of 1940, § 15(c).

111. See *id.* § 205(a)(1), 15 U.S.C. § 80b-5(a)(1). However, Rule 205-3 of the Advisor's Act permits performance fees only if the investment advisor is entering into an agreement with a "qualified client." 17 C.F.R. § 275.205-3 (2005).

112. See Mahoney, *supra* note 42, at 167.

113. A basis point is equal to 0.01%.

well as on the complexity of the securities in which the fund invests.¹¹⁴ So, for a fund with average daily net assets of \$2 billion, an adviser that charged 75 basis points would receive \$15 million per year.

This payment structure reduces an adviser's revenues to the product of a single multiplicand (the assets under management) and a single multiplier (the advisory fee). In order to increase those revenues, therefore, the adviser has but two choices: increase the advisory fees or increase the assets under management. Fee increases, however, often require the consent of fund shareholders,¹¹⁵ the acquisition of which involves both practical and political difficulties, and are capped by what the market will bear. Consequently, fee increases are constrained by practical, political, and economic forces and are, therefore, relatively uncommon.

Accordingly, the more common approach is to increase the assets under management, which an adviser can do also in one of two ways: by making wise investment decisions that increase the returns on a fund's underlying portfolio securities or by persuading new and existing shareholders to invest more money in the fund.¹¹⁶ As long as the assets rise, either approach is equally effective mathematically. One could conceive of a fund closed to additional investment that nonetheless generates more and more revenue for the adviser simply on the strength of successful investment decisions. On the other hand, one could also conceive of an investment adviser increasing its annual revenues without making any profitable investment decisions and, instead, simply recruiting new shareholders to the fund.

Although either scenario holds the potential for equivalent results for the adviser, the two lead to decidedly different consequences for shareholders: growth in a fund achieved solely by increasing investments in the fund is not shared by shareholders. For the shareholders in such a situation, the value of the fund's shares that they hold remains stagnant or may even drop. Theoretically, if a fund increases in size only through new investments, its shareholders may enjoy increased economies of scale but only to the extent that the adviser passes those savings back to shareholders, which is by no

114. Brian K. Reid & John D. Rea, *Mutual Fund Distribution Channels and Distribution Costs*, PERSPECTIVES (Inv. Co. Inst., Wash. D.C.), July 2003, at 15 & fig. 11.

115. See Investment Company Act of 1940, § 15(c), 15 U.S.C. § 80a-15(c).

116. When new and existing shareholders make additional investments in a fund, they do not—in most circumstances—dilute the holdings of existing shareholders because they pay for the new shares they receive with new money. Investments by market timers and late traders, however, are likely to dilute returns by existing shareholders. See Ciccotello et al., *supra* note 97, ¶¶ 16-20.

means certain. Appreciating the divergence in the adviser's interest and the shareholder's interest is critical to understanding the crux of the recent allegations leveled against the advisers.¹¹⁷

b. The Principal Underwriter or Distributor

Outside the investment management industry, when a typical operating company goes public, it will retain an underwriter or syndicate of underwriters to buy its shares first and then to distribute those shares to the wider public.¹¹⁸ The same principle holds true with mutual funds: investment companies hire a principal underwriter, more commonly known as a distributor, to purchase its shares first and then to distribute them to the wider public.¹¹⁹ Because mutual funds are in a sense perpetually going public, however, their relationships with distributors last well beyond just the initial formation of the companies. Indeed, as long as a mutual fund is open to investment, it relies upon a distributor to purchase and to distribute its shares. And, as with the ongoing relationship with the investment adviser, the fund's board of trustees must approve the contractual agreement between the fund and the distributor.¹²⁰

Distributors distribute fund shares through two primary marketing channels: one directly to potential fund shareholders, the other via collaborations with retail brokerage houses. An investor can therefore purchase fund shares either by contacting the distributor directly, typically through a web site or toll-free number listed in the fund's prospectus, or by executing a trade through the investor's broker such as Charles Schwab, Morgan Stanley, or E*Trade. To market to these two channels, distributors will purchase advertisements on television, radio, and other media, and will attempt to persuade brokers/dealers of the value of their funds' shares.

For these efforts, distributors are compensated by payments out of the fund's assets. As a general rule, federal regulations significantly restrict the use of fund assets, but an express exception—Rule 12b-1 of the 1940 Act—provides for the shareholders' funds to be used for the distribution of fund shares by, typically, paying a distributor.¹²¹ The rationale behind this exception is the notion that existing fund

117. See generally Mahoney, *supra* note 42 (examining costs incurred by mutual fund shareholders as a result of agency problem).

118. See LOSS & SELIGMAN, *supra* note 19, at 73-91.

119. See INV. CO. INST., *supra* note 3, at 10.

120. See *id.*

121. 17 C.F.R. § 270.12b-1 (2005).

shareholders may benefit when a fund attracts additional shareholders because larger funds with more assets are capable of enjoying economies of scale that are shared by all shareholders.¹²² Thus, shareholders are assessed distribution fees, more commonly called 12b-1 fees, to finance the distributor's efforts in selling more shares of the fund.

These 12b-1 fees are calculated in much the same way as advisory fees: the distributor is paid a certain number of basis points on the fund's assets under management.¹²³ If, for instance, the 12b-1 fee for a \$500 million fund is 25 basis points, the distributor would receive \$1.25 million per year. And, as do investment advisers, distributors therefore have a strong financial incentive to increase the assets of the funds for which they work. Unlike investment advisers, however, distributors are not involved in investment decisions and therefore cannot increase the fund's assets through prudent money management. All a distributor can do to increase its own revenue is to increase the inflow of new investments to the fund.

c. The Transfer Agent

As is the case with any public company, the maintenance of accurate records of who owns what shares in an investment company is a vital back-office function. Funds typically hire a transfer agent to provide this service and to take care of the concomitant tasks of calculating interest and disbursing capital gains and interest for fund shareholders.¹²⁴ Transfer agents are usually also responsible for mailing account statements, tax materials, and prospectuses and other required disclosure documents to fund shareholders.¹²⁵ A board of trustees will typically approve an administrative services agreement that governs the relationship of a fund and its transfer agent.

122. See Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378, 46,380 (Aug. 2, 2004). Whether shareholders do, in fact, share in these economies of scale is uncertain. Certainly, when advisers fail to pass the savings back to shareholders, as is discussed in the breakpoint section below, investors realize no such savings. Some commentators have questioned whether shareholders receive these savings even in the absence of malfeasance. See, e.g., John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 619-27 (2001) (suggesting that the breakpoints do not capture the economies of scale).

123. Mahoney, *supra* note 42, at 164-65.

124. See INV. CO. INST., *supra* note 3, at 11.

125. See *id.*

d. The Custodian

The most important asset of an investment company is its portfolio of underlying securities and investments. By law, investment companies are required to protect those securities by entrusting them to a custodian.¹²⁶ Custodians are typically large banks that are accustomed to complying with the extensive regulatory regime that governs the protection of investments.¹²⁷ For example, the SEC requires that the custodian segregate mutual fund portfolio securities from any other assets held by the custodian.¹²⁸

As we have seen, in order to carry on the business of a mutual fund, investment companies must contract with these four important service providers: the investment adviser, the distributor, the transfer agent, and the custodian.¹²⁹ If this nexus of contractual relationships appears convoluted and sprawling, it may simplify things to bear in mind that frequently all these third parties are affiliates of one another. For instance, the Dreyfus Premier Growth and Income Fund retains Dreyfus Corporation as its investment adviser, Dreyfus Service Corporation as its distributor, Dreyfus Transfer, Inc., as its transfer agent, and Mellon Bank, N.A., as its custodian.¹³⁰ Each of those entities is a subsidiary of a single global financial services company, Mellon Financial Corporation.¹³¹ In the final analysis, then, the fund has retained just one variegated entity to provide it with all the apparatus it needs to operate as a mutual fund.¹³² Or, more accurately, one sprawling financial services company has created a mutual fund to buy its broad array of professional wares.

126. *See id.*

127. *See id.*

128. *See* Custody of Funds or Securities of Clients by Investment Advisers, Investment Advisers Act Release No. 2176, 68 Fed. Reg. 56,692, 56,693 (Oct. 1, 2003).

129. As with a typical operating company, mutual funds will also retain the services of law firms, accounting firms, and, if need be, public relations firms. Mutual funds often also retain the services of research providers, such as Lipper, to provide performance ratings for their funds, as well as pricing services that specialize in fairly valuing stocks for which no accurate market quotations are available.

130. *See* Prospectus, Dreyfus Premier Growth and Income Fund, Feb. 1, 2005, at 6-7, available at <http://www.dreyfus.com/content/dr/control?Content=/docs/mfc/dreyfus-funds/factsheet.jsp&fundcode=0320#> (follow "Prospectus" link) (last visited Mar. 28, 2006).

131. *See id.*

132. *See id.*

III. THEORETICAL ANALYSIS OF THE INVESTMENT ADVISORY RELATIONSHIP

A. *Applying an Executive Compensation Paradigm*

To understand how the investment management business works, one must understand not only its constituent parts but how those components interact. As has been suggested, no more important relationship exists for a mutual fund than that of the fund with its investment adviser.¹³³ The adviser provides the experience, expertise, strategy, and investment acumen that determines whether a fund succeeds or fails, and the adviser's employees serve as surrogate personnel for the fund. Indeed, the adviser is so integrally entwined with the fund and its operations that separating the two is hard to conceive and almost impossible, in reality, to do.

Yet this intertwined arrangement is also highly unusual in the business world. Typically, a corporation retains its own executives, who in turn hire and oversee the remaining layers of management and staff needed to carry on the enterprise.¹³⁴ Of course, operating companies routinely engage consultants, contractors, and other third-party service providers to perform discrete tasks, but only to supplement, not to replace utterly, the firm's employees. Though these differences are notable and render mutual funds a species of their own, one can nevertheless turn to a well-studied body of corporate law—and its attendant exegetic theories—to understand the dynamic between a mutual fund and its adviser.

The study of executive compensation is the examination of how corporations resolve the oldest quandary of corporate law: the principal-agent problem.¹³⁵ Any business organization owned by one constituency but managed by another is susceptible to a divergence in the interests of these principals and agents.¹³⁶ In conventional operating companies, this agency problem frequently manifests itself in the guise of executives who attempt to maximize their own wealth without regard for, or even to the detriment of, the interests of shareholders.¹³⁷ The primary tool used to harmonize the interests of these two groups is the employment contract that governs executive

133. See *supra* text accompanying notes 102-116.

134. See ROBERT CHARLES CLARK, CORPORATE LAW ¶¶ 6.1-6.3 (1986).

135. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 119-25 (1933).

136. See *id.*

137. See *id.* at 122.

compensation. On behalf of shareholders, an operating company's board of directors will attempt to negotiate with each executive a contract that creates the optimal blend of incentives needed to induce the executive to pursue interests of the shareholders without depleting any more shareholder value than is absolutely necessary.¹³⁸

The board's goal in these negotiations is not necessarily to obtain the best management money can buy, but the optimal management. To be assured of the very best possible management, a board might have to spend far more money than an executive's service is worth in order to obtain a level of expertise that is far more than the enterprise requires. Then, to monitor the executive's behavior to confirm that it aligns with the owners' interests, a board must expend additional resources. At a certain point, the costs of such management and oversight will outweigh the value of any benefits realized by the shareholders. One does not need Jack Welch to run a lemonade stand. The goal of executive compensation is to create an optimal agreement that best balances the management's compensation and incentives, the shareholders' interests, and the costs of reaching and policing such an agreement.¹³⁹

The same principles operate in the investment advisory context, albeit on a different scale. To retain the services of management, the board negotiates not with specific executives but with the investment adviser as a single entity. In effect, the board hires in one transaction all the executives that the fund will need to manage its operations. The advisory agreement upon which the board and the adviser agree governs the compensation that the adviser will receive in exchange for providing management of the fund's assets. The adviser, in turn, will use that advisory fee to pay the salaries of each of its portfolio managers, executives, and other employees. As with individual executive compensation arrangements, the advisory agreement contains—with greater and lesser degrees of success—the ingredients that will determine whether the adviser's interests are aligned with those of the fund's shareholders. The discussion between a mutual fund board and the collective personnel of an investment adviser is, in essence, just one example of executive compensation negotiations. Instead of one executive bargaining with the board, a multitude of executives working together in a single business entity are negotiating as the collective executive. Thus, an extension of the theories of

138. See Bebhuk, Fried & Walker, *supra* note 46, at 753-54.

139. See *id.* at 761-62.

executive compensation into the investment advisory setting is a compelling new way to examine the board-adviser dynamic.

B. The Optimal Contracting Approach

Prior to its recent outbreak of infamy, the mutual fund industry was considered by many commentators to be a paragon of corporate governance.¹⁴⁰ Writers such as these pointed to bulwarks that should, in theory, protect the interests of shareholders, such as arm's-length bargaining between the board of trustees and the investment adviser, robust competition in the mutual fund marketplace, a garrulous disclosure regimen that distributes information about funds and their management to the public, and highly sophisticated shareholders who fully understand the business.¹⁴¹ Many of these same elements are also features of a theoretical framework commonly used to study executive compensation: the optimal contracting approach.

This approach posits that optimal principal-agent contracts can be achieved when the following circumstances are present: (1) the board and the executive conduct their negotiation at arm's length, (2) market forces induce the parties to reach optimal bargains, and (3) shareholders can invoke principles of corporate law to reject compensation packages that are detrimental to their interests.¹⁴² A confluence of these three conditions, the theory posits, should produce optimal executive compensation contracts.¹⁴³ To the casual observer of the investment advisory industry, these three elements might appear to be happily congregated already. But the infamies of the past two and a half years demonstrate the existence of profound flaws in the industry, which strongly suggest that the optimal contracting perspective is incomplete. Before examining what the theory lacks, though, let us first consider what it contains.

140. See, e.g., Phillips, *supra* note 4, at 1, 11.

141. See *id.*

142. See Bebchuk, Fried & Walker, *supra* note 46, at 764; see also Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 548-64 (1984); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1262-65 (1982); Nicholas Wolfson, *A Critique of Corporate Law*, 34 U. MIAMI L. REV. 959, 973-74 (1980). The optimal contracting approach posits that optimal principal-agent contracts can be achieved when a board focuses on three components: (1) securing and maintaining the services of excellent executives, (2) furnishing those executives with incentives to expend their energy and to make decisions that redound to the benefit of shareholders, and (3) keeping the overall costs of such an engagement as low as possible. See Bebchuk, Fried & Walker, *supra* note 46, at 762.

143. See Bebchuk, Fried & Walker, *supra* note 46, at 762.

1. Arm's-Length Bargaining

The optimal contracting approach requires that the two parties engaged in the negotiation of a compensatory arrangement be independent of one another.¹⁴⁴ In addition, the theory posits that, from a position of autonomy, a board will conduct negotiations regarding the compensation with an eye toward only the maximization of shareholder value.¹⁴⁵ In the mutual fund context, this approach would involve the fund board negotiating with the investment adviser to consummate an optimal investment advisory agreement. The investment advisory industry boasts of policies designed to ensure the independence of the board in these bargaining sessions.

The negotiation of advisory agreements is typically conducted between senior representatives of the investment adviser and the board's contracts review committee, comprising members of the board charged with reviewing each fund's principal third-party agreements. Federal regulations require that this committee consist only of independent trustees of the board; that is, only those trustees who are not affiliated with the investment adviser.¹⁴⁶ Typically, the chief executive officer and other senior executives of the investment adviser will (subject to the requirement that a certain percentage of the board be independent) serve on a fund's board of trustees. These "interested" trustees cannot take part in the negotiation of the advisory agreement. To approve a contract between the fund and the investment adviser, a majority of the independent trustees must vote to do so.¹⁴⁷

Frequently, the members of the contracts review committee will meet by themselves with their own legal counsel in executive session to deliberate upon the performance of the investment adviser and the funds under the adviser's management. This process may take place over several months as the trustees review the investment returns of each of the funds and meet with representatives from the investment adviser to discuss strategic approaches under any renewed contract. The trustees will frequently review reports prepared by entities such as Lipper, which set forth how the funds' performance rated when compared to other funds of a similar size and with a common investment objective. From these reports, the trustees can determine

144. *Id.* at 764.

145. *See id.*

146. *See* Investment Company Act of 1940, § 15(c), 15 U.S.C. § 80a-15(c) (2000).

147. *See id.*

whether the adviser has managed any given fund better or worse than the industry average.

Assisting the independent trustees in this process may be attorneys who represent the funds as well as attorneys who represent only the independent trustees.¹⁴⁸ And, as is the case in the world of operating companies, the decision whether to rehire an investment advisor and how much to pay it are matters of judgment, protected by the business judgment rule.¹⁴⁹ The combination of these elements might suggest that the advisory agreement is, indeed, negotiated at arm's length.

2. Market Forces

In addition to the prophylactic benefits of arm's-length negotiation, the optimal contracting approach theory also suggests that market forces will compel advisers to seek an optimal, not an excessive, level of compensation in their advisory agreements. The competitive landscape of the investment management industry certainly appears to contain a multitude of adroit advisers, all eager to provide their services to mutual funds and to reap the rewards of advisory fees. This robust marketplace also sustains a related industry of entities that specialize in monitoring and rating advisers and their funds, such as Lipper¹⁵⁰ and Morningstar,¹⁵¹ which in turn propagates a great deal of information about the various advisers. In addition, the shareholders of many funds are themselves highly sophisticated financial outfits capable of monitoring the reasonableness of the investment advisory agreements.

a. Competition Amongst Investment Advisers

In many ways, the investment management industry appears to be one of the more robust marketplaces in the U.S. economy. Hundreds of investment advisers manage thousands of mutual funds and vie to

148. Retaining "independent counsel," as that term is defined in the rules to the 1940 Act, is a prerequisite for trustees if they want their funds to be able to rely upon any of a series of exemptive rules that are extremely important to the running of an investment company. For Rule 0-1(a)(7)(iii) of the 1940 Act, see 17 C.F.R. § 270.0-1(a)(6)-(7)(iii) (2005).

149. See, e.g., *Nursing Home Bldg. Corp. v. DeHart*, 535 P.2d 137, 144 (Wash. Ct. App. 1975).

150. See Lipper Home Page, <http://www.lipperweb.com> (last visited Feb. 15, 2006).

151. See Morningstar Home Page, <http://www.morningstar.com> (last visited Feb. 15, 2006).

oversee trillions of dollars.¹⁵² On the demand side, almost one hundred million Americans participate in this investment emporium.¹⁵³ One could easily assume that the intensity of this competition should bring all the invisible genius of Adam Smith to bear on the dynamics of the investment advisory agreement.¹⁵⁴

When it comes to selecting a fund in which to invest, shareholders have an almost paralyzing array of choices. With more than 600 mutual fund complexes offering more than 8000 funds, the market offers almost every conceivable type of fund to all manner of investors.¹⁵⁵ Moreover, the market offers many funds of the exact same type—for instance, numerous S & P 500 Index mutual funds exist, all of which offer the exact same investment (save for any disparities in fees charged by the adviser).¹⁵⁶ Surely, then, advisers should be acutely sensitive to the competition they face. The first step they must take to harvest any revenues is to negotiate successfully with the board of a fund over an advisory agreement. Should the adviser demand too high an advisory fee, it may be unsuccessful in persuading the board to agree, and without the advisory agreement, the adviser receives nothing.

After the initial execution of an advisory agreement, the market would appear to compel the adviser to continue performing to the best of its ability. Advisory agreements generally last for only one year at a time,¹⁵⁷ so advisors work on a short leash and therefore a board may, if it chooses, quickly terminate an adviser for doing a poor job.

Many advisers develop mutual fund complexes in which they advise multiple funds.¹⁵⁸ The marginal costs of creating and advising a new fund are low once the adviser has already established its portfolio management and distribution operations. Managing more funds allows advisers to attract more shareholders interested in a broader array of financial products. Thus, the adviser must continue to offer

152. See INV. CO. INST., *supra* note 3, at 70-78.

153. See *id.* at 79.

154. See ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 225 (Random House 1985) (1776).

155. See INV. CO. INST., *supra* note 3, at 13.

156. See, e.g., The Motley Fool, No-Load Index Funds, <http://www.fool.com/mutualfunds/indexfunds/table01.htm> (last visited Feb. 15, 2006) (listing 17 no-load S & P 500 index funds).

157. See Investment Company Act of 1940, § 15(a)(2), 15 U.S.C. § 80a-15(a)(2) (2000).

158. See *supra* text accompanying note 100 (describing examples of extremely large fund complexes).

low advisory fees coupled with high performance in order to induce the board of trustees to approve the launch of new funds by the adviser.

Even more than in the case of compensation for operating company executives, the costs of hiring an adviser are passed directly on to the end customers. When they shop for mutual fund shares, potential investors can read tables included in fund prospectuses that set forth data describing the fees they will pay.¹⁵⁹ Thus, when negotiating an advisory contract, advisers must offer an advisory fee that is acceptable not only to the board but also to potential shareholders. If an adviser demands too high an advisory fee in negotiations with the board, then even if it were to persuade the board to accede to the fee, the marketplace might still reject the fund. Shareholders might simply not purchase the shares, and the fund would struggle to accumulate assets to be managed. Thus, perhaps to an even greater extent than the compensation of individual executives, advisory fees appear to be determined by what the market will bear.

In addition, the consequences of dismissal by a board's termination of an advisory agreement would be profound for an adviser. Not only would the adviser immediately lose all revenues from the assets of the fund in question, but the decision would send a dramatic signal to the market, warning shareholders in other funds of serious problems with the investment adviser. Moreover, in the context of a complex of mutual funds, if a board were sufficiently dissatisfied with an adviser to evict it from one fund, it might easily do so for any of the other funds in the complex. Thus, the market would appear not only to compel an adviser to propose a reasonable advisory fee when seeking a contract but, when operating under that contract, to perform to its utmost.

b. Dissemination of Information

As the supply and demand for mutual funds has grown, so too has the concomitant market for information about those funds. As part of their marketing efforts, many funds announce the performance of their funds in advertisements directed to the investing public.

159. The registration statement under the 1940 Act for open-end mutual funds, set forth on Form N-1A, requires that investment companies include information relating to a description of the fund and its investments and risks (in Item 11 of Form N-1A); the management of the fund (Item 12); the portfolio managers (Item 15); purchase, redemption, and pricing of shares (Item 18); taxation of the fund (Item 19); underwriters (Item 20); the calculation of performance data (Item 21); financial statements (Item 22); and a variety of other topics. See U.S. Sec. & Exch. Comm'n, Registration Statement (Form N-1A), <http://www.sec.gov/about/forms/formn-1a.pdf>.

Individual investors can themselves readily find detailed research on funds through their broker/dealers or from entities that specialize entirely in gathering and reporting information on funds, such as Lipper and Morningstar.¹⁶⁰ Boards of trustees, also, can and often do commission detailed reports on the performance of the funds under their care as part of the process of deciding whether to renew advisory agreements.¹⁶¹

During the lengthy contract renewal process, trustees often focus on how well the investment adviser—and the funds the adviser is managing—are performing. Frequently, the adviser itself will produce reports setting forth this information.¹⁶² Trustees, however, can also solicit more independent, third-party research customized to their fund complex. A report by Lipper, for instance, might set forth such information as the total assets of each fund as of a certain date; the total one-year, three-year, five-year, and ten-year returns for the fund; and the expenses being charged by the adviser and the distributor as a percentage of the fund's average net assets. Perhaps more importantly, these reports also provide comparisons to competitors, setting forth the quintile or decile in which the performance or fees rank as compared to all funds that use a similar investment approach. From these reports, trustees can determine whether an adviser is performing better or worse—and how much so—than the industry average. Similarly, the reports will inform the board whether the shareholders whom it represents are being charged fees in line with industry norms.¹⁶³

Moreover, to the extent that inherent market forces do not produce information enough for shareholders and trustees, federal regulations do. One of the constant tasks that every investment adviser faces is satisfying the enormous disclosure requirements of the 1940 Act and the Advisers Act.¹⁶⁴ For the benefit of current and future shareholders, each fund that an adviser manages must maintain a prospectus that sets forth a great deal of fund data and a Statement of

160. See Lipper Home Page, *supra* note 150; Morningstar Home Page, *supra* note 151.

161. See, e.g., Beagan Wilcox, *How Boards Ensure They're Still Focused on Performance*, BOARDIQ, May 17, 2005, http://www.boardiq.com/home/members/article_search_results.html?id=974211885 (subscription required).

162. See *id.*

163. For example, Lipper provides a suite of advisory contract renewal services geared towards allowing fund trustees to satisfy their requirements under Section 15(c) of the 1940 Act. See Lipper Fund Fact Sheets, Advisory Contract Renewal Services-15(c), http://www.lipperweb.com/products/contract_renewal.asp (last visited Mar. 28, 2006).

164. See, e.g., *supra* note 159 and accompanying text (describing just some of the disclosure required by Form N-1A).

Additional Information (SAI) that sets forth an avalanche.¹⁶⁵ In these documents, as well as in annual reports, semiannual reports, certified shareholder reports, and several other regularly required disclosure documents, advisers must, in extensive detail, lay bare the fees,¹⁶⁶ performance histories,¹⁶⁷ investment strategies,¹⁶⁸ and risks of the funds they manage.¹⁶⁹ A mutual fund will regularly file several hundreds of pages with the SEC each year.¹⁷⁰ For the purposes of negotiating an advisory agreement, then, mutual fund boards have no reason not to consult all the data they need to make a fully informed negotiation.

c. Protection from Sophisticated Shareholders

Despite the deep and widespread ownership of mutual fund shares by the American public,¹⁷¹ by no means are all investors simply future retirees. Many fund shareholders are sophisticated and financially influential entities, with millions and even billions of dollars at their disposal to invest.¹⁷² Government pension plans, university endowments, and even other mutual funds regularly purchase shares in investment companies.¹⁷³ With them, they bring a professional staff of highly knowledgeable financial experts, adroit at determining whether an advisory contract for a particular fund is or is not well calibrated to advance their interests. Their decision not to purchase shares in a fund or to leave it in response to an ill-conceived

165. See *supra* note 159 and accompanying text (describing disclosure requirements set forth in Form N-1A); see also U.S. Sec. & Exch. Comm'n, Information Available to Investment Company Shareholders, Statement of Additional Information, <http://www.sec.gov/answers/mfinfo.htm> (last visited Feb. 15, 2006) (describing disclosure requirements of the SAI).

166. U.S. Sec. & Exch. Comm'n, Registration Statement (Form N-1A), http://www.sec.gov/about/forms/formn_1a.pdf (last visited Mar. 28, 2006).

167. *Id.*

168. *See id.*

169. *See id.*

170. For a sense of the filing requirements, visit EDGAR Company Search, <http://www.sec.gov/edgar/searchedgar/companysearch.html> (last visited Mar. 31, 2006) (enter the name of any mutual fund registrant).

171. See INV. CO. INST., *supra* note 3, at 79-83.

172. The identities of these large shareholders are set forth in the public filings of mutual funds. Item 13 of Form N-1A requires that mutual funds disclose principal holders of their securities, so each fund's SAI will include a list of major shareholders, many of which are institutional investors. See U.S. Sec. & Exch. Comm'n, Registration Statement (Form N-1A), Item 13, http://www.sec.gov/about/forms/formn_1a.pdf (last visited Mar. 28, 2006). Item 13(b) states: "State the name, address, and percentage of ownership of each person who owns of record or is known by the Fund to own beneficially 5% or more of any Class of the Fund's outstanding equity securities." *Id.*

173. In the investment management industry, these funds of funds are frequently called "asset allocation" funds.

advisory agreement would serve as a signal to more passive investors of the lack of an optimal arrangement. The presence of these erudite watchdogs adds yet another protective market force that should drive the terms of an advisory contract toward an optimal equilibrium.

3. Corporate Law Remedies

A third component that works to produce optimal contracts, according to proponents of the hypothesis, is the body of corporate law that allows shareholders to pursue judicial means to challenge advisory contracts that they believe are less than optimal.¹⁷⁴ Specifically, shareholders have the option of bringing a lawsuit—most likely a derivative action—to challenge an advisory agreement that they believe pays the investment adviser too much.¹⁷⁵ Such an action might allege that the board has committed waste or breached its duties of loyalty or care. If successful, this avenue of recourse would necessarily impose a substantial influence on the development of optimal contracts, not only by bringing to bear the force of judicial fiat on the advisory fees but also by creating an environment in which boards and investment advisers must bargain in the shadow of such direct legal remedies.

At a superficial glance, the criteria proposed by the optimal contracting theory might appear to suggest that the investment advisory business is a healthy one—and, indeed, commentators only recently argued that the industry's governance was “a model for corporate America.”¹⁷⁶ But the even more recent proliferation of widespread malfeasance is a strong hint that all is not optimal. The inquiry, then, must turn to the shortcomings of the optimal contracting theory and to possible alternatives.

IV. ALTERNATIVE THEORETICAL CONSIDERATIONS

In rejecting the optimal contracting approach, a trio of commentators has protested that managers wield so much influence over their own pay arrangements that the theory's three requisite

174. See Bebchuk, Fried & Walker, *supra* note 46, at 779-80 (discussing the efficacy of derivative litigation).

175. See Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 573-80 (2001).

176. See, e.g., Phillips, *supra* note 4, at 1.

conditions rarely, if ever, coexist.¹⁷⁷ Moreover, any analysis of executive compensation that fails to appreciate the true extent of managerial power is necessarily incomplete. In advancing this managerial power hypothesis, Lucian Bebchuk, Jesse Fried, and David Walker begin by pointing out the limitations in fact upon arm's-length negotiations, market forces, and legal redress.¹⁷⁸ Although their analysis focuses on operating companies, similar limitations also plague the interactions of boards and advisers in the mutual fund context.

A. *Limitations of the Optimal Contracting Approach*

The same three components of the optimal contract approach that apparently function so well are actually afflicted by serious limitations, some of which are unique to the investment advisory context and some of which maintain in the operating company setting as well.

1. Arm's-Length Bargaining

To enjoy any distance from the investment adviser, whether it is an inch or the length of an arm, a board must truly have an independent character. In the days when every member of the board worked for (or had some other direct affiliation with) the adviser, any negotiation between the two was far more cozy than businesslike. Even today, when many boards contain large majorities of technically independent trustees, one might wonder at the extent to which such legislated independence actually equates with a real freedom to disavow completely the wishes of the investment adviser.

As has been discussed, only the independent trustees of a board may participate in the decision to enter into or to renew an advisory agreement, and a majority of those independent trustees is required to do so.¹⁷⁹ "Independence" in this context is purely a legal determination that the trustee is not an "interested person" of the mutual fund, as that term is defined in Section 2(a)(19) of the 1940 Act.¹⁸⁰ The Act generally deems interested any person who is an officer or employee of the fund or its investment adviser,¹⁸¹ or a close family member

177. See LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 61-79 (2004); Bebchuk, *supra* note 46, at 843-49; Bebchuk, Fried & Walker, *supra* note 46, at 751.

178. See Bebchuk, Fried & Walker, *supra* note 46, at 764-83.

179. See *supra* text accompanying notes 98-102.

180. 15 U.S.C. § 80a-2(a)(19) (2000).

181. *Id.* § 80a-2(a)(19)(A)(i), (B)(i).

thereof,¹⁸² a lawyer of the fund or its investment adviser,¹⁸³ or anyone who has had a significant professional or business relationship with the fund complex or its investment adviser during the past two and a half years.¹⁸⁴

Of course, this definition fails to deem a grandparent or grandchild of the investment adviser's chief executive officer an interested person; nor would it exclude that CEO's partner, best friend, or golfing buddy.¹⁸⁵ A wide array of intimate and yet nominally independent relationships may exist within the regulations. Even the SEC "recognize[s] that 'legal' independence does not equate with 'real' independence."¹⁸⁶ Furthermore, although many trustees may join the board through the efforts of a nomination committee, which itself is comprised of only independent trustees, the adviser always participates to some extent in the process. When a fund is first formed, it is the adviser—as the sole shareholder—who determines who will be the trustees. Thus, even technically independent trustees are likely to be known personally to the members of the adviser who have nominated them, and every subsequent trustee, whether independent or not, will descend from this initial relationship. Thus, the potential for nominees to have a personal and preexisting relationship with the senior management of the adviser is extremely high. Moreover, even if such a relationship does not exist at the outset of a board member's service, collegiality is very likely to develop over the course of service on any board that meets many times a year.¹⁸⁷

Aside from personal connections to the adviser, one must consider where the independent trustees' pecuniary interests lie. While they may, like shareholders, own shares in the funds they oversee, nothing obliges them to do so. From time to time, shareholders propose schemes whereby trustees must purchase shares in the funds they oversee, but shareholder meetings for mutual funds are extremely

182. *Id.* § 80a-2(a)(19)(A)(ii), (B)(ii).

183. *Id.* § 80a-2(a)(19)(A)(iv), (B)(iv).

184. *Id.* § 80a-2(a)(19)(A)(vi), (B)(vi).

185. *See id.* § 80a-2(a)(19).

186. *See* Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378, 46,381 (Aug. 2, 2004).

187. *See* BEBCHUK & FRIED, *supra* note 177, at 31-34 ("Whether or not a particular director was appointed during the CEO's reign, that director is likely to develop a personal relationship with the CEO as well as with other directors who may be even closer to the CEO.").

rare, and such proposals are typically only precatory.¹⁸⁸ On the other hand, independent trustees receive regular paychecks for their services to the funds and, on balance, the larger the number of funds and assets they oversee, the larger their remuneration.¹⁸⁹

Fund complexes typically compensate their independent trustees through either a top-down or bottom-up approach. In a top-down system, the board fixes a compensation figure for its members, the cost of which is then borne by all the funds in the complex on a pro rata basis according to the amount of assets in each fund. A bottom-up approach involves determining a figure to be paid by each unit of assets, which are then added up by all the funds in the complex to arrive at a final sum. If the assets of the complex grow, then this latter system automatically increases the trustees' compensation.¹⁹⁰ In a top-down approach, trustees may feel more at liberty to increase their own remuneration when they know that a greater number of shareholders will bear any added costs. In either system, the trustees' financial incentives are linked to the adviser's with respect to increasing the assets under management—both trustees and advisers will, on balance, be paid more when a fund complex has more assets under management.¹⁹¹ Of course, in order for any assets to be under management, the trustees must approve an advisory agreement. So, in order to receive payment for their services, trustees have an incentive to work with the investment adviser to consummate an agreement.

In addition to these interpersonal and fiscal considerations, board dynamics also limit the degree to which independent trustees and the investment adviser interact at a meaningful distance.¹⁹² For the typical

188. See Brian R. Cheffins & Randall S. Thomas, *Should Shareholders Have a Greater Say over Executive Pay?: Learning from the U.S. Experience*, 1 J. CORP. L. STUD. 277, 286-94 (2001).

189. INV. CO. INST., UNDERSTANDING THE ROLE OF MUTUAL FUND DIRECTORS 21 (1999).

190. See Bonnie Bauman, *Fidelity Directors Got "Huge" Pay Raises Last Year*, BOARDIQ, Feb. 8, 2005, at 1, http://www.boardiq.com/articles/print/20050208/fidelity_directors_huge_raises_last_year (subscription required).

191. Interestingly, trustees also receive more compensation when they are forced to meet more frequently to address pressing issues; such as, for instance, during the heightened investigative and regulatory climate of the past two and a half years. See Bauman, *supra* note 101 ("Director pay climbed 13% in 2004, according to a study just released by Management Practice, a fund governance consulting firm. For the second year in a row, the hike was more attributable to an increase in the number of board meetings than an increase in board retainers.").

192. See BEBCHUK & FRIED, *supra* note 177, at 23-44 ("[S]ignificant deviations from arm's-length contracting have been common in widely held public companies."); Bebchuk, Fried & Walker, *supra* note 46, at 764-74.

board meeting, employees of the adviser are charged with preparing and distributing materials in advance; portfolio managers and other executives of the adviser make technical presentations; and, until quite recently, the chair of the board would almost certainly have been a high-ranking executive of the adviser. Thus, the adviser, through one means or another, has a great deal of influence over the content and tenor of board meetings. More importantly, the adviser, regardless of whether one of its employees officially chairs the board, controls access to data about the inner workings of the fund and the adviser. This combination of personal relationships among the interested and independent trustees, common financial incentives, and the adviser's domination of the board proceedings will inevitably reduce the degree to which any negotiations over the advisory agreement can truly operate at arm's length.

2. Market Forces

The degree to which the market resolutely guides the board and the adviser to an optimal pay arrangement also should not be overstated. Several factors interfere with the theoretically orthodox conception of a marketplace carefully protected by the beneficent forces of competition, information, and the wiser shareholders amongst us.

a. Competition Amongst Investment Advisers

Although there are, indeed, hundreds of advisers and thousands of funds from which a shareholder may choose, the managerial labor market for any particular fund is far from fluid. While, *ab initio*, an investor newly arrived to the mutual fund forum can choose only those funds with the best performance and lowest advisory fees, many investors are not arriving to the agora unfettered. Many are brought by their 401(k) plans to a small corner of the emporium and offered only a limited menu of mutual funds.¹⁹³ Many others are already shareholders in mutual funds. Like individual shareholders, each fund's board of trustees must also decide on an investment adviser. For the board, however, the choice relating to investment advisers is not a wide open selection among the economy's finest performers; it is, instead, simply a binary: to renew or not to renew the advisory agreement with the fund's current adviser.¹⁹⁴

193. See INV. CO. INST., *supra* note 3, at 45-49.

194. See *supra* notes 102-117 and accompanying text.

While it is theoretically possible for a fund board to decline to renew an advisory agreement with the fund's adviser, in practice, such a termination practically never happens. Changing a fund's adviser would, in effect, be to change the very nature of the fund. Suppose a board were, for example, to fire MFS as the investment adviser of a global equity fund and to hire, as a replacement, Putnam. One could reasonably assume that if Putnam were an expert in global equities, it would already advise a global equity fund in its own complex. Thus, to the extent that shareholders of the MFS global equity fund are unhappy with the investment adviser, they do not need to wait for the board to provide a remedy; rather, they have a ready solution of their own at hand: they can simply redeem their MFS shares, exit the fund, and purchase shares of the Putnam fund. To the extent that shareholders have not made such a switch, the board might assume that the shareholders are indicating their satisfaction with MFS as the adviser of the fund. Moreover, because many shareholders invest in a particular fund to obtain the investment management services of a specific investment adviser, a board's decision to change adviser effectively negates the shareholders' preference.

Consequently, the termination of advisory agreements is so rare as to be practically an impossibility. This limitation severely restricts the ability of a fund's board to control the management of the fund, a fact of which investment advisers are acutely aware. Indeed, even following the unprecedented wave of problems that has deluged the industry, not one board of trustees has pointed to these developments and declined to renew an advisory agreement with any investment adviser.¹⁹⁵

Of course, not every investor who refuses to exit a mutual fund is voicing support for the adviser or its fees. Inertia and ignorance are potent supporters of the status quo. Some investors may believe that the board of trustees will protect them from what they believe are truly excessive fees. In this respect, both the trustees and the shareholders may be looking to the other party to object to high advisory fees. In addition, an adviser's fees may not be so high as to drive away shareholders and yet still be higher than is optimal. The paradox of an apparently transparent compensation scheme in which both trustees

195. See Diana B. Henriques, *A Sense of History, A Feeling of Betrayal*, N.Y. TIMES, Jan. 2, 2004, at C1 (quoting former industry leader, Michael F. Price: "You know what the shocking thing to me is? That nobody has had a contract canceled by a board of directors. Even where a chairman was messing around with the fund, the board didn't cancel the contract. What does it take to get fired in this business?").

and shareholders are familiar with the advisory fees is that neither group may feel the need to be the ultimate monitor.

b. Dissemination of Information

Yet if shareholders do have access to advisory fees, perhaps they ultimately retain the ability to protect themselves by shunning advisers with high fees. Alas, this option is handicapped by two added complications that both create a dearth of transparency regarding advisers' compensation. First, the amount of information for any given mutual fund is not just extensive, it is practically overwhelming.¹⁹⁶ Second, the true compensation to the adviser is not captured in one simple number but through a complex agglomeration of multiple variables.¹⁹⁷ So, although most mutual funds do not lock in shareholder capital and, on the contrary, allow shareholders to redeem shares easily, the decision to redeem is useless without the knowledge of when to do so.¹⁹⁸

The prospectus and SAI for any given fund in a major complex can run to well over a hundred pages.¹⁹⁹ As any experienced litigator knows, if one must produce adverse facts, it is often best to do so amidst an avalanche of documents. When advisers disclose their advisory fees, they may provide information for each different class of shares that a particular fund offers and include provisos for redemption fees,²⁰⁰ exchange fees,²⁰¹ account fees,²⁰² temporary fee waivers,²⁰³

196. See *supra* note 159 and accompanying text (discussing disclosure requirements of Form N-1A).

197. In fact, one major mutual fund complex—the UMB Scout family of funds—is now considering a plan to unbundle its fees, so that the board will be able to assess and to control specific expenses. See Bonnie Bauman, *UMB Scout Funds Revamp Fee Structure*, BOARDIQ, Feb. 8, 2005, http://www.boardiq.com/articles/print20050503/more_time_more_money_directors (subscription required).

198. See Brad M. Barber, Terrance Odean, and Lu Zheng, *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows* (December 2003), available at SSRN: <http://ssrn.com/abstract=496315> (documenting, inter alia, no relation between fund flows and operating expenses charged by brokerage firms).

199. See *supra* note 159 and accompanying text.

200. See *supra* text accompanying note 80 and source cited therein. The ICI defines a redemption fee as a fee “paid to a fund to cover the costs, other than sales costs, involved with a redemption.” INV. CO. INST., *supra* note 3, at 20.

201. “This [exchange] fee may be charged when an investor transfers money from one fund to another within the same fund family.” *Id.*

202. Account fees “may be charged by some funds, for example, to cover the costs of providing services to low-balance accounts.” *Id.* When an investor’s holdings in a fund drop to a sufficiently low level, the account fee is designed to prevent the transfer agent from incurring a loss on handling the administrative tasks associated with the account.

distribution fees,²⁰⁴ and other idiosyncratic expenses. If one asked a portfolio manager what the cost is to invest in his or her mutual fund, the answer is almost sure to be, “It depends.” Class *A* shares include front-end sales charges (or loads), class *B* shares include contingent deferred sales charges or back-end loads which vary with the amount of time the shares are held, and some class *C* shares include neither front- nor back-end loads but feature higher fees across the life of the investment.²⁰⁵ In addition, the purchase of a certain threshold of shares might entitle the investor to lower fees on the marginal amounts above certain price breakpoints. For the average shareholder, then, determining the precise cost to invest in any given mutual fund rivals the complexity of calculating the exact cost of a home mortgage with its innumerable fees and closing costs. The fund’s advisory fee and the mortgage’s interest rate are prominent and important guideposts, but they hardly tell the whole story.

These computations are also complicated for the board, which must conclude whether to approve of the fees. As with the compensation of an operating company’s CEO—which might comprise a complicated equation of signing bonuses, deferred compensation, pension benefits, and stock options—the compensation of an investment adviser is a similarly convoluted function of several variables.²⁰⁶ For the trustees of a board that oversees dozens, scores, or even hundreds of mutual funds, the ability to sort through this information—even if provided in convenient reports by Lipper²⁰⁷—is

203. In some recent settlement agreements, investment advisers have agreed to lower the fees they charge investors, though typically only for a finite number of years. *See, e.g.*, Riva D. Atlas, *Janus Agrees to Lower Fees in \$225 Million Settlement*, N.Y. TIMES, Apr. 28, 2004, at C5 (“The Janus Capital Group said yesterday that it would lower fees on its mutual funds as part of a \$225 million settlement with regulators over improper trading in its funds. The New York attorney general, Eliot Spitzer, demanded the fee reduction of \$125 million over five years . . .”); *see also* Press Release, Office of N.Y. Att’y Gen. Eliot Spitzer, Spitzer, Salazar Announce Market-Timing Settlement with Janus Capital Management, LLC (Apr. 27, 2004), available at http://www.oag.state.ny.us/press/2004/apr/apr27a_04.html (agreeing to pay a \$125 million in fee reductions over a five-year period).

204. The distribution (12b-1) fee, “if charged, is deducted from fund assets to compensate sales professionals for providing services to mutual fund shareholders in connection with the purchase and sale of shares or the maintenance of accounts, and to pay fund marketing and advertising expenses.” INV. CO. INST., *supra* note 3, at 21.

205. *See* Rochelle Kauffman Plesset & Diane E. Ambler, *The Financing of Mutual Fund “B Share” Arrangements*, 52 BUS. LAW. 1385, 1385 & n.1 (1997).

206. *See* Bebhuk, Fried & Walker, *supra* note 46, at 775-78 (“The typical CEO’s compensation package is composed of a base salary, an annual bonus, stock options and/or restricted shares, and often other long-term incentive elements.”).

207. Some critics contend that even intermediaries who are expert in compiling and analyzing pricing information, such as Morningstar and Lipper, do a poor job of advising

constrained by the time and expertise that the trustees bring to their positions which are, after all, only part-time.

c. Protection from Sophisticated Shareholders

If average shareholders cannot count on boards to guarantee their financial well being and are unable to parse the fee disclosure for themselves, perhaps they can at least rely upon their more savvy fellow investors to serve as sentinels and to police the system for them. With pension plans, university endowments, and other mutual funds investing in funds, surely their full-time staffs of financial professionals wield sufficient clout and expertise to determine precisely whether any given investment adviser has exceeded the optimal level of fees. And surely these institutional investors will then use their influence to bring back into line any high fees to arrive at an optimal level of compensation for the adviser and the shareholders. More importantly, investment advisers should be sufficiently afraid of driving away the considerable business of institutional investors to avoid setting fees so high as to lose their custom.

Indeed, these institutional investors bring their influence to bear on the pricing system for mutual fund shares. But rather than cross-subsidizing the less sophisticated mutual fund investors amidst them, they do what any healthy person would, if able, when surrounded by an ailing population: they exit the pool altogether. Institutional investors invest in mutual funds through their own class of shares, which come with a customized pricing system far more advantageous to the investors than the typical retail share. Subject to a steep minimum investment, these institutional shares offer far lower advisory and other fees to the funds' most valuable investors.²⁰⁸ Thus, the presence of investing experts in their midst does little to guarantee average investors an optimal pricing system.²⁰⁹

shareholders. *See, e.g.*, David F. Swensen, *Unconventional Success: A Fundamental Approach to Personal Investment* 178-181 (2005) ("The highly touted Morningstar rating system reinforces the investing public's unfortunate tendency to focus on past performance. Purely statistical, backward-looking calculations provide no help in identifying superior managers.).

208. Institutional investors may be required, for instance, to purchase a minimum investment of \$1 million, in exchange for which their assets will be subject to an advisory fee many basis points lower than that of the ordinary, retail investor.

209. Indeed, some regulators, such as the office of the New York Attorney General, have entered settlement agreements pursuant to which fund boards must consider the pricing discrepancies between the retail and investment share classes of the funds they oversee.

3. Corporate Law Remedies

The limitations of lawsuits are well known to potential plaintiffs, regardless of whether their complaints originate from the excesses of operating company executives or investment advisers. Even under the best of circumstances, such derivative suits are extremely difficult to win, given the demand and futility requirements, the protection afforded trustees by the business judgment rule, the ability of a board to protect itself with a special litigation committee, and all the other impediments to success at both trial and appeal.²¹⁰

While an operating company may offer an investment opportunity that truly is *sui generis*, the majority of mutual funds are not very difficult to replicate with competitors' offerings.²¹¹ Therefore, while many fund shareholders may proceed unaware of shortcomings of their advisory fees, if such a shareholder were to grow sufficiently agitated to consider bringing an action to produce a judicially decreed optimal advisory fee, surely a far simpler alternative would exist well before trial: the shareholder could simply redeem his or her shares and reinvest them in a more amenable priced competitor.

Corporate law is, of course, not entirely impotent with respect to bringing redress to wronged shareholders. Indeed, if the events of the past two and a half years have demonstrated anything, it is the power of regulatory action to identify and ameliorate industry excesses. Prior to this full-scale regulatory assault on investment advisers, however, shareholders either did not know how to, or did not care to, initiate private litigation in any concerted way.²¹² Thus, the courts by themselves did little to guide boards and advisers toward optimal investment advisory agreements.

210. See Bebczuk, Fried & Walker, *supra* note 46, at 779-82 (“[C]orporate law permits shareholders to challenge a particular compensation package under a variety of doctrines. However, the obstacles to the success of such a lawsuit all but ensure that courts never review the substantive merits of management compensation arrangements.”).

211. See, e.g., The Motley Fool, No-Load Index Funds, <http://www.fool.com/mutualfunds/indexfunds/table01.htm> (last visited Mar. 28, 2006) (listing 17 no-load S & P 500 index funds).

212. When such suits have been brought in the past, however, a landmark decision has established a standard that has, to date, been insurmountable. See *Gartenberg v. Merrill Lynch Asset Mgmt.*, 694 F.2d 923, 928 (2d Cir. 1982) (“To be guilty of a violation of § 36(b), therefore, the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.”).

B. The Managerial Power Hypothesis

The optimal contracting approach suggests that, when present, arm's-length negotiation, market forces, and corporate law will impel boards and managers to negotiate compensation schemes that optimally align the interests of shareholders and managers.²¹³ Arguably, the current investment advisory industry does not satisfy those three criteria and perhaps, therefore, the absence of optimal contracts in the industry is not surprising. Of course, in the storm of recent upheavals, no one has proved that the advisory agreements between mutual funds and their advisers are less than optimal. Instead, the allegations have focused on a host of other activities by the advisers to the detriment of the funds and, by extension, their shareholders. The optimal contracting approach provides no guidance as to how or why such behavior may have occurred. The managerial power hypothesis, on the other hand, does.

The managerial power hypothesis, like the optimal contracting approach, begins with an acknowledgement of the "agency problem inherent in the manager-shareholder relationship."²¹⁴ Unlike the optimal contracting approach, however, the managerial power hypothesis sees executive compensation not as the remedy to the agency problem but as "part of the problem itself."²¹⁵ Many of the limitations of the optimal contracting approach arise from the fact that managers possess power sufficient to pervert the course of arm's-length bargaining. The managerial power hypothesis predicts that, in such situations, managers will use their power to extract rents, in the form of "compensation more favorable than they would get under arm's-length bargaining."²¹⁶ Extending this perspective to the investment management context, one might expect investment advisers with sufficient power vis-à-vis the board of trustees to exact rents from the funds that they manage.

Indeed, as we have already seen, many investment advisers do possess a great deal of power in interactions with boards of trustees. By virtue of running all aspects of a mutual fund every day, the senior executives of an adviser are far more familiar with the operations, trading strategies, investment success, and regulatory compliance of that fund than the members of the board, who meet to discuss the fund

213. See, e.g., Bebchuk, Fried & Walker, *supra* note 46, at 764.

214. BEBCHUK & FRIED, *supra* note 177, at 61.

215. Bebchuk, Fried & Walker, *supra* note 46, at 784.

216. See *id.* at 787.

only on a part-time basis. Moreover, what the board discusses at those occasional meetings is subject, in large part, to the agenda, reports, and presentations provided to the board by the employees of the adviser. If a board has suspicions of malfeasance, it can certainly consult its separate legal counsel, but the board can hardly subject the adviser to a constant audit of its operations.

In its original incarnation, the managerial power hypothesis suggested that the CEO or other individual officers of an operating company might have power ascendant over the company's board to extract rents.²¹⁷ When one aggregates the influence of the entire management and personnel of a mutual fund into the single investment adviser entity, there can be little doubt that the collective unit has the upper hand with the fund's board of trustees. Not only is the manager in the mutual fund context—that is, the investment adviser—more powerful than the prototypical CEO, but the board of trustees is weaker than the typical operating company's board of directors. While firing a CEO is not an easy matter, doing so is far more straightforward than terminating an advisory contract, which, as I have discussed, is tantamount to terminating the going enterprise of the mutual fund.²¹⁸ While relatively rare, CEO terminations are eminently more common than terminations of advisory contracts.²¹⁹

Furthermore, mutual fund boards are also incapable of wielding direct authority over employees of the investment adviser. While the board of an operating company can choose to discipline any employee in the company, a mutual fund board has no such authority. The individuals who work with a mutual fund are employees not of the fund but of the investment adviser and, as such, do not report to the board of trustees but to the board of directors of the adviser. So although a fund board can express a pointed opinion to the investment adviser and exert indirect pressure, it cannot directly retain, promote, or terminate an employee of the adviser. The mutual fund board is thus deprived of a line-item veto; if it feels deeply enough to wish the dismissal of an individual, it must threaten the termination of the entire advisory relationship. In sum, the board of trustees of a mutual fund

217. *See id.* at 784-86.

218. *See supra* text accompanying note 195.

219. In fact, recently, the termination of a chief executive officer has become somewhat common. *See, e.g.*, Steve Bailey, *A Matter of Governance*, BOSTON GLOBE, Mar. 18, 2005, at E1 (“Corporate boards are suddenly showing the backbone their many critics have been demanding for years. And big-name CEOs are falling like dominoes.”); Pui-Wing Tam, *Fallen Star: H-P’s Board Ousts Fiorina as CEO*, WALL ST. J., Feb. 10, 2005, at A1 (discussing the ouster of former Hewlett-Packard chief executive and chair, Carly Fiorina).

possesses many of the same responsibilities to its shareholders as does the board of an operating company but without anywhere near the same array of tools.

Aside from terminating the investment advisory contract, a board of trustees has perhaps only one instrument of consequence: public complaint. If a board is convinced that an adviser is behaving badly or failing to cooperate, the board can threaten to voice its concern to the SEC or otherwise make its displeasure known publicly. Particularly in today's environment of heightened regulatory scrutiny, such a threat is likely to grab the adviser's attention and may restore some balance of power with the adviser. Similarly, the board can address its concerns to the shareholders of a fund, many of whom are also sensitive to the lingering whiff of impropriety abroad in the industry. At a time when investors have only recently withdrawn billions of dollars from funds tainted by regulatory investigations,²²⁰ an adviser might well be concerned that shareholders offered any reason for concern by their trustees would be quick to abandon a fund. Of course, like all shepherds, boards can threaten such outcries only a few times before they lose their potency.²²¹

Notwithstanding its criticism of the optimal contracting hypothesis, the managerial power perspective "does not imply that there are no constraints at all on compensation and the rents that [managers] can capture."²²² On the contrary, the hypothesis is acutely aware of the outrage that compensation arrangements particularly favorable to managers might spark.

If an executive's compensation arrangement goes far beyond what could be justified under optimal contracting and is perceived that way by outsiders, those outsiders might become angry and upset. If this outrage is sufficiently widespread and intense, it limits the extent to which compensation can be increased in a number of ways.²²³

Investment advisers are similarly sensitive to public censure of their compensation, which could easily prompt substantial redemptions from their mutual fund, which would reduce the assets under their management and, in turn, the fees they receive from advising those

220. See Joe Morris, *More Big Players Hit with Outflows*, IGNITES, June 25, 2004, http://www.ignites.com/articles/print/20040625/more_players_with_outflows ("[In May 2004,] Fidelity had the worst showing of the group, with an estimated \$2 billion in net withdrawals. It had taken in a net \$2.5 billion in April.").

221. See AESOP, AESOP'S FABLES 78 (Laura Gibbs trans., 2002).

222. Bebchuk, Fried & Walker, *supra* note 46, at 786.

223. *Id.*

funds. In many ways, this theory is almost more suited to the investment advisory context than to operating companies, since advisory fees are such a critical ingredient in the decision to invest in a mutual fund. While it is true that an investor might be willing to ignore high advisory fees if a fund is garnering lucrative returns, as a general matter, those fees will have a stronger bearing on an investor's decision to buy mutual fund shares than the compensation of an operating company's chief executive will influence an investor's decision to buy that company's shares.

To minimize outrage and its attendant deleterious effects, a manager will, according to the managerial power approach, seek to reduce the degree to which his or her hunger for compensation is perceived by outsiders. "Because perceptions are so important, the designers of compensation plans can limit outside criticism and outrage by dressing, packaging, or hiding—in short, camouflaging—rent extraction."²²⁴ This camouflage typically takes the form of perquisites, stock options, benefits, and other forms of remuneration to the executive that are either less easy to comprehend than a simple salary or are more capable of being disguised. In applying this theory to the investment management context, one might equate advisory fees to an executive's salary. To what, then, would one compare these disguised perks, options, and benefits? Possibly to the morass of additional fees and expenses buried in funds' prospectuses. But if investment advisers are more powerful than executives, and mutual fund boards of trustees are weaker than operating company boards of directors, one might expect the managerial power hypothesis to apply with even greater force in the investment advisory context. With that premise in mind, perhaps the accretion of disguised benefits is more widespread in the mutual fund context. And perhaps the litany of problems that have recently beset the industry are best thought of as investment advisers' disguised attempts to accrue additional rents.

V. CAMOUFLAGED EXTRACTIONS OF SHAREHOLDER VALUE

Investment advisers are commonly ranked by the amounts of assets they manage.²²⁵ Because their own wealth is such a direct function of those assets under management, the metric is also an easy

224. BEBCHUK & FRIED, *supra* note 177, at 67.

225. *See, e.g.*, Lipper Home Page, *supra* note 150. Note that new SEC rules restrict the degree to which investment advisers may advertise by touting the past performance of the funds they manage. *See* Amendments to Investment Company Advertising Rules, Investment Company Release No. 26,195, 68 Fed. Reg. 57,760, 57,761 (Oct. 6, 2003).

proxy for the advisers' success. For every new dollar of assets in one of its funds, an adviser will realize perhaps a penny or two or maybe even something less in advisory fees. But when those assets grow to a flood of billions of dollars, advisers' profits soon become real money. Of course, amounts like these do not come free from potential conflicts of interest. Advisers constantly face situations in which they must choose between their own pecuniary advancement and their shareholders' best interests. A dynamic shared by many of the mutual fund irregularities of the past two and a half years is the choice by culpable advisers to increase the assets under their management at the expense of their shareholders' interests.

Of course, there are many benign and even affirmatively good explanations for the growth of assets in a mutual fund, and chief among them is an adviser's canny investment decisions that have enlarged a fund to the benefit of all the shareholders. Larger funds can, in theory, enjoy economies of scale from savings on transaction costs which may be shared among investors.²²⁶ These beneficent justifications for the growth of assets under management may help to disguise the advisers' own profit, thereby allowing advisers to reap superoptimal value without detection. In each of the mutual fund improprieties examined below,²²⁷ the advisers' power to control the operations of the fund explains how they positioned themselves to extract rents from their shareholders.²²⁸

226. Economies of scale may be passed on to shareholders in funds through the use of sales-load breakpoints. That is, a fund may offer a discount on the sales charges it imposes on fund shares in proportion to the amount of a shareholder's investment, such that the more money an investor puts into a fund, the less he or she has to pay in sales charges. If an investor invests \$100,000 in a fund, for instance, his or her sales load may be 3.75%; but if he or she increases the investment to \$500,000, the load will drop to 2.00%. One of the improprieties that recently came to light involves investment advisers failing to honor these breakpoints and not giving large shareholders their appropriate discounts.

227. Abuses have also been reported in yet other areas of the fund industry, such as 529 plans. Recently, the state of Utah fired the head of its 529 plan and accused him of stealing money earmarked for the plan. Dale Hatch, deputy executive director of the state's higher education assistance authority, has been accused of committing fraud by skimming money budgeted for administering the plan and putting it into 529 accounts he owned. See Jane J. Kim, *Director of "529" Plan Is Dismissed*, WALL ST. J., July 12, 2004, at C15.

228. Please note that some of the following discussions regarding abuses use hypothetical fact patterns to illustrate the species of malfeasance in question. Others, however, are based on the specific allegations contained in settlement orders signed by regulators and investment advisers. As those settlement agreements rarely contain admissions of liability, however, assume all facts are merely "alleged."

A. *Market-Timing*

One allegation that featured prominently at the initial press conference in which Eliot Spitzer declared malfeasance in mutual funds was market-timing.²²⁹ Unlike some of the behavior that has subsequently been alleged, market-timing is not illegal per se.²³⁰ Indeed, in some respects, the timing of entrances and exists from the market has been a strategy long encouraged by prudent investors—after all, much market behavior is governed by certain cyclical trends, so taking account of that calendar is only reasonable and certainly not against the law. Herein lies one of the sources of confusion with this topic: the term “market-timing” has no fixed definition in the extensive investment advisory literature and regulations. As investigations by the SEC and others evolved, however, regulators eventually made clear that the market-timing of which they disapproved encompassed a variety of investing techniques involving arbitrage of mutual fund share prices through the use of timed transactions.²³¹

Perhaps the best example of market-timing involves time-zone arbitrage, a strategy in which investors attempt to exploit inefficiencies in the pricing of mutual fund shares by scheduling investments according to the behavior of markets across far reaches of the globe.²³² Consider, for instance, an American mutual fund whose portfolio of underlying securities consists solely of a diverse array of Japanese equity securities traded on the Tokyo Stock Exchange. At 4:00 p.m. Eastern time each business day, the fund must determine its NAV by calculating the value of its Japanese holdings (and then adding to that figure any other assets the fund owns, subtracting any liabilities, and dividing that number by the number of fund shares outstanding). The easiest, and often most reliable, indication of the worth of any publicly traded security, Japanese or otherwise, is the price at which it last traded on a public securities exchange. The American fund therefore would, in all likelihood, use the closing price on the Tokyo Stock Exchange for their Japanese securities to determine its own NAV.

229. See Press Release, Eliot Spitzer, *supra* note 1.

230. See Disclosure Regarding Market-timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release No. 26,418, 69 Fed. Reg. 22,300, 22,301-05 (Apr. 23, 2004).

231. See *id.*; see also text accompanying and sources cited *supra* note 21 (discussing specific settlements with MFS and Alliance).

232. Eric Zitzewitz, *Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds*, 19 J.L. ECON. & ORG. 245, 246 (2003).

The potential problems with using the Japanese closing price become very apparent when one considers that the Tokyo Stock Exchange closes at 1:00 a.m. Eastern time²³³—fully fourteen hours before the American fund calculates its NAV. Imagine, for instance that at 3:00 a.m. Eastern time, a massive earthquake strikes the city of Kobe in Japan. Or, on the other hand, that at 4:00 a.m. Eastern time, the Japanese central bank lowers interest rates by a full point more than expected. In either case, the Tokyo Stock Exchange will not open—and therefore not be capable of reflecting these important developments—until 8:00 p.m. Eastern time, four hours after the American fund must calculate its NAV. In essence, by using the closing prices (which predate news that will certainly move the market) for its Japanese stocks, the American fund is trapped in time and operating in the past.

To a savvy investor, news of the earthquake or the drop in interest rates presents an ideal opportunity to arbitrage. By selling shares of the American fund on bad news, the investor will exit the fund before the price of the fund's shares drop, thereby avoiding a certain loss. By buying shares on good news, the investor will enter the fund before the price of the fund's shares rise, thereby locking in guaranteed gains. After all, the American fund will not react to these developments until the following day, when the Tokyo Stock Exchange will have opened, moved significantly up or down, and closed again. If an investor is poised and ready to move huge sums of money into and out of the American fund, it can garner significant profits through this strategy.

Mutual funds are, of course, advised by savvy portfolio managers who are not unaware of these investing techniques. Those managers are not bound in any way to use stale closing prices to calculate the fund's NAV. In fact, on the contrary, they are obliged to value their portfolio securities fairly, which means that they can depart from closing prices if those values are manifestly inaccurate.²³⁴ In such instances, a fund may retain the services of a third-party pricing consultant that specializes in ascribing a fair value to securities—or any other portfolio holdings—for which market prices are not readily available or, in the aforementioned examples, for which market prices

233. See Tokyo Stock Exchange Web site, <http://www.tse.or.jp/English/index.shtml> (last visited Mar. 28, 2006).

234. See Ciccotello, *supra* note 97, ¶¶ 33-35; see also *infra* text accompany notes 245-248 (discussing the fair valuation of portfolio securities).

do not accurately reflect true value.²³⁵ While any experienced portfolio manager can anticipate the effects that an earthquake or interest-rate adjustment will have on the market and can, accordingly, deploy fair valuation strategies to counterbalance those effects, many more subtle events that are harder to obviate can also present opportunities for arbitrage.

Market-timing arbitrageurs do not wait impotently for acts of God to present them with chances to make money. They have learned how to interpret and exploit the effects of much more nuanced occurrences. Even the movement of other world markets, for instance, could create predictable effects on a broad index of Japanese securities. Imagine that after the close of the Tokyo Stock Exchange, the New York Stock Exchange were to rise a certain percentage on the strength of positive developments in the U.S. economy. Such a rally would, with a certain degree of correlation, impact the other markets in the world. Thus, market timers can again move their funds into or out of funds accordingly.²³⁶

Of course, market-timing is not illegal per se. Indeed, some might argue that markets benefit from arbitrage, which encourages greater pricing accuracy. Nevertheless, the market-timing of mutual funds is not harmless. Market timers extract profits, and avoid losses, at the expense of longer-term shareholders who have not moved their assets in and out of the fund.²³⁷ By moving large blocks of cash into a fund in anticipation of a rise in the fund's value, the market timer dilutes the worth of each individual share of the fund.²³⁸ Although the timer's new cash was not invested in the underlying securities whose value has risen, the investment has increased the number of fund shares outstanding.²³⁹ Thus, with a greater denominator, the NAV equation results in profits from positive market movements being shared by a greater number of shareholders.²⁴⁰

In addition, the rapid movements of large amounts of cash in and out of a mutual fund create inefficiencies in the management of the

235. The leading provider of third-party fair valuation services is Investment Technology Group, Inc., which markets its ITG Fair Value Model as "an independent, reliable way to establish fair value prices. In historical back-tests of actual portfolios, the ITG Fair Value Model has significantly reduced the opportunity for market-timing by generating price adjustments that better approximate the next trade of fund holdings." See Investment Technology Group, <http://www.itginc.com/research/fvm.html> (last visited Mar. 28, 2006).

236. See Ciccotello et al., *supra* note 97, ¶¶ 8-10.

237. See *id.* ¶¶ 8-11.

238. See *id.* ¶¶ 16-20.

239. See *id.*

240. See *id.*

fund.²⁴¹ With the arrival of \$20 million, for example, in a \$100 million fund, the portfolio manager must scramble to invest the cash to maximize investment returns in the fund. Similarly, if a timer redeems \$20 million from the same fund, the portfolio manager may have to liquidate certain positions before an opportune moment to sell. Such timing movements also come with transaction costs shared by all shareholders of the fund. Economically, then, market-timing is deleterious to the interests of long-term shareholders. For that reason, many investment advisers prohibit market-timing in their mutual funds and proscribe such activity in their funds' prospectuses.²⁴²

Because market-timing is lucrative, however, certain arbitrageurs are willing to "pay" for the opportunity to do it. In exchange for the ability to move \$25 million rapidly in and out of a particular fund, for instance, a market timer might offer to leave untouched \$50 million of "sticky" assets in a different fund in the adviser's complex.²⁴³ Such an arrangement, of course, pits the interests of the shareholders of the timed fund against the interests of shareholders in the fund with sticky assets. More importantly, though, this arrangement pits the adviser's financial interest against its shareholders' interest. Although the shareholders of the timed fund will forfeit value to the market timer, the adviser will garner higher advisory fees from the additional sticky assets under management. While an adviser may allow investors to market time its funds without running afoul of the law, it cannot do so in violation of its own prospectus. Thus, the advisers who faced prosecution by the SEC and other regulators in connection with this activity were those who publicly claimed that they did not allow market-timing while furtively striking deals with hedge funds and other investors to facilitate it.²⁴⁴

B. Fair Valuation

As the market-timing abuses demonstrate, one key function that an investment adviser must regularly perform is the valuation of each

241. See *id.* ¶¶ 21-22.

242. See Mass. Fin. Servs., File No. 3-1193 (Feb. 5, 2004), Investment Advisers Act Release No. 2213, available at <http://www.sec.gov/litigation/admin/ia-2213.htm> (setting forth a total settlement of \$225 million).

243. A market timer may offer to park the sticky assets in a fund, such as a hedge fund, that provides the investment adviser with a substantially higher management fee than the fund that is being timed.

244. See *id.*; Brewster, *supra* note 13, at 19.

of its fund's portfolios.²⁴⁵ In essence, this process calls for the adviser to calculate its own fees. If the adviser concludes that the fund's assets are worth a great deal, it will receive more revenues from advisory fees; if it concludes that they are worth less, it will receive less. Needless to say, the adviser's incentive to inflate the value of the fund's assets is manifest.

The urge and ability to manipulate the value of a fund's portfolio is diminished a great deal by the use of objective market quotations for underlying securities, as any competent audit would quickly uncover fraud on the part of the adviser. When an adviser departs from market quotations, the risk of arbitrariness—or worse, bias—in the valuation of the portfolio becomes pronounced. Thus, fund boards maintain a pricing committee whose responsibility is to oversee any assets for which market quotations are not readily available.²⁴⁶

One such asset is a security for which available market prices are obviously stale.²⁴⁷ Others include portfolio holdings that are highly illiquid, such as investments in companies that are not publicly traded. If a company that is not publicly traded last sold its shares in a private placement a long time in the past, an adviser and the pricing committee may have a difficult time determining a fair value for those

245. See Alison Sahoo, *SEC: Fair Valuation Guidance Coming Soon*, IGNITES, Aug. 5, 2004, http://www.ignites.com/articles/print/20040805/fair_valuation_guidance_coming_soon.htm.

246. See Investment Company Act of 1940, § (a)(41)(B), Pub. L. No. 768, 54 Stat. 789 (codified at 15 U.S.C. § 80a-2(a)(41)(B) (2000)); 17 C.F.R. § 270.2a-4 (2005); Fin. Accounting Standards Bd., Statement of Financial Accounting Standards No. 118 (1994); Fin. Accounting Standards Bd., Statement of Accounting Standards No. 113 (1992).

247. Independent trustees—in addition to inside counsel, compliance officers, and accountants—have been held liable for their failure to fulfill their valuation duties. In 1998, the SEC for the first time named independent trustees in a cease-and-desist proceeding when it filed charges against Parnassus Investments, investment adviser to the Parnassus Fund. An administrative law judge subsequently held that the independent trustees had aided and abetted the overstatement of the fund's NAV by failing to value appropriately the fund's investment in Margaux, Inc., of which it owned 565,000 shares of common stock and a \$100,000 note convertible into 1.5 million additional shares. Parnassus Investments, et al., Initial Decision Release No. 131, Administrative Proceeding, File no. 3-9317, 1998 SEC LEXIS 1877 (Sept. 3, 1998). Throughout a two-year period in the early 1990s, the fund had ascribed an identical value to its Margaux investment, notwithstanding a series of negative events that occurred during that time, including the company's bankruptcy, its delisting from NASDAQ, and an investigative report linking Margaux's products to the sale of spoiled meat by its largest customer. *Id.* At the end of the two-year period, the fund eventually did reduce its carrying value of the Margaux investment from \$0.344 to \$0.20 per share when Morgan Stanley downgraded the customer's shares from "buy" to "hold." *Id.* The following year, the fund further reduced the carrying value of its investment to \$0.15 per share as a result of further financial difficulties at Margaux. *Id.* Ultimately, the fund sold its investment in Margaux for \$0.24 per share. *Id.*

shares. Unless the board and its pricing committee pay close attention to these determinations, an adviser might be tempted to inflate values of these holdings. Any affirmative decision to increase the value of a holding is likely to draw attention, but an adviser can achieve a similar effect by failing to reduce the value of a stock that clearly has fallen.

Imagine a privately held biotechnology company.²⁴⁸ If a mutual fund were to purchase shares in the company immediately following successful clinical trials of a flagship treatment, one might expect the fund to pay a premium for the company's shares. If six months pass without any additional round of fundraising or other valuation event for the company, the fund's adviser might be justified in continuing to carry the investment at the same value. If the Food and Drug Administration were then to refuse to approve the company's treatment, any reasonable observer would conclude that the value of the company's equity—and any investment in it—had fallen, regardless of whether the company records such a decline overtly as a result of the sale of any more of its shares. Under such circumstances, if the fund's adviser failed to adjust the value of its investment downward, the fund's assets under management would be artificially inflated. Shareholders in the fund would, therefore, be paying too much for the adviser's services.

As a general matter, the procedures by which an adviser prices its illiquid holdings and uses a fair valuation service are monitored by the board of trustees. Given the duties of the board, the trustees' other commitments, and the number of securities in which a fund complex is invested, however, one must wonder to what extent a pricing committee is capable of monitoring all the external developments that could affect the true value of the funds' portfolios. Certainly, the adviser's control of the pricing of fund assets gives it the ability to manipulate these equations to its own financial benefit.

C. *Late-Trading*

Together with market-timing, Eliot Spitzer in his watershed press conference also accused mutual fund advisers of facilitating late-trading.²⁴⁹ Like market-timing, late-trading allows investors to time their movement in and out of mutual funds, typically on the heels of breaking news; unlike market-timing, however, late-trading is unequivocally illegal. Late-trading is the practice of placing or

248. *See id.*

249. *See* Press Release, Eliot Spitzer, *supra* note 1.

canceling orders to buy or sell mutual fund shares after the 4:00 p.m. deadline (as of when mutual funds determine their NAV).²⁵⁰

Mutual fund shares are priced once a day, after the close of the market.²⁵¹ Law-abiding investors who wish to purchase shares in a fund can place an order during business hours and will receive the fund's next available price, which is that day's NAV. Imagine a hypothetical situation in which Bank of America announces, a few minutes after the close of the market, that it is acquiring Fleet Bank. One can safely assume that, upon the opening of the market the next morning, the value of shares in Fleet will rise. If one had placed an order during business hours to buy shares of a mutual fund heavily invested in Fleet, the news would have no impact on that day's NAV, which was calculated as of 4:00 p.m. using closing prices that had not yet reflected the merger announcement. Of course, the next day's NAV would almost certainly rise to reflect the increase in Fleet shares, and a lucky investor could sell his or her shares the following day to realize that gain.²⁵²

Some investors, however, are not interested in being lucky. If they purchased shares in the fund after the merger announcement, and yet still received the stale NAV, they could be assured of enjoying an easy profit from the bounce in share price. The process by which funds price their shares creates administrative gaps into which unscrupulous investors can place late trades. The process of gathering a day's orders to buy and sell a fund is not instantaneous; it takes time, often several hours. During that time, brokers and other financial intermediaries are gathering and relaying their clients' orders to each mutual fund's administrator. At various steps along the way, an intermediary or the investment adviser can insert an extra order, or delete one. As with market-timing, if a fund's underlying securities rise in value, cash from newly arrived investors only dilutes the gains that would otherwise have been enjoyed by the existing shareholders.²⁵³

250. *See, e.g.*, Charles Schwab & Co., Securities Exchange Act Release No. 50,360, Investment Company Act Release No. 26,595 (Sept. 14, 2004) (setting forth SEC allegations of late-trading).

251. *See* Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26,288, 68 Fed. Reg. 70,388, 70,390-91 (proposed Dec. 17, 2003).

252. Although the facts used in this example are hypothetical, actual late-trading allegations are set forth in settlement agreements entered into by the SEC and a number of financial intermediaries. *See, e.g.*, Charles Schwab & Co., Securities Exchange Release No. 50,360, Investment Company Act Release No. 26,595 (Sept. 14, 2004), available at <http://www.sec.gov/litigation/admin/34-50360.htm>.

253. *See* Ciccotello et al., *supra* note 97, ¶ 16.

So, like market-timing, facilitating late-trading breaches the adviser's fiduciary duties.

Of course, pulling or placing late trades would also be an extremely generous favor for an investment adviser to perform for valued customers. An adviser could use such a strategy to retain and entice large investors to its funds, which would naturally increase the assets under management in its funds. Here, again, the adviser's managerial influence in the operations of its funds creates an opportunity for it to extract additional value from shareholders.²⁵⁴

D. Selective Disclosure

Another *douceur* that an investment adviser could offer to its favored customers as a way to entice them to deposit their assets in the adviser's funds is particularized information about the precise portfolio holdings of the adviser's mutual funds.²⁵⁵ While funds must disclose certain information about their top holdings in SEC filings, such disclosure is incomplete and infrequent.²⁵⁶ Often, the investing public learns of a fund's holdings only well after the fact, at which point the information is too stale to exploit.

If an investor learns contemporaneously about the holdings or, even better, in advance, he or she can take advantage of that knowledge by "front-running" the fund.²⁵⁷ Consider, for example, an investor who knows that a large mutual fund has a goal of maintaining ten percent of its assets in Microsoft and rebalances its holdings each month. If the investor then learns that the fund's holdings of Microsoft have dropped to eight percent toward the end of the month, he or she can readily ascertain that the fund will soon have to make a large purchase of Microsoft stock to adhere to its investing policies. An investor with the ability and inclination might aim to buy as much Microsoft stock as possible before the mutual fund does; that is, to front run the fund's purchase. Then, when the mutual fund, with its billions of dollars, begins buying huge blocks of the stock, the value of the shares will rise as a natural consequence of the purchasing activity. The investor in possession of the selectively disclosed fund information will benefit

254. *See id.* ¶¶ 21-22.

255. *See* Selective Disclosure and Insider Trading, Investment Company Act Release No. 24,599, 65 Fed. Reg. 51,716, 51,716 (Aug. 24, 2000).

256. *See* 17 C.F.R. §§ 243.100-243.103, 240.10b5-1 to -2, 249.308 (2005).

257. *See generally* Samuel L. Hayes III, *The Impact of Recombining Commercial and Investment Banking*, 70 BROOK. L. REV. 39, 49-50 (2004) (examining the current regulatory scheme and problems confronting it).

from a quick and definite increase in its newly purchased securities. Of course, the converse phenomenon of avoiding losses is equally possible by selling shares prior to a fund's large-scale liquidations.

These trades will raise the cost or lower the proceeds for the mutual fund that makes its transactions afterwards. Accordingly, the shareholders of the fund will gain incrementally fewer profits or incur incrementally larger costs on the fund's transactions. These amounts may seem negligible to any given shareholder, but of course, therein lies the genius of extracting rents from mutual fund shareholders: any particular act of exploitation may generate substantial profits to an ill-behaving individual while ostensibly impacting each victim very little. As one journalist covering the behavior characterized it: "If you want to steal a lot of money and get away with it, steal a little from a lot of people. They will probably never notice. If they do, they may not think it worth the effort to complain."²⁵⁸

In this way, an investment adviser can dispense²⁵⁹ portfolio holding information as an incentive for sophisticated and wealthy investors to station their assets in the adviser's funds, raising the adviser's assets under management and, consequently, its advisory fees.²⁶⁰

E. Revenue-Sharing

The business of investment management revolves primarily around two different categories of securities: the shares of each mutual fund that the adviser markets to the investing public (fund shares), and the underlying investments that the adviser buys and sells in order to

258. Floyd Norris, *Pile of Pennies Is Adding up to a Scandal in Mutual Funds*, N.Y. TIMES, Nov. 1, 2003, at C1.

259. Of course, this behavior is essentially an investment advisory analog to insider trading. Traders are making use of material nonpublic information. See Selective Disclosure and Insider Trading, Investment Company Act Release No. 24,599, 65 Fed. Reg. 51,716, 51,716 (Aug. 24, 2000) ("We believe that the practice of selective disclosure leads to a loss of investor confidence in the integrity of our capital markets. Investors who see a security's price change dramatically and only later are given access to the information responsible for that move rightly question whether they are on a level playing field with market insiders.").

260. A hybrid of malfeasance by selective disclosure and insider trading is illicit employee trading. At the same time that an adviser can provide valuable information about portfolio holdings to its favored customers, it can also use the information for its own benefit. Or, more accurately, the adviser's employees can take advantage of the information for their own benefit. Portfolio managers, who are the employees of an investment adviser most intimately familiar with a fund's holdings and future plans, can just as easily capitalize on their insider knowledge by front-running fund transactions.

produce gains for shareholders in the fund (portfolio securities).²⁶¹ While an investor who wishes to participate in mutual funds may use a broker/dealer to purchase and redeem fund shares, so, too, will an investment adviser use a broker/dealer to buy and sell portfolio securities. Indeed, the broker/dealer in the two sets of transactions may even be the same entity.²⁶²

If a portfolio manager decides that a mutual fund that he or she oversees should purchase \$25 million worth of shares in Exxon-Mobil, for instance, the manager will relay the order to the investment adviser's trading desk. Employees at the trading desk will then contact broker/dealers about the purchase, and the broker/dealers will quote the trading desk prices at which they will execute the trade. Those quotations may vary, such that the adviser would incur higher or lower transaction costs depending on which broker/dealer it selects to execute the trade. Federal regulations impose upon the adviser a duty to use "best execution" in transactions on behalf of the fund's shareholders.²⁶³ "Best," however, does not necessarily mean "cheapest."²⁶⁴

Imagine two quotations from two different broker/dealers. The first offers to place the trade at five cents a share. The second offers to place the trade at seven cents a share but includes with the bid a package of extensive research on the petrochemical industry. If the value of the research it receives outweighs the cost of the additional two cents per share it will have to pay for the trade, an adviser might reasonably conclude that the second offer is "best." That research is a tool that the adviser can use to do a better job in its role as the manager of the fund's assets, and Section 28(e) of the Exchange Act creates a safe harbor for advisers from liability for paying more than the lowest possible commission rate if the advisers use the additional commissions to pay for research services.²⁶⁵

261. Mercer E. Bullard, *The Mutual Fund as a Firm: Frequent Trading, Fund Arbitrage and the SEC's Response to Mutual Fund Scandal*, 42 HOUS. L. REV. 1271, 1277 (2006) ("Unlike other securities, mutual fund shares are sold at a fixed price set by the fund based on the current net asset value of the fund's portfolio securities.")

262. See Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds, Investment Company Act Release No. 26,341, 69 Fed. Reg. 6438, 6439 (Feb. 10, 2004).

263. See Disclosure of Order Routing and Execution Practices, Release No. 34-43,084, 65 Fed. Reg. 48,406, 48,409 (Proposed Aug. 8, 2000).

264. See *id.*

265. See 15 U.S.C. § 78bb(e) (2000); Securities, Brokerage and Research Services, Release No. 23,170, 51 Fed. Reg. 16,004, 16,005 (Apr. 30, 1986).

The scope of Section 28(e), however, is quite limited.²⁶⁶ Advisers might be tempted to pay for all manner of services through inflated commission fees because they, in fact, are not the ones paying. Mutual fund shareholders pay those transaction fees. Consider an example: In exchange for charging highly inflated commissions, a broker/dealer offers an investment adviser the use of commercial real estate to open a branch office. Bear in mind that the adviser already receives a stream of revenues from which it must pay its operational expenses: the advisory fees it charges shareholders. Under such an arrangement, the fund's shareholders would be paying the adviser twice—once directly through advisory fees, then a second time in the form of inflated transaction costs.

When one considers the enormous volume of trading activity of portfolio securities in which investment advisers engage, the value of the commissions it pays quickly becomes evident. While Section 28(e) attempts to limit the manner of tangible inducements that broker/dealers can use to attract trading business, creative financial executives have nevertheless devised a particularly appealing offering that many advisers have been unable to resist: “shelf space.”²⁶⁷ In the grocery business, one component that factors into the price a retail establishment pays a wholesale provider of goods is the prominence the retailer is willing to give those goods. For example, if a cereal producer offers a grocery store a lower price, the store may be willing to place boxes of Chocolate Frosted Sugar Bombs²⁶⁸ at kids'-eye level.

As in the grocery business, prominent shelf space is highly prized in the investment advisory industry. With thousands of mutual funds from which to choose, customers strolling the aisles of broker/dealers may need some assistance. Morgan Stanley, for example, may therefore offer a list of twenty preferred mutual funds to its customers to help guide their decision.²⁶⁹ With such a prominent position, the funds on that list can be assured of a rise in sales of their fund shares.

266. See Securities, Brokerage and Research Services, Release No. 34-23,170, 51 Fed. Reg. 16,004, 16,005 (Apr. 30, 1986).

267. The SEC uses the term “shelf space” to mean “heightened visibility within [broker/dealers'] distribution systems.” Mass. Fin. Servs. Co., Investment Advisers Act Release No. 2224, Investment Co. Act Release No. 26,409, SEC Docket 2036 (Mar. 31, 2004), available at <http://www.sec.gov/litigation/admin/ia-2224.htm>.

268. The Calvin and Hobbes Searchable Database, <http://www.trangsmogrifier.org/ch/comics/search.cgi?> (search “Chocolate Frosted Sugar Bombs”) (last visited Mar. 4, 2006).

269. Morgan Stanley was, in fact, implicated in revenue sharing wrongdoing by the SEC and settled the matter for \$50 million. See Morgan Stanley DW, Inc., Securities Act Release No. 8339, Securities Exchange Act Release No. 48,789, 81 SEC Docket 1993 (Nov. 17, 2003).

In consideration for the valuable shelf space—and the sale of fund shares sure to follow from it—an adviser might be willing to direct a good portion of its trading activity in portfolio securities to Morgan Stanley, even if Morgan Stanley's commissions might not necessarily satisfy the requirements of best execution.

While the fund's shareholders may pay inordinate transaction costs in such an arrangement, prominent shelf space will insure that money from new investors will flow into the fund. As the assets under management rise, so too of course do the investment adviser's fees. Thus, once again, advisers are faced with a conflict between their own interest and their shareholders' interest, while the managerial power they wield over fund's arcane trading activities gives them the ability to extract value surreptitiously at the shareholders' expense.

VI. CONCLUSION

The scope of illicit behavior uncovered in the investment management industry over the past two and a half years is breathtaking. In creative and diverse ways, investment advisers have repeatedly used their control over vast sums of money to advance their own fiscal interests at the expense of the shareholders for whom they are fiduciaries. While the nature of these abuses has varied widely—from bargains with market timers to complicity with late traders to overpayments for trading commissions—one dynamic has almost always been involved. Employees of the adviser used the power of their intimate knowledge of mutual fund operations to increase the assets they managed and thereby to enhance their own revenues, while a board of trustees without resources or influence stood by impotently.

The optimal contracting approach suggests optimistically that a well-crafted advisory agreement will harmonize the interests of the adviser and the shareholders but fails to account for this type of self-dealing behavior by the adviser. The managerial power hypothesis, however, when extended in a novel approach from the executive compensation paradigm to the investment advisory context, explains why and how advisers had both the motive and the opportunity for extracting rents from shareholders in this bacchanal of malfeasance.

In response to the deluge of improprieties, the SEC and other authorities have already passed a number of new regulations.²⁷⁰ By and

270. See Disclosure of Breakpoint Discounts by Mutual Funds, Investment Company Act Release No. 26,464, 69 Fed. Reg. 33,262 (Jun. 14, 2004); Investment Company Governance, Company Act Release No. 26,520, 69 Fed. Reg. 46,378 (Aug. 2, 2004); Investment Adviser Codes of Ethics, Advisers Act Release No. 2256, 69 Fed. Reg. 41,696

large, though, these new rules do not proscribe the behavior of advisers so much as demand more disclosure. In the view of the SEC, the problem with market-timing, for example, was not so much the practice as the failure to disclose what was really happening. Yet mutual fund shareholders are already overwhelmed by hundreds of pages of disclosure and hardly have an interest in reading more fine print about what their advisers may be doing. In fact, the current disclosure regime is so excessive that the SEC is once again considering overhauling its forms to rejuvenate a system that has grown clogged by so many new regulations.

To be effective, of course, any additional regulation requires additional oversight. But while the SEC's budget is scheduled to remain unchanged this fiscal year, a new rule will soon take effect that will bring hedge fund advisers under regulatory review.²⁷¹ With thousands of new advisers and funds to monitor, how can the SEC possibly increase its vigilance of mutual funds?

With trillions of dollars already under management and untold more possibly to come some day through Social Security reform,²⁷² the industry must embrace changes beyond the merely cosmetic. The depth and breadth of the recent irregularities strongly suggests that superficial patches will not be a long-term solution.

(July 9, 2004); Company Act Release No. 26299, 68 Fed. Reg. 74,714 (Dec. 17, 2003); Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2204.

271. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Advisers Act Release No. 2333, 69 Fed. Reg. 72,054 (Dec. 10, 2004).

272. See *supra* text accompanying note 8 and sources cited therein (discussing the range of projected dollars that might flow into mutual funds in the wake of Social Security reform).