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# THE MUTUAL FUND BOARD: A FAILED EXPERIMENT IN REGULATORY OUTSOURCING

*Alan R. Palmiter\**

*There is no there there.<sup>1</sup>*

Mutual fund boards are a curious institution. Mandated by the Investment Company Act of 1940, they are tasked as “watchdog” supervisors of the management firms that organize, administer and market mutual funds.<sup>2</sup> The fund board and its “independent” directors approve fund transactions with the management firm and ensure compliance with the 1940 Act and implementing SEC rules. Fund directors thus function as outsourced regulators, with their selection and compensation in the hands of the management firm they supervise.

This essay argues that the outsourcing to mutual fund boards of key regulatory functions—principally the review and approval of management contracts—has not lived up to the hopes of the 1940 Act. Fund boards have been weak and even feckless protectors of fund investors, their deficiencies exacerbated as mutual funds have grown into the leading investment vehicle for private retirement savings in the United States.

Gauged by the important metric of management fees—whose negotiation is delegated to fund boards—the experiment in regulatory outsourcing has failed. As the mutual fund industry has grown in size and scope, the fund board has shown itself to be mostly ineffective in negotiating on behalf of fund investors to realize the value from improved information technologies and growing economies of scale. Study after study finds fund expense ratios *growing* over a period when fund assets have exploded.

Just as significant as their poor performance in negotiating lower management fees, fund boards have also failed in their supervision of fund design and marketing. Fund boards, charged with the approval of fund mergers and dissolutions, have acquiesced in the strategy of many fund groups of creating a stable of “above average” funds by merging losers into winners. Fund groups then heavily market the resulting winners (also an activity subject to board supervision) by appealing to the “past is prologue” mentality of many fund investors. Fund boards have failed to respond to the “cognitive biases” of fund investors, a problem aggravated by the shift of

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\* Professor of Law, Wake Forest University. My thanks to Jim Fanto and Ahmed Taha for commenting on an earlier draft, and to Jeff Wolfe and Min He for their research help.

1. GERTRUDE STEIN, *EVERYBODY’S AUTOBIOGRAPHY* 298–300 (1937) (describing how, after returning to California from a lecture tour, Stein sought to visit her childhood home in Oakland, but could not find the house).

2. *See* *Burks v. Lasker*, 441 U.S. 471, 484 (1979).

retirement savings from employer-managed defined-benefit plans to employee-managed defined-contribution plans.

Why has the fund board failed? The structure of the board has hobbled its ability to function as originally envisioned. “Independent directors” are selected and nominated by the management firm, subject to a perfunctory “rubber stamp” by fund investors. The fund board is composed of part-timers who rely on the fund’s management firm for information, direction and compensation. Even if they wanted to, the fund directors cannot realistically threaten to take the fund’s business elsewhere. Negotiation on behalf of fund investors is understandably an empty ritual.

More deeply, the fund board operates without meaningful oversight. Each overseer envisioned by the 1940 Act—the SEC, federal courts and state courts—has deferred to fund directors on the hopeful assumption that oversight will come from elsewhere. Despite regular and continuing attempts by the SEC to strengthen board independence, the agency has failed to create true board independence or to give the board clear guidance. Federal courts, though called on to oversee the board’s setting of management fees, have refused to become mired in valuing management services. State courts accept the bedrock principles of the business judgment rule, thus presuming that fund directors act on an informed basis with a rational basis, in good faith, and without a conflicting personal interest.

Director professionalism, part of a relatively recent “best practices” movement in the mutual fund industry, offers some promise—but at most can only be aspirational. It does not correct the structural impediments of the fund board or create mechanisms that would oversee fund directors. Although fund directors have become more aware of their functions and responsibilities, they continue to be diffident, highly-paid actors in the face of a fund management culture that focuses on building market share, asset size, and profits. Against these odds, director professionalism has little chance.

Ultimately, the mutual fund regulatory regime places its faith in the fund investor market—despite the animating premise of the 1940 Act that disclosure-based market protection is inadequate. Recent studies make clear that fund investors continue to be inept consumers, plagued by informational and cognitive biases. Fund investors are largely ignorant of fund expenses, the relationship of expenses to fund performance, and the mixed relevance of past performance to future returns. They respond only weakly to no-load funds and low fees, and even less to changes in fees and fund risk. The dysfunctional investor market is fueled by fund marketing (approved by fund boards) that shapes and reinforces investor biases.

This essay first reviews the creation and development of mutual fund boards, examining their composition and their intended regulatory role. It considers the institutions charged with overseeing fund boards (the SEC

and courts) and the deference they have shown to fund boards. The essay then presents empirical data on the performance of fund boards drawn largely from the finance literature, data that uniformly suggest that fund boards have failed to adequately supervise fund management firms. Finally, the essay considers various proposed reforms to mutual fund governance and offers a comparison to foreign mutual funds, whose regulatory systems operate without fund boards. Imagine!

## **I. MUTUAL FUND BOARDS—OUTSOURCED SUPERVISOR**

The board of directors is a defining feature of the corporate structure that was adopted by the U.S. mutual fund industry at its inception. The Investment Company Act of 1940 built on this edifice, giving special gatekeeper functions to the board and its “independent directors.” Over time, the SEC has delegated additional responsibilities to the fund board. Under the resulting board-centric structure, the fund board (in theory) supervises the activities of the mutual fund management firm.<sup>3</sup> The fund board carries out its supervisory functions with minimal oversight.

### **A. CORPORATE STRUCTURE: FROM THE BEGINNING**

Investment companies in the United States are a relatively recent phenomenon. The first was organized as a corporation in 1924. U.S. investors were more comfortable with the corporate form, with its supervisory board of directors, compared to the British model of investment trusts that had developed in the late nineteenth century.<sup>4</sup> The corporation, unlike the trust, offered an internal supervisory mechanism to oversee the discretion of the portfolio manager. In the late 1920s investment companies flourished.

Besides supplying a supervisory board of directors, the corporate form offered other advantages. It permitted the investment company to issue various classes of securities—common and preferred stock, debentures, and mortgage bonds. This facilitated leverage for equity investors, promising them above-market returns in a booming market.<sup>5</sup>

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3. Wallace Wen Yeu Wang, *Corporate Versus Contractual Mutual Funds: An Evaluation of Structure and Governance*, 69 WASH. L. REV. 927, 956–58 (1994) (evaluating the comparative merits of the structure and governance of the two dominant forms of mutual funds).

4. The trust permitted investors to buy an interest in a portfolio of securities deposited with a trust company. The trust company committed itself to rules regarding the kinds of securities to be purchased, holding periods, and management of the investment portfolio. JOHN KENNETH GALBRAITH, *THE GREAT CRASH 1929*, at 47–48 (1988).

5. The 1940 Act prohibits leverage by open-end mutual funds, both for investors and in the fund’s portfolio. See 15 U.S.C. § 80a-18(f) (2000) (prohibiting open-end funds from issuing senior (debt) securities to investors); *Id.* § 80a-18(f), (g) (prohibiting open-end funds from borrowing money except temporarily, but not in excess of 5% of the total fund assets, or from a bank unless subject to a 300% asset-coverage condition).

In addition, corporate law (unlike the more rigid law of trusts) permitted a wide range of self-dealing transactions—if approved by the corporation’s disinterested board of directors. The sponsor, typically a financial services firm that had brought the investment company into existence, could manage the investment portfolio and receive fees. Sponsoring investment banks could sell securities to their investment companies, often securities the banks themselves brought to market. Sponsoring securities firms could sell brokerage services, while commercial banks could lend money, to their captive investment companies.

In 1940 when Congress got around to regulating investment companies, it grafted its regulatory scheme onto the existing corporate structure and placed its faith in the fund board as a substitute for investor self-reliance.<sup>6</sup> Congress noted that disclosure under the Securities Act of 1933 and the Securities Exchange Act of 1934 had not deterred “the continuous abuses in the organization and operation of investment companies.”<sup>7</sup> Generally these acts provide only for publicity, but “the record is clear that publicity alone is insufficient to eliminate malpractices in investment companies.”<sup>8</sup>

Having found supervision by fund boards inadequate in the 1920s, Congress oddly chose to strengthen the hand of the board. For many abuses identified by Congress—such as preferential trading by insiders, dilutive pricing of portfolio shares, exorbitant selling charges, undisclosed and unapproved changes in investment policies, unauthorized transfers to new management firms, self-dealing sales of worthless securities, borrowings by insiders without repayment, and lack of transparency on fund finances—the solution was greater board supervision.<sup>9</sup>

Although the 1940 Act does not require the corporate form, the regulatory regime effectively assumes that mutual funds will be organized as (or along the lines of) a corporation. There must be a board of directors (or its equivalent) to oversee fund operations and approve contractual arrangements with the fund’s service providers.<sup>10</sup> There must be shareholder voting to elect board members and approve fundamental

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6. See generally Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 WASH. U. L.Q. 303 (1941); Walter P. North, *A Brief History of Federal Investment Company Legislation*, 44 NOTRE DAME L. REV. 677 (1969); Comment, *Investment Company Act of 1940*, 50 YALE L.J. 440 (1941).

7. INVESTMENT TRUST STUDY, INVESTMENT COMPANY ACT OF 1940 AND INVESTMENT ADVISERS ACT OF 1940, H.R. REP. NO. 76-2639, at 10 (3d Sess. 1940).

8. *Id.*

9. Paul F. Roye, Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm’n, Remarks Before the Am. Law Inst./Am. Bar Ass’n Inv. Co. Regulation and Compliance Conference, *The Exciting World of Inv. Co. Regulation* (June 14, 2001), reprinted in Tamar Frankel & Clifford E. Kirsch, *INVESTMENT MANAGEMENT REGULATION*, at 32–33 (3d ed. 2005).

10. *Investment Company Act of 1940*, in 6-83 SECURITIES LAW TECHNIQUES § 83.01 (Matthew Bender 2006).

changes.<sup>11</sup> These requirements apply whether the fund is structured as a corporation or another form such as a business trust.

Outsourcing to the fund board of a supervisory/regulatory function was consistent with the general approach of the securities laws. The Securities Act of 1933 delegated supervision of public securities offerings to non-governmental watchdogs—namely, the directors and officers of the issuer, the underwriter and the financial auditor. The Securities Exchange Act of 1934 delegated supervision of trading in public markets to self-regulated stock exchanges and the National Association of Securities Dealers. In each case, the SEC and the courts retained a significant oversight role.

Oversight of the fund board, however, is lacking in the 1940 Act. There was—and still is—no self-regulatory oversight body. The SEC is not tasked with reviewing the fund board's ongoing approval of the fund's management contracts and marketing arrangements. The courts, though later assigned a role to oversee management fees, have shunned the responsibility. For both the SEC and the courts, more daunting than the volume of fund transactions has been the problem of valuation of management services. The federal securities regime assiduously avoids delegating questions of value to the SEC or the courts, instead leaving them to markets. In the case of mutual funds, given the doubts about the efficiency of the investor market, the question of value was left to private negotiations between the fund board and the management firm. It was a desperate (and overly hopeful) delegation.

## **B. FUND BOARDS: COMPOSITION AND SELECTION**

The 1940 Act regulates the composition and election of fund directors. A centerpiece of the 1940 Act is the requirement that at least 40 percent of the board be independent of the management firm.<sup>12</sup> Beyond the statutory requirement, current SEC rules condition the use of the more important exemptions on a board composed of a majority of independent directors—creating a *de facto* regulatory minimum.<sup>13</sup> A proposed rule, still in limbo, would increase the proportion to 75 percent and require an independent board chair.<sup>14</sup>

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11. Mutual funds must adopt fundamental policies as to key investment activities—capital structure, permissible investments, investment strategies, risk-reward profile of securities issued by the fund—which can then be changed only by shareholder vote. *See* 15 U.S.C. §§ 80a-8(b), 80a-13(a) (2000).

12. *Id.* § 80a-10(a) (providing that at least 40% of board of directors of registered investment company must consist of individuals who are not “interested persons”).

13. Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24,816, 66 Fed. Reg. 3734 (Jan. 2, 2001).

14. *See* Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378, 46,381 (July 27, 2004). In June 2005, the D.C. Circuit found that the SEC had acted within its authority in adopting the governance rules, but had violated the Administrative Procedures Act by not adequately considering (1) the costs of complying with the governance

The 1940 Act dictates that shareholders elect fund directors, but only for the initial board and to fill vacancies if less than a majority of the board is shareholder-elected.<sup>15</sup> Thus, funds operate without annual board elections.<sup>16</sup> Independent directors must be nominated by a majority of independent directors and elected by shareholders, though vacancies can be filled by the board in the case of the death, disqualification, or bona fide resignation of an independent director where there remain sufficient shareholder-elected directors.<sup>17</sup>

These rules have not, however, created an independent institution of fund supervisors. The definition of “interested person” makes it relatively easy to seat outside directors sympathetic to management firm interests.<sup>18</sup> Independent directors are typically securities industry executives and professionals whose firms provide direct or indirect services to mutual funds. There are no qualification standards for fund directors.<sup>19</sup> Compensation for service on mutual fund boards, particularly for larger mutual fund families, is typically much higher than for service on boards of

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rules and (2) disclosure requirements as an alternative. *Chamber of Commerce v. SEC*, 412 F.3d 133, 136 (D.C. Cir. 2005). After compiling a more developed record of the costs of the new rule, the SEC re-adopted it. *See* Commission Response to Remand by Court of Appeals, Investment Company Act Release No. 26,985, 70 Fed. Reg. 39,390 (June 30, 2005). In April 2006, the D.C. Circuit vacated the rule on the ground that the Commission had not adequately considered its cost, but withheld the issuance of the mandate for ninety days to afford the Commission an opportunity to reopen the record for comment. *Chamber of Commerce v. SEC*, 443 F.3d 890, 909 (D.C. Cir. 2006).

15. 15 U.S.C. § 80a-16(a) (2000) (permitting board vacancies to be filled by the board so long as at least two-thirds of the board remains shareholder-elected). The SEC has taken the position that, beyond the election of the initial board and the filling of vacancies when required by the statute, the requirement of annual meetings is generally a matter of state law. JOHN NUVEEN & CO. INC., *SEC No-Action Letter* [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,383 (Nov. 18, 1986).

16. The fund must be organized in a state that does not require an annual shareholders meeting—a dispensation offered by states looking to attract mutual fund incorporation. DEL. CODE ANN. tit. 12, § 3806 (2006) (generally permitting voting practices that comply with federal rules); MD. CODE ANN., CORPS & ASS'NS § 2-501(b)(1) (2006) (same).

17. 15 U.S.C. § 80a-16(b).

18. For example, executives of brokerage firms are considered “not interested,” so long as their firm has not executed trades for the mutual fund group in the previous six months. *See* U.S.C.A. § 80a-2(a)(19)(A)(v), (B)(v) (West 2006). The same six-month waiting period applies to executives of banks and other lenders to the mutual fund group. *See id.* § 80a-2(a)(19)(A)(vi), (B)(vi). In addition, former officials or business associates of the management firm are considered independent after a two-year waiting period. *See id.* § 80a-2(a)(19)(A)(vii), (B)(vii) (permitting SEC by order to determine that executives who had a “material business or professional relationship” with the mutual fund group lack independence, but only if the relationship arose in the prior two years). *See generally* Larry D. Barnett, *When is a Mutual Fund Director Independent? The Unexplored Role of Professional Relationships under Section 2(a)(19) of the Investment Company Act*, 4 DEPAUL BUS. & COMM. L.J. 155 (2006).

19. Chris Tobe, *Mutual Fund Directors: Governance Changes Proposed for Independent Directors in the U.S.*, 8 CORP. GOVERNANCE 25, 28 (2000) (pointing out that fund experience is not a prerequisite to board service).

operating companies.<sup>20</sup> Moreover, the rules on director tenure discourage new blood on the board.<sup>21</sup> Thus, most fund boards are composed of industry-friendly, highly paid, long-serving directors. The lack of independence of mutual fund directors, even those who carry the label “not interested,” has long been an open secret.<sup>22</sup>

When the election of directors does occur, the process is “largely ritualistic.”<sup>23</sup> The management firm selects the initial board, and new directors (including independent directors) are vetted by the management firm.<sup>24</sup> In the 60 years of mutual fund regulation in the United States, no director nominees have ever been presented to oppose the management slate. Fund shareholders have little choice (if they bother to vote) but to rubber stamp nominees proffered by the management firm.<sup>25</sup> There is no incentive to undertake the expense of a proxy fight. Any fund shareholder dissatisfied with the management firm’s directors would have sold long before.

### C. FUND BOARD: SUPERVISORY FUNCTIONS

The fund board has two essential functions: (1) negotiating and approving the contract with the management firm (thus setting the terms and price of the asset management and marketing services provided fund investors) and (2) supervising the compliance of the management firm and other service providers with the legal requirements of the 1940 Act regulatory scheme.<sup>26</sup>

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20. For example, the compensation of the seven independent directors of T. Rowe Price was increased for 2005 from \$150,000 per year to \$190,000 per year (the independent chair from \$215,000 to \$290,000). See T. Rowe Price Family of Funds 17 (Feb. 28, 2006), available at <http://sec.gov/Archives/edgar/data/75170/000087183906000015/finalproxy06.htm>.

21. Since shareholders must elect new directors only when the number of shareholder-elected directors falls below two-thirds of the board, there is a premium on long-serving incumbents and a penalty against installing new directors. See *supra* note 15 and accompanying text.

22. Robert H. Mundheim & William J. Nutt, *The Independent Directors of Mutual Funds*, WHARTON Q., Spring 1972, at 8, 8.

23. Richard M. Phillips, *Deregulation under the Investment Company Act—A Reevaluation of the Corporate Paraphernalia of Shareholder Voting and Boards of Directors*, 37 BUS. LAW. 903, 908 (1981).

24. William J. Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. PA. L. REV. 179, 215–16 (1971).

25. As the SEC has noted, passivity of fund shareholders is the norm. Mutual funds often find it difficult to obtain a quorum for shareholder meeting, and the voting outcome is almost always consistent with the wishes of the management firm. DIV. OF INV. MGMT., SEC, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 272 n.82 (1992) [hereinafter SEC Staff Report Protecting Investors].

26. James H. Cheek, III, *Report of the American Bar Association Task Force on Corporate Responsibility*, 59 BUS. LAW. 145, 150–54 (2003) (identifying board responsibilities with respect to investment advisory arrangements, distributions arrangements, and other statutory and regulatory responsibilities).



In each area, independent directors have a critical monitoring role. As explained in a recent report by the SEC staff on the virtues of an independent board:

[R]eliance is placed on the independent directors, rather than the Commission, to oversee any conflicts of interest in the transactions permitted by the rules and to protect the interests of fund investors.<sup>27</sup>

Ultimately, the fund board insulates the management firm from direct regulatory oversight.<sup>28</sup> The fund board relieves the SEC (or another oversight body) from responsibility for supervising the management firm and reviewing its fee arrangements with the fund. The board legitimates the management firm as a profit-seeking business.

### 1. Contract Negotiation and Approval

The 1940 Act requires that the fund board annually approve the investment advisory and underwriting agreements between the fund and the management firm.<sup>29</sup> This board is responsible for negotiating and setting the advisory fees and responsibilities of the management firm, the arrangements for buying and selling portfolio investments, and the fund's marketing approach.

The regulatory scheme places the fee-setting responsibility on the board—rather than fund investors, the SEC or the courts. Given the “ponderous task” of evaluating fees and other costs, the regulatory scheme assumes that fund investors are incapable of valuing fund management services and the task would overwhelm the SEC.<sup>30</sup> Over time, fund fees

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27. See U.S. Sec. & Exch. Comm'n, *Exemptive Rule Amendments of 2004: The Independent Chair Condition, A Report in Accordance with the consolidated Appropriations Act 16* (Unpublished Working Paper, April 2005), available at <http://sec.gov/news/studies/indchair.pdf> [hereinafter SEC Staff Report on Independent Chair]. This reliance on independent directors reflects the policy decision in the 1940 Act to subject conflicts transactions in the mutual fund not to “fairness” review by an external decision-maker, such as the SEC or the courts, but rather to oversight by the relatively untested institution of outside directors. *Id.* at 9–11.

28. The fund board also insulates the management firm from investor litigation. Under state corporate law, shareholder derivative suits can be commenced only after the shareholder makes a demand for board action or pleads the futility of demand. Thus, the board serves as a gatekeeper for investor litigation. If an investor challenges illegal conduct by the management firm, the board (or a committee of independent directors) can conduct an investigation and make a business judgment as to the merits of the claim. See Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1026–28 (2005).

29. See 15 U.S.C. § 80a-15(a)(2), (b)(1) (2000) (requiring annual approval of multi-year agreements by either the board of directors or majority vote of the shareholders). The investment advisory agreement must also be approved initially by a majority of voting shares. See *id.* § 80a-15(a).

30. See Wang, *supra* note 3, at 988.

have become increasingly complex, with different kinds of sales charges (front-end, contingent deferred, and 12b-1 fees) and expense ratios.<sup>31</sup>

Fee setting by the fund board involves a negotiation ritual that begins with the management firm proposing fees that the board (sometimes) suggests be lowered. The management firm then accepts whatever marginally lower fees it concludes the market can bear. Take the recent fee negotiation at AIM, a large mutual fund group targeted in the market-trading scandals that came to light in 2003. To resolve charges that the fund group had allowed favored clients to skim profits from long-term investors through rapid trading in and out of funds, AIM (and its affiliated Invesco group) agreed to reduce fees charged to investors by \$75 million over 5 years.<sup>32</sup> In 2005, management proposed a fee reduction of \$17 million. When independent directors demanded further cuts of \$3 million, management “wincing” and agreed.<sup>33</sup> These amounts, however, pale in comparison to the \$742 million in annual revenues for the fund group on \$64 billion in assets under management.<sup>34</sup>

The fund board’s cabined role is not for lack of formal authority. Delegation to the management firm does not strip the board of its authority under state law to “manage and direct” the business and affairs of the fund.<sup>35</sup> Nonetheless, the board is ill equipped and ill situated to do more. It has no independent staff to advise it on matters of investment policy, fund operations, or fund design. It has no realistic option (or threat) to hire a new investment adviser or management firm. And the regulatory structure of the 1940 Act prevents the board from undertaking radical reforms like changing the fee structure from asset-based fees to performance-based fees.<sup>36</sup>

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31. There are two primary visible fees: sales charges and expense ratios. Sales charges are paid by the investor when shares are purchased (front-end load) or when shares are redeemed (contingent deferred sales load). Beyond the load, funds can charge for marketing and advertising expenses through “12b-1” distribution fees. *See* Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16,431, 41 SEC Docket 207 (June 13, 1988) (describing legislative and administrative history leading to adoption of Rule 12b-1).

The expense ratio covers the operational services provided by the management firm—namely, investment management, administration (record-keeping and transaction services to fund investors), and operating expenses (custodial fees, taxes, legal and auditing expenses, and directors’ fees). *See* JOHN C. BOGLE, *BOGLE ON MUTUAL FUNDS 197–201* (1994). In addition, funds pay for trading costs (brokerage fees) that are charged against fund assets. *See* U.S. GEN. ACCOUNTING OFFICE, GAO-03-551T, *MUTUAL FUNDS: INFORMATION ON TRENDS IN FEES AND THEIR RELATED DISCLOSURE 1* (2003) [hereinafter GAO Mutual Fund Fee Report].

32. Tom Lauricella, *Independent Directors Strike Back*, WALL ST. J., July 5, 2006, at R4.

33. *Id.*

34. *Id.*

35. *See* DEL. CODE ANN. Tit. 8, § 141(a) (2006).

36. *See generally* John C. Bogle, Founder and Former Chairman of the Vanguard Group, Remarks to the Boston College Law School, Re-Mutualizing the Mutual Fund Industry—The Alpha & The Omega (Jan. 21, 2004), available at [http://www.vanguard.com/bogle\\_site/sp20040121.html](http://www.vanguard.com/bogle_site/sp20040121.html) (discussing fund directors’ refusal to change the fee structure).

## 2. Compliance Office

The fund board also functions as a compliance office, a role outlined in the 1940 Act and enlarged significantly by SEC rules.<sup>37</sup> The board is tasked with reviewing and approving specified fund practices to regulate conflicts between the fund and the management firm, and to ensure the management firm is in regulatory compliance.<sup>38</sup> By the SEC's count, the fund board is called on under the 1940 Act and its rules to review and approve fund transactions in 27 different situations, some of which are delegated to the full board, while others are delegated only to independent directors. Some compliance functions delegated to the full board include:<sup>39</sup>

- valuation of portfolio securities that do not have a readily-ascertainable market price
- setting the time of day when net asset value is determined
- approval of custody contracts (annually) with members of national securities exchanges, clearing agencies, book-entry systems, and foreign custodians
- approval of the fund's code of ethics, which must be designed to prevent fraudulent, deceptive, or manipulative practices by management firm insiders in connection with personal securities transactions.

Other compliance functions are delegated only to independent directors, on whom the SEC has "relied extensively" to exempt funds from prohibitions under the 1940 Act:<sup>40</sup>

- approval of 12b-1 fees (marketing fees paid from fund assets, as opposed to loads paid by fund investors when buying and selling shares)<sup>41</sup>
- approval of the fund's auditor (which must be an independent public accountant)
- approval of securities transactions with the management firm (or its affiliates) as permitted by various SEC rules

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37. See Wang, *supra* note 3, at 996–1001. Interestingly, the shift of regulatory oversight from the SEC to fund boards arose mostly from 1975–2000, a period characterized by SEC rule-making that exempted management firms from conflict-of-interest prohibitions of the 1940 Act on the condition of approval by independent directors. See Tamar Frankel, *The Scope and Jurisprudence of the Investment Management Regulation*, 83 WASH. U. L.Q. 939, 946 (2005) [hereinafter Frankel, *Jurisprudence of Regulation*] (providing detailed list).

38. See Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. OF ECON. PERSP. 161, 162 (2004) (describing cash flow in mutual funds and the resulting incentives facing fund managers, brokers, and other third parties and the associated conflicts of interest).

39. Wang, *supra* note 3, at 994.

40. SEC Staff Report on Independent Chair, *supra* note 27, at 16.

41. In adopting Rule 12b-1 (which permits use of fund assets to defray marketing expenses), the SEC commented that "the more capable the disinterested directors are of overseeing the kinds of activities of investment companies which are of regulatory significance, the more the Commission will be willing to reduce the regulatory restrictions." Bearing of Distribution Expenses by Mutual Funds, Securities Act Release No. 6254, Investment Company Act Release No. 11,414, 21 SEC Docket 324 (Oct. 28, 1980).

- determination (annually) whether participation in joint liability insurance policies is in the best interests of the fund
- review and approval of fidelity bonds.

The compliance function is largely ministerial, with the board checking off items on the SEC-provided checklist. Recognizing the emptiness of the compliance function, the SEC has tried to relieve boards of some of the tedium, replacing annual review in a number of areas with board action “only when necessary.”<sup>42</sup>

Compliance outsourcing to the board and independent directors, however, is not all encompassing. Certain conflict transactions cannot be approved by the board or its independent directors, but instead require SEC approval. For example, transactions with the management firm beyond those specified in the advisory agreement are prohibited unless they receive prior approval from the SEC.<sup>43</sup> Authorization by the board is not enough.

In performing its compliance function, the board is under no obligation to set up internal controls and rarely acts as an investigator of management firm compliance.<sup>44</sup> Not surprisingly, fund directors rarely discover compliance lapses.<sup>45</sup> Instead, illegality is typically uncovered by the auditor or government regulator with the help of a whistle-blower in the management firm.<sup>46</sup> For example, fund boards were largely absent in identifying or moving to correct the late-trading and market-timing scandals that shook the mutual fund industry in 2003.<sup>47</sup> It was the New York

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42. See Frankel, *Jurisprudence of Regulation*, *supra* note 37, at 986 (summarizing the 1993 change, which was “intended to enhance the effectiveness of investment company boards by substituting more meaningful requirements for an annual review requirement” such as requiring “that directors make and approve changes only when necessary”).

43. See 15 U.S.C. § 80a-17(a), (b) (2000). Under § 17(a), the management firm cannot “knowingly” sell or purchase securities to or from the mutual fund, except when the fund is redeeming its own shares or selling them to its investors. Similar restrictions apply to borrowing from and lending to the mutual fund. *Id.* Under § 17(b), however, the management firm can apply to the SEC for an order exempting a proposed transaction. By statute, the SEC is to consider whether the proposed terms are reasonable and fair and do not involve overreaching, and whether the proposed transaction is consistent with the mutual fund’s investment policies. *Id.*

44. Some have speculated that board passivity is a product of the mind-numbing compliance functions entrusted to it. See, e.g., Tamar Frankel, *Money Market Funds*, 14 REV. SEC. REG. 913, 915 n.18 (1981) (suggesting that increased compliance tasks and fees paid by fund advisors causes directors to become more susceptible to control by the management firm).

45. See Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 617–19 (1982) (discussing court cases where independent directors failed to challenge management self-dealing).

46. See Paul E. Kanjorski, Congressman, Remarks during House Hearing, Mutual Funds: Who’s Looking Out for Investors? 109, 127 (Nov. 6, 2003), available at [http://commdocs.house.gov/committees/bank/hba92982.000/hba92982\\_1.htm](http://commdocs.house.gov/committees/bank/hba92982.000/hba92982_1.htm) (“[W]e really do not have inside capacity to understand what these organizations are doing until a whistleblower comes forward or until an extreme situation occurs where we focus a great deal of light on the subject.”).

47. Mercer E. Bullard, *Comments on Martin Lybecker’s Enhanced Corporate Governance*, 83 WASH. U. L.Q. 1095, 1098–1101 (2005) [hereinafter Bullard, *Comments on Corporate Governance*]. “[M]utual fund scandal was the best evidence that in practice [independent directors] are not effective watchdogs.” *Id.* at 1102–03.

Attorney General, followed by the SEC, who investigated and exposed most of the illegal and fraudulent practices.<sup>48</sup>

The attitude of management firms toward the compliance function is captured by a vignette told by Professor Tamar Frankel:

It was rumored that Securities and Exchange Commission's examiners would form monitoring groups. These groups would sit at the offices of large mutual fund Managers, and supervise their operations, the way FDIC agents sit at large bank offices. Asked for a reaction to this action, I was told in confidence how a senior Manager in one large fund complex reacted. He said something like: "That is sheer waste of money. No one would speak to these monitors and they will be put in a box and forgotten." I was astounded. Here was a golden opportunity to gain the best guarantee of honesty at no cost. It was an opportunity to show the world and the regulators that this fund complex had nothing to hide. I expected the Managers to receive the government monitors with open arms, show them around, and offer them a comfortable office from which to supervise and hopefully report and advertise the fund complex's compliance with the law. This Manager did not expect the investors to value trust.<sup>49</sup>

The SEC has implicitly acknowledged the inadequacies of the fund board in its compliance function. In the rules responding to the late-trading and market-timing scandals of 2003, the SEC required management firms to appoint a compliance officer with significant authority and direct access to the fund board.<sup>50</sup> The SEC stated the hope that these internal compliance officers would serve as whistle-blowers and alert the SEC to non-compliance by recalcitrant management firms. The implicit doubts about the fund board could not have been more obvious.

#### **D. DIRECTORS' DUTIES: EXTERNAL OVERSIGHT**

The fund board performs its supervisory and compliance functions with only minimal external oversight. The 1940 Act gives the SEC only limited authority, and fund investors even less, to challenge fund directors in federal court. Federal courts, consistent with the apparent intent of the legislation, have shunned meaningful review of board activities, particularly with respect to the setting of management fees. Instead, the 1940 Act

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48. Mercer Bullard, *The Mutual Fund as a Firm: Frequent Trading, Fund Arbitrage, and the SEC's Response to the Mutual Fund Scandal*, 42 HOUS. L. REV. 1271, 1272 (2006) (noting that the scandals resulted in dozens of civil and criminal prosecutions and billions in monetary sanctions). Mutual fund scandals revolved around fund practices that allowed favored institutional traders to engage in fund arbitrage, which involves buying fund shares at a discount and redeeming them once the price has been corrected, with profits coming from other fund shareholders. *Id.* at 1285.

49. Frankel, *Jurisprudence of Regulation*, *supra* note 37, at 956.

50. Compliance Programs of Investment Companies and Investment Advisers, Investors Company Act Release 26,299, 68 Fed. Reg. 74,714 (Dec. 24, 2003).

assumes that directors will be accountable as a matter of state fiduciary law and directorial professionalism. State courts have deferred to fund boards under the business judgment rule and state procedural rules on pre-suit demand. A fledgling movement for more professionalism on fund boards offers some hope, but is constrained by the structural weaknesses of the fund board—and ultimately carries no legal weight.

### 1. SEC Oversight

The SEC has been diffident in its oversight of the fund board.<sup>51</sup> Besides regular (mostly hollow) calls for greater board independence and authority, the SEC has done little to make fund governance more responsive to investor needs. The SEC has not armed directors with the information and other resources to effectively bargain on behalf of fund investors.<sup>52</sup> The SEC has not brought enforcement actions against fund directors for nonfeasance in negotiating fund fees or controlling excesses in fund marketing.<sup>53</sup> The SEC has neither sued management firms to challenge their fees nor filed amicus briefs in support of investor litigation making such charges.<sup>54</sup> In short, the SEC has stood by the design of the 1940 Act regime to outsource regulatory supervision of the management firm to the fund board.

The SEC's recent efforts to increase board independence,<sup>55</sup> far from introducing major reforms in board governance, largely codify existing industry practices:

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51. Tobe, *supra* note 19, at 27 (“[F]und directors have done an outstanding job.” (quoting SEC Commissioner Steven Wallman)).

52. For example, the SEC does not require that management firms disclose their profits to their fund boards. See John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: the Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 656–58 (2001) (itemizing SEC inaction).

53. Under § 36(a) of the 1940 Act, the SEC has (limited) authority to seek injunctive action against fund directors for the “breach of fiduciary duty involving personal misconduct.” 15 U.S.C. § 80a-35(a) (2000) (originally enacted as Act of Aug. 22, 1940, ch. 686, Title I, § 36) (action in federal court against any person who “serves or acts” for a registered investment company). Section 36 of the 1940 Act is hereinafter cited as 15 U.S.C. § 80a-35. Under § 36(b) of the 1940 Act, the SEC (along with fund investors) can also sue fund directors and the management firm “for breach of fiduciary duty in respect of [management] compensation.” *Id.* § 80a-35(b). In addition, the SEC could also sue fund directors to enjoin the “violation of any provision of this title, or of any rule, regulation, or order hereunder.” *Id.* § 80a-41(d) (Supp. II 2002).

54. Freeman & Brown, *supra* note 52, at 656.

55. In 2001 the SEC conditioned its ten most commonly used exemptive rules on a board composed of a majority of outside directors. Role of Independent Directors of Investment Companies, Securities Act No. 7932, Exchange Act Release No. 43,786, Investment Company Act Release No. 24,816, 66 Fed. Reg. 3734 (Jan. 16, 2001). The rule also required that funds disclose the fund shares held by directors, including independent directors. In 2004 the SEC sought to increase the proportion of disinterested directors to 75% and add a requirement that the board chair be a disinterested director. Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378 (July 27, 2004). The rule also would enable disinterested directors to hire their own staff and lawyers, and to caucus among themselves.

The rule [mandating a majority of independent directors] will accomplish little. The board majority requirement is nothing but a warmed-over rehash of an SEC Investment Management Division proposal advanced eight years ago. Worse it is beside the point. Today, many, if not most, funds have a majority of directors who are supposed to be independent of the external advisor to keep fees and expenses in line. In many cases, funds' independent directors already populate funds' nominating committees [since funds with Rule 12b-1 plans must have self-nominating independent directors].<sup>56</sup>

The SEC has also turned its attention to improving disclosure to fund investors. Since 1988, the SEC has required that mutual fund prospectuses include a fee table showing fund fees and charges as a percentage of net assets.<sup>57</sup> In 2004, the SEC required that funds disclose in tabular form (in their semi-annual and annual reports) the cost in dollars of an investment of \$1,000 that earned the fund's actual return and incurred the fund's actual expenses during that fiscal period.<sup>58</sup> Funds must also explain the types of costs charged to the fund, not just provide an operating expense ratio—though the SEC does not require a break-down of different fees and operating expenses.

The SEC, however, has rejected individualized disclosure in account statements of actual expenses paid by investors—disclosure strongly recommended in a 2004 GAO report on fee transparency.<sup>59</sup> The GAO asserted “seeing the specific dollar amount paid on shares owned could be the incentive that some investors need to take action to compare their fund's expenses to those of other funds and make more informed investment decisions on this basis.”<sup>60</sup> The SEC concluded such disclosure would not show fees at comparable funds and was concerned about costs for

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56. Freeman & Brown, *supra* note 52, at 657–58. In addition, the use of outside counsel is widespread, given the encouragement of the practice by federal courts. *See Tannenbaum v. Zeller*, 552 F.2d 402, 428 (2d Cir. 1977) (recommending that independent directors receive advice from independent counsel, rather than counsel for the management firm).

57. *See Consolidated Disclosure of Mutual Fund Expenses*, Investors Company Act Release No. 16,244, 53 Fed. Reg. 3192 (1988) (amending Item 3 of Form N-1A to require disclosure of the fund's expense ratio). The SEC-mandated disclosure received poor marks. *See Robert A. Robertson, In Search of the Perfect Mutual Fund Prospectus*, 54 BUS. LAW. 461, 475 (1999).

58. *Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies*, Exchange Act Release No. 33-8393 [2003-2004 transfer binder] Fed. Sec. L. Rep. (CCH) ¶ 87,148 at 89,253 (May 10, 2004) [hereinafter SEC Fund Expense Adopting Release].

59. U.S. GEN. ACCOUNTING OFFICE, GAO-04-317T, MUTUAL FUNDS: ADDITIONAL DISCLOSURES COULD INCREASE TRANSPARENCY OF FEES AND OTHER PRACTICES 3 (2004), <http://www.gao.gov/new.items/d04317t.pdf>.

60. *Id.* at 8.

assembling the information when investor accounts are held by financial intermediaries, such as brokers and financial advisers.<sup>61</sup>

While the SEC showed concern about costs, absent from its releases on enhanced fee disclosure is “how investors can, in light of the newly disclosed information, proceed to the next step . . . whether their interests are best served by doing some comparative shopping.”<sup>62</sup> Without “processable” information that can be understood and used, the benefits of disclosure are wasted. As Professors Cox and Payne argue:

Learning that your expense ratio is 1.29% is helpful but more so if this number can easily be placed in context. What investors wish to know is how this expense ratio compares with comparable investment opportunities. Learning that you rate a nine on a scale of ten in a competition is much more informative than to receive a numerical score when the boundaries of the scale are unknown. Thus, much like unit pricing information for grocery products, providing operating expense and return disclosures in a truly comparative framework is much more likely to elicit an informed choice on the part of investors than if operating expenses or return disclosures are made in isolation.<sup>63</sup>

Of course, this makes sense. But the SEC (like the fund boards it oversees) seems more concerned with industry sensibilities than protection of fund investors. True regulatory reform to empower fund investors (and endanger industry profitability) remains off the table.

## 2. Federal Judicial Oversight

The 1940 Act does not create a comprehensive system of fiduciary duties and gives federal courts only narrow authority to oversee fund boards.<sup>64</sup> In the one area where the 1940 Act explicitly permits fund

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61. See SEC Fund Expense Adopting Release, *supra* note 58, at 89,253 (relying on a 2000 industry estimate that individualized disclosure would entail on-going costs of \$65 million while the procedures adopted by the SEC would entail costs of \$16 million annually).

62. See James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 WASH. U. L.Q. 907, 929 (2005).

63. *Id.* at 935–36.

64. The 1940 Act carefully cabins federal judicial review of fund boards. Section 36(a) permits the SEC (but not explicitly fund investors) to bring actions challenging “a breach of fiduciary duty involving personal misconduct” by fund directors. 15 U.S.C. § 80a-35(a) (2000). Section 36(b) authorizes the SEC and fund investors to sue the management firm and fund board with respect to compensation paid the management firm, which is deemed to have federal fiduciary duties with respect to the compensation. *Id.* § 80a-35(b). Congress, however, deftly avoided defining the standards of “reasonableness” for reviewing management compensation. See Cox & Payne, *supra* note 62, at 922–23 (citing INVESTMENT COMPANY AMENDMENTS ACT OF 1969, S. REP. No. 91-184 (1969); INVESTMENT COMPANY AMENDMENTS OF 1970, H.R. REP. No. 91-1382 (1970)).

The § 36(b) action, although procedurally a derivative suit, is not subject to a demand requirement. *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 527 (1984). Nonetheless, it is burdened by a host of impediments: (1) plaintiffs are not entitled to a jury trial; (2) plaintiffs have the burden of proof, reversing the usual common law burden on self-dealing fiduciaries to prove fairness; (3) damages are limited to the year before the action was instituted; (4) damages are



investors to seek judicial review—the compensation of the fund’s management firm—the federal courts have refused to involve themselves in valuing management services and effectively shunned an oversight role.<sup>65</sup>

Under the articulated standard, management compensation fails review only if it 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.”<sup>66</sup> This means that fee comparisons become largely irrelevant and that fund directors need not bargain for the least expensive investment advisory services for the fund. Fee comparisons are left to fund investors.<sup>67</sup>

Federal courts reviewing allegations of excessive fees have focused on director qualifications and the board’s fee-setting process.<sup>68</sup> Fund directors who meet the statutory standards of independence need only show they followed a prescribed script: frequent meetings (some without representatives of the management firm), fulsome information (including presentations, documents, and legal advice from separate counsel), and documentation of their efforts (negotiation position and strategy, and evaluation of data).<sup>69</sup>

In a critique of federal judicial review under the 1940 Act, Professors Freeman and Brown point out the consistent reluctance of federal courts to engage in any comparative fee valuation:

Post-*Gartenberg* courts have improperly denied the relevance of advisory fee structures actually set by arm’s-length bargaining (as in the pension fund advisory fee analogy). Low-cost fee structures charged by other funds (like Vanguard’s) are likewise found essentially irrelevant, if for no other reason than the fact that, because fund advisors refuse to compete against each other for advisory business, lower prices are not available to the fund. . . . The absence of a competitive market has not become a

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limited to those resulting from the fiduciary breach, thus preventing punitive damages; and (5) federal courts have exclusive jurisdiction. See Freeman & Brown, *supra* note 52, at 642.

65. *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982) (eschewing comparative analysis of fund fees, but then adopting deferential “disproportionately large” test).

66. *Id.*

67. During the hearings on the 1940 Act, the Chief Counsel of the SEC testified, “There is not a single provision in section 15 [requiring board approval of the management firm’s advisory and underwriting agreements] which even remotely assumes to fix what [the management firm] should be paid as compensation. We feel that is a question for the stockholders to decide.” *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 252 (1940) (statement of David Schenker, Chief Counsel, SEC Investment Trust Section).

68. *Krinsk v. Fund Asset Mgmt., Inc.*, 715 F. Supp. 472 (S.D.N.Y. 1988), *aff’d* 875 F.2d 404 (2d Cir. 1989) (rejecting contentions that § 36(b) of the 1940 Act requires fund directors to negotiate the “best deal” possible and that excessive profitability alone proves a breach of duty).

69. Stanley J. Friedman, *The Role of Outside Directors in Negotiating Investment Company Advisory Agreements*, 24 REV. SEC. & COMMODITIES REG. 49 (1991).

reason for enhanced scrutiny, but a justification for fitting the judiciary with blinders.<sup>70</sup>

Not surprisingly, fund boards (and their management firm sponsors) have a perfect record in more than twenty years of litigation challenging fund fees. No management firm, much less a fund director, has been assessed damages in a case alleging excessive fees.<sup>71</sup> Although some cases have been settled, with payments coming from the management firm or fund-paid D&O insurance, the settlements only reinforce the prevailing view that fund directors are not subject to meaningful federal judicial oversight. The courts have declared the question of “value” to be intractable, and left it to the professional judgment of fund directors—and the marketplace.<sup>72</sup>

Recent attempts to open other avenues of federal judicial review have fallen on deaf ears. Federal courts have refused to imply private actions for the “breach of fiduciary duty involving personal misconduct.”<sup>73</sup> Leaving no doubt that the door is closed, some lower courts have explained that even if a private action could be implied it would not cover board nonfeasance that did not involve self-dealing or bad faith.<sup>74</sup>

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70. Freeman & Brown, *supra* note 52, at 651.

71. *Id.* at 642 n.116.

72. See Castillo v. Dean Witter Discover & Co., 1998 U.S. Dist. LEXIS 9489, at \*10, \*23 n.10 (S.D.N.Y. June 25, 1998) (refusing to require disclosure, comparing fund fees, and chiding fund investors for not being more careful in the face of conflicts created by the management firm).

73. Section 36(a) of the 1940 Act authorizes the SEC to bring an enforcement action for such fiduciary breaches, but does not explicitly foreclose private actions. 15 U.S.C. § 80a-35(a) (2000). Some courts have implied a private action under the section. See Fogel v. Chestnutt, 668 F.2d 100 (2d Cir. 1981). More recent courts, however, have held that the section’s failure to mention private plaintiffs forecloses a private action. See Olmstead v. Pruco Life Ins. Co., 283 F.3d 429, 432–36 (2d Cir. 2002); Mutchka v. Harris, 373 F. Supp. 2d 1021, 1025–27 (C.D. Cal. 2005); Davis v. Bailey, 2005 U.S. Dist. LEXIS 38204, at \*7–16 (D. Colo. Dec. 22, 2005) (No. 05-cv-00042-WYD-OES). The cases reflect a jurisprudential shift in implying private actions. See Alexander v. Sandoval, 532 U.S. 275, 287 (2001) (announcing abandonment of “*ancien regime*” for implying private actions and instructing lower federal courts to focus on statutory intent, principally as found in statutory text). See also Arthur Gabinet & George Gowen III, *The Past and Future of Implied Causes of Action under the Investment Company Act of 1940*, 3 VILL. J. L. & INV. MGMT. 45, 45 (2002).

The refusal to imply a private action flies in the face of legislative urgings. H.R. REP. NO. 96-1341, at 28–29 (1980), as reprinted in 1980 U.S.C.C.A.N. 4800, 4810–11. Amending the 1940 Act in 1980, the House Report stated,

The Committee wishes to make plain that it expects the courts to imply private rights of action under this legislation, where the plaintiff falls within the class of persons protected by the statutory provisions in question. . . . In appropriate instances, for example, breaches of fiduciary duty involving personal misconduct should be remedied under Section 36(a) of the Investment Company Act.

*Id.*

74. See Davis, 2005 U.S. Dist. LEXIS 38204, at \*15 n.1 (stating that even if § 36(a) authorized private actions, it would not reach a claim for nonfeasance—namely, the failure of mutual funds to collect settlement moneys in securities fraud class actions—since the section only reached “personal misconduct”).

Federal courts asked to imply greater federal judicial oversight have pointed to the availability of SEC enforcement and the existing judicial review of advisory fees as foreclosing broader judicial intervention.<sup>75</sup> The Supreme Court has given its blessing to this judicial state of affairs, regularly and uniformly denying review of lower court decisions that deny review of fund boards.<sup>76</sup> It seems the Court believes its “watchdog” rhetoric.

### 3. State Judicial Oversight

State courts, responsible for enforcing state-based fiduciary duties, have adopted an even more deferential approach than their federal counterparts. Imposing a demand requirement on investor derivative suits, state courts have refused to even hear cases of board nonfeasance.<sup>77</sup> Plaintiffs bear the nearly insuperable burden of showing that a majority of the board—and thus some of the independent directors—have personal conflicts that would prevent them from deciding a shareholder demand in good faith.<sup>78</sup>

Otherwise, the fund board receives the benefit of the doubt under the business judgment rule.<sup>79</sup> Since independent directors, by definition, do not have *direct* financial interests in management fees, the chances of overcoming the business judgment presumption are close to nil. Absent a showing of payola (beyond regular board compensation) or other corrupt behavior, state law effectively disavows fiduciary review of mutual fund activities.

The faith generally placed in independent directors under corporate law rests on justifications that are inapposite to the mutual fund. In the corporate context, efficient capital markets price corporate governance and react to

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Some have pointed out the inconsistency of this cautious judicial attitude and the 1940 Act policy of protecting fund investors. See William K. Sjoström, *Tapping the Reservoir: Mutual Fund Litigation under Section 36(a) of the Investment Company Act of 1940*, 54 KANSAS L. REV. 251, 278–82 (2006) (arguing for broad interpretation of “personal conduct” beyond self-dealing and personal impropriety, to encompass any board decision not made on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the fund).

75. See Gabinet & Gowen, *supra* note 73, at 58–59.

76. See, e.g., *Kalish v. Franklin Advisors, Inc.*, 928 F.2d 590, 591 (2d Cir. 1991), *cert. denied*, 502 U.S. 818 (1991); *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 835 F.2d 45 (2d Cir. 1987), *cert. denied*, 485 U.S. 1034 (1988); *Grossman v. Johnson*, 674 F.2d 115 (1st Cir. 1982), *cert. denied*, 459 U.S. 838 (1982); *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 636 F.2d 16 (2d Cir. 1980), *cert. denied*, 451 U.S. 910 (1981).

77. See *Werbowsky v. Collomb*, 766 A.2d 123, 144 (Md. 2001) (dismissing derivative litigation unless plaintiff can show that “majority of the directors are so personally and directly conflicted or committed to the decision in dispute that they cannot reasonably be expected to respond to a demand in good faith and within the ambit of the business judgment rule”). The standard is the same whether the question is demand futility or board termination of derivative litigation. See *Langevoort*, *supra* note 28, at 1029.

78. *Werbowsky*, 766 A.2d at 144.

79. *Navellier v. Sletten*, 262 F.3d 923 (9th Cir. 2001) (affirming jury finding that fund trustees had not violated their fiduciary duties in terminating the investment advisory contract).

board governance failures; executive compensation is tied to stock performance and aligns management interests with those of shareholders; institutional investors can use (or threaten to use) their voting rights; and markets in corporate control serve as a backstop if the other mechanisms fail.<sup>80</sup> Although each mechanism has shortcomings, they nonetheless have served to justify a judicial attitude of abstention.

None of the justifications for judicial abstention, however, applies in the mutual fund context. Mutual funds do not operate in efficient markets in which investors price the value of fund management services. Management compensation is based on asset size and directors are paid in cash, thus compensation for neither is linked (given the dysfunctional investor market) to the value of the services provided. Since institutional investors purchase their management services independently of retail investors, they do not modulate pricing of retail fund services. Other intermediaries, such as Morningstar and the financial press, have not been effective in informing investors and valuing fund management services. To the contrary, they have exacerbated investor biases. And no control market exists for mutual funds, since any change of management firms would require board approval or a shareholder insurgency.<sup>81</sup>

#### **4. Professional Oversight**

Fund directors have lately been viewed as a professional corps—with special professional, though largely aspirational, responsibilities. The mutual fund industry has promoted this view.

Proposals for fund governance reform have come from various quarters, most tellingly, the industry itself. For example, in 1999 an ICI advisory group recommended:

- 1) at least two-thirds of each fund board be independent directors, and independent directors designate one of their own as “lead” independent director;
- 2) former officials of the management firm or its affiliates not serve as independent directors, independent directors be selected and nominated by incumbent independent directors, independent directors complete an annual questionnaire on their business, financial and family relationships with the management firm and other service providers, and fund boards adopt policies on retirement of directors;

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80. See, e.g., Ronald J. Gilson, *TRANSPARENCY, CORPORATE GOVERNANCE AND CAPITAL MARKETS 4* (The Latin American Corporate Governance Roundtable 2000), available at <http://www.oecd.org/dataoecd/55/45/1921785.pdf>.

81. As Professor Langevoort points out: “Thinking about mutual funds by imagining them simply as a species of ‘corporations’ in a way that is directly informed by contemporary corporate law theory is completely misguided.” Langevoort, *supra* note 28, at 1032.

3) independent directors establish director compensation, fund directors invest in funds on whose boards they serve, and fund boards obtain D&O insurance and/or indemnification from the fund “to ensure the independence and effectiveness of independent directors;”

4) independent directors meet separately from management when considering the fund’s advisory and underwriting contracts, and independent directors have qualified independent counsel and have express authority to consult with the fund’s independent auditors or other experts, as appropriate;

5) fund boards establish an audit committee (composed entirely of independent directors) that would supervise the fund’s independent auditors; and

6) fund directors evaluate periodically the board’s effectiveness, new fund directors receive appropriate orientation, and all fund directors keep abreast of industry and regulatory developments.<sup>82</sup>

Many of the “best practices” proposals, however, simply call for conduct that is already the industry norm.<sup>83</sup> For example, many fund groups have moved on their own to increase the proportion of independent directors on their boards. The SEC estimates that at least 60% of fund boards meet the 75% independent-directors threshold.<sup>84</sup> The shift to independent chairs has been even more pronounced, with 43% of fund boards led by an independent chair, up from less than 20% only a few years ago.<sup>85</sup>

Has the director professionalism movement borne fruit? The industry says yes. For example, in 2005 fees were reduced on 808 mutual funds, while they rose on 263 funds. In comparison, fees rose on 417 funds and fell on 367 in 2003.<sup>86</sup> But the net 545 funds that reduced fees in 2005 represent less than 10% of the 8000-fund industry.

Ultimately, gains in independent board membership and more active negotiation of fund fees do not change the essential dynamic of mutual fund governance. Fund boards can negotiate only at the margin. The threat to buy fund services elsewhere, always present in a real negotiation, is mostly empty (sometimes even ludicrous) in a negotiation of fund fees or other terms of the management contract. Moreover, the composition of fund boards with executives sympathetic to the profit motives of the

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82. INVESTMENT COMPANY INSTITUTE, REPORT OF THE ADVISORY GROUP ON BEST PRACTICES FOR FUND DIRECTORS iii–iv (1999), [http://www.ici.org/pdf/rpt\\_best\\_practices.pdf](http://www.ici.org/pdf/rpt_best_practices.pdf). See also Freeman & Brown, *supra* note 52, at 658–59 n.200 (summarizing ICI advisory group recommendations).

83. See Freeman & Brown, *supra* note 52, at 659 n.221.

84. Lauricella, *supra* note 32, at R4 (reporting end-of-year 2004 data from the Investment Company Institute).

85. *Id.*

86. *Id.* at R1 (reporting data from Lipper, Inc.).

management firm, cemented by the high levels of compensation for many fund directors, is hardly a harbinger of reform. For example, the \$3 million in fee reductions wrangled by the AIM board in 2005 came at a not insignificant cost.<sup>87</sup> In 2005, the AIM independent trustees received total pay, including deferred retirement benefits, of approximately \$4.4 million, with the independent chair receiving \$359,000 for his board service.<sup>88</sup>

## II. EVALUATION OF OUTSOURCING

Has outsourcing to the mutual fund board worked? The mutual fund industry has argued that mutual fund boards, and the funds they supervise, operate in a “vigorous and highly competitive” market.<sup>89</sup> But many outside the industry, including the SEC, have questioned the power of the market and the effectiveness of fund boards in supervising management firms—primarily as relates to fees and costs. More recently, some have also pointed to the failure of the board in reining in aggressive and misguided marketing practices devised by management firms that prey on investor cognitive biases.<sup>90</sup>

Consider the assumptions that undergird the regulatory outsourcing to mutual fund boards and the evidence of how that outsourcing has worked.

### A. DEBATE OVER THE FUND BOARD

Oversight of mutual fund boards is built on certain hopeful assumptions. The fund industry regularly trumpets its efficiency and the market pressure that fund investors can wield. To the extent there are market inefficiencies, the SEC has sought to empower the fund board by reforming the rules governing fund board composition. Thus, courts reviewing the performance of fund boards have been inclined to use the same standards of deferential review applied to corporate boards, on the assumptions that market discipline by investors and regulatory oversight by the SEC make judicial intervention unnecessary.

#### 1. Market Efficiency

At first glance, the mutual fund industry shows the classic hallmarks of market competitiveness. The supply side of the market has low barriers to entry and has shown great fluidity, with small funds regularly displacing

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87. *Id.* at R4.

88. See AIM INVESTMENT SECURITIES FUNDS, STATEMENT OF ADDITIONAL INFORMATION, APPENDIX D, TRUSTEE COMPENSATION TABLE (2006), <https://www.aiminvestments.com>.

89. *How the Financial System Can Best Be Shaped to Meet the Needs of the American People, Financial Deregulation: Hearing on H.R. 5734: The Financial Institutions Equity Act of 1984 Before the House Comm. on Banking, Finance and Urban Affairs*, 98th Cong., 2d Sess. 1359 (1984) (statement of David Silver, President, Investment Company Institute).

90. JOHN C. BOGLE, THE BATTLE FOR THE SOUL OF CAPITALISM 164–65 (2005) (arguing that salesmanship triumphed over stewardship).

larger funds.<sup>91</sup> The demand side is characterized by potent information and liquidity rights that allow fund investors easily to ascertain fund performance and to redeem their shares and move to better-performing or lower-cost funds.<sup>92</sup>

The industry's argument for market efficiency, repeated by some finance theorists, has superficial appeal.<sup>93</sup> SEC disclosure rules arm investors with extensive information about fund investment policies, returns, management fees, and other costs.<sup>94</sup> And for those investors unwilling to wade through the disclosure documents, information intermediaries (such as Morningstar, newsletters, financial press) provide "extensive coverage and analysis of mutual funds."<sup>95</sup> The asset-based compensation structure, which allows the management firm to share in superior investment results as the asset base increases, provides incentives to both attract and retain fund investors.

The industry, until the late-trading and market-timing stories broke in 2003, regularly trumpeted its mostly scandal-free record. By all appearances, portfolio securities seemed to be in safe hands and management firms (under the watchful eye of majority-independent boards) complied with the rules of the game—multitudinous and ample as they are.

Ultimately, the proof is in the pudding. The record of mutual fund fees, expenses, portfolio turnover, investment strategies, fund design, and marketing has received a good deal of attention in the finance literature. The picture that emerges (described below) is not flattering for the industry. At almost every level, it seems that fund management firms have been systematically taking advantage of the informational and cognitive deficiencies of fund investors. Market efficiency, plausible in theory, seems not to have functioned in practice.

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91. WILLIAM J. BAUMOL, STEPHEN M. GOLDFELD, LILLI A. GORDON & MICHAEL F. KOEHN, *THE ECONOMICS OF MUTUAL FUND MARKETS: COMPETITION VERSUS REGULATION* 117 (Karl Brunner & Paul W. MacAvoy eds., 1990) (finding that under the Justice Department's antitrust guidelines, mutual fund advisers compete in an unconcentrated market, with the 30 largest complexes experiencing a declining market share, and new smaller entrants taking market shares from larger rivals).

92. SEC, *Invest Wisely: An Introduction to Mutual Funds*, available at <http://www.sec.gov/investor/pubs/inwsmf.htm>.

93. See Paula A. Tkac, Federal Reserve Bank of Atlanta, *Mutual Funds: Temporary Problem or Permanent Morass?*, 98 *ECON. REV.* 1, 15 (2004), available at [http://www.frbatlanta.org/filelegacydocs/erq404\\_tkac.pdf](http://www.frbatlanta.org/filelegacydocs/erq404_tkac.pdf) ("The mutual fund industry is . . . no different than any other competitive industry. [Fund investors] exert their power via their aggregated purchasing decisions in a marketplace replete with choices."). Edward B. Rock, *Foxes and Hen Houses?: Personal Trading by Mutual Fund Managers*, 73 *WASH. U. L.Q.* 1601, 1641 (1994) ("[P]roduct markets that are as competitive as the market for mutual funds . . . provide firms with strong incentives to adopt optimal personal trading policies.").

94. Advertising by Investment Companies, Investment Company Act Release No. 16,245, 53 *Fed. Reg.* 3,868 (Feb. 10, 1988).

95. Wang, *supra* note 3, at 965–66.

## 2. Structural Critique

The SEC, on a regular basis, has questioned the *structural* effectiveness of the board and, specifically, its independent members.<sup>96</sup> The SEC's solution to the fund board's perceived weaknesses has been to strengthen the board's structural independence and authority.<sup>97</sup>

Most recently, the SEC has proposed rules that would effectively require that the board be composed of 75 percent independent directors and that the board chair be an independent director.<sup>98</sup> The SEC proposal, which has met judicial resistance, reflects the long-standing regulatory belief (even faith) in the ability of independent directors to serve the interests of fund investors unable themselves to discipline wayward or faithless fund management.

Observers have long noted the structural bias inherent in the fund board, given the method by which non-management directors are selected and their professional and personal ties of directors to the management firm.<sup>99</sup>

In a recent study of fees charged by mutual funds, Professors Freeman and Brown concluded:

Scholarly articles published by finance academics have ridiculed board-approved 12b-1 fees paid by fund shareholders. Law review commentators offer uncomplimentary evaluations of those who control fund management and policies. The SEC has weighed in, questioning "whether changes are needed in the current system." Another federal agency, the General Accounting Office, recently issued a detailed report finding that mutual funds generally do not attempt to compete on the basis of costs (i.e., price competition is muted). . . . [D]ecades of SEC-commissioned studies, rule-making, and jawboning have led to a system that, for the most part, works

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96. SEC Staff Report Protecting Investors, *supra* note 25, at 266 (examining existing governance model to increase board effectiveness, and concluding that board governance is "fundamentally sound").

97. See SEC REPORT ON PUBLIC POLICY IMPLICATION OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337 (1966) (finding inadequate the independence standard under the 1940 Act, since independent directors are often close to the adviser through business or family relationships). In response, Congress amended the 1940 Act in 1970 to tighten the standards of independence and to permit fund investors to seek judicial review of management compensation. 15 U.S.C.A. § 80a-2(a)(19) (West 2006) (defining "interested person"); *Id.* § 80a-35(b) (providing a private action to remedy fiduciary breaches involving fees paid management firm).

98. Investment Company Governance, Investment Company Act Release No. 26,520, 83 SEC Docket 1384 (July 27, 2004). Curiously, the SEC has stated that its rule mandating an independent board chair was not adopted "as a means of enhancing fund financial performance or reducing fund expenses." SEC Staff Report on Independent Chair, *supra* note 27, at 2. Instead, the change was said to improve compliance and ensure fund boards focus on the long-term interests of fund investors. *Id.* One is left to wonder why improved compliance and an investor focus should not produce financial results.

99. See Brudney, *supra* note 45, at 612.



beautifully for those who sell funds to the public, or sell services to funds, but much less admirably for the industry's investors.<sup>100</sup>

In the end, fund directors may perceive their role as supercilious. Fund investors receive disclosure, have available comparative information, and can move their mutual fund investments as they choose. On the assumption of consumer sovereignty, the board is at most a bureaucratic compliance office.

### 3. Doctrinal Critique

More recently, academic commentators have identified the *doctrinal* deference to fund boards, even when composed by a majority of independent directors.<sup>101</sup> They have criticized the judicial approach of federal courts (which defer to state law on questions of board demand and termination of investor suits) and state courts (which defer to independent directors under the business judgment rule).

The transliteration of traditional corporate governance norms to the mutual fund context is simplistic—and misplaced. Unlike their counterparts in operating companies, fund directors are not subject to the threat of shareholder insurgencies or takeover pressures; they lack the realistic power to replace fund management; and they generally rely on the management firm for information, direction, and compensation. And the linking of compensation to performance—as with stock-based compensation in operating companies or performance-based compensation in hedge funds—is diluted by the asset-based compensation in mutual funds.

The doctrinal gap, rather than narrowing, has been widening. Recently, courts have largely sidestepped the wave of investor litigation arising from the spate of late-trading and marketing-timing scandals. Federal courts have refused to imply federal fiduciary duties, and state courts have refused to relieve investors of the board demand and termination procedures of state corporate law.<sup>102</sup>

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100. Freeman & Brown. *supra* note 52, at 611–13 (citations omitted).

101. *See* Langevoort, *supra* note 28, at 1017–18.

102. Federal judicial abstention in this area is not new. In a line of Supreme Court cases on whether fund boards are bound by federal law or state law, the resounding answer has been in favor of state law. *See* *Burks v. Lasker*, 441 U.S. 471, 472 (1979) (finding that state law governs termination of derivative suit, unless inconsistent with policies of 1940 Act); *see generally* *Kamen v. Kemper Fin. Servs. Inc.*, 500 U.S. 90 (1991) (finding that state law controls question of board demand). Only when there is clear federal policy, such as the express private action under § 36(b) to overcome the perceived inability of independent directors to control overreaching management, does federal law control. *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 527 (1984) (finding no demand requirement under § 36(b)).

Even if the federal courts were to expand their currently cabined view of implied private actions under the 1940 Act, fund investors would face the daunting challenge of bringing derivative claims in the face of board demand and dismissal tools available under state law—primarily, Delaware and Maryland where most mutual funds are organized. *See* *Scalisi v. Fund Asset Management L.P.*, 380 F.3d 133, 142 (2d Cir. 2004) (applying Maryland's approach that

Summarizing the sad state of the fund board, Professor Wang in a comprehensive article on the board-centric structure of U.S. mutual funds concluded:

To evaluate the institutional competence of the board, it is essential to inquire into the board's independence and informational advantage. . . . Because directors are not truly independent, they are vulnerable to coalition politics. In addition, because directors have a limited informational advantage over investors, it may not be realistic to expect them to strike the best deals for investors. In this respect, traditional monitoring devices such as fiduciary duties and incentive-compatible contracts are not effective devices to discipline the performance of the board.<sup>103</sup>

## **B. EMPIRICAL DATA ON MUTUAL FUND MARKETS**

How has the mutual fund market performed? Rather than consider the *structural* and *doctrinal* effectiveness of the fund board, the more relevant question is how fund directors have *measurably* fulfilled their role as “watchdogs” for fund investors. Viewing fund governance as a black box, the question is how well fund boards have performed their functions.

Even if fund governance (the supply market) is not working, it is possible that fund investors (the demand market) have exercised their informational and liquidity rights to protect themselves. Again, the question is whether fund investors have exercised their buy/sell rights to demand good performance at low cost. The rich finance literature on the functioning of the mutual fund markets over the past several years provides some answers. The studies reveal a largely dysfunctional supply market with fund boards performing poorly nearly all the tasks assigned to them.<sup>104</sup> The same is true for the demand market, where fund investors by and large possess neither the information nor acumen to protect themselves. Although some recent data suggest greater consumerism among fund investors, the change appears to be at the margin.

### **1. Board Performance**

Academic studies tell a consistent and disturbing story of the failure of fund boards to negotiate lower fees in the face of economies of scale generated by rising fund assets and enhanced computer and tele-

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demand and termination by independent directors is subject to review under the business judgment rule).

103. Wang, *supra* note 3, at 1008.

104. To date, no studies look at the performance of fund boards in supervising late-trading and market-timing practices. The brazen nature of the practices in some fund families raises questions about the effectiveness of fund boards at this, their most basic, task. Nonetheless, whether because of board pressure or management firm response to the SEC's and Attorney Elliot Spitzer's enforcement actions, there is reason to believe the industry has responded to ameliorate the practices.

communications technologies. After reviewing some of the academic literature, the General Accounting Office (GAO) concluded that fund boards “may be keeping fees at higher levels because of [a] focus on maintaining fees within the range of other funds.”<sup>105</sup>

Fund boards have also failed investors in the supervision and approval of marketing by management firms. The studies surveyed by the GAO found that “the information currently provided does not sufficiently make investors aware of the level of fees they pay.”<sup>106</sup> As one study concluded, perhaps kindly, “funds do not compete primarily on the basis of their operating expense fees.”<sup>107</sup> Instead, funds seem to compete on the basis of marketing—with advertisement focused on recent performance results.

*Board hiring/retention of management firm*

- Business connections between fund directors and advisory firms affect hiring, compensation, and performance. Fund boards preferentially hire advisory firms having more business relationships with fund directors. Fund advisors receive higher pay when more connected to the fund directors. Preferential hiring and pay is not compensated by higher performance. In fact, greater connections correspond to a decrease in fund return, before and after advisory fees, of about 1% per year.<sup>108</sup>

*Board negotiation of advisory contracts and fees*

- Expense ratios have risen, even as fund assets have grown and fund management has become more efficient. Weighted average expense ratios for *all mutual funds* (stock and bond funds) rose from 0.73% in 1979 to 0.94% in 1999—a nearly 30% increase.<sup>109</sup> Weighted average expense ratios for *equity funds* grew from 0.64% in 1980 to 0.92% in 2004—an increase of more than 40%—even as equity fund assets rose from \$45 billion to \$4,034 billion.<sup>110</sup>
- Negotiation of advisory contracts appears to be perfunctory. Contractual renegotiations are “rare event[s]” that happen in only 10%

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105. U.S. GEN. ACCOUNTING OFFICE, MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION 8, 47 (2000) [hereinafter GAO Mutual Fund Disclosure Report] (noting that some studies “found that fees had been rising”).

106. *Id.* at 7, 76 (“[A]cademic researchers [and others] saw problems with the fee disclosures” by mutual funds).

107. *Id.* at 62.

108. Camelia M. Kuhnen, *Social Networks, Corporate Governance and Contracting in the Mutual Fund Industry* 6 (Unpublished Working Paper, 2006), available at <http://ssrn.com/abstract=849705> [hereinafter Kuhnen, *Social Networks*].

109. SEC Division of Investment Management: Report on Mutual Fund Fees and Expenses 20 Table 2 (2000), <http://www.sec.gov/news/studies/feestudy.htm>. The report determined that the increase in average expense ratios was primarily due to greater use of 12b-1 fees to pay for fund distribution costs. *Id.* at 21.

110. BOGLE, *supra* note 90, at 155 Box 7.2 (finding that unweighted expense ratios have risen even faster than weighted expense ratios, from 0.94% in 1980 to 1.56% in 2004).

of funds.<sup>111</sup> When they do happen, they produce lower fees for bottom and mid-performing funds that correlate to later positive performance, as well as net inflows. It is “puzzling” that fund boards do not actively renegotiate advisory contracts, given the apparent benefits.<sup>112</sup>

- Fund boards accept higher expense ratios for high-performance funds.<sup>113</sup> Although overall management fees decline somewhat as fund size increases, administrative costs decline more rapidly. That is, advisory fees constitute a profit center for management firms.<sup>114</sup>
- Advisory fees charged mutual funds are not competitive with advisory fees charged pension funds. Advisory fee ratios for public pension clients are roughly half of that for comparable actively managed equity mutual funds—even though the average such mutual fund has assets that are nearly three times larger than the average pension portfolio.<sup>115</sup> On a size-standardized basis, the average actively managed mutual fund pays advisory fees of 0.67%, compared to 0.28% paid by pension portfolios.<sup>116</sup>

111. Camelia M. Kuhnen, *Dynamic Contracting in the Mutual Fund Industry* 8–9 (Unpublished Working Paper, 2005), available at <http://ssrn.com/abstract=687530>.

112. Kuhnen, *Social Networks*, *supra* note 108, at 1 (discussing a study of negotiations of advisory contracts from 1994–2002).

113. Jerold B. Warner & Joanna Shuang Wu, *Changes in Mutual Fund Advisory Contracts* 2 (Simon Graduate School of Business Administration, Working Paper No. FR 05-14, 2005), <http://ssrn.com/abstract=841565> (“[H]igh asset growth increases the likelihood of a contract change.”). Advisory “contract changes often shift the percentage fee up or down by more than a fourth, with fee increases and decreases roughly equally likely.” *Id.* “[F]unds with superior market-adjusted performance are able to raise fees,” yet “[r]ate decreases reflect economies of scale associated with growth.” *Id.* at 6, 2.

114. Freeman & Brown, *supra* note 52, at 625 (using a sample of 2161 funds in 1999, with a total market value of \$2.2 trillion, finding that “advisory and administrative costs decline as fund size increases, but with administrative costs declining much more rapidly”). The authors calculated that if advisory costs had declined by the same percentage as administrative costs, average advisory fees for funds with assets above \$5 billion would have been 28 basis points, rather than 46 basis points. Thus, assuming equal economies of scale for advisory fees and administrative fees, the larger funds charge excess advisory fees of about \$2.5 billion annually. *Id.*

115. Management firms charge retail mutual funds “systematically higher” advisory fees than they charge their pension fund clients, for essentially the same service. Freeman & Brown, *supra* note 52, at 628, 630–32 (analyzing fee data collected in 1999 from 36 public pension funds that had placed 220 equity portfolios under active management with outside investment advisers, representing \$97.5 billion in assets, finding that comparable mutual funds pay about twice as much as the pension fund clients, with the difference more pronounced as the fund/portfolio size increases). The disparity has existed over time. A Wharton study conducted in 1962, looking at a sample of 54 management firms with both mutual fund clients and other clients, found that fee rates charged mutual funds were at least 50% higher in 39 out of the 54 cases, 200% higher in 24 of the cases, and 500% or more higher in 9 of the cases. WHARTON SCHOOL OF FINANCE & COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 2274-87, at 489–94 (1962).

116. Freeman & Brown, *supra* note 52, at 633. The findings are dramatic for large-capitalization funds, where mutual funds pay weighted average advisory fees of 52 basis points, compared to 21 basis points for comparable pension fund portfolios. The fee differential is further exacerbated in view of average fund size, with the average large-cap mutual fund (\$2 billion) almost four times larger than the average pension fund portfolio (\$555 million). *Id.* at 635. That is,

- Higher advisory fees do not buy better performance. High-fee funds under-perform low-fee funds—even before factoring in fees. Advisory fee levels, generally a percentage of fund total net assets, *increase* as a result of recent superior fund performance.<sup>117</sup>
- Actively managed mutual funds are more expensive than they appear. Most actively managed funds engage in shadow indexing, while charging fund investors for active management. On average, most of the variance between the fund's stated active managed assets and the fund's actual shadow indexed assets is explained by the fund's benchmark index.<sup>118</sup> Separating active assets from passive assets, the mean expense ratio for the active portion of the portfolio of actively-managed large-cap equity mutual funds of “5.14% runs more than 500% higher than the published expense ratio of 0.77%.”<sup>119</sup>

*Board approval of loads*

- Nearly two-thirds of equity funds impose distribution fees, as load charges paid directly by fund investors or as annual marketing fees paid pursuant to Rule 12b-1. The true cost of distribution fees to investors is hard to measure because “fund companies have developed distribution arrangements that differ in both the magnitude and timing of fees paid.”<sup>120</sup>
- While 12b-1 fees (paid from fund assets) increase the fund's market share, there is “no evidence” current or new investors derive any benefit from 12b-1 fees.<sup>121</sup> Funds with 12b-1 fees have higher expense ratios and are more likely to fail. Fund investors pay for additional marketing, but garner no additional investment returns—a “dead weight cost.”<sup>122</sup>

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management firms charge the average large cap mutual fund \$10.4 million, while they charge the average pension fund portfolio \$1.2 million—for essentially the same service.

117. Warner & Wu, *supra* note 113, at 26–27. Also finding that advisory fee rates decrease when economies of scale exist and they are associated with growth. *Id.* at 6.

118. Ross M. Miller, *Measuring the True Cost of Active Management by Mutual Funds* 11 (Unpublished Working Paper, 2005), available at <http://ssrn.com/abstract=746926>.

119. *Id.* at 12.

120. Miles Livingston & Edward S. O'Neal, *The Cost of Mutual Fund Distribution Fees*, 21 J. FIN. RES. 205, 206 (1998). The study produced a “simple methodology” that expresses “present value of distribution costs as fraction of original investment for multiple-class fees” during any potential holding period, allowing direct comparison of the effect on investors of distribution fees for different sales arrangements. *Id.* at 214.

121. Ajay Khorana & Henri Servaes, *Conflicts of Interest and Competition in the Mutual Fund Industry* 1–2 (Unpublished Working Paper, 2004), available at <http://ssrn.com/abstract=240596> (studying the period from 1979 to 1998, when mutual fund industry assets grew enormously, the number of active funds tripled, and the market share of each fund declined).

122. Stephen P. Ferris & Don M. Chance, *The Effect of 12b-1 Plans on Mutual Fund Expense Ratios: A Note*, 42 J. FIN. 1077, 1082 (1987) (describing 12b-1 fees as “a dead-weight cost”); Robert W. McLeod & D.K. Malhotra, *A Re-examination of the Effect of 12b-1 Plans on Mutual Fund Expense Ratios*, 72 J. FIN. RES. 231, 239 (1994) (stating that 12b-1 fees are “a dead weight cost” to fund investors that has been increasing over time); Antonio Apap & John M. Griffith, *The Impact of Expenses on Mutual Fund Performance*, 11 J. FIN. PLAN. 76, 80 (1998) (concluding that for variety of equity funds, 12b-1 fees do not add to funds' performance).

- The number of funds with 12b-1 fees is growing, as is the level of 12b-1 fees.<sup>123</sup> Increasingly, 12b-1 fees are charged in funds closed to new investors, “almost all of which are load funds.”<sup>124</sup>
- Load funds, which directly charge investors for marketing expenses, do not out-perform no-load funds. Even before adjusting for loads in returns, no-load funds beat their load counterparts. When loads are figured in, no-load funds perform much better than load funds. And comparing load funds, there is no significant difference in performance between high-load funds and low-load funds even after adjusting for loads.<sup>125</sup>
- Load funds target less-knowledgeable investors and charge higher expenses. The average annual expense ratio of load equity funds has widened since the early 1990s and by 2000–2004 was 50 basis points higher than no-load equity funds.<sup>126</sup>
- In the 1990s, most funds with front-end loads added new share classes, which allowed investors instead to pay annual fees and/or back-end charges. Multiple-class funds attracted shorter-horizon investors, resulting in an increase in fund volatility and a significant drop in fund performance.<sup>127</sup>
- Expensive load funds, without minimum-balance requirements, are targeted at investors in less affluent, less educated, and ethnic minority neighborhoods—a kind of “predatory” money management.<sup>128</sup>

*Board supervision of fund marketing*

- Fund investors who purchase through brokers or financial advisors pay “unjustified” higher costs. Broker customers are often directed to hard-to-find funds, which charge substantially higher fees and provide lower risk-adjusted returns than directly placed funds. “[B]roker-channel funds exhibit no superior asset allocation. . . . While we cannot seem to

123. William P. Dukes, Philip C. English II & Sean M. Davis, *Mutual Fund Mortality, 12b-1 Fees, and the Net Expense Ratio*, 29 J. FIN. RES. 235, 236 (2006).

124. Todd Houge & Jay Wellman, *The Use and Abuse of Mutual Fund Expenses* 13 (Unpublished Working Paper, 2006), available at <http://ssrn.com/abstract=880463>.

125. Matthew R. Morey, *Should You Carry the Load? A Comprehensive Analysis of Load and No-Load Mutual Fund Out-of-Sample Performance*, 27 J. BANKING FIN. 1245 (2003) (using sample of funds free of survivorship bias, evaluating performance across different performance metrics and different ages and styles of funds; finding differences to be statistically significant at one percent level across different performance metrics).

126. Houge & Wellman, *supra* note 124, at 3.

127. Vikram K. Nanda, Z. Jay Wang & Lu Zheng, *The ABCs of Mutual Funds: A Natural Experiment on Fund Flows and Performance* 3 (Unpublished Working Paper, 2003), available at <http://ssrn.com/abstract=510325>.

128. Christopher J. Malloy & Ning Zhu, *Mutual Fund Choices and Investor Demographics* 1 (Eur. Fin. Ass’n 2004 Maastricht Meetings, Working Paper No. 3377, 2004), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=556225](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=556225).

locate tangible benefits delivered by brokers, we remain open to the possibility that substantial intangible benefits exist.”<sup>129</sup>

- Fund families create the illusion of high-rated funds by merging low-performing funds into high-performing funds—marketing the survivor’s healthy past performance. Funds disappear at a rate of approximately 3.6% a year primarily because of multi-year poor performance.<sup>130</sup> The resulting “survivor bias” results in overstatement of fund family performance, by air-painting out below-average funds from the family portrait.<sup>131</sup>
- Fund boards rarely close funds to new investors, even when the fund has reached an optimal size. For actively managed funds, returns (both before and after fees and expenses) decline with lagged fund size. The relationship is most pronounced in funds that invest in small and illiquid stocks, where scale adversely affects liquidity.<sup>132</sup>
- Funds with front-end loads have recently introduced additional share classes, “allowing investors to replace front-end loads with higher annual fees and/or back-end charges.”<sup>133</sup> While increasing fund cash flows by attracting shorter-horizon investors, the result has been a significant drop in fund performance. In fact, fund performance drops and volatility rises as funds increase the proportion of short-horizon investors.<sup>134</sup>

*Board supervision of fund investment strategies*

- Morningstar ratings, on which fund investors irrationally rely, skew the behavior of fund managers. Funds that achieve high ratings tend to increase their risk levels, resulting in a “significant fall off” in performance as managers are unable to “load on momentum stock” after the fund receives the initial five-star rating.<sup>135</sup>

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129. Daniel B. Bergstresser, John M.R. Chalmers & Peter Tufano, *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry* 36 (Unpublished Working Paper, 2006), available at <http://ssrn.com/abstract=616981>. The paper found that investors buying brokered funds underperform direct-channel funds, even before deduction of distribution-related expenses. *Id.*

130. Mark M. Carhart, Jennifer N. Carpenter, Anthony W. Lynch & David K. Musto, *Mutual Fund Survivorship*, 15 REV. FIN. STUD. 1439, 1443–45 (2002). “[The survivor bias is] 0.07% for one-year samples, but a significantly larger 1% for samples longer than 15 years.” *Id.* at 1460.

131. *Id.* at 1439.

132. Joseph S. Chen, Harrison G. Hong, Ming Huang & Jeffrey D. Kubik, *Does Fund Size Erode Mutual Fund Performance? The Role of Liquidity and Organization*, 94 AM. ECON. REV. 1276 (2004). The study found that even after adjusting returns by various performance benchmarks, fund performance “increases with the size of the other funds in the same family.” *Id.* at 1293.

133. Nanda, Wang & Zheng, *supra* note 127, at 1.

134. *Id.* at 22.

135. Matthew R. Morey, *The Kiss of Death: A 5-Star Morningstar Mutual Fund Rating*, 3 J. INV. MGMT. 41 (2005) (examining effect 5-star Morningstar mutual fund rating has on fund performance, strategy, risk-taking, expenses, and portfolio turnover during three-year period after

- Fund managers adapt their investment strategy in the last part of a calendar year according to their performance in the first part, in particular taking greater risk to keep a high Morningstar rating from the beginning of the year.<sup>136</sup>
- Annual trading costs for equity funds average 0.78% of fund assets. Trading costs are negatively related to fund returns, and there is no evidence that average trading costs are recovered in higher overall fund returns. Trading appears to have a greater drag on fund returns than turnover.<sup>137</sup>
- Fund over-trading often occurs because of the presence of short-term investors in long-term funds. Fund managers can use observable investor characteristics to predict investment horizons when investors open an account. The pooling in the same fund of long-term investors and short-term investors costs long-term investors 0.51% in foregone annual returns.<sup>138</sup>
- Larger fund families aggressively market their “winning” funds (the previous year’s best performers) and allocate extra manager resources to these funds.<sup>139</sup> In fact, an investment strategy that purchases a fund family’s past-year winners and shorts its past-year losers produces abnormal positive returns. The strategy is particularly successful in larger fund families, suggesting the latitude of larger families to allocate resources unevenly between funds.<sup>140</sup>
- Fund families strategically allocate performance across member funds to favor those more likely to generate future inflows and higher fee income. Strategic cross-fund subsidization of “high” funds at the expense of “low” funds is between 6 to 28 basis points of extra net-of-style performance per month.<sup>141</sup> This preferential allocation occurs with respect to IPO deals and opposite trades (sometimes actual cross-

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initial 5-star rating; findings “robust across different performance measures and different samples of funds”).

136. Alexei P. Gorjaev, Federic Albert Palomino & Andrea Prat, *Mutual Fund Tournament: Risk Taking Incentives Induced by Ranking Objectives* (Ctr. for Econ. Policy Research Discussion Paper No. 2794, 2004), available at <http://ssrn.com/abstract=270304>.

137. John M.R. Chalmers, Roger M. Edelen & Gregory B. Kadlec, *An Analysis Of Mutual Fund Trading Costs* (1999) (Unpublished Working Paper), available at <http://ssrn.com/abstract=195849>.

138. See Woodrow T. Johnson, *Predictable Investment Horizons and Wealth Transfers among Mutual Fund Shareholders*, 59 J. FIN. 1979, 2012 (2004).

139. See Donald W. Glazer, *A Study of Mutual Fund Complexes*, 119 U. PA. L. REV. 205, 228 (1970) (finding investors are more concerned with the relative performance of aggressive mutual funds).

140. Ilan Guedj & Jannette Papastaikoudi, *Can Mutual Fund Families Affect the Performance of Their Funds?* 24 (Unpublished Working Paper, 2003), available at <http://ssrn.com/abstract=467282> (study of funds in large fund families).

141. José-Miguel Gaspar, Massimo Massa & Pedro P. Matos, *Favoritism in Mutual Fund Families? Evidence on Strategic Cross-Fund Subsidization*, 61 J. FIN. 73, 102 (2006), available at <http://ssrn.com/abstract=557078>.



trading) among “high” and “low value” funds in the same fund complex.<sup>142</sup>

- Fund boards with a greater proportion of independent directors seem to supervise the management firm more diligently than low-proportion funds. Fund performance and the likelihood of replacing underperforming fund managers increases as the proportion of independent directors increases.<sup>143</sup>

## 2. Empirical Data on Investor/Market Effectiveness

Not only does the finance literature raise doubts about fund governance, it also reveals the investor market to be informationally inefficient—the same finding that motivated the 1940 Act and its outsourcing of fund supervision to the fund board.<sup>144</sup> Recent studies show fund investors continue to lack the investment acumen, relevant information, and ability to protect their own interests.<sup>145</sup> The notion, powerful in theory, that mutual fund investors can discipline wayward management firms by exercising their easy “entry/exit” rights has proved mostly empty in practice. Study after study makes clear that most fund investors are unable to fend for themselves.<sup>146</sup>

### *Investor response to fund fees*

- Investors are often ignorant of expenses charged by their funds. According to a survey of fund investors, fewer than 20% could estimate expenses for the largest fund they held.<sup>147</sup> Even sophisticated fund

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142. *Id.*

143. Bill Ding & Russ R. Wermers, *Mutual Fund Performance and Governance Structure: The Role of Portfolio Managers and Boards of Directors* 4 (Unpublished Working Paper, 2005), available at <http://ssrn.com/abstract=687273> (performing a comprehensive analysis of the relationship between performance and governance structure of open-end, domestic-equity mutual funds from 1985–2002).

144. From the beginning, it has been understood that disclosure to investors is not enough. As SEC Commissioner Robert Healy testified in the hearings on the Investment Company Act, “there are certain practices that have happened in connection with investment companies that I think everybody agrees . . . ought to be stopped, and they cannot be stopped by mere disclosure.” SEC Staff Report on Independent Chair, *supra* note 27, at 28 n. 14.

145. See generally, Stephen Choi, *Regulating Investors Not Issuers: A Market Based Proposal*, 88 CAL. L. REV. 279 (2000) (proposing a system regulating investors based on their sophistication).

146. Reviewing the academic literature, the General Accounting Office came essentially to the same conclusion. GAO Mutual Fund Disclosure Report, *supra* note 105, at 7, 76 (“[Academic studies] indicated that the information currently provided does not sufficiently make investors aware of the level of fees they pay,” and some academic researchers and others “saw problems with the fee disclosures [by mutual funds].”).

147. Gordon J. Alexander, Jonathan D. Jones & Peter J. Nigro, *Mutual Fund Shareholders: Characteristics, Investment Knowledge, and Sources of Information*, 7 FIN. SERV. REV. 301, 309 (1998) (joint study of fund shareholders conducted by the Office of the Comptroller of the Currency and the SEC), summarized in Freeman & Brown, *supra* note 52, at 665.

investors lack a good understanding of the historical returns of their fund investments.<sup>148</sup>

- Investors are often unaware that higher fund expenses are a drag on fund performance. In one survey, about 20% of surveyed investors believed that high-fee funds produced better results; more than 60% believed funds with higher expenses produced average results; and fewer than 16% believed higher expenses led to lower than average returns.<sup>149</sup> In another survey, 84% of respondents believed that higher fund expenses correlate with higher fund performance.<sup>150</sup>
- Fund investors are relatively insensitive to advisory fees, paying some attention when they buy, but not as they hold. Funds that reduce their fees gain market share, but only if their fees were above average to start. Low-cost funds do not lose market share by charging higher fees.<sup>151</sup>
- Fund investors have become more sensitive to front-end loads and commissions, but remain insensitive to operating expenses. Over the last 30 years, front-end loads (as well as commissions charged by brokerage firms) have had a consistently negative relation to fund flows.<sup>152</sup> There is no relation (or even a perverse positive relation) between operating expenses and fund flows. Investors purchase “funds that attract their attention through advertising and distribution. . . . mutual fund advertising works.”<sup>153</sup>
- In relatively homogenous fund sectors, such as S&P index funds, investors find it difficult to identify bargains. Investors tend to go with recognized “name brands” based on fund age and family size, with a marked shift in sector assets to more expensive (often new entry) funds.<sup>154</sup>

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148. See generally Dan A. Moore, Terri R. Kurtzberg, Craig R. Fox & Max H. Bazerman, *Positive Illusions and Forecasting Errors in Mutual Fund Investment Decisions*, 79 *ORG. BEHAV. & HUMAN DEC. PROCESSES* 95 (1999).

149. See Alexander, Jones & Nigro, *supra* note 147, at 310.

150. See Neil Weinberg, *Fund Managers Know Best: As Corporations are Fessing Up to Investors, Mutual Funds Still Gloss Over Costs, Hide Top-Dog Pay and Keep Secret How They Cope When Self-Interest Conflicts With Duty*, *FORBES*, Oct. 14, 2002, at 220.

151. Khorana & Servaes, *supra* note 121, at 3–4.

152. Brad M. Barber, Terrance Odean & Zheng Lu, *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows*, 78 *J. BUS.* 2095, 2097 (2005).

153. *Id.* at 2099.

154. Ali Hortacsu & Chad Syverson, *Product Differentiation, Search Costs, and Competition in the Mutual Fund Industry: A Case Study of S&P 500 Index Funds*, 119 *QUARTERLY J. ECON.* 403 (2004). Fund investors also have difficulty identifying the advantage of index investing. See Moore, Kurtzberg, Fox & Bazerman, *supra* note 148, at 96 (hypothesizing that common traits of over-optimism and framing of choices against past performance contribute significantly to investors eschewing index funds, which over time outperform actively-managed funds).

*Investor response to market changes*

- Fund investors over-trade. In turn, investor short-termism drives the short investment horizons of fund managers, not the other way around.<sup>155</sup>
- Fund investors systematically engage in a “buy high, sell low” trading strategy. Monthly data from 1984-2003 show a negative relationship between aggregate net flows into and out of the funds and the returns of the funds in subsequent periods.<sup>156</sup> As a result, fund investors realize lower long-term accumulated return than the “long-term accumulated return on a ‘buy and hold’ position in these funds.”<sup>157</sup>
- Fund investors over-react to market volatility—the “grass is greener” phenomenon. Stock fund investors withdraw assets in response to market volatility—both concurrently and based on past semi-annual and annual volatility.<sup>158</sup> Fund investors over-react both to downside volatility and upside volatility. Stock fund flows, in turn, contribute to market volatility—as “noisy traders” destabilize the overall stock market.<sup>159</sup>
- Fund investors follow the crowd. Net aggregate equity fund flows typically track general investor sentiment. Moreover, there is a self-reinforcing aspect to investor sentiment as higher equity fund flows induce newsletter writers to become more bullish.<sup>160</sup>

*Investor response to past performance*

- Fund investors respond to the heuristic “past is prologue.”<sup>161</sup> Past performance is at best a weak predictor for anticipating fund performance. While one-star and two-star Morningstar ratings generally predict relatively poor future performance, Morningstar’s five-star

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155. Li Jin, *How Does Investor Short-termism Affect Mutual Fund Manager Short-termism 2* (Unpublished Working Paper, 2005), available at <http://ssrn.com/abstract=675262>.

156. Oded Braverman, Shmuel Kandel & Avi Wohl, *The (Bad?) Timing of Mutual Fund Investors 5* (Unpublished Working Paper, 2005), available at <http://ssrn.com/abstract=795146>.

157. *Id.*

158. Dengpan Luo, *Market Volatility and Mutual Fund Cash Flows 3-4* (Yale ICF Working Paper No. 03-21, 2003), available at <http://ssrn.com/abstract=418360>. In the period from 1984-1998, the paper found different results for bond fund investors, who did not respond to past stock market volatility at the aggregate level. *See id.* at 7-8.

159. *Id.* at 8.

160. Daniel C. Indro, *Does Mutual Fund Flow Reflect Investor Sentiment?*, 5 J. BEHAV. FIN. 105, 112 (2004) (using weekly flow data and sentiment indicators from the American Association of Individual Investors and Investors Intelligence).

161. The heuristic, valuable in other consumer activities, reflects the likelihood that fund performance (like that of any randomly constructed stock portfolio) regresses to the mean. This is not true for other consumer goods. For example, a five-star automobile safety crash rating (based on the performance of a sample car in a controlled crash test) is a useful predictor that other cars of the same model and year will perform well in real-life crashes. *See* Consumer Reports, Annual Auto Issue: Safety Feature Comparison 35-38 (Apr. 2006), <http://www.consumerreports.org/cro/index.htm>.

funds generally do not outperform four-star and three-star funds.<sup>162</sup> In fact, a 5-star Morningstar rating may be a “kiss of death.”<sup>163</sup> Three years after a fund receives its initial 5-star rating, fund performance severely falls off across different performance measures and different samples of funds.<sup>164</sup>

- Fund directors, contrary to anecdotal evidence, often hold shares in the funds they oversee.<sup>165</sup> But there is evidence that directors chase performance in their ownership choices, just like other fund investors.<sup>166</sup>
- The “past is prologue” mentality extends to the financial press. Fund rankings by the leading financial publications (Barron’s, Business Week, and Forbes) based on past performance do not predict superior future performance.<sup>167</sup> Most ranked funds (65%) have lower performance in the post-ranking period compared to the pre-ranking period.<sup>168</sup>

#### *Investor response to scandals*

- Response by fund investors to mutual fund scandals has been mixed. Funds affected by scandals experience significantly greater outflow of assets, with the outflow greater the more severe the scandal (as measured by size of regulatory settlement/fine, press coverage, and filing of formal charges). Outflows are greater where the scandal involved a penalized entity, as opposed to individual wrongdoers no longer associated with the fund. But fund scandals first discovered by the SEC do not result in significant outflows. Lastly, strengthened

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162. Christopher R. Blake & Matthew R. Morey, *Morningstar Ratings and Mutual Fund Performance* 20–21 (Unpublished Working Paper, 1999), available at <http://ssrn.com/abstract=168668> (using data set free of survivorship bias and adjusted for load fees). Most studies confirm this result. See, e.g., Andrea Frazzini & Owen A. Lamont, *Dumb Money: Mutual Fund Flows and the Cross-Section of Stock Returns* (NBER Working Paper No. W11526, 2005), available at <http://ssrn.com/abstract=776014> (concluding that fund flows are “dumb money” as heavy fund demand predicts low future returns at long horizons). But some studies come to contrary results. See, e.g., Russ R. Wermers, *Is Money Really ‘Smart’? New Evidence on the Relation Between Mutual Fund Flows, Manager Behavior, and Performance Persistence* 3 (Unpublished Working Paper, 2003), available at <http://ssrn.com/abstract=414420> (finding that when consumers invest heavily in last year’s winning funds, managers of these winners invest these inflows in momentum stocks to continue to outperform other funds for at least two years following the ranking year).

163. Morey, *supra* note 135, at 41.

164. *Id.* at 49–50.

165. Qi Chen, Itay Goldestein & Wei Jiang, *Directors’ Ownership in the U.S. Mutual Fund Industry* 2 (Unpublished Working Paper, 2006), available at <http://ssrn.com/abstract=713462>.

166. *Id.* at 38.

167. Miranda L. Detzler, *The Value of Mutual Fund Rankings to the Individual Investor* 4 (Unpublished Working Paper, 1999), available at <http://ssrn.com/abstract=170851> (looking at 757 funds that were ranked between 1993–1995; finding that ranked funds had higher excess returns compared to peer funds during the pre-ranking period, but similar excess returns in the post-ranking period; finding also that ranked funds had higher risk, measured by standard deviations, in both the pre- and post-ranking periods).

168. See Miranda L. Detzler, *The Value of Mutual Fund Rankings to the Individual Investor*, 8 J. BUS. & ECON. STUD. 48, 50 (2002).

corporate governance controls have no impact on the amount of outflows from a scandal fund.<sup>169</sup>

### C. EVALUATION OF DATA

The data paint a dismal picture of fund board performance. Fund boards have failed in their function to negotiate management fees. In fact, the recent slowing growth of *weighted average fees* (compared to the continuing growth in *unweighted average fees*) highlights the inability of fund boards to lower fees, even as some fund investors have moved to lower-cost funds. That is, fund boards have been less effective in lowering fund fees than fund investors. Even worse than their performance on negotiating management fees, fund boards have achieved nothing for their investors by approving loads—especially 12b-1 fees.

The data tell an equally sad story about fund investors. Fund investors are often ignorant of fund expenses and unaware of their relation to performance. They suffer from cognitive biases, for example that “past is prologue”—a belief they share with the financial press and even fund managers. Fund design and marketing pander to this belief and over-emphasize high Morningstar ratings, which studies show represent a statistical guarantee the fund will regress to the mean. Many fund investors shun index funds, even though they are a proven long-term investment vehicle. Instead, they engage in pathological “buy high, sell low” trading strategies that over-optimistically aim to out-perform the market. Fund managers mirror (or induce) a “grass is greener” bias in their over-trading of portfolio assets and widespread belief that they too can beat the market. Not everyone can be above average.

Even those studies that suggest independent directors provide some value—that is, that fund performance and the likelihood of replacing under-performing fund managers increases as the proportion of independent directors rises—do not establish a causal relationship between board independence and fund results. Instead, it seems more likely that investor-friendly management firms (i.e., those that adopt strategies of low fees, long-term investment policies, responsiveness to failed investment strategies, and investor-appropriate marketing) are more likely to have truly independent directors advising on these matters. In fact, the studies that suggest funds with independent chairs out-perform their management-chaired counterparts lead only to the conclusion that management firms focused on their own profits under-perform firms with an investor focus.<sup>170</sup>

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169. Stephen J. Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals* 9, 24–26 (NYU, Law and Economics Research Paper No. 06-07, 2006), available at <http://ssrn.com/abstract=877896> (reviewing mutual fund scandals from 1994–2004).

170. In fact, the SEC has been unable to point to any evidence that greater board independence has been effective under the SEC’s exemptive rules. Bullard, *Comments on Corporate Governance*, *supra* note 47, at 1106. Indeed, there is “no evidence that the Commission knows

### III. OPTIONS FOR REFORM

Can the fund board be rehabilitated? The mutual fund industry has strong reasons to resist having the board structure dismantled. Outsourcing of regulatory supervision to an internal monitor gives the industry great freedom—particularly when compared to the alternative of external regulation.<sup>171</sup> In areas of fund management subject to board oversight, management firms have the discretion to test the limits of the market.

Not surprisingly, there is no impetus for fundamental reform. The mutual fund industry is quite pleased with the fund board and the results it has produced. Fund directors, without questioning their own value, have supported calls for greater independence and greater role clarity. The SEC willingly parrots the mantra that the fund board is an essential component of fund regulation, particularly since the job falls outside the agency. Perhaps the only mutual fund constituents that might have reservations about the fund board—fund investors—are mostly unaware that there is a fund board or that it has failed them.

After surveying the data on the higher investment advisory fees charged mutual funds compared to pension plans, Professors Freeman and Brown concluded:

The fund industry is over-regulated and under-policed. The absence of a strong corrective influence should not be surprising. Those in control of an industry boasting over \$7 trillion in liquid assets can afford superb lawyers, lobbyists, and public relations specialists. . . . Congress has not shown interest in improving investors' remedies and cannot be counted on to alter the way the fund industry chooses to conduct itself. The SEC generally has contented itself with presenting proposals destined to have little impact on the way most mutual funds do business.<sup>172</sup>

To the extent that some mutual funds have shown a “reform mentality”—lowering management fees, offering life-cycle funds intended to encourage proven long-term investment strategies, and cautioning investors against over-trading—the new attitudes seem driven more by greater investor sophistication than by awakened fund boards. The industry recognizes the scandal-induced skepticism about its product and has every reason to show that its house is in order and that the current regulatory structure is adequate.

But given the long-standing failure of the fund board and the continuing inability of investors to discipline industry excess, the time is ripe for a fundamental re-appraisal of the fund board.

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whether the independent directors have been effective in the context of the operation of the exemptive rules . . . ,” and there is “no evidence that the Commission knows if the exemptive rules themselves have been effective in protecting investors.” *Id.* at 1096.

171. Wang, *supra* note 3, at 958–59.

172. Freeman & Brown, *supra* note 52, at 641–42 (citations omitted).

### A. ALTERNATIVES TO BOARD-CENTRIC STRUCTURES

The recent mutual fund scandals and a slowing stock market have led many to question the efficacy of the fund board. Reform proposals, most of which seek to create additional structures to compensate for the board's failure, have become a cottage industry.

Consider some recent proposals:

**New SRO.** Some reformers have proposed a new self-regulatory organization to oversee mutual funds, thus augmenting fund boards and taking pressure off limited SEC resources. Rather than the current reliance on internal mechanisms, the SRO could engage in more focused rule making, with the SEC (and state attorneys general) using their enforcement powers as a “residual mechanism.”<sup>173</sup>

**New oversight board.** Others have suggested a Mutual Fund Oversight Board, modeled on the Public Company Accounting Oversight Board, which would be responsible for (and only for) establishing uniform minimum standards for fund governance. The new board would perform an investigative and rule-making function, providing the flexibility that the SEC lacks to keep standards current.<sup>174</sup>

**New “expert” directors.** Others would seek to make the fund board more independent and qualified by mandating that the board include a certified financial analyst (CFA)<sup>175</sup>—much like the Sarbanes-Oxley requirement of a financial expert on the audit committee of public companies.<sup>176</sup> The CFA would presumably be better able to recognize excessive fund fees.<sup>177</sup>

**Invigorate mutual fund litigation.** Others would call on courts to make derivative litigation a “serviceable mechanism for serious judicial review in cases of fiduciary breach.”<sup>178</sup> Given the deficiencies of investor market oversight, courts should look at the merits of fund over-pricing.

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173. Joel Seligman, *Should Investment Companies Be Subject to a New Statutory Self-Regulatory Organization?*, 83 WASH. U. L.Q. 1115, 1126 (2005) (arguing for consideration of self-regulatory organization to oversee mutual funds).

174. *Review of Mutual Fund Industry Investigations: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. 2 (2004) (statement of Mercer Bullard, President and Founder, Fund Democracy, Inc.). See generally Patrick McGeehan, *With Critics at the Door, Funds Propose Cleaning Own House*, N.Y. TIMES, Oct. 31, 2003, at C1 (discussing critics' view of the current system and the need for reform). See Mutual Fund Investor Protection Act of 2003, S. 1958, 108th Cong. § 201 (2003) (Senator John Kerry proposed a bill which would have created a Mutual Oversight Board).

175. Tobe, *supra* note 19, at 28 (suggesting CFA, a designation awarded by the Association for Investment Management and Research; also pointing to studies showing that public pension plans with CFA officers have lower fees).

176. See Sarbanes-Oxley Act § 407, 15 U.S.C. § 7265 (Supp. II 2002).

177. Tobe, *supra* note 19, at 28.

178. Langevoort, *supra* note 28, at 1043.

**More investor-usable disclosure.** Others have urged the SEC to mandate greater disclosure of fund expenses—as is required in other financial service industries and consumer markets. Some would require individualized disclosure in account statements that show actual fund expenses, with a break down of fees and other expenses.<sup>179</sup> Some would require that the statements also include how the actual expenses compared with industry ranges and averages.<sup>180</sup>

But others—mostly practicing lawyers—doubt whether the board can be salvaged. Some assert that the SEC’s initiatives to buttress board independence are of “questionable efficacy” and implicitly conclude that the board cannot fulfill its watchdog function.<sup>181</sup> A few have called for the fund board to be eliminated, describing it as “paraphernalia.”<sup>182</sup> As one reform proponent pointed out a fund without directors would not make “an awful lot of difference and would be cheaper to operate.”<sup>183</sup>

Even the SEC has imagined mutual funds without directors. In a 1992 study the SEC staff considered a board-less fund structure, called a unitary investment fund (UIF), as part a comprehensive review of existing fund governance.<sup>184</sup> The concept was a mutual fund that would be treated as a proprietary financial product sold by a sponsor and governed by the terms of a trust indenture. As proposed, the UIF would have a corporate trustee (the sponsor/management firm) that would sell interests in the trust to investors. The trust indenture would spell out fundamental investment policies and the management fee, and could be changed only with some difficulty. A single management fee would cover all fund-related expenses and would be subject to a statutory maximum. The UIF would have no board of directors or shareholder voting, nor would there be judicial review

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179. See U.S. Gen. Accounting Office, *Mutual Fund Fees Additional Disclosure Could Encourage Price Competition* 97–98 (2000), <http://www.gao.gov/archive/2000/gg00126.pdf> (proposing disclosure of total dollar amount of expenses in quarterly statements); Freeman & Brown, *supra* note 52, at 669–670 (proposing that mutual funds be required to itemize their different fund expenses, such as: advisory fees, operating costs, and trading costs).

180. See Cox & Payne, *supra* note 62, at 929. The proposal is similar to one considered by the SEC staff in 1992. See SEC Staff Report *Protecting Investors*, *supra* note 25, at 337 (outlining Unified Fee Investment Company (UFIC), which would have a simplified fee computed as a percentage of fund assets, permitting ready comparison to other similar funds; the fee would cover all fund expenses other than extraordinary expenses and brokerage commissions on the fund’s own transactions).

181. Martin Lybecker, *Enhanced Governance for Mutual Funds: A Flawed Concept that Deserves Serious Reconsideration*, 83 WASH. U. L.Q. 1045, 1085–87 (2005).

182. Phillips, *supra* note 23, at 903.

183. Karen Damato, David Reilly & Karen Richardson, *Do Mutual Funds Really Need Directors?*, WALL ST. J., June 7, 2004, at R1 (reporting comments of Sheldon Jacobs, editor of the No-Load Investor newsletter).

184. SEC Staff Report *Protecting Investors*, *supra* note 25, at 283–84. The idea of a UIF, which was first floated by Stephen West of Sullivan & Cromwell, led to the SEC requesting public comment on the UIF in 1982. Advance Notice and Request for Comment on Mutual Fund Governance, 47 Fed. Reg. 56,509 (Dec. 10, 1982).



of fund fees. The 1940 Act prohibitions against self-dealing transactions would apply, without exception.<sup>185</sup>

Ultimately, the staff rejected the UIF concept as not offering an adequate substitute for board review of fees and other fund operations. The SEC staff seemed unwilling to imagine a model without an independent monitor. Instead, the staff concluded that the board-centric governance structure is fundamentally “sound” and should be retained.<sup>186</sup>

But the idea of a board-less mutual fund is not far-fetched. In fact, the fastest-growing mutual funds in the United States—private hedge funds and some exchange traded funds organized as unit trusts—do not have board structures.<sup>187</sup> Like registered mutual funds, these financial intermediaries pool money that investors entrust to professional managers to make investments on their behalf. Fee setting is a matter of contract, and regulatory compliance is an internal responsibility of the management firm.

Even though hedge funds are subject to nearly identical internal conflicts as *registered* mutual funds, the idea of a fund board to ensure hedge fund compliance and to regulate management activities were not even considered in the recent SEC rule-making to require hedge fund registration.<sup>188</sup> Instead, the SEC rules (which were recently invalidated) would have required that hedge funds registered with the SEC have a compliance officer.<sup>189</sup> The compliance officer, unlike the mutual fund board, would have no authority to validate self-interested activities of the fund manager. The compliance officer—whose functions were to parallel those performed by in-house legal departments and compliance offices in brokerage firms, banks and insurance companies—would have simply been charged with establishing control systems to ensure legal compliance.

The SEC explained the compliance officer’s function in much the same terms as it has described the mutual fund board:

Hedge fund advisers . . . must develop and implement a compliance infrastructure. . . . Our examination staff resources are limited, and we

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185. See Wang, *supra* note 3, at 1024–25 (summarizing UIF proposal).

186. See SEC Staff Report Protecting Investors, *supra* note 25, at 283.

187. Insurance separate accounts are also exempt from the board requirements. The performance of equity funds managed by insurance companies gives reason to pause. In a recent study, insurance funds under perform non-insurance peers by more than 1% in average annual returns. Perhaps, as speculated by the authors of the study, this is due to insurance industry conservatism or lack of investor-driven incentives to pursue superior performance. Or perhaps, a possibility not mentioned by the authors, the weak performance is due to the absence of a fund board. See Xuanjuan Chen, Tong Yao & Tong Yu, *Prudent Man or Agency Problem? On the Performance of Insurance Mutual Funds* 1–3 (August 28, 2004), available at <http://ssrn.com/abstract=589801>.

188. Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (to be codified at 17 C.F.R. pts. 275 and 279), *invalidated* by Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

189. See Investment Advisers Act of 1940, 17 C.F.R. § 275.206(4)-7 (2006), *invalidated* by Goldstein v. SEC, 451 F.3d at 874.

cannot be at the office of every adviser at all times. Compliance officers serve as the front line watch for violations of securities laws, and provide protection against conflicts of interests.<sup>190</sup>

For hedge funds, external regulatory oversight ultimately resides with the SEC under its powers to regulate securities fraud and the fiduciary responsibilities of investment advisers under federal and state law, as well as with investors through contractual protections and their ability to “enter” and “exit” the fund.

### **B. MUTUAL FUND STRUCTURES OUTSIDE OF THE UNITED STATES**

Mutual fund boards are largely a U.S. phenomenon. Most other countries treat mutual funds as an investment “product” offered by investment management firms. The regulatory focus elsewhere is on the management firm, not the investment pool or its legal supervisor. Regulation of product terms (fees and management services), custodial responsibilities, and fund marketing is a matter of government agency supervision, with residual oversight by self-regulatory organizations and courts under a regime of fiduciary duties that fall on the management firm.

Consider the regulation of mutual funds in Germany, Japan and Britain. In Germany mutual funds are not separate entities, but instead segregated asset pools managed by an investment management firm that is regulated by the German Federal Banking Commission (BAKred).<sup>191</sup> Investors enter into a contract with the management firm and acquire participatory units in the segregated assets, with the management firm obligated to repurchase the units if redeemed by the investor. The assets must be kept with a custodian bank, which is obligated to supervise the management firm on behalf of fund investors. Thus, protection of fund investors in Germany is primarily the responsibility of the management firm, which has a statutory duty to act in the interests of fund investors. The management firm, in turn, is supervised by the custodian bank and the BAKred, both of which may bring suit against the management firm for failures to act. The BAKred may dismiss a fund manager who is unfit professionally or who violates the mutual fund rules.

In Japan mutual funds exist as investment trusts, with a trustee that must be a trust company or bank.<sup>192</sup> The trustee enters into a “contract of trust” with an investment trust management company, which must be licensed and is subject to statutory standards. The management company gives advice with respect to trust assets and has fiduciary duties in relation

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190. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. at 72,063.

191. Wang, *supra* note 3, at 951. The BAKred, among other things, specifies the qualifications for the mandatory managing directors of the management firm. *Id.* at 951–52.

192. *Id.* at 953–55.

to the assets, though not necessarily to fund investors. The trustee keeps custody and administers the trust assets. Fund investors have beneficial interests in the trust. The Ministry of Finance regulates the trustee, as well as the terms of the trust contract entered into with the management company. The management company is subject to the rules of a self-regulatory group, the Investment Trust Association.

In Britain mutual funds are unit trusts, constituted under trust law.<sup>193</sup> The trustee contracts with a manager (a firm or individual) that manages the trust assets, though the trustee retains custody and control of the assets. The trustee oversees the manager, though the manager typically appoints the trustee. To qualify as an authorized unit trust, the trust must comply with detailed regulations that cover its constitution, the power and duties of the trustee and manager, investment and borrowing powers, and pricing and valuation. The trustee and manager are both subject to regulation by self-regulating organizations. Government oversight comes from the Department of Trade and Industry, which has delegated most of its powers to the non-governmental Securities and Investment Board.

In addition, since 1997 mutual funds in the United Kingdom can be operated as open-ended investment companies (OEICs), which can be marketed elsewhere in the European Union.<sup>194</sup> An OEIC is established under company law rather than trust law. The OEIC owns the underlying assets and investors own shares that reflect their interests in those assets. The OEIC must have a board, though the only board member required is the authorized fund manager. Although independent directors are permitted, in practice nearly all OEIC boards are comprised of the manager alone. In addition, there must be a depository who has the same responsibilities for custody and oversight that the trustee has in the unit trust.

OEICs were designed to replicate the characteristics of unit trusts but with a corporate structure. For all practical purposes, the two are identical from the investor's standpoint. The OEIC provides a vehicle recognized in continental Europe; there were no other advantages seen to the corporate form. In both the OEIC and unit trust, the authorized fund manager makes the day-to-day investment decisions of the fund, prices portfolio assets, and maintains financial records. The role of the trustee and the depository are essentially identical, to safeguard portfolio assets, oversee the manager's activities, and ensure compliance with FSA rules. FSA regulation is the cornerstone of investor protection in the United Kingdom.

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193. *Id.* at 955–56.

194. American Enterprise Institute, *The Regulation and Structure of Collective Investment Vehicles Outside the United States* (May 2006), <http://www.aei.org/events/filter.all,eventID.1318/summary.asp#> (summary of a presentation by Richard Saunders, Chief Executive of U.K. Investment Management Association).

Investors in each country have, at best, a minimal role in fund governance. In Germany and Japan, investors have no voting rights.<sup>195</sup> In the United Kingdom, investors of unit trusts can vote on only four matters: changing the trust deed, approving departures from stated investment policy, removing the manager, and approving trust mergers.<sup>196</sup>

The “product” structure, compared to the “board” structure, of mutual fund regulation makes clear that investors are purchasing services from an investment management firm. The buck stops with the government regulator, who has collateral support from courts that enforce the fiduciary duties of the management firm and (in some countries) from self-regulatory organizations that set standards of professional conduct.

#### IV. CONCLUSION

At the time of the 1940 Act, it was inconceivable that the fund board would oversee fund families with hundreds of different funds, spanning the full range of modern investment styles, some with over \$1 trillion in assets under management. Equally unimaginable was the reality that mutual funds would become the primary investment vehicle for private retirement savings—surpassing company pension plans, bank accounts, and brokerage investments. And still more far-fetched was the likelihood, or so it seems, that mutual funds would supplant or even absorb the federal social security system as the funding vehicle for retirement income.

Regulatory outsourcing was an innovation of the 1940 Act—in marked contrast to the multi-faceted regulatory approach applied to public offerings under the 1933 Act and the nod to self-regulation of securities firms and stock exchanges under the 1934 Act. Rather than external supervision by the SEC or a self-regulatory organization (none existed), Congress delegated supervision to an internal regulator.

At best, the mutual fund board is an anachronism, a throw back to the time that the mutual fund was seen as an investment holding company (on the model of Berkshire-Hathaway) and the fund board a servant of investor interests. But the board suffers from fundamental structural flaws. Independent directors are neither independent of the management firm nor truly capable of being directors. They are selected by the management firm, rely on it for information and direction, and are paid (sometimes handsomely) not according to the results for fund investors, but based on currying continuing favor with the firm they are supposed to supervise. They are effectively limited in their power to fire the management firm, to revamp the business or sell it to outside buyers, or to enter into tough negotiations on behalf of fund investors.

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195. Wang, *supra* note 3, at 962.

196. *Id.*

The evidence bears out the fund board's inherent weakness and leads to the unavoidable conclusion that internal regulation cannot but fail. In a market that lacks effective arbitrage mechanisms to bring fund expenses into line, the board has no effective means to truly regulate management fees and ensure that fund marketing is in the interests of fund investors. Not surprisingly, as the mutual fund industry has exploded in size, and during a period of unparalleled advances in computer and telecommunications technology, the economies of scale and operational efficiencies have redounded to the benefit of management firms, not fund investors. Likewise, fund boards have approved loads and marketing fees that increase market share, thus boosting fees for the management firm, but without any benefit for fund investors. Rather than focusing fund marketing on investor education, the fund board has permitted advertising that exploits the informational defects and cognitive foibles of fund investors.

It is remarkable that in an industry widely described as heavily regulated, the board-centric structure faces so little accountability. Each of the potential sources of board monitoring—the SEC, federal courts, state courts—has adopted the attitude that somebody is doing the job. The SEC ultimately assumes that fund investors acting in markets will discipline wayward boards; the federal courts defer to the investor market and the regulatory function of the SEC; and state courts apply the business judgment rule, which assumes that markets are more discerning than judges.

At worst the fund board creates an illusion of investor protection. It allows the industry to tell the appealing story (however false) that the board serves as a “watchdog” against internal malfeasance, while fund investors exercise their powerful “entry/exit” rights to discipline management firm over-charging, over-trading, and over-marketing. The very existence of an internal monitor may actually be counter-productive. Rather than constraining management excesses, the presence of the supposedly independent board may actually embolden management firms to disregard their responsibility to fund investors, on the glib belief that the board performs its functions. Behavioral studies show that fiduciaries led to believe that someone else is protecting the interests of their beneficiaries tend to minimize and slacken their own fiduciary performance.<sup>197</sup> A lackadaisical watchdog may be worse than no watchdog at all.

Look again there.

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197. Daylian M. Cain, George Loewenstein & Don A. Moore, *The Dirt on Coming Clean: The Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 1, 9 (2005) (finding that when subjects asked to guess the amount of money in a jar, with the help of an “adviser” who had disclosed conflicting interests, the subjects were more likely to trust the adviser on the theory disclosure evidences good faith, and the adviser feels greater moral freedom to act selfishly on the theory the subject has been put on notice).