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Protecting Mutual Fund Investors: An Inevitable Eclecticism

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___. Protecting mutual fund investors: an inevitable eclecticism

Lyman Johnson[*]

1. INTRODUCTION

After 75 years of experience with the Investment Company Act,[1] improving investor protection remains an ongoing, multi-faceted, and frustratingly elusive endeavor. Certain regulatory approaches have been more – or less – emphasized over the years, but today we still lack an agreed-upon singular "silver bullet" for assuring investor protection and must, of necessity, pursue an ever-evolving, eclectic approach to that central policy goal. Our understanding of open-end investment companies (mutual funds) has been greatly enriched in recent years by theoretical and empirical scholarship, but how best to achieve protection of investors remains, pragmatically, highly contentious and no more tractable.

This chapter describes the various approaches taken to investor protection since 1940 and argues that moving on many, admittedly imperfect, fronts is the best regulatory strategy today and probably the only politically viable one in any event. Board-centered, investor-centered, SEC-centered, and market-centered solutions are all flawed standalone responses, and each of the four can be incrementally improved, but unless broad consensus forms around emphasizing only one or two approaches, investors are best protected through a medley of efforts. Given the dynamics of today's mutual fund industry, regulatory stances must be adaptive and diverse, with each of the four approaches working in tandem with, not in opposition to, the others.

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[1] Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (1940) (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-64 (2012)).

Part 2 identifies the industry abuses that animated enactment of the federal Investment Company Act of 1940 (the "Company Act" or the "Act"). Although the historical particulars of those investor vulnerabilities have changed, the essential plight of the modern investor in a mutual fund remains the same, given the inherent organizational structure of investment companies. Mutual funds are organized under state law – typically that of Maryland corporate law or Massachusetts or Delaware trust law – and thus are subject to state law as well as federal regulation. But state statutes are notoriously lax and do not provide meaningful investor protection.[2] State common law fiduciary duties also govern mutual fund boards of directors, as they do directors of regular corporations and other business entities, but these too have generally proven to be of little remedial significance (Johnson 2008).[3] It is federal law – the Act – that remains the regulatory heart of the investor protection objective.

Part 3 canvases the four key approaches to investor protection, all of which are both understandable and faulty. A board-oriented approach should be retained but with a reconceived vision of the mutual fund board as the investors' representative, pure and simple, not truly a "company" governance body. This is because, unlike the traditional business corporation, mutual funds are not operating companies but are collective action mechanisms, and mutual fund governance is not "board-centric" but is "advisor-centric." The organizational structure of a fund, in which fund assets and management assets are housed in separate vehicles, when coupled with ease of investor exit, undoubtedly makes the mutual fund board far less effective than analogies

[2] In 1996, The National Securities Market Improvements Act significantly preempted state regulation of mutual fund operations and substantive disclosures. States may still require notice filings and payment of certain fees, and they may bring actions relating to fraudulent activity.

[3] A recent Ninth Circuit decision, however, held, somewhat unusually for mutual funds, that a fund's investors could bring a breach of fiduciary duty action against a fund's trustees and investor advisor as a direct rather than derivative action with respect to a mutual fund organized as a Massachusetts business trust. *Northstar Financial Advisors Inc. v. Schwab Investments*, 779 F.3d 1036 (9th Cir. 2015). A subsequent dismissal by the District Court has been appealed.

to corporate governance suggest, as Professor Morley has insightfully observed (Morley 2014). Nonetheless, the board's enhanced if narrowed effectiveness remains important for several reasons, including the need to take seriously the conflicted advisor's fiduciary duties, particularly in shaping salutary ex ante norms in fund-advisor dealings.

As to investor-oriented approaches, the redemption right will always be the most robust investor protection mechanism, but it tends to be a backward-looking ex post solution, and many investors demonstrably stay in high-fee funds, notwithstanding cheaper options offering equivalent returns. Investor-oriented options can be incrementally improved, however, with the key policy issue being whether §36(b) should be substantially bolstered or remain only of ex ante force, with a candid acknowledgement that it currently affords scant hope for meaningful ex post remedial relief. SEC-centered regulation can substantively curb new abuses and offer both guidance to, and investigations of, directors and advisors, and provide agency enforcement on behalf of investors that goes well beyond § 36(b). And although market forces are constrained in some ways, to be sure, industry competition is not insignificant, and recent investor migration toward passive, low-fee funds mitigates somewhat the concern over fund expenses, a central concern in the quest for investor protection.

2. THE INVESTMENT COMPANY ACT AT 75 AND THE CHALLENGE OF INVESTOR PROTECTION TODAY

The Act was adopted in the wake of the SEC's 1938 and 1939 Reports on Investment Trusts and Investment Companies.[4] Those Reports noted the dependence of the shell-like mutual funds on their third party investment advisors and also chronicled a litany of investment fund abuses that

[4] Securities and Exchange Commission, Investment Trusts and Investment Companies, H.R. Doc. No. 707, 75th Cong. 2nd Sess., pt. 1 (1938); SEC, Investment Trusts and Investment Companies, H.R. Doc. No. [ ] 76th Cong. 1st Sess., pt. 2 (1939); SEC, Investment Trusts and Investment Companies, H.R. Doc. No. 279, 76th Cong. 1st Sess., pt. 3 (1939).

harmed investors. These included rampant self-dealing practices, lax custody of securities, inadequate investor information, lack of effective shareholder control over investment objectives or strategies, excessive leverage and inadequate capital, and others.[5] To combat these, the stated purpose of the original Act was "to mitigate and, so far as is feasible, to eliminate the conditions … which adversely affect the national public interest and the interest of investors."[6] Of course, abusive practices have not been altogether eliminated, as the late trading and market timing scandals of the last decade attest.[7] Troubling as various investor-harming practices are, however, they do not cost investors nearly as much as substantial, ongoing management fees,[8] a persistent and perplexing policy concern.

Regulatory efforts, of course, are always a step (or more) behind fast-moving market actors, but the decades-long conundrum of protecting mutual fund investors stems from an unusual, core feature of fund organizational structure, a feature identified long ago by the SEC,[9] noted by the Supreme Court,[10] and theorized as central to understanding funds and their regulation by Professor John Morley (Morley 2014; Morley and Curtis 2010). The investment company exists as a separate corporation or trust formed under state law, it obtains funds from investors (and issues securities in return), and it has a board of directors (or trustees), much like other companies. Management of investment company assets, however, is not undertaken internally, but instead is provided by an external investment advisor pursuant to an advisory

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5 *Id.* *See generally*, Roiter (2015) at ___.

6 Act, § 1(a)(b). The Act today requires that SEC rulemaking action, besides protecting investors, should consider the promotion of efficiency, competition, and capital formation. Act, § 2(c).

7 For a description of these practices, *see* Birdthistle (2006) at 1453-56, 1458-60.

8 *See* Johnson (2008) at 503, n. 28 (collecting authorities).

9 *See supra* note 4.

10 *Burks v. Lasker*, 441 U.S. 471, 480 (1979) (recognizing the potential for abuse inherent in the structure of investment companies).

contract negotiated and approved by the fund's board of directors.[11] Typically, moreover, it is the advisor itself that establishes and sponsors the investment company and then contracts with it to provide all necessary personnel, facilities, and expertise, and make all investment decisions. The company itself, albeit possessing a distinct legal identity, essentially is merely a pool of portfolio securities, options, futures, loans, cash, or cash equivalents.[12] Thus, investor funds are combined via the mutual fund company and portfolio securities are housed in the mutual fund structure, but all management-related assets are located in the separately-organized investment advisor, thereby achieving a sharp partitioning of essential assets and fiduciary focus (fund investors versus advisor shareholders), quite unlike most other business corporations. The advisor manages its own and the company's assets, and quite clearly stands in a dominant and controlling position with respect to the fund and its investors.[13]

From an organizational structure standpoint, this institutional reality has led some to describe mutual funds as "products," not traditional companies or securities,[14] with an urging that regulatory policy reflect that difference. From a governance standpoint, mutual funds are neither board-centric nor shareholder-centric, but instead are advisor-centric, i.e., advisors hold the most power. The central organizational and regulatory concern is that the all-powerful advisor will act to promote its own interests by, for example, extracting excessive fees and other value from fund assets, rather than faithfully serving the interests of investors, leading the

[11] Section 15(c) of the Act requires that the advisory contract be approved annually by a majority of the directors on the fund's board and by a majority of the "non-interested" directors. Act, § 15(c) (2014).

[12] Birdthistle (2006) at 1409-10.

[13] The SEC has expressed its continuing concern that "many boards continue to be dominated by their management companies." Investment Company Governance, Investment Company Act Rel. No. 26, 520, 69 Fed. Reg. 46,378, 46,381 (Aug. 2, 2004).

[14] Morley & Curtis (2010) at 103; Fisch (2010) at 2027-35. Professor Anita Krug (2013) somewhat relatedly advocates a financial services model of regulation because she sees mutual fund investors more as customers than shareholders of a firm. For an acknowledgement of that characterization but also a criticism of it from a regulatory perspective, *see* Langevoort (2005) at 1037 ("Once the mutual fund is viewed as a product to be marketed … then any notion that the producer is a 'fiduciary' is awkward and disorienting."). This issue will be returned to in Part III below.

Supreme Court to note both "the potential for abuse inherent in the structure of investment companies,"[15] and the Act's efforts to address the obvious advisor conflicts.[16]

The advisory contract typically charges a fee based on a percentage of assets managed and not on fund performance. Investors benefit from a lower percentage while the advisor obviously prefers a higher percentage. Moreover, advisors have an incentive to maximize assets under management because that alone raises the aggregate fee even when the performance of the fund falters. Investors, on the other hand, gain only by enhanced fund performance – i.e., higher investment returns – and lower expenses, or both.

Academic literature has identified several conflicts between mutual fund investors and advisors as a result of fund structure.[17] These include differences in financial incentives, differences in investor and advisor risk tolerances, and cross-subsidization of funds within a fund complex.[18] A simple illustration of the first, drawn from an SEC study, highlights the problem:

> New mutual fund investments are highly sensitive to published reports of annual performance. Because greater performance implies greater net fund inflows and greater net inflows imply greater management fees, managers may alter the risk of the fund to indirectly maximize their won compensation. If a fund is ahead of expectations halfway into the reporting period, managers may "pull back" from the strategy preferred by investors and reduce the risk of the portfolio in order to lock-in the present level of returns, attract more assets and maximize fees from investors. Conversely, if the fund is underperforming during the year, managers may be tempted to "gamble" and increase the risk of the portfolio to try and catch up to the market so they can minimize the impact on fees.[19]

The extent to which the inherent structure of the fund-advisor relationship generates investor-harming conduct, in light of such mitigating factors as easy investor exit and some

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15 *Burks v. Lasker*, 441 U.S. 471, 480 (1979).

16 *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536-41 (1984). *See also, Jones v. Harris Assoc., L. P.*, 559 U.S. 333, 338 (2010).

17 Memorandum from Chester Spratt, Chief Economist, Office of Economic Analysis, SEC, to Inv. Co. File S7-03-04, at 10 (Dec. 29, 2006) [hereinafter OEA Study] (reviewing literature), *available at* http://www.sec.gov/rules/proposed/s70304/oeamemo122906-litreview.pdf.

18 *Id.* at 5-7 (describing conflicts and academic literature).

19 *Id.* at 5 (citing literature); *see also* Jeff D. Opdyke, *Mutual Funds Avoid Risk to Lift Ratings*, WALL ST. J., Feb. 28, 2007, at D2 (describing Goldman Sachs study indicating that large-company equity mutual funds sidestep risk to reduce price volatility and gain higher Morningstar ratings so as to attract and retain assets under management).

degree of competition in the mutual fund market, has been widely and inconclusively debated.[20] The innate conflict between advisors and investors is hard to deny, however, and is compounded by another common feature of investment companies: officers and employees of the investment advisor frequently serve on the investment company's board of directors. As members of the investment company board, they owe a duty of loyalty to fund investors.[21] As decisionmakers for the advisor, however, they both personally benefit from and are in a position to take actions that are good for the advisor but adverse to the interests of investors. The significance of this structural conflict of interest is significantly exacerbated by investor inability to directly observe or communicate with and influence the advisor, thus dampening investor self-help.

In addition to structural concerns, there are a limited number of investment advisors, notwithstanding that there are thousands of mutual funds. For example, in 2013, the vast majority of the 7,707 U.S mutual funds, having 23,353 different series, were managed and advised by the top 300 investment advisors.[22] Thus, investor movement away from a particular fund is not necessarily movement away from an advisor. And individual directors frequently serve on more than one company board within a mutual fund complex managed by the same advisor. A 2014 survey, for example, revealed that 86% of fund families under the same advisor had "unitary boards" where the same individuals served on the board of every fund in the family.[23] Thus, problems with conflicts between one company and its advisor likely plague all funds in the same family.

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[20] *See* Morley & Curtis (2010) at 92, n. 11 (citing literature). *See infra* Part 3D.

[21] Johnson (2008) at 507.

[22] FT Special Report: Top 300 Investment Advisers (June 26, 2014), *available* at http://ft-static.com/content/images/6c30552e-fb45-11e3-8959-00144feab7de.pdf.

[23] Overview of Fund Governance Practices, 1994-2014, Investment Company Institute and Independent Directors Council 5 (2015). This is up from 81% in 2007. Investment Company Institute and Independent Directors Council, OVERVIEW OF FUND GOVERNANCE PRACTICES, 1994-2006 (2007). *See* Sophie Xiaofei Kong & Dragon Yongjun Tang, *Unitary Boards and Mutual Fund Governance*, 31 J. FIN. RES. 193 (2008).

In sum, the two warring constants since 1940 have been the centrality of investor protection as a policy goal and the conflict-prone, advisor-controlled organizational structure of mutual funds.[24] The various regulatory initiatives historically aimed at augmenting investor welfare in light of this institutional reality are traced below.

3. VARIED, CONCURRENT APPROACHES TO INVESTOR PROTECTION

Today, protection of mutual fund investors is sought through various approaches. These approaches have evolved over 75 years and include board-centered efforts, investor-focused efforts, direct SEC regulation, and reliance on the workings of competitive markets. All of these initiatives have clear shortcomings that commentators have eagerly pounced on, and, to different degrees, most are changing on an ongoing basis, with investor-oriented efforts being the most stagnant in recent decades. Given the inherent structural conflict at the heart of mutual fund organization, the current multi-front regulatory stance is, Sisyphus-like, inevitably fated to be inadequate while also being, overall, a pragmatic strategy likely to endure unless consensus for a fresh approach forms among various powerful constituencies associated with the industry.

A. Board-Centered Efforts

1. The Overloaded, Conflicted But Unavoidable Mutual Fund Board

A mutual fund board plays an important but far more limited governance role than does a typical corporate board. This stems from the fact that, as noted in Part 2 above, the fund's assets are entirely managed by the investment advisor. In fact, the advisor organizes the fund and,

[24] Professor Morley argues that the organizational structure of mutual funds – what he calls the "separation of funds and managers" – benefits fund investors and is a central and longstanding feature of fund structure for that reason. Morley (2014) at 1232, 1279. At the same time, the structure presents a pointed clash of interests, with the relevant issue being whether one or more regulatory approaches best addresses that clash.

owning the initial securities of the fund, appoints directors and approves the advisory contract between the fund and itself. Only then, with the chief governance mechanism already in place, does the fund sell securities to outside investors. In short, the advisor, not outside investors or an independent fund board, is the moving party with respect to hiring fund management.

The chief responsibilities of the board under the Act are to annually evaluate and approve the advisory agreement, with a majority of independent directors so voting;[25] annually approve distribution arrangements, including Rule 12b-1 plans permitting the use of fund assets to pay distribution expenses;[26] value securities for which market quotations are not readily available;[27] approve of an auditor;[28] make arrangements for third-party custody of securities;[29] and monitor affiliated transactions.[30] Boards also must oversee risk management and monitor fund compliance programs – recently bolstered by SEC rules requiring funds and advisors to have Chief Compliance Officers[31] – and they must adopt proxy voting guidelines. Boards, however, do not chart the investment strategy of the fund or actually manage fund assets, both of which are done by the advisor. Boards have the right to, but apparently never do, terminate an advisor. Changing advisors requires a shareholder vote – deeply problematic as Professor Morley notes (Morley 2014) – and industry norms make it essentially taboo. After all, investors choose funds because of their advisors, not because of their directors.[32] Mutual fund governance, in short, is decidedly "advisor-centric," not "board-centric" in thrust.

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[25] Act, § 15(a), (c).

[26] 17 C.F.R. § 270.12b-1 (2012).

[27] Act, § 2(a) (41).

[28] *Id.*, § 32.

[29] *Id.*, § 17(f).

[30] *Id.*, §§ 10(f), 17 (a), (d), (e).

[31] 17 C.F.R. § 270.38a-1.

[32] Investors in most business corporations likely base their investment decisions on who the company's managers are, not who the directors are. Given the board-centric nature of corporate governance, coupled with more engaged investor voting and activism in that milieu, disenchantment with managers frequently

Acknowledging the reality of the advisor-primacy nature of fund governance,[33] and preserving broad advisor control over fund management, the Act permits directors affiliated with the investment advisor to comprise up to 60% of board positions.[34] In other words, only 40% of the fund directors must not be "interested persons." Moreover, the concept of "interestedness" under the Act is far narrower than the concept of "independence" under Delaware corporate law,[35] and certain types of directors who lack independence under the latter would be considered independent under the Act.[36] Thus, not only does the Act require fewer directors, numerically, to be independent, the Act has a more generous definition of independence than does Delaware corporate law in key conflict contexts, such as with self-dealing transactions, dealing with derivative litigation, and addressing mergers and sales. Whatever one thinks of the tendency to draw from corporate governance analogies,[37] for a body of federal law that exists to address an inherent conflict, the chief governance body for monitoring that conflict is not very strictly configured. Moreover, mutual fund directors, realistically, cannot truly *function* independently in the Delaware sense of retaining the power to say "no" to the investment advisor or its contract,[38] because the advisor is indispensable to the fund and investors purchase the fund because of its advisor, not because of its directors.

Notwithstanding the Act itself, citing parallel developments in corporate governance generally,[39] in 2001 the SEC conditioned reliance on certain exemptive rules on a mutual fund

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leads to management departure, whereas with advisor-centric mutual funds and easy investor exit, such disenchantment is more likely to lead to investor departure.

[33] Roiter (2015) at ___.

[34] Act, § 10(a).

[35] Act, § 2(a)(19); *see* generally, Johnson (2008).

[36] *Id.*

[37] *See, e.g.*, Krug (2013), Birdthistle (2006), Langevoort (2005), Palmiter (2006b), Markham (2006).

[38] *See Kahn v. Tremont*, 644 A.2d 422 (Del. 1997); *In re First Boston S'holders Litig.*, 1990 WL 78836 (Del. Ch.) (describing "the power to say no.").

[39] Roiter (2015) at note 172.

board having a majority of independent directors.[40] Besides requiring a majority of independent directors in order to rely on those exemptive rules, the independent directors must select and nominate other independent directors, counsel for the independent directors must be independent, boards must conduct annual self-assessments, and independent directors must meet in executive session at least quarterly.

Due to various onerous substantive restrictions in the Act that require express SEC waiver, the ability to broadly rely on a host of exemptive rules is very significant to funds and their advisors. This agency action on the independent director front, however, followed rather than caused the industry's own movement toward boards with a majority of independent directors, likely the result of evolved corporate norms generally. This eventual industry trend toward greater independence had been given a strong judicial endorsement in 1979 when the Supreme Court characterized independent directors as the "cornerstone" of efforts to address fund conflicts.[41]

This policy initiative by the SEC reflected an effort to shift more of the burden of oversight of funds and their advisors to independent directors and away from the agency, a reversal of earlier agency skepticism about the efficacy of boards (Roiter 2015). This may have stemmed from a sincere if altered belief that boards with a majority of independent directors were truly up to this monitoring task, but it no doubt was the product of necessity as well, because the SEC simply could not continue direct oversight of the rapidly growing mutual fund industry.[42] A 2004 effort by the SEC to require that 75% of a fund's board members be

[40] Role of Independent Directors of Investment Companies, Investment Company Act Rel. No. IC-24816, 66 Fed. Reg. 3734 (Jan. 16, 2001).

[41] *Burks v. Lasker*, 441 U.S. 471, 482 (1979). *See also*, Bullard (2008) at 309.

[42] In 1990, there were 2,395 mutual funds but at the end of 2000, there were 6,876. Rob Silverblatt, *Are There Too Many Mutual Funds?*, U.S. NEWS & WORLD REPORT (June 10, 2013).

independent and that the board have an independent chair was twice struck down on procedural grounds.[43]

In sum, today mutual fund boards have a growing number of responsibilities as the SEC looks to independent directors to play a larger role in protecting investors. For example, new regulation of money market funds – phased in beginning in July 2015 – will require the board to decide whether and when to impose liquidity fees and redemption gates.[44] And the SEC recently brought actions against independent fund trustees for failure to satisfy their § 15(c) requirements in approving the advisory contract,[45] an obvious strong signal to fund boards generally to take seriously that baseline responsibility. Compliance and risk management also now loom large as key responsibilities of fund directors. But boards, as always, still lack real power over the fund's investment strategy, assets, and management because those are controlled by the advisor. Thus, more and more is expected of a body that does not grow in core strength. Perhaps the board, as Professors Morley and Curtis, like Professor Krug, propose (Morley and Curtis 2010; Krug 2013), should be eliminated. Or, perhaps, like the mutual fund itself, the mutual fund board is misconceived.

2. Reconceiving the Misconceived Board

a. *Mutual Funds as Collective Action Mechanisms*

Although almost all mutual funds are organized as corporations or trusts, with each considered a "company" under the Act, any organized group of unincorporated persons also can

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[43] Johnson (2008) at 498, nn. 3-5 (describing the litigation). Nonetheless, as of 2014, eighty-three percent of all fund complexes report that 75% or more of their directors are independent. Overview of Fund Governance Practices, 1994-2014, Investment Company Institute and Independent Directors Council 1, 6 (2015).

[44] *See* Sean Graber & John J. O'Brien (2015) at 5.

[45] Commonwealth Capital Management, Investment Company Act Release No. 31678 (June 17, 2015). The SEC stated that, "As the first line of defense in protecting mutual fund shareholders, board members must be vigilant,…" *Id.*

be a "company."[46] As companies, mutual funds have distinctive legal personhood, and corporate personality necessarily entails important rights, as seen in the corporate context in the Supreme Court's 2014 *Hobby Lobby* decision.[47] In 2011, the Supreme Court took corporate personality quite seriously in the mutual fund context by holding that the board, not the advisor, had "ultimate authority" over a fund, and thus the advisor was not liable for "making" a statement for Rule 10b-5 purposes.[48] As a matter of state law and the Act's definition, that ruling made sense; as a matter of organizational structure and market reality, it was absurd.[49] But in fact, the entire edifice of federal mutual fund policy is built on this same faulty predicate of misemphasizing the significance of state law organizational form.

For a mutual fund to be organized as a trust or corporation under state law is to be whole and sufficient as a legal entity. To be a functioning mutual fund, however, legal existence is a necessary component, but it is not sufficient without also engaging an investment advisor. Federal mutual fund policy, however, can take seriously the separate legal personality of state-created corporate/trust entities without also taking their company governance regime seriously, given that critical advisory services are external and not internal to the company. A mutual fund thus is a legally distinct entity, but as such it is best understood as an organizational mechanism for pooling investor assets and efficiently coordinating collective action by investors, who are the sole constituency. Such a fund is "mutual" in that it is the investors alone who stand in a

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46 Act, § 2(a)(8).

47 *Burwell v. Hobby Lobby Stores, Inc*., 134 S.Ct. 2751 (2014).

48 *Janus Capital Group, Inc. v. First Derivative Traders,* 131 S.Ct. 2296 (2011). The SEC has sought to limit the *Janus* holding in enforcement actions by interpreting it as applying only to claims under Rule 10b-5(b), and not to claims under Rule 10b-5(a) or (c). In the Matter of John P. Flannery and James D. Hopkins, Securities and Exchange Commission, Investment Company Act Rel. No. 31374 (Dec. 15, 2014); accord, *SEC v. Strebinger*, 2015 WL 4307398 (N. D. Ga.).

49 Morley (2014) at 1287, n. 145 (citing scholarly consensus).

common relationship to one another via the "fund" vehicle.[50] The fund, moreover, has no purpose other than to act in the investors' interest. Thus, there is no "corporate" business purpose separate and distinct from advancing investor interests; nor, therefore, is there any business necessity for "locking in" investor capital, which explains the easy redemption right and ability to withdraw fund assets at will. And the mutual fund has also are no other non-investor stakeholders, such as employees, consumers, and so on.

This characterization of mutual funds, while distinguishing them from corporations generally, does not, however, mean that investments in such funds are better understood as products as some commentators contend (Morley 2014; Fisch 2010). Purchasing a security in a fund is the pathway to procuring a financial good, to be sure, but the security carries other attributes as well. Importantly, it includes the right, along with other investors, to have their dispersed, collective interests represented by a body (the board) owing fiduciary duties to them precisely because they are many in number and dispersed, unable to monitor quality firsthand, and thus in need of a spokesperson. This is not the case with individual purchasers of products. The security also carries a standing redemption right entitling the holder to exchange the security for cash from the fund, thereby withdrawing assets from the fund provider, also a feature unlike a consumer product lacking a money-back guarantee. And even though the board does not govern as does a traditional board that oversees a discrete enterprise requiring locked-in assets, the board nonetheless is the representative of investors in their dealings with the advisor, somewhat akin to a corporate board negotiating a sale with a third-party tender offeror on behalf of investors. The mutual fund vehicle thus efficiently organizes and facilitates investor pooling of funds to a scalable investment level, and the retention of a board to act for investors in dealing with the

[50] The term "mutual fund" is the customary, marketplace term. The legal term is "open-end company." Act, § 5(a)(1).

advisor places in a small decisionmaking body a focused responsibility for those aspects of investor welfare not advanced by investor exit, thus reducing collective action and free riding issues.

b. *The Mutual Fund Board as Investor Governance Representative, Not Company Directors*

Correctly understanding a mutual fund as a distinct legal person defined under the Act as a "company," but one with a special, limited purpose of pooling investor assets and advancing investor interests, thus alters how we see the board of directors. The board does not advance some larger "corporate" purpose as do regular business companies such as Apple or Ford or countless others, but that does not mean the board serves no purpose as some contend (Morley 2014; Krug 2013), only that its function differs from that of a typical corporate board (Roiter 2015). The board is the investors' representative, pure and simple. Of course, the board's primary responsibility is the annual negotiation of the advisory contract. The widely dispersed investors cannot all interact with the advisor, just as bondholders cannot engage efficiently with an institutional borrower but must instead act through a trustee under a trust indenture. Negotiating the advisory contract is an especially central and financially important function given that the advisor itself stands in a fiduciary relationship to the investors with respect to its fees.[51] Courts always have strictly scrutinized self-dealing by fiduciaries and one meliorating consideration in the judicial review of such interactions is the interjection of an independent investor representative to bargain with the conflicted fiduciary.[52] Bargaining in the mutual fund

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[51] Act, § 36(b).

[52] *See, e.g.,* Kahn v. M&F Worldwide Corp, 88 A.3d 635 (Del. 2014). Of course, in § 36(b) litigation such judicial scrutiny has been distressingly absent. Johnson (2008).

setting may be constrained, but without a board the conflicted advisor would simply set its own fees.

Boards of regular business corporations could manage their companies if they chose to,[53] but in public companies they internally delegate that function to skilled officers, who are employees of the company itself. Boards of mutual fund companies, by way of contrast, cannot manage the fund internally; they hire no employees but instead contract with the advisor for all operational aspects. Moreover, the Act substantially limits the board's role in setting investment strategy (Roiter 2015); both structurally and operationally, the advisor controls strategy. Thus, mutual fund boards, as shareholder representatives only – not company directors – make no "business" decisions, and application of the business judgment rule to them makes no conceptual or policy sense. Courts therefore should not invoke that ill-suited doctrine in the mutual fund context.

Boards of mutual fund companies, in relation to investors, more closely reflect what Michael Jensen and William Meckling, in their seminal 1976 work,[54] term a "principal-agent" relationship. Jensen and Meckling, non-lawyers, articulated an organizational theory to explain, generally, the relationship of shareholders to directors in a business firm. In using the simplifying terminology of principal-agent, they failed to capture legal reality because corporate directors of operating companies are not agents of shareholders or of the companies they direct.[55] But in the mutual fund organizational structure, even though directors are not subject to direct control by shareholders, they have no purpose other than to advance investor interests and are

[53] In many non-public companies there is considerable overlap of directors and managers.

[54] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 309 (1976).

[55] *See* David Millon, *Radical Shareholder Primacy*, 10 U. ST. THOMAS L. J. 1013, 1022-23(2014).

much closer to Jensen and Meckling's conception of an "agent" for their "principal" (investors) than is a corporate board.

The board, functionally, mediates between the investors qua investors and the advisor. It represents the collective interests of the investors, and is to act on their behalf and solely in their best interest. It should be the consummate investor advocate, and, exercising broad discretionary power over the investors' non-exit relationship to the advisor via the advisory contract, the board stands in a fiduciary relationship and owes fiduciary duties.[56] Conceiving of boards in this way gives far sharper focus to their role – and the challenges they face – than does the faulty notion that they somehow govern a "company."

Conceiving of the mutual fund board as a representative (or agent) of investors via the vehicle of the fund itself accomplishes several purposes. First, it more realistically describes the narrowed function of the board than does the faulty business corporation director analogy. Second, it accounts for the persistent institutional and marketplace reality that mutual fund boards exist, however roundly criticized and constrained they may be. Third, of necessity, given an enduring fund structure employing external advisors, someone must, on behalf of investors, negotiate the advisory contract, lest the conflicted advisor simply set its own fee; that someone is the board. Fourth, and relatedly, as a fiduciary the advisor is better able to demonstrably fulfill its fiduciary duty to investors if it bargained over that fee with an independent representative who itself is a fiduciary.[57] Fifth, although § 36(b) has proven to be a very anemic ex post remedial provision, likely the customary negotiating ritual between boards and advisors has generated industry norms and a culture that overall are better for investors than would be the case

[56] *See* Ernest J. Weinrib, *The Fiduciary Obligation*, 25 U. TORONTO L. J. 1 (1975) (explaining the rationale for a relationship being fiduciary in nature); but *see* Act, § 36(a)(SEC may bring action only where breach of fiduciary duty involved personal misconduct).

[57] This is not to say that courts have done a good job on this point in the § 36(b) fee litigation context, because they have not, as discussed in Part B below.

with unilateral advisor fee setting. And these norms can, in theory, constrain advisors and bolster board bargaining power ex ante. Finally, however easy fund-to-fund fee comparison is for most reasonably savvy investors, it appears that many mutual fund investors do not shop for low fee providers because high-fee funds continue to exist and continue to hold substantial assets (Morley & Curtis 2010), notwithstanding recent inroads by passive, low-fee funds.[58] Thus, competition alone appears not to uniformly drive down fees. The board, therefore, within acknowledged constraints, may be able to exert pressure to constrain or reduce fees in higher-fee funds in a way market forces alone do not. A board-centered approach, however, whatever the arguments for preserving efforts on this front, is inadequate by itself for assuring investor protection, and is only one component of a multi-faceted strategy aimed at that goal.

B. **Investor-Focused Efforts**

Notwithstanding the SEC's modern return to focusing on boards as a pivotal means for enhancing investor protection, both the SEC and the Act itself have also emphasized investor-focused efforts. Although investors have long had certain voting rights and, since 1970, a potential claim against the advisor for excessive fees, these are of little governance or disciplinary significance. Other corporate accountability forces such as a market for corporate control, activist institutional investors, and performance-based management compensation also are largely absent from the mutual fund industry. Today, the investor redemption right is of paramount importance, and other investor-focused efforts have stagnated and need bolstering.

[58] This is described in Part D below.

1. Voting and Exit

Although the Act requires an investor vote on the advisory contract, this measure for protecting investors is sidestepped at the fund's formation by the advisor voting, as the initial investor, to approve the contract. Advisory contracts can be extended without an investor vote if independent directors annually vote to approve the agreement. Incumbent directors also may fill board vacancies as long as, thereafter, at least two-thirds of fund directors have been elected by investors.[59] Any change in advisor, fees, or investment policies, however, would require a vote of existing investors.[60] This itself likely constrains a board's willingness to terminate, or threaten to terminate, an advisor in negotiations. The Act does not require annual shareholder meetings, and investor voting initiatives and director election contests are virtually unknown (Morley 2014). In short, investor suffrage plays a limited role in protecting mutual fund investors.

Mutual fund investors, unlike shareholders in regular business corporations, can withdraw cash from the fund by exchanging their securities. This redemption right is, in practice,[61] available on a daily basis and, in essence, means investors have a standing "put" option to liquidate their position. Professor Morley has argued at length that this exit right is the "dominant" investor strategy and that it almost completely eliminates investor incentives to use board representation, voting, and fee litigation, and, therefore, those approaches are of limited value (Morley & Curtis 2010; Morley 2014). Assessing on a cost/benefit basis a disgruntled

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[59] Act, § 16(a).

[60] Act, §§ 13(a)(3), 15(a).

[61] As Professor Morley notes, the Act mandates only that investors be permitted to withdraw funds within seven days of demand, Act, § 22(e), but, in practice, almost all funds permit daily redemption. Morley (2014) at 1247, n. 42.

investor's choices among exit, activism, or doing nothing, Morley concludes that exit and doing nothing are more likely than an activist voting strategy.[62]

Morley's analysis illuminates why activism is not an attractive option for investors, but it does not explain why some dissatisfied investors do nothing while others exit. These are starkly different responses and open the door to the need for other approaches to investor protection, given this phenomenon. As Morley acknowledges,[63] and an SEC study has confirmed, evidence establishes that some investors neglect their investments, with such inaction resulting in "sticky" fund assets, or they choose funds for the wrong reasons. This seems to be a significant behavioral hurdle to exclusive reliance on exit as a protective mechanism.

Moreover, even less supine mutual fund investors may not be as vigilant or adept as easy exit implies. Investors may exit for wrong reasons just as they may stay invested for too long in pricey or underperforming funds. And investors who exit cannot prevent already-incurred high fees, wrongdoing, or poor performance, nor can they easily detect the latter two elements on an ongoing basis. Their exit option largely, at least from a dissatisfaction standpoint, is past-looking; it treats a problem prospectively but does not necessarily prevent or rectify past harms or ongoing harm to remaining investors. And determining where to put funds, once withdrawn, requires time, effort, and study of the manifold possible investment options, itself daunting for many and likely one factor leading to inertia for many investors. Exit is powerful and attractive, but it is not a panacea.

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[62] *Id.* at 1251. Mutual funds themselves, however, are increasingly joining activists in seeking change at U.S. companies. David Benoit and Kirsten Grind, Activists' Secret Ally: Big Mutual Funds, WALL ST. J., Aug. 10, 2015, at A1.

[63] Morley & Curtis (2010) at 114.

2. § 36(b) Litigation

a. *Unlikely Ex Post Remedies; Ex Ante Norm Shaping*

After decades of a board-centered approach to investor protection, as supplemented by investor exit and voting rights, in 1970 Congress sought to bolster the investor-oriented approach.[64] Congress added § 36(b), which creates a cause of action against the investment advisor for excessive fees. This followed a 1966 study by the SEC that concluded it was "unrealistic" to believe independent directors could protect investors in their fee negotiations with the advisor,[65] for the simple reason that directors cannot realistically threaten to terminate the advisor, thus weakening their bargaining position.[66]

Section 36(b) specifies that an investment advisor of a registered investment company "shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services."[67] The section provides that the SEC or a security holder of the company, but not the company itself, may bring an action on behalf of the company against the advisor or any affiliated person "for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such adviser or person."[68] Strictly speaking, the action is not a "derivative" action because the company itself cannot initiate a lawsuit.[69] This frees an investor from any need to make a demand on the board of directors before beginning the suit.[70] Section 36(b)(1) mandates that the plaintiff "shall have

64 Investment Company Act of 1970 § 36, 15 U.S.C. § 80a-35(b).

65 SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89TH CONG. 2ND SESS. at 148 (1966).

66 *Id.* at 131. Of course, in the early 2000s, the SEC once again argued that independent directors were important to investor protection. *See supra* notes 39-43 and accompanying text.

67 Investment Company Amendments Act of 1970 § 36(b), 15 U.S.C. § 80a-35(b) (2000).

68 *Id.*

69 *Id.*; *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (1984).

70 *Fox*, 464 U.S. at 527-28.

the burden of proving a breach of fiduciary duty."[71] Personal misconduct, however, is not an element of the claim.[72] No action may be brought against a person who is not the recipient of compensation, and any award of damages against such recipient is limited to actual damages resulting from the breach of fiduciary duty; punitive damages may not be recovered.[73] Damages cannot be recovered for any period prior to one year before the action is commenced.[74] Federal courts have exclusive jurisdiction,[75] and there is no right to a jury trial.[76]

In sum, as noted by the Supreme Court,[77] in 1970 Congress adopted a two-fold regulatory approach to advisor conflicts. This strategy relied in part on "the structural requirement" of disinterested director negotiation with the investment advisor under section 15, and in part on meaningful private fiduciary duty litigation initiated by investors under section 36(b).[78] The court described this as a "policy choice" to provide "independent checks on excessive fees."[79]

Section 36(b) has been a remedial failure. No investor ever has obtained a verdict, and the SEC apparently has brought only two cases under that section, the latest in 1980.[80] The Second Circuit laid out a six-factor test to guide statutory analysis in the seminal case of *Gartenberg v. Merrill Lynch Asset Management*,[81] a test somewhat modified by the Supreme Court in 2010 in *Jones v. Harris Associates L.P*.[82] But in the several years since *Jones*,[83] no

[71] 15 U.S.C. § 80a-35(b)(1).
[72] *Id.*
[73] *Id.* § 80a-35(b)(3).
[74] *Id.*
[75] *Id.* § 80a-35(b)(5).
[76] *Krinsk v. Fund Asset Management, Inc*., 875 F.2d 404 (2d Cir. 1989).
[77] *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 538-41 (1984).
[78] *Id.*
[79] *Id.* at 541.
[80] James G. Cavoli, et al., *The SEC's Mutual Fund Fee Initiative: What to Expect*, 16 SEC. LITIG. & REG., Issue 14, at p. 2, nn. 8-9 (2010).
[81] 694 F.2d 923 (2nd Cir. 1982).
[82] *Jones v. Harris Associates L. P.*, 559 U.S. 333 (2010). The Court indicated that courts may compare an advisor's fees charged to retail investors with the advisor's fees to institutional clients. 559 U.S. at 349.
[83] On remand from the Supreme Court in Jones, the Seventh Circuit again entered summary judgment for the defendants. 611 Fed. App'x. 359 (7th Cir. 2015).

investor has yet obtained a verdict under § 36(b), and, although some cases settle, most end through defendants' motions to dismiss or motions for summary judgment.[84]

The threat of § 36(b) litigation may have a salutary ex ante constraining effect on advisory fees, but behavioral deterrence of excessive fees would be far stronger with at least an occasional outright investor victory. A liability section that never leads to verdicts should be re-assessed, either to be scrapped as a failure or bolstered. Several changes are in order.

b. *Reform*

First, the SEC should initiate § 36(b) claims or suggest the section's repeal. Its failure to pursue claims indicates either a lack of belief in the section or a misguided conviction that private litigation is sufficient. The agency should address this supposedly core feature of regulatory strategy and it can do so without heeding faulty assertions that its actions would comprise rate regulation of advisory fees.[85] Second, as this author has argued (Johnson 2008), courts using the *Gartenberg* factors should be far more demanding as to what constitutes an "independent" director, and place the burden of production of evidence (not the ultimate burden of proof) on the advisor with respect to this factor under § 36(b)(2). Doing so will help judicial review of mutual fund litigation catch up with corporate governance norms that have outstripped lagging mutual fund practices. The Supreme Court in *Jones* noted that a measure of deference to the mutual fund board was appropriate only depending on circumstances; a non-independent board should receive little or no judicial deference. Third, the current remedy under § 36(b),

[84] In an August 2015 decision, one federal district court did deny defendants' motion for summary judgment in the first "manager of managers" case to reach that stage where plaintiff challenged fees charged by an advisor that delegated substantial duties to subadvisors. Sivolella v. AXA Equitable Insurance Co. No. 3:11-CV-04194 (D. N. J. 2015). Many excessive fee actions are now brought on a theory of improper delegation to subadvisors, and frequently these claims survive motions to dismiss.

[85] The SEC, but not private investors, may also bring an aiding and abetting action against those who substantially assist another in violating § 36(b) or other provisions of the Company Act. Dodd-Frank Wall Street Reform and Consumer Protection Act, 55. Pub. L. No. 111-203, § 929M (2010).

being restitutionary in nature, simply requires restoration of ill-gotten gain and does not sufficiently compensate investors or deter advisors. The sanction should be stiffened.[86] Fourth, the investment advisor can readily be characterized as an agent of the mutual fund, thereby owing the usual array of duties, including loyalty, automatically owed by an agent to its principal.[87] This affords additional remedies and applies to subadvisors and portfolio managers as well; as subagents they too owe an ultimate duty of loyalty to fund investors.[88] Fifth, arbitration of § 36(b) claims is worth a try, either on a voluntary or pilot program basis. Perhaps investors will fare no better but they will likely fare no worse. Of course, neither advisors nor plaintiffs' lawyers may be keen on this change if it is perceived as adverse to their interests. Finally, recovery under § 36(b) should go to the affected investors, not to the fund itself, as the damage incurred and recovery obtained are mismatched when the fund recovers. After all, the important exit right is an individual investor right and excessive fees directly damage investors who may have exited the fund, as well as those who stayed in, while they are a windfall to later investors. Therefore, an action to recover damages should be direct in nature and the verdict/settlement should be paid to affected investors to align the damage and remedy.[89] Overall, § 36(b) has not lived up to its promise.

C. **Ongoing Regulation by the SEC**

The regulatory philosophy of the Company Act differs markedly from that of state corporate law and that of other federal securities laws such as the Securities Act of 1933 and the

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86 For a description of various remedies available upon a breach of fiduciary duties, *see* Deborah A. DeMott, *Disloyal Agents*, 58 ALA. L. REV. 1049, 1056-61 (2007).

87 RESTATEMENT (THIRD) OF AGENCY § 8.01-§ 8.13 (2006) (describing agent's duties).

88 *Id.* at § 3.15(i) & cmt. d (defining subagent and its duty of loyalty).

89 *See supra* note 3 (describing recent Ninth Circuit case ruling that investors may bring a direct action in a non-§ 36(b) context).

Securities Exchange Act of 1934. State corporate law leaves most important decisions in the hands of boards of directors, with very little substantive regulation or constraint. The Securities Act and the Exchange Act likewise impose few substantive constraints, largely relying, instead, on a policy approach of full disclosure.

In sharp contrast, the Act contains extensive regulatory mandates from which only the SEC, not the mutual fund board, may grant exemptive relief. For example, most fund transactions with advisors are prohibited, capital structures are restricted (as by forbidding preferred stock and limiting leverage),[90] and the pricing and process of distributing securities are regulated. The SEC alone may provide waivers and exemptions.[91] This reflects the dominance of the advisor-primacy over a board-primacy model of governance, as further augmented by requiring direct governmental approvals, rather than board consent or investor approval. Too, it credits easy entrance and exit by investors as conveying some level of satisfaction with or relief from fund activities, but at the same time it reflects deep suspicion of board judgments on key issues even as boards are entrusted with the most critical issue of all – the advisor contract.

The severity of this regulatory approach has been used by the SEC as a lever to advance its reform agenda. Thus, in order to obtain exemptions from ten rules[92] – including that for Rule 12b-1 fees – mutual funds must comply with the SEC's "suggested" governance standards, including a board with a majority of independent directors, independent counsel for those directors, mandatory quarterly executive sessions, and so on.

Government regulation of mutual funds is inescapably extensive and ongoing, rather than episodic, both because of board weakness due to inherent dependence on the advisor and rational investor apathy toward governance efforts due to easy exit. For the SEC, the key policy question

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90 Professor Morley has argued in favor of permitting debt/leverage by funds. Morley (2013).

91 Act, § 6(c). *See also* Act, §§ 17(a), (b).

92 *See* Roiter (2015) at n. 175 for a list of these rules.

is where, in a dynamic and complex industry, the agency can most effectively focus its efforts at any particular time, in light of investment trends (such as, for example, the emergence of alternative mutual funds following hedge fund-like strategies) and shifting market conditions. This requires, first of all, gathering "market intelligence," not just systemically but with specific respect to large numbers of individual providers. Much focus here rightly should be on rules directed at, and frequent investigations of, the advisor itself, under the Investment Advisor Act,[93] both because of advisor importance and because the most significant advisors are far fewer in number than mutual funds themselves. But companies themselves, according to SEC Chair Mary Jo White,[94] must provide the agency and investors with more data on fund investment in derivatives, liquidity, securities lending practices, and valuation of their holdings. Toward this end, in May 2015, the SEC proposed new rules requiring monthly reporting by mutual funds on their use of derivatives contracts, both to aid investors in identifying fund-specific risk and the SEC in monitoring industry-wide risk.[95] In addition, the proposed rules require greater disclosure with respect to fund securities lending practices, liquidity and valuation of portfolio holdings, and certain basic risk metrics relating to fund exposure to changes in asset prices.[96] The SEC also proposed liquidity risk management rules in September 2015. Among other requirements, a new proposed Rule 22e-4 would require funds to establish a liquidity risk management program and determine a minimum percentage of assets that must be converted to cash within three days.[97] In 2016 the Department of Labor adopted a Rule imposing a fiduciary duty standard on all investment advisors and broker-dealers providing services to ERISA plans

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93 The Investment Advisers Act of 1940, codified at 15 U.S.C. § 80b-1 through 80b-21.

94 Mary Jo White, *Speech*, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, Dec. 11, 2014, *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370543677722.

95 SEC, *Investment Company Reporting Modernization,* Investment Company Act Release No. 31610 (May 20, 2015).

96 *Id.*

97 SEC, Open-End Liquidity Risk Management Programs, Investment Company Act Release No. 31835 (September 22, 2015).

and IRAs, a rule promptly challenged by various business groups in a June 2016 lawsuit.[98] And of course, new money market rules were adopted in July 2014 and phase in starting in July 2015.[99] They require certain institutional funds to price and transact at a "floating" net asset value (NAV), charge liquidity fees, and impose redemption gates temporarily limiting withdrawals during periods of market stress.

The SEC's role in mutual fund regulation goes beyond formal rule-making. The agency also provides extensive ex ante guidance, both informally and through speeches, no-action letters and regular Investment Management Guidance Updates. The latter provide clarification, advice, offer staff summaries, occasionally carry stern admonitions, and they frequently address significant matters such as the unbundling of proxy proposals and the nature and presentation of prospectus disclosures, along with the usual run of agency reminders.

Finally, ex post enforcement of the Act and agency rules by the SEC through its Asset Management Unit is essential. Private investor litigation, as noted, largely is ineffective from a remedial standpoint. The SEC is more nimble, has greater resources and regulatory leverage to pursue sanctions for wrongdoing, and can engage in informal "rule-making through enforcement." That sustained agency initiatives in fund enforcement activities are needed can be seen in the ongoing, egregious nature of many practices in this industry. For example, early in 2015 three advisors were sanctioned for falsely reporting a basic metric, "assets under management."[100] And in April 2015 Blackrock agreed to be censured and pay a penalty under the Act because one of its top portfolio managers formed a joint venture with a public company held in his managed

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[99] *Money Market Fund Reform: Amendments to Form PF*, Investment Company Act Release No. 31166 (July 23, 2014). *See* Michael Caccase, et al., *SEC Adopts Final Rules Governing the Structure and Operation of Money Market Funds*, The Investment Lawyer (October 2014).

[100] Peter D. Fetzer, *Recent SEC enforcement actions target false reporting by investment advisers regarding assets under management*, LEXOLOGY (April 30, 2015).

funds, a remarkable fact not disclosed to the fund's board of directors or its clients.[101] Investors, of course—and likely boards themselves—simply are unable to detect this kind of intra-advisor wrongdoing.

As with all government enforcement, the recurrent issue is selecting priorities. Advisor conflicts of interest are, as recently described by the Co-Chief of the Asset Management Unit, an "overarching, perennial priority."[102] Again, this simply acknowledges the reality of board failure and investor ineptitude in policing this basic problem. A steady flow of fund wrongdoing such as deviating from investment guidelines, pursuing undisclosed investment strategies, overstating performance of and assets under management, and finding creative ways to use fund assets to pay intermediaries outside of a fund's Rule 12b-1 plan, as seen in the SEC's 2015 Distribution-in-Guise Initiative,[103] to cite a few, all ensure that direct government oversight of mutual fund activity in the name of investor protection will not disappear soon.

D. The Competition Debate: Constraints; Passive, Low-Fee Funds

The debate about the degree to which competitive forces in the mutual fund industry serve to protect investors is longstanding and ongoing. Certain factors, as a theoretical matter, might serve to align investor and advisor interests without regulatory (or at least without additional regulatory) intervention. For example, the mutual fund industry is said to be competitive with more than 7,700 funds in existence at the end of 2013. Advisors seeking to enhance their reputations in order to attract greater fund inflows and facilitate their own

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[101] Philip Shecter, *Investment adviser conflicts of interest – blackrock censured; compliance officer personally liable*, LEXOLOGY (April 21, 2015).

[102] Julie M. Riewe, *Speech, Conflicts, Conflicts Everywhere*, Feb. 26, 2015, *available at* www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html#.VRsP7phO4-A.

[103] In September 2015, the SEC charged First Eagle Investment with improperly using fund assets to pay distribution expenses, outside the company's board-adopted 12b-1 plan. First Eagle settled for about $40 million. SEC Press Release 2015-198, SEC Charges Investment Adviser With Improperly Using Mutual Fund Assets to Pay Distribution Expenses, http://www.sec.gov/news/pressrelease/2015-198.html.

advancement in the advisor labor market have an incentive to perform well on behalf of investors. Investors' ability to redeem mutual fund shares at net asset value also may impose discipline on fund managers because investors can exit the fund without dampening the price of fund shares. These factors lead some, such as Professor Paul Mahoney and Professors John Coates and Glenn Hubbard,[104] to argue that fund markets are "consistent with competition,"[105] and thus to favor reliance on competition as a means for reducing the adverse effects of investor-advisor conflicts.

The competitive goal for fund providers is to maximize the assets under management, because advisory fees are set as a percentage of that number. High performance and/or low expense ratios may be a means to that end – though they are not necessarily so – but the goal itself is substantial assets under management. From the investor's perspective, the goal is net gain, which is simply investment returns minus expenses. Theoretically then, the competition argument goes, investor assets should flow to those funds that offer the best gains, via a combination of investment performance and/or low expenses. Those funds, then having more assets under management, will in turn necessarily generate higher fees for their advisors.

As noted in an important SEC study, however, several constraints may inhibit the effectiveness of competitive forces in mitigating conflicts between investors and advisors.[106] These include lack of investor knowledge about management and how to assess managerial skill; high search and switching costs in fund selection; tax considerations on selling shares; and excessive reliance on reputation, trends, and recommendations. To many, these constraints demonstrate substantial shortcomings in a strategy relying only on market forces to align

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[104] Paul Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. ECON. PERSP. 161 (2004); John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151(2007).

[105] Coates & Hubbard, *supra* note 104 at 151, 163.

[106] OEA Study, *supra* note 17 at 8-10.

investor and advisor interests.[107] For example, one study found that Morningstar rankings are inaccurate predictors of future fund performance,[108] yet investors may still chase performance. Moreover, Professor Langevoort (Langevoort 2005) has identified several other ways in which market forces, possibly at work to some degree in corporate law, are lacking in the mutual fund industry. Salient differences include the lack of stock or stock option grants to align investor and management interests, the absence of active institutional investors advocating governance reforms, the absence (at least in mutual funds, though not in closed-end funds) of a market for corporate control (i.e., no hostile takeovers), and manager compensation based on the value of assets (i.e., size, not performance). Overall, these features may lead to mutual fund assets being "sticky," rather than mobile, as market theory posits.[109] Congress recognized as much in 1970: "But in the mutual fund industry… these marketplace forces are not likely to operate as effectively."[110]

The regulatory debate invariably centers on whether advisor fees are somehow "excessive" in light of essentially fixed costs, or are simply the natural outgrowth of offering investments that, in aggregate, many investors find attractive. Given capital mobility, coupled with the demise of about 7% of funds every year even as new funds emerge,[111] fund managers contend they face heady competition to hold assets. This dynamic, at least recently, seems to be at work to some extent. A 2015 Morningstar study reveals that retail investors have gravitated

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[107] *Id. See* John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 651 (2001).

[108] Christopher R. Blake & Matthew R. Morey, *Morningstar Ratings and Mutual Fund Performance*, 35 J. FIN. & QUANTITATIVE ANALYSIS 451 (2000) (noting exceptions for low-rated funds); *see* Remarks of Professor Alan Palmiter, Conference, *The $7 Trillion Question: Mutual Funds & Investor Welfare,* 1 J. BUS. & TECH. L. 23, 26 (2006) ("[T]he [Morningstar] rating is a very powerful predictor of future performance—but negatively!").

[109] OEA Study, *supra* note 17 at 9. Professor Sendhil Mullainathan observes that "investors often choose what to do with their money once, and leave it there for a long time." *Investing in the Dark*, N. Y. TIMES, July 12, 2015, BU 11.

[110] S. REP. NO. 91-184, 5 (1970), as reprinted in 1970 U.S.C.C.A.N. 4897, 4901.

[111] Silverblatt, *supra* note 42 (citing numbers provided by John Bogle).

toward lower cost funds such as index funds.[112] In fact, 95 of the 100 lowest cost funds in 2014 were index funds.[113] Vanguard Group, the largest provider of index-tracking funds, gained $216 billion of the $244 billion moved into passively managed funds in 2014.[114] Recently, moreover, passively-managed, low fee funds have generally outperformed actively-managed, higher fee funds.[115] Whether investors will continue to adhere to a low fee fund strategy if tempted by higher returns at high-fee funds remains unknown. In spite of improved investor understanding that, unlike the children of Lake Wobegon, by definition not all investors can achieve above average returns, many individuals – perhaps a dwindling but still significant number – likely will try.

As noted, moreover, advisors benefit from the higher fee revenue generated simply by the influx of investor assets. Yet, given economies of scale, if costs trail the heightened revenue, overall net fee income increases nonetheless. Thus, for example, in 2014 overall fee revenue rose 75% over a decade before, but the asset-weighted expense ratio declined only 27%, spurring net income.[116]

Professor Stewart Brown, in mid-2015 (Brown 2015), seized on advisor profit margins and other financial measures to support a position he long has advocated: that the mutual fund advisory industry is extraordinarily profitable and such evidence is consistent with a lack of price competition in the industry. Brown sets out specifically to refute the claim of Coates and Hubbard (2007) that mutual fund markets are "consistent with" competition. Citing industry-

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[112] Jeff Sommer, *Fees on Mutual Funds Fall. Thank Yourself*, N.Y. TIMES, May 10, 2015 at B3 (describing the Morningstar report, "2015 Fee Study: Investors Are Driving Expense Ratios Down.").

[113] *Id.* Professor Mullainathan notes, however, that index funds can have as much variability in fees as actively managed funds. Mullainathan *supra* note 109.

[114] Kirsten Grind, *Vanguard Sets Record Funds Inflow*, WALL ST. J., Jan. 4, 2015. Through October 2015, Vanguard had taken in an additional $196 billion of investor cash and was on pace to exceed its record-breaking 2014 performance. Sarah Krouse, Vanguard Group Took In $196 billion of Investor Cash Through October, WALL ST. J., Nov. 15, 2015.

[115] *Id.*

[116] Sommer, *supra* note 112.

wide data on operating profit margins, along with other profitability and return on equity metrics for a subset of publicly traded firms providing advisory services, Brown concludes that the growth in assets under management without corresponding fee reductions is not "consistent with" price competition.

He argues too that a significant percentage of mutual fund investors are not knowledgeable about fund fees and that we do not know what percentage of total fund assets are fee sensitive. Although Morley and Curtis (2010) persuasively argue that voting rights will do little to protect investors as long as at least some funds are competitive, from a regulatory standpoint that still leaves many investors consistently paying high fees, along with the persistent policy challenge of what, if anything, to do about that fact. Brown's study, and expected forthcoming industry counterarguments, will keep the competition debate alive and unresolved for at least the near future, if not long beyond.

4. CONCLUSION

The unsettled competition debate, along with dynamic industry flux, occurs quite apart from the intrepid activities of investment company boards and the SEC. Both bodies are equipped to curb certain advisor abuses and they can help shape more salutary institutional norms and practices, but they cannot fine-tune fees or change investor behavior. And § 36(b) litigation as it stands today may shape industry norms ex ante, but it is of little remedial significance to fees and capital flows, leaving exit as the key investor-oriented protection. Still, however flawed, the Act's eclectic approach to protecting mutual fund investors seems likely to endure both on pragmatic grounds and for lack of a demonstrably better approach.

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