MUTUAL FUND CONFLICTS OF INTEREST IN THE WAKE OF THE SHORT-TERM TRADING SCANDALS: ENCOURAGING STRUCTURAL CHANGE THROUGH SHAREHOLDER CHOICE

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INTRODUCTION

Over the last twenty-five years, mutual funds have amassed staggering wealth; the industry's assets now total approximately $8.1 trillion.[1] The vast majority of this money belongs to millions of U.S. investors,[2] who entrusted their savings to mutual funds under the protection of a legal regime devoted to the principle that fund managers are to hold investor interests paramount.[3] Much evidence suggests, however, that this has not been the case. Taking advantage of a vastly deficient governance structure, mutual fund management companies have systematically put their own interests ahead of their investors.

The root of this problem lies with how mutual funds are typically organized. Traditionally, funds are set up as their own legal entities. Unlike a normal business, however, a mutual fund has no true employees of its own.[4] The company is only a shell, the affairs of which are primarily managed by its investment adviser – a separate company with a separate ownership constituency.[5] This structure creates a direct conflict of

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1. INV. CO. INST., 2005 INVESTMENT COMPANY FACT BOOK 3 (45th ed. 2005) [hereinafter FACT BOOK] (compiling data as of year-end 2004).

2. 92 million individuals in 54 million U.S. households owned mutual funds in 2004. *Id.* at 29.

3. *See* 15 U.S.C.A. § 80a-1(b) (West 2005).

4. Compliance Programs of Investment Companies and Investment Advisers; Final Rule, Investment Company Act Release No. 26,299, Investment Advisers Act Release No. 2204, 68 Fed. Reg. 74,722 (Dec. 24, 2003) [hereinafter Compliance Release].

5. *See* JOHN C. BOGLE, COMMON SENSE ON MUTUAL FUNDS: NEW IMPERATIVES FOR THE INTELLIGENT INVESTOR 377 (1999) [hereinafter BOGLE, NEW IMPERATIVES]; John C. Bogle, Founder & Former CEO, Vanguard Group,

interest between fund investors and fund management. Advisers increase their revenue by raising the fees charged to investors and increasing their assets under management. The pursuit of higher fees and larger funds, however, undermines investor returns.

In order to protect investors from management overreaching, the advisers are overseen by a multilayered governance structure. This structure, however, is itself plagued by conflicts of interest and other constraints that render it ineffectual. Lacking meaningful oversight, management companies have continuously increased fees and aggressively sought out new investors so as to enlarge their funds.

Moreover, evidence suggests that fund participation in the recent late trading and market timing scandals – a tremendous blemish on the industry – was motivated principally by management's desire to increase fund size. According to the SEC, investors were often permitted to take part in these activities in exchange for promises that they would place large amounts with funds under a cooperative management company's control.[6] By engaging in late trading and market timing, these individuals reaped tremendous gains, while average fund investors bore the costs in the form of dilution and increased overhead.

These recent scandals prompted the SEC to take regulatory action. Specifically, the SEC adopted approximately a dozen amendments to existing rules, focusing not only on late trading and market timing, but also on reforming the industry as a whole, with a particular focus on improving fund governance.

The new rules, however, will likely do little to alter the behavior of management companies. Many of the reforms, in-

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Keynote Speech Before The American Institute of Certified Public Accountants Personal Financial Planning Conference: Has Your Fund Manager Betrayed Your Trust? Consider the "Stewardship Quotient" (Jan. 5, 2004) (transcript *available* at http://www.vanguard.com/bogle_site/sp20040105.html) [hereinafter Bogle, "Stewardship Quotient"].

6. *See* Stephen M. Cutler, Director, Division of Enforcement, Sec. & Exch. Comm'n, Testimony Concerning Recent Commission Activity to Combat Misconduct Relating to Mutual Funds Before the Senate Committee on Banking, Housing, and Urban Affairs (Nov. 20, 2003) (transcript *available at* http://www.sec.gov/news/testimony/ts112003smc.htm) [hereinafter Cutler Testimony].

cluding both those aimed directly at the scandals themselves and those with a broader focus, largely overlap with current law or industry practice. Even those that do effect significant changes appear to be of limited usefulness because they do not address the governance flaws that necessitated reform in the first place.

In order to truly reform the industry, the SEC must take steps to encourage internal fund management. If funds are run by their own officers and employees, the conflicts of interest that have undercut investor returns and motivated scandal in the industry disappear. Before mandating that funds take this path, however, a market-based approach should be tested.

The SEC can create a shift toward a more shareholder-friendly governance structure by requiring improved disclosure regarding fees and fund structure and taking steps to publicize these issues. Increased investor awareness is the key to a competitive mutual fund marketplace in which internally managed funds have the potential to prosper as a result of their structural advantages.

The first part of this article describes the nature of mutual fund investing, including the traditional fund management structure and the conflicts of interest that result from this arrangement. The paper then goes on to discuss the governance framework currently in place to manage these conflicts, with emphasis on why it has failed to protect investors. Section IV provides an analysis of the market timing and late trading scandals, as well as the SEC's response. The final section proposes a different approach for the SEC – one which relies on the decisions of informed shareholders to usher in industry reform.

I.
MUTUAL FUND ECONOMICS AND OPERATIONS

A mutual fund can be viewed from an economic perspective and a legal one. The economic perspective is concerned with the principal financial aspects of the fund as an investment, while the legal perspective focuses on the complex of rules in which it operates. Because this paper focuses on the interaction of these two concepts, it is helpful to provide a bit of background about each.

A. *Economic Perspective*

A mutual fund, at its core, is an investment vehicle. The money of many investors is collected, pooled together, and then invested in accordance with a predetermined strategy. There are thousands of different funds, with varied approaches to investing. Many focus on U.S. and international equities, bonds, and money market instruments. For any given type of security in which a fund invests, there are different allocation strategies. In a "large growth" equities fund, for example, the portfolio manager invests fund assets only in the stock of those companies with large market capitalizations that the manager believes to be the fastest growing.[7]

Individual investors do not directly own the stock or other assets in which a fund invests. Instead, they have an interest in a pro rata share of the fund itself, which in turn owns the portfolio securities.[8] This stands in contrast to paradigmatic investing, where a single investor purchases an asset, such as a share of common stock, and owns that property individually. Another distinction between mutual fund investment and traditional investment is in the way investors cash-out their stakes. In the traditional setting, investors sell their assets to others for market value when they desire liquidity. In the fund environment, on the other hand, an investor's ownership interest in the fund is sold back to the fund for a price equal to the pro rata portion of the fund's portfolio that the investor's share of the fund represents.[9]

Mutual funds are an attractive investment for a number of reasons. One benefit is that by pooling their assets with others, investors are able to attain greater diversification of their individual portfolios than they would if they invested alone. An individual with a limited amount to invest cannot purchase a wide array of securities. If he puts his money in a

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7. The categorization described corresponds to one of Morningstar's nine mutual fund "style boxes."

8. *See* Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Securities Act Release No. 33-8188, Exchange Act Release No. 34-47,304, Investment Company Act Release No. 25,922, 68 Fed. Reg. 6565 (Feb. 7, 2003) [hereinafter Proxy Release].

9. *See* 15 U.S.C.A. § 80a-2(a)(32) (West, Westlaw through P.L. 109-40) (defining a "redeemable security," which is the type offered by mutual funds).

mutual fund, however, he will own a pro rata share of a fund with holdings in potentially thousands of equities. Broad diversification is valuable because it is a means of hedging against risk (e.g., investors are much less likely to lose their investment when it is spread across a variety of stocks, rather than placed exclusively with a single company).

Moreover, mutual funds allow investors to delegate management of their savings to professional portfolio advisers. A single investor need only choose an investment strategy; it then becomes the responsibility of the adviser to select assets which fit into this strategy. The selection of assets ostensibly will be based on more thorough research and better information than that which the single investor could access.[10]

Investors, however, must pay for these benefits. Mutual funds charge a variety of fees; some are one-time expenses, while others reoccur annually. The most common type of one-time expense is a sales charge (often referred to as a "load").[11] The paradigmatic load is assessed at the time the initial investment is made, and it is typically a specified percentage of that outlay. But sales loads are not always charged at fund initiation. A so-called "back-end load" is paid when an investor cashes out. One type of back-end load – the contingent deferred sales load – decreases over time, so that if an investor stays in a fund long enough the charge disappears.[12]

Funds may come with other types of one-time expenses as well. Some funds, for example, charge redemption fees. When investors exit a fund with a redemption fee, they must leave with the fund a certain percentage of the amount redeemed.[13]

The fees that are most burdensome in the long run, however, are the recurring annual fees. First, investors must pay a fee for fund management, which is essentially a charge for the portfolio adviser's services (e.g., picking the stocks in an equity fund). Second, they are assessed a fee for fund administra-

10. *See* 16A WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 8275 (perm. 2004).

11. *See* Sec. & Exch. Comm'n, Invest Wisely: An Introduction to Mutual Funds, http://www.sec.gov/investor/pubs/inwsmf.htm (last visited July 25, 2005) [hereinafter SEC, Invest Wisely].

12. *See id.*

13. *See id.*

tion, which includes ancillary expenses such as legal and auditing fees, transfer agent fees, and custodial fees. Finally, some funds charge for distribution. This expense, a so-called "12b-1 fee," is earmarked for the advertising and marketing costs incurred by the fund, as well as other expenditures associated with selling fund shares. The amount of each of these charges is again a specified percentage of the investor's fund holdings. The fees are commonly added together to arrive at a single figure (the "expense ratio") that is deducted from the investor's portfolio each year.[14]

The various fees described above are combined by mutual funds into endless permutations. Many funds even offer multiple classes of ownership in the same fund, each with a different cost structure.[15] The complexity of fund expenses, in addition to other concerns both unique to this type of investment and present in investing in general, has led to extensive regulation of mutual funds.

B. *Legal Framework*

The investor protection regime with respect to mutual funds is made up of both state and federal law. Funds are business entities governed by boards of directors bound by state-law fiduciary duties to put shareholder interests first and act with due care.[16] Those who invest in the fund (even though they may see themselves merely as co-owners of an asset pool) are actually the corporate shareholders and the fund's board is duty-bound to protect them.[17]

These common law protections are supported by numerous federal regulations. Most important is the Investment Company Act of 1940 (the "ICA").[18] This statute defines a mutual fund as an "investment company," and contains complex substantive rules touching on nearly all aspects of the entity's governance and procedures. Moreover, funds are subject to

14. *See id.*

15. *See id.*

16. *See* Div. of Inv. Mgmt, Sec. & Exch. Comm'n, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 252 (May 1992) [hereinafter PROTECTING INVESTORS REPORT].

17. *See* Proxy Release, *supra* note 8, at 6565.

18. 15 U.S.C.A. §§ 80a-1 – 80a-64 (West 2005).

the Securities Act of 1933 (the "'33 Act")[19] and the Securities Exchange Act of 1934 (the "'34 Act").[20] Most notably, the '33 Act requires funds to register public offerings of their shares with the SEC.[21] It also mandates that all potential fund investors receive a prospectus[22] and that upon request, the fund provide them with a document known as a Statement of Additional Information (the "SAI").[23] The prospectus serves as the primary investor reference document; it focuses on fund fees, strategy, and risks.[24] The SAI provides a more thorough overview and includes technical and historical information regarding the fund.[25] The '34 Act is less central to fund operations, as many of its provisions are superceded by the ICA.[26] This statute does, however, bear on the substantive and procedural requirements of shareholder voting.[27]

The Investment Advisers Act of 1940 is the remaining principal component of the legal regime governing mutual fund investor protection.[28] This statute does not regulate the fund directly, but it is nevertheless relevant because its rules pertain to the entity's nervous system – its investment adviser. As discussed in the introduction, fund management is not handled by the fund itself. Instead, the investment adviser supervises its affairs.[29] Advisers may be held by public or private owners, and many of the largest belong to financial conglom-

19. 15 U.S.C. §§ 77a – 77aa (2000).

20. 15 U.S.C. §§ 78a – 78mm (2000).

21. *See* PROTECTING INVESTORS REPORT, *supra* note 16, at 352.

22. *See* 15 U.S.C. § 77j (2004); PROTECTING INVESTORS REPORT, *supra* note 16, at 347.

23. Form N-1A governs mutual fund registration under the '33 Act. *See* Forms Prescribed Under the Securities Act of 1933, 17 C.F.R. §239.15A (West 2005). Among other things, this form notes the SAI delivery requirements. *See* Form N-1A, OMB No. 3235-0307, Item 1(b), *available at* http://www.sec.gov/about/forms/formn-1a.pdf [hereinafter Form N-1A].

24. *See* Form N-1A , *supra* note 23, at Part A.

25. *See id.* at Part B.

26. *See* Victoria E. Schonfeld & Thomas M.J. Kerwin, *Organization of a Mutual Fund*, 49 BUS. LAW. 107, 154 n.328 (1993).

27. *See* 15 U.S.C.A. § 78n (West 2005). *See also* Amendments to Proxy Rules for Registered Investment Companies, Securities Act Release No. 7102, Exchange Act Release No. 34,832, Investment Company Release No. 20.614 (Oct. 13, 1994) (discussing certain of the '34 Act provisions that apply to investment companies).

28. 15 U.S.C.A §§ 80b-1 to 80b-21 (2000).

29. *See* BOGLE, NEW IMPERATIVES, *supra* note 5.

erates, such as banks, brokerage firms, and insurance companies.[30] Under this statute, advisers are required to register with the SEC[31] and are subject to anti-fraud[32] and reporting provisions.[33]

II.
MUTUAL FUND CONFLICTS OF INTEREST

The primary motivation for placing one's money with a mutual fund is the hope of decent returns. Ensuring this result within the confines of a given investment strategy should be the sole focus of a fund's manager.

Unfortunately, this is not always the case. Portfolio advisers also serve a completely different constituency – one with conflicting expectations. Those who are responsible for running the fund are board members, officers, and employees of the investment adviser. As such, they are duty-bound to serve the interest of that company's owners. This group earns a return on its investment through the revenue generated by the fees the adviser charges to fund shareholders.[34] Herein lies the conflict of interest. The management company is motivated to maximize its total fees, and can do so by seeking to increase both the fees charged to individual investors and the total assets under management (the more assets in the fund, the larger the base on which fees can be assessed). To act on these motivations, however, is contrary to the interest of fund shareholders.

The amount a shareholder pays in fees directly reduces his returns. Moreover, the effect is much more pronounced than the diminutive annual percentage figure implies (expense ratios are usually under two percent). Long-term investing has the potential to yield high returns because one is able to reinvest earnings from the original investment. But when this money is paid in fees instead of left with the fund, this effect is lost, and the results are dramatic. For example, take two hypothetical investments of $10,000, each in a fund with an annual return of 10% before expenses. In a fund with an

30. *See* Bogle, "Stewardship Quotient," *supra* note 5.
31. *15 U.S.C. § 80b-3* (2000).
32. *15 U.S.C. § 80b-6* (2000).
33. *See 15 U.S.C. § 80b-4* (2000).
34. *See* BOGLE, NEW IMPERATIVES, *supra* note 5, at 381.

expense ratio of 1.5%, the initial investment would grow to $49,725 over a ten-year period. In contrast, the $10,000 outlay would grow to $60,858 in a fund with an expense ratio of only 0.5%. Thus, an expense ratio difference of 1% results in a loss of $11,133 – a difference of 18%.[35]

Though the effect may not be as easy to demonstrate, the aggressive pursuit of new fund shareholders with the purpose of increasing total assets under management is also deleterious to investor interests. First, when certain funds become too large, they lose their ability to effectively pursue the strategy on which they were founded.[36] For example, a fund that has earned a high return based on its investment in a particular type of security may not be able to procure enough of that asset to replicate this success for a broader shareholder base.[37]

Second, bringing in new investors to the fund is expensive. Though the investment adviser pays for the advertising and marketing services engaged for this task, the money allocated for these purposes comes from shareholder fees.[38] The use of some shareholder money on this task is justifiable. When a shareholder wishes to cash-out, the fund is required to buy the relevant shares.[39] Thus, a fund must constantly be seeking new shareholders or risk being redeemed out of existence.[40] This result would harm the investment adviser and the shareholders alike.

But when an adviser overspends on advertising – seeking size for its own benefit rather than the fund's – it hurts current investors because they end up paying for something that is actually contrary to their interests. They would be better off if, instead, the money were left in the fund's portfolio. The overzealous pursuit of new shareholders, therefore, harms existing shareholders in two ways: (1) it can lead to the creation of a

35. SEC, Invest Wisely, *supra* note 11.

36. BOGLE, NEW IMPERATIVES, *supra* note 5, at 334.

37. Samuel S. Kim, Note, *Mutual Funds: Solving the Shortcomings of the Independent Director Response to Advisory Self-Dealing Through Use of the Undue Influence Standard*, 98 COLUM. L. REV. 474, 481 (1998).

38. *See* BOGLE, NEW IMPERATIVES, *supra* note 5, at 335.

39. *See supra* note 9 and accompanying text.

40. Economies of scale are another benefit to a mutual fund with increased size. But, as discussed *infra* pp. 105-106, since evidence indicates that the savings are not passed on to investors, it is not included in this discussion.

fund that is too big to pursue its own strategy; and (2) shareholder money is wasted on the expenditures associated with the pursuit itself.

Extensive state and federal law governing mutual fund operation is designed to shield shareholders from both the conflicts of interest described above and the abuses that these divergent interests invite. The current regulatory framework, however, offers inadequate protection.

III.
THE CURRENT LEGAL REGIME AND ITS SHORTCOMINGS

The governance structure of a mutual fund is based on the corporate paradigm. As in a traditional corporation, management oversight in a mutual fund is the responsibility of the shareholders themselves and the board they select to protect their interests.

However, a mutual fund is not run like a normal business entity. Recognizing this, regulators have created a federal regime that both supplements and bends the basic corporate law constraints to better correspond to the practical realities of the fund industry. But this multi-tiered structure is inadequate in many respects, leaving shareholders susceptible to far-reaching management abuse.

A. *Shareholder Rights*

The first line of protection is the fund shareholders themselves, but they are ill-suited to ensure that their own interests are protected. Shareholders in a traditional corporation are given some authority to control operations. Among other things, they are responsible for annually appointing their company's board of directors.[41] In theory, only those directors with policy positions favored by the shareholders will earn reelection. In mutual funds, investors are given the power to vote for the board of directors, but it is not mandated that they do so each year.[42]

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41. *See, e.g.*, General Corporation Law, DEL. CODE ANN. tit. 8 § 211(b) (2005).

42. *See* John Nuveen & Co. Inc., SEC No Action Letter, 1986 WL 67424, at *4 (Nov. 18, 1986).

Moreover, the fund's management company is permitted to appoint the original board. The composition of this body is subject to shareholder approval,[43] but this is merely a formality because at the fund's inception, the sole shareholder is the management company itself.[44] Thus, the individual investors that truly populate the fund have no say on the make-up of the original board – and little changes after that. Board members are permitted to select replacements so long as two-thirds of the members have been approved by the shareholders (even if only by the initial one).[45] And because turnover on fund boards is low, shareholders rarely exercise their voting rights.[46]

While the board appointment rights of mutual fund investors are attenuated, their say in other matters has the potential to be profound. Most importantly, shareholder consent is required with respect to 12b-1 fees[47] and the fund's contract with its investment manager.[48] The fund contract is the principal agreement underlying mutual fund operations whereby the investment adviser agrees to manage the fund's portfolio in exchange for a fee. Neither the initiation of 12b-1 fees nor the adoption of the management contract at the fund's infancy is subject to oversight by the true investors. The initial shareholder, i.e., the management company, may approve these items without further confirmation.[49] These pre-existing fee arrangements, however, do not leave the investors helpless: increasing fund costs by altering either of them requires investor approval.[50] Moreover, the shareholders, by majority vote, have the right to terminate the fund's investment adviser[51] or the 12b-1 fee arrangement[52] at any time.

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43. 15 U.S.C.A. § 80a-16(a) (West 2005).

44. *See* Schonfeld & Kerwin, *supra* note 26, at 133. *Cf.* Investment Co. Institute, SEC No-Action Letter, 1992 WL 400454, at *1 (Nov. 6, 1992) (advising that no vote of the public shareholders is necessary in connection with the initial board's appointment) [hereinafter ICI No-Action Letter].

45. 15 U.S.C.A. § 80a-16(a).

46. *See* Schonfeld & Kerwin, *supra* note 26, at 123.

47. 17 C.F.R. § 270.12b-1 (West 2005).

48. *See 15 U.S.C.A. § 80a-15(a)* (West 2005).

49. *See* ICI No-Action Letter, *supra* note 44, at *1.

50. 17 C.F.R. § 270.12b-1 (2005). *See 15 U.S.C.A. § 80a-15(a);* PROTECTING INVESTORS REPORT, *supra* note 16, at 279.

51. 15 U.S.C.A. § 80a-15(a).

52. 17 C.F.R. § 270.12b-1.

The shareholders' considerable power, however, goes unnoticed. It is unheard of for shareholders to replace an adviser[53] and fees are consistently being raised with their consent.[54] This pattern appears to be the result of apathy and ignorance among investors. The SEC has acknowledged that "[m]any industry participants and observers have told the staff that investment companies often find it difficult to obtain a quorum [at annual meetings], meeting attendance is usually sparse, and vote outcome is almost never contrary to the wishes of management."[55] This lack of concern is compounded by a lack of knowledge, particularly with respect to fees – the matter where the conflict of interest between shareholders and their adviser is most acute. This phenomenon has been noted in numerous studies. One report found that 75% of shareholders could not accurately define an expense ratio.[56] In another, it was said that "a majority do not even realize they are paying fees."[57] One analysis, which is particularly telling, looked at how investor knowledge of fees decreased after the initial investment. Of mutual fund investors, 43% claimed they knew the expenses associated with their largest mutual fund at the time of their original outlay, while only 18.9% could even estimate the expenses they were paying at the time they were asked by the analyst.[58] It is not surprising that management encounters little resistance to fee hikes, when only one in five shareholders can estimate his current expenses.

The shareholders' lack of interest in fund governance and their ignorance concerning fees is probably the result of a combination of factors. One potential problem is that publicly available information about mutual funds is not inviting. In fact, two recent SEC chairmen have impugned the primary source of investor information – the fund prospectus. Richard

53. *See* PROTECTING INVESTORS REPORT, *supra* note 16, at 273.

54. *See id.*

55. *Id.* at 272-73 n.82.

56. Investors Need to Bone Up on Bonds and Costs, According to Vanguard/MONEY Investor Literacy Test, BUS. WIRE, Sept. 25, 2002.

57. BOGLE, NEW IMPERATIVES, *supra* note 5, at 344.

58. Gordon J. Alexander et al., *Mutual Fund Shareholders: Characteristics, Investor Knowledge, and Sources of Information* 11-12 (Office of the Comptroller of the Currency, Economics Working Paper No. WP97-13, 1997), *available at* http://www.occ.treas.gov/ftp/workpaper/wp97-13.pdf.

Breeden recently stated that he thinks "mutual fund prospectuses, for the most part, read like gobbledygook."[59] And Arthur Levitt has lamented that this disclosure document is "impossible to understand" and "written in impenetrable legalese."[60] The density of fund disclosure noted by these experts may cause some shareholders to simply ignore it.

The nature of a mutual fund as an investment may also play a role. Mutual funds are designed and marketed as passive investment vehicles. This may attract those who are not inclined to closely monitor their investments. It also may serve as a signal to shareholders that they do not necessarily need to follow matters too closely.

Ironically, this perception is likely reinforced by fund governance structure. As discussed in the next section, shareholders are supposed to be protected by their board of directors. Fee hikes and other major management decisions are only valid if the board consents.[61] Because they trust the board, shareholders may feel that their own participation in management oversight is unnecessary.

Finally, even those shareholders who are informed and willing to participate in governance face incentives that keep dissention muted. Thus, what may look like apathy may in some cases actually be economically rational behavior. This is because the theoretical possibility of opposing management is undermined by practical constraints. In many public corporations, thwarting company leadership is a realistic possibility because large percentages of shares are held by small groups of institutional investors. Mutual funds lack this attribute. The shareholder base is diffuse, making it difficult to gather enough votes to form meaningful opposition.[62] Coupled with the increased difficulty of mounting a challenge to mutual fund leadership is the relative ease of exit. Because funds are required to redeem shares whenever investors demand it, those who are dissatisfied with a fund's fees or management

59. Diana B. Henriques, *A Sense Of History, A Feeling Of Betrayal*, N.Y. TIMES, Jan. 2, 2004, at C1.

60. ARTHUR LEVITT, TAKE ON THE STREET: HOW TO FIGHT FOR YOUR FINANCIAL FUTURE 44 (2003).

61. *See* PROTECTING INVESTORS REPORT, *supra* note 16, at 255-60.

62. *See* FACT BOOK, *supra* note 1, at 29 (reporting that 90% of mutual fund assets are owned by individuals).

may decide that it is easier to cash-out than to muster the votes necessary to defy an incumbent.[63]

Whatever a particular shareholder's motivation, it remains true that in the aggregate, shareholders are poor monitors of management behavior. They are not, however, the primary guardians against abuse. That task belongs to the fund board of directors.

B. *Board Oversight*

Normally, a board of directors sits at the head of a functioning business entity. Its duty is to oversee the general operation of the company, and in doing so, to police for abuse by the company's leadership. In contrast, a fund's board leads an entity without operations or employees that are truly its own.[64] As such, its role must differ.

Recognizing that this is the context in which a fund board operates, Congress has specifically enumerated its oversight duties, which at times significantly depart from those of a traditional corporate board. Conflicts of interest and practical constraints, however, undermine the board's ability to fulfill its specially-created role.

1. *Board Responsibilities*

A fund's board has myriad technical responsibilities,[65] but its central task is to protect shareholders from overreaching by the fund's investment adviser. It is given considerable clout with respect to the major fund contracts in order to fulfill this responsibility.

The main agreement underlying mutual fund operations is that regarding the provision of portfolio management. But the fund enters into an array of other contractual relationships as well. Primary among the remaining agreements is one with the fund's underwriter – the entity responsible for distributing the fund's shares. Both the advisory and underwriting contracts must be approved by the board.[66] The ICA does not require that the other contracts, which provide for fund ad-

63. Certain shareholders may, however, face countervailing economic incentives to remain. *See* PROTECTING INVESTORS REPORT, *supra* note 16, at 273.

64. *See* Compliance Release, *supra* note 4, at 74,722.

65. *See* PROTECTING INVESTORS REPORT, *supra* note 16, at 255-60.

66. *See* 15 U.S.C.A. § 80a-15 (West, Westlaw through P.L. 109-40).

ministration and certain ancillary services, be so approved.[67] Though the code treats each contract independently, industry practice is that substantially all of the services are provided by the fund's adviser.[68]

The main contracts are constantly subject to board review. Neither the advisory nor the underwriting agreement may last for more than two years, and either the board or the shareholders themselves must annually approve the renewal of those contracts with terms longer than one year.[69] Because the board is continually asked to revaluate the adviser and the underwriter, it must take steps to monitor their performance.[70] In fact, with respect to the investment advisory contract, the ICA specifically requires that the board request and evaluate all materials it deems relevant to its decision whether to approve.[71]

The cluster of contracts over which the board presides lay out the central terms regarding the fund's operations and many of the costs of ownership. However, a potentially significant shareholder expense – the 12b-1 fee – falls outside the scope of these agreements. In order to protect shareholders from the overuse of 12b-1 fees, the board is tasked with determining their propriety as well.[72]

In theory, the board is the shareholders' agent, representing their interests in arms-length negotiations over how the fund is to be managed and what the investor costs will be. Though this model is academically appealing, it breaks down in practice.

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67. *See* PROTECTING INVESTORS REPORT, *supra* note 16, at 258. If the contract is with an affiliate of the adviser, however, the board would likely consider it. *Id.*

68. BOGLE, NEW IMPERATIVES, *supra* note 5, at 375.

69. 15 U.S.C.A. § 80a-15 (West 1997).

70. *See* Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Securities Act Release No. 33-8433, Exchange Act Release No. 34-49,909, Investment Company Act Release No. 26,486, 69 Fed. Reg. 39,798 (June 30, 2004) [hereinafter Methodology Disclosure Release].

71. *Id.* (noting that the adviser has a corresponding duty to provide such materials). *See* 15 U.S.C.A. § 80a-15(c) (West 1997).

72. *See* 17 C.F.R. § 270.12b-1(b)(2) (2005).

2. *Board Conflicts and Independent Directors*

The more closely a fund board is examined, the less it looks like that of a paradigmatic corporation. Shareholders rarely vote on board membership and the board's principal role is that of contract negotiator and administrator rather than policy setter. These attributes lead to a severe conflict of interest. The board's members are chosen not by the shareholders, but by the investment adviser, which is in fact the counterparty to the most important contracts the board oversees. Thus, management appointees, a certain number of which may actually be employees of the adviser,[73] are given the responsibility of protecting shareholders from a management-friendly contract. It appears that these individuals would have little incentive to vigorously defend shareholder rights.

Recognizing this conflict, the ICA requires that certain decisions be approved by a majority of the *independent* directors. Most importantly, independent directors must consent to the investment advisory and underwriting contracts[74] and any imposition or increase of 12b-1 fees.[75] Thus, for these matters, not only must the full board consent, but a majority of the independent directors must also agree.

The ICA sets out qualifications that must be met in order for an individual to qualify as independent. Among other things, the rules exclude those who are employees of either the fund's investment adviser or its principal underwriter, as well as immediate family members of these individuals.[76] As a whole, the rules go quite far to eliminate from consideration all those with material ties to the fund's operations.[77]

Despite the detailed provisions designed to achieve the contrary, however, independent directors are in fact beholden to the adviser. As the SEC acknowledges, "'legal' independence does not equate with 'real' independence."[78] All direc-

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73. *See id.* § 270.0-1(a)(7)(i) (2005) (permitting at least 25% of the board to be affiliates of the adviser).

74. *See* 15 U.S.C.A. § 80a-15(c).

75. *See* 17 C.F.R. § 270.12b-1(b)(2).

76. Independent directors are technically those who are not "interested persons," as defined in 15 U.S.C.A. § 80a-2(a)(19) (West 2005).

77. *See id.*

78. Investment Company Governance, Final Rule, 69 Fed. Reg. 46,378 (Aug. 2, 2004) [hereinafter Fund Governance Release].]

tors, both independent and non-independent, are initially chosen by the investment adviser.[79] And though the "independent" directors may not be employees of the fund, the industry practice appears to be to choose individuals with personal ties to the adviser and its top officers.[80] The CEO's golf partner is just as unlikely to be a shareholder activist as the company's executive vice president.

Moreover, the composite of rules that define independence are largely undermined once an individual is chosen for board membership because the independent director, in substance, appears to be nothing more than an employee of the adviser – an individual the rules would have certainly eliminated. Since shareholders rarely participate in fund affairs, the compensation and tenure of independent directors – two touchstones of the employment relationship – are really under management's control.[81] Thus, the bonds of a de facto employee/employer relationship further compromise director independence. While on paper, an independent director's job description may require him to keenly watch over the manager, it is doubtful that this is really the way he will earn the company's loyalty.

In addition, independent director compensation is often quite high. At large fund families, directors can receive greater than $100,000 per year for their services,[82] with some complexes paying far more than that.[83] Such pay for what is in essence a part time job.[84]

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79. *See supra* notes 41-42 and accompanying text. Nominations for filling vacancies in their ranks are the job of the independent directors. *See* 17 U.S.C. § 270.0-1(a)(7) (2005). The extent to which the independence of these individuals is compromised casts doubt on whether they will select anyone more independent than themselves. *See* discussion *infra* pp. 99-101.

80. *See* BOGLE, NEW IMPERATIVES, *supra* note 5, at 362.

81. *See* PROTECTING INVESTORS REPORT, *supra* note 16, at 264 n.60; Kim, *supra* note 37, at 497.

82. *See* Carla Fried, *Unleashing Directors and Urging Them to Bark*, N.Y. TIMES, Apr. 4, 2004, at 3.

83. *See* Gretchen Morgenson, *Who's Watching Your Fund Manager?*, N.Y. TIMES, Sept. 14, 2003, at 31 (describing elevated compensation at some funds).

84. *See, e.g.*, Sara Calian & Robert McGough, *Part-Time Bonanza: Mutual Funds' Pay for Directors is Up, and So is Criticism*, WALL ST. J., May 5, 1995, at A1 (describing one outside director's work for a particular fund family as a part-time job – about two days a week – which consisted mostly of paperwork).

The high compensation raises further concerns about the independence of these directors. An independent director is not incentivized to staunchly defend shareholder rights when it could cost him his position and with it, his sizeable salary. Moreover, the pay rate suggests an implicit *quid pro quo* – high compensation in exchange for lax oversight – a suspicion supported by a recent Morningstar study that found a positive correlation between directors' compensation and fund fees.[85]

The lofty compensation agreements, as well as the other concerns mentioned above, demonstrate the extent to which "independent" directors have no reason to act that way. They are supposed to protect the interests of an amorphous group of strangers who, as discussed above, are not paying attention. Though it is contrary to their formal obligations, it makes much more sense for directors to curry favor with management – the company that controls their employment and to which they may have personal ties.

So far, this section has discussed the structural restraints on management overreaching in the fund context, and discussed why each check on its power – the shareholders, the board, and the independent directors – appear to lack either the tools or the incentive to truly act as effective monitors. The next section discusses why binding advisers and board members as fiduciaries does little to counterbalance these problems.

3. *Fiduciary Duties*

A fundamental concept of general corporate law is that the members of a board of directors are fiduciaries, meaning they owe the shareholders a duty of care and loyalty when tending to corporate matters.[86] The duty of care requires that the board attend to its duties with reasonable diligence.[87] And while it may appear that mutual fund board members are not conducting a thorough review of the matters entrusted to their care, proving a lack of reasonable diligence is quite difficult. The board's decisions are protected by the business judgment rule, under which board members' actions are typically upheld as long as they appear to fall within some range of ra-

85. *See* Kim, *supra* note 37, at 496-97.
86. *See* PROTECTING INVESTORS REPORT, *supra* note 16, at 255 n.10.
87. *See id.*

tionality.[88] Moreover, a board's decision to approve an advisory agreement is generally made pursuant to a consultant's report recommending such action.[89] Expert reports like this tend to shield boards from allegations that they have breached their fiduciary duty.[90]

More importantly, lack of care is not the central issue. To the extent a board's actions appear to be little more than a rubber-stamp, it is more likely the result of the inherent conflicts of interest rather than negligence. Such a claim implicates the duty of loyalty, but not the duty of care. The loyalty obligation takes many forms, but, loosely stated, it requires that board members act with fairness and good faith, and that they refrain from putting their own interests ahead of those of the corporation and its shareholders.[91]

Investors have filed lawsuits claiming that excessive fees constitute a breach of this duty. The standard erected by the courts in judging these claims, however, renders this theory of liability practically futile except in the most egregious circumstances. Once the shareholders or directors approve the fee, proof of a violation requires evidence that the fees were so shockingly excessive as to constitute a waste of corporate assets.[92]

To assist shareholders in overcoming this hurdle, Congress enacted Section 36(b) of the ICA. This rule provides for a fiduciary duty to shareholders with respect to the fees the adviser or its affiliates receive.[93] It is clear that fund advisers are implicated by this duty, but the extent to which board members are impacted is ambiguous. Though at one point the code provides for director liability,[94] it also requires that a defendant be the recipient of the challenged fees, seemingly

88. William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1296 (2001).

89. BOGLE, NEW IMPERATIVES, *supra* note 5, at 369.

90. *See* 3A FLETCHER ET AL., *supra* note 10, at § 1083.

91. *See id.* at § 837.60.

92. *See Saxe v. Brady, 184 A.2d 602, 615 (Del. Ch. 1962).*

93. *See* 15 U.S.C.A. § 80a-35(b) (West 2005).

94. *Id.*

excluding that group.[95] Based on this contradiction, many courts have found 36(b) inapplicable to fund boards.[96]

Lack of clarity with respect to the parties covered by this rule is only one concern. In addition, the statute says very little about how to determine whether a breach has occurred. The provision's main substantive guidance is that director or shareholder approval of the fee is only one factor courts are to consider in their review.[97] Given this ambiguity, judges have filled in the content of the legislation. Though there have been varied approaches, the seminal case is the Second Circuit's ruling in *Gartenberg v. Merrill Lynch Asset Management, Inc.*[98] In this case, the court adopted a standard noticeably similar to the approach in place under the common law duty of loyalty, holding that "to be guilty of a violation of § 36(b) . . . the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."[99] True to the legislature's mandate, in determining whether this standard was met in this case, the court viewed the informed consent of the independent directors as instructive, though not dispositive.[100]

This interpretation seems to leave the legislation nearly toothless. The advisers are protected from an adverse finding by a favorable standard that is rendered more so because it takes into account independent director approval, a group whose loyalty is suspect. Understandably, plaintiffs have a poor record when bringing excessive-fee cases under this doctrine.[101]

In the end, it seems that the threat of a lawsuit for breach of fiduciary duty is of trivial import. The board appears to

95. *See id.* § 80a-35(b)(3).

96. *See, e.g.*, Jerozal v. Cash Reserve Mgmt., Inc., 1982 WL 1363 (S.D.N.Y. Aug. 10, 1982); Cohen v. Fund Asset Mgmt., Inc., 1980 WL 1488 (S.D.N.Y. Mar. 31, 1980). *See also* Edward Brodsky & M. Patricia Adamski, *Law of Corporate Officers and Directors: Rights, Duties and Liabilities* § 17:04 (2005).

97. *See* 15 U.S.C.A. § 80a-35(b)(2).

98. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., *694 F.2d 923 (2d Cir. 1982).*

99. *Id.* at 928.

100. *See id.* at 930.

101. *See, e.g.*, Werner Renberg, *Sixth Men or Fifth Wheels: Do Fund Directors Earn Their Paychecks?*, BARRON'S, Aug. 12, 1991, at M14 (asserting that shareholders have lost every excessive-fee case).

have little to fear from litigation; only conspicuously wrongful conduct will be captured by the duty of loyalty. Moreover, the new standard in 36(b) shifts the focus of liability from the board to the adviser, potentially exposing the board to even less scrutiny. Despite this new duty, however, the adviser is unlikely to pursue higher fees with any less vigor; the statutory fiduciary duty to which it is now subject imposes very minimal restraints.

Moreover, any incentive for shareholder-friendly behavior that might be created by fiduciary duties is further undermined by the practical restrictions on board power; there are nearly insurmountable hurdles in the way of substantive change.

4. *Practical Constraints*

A fund board faces myriad incentives to favor the adviser. But even if directors were unbiased shareholder guardians, the practical restraints on their power would likely render them unable to fulfill their responsibilities.

Fund directors typically serve on multiple boards – sometimes as many as several hundred.[102] It seems unlikely that an individual sitting on many boards would have the time to attend to all of the tasks those numerous positions would require. It appears, therefore, that the common practice of interlocking board memberships stands in the way of proper governance. It also exposes the fiction of substantive board oversight; this phenomenon likely only exists because board members in practice undertake only a cursory review of fund affairs.

In addition, a fund board is largely handcuffed when negotiating the renewal of the fund's investment advisory contract – its most important duty. For a legitimate negotiation to take place, the board must have the option to opt out of the contract. Though this option may exist on a theoretical level, in reality, the threat of departure can be no more than a bluff. The adviser provides nearly everything necessary for the fund to function. In addition, it is responsible for the fund's very existence – it formed the fund, designed its strategy, and undertook all the risk commensurate with the fund's beginnings.

102. *See* Morgenson, *supra* note 83.

It appears unlikely that a board would decide to leave all this behind in favor of a new and untested rival company.

Other significant practical hurdles also exist. Though it is within the board's power to leave an adviser, shareholder consent is necessary to hire a new one.[103] Obtaining such consent would likely be a daunting task. The difficulty of capturing shareholder attention has already been described. Moreover, in this situation, those pushing for a new adviser would likely butt up against a management proxy campaign waged as a last ditch effort to remain in control of the fund. The current manager would have the inside track for many reasons. Among other things, shareholders may feel a sense of brand loyalty to their fund complex, they may have an affinity to the individual advising their fund, or they may simply be more comfortable with the status quo. Altering shareholders perceptions with respect to these subjective areas would be an overwhelming task.

In the face of the obstacles discussed so far, it appears unlikely that a board would choose to leave its adviser. And even if a board decided to do so, it would have to seek out a competitive adviser on its own because these companies rarely (if ever) compete for management of existing funds.[104] It is possible that advisers do not compete because they recognize how unlikely it is that a fund board would make such a move in the face of the systemic constraints on its action. More likely, however, is that potential competitors do not want to engage in price competition and thereby open the door to downward pressure on the management fees for their own funds. Given this disincentive to compete, a board would likely have trouble convincing a management company to even submit a proposal.

Indeed, such a request would likely catch a fund manager off guard, as fund directors generally do nothing to encourage competition among advisers: alternative managers are not invited for consideration in the periodic advisory contract review process.[105] Thus, it is the lack of initiative, on the part of both the fund boards and other management companies that leaves

103. 15 U.S.C.A. § 80a-15(a) (West 1997).

104. *See* John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Costs of Conflicts of Interest*, 26 J. CORP. L. 609, 655 (2001).

105. *See id.* at 655 n.205.

competition muted. The absence of any semblance of a competitive environment illustrates the extent to which the board's frequent review of the fund's advisory agreement is a mere formality – a conclusion supported by the fact that it is almost unheard of for a fund to switch advisers.[106]

This state of affairs is not surprising. The lack of competition, coupled with the other practical limits on the board's power, makes the prospect of changing managers unlikely even for a truly independent board. In the real world, where all board members are faced with substantial incentives to back the adviser, that option is illusory.

Looking at the structural and motivational landscape in which a fund board operates reveals that it lacks both the tools and the incentive to stand up to a fund's adviser. This being the case, relying on the board to check management power appears ill-advised.

C. *Summary*

A series of elaborate legal rules designed for the protection of shareholder interests is in place. But these laws, however well intentioned, have resulted in a Potemkin village – a complex façade that fails to protect against management overreach. Each level of oversight is undermined by conflicts of interest or practical impediments. As discussed below, it is the shareholders who suffer the repercussions of this faulty structure.

IV.
EVIDENCE OF SHAREHOLDER HARM

Plagued by conflicts of interests and other constraints, the intricate regime in place to curb management power has done a poor job of protecting shareholders in the key areas where their interests diverge from the interests of management. Evidence suggests that shareholders are paying too much for investment advisory services and that too much of their money is being spent on fund expansion.

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106. *See* Peter Tufano & Matthew Sevick, *Board Structure and Fee Setting in the U.S. Mutual Fund Industry*, 46 J. FIN. ECON. 321, 325 (1997) (this study revealed only three instances where a fund manager was replaced against its will).

A. *Mutual Fund Fees*

Studies show that mutual fund fees have consistently risen, as have assets under management. This combination provides a windfall for the investment adviser. The SEC issued a report several years ago that showed that expense ratios in the industry had climbed nearly 20% over the period from 1979 to 1999.[107] The analysis also indicated that assets under management had increased 8,520% over that time period – from $51.7 billion to $4.5 trillion.[108]

A study over a longer time period focusing only on equity funds produced even more alarming results. According to this analysis, in 1966 the expense ratio for the average equity fund was 0.87%.[109] By 2004 that figure was 1.62% (an 86% increase).[110] During the relevant time period for this study, assets for this type of fund grew from $26.3 billion to $3.7 trillion.[111]

With assets growing as they have, fees should be decreasing instead of rising. It has been shown repeatedly by various studies[112] and acknowledged by fund managers[113] that econo-

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107. *See* Sec. & Exch. Comm'n, *Division of Investment Management: Report on Mutual Fund Fees and Expenses*, Part III.C.2 (2000), *available at* http://www.sec.gov/news/studies/feestudy.htm.

108. *Id.* at Part III.C.1.

109. John C. Bogle, Founder & Former CEO, Vanguard Group, Remarks Before the Institutional Investor Magazine Mutual Fund Regulation and Compliance Conference: Mutual Funds in the Coming Century . . . While We're At It, Let's Build a Better World (May 5, 2004) (transcript available at http://www.vanguard.com/bogle_site/sp20040505.html).

110. *Id.*

111. *Id.* The mutual fund industry lobbying organization, the Investment Company Institute (the "ICI"), has repeatedly attempted to rebut the findings of the above mentioned reports. *See, e.g.*, ICI, *Total Shareholder Costs of Mutual Funds: An Update*, 11 FUNDAMENTALS 4 (2002), *available at* http://www.ici.org/pdf/fm-v11n4.pdf. The ICI's methodology, however, has been subject to compelling criticism. *See, e.g.*, John C. Bogle, Founder & Former CEO, Vanguard Group, Full Statement Before the U.S. House of Representatives Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services: Mutual Fund Industry Practices and their Effect on Individual Investors, Exhibit VII (Mar. 12, 2003) (transcript available at *http://www.vanguard.com/bogle_site/sp20030312a.html*); Freeman & Brown, *supra* note 104, at 621-27.

112. Freeman & Brown, *supra* note 104, 621-22.

113. *See* General Accounting Office, *Mutual Fund Fees Additional Disclosure Could Encourage Price Competition* 36 (2000) (citing industry officials inter-

mies of scale exist in the fund industry. Thus, the cost of fund management does not rise commensurately with assets, meaning that if fees per shareholder remain constant as assets increase, adviser profits climb. According to this same logic, economies of scale would allow an adviser to lower fees and maintain the same profit margin. This potential has not been realized, however, as advisers have continued to raise fees even in the face of diminishing relative costs.

Rising fees, combined with growing assets, give the advisers enormous returns. The vastly expanded asset base and higher fees means they are bringing in much more money overall. And the existence of economies of scale means that a greater percent of that is profit. This phenomenon is reflected in the pretax profit margins in the industry, which, even after the recent scandals, is reported to be 36%, far surpassing the returns earned by most other financial service providers.[114]

Fund boards, by permitting fee increases as assets climb, look more like the adviser's partner than its adversary. This complacence is similarly evident when considering the board's reaction to fund expansion efforts.

B. *Marketing of Fund Shares*

Share distribution is another area in which it appears that management has been given free reign. In order to increase assets under management, advisers spend vast amounts of money on marketing shares of their mutual funds – money that otherwise could be left with current shareholders. It was recently estimated that the mutual fund industry spends $10 billion per year on marketing, which at the time represented 20% of the total fees paid by investors.[115]

Such excessive expenditures highlight the lack of restraint within the industry. The absence of any board resistance, despite widespread knowledge of these expansive marketing efforts, further demonstrates the extent to which boards are ig-

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viewed as generally agreeing that economies of scale exist), *available at* http://www.gao.gov/new.items/gg00126.pdf.

114. Kristin Adamonis, *Fund Industry Embarks on Fee Diet*, FRC MONITOR, June 2004, at 1, *available at* http://www.frcnet.com/FreeResearch/FRC/pdf/Fund%20Industry%20Embarks%20on%20Fee%20Diet.pdf.

115. BOGLE, NEW IMPERATIVES, *supra* note 5, at 335.

noring shareholder interests – a phenomenon that was on display in the most recent scandals.

C. *Short-Term Trading Scandals*

The adviser's unchecked efforts to increase fund size were at the heart of the market timing and late trading scandals that came to light in the fall of 2003. This section describes the scandals, the advisers' motivation for participating in them, and the deleterious effect they had on shareholder returns. It also examines the resulting litigation and regulatory response.

1. *Market Timing*

Market timing generally refers to the practice of rapidly purchasing and selling securities in the hopes of earning a profit based on short-term movements in price. This strategy carries a fairly high degree of risk: if an investor guesses wrongly about the direction of the market, he may be met with sharp losses. Though many experts condemn this approach, it is not unethical or illegal.[116]

The market timing that earned the ire of regulators, however, was far less innocent. Investors who decide to play the market timing game quickly move their money in and out of mutual funds, but they virtually eliminate the risk of error by basing their predictions about the fund's price movements on a flaw in the way mutual funds are valued – a flaw that provides a clear signal of the fund's future direction. Because their risk of loss is eliminated, market timers engage in a form of arbitrage.

The mispricing that opens funds up to this strategy is the result of the following process: Mutual fund shareholders may buy and sell their shares at any time. When they do so, the price of each share is based on the fund's net asset value per share.[117] This is calculated by dividing the total value of the fund's portfolio by the number of shares outstanding. The calculation is performed once a day, usually at 4 p.m. eastern

116. *See, e.g.*, Carole Gould, *Mutual Funds; The Time Is Right. And Wrong, Too.*, N.Y. TIMES, Nov. 8, 1992, § 3, at 16 (discussing funds devoted to market timing).

117. 17 C.F.R. § 270.22c-1 (2005).

standard time – the closing time of the New York Stock Exchange.[118]

Mutual fund timers can take advantage of the fact that this price does not always reflect the actual value of the fund. Take for example the case of an international equity fund – one which holds in its portfolio stocks of companies traded on the Asian markets. When the market closes at 4 p.m. in New York, it is early morning in Asia, meaning that these securities have not been trading for many hours when their prices are taken into account in order to determine the value of a fund's portfolio. By this time, much may have transpired in other financial markets, making it clear whether the Asian exchanges will rise or fall when they reopen. If a market timer can tell from this information that – as a result of the stale prices in Asia – the fund will be undervalued when priced at 4 p.m., he can purchase the fund's shares only to sell them once the Asian markets rise and the value of the fund's portfolio increases commensurately. Conversely, if market timers can tell that the fund is overpriced, they can sell their fund shares and repurchase them once the true value is reflected. While much of the controversial market timing took place in international funds as described above, the same principle can be applied to take advantage of stale prices in funds that hold thinly traded domestic stocks or high-yield bonds.[119]

2. *Late Trading*

Late traders use a similar strategy – again taking advantage of mutual fund pricing. Late traders buy mutual fund shares after 4 p.m., but are allowed to engage in these transactions at the 4 p.m. price. This is advantageous because after the fund shares are valued, world markets may move in such a way that would indicate with high certainty what will happen to the fund's value the next day. Using this information, these traders can decide whether to buy or sell their shares, and then reap a profit once this information is reflected in the fund's net asset value. In one of the most highly publicized scandals, it was alleged that traders for Canary Capital were permitted to receive that day's price while entering into trans-

118. *See* Richard L. Levine et al., *Mutual Fund Market Timing*, FED. LAW., Jan. 2005, at 28.

119. *See id.* at 30.

actions as late as 8:30 p.m.[120] At that point, there would be ample information for these individuals to reasonably predict the next day's fund price.

3. *Impact on Shareholders*

Market timing and late trading have the potential to yield enormous profits to the arbitrageur. For example, investors market timing international funds can earn uncompounded returns in the range of 35% – 70% per year.[121] These profits come at the expense of long-term shareholders investing in the fund, who suffer in several respects.

When market timers or late traders move in and out of the fund, selling at artificially high prices and buying at artificially low ones, they are diluting the interests of the long-term shareholders. Take for instance an international equity fund with $500 million in assets and a net asset value of $25 per share. Assume that the fund holds stock in Asian markets, and that after shares in these companies cease trading, financial events in other parts of the globe make it clear that these exchanges will rise the following day. If market timers invest $6 million in the fund, and the following day the fund increases 2% in value, at which point they cash out,the market timers make a profit of about $120,000, more or less overnight. The long-term shareholders, however, would only earn 1.98%. 2 basis points are skimmed off the return by the market timers.[122] This is a result of the fact that the market timers' $6 million was not actually in the fund when it invested in the Asian markets; the investment was made after the fact at an artificially low price. Therefore, this money did not earn any return for the fund based on these market movements. Yet when it is withdrawn, the shareholders participate in the fund growth as if the money had been there all along, which in turn dilutes the return of the fund as a whole. Though a two basis point difference may seem small, it adds up in the long run. One commentator has estimated that the practice of market

120. Diana B. Henriques, *Spitzer Casting a Very Wide Net*, N.Y. TIMES, Oct. 12, 2003, § 3, at 1.

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

122. This example is drawn from Floyd Norris's, *Pile of Pennies Is Adding Up To a Scandal in Mutual Funds*. N.Y. TIMES, Nov. 1, 2003, at C1.

timing alone has recently cost shareholders $4 billion per year.[123]

Shareholders suffer other hidden slights as well. Market timing and late trading involve large influxes of cash in and out of the fund. As mentioned earlier, when a shareholder sells his shares in a mutual fund, the sale is made to the fund itself (i.e., the shares are redeemed). In order to ensure that it has enough money on hand to accommodate the large redemption requests of short-term traders, advisers must set aside large amounts of cash. This means that some shareholder funds are not invested pursuant to the fund's investment purpose. This is especially harmful in a rapidly appreciating market where this money could have been placed in high yielding investments. Similarly, if the fund is ever short on cash needed for redemption, it may be forced to sell off some of its investments, which may come at an inopportune time.

Finally, movements in and out of funds are not cost free; various intermediaries must be compensated for carrying out these transactions. These costs are paid out of fund assets and therefore reduce the returns for all shareholders.[124] With market timers and late traders consistently moving large amounts of money, these costs rise and aggregate investor returns fall.[125]

These expenses, together with the other side effects of short-term trading, lower the returns of the average investor. Short-term traders cannot carry out these strategies without the cooperation of the fund management companies.

4. *Adviser Participation*

During the recent scandals, the adviser and its staff generally did not benefit directly from the arbitrage opportunities that arise out of late trading and market timing (though there

123. *See* Zitzewitz, *supra* note 121, at 277.

124. *See* Request for Comment on Measures To Improve Disclosure of Mutual Fund Transaction Costs; Proposed Rule, Securities Act Release No. 33-8349, Exchange Act Release No. 34-48,952, Investment Company Act Release No. 26,313, 68 Fed. Reg. 74,820 (Dec. 24, 2003).

125. *See* Mutual Fund Redemption Fees; Final Rule, Investment Company Act Release No. 26,782, 70 Fed. Reg. 13,328 (Mar. 18, 2005) [hereinafter Redemption Fees Release].

are notable exceptions where advisory firm insiders took part in these activities).[126] More frequently, the advisers' gains were indirect; it appears they permitted the trades to go on in exchange for the promise that the participants would increase their investments in other funds managed by the adviser.[127] The SEC's finding with respect to Alliance Capital's transgressions noted the following:

> Alliance Capital permitted certain of its mutual funds to be timed by agreement with certain timers, and with brokers acting on behalf of timers. In return for this "timing capacity," Alliance Capital solicited, at various times and in varying proportions, timers to make long-term investments, so-called "sticky assets," in hedge funds, mutual funds, and other investment products managed by Alliance Capital.[128]

The drive to increase assets is motivated by the powerful lure of higher fees – the principal ramification of the conflict of interest between fund management and shareholders. Again, the words of the SEC are telling. In connection with the Alliance Capital proceedings, the Commission reasoned as follows:

> The fee structure through which Alliance Capital earned management fees meant that Alliance Capital earned fees from the timing relationships at the expense of long-term shareholders . . . Alliance Capital earned fees from management of mutual funds based on a percentage of assets under management, generally up to one percent. Thus, to the extent timers

126. *See, e.g.*, Riva D. Atlas, *Fund Executive Accepts Life Ban in Trading Case*, N.Y. TIMES, May 21, 2004, at A1 (describing the $60 million settlement paid by Richard Strong for market timing activities he engage in as CEO of Strong Capital Management).

127. *See* Cutler Testimony, *supra* note 6. John Coffee described the practice as a "pattern . . . in which the mutual fund's investment advisor receives an implicit bribe for permitting sophisticated investors to exploit retail investors." John C. Coffee Jr., *A Course of Inaction: Where was the SEC When the Mutual Fund Scandal Happened?*, LEGAL AFF., Mar./Apr. 2004, at 46.

128. In the Matter of Alliance Capital Management, L.P., Investment Company Act Release No. 26,312A, Jan. 15, 2004, ¶ 16, *available at http://www.sec.gov/litigation/admin/ia-2205a.htm.*

increased assets under management, Alliance Capital earned greater fees.[129]

Alliance is just one example of the many advisers caught up in these scandals. Like many others, it permitted these activities to go on in order to increase total assets, and therefore total fees.[130] As the incentives that triggered the illicit behavior are common to all externally managed funds, it is no surprise that short-term trading arrangements were found to exist industry-wide.[131] These scandals serve to demonstrate how flawed organizational incentives can lead to broad abuse.

The scandals also impeach the governance structure designed to protect shareholders from activities of this sort. According to former SEC Chairman Richard Breeden, "[v]iolations seem to have been committed or tolerated by people at the very highest level."[132] Moreover, in one of the most publicized scandals, it was alleged that the fund's independent directors were aware of the adviser's arrangement with market timers.[133] But the board's culpability is evident irrespective of the allegations in individual cases. The market timing that just recently came under fire has been in existence for decades. Long before the SEC stepped in, market timing was a well known industry practice that clearly hurt shareholders, yet fund boards did not resist it.[134] These broader implications were not lost on the SEC, which adopted a slate of reforms, aimed both directly at short-term trading and at the industry in general. This rule-making followed a flood of litigation.

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129. *Id.* ¶ 14.

130. *See, e.g.*, Floyd Norris, *Can Confidence Be Restored?*, N.Y. TIMES, Oct. 5, 2003, § 3, at 13 (discussing one of the abuses, the author explains "Bank of America officials seem to have been lured by the prospect of other business from the [market timer] . . . And a decision to put more money into a family of funds increases the management fees for the fund manager and, perhaps, allows marketing officials to meet their goals").

131. The SEC sent information requests to 88 of the largest mutual fund complexes. One-half of the companies admitted to having arrangements with market timers. *See* Cutler Testimony, *supra* note 6.

132. Diana B. Henriques, *A Sense Of History, A Feeling Of Betrayal*, N.Y. TIMES, Jan. 2, 2004, at C1.

133. *See* Fried, *supra* note 82.

134. *See* Zitzewitz, *supra* note 121, at 249.

5. *Government Response*

The market timing and late trading scandals are widely considered to be the largest ever to tarnish the industry.[135] Those implicated in the abuses were met with suits by the New York Attorney General and enforcement actions by the SEC, while the industry as a whole is now subject to a host of new federal regulations.

a. Litigation

The basis of the late trading allegations is fairly straightforward. According to Rule 22c-1 under the ICA, mutual fund purchases and sales are required to be priced in accordance with the next net asset value calculation following when an order is received.[136] By allowing those who place their trades after 4 p.m. to receive that day's price, advisers violated this rule.

Market timing, on the other hand, is not clearly illegal. The market timing suits brought against the fund companies alleged that they were permitting this activity contrary to their own stated policies. A fund's prospectus will often indicate that the fund either discourages, forbids, or limits market timing.[137] For example, the prospectus for the Janus High Yield Fund, one of the funds that was used as a vehicle for market timing, warned, "[f]requent trades in your account can disrupt portfolio investment strategies and increase expenses for all fund shareholders. The funds are not intended for market timing or excessive trading."[138] But such provisions were ignored, giving rise to suits based on violations of various securities fraud rules and breaches of fiduciary duties.[139]

The state and federal causes of action arising from the scandals led to more than $3 billion in fines and settlements

135. *See, e.g.,* Paul Krugman, *Fund and Games,* N.Y. TIMES, Nov. 18, 2003, at A25 (citing former SEC Chairman, Arthur Levitt, as calling the mutual fund abuses the worst financial scandal in 50 years).

136. 17 C.F.R. § 270.22c-1 (2005).

137. *See* Levine et al., *supra* note 118, at 32; *see* Cutler Testimony, *supra* note 6, at 18.

138. *See* Landon Thomas, Jr., *S.E.C. Putting Mutual Funds Under Scrutiny on Late Trading,* N.Y. TIMES, Sept. 5, 2003, at C1.

139. *See* Levine et al., *supra* note 118, at 32.

paid by fund advisers.[140] In addition, they inspired a bevy of reforms.

b. SEC Rulemaking

The Commission has recently been engaged in a flurry of rulemaking activity with respect to mutual funds. It enacted reforms aimed narrowly at late trading and market timing, and also took on larger issues such as internal controls and board governance. Despite the appearance of activity, however, the reforms are unlikely to help shareholders. Many of the rules overlap with current law or industry practice. Those that do mandate change will likely be undermined by the same flaws in the governance system that paved the way for the scandals to occur in the first place. The following sections detail the most important aspects of the SEC's recent reforms

i. Governance Reforms

The SEC recognized that the short-term trading abuses were both a reflection of the conflicts of interest between management and shareholders, and an indictment of the governance structure in place to control them.[141] Acknowledging that the recent scandals were symptomatic of a larger problem, the SEC adopted a handful of reforms designed to improve board oversight of management companies. One group of amendments was aimed at the actions of the board as a whole. The new rules require that the board conduct an annual self-assessment,[142] and that it explain to shareholders in its semi-annual reports[143] both the rationale behind its vote to approve the investment advisory contract, and the decision-making procedure that led to the approval.[144]

The central focus of the board governance reforms, however, was on increasing independence. Along these lines, the SEC adopted rules requiring that that the board chairman be

140. *See* Heather Timmons, *2 Fund Groups Agree to Pay $450 Million to End Inquiry*, N.Y. TIMES, Sept. 8, 2004, at C1.

141. *See* Fund Governance Release, *supra* note 78.

142. 17 C.F.R. § 270.0-1(a)(7)(v) (2005).

143. These reports, which include mainly financial information, are required by regulations under the ICA. *See id.* § 270.30e-1 (2005); SEC Form N-CSR, OMB No. 3235-0570, *available at http://www.sec.gov/about/forms/*formn-csr.pdf.

144. SEC Form N-1A, *supra* note 23, at Item 22(d)(6).

independent, that all independent directors meet alone once a quarter, and that 75% of the board be composed of independent members (unless the board consists of only three individuals, in which case two-thirds will suffice).[145] The new policies also require funds to explicitly authorize independent directors to hire experts and other staff to assist them in their duties.[146]

ii. Internal Controls

The SEC adopted a complementary approach to management oversight as well. These reforms focus on developing internal controls within funds and their advisory firms. To this end, the SEC now requires that funds[147] and their managers[148] have a system of policies and procedures in place designed to ensure compliance with federal securities laws. Since all of the fund's affairs are handled by its adviser and other ancillary service providers, its policies will designate how the fund board is to monitor whether those companies are complying with their own controls.[149] Additionally, both the fund[150] and the adviser[151] are now required to have a chief compliance officer (although the SEC admits that they will likely be the same person), whose job is to ensure that the policies are observed. The fund's chief compliance officer reports directly to the fund board and may be dismissed at its discretion so long as a majority of the independent directors concurs in the decision.[152]

In a similar vein, the SEC adopted rules requiring that each investment adviser adopt a code of ethics setting forth a "standard of business conduct" emphasizing the advisers' fiduciary obligations and mandating compliance with federal securities laws.[153] According to the SEC, such a code "should set out ideals for ethical conduct premised on fundamental prin-

145. *See* 17 C.F.R. § 270.0-1(a)(7)(i) (2005).
146. *See id.* § 270.0-1(a)(7)(vii).
147. *Id.*. § 270.38a-1.
148. *Id.* § 275.206(4)-7.
149. Compliance Release, *supra* note 4, at 74,717.
150. *See* 17 § C.F.R. 270.38a-1(a)(4) (2005).
151. *Id.* § 275.206(4)-7(a).
152. *Id.* § 270.38a-1(a)(4)(ii) (West 2005).
153. *Id.* § 275.204A-1(a)1, (a)2.

cipals [sic] of openness, integrity, honesty and trust."[154] The chosen standard, however the adviser chooses to express it, must be disclosed to potential clients.[155]

iii. Rules Directly Targeting Market Timing and Late Trading

In addition to the rules described above, focusing on broad oversight issues, the SEC enacted reforms targeted specifically at the recent abuses. These amendments focus on deterrence, monitoring, and disclosure. One deterrence measure permits funds to charge redemption fees of up to 2% for recently purchased shares.[156] Redemption fees cut into the profits of short-term traders, thereby making their strategy less attractive.

The SEC also adopted rules designed to increase shareholder transparency. It is common practice for broker-dealers to hold a number of mutual fund shares in an omnibus account. Redemptions are processed from that account, but the fund cannot see the identity of the parties for whom those trades are administered or their transaction histories, making it difficult to detect market timers and charge redemption fees to short-term traders. The new rules are designed to alleviate this problem by requiring that funds enter into agreements with the broker-dealers that process their trades requiring that the broker-dealers provide shareholder transaction and identification information at the funds' request.[157]

Lastly, the SEC adopted a series of disclosure rules. Fund prospectuses now must discuss the risks short-term trading poses to the shareholders at large and the protections the fund has in place to address those risks.[158] In addition, funds

154. Investment Adviser Code of Ethics; Final Rule, Investment Company Act Release No. 26,492, Investment Advisers Act Release No. 2256, 69 Fed. Reg. 41,697 (July 9, 2004) [hereinafter Code of Ethics Release].

155. *See* Form ADV, OMB No. 3235-0049, Part II, Item 9, *available at* http://www.sec.gov/about/forms/formadv.pdf.

156. *See* 17 C.F.R. § 270.22c-2(a)(1)(i) (2005).

157. *See id.* § 270.22c2(a)(2)(i). *See also* Redemption Fees Release, *supra* note 125, at 13330-31.

158. *See* Form N-1A, *supra* note 23, at Item 6(e). If a fund has arrangements permitting short-term trading, they must be described in the SAI. *See id.* at Item 18(e).

are required to explain when they use a technique known as fair value pricing, and the ramifications of this procedure.[159]

Fair value pricing is a strategy for defeating market timers, who make their profits based on the spread between the actual value of a security and the price used to value it by the fund. Funds have the freedom to minimize this spread by estimating the true value of the security and using that estimate when calculating the fund's net asset value. This is called fair value pricing. According to the new rules, a fund's policy regarding when and under what circumstances it will engage in fair value pricing must be described to its shareholders.

The SEC also included disclosure rules aimed at illuminating for shareholders certain attributes of fund management that played a role in the scandals. The new rules require a fund to discuss in its Statement of Additional Information any other accounts that are supervised by its portfolio manager, as well as the material conflicts of interest that may arise from these multiple responsibilities.[160] In addition, a fund must disclose certain details about the portfolio manager's compensation,[161] as well as the approximate value of fund securities owned by the manager.[162]

The disclosures in the paragraph above relate to the conflicts of interest motivating management's participation in the scandals. As discussed earlier, the primary reason advisers curried favor with short-term traders was to secure greater assets under management. The entity-level motivation to increase fund size leads to compensation structures that encourage this result. Portfolio managers are paid based on the value of the funds they manage.[163] Thus, getting a boost of assets from short-term traders could directly increase compensation. Moreover, if a manager runs more than one fund, he or she can reap potentially large rewards by permitting market-timing

159. *Id.* at Item 6(a)1.

160. *Id.* at Item 15(a).

161. *Id.* at Item 15(b).

162. *See id.* at Item 15(c).

163. Disclosure Regarding Portfolio Managers of Registered Management Investment Companies; Final Rule, Securities Act Release No. 33-8458, Exchange Act Release No. 34-50,227, Investment Company Act Release No. 26,533, 69 Fed. Reg. 52,791 (Aug. 27, 2004) [hereinafter Manager Information Disclosure Release].

in one fund in exchange for placement of long-term assets in a different fund.

Disclosures relating to compensation structure and overlapping fund management positions shed light on this conflict. Giving shareholders insight into the size of a manager's ownership interest is designed to help in a similar fashion. It allows "investors [to] assess the extent to which the portfolio manager's interests are aligned with theirs."[164] The greater their personal investment in the fund, the less likely it is that the managers will permit activities, such as short-term trading, that undermine fund returns.

Portfolio managers and their funds face the task of complying with an entire slate of reforms. The SEC amendments touch on both the highest levels of fund governance and the technical details of shareholder accounting. Though the new rules are broad in scope, their impact will probably be largely superficial.

c. Analysis of SEC Reforms

The SEC's new rules do not appear to be a significant step forward. One striking aspect of these reforms is the extent to which they overlap with rules that were already in place or mandate what was already industry practice. In addition, the amendments that do add new responsibilities depend on a high level of shareholder interest and an active board – attributes that have proven to be lacking thus far.

i. Similarity to the Former State of Affairs

Many of the newly adopted regulations go little beyond preexisting law and industry practice. This is true for those rules focused on board governance as well as those concerning internal controls or specifically aimed at short-term trading.

With respect to the governance rules, only the independent chairmanship requirement and the amendment mandating a heightened proportion of independent directors appear to usher in substantive change. Only 20% of funds have independent chairmen and most funds have boards that are only

164. *Id.* at 52,792.

two-thirds independent.[165] The other reforms are mild. The new rules mandate that a fund's independent directors be explicitly authorized to hire their own staff.[166] This merely requires funds to inform directors of what is already their legal right.[167] In addition, the new prospectus disclosure regarding the board's decision-making process with respect to advisory contracts is mainly just a change of location. Similar information was already required in the SAI and shareholder proxy statements.[168] Finally, it was already common in the industry for funds to conduct annual self-assessments[169] and have separate meetings of their independent directors.[170]

The new internal control rules are also largely redundant with current law or practice. At the time of adoption, the SEC conceded that compliance programs complete with complex oversight mechanisms were largely already in place. According to a release on this topic, "many . . . funds and advisers . . . have well-staffed compliance departments. Many conduct periodic reviews of their compliance programs and some hire independent compliance experts to review the adequacy of their compliance programs and the effectiveness of their implementation."[171] Indeed, this leaves little to improve on. Moreover, ethical codes were already a legal mandate. In arguing that this new requirement would impose few costs, the SEC admitted that advisers were "already required to maintain various policies and procedures that would constitute core elements of their codes of ethics."[172]

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165. Fund Governance Release, *supra* note 78, at 46,391 (dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins).

166. 17 C.F.R. § 270.0-1(a)(7)(vii) (West 2005).

167. *See* Fund Governance Release, *supra* note 78, at 46,387.

168. Methodology Disclosure Release, *supra* note 70, at 39,798-99 & n.16.

169. *Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Understanding the Fund Industry from the Investor's Perspective Before the Senate Committee on Banking, Housing, and Urban Affairs,* (Feb. 25, 2004) (testimony of James S. Riepe, Vice Chairman T. Roe Price Group, Inc.) (transcript available at *http://www.ici.org/statements/tmny/04_sen_riepe_tmny.html).*

170. Fried, *supra* note 82.

171. Compliance Release, *supra* note 4, at 74,724.

172. Code of Ethics Release, *supra* note 154, at 41,703.

The same trend appears in the rules aimed at market timing and late trading. The new rules only clarify[173] an existing regulation mandating discussion of fair value pricing.[174] Moreover, it was already common practice for funds to discuss their policies on short-term trading.[175] In fact, fund non-compliance with *disclosed* market timing policies was the basis of the government lawsuits.[176]

A few of these rules, however, do usher in change. The SEC's acceptance of a 2% redemption fee is a retreat from its former position. While such fees were permitted before, the SEC required that they be tied strictly to the costs incurred in processing the transaction.[177] In addition, the rules requiring greater transparency from broker-dealers with respect to shareholder information reflect a departure from the previous state of affairs. The same is true for reforms that mandate increased disclosures concerning a portfolio adviser's compensation, fund ownership and role within the complex.

That said, the fact that many of the rules are of little substance should not be ignored. Adopting reforms that are such in name only is not innocuous. As Commissioners Glassman and Atkins put it in their dissent to the newly adopted governance rules, the impetus behind many of these reforms may have been to "appear proactive."[178] Creating this appearance does not benefit shareholders. If the SEC looks aggressive, it merely reinforces shareholder apathy. If they believe the SEC has the problem under control, there is no reason for them to take action.

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173. Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Securities Act Release No. 33-8408, Investment Company Act Release No. 26,418, 69 Fed. Reg. 22,300 (Apr. 23, 2004) (to be codified at 17 C.F.R. pts. 239, 274) [hereinafter Short-Term Trading Disclosure Release].

174. Registration Form Used by Open-End Management Investment Companies, Securities Act Release No. 33-7512, Exchange Act Release No. 34-39,748, Investment Company Act Release No. 23,064, 63 Fed. Reg. 13,915, 13,933, 13,933 n.153 (Mar. 23, 1998) (to be codified at 17 C.F.R. pt. 230).

175. Compliance Release, *supra* note 4, at 74,720.

176. *See infra* p. 111.

177. *See* Redemption Fees Release, *supra* note 125, at 13,331. *See also* Neuberger and Berman Genesis Fund, Incorporated, SEC No-Action Letter, 1988 WL 235038, at *3-*4 (Sept. 27, 1988).

178. Fund Governance Release, *supra* note 78, at 46,392.

Moreover, the rationale behind mandating what is already industry practice seems especially tortured. The short-term trading scandals are just the latest example of the extent to which long-term shareholders are an industry afterthought. Therefore, if these safeguards are already in place, they have proven themselves ineffective. As such, universal implementation should add little.

Problems with the underlying rationale are not confined to this area. Even the substantive reforms rest on a shaky foundation.

ii. Misplaced Reliance on Active Oversight

Those rules that add new obligations will likely have muted impact because they fail to take into account the blasé attitude shareholders and boards have shown toward fund affairs. One theme of the reforms has been to add disclosure. For instance, shareholders now have broader access to information about the board's management contract review process and the portfolio manager's compensation, overlapping responsibilities, and fund ownership. The theory is that shedding additional light on these aspects of fund operations will spur reform, as shareholders reward those companies with progressive policies, and others change their behavior in order to keep up.[179]

Though the concept is sound, the SEC's application is flawed. Only if investors read and understand the disclosures will they be able to use them in their decisions. However, shareholders have a history of apathy concerning matters relating to their mutual fund ownership.[180] In order to reach them, therefore, disclosure should be straightforward and placed in a location where shareholders are likely to see it. The reforms adopted by the SEC have neither attribute: the new disclosures are not overtly connected to central shareholder concerns and they are buried deep in fund disclosure materials.[181] Consequently, the reforms are unlikely to bring about change.

179. *See, e.g.*, Manager Information Disclosure Release, *supra* note 163, at 52,798.

180. *See infra* pp. 96-97.

181. *See infra* pp. 112-115.

Moreover, the new requirements are not cost-free. Though some advisers may absorb the costs, others will likely pass them on to shareholders. According to some estimates, the new disclosures could end up costing individual shareholders $55 – 125 per year.[182] It is quite possible that these added requirements could hurt shareholders more than they help them.

Shareholder apathy is not the only issue skirted by these reforms. Generally, the rules reaffirm the SEC's faith in the board and the role of independent directors. Several of the reforms depend entirely on the actions of the board. For instance, the SEC's redemption fee rule, as originally proposed, required all funds to charge such fees. As enacted, however, they are not required, but may be imposed if the board determines they are in the fund's best interest.[183] In addition, the new rules requiring that broker-dealers provide shareholder identity and transaction details only apply when the board asks for such information.[184]

This reliance on the board is misplaced. As discussed previously, the board of directors is a body riddled with conflicts of interest that has remained passive as management has increased fees and taken steps to maximize assets under management – including facilitating late trading and market timing.[185] It does not follow to place further discretion regarding such matters in its hands.

The SEC, however, may be hoping that other reforms make the prospect of meaningful board oversight more likely. One step in that direction – the requirement of annual self-assessments – seems only peripheral. Rather, the focus is on rules designed to increase the influence of independent directors: they will now dominate in number, one among them will hold the most important position on the board, and they must meet independently each quarter.[186] These reforms attempt

182. Riva D. Atlas, *For Mutual Funds, First the Slap. Now Comes the Pinch*, N.Y. TIMES, Aug. 26, 2004, at C1.

183. Redemption Fees Release, *supra* note 125, at 13,329-31.

184. *See* 17 C.F.R. § 270.22c-2(a)(2)(i) (2005).

185. *See infra* pp. 98-110.

186. *See* 17 C.F.R. § 270.0-1(a)(7) (2005).

to create an atmosphere where the ideas of the independent directors may freely manifest themselves.[187]

This goal, even if achieved, is unlikely to help. The problem is not that the perspective of the independent director is being quashed.[188] Rather, the problem is that the entire board speaks with one management-friendly voice as a result of the conflicts of interest inherent in the governance system. Since independent directors do not adequately protect shareholders, it is futile to give them more clout.

In sum, the SEC's recent reforms are unlikely to alter the industry landscape. Many of the new rules diverge little from the state of affairs at the time of the scandals, and those that do mark substantive change unrealistically rely for their impact on shareholder and board activism. Thus, despite the recent flurry of activity, mutual fund regulation still appears to be lacking. Management's incentive to maximize fees and fund size still exits, and little has been done to protect shareholders from overreaching in this regard.

V.
A Market-Based Proposal for Reform

The root cause of the problems discussed in this paper is the external management structure prevalent in the mutual fund industry. Because fund advisers earn a profit by maximizing the amount of fees, they are incentivized to act contrary to shareholder interests. An elaborate governance structure is in place to protect fund investors from management abuse, but these controls have proved ineffective. The recently adopted measures do little to change this.

When funds are managed internally, the conflict of interest between managers and shareholders that has contributed to excessive fees, extensive marketing efforts, and the short-term trading scandals is eliminated. This alternative structure should not be forced upon the industry, but the SEC should

187. *See, e.g.*, Fund Governance Release, *supra* note 78, at 46,381 (expressing the concern that "many boards continue to be dominated by their management companies").

188. *See, e.g.*, Fried, *supra* note 82 (quoting Marvin L. Mann, lead independent director at Fidelity, as saying "I cannot think of one instance . . . where I or any other independent director wanted to put something on the agenda and met resistance from management").

take steps that will assist market forces in moving the industry in that direction.

A. *Internal Mutual Fund Management and Its Virtues*

Not all mutual funds are mere shell entities, completely dependent on their advisers for survival. A fund can be run by its own board of directors, officers, and employees.

This structure significantly alters management incentives. An external management company earns profit for its owners through the fees it collects. Thus, it is motivated to increase assets under management and the amount charged to each investor – both of which are detrimental to fund shareholders.[189] Once management is brought in house, however, this conflict of interest disappears. No longer are managers beholden to owners seeking fee-based profits. Those working for the fund serve only one constituency – the fund shareholders – and their interest is in lower fees. Moreover, since there is no longer the drive to increase the total amount of fees, there is no longer an incentive to increase fund size beyond the point where it is advantageous to shareholders. Thus, internally managed funds have no reason to engage in extraordinary marketing measures or to cooperate with late traders or market timers. In sum, internal fund management alleviates the conflicts of interest that motivate the shareholder harms discussed in this article.

Further, the theory that internally managed funds would better represent shareholder interests has proven true in practice. In the 1960's the SEC became concerned with the growth of the mutual fund industry and whether economies of scale were being shared with fund shareholders. It commissioned a study by the Wharton School[190] (the "Wharton Study") and followed that with its own review (the "Public Policy Report").[191] Both pieces concluded that the internally managed funds of the time had consistently lower fees than the remainder of the industry.[192] In fact, according to the SEC's findings,

189. *See infra* pp. 93-95.

190. WHARTON SCHOOL OF FINANCE & COMMERCE, A STUDY OF *Mutual Funds*, H.R. REP. NO. 87-2274 (1962) [hereinafter WHARTON REPORT].

191. SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337 (1966) [hereinafter PUBLIC POLICY REPORT].

192. *See id.* at 103; WHARTON REPORT, *supra* note 190, at 485.

the fees for internally managed funds were a bit more than half those of its larger competitors.[193]

The benefits of internal management are clearly evident today as well. The Vanguard Group, the second largest mutual fund complex,[194] is internally managed.[195] This company has eschewed the trend toward high fees and vast marketing arms. Vanguard's fees are consistently lower than those of its competitors. While the industry's average expense ratio in 2004 was 1.35%, Vanguard's was only .23%.[196] The disparity holds true when comparing funds with similar investment strategies as well. A study showed that the company's domestic equity funds, for instance, had costs that were far lower than its competitors.[197]

The difference is equally stark when looking at the pursuit of new shareholders. The average mutual fund spends enormous amounts on advertising, while Vanguard spends relatively little.[198] Moreover, Vanguard has made headlines for closing some of its most successful funds for fear that they would soon grow too large. For example, the company closed its vastly popular Windsor fund in 1985.[199]

Finally, Vanguard was left unscathed by the recent scandals, as it was not implicated by the SEC or the New York Attorney General.[200] Again, this follows from the company's struc-

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193. *See* PUBLIC POLICY REPORT, *supra* note 191, at 11.

194. Tim Gray, *Mutual Funds Report: Vanguard Sprints but Says It's Not Racing*, N.Y. TIMES, Jan. 9, 2005, at § 3, at 25.

As of May last year, Vanguard's market share was 9.6%. John C. Bogle, Founder & Former CEO, Vanguard Group, Remarks On Receiving the First Lifetime Achievement Award of Marketing: Marketing and Fiduciary Duty – Strange Bedfellows? (May 12, 2004) (transcript available at *http://www.vanguard.com/b*ogle_site/sp20040512.htm).

195. *See* BOGLE, NEW IMPERATIVES, *supra* note 5, at 376.

196. Gray, *supra* note 194.

197. *See* Freeman & Brown, *supra* note 104, at 638. The portfolio advisory services for Vanguard's actively managed equity funds tend to be outsourced to other fund managers in the industry. Vanguard's staff monitors these companies and negotiates extremely low fees on behalf of its shareholders. *See id.* at 638-39; ROBERT SLATER, JOHN BOGLE AND THE VANGUARD EXPERIMENT: ONE MAN'S QUEST TO TRANSFORM THE MUTUAL FUND INDUSTRY 123 (1997).

198. Thomas Easton, *The Gospel According to Vanguard*, FORBES, Feb. 8, 1999, at 114.

199. SLATER, *supra* note 197, at 172-73.

200. Atlas, *supra* note 182.

ture; its management, feeling no pressure to increase fund size, had no incentive to cater to short-term traders. The company's rectitude also likely stems from its active use of fair value pricing.[201] Vanguard is one of the few companies that employs this shareholder-friendly preemptive measure.

Both theory and observation support the conclusion that shareholders of internally managed funds are better served than those that have entrusted their money to external advisers. If all funds were managed by their own staff, the injustices noted above would likely fade away. The question, therefore, becomes how to effectively restructure the industry.

B. *Mandated Restructuring*

One way to bring about reorganization is to require that funds be managed internally. Though mandating this structure is theoretically attractive, it is unrealistic and uncalled for at this time. In its Public Policy Report, the SEC considered this alternative. It conceded that it was the most direct way to address the conflicts of interest in the mutual fund industry, but dismissed the option as too sweeping.[202]

This assertion is still valid today. It is arguable that the recent scandals, along with the other abuses in the industry, more than counterbalance the Commission's earlier concerns regarding the magnitude of such a move. But while the need for reform may be even graver, the prospect of mandating internal fund management is at least commensurately more drastic. When the SEC originally considered this proposal, the industry was diminutive by comparison – funds had a total of $38.2 billion[203] under management. The figure is now more than 200 times that,[204] making industry-wide restructuring a truly vast undertaking.

At this time, such a move is probably out of reach. The industry's lobbyists are extremely powerful: recent victories include winning exemption from major portions of the Sarbanes

201. Diana B. Henriques, *A Band-Aid for the Fund Industry's Broken Leg?*, N.Y. TIMES, Nov. 21, 2003, at C1.

202. PUBLIC POLICY REPORT, *supra* note 191, at 147.

203. *Id.* at 2.

204. FACT BOOK, *supra* note 1, at 59 (includes a table indicating total net assets in the industry of $8.1 trillion).

Oxley Act[205] and watering down a House bill passed in response to the short-term trading scandals.[206] Extensive change would probably also be fought from within the federal government. Chairman Donaldson, who presided over the SEC's mild response to the short-term trading abuses and is now retired, was derided for being an overly ambitious regulator.[207] On top of that, certain of the recent governance reforms were challenged by the U.S. Chamber of Commerce.[208]

A battle with these forces is one the SEC is unlikely to win, and should be avoided at this time. An incremental approach is a more suitable solution at present. In general, a less intrusive measure should be given a chance to work before a drastic alternative is chosen. In this case, a viable hands-off strategy is available.

C. *Building a Competitive Fund Marketplace by Cultivating Investor Knowledge*

Disclosure has long been utilized as a tool to encourage a more efficient allocation of shareholder resources. Most recently, it was incorporated into new rules promulgated in the wake of the short-term trading scandals. When justifying its newly mandated disclosures regarding a fund's market timing policies, for instance, the Commission pointed to two related benefits. First, exposing shareholders to such information enables them to channel their money to funds with favorable policies. Additionally, the increased demand for funds with these policies will prompt other funds to adopt them.[209] By increas-

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205. *See* Stephen Labaton, *S.E.C.'s Oversight of Mutual Funds is said to be Lax*, N.Y. TIMES, Nov. 16, 2003, at 11.

206. *See* Stephen Labaton, *S.E.C. Plan Would Force Fund Board's to Change*, N.Y. TIMES, Jan. 15, 2004, at C1.

207. Joseph Nocera, *Donaldson: The Exit Interview*, N.Y. TIMES, Jul. 23, 2005, at C1.

208. The D.C. Circuit found that the SEC's analysis on which certain reforms were based had fallen short, and mandated that the Commission consider them further. *See* U.S. Chamber of Commerce v. Sec. & Exch. Comm'n, 412 F.3d 133 (D.C. Cir. 2005). This was quickly done, and the rules were reaffirmed by the SEC in one of Chairman Donaldson's last acts in office. *See* Investment Company Governance; Final Rule, Investment Company Act Release No. 26,985, 70 Fed. Reg. 39,390 (July 7, 2005).

209. *See* Short-Term Trading Disclosure Release, *supra* note 173, at 22,310-11.

ing investor awareness, the SEC is hoping that market forces will cause the industry to reform itself.

The same concept can be applied to the issue of fund management structure. Internally and externally managed funds offer essentially the same product – portfolio advising. The central task of those running a fund is picking securities that will offer the fund's investors the best returns. Internally managed funds, however, have an enormous competitive advantage in providing this service: they offer lower fees and are unburdened by deleterious conflicts of interest.

If shareholders understand this weighty information, they frequently will have a strong incentive to allocate their investments to internally managed funds. Moreover, the heightened demand for such funds should lead to the creation of more run in this manner. Increasing investor awareness thus carries the potential to reform the industry through shareholder choice rather than SEC mandate.

1. *Improving the Quality and Availability of Investor Information*

In order to recognize the benefits of internal management, shareholders must be exposed to compelling information on the topic. The SEC has enacted numerous reforms over the past half-century designed to give shareholders access to sound fund data. In addition, an entire industry has developed that bombards investors with endless information. A wealth of research and analysis can be found on websites like morningstar.com and in a vast array of publications.

Despite these developments, investors lack pertinent knowledge that bears on important aspects of their investment decisions. Certain information gets lost in the clutter and some remains mostly out of sight. In order to improve investor knowledge, the SEC should undertake measures to highlight the costs associated with mutual fund ownership and expose investors to how mutual funds are structured.

Currently, investors are under-informed about costs and do not view them as a central consideration in their investment decisions, despite their undeniable impact on returns.[210] This apathy is something the SEC needs to address. Getting shareholders to understand the long-term effects of fees on

210. *See* Alexander et al., *supra* note 58, at 11-13.

their investments is central to creating a competitive environment amenable to internally managed funds. This is where the benefits of an internal structure are most clearly evident. But only if shareholders understand the ramifications of lower costs will they recognize this advantage.

In addition to more poignant fee disclosure, the SEC should mandate enhanced discussion of management structure. The Commission has emphasized repeatedly the conflicts of interest inherent in traditional external management, without mentioning that an alternative exists. Instead of ignoring internal management, the SEC should take steps to make structure a mainstream consideration in the investment decision. If investors realize that there is an alternative to the conflict-plagued status quo, then they will likely take it.

Reaching investors, however, is not an easy task. Mutual fund matters rarely piqué shareholder interest. Moreover, there is heavy competition for their attention because so much information is already provided. Ignoring this state of affairs likely renders new disclosures meaningless.

Careful placement, however, can overcome these hurdles. The SEC has an overabundance of disclosure documents at its disposal to help it cut through this morass – and several stick out as the most likely to capture an investor's eye. These include fund prospectuses, defined contribution plan documents, and shareholder account statements. Moreover, to emphasize these new disclosures, the SEC should draw attention to them – through public statements, press releases or otherwise – when they are released. These steps should go far to ensure that this important information does not go unnoticed.

a. Prospectus Disclosure

The prospectus is the primary federally mandated disclosure document and is a resource relied on heavily by investors.[211] It is the place where investors would expect essential information to be found. Therefore, cost and management structure information should be prominently featured in this document.

Fund prospectuses are already required to include detailed fee information, including a table showing the cost that

211. *Id.* at 9.

a particular shareholder would incur with a $10,000 investment over a one, three , five, and ten year period.[212] But the prospectus is not required to include information about a fund's management structure. Such information should be required. A fund should have to explain whether it has its own employees or instead relies on an adviser. The discussion should detail the conflicts of interest that may inhere in a fund's particular structure, along with the steps taken to combat them. Those shareholders who take the time to read the prospectus will be alerted to this important component of the fund in which they are considering investing. For those shareholders not so inclined, the SEC should reach out through more approachable mediums.

b. Employee Contribution Plan Disclosure

The last dozen years have been marked by tremendous growth in participant-directed defined contribution plans, e.g., 401(k) programs.[213] These plans, whereby investors place a portion of their salaries (often partially matched by a contribution from their employer) into a retirement account, are replacing defined benefit plans in which an employer would guarantee payments of a certain amount to employees upon retirement.[214] Whereas before, the employer would choose how to invest employee money in order to provide a set return, now it is the investors' job to manage their investments wisely. This represents a tremendous shift in money management responsibility from the employer to the employee. When employees choose to participate in a plan, they often have to select one of several options with investment strategies that vary along the risk/reward spectrum.

A large portion of these savings plan contributions has found its way into mutual funds. In fact, in 2004 the fund industry claimed $1.1 trillion in 401(k) assets (up $170 billion from the year before).[215] This new mechanism for mutual fund investment raises several issues in terms of investor aware-

212. Form N-1A, *supra* note 24, at Item 3.

213. *See, e.g.*, FACT BOOK, *supra* note 1, at 41 (showing asset growth in 401(k) plans from $553 billion to $2.1 trillion from 1992 through 2004).

214. *See* Eduardo Porter, *When it Comes to Managing Retirement, Some People Simply Can't*, N.Y. TIMES, Mar. 18, 2005, at C3.

215. FACT BOOK, *supra* note 1, at 41.

ness. A study conducted in the mid-nineties, which compared investor savvy according to the purchasing channel utilized when making an investment, found that those who invested in mutual funds through their participation in employer pension funds were the least knowledgeable about their affairs. When responding to a nine question quiz testing general mutual fund awareness, these individuals answered on average only 1.57 items correctly.[216] Meanwhile, the average for investors who had invested in a fund through only one channel was 4.4.[217] Moreover, pension fund investors were particularly behind with respect to knowledge about fund expenses.[218]

This is unsurprising considering that, though the investment alternatives provided to employees vary in terms of strategy, it is rare for an employer to provide multiple options with similar investment parameters at different costs.[219] Thus, the issue of cost may be muted for these investors because they are forced to accept the only option provided for them given the investment strategy they prefer.

There is hope, however, that improved disclosure could increase awareness among these investors. According to the survey mentioned above, investors consider the employer-provided materials as the best source of information regarding their mutual funds.[220] This suggests that investors actually pay attention to these documents, making them an ideal location for disclosure regarding costs and structure.

Currently, plan documents have little mandated content with respect to these items. Disclosure to participants in such plans falls under the auspices of the Department of Labor, and pursuant to regulations under Section 404(c) of the Employment Retirement Income Securities Act, employers must provide certain information in order to claim immunity from shareholder suits arising out of poor investment returns.[221]

Right now these rules require that information concerning the annual expenses of a plan's investment alternatives be

216. Alexander et. al., *supra* note 58, at 17.

217. *Id.*

218. *Id.* at 12.

219. *See id.* at 12.

220. *Id.* at 10.

221. *See* 29 C.F.R. § 2550.404c-1 (2005).

available upon request.[222] Instead, the code should mandate such information be included in documents delivered to employees. In addition, simplified disclosure should be mandated that discusses the impact of these costs over time. The best way to handle this is to require that the fee table found in fund prospectuses be duplicated.[223]

The prospectus should also serve as the model for disclosure of management structure. Like the prospectus, plan documents should include a description of the mechanics of a fund's operations. Including this information will help reinforce to investors that structure is an important component of a fund's makeup.

Through improved prospectus and benefit plan disclosure, investors can be informed at the time of their initial decision. But new investors should not be the only target. Because mutual fund shares can be redeemed at any time, investors have the ability to constantly reevaluate their commitment to a particular fund. Account statements are the most promising location for capturing the attention of current shareholders.

c. Shareholder Account Statements

Shareholders often lose track of fees after they make their initial investments.[224] The SEC, however, has recently enacted reforms increasing ongoing disclosure. Most importantly, these rules require that a fund disclose in its semi-annual shareholder reports the dollar amount in fees an investor with a $1,000 investment would have paid given the fund's expense ratio and returns.[225]

This new disclosure requirement is a step forward, but it does not go far enough. It is useful for shareholders to see fees in terms of dollars rather than percentages, but it would be much more helpful if the information pertained directly to the shareholder's particular investment. In other words,

222. *Id.* § 2550.404c-1(b)(2)(i)(B)(2)(i).

223. *See* Form N-1A, *supra* note 23, at Item 3 (describing the fee table).

224. *See supra* note 58 and accompanying text.

225. Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies; Final Rule, Securities Act Release No. 33-8393, Exchange Act Release No. 34-49,333, Investment Company Act Release No. 26,327, 69 Fed. Reg. 11,244, 11,246 (Mar. 9, 2004) (to be codified at 17 C.F.R. pts. 210, 239, 249, 270, and 274).

shareholders would benefit if told directly the fees they paid over the relevant time period.

This option was eschewed as too costly by the SEC, which relied for its conclusion on an estimate by the industry's lobbyists (the Investment Company Institute).[226] The expenses, however, are a subject of debate. In its own study, the Government Accountability Office (the "GAO") concluded that on a per shareholder basis they would not be exorbitant.[227] The GAO also looked at the Investment Company Institute's figures and concluded that even under those estimates, costs would be manageable.[228] Given this information, it seems that mandating such disclosure would be advisable.

Moreover, instead of being hidden in shareholder reports, such information should be included in account statements. A recent survey showed that shareholders pay attention to these documents.[229] Indeed, the impact of costs should jump out at investors if they see their returns juxtaposed next to the fees paid – especially in a time of slumping profits.

Through increasing disclosure in the ways mentioned above, the SEC can draw shareholder attention to cost and structure. But the impact would be far greater if the Commission makes an effort to actively engage the issues.

d. Drawing Popular Attention

To reinforce these new disclosures, the SEC should do its best to publicize them. In addition to issuing releases concerning these measures, this means scheduling press conferences, writing press releases, and discussing the measures when relevant at other public forums. In its discourse, the Commission should be candid about the impact of costs and management structure on shareholder returns. It should explain the concerns with external management that motivated

226. *See id.* at 11,247.

227. *See* Richard J. Hillman, Director, Financial Markets and Community Investment, General Accounting Office, Testimony Before the Subcommittee on Financial Management, the Budget and International Security, Committee on Governmental Affairs, U.S. Senate: Mutual Funds: Additional Disclosure Could Increase Transparency of Fees and Other Practices 6 (Jan. 27, 2004) (transcript *available at* http://www.gao.gov/new.items/d04317t.pdf).

228. *See id.* at 6-7.

229. *See id* at 5-6.

the new rules and its hope that added disclosure with respect to these issues will bring about reform.

If the SEC can capture the public's interest, the measures will be much more effective. History shows that market pressure has come to bear on the industry when it has been in the spotlight. Attention brought to the industry by the Wharton Study and a series of fee-related shareholder suits led to some decline in fees at that time.[230] More recently, those companies most severely implicated by the recent short-term trading scandals have suffered significant shareholder exoduses. For example, as of June 2004, Janus lost $20 billion in assets and Putnam had $35 billion withdrawn just from its stock and bond funds.[231] In addition, the added attention brought on by the scandals led to some lowering of fees. By July 2004, twice as many funds had actually lowered fees as had done so the previous year.[232] These past trends shows that public scrutiny can change behavior. With this in mind, the SEC should do its best to draw attention to these reforms.

By mandating that funds improve disclosure and communicating directly with the public, the SEC can shed light on the issues of cost and management structure. Raising public awareness of these subjects will help internally managed funds compete with their peers. But lack of investor knowledge is only part of the problem. There is also a paucity of alternatives.

2. *The Advent of More Investment Options*

Even if investors appreciate the benefits of internal management, in the current environment, there are few alternatives. The only internally managed mutual fund complex is the Vanguard Group.[233] Vanguard manages about 165 funds,[234] which is a small fraction of the over 8,000 available.[235] Thus, investors may not find the strategy or manager they prefer within Vanguard's fund family.

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230. *See* PUBLIC POLICY REPORT, *supra* note 191, at 132.

231. Atlas, *supra* note 182.

232. *Id.*

233. *See infra* p. 120.

234. *See* Vanguard, *Who We Are, available at* http://flagship2.vanguard.com/VGApp/hnw/content/Home/WhyVanguard/AboutVanguardWhoWeAreContent.jsp (last visited July 31, 2005).

235. *See* FACT BOOK, *supra* note 1, at 3.

Knowledge is the cure to this problem as well. As more investors understand the upside of internal management, demand for funds run in this way should increase. This market pressure should cause the introduction of more internally managed funds in order to fill the void. Thus, by providing shareholders with pertinent information, the SEC can bring economic forces to bear upon the industry that will incentivize the creation of shareholder-friendly alternatives.

3. *A Proven Strategy*

On a smaller scale, the approach proposed here already appears to be working. Vanguard consistently emphasizes costs and reveals its internal structure on its website and in print advertisements. Investors have responded by pouring their savings into the company's funds. It is among the largest mutual fund groups and consistently grows faster than its competitors.[236] Its growth in fact accelerated as of late when investors moved their money out of funds implicated in the scandals and into Vanguard.[237] Thus, it seems that the message espoused by Vanguard and advocated here is already being heard by a certain group of investors.

Moreover, as demand for Vanguard funds has increased, the company has responded by continuously expanding the range of offerings in its family.[238] This illustrates that at least in a subset of the mutual fund market, economic forces are encouraging the creation of internally managed options.

VI.
CONCLUSION

As a result of external management, conflicts of interest permeate the mutual fund industry. Checks on management power imposed by state corporate law and federal securities regulation have proven to be no match for them. Though the late trading and market timing scandals have provided further evidence that the system is in need of meaningful reform, the SEC's regulatory response was uninspired. In order to fulfill its mission of protecting investors, the Commission needs to

236. *See* SLATER, *supra* note 197, at 139.
237. *See* Gray, *supra* note 194.
238. *See, e.g.*, SLATER, *supra* note 197, at 142.

draw attention to fund structure and its practical effects on shareholders by creating and publicizing new disclosure requirements. By creating a base of greater investor knowledge, the reforms would set the stage for industry restructuring through shareholder choice.