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CORPORATE VERSUS CONTRACTUAL MUTUAL FUNDS: AN EVALUATION OF STRUCTURE AND GOVERNANCE

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Abstract: This Article develops an analytic framework to evaluate the comparative merits of the structure and governance of the two dominant types of mutual funds—the Corporate Fund (the U.S. model) and the Contractual Fund (the German, Japanese and British models). The former is characterized by centralized decision-making functions, while the latter employs a more decentralized structure. The semi-hierarchical structure of the Corporate Fund leads to significant transaction costs such as influence, intervention and collective decision-making costs. Specifically, the board of directors is not effective in negotiating performance-related terms (e.g., fees), and shareholder suits based on fiduciary duties do not adequately address the thorny issue of who monitors the monitor. In addition, although shareholder voting on specific issues may be desirable, the concept of voting for directors is contrary to the realities of the mutual fund business. Therefore, the Corporate Fund has placed too much reliance on the board's discretion.

A conceptual analysis of the Contractual Fund demonstrates that its structural design and underlying rationales are fundamentally sound. Of the two Contractual Fund proposals considered by the SEC, the Unitary Investment Fund should be rejected because it provides no effective substitute for the board's oversight. The Unified Fee Investment Company proposal is a better alternative not only because competitive forces would provide adequate discipline with respect to its simplified fee schedule, but also because the investment manager would be better motivated to coordinate a mutual fund's operations. This proposal can be further improved by shifting the regulatory focus to the investment manager and by replacing the board of directors with institutional monitors such as a trustee. Accordingly, the SEC should implement the proposal to promote organizational competition with the Corporate Fund.

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I. INTRODUCTION

Mutual funds, a type of collective investment vehicle, pool money from public investors and invest in a variety of securities.[1] In simplified terms, they "split ownership into capital supplying and investment, and professionalize[] the investment function."[2] In the United States, the vast majority of mutual funds take a "corporate" form. While the law does not expressly require that mutual funds be organized as corporations, it does impose requirements that assume the standard structure of corporate democracy: a board of directors, whose function is to oversee the operations of the mutual fund and review contractual arrangements with outside service providers (e.g., investment advisers); and shareholder voting to elect board members and approve fundamental changes. In this Article, such an organizational structure of mutual funds is referred to as the "Corporate Fund Model," or simply as the "Corporate Fund."[3]

Over the years, commentators have expressed skepticism about the effectiveness of boards of directors and the value of shareholder voting in governing the Corporate Fund. Some have argued that boards of directors are not effective monitors of the service providers. Others have asserted that costs incurred in complying with shareholder voting requirements outweigh any benefits to shareholders. While some commentators have called for improvements to current governance arrangements, others have advocated alternative governance arrangements as ways of streamlining investment company governance requirements and reducing operating costs.[4]

1. Collective investment vehicles are not limited to mutual funds. Other vehicles include commodities pools (i.e., pools containing futures contracts or exchange-traded commodity options as assets) and real estate pools, mortgage and asset-backed pools, which are beyond the scope of this Article. For an introduction to the regulation of collective investment vehicles, see generally Stephen K. West, *The Investment Company Industry in the 1990's* 42–51 (1990) [hereinafter *West Report*]. For an introduction to the regulation of commodity pools, see generally Philip McBride Johnson & Thomas Lee Hazen, *Commodities Regulation* (2d ed. 1989).

2. *See* Robert Charles Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises,* 94 Harv. L. Rev. 561, 564 (1981).

3. It is important to distinguish the structure of the Corporate Fund from that of other hierarchical structures such as publicly-held corporations. After all, the Corporate Fund is merely a "corporate anomaly." Leland E. Modesitt, *The Mutual Fund—A Corporate Anomaly,* 14 UCLA L. Rev. 1252 (1967); *see also infra* part III.A.

4. *See, e.g.,* Advance Notice and Request for Comment on Mutual Fund Governance, Investment Company Act Release No. 12,888, 47 Fed. Reg. 56,509 (Dec. 10, 1982); Richard M. Phillips, *Deregulation under the Investment Company Act—A Reevaluation of the Corporate Paraphernalia of Shareholder Voting and Boards of Directors,* 37 Bus. Law. 903 (1982).

From a comparative institutional perspective, the plea for an examination of alternative governance arrangements is warranted. After dealing with the Corporate Fund Model for more than fifty years, people have come to accept the corporate structure as the natural scheme for mutual funds. It is not. In fact, in Europe, Japan, and most other countries, Corporate Funds are in a decided minority compared to a form of organization established under contract or trust law.[5] While such a form of mutual funds shares some similar structural features with the Corporate Fund, it offers no centralized control mechanism and provides limited, if any, investor voting. Because these arrangements are predicated on the belief that a mutual fund is more suited to a contractual arrangement than to corporate democracy, they can be categorized as the "Contractual Fund Model," or simply as the "Contractual Fund."[6]

We have thus witnessed two different forms of mutual funds operating in the global financial markets, which nevertheless perform essentially the same economic functions. If the primary goal of a business organization is to achieve systemic efficiency or to economize on transaction costs, then what are the comparative merits between the Corporate Fund Model and the Contractual Fund Model? Which type of collective investment arrangement can maximize efficiency and minimize opportunism? To answer these questions, it is necessary to undertake an institutional analysis, studying markets, hybrids and hierarchies together.[7] Since the Corporate Fund and the Contractual Fund are intermediate forms of business organizations, together they offer an interesting subject for comparative institutional analysis.[8]

Such a comparative study involves more than a pedagogical inquiry. It has tremendous implications for the regulation of both domestic and foreign mutual funds. The globalization of securities markets is beginning to put American mutual funds in competition with foreign mutual funds that have a different organizational structure.[9] Such

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5. For a discussion of contractual mutual funds, see *infra* part III.B.

6. For an explanation of the term "Contractual Fund," see *infra* notes 93–96, 386–90 and accompanying text.

7. As argued by Williamson: "[T]he Logic of economic organization becomes more evident when markets, hybrids, and hierarchies are studied together." Oliver Williamson, *Economic Institutions: Spontaneous and Intentional Governance,* 7 J.L. Econ. & Org. 184 (1991).

8. Comparative institutional economics is an important research tool in understanding the law and economics of business organizations. Such analysis is made possible through theoretical tools such as transaction costs economics. Simply put, transaction costs economics seeks to explain the existence of firms, organizations within which markets were replaced by hierarchy and command. *See infra* part III.D.

9. *See infra* part V.D.2.

competition might not only be between products, but might also be between the different organizational structures. In addition, to promote international trade of financial services, it is necessary to remove trade barriers in cross-border transactions of mutual funds.[10] Thus, even assuming the Corporate Fund and the Contractual Fund are equally competitive investment vehicles, regulators must still come to grips with the question of how to regulate foreign contractual funds operating in the United States, taking into consideration principles such as investor protection.[11] In light of such significant implications, a study of their comparative merits takes on a sense of urgency.

Against this background, the Division of Investment Management ("Division") of the Securities and Exchange Commission (SEC) completed a comprehensive report[12] which examined, among other issues, the feasibility of the existing governance model of the Corporate Fund. The purpose was to analyze whether changes could be made to the existing structure that would increase the effectiveness of the board of directors in monitoring conflicts of interest and to provide shareholders with more meaningful voting opportunities.[13] After comprehensive review of the structure of the Corporate Fund, the Division concluded that the governance structure of the Corporate Fund is "fundamentally sound" and should be retained, with some modifications.[14]

The *SEC Report* also considered the feasibility of permitting two proposals derived from the Contractual Fund Model: the "unitary

10. There has been a great deal of debate on how best to increase cross-border sales of investment company shares. *See generally* SEC Request for Comments on Reform of the Regulation of Investment Companies, Investment Company Act Release No. 17,534, 55 Fed. Reg. 25,322, 25,324–38 (June 15, 1990). For a discussion of the business aspects of internationalization, see, *e.g.*, Heidi Fiske, *The Environment for the Investment Company Industry in the 1990s* 61–67 (1990).

11. For instance, the current U.S. regulatory framework on mutual funds presents a challenge to foreign mutual funds seeking to market its securities in the United States. Specifically, § 7(d) prohibits a foreign investment company from making a public offering of its shares in the U.S. unless the SEC issues an order permitting it to register under the Investment Company Act of 1940 ("Act"). Under this section, the SEC must find that "by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of [the Act] against such company and that the issuance of such order is otherwise consistent with the public interest and the protection of investors." Investment Company Act of 1940, 15 U.S.C. § 80a-7(d) (1994). In doing so, it is necessary to understand the structure and governance of foreign mutual funds.

12. Division of Inv. Management, U.S. Sec. and Exch. Comm'n, *Protecting Investors: A Half Century of Investment Company Regulation* (May 1992) [hereinafter *SEC Report*].

13. *Id.* at 253.

14. *Id.* at 263–82.

investment fund" (UIF)[15] and the "unified fee investment company" (UFIC).[16] The UIF has two predominant features: a single fee to cover all management expenses and the elimination of the governance structure (e.g., the board of directors and shareholder voting). The Division recommended against implementation of the UIF because it believed that the UIF "would raise significant investor protection concerns, would not reduce costs substantially, and would not significantly promote internationalization."[17] However, in an effort to streamline the fee structures of the Corporate Fund, the Division recommended the implementation of the UFIC proposal. The UFIC proposal would incorporate the single fee aspect of the UIF while retaining the governance structure of the Corporate Fund.[18]

How do we go about assessing the validity of these policy analyses and recommendations? Since the Corporate Fund and the Contractual Fund are driven by different organizational designs and underlying rationales, it is difficult to evaluate their comparative merits without a unified analytic framework. For example, with respect to the Corporate Fund, the Division argued that the oversight function performed by its board of directors has served investors well, at minimum cost. Lacking an analytic framework, however, the Division had to base this conclusion on an oversimplified costs calculus, rather than on a systematic framework that permits detailed analysis of transactions among the various constituencies of the mutual fund.[19] In addition, without an explanation of the rationales underlying the Contractual Fund Model, it is unclear why the UIF should be rejected and the UFIC implemented. In fact, some commentators have presented their arguments at such a high level of generality that an assessment of their positions is very difficult.[20] Therefore, to meaningfully evaluate the Corporate Fund and the Contractual fund, it is necessary to adopt a unified framework.

15. *See infra* part VI.B.1.

16. *See infra* part VI.B.2.

17. *SEC Report, supra* note 12, at 289.

18. *See infra* notes 379–94 and accompanying text.

19. Some scholarly works have applied an analytic framework to analyze the governance structure of publicly-held corporations. *See, e.g.*, Oliver Williamson, *Corporate Governance*, 93 Yale L.J. 1197 (1984). However, few have adopted a unified transaction costs analysis to the mutual fund context.

20. For instance, one opponent of the UIF noted that the contractual type of mutual funds may not be suitable for the domestic industry because they were developed "under different conditions and in different environments." Letter from Debevoise & Plimpton, Counsel to the Independent Trustees of the Fidelity Funds, to Jonathon G. Katz, Secretary, Securities and Exchange Commission (Oct. 10,

This Article attempts, from within the law-and-economics tradition, to evaluate the Corporate Fund and the Contractual Fund from a comparative institutional perspective. It develops an analytic framework for the analysis of mutual fund structures and uses this framework to evaluate the comparative merits of the structure and governance of various mutual fund models, including the UIF and UFIC.[21] Part II examines the fundamental structure of mutual funds and defines the "firm" in the mutual fund context. Part III introduces the Corporate Fund (the U.S. model) and the Contractual Fund (the German, Japanese and British models) and then compares their major structural differences. Part IV adopts the hypothetical contracting approach to consider the possible control functions that rational and fully-informed parties would have allocated to the third-party monitor, taking into account the bargaining attributes and constraints inherent in the mutual fund context.

Based on the observations drawn in Part IV, this Article evaluates the structure and governance of the Corporate Fund and the Contractual Fund in Part V and Part VI, respectively. Part V first examines the board's effectiveness from an organizational perspective and considers its performance with respect to each assigned responsibility. After assessing the SEC's reform proposals regarding the governance of the Corporate Fund, Part V concludes by assessing the role of the board of directors as Coordinator-Monitor. Since the Contractual Fund is not a well understood arrangement, Part VI begins with a conceptual analysis of the Contractual Fund. Part VI then evaluates the UIF and the UFIC proposals and offers some suggestions for improvement. This Part finally examines the relationship between monitoring arrangements and governance structure and recommends that the UFIC be permitted as an optional form to promote organizational competition.

II. THE FUNDAMENTAL STRUCTURE OF THE MUTUAL FUND

This Part provides the practical and theoretical background necessary for evaluating the structure of different forms of mutual funds.[22] Section

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1990) (on file with author). Yet this opinion made no efforts to identify, let alone examine, such different conditions and environments.

21. *See infra* part IV.

22. This Article focuses on mutual funds. The reasons are threefold. First, mutual funds are by far the dominant investment companies in the U.S. market (95% of industry assets) and the global market. *See, e.g.*, Investment Co. Inst., *1991 Mutual Fund Fact Book* at 55–58 (1991) [hereinafter *ICI Fact Book*]. Second, in many important jurisdictions these are the only form permitted in the securities markets. A comparative study of business organizations will be more meaningful if confined to organizations that share as many common features as possible. Third, because of its

A introduces the economic functions of mutual funds. Section B analyzes the contractual relationship between the investment adviser and the investors. Section C examines the concept of segregated assets in the mutual fund context and the role of the third-party monitor. Section D defines the object of inquiry.

A. Economic Functions of the Mutual Fund

"Mutual funds" are financial intermediaries which pool money from investors and entrust such money to professional managers to make investments on behalf of the investors. A mutual fund is an open-ended company, in which the public may purchase interests representing pro rata portions of the pooled assets' average net assets.[23] It engages in a continuous offering of its shares, and investors have the right to redeem their shares at their current average net asset value.[24]

Mutual funds offer two primary benefits. First, by pooling the financial resources of dispersed investors, they allow investors to gain lower-cost access to the expertise of professional managers. What is professional management? Mutual funds make financial investments in the securities markets. Successful investment management requires judgment and specialized knowledge. In selecting the securities in which to invest, the investment adviser first performs extensive economic and financial research.[25] The aim of this research is to develop data so that intelligent decisions can be made about securities in the fund's portfolio.

However, unlike "real" investments, securities are mere intangibles that represent something else (e.g., intrinsic value), but that something else is itself extraordinarily complex.[26] Moreover, since mutual funds invest primarily in secondary markets, investment management

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redemption right feature, the mutual fund provides an excellent stylized model for the evaluation of organizational structures.

23. The term "open-ended company" is defined as a management company that is offering for sale or has outstanding a redeemable security that it issues.

24. Mutual fund investors can cash in all or part of their shares at any time and receive the current value of their investment. *See* 1 Tamar Frankel, *The Regulation of Money Managers* 336–41 (1978).

25. Security analysis involves the application of complex models such as a capital asset pricing model. Portfolio managers use sophisticated portfolio management theories (e.g., risk-reward, stock-picking, efficient market hypothesis and indexation) to conduct securities analysis. *See* William F. Sharpe & Gordon J. Alexander, *Investments* 134–93 (4th ed. 1989).

26. The value of a common stock is the present value of some long-term, future stream of business income, which itself often defies meaningful calculation. *See, e.g.*, Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. Rev. 761 (1985).

inevitably calls for predictions as to what these markets will do.[27] Such uniqueness was captured in Keynes's often quoted observation that investment management resembles a newspaper beauty contest.[28]

Second, mutual fund investors gain low-cost access to the advantages of wide diversification of ownership in the securities market. According to modern finance theory, an efficient portfolio is one that secures the maximum return for a given level of risk.[29] It follows that the riskiness of a portfolio depends on the co-variance (the extent to which asset prices move together) of its holding, not on the average of the risks associated with its individual investments. In other words, a lot of risky bets might together prove low-risk, as long as their return did not move in the same direction at the same time.[30] Thus, diversification is essential to eliminating what appears to be demonstrably unproductive risk taking in specific securities (unsystematic risk).[31] For most individual investors, cost alone generally precludes achieving adequate diversification. Diversification, therefore, is at the very heart of mutual investing.

In addition to professional management and diversification, mutual funds provide other benefits. In jurisdictions that impose no officially fixed commission rates, mutual funds provide the benefit of lower transaction costs resulting from volume discounts on brokerage commissions.[32] Moreover, to keep attuned to investor needs, mutual fund industries in some countries have adapted and expanded their

27. However confident the investor may be as to the soundness of her valuation, success depends largely on what measure of value the prospective buyer will adopt. *See, e.g.*, Louis Lowenstein, *Is Speculation "The Essential Native Genius of the Stock Market"?*, 92 Colum. L. Rev. 232 (1992) (reviewing Walter Werner and Steven T. Smith, *Wall Street* (1991)).

28. In this contest the winners are the ones

> whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of other competitors, all of whom are looking at the problem from the same point of view . . . . We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be.

John Maynard Keynes, *The General Theory of Employment Interest and Money* 156 (2d ed. 1973). Thus, security analysis involves the study of business fundamentals as well as crowd psychology.

29. Sharpe, *supra* note 25, at 154–93.

30. *Only Perform: A Survey of Investment Management*, Economist, Nov. 27, 1993, at 8.

31. Sharpe, *supra* note 25, at 119–34.

32. Specialized mutual funds play other functions too. For instance, some mutual funds have the power to turn illiquid investments such as municipal bonds, junk bonds, or small-company stocks into highly liquid ones. To sell some not so liquid municipal bonds, an investor might have to wait days or take a lower-than-market price from a dealer. But that same investor can usually sell shares in a municipal-bond fund that very day at a price equal to net asset value, without having to give up a dollar on price.

services to suit investors' needs. For instance, many mutual funds offer automatic reinvestment programs, automatic withdrawal,[33] exchange privileges[34] and other services. Automatic reinvestment programs allow investors to have dividends and capital gain distributions from their mutual fund investment turned back into the fund, automatically buying new shares and expanding their current holdings.[35]

An important addition to the family of mutual funds is the money market fund. This type of mutual fund invests in very high quality short-term debt (money market) instruments such as Treasury bills, commercial paper, and bank certificates of deposit. There is some fluctuation in the market value of these securities, but because their maturity is typically less than six months, the change in the market value is sufficiently small that these funds allow their shares to be redeemed at a fixed value. In addition, any changes in the market value of these securities are included in the fund pays. Because these shares can be redeemed at a fixed value, they usually allow shareholders to redeem shares by writing checks above some minimum amount (e.g., $500) on the fund's account at a commercial bank.[36] In this way, shares in money market funds effectively function as checkable deposits that earn market interest rates on short-term debt securities.[37]

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33. Automatic withdrawal means investors can make arrangements with the fund to automatically send them checks from the fund. This system works well, for instance, for retirees who want to receive regular supplements to their other income. Investment Co. Inst., *Directory of Mutual Funds* 7 (1992) [hereinafter *Directory*].

34. For a discussion of exchange privileges, see *infra* notes 205–206 and accompanying text.

35. *Directory, supra* note 33, at 7.

36. As of May 1992, money market funds accounted for 41% of the mutual fund industry's assets. *SEC Report, supra* note 12, at xix. In contrast to the "stand-alone" funds, some money market funds are offered as one part of a comprehensive financial product. One example is the Cash Management Account Program (CMA Program) offered by Merrill Lynch. The CMA Program, the first "central asset account," offered participants a unique package that, through a sophisticated computer system, combined (a) the CMA Money Fund, (b) a traditional securities brokerage margin account, and (c) a VISA debit card and checking privileges. Reports on each account were combined in a comprehensive monthly statement. *See generally* Merrill Lynch, *Cash Management Account Program Description* (Sept. 17, 1991); Merrill Lynch, *CMA Money Fund, CMA Government Securities Fund, CMA Tax-Exempt Fund, Prospectus* (July 29, 1991).

37. It is important to note that some mutual funds are market index funds. They construct portfolios to mirror a specific market index. "These index funds are expected to provide a rate of return over time that will approximate or match, but not exceed, that of the market which they are mirroring. Index funds offer a number of investment choices that include various stock market indexes or indexes of international or bond portfolios." *Directory, supra* note 33, at 13. Because the managers of index funds do not make investments based on their own investment research, investors essentially employ the administrative services, instead of the management services, of these managers.

The economic organization of mutual funds offers several efficiency gains. The theory of the firm emphasizes the costs of markets and points out that when non-market structures can accomplish desired results at lower costs, people will organize themselves into such structures—firms—in order better to achieve those results.[38] A mutual fund is also a firm—an aggregation of human assets (i.e., fund management service) and capital assets (investment funds) for a sufficient period of time to permit greater specialization. According to transaction-cost economics, this arrangement reduces the costs associated with repeated learning and haggling for management services. Thus, the mutual fund arrangement is to some extent sheltered from market forces in an effort to take advantage of these efficiency gains.

Mutual funds play a very significant role in the financial markets and the overall economy. Entrusted with $2 trillion of savings, mutual funds are altering the way Americans save and invest, offering a menu of investments unthinkable a decade ago.[39] "By channeling the savings of millions of consumers into hundreds of billions of dollars of investments, mutual funds are reshaping the U.S. financial landscape and the economy itself."[40] For example, they have lowered the cost of capital for industry and government alike. During a period when banks and other institutions have been shrinking in importance, mutual funds have been providing the capital for financially strapped companies to rebuild their balance sheets. In addition, the managers of mutual funds, through their control of billions of dollars of individual investors' assets, carry enormous clout with the management of the companies in whose stocks and bonds they invest.[41]

38. R. H. Coase, *The Nature of the Firm*, 4 Economica 386 (1937).

39. It has been reported that "1 in 4 Americans owns mutual funds directly or through group plans; half the families have incomes of less than $50,000, making funds the primary financial asset of the middle class." John Greenwald, *The Siren Call of Mutual Funds*, Time, Nov. 8, 1993, at 59.

40. Jeffrey M. Laderman & Geoffrey Smith, *The Power of Mutual Funds*, Bus. Wk., Jan. 18, 1993, at 62.

41. In their capacity as institutional shareholders, mutual funds can assess corporate managers' performance and influence corporate actions. *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. Rev. 811 (1992); Mark J. Roe, *Political Elements in the Creation of Mutual Fund Industry*, 139 U. Pa. L. Rev. 1469 (1991); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 Geo. L.J. 445 (1991).

B. The Adviser-Investor Contractual Relationship

Despite the size and growing variety of investor services, the typical mutual fund remains a bilateral relationship. Stripped to its essentials,[42] it involves two parties—an Investment Adviser[43] ("Adviser") and a group of dispersed investors.[44] The Adviser, a functionally autonomous business organization,[45] is typically the one who puts a mutual fund together for investors. This is why the prospectus and other selling documents of the mutual fund invariably set forth not only the name but the management make-up of the Adviser so that investors can decide for themselves whether to employ its portfolio management service.[46]

The Adviser-Investors contractual relationship is similar to a cluster of contracts entered into between the Adviser and each individual investor. It is to the Adviser that the investor looks for the management of his money. The total range of enforceable expectations and understandings in the bilateral arrangement is matched by corresponding responsibilities and duties of the Adviser.[47] In this sense, the mutual fund is truly the

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42. Bilateral mutual funds do exist in the marketplace. One example is the collective investment funds created and managed by trust companies or the trust departments of state and national banks. For a discussion of such investment vehicle, see, *e.g., West Report, supra* note 1, at 42–44.

43. In this Article, the term "Adviser" is used to refer to the firm who provides portfolio management service to a mutual fund. Unless otherwise specified, the term "Adviser" is sometimes interchangeable with other terms such as "investment adviser" or "management company." For a legal definition of the term, see *infra* note 81 and accompanying text.

Although the Adviser-investors bilateral relationship is the norm in the mutual fund industry, a number of mutual fund groups have "internalized" management service. One notable example is the Vanguard Group, which is owned by the shareholders of its mutual funds. Under such ownership structure, Vanguard provides its management services at cost. *See, e.g.,* Jonathan Clements, *Fidelity Takes a Swipe at Rival Vanguard,* Wall St. J., Dec. 1, 1992, at C1.

44. Different jurisdictions use different terms to denote investors of mutual funds. They include, for example, shareholders (in the U.S.), unit holders (in the United Kingdom) and beneficiaries (in Japan). *See infra* parts III.A–B. This Article will use the term "investors" to refer to the suppliers of mutual fund capital. Where appropriate, however, technical terms such as shareholders (in the U.S.) or unitholders (in the United Kingdom) will be used. Thus, the term "investors" is interchangeable with "shareholders" or "unitholders."

45. It is important to distinguish the Adviser as an institution from its individual portfolio managers—specialists employed by the Adviser to conduct investment management activities. *See, e.g.,* Carole Gould, *Mutual Funds: Where is the Manager's Money?,* N.Y. Times, May 10, 1992, at F16; *see also infra* notes 176–81 and accompanying text.

46. For instance, one item of disclosure reads as follows: "Fidelity is one of America's largest mutual fund companies in the country, and is known as an innovative provider of high-quality financial services to individuals and institutions." Fidelity Magellan Fund, *Prospectus* 9 (May 20, 1993).

47. Nathan D. Lobell, *Rights and Responsibilities in the Mutual Fund,* 70 Yale L.J. 1258, 1265 (1961).

matrix of two social drives (of the Adviser and of the investor) expressing themselves in a bilateral advisory relationship.[48]

There are certain differences, however, between a mutual fund and a simple investor-adviser relationship. Because of the central administration of the pooled assets, the fund management cannot confer with individual investors in making investment policy. Fund investors with similar preference patterns are expected to select themselves by investing in a particular fund. This is achieved by the fact that the fund's policy, portfolio, and record are disclosed to each potential investor, giving him the opportunity to select the fund whose objective is closest to his own. In determining whether to purchase the shares of a mutual fund, investors need to decide whether to employ the investment management services of a particular adviser. Thus, from the investors' perspective, the mutual fund is a collective investment vehicle, with each investor owning a proportionate interest in an undivided aggregate of assets.

The bilateral arrangement embodies the major terms of the mutual fund. In establishing a mutual fund, the Adviser stipulates the investment objectives of the mutual fund in the prospectus and other selling documents. The investment objectives of the mutual fund are important to both the Adviser and the investors. The Adviser uses them as a guide when choosing investments for the fund's portfolio. Investors use them to determine which funds are suitable for their needs. Investment objectives are usually described in terms of one or more main goals, with different risk and return level. These may include stability—protecting the principal from loss; growth—increasing the value of the principal; and income—generating a continuous flow of income through dividends.[49] Thus, a mutual fund's investment objectives cover a wide range, from higher risk in the search for higher returns to immediate income from more stable investments.[50]

The bilateral contract also stipulates and describes a list of the fundamental features. These enumerated features cannot be changed without shareholder consent. The required features on which a fundamental choice has to be made and disclosed include: whether the

48. *Id.* at 1263.

49. In the United States, the Investment Company Institute classifies mutual funds into 22 major categories of investment objectives. *See ICI Fact Book, supra* note 22, at 24–26.

50. For an introduction to the regulation and development of mutual funds in other major countries, see *Managing Money: A Legal Guide to the World's Investment Fund Markets,* Int'l Fin. L. Rev. (1990) [hereinafter *World's Investment Fund*].

fund is open- or closed-end and diversified or non-diversified, whether the issuance of senior securities will be permitted, and whether the fund will concentrate its investments in a particular industry or group of industries. In addition, the contract may prohibit or limit certain investments and practices. For example, it may prohibit margin purchases, joint trading accounts, short sales and activities as a distributor of its own securities. Finally, whether and how much to pay in dividends, a recurrent policy problem for corporate directors, is usually pre-determined in a mutual fund operation.[51]

In exchange for creating and managing such a collective investment vehicle, the Adviser's costs include writing up the terms of the deal, bearing the initial costs of the fund, and providing the management service. The Adviser's efforts to set up a mutual fund involve potential risk and return. If the mutual fund cannot be established successfully or, after it is established, the Adviser's income does not cover the operating expenses, the Adviser will be forced to bear all of the initial and operating costs. In return, the Adviser expects to be compensated for the services he provides, and the prospectus and other selling documents therefore contain statements of any fees charged by the fund.

To summarize, a mutual fund involves an Adviser-Investor contractual relationship. It presents key elements of an economic contract: the investment objectives and policies, risk and return, compensation for the service, the termination or withdrawal (redemption) right, etc. The terms in the arrangements are contracts because their value (or detriment) is reflected in price,[52] even though the Adviser may use its discretion in devising certain features of a mutual fund and in effect say to potential investors "take it or leave it."

C. The Investment Pool and Third-Party Monitor

As an investment vehicle, a mutual fund aggregates investment capital from investors. To obtain expert management, each investor of a mutual

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51. In fact, in the United States, in order to avoid being taxed on dividends and gains, most mutual funds commit in advance to pay out dividends and gains. Under subchapter M of the Internal Revenue Code, in order to avoid federal taxation at the investment company level, a United States registered investment company must, among other things, distribute to its shareholders at least 90% of its gross income derived from sources such as dividends and interests. Similar rules apply to ordinary income and capital gains. *See id.* at 67–74.

52. These contracts may not be negotiated. However, the pricing and testing mechanism are all that matter, as long as there are no effects on third parties. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 16–17 (1991).

fund delegates the disposal right to the Adviser so that systematic investments can be made. By aggregating all the assets, the pooled fund can diversify and achieve economies of scale, making investments in a more efficient way. Because the Adviser is an independent business entity with its own assets, it is advisable to segregate the pooled assets from the Adviser's assets.[53] Thus, we may actually identify a pool of definable assets which is segregated from both the Adviser and the Investors for the purpose of making investments ("Investment Pool").

Because the Investment Pool is organized and operated by the Adviser, there is obvious potential for conflict between the interests of the Adviser and the interests of the Investors. This is especially the case because, unlike "search" goods such as clothing, investment services are "experience" goods whose quality cannot be ascertained in advance.[54] An inherent feature of investments is that their risk cannot be adequately assessed on the basis of existing information about them because risk also depends on the integrity and skill of those who will be managing the investment in the future. Hence, it is important to monitor the behavior of the Adviser.

How can the Investors align the Adviser's objectives with their own? According to principal-agent theory, because the Investors and the Adviser are well aware of the opportunities for cheating, shirking or even stealing, they must undertake some measures, such as placing the Adviser on an incentive plan, to minimize potential conflicts of interest.[55] Even under an optimal incentive scheme, however, the Adviser will put some weight on its own objectives at the expense of those of the Investors, so that conflicting interests remain. "Agency costs" arise because the interests of the Adviser and the Investors can conflict; thus, both the Adviser and the Investors must employ different mixes of bonding devices, monitoring devices, and residual costs of this divergence of interest.[56] The trick is to hold the total costs of these items (i.e., agency costs) as low as possible.

53. *See infra* part VI.A.3.

54. A. C. Page & R. B. Ferguson, *Investor Protection* 37 (1992).

55. Principal-agent theory recognizes conflicts of interest between different economic actors, formalizing these conflicts through the inclusion of observability problems and asymmetries of information. Pursuant to this theory, it is impossible for the owners to implement their own profit-maximization plan. *See, e.g.*, Bengt Holmström, *Moral Hazard and Observability*, 10 Bell J. Econ. 74 (1979); Steven Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 Bell J. Econ. 55 (1979).

56. Following the usage established by Jensen & Meckling, the combination of monitoring, bonding and residual costs will be referred to as agency costs. Agency costs include the costs of structuring, monitoring, and bonding a set of contracts among agents with conflicting interests.

Minimizing agency costs is complicated by the fact that shareholder monitoring of the Adviser's actions will often be compromised because of the collective action problem. Monitoring the Adviser is an example of what economists call a collective good; that is, it benefits all investors whether or not they pay for it. Rationally, investors would prefer to "free ride" on the efforts of others rather than subscribe to their pro rata share of the costs of monitoring the Adviser.[57] Moreover, since individual investors hold only small proportions of claims entitled to control and, more significantly, no investor has enough wealth invested in the mutual fund to make it worthwhile to devote time to review and monitor the behavior of the Adviser, no individual investor has either the power or incentive to monitor the Adviser efficiently.[58] This is the case even though monitoring is worthwhile for all investors taken together.

Ideally, the advisory relationship would be governed by specific rules that dictate how the Adviser should manage the asset in the Investors' best interest. However, because asset management necessarily involves risk and uncertainty, the specific behavior of the Adviser cannot be dictated in advance in a "contingently complete contract."[59] In addition, since disputes may occur in the future it may be necessary to include a dispute resolution mechanism.[60] Therefore, to mitigate investor apathy and free rider problems, it is desirable to appoint an independent "Monitor" to assume monitoring functions.

Agency costs also include the value of output lost because the costs of full enforcement of contracts exceed the benefits. Among such costs, monitoring costs are the most important because transactions involving joint production such as mutual funds require careful monitoring so that each actor's contribution can be assessed. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. Fin. Econ. 305, 308–10 (1976).

57. For every mutual fund investor, the benefits to be gained from monitoring must be weighed against its costs, e.g., the opportunity costs of diverted time that could be expended on other profit-seeking activities. This is particularly the case where the number of investors is likely to be large, thereby making it difficult for them to communicate and to agree on objectives. For a discussion of collective action problems, see, *e.g.,* Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* 55–56 (2d ed. 1971); Russel Hardin, *Collective Action* (1982).

58. *See* Robert Charles Clark, *Corporate Law* 389–400 (1986).

59. In the parlance of economists, the term "incomplete contract" describes any contract short of the ideal of a complete contingent contract, which has been drafted with all contingencies in mind and provides for optimal performance on every contingency. *See, e.g.,* Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules,* 101 Yale L.J. 729 (1992); Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules,* 99 Yale L.J. 87 (1989).

60. *See* Oliver D. Hart, *Incomplete Contracts and the Theory of the Firm,* in *The Nature of the Firm: Origins, Evolution, and Development* 141 (Oliver E. Williamson & Sydney G. Winter eds., 1991).

The term "monitoring" is an intentionally vague term—it is used to connote various activities in addition to its disciplinary connotation.[61] It could include a variety of functions, some active, some passive. One of the active functions can be called the "control" function; that is, the power to exercise a controlling influence over the management or policies of a business association. In its broadest sense, control can be defined as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."[62]

One of the passive functions is the "gatekeeper" function, which connotes duties imposed on private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers.[63] Pursuant to this function, the Monitor may be charged with the responsibility to monitor the Adviser's compliance with all applicable laws and regulations. This watchdog function is sometimes imposed on third parties, such as accountants and lawyers, to detect frauds on their clients. A related function is the corrective function. As an example of this function, if the Adviser made an inadvertent mistake, the Monitor may be authorized to "ratify" such a mistake.

Structural issues, such as the role to be played by the Monitor, are by no means the natural byproducts of specialization in a business organization.[64] Since the severity of such problems varies with each type of economic organization, it is wrong to assume that the interests of managers in an industrial organization diverge in the same way as those of the Adviser of a mutual fund. For instance, because mutual fund

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61. According to Alchian & Demsetz, the term "monitor" connotes measuring output performance, apportioning rewards, observing the input behavior of inputs, and giving assignments or instructions in what to do. *See* Arman A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization,* 62 Am. Econ. Rev. 777, 782 (1972). For a discussion of the role of monitoring in business arrangements such as secured financing, see, *e.g.*, Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Crediiors,* 88 Yale L.J. 1143 (1979).

62. 17 C.F.R. § 230.405 (1993). The term control" assumes an important role in the regulation of business organizations. For instance, a basic concept running through all of the statutes administered by the SEC is that of control. *See generally* A. A. Sommer, Jr., *Who's "In Control"?—S.E.C.,* 21 Bus. Law. 559 (1966).

63. *See* Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy,* 2 J.L. Econ. & Org. 53 (1986).

64. For instance, commenting on the political perspective of corporate agency problem, Grundfest argued that "the form, nature, and severity of corporate agency problem will reflect the push and pull of political considerations as much as the flow of economic events." Joseph A. Grundfest, *Subordination of American Capital,* 27 J. Fin. Econ. 89, 110 (1990).

investors hold fluctuating claims,[65] the monitoring problems they face may be different from those of the bank depositors[66] or corporate shareholders.[67] Thus, the allocation of monitoring functions reflects the bargain made as to the other elements as well as the underlying economic realities those bargains reflect and create.

D. *Defining the Object of Inquiry: The Mutual Fund as a Trilateral Arrangement*

To undertake an inquiry on the structure and governance of the mutual fund, it is necessary to first define the object of inquiry, i.e., what kind of business organization or economic relationship are we dealing with? In other words, what is the "firm" which constitutes the object of this inquiry?[68] It is said that the continuum of possible business structures is anchored by two extremes, one pure contract, the other pure organization.[69] On the contract end of the continuum, parties use arm's-length contracts to organize production. These contracts specify the terms on which the entrepreneur can acquire services from the other factors under all possible future circumstances. On the organization end of the continuum, "few arm's-length contracts are specified: the entrepreneurial factor buys up . . . the other factors. The firm vertically integrates."[70]

The study of American corporate governance concentrates on the structure of a single firm, say, General Motors. People tend to define the "firm" as including only the wholly-owned subsidiaries of the core firm. This "entity approach" is a convenient device for communication, especially with respect to complex socio-economic organizations. For

65. *See infra* part IV.B.4.

66. Depositors typically hold fixed claims against the depositary bank. *See, e.g.*, Helen A. Garten, *Banking on the Market: Relying on Depositors to Control Bank Risks*, 4 Yale J. on Reg. 129, 129–35 (1986).

67. Corporate equity holders are residual claimants because they get paid last, after debt investors, employees, and other investors with fixed claims. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *supra* note 52, at 10–11.

68. The theory of the firm involves a three-tier inquiry: (1) what is the firm, that is, how do we define the boundary between market and hierarchy; (2) what is the efficient boundary of the firm, and what activities should be undertaken within it; and (3) how are decisions made and monitored within the firm (that is, the traditional corporate governance problem)? *See, e.g.*, Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese Keiretsu: Overlaps Between Corporate Governance and Industrial Organization*, 102 Yale L.J. 871, 883 (1993).

69. *Id.* at 884–85.

70. *Id.* at 885.

instance, when a large, publicly-held corporation raises new equity capital, we often speak of it as "selling" common stock to the public. Similarly, a mutual fund invariably has an identification, say, the Fidelity Magellan Fund.

Because mutual funds are large and centrally managed pools of assets, they invite analogies to vertical integrations such as those in industrial corporations. However, as some theorists have argued, reification of a business firm can be misleading.[71] The mutual fund is often equated with the fund's Investment Pool, especially in the case where the Investment Pool is an incorporated entity or assumes the standard structure of corporate democracy.[72] Thus, the Fidelity Magellan Fund should not be understood as a functionally autonomous entity and therefore a "firm." It is the Fidelity Investments Group, a separate autonomous entity, which provides the Fidelity Magellan Fund with expert management and other related services. By investing in the Fidelity Magellan Fund, the Investors are, in effect, doing business with the Fidelity Investment Group.

This Article therefore takes as the structure that requires understanding not a single legal entity in isolation (e.g., the Adviser or the Monitor), but the trilateral arrangement consisting of the Adviser, the Investors and the Monitor. Pursuant to such trilateral arrangement, the Investors provide the investment capital, the Adviser expert management, and the Monitor monitoring functions. The mutual fund should thus be considered as a hybrid mixed mode—a business association that is characterized by an interlocking web of contracts. It is the trilateral, interlocking web of contracts that gives rise to the "firm" of the mutual fund.

Our definition of the mutual fund will not be affected by the fact that a mutual fund often involves third-party service providers other than the Monitor. For example, mutual fund shares are sometimes sold through broker/dealers at net asset value plus a sales charge.[73] Other service providers, such as transfer agents and underwriters,[74] also get involved in

71. As Jensen & Meckling argue: "The firm is not an individual.... The 'behavior' of the firm is like the behavior of a market, i.e., the outcome of a complex equilibrium process." Jensen & Meckling, *supra* note 56, at 311.

72. *See infra* part III.A.

73. *See ICI Fact Book, supra* note 22, at 34; *see also* Amy Dunkin, *Funds: Don't Ignore the In-House Brand,* Bus. Wk., Nov. 8, 1993, at 102.

74. The transfer agent performs the investment record-keeping services. It will issue new shares, and distribute dividends and capital gains to shareholders. *See ICI Fact Book, supra* note 22, at 11. The principal underwriter arranges for the distribution of the fund's share to the investing public. *Id.*

the operation of a mutual fund.[75] Such services could be considered as "operations at the periphery" in the sense that the functions they provide could either be carried out within the firm (e.g., by the Adviser, the Monitor, or their affiliates) or across the market through arm's-length transactions. In other words, they raise the following question concerning the theory of the firm: what is the efficient boundary of the firm—that is, what activities should be undertaken within the mutual fund? As such, the second-tier inquiry has no direct bearing on how we define the firm of the mutual fund.[76]

To summarize, the mutual fund can be defined as a trilateral arrangement among the Adviser, the Investors and the Monitor. Rather than focusing on a single business entity in isolation, this Article takes the entire structure—the interlocking webs of contracts among the three economic actors—as the "firm" of the mutual fund.

III. THE CORPORATE FUND VERSUS THE CONTRACTUAL FUND

This part compares the structure and governance of the Corporate Fund and the Contractual Fund. Sections A and B examine the regulatory frameworks governing the Corporate Fund Model, as exemplified by mutual funds in the U.S., and the Contractual Fund Models in Germany, Japan, and United Kingdom, respectively. Since the concern here is the structure and governance of mutual funds, this Article focuses on structural rules—rules that govern the allocation of decision-making power among the agents (e.g., the Adviser or the Monitor), the conditions for the exercise of decision-making power, and the allocation of control over these agents.[77] Section C compares the major structural differences, or structural rules, between the Corporate Fund and the Contractual Fund. Taking the transaction costs approach, section D puts the Corporate Fund and the Contractual Fund in a comparative institutional perspective.

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75. Sometimes the Adviser even provides the fund with general administrative services and office space. *See* Wharton School of Finance and Commerce, *A Study of Mutual Funds,* H.R. Rep. No. 2274, 87th Cong., 2d Sess. 8 (1962).

76. This question will be addressed below. *See infra* part VI.A.1.

77. Corporate rules can be divided into three categories: structural rules, distributional rules and fiduciary rules. *See* Melvin Eisenberg, *The Structure of Corporation Law,* 89 Colum. L. Rev. 1461, 1462 (1989).

A. *The U.S. Corporate Fund*

In the United States, the Investment Company Act of 1940 ("Act") and other Federal securities regulations regulate mutual funds as one category of "Investment Companies."[78] "[T]he Act is not a disclosure statute; it is a statute that regulates a type of a financial institution, more akin to banking laws and insurance statutes."[79] While the Act does not expressly require that mutual funds be organized in corporations, it does impose requirements that assume the standard structure of corporate democracy: a board of directors, whose function is to oversee the operations of the mutual fund and police conflicts of interest; and shareholder voting to elect board members, and to approve or disapprove fee arrangements and other fundamental changes. These requirements also apply to mutual funds that are not corporations but are organized in other forms such as a business trust.[80]

Like ordinary corporations, the investment company establishes a hierarchical and centralized management body. The board of directors is principally responsible for reviewing and evaluating the management and distribution arrangements of the Adviser. Directors' duties include monitoring and supervising compliance with the investment objectives and policies of the fund, its portfolio transaction practices and general business conduct.

An investment company's assets are typically managed by its "Adviser,"[81] pursuant to a contractual arrangement which is subject to general review by its board of directors (or its equivalent such as a board

78. Investment Company Act of 1940, 15 U.S.C. § 80a-1 to -64 (1994). In the United States, collective investment vehicles operating in the securities market are called "Investment Companies." § 80a-3. They are classified by the Investment Company Act into three types: (1) face-amount certificate companies, (2) unit investment trust, and (3) management investment companies. § 80a-4. Management investment companies are subdivided into "open-end" investment companies and "closed-end" investment companies. § 80a-5. Among them, the open-end investment company is the statutory terminology for a "mutual fund," indicating that it stands ready to redeem (buy back) its shares on a daily basis.

79. Letter from Tamar Frankel, Professor of Law, Boston University, to Kathy MacGarth, Director, Securities and Exchange Commission 1 (Jan. 26, 1990).

80. Mutual funds are categorized as management investment companies, which may be structured as a partnership, trust or corporation. Indeed, the definition of an "investment company" includes entities organized in any form whatsoever. *See* §§ 80a-3(a), -2(a)(22), and -2(a)(8) (defining "investment company," "issuer," and "company," respectively).

81. The term "investment adviser" is defined as "a person or company." § 80a-2(a)(20). This is the person or company "who pursuant to contract . . . regularly furnishes advice . . . with respect to the desirability of investing in, purchasing or selling securities . . . or is empowered to determine what securities . . . shall be purchased or sold . . . ." *Id.*

of trustees).[82] The Act requires that no more than sixty percent of the board of directors be affiliated with the Adviser, so as to help assure the independence of the board.[83] The directors must annually approve the advisory agreement between the mutual fund and the Adviser.[84] Additionally, the Investment Advisers Act applies to the advisory contract entered into between an investment adviser and an investment company.

State laws give shareholders of corporations various rights which reflect traditional notions of corporate democracy.[85] As an additional safeguard against self-dealing by the Adviser, the Act accords voting powers to mutual fund shareholders beyond those required by state corporation law.[86] For instance, the management contract must be approved initially by a majority of the mutual fund's voting shares;[87] subsequent changes to the contract also must be approved by shareholders.[88] In addition, the Act requires that shareholders elect a board of directors. Section 16(a) generally prohibits any person from serving as a director unless elected by a majority of the mutual fund's voting shares. An exception to this requirement, however, permits vacancies in the board to be filled in "any otherwise legal manner" if,

82. Some contracts are technically "management" contracts under which the manager makes buying and selling decisions subject to report to the board of directors or trustees. Others are technically "advisory" contracts in which the manager makes recommendations to the board.

83. Section 80a-10(a) requires that at least 40% of the board of directors of a registered investment company consist of individuals who are not "interested persons," as defined in § 80a-2(a)(19). This Article refers to such individuals as "independent directors."

84. This agreement should be approved by a majority vote of the shareholders of the mutual fund or by a majority of the board of directors. § 80(a)-15(a)(2).

85. All of these forms of securities pools, unless grandfathered, must have a group of persons that operate in a way similar to corporate directors. However, the requirement of shareholder voting has decreased following the 1986 SEC interpretive position that the Act does not require annual meetings to elect directors and related changes in state law following that pronouncement. John Nuveen & Co., Inc., SEC No-Action Letter [1986–1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,383 (Nov. 18, 1986).

86. Section 18 requires that, with limited exceptions, every share of mutual fund stock must be "voting stock and have equal rights with every other outstanding voting stock." § 80a-18.

87. § 80a-15(a); 17 C.F.R. § 270.12b-1(b)(1) (1994). Shareholders are also required, under §§ 80a-15(a)(3) and -15(a)(4), respectively, to approve a new management contract following the board's termination of a management contract and to approve any assignment of the contract. §§ 80a-15(a)(3), -15(a)(4). Under regulation 15a-4, this vote must occur within 120 days after the termination or assignment. 17 C.F.R. § 270.15a-4.

88. § 80a-15(a); 17 C.F.R. § 270.12b-1(b)(4). Either shareholders or the board must annually approve multiyear advisory and principal underwriting contracts. §§ 80a-15(a), -15(b). In addition, taken together, §§ 8(b) and 13(a) effectively require a mutual fund to adopt fundamental policies with respect to certain key investment activities, which policies are changeable only by shareholder vote. § 80a-8(b), -13(a).

after the vacancy is filled, at least two-thirds of the directors are shareholder-elected.[89]

The Act contains numerous provisions designed to prevent self-dealing and other conflicts of interest, maintain the integrity of fund assets, and prevent the fund and its shareholders from paying excessive fees. In addition, it also imposes broad prohibitions against transactions by a mutual fund with its affiliates and joint transactions involving both the mutual fund and its affiliates. Conflicts of interest regulated by the Act can be divided into two types: (1) transactions in which the affiliated persons are on the other side of the bargaining table from the mutual fund; and (2) transactions in which the affiliated persons and the investment companies are on the same side of the bargaining table. One example of how the Act regulates the first type of transactions is section 17 of the Act, which prohibits affiliated persons of a mutual fund from transacting business with that fund without advance approval from the SEC.[90]

In addition to the Adviser, a mutual fund usually contracts with a custodian, a transfer agent, a principal underwriter, a sales force, and other third-party service providers to distribute fund shares. Under the Act, principal underwriting contracts are subject to similar board scrutiny. Such contracts and any renewals must be evaluated and approved by the independent directors.[91] Multiyear contracts also must be approved annually by the board or by a majority shareholder vote.[92]

B. *Three Models of the Contractual Fund*

This section focuses on Contractual Fund Models in three jurisdictions: Germany, Japan and United Kingdom. Although these types of mutual funds may be constituted under either contract or trust law, this Article groups them in the same category. The difference between "contract" or "trust" merely reflects two perspectives from which to view the similar structural arrangement. From an organizational perspective, a mutual fund that is organized as a trust can

89. § 80a-16(a). In addition, under § 16(b), shareholders are required, with certain exceptions, to elect independent directors for a period of three years following the assignment of a management contract, if the vacancy occurs in connection with the manager's reliance on the safe harbor provided by § 15(f)(1)(A). § 80a-15(f)(1)(A).

90. For a discussion of the regulation of affiliated transactions, see, *e.g.*, Robert Pozen, *Financial Institutions: Investment Management* 297–320 (1977).

91. § 80a-15(c).

92. § 80a-15(b)(1).

still be viewed as a contractual being as long as it is non-hierarchical in structure.[93] From a property rights perspective, a mutual fund organized under a contract may involve the "trust" concept. Since the Investment Pool of a mutual fund has to be segregated from both the Adviser and the investors, it often conjures up the trust metaphor.[94]

The term "Contractual Fund," contrasted with "Corporate Fund," emphasizes the structural differences between decentralization and centralization. The term "Contractual Fund" captures this important feature of decentralization because "the nature of contract was to disperse decision making widely."[95] It is important to note that the term "contract" is used in a broader sense, in much the same way that economists would use that term.[96] For example, we enforce the terms of a trust arrangement even though its beneficiaries had no say in their framing. This arrangement can be considered as a contract because its value is reflected in price.

1. The German Model

In Germany, the Domestic Investment Company Act (*KAGG*) governs the organization and supervision of mutual funds. The principal regulatory body charged with the application and implementation of this law is the German Federal Banking Commission (*BAKred*). The *BAKred*'s principal duties are the supervision of management companies, including the determination of the necessary qualifications of the two

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93. Note that the creation of a business trust in some states of the United States is regulated by statute. *See, e.g.*, Mass. Ann. Laws ch. 182 (Law. Co-op. 1987). For these business trusts, the "corporate" requirements such as a board of directors still apply. § 80a-2(a)(20)(h). Since these trusts are characterized by centralized management and control, they should not be considered as Contractual Funds; rather, they can be regarded as a type of the Corporate Fund.

94. The division of the legal and equitable interest is unique to trusts. A trust is a "fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it." Restatement (Second) of Trusts § 2 (1959). As indicated by the definition, the trustee holds the legal title of the property for the benefit of another person, who has an equitable interest in the trust.

95. James Willard Hurst, *Law and Economic Growth: The Legal History of the Lumber Industry in Wisconsin* 333 (1964). The term "contractual" fund is preferable to "trust" fund. For instance, it was argued that the concept of trust is not helpful for understanding commercial relations compared to a more calculating behavior paradigm. *See* Oliver Williamson, *Calculativeness, Trust, and Economic Organization,* 36 J.L. Econ. 453 (1993).

96. To an economist, an implied contract is one that is enforced through marketplace mechanisms such as reputation effects rather than in a court. For a discussion of the different conceptions about "contract" between lawyers and economists, see Jeffrey N. Gordon, *The Mandatory Structure of Corporation Law,* 89 Colum. L. Rev. 1549, 1549–50 (1989).

required managing directors of such companies. It also closely supervises the activities of these companies and the establishment and operation of the individual funds they establish.[97]

Mutual funds in Germany have to be constituted according to contract law—in other words, as a mutual fund managed by a management company.[98] Under this scheme, the investor acquiring a mutual fund share enters into a contract with a manager whereby he acquires a participation in a certain asset pool. The management company is the entity that issues shares in the asset pool, and the investor is entitled to require the repurchase of those units by the manager.[99] The management company must keep the fund's assets separate from its own assets and those of other funds it controls.

For a better understanding of the structure of German mutual funds, it may be helpful to recall that the German Model of investment funds is not based on the U.S. Corporate Fund Model. As Carl Hardenberg notes,

> [T]he German concept may be described as a contractual type of arrangement where the money contributed by the unit holder and the securities bought therewith do not form part of the investment company's own assets but are treated as separate funds bought by the investment company . . . in the form of fractional co-ownership (securities funds) for the unit holder.[100]

Such a collection of segregated assets, called *Sondervermoegen,* is a separate estate; it has no legal personality or existence.[101] Unlike

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97. *See World's Investment Fund, supra* note 50, at 101.

98. The manager of a mutual fund is generally a corporation founded by a group of experienced investment advisors who are the sole shareholders of the management company. The manager has its own equity capital arising solely from the subscriptions of its shareholders. A manager may be organized only as a stock corporation or as a limited company. Pursuant to German law the manager is called a *Kapitalanlagegesellschaft* (translated as "investment company"). Even if they are organized, which is the rule, as GmbH, they must have a two-tier structure like any AG. In other words, in addition to a management board they must have a supervisory board. An investment company must have a minimum registered share capital of DM5m. *See generally* Jurgen Baur, *Investmentgesetze: Kommentar zum Gesetz über Kapitalanlagegesellschaften (KAGG) und zum Gesetz über den Vertrieb ausländischer Investmentanteile (AuslInvestmG)* (1970).

99. In Germany, pure closed-end funds, in which the investor enjoys no such right, may not be organized. In addition, it is impractical to organize a corporate mutual fund. This is primarily because German corporate law is based on the concept of fixed par value shares. *See* Bruce Butler & Michael Thoma, *The Role of the Depotbank for a Mutual Fund Doing Business in Germany,* 26 Bus. Law. 1604 (1971).

100. Carl Graf Hardenberg, *Amendment of German Investment Fund Laws,* 18 Int'l Bus. Law. 224, 224 (1990).

101. *Union-Investment Gesellschaft m.b.H.*, Investment Company Act Release No. 12,863, 47 Fed. Reg. 57,179 (Dec. 1, 1982).

investment companies in the U.S., it is an unincorporated collection of assets. It has no employees, cannot transact business, and can neither sue nor be sued. The assets have to be kept with, and must be supervised by, a custodian bank—called *Depotbank*—which must be a German banking institution subject to the supervision of the *BAKred*.[102] These two devices—the creation of a *Sondervermoegen* and the appointment of a *Depotbank*—are the primary legal safeguards for investors of a German fund.[103] All money invested becomes part of the *Sondervermoegen* which is safeguarded by the *Depotbank*. The investor does not become a shareholder of the manager but has merely a joint interest in the *Sondervermoegen*, represented by a certificate.

The management company, as the enterprise organizing and managing the segregated assets, conducts transactions in its own name but for the investors' account. The custodian bank is responsible for the safekeeping of the fund's assets. In addition, it sells and redeems certificates representing an interest in the *Sondervermoegen*.[104] The custodian bank acts solely in the interest of investors, but is subject to instructions by the manager unless these instructions are in violation of applicable law or the conditions of the contract with the investors. The appointment of such a bank requires approval by the regulatory agency—*BAKred*. In addition, the *BAKred* may under certain circumstances order the appointment of a custodian.

German law provides substitute safeguards for independent directors. It imposes a duty on management to act in the interest of fund shareholders, and it provides for independent review of management by the fund's custodian bank and by the *BAKred*, both of which may bring suit against the manager for management's failure to so act. The *BAKred* may also dismiss a manager who is unfit professionally or who violates laws regulating mutual funds.[105]

2. *The Japanese Model*

The primary law governing investment trusts, the functional equivalents of mutual funds in Japan, is the Securities Investment Trust

102. In addition, a manager is required to qualify as a banking institution and is therefore subject to all banking supervisory regulations. In practice, the most important requirement is the appointment of two qualified individual managers, who must not simultaneously be linked to the custodian bank. *See World's Investment Fund, supra* note 49, at 101.

103. Butler & Thoma, *supra* note 99, at 1604–05.

104. *Id.* at 1605.

105. *World's Investment Fund, supra* note 50, at 102.

Law.[106] The law sets standards for the licensing and operation of the investment trust management company, describes the rights of beneficiaries, specifies terms to be set forth in a "contract of trust" between the management company and the trustee, provides for supervision of the management company, and requires the establishment of a self-regulated Investment Trust Association.[107]

A license from the Ministry of Finance is required before a company may engage in the business of investment trust management. In reviewing applications for licenses, the Ministry will consider whether (1) the applicant is sufficiently qualified to engage in management of an investment trust in light of its personnel structure and experience in securities investment; (2) the applicant's business prospects are sufficiently bright; and (3) the applicant's engagement in the investment trust business is "necessary and appropriate in light of the existing condition of the securities investment trust business and the securities markets." In addition, the applicant must show that he has at least 50 million Japanese Yen in capital.[108]

Mutual funds in Japan are of the contractual type. A mutual fund comprises three primary parties: a management company, a trust company, and the investors. Under the Japanese investment trust scheme, the manager gives direction for the management of trust properties, while the trust company administers and keeps custody of the properties. The manager and the trustee enter into a trust agreement in accordance with a trust deed approved by the Ministry of Finance.

The manager has a fiduciary responsibility in relation to the fund assets. Its main responsibilities include executing trust deeds, concluding investment trust agreements with trustees, issuing beneficiary certificates which are authenticated by the trustee, and giving directions to the trustee for investment of the mutual fund.[109] The trustee of a mutual fund must be a trust company or bank engaged in the trust business, which requires a license. The benefits accruing from trusts established under these arrangements are distributed among, and

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106. It should be made clear that investment trusts in Japan are unique to Japan. Professor Hideki Kanda, a law professor at Tokyo University and head of an advisory commission on mutual funds, recently commented that Japanese investment trusts are structured so they are similar to a deposit, with a face value and an expected fixed return. James Sterngold, *A New Leaf for Japan's Mutual Funds?*, N.Y. Times, Jan. 2, 1994, at F13.

107. *See World's Investment Fund, supra* note 50, at 106.

108. *Id.* at 107.

109. The Investment Trusts Association in Japan, *Investment Trusts in Japan* 6 (1990) [hereinafter *Japan Trusts*].

acquired by, the investors. Cash and other assets are transferred to the custody of the trust company, and the funds thus acquired are given the status of unincorporated independent trust property.[110]

3. *The British Model*

The mutual funds industry in the United Kingdom is regulated by a system of controls established under the Financial Services Act of 1986.[111] Conceived originally as a system of self-regulation, it has become instead a quasi-statutory model of detailed and rigid rules. The Department of Trade and Industry is responsible for supervision of the regime.[112] It has delegated most of its powers to a non-governmental body known as the Securities and Investment Board (SIB). The SIB has produced a rule book which is designed to achieve investor protection, containing detailed requirements for players in the financial services arena. Five industry associations known as Self-Regulating Organizations (SROs) have been established. All persons who participate in the operation or marketing of investment funds in the United Kingdom are regulated.

In the United Kingdom, the functional equivalent of a mutual fund is called a "unit trust," which is constituted under trust law.[113] A unit trust is a collective investment scheme with property held in trust for participants and is typically evidenced by a trust deed between a trustee and a manager. To qualify as an "authorized unit trust," a trust has to comply with detailed regulations which cover such matters as its constitution, the powers and duties of the manager and the trustee, scheme particulars, investment and borrowing powers, and pricing and valuation.[114]

The manager manages the assets of the unit trust, but the trustee has custody and control of it and holds it in trust for the participants. The manager and the trustee must be independent of each other. The trustee bears the prime responsibility for ensuring that the manager adheres to the statutory and other rules in his administration of the scheme.[115]

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110. *Id.* at 11.

111. *See World's Investment Fund, supra* note 50, at 88.

112. *Id.*

113. Investment funds in the U.K. are mainly comprised of "investment trusts" and "unit trusts." An investment trust is a closed-end company with its share listed on the International Stock Exchange of the U.K. and the Republic of Ireland. *See id.* at 88–89.

114. *Id.* at 89.

115. John W. Vaughan, *The Regulation of Unit Trusts* 38 (1990).

Physical custody of the documents of title to the scheme's property may be entrusted to a third party by the trustee, and such person may also become the registered holder of the property. Restrictions on the power to delegate exist to protect the trust.[116]

C. *Major Structural Differences*

Now that the structural rules governing the Corporate Fund and the Contractual Fund have been introdued, it is opportune to summarize the structural differences between the two. The focal point here is how these two funds differ in allocating decision-making power and control among the three economic actors (e.g., the Adviser, the Monitor, and the investors). In addition, we are interested in determining what conditions are necessary for the exercise of such decision-making power and control. It is important to note that, since the Corporate Fund and the Contractual Fund are driven by different organizational designs and underlying rationales, the differences summarized here are stylized. As such, they carry limitations: to highlight the structural differences, simplifying observations must be made. In fact, because the globalization of securities markets is beginning to put American mutual funds in competition with foreign mutual funds, the structural differences of these models appear to be converging.[117]

1. *Pool-Centered Versus Adviser-Centered Regime*

In both the Corporate Fund and the Contractual Fund, the relation of the Adviser to the Investment Pool is regulated to some degree, but the result is quite different. In the case of the Corporate Fund, the operation and structure of the Investment Pool is the focus and the board of directors has the ultimate responsibility for coordination and management of the mutual fund. Like an ordinary industrial corporation, the Corporate Fund establishes a specialized decision control structure, a decision hierarchy, in which the board ratifies and monitors the decision initiatives of the manager and evaluates its performance.[118] Under this structure, the Adviser invariably is required to "make investment decisions . . . and supervise[] the acquisition and disposition of securities

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116. *Id.* at 34.

117. *See infra* part VI.B.

118. For a discussion of the concept of decision hierarchy, see, *e.g.*, Alchian & Demsetz, *supra* note 61.

by the fund, all in accordance with the Fund's investment objective[s] and policies and under the general supervision of the Fund's Board of Directors."[119]

As a business association the typical Corporate Fund is unique from the moment of its inception. Promoters or sponsors ("Sponsor")[120] engaging in the mutual fund business are likely to proceed in a manner different from promoters interested in establishing other types of business associations. They may already be in the investment management business through the *X* advisory company, licensed as an investment adviser under the 1940 Investment Advisers Act. They will try themselves, or through an affiliate or separate broker-dealers, to form the *Y* mutual fund, owning its initial shares, often a minute fraction of those which will eventually be issued. Together they will cause the directors to be elected. The board of directors, including independent directors, will review many contracts, including the investment advisory contract. Eventually, it is the *Y* fund which will offer shares to the public, but the actual management of that fund will be the work of the *X* management company.[121]

In contrast, in the case of the Contractual Fund, the Adviser or its equivalent[122] is the focus. The Contractual Fund is a contractual entity which is not independent of its Sponsor or Adviser. It is more like a proprietary financial product because its design and operation and success or failure are entirely the responsibility of its Adviser. The Contractual Fund is premised on the belief that the design and operation of a fund and its success or failure are the responsibility of the Adviser.[123]

119. Emerging Markets Growth Fund, Inc., *Prospectus* 15 (Dec. 2, 1991).

120. The term "Sponsor" is not a defined term under the Act. According to common usage, the Sponsor, or promoter, of a business organization performs a useful economic service. The Sponsor contributes business imagination, plus the judgment and skill necessary to execute the idea. As the entrepreneur, the Sponsor's function is to encounter risks and to confront uncertainty. For a discussion of the role of the Sponsor in ordinary corporations, see William Cary & Melvin Eisenberg, *Corporations* 130–40 (1990).

121. For instance, a group of engineers seeking their fortune in the electronics business normally will form an electronics company and contribute their money and services in exchange for stock. That company will be the organization through which they will manufacture and sell electronics devices. They will hold shares in the company and, if they invite the public to join in financing the business by purchasing stock, they will share their ownership with members of the public. *See generally* James K. Sterrett II, *Reward for Mutual Fund Sponsor Entrepreneurial Risk*, 58 Cornell L.R. 195 (1973).

122. The counterpart of the Adviser in the Contractual Fund context is called the "Investment Manager." *See infra* part VI.A.1.

123. For instance, the Financial Services Regulation of the United Kingdom provides that:

As such, the Adviser should not be subjected to the organizational control of any hierarchical superiors. The Adviser is responsible for all services necessary for the operation of the mutual fund, with the possible exception of the custodial services. The Adviser, therefore, must either perform these services itself or contract with third parties to provide them. From an investor's perspective, a Contractual Fund is like a "pay-as-you-go" vehicle. Most costs of operating the fund and distributing its shares will be financed by the Adviser out of a pre-set fee or its own resources.

2. *Hierarchical Discretion Versus Contractual Rules*

Mutual funds are relatively recent innovations, but the main problem that they deal with—the optimal control of discretionary power possessed by those who act on behalf of others—is an old one. Since discretionary power is susceptible to abuse, it may be efficient in many circumstances to counteract it with rules. The major feature of a rule is that it leaves no discretionary power to the decision-maker. In other words, a rule prevents the use of the decision-maker's own information, which may or may not be private or superior information. Rules are impersonal and may involve a loss of useful information.

In regulating the behavior and decisions of agents, what is the perfect mix of rules and discretion? Every business association is characterized by a certain mix of rules and discretion.[124] A few scholars have studied the comparative merits of rules versus discretion in the context of business organizations. For instance, Oliver Williamson noted that debt governance works mainly out of rules, while equity governance allows much discretion.[125] He argued for the use of debt (rule) to finance redeployable assets and the use of equity (discretion) to finance non-redeployable assets.[126]

> It is the duty of the manager to manage the property of the [mutual fund] and it is his right and duty to make decisions as to the constituents of that property from time to time in accordance with . . . the trust deed, [the laws and regulations], and the most recently published [prospectus].

Financial Services (Authorized Unit Trust Schemes) Regulation § 4.01 (1988), in Vaughan, *supra* note 115, at 34.

124. For example, Lewis & Sappington argued that rules arise when an agent has "countervailing incentives" to misrepresent private information. *See* Tracy R. Lewis & Sappington, *Inflexible Rules in Incentive Problems*, 79 Am. Econ. Rev. 69 (1989).

125. This is because a rule-governed regime may force liquidation in the event of a breach of the rules. *See* Oliver Williamson, *Corporate Finance and Corporate Governance*, 43 J. Fin. 567 (1988).

126. *Id.* at 575–82.

Two examples will illustrate this point. One type of business arrangement characterized by hierarchical discretion is the board of directors of an ordinary corporation, which interposes a centralized management system. Under such a model the board of directors is charged with open-ended responsibilities such as reducing management shirking and evaluating the management's performance. In contrast, a business arrangement characterized by contractual rules is the "indenture trustee" associated with a bond offerings.[127] The function of the indenture trustee is to monitor the bond issuer's compliance with the indenture on behalf of corporate and municipal bondholders.[128]

The Corporate Fund and the Contractual Fund also have different rules/discretion mixes. The Corporate Fund is characterized by broad delegation of discretionary authority. As discussed above, the board has primary responsibility under the Act for evaluating the reasonableness of a number of different fees and charges for investment advice, distribution, and administration. The Act and its rules also make the board responsible for policing various operational conflicts, and gives the board the authority to permit various types of transactions to go forward without prior Commission review of individual exemptive applications. As such, the board of the Corporate Fund is empowered with considerable discretionary power and is charged with the responsibility for making many business judgments.

Contrary to the Corporate Fund, the Contractual Fund relies more on rules than on discretion. The typical mutual fund contract comprises standard terms or rules, with allowances for variations (i.e., discretion) only in exceptional cases. To ensure the performance of the contract terms, the Monitor (e.g., trustee or custodian) is charged with the responsibility to "take reasonable care to ensure that the [fund] is administered by the manager in accordance with [the management contract, regulations, and the prospectus]."[129] Hence, instead of interposing a hierarchical board, the contractual fund interposes a Monitor who takes instructions from the Adviser and simultaneously monitors the Adviser's performance.

127. The role played by a bondholder trustee is governed by the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa–bbb (1976) (setting forth requirements for bonds, debentures, notes, and other debt securities offered to the public by mail or in interstate commerce and requiring a qualifying indenture and trustee).

128. For the evolution of the trustee's standard of conduct, see Victor Brudney & Marvin A. Chirelstein, *Corporate Finance* 139–50 (3d ed. 1987).

129. Vaughan, *supra* note 115, at 34.

Procedures for the replacement of the Adviser (or the manager in Contractual Fund jurisdictions) will illustrate this difference. With respect to the Corporate Fund, the board of directors is required to review the management contract annually. However, no decision rules or guidelines are provided to the directors. In a British unit trust, by contrast, the trustee may serve written notice on the manager causing its removal only in one of the six events stipulated in the regulations. They include, for instance, the manager going into liquidation or a receiver being appointed for any part of the manager's activities.[130] In addition, instead of making the trust responsible for policing various operational conflicts, Contractual Fund jurisdictions often impose direct requirements on prohibited or permitted transactions. Thus, the Adviser or its equivalent normally would not engage in activities that rely on rules conditioned on the Monitor's oversight.

3. *Investor Participation in Fund Governance*

When ownership of a business organization is shared among a class of investors, a method for collective decision-making, such as voting, is often devised.[131] Voting serves two distinct purposes. First, voting is most commonly thought of as a method of making allocation decisions, that is, choosing among various alternatives ("Issue Voting"). In contractual terms, it is used to supply or renegotiate substantive terms in the contract. The second type of voting serves as a means of controlling the behavior of agents ("Election Voting").[132] Viewed from a contractual perspective, the right to vote in a mutual fund is the right to make all

130. One legal commentator argued that the regulation "does not seem to impose a duty on the trustee to remove the manager in the event of one of these situations arising, but it is likely that one exists nonetheless." *Id.* at 36.

131. As Richard Buxbaum notes, "there are conceivable forms of investment in which owners would have no participation rights. The pure trust... is a possible example." Richard M. Buxbaum, *The Internal Division of Powers in Corporate Governance,* 73 Cal. L. Rev. 1671, 1672 (1985). Buxbaum goes on to note that "[t]he fullest argument for this passive form is that of G. Roth, *Das Treuhandmodell Des Investmentrechts* 172, 332 (1972) (arguing that the pure trust, which involves a higher fiduciary responsibility and recognizes the need for external legal enforcement, better controls management than the corporate form of ownership with its myth of small investors supervising and controlling management.)." *Id.* at 1672 n.4.

132. Shareholder participation is an important tool in monitoring managers. For example, a properly functioning "market for voice," which in turn is predicated upon effective shareholders' voting rights in a merger or takeover context, is an essential underpinning of the entire efficiency-monitoring concept. *See* Frank Easterbrook & Daniel Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer,* 94 Harv. L. Rev. 1161 (1981).

decisions not otherwise provided by the bilateral contract.[133] Since elected agents (e.g., board of directors) typically have different interests than the electorate, the threat of removal potentially limits the divergence between a representative's actions and her electorates' interests.[134]

To what extent are the investors of a Corporate Fund afforded such participation rights? The Corporate Fund provides extensive Issue Voting and Election Voting[135] because state laws give shareholders of corporations various voting rights.[136] Furthermore, as an additional safeguard against self-dealing by the manager, the Act grants voting powers to mutual fund shareholders beyond those required by state corporation law.

With respect to Issue Voting, management contracts must be approved initially by a majority of the mutual fund's voting shares;[137] subsequent changes to the management contract also must be approved by shareholders.[138] In addition, taken together, sections 8(b) and 13(a) effectively require a mutual fund to adopt fundamental policies with respect to certain key investment activities, and these policies may be changed only by shareholder vote.[139] With respect to Election Voting, the Act requires that shareholders elect a board of directors.[140]

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133. Although "[v]otes may not look much like contracts, the structure of voting . . . is contractual." Easterbrook & Fischel, *supra* note 52, at 63.

134. *See* Buxbaum, *supra* note 131, at 1671–78.

135. Section 18 requires that, with limited exceptions, every share of mutual fund stock must be "voting stock and have equal voting rights with every other outstanding voting stock." 15 U.S.C. § 80a-18(i) (1984).

136. The Act also imposes these rights on non-corporate forms such as trusts. All of these forms of securities pools, unless grandfathered, must have a group of persons that operate in a way similar to corporate directors. However, the requirement of shareholder voting has decreased following the 1986 SEC interpretive position that the Act does not require annual meeting to elect directors and related changes in state law following that pronouncement. John Nuveen & Co., Inc., *supra* note 85.

137. § 80a-15(a); 17 C.F.R. § 270.12b-1(b)(1). Shareholders are also required, under § 80(a)-15(a)(3) and -15(a)(4) respectively, to approve a new management contract following the board's termination of a management contract and to approve any assignment of the contract. Under regulation 15a-4, this vote must occur within 120 days after the board termination or assignment. 17 C.F.R. § 270.15a-4.

138. § 80a-15(a); 17 C.F.R. § 270.12b-1(b)(4). In addition, either the shareholders or the board must annually approve multiyear advisory and principal underwriting contracts. § 80a-15(a)(2)-(b)(1).

139. § 80a-8(b), -13(a). In general, the activities that must be governed by a fundamental investment policy deal with those elements of capital structure, permissible investments, and investment strategies that significantly affect the investment characteristics and the risk-reward profile of the securities issued by a mutual fund. *See SEC Report*, *supra* note 12, at 261–62.

140. Section 16(a) generally prohibits any person from serving as a director unless elected by a majority of the mutual fund's voting shares. § 80a-16(a)

Compared to the Corporate fund, Contractual Funds depend much less on investor voting. However, the role of investor voting varies with each jurisdiction. For instance, investors in Germany[141] and Japan[142] do not have voting rights. In the United Kingdom, investors of unit trusts have some limited voting rights. Specifically, British investors at a duly convened meeting are allowed to vote on four things: (a) to sanction any modification, alteration, or addition to the provisions of the trust deed which shall be agreed to by the trustee and the manager; (b) to approve a manager's departure from a policy, a statement of which has been included in scheme particulars (i.e., prospectus); (c) to remove the manager; and (d) to approve an arrangement for the amalgamation of the scheme with another body or scheme.[143]

In the absence of a comprehensive collective decision-making mechanism, the parties must use other means to fill contractual gaps and resolve disputes. One such means is provided by the bilateral contract between the Adviser and the investors, which is more detailed in the case of the Contractual Fund than that of the Corporate Fund.[144] Another is found in the "vetting system" in Contractual Fund jurisdictions, which serves to ensure the integrity of mutual fund operation.[145]

D. Comparative Institutional Analysis

The study of the economics of organizations has focused on several questions: what determines the boundary between organizations and markets? How does what happens within organizations differ from what happens between actors in markets? Ronald Coase provided the classic answers to these questions: markets and organizations differ in the manner in which transactions occur, and the boundary between the two is determined so as to minimize transactions costs.[146] What lay beyond the learning and haggling costs that, according to Coase, are a major component of market transactions? Oliver Williamson has offered the deepest and most far-reaching analysis of these costs. [47]

141. *See World's Investment Fund, supra* note 50, at 101–102.

142. *See Japan Trusts, supra* note 109, at 6.

143. *See* Vaughan, *supra* note 115, at 76.

144. *See infra* part VI.A.1.

145. *See infra* part VI.D.1.

146. *See generally* Coase, *supra* note 38.

147. *See generally* Oliver E. Williamson, *The Economic Institutions of Capitalism* (1985); Oliver E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (1975); *see also infra* notes 168–73 and accompanying text.

In addition to transaction costs economics, other theories offer alternative theoretical perspectives from which to view the firm. For instance, the principal-agent theory recognizes conflicts of interest between different actors, formalizing these conflicts through the inclusion of observability problems and asymmetries of information. This theory develops the idea that these agency problems are foreseen, and are addressed *ex ante* through efforts to align the incentives of managers and shareholders.[148] Another school of theorists views the firm simply as a nexus of contracts. Viewing the firm as a nexus of contracts draws attention to the fact that contractual relations are an essential aspect of the firm.[149]

Recent research on the theory of the firm begins with the premise of incomplete contracts: with complete contracts, all contingencies are taken care of, and it makes little difference whether the transaction occurs within a firm or between firms. The transaction cost treatment of the firm has been developed more rigorously in the context of comparative incomplete contracting. For instance, viewing the firm as a set of property rights, Grossman and Hart focus attention on the role of physical, that is, non-human, assets in a contractual relationship. Just as traditional theory emphasized the "residual rights to profits" that were vested in the ownership of firms, they emphasize the "residual rights of control" that are vested in ownership.[150] Another perspective emphasizes that unforeseen contingencies provide different incentives to various parties to take actions; however, the costs and benefits of taking action may be affected by the organizational structure. Thus, organizational forms can be viewed as forms of making commitments.[151]

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148. For a discussion of incentive arrangements adopted in the mutual fund context, see *infra* part IV.B.3.

149. The nexus of contract theory is often associated with Jensen and Meckling. *See* Jensen & Meckling, *supra* note 56, at 310–11 (1976).

150. *See generally* Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration,* 94 J. Pol. Econ. 691 (1986).

151. As North writes, "[a] commitment is credible in either of two senses, the motivational or the imperative. A commitment is motivationally credible if the players continue to want to honor the commitment at the time of performance. In this case it is incentive compatible and hence self-enforcing. It is credible in the imperative sense if the player cannot act otherwise because performance is coerced or discretion is disabled." Douglass C. North, *Institutions and Credible Commitment,* 149 J. Inst. & Theoretical Econ. 11, 13 (1993); *see also* Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations,* 22 J.L. & Econ. 233 (1979).

As discussed above, the trilateral structure of the mutual fund falls in the mid-range of the corporation/contract continuum.[152] The Corporate Fund is more centralized in decision-making function, while the Contractual Fund disperses its decision-making function widely. Thus, the Corporate Fund and the Contractual Fund represent two intermediate forms of business organization that differ primarily in their degree of contractual incompleteness.[153] This is because, compared with the Contractual Fund, the Corporate Fund is a radically incomplete contract, giving the board of directors considerable discretion to make business judgments.[154]

As two intermediate forms of mutual funds, the Corporate Fund and the Contractual Fund represent solutions to the problems of coordination and motivation. These problems give rise to transaction costs that differ depending on the nature of the transaction and the way that it is organized.[155] Thus, this Article conducts a comparative institutional analysis of the Corporate Fund and the Contractual Fund. Such analysis is important because we cannot say one form of mutual fund is "inefficient" unless the other form would do better for each person on average across the circumstances in which it operates.

IV. A FRAMEWORK FOR EVALUATING MUTUAL FUND STRUCTURE

This part develops a unified framework to evaluate the comparative merits of the Corporate Fund Model and the Contractual Fund Model. Section A adopts the standard of hypothetical contracting to postulate a bargaining between the Adviser and the Investors over how to allocate monitoring functions to the Monitor. Section B examines the attributes and constraints of contracting, taking into consideration the unique features of mutual funds.

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152. *See supra* notes 68–70 and accompanying text.

153. For a discussion of the relationship between contractual incompleteness and business organizations, see Oliver E. Williamson, *The Logic of Economic Organization* 74 (1989).

154. The comparative merits between centralization and decentralization have long been a major theme of organization and economics. *See, e.g.*, Joseph E. Stiglitz, *Symposium on Organizations and Economics*, J. Econ. Persp., Spring 1991, at 19. For a general discussion of the comparative merits between concentration and diffusion of decision controls in business organizations, see, *e.g.*, Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & Econ. 301 (1983).

155. *See* Paul R. Milgrom & John Roberts, *Economics, Organization and Management* 28–32 (1992).

A. *Hypothetical Contracting over Allocating Monitoring Functions*

In the simple model of an Adviser-Investors contract, there is no place for third-party control. The third party arises in response to the need for contractual integrity. Allocation of third-party control thus becomes a bargaining variable between the Adviser and the Investors. Since the institutional details of the trilateral arrangement are shaped by monitoring considerations,[156] this section isolates the monitoring element from the other elements of the bargaining.

According to the standard of hypothetical contracting, we should identify and adopt the arrangement that rationally and fully informed parties would have adopted *ex ante*.[157] In a hypothetical *ex ante* contracting, rational and fully informed parties would recognize that problems of information and collective action are likely to arise, and they would therefore take these problems into account in allocating control functions to the third party. The normative objective of my analysis is efficiency, measured by the maximization of the *ex post* wealth of the contracting parties.[158]

The hypothetical bargaining approach is particularly fitting in the mutual fund context because the two general arguments that can be used to justify intervention—the imperfect information argument and the externality argument—are not applicable in this context. First, mutual funds operate in a very efficient and competitive market.[159] In the past twenty years the SEC has developed standards for disclosing and advertising fund performance and other information.[160] These actions have permitted the evolution of an information industry that tracks funds. Specialized newsletters, for example, are published by a host of organizations, and many financial and general interest publications

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156. *See, e.g.*, Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 Yale L.J. 49, 50 (1982).

157. This is the standard adopted by many corporate law scholars. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 Colum. L. Rev. 1416, 1433 (1989).

158. *See id.* For a discussion of the concept of efficiency, see, *e.g.*, A. Mitchell Polinsky, *An Introduction to Law and Economics* 7 (1989). In a sense, hypothetical contract arguments are not really contractualist at all. A better term would be welfarism, for in the case of hypothetical contracts it is to the welfare of the parties, and that alone, that one must look, in the absence of any other basis for imputing an agreement to them. *See* Anthony T. Kronman, *A Comment on Dean Clark*, 89 Colum. L. Rev. 1748 (1989).

159. At the end of 1990 there were more than 3,108 mutual funds in the United States. These funds offer similar services, with competitive fees. *See ICI Fact Book*, *supra* note 22, at 22.

160. 17 C.F.R. §§ 23(o), 23(p), 29(x), 27(o). *See, e.g.*, Advertising by Investment Companies, Investment Company Act Release No. 16,245, 53 Fed. Reg. 3,868 (Feb. 10, 1988).

provide extensive coverage and analysis of mutual funds.[161] Moreover, the mutual fund market has a heavy institutional component. Recent statistics indicate that institutional investors purchased more than one third of the total number of all mutual fund shares.[162] Since mutual funds must offer shares on the same terms to all investors, unsophisticated investors can free ride on the efforts of sophisticated investors.

Second, mutual funds are not characterized by significant externalities or third-party effects. In the mutual fund context, the bargaining between the Adviser and the investors produces minimal third-party effects. For example, the possibility that the bilateral bargaining will have externalities with respect to bondholders is low. This is because a mutual fund may not issue debt securities and may not borrow money except in certain circumstances.[163]

The lack of third-party effects in the mutual fund context stands in sharp contrast to the externalities which can be produced by the interaction of the bondholders, stockholders and management of a publicly-held corporation. In the context of a publicly-held corporation, the contractual structure consists of two separate contracts, one between bondholders and stockholders, and one between stockholders and management. Since the purposes of the various parties are seldom consistent, coherent interpretation of interlocking terms is hindered and may cause damages to bondholders.[164] In the mutual fund context, however, because the Adviser-Investors contract does not have externalities with respect to third parties such as bondholders, the

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161. Specialized newsletters are published by a host of organizations. Investors can get information in reference works like *Morningstar Mutual Fund Sourcebook* or *Standard & Poor's/Lipper Mutual Fund Profiles*. For an introduction to one of the leading publishers, see Barry Vinocur & Robert N. Veres, *Mutual Funds the Morningstar Way*, Investment Advisor, Jan. 1993, at 40 (Morningstar has established itself as the prominent mutual fund data source.).

In addition, many financial publications such as the *Wall Street Journal* and *Money Magazine* provide extensive coverage, including periodic rankings of performance and fund expense ratio. Even general interest publications regularly publish statistics on mutual fund performance. *See, e.g.*, N.Y. Times, *How Mutual Funds Performed*, Jan. 9, 1993, at Y32 (publishing a table showing the 1992 performance of more than 3,000 stock and bond funds).

162. At the end of 1990, 34% of all mutual funds were held by institutions, up from the 32% share they held at the end of 1989. *See ICI Fact Book*, *supra* note 22, at 53.

163. A mutual fund may not issue debt securities. Nor may it borrow money except (1) for temporary purposes in amounts not in excess of 5% of the total assets of the company at the time of the loan or (2) from a bank, provided that immediately after any such borrowing the investment company maintains 300% percent asset coverage for the loan and for any other borrowing. *See* §§ 80a-18(f), (g).

164. *See* Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 Colum. L. Rev. 1449, 1458–59 (1989).

Adviser and Investors bear the full costs of their decisions and reap all the gains.

If we take efficiency as a positive principle, the structure and governance of a mutual fund are simply efficient choices made by both the Adviser and the Investors. The take-it-or-leave-it form can be regarded as bargaining for an outcome, although not necessarily bargaining for a specific process. The investors only assign to the third party those things they cannot do or decide for themselves. In other words, rational parties will weigh the benefits of employing a third party against its costs. It is inevitable that some amount of shirking or self-dealing will occur on the Adviser level. The question is whether these costs can be cut by the second-tier agent—the Monitor—or whether that agent is not itself more costly.

It should be noted that, although the contractual view of mutual funds provides a useful framework of analysis, adopting a contractual view does not entail accepting any particular position of mandatory rules. For instance, it is possible to adopt a contractual framework to state reasons for supporting mandatory rules.[165] In fact, as will be demonstrated below, it is advisable to adopt mandatory rules for mutual funds within the contractual framework.[166] In addition, most of the bargaining elements are interactive and interrelated. If the Monitor is allocated with more power, then it follows that the Investors may have less control over the process; and vice versa.

Despite the global scope of the subject matter, this Article assumes that the "venue" of the bargaining is the United States securities and mutual fund market, subject to the bargaining attributes and constraints of the U.S. marketplace. This assumption is fitting because this Article evaluates mutual funds from an American perspective, and will consider below two Contractual Fund proposals intended to improve the governance structure of mutual funds in the United States.[167]

B. Contracting Attributes and Constraints

Hypothetical bargaining requires an examination of context. As pointed out by Ronald Coase, there are costs to carrying out transactions, and these transaction costs differ depending on the nature of the

165. *See, e.g.*, Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 Harv. L. Rev. 1820 (1989).

166. *See infra* part V.B.2; parts VI.C.–D.

167. *See infra* part VI.B.

transaction and on the way a mutual fund is organized.[168] This section considers the attributes of the underlying transactions in the mutual fund context in order to devise value-maximizing governance arrangements.

1. Organizational Capital and Fund Management

Modern theories of institutional economics recognize the role that organizational capital plays in influencing the monitoring structure of a business firm.[169] Thus it is important to examine the organizational capital of the mutual funds—the financial assets provided by the Investors and the human assets offered primarily by the Adviser. In addition, it is desirable to examine the nature of business that the mutual fund conducts.

a. Liquid Capital

First, consider the asset specificity of the mutual fund. Asset specificity refers to the degree to which an asset can be redeployed to alternative uses without sacrificing productive value.[170] From a property rights perspective, the "firm" of the mutual fund can be viewed as a set of financial assets.[171] Oliver Williamson was the first to recognize that transaction costs may assume particular importance in situations where economic actors make relationship-specific investments—investments to some extent specific to a particular set of individuals or assets.[172] He argued that holders of such investments are vulnerable to the hold-up problem.[173] That is why, in Williamson's view, bringing a transaction

168. *See generally* Coase, *supra* note 38.

169. *See* Milgrom & Roberts, *supra* note 155, at 29–34.

170. *Id.* at 30–31. The concept of asset specificity has wide applications in the analysis of business firms. For an application of asset specificity to the structure of corporate law firms, see, *e.g.*, Ronald J. Gilson & Robert H. Mnookin, *Coming of Age in a Corporate Law Firm*, 41 Stan. L. Rev. 567 (1989) (examining the organizational structure of a corporate law firm in light of its dominance of human capital).

171. One way to resolve the question of how integration changes incentives is spelled out in recent literature that views the firm as a set of property rights. This is because ownership of an asset goes together with the possession of control over that asset. *See generally* Bengt R. Holmström & Jean Tirole, *The Theory of the Firm*, in 1 *Handbook of Industrial Organization* 61 (Richard Schmalensee & Robert D. Willig eds., 1989).

172. Williamson argues that the principal dimension on which transaction cost economics relies is the condition of asset specificity. *See* Williamson, *supra* note 153, at 69–70.

173. For example, utilities firm *A* has to locate and invest in an electricity generating plant adjacent to a coal mine belonging to supplier *B*. In Williamson's view, bringing a transaction from the market into an industrial organization—the phenomenon of vertical integration—mitigates this

from the market into a vertical integration mitigates such opportunistic behavior.

In contrast, mutual funds consist primarily of liquid assets rather than relationship-specific assets.[174] As a matter of law, a mutual fund may not invest more than fifteen percent of its assets in illiquid securities.[175] Liquid assets are non-specific assets that can easily be redeployed to alternative uses and by alternative users without sacrifice of productive value. This is because external markets will provide a guide to the parties' opportunity costs even after the relationship is underway. Thus, for mutual fund investors, liquidity is a virtue because no one wants to be "locked in."

b. Human Capital

Secondly, consider the human assets of the mutual fund. Up to now it has been assumed that mutual funds consist of financial assets only. However, a business firm can be a meaningful entity even if its ownership of physical or financial assets is quite limited. Examples include investment banks and law firms. In addition to financial assets, the mutual fund also consists of other intangible assets such as goodwill and reputation. The Adviser is the one who actually conducts the productive activities of the mutual fund. In other words, a mutual fund is the embodiment of the efforts, expenses, and goodwill of its Adviser. Thus, it is fair to say that the Adviser carries the institutional reputation of the mutual fund it creates.[176]

c. The Nature of Fund Management

Thirdly, consider the internal organizational structure of the mutual fund. Mutual fund "management" consists primarily of investing and reinvesting money according to a stated policy. The fundamental service

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opportunistic behavior and improves investment incentives. This is because once the parties sink their investments, they are to some extent locked into each other. *See* Oliver E. Williamson, *The Economic Institutions of Capitalism*, 21–30 (1985).

174. Such assets should be distinguished from physical assets which are more illiquid and relationship-specific. *Id.* at 21–30.

175. In the SEC's view, an illiquid security is any security that cannot be disposed of within seven days in the ordinary course of business at approximately the amount at which the fund has valued the instrument. *See* Guide 4 to Form N-1A, Revision of Guidelines to Form N-1A, Investment Company Act Release No. 18,612 [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,930 (Mar. 12, 1992). No explicit liquidity standards are applicable to closed-end investment companies.

176. *See infra* part VI.A.1.

an Adviser offers is expert assistance in the selection of investments through which investors can achieve their investment objectives. The Adviser must acquire information and employ a reasonable decision-making process when determining whether to act on the information.

Within the internal organization of the entity acting as Adviser, such specialized knowledge relating to portfolio management is concentrated in a small number of people. As such, unlike large, complex organizations, these investment decisions do not go through a "decision hierarchy" before they are approved and finalized.[177] The internal organization of the Adviser bears out this hypothesis: the portfolio management of most mutual funds is conducted by a single portfolio manager, and only a few are run by committees.[178]

Due to the specialized nature of such knowledge, the small number of persons who possess such knowledge are the ones who actually make the investment decisions. Mutual funds often market their investment vehicles by using the individual portfolio managers' track record.[179] In fact, mutual funds investors are often advised to watch for a change in

177. For instance, publicly-held corporations are one organizational form that is characterized by a decision hierarchy. In 1932, Berle and Means announced the separation of ownership and control in American industry. They reported that owners of major corporations had become atomistic shareholders lacking the ability, skill, information, and often the incentives to monitor the performance of specialized managers. Thereafter, the corporate governance debate became a search for a mechanism to bridge the separation of ownership and control by holding managers accountable for their performance. Adolf A. Berle, Jr. & Gardiner C. Means, *The Modern Corporation and Private Property* (1932). Alfred Chandler argues that the increasing complexity of business was a more important cause of separation than the dispersion of stock holdings. Alfred D. Chandler, Jr., *Scale and Scope: The Dynamics of Industrial Capitalism* 232 (1990).

178. There are a few funds managed by committee, or at least by a few money managers who split up the assets and are each responsible for their portion. *See, e.g.*, Thomas Watterson, *Spurning the Manager in Favor of a Committee*, Boston Globe, Aug. 11, 1991, at 38.

This system can be justified on efficiency grounds: In a non-complex organization, specific knowledge important for decision management and control is concentrated in one or more agents. Because the bare facts contained in such specialized knowledge are often uninterpretable, it is difficult and costly to transfer or communicate such knowledge to others. *See, e.g.*, Fama & Jensen, *supra* note 154, at 305–07; Harold Demsetz, *The Theory of the Firm Revisited*, in *The Nature of the Firm: Origins, Evolution, and Development*, 159, 175 (Oliver E. Williamson & Sidney G. Winter eds., 1991). Hence, concentration (or decentralization) of decision-making function represents significant savings on information transmission within the organization of the manager. In addition, confining investment decisions to a small number of individual portfolio managers enables the manager to conduct performance measurement, establish accountability, and provide incentive compensation more effectively.

179. However, there is no easy way to determine whether the individual portfolio manager who compiled that record is still around. In an effort to address this concern, the SEC has recently promulgated rules requiring closed-end funds to tell investors the names of those who manage the funds. *See* Sandra Block, *SEC Says Closed-End Mutual Funds Must Identify Managers for Investors*, Wall St. J., Nov. 20, 1992, at A3.

management; if successful managers leave a fund, then investors should at least keep a closer eye on the performance of the fund until they are comfortable with new portfolio managers.[180] Since it is very costly to transfer such specialized knowledge to others, regulators should be careful when considering whether or not to create a regulatory structure which will permit an institutional superior or "higher-up" to interfere with the productive activities of the Adviser.[181]

d. *Summary*

The nature of the organizational capital of the mutual fund has profound implications on its optimal monitoring structure. First, viewing the mutual fund as a repository of reputation highlights the importance of the Adviser in the organization of the mutual fund. Second, because mutual funds consist primarily of financial assets and typically have minimal lock-in effects, investors should be less concerned about post-contractual opportunism on the part of the Adviser. Third, the specialized nature of fund management suggests that a complex decision hierarchy is not suitable for mutual funds. Therefore, it can be argued that, in the absence of overriding concerns, the Adviser should be permitted to share significant control over the operations of the mutual fund.[182]

2. *Performance Observability*

Managerial theory indicates that observability problems are created when the firm's owners cannot easily observe the manager's performance *ex ante* (or even *ex post*).[183] The asymmetry of information that results from this lack of observability can create various incentive problems, such as moral hazard, because owners cannot contract for behavior they cannot observe.[184]

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180. Investors of mutual funds have often been advised to keep "current" on who the portfolio manager is. *See, e.g.*, Jim Melloan, *Want to Break Up with Your Fund?*, Worth, Apr. 1994, at 118.

181. For example, Demsetz points out that, "[r]oughly speaking (since other things also matter), the vertical boundaries of a firm are determined by the economics of conservation of expenditures on knowledge." Demsetz, *supra* note 178, at 173.

182. *See infra* part VI.A.

183. The source of this moral hazard or incentive problem is an asymmetry of information that results because individual efforts cannot be observed and hence contracted upon. *See* Holmström, *supra* note 55, at 74.

184. *See, e.g.*, Shavell, *supra* note 55.

a. Total Return and Risk Level

How do observability problems affect the structure of mutual funds? The investment decisions that Advisers make are fully priced in the securities market.[185] Because a mutual fund is required to compute net asset values daily, the public nature of such figures (and the amounts distributed to investors) makes its performance record very transparent. A mutual fund is required to calculate its net asset value per share on a daily basis, subject to certain exceptions.[186] Although the investors cannot observe the efforts of the Adviser directly, they can infer them from the observed outcomes. Since net asset value provides accurate price signals, it can serve as an objective valuation mechanism and as a low-cost method of evaluating the investment return of mutual funds. Thus, due to such *ex post* observability, the Adviser's performance is measurable at a low cost.

This ease with which a mutual fund's performance may be measured makes the management of mutual funds an outcome-oriented business. Although it is difficult to observe the care and skill exerted by the Adviser, it is easy to observe the outcomes of investment. Admittedly, an outcome-oriented mentality may be morally disheartening because outcomes depend as much upon chance as on the Adviser's efforts.[187] For instance, it is common to hear portfolio managers attempt to explain their poor performance by stating, "We went short thinking interest rates would go down and they didn't." Similarly, they often explain good performance by stating, "We made a good bet on [insert your favorite issuer or industry]." This mentality is why concern with investment return is an everyday reality of the mutual fund business.

It should be noted that mutual fund performance means more than "total return"—the percentage change in a mutual fund's net asset value

185. The price of stocks traded in securities markets is to a considerable extent established by professional investors such as managers of mutual funds. *See, e.g.*, Ronald J. Gilson and Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549 (1984).

186. 17 C.F.R. § 270.22c-1 (1993). Net asset value is computed by adding up the value of the fund's investments, cash, and other assets, subtracting its liabilities, and then dividing the result by the number of shares outstanding. For example, securities for which market quotations are readily available are valued at their market value. 15 U.S.C. § 80a-2(a)(41).

187. Given the somewhat speculative nature of investment management, sometimes efforts spent by the Adviser (and its individual portfolio managers) bear little direct relation to outcomes. After all, it is sometimes difficult to distinguish between investment and speculation or gamble. *See, e.g.*, Sharpe & Alexander, *supra* note 25, at 5–7. This is particularly true for mutual funds, where past performance is no guarantee of an Adviser's future performance. *See* Barbara Donnelly, *Past Is No Guarantee of Manager's Future*, Wall St. J., Oct. 27 1992, at C1.

over a specified period of time.[188] From an investor's perspective, good performance can be defined as the delivery of total returns that are, with reasonable consistency, superior to those achieved by other mutual funds with similar investment policies, objectives, and structures. Thus, in evaluating the performance of mutual funds, investors should take into account the risk element.[189]

b. Fees

In addition to total returns and risk levels, investors value other factors such as fees, because total return is almost always calculated before the deduction of fees and other costs.[190] After all, each dollar of fee that an investor pays reduces his or her total return by a precisely equal amount. The amount of fees paid by investors is not easily observable. One reason is that it is difficult to ascertain the level of indirect costs associated with the management of a particular fund.[191] The uncertainty created by these indirect costs makes it difficult for investors to observe *ex ante* the level of the Adviser's income from both direct and indirect sources.

For example, expenses such as research costs are difficult to attribute, because research is nearly always performed collectively within a fund complex.[192] In addition, most of the expenses assumed by the Adviser are incurred jointly for all the funds and accounts in the complex. As such, the portion of the fees benefiting a particular fund is not directly ascertainable. One way to solve this problem is to use a pre-set fee rate in the prospectus and contract so that investors can better evaluate the value of mutual fund products.[193]

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188. The ending net asset value is adjusted to take into account the reinvestment of all income dividends and any capital gains distributions made by the fund.

189. *See infra* part VI.C.2.

190. Such costs include, for example, taxes payable by the shareholder on the income from dividends and capital gains distributions.

191. Indirect costs are costs that cannot be traced to the cost object in an economically feasible way. *See, e.g.*, Charles T. Horngren et al., *Cost Accounting: A Managerial Emphasis* 26–27 (1994); *see also infra* notes 242–54 and accompanying text.

192. For example, the Fidelity group is supported by a team of more than 200 analysts who monitor investment opportunities worldwide. *See* Fidelity Magellan Fund, *Prospectus*, May 20, 1993, at v.

193. *See infra* part VI.B.1.b.

c. *Quality of Services*

Another performance-related term is the quality of services provided by the Adviser and its affiliates. There are funds with good performance records which have not been successful and vice versa. Although Advisers that perform well generally attract more assets, investors often do not move from bad mutual funds rapidly. This is because investors value service quality as well as investment returns.[194]

3. *Compensation and Incentive Effects*

Good incentive schemes serve to decrease moral hazards and, hence, attenuate the need for third-party monitoring. One way to align the interests of the Adviser and the Investors is to make incentive-compatible arrangements whereby the Adviser's compensation is closely tied to the Investors' gain. Empirical studies have shown that incentive compensation schemes often have alignment effects. For example, in the case of publicly-held corporations, studies have shown that there is a statistically modest relationship between shareholder gain, measured by returns to common stock, and executive salaries and bonuses.[195]

The compensation schemes commonly associated with mutual funds have even stronger alignment effects. Advisers of mutual funds typically get paid a percentage of the net asset value of the fund. This compensation method can be justified under efficiency rationales: if quality standards are easy to specify and monitor, then principals might prefer piece rates over time rates, or profit-sharing over fixed payments.[196] Because the Adviser's investment decisions largely determine performance outcomes, mutual funds are able to provide effective incentives to the Adviser.

194. Whether service quality is measurable is a more controversial issue. *See infra* part VI.C.1.

195. In a study of the relation between top management pay and corporate stock performance, Jensen and Murphy estimated that a CEO's compensation changes by $3.25 for a $1,000 change in stock value. Michael C. Jensen and Kevin Murphy, *Performance Pay and Top Management Incentives,* 98 J. Pol. Econ. 225 (1990). However, there are many corporations in which executive compensation bears little relation to any rational measure of corporate performance. This is probably because it is very difficult to quantify the causal relationship between the executive's performance and corporate performance. Therefore, corporate managers are paid for their efforts as well as for corporate performance. *See, e.g.,* Eisenberg, *supra* note 77, at 1489–95.

196. *See, e.g.,* James Roumasset & Marila Uy, *Piece Rates, Times Rates, and Teams: Explaining Patterns in the Employment Relation,* 1 J. Econ. Behav. & Org. 343 (1980); Joseph E. Stiglitz, *Incentives and Risk Sharing in Sharecropping,* 41 Rev. Econ. Stud. 219 (1970).

The incentive effects are twofold: first, an Adviser's interest in preserving and expanding his client base provides considerable motivation to carry out his responsibilities; and second, the standard fee arrangement offers the Adviser an adequate basis for sharing in the fruits of superior investment results.[197] Such *ex post* observability has implications on incentive effects concerning management fees.

How observable are costs, such as distribution costs, involved in operating a mutual fund? In no other section of the financial services field are cost and value more closely linked. In the case of mutual funds it might be said that knowing the price of everything reveals the value of everything, since each dollar of cost that an investor pays reduces his return by a precisely equal amount. Thus, it is important that the Adviser bears a share of the wealth effects of mutual fund costs. One way to control costs is to set forth a pre-determined formula in the contract. This practice would motivate service providers to both economize on present costs and estimate future costs more accurately.

4. Redemption Rights and Exchange Privileges

Loyalty and exit remain essential elements of business associations as well as political systems. In this respect, Hirschman's concepts of exit, voice, and loyalty can serve as a framework for the various rules concerning corporate governance.[198] For example, corporate law often provides adequate conditions for "exit," such as the dissenting shareholders' appraisal remedy in merger transactions.[199] The following discussion focuses on redemption rights and exchange privileges.

a. Redemption Rights

One distinctive feature of mutual funds is the redeemable nature of the claims that investors hold. A redeemable security is defined in the Act as

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197. Note, however, that this compensation scheme is not entirely performance-based. The Investment Advisers Act generally prohibits a registered investment adviser from receiving compensation on the basis of a share of capital gains in, or capital appreciation of, a client's account. Subject to specific requirements, limited exemptions from that prohibition are available for advisory contracts with registered investment companies such as mutual funds. Regulation 205-1; 15 U.S.C. § 80b-5(a)(1).

198. This much-used paradigm of exit, voice and loyalty, stems from Albert O. Hirschman, *Exit, Voice, and Loyalty* (1970).

199. *See, e.g.*, Commission on Corp. Laws, Am. Bar. Ass'n Section of Corp., Banking & Bus. Law, *Changes in the Model Business Corporation Act Affecting Dissenters' Rights*, 32 Bus. Law. 1855 (1977). *See also* Cary & Eisenberg, *supra* note 120, at 1094–1117.

one which entitles the holder at its option to receive his or her pro rata share of the pool's "current" net assets or the cash equivalent.[200] Under the Act, current net asset value is computed daily.[201] Thus, mutual fund investors hold fluctuating claims, not a fixed claim like debt holders, or residual claims like corporate stockholders.

Redemption can be regarded as a form of residual right of control—the right to make any decisions concerning the asset's use that are not explicitly controlled by law or assigned to another by contract.[202] Such rights are self-enforcing because their enforcement is not dependent on judicial intervention or third-party decisions. The availability of accurate and inexpensive *ex post* market signals is helpful to investors deciding whether to exercise redemption rights. As such, redemption rights are superior to shareholder's appraisal rights in publicly-held corporations.[203]

Admittedly, in determining whether to exercise redemption rights investors have to take into consideration factors such as redemption fees and tax consequences. Redemption fees make it costly for investors to sell their interests. However, the number of mutual funds that charge redemption fees are small, and market constraints do not give managers free hands to impose redemption fees. In determining whether to charge redemption fees, the manager has to balance many factors, such as the impact on marketability of fund shares. That is why only 134 of the 3,000-plus funds charge redemption fees.[204] As a result, the presence of

200. 15 U.S.C. § 80a-2(a)(32).

201. 17 C.F.R. § 270.22c-1(b) states "current net asset value . . . shall be computed no less frequently than once daily." Note that under the Act, open-end investment companies (i.e., mutual funds), which are redeemable daily, and closed-end investment companies, which are not redeemable, are two extremes in the continuum of liquidity. However, as a result of recent reform, it is possible for investment companies to offer investors funds with intermediate degrees of liquidity not currently available to shareholders of closed-end and open-end funds. *See* Periodic Repurchases by Closed-End Management Investment Companies; Redemptions by Open-End Management Investment Companies and Registered Separate Accounts at Periodic Intervals or With Extended Payment, Investment Company Act Release No. 18,869, 57 Fed. Reg. 34,701 (Aug. 6, 1992).

202. For a discussion of the concept of residual rights of control, see generally Grossman & Hart, *supra* note 150.

203. For a discussion of appraisal rights in publicly-held corporations, see, *e.g.*, Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 Colum. L. Rev. 1599, 1613–15 (1989).

204. Carole Gould, *Readers' Mail: A Question of Risk*, N.Y. Times, Feb. 20, 1994, at F14. One concern is the equality issue: in most funds, all investors have to shoulder the transaction costs incurred by a fund when other investors sell their interests. The redemption fees are supposed to compensate the long-term shareholders for transaction expenses incurred to meet redemptions by short-term traders. Thus, redemption fees directly benefit a fund's remaining shareholders. *Id.*

redemption fees does not pose a serious barrier to most mutual fund investors.

In effect, redemption rights are a special form of diffuse control in mutual funds. The withdrawal decisions of redeemable claim holders affect the resources under the Advisers' control, and they do so in a more direct fashion than customer decisions in other business organizations. In other words, the decision of the claim holder to withdraw resources is a form of partial takeover or liquidation which deprives management of control over a portion of the fund's assets.[205] Thus, this control right can be exercised independently by each claim holder. Since investors can look after their own interests and withdraw claims on demand without jeopardizing the viability of the organization, the need for their surveillance is accordingly attenuated.

b. Exchange Privileges

Another related feature of some mutual funds is an exchange privilege. A prime attraction of investing with a large family of mutual funds is the ability to shift easily among its offerings—from a conservative stock fund to an international fund to a short-term bond fund. Many mutual funds are part of a "family of funds" (a group of funds managed by the same Sponsor/manager company) and may offer an option called an exchange privilege.

An exchange privilege allows an investor to transfer shares from one of these funds to another. Exchange policies vary from fund to fund. Generally speaking, the fee for an exchange is nominal.[206] In addition, the procedures for exercising exchange privileges are easy to follow. In fact, it is sometimes possible to use automated services available through a telephone to make exchanges between a family of funds.[207]

c. Summary

To summarize, the availability of redemption rights and exchange privileges within mutual fund complexes has resulted in high investor mobility and a competitive environment for mutual funds. Hence,

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205. Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & Econ. 327, 338 (1983).

206. *See ICI Fact Book*, *supra* note 22, at 7. *See also* Andree Brooks, *Avoiding Unnecessary Costs in Switching Among Mutual Funds*, N.Y. Times, Jan. 29, 1994, at F30.

207. *See, e.g.*, Fidelity Magellan Fund, *Prospectus*, May 20, 1993, at 18.

allocating certain control functions to a third party might not be necessary or even desirable if the costs of such allocation are larger than the costs of exercising redemption rights or exchange privileges.

5. *Other Market Constraints*

Like managers of publicly-held corporations, the Adviser's behavior is to a considerable extent shaped by the constraints imposed by market forces. In the context of publicly-held corporations, studies on market constraints typically include a product market, corporate control market, managerial labor market, and capital market.[208] It is well recognized that competition in these markets reduces managerial slack.[209]

In the mutual fund context, the market for corporate control (proxy fights, direct purchase of shares, and mergers) does not really exist. Whether a takeover will occur depends largely on whether the value of the company in the eyes of some potential buyer exceeds the sum of the company's total market price. In other words, such a market exists because there is a substantial gap between share value and the intrinsic value of the organization. In the case of a mutual fund, however, there exists no such gap to warrant the costs of a takeover.[210]

Nevertheless, mutual funds operate in a competitive environment because they live or die based on their ability to replenish their redeemable assets with the sale of new securities. On the market side, four factors substantiate this assertion. The first three factors measure the market's elasticity of demand for mutual funds. The last factor measures the consumer's elasticity of demand for a particular fund. Consider the concentration of the industry. One study indicates that (1) according to the Justice Department's guidelines, the mutual fund advisers compete in an unconcentrated market; and (2) the 30 largest complexes experienced declining market share, indicating that new entrants and smaller managers have been successful in gaining shares from their larger rivals.[211]

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208. *See* Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 Harv. L. Rev. 1820, 1841–48 (1989).

209. For example, Hart argued that if product markets are perfectly competitive, there will be no supernormal profits and hence managers must maximize profits just to survive. *See* Oliver D. Hart, *The Market Mechanism as an Incentive Scheme*, 14 Bell J. Econ. 366 (1983).

210. This, of course, has something to do with the organizational capital of the mutual fund. *See supra* part IV.B.1.

211. William J. Baumol et al., *The Economics of Mutual Fund Markets: Competition Versus Regulation* 117 (1990).

The second factor concerns the conditions of entry. Conditions of entry apply to two levels: (1) the market for advisers; and (2) the market for funds. In both cases, the statistics indicate that there are no "significant entry barriers" in the mutual fund industry.[212] Overall, the absence of redemption fees for most funds, the high liquidity of mutual fund assets, and the exchange privileges within some mutual fund complexes have resulted in high investor mobility and a competitive environment for mutual funds. In addition, a recent research study predicts that in the 1990s, overcapacity, new competitors (notably banks and foreign firms), downward pressures on revenues, and upward pressure on costs will combine to make the mutual fund business an even fiercer game.[213]

In terms of internal organization of mutual funds and their Advisers, empirical results strongly support the findings of "economies of scope."[214] Most mutual funds are typically organized as part of a few large corporate complexes controlled by investment advisers. Each Adviser offers multiple mutual fund products (e.g., growth funds, income funds, and money market funds); each fund in a complex is usually a separate legal entity. In practice, the majority of funds are little more than organization tools with few, if any, employees other than officers and directors. Each fund incurs only minimal fixed costs. This structure reveals how a mutual fund complex maximizes its internal economies of scope and diversifies the entrepreneurial risks of the various mutual funds it organizes. Economies of scope are thus realized by sharing the advisory cost among all contracting funds within a fund complex. The greater the number of funds offered by the complex, or the greater the number of overall shareholders for the complex, the more significant the economies of scope.

From the standpoint of individual mutual funds, it can be argued that some funds have reached "economies of scale" because the per unit cost of performing transactions decreased as the number of transactions increased.[215] Under such circumstances, related conflicts may arise in

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212. *Id.*

213. *See* Fiske, *supra* note 10, at 6.

214. Economies of scope (in the form of cost savings) typically arise from joint usage of fixed resources. *See, e.g.*, Robert S. Pindyck & Daniel L. Rubinfeld, *Microeconomics* 221–24 (1989).

215. Economies of scale, defined in a cost perspective, means that the cost of production increases proportionately less than output as output increases. *Id.* at 187. Allocation of costs against different product lines or segments of the same product is an art rather than a science. The issues of economies of scale and dividing entrepreneurial reward will be examined below. *See infra* part V.B.1.; part VI.A.1, B.2.

connection with dividing the benefits of any economies of scale that may be generated as the assets of the company increase. This is because advisory fees typically are calculated as a percentage of assets under management even though the cost of providing investment advisory services—consisting largely of salaries and overhead—is relatively fixed (e.g., a portfolio manager can manage $500 million nearly as easily as $100 million). An advisory fee that does not scale down as company assets increase consequently may yield enormous profits to the Adviser.

V. AN EVALUATION OF THE CORPORATE FUND

I have developed a framework for evaluating how monitoring functions ought to be allocated to the Monitor, which, in the case of the Corporate Fund, is the board of directors. This part applies the normative observations developed above by analyzing the structure and governance of the Corporate Fund.

A. The Effectiveness of the Semi-Hierarchy

What kind of structure does the Corporate Fund take? On the one hand, the Adviser, a functionally autonomous entity typically governed by a separate board of directors, sponsors and manages the mutual fund. On the other, an investment company's own board of directors is responsible for the organic or structural integrity of the investment company. The Corporate Fund is in essence a "semi-hierarchy" because it establishes a hierarchical decision-control mechanism yet eschews outright ownership of the Adviser. Given its semi-hierarchical structure, the Corporate Fund has been referred to as a corporate anomaly.[216]

It is often believed that hierarchical organizations, including semi-hierarchical ones, can do everything contractual arrangements could do and do so at least as well.[217] They may be able to secure the best of two worlds—enjoying the incentive advantages of independent firms while still facilitating close planning where necessary. As I will argue below, such a structure involves certain transaction costs which sometimes go unnoticed. This section first examines the board's independence and informational advantage and then considers the potential costs of such a semi-hierarchy.

216. *See* Modesitt, *supra* note 3.

217. *See* Stiglitz, *supra* note 154, at 18.

1. The Board's Independence and Informational Advantage

The most enduring institution for minimizing agency cost has been the independent director. The concept that shareholders can elect non-employee directors to monitor management performance has reached the status of conventional wisdom.[218] That is why the American Law Institute[219] and the Delaware courts[220] have come to accord independent directors a primary monitoring role. Similarly, the Corporate Fund also accords independent directors a primary monitoring role.

a. Independence

As discussed above, section 10(a) of the Act provides that at least forty percent of the board of directors of a mutual fund must consist of independent directors. This requirement is predicated on the belief that the mutual fund governance system works best when the functions required of independent directors are performed by individuals who are truly independent.[221] However, the lack of independence of the directors of mutual fund boards, including the independent directors, is well documented.[222] As one critic commented, "Who picks the unaffiliated directors? The affiliated men pick the unaffiliated men. The men who need to be watched pick the watchdogs to watch them."[223]

Both the *Wharton Report* and the *SEC Public Policy Report* attributed the lack of effective independent director control largely to the existing

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218. *But see* Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors,* 43 Stan. L. Rev. 863 (1991) (analyzing failings of outside director concept).

219. *See Principles of Corporate Governance: Analysis and Recommendations* § 3A.01 (Proposed Final Draft 1992).

220. The Delaware courts have assigned special weight to outside director's decisions. *See, e.g.,* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (finding merger failed fairness test where feasibility study not shown to outside directors).

221. Note that inside directors have their own advantages. As Fama noted, outside directors have more independence and objectivity, but inside directors have more information and their careers are at stake. *See* Eugene F. Fama, *Agency Problems and the Theory of the Firm,* 88 J. Pol. Econ. 288 (1980); *see also* John L. Grant, *Shield Outside Directors From Inside Seduction,* Wall St. J., Nov. 23, 1992, at A14.

222. *See, e.g.,* William J. Nutt, *A Study of Mutual Fund Independent Directors,* 120 U. Pa. L. Rev. 179 (1971); Robert H. Mundheim & William J. Nutt, *The Independent Directors of Mutual Funds,* Wharton Q., Spring 1972, at 8.

223. *Conference on Mutual Funds: The Mutual Fund Management Fee,* 115 U. Pa. L. Rev. 726, 739 (1967) (remarks of Abraham L. Pomerantz).

selection process.[224] In effect, the power to place a slate of directors before the shareholders through the proxy mechanism is tantamount to the power of appointment. Thus, the issue is not who will elect the directors but who should select the candidates who will stand for annual elections or fill interim terms. The Adviser who wants to engage in mutual fund business is typically the one who incorporates the investment company, owns its initial shares, and nominates the initial board members, including the independent board members.[225] Because the Adviser controls the mutual fund from the moment of its inception, this co-dependency problem is more serious than that of ordinary publicly-held corporations.

b. Informational Advantage

A potential advantage of incorporating the board into the governance structure of the Corporate Fund is the possibility that the board may use its expertise and access to information. Unfortunately, independent directors are ill-equipped for this task because they have only limited resources at their disposal. Like their counterparts in publicly-held corporations, directors of a mutual fund, acting in that capacity, are usually generalists. Admittedly, these are people with specialized knowledge, competence and skill (e.g., as a lawyer or a banker). However, in light of the specialized nature of the fund management business, they must have pertinent and unbiased information if they are to "direct" the investment process of the Adviser.

What are the sources of such pertinent and unbiased information? The Act imposes a duty on the directors to request and evaluate, and a duty on the Adviser to furnish, the information reasonably necessary to evaluate the terms of the investment company's service contracts, including the contract between the investment company and the Adviser.[226] Some are generally available and some are prepared especially for this purpose in accordance with the Adviser's routine practice or at the request of the directors. The primary source of information, however, will be the Adviser.

224. Candidates for subsequent elections are in most fund complexes selected by a nominating committee composed of both affiliated and independent directors. *See* Nutt, *supra* note 222, at 215–20.

225. *See supra* notes 120–21 and accompanying text.

226. 15 U.S.C. § 80a-15(c).

The available information can be both hard (e.g., numbers and statistics) and soft (e.g., opinions and strategies). It is also a common practice to use materials prepared by outside experts. For example, such materials are typically used to provide comparisons of fee structures, expense levels and performance (e.g., Lipper Analytical Services or the *Wall Street Journal*). Some of the information, such as materials prepared by outside experts, can be relatively objective and thus can shed light on the performance and internal operation of the Adviser. Other information provided by the Adviser, however, may be somewhat biased.

If information provided by the Adviser is biased or not sufficiently pertinent, could the directors rely on information prepared by the internal staff of the investment company? The answer is no. Unlike ordinary corporations, the investment company has no employees that are truly its own.[227] Since these officers are employed and compensated by the Adviser, it would be imprudent to assume that they can be impartial in their duties. Not surprisingly, one commentator has recently observed that the board of the Corporate Fund has no "teeth" because directors are not adequately informed about fund operations.[228]

In an attempt to address this concern, the SEC has considered requiring mutual funds to provide independent directors with their own staff or counsel. However, this idea was rejected because of the cost concerns.[229] Therefore, it may be a mistake to think that the board has information superior to the information available to some of the mutual fund's investors (e.g., institutional investors).[230]

2. *The Costs of the Semi-Hierarchy*

It is believed that the governance costs of the Corporate Fund are insignificant. For instance, Lipper Analytical Services, Inc. estimated that total governance costs do not exceed two basis points for the typical investor.[231] Compared with an average total expense ratio of 1.118% (approximately 112 basis points) for 2,731 funds, such costs may be

227. *See SEC Report, supra* note 12, at 251 n.3.

228. *See* letter from Bruce Oliver, former chairman of John Hancock Group of mutual funds, to Jonathan Katz, Secretary of the Securities and Exchange Commission 3 (July 27, 1990) (commenting on the reform of mutual fund structures).

229. *See SEC Report, supra* note 12, at 268.

230. One third of mutual fund investors are institutional investors. *See supra* note 160 and accompanying text.

231. Letter from Lipper Analytical Services, Inc. to Jonathan G. Katz, Secretary, SEC (Oct. 9, 1990), File No. S7-11-90, at 1.

considered insignificant.[232] However, since directors are empowered to make decisions and give directions regarding the operation of the fund on an ongoing basis, the Corporate Fund will incur transaction costs from three major sources.

a. Influence Costs

"Influence costs" are the first item of these three sources.[233] The most obvious and direct of the costs associated with the monitoring function are the director's salary and the costs of providing information to support the director's decision-making process, including the time the Adviser (or other information providers) spends reporting information to the directors. More importantly, because the Adviser often would want to seek unproductive interventions (e.g., in conducting self-interested transactions), it may expend resources trying to *influence* the decision maker. Even if these attempts fail, the resources expended represent influence costs. If the influence activities are successful, the inferior quality of the decisions made and implemented will also represent influence costs.

There are reasons to believe that directors of the Corporate Fund may be vulnerable to influence activities. Directors are empowered to scrutinize many service contracts and hence to bargain for fees and allocate expenses. The directors are nominated by, and serve at the pleasure of, the Adviser or its affiliates. The Adviser or its affiliates provide, or mandate, much of the information received by the directors. Under such circumstances, it is possible that the Adviser may fail to report completely and accurately the information needed for the board to make good decisions. Of course, the magnitude of influence costs depends on factors such as the kind of procedures that govern decision-making and the form of the decision rule (e.g., *carte blanche* or detailed rules). However, although many of the more egregious examples of influence activities depend on a corruptible centralized authority, even an "incorruptible" authority may be amenable to influence.[234]

232. *Id.*

233. The term "influence costs" refers to the large amounts of time, ingenuity, and effort that go into these attempts at influence. *See* Milgrom & Roberts, *supra* note 155, at 193.

234. Most business organizations are vulnerable to influence activities. For discussions on politics in publicly-held corporations, see, *e.g.*, John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 Geo. L.J. 1495 (1990); John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 Mich. L. Rev. 1, 81–86 (1986).

b. *Intervention Costs*

Intervention costs are the second major source of transaction costs. The board of directors of the investment company is equipped with authority to approve multiple service contracts, including the investment management contract. However, the Adviser, as a profit-seeking enterprise, is a functionally autonomous entity with its own internal system of accountability and discipline. In addition, the design and operation of a mutual fund and its success or failure are primarily the responsibility of the Adviser. When the board intervenes in the operation of a free-standing business such as the Adviser, intervention costs can occur. For instance, any intervention makes it more difficult for investors to evaluate the Adviser's performance and, hence, undermines the market's ability to provide the appropriate incentives.[235] Contrast this with what happens if the Adviser is a subsidiary of the investment company: in this situation, the costs of such intervention are relatively low.

To constrain influence and intervention costs, it is possible to impose on the Adviser fiduciary duties of loyalty and care,[236] enforced through lawsuits. However, courts are not necessarily at center stage in this process, and legal rules can only have minimal deterrent effects on influence and intervention activities. After all, the effort to establish standards of conduct under the third party's duty of care poses a number of practical and metaphysical difficulties.[237]

In fact, most decisions made by the board of the Corporate Fund are covered by the business judgment rule. The rule provides that, in the absence of self-interest, the business judgment of directors will not be challenged or overturned by courts or shareholders, and the directors will not be held liable for the consequences of their exercise of business

235. *See infra* part VI.A.1–2.

236. Such legal rules are common in business associations. In the context of corporations, the duty of care demands that members of the board (and officers) invest a certain amount of time and effort and exercise a certain level of skill and judgment in the operation of the firm. The duty of loyalty requires that directors (and officers) put the interests of the shareholders ahead of their personal gain and subject them to oversight in transactions involving conflicts of interest. *See, e.g.*, Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 Stan. L. Rev. 927, 927–28 (1983).

237. *See generally* Philip C. Sorensen, *Discretion and Its Limits—An Analytical Framework for Understanding and Applying the Duty of Care to Corporate Directors (and Others)*, 66 Wash. U. L.Q. 553 (1988). This is especially the case when these decisions are mixed-motive decisions. *See* Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 Tex. L. Rev. 1351 (1989).

judgment, even if their judgment turns out to be wrong.[238] The business judgment rule is an especially deferential approach. Behind the rule lies a recognition that the total wealth of investors as a class would be lower if directors' decisions were routinely subjected to strict judicial review.

My analysis of the ineffectiveness of imposing fiduciary duties upon the board is not intended as an attack on the business judgment rule. The truth is that, given the nature of discretionary decisions, they cannot easily be subjected to detailed and enforceable legal standards and guidelines. The rule simply reflects limits on the use of fiduciary rules to assure contractual performance—people would not serve as directors if they were deemed to be guarantors of the wisdom of their good faith decision-making. Thus, legal rules and *ex post* enforcement would not be effective in disciplining influence activities.[239]

If fiduciary rules are not effective in disciplining the board of directors, other devices may serve to align the interests of the directors with those of the investors. One possibility is incentive-compatible contracts. The typical independent director of a mutual fund is paid an annual retainer fee. In addition, each director receives some remuneration for each meeting attended. Because this is not performance-based compensation, the directors are not provided with incentive-compatible contracts.

c. *Collective Decision-making Costs*

Collective decision-making costs are the third major source of transaction costs. When ownership of a business organization is shared among investors, a method for collective decision-making is often devised. As discussed above, the Corporate Fund provides extensive Issue Voting and Election Voting. As methods for aggregating the preferences of investors, such collective choice mechanisms often involve substantial costs in comparison to market contracting.[240]

238. In other words, if a deliberate decision by the third party on whether or how to conduct a given activity satisfies the conditions of the business judgment rule, the board may be insulated from liability even though the decision was not a reasonable one. *See* Melvin A. Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. Pitt. L. Rev. 945 (1990).

239. *See generally* Bayless Manning, *The Business Judgment Rule in Overview*, 45 Ohio St. L.J. 615 (1984).

240. *See* Henry Hansmann, *Ownership of the Firm*, 4 J.L. Econ. & Org. 267, 272-80 (1988). Henry Hansmann extends the transaction cost analysis of firm organization by introducing as a key variable the cost of collective decision-making. *See* Roberta Romano, *Foundations of Corporate Law* 5 (1993).

To begin with, such a decision-making process may yield decisions that are collectively inefficient in the sense that they do not maximize aggregate shareholder surplus. Thus, if the preferences of the median voter are not those of the mean, a majority voting mechanism may yield decisions that are not only inefficient but inferior, from a welfare standpoint, to those that would be reached if the shareholders simply contracted as individuals. Moreover, the process of collective decision-making itself can have high transaction costs. These costs include the costs of proxy solicitation (e.g., legal and accounting fees incurred in connection with preparing proxy material), the costs of resolicitation if necessary in order to achieve a quorum, and the costs of holding annual or special meetings of shareholders.[241]

d. Summary

In conclusion, because independent directors do not possess fully adequate information and cannot be regarded as truly impartial, it is not realistic to expect the board to bargain effectively on behalf of the investors. This is particularly the case when there are no effective mechanisms, such as fiduciary rules or incentive-compatible arrangements, to motivate or discipline the directors. Thus, to equip the board with considerable discretionary power may bring with it significant transaction costs that otherwise would not be present.

B. The Responsibilities of the Board of Directors

In evaluating the structure and governance of business organizations, institutional details matter. Because the Corporate Fund relies on the board of directors to protect investors in a variety of conflict of interest situations, it is important to examine the board's legal responsibilities in each situation. The responsibilities of the board can be divided into four categories. First, under the Act the board has primary responsibility for evaluating the reasonableness of a number of different fees and charges for investment advice, distribution, administration, and shareholder services. Second, the Act and its rules also make the board responsible for policing various operational conflicts. Third, the board is required to monitor whether the Adviser and its affiliates have complied with the rules and regulations applicable to the mutual fund. Fourth, the board assumes general oversight responsibilities and other gap-filling

241. *See SEC Report, supra* note 12, at 274–76. *See also infra* part V.C.1–2.

functions. This section examines each of these categories in greater detail below.

1. *Evaluating Fees Paid to Advisers and Their Affiliates*

Fees paid from a mutual fund's assets to the Adviser and its affiliates directly affect shareholders' investment return—the higher the fee, the lower the return. To ensure the reasonableness of fees paid to the Adviser and others, the Act imposes varying requirements upon the board when it evaluates fees paid to the Adviser and its affiliates. sections 15(a) and 15(d) charge the board of directors with the responsibility for evaluating the Adviser's contract with the investment company and the compensation paid under the contract.[242] Principal underwriting contracts are subject to similar scrutiny. Multiyear contracts also must be approved annually by the board or by a majority shareholder vote. The board is also required to review and evaluate asset-based distribution fees. A mutual fund's board likely would also review any service contract, such as transfer agency and custodial agreements.

a. *Fee Negotiations*

There are several reasons why fees should be evaluated by the board rather than the investors.[243] One of the most important reasons is that for investors of the Corporate Fund, determining fees is a ponderous task. As the SEC Report indicated, in the last two decades mutual fund fee structures have grown increasingly complicated. The variety of charges and operating and distribution expenses are difficult to aggregate, cannot be readily compared among funds, and cause investor confusion.[244] Let us review these complex fee structures.

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242. 15 U.S.C. §§ 80a-15(a), 15(d).

243. When section 15 was enacted in 1940, the chief counsel of the SEC testified that "[t]here is not a single provision in section 15 which even remotely assumes to fix what [Advisers] should be paid as compensation . . . . We feel that is a question for the stockholders to decide." *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency,* 76th Cong., 3d Sess. 252 (1940) (statement of David Schenker, Chief Counsel, SEC Investment Trust Study).

244. Investors of mutual funds have to pay sales charges—the costs of buying a fund, commonly called the "load." Most funds take loads out of initial investments. When loads are levied on withdrawals, they can take two forms. Deferred charges decrease over time; redemption fees arise when investors sell shares. In addition to sales charges, the investment company incurs overheads—management fees, advisory fees, transfer agent fees and bookkeeping fees, etc. To make matters worse, some mutual funds have a 12b-1 plan, which allocates shareholder money for

There are primarily two visible fees:[245] sales charges and expense ratios. Operating expenses are paid annually but sales charges are paid only when shares are purchased. "Load" is defined as the difference between the public offering price paid by investors and the current net asset value of the fund per share, less any portion of such difference deducted for administrative expenses not properly chargeable to sales or promotional activities. [246] There are no initial sales charges incurred in the purchase of no-load funds. Nonetheless, no-load funds shareholders often pay for marketing and advertising expenses indirectly in the form of a charge known as a "12b-1" distribution fee.[247] A 12b-1 fee is an extra fee paid to the fund's Adviser to help finance the costs of marketing the fund's shares. Among the various forms of sales charges are the regular load, the contingent deferred sales load,[248] and the low load. Sales charges are the predominant form of transaction charges applicable to fund shares—that is, charges paid directly by the investor making the transaction, as distinguished from the fund itself.[249]

The second of these two types of fees is the expense ratio, which represents the total cost of ownership (as distinguished from acquisition) of a fund's shares. Generally, there are three major categories of expenses which will be incurred in procuring the services necessary for a fund's operations. The first major expense category is the investment

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distribution costs. *See infra* note 247 and accompanying text; *see also SEC Report, supra* note 12, at 291–98, 332–33.

245. One large invisible cost, often ignored because of its invisibility, is the cost the fund incurs in executing its portfolio transactions.

246. *See* 15 U.S.C. § 80a-2(a)(35).

247. A 12b-1 fee is so named because it relates to a particular regulatory paragraph. *See* 17 C.F.R. § 270.12b-1. A 12b-1 fee is an extra fee paid to the fund's Adviser to help finance the costs of marketing the fund's shares. Paragraph 12b generally provided that a mutual fund may not act as a distributor of its securities, except through an underwriter, in contravention of any rules prescribed by the SEC. In 1980, the SEC prescribed rule 12b-1, which governs the use of fund assets for distribution. Since the adoption of the rule, more than half of all mutual funds have enacted rule 12b-1 plans, using these charges, alone or with sales loads, as the primary means of financing distribution. The legislative and administrative history leading up to the adoption of rule 12b-1 is recounted in detail in 53 Fed. Reg. 23,258 (1988) (proposed June 13, 1988).

248. Contingent deferred sales loads are "contingent" since they are paid only on redemptions that occur within a specified period after purchase and may be expressed as a percentage of either the original purchase price, or more typically, the redemption proceeds. Shortly after the adoption of rule 12b-1, the SEC issued the first of many exemptive orders allowing the deduction of contingent deferred sales loads upon redemption of fund shares. E.F. Hutton Investment Series, Inc., Investment Company Act Release No. 12,079, 46 Fed. Reg. 60,703 (Dec. 4, 1981) (Notice of Application); E.F. Hutton Investment Series, Inc., Investment Company Act Release No. 12,135, 24 SEC Docket 528 (Jan. 4, 1982) (Order).

249. *See, e.g.*, John C. Bogle, *John Bogle on Mutual Funds* 197–201 (1994).

management fee paid to the Adviser for portfolio supervision and for general management of the fund's operations. The second expense category includes administration fees which are incurred largely to provide record-keeping and transaction services to fund shareholders. The third expense category includes other operating expenses such as custodial fees, taxes, legal and auditing expenses, and directors' fees.[250]

It is becoming increasingly difficult to separate sales charges and expense ratios. For one thing, sales charges are often included in the fund's total expense ratio. Of further confusion to investors, fees with the same label pay for different services. For example, some advisory contracts provide for portfolio management only. Other advisory contracts also provide for administrative, shareholder accounting, and transfer agent services. Compounding the labeling problem, particular fees are obscured by their placement in either the fund or the shareholder account, or by shifting their timing among the point of purchase, the investment period, and the point of exit.[251] Consequently, investors do not have the ability to price fees and services offered by mutual funds.

If investors are confused by the industry's multiple fee structures, to what extent can the boards of mutual funds ameliorate such confusion? As examined above, the board is vulnerable to coalition politics, and its screening authority gives rise to influence activities and costs. Hence, the arm's-length bargaining between the board and the Adviser and its affiliates is more apparent than real. Despite the assumed advantage of the board of directors, mutual fund fees have been escalating even though the industry's growth, a tenfold increase in assets over the past decade, has allowed huge economies of scale.[252] This shows that boards have not done well in cutting fees. Although they sometimes negotiate fee rates below that proposed by the Adviser, the amount of the reduction is usually marginal.[253]

250. *Id.*

251. *See SEC Report, supra* note 12, at 336.

252. *See* Jeffrey M. Laderman, *Are Fund Managers Carving Themselves Too Fat a Slice?*, Bus. Wk., Mar. 23, 1992, at 78; *See also* Carole Gould, *Fees—Front, Back and Sideways*, N.Y. Times, Mar. 15, 1992, at F14.

253. *See, e.g.*, Werner Renberg, *Sixth Men or Fifth Wheels: Do Fund Directors Earn Their Paychecks?*, Barron's, Aug. 12, 1991, at M13–14. Note that the Adviser is not hired by the mutual fund, but rather organizes and promotes it. Consequently, the Adviser may plausibly claim some reward for bearing entrepreneurial risk; because the Advisor does not normally take the customary promoter's risk—equity shares in the newly organized fund—it may take the reward instead in the form of higher advisory fees. *See* Sterrett, *supra* note 121, at 195. For a discussion of why it is difficult to set a standard against which the fairness of such fees can be measured, see Frankel, *supra* note 24, at 252–58.

How about expense ratios? Given the clear financial impact of expenses on mutual fund performance, along with the exponential growth of industry assets, one might expect that fund expense ratios would have declined over the years. However, the reverse has proven true. In 1956, the average expense ratio of U.S. equity funds was 0.79%. Today, when computers and telecommunications have vastly simplified a wide variety of functions, managing money should cost far less. But it doesn't. The expense ratio of equity funds currently averages 1.45%, or nearly twice the 1956 level.[254] Because directors are supposed to accurately allocate the expenses incurred by each fund, they are not excused from failing to watch these costs.

b. Litigation on Fees

The Act imposes fiduciary duties on a board's negotiation of fees.[255] section 36(b) imposes upon advisers and directors a fiduciary duty with respect to the management fees they receive.[256] The fiduciary duty imposed by section 36(b) is unique in that it relates to the compensation received for performing fiduciary functions, rather than the performance of those functions. The provision encompasses compensation for services or payments of a material nature paid by the investment company or its shareholders. However, Congress did not expressly define the standard courts should apply when determining whether an Adviser has breached its fiduciary duties. The cases which have examined the negotiation process provide some clues as to the effectiveness of fiduciary duties in policing fee negotiation.[257]

The standard and factors applicable to claims under section 36(b) were first set forth in the *Gartenberg* cases—the 1981 district court and 1982 Second Circuit decisions in *Gartenberg v. Merrill Lynch Asset*

254. *See, e.g.*, Riva Atlas, *Watch Those Costs*, Forbes, Aug. 30, 1993, at 112.

255. For an introduction to fiduciary duties, see, *e.g.*, Easterbrook & Fischel, *supra* note 52, at 90–108.

256. Section 36(b) provides that the Adviser "shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid . . . by [the fund] to such investment advisor or any affiliated person." 15 U.S.C. § 80a-35(b). Section 36(b) was added by the Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 20, 84 Stat. 1413, 1429 (1970). For a discussion of the legislative history of section 36(b), see William P. Rogers & James N. Benedict, *Money Market Fund Management Fees: How Much is Too Much?*, 57 N.Y.U. L. Rev. 1059 (1982). In addition, through regulation 12b-1, this fiduciary duty extends to payments by the fund related to the distribution of fund shares. 17 C.F.R. § 270.12b-1(b)(2), -1(b)(3)(iii).

257. Most lawsuits have centered on the so-called 36(b) issue.

Management, Inc.,[258] and the 1983 district court and 1984 Second Circuit decisions in *Gartenberg v. Merrill Lynch Asset Management, Inc.*[259] These decisions articulated a standard which requires that mutual fund arrangements bear a reasonable relationship to the level of fees that would have been negotiated in an arm's-length bargain. After reviewing all the relevant factors, the *Gartenberg* court concluded that "in assessing whether an advisory fee is reasonable a reviewing court must look to *all* the costs and benefits associated with the Fund."[260] As fiduciaries, the directors have no obligation to bargain for the least expensive investment advisory services for the fund.[261]

Moreover, in *Krinsk v. Fund Asset Management, Inc.*,[262] the Second Circuit rejected the plaintiff's contentions that section 36(b) requires fund directors to negotiate the "best deal" possible for shareholders and that excessive profitability alone should suffice for proving a violation of section 36(b). The court found the nature and quality of services provided to investors, particularly the fund's performance, to be excellent, and rejected plaintiff's proposal to measure the fund's yield on a risk-adjusted basis.[263] Emphasizing the importance of the deliberations by the fund's directors, the court held that, in evaluating the reasonableness of compensation under section 36(b), it should examine factors such as the expertise of the directors, whether they are fully informed, and the extent of the care with which they perform their duties.[264]

To fulfill the procedural requirements of arm's-length bargaining, directors of mutual funds have been advised to perform several tasks: (1) meet from time to time without representatives of the Adviser and arrange meetings "replete with presentations"; (2) receive ample material and information as well as legal advice from separate counsel; and (3) document the formulation of a negotiation position and strategy that can be shown to be the result of the directors' own evaluations of the data.[265]

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258. 528 F. Supp. 1038 (S.D.N.Y. 1981), *aff'd*, 694 F.2d 923 (2d Cir. 1982), *cert. denied*, 461 U.S. 906 (1983).

259. 573 F. Supp. 1293 (S.D.N.Y. 1983), *aff'd*, 740 F.2d 190 (2d Cir. 1984).

260. 740 F.2d at 194.

261. *See generally* James N. Benedict et al., *Developments in Management Fee Litigation*, 22 Rev. Sec. & Commodities Reg. 157 (1989).

262. 715 F. Supp. 472 (S.D.N.Y.), *aff'd*, 875 F.2d 404 (2d Cir. 1989).

263. *Id.* at 502–03.

264. *Id.*

265. *See, e.g.*, Stanley J. Friedman, *The Role of Outside Directors in Negotiating Investment Company Advisory Agreements*, 24 Rev. Sec. & Commodities Reg. 49 (1991).

As long as the procedural requirements are met, the courts have shown no inclination to limit fees because they are ill-suited to substitute their own business judgment for that of the fund's board of directors. Thus, fiduciary duties serve only to exalt form over substance.

Although to date Advisers and directors of mutual funds have won all the 36(b) cases that have been adjudicated, they have often chosen to terminate impending litigation by agreeing to costly settlements.[266] Consequently, even following these court decisions, one can only expect the board to continue the middle-of-the-road approach—adding more breakpoints and implementing sliding-scale fee structures that reduce percentage fee rates as net assets increase. In *Kalish v. Franklin Advisers, Inc.*, for example, the independent directors, after prolonged negotiations with the affiliated directors, only managed to marginally modify management fee rates.[267]

The truth is that independent directors are charged with an impossible mission. In evaluating the fee structure of a mutual fund, the board has to take into consideration factors such as the Adviser's performance (i.e., investment returns and risk levels), its direct and indirect income, and direct and indirect costs incurred in managing the mutual fund. None of these factors are easy to ascertain. This problem becomes even more complicated because a reasonable profit must include a reward for entrepreneurial risk.[268] Thus, such fees are by no means the result of arm's-length bargaining; rather, they are simply the result of politicking.

2. *Policing Operational Conflicts of Interest*

In addition to policing conflicts concerning fees, the board of directors also polices a number of operational activities. The Act and the SEC's rules give independent directors several specific responsibilities. For example, the independent directors select the company's independent public accountants,[269] oversee securities transactions involving affiliates

266. *See, e.g., West Report, supra* note 1, at 56.

267. The management fee was adjusted from 0.45% to 0.44% on net assets in excess of $10 billion up to $12.5 billion; 0.42% on assets in excess of $12.5 billion up to $15 billion; and 0.40% on net assets in excess of $15 billion. Prior to the effectiveness of this modification, the fee schedule of the fund was 0.625% on the first $100 million of net assets; 0.50% on the next $150 million; and 0.45% on amounts over $250 million. *See* Kalish v. Franklin Advisers, Inc., [1990–1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,861 (2d Cir. Mar. 21, 1991).

268. *See infra* part VI.A.1.

269. 15 U.S.C. §§ 80a-32(a)(1), -31(a)(1).

to the extent such transactions are permitted by various rules,[270] determine annually whether participation in joint liability insurance policies is in the best interests of the company,[271] and review and approve fidelity bonds.[272]

In some cases, the full board must approve operational activities. For example, the full board values certain types of portfolio securities[273] and sets the time of day at which net asset value is determined.[274] The board annually approves custody contracts with members of national securities exchanges, clearing agencies, book-entry systems, and foreign custodians.[275] Finally, the board approves an investment company's code of ethics, which must be designed to prevent fraudulent, deceptive, or manipulative practices by investment company insiders in connection with personal securities transactions.[276]

Conflicts of interest arise because the Adviser, in addition to portfolio management service, also provides other services to the investment company.[277] It can be argued that disciplinary forces exerted by various markets may lead the Adviser and its affiliates to pursue value-maximizing activities. When a transaction is value-decreasing, its adverse effect on net asset value and operating expenses makes it on the whole unattractive to the Adviser. For example, for situations that do not involve a potential transfer of value from the investment company to the Adviser, incentive effects and other market forces are usually effective in motivating the Adviser to maximize net asset value.

The effectiveness of market discipline varies depending on the type of conflict of interest involved. Although investors may have the ability to price the economic terms of the management contract, they may not have the ability to price the other terms or transactions.[278] In particular,

270. *See, e.g.*, §§ 80a-10(f), -17(a), -17(e); 17 C.F.R. §§ 270.10f-3, .17a-7, .17e-1.

271. 17 C.F.R. § 270.17d-1(d)(7).

272. 17 C.F.R. § 270.17g-1.

273. 15 U.S.C. § 80a-2(a)(41); 17 C.F.R. § 270.2a-4 (directors are responsible for valuing portfolio securities and other assets for which market quotations are not readily available).

274. 17 C.F.R. § 270.22c-1(b).

275. 17 C.F.R. §§ 270.17f-1, .17f-4, .17f-5.

276. 17 C.F.R. § 270.17j-1.

277. To be precise, the term "conflict of interest" should be distinguished from "self-dealings." For a definition of such terms in the context of publicly-held corporations, see, *e.g.*, Robert Charles Clark, *Corporate Law* 141, 159 (1986). Following the usage of the SEC, this Article uses the term "conflict of interest" to refer to transactions with affiliated persons covered by the Act. *See SEC Report, supra* note 12, at 255.

278. *See, e.g.*, Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 Colum. L. Rev. 1599, 1563 (1989).

investors can hardly rely on market discipline to monitor transactions that are significantly redistributive. Significantly redistributive transactions are transactions that involve a potential transfer of significant value from investors (or the segregated assets of the fund) to the Adviser. For such transactions, market discipline may not be effective in discouraging the manager from seeking value-decreasing transactions if the size of the potential transfer involved (the distributive element) is significantly larger than the magnitude of the potential effect on overall value (the efficiency element).[279]

For instance, market forces may not be adequate in disciplining transactions between the investment company and the Adviser or its affiliates. The Adviser would want to conduct these transactions because the *direct* benefit to it or its affiliates may substantially exceed the adverse effects on its compensation from reductions in net asset value. Under these circumstances, investors may need directors to scrutinize or approve such transactions.

In the Act, directors were given only limited duties. Rules adopted since 1940, however, have increased the board's duties.[280] The promulgation of these rules was the beginning of a substantial shift of responsibilities for detailed oversight from the SEC to directors.[281] The underlying rationale for the current approach is that it limits the number of affiliated transactions requiring SEC approval and is, therefore, less costly and more efficient. As a substitute for SEC oversight, however, the board approval mechanism brings significant costs if its own. As discussed above, the board's approval mechanism may be costly because of the lack of independence and the opportunities for influence costs. Hence, alternatives should be considered.

In addition to adding more exclusions,[282] one possibility is to replace board screening with inflexible or prophylactic rules (i.e., to detail the

279. *See* Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law,* 105 Harv. L. Rev. 1437, 1461–67 (1992).

280. In 1980, the SEC eliminated absolute prohibitions in the statute if the directors or the independent directors adopted and monitored procedures to protect investors. There is some contention that the increased responsibilities may have caused directors to become even more susceptible to control by the Adviser. *See* Tamar Frankel, *Money Market Funds,* 14 Rev. Sec. of Commodities Reg. 913, 915 n.18 (1981).

281. *See West Report, supra* note 1, at 20. In addition, the SEC Report recommends permitting mutual funds to engage in some transactions with remote affiliates with the approval of their directors, including their independent directors. *See SEC Report, supra* note 12, at 488–91.

282. Recognizing the need to eliminate SEC review for transactions that do not pose significant potential for abuse, the SEC Division recommends some exclusions and changes to the current regulations on affiliated transactions. *See SEC Report, supra* note 12, at 482–501.

prohibited affiliated transactions in the contract and prospectus). Thus, for example, the criteria to be followed by an Adviser of a money market fund to comply with Regulation 2a-7 could be detailed in the contract. Of course, one disadvantage of such inflexible rules is that they would impose opportunity costs on mutual funds. But compared to the potential costs of board discretion, such opportunity costs may well be marginal.[283]

This is not to argue that the board should play no role in policing operational conflicts. Some transactions are so unique as to require individual consideration by the board. Under such circumstances, the board should be given an oversight function. These transactions include open-ended conflicts which can only be policed on an ad hoc basis. For example, brokerage commissions paid on the fund's portfolio transactions are, by their very nature, variable costs. To police the potential conflicts of interests between the Adviser and brokers, a rule requiring the Adviser to use only unaffiliated brokers would not be desirable. Such a rule would not only impose opportunity costs on the fund but, more importantly, would not eliminate concerns about reciprocal agreements.[284]

3. *Monitoring Compliance*

In addition to the specific functions relating to the evaluation of fees and operational conflicts, the board assumes a narrow supervisory

283. In this regard, the ALI's *Principles of Corporate Governance* also takes this position. *Principles of Corporate Governance: Analysis and Recommendations* § 5.09 (Proposed Final Draft 1992). Section 5.09 (Effect of a Standard of the Corporation) provides that if a director or senior executive relies upon a standard that authorizes certain conflict-of-interest transactions, and the standard was authorized in advance by disinterested directors, following proper disclosure, the standard is to be deemed equivalent to an authorization of the action in advance by disinterested directors. Such a rule provides a practical convenience for the treatment of conflict-of-interest transactions, because after such a standard is initially adopted, it can be employed on a recurring basis without the usual formalities of disinterested board approval. *Id.*

284. For the same reason, in proposing the unitary investment fund model the Investment Company Institute recommended that specific trustee oversight on this matter should be an exception to the general rule that the trustee not function as a substitute for the board. *See* Investment Company Institute, *Comments on the Reform of Regulation of Investment Companies* 32 (1990). Since negotiated commission rates have been introduced, an Adviser's duty to obtain the best execution has become more complex. For a discussion of the selection of brokers and payment of commissions by institutional managers, see, *e.g.*, Applicability of the Commissioner's Policy Statement on the Future Structure of Securities Markets to Selection of Brokers and Payment of Commissions by Institutional Managers, Exchange Act Release No. 9,598 [1971–1972 Transfer Binder] Fed. Sec. L. Rep. ¶ 78,776 (May 9, 1972).

function that can be called the "compliance function."[285] Pursuant to such a function, the directors are charged with the responsibility of reviewing the adequacy of the fund procedures for ensuring that its employees comply with all applicable laws and regulations. In this context, the directors basically perform a whistle-blower function—they are required to take reasonable care to ensure that the fund is administered in accordance with applicable laws and regulations as well as contractual terms. For instance, although the directors may not have sufficient expertise to develop policies on how fund assets should be invested, they do have the responsibility to see that the Adviser's investment strategy is consistent with the goals of most shareholders.

Like a trustee in a trust indenture,[286] directors exercise limited discretion in conducting the supervisory function. In other words, conducting such function does not necessarily involve many business judgments. Since directors' compliance monitoring is subject to rules and regulation and as such involves limited influence costs, the compliance function is justified.

To carry out this gatekeeper function, directors need to be equipped with a discovery function—the authority to discover the misconduct or violation.[287] Such duties include taking actions to investigate and report possible misconduct to appropriate authorities. Some commentators have argued that the efficacy of the directors in actually discovering mistakes or bad practices is exaggerated. It is invariably the auditor, SEC inspection, confession, or disclosure by the Manager that uncovers these situations—not the investigative work of the directors.[288] The SEC Report seems to recognize this point. Specifically, it recommends that

285. *See, e.g.*, 17 C.F.R. § 270.17j-1.

286. An example is the indenture trustee. A standard term in a trust indenture reads: "The trustee undertakes to perform such duties and only such duties as are specifically set forth in this Indenture, and no implied covenants or obligations shall be read into this Indenture against the Trustee." *See* Sullivan & Cromwell, *Standard Closed-End Indenture Provisions: Unsecured Securities Offered in the United States* 42 (1985). This provision conforms to section 315 (a)(1) of the Trust Indenture Act of 1939: "[t]he indenture trustee shall not be liable except for the performance of such duties as are specifically set out in such indenture." 15 U.S.C. § 77ooo(a)(1) (1988).

287. An example of this kind of "failure to supervise" obligation is stipulated in section 15(b)(4)(E) of the Security Act of 1934. This section imposes sanctions against a broker-dealer if the firm has "failed reasonably to supervise, with a view to preventing violations [of federal securities laws], another person who commits such a violation, if such other person is subject to his supervision." 18 U.S.C. § 78o(b)(4)(E).

288. *See West Report*, *supra* note 1, at 64.

rules that impose specific duties and responsibilities on the directors should not require them to "micro-manage" operational matters.[289]

4. *Overseeing the Fund's Operation*

The duties imposed on directors by the Act are in addition to those imposed by state law. Under state law the role of the board of directors is to provide management direction. Hence, pursuant to a typical investment advisory contract, the Adviser of the fund is required to make all investment decisions in a manner consistent with the fund's investment objectives and policies and is subject to the overall supervision of the fund's board of directors. Thus, by subjecting the Adviser to its direction and supervision, the board is authorized to intervene in or exercise decision control over some internal activities of the Adviser to the extent that such activities relate to the investment process of the fund.

a. *Directorial Function*

An active board has many reasons to assume some directorial functions. For example, when a pattern of poor performance develops, the independent directors may ask the Adviser for an explanation. If they are not satisfied with this explanation, they are entitled to make further inquiries before deciding whether to continue the contract. For instance, they can review the investment management process or help define the investment strategy of the fund. However, one cannot, without distorting the nature of the mutual fund, apply to fund directors the same freedom or responsibilities in the remaking of fund policy as are applied to corporate directors in other types of businesses.

As discussed above, mutual fund management consists primarily of investing and reinvesting money according to a stated policy. Occasions for business judgments, apart from the simple determinations of whether and when to buy and sell securities, occur only rarely. For example, whether and how much to pay dividends, a recurrent policy problem for corporate directors, is, as a matter of practice, automatically determined in the operation of a mutual fund. Under such circumstances, why should the Adviser be subject to the overall supervision of the fund's board of directors?

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289. *See SEC Report*, *supra* note 12, at 266, 269–271.

In a multi-divisional firm (e.g., publicly-held corporations), the board of directors normally would provide the benefits of facilitating internal coordination[290] or making strategic decisions.[291] This is not the case for mutual funds. As discussed above, because the organization of a mutual fund is non-complex and fund management requires specialized knowledge,[292] the investment company does not need a centralized body such as the board to coordinate production activities or make strategic decisions. In other words, because the investment company is a legal shell only, the centralized board cannot be justified as a hierarchical superior within the entity.

The real economic actor that the board would want to supervise is, of course, the Adviser. Assume that the *X* fund performed poorly last quarter—say the yield rate has fallen within the bottom quarter of all funds in the same category. The directors of the fund feel strongly (presumably with good reasons) that the individual portfolio manager should be replaced. The Adviser, however, has expressed full confidence in the individual portfolio manager and believes that his poor performance is really temporary.[293] Under these circumstances, should the board intervene by asking the Adviser to replace the portfolio manager? If the board makes such a request (or demand), should the Adviser comply with the direction or should it follow its own judgment? If the Adviser decides to comply, then to what extent should the board get involved in the selection and replacement process?

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290. For example, one of the primary functions of the board in multi-divisional firms is to coordinate activities among large and complex organizations. Because the agents/managers of the firm are bounded-rational in information processing, communication, and computation, they are limited by their capacity to learn. In hierarchical organizations, the coordination problem can usually be solved by authority. The boss is able to coordinate decisions of his subordinates by receiving from them reports concerning the information they possess, and by telling them what to do. Milgrom & Roberts, *supra* note 155, at 150–58.

291. In the literature of organizational economics, hierarchy is viewed as a mechanism in which a strategic decision centrally made at the top level is decomposed through each successful level into a command of specialized tasks for each operating unit at the bottom level. The major benefit arising from this mechanism is the utilization of economies of specialization in operating tasks. That is why modern corporations—the so-called M-form firms—are characterized by a top team of generalists (i.e., the board of directors). *See* Oliver F. Williamson, *Organization Form, Residual Claimants, and Corporate Control,* 26 J.L. & Econ. 351, 351–55 (1983).

292. See *supra* part IV.B.1.

293. In the mutual fund business past performance is no guarantee of an Adviser's future. *See, e.g.,* Barbara Donnelly, *Past Is No Guarantee of Manager's Future,* Wall St. J., Oct. 27 1992, at C1 ("Short term losers aren't necessarily bad managers. They may just be the victims of bad luck. The shorter the track record under consideration, the harder it is to know for sure who's competent and who's not.").

The Adviser is rewarded or punished as a result of good or bad performance. Its profits and compensation depend on the operation and success of the fund. In contrast, the directors of the fund receive a fixed salary only. Between the Adviser and the directors of the fund, who is better motivated to ensure the superb performance of the fund? If a fund performs poorly and many investors redeem their shares, who is going to suffer the most? The reality is that the individual portfolio manager (or the internal management committee) is accountable to the Adviser, and the directors of a fund should not have the power to change the operational aspects of the fund.[294] The board should defer to the Adviser's legitimate interest in controlling the portfolio management process. Thus, the internal hierarchy of the Adviser (and its own board) should decide for itself who should run the fund and how to run it.

It may be argued that since the boards of most funds will choose to be passive supervisors anyway, the fact that they are empowered to interfere will not cause troubles and incur costs. As the example discussed above illustrates, the board's intervention could incur the cost of information acquisition, negotiations, and time. More importantly, directorial monitoring gives the board considerable discretion to make decisions that can affect the benefits and costs of the operations of a particular mutual fund, thereby inviting influence activities from the Adviser. Given the entangled relationship between the board and the Adviser, such influence activities could easily lead to coalition politics.

b. Dispute Resolution Function

The board of directors does provide one potential benefit in exercising residual decision-making power.[295] Assume that an investor of a mutual fund alleges, without foundation, that the Adviser has made certain improper expense allocations. Because the management contract does not provide a clue as to how to deal with such an unforeseen contingency, the board of the fund is authorized to conduct an investigation and make a business judgment as to the merits of the claim. Hopefully, its informed decision can protect the Adviser against unwarranted charges of improper allocation. When mistakes or

294. *See* Nathan D. Lobell, *The Mutual Fund: A Structural Analysis*, 47 Va. L. Rev. 181, 192 (1961).

295. One may interpret "owning an asset" to mean having the *residual* rights of control—that is, the right to make any decisions concerning the asset's use that are not explicitly controlled by law or assigned to others by contract. *See, e.g.*, Grossman & Hart, *supra* note 150; Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. Pol. Econ. 1119 (1990).

violations of law do occur, the independent directors are able to exert pressure on the Adviser to act in the best interest of shareholders. Actions that may be taken by the Adviser include prompt and full disclosure of the problem or reimbursement to the mutual fund so that shareholders are properly remedied.

Assume further that an employee of the Manager has made an inadvertent mistake in calculating the daily net asset value of the fund. From the point of view of the Manager, an approval mechanism would serve to protect it from liabilities for taking various actions which it believes are in the best interest of the fund. Without informed approval by the third party, these decisions would have to made by the regulators (e.g., the SEC) or, if litigation ensued, the courts. Whether the internal decision-making body is more desirable than the external mechanisms (e.g., regulators and courts) depends on a number of factors: the costs of corporate governance, the costs of influence activities, and the costs and institutional competence of such external mechanisms.[296]

c. *Summary*

In conclusion, the board of directors of the Corporate Fund provides few benefits in the way of facilitating coordination and making strategic decisions. On the other hand, the selective intervention system could incur significant costs, including influence costs and intervention costs. Finally, the residual decision-making power of the board does provide some benefits by settling disputes internally.

C. *SEC Reform Proposals*

The SEC Report reexamined the adequacy of the governance structure for investment companies. It concluded that the corporate regulatory structure is fundamentally sound and should be retained, with limited modifications. With respect to the board of directors, the Division believes that the structure can be streamlined and improved by changes to both the board's structure and its responsibilities. With respect to shareholder voting, the Division proposed to eliminate several obsolete shareholder voting requirements and to modify others to comport with

296. For a discussion of the court's competence in settling disputes on corporate law, see John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role,* 89 Colum. L. Rev. 1618 (1989).

the realities of modern-day securities markets. This section evaluates these reform proposals.

1. *The Role of the Board of Directors*

The SEC Report proposed three modifications with respect to the board of directors. First, it recommended certain measures to enhance the independence of the board of directors. Second, independent board members should be given separate authority to protect shareholder interests by terminating advisory contracts. Third, the Report recommended eliminating provisions in certain rules under the Act that make independent directors responsible for detailed findings of fact or for reviews and findings that involve more ritual than substance.[297]

By and large, these proposals would both streamline the structure and increase the responsibilities of the board of directors. For instance, the proposal to increase the minimum proportion of independent directors on the board from forty percent to a majority would enhance the independence of the board. In addition, because a board of directors is ill-equipped to "micro-manage" operational matters, rules that impose specific duties and responsibilities on the independent directors are appropriately eliminated. Because these proposals can be undertaken without undue expense, they should be implemented.

However, even if the proposals are adopted, the Corporate Fund still demonstrates an over-reliance on the board of directors.[298] Consider, for example, the proposal to give independent board members separate authority to terminate advisory contracts.[299] Although the law is fairly specific about the process of approving and terminating contracts, it does not require the board to specify the reasons for replacing an Adviser. Since the primary function of the board is to monitor the Adviser's

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297. *See SEC Report*, *supra* note 12, at 266–271.

298. For a discussion of court cases where independent directors have not successfully challenged or even attempted to challenge certain management actions that allegedly violated the Act's self-dealing prohibitions, see Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 Harv. L. Rev. 597 (1982).

299. Section 15(c) provides that entry into or renewal of the contract must be approved by vote of at least a majority of the independent directors. To facilitate such an evaluation, section 15(c) further provides the directors with information rights (the right to obtain relevant information from the manager). 15 U.S.C. § 80a-15(c). Management contracts continuing in effect for a period of more than two years must be approved annually by either the full board or a majority of the company's outstanding shares. § 80a-15(a)(2). The full board has the authority to terminate the management contract at any time, but such authority is not expressly given to the independent directors. § 80a-15(a)(3).

performance, presumably "bad performance" is one of the main reasons for replacement.

The individualistic nature of the mutual fund investment makes this power unnecessary. Viewed from a contractual perspective, parties to the mutual fund should expect the fund to be long-standing as a *collective* investment vehicle. Some might argue that, since the quality of a mutual fund is non-contractible, a mutual fund should be of limited duration. But this is already true: due to the availability of a redemption right, the mutual fund contract is, in effect, a contract of indefinite duration. Regardless of whether the board is given the right to renew or terminate the contract, investors could always terminate the contract on an *individual* basis, with low costs.

This individualistic approach more accurately reflects the realities of mutual fund investment, because the duration of the contract with the fund is decided by the individual investor, rather than by a collective decision-making process. After all, securities investment is a personal decision. Just as there are a variety of theories on when and which funds to buy, so are there numerous strategies for selling. For instance, factors that may contribute to an individual's decision to sell may include the fact that the portfolio manager has changed, the expense ratio has grown unreasonable, the performance is consistently lagging that of a comparable stock or index, or the performance is lagging behind that of funds with a similar style. Given these diverse individual reasons for deciding to sell, why authorize the board to review or terminate the management contract?

Some may argue that the fear of firing may have a salutary effect, acting as a deterrent to shirking and managerial consumption of excessive perquisites. However, investors' redemption rights can achieve the same goal, and replacing the Adviser is simply not a practical option under normal circumstances. The Adviser, not the investment company or its board, manages the fund's portfolio and operates its daily business.[300] Furthermore, the Adviser and its affiliates often are the fund's other service providers. These factors make termination much more difficult.

Moreover, many investors invest in a fund based on the Adviser's reputation and would leave the fund should the Adviser be terminated. Hence, the possibility of disrupting the fund's operation and the risks and uncertainty involved in replacing the Adviser with a new and untested

300. Securities and Exch. Comm'n., *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 131 (1966).

one make termination of the existing advisory relation an unrealistic alternative for the board.[301] In effect, if the board replaces the Adviser, it would have to set up a new fund. The authority of the board to replace the Adviser on the ground of bad performance also raises a legitimacy issue. Since reasonable persons could differ on what constitutes "bad" performance, evaluating the Adviser's performance should be left to individual investors. Probably because of such concerns, boards of directors seldom fire mutual fund Advisers.[302] It therefore may be desirable to encourage the long-term stability of the joint undertaking.[303]

This is not, however, to argue that the board should not have the authority to fire the Adviser under *any* circumstances. The Adviser should be fired if and only if it materially breaches the management contract or if there is a fundamental change of circumstances that frustrates the purpose of the mutual fund. This is desirable because these are causes for termination that the investors would have agreed upon had they been consulted. For example, the law could provide that the Adviser should be fired when it is insolvent or when it is reasonable to believe that removal is in the best interest of all investors.[304] This "floodgate approach" would minimize the monitoring costs because the board would not expend duplicative efforts to monitor the performance of the Adviser.

Some might argue that board members take the severity of their decision to terminate an Adviser into account when making replacement decisions. However, since the Adviser may expend resources trying to bring about a renewal decision, the *carte blanche* approach would incur

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301. *Id.* at 131. As one representative in the industry argues: "Having given the [fund] our name, we feel ourselves responsible, and we would refuse to permit anyone else to manage them." *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency,* 76th Cong., 3d Sess. 600 (1940).

302. *See, e.g.,* Renberg, *supra* note 253, at M14. For instance, recent statistics show that 15 funds ranked in the bottom 25% of all stock funds in at least 7 of the past 10 calendar years, and some of the Advisers that generated such bad results with alarming regularity are still around. *See* Jonathan Clements, *Some of These Turkeys Never See Gravy,* Wall St. J., Nov. 27, 1992, at C1.

303. For example, arguing against free termination of the management contract by the Adviser, one authority in the United Kingdom observed that being able to promote a scheme to the public carries with it a responsibility to continue the scheme for so long as there are investors wishing to participate. *See* Vaughan, *supra* note 115, at 36–42.

304. In the United Kingdom, for example, the circumstances under which a trustee may remove the manager include (a) that the manager has gone into liquidation, and (b) that the trustee has good and sufficient reason to believe that a change of manager is in the interests of the holders. *See id.* at 36.

significant costs arising from influence activities.[305] Because both the board and the investors monitor the same type of activities, this would yield overlapping monitoring costs. From an economic perspective, both under-monitoring and over-monitoring are undesirable.

2. *The Role of Shareholder Voting*

It is important to note at the outset that the description of investors as "shareholders" in the Corporate Fund does not suggest that they are entitled to the same set of shareholder rights as corporate shareholders. Their participation rights should be based on a cost/benefit analysis of collective decision-making in the fund context rather than a preconception of the rights associated with "shareholder" or "owner."

As discussed above, shareholder voting is a means for investors to participate in fund governance. The combination of explicit contracts, structural rules, and fiduciary rules still leaves much to the discretion of the board. Thus, shareholder voting must fill in the details. However, because voting is expensive, mutual fund investors may desire to conserve its use. Indeed, the collective action problems that attend voting in large business organizations suggest that voting rarely serves any function except *in extremis*. When many are entitled to vote, no one expects to have sufficient votes to decide the contest. Consequently, none of the voters has the appropriate incentive to study the fund's affairs and vote intelligently. On the other hand, shareholder voting does play an important role in connection with a limited range of investment company operational activities such as investment company mergers or changes in an investment company's investment objective.

Admittedly, the cost of shareholder voting has decreased significantly as a result of an interpretive position that the Act does not require an annual meeting to elect directors.[306] In addition, several states have special corporate law structures that effectively do not require shareholder meetings other than those required by the Act.[307] These

305. Consider an example of such a cost: during the contract renewal time, ordinarily one function of legal counsel is to prepare a memorandum (almost universally called in the trade the "Gartenberg Memorandum," after the famous § 36(b) fee litigation) summarizing for the directors their responsibilities under relevant laws. *See* Friedman, *supra* note 265, at 56.

306. John Nuveen & Co., Inc., *supra* note 85. This no-action letter pointed out that section 16(a) expressly requires a meeting to elect directors only (1) for the initial board and (2) to fill vacancies if less than a majority of the board is elected by shareholders. The letter took the position that the necessity for annual meetings was generally a question of state law.

307. Del. Code Ann. tit. 12, § 3806 (Supp. 1992); Md. Code Ann., Corps & Ass'ns § 2-501(b) (Supp. 1991).

positions suggest that shareholder voting requirements should be streamlined but not eliminated.

The SEC Report proposed to eliminate several obsolete shareholder voting requirements,[308] to modify others to comport with the realities of modern-day securities markets, and to add an express voting requirement for changes in investment objectives.[309] These recommendations are premised on the belief that investors should continue to have the opportunity to vote on proposals that significantly alter the nature of the investment.

However, the election voting requirements serve no practical purpose. The Corporate Fund provides shareholders with the right to elect the board of directors to operate the investment company in the best interest of the shareholders.[310] For this purpose, section 16(a) expressly requires a shareholder meeting to elect directors (1) for the initial board; and (2) to fill vacancies if less than a majority of the board is elected by shareholders.[311]

Election voting is used to delegate (and recall) monitoring functions to the board of directors. Unlike election voting in publicly-held corporations, which serves many important functions,[312] election voting in mutual funds seldom plays an important role. The reasons are twofold. First, there is no analog in the mutual fund context to the large shareholder in the corporation who may be willing to undertake monitoring, either directly or through voting. In fact, voting in publicly-held corporations is often justified by the market for corporate control, which functions through the processes of proxy fights, direct purchase of shares, and mergers.[313] In contrast, the market for corporate control is

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308. These include ratification of investment company auditors, initial approval of advisory contracts and rule 12b-1 plans. *See SEC Report, supra* note 12, at 277–78.

309. The *SEC Report* recommended that §§ 8(b) and 13(a) of the Act be amended to classify as fundamental a company's investment objective. *Id.* at 278.

310. Despite the usual link between risk of loss and control, in some situations the holders of the principal residual claim may be entirely content not to have control. *See* William A. Klein, *The Modern Business Organization: Bargaining Under Constraints,* 91 Yale L.J. 1551, 1557–59 (1982); *see also* Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts,* 42 Stan. L. Rev. 927 (1990) (noting that the distinguishing feature of franchising is that franchisees own assets that are subject to the franchisor's control).

311. 15 U.S.C. § 80a-16(a).

312. For a discussion of shareholder participation in the governance of publicly-held corporations, see, *e.g.*, SEC, *Staff Report on Corporate Accountability* (1980).

313. Some commentators have justified voting on the ground of its function as a corporate control mechanism. This is because collective action problems may be overcome by aggregating the shares (and the attached votes) through acquisitions, such as mergers and takeovers. *See* Henry G. Manne,

practically non-existent for mutual funds.[314] For instance, arguing that shareholder voting in mutual funds serves a "largely ritualistic purpose," one observer pointed out that there have been no shareholder director nominees selected to oppose management nominees, no instances where an incumbent manager has been ousted through a proxy fight, and apparently no successful opposition to any management proposal for a management contract or for other matters requiring a vote.[315]

Second, the extent of voting is influenced by the existence of adequate dissenters' remedies such as redemption rights. Mutual fund investors have a trade-off between liquidity and control. Investors that want liquidity may hesitate to accept control.[316] The importance of "liquidity" to mutual fund investors cannot be overemphasized—in most mutual fund prospectuses, the issue of redemption always occupies a prominent place.[317] If an easy, low-cost exit (e.g., redemption rights) is possible, the members will rationally have less interest in exercising a more costly "voice."[318] Thus, one report on mutual funds concluded that "the very concept of shareholder control through the exercise of voting rights may be contrary to the realities of the mutual fund business."[319]

Since most mutual funds have a heavy institutional component, one possibility is that these institutional investors could initiate changes in board composition. Such institutions, for example, could comment on nominees for director positions to ensure that the most qualified persons are elected as independent directors. Institutional investors, of course, are faced with the exit/voice option. Unlike institutional investors in

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Some Theoretical Aspects of Share Voting, 64 Colum. L. Rev. 1427 (1964) (arguing that shareholder voting is important chiefly as a necessary incident to the market for corporate control).

314. *See SEC Report, supra* note 12, at 273.

315. *See* Phillips, *supra* note 4, at 908.

316. For a discussion of such a tradeoff for institutional shareholders in participating in corporate governance, see generally John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 Colum. L. Rev. 1277 (1991).

317. For instance, the Table of Contents of the prospectus of Fidelity Magellan Fund contains 18 headings. One of them is entitled *How to Redeem Shares*. Fidelity Magellan Fund, *Prospectus* 2 (May 20, 1993).

318. This argument, of course, is a context-specific application of Hirschman's generalization that the members of any organization face a choice between "exit" and "voice." *See* Hirschman, *supra* note 198.

319. Wharton School of Finance and Commerce, *A Study of Mutual Funds*, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 7–8 (1962). The SEC does not dispute the contention that mutual fund shareholders are passive. The SEC Staff Report noted that many observers have told the staff that mutual funds often find it difficult to obtain a quorum, meeting attendance is usually sparse, and a vote outcome is almost never contrary to the wishes of the investment adviser. *See SEC Report, supra* note 12, at 273 n.82.

publicly held corporations, however, there is no empirical evidence that mutual fund institutional investors are actively involved in the election process or have placed their representatives on investment company boards of directors. Institutional investors of publicly held corporations and those of mutual funds differ in one major respect: the former often cannot sell much of their portfolio in any reasonable time frame, while the latter have much more liquidity and thus are less stuck with the investment.[320]

D. *Concluding Remarks: The Board as Coordinator-Monitor*

A mutual fund is a trilateral arrangement comprised of three actors—the Adviser, the investors, and the Monitor. The Corporate Fund has been characterized as an intermediate form of business organization which, contrasted with the Contractual Fund models in Germany, Japan, and the United Kingdom, is more centralized in its decision-making functions. Adopting organizational efficiency as a positive principle, this Article has developed a contractual framework to explain when the specific monitoring functions should be allocated to the Monitor (or the board of directors in the case of the Corporate Fund). Based on the foregoing discussions, the following observations are warranted.

The Corporate Fund can be regarded as a semi-hierarchy. To evaluate the institutional competence of the board, it is essential to inquire into the board's independence and informational advantage. As I have argued above, because directors are not truly independent, they are vulnerable to coalition politics. In addition, because directors have a limited informational advantage over investors, it may not be realistic to expect them to strike the best deals for investors. In this respect, traditional monitoring devices such as fiduciary duties and incentive-compatible contracts are not effective devices to discipline the performance of the board. Thus, the semi-hierarchy of the board leads to transaction costs such as influence costs and intervention costs.

In a Corporate Fund, the board's responsibilities can be divided into four categories: (1) approval of fees and expenses; (2) scrutiny of operational conflicts; (3) monitoring of compliance; and (4) general oversight. Four comments are in order with respect to the effectiveness of these specific responsibilities. First, the board structure has not been

320. Institutional investors, who increasingly own large unmarketable blocks, must accept substantial price discounts in order to liquidate these blocks. *See* Coffee, *supra* note 316, at 1288–89.

effective in policing economic terms such as fees and expenses. Second, it may be desirable for the directors to approve operational transactions that are significantly redistributive in nature. However, to minimize influence activities, some of the board's discretion should be replaced by inflexible rules. Third, the board should be responsible for ensuring that the Adviser and its affiliates comply with the rules and regulations governing the mutual fund's operations. Fourth, as a general rule, the board's "directorial" function—telling the Adviser how to manage the mutual fund—is unwarranted. However, as a dispute resolution mechanism, the board's approval functions can sometimes protect the Adviser against charges of improper conduct.

The board of directors of the Corporate Fund should be regarded as not only the "Monitor" but also the "Coordinator" of mutual fund operations. From an organizational perspective, the board may not be uniquely qualified to function as Coordinator. For one thing, the board's independence and informational advantage may be more apparent than real. In addition, the Corporate Fund does not provide economic incentives and effective devices to discipline the board's performance. Fortunately, the market has largely "practiced around" the institutional design of the Corporate Fund. Rather than acting as an active coordinator, the board mainly serves as a passive Monitor.[321] However, because the market cannot contract around all the inefficient legal rules applicable to the Corporate Fund, the Corporate Fund still incurs significant transaction costs.

Once we realize that the Corporate Fund may be economically costly, alternative mutual fund structures should be considered.[322] For instance, because the board exercises broad discretion and cannot be effectively monitored, perhaps discretion should not be allocated to the board in the first place. One way to achieve this is to adopt structural rules so that investors themselves can evaluate and discipline mutual funds more easily. After all, what the investors can do for themselves should not create duties for the board of directors. We should therefore be willing to look afresh at the merits of alternative mutual fund structures.

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321. The debate over passive versus active boards is not limited to mutual funds. For instance, Scott suggests two fundamental and contrasting perspectives for publicly-held corporations. The "active model" of monitoring requires directors to inquire and obtain information about the firm and to be active participants in corporate decision-making. The "passive model" of monitoring requires the board to play a mostly formal role in policy-making. Under this model monitoring would focus not on the formation of policy decisions but on the results of these decisions such as replacement decisions. *See* Scott, *supra* note 236, at 933–35.

322. *See supra* part III.D.

VI. AN EVALUATION OF THE CONTRACTUAL FUND

As discussed in part V above, by employing a semi-hierarchical governance structure, the Corporate Fund incurs significant transaction costs. The question is whether these costs can be cut by an alternative governance structure that is less costly. The alternative examined here is a contractual arrangement that is not independent of its Sponsor and Adviser.

A. Conceptual Analysis of the Contractual Fund

The following analysis consists of three parts. Part one posits that the Adviser, rather than the board, should assume the central role as the coordinator of a mutual fund. Part two considers a contractual governance system where market forces could effectively prevent post-contractual opportunism and discipline performance-related terms stipulated in the bilateral contract. Part three focuses on institutional monitoring arrangements designed to address contractual failures.

1. The "Investment Manager" as Coordinator

To understand the concept of the Contractual Fund, it is important to view the role of the Adviser as the coordinator of the mutual fund's operations, not merely as an outside service provider. This claim is supported by three arguments. First, from the standpoint of efficiency, the sponsoring and the advisory functions can usually be conducted by the same business firm, an investment manager ("Investment Manager"). Second, the Investment Manager should have common control over periphery activities such as distribution and administration. Third, the Investment Manager should be allowed to write its own ticket; that is, its handiwork is final in all but exceptional instances.

a. Investment Manager as Sponsor and Adviser

First, consider the possibility of combining the functions of the Adviser and the Sponsor in the Investment Manager. As discussed above, the Sponsor[323] and the Adviser each perform a distinct economic function: the Sponsor pays the seed capital and takes entrepreneurial risks, while the Adviser provides investment advisory service. While the

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323. For the concept of the "Sponsor," see *supra* notes 120–21 and accompanying text.

Adviser is invariably licensed as an investment adviser, the Sponsor may be licensed as an investment adviser, a broker-dealer, an insurance company, or even a bank. Under the current regulatory scheme the Adviser and the Sponsor may or may not be the same business firm.

Consider the entrepreneurial risks assumed by the Sponsor. A mutual fund is the embodiment of the Sponsor's efforts, expenses, and goodwill.[324] The Sponsor identifies the opportunity, pays the seed capital,[325] and bears the organizational expenses and entrepreneurial risk of organizing a fund.[326] It usually incurs initial losses when establishing a fund, i.e., it absorbs the expenses investors would be forced to shoulder if the fund were internally managed. In addition, it might have to shoulder the unprofitable burden of selling and distributing its shares during the formative period at heavy expense and small return. Thus, Sponsors run the risk that their organizational and promotional efforts will not result in sufficient funds under management to adequately reward them for their services.

The entrepreneurial reward of a mutual fund Sponsor may be distinguished from that of a corporate Sponsor. A corporate Sponsor's entrepreneurial risk is rewarded in the form of capital appreciation of the firm's corporate shares when the entrepreneur sells off a portion of the firm's residual claims to investors.[327] At the initial stage, the corporate Sponsor often acquires his ownership interest in the corporation—equity shares—at a cost lower than that paid by other equity shareholders who invest in the corporation later on. The corporate Sponsor is rewarded later by selling, in an initial public offering, all (if he wants to drop his managerial position) or some (if he wants to retain his managerial position) of his stock.

In contrast, mutual fund Sponsors cannot share in the success of their entrepreneurial efforts in the same way as corporate entrepreneurs do

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324. In fact, because Advisers are the sponsors of mutual funds, they sometimes claim the right to the name of the mutual fund which they created. *See* 2 Tamar Frankel, *supra* note 24, at 208–12.

325. Section 14(a)(1) of the Act provides that a mutual fund should have a net worth of at least 100,000 dollars prior to the commencement of a public offering of its securities. 15 U.S.C. § 80a-14. "Legislative history indicates that Congress imposed a minimum net worth requirement for [mutual funds] to prevent organizers [from] forming and later abandoning the company to the detriment of investors." *Investment Trusts and Investment Companies: Hearings on H.R. Doc. No. 10065 Before a Subcomm. of the Comm. on Interstate and Foreign Com.*, 76th Cong., 3d Sess. 116 (1940).

326. No reputable distributor would offer shares of a mutual fund whose initial balance sheet shows a large capital deficit due to organization expenses.

327. Similarly, the costs of bearing the risk of the enterprise is reflected in residual earnings. Consequently, in his capacity as the shareholder, the promoter shares both risk and return of the corporate enterprise. *See* Easterbrook & Fischel, *supra* note 52, at 8–15.

because mutual funds cannot issue cheap stock.[328] A mutual fund, by definition, stands ready to redeem its own shares upon the demand of the investors at the net asset value of the enterprise.[329] In addition, the value of a fund's shares is always directly related to the market value of the fund's portfolio. No mutual fund shares may be sold at less than the "current public offering price" described in a prospectus.[330] Thus, Advisers cannot receive shares for their sponsoring services, brand equity and organizational expenses because reallocation of equity ownership to Advisers is not permitted.

As such, the entrepreneurial reward of a fund Sponsor comes not from selling off cheap shares but from sources such as management fees.[331] Management fees can be considered as a reward for the initial entrepreneurial risk each Adviser takes when it first organizes a fund and as repayment of the losses experienced until the fund reaches an asset level sufficient to be self-supporting. In addition, ongoing operation risks may be considered to be an element of reasonable management. For example, Advisers must bear the risks of general industry-wide investor dissatisfaction or disinterest in mutual funds, with a consequent reduction in sales and an increase in redemptions. Such disaffection may be caused by extraneous considerations, such as economic recession, rather than by the Adviser's poor performance. Thus, the management fees can be justified both as compensation for advisory services provided by the Adviser and as the reward for entrepreneurial risks taken by the Sponsor.

From an economic standpoint, combining sponsoring and advisory functions in an Investment Manager may be efficient. After all, it is very

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328. Section 22(g) of the Act requires that shares be sold only in exchange for cash and securities, except in cases of reorganization or dividend distribution to security holders. 15 U.S.C. § 80(a)-22(g).

329. Such pricing regulation is justified because existing and continuing investors should not have the value of their units diluted as a result of the issuance and redemption of units of a mutual fund. The principle on which pricing regulation is based is that of fairness between incoming, outgoing and continuing participants. Congress was well aware of these potential abuses and adopted § 22 to deal with the issue for mutual funds. *See, e.g., West Report, supra* note 1, at 31.

330. The baseline of that price must be the "current net asset value" of the fund. 15 U.S.C. § 22(a)1, 22(d). Most jurisdictions employ this single pricing system, under which prices are calculated on the same basis regardless of whether units are being bought or sold and irrespective of whether a fund is growing or shrinking. In contrast, the United Kingdom adopts a "dual pricing system" under which prices are determined by the offer and bid net asset values of a fund. These prices are fixed at the discretion of the manager within the overall limits set by regulation. *See* Page & Ferguson, *supra* note 54, at 194–96. The thrust of such differing pricing systems—to prevent managerial abuse and to ensure non-dilution of assets—is the same.

331. *See* Sterrett, *supra* note 121, at 199.

difficult to decide which portion of the management fees should be considered as the reward for entrepreneurial risk and which portion the compensation for management services. Under these circumstances Investment Managers should be able to assume both functions and bear the attendant risk and return of the mutual fund operation. In so doing, the Investment Manager's entrepreneurial reward or compensation can be contingent, to a significant degree, on the success of the business.

b. Common Control over Peripheral Activities

Second, periphery services such as distribution and administration should be under the Investment Manager's control. Since distribution services are complementary services, it may be more efficient to charge the Investment Manager with the responsibility of determining how mutual fund shares should be distributed. According to the principle of unity of responsibility, complementary activities should be brought under common control or ownership.[332] This policy makes it easier to evaluate performance and costs and to provide incentives.

In fact, market practice has borne out this principle. Today, many necessary marketing or operations services, including investment advisory, administration, and distribution services, are provided by the Adviser and its affiliates. For instance, although the Fidelity Magellan Fund is managed by Fidelity Management & Research Company, its investment advisory, distribution, and transfer agency services are provided by other affiliates of the company.[333] With respect to distribution, the sale of fund shares is usually contracted out, on an exclusive basis, to a "principal underwriter," which in most cases is the Adviser itself or a close affiliate. Principal underwriters typically confine themselves to wholesale transactions and leave the public selling to independent retail dealers under a sales agreement.[334]

Admittedly, there is no bright line to delineate the boundary of a mutual fund. Some activities (e.g., selling fund shares) may be conducted by an internal branch of the Sponsor/Adviser, some by its affiliates, and others by third-party service providers that are not related

332. Theorists on managerial science have developed this principle. According to this principle, final responsibility for all the jobs needed to accomplish a particular task should reside with a single entity. *See, e.g.*, Milgrom & Roberts, *supra* note 155, at 410–11.

333. Fidelity Magellan Fund, *Prospectus*, May 20, 1993, at 3, 23.

334. *See SEC Report*, *supra* note 12, at 291–94.

to the Sponsor/Adviser at all.[335] But we should not be too concerned about how to draw the boundary between the mutual fund and the market. Because there is a competitive market for these peripheral services, it does not really matter whether the services are internalized or conducted through market contracts.

c. *Writing the Ticket*

Once the Investment Manager has common control over the core operations of the mutual fund, it should also be charged with the responsibility of putting the mutual fund together. Why should this be the case? The fundamental bargaining elements between the Investment Manager and the Investors include risk of loss, return, and control. Because these elements are interrelated, the person with the greatest risk of loss generally will have control over the relationship. It follows that allocation of control determines who has the right to make the various decisions affecting the business.[336]

Although the Investment Manager is not a major shareholder of the mutual fund, it is nevertheless a major stakeholder. Under the Jensen-Meckling model, as the Investment Manager's stake in the enterprise increases, its incentive to misbehave decreases. As a result, the need to monitor is reduced.[337] Because the Investment Manager shares significant risks and returns in the mutual fund enterprise, it is natural for it to share significant control as well. In other words, the Investment Manager may be more justified in seeking "hire capital" from a group of passive investors than in subordinating itself to a pre-monitoring mechanism like the board of directors.

Once the Investment Manager becomes the Coordinator of the mutual fund operations, it is feasible for investors to conduct bilateral bargaining with the Investment Manager. As the Coordinator, the Investment Manager is responsible for the mutual fund's design and operation and for its success or failure. Thus, a mutual fund is not really independent of the Investment Manager, because the fund is a financial product that the Investment Manager produces.

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335. In fact, many of the services are provided by the Sponsor/Manager itself or its affiliates. *See, e.g., SEC Report, supra* note 12, at 255–60.

336. For a discussion of the interrelationship between risk, return, and control, see, *e.g.*, William A. Klein & John C. Coffee, Jr., *Business Organization and Finance: Legal and Economic Principals* viii–x, 42–44 (3d ed. 1988).

337. *See* Jensen & Meckling, *supra* note 56, at 305.

This contractual arrangement may prove to be a blessing to the investors. From their perspective, the contractual arrangement acts as a "pay-as-you-go" vehicle. Because the investors can evaluate the institutional reputation of the Investment Manager and price the contract terms themselves, they have the ability to accept or reject the contractual terms proposed by the Investment Manager. Once they are capable of bargaining with the Investment Manager by themselves,[338] it would be redundant for a hierarchical higher-up such as the board of directors to pre-approve these terms.

2. *Contractual Governance and Market Discipline*

Some have argued that the unique nature of the mutual fund industry has made arm's-length bargaining impossible, and that the marketplace consequently cannot be relied upon to curb excessive fees.[339] Admittedly, by allowing the Investment Manager to write the ticket, we should be concerned about the possibility of post-contractual opportunistic behavior. To a considerable extent the contractual governance structure is quite effective in controlling such behavior[340] because it not only facilitates performance evaluation but also provides perfect incentives. In particular, as far as economic terms are concerned, arm's-length bargaining between the Investment Manager and the investors is possible and should be permitted.

a. *Performance Evaluation*

How does the contractual governance structure facilitate the evaluation of the fund's performance? Recall that in the Corporate Fund the investment company, acting through its board of directors, has to enter into multiple service contracts with multiple service providers. As discussed above, the board of directors of the Corporate Fund is not very effective in allocating costs and expenses to mutual funds. The reasons are twofold. First, directors of the Corporate Fund may lack independence and informational advantages. Second, due to the

338. By bargaining, I mean the ability to change the results rather than merely the ability to engage in the bargaining process.

339. *See* SEC, *Report on the Public Policy Implications of Investment Company Growth,* H.R. Rep. No. 2337, 89th Cong., 2d Sess. 12–13 (1966).

340. There is extensive literature on self-enforcing contracts. *See, e.g.,* Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance,* 89 J. Pol. Econ. 615 (1981); L. G. Telser, *A Theory of Self-Enforcing Agreements,* 53 J. Bus. 27 (1980).

complexity of a mutual fund's fee structures, it is very difficult for the directors to effectively allocate indirect income and costs as well as to determine entrepreneurial reward. Thus, for directors and investors alike, determining fees is a ponderous task.

The Contractual Fund provides a solution to this coordination problem. Because the Investment Manager and the investors of the Contractual Fund have a direct contractual relationship, the Investment Manager can set a single, fixed fee in exchange for all services necessary for the fund's operation and can commit to provide or contract with third parties for these services. All expenses, except brokerage commissions on the fund's own portfolio transactions and extraordinary costs, would be paid from the single fee or from the Investment Manager's own resources.[341] To facilitate performance evaluation, the Investment Manager can disclose the level of fees so that investors can evaluate the "totality" of costs they pay for investing in a mutual fund.

Some may argue that "bundling" the fee would leave investors without specific information as to the costs of particular aspects of a fund's operations. This should not be considered a disadvantage. Given the complexity of current fee structures, few investors can analyze the specific expense items in fund financial statements in a meaningful way. Because the unitary fee structure of the Contractual Fund would result in increased investor focus on bottom-line fund expenses, it can better facilitate investors' evaluation of mutual fund performance. After all, investors should be concerned primarily with the "totality" of the fund's performance, including total returns and fees.[342]

b. Economic Incentives

As the Coordinator of the mutual fund's operations, the Investment Manager must be properly motivated to provide good services. For instance, the fee payable to the Investment Manager can be computed as a percentage of fund assets and deducted from assets on a daily basis.[343] Let us consider how such a compensation scheme could motivate the Investment Manager to provide quality services to the investors.

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341. *See infra* part VI.B.2.

342. *Id.*

343. As discussed above, incentive-compatible contracts can motivate the Investment Manager. *See infra* notes 380–81 and accompanying text. For a fee schedule to be pareto optimal, it must implicitly serve to allocate the risk attaching to the outcome of the agent's activity in a satisfactory way and to create appropriate incentives for the agent. *See* Shavell, *supra* note 55, at 55–60.

Suppose an investor feels very unhappy about a mutual fund because its transfer agent has always been tardy in providing shareholder services. After making repeated complaints to no avail, he or she has two options: replace the transfer agent or leave the fund by exercising the redemption right. Which course of action would the investor likely pursue? Probably the latter. After all, from the investor's perspective, it is much more burdensome to convince (or demand) the board to make a replacement decision than to vote with one's feet. If the investor does exercise his or her redemption right, the Investment Manager (as well as the transfer agent) will be penalized because the redemption will decrease the amount of management fees. Thus, the Investment Manager is motivated to provide quality services, such as transfer agency services, in order to maximize its own returns.

Another type of market discipline is the new issues market for mutual funds. Because mutual funds continuously offer shares in the market, the Adviser's success (and profitability) depends primarily on its ability to replenish a fund's redeemed assets with the sale of new securities. Thus, the Adviser holds an ongoing entrepreneurial stake in the mutual fund enterprise. A mutual fund carrying the brand name of the Sponsor/Adviser group is the primary source of competitive advantage. In fact, because the Sponsor/Adviser's goodwill is on the line,[344] some have argued that a mutual fund can be perceived as a proprietary financial product produced by the Investment Manager.[345]

Finally, the contractual arrangement does not provide the Investment Manager with an opportunity to "hold up" the investors. Because the asset-specificity of the financial assets that the investors hold is low, investors do not suffer from a lock-in problem.[346] In addition, investors are not too concerned about the fact that periphery functions are controlled by the Investment Manager. Because these services are

344. One of the most important assets of a Sponsor/Adviser group is its company name. Because the name of a mutual fund usually represents valuable goodwill, it can be considered as a type of equity investment by the Sponsor/Adviser. *See, e.g.*, David A. Aaker, *Managing Brand Equity*: Capitalizing on the Value of a Brand Name 1–25 (1991).

345. *See West Report*, *supra* note 1, at 19. This description, however, should be qualified. Some funds occasionally change names due to interminable corporate identity crises and bad performance. Moreover, some funds which bear one Adviser's name may be managed by another corporate group. For example, Shearson Lehman Brothers Growth and Opportunity Fund is now managed by Salomon Brothers. *See* Susan Antilla, *Weill's $53 Billion of Lagging Assets*, N.Y. Times, Mar. 14, 1993, at F15. A mutual fund may cease to be a proprietary product once it loses the identity of its original Sponsor/Adviser.

346. As discussed above, mutual funds consist of liquid assets that can easily be redeployed to alternative uses without sacrificing productive value. *See supra* part IV.B.1.

peripheral and delegable functions, their providers are not likely to create monopoly rents or appropriable quasi-rents.[347]

c. *Summary*

In conclusion, when the success of a project depends on the coordinated execution of several tasks that makes it difficult to assess the performance of each task separately, then it is usually best to make a single entity responsible for all the related tasks. Thus, the underpinning of the Contractual Fund is a recognition that a mutual fund is, in many instances, a proprietary product that investors choose on the basis of the Investment Manager's reputation, skill and services. To minimize agency costs, the investors rely on market constraints and performance arrangements to discipline the Investment Manager. In other words, as far as economic terms are concerned, the external monitor of the Contractual Fund—the market—can effectively replace the internal monitor of the Corporate Fund—the board of directors.[348]

3. *Depositary or Trustee as Monitor*

When market discipline is not effective at preventing the opportunistic behavior of the Investment Manager, a Monitor should be installed to ensure the performance of the management contract. For instance, in the case of the Corporate Fund it may be desirable for the board of directors to police operational transactions (e.g., affiliated transactions) that are significantly redistributive.[349] Similarly, a Contractual Fund benefits from the oversight function that a Monitor performs.

How do the Investment Manager or the investors put a Monitor into place in a Contractual Fund? Under the Corporate Fund, the investors

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347. A monopoly rent is the increased value of an asset protected from market entry over the value it would have had in an open market. In contrast, an appropriable quasi rent can occur with no market closure or restrictions placed on rival assets. Once installed, an asset may be so expensive to remove or so specialized to a particular user that if the price paid to the owner were somehow reduced the asset's services to that user would not be reduced. *See* Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process,* 21 J.L. & Econ. 299 (1978).

348. This protection can be considered as a hybrid of invisible hand techniques as well as a conscious contractual protective governance structure. *See* Oliver E. Williamson, *Economic Institutions: Spontaneous and Intentional Governance,* 7(sp.) J.L. Econ. & Org. 159 (1991).

349. For examples of operational transactions, see *supra* notes 273–76 and accompanying text.

choose the Monitor—the board of directors—through Election Voting.[350] The agency costs associated with the appointment of the board of directors are simply the investors' "monitoring" expenditures. In contrast, in the Contractual Fund the Investment Manager chooses a Monitor prior to the formation of the fund and proposes its appointment as a contract term. This voluntary arrangement may not come as a surprise. Pursuant to principal-agent theory, the Investment Manager may be willing to expend "bonding" expenditures to induce investors to believe its promises.[351] Although the process of appointment is quite different, the result may not be. In either model, the agent—the Adviser or the Investment Manager—bears all the agency costs associated with the firm's governance arrangement.[352]

Note, however, that monitoring problems need not always be solved through the firm internally. In fact, one does not need to look far to see examples of market solutions to these problems of monitoring, such as auditing by independent public accountants. In a Corporate Fund, the Monitor (i.e., the board of directors) selects the fund's independent public accountant.[353] In many Contractual Fund jurisdictions, it is also up to the Monitor to approve the auditors.[354]

One of the most important regulatory requirements for mutual funds relates to the safeguarding of the assets in the Investment Pool. The following discussion is divided into four components. The first component examines why mutual funds need custodians in the first place. The second considers how the depositaries operate in the German Model. The third explores the role played by the Trustee in the British Model. Finally, the fourth component investigates the institutional safeguards designed to ensure the integrity of the depositaries or the trustees.

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350. Because agency problems are foreseen, they can be addressed *ex ante* through efforts to align the incentives of the manager and shareholders. *See supra* part III.A.1; part V.C.2.

351. *See* Jensen & Meckling, *supra* note 56, at 305–310.

352. Jensen and Meckling argue that it makes no difference who actually makes the agency costs expenditures—the promoter/sponsor bears the full amount of these costs and a wealth reduction in all cases. The promoter/sponsor of the firm bears all the agency costs associated with the firm's governance arrangement. *Id.* at 305, 310–11.

353. 15 U.S.C. § 80a-31(a)(1).

354. Under the British Model, the auditor of a unit trust is appointed by the manager and approved by the trustee. *See* Vaughan, *supra* note 115, at 35.

a. *The Need for Custodial Service*

As in the case of other business organizations, the separation of ownership from control creates opportunities for managers to misappropriate the assets or the value of these assets.[355] This problem is particularly acute for mutual funds. Because a large portion of mutual funds' assets are held in a highly liquid form, insider misconduct (e.g., embezzlement of funds) is relatively easy to commit.[356] Thus, the custodian who keeps custody of the assets of the fund is an important player. The custodian, which may be a bank, will have functions including safeguarding the fund's assets, making payments for the fund's portfolio of securities, and receiving payments when securities are sold.[357]

The operation of a mutual fund requires frequent consummation of securities transactions as well as a strict accounting for every penny of capital, capital gains, and income. Consequently, it may be desirable to install added safeguards over the fund's assets. For instance, the custodial contract can regulate the mechanics of how the investment company's or the Adviser's personnel access the assets in their custody.[358] The benefits of allocating such a function to the Adviser probably outweigh the costs of doing so.

b. *Depositary as Monitor*

In Germany, although the *Depotbank* acts solely in the interest of the investors, it is subject to the manager's instructions unless these instructions violate relevant laws and regulations.[359] The *KAGG* requires actual physical separation of the *Sondervermogen* from the assets of the

355. Misappropriation and self-dealings are usually policed by the duty of loyalty under corporate law. *See* Scott, *supra* note 236, at 937. In its broadest sense, appropriation could take two forms, one blatant, the other subtle. The former includes outright theft, diversion, or conversion; the latter comprises self-interested transactions or taking secret commissions given by third parties transacting with the mutual fund.

356. *See* Robert Charles Clark, *The Soundness of Financial Intermediaries*, 86 Yale L.J. 1, 27 (1976).

357. Pursuant to § 17(f) of the Act, mutual funds must place and maintain their securities and similar investments in the custody of a qualified custodian. A qualified custodian is either: (1) a bank, (2) a member of a national securities exchange pursuant to regulations prescribed by the SEC, (3) the company itself in accordance with the regulations prescribed by the SEC, or (4) a central clearing system pursuant to regulations prescribed by the SEC. 15 U.S.C. § 80a-17(f).

358. *Id.*

359. *See supra* part III.B.1.

manager. The legal relationship between the *depotbank* and the manager is a matter of contract. The law grants the manager a claim against the *Depotbank* for payment out of the *Sondervermoegen* of the manager's proper fees and expenses. The *Depotbank* also has the right to terminate the manager's authority to deal with the *Sondervermoegen* under certain circumstances.[360]

The *KAGG* regulates the extent of this contractual relationship between third parties and the manager. The *KAGG* prohibits direct claims by third parties against the *Depotbank* with respect to the *Sondervermoegen*, although such claims may arise indirectly if the third parties attach the manager's claim against the *Depotbank* for payment of the manager's fees and expenses.[361] The *Sondervermoegen* is not a legal entity capable of entering into legal transactions. All transactions must be undertaken by the manager, which is authorized to deal with the *Sondervermoegen* in its own name.[362]

In transactions relating to the *Sondervermoegen*, the manager is the contractual party with the third person. Any property acquired, however, immediately becomes part of the *Sondervermoegen* as a matter of law without passing through the manager. The property is thus never subject to attachment by manager's creditors, and the *Sondervermoegen* is not included in the manager's assets in bankruptcy. The legal obligations of the *Depotbank* inure primarily to the benefit of the certificate holders. The investor may sue the *Depotbank* as a third-party beneficiary.[363]

c. *Trustee as Monitor*

In Great Britain, the duties of the trustee of a unit trust include the following: (1) to carry out the instructions of the managers (subject to law and regulations); (2) to take custody of the assets and hold them in trust for the investors; and (3) to take reasonable care to ensure that the manager calculates issue and redemption prices.[364] Compared to the board of directors of the Corporate Fund, there are fewer specific items

360. *KAGG* §13(4) grants the *depotbank* the right to terminate the investment company's authority if the investment company is dissolved for any reason other than those specified in the *KAGG*, if a composition of creditors proceedings is instituted, or if the manager is prohibited by a court order from dealing with the *Sondervermoegen* generally. *See* Butler & Thoma, *supra* note 99, at 1608.

361. *Id.* at 1607.

362. *Id.*

363. *Id.* at 1606-08.

364. *See* Vaughan, *supra* note 115, at 38.

that require direct trustee consideration. Moreover, although the manager and the trustee must be independent of each other, the trustee and the custodian do not need to be separate entities.[365]

In Great Britain, it is permissible for the trustee to delegate the custodial function to a custodian. In doing so, the trustee is obligated to make reasonable inquiries to ensure that the custodian is fit and proper and that arrangements have been made to protect the rights of the trustee in priority over those of other creditors of the custodian.[366] Of course, it may sometimes be necessary for the custodian to exercise some kind of discretion. For instance, the custodian should be required to alert a designated regulatory body if it receives unusual instructions in dubious situations.[367]

d. Institutional Competence and Safeguards

The most obvious replacement for the independent directors would be a trustee or depositary, in much the same way that a "depositary" is used in the European Council Directive on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities ("UCITS Directive").[368] The UCITS Directive establishes a scheme for the recognition and marketing of mutual funds throughout the Community. The UCITS Directive deals with the coordination of Member States' provisions relating to "undertaking for collective investment in transferable securities" (UCITS).[369] It covers only open-ended UCITS, both unit trusts and investment companies. Its aim is to ensure that, once authorized in one Member State, the units or shares of UCITS may be marketed throughout the Community.[370]

365. *Id.*

366. Council Directive 85/611, art. 8, 1985 O.J. (L 375) 3, 5, as amended by Council Directive 88/220, 1988 O.J. (L 100) 31 [hereinafter UCITS Directive] ("It must furnish sufficient financial and professional guarantees to be able effectively to pursue its business as depositary and meet the commitments inherent in that function.").

367. For instance, the role of custodian has received close attention in the United Kingdom. This was prompted by the Maxwell scandal, in which assets belonging to pension schemes were diverted by the fund manager. *See* Michael Cowley & Andrew Sutch, *Defining the Role of Custodians*, V Global Investor, Mar. 1993, at 56.

368. UCITS Directive, *supra* note 366.

369. *Id.* at 3.

370. *Id.* The UCITS Directive prescribes a common denominator approach to protecting investors in certain mutual funds qualifying as UCITS.

Under the UCITS Directive, a fund's depositary is supposed to act in a general oversight capacity for all fund operations. Thus, depositaries are subject to public control due to the important functions that they assume. For instance, to be eligible to perform as a depositary or trustee, an entity must demonstrate financial and professional soundness.[371] In addition, to ensure that the depositary and the Investment Manager conduct mutual monitoring, not mutual collusion, the depositary and the Investment Manager must act independently and solely in the interest of the investors.[372]

Compared to the board of directors, employing the depositary as the Monitor offers two advantages. First, because the depositary and the Investment Manager must interact (e.g., settle transactions or communicate changes in asset value) on a regular basis, the depositary can acquire low-cost information about the Investment Manager. This mutual monitoring system can tap this information for use in the monitoring process.[373] Second, because depositaries (like the Investment Managers) are typically compensated on the basis of account size, they bear a major share of the wealth effects of their performance. In contrast, boards of directors of the Corporate Funds do not bear a major share of the wealth effects of their monitoring decisions because they receive fixed salaries.

B. *Two Contractual Fund Proposals*

Disenchantment with the present Corporate Fund structure has led some to endorse simplified governance arrangements such as the Unitary Investment Fund (UIF) and Unified Fee Investment Company (UFIC).[374] The UIF proposal—a structure closer to that of the Contractual Fund—represents a somewhat radical departure from the Corporate Fund. The UFIC proposal, on the other hand, is closer to that of the Corporate Fund and deviates less from the Corporate Fund Model.[375]

371. *Id.*. at art. 8 ("It must furnish sufficient financial and professional guarantees to be able effectively to pursue its business as depositary and meet the commitments inherent in that function.").

372. *Id* at art. 10. For a discussion of collusion in organizations, see, *e.g.*, Jean Tirole, *Hierarchies and Bureaucracies: On the Role of Collusion in Organizations*, 2 J.L. Econ. & Org. 203 (1986).

373. *See* Fama & Jensen, *supra* note 154, at 310–11.

374. This Article uses the term Contractual Fund to include both UIF and UFIC, which are considered subtypes of the Contractual Fund.

375. For a discussion of the contract-organization continuum, see *supra* notes 69–70 and accompanying text.

Because the UIF and the UFIC share some important features with the Contractual Fund, they can be considered as stylized models of the Contractual Fund.[376] The following section examines these two proposals.

1. *UIF as a Proprietary Product*

Originally proposed in 1980,[377] the UIF is an alternative form of mutual fund whose structure is predicated on the belief that a mutual fund is a proprietary product, more suited to a contractual arrangement than to corporate democracy. In response to this proposal, the SEC requested public comment on the UIF in 1982.[378] Most commentators opposed the UIF, based largely on concerns about the adequacy of investors for the UIF's investments.

The term "Unitary Investment Fund" is used presumably because, unlike the Corporate Fund, it is a contractual being which is *not* independent of its Sponsor or investment adviser.[379] In most Contractual Fund jurisdictions, the Investment Pool, even though not subordinated to a corporate entity, is nevertheless legally required to be segregated from the manager and its assets. In other words, the Investment Pool is still regulated and operated as if it were an independent entity.[380]

a. *The UIF Proposal*

As proposed, the UIF would have the following key features:[381]

(1) The UIF would be an optional form of investment company, similar in form to a trust, with a corporate trustee (the sponsor/manager), a trust indenture (which would spell out fundamental investment policies and the management fee), and investors holding interests in the trust.

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376. Note, however, that Contractual Funds may have different arrangements. For instance, unlike the UFIC, many mutual funds in Contractual Fund jurisdictions do not really charge a unified fee. *See generally World's Investment Fund, supra* note 50.

377. The concept of UIF was first proposed by Stephen West of Sullivan & Cromwell. *See* Stephen K. West, Address at the General Meeting of the Investment Company Institute (May 1, 1980).

378. Advance Notice and Request for Comment on Mutual Fund Governance, Investment Company Act Release No. 12,888, 47 Fed. Reg. 56,509 (Dec. 10, 1982).

379. *See West Report, supra* note 1, at 63.

380. A notable example is the concept of *Sondervermoegen* in the German investment fund. *See supra* notes 359–63 and accompanying text.

381. *See SEC Report, supra* note 12, at 283–84.

(2) A single management fee would cover all expenses, except for extraordinary expenses and shareholder account services. The fee would be subject to a statutory maximum, which the SEC could increase by rulemaking. No limit would be placed on the percentage of the fee that could be used for distribution expenses.

(3) The UIF would have no board of directors or shareholder voting, nor would section 36(b) apply.

(4) During an initial period (perhaps five years) the indenture could not be amended without an exemptive order from the SEC. Thereafter, the Sponsor could amend the indenture at any time upon adequate notice to investors. Shareholders objecting to a change could redeem.

(5) The UIF would either be no-load or would refund the sales charge upon redemption in most situations.

(6) All section 17 prohibitions concerning transactions with affiliates would apply. Because there would be no board of directors to prevent the Sponsor's brokerage affiliate from charging excessive commissions to a UIF, agency transactions with affiliates currently allowed under section 17(e) would be prohibited.

(7) The UIF could not engage in activities that rely on rules or exemptive orders conditioned on director oversight unless mechanical rules or individual exemptive orders were substituted for each oversight.

b. Evaluation of the UIF

Pursuant to this proposal, the UIF would have a simplified governance structure—with neither voting shareholders nor a board of directors—and a relatively simple fee arrangement. Since the time of this proposal, a number of variations have been suggested.[382] For example, some advocates of the UIF now take the position that even UIF shareholders should have voting rights. Others, citing investor protection concerns, have recommended that any UIF structure retain an independent trustee to exercise oversight over the affairs of the company.[383] However, none of these advocates has generated specific details of the structure and operation of the UIF and its monitoring structure.

382. *See, e.g.*, Phillips, *supra* note 4, at 905.

383. Others, citing investor protection concerns, have recommended that any UIF structure retain an independent trustee to exercise oversight over the affairs of the mutual fund. *See, e.g.*, Investment Company Institute, *Comment Letter on the Reform of Regulation of Investment Companies*, Release No. 33-6868, Oct. 5, 1990, at 30.

Assuming that the single-fee approach would be an adequate substitute for the current system of director review of fees,[384] the question remains whether the corporate model is necessary for other investor protection purposes. As discussed above, in the absence of a third-party monitor, a contractual governance regime is unlikely to effectively police some operational transactions that involve a potential transfer of significant value from investors to the Investment Manager or its affiliates. That is why, under the Act and the rules thereunder, directors oversee mutual fund operations in many areas that do not involve fees.

One alternative would be to substitute greater oversight and examination by the SEC. This would involve some kind of merit review conducted by the SEC. For example, a UIF's registration statement under both the Securities Act and the Investment Company Act would have to be declared effective by the SEC before shares could be sold, thereby giving the SEC the opportunity to review the management contract as well as the proposed prospectus disclosure.[385] However, this suggestion may be unrealistic given fiscal constraints. For instance, the SEC reportedly already is nervous that its staff assigned to inspect funds may be stretched too thin.[386]

In conclusion, mutual fund investors should have certain protection provided by an independent monitor and, to a lesser degree, by shareholder voting. Because the UIF proposal provides neither the protection of the Act's governance requirements nor the similar protection of a foreign regulatory system,[387] it should be rejected. Thus, we should consider alternative structures which can adequately address investor protection concerns while minimizing transactions costs.

2. *UFIC with a Simplified Fee Structure*

Having rejected the UIF proposal, the Division considered a possible variation that would reflect the proprietary nature of a mutual fund and at

384. For an evaluation of the single fee approach, see *infra* part VI.B.2.

385. Currently, a mutual fund is automatically registered under the Act upon filing a notification of registration on Form N-8A. 15 U.S.C. § 80a-8(a). Typically, a Securities Act registration statement for shares of a mutual fund includes a delaying amendment and is declared effective by the SEC only after review and comment by the SEC staff. If, however, a Securities Act registration statement were filed without a delaying amendment, it would become effective automatically in twenty days. *See* 15 U.S.C. § 77h(a) (1988); 17 C.F.R. § 230.473 (1994).

386. It was recently reported that only 126 federal examiners keep tabs on nearly 3,800 mutual fund portfolios with assets of $1.6 trillion. *See* Michael Schroeder, *The SEC May Not Have Enough Guns*, Bus. Wk., Jan. 18, 1993, at 68.

387. *See supra* part VI.A.3.

the same time retain the watchdog function of the directors of the Corporate Fund. Adopting the single fee aspect of the UIF, the Division proposed the Unified Fee Investment Company (UFIC) to promote competitive pricing and consumer choice.[388]

a. The UFIC Proposal

The UFIC is an optional, additional form of investment company. Its purpose is to provide investors with a simplified fee structure, the bottom-line expenses and investment performance of which could be readily compared to other funds of the same type. The proposal includes several major features:

The Unified Fee. A UFIC would have a single, fixed fee computed daily as a percentage of fund assets and expenses. This unified fee, together with the resources of the "Investment Manager" (to be defined in the Act as the Sponsor-Adviser of a UFIC), would cover all fund expenses other than extraordinary expenses and brokerage commissions on the fund's own transactions.[389] To promote full disclosure and investor choice, the level of the fee would be prominently displayed on the cover page of the prospectus and in all sales literature and advertising. There would be no separate sales charges, redemption fees, or distribution fees.[390] The SEC Report argued that fee levels would be dictated by competitive pressures in the marketplace.

The Board of Directors. Two thirds of the directors would be required to be non-interested, and after the fund Sponsor establishes the initial board, the directors would be self-nominating with respect to any vacancies to be filled.[391] The duties of the board would include evaluating and approving the advisory contract as well as its continuance beyond the initial two-year period. In addition, the UFIC's independent directors would separately evaluate and approve the initial contract and any renewal of the contract. The UFIC board, however, would not be responsible for approving the fee with the Investment Manager. In addition, the UFIC's board of directors would not be required to

388. *See SEC Report, supra* note 12, at 337.

389. "Extraordinary expenses" would be defined by SEC rule. *See SEC Report, supra* note 12, at 340.

390. However, to protect investors should competition not restrain fee levels for the UFIC, the Act would prohibit "unconscionable or grossly excessive" unified fees. *Id.* at 332.

391. *Id.* at 341–44.

authorize, review, or evaluate the component of the unified fee representing asset-based distribution fees.[392]

The Division also recommended that a new paragraph (g) of section 15 "specify that the board, including the independent directors voting separately, must approve and periodically review all material contracts the Investment Manager has executed."[393] The board must also review other contracts furnishing services to the fund to ensure provision of adequate services to the fund. The suggested revision also would provide that either the full board or its independent directors may terminate a material contract at any time, on appropriate notice.[394] This material contract review would ensure that the UFIC is provided the level of services needed for its safe operation.

Shareholder Rights. UFIC shareholders would not vote to approve, amend, or terminate advisory contracts. Instead, shareholders would receive 90 days written notice of any management or advisory fee change.[395] Because there would be no front-end sales loads or other sales charges, but rather the ongoing, daily deduction of the unified fee, dissatisfied investors would be expected to "vote with their feet" regarding the fee. UFIC shareholders would have all other voting rights currently required by the Act.[396]

b. Evaluation of the UFIC Proposal

First of all, consider the significance of the UFIC proposal to the Corporate Fund structure. As if to downplay its significance, the SEC Report discussed the UFIC proposal in Chapter 8, "The Sale of Open-End Investment Company Shares,"[397] instead of in Chapter 7, "Investment Company Governance," as with the UIF.[398] According to the Division, the proposal would "promote price competition and result in more economical and efficient distribution methods," because it would provide a simplified method of distribution financing.[399] The Division

392. *Id.* at 342.

393. *Id.*

394. *Id.*

395. *Id.* at 343. Note also that a fee could not be charged until it had been in effect for one year. *Id.*

396. *Id.* at 343–44.

397. *Id.* at 332–45 (Part IV of chapter 8 is entitled "The Unified Fee Investment Company: An Alternative.").

398. *Id.* at 282–89 (Part IV of chapter 7 is entitled "Alternative Governance Arrangements.").

399. *Id.* at 297.

apparently considered the UFIC proposal to be a modified version of the Corporate Fund.[400] After all, like the Corporate Fund, the UFIC would have a board of directors to police operational conflicts and to approve a variety of operational activities.

Viewed from another perspective, however, the UFIC can be considered a type of Contractual Fund because its simplified fee concept goes beyond distribution financing. Under the proposal a UFIC would be organized and operated by the Investment Manager. A written "management contract" would specify a single, unified fee payable to the manager in exchange for *all* services necessary for the UFIC's operation and would bind the manager to provide or contract with third parties for these services. Consequently, a direct contractual relationship would exist between the Investment Manager and the investors and, at least as far as fee-related matters are concerned, the corporate machinery would be eliminated. Because the Investment Manager would be able to assume some important coordination functions and to write some economic terms without going through a pre-approval system, a UFIC can be considered a modified version of the Contractual Fund.[401]

This proposal is a great step toward realism. As discussed above, alternative forms of distribution charges, such as the Regulation 12b-1 fees and contingent deferred sales loads, have become increasingly prevalent and have resulted in complex distribution arrangements.[402] In addition, the Act made lawful a system of retail price maintenance and impeded price competition with respect to front-end sales loads.[403] Consequently, the variety of charges and operating and distribution expenses of bond and stock funds are difficult to aggregate, cannot be readily compared among funds, and cause investor confusion. Thus, it is important to develop an integrated cost comparison that considers the two visible costs—sales charges and expense ratios. Because the unified fees are intended to represent the "totality" of the sales charge and

400. The UFIC proposal is one of the three general recommendations with respect to the sale of mutual fund shares.

401. *See supra* notes 316–31 and accompanying text.

402. *See supra* notes 243–54 and accompanying text.

403. To prevent abusive trading practices that resulted from the backward pricing method used by funds before 1940, the Act required that all sales of mutual fund shares be made at a fixed offering price specified in the prospectus. The base price of a mutual fund is always derived from net asset value, so this requirement fixed the sales load component of the public offering price. Although this provision, § 22(d), minimized the identified trading abuses, it also made lawful a system of retail price maintenance and eliminated all secondary market trading. Thus, the Act provided that the sale of mutual fund shares is exempt from normal antitrust law principles of free competition. *See SEC Report, supra* note 12, at 291–315.

expense ratios (subject to limited exceptions), investors should be able to make their own decisions concerning appropriate expense levels.

The UFIC fee levels would be market-based and would not be subject to regulatory limits. Because of the perceived competitive element, the board of directors would be relieved of the responsibility under Federal law of reviewing the level of management fees. To this end, the fiduciary duty of the Investment Manager with respect to compensation and other elements of section 36(b) would be eliminated and the unified fee would not be subject to private litigation.[404]

One benefit of the UFIC is that the unified fee would enable Investment Managers to build internal budgets, gauge performance of internal divisions, obtain service costs of all the service providers, and reduce record-keeping costs of the mutual fund operations. Bundling all costs of operation and distribution into a single fee should reduce the time and expense of detailed accounting reports, legal analyses, and deliberations surrounding expenditures from fund assets that must be allocated for advisory, distribution, and other services. Thus, the unified fee concept can be analogized to the standard cost accounting adopted by many industrial and service corporations.[405]

In conclusion, the benefits of the UFIC seem clear: increased investor and media focus on bottom-line fund expenses, in general, and the importance of these costs to investment performance, in particular. Because of increased investor awareness of fund expenses and its effect on investment return, and the evolution of an information industry that tracks funds,[406] market forces have become a more effective restraint on expenses. Some would argue that permitting a "bundled" fee would afford the Investment Manager the opportunity to build an excessive profit into the single fee. However, given that the single fee is easy to "price" and that minimum exit barriers exist, the market will work to keep fees at reasonable levels.[407]

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404. *See id.* at 341–43.

405. *See, e.g.*, Charles Horngren et al., *Cost Accounting: A Managerial Emphasis* 224–36 (1994).

406. One example is the Business Week rating, which regularly publishes information on both sales charges and operation expenses. *See, e.g.*, Jeffrey M. Laderman, *The Best Mutual Funds*, Bus. Wk., Feb. 15, 1993, at 68–73.

407. It is very important to link "pay" to "performance." For instance, in an effort to address this issue, the SEC has promulgated rules to force more disclosure of executive pay. *See, e.g.*, Kevin G. Salwen, *SEC To Allow Investors More Room To Talk*, Wall St. J., Oct. 15, 1992, at C1, C12.

3. *Summary*

As the foregoing discussion suggests, while the UIF proposal should not be adopted, the UFIC proposal has merit and should be implemented. The UIF proposal should be rejected because it provides no effective substitute for the oversight of the board of directors. On the other hand, the UFIC proposal has merit, not only because competitive forces would provide adequate discipline with respect to its simplified fee schedule, but because the Investment Manager would be better motivated than the board to coordinate a mutual fund's operations. In addition, the UFIC proposal goes a long way toward streamlining shareholder voting requirements, especially voting requirements with respect to fee-related issues. Because protection would still be retained for matters other than fees, the UFIC is a hybrid between the Corporate Fund and the Contractual Fund which may have some efficiency advantages.

C. *Suggestions for Improving the UFIC Proposal*

1. *Beyond Unified Fee*

It is often believed that the three sides of the "eternal triangle" of mutual fund investing are potential reward, potential risk, and cost[408] The other important element—service quality—is often ignored. Everyday nuisance-type problems, such as late or inaccurate statements or dividend checks, may be a sign of the overall incompetence of a mutual fund. Should the market-oriented approach of the unified fee arrangement be extended to service quality? According to the UFIC proposal, although the board of the UFIC would not be responsible for negotiating the level of the fees and expenses, it would still be required to oversee the level of services provided to the UFIC through review of all material service contracts.

The SEC argued that "[w]ithout a third-party monitor to oversee the level of services, investors would be virtually left to their own devices, but typically without the expertise, incentive or power to assess the quality of these services."[409] However, if investors have the ability to compare fees, why can't they evaluate mutual fund services as well? Customers of a bank do not normally appoint an independent bargaining agent to oversee the services provided by their bank. Why then should

408. *See, e.g.*, Bogel, *supra* note 249, at 190.

409. *See SEC Report*, *supra* note 12, at 285.

investors have to rely on the board of directors to monitor the services they receive?

Admittedly, services differ from other items (e.g., investment returns) in that they are difficult to measure and to evaluate. Unlike tangible goods, mutual fund services cannot be tested and verified in advance of sale to assure quality. The way investors evaluate mutual fund services is more complicated and varied than the way they evaluate, say, automobiles.[410] However, because the only criteria that count in evaluating service quality are defined by investors, the board of directors should not be charged with the responsibility of evaluating service quality. Because service-quality perceptions stem from how well a provider performs vis-à-vis investors' expectations about how the provider should perform, all other judgments, including the judgment of the board of directors, are irrelevant.

In evaluating the overall performance of mutual funds, investors take into consideration four interrelated elements: investment return, fees and expenses, risk level, and service quality. In doing so, investors do not isolate the level of service from the other elements; rather, they look for an acceptable mix of all elements. In other words, investors ask themselves whether the fees charged by the Investment Manager and its affiliates are consistent with the services provided. The price factor therefore plays an important role in shaping investors' expectations of the level of services.[411] If existing investors become unhappy with the level of services, they may well redeem their shares. Similarly, prospective investors may invest in a particular mutual fund partly because it has a reputation for providing good service.

The Division further argued that, as a result of price competition, the Investment Manager might be tempted to skimp on or eliminate the basic services needed to operate an investment company.[412] These temptations could create serious investor protection problems, if, for example, the Investment Manager hired an incompetent custodian.[413] But these

410. Quality measurement and quality assurance in services are in their infancy. It is still controversial whether quality can be measured meaningfully. Research on customers' view of service quality still leave many questions unanswered. How exactly do customers evaluate the quality of a service? Do they directly make a global evaluation or do they assess specific facets of a service in arriving at an overall evaluation? If the latter, what are the multiple facets or dimensions on which they evaluate the service? *See* Valerie A. Zeithaml et al., *Delivering Quality Service: Balancing Customer Perceptions and Expectations* 16 (1990).

411. *Id.* at 15–20.

412. *See SEC Report*, *supra* note 12, at 341.

413. *Id.*

concerns can be addressed by imposing mandatory quality terms. At the very least, the basic services needed to operate investment companies can be maintained by the standard minimum quality terms.[414] For instance, the SEC has adopted a rule that regulates management personnel's access to assets in the custody of a broker-dealer or to the fund itself.[415]

Mutual fund service providers are strongly motivated to provide quality service to assure investor satisfaction and loyalty. Although the true costs and benefits of service quality cannot be measured,[416] recent studies show that most service providers do recognize the importance of service quality. For example, a recent survey reported that over 80% of the 73 mutual fund complexes stated that they view quality as a strategic initiative within their organizations. In addition, 84% indicated that they survey shareholders on a periodic basis to determine their level of satisfaction with the quality of service provided.[417]

To summarize, because investors have the ability to price service quality, the effectiveness of the board's function to scrutinize service terms is questionable. Moreover, minimum quality terms and economic incentives would adequately motivate the Investment Manager to provide quality service. Therefore, performance-related terms that fall into the purview of investors' choice should include not only fee levels but also service quality.

2. *Risk Disclosure*

It has been argued that the Act is not a disclosure statute; rather, as with banking laws and insurance statutes, it regulates a type of financial institution.[418] Nevertheless, disclosure still plays a very important role in mutual fund regulation.[419] Because ultimately investors have to make investment decisions for themselves, they should be afforded the

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414. Minimum quality terms relieve the investors of the need to choose between undertaking an expensive search for information and the risk of making a potentially disastrous choice. For a discussion of minimum quality terms that protect investors from misinformation, see, *e.g.*, Victor P. Goldberg, *Institutional Change and the Quasi-Invisible Hand*, 17 J.L. & Econ. 461, 488–91 (1974).

415. The actual mechanics for custody arrangements are set forth in rule 17(f)-3 covering custody by the fund itself. 15 U.S.C. § 80a-17(f). The rule is augmented by the publication of a model custody agreement. *See West Report, supra* note 1, at 29–30.

416. For a discussion of the costs and benefits of service quality, see, *e.g.*, W. Earl Sasser, Jr., et al., *The Service Management Course: Cases and Readings* 283–84 (1993).

417. *See* Investment Company Institute (with the assistance of Coopers & Lybrand), *Mutual Fund Transfer Agents: Trends & Billing Practices* 73, 74 (1992).

418. *See* Frankel, *supra* note 24, at 28–34.

419. *See, e.g.*, *West Report, supra* note 1, at 27–28.

information necessary to shop for the right fund by comparing past performance, including past returns, risk levels, fees, and service quality.[420]

As discussed above, investment return should be evaluated by the investors, not the board. Some, however, may argue that the board of directors be allowed to assess risk. For instance, in determining the appropriate level of management fees, the board can factor in the risk level of the fund.[421] From a practical perspective, risk can be defined as the potential for losing money.[422] If your mutual fund is volatile—if its net asset value is subject to sharp fluctuations—it is risky.[423] Investors are probably not going to get too upset about sharp moves to the upside.

Although the method for assessing risk is critical for investors, it is very difficult to develop a single accurate measure of risk. One problem is that risk can mean something different for each investor. Some investors can tolerate losing for years for a high ultimate return; others willingly sacrifice higher returns for fewer interim losses. And risk changes over time. Volatility penalizes short-term investors. For the long term, outpacing inflation becomes the biggest risk. As a result, the various risk ratings created by fund researchers, newsletter editors, and financial publications are all flawed.[424] Because risk-return assessment is a personal thing, the board should not be allowed to asses risks. Although it is very difficult to devise an accurate risk rating system, this

420. The importance of disclosure in mutual fund regulation cannot be overemphasized. Take Japanese mutual funds as an example. Japanese funds generally do not state clearly their investment philosophies, and they do not provide breakdowns of their investments or the specific securities owned. Hence, there is a tremendous need for unbiased information. *See* James Sterngold, *World Markets: A New Leaf for Japan's Mutual Funds?*, N.Y. Times, Jan. 2, 1994, at F13.

421. The directors evaluate the performance by comparing each fund's achievement of its objective against a selection of comparable mutual funds with similar objectives and risk levels. *See, e.g.*, Nutt, *supra* note 222, at 232–38.

422. There are other ways to define it, but for investors this is the most significant way.

423. Note that the Act has restricted the investment risks of mutual funds. For instance, shareholder redemption rights and the related liquidity requirements restrict investment freedom. *See supra* part IV. B. 4.

424. For instance, the Morningstar rating system, one of the more popular risk rating systems, is computed by subtracting the risk-free return on a three-month Treasury bill from a fund's monthly return. The number of months with negative results are divided by the number of months in rating periods of three, five, or ten years, then compared with other funds, with the average risk rating being 1.0. For example, Fidelity Magellan has a five-year risk rating of 0.79, meaning it carried just three-quarters of the average risk of equity funds. "The advantages of this method are that it penalizes funds only for losses, not unusual gains, and avoids comparisons with irrelevant indexes. But it is merely a historical rating, not a predictive one." Carole Gould, *Grasping the Slippery Idea of Risk*, N.Y. Times, Dec. 12, 1993, at F14.

should not be an excuse for not providing investors with risk measures most meaningful for them.[425]

3. Regulating the Investment Manager

Legislation will be required to implement the UFIC proposal. To what extent should the UFIC or its Investment Manager be regulated? The Division proposed that the term "Investment Manager" be defined to distinguish the Sponsor and manager of a UFIC from the Investment Advisers of other mutual funds. In addition, the term "Investment Manager" would be added, where appropriate, to provisions of the Act and rules that refer to a fund's "Investment Adviser."[426] It appears that the SEC Division desires to implement the UFIC proposal with minimum changes to the present regulatory scheme. It is doubtful, however, that this minimalist approach would work.

As the coordinator of the UFIC, the Investment Manager would take substantial entrepreneurial risks, because all costs of operating the UFIC and distributing its shares (other than portfolio transaction costs and extraordinary expenses) would be financed by the Investment Manager out of the unified fee or out of its own resources. In addition, the unified fee would not be changed until it had been in effect for one year,[427] even though the costs will vary over time. Thus, the Investment Manager runs the risk that its organizational and promotional efforts will not garner sufficient funds under management to reward its services adequately.[428] Because the UFIC places greater economic risk on the Investment Manager, this implicates regulatory concern.

Unlike the Investment Company Act, the Advisers Act relies much more heavily on disclosure and antifraud provisions than on substantive

425. In fact, legislators and regulators are speaking with Morningstar Inc., the leading mutual fund research company, about developing a universal risk-rating system for mutual funds. *Id.*

426. For example, § 36(a) would be amended to include the Investment Manager among those persons whom the SEC may sue for breach of fiduciary duty involving personal conduct. *See SEC Report, supra* note 12, at 338 n.186.

427. *Id.* at 343.

428. This makes sense because it is a familiar pattern in the principal-agent literature that an agent must bear non-diversifiable risk to create an incentive. In addition, the manager can "average out" such risks by organizing a wide variety of different mutual funds and, because they have more wealth, they can better absorb the risks that remain. *See e.g.,* Robert S. Pindyck & Daniel L. Rubinfeld, *Microeconomics* 145–57 (1989).

regulation.[429] The objective of the Advisers Act was to have all advisers, with certain exceptions, register and identify themselves and the nature of their business.[430] Currently any person (other than a criminal or a violator of securities law) is entitled to register and give investment advice to the public, regardless of his experience or financial condition. As such, the Advisers Act emphasizes disclosure and fiduciary obligations and does not regulate financial safety and soundness.[431] Although this regulatory scheme may work well with investment advisers that advise on Corporate Funds, it is not suitable to regulate Investment Managers of UFICs.

One necessary component of the legislation governing Investment Managers would be financial soundness. Capital requirements are the most powerful source of discipline for financial institutions. When maintained at an appropriate level, they reduce the incentive to take excessive risks and provide a cushion against loss. A meaningful capital standard also serves as a check against uncontrolled growth, because the permissible level of operations can be directly tied to capital requirements.[432]

More fundamentally, the focus of regulation should be shifted from mutual funds generally to the Investment Managers. We should regulate Investment Managers as persons who sponsor and advise mutual funds. In fact, they should be treated as a separate category of financial services firms. The approach would be similar to the approach taken by the Commodity Exchange Act.[433] It would involve a regulatory statute that focuses on the conduct and activity of the Investment Manager with respect to all mutual funds under its management. Meanwhile, the regulation of the Investment Pool itself would still be extensive.[434]

429. Alan Rosenblat & Martin E. Lybecker, *Some Thoughts on the Federal Securities Laws Regulating External Investment Management Arrangements and the ALI Federal Securities Code Project*, 124 U. Pa. L. Rev. 587, 654–60 (1976).

430. Although the idea was that professional and financial qualifications could be developed over time, none have been. *See West Report*, *supra* note 1, at 34.

431. *Id.* at 228–30.

432. Note, however, that minimum capital requirements should be used with care because they could incur costs such as administrative costs and error costs. *See e.g.*, Easterbrook & Fischel, *supra* note 52, at 60–62.

433. In the case of commodity pools, or pools containing futures contracts or exchange-traded commodity options as assets, the pools themselves are not regulated. *See West Report*, *supra* note 1, at 44–47.

434. This is the approach taken by many Contractual Fund jurisdictions such as Germany. *See supra* parts III.B.1, VI.A.3.

This concept has many desirable aspects. Because of its focus on the forest rather than the trees, it would place the regulatory focus on the actual service being performed—the management of collective investment vehicles.[435] In particular, this approach would focus on the regulation of fund complexes rather than individual funds. Today, most mutual funds are members of one fund complex or another. Most fund complexes comprise a large variety of funds with different objectives and policies but are managed, administered, and distributed by a single central entity—an Investment Manager. Given the recent history of the increasing size and importance of fund complexes in the fund industry, mutual funds should be regulated from the point of view of the Investment Manager.

Because a fund complex concentrates on the total return of all the funds sponsored by it, rather than the performance of a single particular fund, this unitary approach would be more effective. This is especially the case where many mutual funds have a set of directors sitting across the complex or a group of funds (e.g., equity funds) of the complex. A conflict of interest problem may arise because the same directors are supposed to jointly determine fee rates and structures for "all" funds under their directorship.[436] Thus, we should develop a unitary approach to regulate Investment Managers, such as Fidelity, who operate fund complexes.

D. *Paternalism and Alternative Monitoring Arrangements*

The foregoing suggestions regarding the UFIC proposal were made from within the regulatory framework of the Investment Company Act and the Advisers Act. Yet it is possible to look beyond this framework and to draw lessons from the Contractual Fund Models for other monitoring arrangements. However, because the regulatory systems governing the Contractual Funds are often driven by different rationales from those underlying the Corporate Fund, it is necessary to examine

435. For a discussion of the regulation of mutual fund complexes, see Donald W. Glazer, *A Study of Mutual Fund Complexes*, 119 U. Pa. L. Rev. 205 (1970).

436. For instance, Fidelity has more than $200 billion in assets under management, and the number of Fidelity mutual funds is well over 200. The number of shareholder accounts exceeds 10 million, and the number of investment analysts and portfolio managers is in excess of 200. *See, e.g.*, *Keeping Both Hands in View*, Economist, Jan. 22, 1994, at 77–78; Geoffrey Smith, *What's Behind Fidelity's Riveting Results*, Bus. Wk., Nov. 22, 1993, at 68. For a discussion of the role of independent directors in mutual fund complexes, see, *e.g.*, Nutt, *supra* note 222, at 230–50.

such rationales before more fundamental reform measures can be considered.

1. *Paternalism and Governmental Supervision*

First, let us consider the role of paternalism in regulating mutual funds. In general, any legal rule that prohibits an action on the ground that it would be contrary to the actor's own welfare is paternalistic.[437] One primary justification for government paternalism is that the government knows better than investors. In contrast, many economists argue for contractual rule making in corporate law on the ground that government intervention is unlikely to improve investor welfare.[438] However, it is fair to say that governmental agencies, such as the SEC, may have better information about what would really promote the welfare of the investors than the investors themselves do, even though governmental agencies may have imperfect incentives.[439]

Paternalism takes many forms. Up to this point, this Article has focused primarily on paternalistic rules that mandate the structure and governance of mutual funds. The structure and governance of the Corporate Fund and the Contractual Fund represent two forms of paternalism on structural rules. Viewed from a contractual perspective, the Corporate Fund, by interposing a corporate democracy between the Adviser and the investors, is less contractual than the Contractual Fund because the Corporate Fund places more reliance on the semi-hierarchy. Thus, in this sense the Corporate Fund is more paternalistic than the Contractual Fund.

However, paternalism goes beyond structural rules. The Contractual Fund jurisdictions rely on another form of paternalism—the vetting system, or entry regulation. In most of the Contractual Fund jurisdictions, such as Japan and many of the European Community countries, licensing and authorization procedures restrict market entrance to only "fit and proper" applicants.[440] Of particular importance are the

437. *See* Anthony T. Kronman, *Paternalism and the Law of Contracts*, 92 Yale L.J. 763 (1983).

438. *See, e.g.*, Easterbrook & Fischel, *supra* note 157. For a useful summary of the debate on contractual freedom in corporate law, see Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 Colum. L. Rev. 1395 (1989).

439. For a discussion arguing for paternalism, see Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 Colum. L. Rev. 1703 (1989).

440. For instance, in the United Kingdom the primary role in the supervision of unit trusts is played by the Securities and Investment Board. The board is required to "vet" the unit trust scheme. *See* Vaughan, *supra* note 115, at 16–22.

requirements that the applicants demonstrate good repute, managerial expertise,[441] and adequate capital backing.[442] Rather than regulating how mutual fund contracts should be formed, the vetting system, in effect, decides who is qualified to enter into the mutual fund business.

The vetting system may be unduly paternalistic and subject to abuse and favoritism. For one thing, entry restrictions reduce competitive pressures and create monopoly rents for the existing participants. They also provide an incentive to the relevant governmental agencies to exchange such licenses for illegitimate favors. Moreover, entry restrictions raise issues of equity. The regulators must decide which of the many potentially qualified entities should be entitled to a license.[443]

The vetting system may nevertheless have relative advantages over the more open United States system in a wide variety of contexts. Because of the difficulty and costliness of presenting and assessing a full array of information about financial institutions, it may be more efficient for a supervisor to make his or her own judgments on the basis of qualitative assessment. Such judgments can be transferred to the market in the form of an approval, a license, or quality standards.[444]

For instance, as discussed above, the current United States system governing investment advisers, if applicable to Investment Managers of UFICs, is inordinately risky for investors. Because of the direct or indirect exposure to small investors, a possibility would be to impose some net capital magnitude as a requirement.[445]

In most Contractual Fund jurisdictions, both the Investment Managers and depositaries (or trustees) are subject to government supervision. In the European Community, the UCITS provides that the competent authorities should approve the Investment Manager and the choice of depositary,[446] and the depositary may not be replaced without the

441. UCITS Directive, *supra* note 366, at art. 4, para. 3 ("The competent authorities may not authorize a UCITS if the directors of the management company, of the investment company, or of the depositary, are not of sufficiently good repute or lack the experience required for the performance of their duties . . . .").

442. *Id.* at art. 5 ("A management company must have sufficient financial resources at its disposal to enable it to conduct its business effectively and meet its liabilities.").

443. In the United States, any person may sponsor a mutual fund provided it has the necessary seed capital of $100,000 and is not subject to statutory disqualification. Hence, it is not uncommon for individual entrepreneurs to enter into the mutual fund business. For one story on a mutual fund entrepreneur, see Seth Lubove, *Do It Yourself*, Forbes, Aug. 30, 1993, at 124.

444. *See* Page & Ferguson, *supra* note 54, at 38.

445. *See generally* Clark, *supra* note 356.

446. UCITS Directive, *supra* note 366, at art. 2, para. 2.

approval of the competent authorities.[447] The UCITS reflects the paternalistic spirit of Member States. For instance, in Germany, the appointment of the depositary requires approval by the German Federal Banking Commission. The Commission may under certain circumstances order the appointment of a new depositary.[448] In the United Kingdom, the trustee may only retire when a replacement has been appointed by the manager by means of a supplementary deed. In addition, notice of the proposed changes must be sent to the Board. Effect can be given to the proposed changes upon board approval or if the board fails, within one month, to give notice of its refusal to approve the changes.[449]

Although regulatory supervision may be unduly paternalistic, it may be justified for investor protection. For instance, regulators may be able to facilitate the coordination of the multiple contracts that constitute the mutual fund.[450] Since a mutual fund consists of an interlocking web of contracts among the Adviser (or the Investment Manager), the Investors, and the Monitor, everyone may find it easier to contract against a set of fixed background rules. For instance, investors, at the time they determine whether to invest in a particular mutual fund, may care about the terms governing the Investment Manager-Monitor relationship and the extent to which those terms are modifiable. If all the terms in the contract are negotiable, then investors must deal with contingencies introduced by this contractual uncertainty. Some terms are more central to the investors' concerns, specifically, those concerning the professional qualifications of the Investment Manager and the Monitor. Regulators therefore can reduce the costs of drafting the management contract.[451]

Another form of paternalism that would influence the structure of mutual funds is self-regulatory organization (SRO) for mutual funds. The term "self-regulation" includes a broad range of subjects, including self-certification, use of independent auditors, and an industry-sponsored oversight group.[452] The SEC published its most recent proposal in

447. *Id.* at art. 4, para. 4.

448. Butler & Thoma, *supra* note 99, at 1604–05.

449. Vaughan, *supra* note 115, at 38.

450. A mandatory term may reduce the costs of drafting the corporate contract and facilitate coordination. *See, e.g.*, Kornhauser, *supra* note 164.

451. Contract law itself protects third-party beneficiaries of contracts from subsequent modification of the promisor's duties. *See* E. Allen Farnsworth, *Contracts* § 10.8, at 768–77 (2d ed. 1990).

452. For instance, in the United Kingdom the self-regulation contemplated by the Financial Services Act of 1986 is now in place. The Financial Intermediaries Managers and Brokers

1983.[453] This proposal does not contemplate a true SRO, but rather a private entity to conduct investment company examinations. Currently, the U.S. does not have a strong SRO to assume the inspection and monitoring responsibilities or to police economic regulations such as fees.[454]

2. Alternative Monitoring Arrangements

Obviously, even the most paternalistic regulator cannot be an effective substitute for a Monitor in the Adviser-Investor bilateral relationship. The question, then, is what type of monitoring arrangements can best serve the Investors' needs? Recall that the Corporate Fund employs a board of directors as the Monitor, while the Contractual Fund uses an institutional monitor such as a depositary or a trustee.

The machinery of a mutual fund's board of directors, of course, is derived from ordinary corporations, such as publicly-held industrial corporations.[455] Because the board has to make many business decisions day in and day out, it is characterized by the breadth of its discretionary power.[456] One primary advantage of the board is that, through a collective decision-making process, a small group of individuals can make informed and deliberated business decisions, especially strategic decisions.[457] Another advantage is that different constituencies of the corporation, such as labor, shareholders, suppliers, and lenders, can have representation on the board.[458] Thus, the device of the board of directors may serve ordinary industrial corporations well.

Regulation Association (FIMBRA) is the one that is most relevant to mutual funds. *See World's Investment Fund, supra* note 50, at 88.

453. Concept of Utilizing Private Entities in Investment Company Examinations and Imposing Examination Fees, Investment Company Act Release No. 13,044, 48 Fed. Reg. 8,485 (Mar. 1, 1983).

454. *See West Report, supra* note 1, at 78–81. The foregoing discussion is not intended to be the definitive statement on the role of paternalism and government supervision in regulating mutual funds. My view is that paternalism may have relative advantages over market forces in a variety of contexts. Therefore, both theorists and regulators ought to face up to this point and then see what headway, if any, can be made in devising principles for setting the optimal mix.

455. 1 Harold Marsh, Jr., *Marsh's California Corporation Law* § 8.1, at 401–02 (2d ed. 1983) ("A corporation requires some form of government, as does any entity composed of individuals. The government of a corporation is generally entrusted to a board of directors comprised of the elected representatives of the shareholders.").

456. This explains why most decisions of the corporate board are protected under the business judgment rule. *See supra* notes 236–39 and accompanying text.

457. Kenneth R. Andrews, *From the Boardroom: Rigid Rules Will Not Make Good Boards,* Harv. Bus. Rev., Nov.–Dec. 1982, at 34, 44.

458. For a discussion of the composition of the board, see, *e.g.,* Williamson, *supra* note 19.

However, these advantages are not present in the context of the board of directors of the Corporate Fund. For one thing, due to the specialized nature of fund management, there is no place for the board to make strategic decisions. Moreover, because the mutual fund involves a comparatively simple relationship and its investors have minimal exposure to lock-in effects, few investors or other constituents would seek representation on the board. This is especially the case for a Contractual Fund such as the UFIC, where the board's role is limited largely to monitoring agency problems.

With the adoption of the simplified fee structure, the UFIC's board would exercise substantially less discretionary power than the board of the Corporate Fund. Because the UFIC would not benefit from the machinery of the board of directors, a trust form may better suit the UFIC. For some enterprises in the United Kingdom and the United States, the business trust has been used in preference to corporate and other forms of business entities.[459] How does the trust form operate in the case of the UFIC?[460] The various functions that are assigned to directors in the Corporate Fund can be handled by direct requirements in the contractual documents (e.g., trust indenture). In addition, UFICs would not be able to engage in activities that rely on rules or exemptive orders conditioned on the trustee's oversight (as the Corporate Fund would under the board's oversight).

The most obvious means of replacing the independent directors would be to substitute a trustee or custodian for them, in much the same way that a "depositary" is used in the UCITS. Under the UCITS Directive, a fund's depositary is required to act in a general oversight capacity for all fund operations.[461] Similarly, the UFIC can use a financial institution as its trustee. The role played by the trustee or depositary of the Contractual Fund may be analogized to that of an indenture trustee.[462]

459. Generally speaking, the concept of split ownership is used with some frequency in common law countries to facilitate investments in a variety of forms, including the unit trusts in the United Kingdom and the real estate investment trusts in the United States. Recognition and use of business trusts and similar concepts in civil law countries is limited, but appears to be growing. *See generally* Emmanuel Gaillard & Donald T. Trautman, *Trusts in Non-Trust Countries: Conflict of Laws and the Hague Convention on Trusts,* 35 Am. J. Comp. L. 307 (1987).

460. It should be noted that business trusts can be treated in the same way as corporations. After all, legal identity means only that the segregated assets have a name or are identifiable as a distinct corpus so that the assets may transact and be recognized as an independent pool of assets.

461. UCITS Directive, *supra* note 366, at art. 7.

462. For a discussion of the trustee's adequate powers to protect the bondholders, see *Tenth Annual Report of the Securities and Exchange Commission* 153–55 (1944).

What are the benefits of an institutional monitor such as a trustee? Admittedly, many independent directors of the Corporate Fund are well-known personalities with considerable potential reputational losses to bear. However, compared to individual directors, an institutional monitor's reputational loss from "mismonitoring" will normally outweigh that of a natural person. The financial institutions that serve as trustees are long-lived and stand to lose a great deal of future business if their reputations are tarnished by negligent behavior.[463] As such, it is easier for investors of the UFIC to price the reputation of the trustee.

E. *Concluding Remarks: The Case for Organizational Competition*

After fifty years of dealing with the Act, people have come to accept the required model as the natural scheme of things for mutual funds. However, absent regulation, the organizational structure that will survive in business activities will be the one that delivers the product demanded at the lowest price while covering costs.[464] The available evidence suggests that it is advisable to reexamine the Act's "one structure fits all" approach to mutual fund governance.

For one thing, even a casual inspection of alternative arrangements prevalent in other jurisdictions suggests that the Corporate Fund Model may not be an efficient organizational form for mutual funds. Throughout the world, the requirement that mutual funds be organized and governed as if they were free-standing corporations is the exception rather than the rule. In Europe, Japan, and the rest of the world, the corporate form of mutual fund is in a decided minority compared to a contractual form of organization.[465]

Moreover, even in the United States, it is only for mutual funds and closed-end funds that the Corporate Fund Model is required. Where it is not required, it is hardly ever chosen by the Sponsors. For instance, outside the Act's jurisdiction, banks' collective investment funds and commodities' pooled assets vehicles have avoided the corporate structure.[466] Admittedly, the mutual fund industry has substantially

463. Presumably many trustees would engage in similar dealings with other customers, and news of a trustee company that makes mistakes would spread rapidly to future customers as well. *See* Klein & Leffler, *supra* note 340.

464. Fama & Jensen, *supra* note 205.

465. *See supra* part III.B.

466. *See generally* Donald W. Smith & Marie J. Lilly, *Legal Overview of Bank-Managed Investment Funds*, paper presented at Virginia Bankers Ass'n Trust Employee Benefits Seminar (Sept. 11, 1990).

"practiced around" the Corporate Fund Model to minimize the adverse effects of the structural constraints. For instance, boards of directors have seldom intervened in the overall management of mutual funds or terminated advisory contracts.[467] Nevertheless, because the industry cannot contract around all the legal constraints imposed by the Act, the structure and governance of the Corporate Fund still leaves much to be reformed.

From a theoretical perspective, an organization is inefficient if there is another organization that would be superior for each person on average across the circumstances in which the organization operates.[468] It has been argued that mutual funds have prospered under the current regulatory system and have not experienced the abuses that have recently plagued other financial institutions.[469] The force of this argument is undermined, however, by the example of the Contractual Fund, which has worked reasonably well throughout the rest of the world. For instance, the favorable history of investor protection in the United States has also been enjoyed in the United Kingdom.[470] Without economic natural selection, it is premature to assume that the Corporate Fund is the superior organizational structure because the U.S. mutual fund industry has a reputation for integrity.

In this globalized economy, the appropriate type of regulation can no longer be determined without carefully considering the regulations imposed by competing states.[471] Competition exists not only among products but also among governance systems.[472] This heightened international competition has required the Corporate Fund Model to

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467. For the role of the board in mutual fund management, see *supra* notes 290–305 and accompanying text.

468. *See* Milgrom & Roberts, *supra* note 155, at 24.

469. *See SEC Report, supra* note 12, at 265. For a discussion of abuses that have plagued banking institutions, see Kenneth E. Scott & Barry R. Weingast, *Banking Reform: Economic Propellants, Political Impediments* (1992).

470. In reviewing the mutual fund industry in the United Kingdom, a renowned legal scholar once commented that the British unit trusts have a "scandal-free operation." L.C.B. Gower, *Review of Investor Protection: A Discussion Document*, para. 8.18 (1982).

471. For a discussion of international regulatory competition, see, *e.g.*, Joel P. Trachtman, *International Regulatory Competition, Externalization, and Jurisdiction*, 34 Harv. Int'l L.J. 47 (1993).

472. *See, e.g.*, Statement of the Business Roundtable, *Corporate Governance and American Competitiveness: March, 1990*, 46 Bus. Law. 241 (1990) (discussing the competitiveness of business organizations).

compete with various forms of the Contractual Fund operating in other jurisdictions.[473]

One example of a regulatory regime which fosters organizational competition is that adopted by the European Community. There, the effort to promote the internationalization of mutual fund markets resulted in the UCITS Directive.[474] The UCITS Directive prescribes a common denominator approach to protecting investors in mutual funds qualifying as a UCITS.[475] For instance, article three of the UCITS Directive provides that a UCITS may be constituted either under the law of contract (as common funds managed by management companies), under the law of trust (as unit trusts), or under statute (as investment companies).[476] Each Member State must adopt domestic legislation to implement the UCITS Directive, but each is free to choose a form and method of implementation consistent with its legal system.[477]

In addition to reforming the current governance structure of the Corporate Fund, the SEC should permit the UFIC as an optional form of mutual fund. Because the UFIC would not be mandated, but would be an optional form of organization, it would introduce to an already complex market a vehicle that departs in significant respects from the current mutual fund model. In France, for example, both the Corporate Fund Model and the Contractual Fund Model are permitted.[478] We should likewise permit experimentation and innovation in the choice of organizational forms so that more efficient forms of mutual funds can be developed.

473. *See generally SEC Report, supra* note 12, at 185–91.

474. *See* UCITS Directive, *supra* note 366.

475. A UCITS from one European Community Member State may sell its shares in any other Member State, subject only to the host country's marketing, advertising, and tax laws. For a discussion of the common denominator approach, see David Reid & Andrew Ballheimer, *The Legal Framework of the Securities Industry in the European Community under the 1992 Program*, 29 Colum. J. Transnat'l L. 103, 132–36 (1991).

476. UCITS Directive, *supra* note 366, at art. 1, para. 3.; arts. 5–11 (setting forth obligations regarding the structure of unit trusts); arts. 12–18 (setting forth obligations regarding the structure of investment companies and their depositaries).

477. *Id.* at arts. 1–4.

478. Francoise Delavenne, *Open-End Mutual Funds in France*, in *Funds and Portfolio Management Institutions: An International Survey* 131 (Stefano Preda ed.) (1991). In France the Contractual Fund, called SICAV, seems to be the more popular form of mutual fund. *Id.*

VII. CONCLUSION

This Article has attempted, from within the law-and-economics tradition, to evaluate the structure and governance of the Corporate Fund and the Contractual Fund from a comparative institutional perspective. The fundamental structure of the mutual fund can be defined as a trilateral arrangement consisting of the Adviser, the Investors, and the Monitor. The Corporate Fund and the Contractual Fund represent two solutions to the problems of coordination and motivation. As intermediate forms of business organizations, the Corporate Fund is more centralized and the Contractual Fund more decentralized in decision-making functions. Based on the lessons drawn on this framework, the following normative observations seem warranted.

In the case of the Corporate Fund, the board of directors often lacks either true independence or an informational advantage over many investors, especially institutional investors. As such, the centralized control mechanism—a semi-hierarchy—leads to significant transaction costs such as influence, intervention, and collective decision-making costs. With respect to specific responsibilities, the board has not been effective in negotiating performance-related terms (e.g., fees) for investors. In this respect, fiduciary duties on management fees and other payments which are policed by shareholder suits do not adequately address the thorny issue of who monitors the monitor. On the other hand, the board does play an effective role in scrutinizing operational transactions that are significantly redistributive in nature. In addition, the board's discovery and corrective watchdog functions are desirable. Therefore, we should guard against placing too much reliance on the board's discretion.

In this respect, the SEC Report's recommendations to reform the Corporate Fund, if adopted, would markedly streamline and improve the current corporate structure. However, even as amended, the Corporate Fund Model would still place too much reliance on the effectiveness of the board of directors and shareholder voting. For instance, without specific decision-making rules, the authority of directors (including independent directors) to terminate the advisory contract could lead to an abuse of the board's power. With respect to shareholder voting, although issue voting may be desirable in some situations (e.g., to vote on proposals that significantly alter the nature of the mutual fund), election voting serves little practical purpose in the mutual fund context.

To summarize, the board of directors of the Corporate Fund functions not only as the Monitor but also as the Coordinator of the mutual fund.

As a matter of institutional design, this active model can both undermine organizational efficiency and put the legitimacy of the corporate democracy into question. Admittedly, the mutual fund market has "practiced around" many of the Corporate Fund's undesirable legal constraints.[479] However, because the Corporate Fund represents a poor allocation of coordinating and monitoring functions among the trilateral parties, its structure might still be economically inefficient. Therefore, we should take off the "corporate governance blinders" and look afresh at alternative models.

In the case of the Contractual Fund Model, a conceptual analysis suggests that its structure is fundamentally sound. Combining the functions of the Sponsor, the Advisor, and the Investment Manager can coordinate a mutual fund's essential operations without going through a pre-approval mechanism such as the board. To minimize post-contractual opportunism, the contractual governance regime adequately motivates the Investment Manager with economic incentives and enables investors to evaluate mutual fund performance more effectively. To the extent there are contractual failures (e.g., serious conflicts that are not readily monitored by the Investors), the Contractual Fund interposes depositaries or trustees to perform more limited monitoring functions, which may result in lower transaction costs.

This Article also considered two Contractual Fund proposals—the Unitary Investment Fund (UIF) and the Unified Fee Investment Company (UFIC). The UIF proposal should be rejected because it provides no effective substitute for the oversight of the board of directors. On the other hand, the UFIC proposal has merit, not only because competitive forces would provide adequate discipline with respect to its simplified fee schedule, but because the Investment Manager would be better motivated to coordinate a mutual fund's operations than the board would be. Because governance protection would still be retained for matters other than fees, the UFIC is an efficient hybrid between the Corporate Fund and the Contractual Fund.

The UFIC proposal can be improved in the following ways. First, since the performance of a mutual fund is a unitary concept, investors should be allowed to evaluate for themselves not only unified fees but also quality of services. Second, because risk assessment is an essential

479. As Romano argues, the most important lesson to be drawn from comparative institutional study is that "private parties are quite resourceful in adapting their affairs to minimize the adverse effects of regulation." Roberta Romano, *A Cautionary Note on Drawing Lessons from Comparative Corporate Law,* 102 Yale. L.J. 2021, 2022 (1993).

element of mutual fund investment, the Investment Manager should be required to disclose the risk level of the mutual fund. Third, in light of the significant role that the Investment Manager plays in a UFIC, it is desirable to establish a regulatory scheme that focuses on the Investment Manager's conduct and financial soundness. Finally, if we look beyond the current regulatory framework and obtain further guidance from Contractual Fund Models, alternative monitoring arrangements should be considered. One possibility is to replace the UFIC's board of directors with institutional monitors such as a trustee.

The most important consequence of a collective investment fund being subject to the Act is the requirement that it adopt a corporate form of governance. As the experience in the European Community demonstrates, this "one structure fits all" system is open to challenge. Admittedly, whether the UFIC proposal is more efficient than the current Corporate Fund Model is an empirical question which cannot be answered without putting the UFIC proposal into actual practice. Given that the Corporate Fund incurs significant transaction costs, alternative structures should be considered. The Contractual Fund offers a fitting alternative because it is conceptually sound and has been successfully implemented in many jurisdictions. Therefore, as a modified version of the Contractual Fund, the UFIC proposal should be implemented to promote organizational competition with the Corporate Fund.