Conflicts of Interest

Corporate Governance and Financial Markets

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KLUWER LAW INTERNATIONAL

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CENTRE DE DROIT BANCAIRE ET FINANCIER

Published by:
Kluwer Law International
P.O. Box 316
2400 AH Alphen aan den Rijn
The Netherlands
E-mail: sales@kluwerlaw.com
Website: http://www.kluwerlaw.com

Sold and distributed in North, Central and South America by:
Aspen Publishers, Inc.
7201 Mc Kinney Circle
Frederick, MD 21704
United States of America

Sold and distributed in all other countries except in Switzerland by:
Turpin Distribution Services Ltd.
Stratton Business Park
Pegasus Drive, Biggleswade
Bedfordshire SG18 8TQ
United Kingdom

Sold and distributed in Switzerland by:
Schulthess Médias Juridiques SA
Zwingliplatz 2, Postfach
CH-8022 Zurich
and
21, rue du Mont-Blanc
CH-1201 Geneva

This book is part of the 'Publications du Centre de droit bancaire et financier' series.

ISBN 90-411-2578-7

ISBN 978 3 7255 5332 7

www.schulthess.com

Chapter 12

United States Mutual Fund Investors, Their Managers and Distributors

*Tamar Frankel**

The concept of conflicts of interest is rich, varied and complicated. Mutual funds provide a prime example of conflicts of interest issues and will be the focus of this paper. The parties are public investors in mutual funds, managers of mutual funds and distributors that sell mutual fund shares and trade in the funds' portfolios. The issues are difficult because each party can justify its claims, and public policy supports each claimant. Thus, everyone can be right, but the results of the claims of at least two parties can be completely wrong. The ultimate victims of conflicts of interest in this case are mostly the shareholders of mutual funds and the financial system as a whole. And even though the problems are not new and many solutions have been tried, none of the solutions has lasted.

This paper is divided into five sections. Section 1 deals with the nature of conflicts of interest – what they mean and when they matter. Section 2 provides an overview of mutual funds and their promoters. Section 3 discusses how mutual fund managers' relationships with distributors pose serious conflicts of interest in their relationships with investors. Section 4 examines the models and theories on which the parties base their claims. The final section, Section 5, discusses possible ways of addressing conflicts of interests between mutual funds managers and distributors and the interests of the investing shareholders. The conclusion suggests that, without an appropriate strong culture of honesty, none of the solutions will work over time.

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L. Thévenoz and R. Bahar (eds.), *Conflicts of Interest: Corporate Governance and Financial Market*, pp. 363–394.

I. CONFLICTS OF INTEREST IN THE UNITED STATES: WHAT THEY MEAN AND WHEN THEY MATTER

Not all conflicts are wrongful. People's interests can complement each other, be identical or conflict. But only a certain kind of relationship gives rise to legal issues. The category in which wrongful conflicts of interest arise in the mutual fund area is the category of fiduciary law. It is when fiduciary law arises that conflicts of interest are wrongful.

A. When Does Fiduciary Law Arise?

Fiduciary law arises when:

- One party (the fiduciary) undertakes to provide services to another (the entrustor), and
- Public policy values the services.
- The entrustor entrusts property or power to the fiduciary. For example, an agent is entrusted with the power to bind the principal to legal obligations. A trustee is entrusted with the trust assets and the discretion (power) to manage them. Corporate management is entrusted with insider information regarding the affairs of the corporation.
- Most importantly, the entrustment is for the purpose of allowing the fiduciary to perform its services more efficiently.[1]

For example, a lawyer is entitled to his fees under a contract with the client. However, to perform his services, the lawyer must have the power to represent his client in court and in many cases to bind the client to legal obligations. A physician is entitled to a fee under a contract with the patient. However, to perform his service, the doctor is entrusted with the patient's health and well being, and at times with control over the patient's body. The purpose of the entrustment is to enable the physician to perform his services more effectively.

The fundamental point in fiduciary law is that the entrusted power or property never belongs to the fiduciary. The entrustment is not made in exchange for the services or for anything else. It is made for the purpose of benefiting the entrustor. Sometimes the benefit is exclusive, as when the money manager receives the investor's savings to manage. Sometimes entrustment may be shared, as in the case of a partnership, where each partner has an undivided interest in the partnership assets and the power to bind the partnership as a whole. Often the entrustor takes the action as a result of the fiduciary's advice, as in the case of a subscriber to an investment advisory letter. But there is always the principle that the entrusted power or property is not given as an exchange but is given for the benefit of the entrustor. Ownership remains with the entrustor.

Thus, fiduciary law recognizes a split ownership. To the rest of the world the fiduciary may be the owner of the property, as the money manager is. He can

1. T. Frankel, 'Fiduciary Law' (1983) *California Law Review* 71, 795–836.

therefore deal freely with the property, even in violation of his duties, and the public has no right to know whether he is the true owner or not (unless there is clear notice). But *vis-à-vis* the entrustor, the fiduciary has no rights to the entrusted property or power. This is why an entrustor who entrusts property to the fiduciary is called the 'beneficial owner.' The benefits from the property, though not the control of the property, belong to the beneficial owner.

For a number of reasons, the entrustor is vulnerable to abuse of the entrusted power or property. The fiduciary receives the entrusted power and property first. It is only then that he begins to perform the promised services. Thus, the entrustor gives first; the fiduciary gives (services) later. By definition, the transfer to the fiduciary is not a simultaneous exchange.

- It is highly costly to monitor, verify and ensure that the fiduciary will indeed abide by his promise and deal with entrusted power or property only for the benefit of the entrustor. Not only is the fiduciary entrusted with power or property in advance, but also he usually has expertise that the entrustor lacks. Therefore, the entrustor must take a significant risk of loss in the relationship. In fact, the cost to the entrustor may exceed the expected benefits from the relationship.
- Market monitoring and enforcing the fiduciary's obligations is ineffective, either because of the costs to entrustors or because fiduciaries do not compete on particular aspects of their services and usually because revelations about the abuse of trust by fiduciaries can be well hidden. After all, fiduciaries receive the power or property voluntarily.
- The results of the services are not always related to the honesty of the fiduciary or the quality of the services. For example, the physician may be an expert, but the patient can still die. The money manager may be honest, but the value of the portfolio may fall as the result of unrelated political events.
- The cost to the fiduciary of proving his trustworthiness is very high, and can exceed the compensation and other benefits from the arrangement.

In sum, fiduciary duties arise when the costs to the entrustor on the one hand, and the costs to the fiduciary on the other hand, are too high to induce both parties to interact.

The strictness of fiduciary duties depends on the magnitude of the conditions in which fiduciary relationships arise. The duties of the fiduciary reflect the magnitude of the entrusted power or property, the cost of monitoring the honesty of the fiduciary, and the cost to the fiduciary of guaranteeing that honesty. For example, the fiduciary duties of an agent who acts under the close supervision of the principal are lower than the duties of an agent that has broad discretion, far from the principal's reach. The duties of an adviser to the subscribers of his advisory letters are lower than the duties of an adviser that controls and manages the client's assets. The duties of a manager of a mutual fund, whose investors can sell or redeem their shares, are lower than those of a trustee that can be removed only by a court. Thus fiduciary duties are calibrated. A fiduciary's conflict of interest is dangerous because, by definition, the entrustor will not have full control over the use of the entrusted property or power. If the entrustor does not cede control, the very utility of the relationship will be undermined. However, the greater the degree of control the entrustor has over the decision regarding his power or assets, or over the fiduciary, the more the entrustor can fend for himself. Hence, the duties of the fiduciaries will depend on the degree to which the entrustor can fend for himself.

Fiduciary duties may be imposed even before the parties enter the relationship. Because in each of these cases the parties start the negotiations with an anticipation of a fiduciary relationship, fiduciary rules may apply, even before the parties reach the agreement to interact. A client or a patient who anticipates a fiduciary relationship starts the negotiation with an understanding of the nature of the relationship and the inherent entrustment that it will involve.[2] Lawyers and physicians as well as other fiduciaries are interested in creating the image of trusted persons, far more than the parties involved in sales or manufacturing. The thrust of fiduciary services is the entrustment of power and property in advance for the purpose of benefiting the entrustor.

It is important to note that the inability of entrustors to protect themselves does not arise from their lack of sophistication or other inherent weakness. Rather, the weakness stems from the very nature of the relationship. If entrustors attempt to control the fiduciaries in order to protect themselves, the very utility of the relationship will be undermined. The entrustors might not be able to monitor the investment manager for lack of expertise. Even if the investors have the expertise, the monitoring will deprive the investors of time to engage in other functions. Investors might as well manage their property themselves and save the fees. Thus, fiduciary duties are linked to a social structure that values specialization of talents and functions.

The remedies for breach of fiduciary duties include accounting. Because the fiduciary relationship results in 'beneficial ownership' that remains vested in the entrustor, the remedies for wrongful benefits reaped by the fiduciary include accounting for the ill-gotten profits. Thus, not only damages for breach of promised obligations but also accounting for the misappropriated power or property and any profits from such appropriated power or property rightly belong to the entrustor.

2. Advisers who charge fees that are significantly higher than the fees normally charged by other advisers may violate para. 206 of the Advisers Act. See, e.g., *Anthony Belmonte*, SEC No-Action Letter, 1993 SEC No-Act. LEXIS 930 (13 August 1993) ('The staff believes that an investment adviser that charges a fee for its services that is larger than that normally charged by other advisers [taking into consideration factors such as the size, location and nature of the advisory businesses to be compared] has a duty to disclose to its clients that the same or similar services may be available at a lower fee'); *Shareholder Servs. Corp.*, SEC No-Action Letter, 1989 SEC No-Act. LEXIS 159 (3 February 1989) (similar; stating staff belief that 'whether a particular fee violates section 206 depends upon whether the fee is reasonable in relation to the services provided, which necessarily involves examining the facts and circumstances surrounding a particular adviser/client relationship'); *Berkman Ruslander Pohl Lieber & Engel*, SEC No-Action Letter, 1977 SEC No-Act. LEXIS 68 (6 January 1977) ('Depending upon the specific circumstances, an annual fee of 3% of the portfolio value may require that the adviser make such disclosure').

Similarly, if the fiduciary becomes bankrupt, the entrusted property does not become part of the trustee's estate. The beneficiaries can claim the entire property, rather than become unsecured creditors of the estate in the bankruptcy proceedings.

1. The Issue of the Fiduciaries' Fees

When the entrustors establish the relationship with the fiduciaries, they can bargain at arm's length. Even then, the proposed relationship is based on an assumption that the entrustors can rely on the fiduciaries if the fiduciaries hold themselves out to provide trust services, such as lawyers' advice. In any event, even if an arm's-length bargain is reached before the entrustment of the power or property, after the entrustment the nature of the relationship changes into a fiduciary relationship. The fiduciary holds the entrustors' money or power and any further amounts that the fiduciary charges are far more within his control. At that point, even if the fiduciary renegotiates the contract terms, the bargain is not at arm's length. The fiduciary holds the entrusted power or property and the entrustors are at his mercy, and may not even have the information needed to conduct an arm's length bargain. Thus, often, in the case of millions of mutual fund shareholders, there is no negotiation. The fiduciaries hold the power to determine how much their services are worth, and how much they worked and how much compensation they deserve. The entrustors do not have the information and cannot bargain or fend for themselves.

2. The Contest of Categories

We categorize information to put our thoughts in order. The main images of categories must remain clear even if the categories are foggy at the fringes. U.S. fiduciary law is a common law-based category, which differs from the contract category. To the best of my understanding, fiduciary law is not recognized in the civil law system. And yet, both the civil law contract and fiduciary law address the same problems. Not only that, but both are guided by similar principles and policies and reach very similar results, except for the type of remedies that they provide for conflicts of interest. In fact, the different remedies they provide signal their fundamental difference.

The source theories of fiduciary law and the civil law contract are fundamentally different. Fiduciary law derives from the category of property. Civil law is contract-based. The following guidelines may help define fiduciary law.

Some academics in the United States have argued that fiduciary law is a branch of contract law. These scholars deny the necessity of a separate category of fiduciary relationship. Every consensual relationship is contractual, they argue, and these relationships form a special situation in contracts. Most scholars and courts, however, do not deny the existence of fiduciary law as a category. They do, however, water down the substance of fiduciary duties and think in terms of contracts.[3]

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3. See e.g., T. Frankel, 'The Seventh Circuit Decision in Wsol v. Fiduciary Management Associates and the Amendment to Rule 12b-1' (August 2004) *Investment Lawyer* 11, 14; the court treats

Despite the arguments, a number of clear differences exist between contract and fiduciary relationships.

First, in contract, the money that the entrustor-investors hand over to their managers becomes the property of the managers, subject to the managers' contractual promises to behave according to the explicit and implied provisions of the agreement between the parties. Under such contracts, the entrustor-investors hand over their money at the outset of the relationship, and are promised payment from the gains, or offset against the losses. While the money is owned by the managers, the investment risks are borne by, and gains will be paid to, the entrustor-investors.[4]

Second, in contrast, the courts might presume that the parties have agreed upon terms and duties similar to those of fiduciary rules, unless the entrustor-investors explicitly waive these duties.[5] The duties, however, are not duties established by law, but obligations stemming from the contract.[6]

Third, contract does not recognize the remedy of accounting. It does include somewhat similar remedies, but none is based on the notion that entrusted power or assets continue to belong to the entrustor.

3. The Prohibition on Conflicts of Interest

In contract, conflict of interest is assumed, understood and accepted. The contract image is that of an exchange. Conflicts of interest exist in all exchange transactions. Each party has interests which conflict with those of the other parties. For example,

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fiduciary law as contract law and holds that investors cannot complain if they pay 'market price' brokerage fees regardless of the actual brokerage charges.

4. It should be noted that if the investors' money is given as a loan, the debtors are not fiduciaries. The reason for this is because the contract can be designed to protect the lenders. Which is why the debtors can do with the money whatever they choose, subject to the terms of the contract among the parties. If the parties' bargaining powers are not balanced, particular provisions of the law are in place to protect them, when there is a public policy to encourage the parties' interaction. For example, public policy is designed to encourage people to use banks and insurance companies. Therefore, even though banks and insurance companies are debtors, they are required by law to conduct their business in such a way as to ensure that they will abide by their promises. Thus, even though banks and insurance companies are debtors, the law interferes to protect the creditors (depositors) and makes the conflicts of interest of the debtors acceptable. Similarly, when the investing public is the creditor and large institutions are the debtors, such as when large corporations issue bonds, the law imposes on the debtor's duties that protect the public by requiring the debtors who issue bonds to make certain disclosures. A similar distinction is made in corporate law. The corporation and the directors owe a fiduciary duty to the shareholders—holders of equity, but not to the debtors—holders of corporate bonds.
5. D.R. Fischel and F.H. Easterbrook, 'Contract and Fiduciary Duty' (1993) *Journal of Law and Economics* 36, 425–446.
6. In fact, before 1940, many investors asked wealthy people to take their money. The investors assumed that the wealthy people, who made money for themselves, would also make money for the small investors. This, however, did not happen. The wealthy people instead found ways to reap benefits from the small investors' money. For example, the small investors received non-voting types of securities. They did not receive equal profits and had no say in the division of the profits. The courts were unsympathetic. After all, the investors knew what they were buying, and the wealthy, controlling persons had no duty to meet the investors' expectations.

the buyer wants to pay less and the seller wants to be paid more. But this conflict of interest does not necessarily prevent people from interacting in an exchange. That is because their conflicts are not as strong as their mutual interest in interacting. Thus, the desires of the buyers to buy are stronger than their desire to pay less; and the sellers' wishes to sell are stronger than their desire to be paid more.[7]

The question of whether the parties should help each other in making the decision to enter the transaction involves the question of whether the 'help' is against the parties' own interests or in furtherance of their interests. Should the seller tell the buyer that the same item is sold for less in another shop across the street? Should the seller be prohibited from telling the buyer a lie, for example, that the item is of a higher quality? To what extent should each party volunteer information that is useful to the others? To what extent should each be responsible for the other's welfare? In reality, the parties may indeed help each other, for example, to establish the reputation of trustworthiness and fairness. But that is not the question. The question is whether the law requires contract parties to take care of each other's interests.

In the United States, contract law answers these questions more or less in the following manner: each party is responsible for its decision. No party is required to volunteer information unless the other party asks for it. No party is required to care for the other party's welfare. If asked, a party may refuse to answer. But if a party decides to answer, the answer should be the truth.[8] Numerous statutory laws change this basic rule. Consumer protection laws require one party to give the other certain information, often in writing.[9] The buyers of securities and corporate shareholders are entitled to full and detailed information, as specified in securities laws and corporate law.[10] But unless the statutes require, the assumption is that the parties can and should fend for themselves. The sellers may remain silent, unless their silence is misleading in the context of their relationships or the environment. They need not negotiate with the other party's interests in mind.

Thus, in exchange situations the conflicts of interest are quite clear, and each party is expected to fend for itself. In some relationships, however, within the

7. What happens in actual situations is far more complex than this bare-bones simplistic description. Often the sellers' consent to be paid less is contingent upon the promise of future benefits (e.g. receiving more work). In some cases, the consent of the buyers to pay more depends on their degree of need for the item. Each party may view the importance of the transaction differently. Each may value the collaboration and the transaction differently. As long as each party is capable of making an independent and free decision, the law will enforce the bargain. Of course, the words 'capable of making its decision' and 'free decision-making' are open to different interpretations.
8. E.A. Farnsworth, *Farnsworth on Contracts* (3rd edn, Aspen, 1990), 1:§4.9, at 465, stating that society has an interest in avoiding misleading information, notwithstanding the rule.
9. See, for example, J.C. Pendergrass: 'The Real Estate Consumer's Agency and Disclosure Act: The Case Against Dual Agency,' (1996) *Alabama Law Review* 48, 291, no. 80, which states 'Though the doctrine of caveat emptor applies to the sale of used residential real estate in Alabama, see *Hays v. Olzinger, 669* So. 2d 107, 108 (Ala. 1995), a real estate broker has a duty to disclose a home's defects to a buyer where there is a fiduciary or confidential relationship between the broker and the buyer, see *Cooper & Co. v. Bryant*, 440 So. 2d 1016, 1019 (Ala. 1983).'
10. 15 USC §77e (2000).

exchange context or outside it, one party is expected and required to deal in the interests of the other party, and the other party is entitled to rely on that requirement. Conflicts of interest in such situations acquire a different meaning and are subject to very different rules.

Fiduciary conflict of interest is not assumed, is not understood, and is certainly not accepted. The very purpose of the entrustment is to benefit parties other than the fiduciary. Some fiduciaries are paid for services but must hold the power or property entrusted to them for the benefit of the entrustors. But some fiduciaries are not paid, and yet, if they have been entrusted with valuables for the purpose of serving the entrustors they may not benefit from the entrusted valuables. For example, if I give my neighbour USD 100 to buy groceries for me and he accepts, he is my fiduciary with respect to the USD 100. If he bought groceries for less, the rest of the money is mine, not his. That is so even if he did not benefit from the relationship.

Because the relationship can involve degrees of control by the other party, the prohibited conflict of interest is calibrated accordingly. When the fiduciary has full control and the beneficiary has no actual and legal power to control the fiduciary, as is the case of private trusts, conflict of interest is fully prohibited under fiduciary law.[11] When the fiduciary has partial control, conflict of interest rules may switch to contract, to the extent that the entrustor could have monitored and prevented the conflict. Fiduciary law was never precise. Perhaps the law was never meant to be precise. The imprecision can bar fiduciaries from gaining, but it also creates a self-enforcement mechanism. It does not lend itself to a cost-benefit analysis but rather to a knee-jerk reaction to a constant question: 'Am I in a conflict of interest?'

In sum, fiduciary law requires that the interests of the entrustors be paramount. The fiduciaries must suppress their own interests and the temptations to further their interest or the interests of parties other than the entrustors. That is the understanding. In this context, conflict of interest acquires a different, pejorative meaning. There is no right to have a conflict of interest as in the case of a contract. This conflict of interest denotes abuse of trust unless it is corrected.

II. AN OVERVIEW OF MUTUAL FUNDS AND THEIR PROMOTERS

A. THE TWO PARENTAL PROMOTERS

Mutual funds are vehicles for 'mass-produced' expert investment management services. Rather than offering personalized services, mutual funds offer standardized services to numerous investors by selling them shares in a fund that is managed

11. See for example, A.W. Scott and W.F. Fratcher, *The Law of Trusts* (4th edn, Little, Brown, 1987), 1: §2.

by expert managers.[12] The added benefits from these services are reduced investment risk by diversification and savings by economies of scale from large volume of assets and transactions.[13] Thus, one kind of mutual fund promoter is an expert adviser who wishes to offer his services to numerous investors. This type of promoter originated from the prototype of a trustee that catered to wealthy persons, their families, and their heirs. These trustees had investment acumen, and some wished to expand their services to the public by creating mutual funds.[14]

The second type of mutual fund promoter is the distributor. During the 1920s, for example, when the public had an insatiable appetite for stocks, distributors established many mutual funds, including funds of funds – that is, mutual funds that held mutual fund shares – all based on one portfolio, to satisfy the public's demand.[15] Today, distributors may establish mutual funds or pool long-term investors and invest their savings for them in mutual funds. This type of group of investors is, for example, those who hold 401(k) plans.[16] The two types of promoters – the managers and the distributors – usually cooperate, each in their area of expertise.

Therefore, mutual funds have two 'parents': the descendents of the professional trustee and the distributors that sell and trade in securities. Each of these promoters has incentives to create such funds and increase their assets. The existence and collaboration of these two 'parents' explains many of the fiduciaries' conflicts of interest issues, the violations of duties to investors, as well as the growth of mutual funds and the financial success of their promoters.

B. THE STRUCTURE OF UNITED STATES MUTUAL FUNDS AND THE MANAGERS' ROLE, STATUS, AND INCENTIVES

Mutual funds can be organized in any form their promoters offer. However, superimposed on the legal form the promoters choose is a corporate form. With few exceptions, all mutual funds must have an elected board of directors,[17] some of whom must be disinterested,[18] that is, unrelated to the managers. The managers, however, operate the mutual funds much like the Chief Executive Officers of a corporation. In corporate law, it does not appear that CEOs can be outsourced.[19]

12. See T. Frankel and A.T. Schwing, *The Regulation of Money Managers* (2nd edn, New York, Aspen, 2001), 1: 1–5 (hereinafter: T. Frankel and A.T. Schwing).
13. T. Frankel and C.E. Kirsch, *Investment Management Regulation* (3rd edn, Fathom, 2005), 1 (hereinafter: T. Frankel and C.E. Kirsch).
14. T. Frankel and C.E. Kirsch, p. 11.
15. J. K. Galbraith, *The Great Crash, 1929* (New York, Houghton Mifflin, 1988), pp. 46–65.
16. 26 USC §401(k) (2000 & Supp. II 2002).
17. 15 USC §80a-16 (2000).
18. 15 USC §80a-2(a)(19) (2000 & Supp. II 2002).
19. There is one instance in which corporate directors can be deputized by an entity. That is under section 16 of the Securities Exchange Act of 1934, 15 USC §78p (2000 & Supp. II 2002). However, even in these types of cases the director is a person and not an entity, and the context is quite limited. See *Dreiling v. American Express Travel Related Services Co.*, 351 F. Supp. 2d 1077 (2004).

CEOs cannot form an entity that offers CEO services to more than one corporation. Mutual fund managers, however, face no such restrictions. To a great extent, these managers resemble a law office that offers legal advice to clients in contrast to an in-house general counsel. Therefore, the managers invest their own money and hire their own portfolio managers, accountants, and lawyers, buy their own software, and establish their own controls and other parts of the operational infrastructure of the funds that they manage.

1. Managers' Incentives Focus on the Sale of Their Mutual Funds Shares, as Compared to Trustees of Private Trusts

We refer to those who offer investment advice to individuals and groups as 'managers'. We also use the term managers to refer to those who manage mutual funds. 'Trustees of private trusts' are those who manage the assets under a trust instrument for relatively few persons, usually families. Managers are highly regulated in the United States.[20] In contrast, the contents of the financial products offered by mutual funds and by managers are rarely regulated. And if they are, the regulation is usually in the form of required disclosure.[21]

C. The Managers Manage Funds as Chief Executive Officers Manage Corporations

However, because managers serve more than one fund, they act as 'outsourced CEOs'. From their perspective, these managers manage one enterprise, much like a law firm. From the perspective of the investors in each fund, the managers manage different enterprises, much like the view of each client of the law firm.

The measures used to compensate managers vary. Some managers charge hourly fees.[22] Managers who act as financial planners may charge a one-time commission; that is, a percentage of the amount of investments that the investors make.[23] Some managers charge subscription fees for their advisory letters. But usually the compensation which is charged by managers of mutual funds who manage the investors' money is similar to the compensation paid to trustees of private trusts. These managers and trustees charge a percentage of the assets under management. There are, however, managers of mutual funds who charge a percentage of the profits that the investors receive, that is, performance fees. Such a measure is limited

20. Investment Advisers Act of 1940, 15 USC §§80b-1 to -21 (2000 & Supp. II 2002); Investment Company Act of 1940, 15 USC §§80a-1 to -64 (2000 & Supp. II 2002); a minor amendment to the Investment Company Act in 2004 is not included in the 2002 Supplement.
21. See 15 USC §80a-8(b) (2000).
22. J.J. Haas and S.R. Howard, 'The Heartland Funds' Receivership and its Implications for Independent Mutual Fund Directors' (2002) *Emory Law Journal* 51, 209.
23. S.K. Foster, 'Financial Planning: Is It Time for a Self-Regulatory Organization?' (1987) *Brooklyn Law Review* 53, 148–149. There are three types of financial planners: fee-and-commission, fee-only and commission-only planners. Fee-and-commission planners charge for their plans and sell on commission some or all of the products that they recommend.

to managers who serve sophisticated investors or investors who have a minimum amount, such as USD 1 million.[24]

Underlying the measures of compensation are certain assumptions about the incentives that managers (and trustees) are offered, linked to their relationships with the investors. The assumptions underlying compensation in the form of a percentage of the assets under management are that managers and trustees will have an incentive to increase those assets. If they do, the managers' and trustees' compensation also increase. The percentage is calculated on a higher amount of assets.

However, at this juncture, the managers and trustees part ways. Trustees can increase the trust assets under management mostly by performance. In addition, traditional trust law requires trustees to segregate trust assets from their own assets, or from the assets of others, subject to express exceptions. Thus, trustees cannot benefit from economies of scale that result from the growth of assets under management, except when the trust assets appreciate by performance.

In contrast, managers of mutual funds are not prohibited from pooling investors' money.[25] Thus, mutual fund managers can increase the amount of assets under their management not only by performance, but also by selling more shares in the portfolios that they manage. Any pool of money can be incorporated and any such pool could become the issuer of securities that offers the securities (a piece of the managed portfolio) to the public.

It should be noted that, even when trustees are permitted to pool trust assets, as bank trust departments are free to do, the comptroller of the currency's rules do not permit bank trust departments to aggressively advertise their investment acumen, but only their trust services.[26] Among other reasons, this prohibition maintained the distinction between bank trust departments and mutual funds.[27] Trustees may not mount an aggressive program to sell their services while managers of mutual funds may do just that.

This difference between mutual fund managers and traditional trustees is far more significant than it appears at first glance. While performance can raise the amount of assets by 20 per cent, or even 100 per cent, the aggressive sale of fund shares can raise the amount of assets under management by 1,000 per cent. Successful sales may depend on performance, but, as experience has shown, success depends as much if not more on the sales effort. The sale of mutual funds can be difficult under certain economic situations, and may require aggressive sales pressure. Americans are not ardent savers. The real effort in the mutual fund area

24. 15 USC §80b-5(b) (2000).
25. The managers can pool their investors' assets or can create a vehicle for the assets such as a limited partnership, a business trust, or a corporation. Superimposed on any such structure is a structure similar to that of a corporation. T. Frankel and A.T. Schwing 1: para. 1.02[B][2][j].
26. 12 C.F.R. §9.18 (2005) (the rule of the Comptroller of the Currency regarding bank trust departments).
27. Testimony of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, Concerning Proposed Revisions to Rules Governing Bank Common Trust Funds, Before the Subcomm. on Telecommunications and Finance of the Comm. on Energy and Commerce, 101st Cong. 1990.

may be characterized by convincing investors to save; to part with their money and hand it to the managers for management. Thus, in contrast to trusts, for managers, the role of the broker dealers in increasing the assets under management cannot be emphasized enough.

D. Solicitors

There are managers who specialize in advising pension funds and other large institutional investors. Some of these managers use solicitors, either as employees or as independent contractors to solicit these institutional investors. Like distributors, the solicitors usually receive a commission calculated as a percentage of the money they bring to the adviser. The source of the contacts with the potential clients varies. But some of the contacts are broker dealers who have served the institutional investors, such as the pension funds. These distributors-contacts can be closely connected to the employees or independent solicitors for the managers. But what can the contacts provide for the solicitors? In some cases the contacts may demand part of the solicitors' compensation (a percentage of the percentage). In others, however, the best way for everyone to gain is to compensate the solicitors by providing them with brokerage business for the funds' portfolios.

But suppose the solicitors or distributors to whom the brokerage business is allocated cannot themselves execute the large transactions? The solicitor will receive brokerage business. The fund will be charged a 'market price,' for example, of six cents per share. The solicitor will then connect to a reputable broker dealer, who will execute the transaction for a fraction of the commission, for example, two cents per share. The solicitor will pocket the difference of four cents per share for the services of bringing to the adviser money to manage. Thus, the adviser benefits by gaining more valuable business at no cost. The solicitor benefits by four cents per share. The broker that executed the transaction earns a fair commission. The investors pay the 'market price.' This, in brief, is the arrangement of 'give-ups'.

E. The Distributors' Role, Status and Incentives

Distributors perform two functions for mutual funds. One function is to sell the funds' shares. The other function is to sell and buy securities for the funds' portfolios. Generally, the business of selling mutual fund shares to individuals is not attractive to distributors, unless the buyers are pension funds and other institutional investors. Sale to institutions reduces the distributors' cost. But even selling to pension funds requires a great deal of effort. In addition, the sale of redeemable shares, which in previous decades constituted approximately 80 per cent of the fund shares,[28] is unattractive to distributors. Redeeming shareholders go directly

28. J.C. Stein, 'Why Are Most Funds Open-End? Competition and the Limits of Arbitrage' (2005) *Quarterly Journal of Economics* 120, 251–252; the majority of the mutual funds and hedge funds are open-end funds offering the shareholders the right to redeem their shares.

to the funds, and not to an intermediary. That is, they do not resort to distributors. Therefore, distributors serve only buyers of redeemable securities. The distributors are engaged only in servicing the buyers, but not in servicing the sellers. Therefore, the transactions available to distributors in redeemable securities are fewer. Not surprisingly, distributors demand higher compensation for these sales. The second brokerage function, of trading in mutual funds' assets, is lucrative for distributors. The portfolios are large and bring significant economies of scale. Therefore, distributors are eager to offer deep discounts on usual commissions to receive very large orders to trade.

F. Distributors' Compensation

Distributors' compensation is measured by a percentage of the money that constitutes the transaction. This percentage measure reflects the recognition that larger transactions involve more work and responsibility. Unlike managers, who are paid periodically throughout their management period, distributors are paid only when the transaction is closed. That timing presumably offers distributors incentives to convince the parties to transact and to close the transaction as quickly as possible. Both measures of compensation are traditional, determined mainly by market practices.

G. The Alliance: What Managers Want From Distributors and What Distributors Want in Return

Managers have a strong incentive to induce distributors to sell the shares of the mutual funds that the managers manage. The funds' increased size also reduces the costs of managing the fund assets. Size produces economies of scale, particularly when the shareholders are long-term shareholders. The number of fund managers does not increase proportionately to the amounts under management. Shareholder services cost less than the fee increases. Finally, the more investors purchase fund shares the more other investors they are likely to bring along. Investors often create cascades (both of purchases and of sales-redemptions). The reason for this is because most investors do not study their mutual funds to determine their worth. Instead, they simply follow others on the assumption that they have done their 'homework.' Once a cascade begins in earnest, people will follow others even in contradiction to their own information and convictions.[29]

In contrast, selling fund shares is not highly profitable for broker dealers. Selling and buying large blocks of securities is far more lucrative, which is precisely what the large investment banks seek. Moreover, few investment banks, such as Merrill Lynch, have a network of broker dealers who sell to retail investors. Banks that enter the mutual fund area often use their tellers as a sales force to steer

29. T. Kuran and C.R. Sunstein, 'Availability Cascades and Risk Regulation' (1999) *Stanford Law Review* 51, 711.

the depositors to their advisory services. This adviser then sells the depositors' mutual fund shares or other investment services. In sum, distributors and managers have dual ties. Managers seek buyers (large and small) and distributors seek large transactions (sales and purchases). This synergy of the two parties opens the door to problems for the investors, both those who wish to buy mutual fund shares and those who have invested in mutual fund shares.

The connection between managers and broker dealers and their exchange of benefits, including give-ups in one way or another, raises the problem of conflicts of interest. Regardless of the extent to which distributors were permitted to indirectly compensate managers for fund brokerage business, there was the proviso that the managers should first and foremost consider the quality of the distributors' execution of the transaction. They should choose the best distributors to execute the transactions for their funds, and assuming there were more than one broker with the same qualities offering the same conditions, then, and only then, could the managers choose the ones who were selling their funds' shares. This guide was presumed to solve the conflict of interest that tainted the decision to choose the distributors to execute the transactions of the fund's portfolio. But that was not enough.

Thus, managers are interested in the sale of fund shares, in which distributors are not eager to engage. But managers can allocate large portfolio trades to distributors, in which distributors are eager to engage. It therefore makes good business sense for managers to compensate distributors who sell fund shares. It also makes good sense for distributors to pay managers for allocating to distributors large portfolio transactions. It makes sense for managers to pay distributors for the sale of fund shares not with dollars from the managers' pockets, but with brokerage business for the funds' portfolios. If the assets in the funds belonged to the managers this would be a perfectly logical and legitimate exchange. The more a broker sells fund shares the more lucrative business of trading the funds' portfolio the adviser will allocate to the broker. This sensible business arrangement, however, raises difficult issues.

H. GIVE-UPS AND THEIR EVOLUTION

Generally, distributors who sell mutual fund shares are not the same distributors who execute large portfolio transactions for mutual funds. The sellers of fund shares are retail distributors who have ongoing contacts with clients, whether individuals or institutional. The distributors who trade in large fund portfolios' shares are those who have a wholesale facility, and are connected to other buyers and sellers of very large blocks of shares.

Managers sought to compensate those who were selling mutual fund shares. Large distributors were eager to offer managers discounts for executing large portfolio transactions. It is not surprising that the practice of give-ups developed in the 1960s.[30] Managers required large investment banks who sought large funds' port-

30. T. Frankel and A.T. Schwing 2: 15.02[A]; 4: §27.01[B][3].

folio transactions to give up some of their commissions and pay the discounts to broker dealers who sold fund shares. The discounts that these large wholesale distributors were willingly giving up were not paid to the managers directly. Instead, the discounts were paid to the distributors who sold fund shares in which the managers had an interest.

Other forms of hidden give-ups and payments for the sale of mutual fund shares abound. For example, if the adviser offers the investment bank back-room services at a substantial discount, the discount can be counted towards the sale of fund shares, or perhaps the 'introduction' to institutional investors, such as pension funds. The calculation can be easily adjusted: The more sales the bank makes, the more brokerage business it can receive either to execute in its own departments or to 'farm out' to other investment bankers at a discount and pocket the difference.

1. Revenue Sharing

Over the past 15 years, broker dealers who once sold fund shares have begun to demand what became known as 'revenue sharing'. They demanded not only a percentage of the price of the stock they sold, but also a percentage of the management fees that the managers received for managing the funds.[31] The salespersons argued that the managers were enjoying far greater compensation from the money that the salespersons brought to them and therefore demanded part of these compensations. For example, large share distribution broker dealers, such as Charles Schwab, demanded payment for a preferred higher placing of mutual funds that Schwab displayed to their customers. This idea was modelled on the way supermarkets displayed products. It appears that supermarkets charge the producers who want to display their wares on higher shelves, or to the right of the entry to the store, where most buyers usually turn. Similarly, investors do not scan the thousands of available funds, but usually choose among the first 20 to 30 funds on the list. Large managers, including the largest (Fidelity), paid Charles Schwab to place their funds close to the top of the list. But only at the beginning of 2005 did Fidelity disclose that it was making these payments to the distributor.[32]

III. MANAGERS AND INVESTORS' CONFLICTS OF INTEREST: THE SALE OF FUND SECURITIES AND ALLOCATION OF FUND BROKERAGE BUSINESS

We noted that managers are interested in the sale of fund shares, in which distributors are not so eager to engage, but managers can allocate large portfolio trades to

31. See 'Milberg Weiss Announces the Filing of a Class Action Suit against UBS-AG, and Certain of Its Affiliates, Officers and Directors on Behalf of Purchasers of Certain UBS Funds' *Business Wire*, 1 August 2005.
32. J. Waggoner, 'Investing: Fund Sales Practices Might Be Costing You' *USA Today*, *Money*, posted November 20 2003, <ssrn.www.usatoday.com/money/perfi/columnist/wagon/2003-11-20-mym_x.htm>, last visited August 18 2005; brokerage firms have 'preferred lists.' Fund managers pay to be on these lists.

distributors, in which distributors are eager to engage. It therefore makes good business sense for managers to compensate distributors who sell fund shares, not with dollars from the managers' pockets, but with brokerage business for the funds' portfolios.

However, an arrangement of this sort creates conflicts between the managers' interest and the interests of the shareholders of the funds.

A. MISAPPROPRIATION OF THE DISCOUNTS

First, managers could be tempted to benefit from the discounts that distributors offer by diverting these discounts to distributors that sell fund shares (and thereby increasing the managers' fees). But if the managers do not own the invested money but the shareholders do, then the discounts that the distributors are ready to pay for the business of trading in funds' portfolios belong not to the managers, but to the shareholders. After all, it is the shareholders' assets that are being traded and it is the shareholders' money that is being charged with the costs of the trading. Unless the shareholders benefit from the larger size of the fund, or unless the shareholders agree to the charges and the payments to the managers, the shareholders suffer losses.

B. POOR EXECUTION OF TRADES

Second, managers who use distributors that offer benefits in exchange for portfolio brokerage business face conflicts between their own interest and the interest of the shareholders. Managers face the temptation to engage those distributors rather than choose the best available broker for the transaction. Trading in large volumes of shares requires an understanding of the markets, and the knowledge of how to sell the vast number of shares without depressing the market or buy a large number of shares without raising market prices. Such distributors usually find ways to balance their sales and purchases in order to avoid market gyrations that would harm their clients' interests, or find the sellers or buyers of such large quantities of shares and negotiate the prices successfully. Thus, unqualified distributors that cannot trade in large blocks of shares but sell fund shares to individual investors or institutional investors could be allocated fund portfolio business to the detriment of the fund shareholders.[33] As a result, investors might be harmed by poor execution of portfolio transactions.

33. As mentioned earlier, the consequences of this disparity of abilities drove to a market solution. At the behest of the managers, the wholesale distributors who traded in fund portfolios 'gave up' some of their benefits to the retail distributors who sold fund shares. The adviser benefited from the larger sales: receipt of higher fees as a percentage of the assets under management. It also benefited by paying for the sales with the discounts to which the fund shareholders were entitled. The fund shareholders paid the distributors the 'market commissions' in full, and did not benefit from the economies of scale as their funds grew.

C. Increased Turnover (Churning)

Third, since placing portfolio transactions can benefit the managers by financing the sale of fund shares, managers may be tempted to increase the turnover of the portfolio transactions. This increases the investors' costs and reduces the returns from their investments.

D. Disadvantages of Fund Size

Fourth, very large funds are not necessarily beneficial to their shareholders. Size may restrict their managers' flexibility to trade when opportunities arise. To be sure, the shareholders could benefit from the economies of scale, but that depends on the adviser's frugality and moderation.

E. Misappropriation of Economies of Scale

Fifth, the issue of economies of scale raises further conflicts of interest. Large portfolios present savings to the managers: their size offers economies of scale. The cost of managing a fund of USD one billion is not ten times greater than the cost of managing a fund of USD 100 million.

If the managers use the economies of scale for their own benefit, or for the benefit of other funds that the managers are interested in shoring up, they rob the shareholders in the large funds of the benefits. The arguments concerning the fees and the expenses can be played over in this context, as well.

F. Even Direct Cash to Distributors Comes from the Investors' Pockets

Even if the managers pay dollars to the distributors who sell fund shares, the dollars in fact come from the shareholders' pockets. Managers may simply increase their fees. Unless the investors shop for mutual fund shares according to the fees they charge, or the shareholders are represented in their negotiations with the managers, or legal constraints are applied on the amounts that managers can charge, the shareholders will have to pay whatever the managers charge. And there is no limit to the amount of shares they wish to sell and the resultant fees that they want to collect.

G. Opening the Doors to Other Abuses: The Issue of Culture

More generally, if managers use the model of give-ups, they can move to other areas in which they charge investors with market prices rather than actual costs and use the differences for their own benefit. For example, managers may charge investors the market price for back-office bookkeeping, which is higher than the actual cost to the managers.

H. THE LAW'S RESPONSE

In the late 1960s, after give-ups became widespread, the Securities and Exchange Commission reacted by holding hearings and denounced the practice. Parallel to the prohibition by the Commission, the National Association of Securities Dealers, the self-regulatory organization of all securities broker dealers, promulgated Rule of Conduct 2839(k), which prohibits distributors from offering managers benefits by selling fund securities. Thus, in the allocation of funds' brokerage business (1) managers were prohibited from accepting bribes or kickbacks by the sale of fund securities and (2) distributors were prohibited from offering bribes or kickbacks by the sale of fund securities. Regardless of the terms of the rules, the understanding was that both managers and distributors were prohibited from exchanging the managers' benefit from the sales of fund securities for the distributors and underwriters' benefit of gaining fund brokerage business.

In the 1980s the interpretation of the strict prohibition became softer. Managers were permitted to consider and take into account the contribution of a brokerage firm to the sale of shares when allocating portfolio business to it. Distributors were permitted to offer sale of fund securities to facilitate such managers' considerations. After the discovery of a direct quid pro quo among managers and distributors and many forms of indirect benefits that amounted to the same thing, this soft prohibition has now hardened again into an unconditional prohibition. Since 2003, managers have been prohibited from considering or rewarding distributors who sold fund shares with brokerage business of the funds. And distributors are prohibited from offering such sales in exchange for fund brokerage business.

I. ANOTHER CRACK IN THE WALL: PERMISSIBLE SOFT DOLLARS ARRANGEMENTS

Since 1975 distributors have been permitted to offer managers and managers were allowed to receive free 'research' from distributors.[34] Research was broadly defined.[35] Thus brokerage business allocation became a source of benefits to managers, and could influence their choice of distributors to whom the managers will allocate fund brokerage business. In recognition of the conflict of interest that such free research might produce, managers were required to ensure that the distributors they choose for fund portfolio transactions would provide 'best execution'.[36] However, best execution of the transactions did not imply the cheapest execution.

The prohibitions on paying for sales and research by brokerage business were relaxed on the same grounds: the complaints of small distributors and the desire to equalize their position with those of the large underwriting firms. Small distributors could not provide best execution of fund portfolio transactions. Neither did small distributors have the facilities to offer the research that large underwriting firms

34. 15 USC §78bb(e) (2000); Frankel & Schwing 2: §15.02[D].
35. Brokerage and Research Services, Exchange Act Release No. 34–23170 (23 April 1986).
36. Ibid.

prepared. In both cases, their sales of fund shares were not compensated by the lucrative brokerage business. The relaxation was aimed at equalizing their situation with that of the large firms.[37] In the large brokerage firms that offered both services – selling fund shares and trading in funds' portfolios – the conflicting interests surfaced between the departments that sold fund shares and the departments that traded in the shares. The sellers demanded benefits knowing that the traders would have received less brokerage business otherwise.

J. THE DILEMMA: THE COMMODITY CONTRACT APPROACH

The recognition of conflicts of interest in the fiduciary category, which are prohibited, can be vigorously disputed if the managers' services are viewed as the sale of a commodity under a contract.

Unlike other fiduciaries, such as lawyers and doctors, advisory services can be viewed as more similar to commodities. The results of managers' services are quantifiable and can be compared to the results of other investment managers' services. The investors either gain or lose specific amounts of US dollars. These are somewhat different from the specific results of a particular court case or particular patient. Each court case and each patient is unique.

In addition, if managers are judged by the long-term results of their services, they cannot blame events beyond their control. The assumption is that the results cannot be consistently disappointing in the long-term. In face-to-face negotiations, the parties establish a benchmark, and the results are based on a long-term period, such as three or often even ten years. This aspect of advisory services points to the sale of a commodity rather than the service of a fiduciary.

In addition, small investors do not negotiate with managers. These investors most often evaluate advisory services the way they evaluate any commodity—by the short-term results. Even if they receive information about performance after one, five and 10 years, most investors will judge the particular managers on a far shorter-term basis. Therefore, it may be argued that the managers should be treated as the sellers of a commodity. In that case, they are carrying on a business.

In addition, managers not only manage, but also invest in the infrastructure of mutual funds. The managers are the owners of the operational aspect of the management. Thus, they run a business and ought to be treated as such. Therefore, the buyers of commodities have no claim to information, or to any savings, or to the profits that the sellers or manufacturers have made. The price of the commodities is

37. Prior to 1986, managers were permitted to receive only 'research' that was produced by the firms who executed portfolio transactions. In fact, it was the practice of such large firms was to provide such research, for example, on particular corporations, as a courtesy and an advertisement. In 1986, the Securities and Exchange Commission allowed small distributors to purchase research in the market and provide it to managers in exchange for brokerage business. If the distributors did not have the facilities for executing the transactions, they then farmed out the execution to the large firms for a smaller amount and captured the discount. During the past 25 years a large market has developed in soft dollar 'research'.

all the buyers are entitled to evaluate, so long as the buyers can shop for cheaper or better commodities, the exchange of which is subject to specific consumer legislation. If a competitive market exists for the managers' services, the services (and the costs) should be treated as commodities. Thus, the difficulty in deciding who should benefit from the discounts that broker dealers offer for large portfolio transactions disappears. Similarly, the issue of just who is entitled to the economies of scale when the funds have grown disappears.

The savings that managers manage to squeeze out of performing the service belong entirely to the managers. If fund managers manage to save costs by a smart use of managerial techniques or software or attraction of the right talent, the benefits belong to the managers and not to the shareholders. The following story illustrates this approach.

1. One Case

In this case, an adviser who caters mainly to institutions employed a solicitor who was paid a commission for any business that he generated. He had previous contacts with distributors from whom he sought help. One of these distributors, the 'introducing broker' who solicited institutional business for this adviser's employee, induced the trustees of a pension fund to transfer to the adviser USD 260 million for management.[38] But even broker friends do not help get business for nothing. These distributors wanted portfolio fund brokerage business. The employee-solicitor persuaded the adviser's personnel to allocate to the 'introducing broker' a certain amount of fund brokerage business at six cents per share, known as the 'market price'. The introducing broker could not perform the services. He transferred the execution to a reputable broker for 2 cents per share and pocketed the four cents per share. That was the broker's compensation for the introduction. The employee-solicitor received a commission from the adviser.

What was wrong with this transaction, if anything? According to the Court of Appeals of the Seventh Circuit, nothing whatsoever.[39] After all, the investors paid the market price of six cents for execution. The introducing broker guaranteed the good execution (even though he was a crook). The adviser did not receive anything of value, but instead was paid for the services it provided to the pension fund. The adviser received nothing by getting USD 260 million to manage, even though it hired and paid a solicitor to generate the business. It appeared that the court did not consider getting the business of any value, and that the court did not consider the fact that the investors paid more for the execution of the transactions than two cents per share, which was the actual, not market, price paid. It did not consider the fact that a third party pocketed the difference.

38. This influence included bribery. *Wsol v. Fiduciary Management Associates*, 266 F.3d 654 (7th Cir. 2001), *cert. denied*, 535 U.S. 927 (2002); see also T. Frankel, 'The Seventh Circuit Decision in Wsol v. Fiduciary Management Associates and the Amendment to Rule 12b-1' (August 2004) *Investment Lawyer* 11, 11–16.
39. Ibid.

It seems that the court viewed the duties of the adviser to the investors as contractual. Investors bought services and agreed to pay the 'market price' for transactions in their portfolio. The savings that the adviser could shave off belonged to the adviser. Or at least, the savings were not the business of the investors, but instead were the profits of the adviser. The adviser, after all, was smart enough to gain new business and pay for it with the investors' transactions money (below what they presumably agreed to pay: the market price). The model of the relationship dictated the results. The conflicts of interest were fine. Investors should protect themselves if they do not like the results of the services. After all, many managers must compete ferociously for business.

This case demonstrates the difference between conflicts of interest in a contract relationship and conflicts of interest in a fiduciary relationship. Contract and fiduciary relationships share a basic feature: both are voluntary and consensual. Contract and fiduciary categories are not mutually exclusive. Some provisions of a consensual transaction may be judged under contract law, but others must be judged under fiduciary law.[40] As a result, some conflicts of interest fall into the category of contractual relationships, while others fall into the category of fiduciary relationships. In fact, there is a slippery slope in the definition and duties regarding conflicts of interest.

In the contract relationship, the adviser promises the investors a managed portfolio. He also promises to incur no more than the market costs for the product: the managed portfolio. The adviser in fact has either 'rented' or borrowed the assets of the clients. In both cases, the adviser can do what he likes with the assets for his own benefit, as long as he pays the investors what he promised. He promises the clients a return linked to the performance of the markets, repayment of the investments under certain terms, and charges in accordance with market prices. The rest of the benefits from controlling the money belong to the adviser.

A fiduciary relationship is entirely different. Theoretically, the same rules that now compose fiduciary law can also be presumed and embedded in the contract arrangement. The contract may state that investors' money never becomes the adviser's money; that the benefits from everything that the money produces belong to the investors, not to the adviser; and that if the adviser receives a deduction in price or charge, the deduction belongs to the investors. The contract can emphasize that the only amount that belongs to the adviser is the fees and charges explicitly and specifically agreed upon. And nothing else. In this case, the question would be whether the investors can waive these 'contract' provisions, and whether the court can have the flexibility to fashion other presumed rules into contracts in somewhat different situations. In that case, there is no difference between fiduciary duties and contract duties. There will be no difference between fiduciary conflicts of interest and contractual conflicts of interest.

Fiduciary duties and contractual duties will coincide, except for three additional items. First, the courts should be more inclined to broadly interpret the agreement

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40. Ibid.

and the presumed basis on which the former type of duties is grounded. They should not be as constrained to follow the wording of the contract. Second, a breach of this fiduciary type of agreement should be considered abuse of trust and embezzlement, carrying with it a stigma that is extremely different from a mere contractual breach. It should carry with it the branding of dishonesty. And third, remedies for a breach of the fiduciary duty should include not only damages to the victims, but also every penny of profit that it received directly and indirectly in connection with the transaction. That should include not only the particular breach, but any other profit emanating from the relationship, even if not in breach. When all this is done, the difference between the contract and the fiduciary duties disappears.

A number of objections are voiced against this approach. First, even when managers compete among themselves, it is extremely difficult for investors to ascertain and evaluate the services that the managers offer. In addition, the quality of the services may be high, but the results may not. If the managers' 'commodity' cannot be evaluated by the results of their services, the managers should collect their fees even on disappointing results. Their fees should reflect the quality and efforts of their services, but the savings from discounted commissions should belong to the investors.

More importantly, investors expect managers to serve the investors' benefits exclusively, with the exception of the advisory fees. All fees and expenses must be clearly specified, and never hidden, so that investors can know and agree to them. The residue belongs to the investors. This is the investors' basis for trusting managers. Performance cannot gain trust if it is coupled with a high risk of embezzlement. This brings us back to fiduciary duties.

Congress, regulators and most courts have rejected the contract analysis. The Securities and Exchange Commission charged the adviser in the case described above with using investors' brokerage business and the discounts for its own benefit, by paying with what belonged to the investors (allocation of brokerage business) for new business (which was worth a great deal to the adviser). The employee-solicitor was charged as well for the pressure he put on the adviser's personnel to allocate brokerage business to his broker-contacts so that they would 'introduce' him to institutional investors and generate new business for the adviser.[41]

IV. THEORETICAL MODELS FOR MANAGERS TO ADDRESS MANAGERS' CONFLICTS OF INTEREST

A. What is Wrong with Rewarding Managers with Benefits from Their Control over Investors' Money?

If a broker charges two cents per share and gives the adviser four cents, the broker has paid a kickback that will injure the shareholders of the fund. That is because

41. See e.g., *Wsol v. Fiduciary Mgmt. Assocs.*, 266 F.3d 654 (7th Cir. 2001), *cert. denied*, 535 U.S. 927 (2002); T. Frankel, 'The Seventh Circuit Decision in Wsol v. Fiduciary Management Associates and the Amendment to Rule 12b-1' *Investment Lawyer* 11 (August 2004), 14.

the broker was prepared to offer his services for two cents per share and the fund shareholders paid six cents per share for the service. The fund shareholders paid more than the cost of the broker's services.

But what if the shareholders agreed that the adviser would charge them the market price and pocket whatever he could squeeze out of the distributors? One could question such an agreement, considering the disturbing possibility that the adviser might not choose the best broker, or the cheapest, but the broker who would pay him the most. The second assumption would be that such a broker would seek to recoup these costs by providing the least expensive service. In short, the fund will be paying for services that cost more than they are worth, and the adviser will collect the difference. This is the adviser whom the shareholders trusted to manage their money for their benefit. The shareholders would not be able to spot the broker's payment to the adviser because the shareholders do not have control over the managers' operation. If brokerage expenses are charged to investors at cost, then kickbacks of any sort (whether by increasing the price or reducing the quality) constitute a diversion of the investors' money to the managers for the managers' benefit. The answer to conflicts of interest differs depending on the choice between contract and fiduciary categories. The answer depends on how we view the managers and their relationships with the investors in the mutual funds. What model should we use to resolve the issues?

Are the managers offering personal services to the funds and indirectly to each of the fund shareholders, or are the managers managing a business of offering management services? Managers for individual wealthy investors are viewed as fiduciaries in personal relationship with their clients. What is the status of the relationship of the managers to mutual funds? In fact, a similar question is often asked in the corporate context: is the relationship between the corporation and its managers personal or is it derivative? In other words, is the relationship linked to the corporation rather than to each shareholder?

The issue in mutual funds is somewhat different from that of corporations, essentially because the services that the adviser offers the shareholders of the mutual fund are very similar to that offered to individual investors. The difference lies mainly in the fact that the services are standardized and not tailored to the needs of each investor. Unlike the corporate enterprise, the mutual fund enterprise replicates personal management services. Even though shareholders of mutual funds are limited in their ability to sue the managers directly, the nature of the services the adviser renders and the resulting duties on the funds' directors are similar to those offered to large individual investors. The funds, representing a pool, are an aggregate of such personal advisory relationships. Managers of mutual funds are similar to law firms that serve individual and corporate clients. This is the view of managers under the Investment Company Act of 1940.[42]

In fact, the prohibitions on managers' conflict of interest transactions are quite detailed. Under the Investment Company Act of 1940, they are permitted only by an

42. 15 USC §§80a-1 to 80a-64 (2000 and Supp. II 2002)

exemption of the Securities and Exchange Commission.[43] When the number, assets and transactions of mutual funds grew dramatically, the Securities and Exchange Commission allowed some conflict of interest transactions by rules, subject to the approval of the majority of the funds' disinterested directors.[44]

As far as advisory fees and advisory contract terms, however, the American policy is to avoid government involvement in business negotiations. Hence, the fees were to be determined by negotiation between the managers and the boards of directors of the funds. Early on another provision required that the majority of the disinterested directors on the board agree on the fees and other terms in the advisory contract. The contract must be approved annually.[45] In 1970 Congress added a special section in the Investment Company Act, 36(b), which imposed a fiduciary duty on managers regarding excessive fees, and established a special procedure to allow shareholders of mutual funds to challenge excessive fees in the courts.[46] Cases on this issue demonstrate the theoretical models on which the courts based their interpretation of the section.

Prior to the recent round of litigation, regulators and others considered advisory fees to cover only the value of the advisory services. Therefore, if the managers used the fees for anything other than the services that they offered, these additional amounts were considered excessive. Hence, managers who used their fees to pay distributors for selling fund shares were considered to have charged excessive fees. In sum, fees could cover only the cost of providing the advisory and other services to the funds.

During the early 1980s, including the later fees litigation,[47] the model of managers as personal fiduciaries of the investors changed. The emphasis shifted from the type of services that the managers offered to the fact that the managers were managing a business that offered fiduciary services. Therefore, if advisory fees include profits, the managers can do whatever they want. Hence, managers could use their fees to compensate distributors for selling fund shares.

B. The Disclosure and Implied Consent Solution

Most fiduciary duties are default rules. If the fiduciary discloses the conflict and the entrustor agrees to the transaction, the fiduciary is relieved of liability.[48] In the context of mutual fund fees, the issue is more complicated. The fees are disclosed in the prospectuses that each investor receives. There are other easy-to-reach sources that offer the information. Why, then, should the managers be burdened with a fiduciary duty with respect to the fees? It should be noted that the fees are part of the

43. Ibid. §80a-10(f), 17(a),(b),(d),(e), 23.
44. See e.g., Rule 12b-1, 17 C.F.R. §270.12b-1 (2005).
45. 15 USC §80a-15(a) (2000).
46. Ibid. 15 USC §80a-35(b) (2000).
47. E.g. *Krinsk v. Fund Asset Management, Inc.*, 875 F.2d 404 (2d Cir. 1989).
48. T. Frankel, 'Fiduciary Duties as Default Rules' (1995) *Oregon Law Review* 74, 1,209–1,220.

exchange process—definitely a contract posture, even though it is established with a fiduciary. In the case of mutual funds, the directors, including the majority of the disinterested directors, are supposed to represent the investors. These disinterested directors are expected to negotiate with the adviser at arm's length.[49] However, these directors for many years rarely pressed the managers on the fees and expenses issues – even in appropriate situations; a situation which has led the Securities and Exchange Commission to tighten the rules recently. The agency required the directors to disclose their reasons for approving the advisory contract, including the reasons for approving the advisory fees.[50]

The counterargument to these demands is that the shareholders who purchase fund shares, and those who have the freedom to redeem the shares, should not be protected by the disinterested directors.

One could argue that investors evaluate advisory fees as they do any other commodity, and therefore fiduciary rules should not apply to fees. Since the investors in shares are not in personal relationship with the adviser, the adviser cannot influence them. They can and should shop for the best advisory services, including the least expensive, as they would for any other commodity available on the market. Since managers compete fiercely, the protection of investors under fiduciary law is misguided. In such cases the conflicts of interest appear loud and clear. There is no need to distinguish between what is conflicted and what is not. The argument aims at the results. If the investors can fend for themselves, then there is no need for the imposition of fiduciary duties, and the contract regime should apply. This argument is linked to the shift from personal advice to the impersonal sale of advice as a commodity. If such a shift is effected, the chances are that the shareholders will view their relationship with the adviser as less fiduciary and more contractual, and that they will better understand that managers are not the trustworthy servants they might appear to be. The long-term results may be to truly change the relationship into a contractual relationship. Whether the investors would then entrust their savings to the managers is another matter.

C. MUTUAL FUNDS AS BUSINESSES

The view of managers as businesses brought with it a permission to do what they liked with the profits, and opened the door to Rule 12b-1.[51] The Rule allows the funds to finance the distribution of their shares, the way any business finances the distribution of its products. To be sure, the rationale of the rule based its permission on the benefits to the shareholders. The larger the fund, it was expected, the

49. Division of Investment Management, Securities and Exchange Commission, 'Report on Mutual Fund Fees and Expenses' (December 2000), available at <www.sec.gov/news/studies/feestudy.htm> (last modified 10 January 2001).
50. Proposed Amendment to Rule 12b-1, 17 C.F.R. para. 270.12b-1 (2005), IC-26356, 2004; Amended NASD Conduct Rule 2830(k), approved by the Securities and Exchange Commission, Rel. No. 34–50883, Dec. 12, 2004.
51. 17 C.F.R. §270.12b-1 (2005).

more economies of scale the shareholders would receive. The reality, however, was different. Large funds did not significantly reduce their fees. Rather, managers based the lack of reduction on new and additional services that they were offering investors, and on the fact that investors continued to invest.[52] That is, they did not care about the fees. The conflict of interest on this score came full circle. The investors financed the sales of the fund shares directly (up to one per cent of the assets in the funds). The managers financed additional sales from profits that they were entitled to receive. They also borrowed to finance additional sales.

In sum, to release fiduciaries from strict prohibitions on conflicts of interest under United States law, a number of theoretical shifts are possible:

- Shift a transaction from fiduciary law category to contract law category.
- View the managers as conducting businesses for the sale of fiduciary services as commodities and not as fiduciaries who give trust services for the benefit of their clients. If the managers are businesses plying for the sale of their wares then they have the right to charge investors as much fees and expenses as the market would bear, to hire solicitors and to pay them from the profits the managers make. It is then no one's business, except the Internal Revenue's and their own shareholders, how much they earn.
- View the funds as businesses managed at the managers' discretion including the sale of funds' shares.

D. THEORETICAL FRAMES FOR REMEDIES ON CONFLICTS OF INTEREST

Conflicts of interest can be addressed in two ways: by liabilities or by exercise of ownership rights. In an article entitled 'Conflicts of Interest in Publicly-Traded and Closely-Held Corporations: A Comparative and Economic Analysis,'[53] Zohar Goshen classifies two responses to conflicts of interest. One response is by resorting to the court's decision that would impose liabilities on violators of fiduciary duties.

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52. Securities and Exchange Commission, Release Nos. 33–6254, IC-11414, File No. S7–743, *45 FR 73898*, 7 November 1980:

    'The Commission is taking these actions because it believes that directors and shareholders of open-end management investment companies should be able to make business judgments to use fund assets for distribution in appropriate cases but that, in view of the investment adviser's conflict of interest with respect to any recommendation to bear distribution expenses and because of uncertainties about whether such companies are likely to benefit from such expenditures, any such exercise of business judgment should be subject to conditions designed to ensure that it is made by persons who are free of undue management influence and have carefully considered all relevant factors.' and 'The directors must decide, in the exercise of their reasonable business judgment and in light of their fiduciary duties under state law and under the Act, that there is a reasonable likelihood that a plan will benefit the fund and its shareholders.')

53. Z. Goshen, 'Conflicts of Interest in Publicly-Traded and Closely-Held Corporations: A Comparative and Economic Analysis' (July 2005) *Theoretical Inquiries in Law* 6, 277–300.

The other response is by imposing on fiduciaries a duty to seek the owners' consent. Liabilities are imposed by the courts, and are subject to the constraints and dictates of the law. The owners' consent is not constrained. However, while liabilities are accompanied by the power to impose punishments on violators and award remedies to victims, the owners are not empowered to impose such legal punishments and remedies.[54] In addition, while the decision of the courts strives to be objective, the decision of the owners to consent or refuse consent to conflicts of interest can be subjective. Owners need not explain or justify their consent or refusal to consent.[55]

E. Mutual Funds Regulation Adopted Both Responses to Conflicts of Interest

First, the law establishes directors as the spokespersons of the owners and empowers them to approve (or not approve) the contract with the adviser.[56] The directors are also required by law to monitor the adviser's activities, codes of ethics, expenses, and operations.[57] However, because the directors are fiduciaries, they lack the freedom of the owners to determine arbitrarily the fees and expenses of the managers. Thus, in addition to their powers the directors are required to follow both process and substantive principles in their approval of the contract between their mutual funds and the managers.[58] Advisory contracts may be approved by the shareholders as well.[59] These shareholders are not constrained by standards or qualification except the ownership of the shares. The remedy against the managers is a 'market remedy' however. It is simply to not renew the contract. In light of the fact that such a non-renewal may be very damaging to the shareholders, there are very few cases in which such a non-renewal occurred. Therefore, this market solution is not very powerful or effective. It does, however, allow directors to deal with the adviser in the shadow of this strong remedy.

In addition, most mutual funds in the United States are of the open-end vintage. The market remedy for wayward managers in this structure is far stronger than the legal remedy. The shareholders of such funds have the right to redeem their shares at *pro rata* share asset value within seven days of demand, with very few extreme exceptions.[60] The shareholders' power is the owner's power. They do not have to comply with any standard of fairness or otherwise. Their decision is subjective. Their redemption is powerful because they can liquidate the funds' assets, not merely the price of the fund shares in the markets. That reduces the managers' fees and increases the costs of managing the funds.

54. Ibid. at 282–284.
55. Ibid. at 284.
56. 15 USC §80a-15(a), (c) (2000).
57. 15 USC §80a-15(c) (2000).
58. See T. Frankel and A.T.. Schwing 2: §§9.05, 12.03[D][5].
59. 15 USC §80a-15(a) (2000).
60. 17 CFR §270.22c-1 (2005).

Similarly, investment companies that issue non-redeemable shares are subject to the shareholders' ability to sell the shares on the market and thus reduce the share price if supply exceeds demand for the shares. This does not reduce the funds' assets, but makes it difficult for the funds' managers to increase money under management by issuing new securities. Finally, such funds may be subject to hostile takeovers, when the fund shares are sold at a discount and the funds show very poor performance. Redemption and sale of shares are the owners' remedies. They require not objective reasons. However, they are also not accompanied by the punishments and remedies that regulators and the courts have at their disposal. In recent activity of the Securities and Exchange Commission, the agency passed rules to increase the power of the disinterested directors and required the chairperson of the board to be a disinterested director. This move has spawned litigation.[61] In addition, there are currently a number of cases brought by investors on the fees, and attempts to reconsider the basis for the advisory fees.[62] Not surprisingly, there are academic arguments in support of both trends.

Moreover, the law imposes specified direct legal constraints on the fiduciaries, and subjects them to liabilities. The enforcement of these constraints is left to the Securities and Exchange Commission and the courts. These entities follow principles established in the law.

F. The Change in Judicial Interpretation of Statutes

Before 1975, courts tended to interpret the statutes by examining the problems that the legislators sought to address and the policies that they adopted. Since 1975 the courts' tendencies and directions have changed. The focus has been on the 'ordinary' or 'literal' meaning of the statutory language and the specificity of the prohibitions, including prohibitions on breach of fiduciary duties. Thus, the fiduciaries could read the statute narrowly, and whatever was not expressly prohibited or required was interpreted as being permissible.[63] This form of interpretation for fiduciary duties had an effect of allowing fiduciaries to gain more in gray areas. That could be deemed efficient: allowing fiduciaries to create value for themselves. However, by eliminating the gray areas the interpretation dramatically increased the cost of enforcing the prohibitions.[64] No amount of rules would prevent circumvention of the spirit and purpose of the law. The Library of Congress could not hold all the rules that would be required to specifically prohibit activities that would result in abuse of trust. Thus, the literal interpretation not only limited judicial activism

61. *Chamber of Commerce v. Securities and Exchange Commission*, 412 F.3d 133 (D.C. Cir. 2005).
62. See, e.g., *Krantz v. Prudential Invs. Fund Mgmt.*, 305 F.3d 140 (3d Cir. 2002) *cert. denied*, 537 U.S. 1113 (2003); *Green v. Nuveen Advisory Corp.*, 295 F.3d 738 (7th Cir.) *cert. denied*, 2002 U.S. LEXIS 9267 (2002); *Green v. Fund Asset Mgmt.*, 286 F.3d 682 (3d Cir.), *cert. denied*, 2002 U.S. LEXIS 6512 (2002); *Olmsted v. Pruco Life Ins. Co.*, 283 F.3d 429 (2d Cir. 2002).
63. See T. Frankel, *Trust and Honesty, America's Business Culture at a Crossroad* (New York, Oxford, Oxford University Press, 2005), Chapter 8.
64. Ibid.

but also increased the need for more rules, greater supervision of fiduciaries, and tighter punishments. It may well be that the literal interpretation and the specificity approach have contributed to increasing conflicts of interest transactions and hidden and new ways to bribe and receive kickbacks in the mutual fund area. Fiduciary duties must be interpreted with a view to furthering the purpose of the rules. Rules that are designed to avoid conflicts of interest should be designed to provide a gray area and uncertainty to help enforce the purpose of the rules.

G. The Puzzle and the Danger

For the past 25 years the relaxation of the prohibition on conflicts of interest has progressed. Prohibitions were especially avoided or simply violated during the 1990s. This behaviour is hard to explain. It is especially puzzling because the 1990s were the bubble period during which the stock market rose significantly, until it fell in the year 2000. One may speculate that the financing of the sale of mutual funds contributed to the bubble of those years. But whatever the reason, managers gained much and sought to gain more.[65] This is not the first time that the enforcement of barriers against temptation has decreased during prosperous years and heightened during the lean years.

The new puzzle is not that rogue managers and distributors have violated the law and abused their trust. The puzzle is that so many have either accepted fraud as 'a way of life' or justified it: 'It is bad, but not so bad. Besides, everyone does it, and I must do it too to survive in a competitive market.' A yet more pernicious approach has emerged when so many actors are violating the law that enforcement becomes too expensive and embarrassing. In such a case the prohibition has been redefined to weaken or even eliminate it. The mutual fund industry and some academics are attempting the redefinition approach. Theories, such as contract relationships, market transactions, and the sale of fiduciary services as commodities have helped water down or eliminate the prohibitions on fiduciaries' conflicts of interest or the entire fiduciary category. Some arguments are based on a comparison between what the investors lose and what the managers and distributors gain. For each investor the amounts that managers misappropriate are very small, although over the years it may slowly become significant. Yet a very small daily amount taken for each investor becomes quickly enormous for the managers and distributors. It is so easy to earn so much by taking so little. It is easy to justify the taking by exaggerating the adviser and broker contribution to passive investors and berating investors' demand for more. And it is still easier to take when 'everyone takes.'

The law can help constrain temptation of fiduciaries to abuse their trust, but it cannot be fully effective. During the 5 years from 2000 to 2005, regulators conducted investigations, brought cases, and obtained either judgments or settlements against many mutual fund managers. It is not clear, however, whether these cases

65. Ibid. See also T. Frankel, 'Regulation and Investors' Trust in the Securities Markets' *Brooklyn Law Review* 68 (2002) 439–448.

will produce a more self-limiting cadre of managers in the future. The conflicts of interest are significant, the temptations to abuse trust are powerful, and close monitoring is rare if not impossible. Distributors and managers can communicate in very subtle ways. There are so many ways in which the quid pro quo bribery and kickbacks can be hidden. More importantly, many distributors and managers berate the laws and the government that enforces them. The greatest danger to the financial system is when the taking becomes a habit for fiduciaries and suspicion and risk of misappropriation bring about investors' demands for higher returns.[66]

H. IS THE CONCERN ABOUT CONFLICTS OF INTERESTS DESCRIBED IN THIS PAPER EXAGGERATED?

Even if we reject the theories that justify the conflict of interest transactions described in this paper, and even if we view the transactions as prohibited, is the concern in regard to the conflicts not exaggerated? Viewing the scene as a whole, it seems that:

– There are enormously strong incentives for managers and distributors to benefit from servicing millions of investors.
– The losses investors suffer as a result of the conflicts of interests are rather small as compared to the enormous benefits that managers and distributors can reap from such transactions.
– The costs of monitoring and enforcing the current rules are prohibitive.

Thus, from a cost-benefit viewpoint, a simple and more reasonable solution would be to allow the offering of mutual funds securities to state one number that investors would be charged. That would contain the fees and costs, whatever they are, and whoever receives them.

I. THE ISSUE OF CULTURE

The solution suggested in the previous section, however, ignores human nature and the impact of habit and culture on human behaviour. If that solution is allowed, the current arrangements are likely to expand to other areas. After all, there is no limit to how much money one can have. For example, higher performance can be coupled with higher risks, which investors may find hard to gauge. Besides, not all investors follow their investments closely, and some might not overcome their inertia. There are also cases in which investors follow charismatic managers, regardless of performance.

As always, the concern is that investors may trust market actors for a sustained period, and then, with little warning, decide to withdraw that trust. The decision may

66. This speculation is based on G.A. Akerlof's famous article 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism,' (1970) *Quarterly Journal of Economics* 84, 488–500.

be reasoned. It may also depend on the persons and ideas that the investors follow. If, for whatever reason and under whatever circumstances, investors decide that they will withdraw trust, and if there might be other competitors for the investors' money, then mutual funds will be decimated and remain only with tax-deferred investments. Even those tax-deferred investors may find ways to escape the mutual funds. To be sure, this scenario is speculative, but here again, the cost and probability of such a run must be factored into the calculation described above.

Moreover, permitting managers and distributors to view investors' money as partly their own can become a habit and solidify into a culture. A culture is a social habit. Like a habit, a culture implies that members of society assume that everyone behaves in a certain way and that everyone expects others to behave in the same way. In Western culture, no competitor assumes that competitors will kill each other. In the culture of the Mafia, at least in the past, it was assumed that competitors would kill each other at the first opportunity. Like custom, culture grows with repetition. Like habit, it becomes an irrefutable assumption, as to both one's own behaviour and the behaviour of others. A culture in which distributors and managers deal with investors' money in conflict of interest will affect the investors' culture as well. Investors will expect such a conflict of interest (whether or not it exists in reality). The reaction of the investors may differ. They may continue to trade but agree to pay less for fees, or demand guarantees or cease to buy mutual funds altogether. Thus, regardless of what investors do, the costs to the managers, to distributors and to the system are bound to rise.[67]

As a result, managers might not even consider alternative options. Here, perhaps, lies the greatest danger to the financial system generally, and to the mutual funds system in particular. The 1990s sowed the seeds of the approaches that came to fruition, and that are still rooted in the managers' approach and attitudes. To be sure, there are arguments about where the line to conflicts of interest should be drawn.

If the arguments cease and the conflicts are allowed and legitimized, there is a good chance that the conflicts will spread on the same basis and rationale to other areas of services. The benefits to managers and distributors might be still greater and the cost to investors might rise. If the current conflicts do not shake investors' trust, other conflicts will, at some point, shake them into action.[68] These are of course speculations. However, so is the idea that nothing will happen if the current conflicts are permitted.

V. CONCLUSION

The fee structure of mutual fund managers is fraught with incentives leading to conflicts of interests; that is, provided the managers are viewed as fiduciaries who

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67. T. Frankel, *Trust and Honesty, America's Business Culture at a Crossroad, (New York, Oxford, Oxford University Press, 2005), Chapter 4.*
68. Ibid.

manage other people's money and not as the sellers of a commodity composed of a piece of a managed portfolio. The buyer of such a commodity, however, is exposed to serious risks regardless of how the relationship is characterized. The legal response in the United States was to provide investors with (1) representatives to monitor managers and approve the terms of the contract with the adviser on the investors' behalf; (2) monitoring by the regulators; and (3) resort to the courts. These mechanisms must be based on principles and standards. Directors, regulators and the courts must all follow the principles, standards and processes prescribed by law. Investors are afforded a fourth protection by the redeemability of the investors' shares. Unlike directors, regulators and the courts, redeeming shareholders need not follow any principles and standards. They have the owners' right to withdraw from the relationship for whatever reason.

Despite these protections, conflicts of interest are very strong when the losses each investor suffers are very small as compared to the enormous benefits that the managers and the distributors can stand to gain from an arrangement. The previous section suggests that the key to maintaining investors' trust and the financial system is a culture of honesty among managers and distributors. The key is in their self-imposed self-limitation and barriers to temptation. Rules can help. But culture is the decisive factor.

Summary of Contents

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