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Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty

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PRIVATE LITIGATION TO ENFORCE FIDUCIARY DUTIES IN MUTUAL FUNDS: DERIVATIVE SUITS, DISINTERESTED DIRECTORS AND THE IDEOLOGY OF INVESTOR SOVEREIGNTY

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The scandals of 2003 involving late trading, market timing, and the selective disclosure of portfolio information have brought renewed attention to the long-recognized problems of enforcing fiduciary obligations in mutual funds.[1] Intense regulatory and judicial attention in the late 1960s and 70s focused on the disappointing behavior of fund fiduciaries with respect to either the payment of or failure to recapture larger than necessary brokerage commissions and other kinds of diversions that enriched fund sponsors. Private litigation took the lead in seeking remediation, and the famous cases which resulted—*Moses v. Burgin*,[2] *Rosenfeld v. Black*,[3] and *Fogel v. Chestnutt*,[4] among others—set a tone of high investor expectations of care and loyalty.

Gradually, however, the judicial stance softened, with the Supreme Court's 1979 decision in *Burks v. Lasker*[5] being pivotal. Courts increasingly seized on the presence of "disinterested" directors on mutual fund boards—something effectively mandated by rules under the Investment Company Act of 1940[6] (the "'40 Act")—as reason to reduce

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1. For a good overview of the law and economics associated with these events, see Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. ECON. PERSP. 161 (2004). On the underlying market timing issue, decided well before the scandals broke, see Windsor Sec., Inc. v. Hartford Life Ins. Co., 986 F.2d 655 (3d Cir. 1993); First Lincoln Holdings, Inc. v. Equitable Life Assurance Soc'y, 164 F. Supp. 2d 383 (S.D.N.Y. 2001). *See also* Conrad S. Ciccotello et al., *Trading at Stale Prices with Modern Technology: Policy Options for Mutual Funds in the Internet Age*, 7 VA. J.L. & TECH. 6 (2002).

2. Moses v. Burgin, 445 F.2d 369 (1st Cir. 1971).

3. Rosenfeld v. Black, 445 F.2d 1337 (2d Cir. 1971) (sale of advisory contract).

4. Fogel v. Chestnut, 533 F.2d 731 (2d Cir. 1975).

5. Burks v. Lasker, 441 U.S. 471 (1979).

6. The Act requires that at least forty percent of the fund's board be disinterested, except in very unusual circumstances (section 10(a)), and effectively requires a majority of disinterested directors if the fund's principal underwriter is an affiliate of the adviser. The SEC in turn has made crucial regulatory privileges turn on whether the board has a majority of disinterested directors for all funds. *See* Role of Independent Directors of Investment Companies, Securities Act Release No. 7932,

the level of judicial scrutiny to allegations of breach of fiduciary duty, even under statutory provisions that indicate a special federal sensitivity to such breaches.[7] Not coincidentally, cases became harder for plaintiffs to win.

None of this should come as a surprise to those familiar with the parallel legal history of private securities litigation generally. After a period in which investor rights flourished, the mid-1970s brought a sudden wave of judicial skepticism—fear of strike suits became reason enough to cabin otherwise investor-friendly doctrines.[8] Regulatory competition at the state level of law-making became a virtue,[9] not the cause for fear of a race to the bottom (and hence the appeal to a large-scale federalization of corporate law) that it had been to the generation before. State law was promoting the role of independent directors and the "cleansing" processes of corporate governance as a substitute for judicial intervention.[10] There is no doubt that these trends were influential in the mutual fund area,[11] explaining much about the diminishing demands of the case law.

The aim of this paper is to critique some of the key judicial steps, with particular attention to private securities litigation that takes the form of a derivative action on behalf of a particular fund. My critique will not dwell on the pending cases directed against the late trading and market timing abuses in any great detail, although these surely are important.[12] As New York Attorney General Elliot Spitzer emphasized in his remarks and enforcement philosophy after exposing the misbehavior, these issues—though involving many hundreds of millions of dollars in the aggregate—were relatively small compared to other matters of concern in an $8 trillion

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Exchange Act Release No. 43,786, Investment Company Act Release No. 24,816, 66 Fed. Reg. 3734 (Jan. 16, 2001). In response to the scandals, the standard for gaining those privileges was extended to a requirement of seventy-five percent disinterested directors and an independent board chairman, among other governance reforms. Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378 (Aug. 2, 2004). This rulemaking was struck down on procedural grounds in Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005).

7. *See infra* notes 59–85 and accompanying text.

8. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

9. Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).

10. *E.g.*, ROBERT C. CLARK, CORPORATE LAW ch. 5 (1985). For a classic critique, with substantial attention to mutual fund directors, see Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 618–19 (1982).

11. For a contemporaneous call for an increased role for disinterested directors on conflict transactions, see Alan Rosenblat & Martin E. Lybecker, *Some Thoughts on the Federal Securities Laws Regulating External Investment Management Arrangements and the ALI Federal Securities Code Project*, 124 U. PA. L. REV. 587 (1976).

12. On the applicability of section 36(a) to late trading and market timing, see SEC v. PIMCO Advisors Fund Mgmt. LLC, 341 F. Supp. 2d 454, 471 (S.D.N.Y. 2004).

industry.[13] The broader issues involve fiduciary responsibility across a wide range of matters including management fees, distribution expenses, brokerage commissions, and the like.

This article focuses on independent directors and the processes of mutual fund corporate governance. To be clear, I believe (and research shows) that disinterested directors do add value as a form of shareholder protection, and this fact justifies the SEC's efforts to strengthen their role. But they are far from a panacea. While that point alone is almost trite, exploring some of the unique features of mutual fund governance shows why judges and policymakers should not even try to reason by analogy to governance in other kinds of corporations. Yet that is exactly what *Burks*[14] and its progeny have done. Even more interesting is considering the governance consequences of the primary distinction between mutual funds and business corporations: the convergence of the capital and product markets that occurs when the products being sold by the mutual fund are its own securities. Here, the ideology of consumer sovereignty easily crowds out a strong norm of fiduciary responsibility. "Disinterested" directors see little need to measure the behavior of the fund's advisor by reference to anything other than marketplace success—and indeed can be chosen precisely *because* they embrace the ideology of the markets and see the law's assignment to them of strong fiduciary responsibilities as something of an exercise in formalism. If this happens, as I suspect is commonplace, then their checking power will be moderate at best, and the case law's assumption of more, the basis for the decreasing judicial oversight we have seen over the last twenty-five years, misplaced.

I. MUTUAL FUND LITIGATION TO REMEDY FIDUCIARY BREACHES

The typical mutual fund is organized by a sponsor who expects to profit by providing advisory and other services to the fund, with returns growing as the fund grows in size.[15] The fund itself is often a corporation (though it may be an investment trust or some other form of business organization) chartered under state law, managed by or under the director

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13. *See Spitzer Says Advisers Overcharged Funds; Fund Boards Breached Duty to Shareholders*, 36 Sec. Reg. & L. Rep. (BNA) 189 (Feb. 2, 2004).

14. Burks v. Lasker, 441 U.S. 471 (1979).

15. *See* ROBERT C. POZEN, THE MUTUAL FUND INDUSTRY 13–14 (2d ed. 2002); *see generally* TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISERS (2d. ed. 2004). External management is not the only structure on which the fund industry can be based, nor necessarily the best one. *See* John C. Bogle, *Re-mutualizing the Mutual Fund Industry—The Alpha and the Omega*, 45 B.C. L. REV. 391 (2004).

of its own board of directors. The sponsor—playing the role of promoter in corporation law—chooses the initial board, which then enters into a management contract with the fund by which it provides advisory and other services (e.g., brokerage or custodial services) through one or more sponsor-owned entities. The fund, then, is externally managed, with few or no employees of its own. The main role of its board of directors is to negotiate and oversee the delegation to the sponsor. Commonly, the sponsor creates many individual funds, with differing investment objectives, having the same affiliations.

External management, of course, makes the sponsor (the fund's advisor) the focal point of regulatory concern. Conflicts of interest abound. Most obviously, because the advisor is typically paid its fee as a percentage of assets under management, there is an incentive to increase assets at shareholder expense even though increasing the size of the fund does not increase (and can sometimes decrease) returns to its investors.[16] The recent market timing and late trading scandals were just variations on this—the advisors allegedly acquiesced in these activities by hedge funds and others in order to gain or keep other "sticky" assets from those investors.[17] Another conflict comes from the large stream of brokerage commission income paid by the fund to an affiliate, which may not be negotiated at arm's length.[18]

Concern about the potential for conflicts was a primary motivation for the large-scale federalization of mutual fund regulation that occurred in 1940.[19] While Congress retained state chartering of investment companies (and hence a residual layer of regulation under state corporate law), mutual funds became subject to a unique and detailed regulatory scheme under the direction of the SEC that departed considerably from traditional patterns of state law.[20] Perhaps most striking was section 17's near-absolute prohibition on self-dealing transactions except as approved by the SEC,

16. *See* Joseph Chen et al., *Does Fund Size Erode Mutual Fund Performance? The Role of Liquidity and Organization*, 94 AM. ECON. REV. 1276 (2004).

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

18. *See* Susan Pulliam & Gregory Zuckerman, *SEC Examines Rebates Paid To Large Funds*, WALL ST. J., Jan. 6, 2005, at C1; *Adviser Group's Study Finds Costs Disclosed by Funds Understate "True Costs*,*"* 36 Sec. Reg. & L. Rep. (BNA) 199 (Feb. 2, 2004).

19. *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 222–29 (rev. ed. 2003).

20. There was also a political element to the development of the '40 Act. For a while, at least, its strict regulation of the investment company industry stunted the growth of concentrated pools of investment capital, something that corporate officers and directors, commercial banks, and others would find to their liking. *See* Mark J. Roe, *Political Elements in the Creation of a Mutual Fund Industry*, 139 U. PA. L. REV. 1469 (1991).

rejecting the "fairness" standard that dominates in state corporate law.[21] Independent directors became mandatory, with an explicit statutory definition of disinterestedness.[22]

As originally enacted, section 36 of the '40 Act contained a prohibition against breaches of fiduciary duty involving "gross misconduct or gross abuse of trust" by those in a position to exploit mutual fund investors, particularly the fund's advisor.[23] In response to a series of studies of continuing problems in the fund industry, Congress made major changes to the '40 Act in 1970, specifically revising section 36 by adding an express private right of action under new subsection (b) to remedy breaches of duty involving compensation and fees paid by the mutual fund to affiliated parties.[24] Section 36(a) was also revised, making it easier to reach other fiduciary breaches by simply requiring that they involve "personal misconduct."[25] The legislation did not provide for an explicit private right under subsection (a), but the available legislative history seemed supportive of judicial implication—which at the time was commonplace throughout the federal securities laws.[26] For the most part, courts took this as enough to justify an implied right under section 36(a), although the matter is now heavily contested.[27]

Section 36 is not the only private litigation weapon designed to combat breaches of fiduciary duties.[28] The securities laws are filled with antifraud provisions, and as is by now familiar, the line between fraud and breach of fiduciary duty is extremely blurred.[29] When a fiduciary duty exists, there is an affirmative duty to disclose. Because mutual fund advisors are plainly fiduciaries in the eyes of the law and their actions almost always touch on the purchase or sale of securities, plaintiffs have the ability to invoke cases

21. For an analysis, see CLARK, *supra* note 10, at 188–89.

22. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 1067–70 (4th ed. 2004).

23. 15 U.S.C. § 80(a).

24. 15 U.S.C. § 80a-36(b).

25. 15 U.S.C. § 80a-36(a).

26. On this background, see Arthur S. Gabinet & George M. Gowen III, *The Past and Future of Implied Causes of Action Under the Investment Company Act of 1940*, 3 VILL. J.L. & INVESTMENT MGMT. 45 (2001–2002).

27. *See infra* notes 51–56 and accompanying text.

28. For an overview of the wide range of claims being made by plaintiffs in the late trading/market timing litigation, see James Benedict & Mary Dukla, *Recent Developments in Litigation Under the Investment Company Act of 1940*, *in* PLI INVESTMENT MANAGEMENT INSTITUTE 2004: A SEMINAR FOR '40 ACT LAWYERS (2004).

29. *See* Donald C. Langevoort, *Seeking Sunlight in Santa Fe's Shadow: The SEC's Pursuit of Managerial Accountability*, 79 WASH. U. L.Q. 449 (2001); Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859 (2003).

like *United States v. O'Hagan*[30] and *SEC v. Zandford*[31] as ways of turning hidden breaches of fiduciary duty into securities fraud.[32] And because mutual funds are constantly making public distributions of their own securities, the Securities Act of 1933[33] (the "'33 Act")—with its potent express rights of action under sections 11 and 12(a)(2) for material misstatements or actionable omissions—applies as well. Plaintiffs make much in their market timing and late trading allegations of potential misrepresentations in mutual fund disclosures regarding fund policies with respect to quick redemptions, for good reason. Upon a showing of an actionable misrepresentation, the '33 Act provisions are especially plaintiff-friendly on matters of state of mind, reliance and causation. Specifically within the '40 Act, plaintiffs can also by-pass section 36 if they like and ask the court to imply a right of action directly under some other section, such as (in the recent scandals) section 22 and rule 22c-1, dealing with mutual fund pricing in sales and redemptions.[34]

Without necessarily being critical of such uses in private litigation, they are all indirect mechanisms for seeking relief that is founded on a breach of fiduciary duty, whereas section 36 has as its subject the problem of remedying the fiduciary breach. These litigation alternatives often have the troubling effect of limiting recovery to purchasers or sellers rather than holders and of making the fund itself the primary defendant, either as the issuer of the securities or author of the disclosure, rather than as the breacher.[35] To be sure, doctrines of controlling person liability, indemnification and contribution might ultimately shift the burden to the real wrongdoer, but not until after the fund and its investors have incurred substantial transaction costs. My focus is mainly on section 36 because it gets right to the point, against the right party.

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30. United States v. O'Hagan, 521 U.S. 642 (1997) (insider trading under the so-called "misappropriation theory").

31. SEC v. Zandford, 535 U.S. 813 (2002) (breach of fiduciary duty in brokerage context).

32. In the *PIMCO* case, an SEC enforcement proceeding, the court doubted whether a concealed breach by itself would constitute fraud, and hence emphasized the affirmative misrepresentation aspect of the claims. *See* SEC v. PIMCO Advisors Fund Mgmt. LLC, 341 F. Supp. 2d 454, 469 (S.D.N.Y. 2004). The court was mistaken in its reading of the law. The court did readily accept the applicability of Section 36(a), which does not require a showing of fraud. *Id.* at 471–72.

33. 15 U.S.C. § 77.

34. Another avenue that plaintiffs have explored is to seek rescission of contracts with the fiduciary, along with ancillary relief, under section 47 of the Investment Company Act or section 415 of the Investment Advisers Act of 1940, taking advantage of the very broad articulation of fiduciary obligations imposed on advisers in the case law. *See* H. Norman Knickle, *The Investment Company Act of 1940: SEC Enforcement and Private Actions*, 23 ANN. REV. BANKING & FIN. L. 777, 843–46 (2004).

35. *See* Mahoney, *supra* note 1, at 177.

A. Section 36(b)

As noted earlier, section 36(b) creates an express private right of action (as well as enabling the SEC to bring suit) with respect to breaches of fiduciary duty involving "the receipt of compensation for services, or of payments of a material nature, paid by [the fund or its shareholders] to such investment adviser or any affiliated person of such investment adviser."[36] Subsection (1) makes clear that the breach need not involve personal misconduct, in contrast to section 36(a).

One interpretive issue involves the dividing line between the two subsections. Many of the difficulties for plaintiffs that we are about to see under subsection (a) are avoidable if an action can be brought under subsection (b), and arguably, many alleged breaches of fiduciary duty—for example, late trading or market timing—relate to compensation or payments to the adviser because the motivation is to increase or preserve the adviser's income. The courts have not been consistent here, but many cases limit subsection (b) to matters directly related to payments from the fund to the adviser based on the problem of excessive fees because of adviser domination and control.[37]

Nor are plaintiffs in clear sailing simply because they have situated their claim within subsection (b). The case law has struggled with plaintiffs' burden of proof relating to what constitutes excessive or inappropriate compensation. The key case is *Gartenberg v. Merrill Lynch Asset Management Inc.*,[38] which reads enigmatically to say the least, but in the end takes a plainly pro-defendant approach. Plaintiffs challenged the advisory fee paid to Merrill Lynch by its massive money market fund as excessive.[39] The district court dismissed on grounds that fees approved by independent directors are valid if deemed fair compared to fees charged by other advisers to similar funds.[40]

On appeal, the plaintiffs argued that this was a foolish test.[41] If the industry remains dominated by conflicts of interest, then excessive fees

36. *See generally* FRANKEL, *supra* note 15, § 12.03; William P. Rogers & James N. Benedict, *Money Market Fund Management Fees: How Much is Too Much?*, 57 N.Y.U. L. REV. 1059 (1982).

37. For an overview of the case law, see FRANKEL, *supra* note 15, § 34.03[C]; Benedict & Dukla, *supra* note 28. The concern regards the need to interpret section 36(b) so that it does not become a catch-all for mismanagement, *see* Migdal v. Rowe Price-Fleming Int'l, Inc., 248 F.3d 321 (4th Cir. 2001) (limited to excessive fees); Green v. Fund Asset Mgmt., L.P., 147 F. Supp. 2d 318, 328–30 (D.N.J. 2001), *aff'd*, 286 F.3d 682 (3d Cir. 2002) (broader scope).

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

39. *Id.* at 925.

40. *Id.* at 926–27.

41. *Id.* at 927–28.

will be the norm, and the norm should then not be made the benchmark for propriety.[42] And throughout much of the opinion, the Second Circuit seems to concur, explaining how Congress was dissatisfied with governance practices and how the market does not work as an adequate check on overreaching.[43] Yet the standard adopted by the court is very restrained, affording plaintiffs a remedy only when the fee "is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[44] This test resembles the state law test for corporate waste, even though the legislative history behind section 36(b) explicitly wanted something more than a waste test,[45] signaling little promise of success on the merits. Obviously, the court was uncomfortable getting more deeply into the business of fee-setting on its own—it is indeed hard to devise a principled substantive basis for striking down a fee that is fully disclosed and not outside of industry norms.[46] Since *Gartenberg*, predictably, plaintiffs have fared poorly in their attacks on fees and 12b-1 plans,[47] notwithstanding ample grounds for concern that both tend toward excess industry-wide.[48]

B. Section 36(a) and Other Remedies for Fiduciary Breaches

In contrast to subsection (b), section 36(a) extends to all breaches of fiduciary duty involving personal misconduct, and hence is more likely to be invoked with respect to concealed breaches of duty. Some courts have construed the misconduct language to require some breach of the duty of

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42. *Id.*

43. *Id.* at 927–30.

44. *Gartenberg*, 694 F.2d at 928. The court identified a series of six factors that could aid in this inquiry. Approval by disinterested directors is a factor, though not controlling. *See* FRANKEL, *supra* note 15, § 12.03[D-E].

45. *See* S. REP. NO. 91–184, at 15–16 (1969). The legislative history does make clear that judicial oversight is not to operate as a form of rate regulation, and that the main issue is to assure that the fee structure is revised periodically to reflect changes in asset size, etc. *See* Richard Phillips, *Mutual Fund Independent Directors: A Model for Corporate America?*, 9 Investment Company Institute Perspective, Aug. 2003, at 1, 10.

46. A court might insist on something like a reasoned justification of the fee in light of performance, services, costs, etc., and call into question supra-normal fees when no supra-normal performance or level of service can be articulated.

47. *E.g.*, Krinsk v. Fund Asset Mgmt., Inc., 875 F.2d 404 (2d Cir. 1989).

48. For a useful collection of materials exploring the economics of the fund industry and nicely posing the questions involved in choosing market-based or regulation-based responses, see WILLIAM BAUMOL ET AL., THE ECONOMICS OF MUTUAL FUND MARKETS: COMPETITION VERSUS REGULATION (1990).

loyalty,[49] but others have been willing to extend it to egregious examples of failed oversight, so that culpably acquiescent directors can also be named as defendants.[50]

There is a lively debate over whether there is an implied private right of action under section 36(a), or indeed, anywhere under the '40 Act.[51] Until recently, courts plainly thought so,[52] largely because of supportive language in the legislative history of 36(a) and the fact that its drafting occurred at a time when judicially implied private rights were commonplace.[53] An immense amount of litigation under the '40 Act has gone forward with little doubt about the viability of implied rights. But recently, taking a cue from more recent Supreme Court cases (particularly *Central Bank of Denver v. First Interstate Bank of Denver*[54]), lower courts have begun to question whether the liberal implication is still sustainable—most notably, in the Second Circuit's decision in *Olmsted v. Pruco Life Insurance Co. of New Jersey*.[55] In the past year, a number of district courts have taken this as enough reason to overturn the decades of authority in favor of an implied right under section 36(a).[56]

Because this involves a jurisprudential question far removed from my main subject, I do not want to climb into the implied rights thicket. As noted earlier, even if there is no implied right under the '40 Act, it is not particularly hard to bring an action for a secret breach of fiduciary duty under Rule 10b-5, where an implied right is beyond question. The more relevant question is what form private litigation to enforce fiduciary duties takes, whether under section 36(a) or otherwise, which brings us to the problem of the derivative lawsuit.

By and large, courts have found most claims of breach of fiduciary duty under the '40 Act to be ones where the harm is to the fund rather than shareholders and hence must be brought derivatively,[57] which is consistent

49. *See, e.g.*, SEC v. Commonwealth Chemical, 410 F. Supp. 1002 (S.D.N.Y. 1976).

50. *See, e.g.*, Strougo v. Scudder, Stevens & Clark, F. Supp. 783 (S.D.N.Y. 1997).

51. *See, e.g.*, Gabinet & Gowen, *supra* note 26.

52. *E.g.*, Tannenbaum v. Zeller, 552 F.2d 402 (2d Cir. 1977).

53. *See* Cannon v. Univ. of Chicago, 441 U.S. 677 (1979).

54. Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

55. Olmsted v. Pruco Life Ins. Co. of New Jersey, 283 F.3d 429 (2d Cir. 2002). *Pruco*, however, involved two statutory sections that were adopted in the 1990s, well after the Supreme Court had turned to a more restrictive approach. For an earlier expression of doubts about implication, albeit in dicta, see Boland v. Engle, 113 F.3d 706, 715 n.9 (7th Cir. 1997).

56. *E.g.*, *In re* Eaton Vance Mut. Fund Litig., 380 F. Supp. 2d (S.D.N.Y. 2005); *In re* Mut. Funds Inv. Litig., 384 F. Supp. 2d 845 (D. Md. 2005); Chamberlain v. Aberdeen Asset Mgmt. Ltd., [2004–2005 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,113 (S.D.N.Y. 2005).

57. *E.g.*, Strougo *ex rel.* Brazil Fund, Inc. v. Scudder, Stevens & Clark, Inc., 964 F. Supp. 783 (S.D.N.Y. 1997). For a collection of the case law, see Benedict & Dukla, *supra* note 28.

with corporate law as generally understood. Specific cases may point otherwise: For example, in *Strougo v. Bassini*,[58] the Second Circuit allowed a direct claim to proceed with respect to charges that a closed-end investment company's directors authorized a dilutive rights offering that operated coercively on individual investors. That holding, too, seems right, but because of the plausible claim of coercion. Most breaches of duty (including late trading and market timing) will not have a similar impact.

If a claim is derivative, then the interesting questions begin, all dealing with how much discretion the fund's independent directors should have to take control of the suit away from the plaintiffs. The issue of demand on directors is the common entry portal to this issue. What are the standards for demand required or demand excused, and will special litigation committees of disinterested directors be able to settle or terminate the case over shareholder objections?[59] Curiously, this is an area of securities law in which the Supreme Court has labored repeatedly in the last few decades. Two of those cases, though understandable on their facts, have set the law on a questionable course.

The first was *Burks v. Lasker*,[60] an action arising out of a mutual fund's purchase of Penn Central commercial paper just before its insolvency. A derivative suit was brought on a number of grounds (though apparently not section 36(a)), and the question was whether the fund's disinterested directors had the power to terminate the lawsuit.[61] The Second Circuit said no, adopting a federal per se rule.[62] The Supreme Court treated the question as one of choice of law,[63] and held—crucially—that '40 Act claims touching on corporate governance should look to state law where the matter is not specifically addressed in the Act or its rules.[64] In other words, there is no federal common law of corporations for mutual funds.[65] The Court thus held that the law of the state of incorporation applies to permit termination in a given case except to the extent that the particular state law rule is inconsistent with the policies underlying the '40 Act.[66] Because the lower court had made no state law determination, the case

58. Strougo v. Bassini, 282 F.3d 162 (2d Cir. 2002).
59. For a more extensive discussion of the case law on this issue, see FRANKEL, *supra* note 15, § 34.07[G].
60. Burks v. Lasker, 441 U.S. 471 (1979).
61. *Id.* at 473.
62. Lasker v. Burks, 567 F.2d 1208 (2d Cir. 1978).
63. Burks v. Lasker, 441 U.S. 471, 475 (1979).
64. *Id.* at 478, 486.
65. *Id.* at 477–78.
66. *Id.* at 486.

was remanded for further proceedings.[67] But the Court made clear that it expected that the disinterested directors would be given a substantial role: "[I]t would have been paradoxical for Congress to have been willing to rely largely upon 'watchdogs' to protect shareholder interests and yet, where the 'watchdogs' have done precisely that, require that they be totally muzzled."[68]

The other deferential Supreme Court case came a little more than a decade later, in *Kamen v. Kemper Financial Services, Inc*.[69] In a procedurally odd setting, plaintiffs brought a proxy rule-based complaint derivatively against the fund's adviser, again without making any demand on the fund's directors.[70] *Burks* notwithstanding, the Seventh Circuit drew from the American Law Institute's Principles of Corporate Governance to impose a federal "universal demand" requirement, which it invoked to dismiss the suit.[71] Not surprisingly, the Supreme Court reversed, repeating that state law presumptively controls—in essence, that futility *can* sometimes excuse demand.[72] Thus, Maryland law would have to be consulted to determine its approach to demand futility, and that doctrine would be respected unless inconsistent with the '40 Act's philosophy. Again, there was remand.[73]

Neither holding is itself necessarily all that troubling—neither ever explicitly addresses the more important question of what posture toward director termination of derivative suits is consistent with the policies of the '40 Act. What is surprising, however, especially in *Kamen* but also in *Burks*, is the reverential tone with respect to state law on such a crucial question of mutual fund governance. After all, so much of the '40 Act rests on a repudiation of the traditional protections of state corporate law.[74] But the language of the opinions speaks of the virtues of certainty and predictability from looking to state law, without much hint of doubt about the underlying political choices.

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67. *Id.* at 486.
68. Burks v. Lasker, 441 U.S. 471, 485 (1979).
69. Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90 (1991).
70. *Id.* at 93–94.
71. *Id.* at 94–95.
72. *Id.* at 98–99.
73. On remand, the complaint was dismissed. *See* Kamen v. Kemper Fin. Servs., Inc., 939 F.2d 458 (7th Cir. 1991).
74. *See* Meyer Eisenberg & Richard M. Phillips, *Mutual Fund Litigation—New Frontiers for the Investment Company Act*, 62 COLUM. L. REV. 73 (1962). In an old but well known case, *Levitt v. Johnson*, 334 F.2d 815 (1st Cir. 1964), the First Circuit had approached demand futility from the standpoint of the '40 Act's skepticism about mutual fund governance.

It is thus tempting to put the two cases in the same conservative, federalism-laden vein as better known decisions of the period, like *Santa Fe v. Green*[75] under Rule 10b-5. But *Burks* was written by Justice Brennan and *Kamen* by Justice Marshall, and these were the Court's two leading liberals. At least *Kamen's* infatuation with state law may largely be the product of a misimpression—the opinion seems to assume that universal demand was starkly anti-plaintiff, so that fund shareholders were the happy beneficiaries of the Court's ruling. In fact, the ALI rule invoked by the Seventh Circuit was more a way of trivializing demand, shifting substantive attention to the merits of any subsequent effort by the directors to terminate. While the ALI approach to that question was something of a compromise,[76] it called for more thorough judicial review than that afforded in many states—including, as we shall shortly see, Maryland.

Kamen's main effect, then, was to move the crucial question back to the states with a strong hint to accept whatever outcome state law generates. To be sure, the '40 Act "check" first articulated in *Burks* still applies. However, the admiring tone toward state law corporate governance solutions was unlikely to prompt much judicial skepticism. And that is precisely what has happened, well illustrated by the recent Second Circuit decision in *Scalisi v. Fund Asset Management, L.P.*[77] Plaintiffs brought a case under section 36(a) and other provisions against Merrill Lynch's Fund Assent Management Company, advisor to the Merrill Lynch Focus Twenty Fund, based on purchases of Enron stock for the fund portfolio.[78] They refused to make demand on futility grounds, claiming that the fund directors were controlled persons because they served on forty-nine Merrill fund boards, collecting between $160,000 and $260,000 in annual fees.[79] Plaintiffs argued that the '40 Act test for disinterestedness should apply for determining when directors lack the

75. 430 U.S. 462 (1977).

76. *See* John C. Coffee Jr., *New Myths and Old Realities: The American Law Institute Faces the Derivative Action*, 48 BUS. LAW. 1407 (1993).

77. Scalisi v. Fund Asset Mgmt., L.P., 380 F.3d 133 (2d Cir. 2004).

78. *Id.* at 136.

79. *Id.* at 136. This type of claim about disinterested directors is frequently raised by plaintiffs, without much success. *See* Migdal v. Rowe Price-Fleming Int'l, Inc., 248 F.3d 321 (4th Cir. 2001); *see also* Benedict & Dukla, *supra* note 28. Reacting to such criticisms, the SEC has required greater disclosure about multi-board service, but has not actually taken the position that such persons are controlled, and hence disinterested. In response to a district court case, *Strougo* ex rel. *Brazil Fund, Inc. v. Scudder, Stevens & Clark, Inc.*, 964 F. Supp. 783 (S.D.N.Y. 1997), that called the independence of such directors into question, Maryland revised its corporation law statute to provide that a director deemed disinterested under the '40 Act would be deemed independent under Maryland law. *See* FRANKEL, *supra* note 15, § 34.07[G], at 34–143.

independence to enable them to fairly evaluate the derivative suit.[80] The Second Circuit rejected the argument, finding that Maryland law controlled on all issues relating to demand futility.[81] It then applied the severe test set forth by the Maryland Court of Appeals in *Werbowsky v. Collomb*,[82] making the question turn on whether "'a majority of the directors are so personally and directly conflicted or committed to the decision in dispute that they cannot reasonably be expected to respond to a demand in good faith and within the ambit of the business judgment rule.'"[83] Although this only dealt with demand rather than a subsequent decision to terminate, the Maryland court was clear as to the latter as well: When demand is required, a decision by the board to reject the demand and terminate the litigation would be tested under the business judgment rule.[84]

What is jarring about *Scalisi* and similar cases, of course, is that the analysis contains nothing about the '40 Act's philosophy about corporate governance, which both *Burks* and *Kamen* said is the check on the otherwise automatic incorporation of state law.[85] The *Scalisi* plaintiffs had a reasonable methodological point: if state law has to cohere with the '40 Act approach, then the '40 Act test for disinterestedness should at least be informative, if not compelling. At the very least, a fresh look at the federal philosophy of mutual fund governance on as important and controversial a question as the termination of derivative suits was in order. That the *Werbowsky* approach was deliberately more limited (and hence defendant-friendly) than the "reasonable doubt" approach used by Delaware courts[86] might have at least caused the Second Circuit to wonder whether the '40 Act philosophy sets limits on deferring to the board's preferences about the lawsuit when a serious claim of breach of fiduciary duty is made.

The unsatisfying nature of the inquiry is underscored by looking at a third Supreme Court decision dealing with demand requirements in mutual fund litigation, *Daily Income Fund, Inc. v. Fox*.[87] At issue in *Fox* was whether there was a demand requirement under section 36(b), the express

80. *Id.* at 139.

81. *Id.* at 139–40.

82. Werbowsky v. Collomb, 766 A.2d 123 (Md. 2001).

83. Scalisi v. Fund Asset Mgmt., L.P., 380 F.3d 133, 139 (2d Cir. 2004) (quoting *Werbowsky*, 766 A.2d at 144). The court described this as an "extremely limited" inquiry, pointing specifically to the dangers that derivative litigation can pose to the corporation. *Werbowsky*, 766 A.2d at 144.

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

85. Kemper v. Kamen Fin. Servs., Inc., 500 U.S. 90, 108 (1990); Burks v. Lasker, 441 U.S. 471, 484–85 (1979).

86. *E.g.*, *In re* Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003).

87. Daily Income Fund, Inc. v. Fox, 464 U.S. 523 (1984).

right of action for compensation-related breaches of fiduciary duty.[88] The Court said no, largely by reference to text and legislative history.[89] In exploring that history, the Court recounted legislative doubts leading up to the 1970 amendments about whether disinterested directors could really be counted on as a check on excessive fees and other compensation.[90] Hence it was reasonable to draft the statute in a way that would allow the private litigation to go forward without any director control.[91]

While one could read this as limited to litigation about fees, the point is really a broader one. If Congress in 1970 thought directors were weak enough links in the governance process that shareholder litigation regarding fees and compensation should bypass them, it is not immediately obvious why the same skepticism would not be appropriate in non-fee cases alleging personal misconduct. Although *Burks* seemingly forecloses complete disregard of board judgment in non-36(b) cases, the embedded '40 Act philosophy would seem to call for *some* meaningful review of a board's decision to terminate—not the opposite extreme of business judgment deference.

II. A CRITIQUE OF DEFERENCE IN THE MUTUAL FUND AREA

A. *The Blending of Mutual Fund and Corporate Law*

As noted earlier, one obvious hypothesis for why the case law evolved toward a deferential posture is that courts came to see mutual funds as business corporations (or equivalent entities) and joined into the same spirit that intellectually dominated the late 1970s through the 1990s—the belief that market forces provide a stronger and more efficient discipline on corporate behavior than strong legal intervention, justifying deference. In this view, the competition for charters drives state law toward optimality, a discipline not at work at the federal level.[92] *Burks* and *Kamen* especially are less about the unique features of mutual funds and very much about general principles of corporate governance, drawing heavily from the prevailing thought of the time. This federalist, anti-regulatory genre was at an intellectual peak at the end of the 1980s: Consider that *Kamen* was decided in 1991, contemporaneous with other judicial tributes

88. *Id.* at 524.
89. *Id.* at 534, 536.
90. *Id.* at 538–41.
91. *Id.*
92. *See* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993).

to managerial autonomy, such as *Business Roundtable v. SEC*[93] on shareholder voting rights (1990) and the Delaware Supreme Court's *Time-Warner* decision (1989),[94] which eschewed any serious judicial inquiry into takeover defensive tactics designed to preserve a chosen business strategy.

If so, there are two justifiable reactions. The first is that even with respect to corporate law generally, the romanticism of the markets has faded, and concern about excessive managerial power in the absence of legal intervention has resurfaced. The "race to the top" hypothesis is more heavily contested than it was fifteen years ago,[95] in favor of a more ambiguous vision built on path dependency in which the only potential check on Delaware's autonomy is the sometimes serious (but usually not) threat of federal intervention.[96] If the mutual fund case law is still being influenced by a vision in which corporate federalism is an unqualified matter of faith, then that is reason enough to reconsider.

The second is more fundamental: Mutual funds are not enough like business corporations for there to be any more than a facile analogy. Any plausible theory of effective market discipline in corporate law generally rests on some combination of the following: an efficient capital marketplace that prices both good and bad corporate governance with reasonable precision; compensation of key insiders using stock or options, so as to better align the interests of managers and investors; the emerging power of institutional investors who can actually threaten to exercise their voting rights; and a reasonably active market for corporate control. Without passing judgment on the sufficiency of any of these in the world of corporations—each is contestable there as well, as the contemporary corporate law literature points out—the simple fact is that none even arguably operates with any power in the world of mutual funds. Because mutual funds are not traded in an organized market, arbitrage opportunities cannot work to keep prices in line with rational expectations.[97] Mutual fund prices are simply the product of net asset value at the time of purchase or redemption. Insider compensation is largely based on assets as well, which creates the conflict rather than aligns insider-shareholder

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93. Bus. Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (striking down SEC rule 19c-4 as an undue interference with state primacy in corporate governance).

94. Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989).

95. *E.g.*, Lucian Ayre Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553 (2002).

96. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003).

97. *See* Edwin J. Elton et al., *Are Investors Rational? Choices Among Index Funds*, 59 J. FIN. 261 (2004).

interests, and directors are typically paid all or mostly in cash. Institutional shareholder voice does not exist in the fund area, and there is no external market for corporate control at all because shareholders can only sell their shares back to the fund. Thinking about mutual funds by imagining them simply as a species of "corporations" in a way that is directly informed by contemporary corporate law theory is completely misguided.

B. The Convergence of Capital and Product Markets

However, that there is not a good analogy between business corporations and mutual funds does not mean that there might not be some alternative market-based mechanism that justifies a comparable skepticism about the need for intensive federal regulation. Critics of '40 Act-style regulation are on firmer ground in arguing that, because mutual fund shares are continually being offered and redeemed, investors impose an even more direct and powerful discipline than in corporations generally. This convergence of the capital and product marketplaces, they would say, means that any fund adviser seeking to increase assets will have to offer an attractive bundle of skillful portfolio management and credible shareholder protections lest it lose in the marketplace to higher quality competitors.[98]

This, of course, is not an argument against any need for law or in favor of complete director autonomy.[99] As in any market that might suffer from a "lemons" problem, there is always the possibility of concealed opportunism: Funds will emerge that mimic others but cheat, or once-respectable funds will find that they can no longer successfully compete in the market and try some last-period strategy built on deception to milk the assets that remain. In a highly competitive marketplace characterized by ease of entry, policing for deceptive misbehavior is still important. But competition gives the fund ample incentive to use corporate governance as a bonding mechanism to find new investor money and keep the money it has under management, so that residual regulation need not be heavy-handed, and presumably the states would compete to offer efficient mechanisms to help high quality funds credibly overcome the lemons problem. In other words, the kind of state law-oriented, deferential

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98. *See* BAUMOL, *supra* note 48.

99. *See* Robert Charles Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treaties*, 94 HARV. L. REV. 561 (1981). Obviously, there must be some mechanism to prevent the misappropriation of funds or excessively risky behavior—something common to the regulation of all financial institutions.

approach we have seen from the case law would be quite plausible if the basic market discipline works.

For the discipline to operate, however, the product market must be rational, with mutual fund investors looking out for their own interests with reasonable diligence. Diligence would not necessarily be required from every investor: conventional economic analysis teaches that the less sophisticated consumer will be protected so long as the producer realizes that it must persuade enough sophisticated consumers to purchase the same product. The theory does not work, however, if the market can be segmented with similar but different products, with inferior products being marketed to the less sophisticated.[100] In contrast to an organized trading market, as noted earlier, there is no opportunity for arbitrage, so that smart money alone cannot correct any mispricing.

Questions about consumer decision-making are empirical and there is now enough data on mutual fund investor behavior to gain some useful insight. Inquiries into the relationship between mutual fund costs and returns to investors have produced what Paul Mahoney calls "discomfiting results."[101] Higher costs do not translate into any obvious advantages to investors—several studies show a *negative* relationship between returns and both fees and trading expenses.[102] Much of this research is an outgrowth of the most robust finding in the market efficiency literature: that market-beating strategies are hard to find or sustain, and those who pay for above-average performance are likely to be disappointed should they ever come to understand their results.[103] To be sure, investors may be gaining utility through other features of the mutual fund investment, such as good custodianship and record-keeping, asset allocation or retirement

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100. *See* Mahoney, *supra* note 1, at 168–69.

101. *Id.* at 169; *see also* Ronald Wilcox, *Bargain Hunting or Star Gazing? How Consumers Choose Mutual Funds*, 76 J. BUS. L. 645 (2003).

102. *E.g.*, Martin J. Gruber, *Another Puzzle: The Growth in Actively Managed Mutual Funds*, 51 J. FIN. 783 (1996); Burton G. Malkiel, *Returns from Investing in Equity Mutual Funds 1971 to 1991*, 50 J. FIN. 549 (1995).

103. Survey evidence suggests that investors have misguided beliefs about the relationship between costs and performance; some eighty percent believe that higher costs typically generate better returns. *See* Gordon J. Alexander et al., *Mutual Fund Shareholders: Characteristics, Investor Knowledge and Sources of Information*, 7 FIN. SERV. REV. 301 (1998). For an interesting social psychology study suggesting that even fairly sophisticated investors do not have a good understanding of even their historical returns from mutual fund investments, see Don A. Moore et al., *Positive Illusions and Forecasting Errors in Mutual Fund Investment Decisions*, 79 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 95 (1999). Recent evidence does suggest that mutual funds may have superior stock picking ability but that the positive abnormal returns are not passed on to investors once transaction costs and expenses are taken into account. *See* Russ Wermers, *Mutual Fund Performance: An Empirical Decomposition into Stock-Picking Talent, Style, Transactions Costs, and Expenses*, 55 J. FIN. 1655 (2000).

planning advice, even if returns themselves are not abnormal. But there is no good evidence that these benefits correlate with expenses any better than returns do.

This leads to the suspicion that the market for mutual funds is indeed segmented into more and less sophisticated consumer groups, with funds (or even classes within the same fund) with different quality attributes appealing to different segments.[104] One rough division is between no-load funds and funds sold by brokers, which tend to have heavy distribution expenses. A recent study by Bergstresser, Chalmers, and Tufano[105] looked at a number of differences between the two groups and found that broker-sold funds—purchased by those self-identified as preferring to rely on the advice of trained professionals—falling short on most all dimensions:

> The bulk of our evidence fails to identify tangible advantages of the broker channel. In the broker channel, consumers pay extra distribution fees to buy funds with higher non-distribution fee expenses. The funds they buy underperform those in the direct channel even before deductions of any distribution related expenses. . . . [They] exhibit no superior asset allocation. . . . Finally, realized flows of money into individual funds appear to flow into funds with larger front end loads. . . .[106]

While the authors cannot eliminate the possibility of some other offsetting utility gains apart from returns, the more likely explanation is some combination of investor ignorance and potent salesmanship by the brokers.

Other empirical evidence points in the same direction. For example, as the SEC has long feared, there is strong evidence of trend-chasing by mutual fund investors, that is, buying funds with strong recent performance,[107] even though there is little reason to suspect the hot hand to

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104. *See* Elton et al., *supra* note 97. Ronald Wilcox, *supra* note 101, surprisingly suggests that errors are particularly frequent among those from whom it might least be expected: higher-educated, higher-income groups, including those with above-average knowledge of basic financial principles.

105. Daniel Bergstresser et al., *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry* (Mar. 15, 2005) (working paper, Harvard Business School), *available at* http://ssrn.com/abstract=616981.

106. *Id.* at 33. The point here is simply a descriptive one—that the market for mutual fund shares exhibits suboptimal rationality, especially in certain market channels. It is not meant to suggest abuse: One could well argue that paying brokers to sell shares (even inferior ones) to less sophisticated investors is better than leaving those investors to their own choices, or to choices driven by sellers of other investment products (e.g., insurance, bank products, or affinity programs) that would leave them even worse off.

107. *See* Prem C. Jain & Joanna Shuang Wu, *Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows*, 55 J. FIN. 937 (2000); Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FIN. 1589 (1998).

continue for more than a brief period of time, at best.[108] Not surprisingly, this is especially so with brokered fund purchases, but operates in both segments, which in turn invites various forms of opportunism. For example, advertising can readily distort decisions by investors already inclined to overweight recent performance.[109] Window dressing occurs at the end of quarters, just before public reporting, to embellish results.[110] Funds that lag their competitors in the tournament for new money engage in riskier portfolio behavior in an effort to catch up.[111] The SEC has noticed the practice of creating many new funds with small initial capitalization.[112] A few are bound to be lucky and their performance is thereupon heavily advertised; the remainders are quietly merged into other funds.

That new money is sensitive to recent performance is not all bad, even if it suggests trend-chasing behavior—at least good performance by fund managers is rewarded, a key to any marketplace discipline. Unfortunately, the performance sensitivity is asymmetric.[113] Money does not exit poorly performing funds with the same velocity, meaning that laggards are likely to have money from which to take abnormally high fees and other expenses for some time. The final period problem, discussed earlier, can last for quite a while even if a fund is persistently inferior.

Given this, there is ample reason to doubt the sensitivity of the mutual fund market to subtle or difficult-to-interpret information. In a direct test of these doubts, Barber, Odean, and Zheng study differences in fund flows as between sales loads and operating expenses.[114] On average, investors appear to have learned to avoid high sales loads (i.e., there is a net outflow from such finds, all other things being equal). On the other hand, there is, if anything, a "perverse" positive relationship between fund flows and high operating expenses. They attribute this to the advertising purchased

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108. *See* Mark M. Carhart, *On Persistence in Mutual Fund Performance*, 52 J. FIN. 57 (1997).

109. *See, e.g.*, Jain & Wu, *supra* note 107.

110. *Cf.* James Lakonishok et al., *Window Dressing by Pension Fund Managers*, 81 AM. ECON. REV. 227 (1991).

111. *See* Keith C. Brown et al., *Of Tournaments and Temptations: An Analysis of Managerial Incentives in the Mutual Fund Industry*, 51 J. FIN. 85 (1996).

112. *See In re* Van Kampen Inv. Advisory Corp., Investment Act Release No. 23,996, [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,203 (Sept. 8, 1999).

113. *See* Gruber, *supra* note 102; Richard A. Ippolito, *Consumer Reaction to Measures of Poor Quality: Evidence from the Mutual Fund Industry*, 35 J.L. & ECON. 45 (1992). For a discussion of why, see William N. Goetzmann & Nadav Peles, *Cognitive Dissonance and Mutual Fund Investors*, 20 J. FIN. RES. 145 (1997).

114. Brad M. Barber et al., *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows*, 78 J. BUS. 2095 (2005).

by distribution fees and to consumers' difficulties in processing more subtle cost information.

No doubt more work than this is necessary to understand the mutual fund market thoroughly, but what we know about the marketplace suggests that a belief that regulation beyond disclosure is unnecessary because mutual fund investors carefully look out for their own interests is misplaced. Serious agency cost problems remain.[115] And if the market check is suboptimal, the conditions will be not present to make fund promoters choose legal regimes or corporate governance practices that align with investor interests so as to operate as a "race to the top." Choice of directors and other practices are exceedingly subjective and hard to evaluate. And if this is so, the demand by funds for high quality law to make claims of shareholder protection more credible will be low.

This by itself counsels against undue reliance either on state law or "disinterested" directors chosen, explicitly or implicitly, by fund sponsors. State law will likely cater to sponsor interests, not to the degree of no investor protection at all—that might be enough to generate adverse investor reaction—but to a balance decidedly tilted toward generating returns for the sponsors through impression management rather than rigorous controls. The fact that two states, Maryland and Massachusetts, dominate the incorporation business for mutual funds is troublesome under this hypothesis, and we have already seen Maryland's choice of policy in the derivative litigation setting.

C. The Ideology of Product Market Competition

In a widely noted op-ed piece responding to the mutual fund scandals entitled *What Mutual Fund Scandal?*, Henry Manne argued that the matter was seriously overblown: Mutual fund investors care deeply about total returns, and fiduciary breaches that diminish returns within the time horizons of the typical investor will be punished by a highly competitive market.[116] Yet we have just seen that, descriptively, there is reason to doubt the market's sensitivity to either questionable performance or subtle opportunism.

115. In addition to fees and expenses, there is evidence that investors are insensitive to money paid to brokerage affiliates at seemingly above-market rates. *See* Miles Livingston & Edward S. O'Neal, *Mutual Fund Brokerage Commissions*, 19 J. FIN. RES. 273 (1996); Mahoney, *supra* note 1, at 172.

116. Henry G. Manne, *What Mutual Fund Scandal?*, WALL ST. J., Jan. 8, 2004, at A22. For a criticism, see Mahoney, *supra* note 1, at 176, pointing out that hidden opportunism is inconsistent with rational investor protection even if the costs are captured in disclosed total returns.

We need only tweak Manne's claim slightly, however, to capture something slightly different and, to many, more persuasive. As a normative claim, Manne may be read to say that the information about how the funds are managed is available for investors to use as they wish. If investors fail to exercise diligence that seems to comport with common sense (or if they rationally fail to respond to problems that have only small dollar effects on their investments), there is no reason to treat it as a serious moral or regulatory failure on the supply side. The mutual fund industry has a high degree of transparency, and transparency is all that regulation should seek in marketplace transactions.

My aim is not to contest this normative judgment. For my purposes, it is enough to acknowledge the obvious: that many people genuinely accept a conservative, anti-paternalistic vision of consumer responsibility.[117] Within this belief system, the fair test of a product is consumer acceptance in the absence of serious deceit. And mutual fund investments are products—no different, really, from health care, insurance, bank deposits, residential real estate, and other important settings where consumers are often less than diligent. In fact, because of securities regulation and the sophistication of the financial media, the transparency in the mutual fund area is probably superior to that for most of those other important household decisions.

My first hypothesis is that this ideology has been internalized by the mutual fund industry. Whether this is a self-serving inference or not is less important than where the inference leads. The key point is this: Once the mutual fund is viewed as a product to be marketed within liberal societal expectations as to fair advertising like any other, then any notion that the producer is a "fiduciary" is awkward and disorienting.[118] The transaction is instead simply embedded in the morals of the marketplace.[119] To be sure, the law disagrees—the adviser *is* deemed a fiduciary to the fund and its investors. From a business standpoint, however, the law's move makes

117. Such beliefs seem to relate to a broader set of political and ideological values. On the correlation between political ideology and critical attitudes toward cognitive bias as an explanation for suboptimal behavior, see Philip E. Tetlock, *Cognitive Biases and Organizational Correctives: Do Both the Disease and Cure Depend on the Politics of the Beholder?*, 45 ADMIN. SCI. Q. 293 (2000).

118. This problem exists in many areas where the expectations of law may conflict with the self-conceptions in a certain line of business. For a collection of such settings, see generally DEBORAH A. DEMOTT, FIDUCIARY OBLIGATION, AGENCY AND PARTNERSHIP: DUTIES IN ONGOING BUSINESS RELATIONSHIPS (1991). The broker-dealer field is a good example. *See* Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627 (1996).

119. While marketing efforts often portray funds and their sponsors as committed to a trust-based relationship, adherents treat that as common puffery, not an enforceable representation.

little sense. We do not engage in the same principal-agent fiction in most other products of similar significance (consider bank deposits or insurance policies). The analogy from the world of corporations, where the idea of investor ownership has at least some intellectual purchase, does not follow because that is premised on a collective lock-in of equity capital that is not present in mutual funds.[120] Exit is simple. Thus, those inside the fund industry are more likely to act out the law's demands as something of an exercise in formalism without seeing much in the way of realism or legitimacy. In fact, in the 1980s, there were serious proposals to do away with the investor ownership model so as to bring the mutual fund's legal structure closer to marketplace realities.[121]

My second hypothesis is that independent directors of mutual funds will commonly share this normative vision based on consumer sovereignty and will be chosen *because* they do. If so, this has a subtle but important effect on how they self-define their roles as directors. If shareholders are responsible for their own choices, directors are less likely to feel obliged to act aggressively on their behalf. Net inflows of money are the proper metric for testing product quality, not the directors' subjective impression of a fair price. That is to say, they do not see themselves as there to engage in serious bargaining with the sponsors as shareholder representatives, because that is not needed; that, in turn, absolves them from the otherwise uncomfortable exercise of serious fiduciary control.[122] The shareholders can vote with their feet. In turn, consumer acceptance notwithstanding, unduly high fees or other forms of rent-seeking by the sponsor ratifies their relaxed approach.

That would explain a good bit of the empirical and anecdotal data without at the same time buying into the extreme view that all outside directors are mere puppets dominated or controlled by fund sponsors. To those who accept the ideology of consumer sovereignty, the only thing that could justify bargaining down a fully-disclosed management or 12b-1

120. *See, e.g.*, Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387 (2003); Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000).

121. *See* Richard Phillips, *Deregulation under the Investment Company Act—A Reevaluation of the Corporate Paraphernalia of Shareholder Voting and Boards of Directors*, 37 BUS. LAW. 903 (1982). More recently, Phillips has described the role of the independent director in a way that is very close to a consumer sovereignty model. *See* Phillips, *supra* note 45.

122. This plainly is the way those inside the industry view the directors' role, which makes it likely that the director selection process will seek those who agree. For a good illustration of the tension between this vision and the stronger image of the director as the shareholders' faithful bargaining agent, see Mercer E. Bullard, Context and Commentary, *The Mutual Fund Summit*, 73 MISS. L.J. 1129, 1141–46 (2004) (describing panel discussion).

fee would be perceived consumer resistance, which as we have seen can often be overcome by good marketing.[123] It can even provide the rationalization for using mutual fund assets for fairly aggressive distribution tactics. What to a critic might seem the exploitation of consumer biases becomes a means of differentiation from other financial products, including many products marketed with less consumer protection than mutual funds (e.g., insurance and bank products). High commissions paid to brokers are justified by the belief that without such tactics, consumers will make much worse decisions.[124] Within this ideology, the role of the disinterested mutual fund director is fairly minimal: Act out some basic legal and regulatory formalities, and keep the fund and its adviser within rather expansive bounds of acceptable marketing practices.[125]

When consumer acceptance becomes the only practicable measure of both legitimacy and success, the competitive impulses of the adviser are less likely to be checked. There is interesting psychological evidence that people feel *more* free to behave opportunistically once they have disclosed their conflicts of interest.[126] Moreover, many fund sponsors are themselves publicly-traded companies or parts of large publicly-traded financial services firms. Pressures for sustained revenue and earnings growth in an extraordinarily competitive financial services market mean more marketing aggressiveness in the face of diminishing marginal returns. When careers depend on meeting increasingly unrealistic growth targets, fear of falling short often leads to one of two forms of cheating, if not both: deception in the product market and concealed opportunism

123. Good marketing, in turn, may be little more than providing high-powered incentives to brokers and other salespeople. *See* Edward S. O'Neal, *Mutual Fund Share Classes and Broker Incentives*, FIN. ANALYSTS J., Sept.–Oct. 1999, at 76.

124. *See* Bergstresser et al., *supra* note 105, at 11, noting that empirical studies of broker-sold funds cannot test against what the investor would have done in the absence of broker intervention. On similar thinking in the brokerage industry generally, see Langevoort, *supra* note 118.

125. The applicable norms in American society with respect to consumer purchases are fairly lax, of course. *See, e.g.*, THOMAS FRANK, ONE MARKET UNDER GOD: EXTREME CAPITALISM, MARKET POPULISM AND THE END OF MARKET DEMOCRACY (2000); Samuel Bowles, *Endogenous Preferences: The Cultural Consequences of Markets and Other Economic Institutions,* 36 J. ECON. LITERATURE 75 (1998). For a discussion of the ideology of consumer sovereignty in a legal context, see Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: Some Evidence of Market Manipulation*, 112 HARV. L. REV. 1420 (1999); *see also* Douglas Kysar, *Preferences for Processes: The Process/Product Distinction and the Regulation of Consumer Choice*, 118 HARV. L. REV. 525, 584 (2004).

126. *See* Daylian Cain et al., *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 1 (2005). There are two effects. One is that the disclosure does not prompt an adequate form of self-protection, perhaps because the person to whom the disclosure is made takes the disclosure as evidence of good faith. The other is that the person making the disclosure feels greater moral freedom to act selfishly, now that the other person has been put on notice.

designed to find revenue sources to offset the shortfall.[127] The late trading and market timing scandals fall into the latter category. There is no reason to believe that disinterested fund directors would desire, much less encourage, these behaviors. But by accepting the ideology of consumer acceptance as the measure of success, they contribute to an environment where such behaviors become more predictable.

D. Watchdogs?

If my suspicions are accurate, then we can draw some legal conclusions. It is not fair to say that the '40 Act and the SEC have been wrong to invest regulatory resources in director independence. One can have relatively moderate expectations for the performance of disinterested directors and still believe that the strategy adds *some* value, and there is a body of evidence to support this.[128] Research by Khorana, Tufano, and Wedge on merger decisions by fund boards is an example.[129] When funds persistently generate poor returns for investors, the most practicable remedy is a merger into some other fund, where better returns may be more likely. The interesting question is how quickly boards make this decision. Although the results are discomfiting along a number of dimensions (e.g., higher paid boards are slower to react if the effect is to reduce director wealth), the main effect is that more independent boards—most noticeably in the rare case when the board is *entirely* disinterested—react somewhat faster and tolerate less underperformance. They read their results to suggest that outside directors are not anachronistic and might play some useful role, especially if strengthened. But again, the role here is one where the directors act in the face of obvious underperformance and hence a reduction or disappearance of net inflows. Consumerist directors are more likely to take that task fairly seriously even if they are not aggressive bargainers over fees and distribution expenses.

My hypothesis thus acknowledges the plausibility of disinterested director control at the margins. So I would expect, for instance, that even in the absence of regulatory pressure, most fund directors would react to

127. *See* Brown et al., *supra* note 111, on the incentive pressures; *see also* Judith Chevalier & Glenn Ellison, *Risk Taking by Mutual Funds as a Response to Incentives*, 105 J. POL. ECON. 1167 (1997).

128. *See* Peter Tufano & Matthew Sevick, *Board Structure and Fee-setting in the U.S. Mutual Fund Industry*, 46 J. FIN. ECON. 321 (1997).

129. Ajay Khorana et al., Board Structure, *Mergers and Shareholder Wealth: A Study of the Mutual Fund Industry* (Feb. 15, 2005) (working paper, Georgia Institute of Technology), *available at* http://ssrn.com/abstract=621081.

the discovery that advisory personnel were deliberately permitting late trading to occur, an unambiguous violation of rule 22c-1. The problem arises when ambiguity exists, as with market timing, which has largely turned into a question of how quickly large investors should be allowed to redeem after their purchase.[130] With respect to a subjective judgment like this, various forces go to work, familiar in the corporate law literature,[131] that can easily lead to a reaction like Manne's: "What scandal?"[132] To directors heavily invested in the consumer appeal of the mutual fund product, there is a temptation to rationalize subtly opportunistic behavior by fund insiders as tolerable because it is commonplace and ultimately reflected in the performance disclosed to fund investors. Investors' failure to respond (i.e., continuing net inflows) then becomes proof that it is not that troubling.

In the absence of some means of forcing on the industry disinterested directors whose ideology is fiduciary rather than consumerist—and merely making the board chairman independent or increasing the number of disinterested directors will not do this, even though both are positive steps—the more reasonable legal reaction is to keep expectations in check. Whatever the merits of the debate in corporate law generally, the influences in the mutual fund marketplace are too weak simply to presume that directors will act as faithful fiduciaries in the strong, legal sense of the term. The idea was well articulated by the Supreme Court in *Fox*, attributing to Congress the belief that the value of independent directors was such that a dual strategy made more sense: independence *plus* private fiduciary duty litigation under section 36(b) that is outside the control of those directors.[133] Unfortunately, for whatever reasons, *Burks* and *Kamen* seem to have missed the message, leading to what we see in *Scalisi*. Not only is there a thoughtless abdication to state law but also undue deference to disinterested directors on the question of termination of derivative litigation under section 36(a). Again, it is hard to see how the approaches under subsections (a) and (b) square.

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130. *See* Mercer E. Bullard, *The Mutual Fund as a Firm: Frequent Trading, Fund Arbitrage and the SEC's Response to the Mutual Fund Scandal*, 42 HOUS. L. REV. (forthcoming 2006). As Bullard points out, the market timing problem could better be addressed by revising the pricing process to eliminate stale prices.

131. *See, e.g.*, James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 L. & CONTEMP. PROBS. 83 (1985); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797 (2001).

132. *See supra* note 116.

133. *See supra* notes 87–91 and accompanying text.

On the specific question of director termination of derivative suits, then, the kind of deference we have seen is unwise. Because issues of demand and termination are closely bound up in fear of speculative litigation, courts might not want to abandon completely a mechanism that can serve to weed out frivolous suits.[134] It would not be unreasonable for courts to decide that they would entertain motions to dismiss based on the recommendation of a special litigation committee of disinterested directors, but at the very least, that would warrant a reasonableness-based review related to the merits of plaintiffs' complaint, not business judgment deference.[135]

III. CONCLUSION

The case law under section 36 poses an unfortunate number of obstacles to recovery, including undue deference to disinterested directors and the processes of corporate governance. The recent genre of case law has largely missed the point about the differences between mutual funds and business corporations (not to mention doubts about deference in corporations generally), differences that are a main reason we have federal legislation that adopts so different a posture with respect to the governance and management of mutual funds and other investment companies.

The SEC probably bears some responsibility here for the enthusiasm with which it has embraced disinterested director responsibilities over the last two decades. The strategy, set in motion in the '40 Act itself, is reasonable if seen as just that—a strategy rather than a solution. Predictably acting as if there was more promise in the strategy than there really is, however, the Commission made it easier for the courts to buy into the idea that disinterested directors were a dependable check, reducing the need for judicial oversight. As we have seen, the economics of the mutual fund marketplace do not justify that much faith. And if my hypothesis is right that most disinterested directors genuinely believe in a market-based rather than fiduciary-based definition of the director's role, attention will mainly be focused on monitoring the consumer acceptability of the product. Such directors feel no duty to compensate for any flaws in the market by adopting an oppositional attitude toward the fund sponsors, fiduciary rhetoric notwithstanding. Under the market-based model, any interest in ethics is subsumed into either avoidance of legal sanction or

134. Note that the Private Securities Litigation Reform Act does not apply to lawsuits brought under the '40 Act.

135. *See, e.g.*, Fink v. Codey (*In re* PSE & G Shareholder Litig.), 801 A.2d 295 (N.J. 2002).

loss of reputation from highly salient misconduct. That is not much unless the threat of legal sanction is serious and/or investors are attentive. Because consumer attentiveness increases mainly in response to law-generated scandals, the prima facie case for judicial intervention to remedy fiduciary breaches—in which private litigation would seem to be a necessary component—seems strong.

The obstacles that cases like *Scalisi* create encourage plaintiffs to look elsewhere for relief: rule 10b-5, the Securities Act, the rescissionary remedy under the Advisers Act, etc. But as noted earlier, this is unduly complicating and creates the likelihood of pocket-shifting in ways that probably hurt mutual fund investors more than help them. In compensatory terms, the victims of most fiduciary breaches are current fund shareholders and shareholders who have redeemed at prices lower than they would have been in the absence of the breach. Privileging traders over holders—which is the effect of class actions under the 10b-5 or the Securities Act—is not right. One could, of course, use rule 10b-5 somewhat differently, by thinking of the fund itself (the seller) as the victim of a concealed fiduciary breach "coinciding" with purchases of fund shares.[136] But that presumably takes the form of a derivative suit and so probably just brings us back to the troubling obstacles in the case law.

The best response would be for courts to take a few steps back and correct for the overreaction in the direction of disinterestedness and the processes of governance, making derivative litigation a serviceable mechanism for serious judicial review in cases of fiduciary breach.[137] *Fox* provides the justification in '40 Act terms,[138] and both *Burks* and *Kamen* did put in place the safety valve of consistency with the philosophy of the

136. *See supra* notes 29–32. The late trading and market-timing cases have a direct insider trading component to the extent that advisors passed on nonpublic information about a fund's portfolio to outside investors to facilitate their timing activity. While a conventional insider trading case might be hard to maintain because the outsiders traded with the fund itself (which knew the same facts about its portfolio), a conceptually sound *O'Hagan*-type argument could still be made.

137. As noted earlier, I would balance this with equal attention to the need to winnow out meritless lawsuits early on in the litigation. This leads to a more general disclaimer. Demonstrating that the market works imperfectly does not by itself justify any given alternative strategy. It is entirely possible that the agency costs associated with aggressive litigation are sizable, so that the net benefits to investors are minimal. On section 36 specifically, as indicated, I think mechanisms can be crafted that achieve a healthy balance. With respect to broader mutual fund reforms, Paul Mahoney and other skeptics of regulation may well be right that the better strategy is to try to enhance competition (e.g., by allowing different kinds of pricing practices) as opposed to regulating fund activities even more heavily. *See* Mahoney, *supra* note 1, at 179–80; *see also* Bogle, *supra* note 15 (advocating a move back toward internal management arrangements).

138. *See supra* notes 87–91 and accompanying text.

Act that offers the rationale.[139] It would not be that much of a step to say that in light of what we now know about the mutual fund marketplace, claims of demand futility ought get more sympathetic treatment as a matter of federal policy and that if serious allegations of breach of duty are made on behalf of fund shareholders, courts should take a hard look a the merits before deferring to the fund's internal governance processes.

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139. *See supra* notes 60–77 and accompanying text.