

JOHN MORLEY & QUINN CURTIS

Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds

ABSTRACT. Unlike shareholders of ordinary companies, mutual fund shareholders do not sell their shares—they redeem them from the issuing funds for cash. We argue that this unique form of exit almost completely eliminates mutual fund investors' incentives to use voting, boards, and fee liability. Investors will almost never become active in their funds even if the investors are large and sophisticated and even if most of the mutual fund market is not competitive. We also catalogue a number of unintended and harmful ways in which exit distorts voting, boards, and fee liability. Exit interacts with voting, for example, to make firing managers impossible and to prevent investors from receiving notice of fee increases. Exit also interacts with fee liability to cause recoveries to go to the wrong investors and to discourage investors from moving to lower-fee funds. Though exit gives investors a powerful tool to protect their interests, the net effect of exit on many investors is ambiguous, because investors who do not use their rights to leave underperforming funds cannot expect activism by other investors to improve the funds. Ultimately, exit causes mutual funds to look more like products than like ordinary companies. Voting, boards, and fee liability therefore have limited value, and whatever benefits they now achieve could be achieved more effectively and at lower cost by product-style regulation that applies automatically without investor action or that prompts investors to use exit rights effectively.

AUTHORS. John Morley is Associate Professor of Law, University of Virginia School of Law. Quinn Curtis, J.D., Yale Law School 2009; Ph.D. Candidate, Yale School of Management, Department of Finance. We wish to thank Ian Ayres, Douglas Baird, William Birdthistle, John Coates, Henry Hansmann, Mariana Pargendler, Eric Roiter, Gabe Rosenberg, and Roberta Romano for valuable comments. We also thank workshops at Brigham Young University, Brooklyn Law School, Cardozo Law School, UCLA, the University of Chicago, the University of Colorado, and the University of Virginia. The John R. Raben Fund at Yale Law School and the Yale Law School Center for the Study of Corporate Law provided generous financial support.



ARTICLE CONTENTS

INTRODUCTION	87
I. BACKGROUND	91
A. Summary of Regulation	92
1. Voting	92
2. Boards	93
3. Fee Liability	96
B. Existing Thought on Mutual Fund Governance	98
II. EXIT AS A DOMINANT STRATEGY	102
A. The Basics of Exit in Mutual Funds	102
B. The Exit/Activism Decision	105
C. The Costs and Benefits of Activism	106
D. The Benefits of Exiting	110
E. The Costs of Exiting	112
1. Switching Costs	112
2. Search Costs	114
F. Evidence on Shareholder Involvement in Activism	115
1. Voting	115
2. Fee Liability	117
3. Boards	118
G. Contrast with Ordinary Companies and Closed-End Funds	119
III. HARMFUL INTERACTIONS BETWEEN EXIT, VOICE, AND FEE LIABILITY	120
A. Voting	121
B. Boards	123
1. Doubtful Benefits	123
2. Significant Harms	125
C. Fee Liability	126
IV. EXIT'S AMBIGUOUS CONSEQUENCES	129
V. POLICY PROPOSALS	131

A. A Shift in Regulatory Style	131
B. Voting	132
C. Boards	133
D. Fee Liability	136
VI. THE PERSISTENCE OF VOTING, BOARDS, AND FEE LIABILITY	140
CONCLUSION	142

INTRODUCTION

Since the publication of a widely read book by Albert Hirschman in 1970, social scientists have come to agree that all organizations give to their members and owners some combination of the same three basic kinds of rights: exit, voice, and liability.¹ Social scientists have devoted considerable effort to understanding the relationships among these different categories of rights and the ways in which these rights complement and substitute for one another. This Article explores the relationships among these categories through a case study of a peculiar kind of organization: the American open-end mutual fund. As a result of regulation and market forces, mutual funds combine exit, voice, and liability in fascinating and highly unusual ways. By studying mutual funds, we hope both to gain general insight into the relationships among exit, voice, and liability and to learn something concrete about the protection of mutual fund investors.

The study of mutual fund regulation is important and timely. At the end of 2009, the mutual fund industry held assets worth more than \$11 trillion and comprised approximately one-fifth of America's household financial assets and retirement savings.² Additionally, a form of liability unique to mutual funds that allows investors to sue their fund managers under the Investment Company Act of 1940 (ICA) for excessive fees was the subject of a recent Supreme Court decision, *Jones v. Harris Associates L.P.*³ The case produced a widely discussed dispute between Judges Frank Easterbrook and Richard Posner in the Seventh Circuit⁴ and extensive amicus briefing in the Supreme Court by corporate law professors and financial economists.⁵

-
1. ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970). Hirschman's original categories included loyalty in place of liability. The substitution of liability for loyalty was recently made by Henry Hansmann and Reinier Kraakman. Henry Hansmann & Reinier Kraakman, *Exit, Voice and Liability: The Dimensions of Organizational Structure* (June 2008) (unpublished working paper, on file with authors).
 2. INV. CO. INST., 2010 INVESTMENT COMPANY FACTBOOK 9 fig.1.1, 10 fig.1.2, 112 fig.7.17 (50th ed. 2010).
 3. *Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418 (2010).
 4. *Jones v. Harris Assocs. L.P. (Jones I)*, 527 F.3d 627 (7th Cir. 2008), *reh'g denied*, 537 F.3d 728, 729 (7th Cir. 2008) (Posner, J., dissenting), *vacated and remanded*, 130 S. Ct. 1418 (2010).
 5. Brief of AARP & Consumer Federation of America as Amici Curiae in Support of Petitioners, *Jones*, 130 S. Ct. 1418 (No. 08-586); Brief of Law & Finance Amici Curiae in Support of Respondent, *Jones*, 130 S. Ct. 1418 (No. 08-586); Brief of Amici Curiae Law Professors in Support of Petitioners, *Jones*, 130 S. Ct. 1418 (No. 08-586); Brief of Robert

To date, commentary about excessive fee liability and forms of shareholder voice in mutual funds, such as voting and boards of directors, has framed the debate about these matters almost entirely in terms of the robustness of market competition.⁶ Those who believe in the importance of statutory mandates for voting, boards, and fee liability, such as Judge Posner, argue that these mandates are necessary because competition among funds for investors is not robust enough to protect investors on its own. Those who say voting, boards, and fee liability are not necessary, such as Judge Easterbrook, argue that competition is adequate on its own. The perceived connection between competition and the need for governance and fee liability has produced an extensive debate in academic journals and amicus briefs before the Supreme Court about whether the mutual fund market is competitive.

Our perspective differs radically from both sides of this existing debate. We argue that the problem with voting, boards, and fee liability in mutual funds is simply that investors will almost never use them. Investors will almost always prefer instead either to do nothing or to use a unique right of exit that is not available in ordinary companies. Mutual fund investors can be expected to behave this way *under any reasonable view of mutual fund market competition and regardless of whether investors are large and sophisticated or small and unsophisticated*.

Mutual funds differ from ordinary companies in all three categories of shareholder rights, but they are most unusual in terms of exit. In ordinary companies, individual shareholders can exit, but assets cannot. When a shareholder sells, the assets that underlie the shares remain stuck inside the company. In a mutual fund, in contrast, shareholders do not sell their shares—they redeem them from the issuing funds for cash. When a shareholder redeems, the fund pays the underlying assets to the shareholder, the fund correspondingly declines in size, and the shares are extinguished.

For our purposes, mutual funds look more like products or services than like ordinary companies. Just as buyers of auto tires and breakfast cereal can sever their relationships with manufacturers by refusing to buy their products any longer, investors in mutual funds can sever their relationships with managers by withdrawing their money and refusing to pay managers' fees any longer. The force that disciplines fees and returns, therefore, is not financial market arbitrage or shareholder voting, but product market-style competition.

Litan, Joseph Mason & Ian Ayres as Amici Curiae Supporting Petitioners, *Jones*, 130 S. Ct. 1418 (No. 08-586).

6. See *infra* Section I.B for a literature review.

This kind of competition may be imperfect, as competition sometimes is in other product markets, but it is still a kind of product market competition.

We make four primary claims about the significance of exit in mutual funds. First, exit almost completely eliminates mutual fund investors' incentives to use fee liability, voting, and boards of directors. We support this claim in the body of this Article with a detailed exploration of a mutual fund investor's decision problem. We can illustrate the basic intuition, however, with a simple (albeit rough) example.

As a consequence of exit rights, mutual fund share prices are always exactly equal to the net asset value (NAV) of the issuing funds. The NAV is the pro rata portion of a fund's assets that corresponds to each share. The NAV is unaffected by expectations about future fees or portfolio changes. Indeed, it is possible for shares in two funds with different expected returns to have the same NAV.⁷

Imagine, therefore, two mutual funds with identical NAVs and different expected returns. Investors in the fund with the lower expected returns could theoretically improve the fund's returns by voting and fee liability. But they will not bother, because they will prefer instead to redeem their shares in the low-return fund and switch to the high-return fund. Since the two funds have *the same share price*, it costs no more to invest in the high-return fund than in the low-return fund. And since mutual fund share prices do not reflect expected returns, any improvement that voting and fee liability may be expected to produce in a fund *in the future* will not be reflected in the share price at which an activist investor can sell *today*.

Shareholders of ordinary companies cannot switch so easily. Switching from a company with low expected cash flows to one with high expected cash flows is costly, because shareholders in a company with low expected cash flows can only sell their shares at a low price reflecting the low expectations. And they can only buy shares in a company with higher expected cash flows at a higher price reflecting the high expectations. Additionally, activism that improves a company's future returns raises the stock price in the present, creating immediate value for activist investors. Sometimes, therefore, it makes more sense for an ordinary company's shareholders to use voting and boards to improve the company's returns and raise the share price than to sell at the current price.

7. Imagine, for example, two funds with identical portfolios and identical numbers of shares outstanding today but different fees and different changes to the portfolio expected during the coming year. The returns on shares in these two funds will be different in the coming year, but their NAVs today will nevertheless be the same.

The claim that exit destroys incentives to use voice and fee liability is consistent with any reasonable view of mutual fund market competition, because nearly every commentator in the debate about mutual fund market competition agrees that at least some funds in every investing style offer competitive fees and returns (even if many funds do not).⁸ And investors will prefer exit to activism so long as they can locate even one competitive fund with a given investing style.

The claim that exit destroys incentives to use voice and fee liability is also consistent with any reasonable view of mutual fund investors' size or sophistication. Although large and sophisticated investors often become active in ordinary corporations, they do not become active in mutual funds, since even large and sophisticated investors stand to gain more from exit than from activism. And although small and unsophisticated investors will sometimes fail to exit mutual funds because they lack time or knowledge, they will fail to use voting and fee liability for the very same reasons.

Second, exit distorts the operation of voice and liability in mutual funds. For example, exit causes fee litigation recoveries to go to the wrong investors. It also causes fee litigation to be even more completely dominated by plaintiffs' lawyers than ordinary class action litigation is, to be unlikely to target the highest-fee funds, and to discourage investors from moving to lower-fee funds. Exit also interacts with voting to make firing managers impossible, to make boards of directors unrepresentative of shareholders, and to prevent shareholders from receiving notice when funds raise their fees.

Third, even though the form of exit available in mutual funds is more favorable to shareholders than its counterpart in ordinary companies, the net effect of exit on the least sophisticated mutual fund investors is ultimately ambiguous. Because exit eliminates activism, investors who fail to exit underperforming funds (perhaps because these investors lack time or sophistication) cannot expect activism by other investors to improve these funds. Investors also cannot rely on financial arbitrage to maintain the efficiency of share prices, creating the possibility that uninformed investors will end up in low-return funds.

Finally, we propose a general shift in the approach of mutual fund regulation. Voting has no value without the possibility of meaningful investor participation. And even though boards and fee liability are capable of functioning autonomously without investor participation, their value is limited and their costs are substantial.

8. See *infra* notes 92–99 and accompanying text.

To the extent that regulation is necessary, therefore, it should resemble product regulation. That is, it should apply automatically without shareholder action or should enable competition by encouraging investors to redeem more effectively. Whatever benefits voting, boards, and fee liability may achieve in spite of shareholders' unwillingness to use them could be achieved more effectively and at lower cost by product-style regulation that dispenses with fictions about shareholder involvement.

Part I of this Article reviews the legal structure of voting, boards, and fee liability in mutual funds and argues that the existing literature on mutual fund governance has revolved almost exclusively around market competition. In Part II, we argue that mutual fund investors have no incentive to use voice or excessive fee liability under any reasonable view of market competition. We show in Part III how exit distorts voice and fee liability in unintended ways. Part IV explains why exit both harms and hurts some investors. Part V proposes a shift toward product-style regulation. Part VI suggests that voting, boards, and fee liability may persist precisely because they fail—and because this failure benefits important political constituencies.

I. BACKGROUND

Section A of this Part describes the legal structure of voting, boards, and liability in mutual funds, and Section B reviews the law-and-economics literature on mutual fund governance and liability.

Since the legal background in Section A is lengthy and technical, we provide this five-sentence summary so that readers who wish to do so can skip straight to the literature review in Section B. Mutual fund shareholders are required by regulation to vote on changes in management, fees, and investment policy, and to elect directors. Directors are required to vote annually on existing advisory and fee arrangements and to review various technical compliance and conflict-of-interest matters. Shareholders can sue mutual fund advisers for breach of fiduciary duty with respect to fees, with only disgorgement remedies allowed and recovery going directly to the funds, rather than to investors. The Supreme Court recently articulated the standard for mutual fund fee liability in *Jones v. Harris Associates L.P.*⁹ The *Jones* standard permits shareholders to challenge the absolute level of fees rather than merely the manner in which fees are set and explicitly cautions courts not to rely on comparisons to fees set by similar mutual funds, meaning that fees at or below prevailing market levels may be suspect.

9. 130 S. Ct. 1418 (2010).

A. Summary of Regulation

A mutual fund is a pool of investment securities that issues only redeemable common stock, is sold widely to the public, and is composed almost entirely of debt or minority equity holdings in many companies. To sell shares widely to the public, a mutual fund must register with the SEC and comply with the ICA.

The professional financial managers (or “advisers”) who actually run mutual funds’ day-to-day operations are typically legally distinct from the funds. Funds formally contract with adviser entities for management services, and the adviser entities employ individual portfolio managers.¹⁰ As a practical matter, however, mutual funds do not hire investment advisers; rather, funds are typically organized by their advisers, and their boards of directors are initially selected by advisers. Most advisory companies counsel several mutual funds, all of which are usually marketed under a single brand in a fund “complex,” such as Fidelity, Vanguard, or BlackRock.

By giving investors equity only in the funds and not in the advisory businesses, advisers ensure that they get to keep the fees that they charge. The legal distinction between advisers and funds is thus similar in spirit to the distinction between financial advisers and their clients, banks and their customers, trust companies and their clients, and manufacturers and their products.¹¹

1. Voting

Voting in mutual funds is alternately more extensive and less extensive than voting in ordinary corporations.¹² The ICA and its regulations require shareholders to vote on advisory agreements.¹³ This means, in effect, that changing a fund’s adviser (though not the individual employees who work for

10. This is usually the case, but it is not required by law.

11. The extent to which the legal distinction between funds and their advisers generates conflicts of interest has been debated extensively. See William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401 (2006); Tamar Frankel, *Advisory Fees: Evolving Theories*, INV. L., Feb. 2003, at 21; John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609 (2001); Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. ECON. PERSP. 161 (2004).

12. For a summary of voting rules, see TAMAR FRANKEL & CLIFFORD E. KIRSCH, INVESTMENT MANAGEMENT REGULATION 265-300 (3d ed. 2005).

13. Investment Company Act of 1940 § 15(a), 15 U.S.C. § 80a-15(a) (2006).

the adviser and carry out the fund's day-to-day operations) requires shareholder approval.

In practice, advisers avoid shareholder votes on advisory contracts at the time funds are started by distributing all of a fund's initial shares to affiliates of the advisers and then holding a vote on the contract before any shares have been sold to the public.¹⁴ The ICA then allows initial contracts and board members' terms to be extended indefinitely without shareholder votes, so long as independent directors vote annually to approve the contracts.¹⁵ Material changes, including changes in fees and advisers, must receive approval from shareholders.¹⁶ Shareholders must also vote to elect new directors when required and to approve changes in certain key investment policies.¹⁷

For most matters, the ICA requires a favorable vote of the lesser of a majority of shares outstanding or two-thirds of shares present, provided at least a majority is present or represented by proxy.¹⁸ The Exchange Act's proxy rules apply in substantially the same form to mutual funds as to ordinary operating companies.¹⁹

Private contracting rarely requires shareholder votes beyond the minimum required by statute. Since mutual funds do not have to hold annual shareholder meetings, for example, they almost never do.²⁰

2. Boards

As with voting, boards in mutual funds are alternately more shareholder-friendly and less shareholder-friendly than boards in ordinary corporations. The ICA effectively requires all mutual funds to have boards of directors.²¹ A

14. SEC, DIV. OF INV. MGMT., PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 277 (1992) [hereinafter SEC HALF CENTURY REPORT], available at <http://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf>; Bibb L. Strench, *Board Structure and Processes*, in MUTUAL FUND REGULATION § 14:3 (Clifford Kirsch ed., 2010).

15. 15 U.S.C. § 80a-15(a)(2) (2006).

16. *Id.* § 80a-15(a).

17. *Id.* §§ 80a-8(b), 80a-13(a).

18. *Id.* § 80a-2(a)(42).

19. 17 C.F.R. § 270.20a-1 (2009).

20. The desire to avoid statutory annual meeting requirements is a key reason why mutual funds have long organized as Delaware or Massachusetts statutory business trusts or Maryland corporations. See John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165, 171, 187 (1997).

21. The ICA does not directly require funds to have boards, but it does require boards to perform several functions that no fund could legally do without.

single board generally oversees multiple funds within a complex.²² The ICA imposes on boards a detailed and extensive set of mutual fund-specific compliance duties.²³

Shareholder election of directors is limited. The ICA requires directors to be elected when a fund is first started, but these votes can be avoided for initial directors in the same manner that votes can be avoided for initial advisory contracts.²⁴ Initial directors may then serve indefinitely without reelection²⁵ and can appoint replacement board members without holding shareholder votes unless the percentage of directors that has never been elected by shareholders exceeds certain thresholds.²⁶ Since 2001, the SEC has allowed only uninterested directors to nominate new uninterested directors.²⁷

Independent directors are required to review various contracts with and fees paid to service providers. A majority of independent directors must vote on advisory contracts when the contracts are first ratified by shareholders and then must vote on yearly renewals of these contracts.²⁸ Rule 12b-1 fees,²⁹ which allow fund assets to be used to pay distribution expenses, must also be voted on by independent directors. Contracts with principal underwriters, auditors, and custodians are also subject to independent director review.³⁰

Independent directors must also vote on various transactions in which managers are potentially conflicted. The ICA's general approach is to prohibit or to restrict tightly most conflict-of-interest transactions, but SEC rules loosen some of these restrictions if independent directors approve. For example, a fund's directors must review purchases of securities from any underwriting

22. Sophie Xiaofei Kong & Dragon Yongjun Tang, *Unitary Boards and Mutual Fund Governance*, J. FIN. RES. (forthcoming), available at <http://ssrn.com/abstract=1033057>. Shareholders have occasionally sued over this practice, without success. See, e.g., *Krantz v. Fidelity Mgmt. & Research, Co.*, 98 F. Supp. 2d 150 (D. Mass. 2000).

23. For a summary of boards' responsibilities, see SEC, EXEMPTIVE RULE AMENDMENTS OF 2004: THE INDEPENDENT CHAIR CONDITION 3-30 (2005), available at www.sec.gov/news/studies/indchair.pdf.

24. *Supra* note 14 and accompanying text.

25. Investment Company Act of 1940 § 16(a), 15 U.S.C. § 80a-16(a) (2006) (limiting terms to five years for members of classified boards but specifying no terms for unclassified boards).

26. 15 U.S.C. § 80a-16(a)-(b).

27. Role of Independent Directors of Investment Companies, 66 Fed. Reg. 3734 (Jan. 16, 2001) (to be codified at 17 C.F.R. pts. 239, 240, 270, 274).

28. 15 U.S.C. § 80a-15(a).

29. 17 C.F.R. § 270.12b-1 (2009).

30. 15 U.S.C. §§ 80a-15(c), -17(f); 17 C.F.R. §§ 270.17g-1, .32a-4.

syndicate that includes an affiliate of the fund's adviser,³¹ securities transactions between the fund and another client of the adviser,³² mergers between the fund and another fund,³³ and purchases of joint liability insurance with other funds in the complex.³⁴

Boards must also review various technical matters that involve only indirect conflicts of interest with managers. They establish general policies for portfolio valuation, including the valuation of illiquid securities and securities traded on foreign exchanges.³⁵ They also review the use of derivatives, lending of portfolio securities, participation in repurchase agreements,³⁶ and issuance of multiple classes of stock.³⁷

Mutual fund boards are much less involved in strategy than are ordinary company boards. Mutual fund boards spend the overwhelming majority of their time on compliance matters rather than on investing strategy.³⁸ The contracts that boards negotiate with advisers are generally only two or three pages long and specify very little about strategy.³⁹ Boards usually exercise only informal authority over strategy by asking advisers hard questions. As a practical matter, boards never fire management companies (although they may occasionally suggest, but not force, the removal of individual portfolio managers).⁴⁰

The ICA regulates boards' composition. By statute, forty percent of each board's members must be independent,⁴¹ and regulations passed in 2001 effectively increased the minimum number of independent directors to a

31. 17 C.F.R. § 270.10f-3.

32. *Id.* § 270.17a-7.

33. *Id.* § 270.17a-8.

34. *Id.* § 270.17d-1(d)(7).

35. *Id.* § 270.22c-1.

36. Securities Trading Practices of Registered Investment Companies, 44 Fed. Reg. 25,128 (Apr. 27, 1979) (to be codified at 17 C.F.R. pt. 271).

37. 17 C.F.R. §§ 270.18f-3(c)(v), (d), (e).

38. See, e.g., ABA FED. REGULATION OF SEC. COMM., FUND DIRECTORS GUIDEBOOK 49-50 (3d ed. 2006).

39. See, e.g., Investment Management Agreement, The Lazard Funds, Inc., available at http://www.sec.gov/Archives/edgar/data/874964/000093041305006847/c37673_ex99-d1.txt; Management Contract between Fidelity Advisor Series I, Fidelity Advisor Balanced Fund, and Fidelity Management & Research Company, available at <http://www.sec.gov/Archives/edgar/data/722574/000072257407000110/d1.htm>.

40. See *infra* Section II.F.

41. Investment Company Act of 1940 § 10(a), 15 U.S.C. § 80a-10(a) (2006).

majority.⁴² After the market-timing and late-trading scandals in 2004, the SEC tried without success to implement rules requiring board chairs and 75% of directors to be independent.⁴³

3. *Fee Liability*

As with voting and boards, mutual funds' liability to shareholders is alternately greater and lesser than ordinary corporations' liability to shareholders. Mutual funds and their managers are potentially subject to the same kinds of litigation under the '33 and '34 Acts as ordinary companies.⁴⁴ Their state law fiduciary liability is unclear, however, since mutual funds are usually organized as statutory business trusts.⁴⁵ Under the ICA, directors, officers, and affiliates of funds and managers are liable for general breaches of fiduciary duty only when they involve personal misconduct.⁴⁶

Mutual funds' liability for excessive fees, however, is clearly much greater than comparable liability for executive compensation in ordinary companies. According to section 36(b) of the ICA, "[T]he investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature"⁴⁷ Suits can be brought under this section by the SEC or by investors on behalf of a fund in a manner similar to a derivative suit.⁴⁸ Recovery goes only to the fund and is limited to disgorgement of the portion of fees charged in violation of the fiduciary duty not more than one year prior to

-
42. Role of Independent Directors of Investment Companies, 66 Fed. Reg. 3734 (Jan. 16, 2001) (to be codified at 17 C.F.R. pts. 239, 240, 270, and 274).
 43. Investment Company Governance, 69 Fed. Reg. 46,378 (Aug. 2, 2004) (to be codified at 17 C.F.R. pt. 270). The D.C. Circuit blocked the SEC from implementing these rules on the ground that the SEC did not consider the costs of compliance. *Chamber of Commerce v. SEC*, 412 F.3d 133 (D.C. Cir. 2005). The rules' fate remains uncertain. Adam Cook, Note, *Now You See It, Now You Don't: The Uncertain Fate of the SEC's Governance Rule on Mutual Fund Director Independence*, 59 RUTGERS L. REV. 603 (2007).
 44. For a history and general outline of SEC and private litigation against mutual funds, see H. Norman Knickle, *The Investment Company Act of 1940: SEC Enforcement and Private Actions*, 23 ANN. REV. BANKING & FIN. L. 777 (2004).
 45. Larry D. Barnett, *The Regulation of Mutual Fund Boards of Directors: Financial Protection or Social Productivity?*, 16 BROOK. J.L. & POL'Y 489, 506-34 (2008); Robert H. Sitkoff, *Trusts as "Uncorporation": A Research Agenda*, 2005 U. ILL. L. REV. 31.
 46. Investment Company Act of 1940 § 36(a), 15 U.S.C. § 80a-35(a) (2006).
 47. 15 U.S.C. § 80a-35(b).
 48. *Id.*

the commencement of the suit. Only individuals or entities who actually received the fees can be sued, which means directors generally cannot be sued.

The standard for liability for excessive fees under section 36(b) was recently established by the Supreme Court in *Jones v. Harris Associates L.P.*⁴⁹ *Jones* adopted a standard that had been established many years earlier by the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management*.⁵⁰ Under *Gartenberg* (and now *Jones*), “[t]o be guilty of a violation of § 36(b), . . . the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.”⁵¹ A fee does not actually have to be reasonable; it only has to fall “within the range of what would have been negotiated at arm’s-length in the light of all of the surrounding circumstances.”⁵² *Gartenberg* created a six-factor analysis.⁵³ Only one of these factors is the prevailing market fee level; both *Gartenberg* and *Jones* emphasized quite clearly that the fee required by the standard could be below prevailing market levels. *Gartenberg* and *Jones* do not require proof of misconduct or duplicity in setting fees—merely charging a fee outside of the reasonable range is enough. The Supreme Court’s only modification to the *Gartenberg* standard was to clarify that courts may compare the fees that an adviser charges to institutional clients to the fees that the adviser charges to its retail mutual funds.⁵⁴

49. 130 S. Ct. 1418 (2010).

50. *Jones*, 130 S. Ct. at 1426; *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923 (2d Cir. 1982). For a more detailed summary of the history of mutual fund fee litigation doctrine prior to the Supreme Court’s opinion in *Jones*, see William A. Birdthistle, *Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence*, 2010 U. ILL. L. REV. 61.

51. *Jones*, 130 S. Ct. at 1426; *Gartenberg*, 694 F.2d at 928.

52. *Jones*, 130 S. Ct. at 1425; *Gartenberg*, 694 F.2d at 928.

53. Another Second Circuit opinion summarized these factors: “(a) the nature and quality of services provided to fund shareholders; (b) the profitability of the fund to the adviser-manager; (c) fall-out benefits; (d) economies of scale; (e) comparative fee structures; and (f) the independence and conscientiousness of the trustees.” *Krinsky v. Fund Asset Mgmt.*, 875 F.2d 404, 409 (2d Cir. 1989).

54. The *Gartenberg* court had explicitly declined to compare fees charged to mutual funds and institutional clients, noting that the “services required by each type of fund differ sharply.” 694 F.2d at 930 n.3. By contrast, the Supreme Court in *Jones* held that “courts may give such comparisons the weight that they merit in light of the similarities and differences between the services that the clients in question require . . .” 130 S. Ct. at 1428 (2010).

The *Gartenberg* standard was in question because the Seventh Circuit's opinion in *Jones*,⁵⁵ authored by Judge Easterbrook, had expressly rejected that standard. Easterbrook wrote:

A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation. . . . A trustee owes an obligation of candor in negotiation, and honesty in performance, but may negotiate in his own interest and accept what the settlor or governance institution agrees to pay.⁵⁶

While Easterbrook clearly rejected the *Gartenberg* standard, he did not completely foreclose the possibility of fee liability. He added, "It is possible to imagine compensation so unusual that a court will infer that deceit must have occurred, or that the persons responsible for decision have abdicated"⁵⁷

Judge Posner criticized Easterbrook and supported the *Gartenberg* standard in a widely publicized dissent from the Seventh Circuit's denial of the plaintiffs' petition for a rehearing en banc.⁵⁸ Like Posner, the Supreme Court expressed skepticism about the capacity of competition among funds to keep fee levels low.⁵⁹

B. Existing Thought on Mutual Fund Governance

The standard law-and-economics approach to boards, voting, and fee litigation has been to argue that they are less important in mutual funds than in ordinary corporations because mutual funds compete more directly for investors' money than ordinary corporations do.⁶⁰ Since advisers' fees are set as

55. *Jones I*, 527 F.3d 627 (7th Cir. 2008), *reh'g denied*, 537 F.3d 728 (7th Cir. 2008) (Posner, J., dissenting), *vacated and remanded*, 130 S. Ct. 1418 (2010).

56. *Jones I*, 527 F.3d at 632.

57. *Id.*

58. *Jones v. Harris Assocs. L.P.*, (*Jones II*) 537 F.3d 728 (7th Cir. 2008) (Posner, J., dissenting).

59. *Jones*, 130 S. Ct. at 1429 (2010) ("[C]ourts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers. These comparisons are problematic because these fees, like those challenged, may not be the product of negotiations conducted at arm's length." (citing *Jones II*, 537 F.3d at 731-32 (Posner, J., dissenting))).

60. The appropriateness of the analogy between mutual funds and ordinary operating companies has been debated directly by a few commentators. See, e.g., Birdthistle, *supra* note 11; Donald C. Langevoort, *Private Litigation To Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017 (2005); Jerry W. Markham, *Mutual Fund Scandals—A Comparative Analysis of the Role of Corporate Governance in the Regulation of Collective Investments*, 3 HASTINGS BUS. L.J.

a percentage of total assets under management, advisers have a strong incentive to attract new investors and to keep existing investors from redeeming. This is what we call the “market discipline” view of mutual fund governance, because market discipline is said to take the place to some degree of the more usual forms of governance. This view has been associated most prominently with John Coates and Glenn Hubbard, who have argued that the mutual fund industry is highly competitive.⁶¹ It has also been associated with Eugene Fama and Michael Jensen, particularly in the finance literature,⁶² and with Judge Easterbrook’s opinion in *Jones*.⁶³

Though the market discipline view has been influential, belief in the appropriateness and value of voting, boards, and fee litigation in mutual funds has nevertheless persisted among many law-and-economics scholars for two reasons. One is that, even to its most ardent advocates, the market discipline view says only that governance and fee litigation are less important in mutual funds than in ordinary corporations, and not that they are inappropriate. Voting, boards, and fee litigation are therefore believed to be useful supplements to market competition. Coates and Hubbard, for example, have expressed faith in the general notion of fee litigation and in boards of directors by endorsing aspects of fee litigation doctrine that focus on boards and arguing

67 (2006); Alan R. Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 165 (2006); Richard M. Phillips, *Deregulation Under the Investment Company Act—A Reevaluation of the Corporate Paraphernalia of Shareholder Voting and Boards of Directors*, 37 BUS. LAW. 903 (1982); A. Joseph Warburton, *Should Mutual Funds Be Corporations? A Legal & Econometric Analysis*, 33 J. CORP. L. 745 (2008).

61. R. GLENN HUBBARD ET AL., *THE MUTUAL FUND INDUSTRY: COMPETITION AND INVESTOR WELFARE* (2010); John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151 (2007); see also D. Bruce Johnsen, *Myths About Mutual Fund Fees: Economic Insights on Jones v. Harris* (George Mason Law & Econ. Research Paper No. 09-49, 2009), available at <http://ssrn.com/abstract=1483862> (pointing out that a competitive market should reward good funds). Todd Henderson has criticized section 36(b) more directly, focusing less on the severity of the problem that it is intended to solve than on its costs and benefits as a potential solution. M. Todd Henderson, *Justifying Jones* (John M. Olin Law & Econ. Working Paper No. 491, 2009), available at <http://ssrn.com/abstract=1499410>. Larry Ribstein has also criticized excessive fee liability and governance, arguing that the mutual fund industry is competitive and that mutual fund regulation is unresponsive to the needs of the industry and investors because it is administered at the federal level and is not subject to state-level competition. Larry Ribstein, *Federal Misgovernance of Mutual Funds*, 2009-2010 CATO SUP. CT. REV. (forthcoming 2010).
62. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 317-18 (1983).
63. *Jones I*, 527 F.3d 627, 634 (7th Cir. 2008).

that boards can engage in “real bargaining” with managers.⁶⁴ Coates has individually said that voting can potentially be useful, suggesting that boards of directors are valuable in mutual funds because shareholders can, at least theoretically, vote for and influence them.⁶⁵

The second reason that the market discipline view leaves room for voting, boards, and fee litigation is that the assumption that the mutual fund market is competitive is open to dispute. If one does not believe the market is competitive, then voting, boards, and fee liability appear to be very important. The disagreement between Judges Posner and Easterbrook, for example, comes down to their differing assessments of the mutual fund market’s competitiveness.⁶⁶ Numerous behavioral economics-minded commentators, including several prominent law professors writing amicus briefs in *Jones*, have expressly connected the need for voting, boards, or fee liability to failures of market competition in mutual funds.⁶⁷ The belief that the urgency of voting, boards, and litigation in mutual funds hinges on the market’s competitiveness has produced an extensive debate about the market’s competitiveness.⁶⁸

There have been no empirical studies of voting in mutual funds. We are currently at work on a paper that will present the first empirical study of

64. Coates & Hubbard, *supra* note 61, at 211.

65. John C. Coates IV, *Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis*, 1 J. LEGAL ANALYSIS 591, 624 (2009). Coates recently joined a group of law and finance professors in an amicus brief in *Jones* arguing that courts should be allowed to consider evidence of the mutual fund market’s competitiveness for purposes of section 36(b) liability. Brief of Law and Finance Amici Curiae in Support of Respondent, *Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418 (2010) (No. 08-586). Notably, the brief did not push for the adoption of Easterbrook’s standard.

66. See *Jones II*, 537 F.3d 728, 730 (7th Cir. 2008) (Posner, J., dissenting).

67. See, e.g., Brief of AARP & Consumer Federation of America as Amici Curiae in Support of Petitioners, *Jones*, 130 S. Ct. 1418 (No. 08-586); Brief of Amici Curiae Law Professors in Support of Petitioners, *Jones*, 130 S. Ct. 1418 (No. 08-586); Brief of Robert Litan, Joseph Mason & Ian Ayres as Amici Curiae Supporting Petitioners, *Jones*, 130 S. Ct. 1418 (No. 08-586); Birdthistle, *supra* note 50, at 88-96; Lyman Johnson, *A Fresh Look at Director “Independence”: Mutual Fund Fee Litigation and Gartenberg at Twenty-Five*, 61 VAND. L. REV. 497, 505-13 (2008).

68. E.g., Freeman & Brown, *supra* note 11; John P. Freeman, Steward L. Brown & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 OKLA. L. REV. 83 (2008); Ali Hortaçsu & Chad Syverson, *Product Differentiation, Search Costs, and Competition in the Mutual Fund Industry: A Case Study of S&P 500 Index Funds*, 119 QJ. ECON. 403 (2004); Sunil Wahal & Albert Yan Wang, *Competition Among Mutual Funds*, J. FIN. ECON. (forthcoming), available at <http://ssrn.com/abstract=1130822>; Ajay Khorana & Henri Servaes, *Conflicts of Interest and Competition in the Mutual Fund Industry* (July 2004), available at <http://ssrn.com/abstract=240596>.

excessive fee liability.⁶⁹ Boards have been studied extensively.⁷⁰ Empirical studies of board composition have generally lacked an explicit theory about how mutual fund boards and ordinary corporate boards differ, however. Indeed, many of these studies treat mutual fund boards as simply case studies in the functioning of ordinary corporate boards.⁷¹

The SEC remains strongly committed to voting, boards, and fee liability. The early 1980s saw a proposal to create a separate class of mutual fund known as a “Unitary Investment Trust” that would have had no voting, boards, or fee litigation.⁷² The proposal failed, however, and the SEC has instead made several attempts to strengthen and expand the role of mutual fund boards in recent years. In 2001, the SEC increased the minimum percentage of independent directors for most funds from 40% to 50%,⁷³ and in 2004 tried without success to increase this minimum percentage to 75%.⁷⁴ Additionally, following the late-trading and market-timing scandals that swept the mutual

-
69. Quinn Curtis & John Morley, *An Empirical Study of Mutual Fund Excessive Fee Litigation: Do the Merits Matter?* (July 27, 2010) (unpublished manuscript, on file with authors).
70. At the end of 2006, the SEC compiled a summary of the empirical literature on mutual fund board composition. Memorandum from Chester S. Spatt, Chief Economist, SEC Office of Econ. Analysis, to Inv. Co. Governance File S7-03-04 (Dec. 29, 2006) [hereinafter SEC Literature Review], <http://sec.gov/rules/proposed/s70304/oeamemo122906-litreview.pdf> (providing a literature review on independent mutual fund chairs and directors); Memorandum from Chester S. Spatt, Chief Economist, SEC Office of Econ. Analysis, to Inv. Co. Governance File S7-03-04 (Dec. 29, 2006), <http://ftp.sec.gov/rules/proposed/s70304/oeamemo122906-powerstudy.pdf> (providing a power study of evidence on independent mutual fund chairs); see also SEC, *supra* note 23 (providing a qualitative rationale for changes in board independence rules). Since the summary was compiled, a handful of additional papers have further contributed to the debate. *E.g.*, Martijn Cremers et al., *Does Skin in the Game Matter? Director Incentives and Governance in the Mutual Fund Industry*, 44 J. FIN. & QUANTITATIVE ANALYSIS 1345 (2009); Lauren Cohen, Andrea Frazzini & Christopher Malloy, *The Small World of Investing: Board Connections and Mutual Fund Returns* (Nat’l Bureau of Econ. Research, Working Paper No. 13121, 2007), available at <http://www.nber.org/papers/w13121>; Kong & Tang, *supra* note 22; Felix Meschke, *An Empirical Examination of Mutual Fund Boards* (Mar. 15, 2007) (unpublished manuscript), available at <http://ssrn.com/abstract=676901>.
71. The most widely cited empirical article in the financial economics literature on mutual fund boards pitches itself this way. Peter Tufano & Matthew Sevick, *Board Structure and Fee-Setting in the U.S. Mutual Fund Industry*, 46 J. FIN. ECON. 321, 322 (1997).
72. SEC HALF CENTURY REPORT, *supra* note 14, at 283-84; Phillips, *supra* note 60.
73. Role of Independent Directors of Investment Companies, 66 Fed. Reg. 3734 (Jan. 16, 2001) (to be codified at 17 C.F.R. pts. 239, 240, 270, and 274).
74. Investment Company Governance, 69 Fed. Reg. 46,378, at 46,389 (Aug. 2, 2004) (to be codified at 17 C.F.R. pt. 270.)

fund industry in 2003 and 2004, the SEC issued a bevy of rules increasing boards' formal responsibilities.⁷⁵

II. EXIT AS A DOMINANT STRATEGY

We think that the current debate about mutual fund governance and fee liability misses the point, which is that *under any reasonable view of mutual fund market competition*, shareholders will almost never choose to vote or sue their funds for excessive fees, preferring instead to switch funds or do nothing.⁷⁶ Exit, in other words, is a “dominant” strategy relative to voting and fee litigation.

A. *The Basics of Exit in Mutual Funds*

Mutual fund investors can redeem their shares from the funds that issue them for a cash amount equal to a pro rata share of the funds' assets after debts and liabilities. This amount is called the funds' net asset value per share (NAV). Shareholders can usually redeem their shares on less than twenty-four hours' notice.⁷⁷ Mutual funds are sometimes called open-end funds and stand in contrast to closed-end funds, which also hold portfolios of securities but do not allow redemption. Like the shares of ordinary operating companies, closed-end funds' shares are generally bought and sold on exchanges.

Since a fund's NAV is explicitly tied to the value of the fund's current holdings, the NAV does not reflect the value of fees and portfolio changes

75. *Id.*

76. An alternative way of expressing our point may be located in the “capital lock-in” literature, which views boards not as a form of voice, but as “mediating hierarchs” with the authority to take actions that minimize shirking and mediate disputes about how to divide surpluses among various corporate stakeholders. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999). Boards' roles are premised on the fact that stakeholders cannot receive the full value of their contributions if they exit and are therefore subject to exploitation by other stakeholders. Under this view of boards' roles, they are unnecessary in mutual funds not because they are useless as a form of voice, but because shareholders and other stakeholders can withdraw their contributions from mutual funds more easily than from other corporations and are therefore not subject to exploitation.

77. The daily nature of redemptions in most funds is what made the market-timing and late-trading scandals of 2003 and 2004 possible. *See, e.g.*, Eric Zitzewitz, *How Widespread Was Late Trading in Mutual Funds?* (December 2005) (unpublished manuscript), available at <http://ssrn.com/abstract=456360>.

expected in the future.⁷⁸ The NAV reflects the expected returns of the *individual securities* in a fund's portfolio, but not the expected return of a *fund itself*, which includes expected fees and expected changes to the fund's portfolio as well as the expected returns of the securities already in the portfolio.

One consequence of the disconnect between a fund's NAV and its expected returns is that two mutual funds can sell at the same price even if they have different expected returns. Imagine, for example, two funds with identical portfolios and identical numbers of shares outstanding today but with different fees and different changes to their portfolios expected during the coming year. The two funds will have different returns over the coming year, but their NAVs will nevertheless be the same today.

Ordinary company investors, in contrast, can sell their shares but cannot redeem them to recover a pro rata portion of the firm's assets. Sales are an incomplete form of exit, because sale prices always reflect expected returns and investors therefore cannot disentangle themselves from a company's future fate. Even if an investor in an ordinary company with bad managers sells, for example, she can only do so at a low price reflecting low expectations about the quality of management.

Perhaps the most profound consequence of exit and NAV-pricing is that the market for mutual fund shares looks much more like a market for products or services than a market for ordinary company shares.⁷⁹ Just as buyers of auto tires, breakfast cereal, financial advice, and legal services can sever their relationships with suppliers by refusing to buy from the supplier again, investors in mutual funds can sever their relationships with managers by withdrawing their money and refusing to pay managers' fees again. And the force that tends to discipline mutual fund fees and returns is not financial arbitrage but competition among suppliers for buyers. Just as it is hard to sell poor-quality products at a high price, it is hard to sell low-return mutual funds at a high fee.

Note that mutual funds' resemblance to products is an outgrowth of exit rights and not of the fact that mutual funds are marketed to households. The

78. This point has been observed before and is a well-known problem in mutual fund taxation, since mutual fund share prices do not reflect expected tax liabilities. See, e.g., Michael J. Barclay, Neil D. Pearson & Michael S. Weisbach, *Open-End Mutual Funds and Capital-Gains Taxes*, 49 J. FIN. ECON. 3 (1998); Coates, *supra* note 65.

79. The product analogy has been suggested by others. See, e.g., Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961 (2010). One part of our contribution is to point out that the product analogy depends entirely on open-end mutual funds' exit feature and not on the nature of their clientele or any other aspect of their functioning.

line between products and conventional corporate shares depends on exit rights, rather than on buyer characteristics.

Note also that NAV-pricing is not an outgrowth of regulation or an arbitrary feature of contract; it is an inevitable consequence of redemption rights. This is why open-end hedge funds, which are not subject to mutual fund regulation, also sell and redeem at NAV. Funds generally cannot sell or redeem at prices that depart significantly in either direction from their NAVs. A fund cannot sell for less than its NAV or redeem for more than its NAV because doing so would amount to giving away money and would very quickly result in the fund's demise. Imagine, for example, a fund with \$100 in assets and 100 shares outstanding. The NAV would be \$1. If the fund redeemed at a price above its NAV, say \$2, the fund would run out of money after redeeming only 50 of its 100 shares, creating a race to redeem among the 100 shareholders.⁸⁰ Similarly, a fund cannot sell for significantly more than its NAV or redeem for significantly less than its NAV, because that would be tantamount to a kind of fee and market competition would drive it down. If, for example, a fund redeemed at only 90% of its NAV, then shareholders' returns would be reduced by 10% relative to what their returns would be in the absence of the redemption discount. Shareholders would therefore gravitate toward funds that redeemed at values closer to their NAVs, forcing the fund in our example to reduce its redemption discount in order to retain its investors and attract new ones.

Shares also cannot trade on a secondary market at prices that depart significantly from the shares' NAV so long as mutual funds themselves sell and redeem at NAV. A fund's standing offer to redeem and sell at its NAV places both a floor and a ceiling on the secondary market price.⁸¹ No buyers will ever

80. This is effectively what happened to Bernie Madoff, who redeemed shareholders in his open-end hedge fund at a fictional NAV that was above the fund's actual NAV. A version of this problem is also what makes money market funds unstable and vulnerable to runs. Money market funds try always to redeem at \$1, even when their NAVs fall below \$1.

To complete our example above, if our fund *sold* new shares at a price *below* NAV – say, 100 new shares at 1 cent each – the NAV would fall to just slightly more than 50 cents (\$101 divided by 200 shareholders). The new shareholders would pay only 1 cent for a share worth 50 cents and the old shareholders would lose half the value of their shares. That is clearly not sustainable.

81. If redemption occurred only at highly infrequent intervals of several years, as it does in private equity funds, then we could imagine the development of a secondary market with prices that departed significantly from NAV. See, e.g., Henry Lahr & Christoph Kaserer, *Net Asset Value Discounts in Listed Private Equity Funds* (Ctr. for Entrepreneurial & Fin. Studies, Working Paper No. 2009-12, 2010), available at <http://ssrn.com/abstract=1494246>. By statute, however, mutual funds must redeem within seven days. 15 U.S.C. § 80a-22(e) (2006).

pay more than NAV so long as they can buy from the fund at NAV, and no sellers will ever sell for less than NAV so long as they can sell to the fund (i.e., redeem) at NAV.

Synthetic derivative contracts that allow bets on future movements in mutual fund share prices can easily be imagined, and they might even be profitable for the parties who engage in them. But such contracts cannot cause mutual funds to redeem and sell at any price other than the funds' NAVs for the mechanical reasons described above. And so long as mutual funds buy and sell their own shares at NAV, the prices of mutual fund shares on secondary markets also will not depart from NAV.

B. The Exit/Activism Decision

Consider the choices of a mutual fund investor dissatisfied with the fees charged by a fund in which she is already invested.⁸² We focus on fees, rather than other factors that might affect returns, because fees are simple and because there is a strong consensus in the financial economics literature that fees are the most economically and statistically significant predictor of mutual fund returns.⁸³ The argument easily generalizes, however, to an investor who is dissatisfied with a fund's overall performance.

The investor has three options. Each has benefits and costs. The first option is simply to do nothing. The second is what we will call "activism": the investor can attempt to reduce fees in the fund in which she already holds shares. The investor could do this either through the machinery of shareholder "voice" (voting to lower fees or change managers or putting pressure on the fund's directors) or through the machinery of "liability" (suing under section 36(b) of the ICA to recover excessive fees). And the third is what we will call "exit" or "switching": the investor can redeem her shares and switch to a different fund with similar investing goals and lower fees. Note that an investor in an ordinary company has the first two options, but not the third, as investors in ordinary companies cannot unilaterally exit through redemption.

The investor will only choose the second option—activism—if it is better than the other two options. We can therefore think of the other two options

82. We focus on the decision problem of an investor already invested in a fund rather than an investor investing in a fund for the first time because an investor already in a fund is less likely to shop funds than an investor coming to the market for the first time. Moving funds entails certain costs, such as taxes and redemption fees, that investing for the first time does not. We are trying to address the most difficult case for our argument.

83. See, e.g., Mark M. Carhart, *On Persistence in Mutual Fund Performance*, 52 J. FIN. 57, 58 (1997).

(doing nothing and switching) as generating two preconditions for activism, both of which must be met before an investor will choose activism. The first condition is that the benefits of activism must exceed the benefits of doing nothing. Put differently, the benefits of activism must exceed the costs. A similar condition applies in ordinary companies, since ordinary company investors also have the option to do nothing. We will show below, however, that because of mutual funds' unique exit rights, the application of this condition is less favorable to activism in mutual funds than in ordinary companies.

The second condition for activism is that the net benefits of activism (that is, the benefits of activism minus the costs) must exceed the net benefits of switching. This requirement is unique to mutual funds, since there is no analogue in ordinary companies for switching investments through share redemption.

These two conditions generate an analytical framework that is quite intuitive, and they suggest the basic considerations that we explore below: the costs and benefits of activism and the costs and benefits of switching.

C. The Costs and Benefits of Activism

In this Section, we argue that as a result of exit rights, the benefits of voting and fee litigation are low enough and the costs are high enough that the two conditions for activism in mutual funds can almost never be satisfied.

The first condition (that the benefits of activism exceed the costs) applies in ordinary companies as well as in mutual funds. Investors' individual stakes are too small to make activism worthwhile. This is simply the standard coordination and collective action problem that is well known in the study of corporate governance.⁸⁴ An investor with a small stake internalizes a large portion of the costs of activism but only a small portion of the benefits. In ordinary companies, activism is unlikely when shareholders are small and widely dispersed but more likely when investors are particularly large or particularly sophisticated. This standard collective action problem is often said to be unusually acute in mutual funds, because mutual funds are marketed primarily to household investors who have small amounts of money and low levels of sophistication. The unusual acuteness of this standard collective action problem in mutual funds is therefore widely believed to be the whole explanation for the lack of activism in mutual funds.

84. See, e.g., ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1933).

We agree that this standard collective action problem is an important part of the explanation for mutual fund investors' passivity. However, we maintain that it is not the whole explanation. Activism in mutual funds is not simply uncommon, as in ordinary companies; it is unheard of. And it is unheard of even in institutional mutual funds, many of whose investors are sophisticated and own large stakes and might seem to be the kind of investors who could overcome the standard collective action problem and become active. Indeed, nothing would prevent large and sophisticated investors from buying up controlling stakes in retail mutual funds if activism was profitable, but in practice they never do. Moreover, as we explain below, activism is quite common in closed-end mutual funds, which have ownership patterns similar to those of open-end mutual funds and are subject to virtually identical governance regulations. A complete explanation of mutual fund investors' passivity therefore rests on an understanding of how exit discourages activism in ways that go beyond the standard collective action problem.

Exit alters the operation of the first condition in mutual funds (that the benefits of activism exceed the costs) because exit prevents share prices from reflecting the full discounted present value of activism. Unlike an ordinary company's shares, a mutual fund's shares cannot be bought at a discount relative to those of a fund with an identical portfolio even if the fund has higher fees or less competent managers than the fund with the identical portfolio. Similarly, an investor cannot sell a fund at a premium relative to a fund with an identical portfolio even if the investor's activism has lowered the expected fees or improved the expected quality of management. An investor who organizes a shareholder vote to oust the managers or reduce the fees thus enjoys the benefits of her activism only during the period in which she remains in the fund. An investor in an ordinary company, in contrast, enjoys the full discounted present value of all future benefits of her activism, since they are reflected in the prices at which she buys and sells the shares.⁸⁵

Moreover, because of exit rights, the cost of voting and lobbying is unusually high in mutual funds. Even if one dissatisfied investor thinks that it might be profitable to stay and push for change, many will not and will exit for better funds. The investor base of a mutual fund at any given moment will therefore consist mostly of investors who are either content with the status quo or simply apathetic. Getting these investors to approve significant changes is extremely difficult.

85. Note that exit does not necessarily reduce the value of activism to future investors. Activism in a mutual fund could conceivably generate value that outlasts an activist's investment, just as it can in an ordinary company. Rather, exit eliminates present investors' ability to benefit from the value that will be enjoyed by investors in the future.

The cost of voting is also high because exit gives management control over the shareholder base. The flip side of redemption from issuers is purchase from issuers: while shares can theoretically be purchased in the open market, they would have to be purchased at a premium to NAV, since potential sellers can obtain NAV for their shares more simply by redeeming their shares. In practice, therefore, almost all shares are purchased from managers. But if managers consider a shareholder to be a threat to their control, they can simply refuse to sell the shareholder any shares.

The first condition for activism is therefore uniquely hard to satisfy in mutual funds with free exit. But perhaps the more powerful explanation for the absence of activism in mutual funds comes from the second condition for activism—that the net benefit of activism must exceed the net benefit of switching. This condition applies uniquely to mutual funds, and it is almost mechanically impossible for it to hold.

The most that an institutional investor could hope to obtain by voting or lobbying would be to reduce fees to the fund's marginal cost, since a fund manager would prefer to close down rather than to charge fees below this level.⁸⁶ But this is the same level of fees that economic theory predicts would prevail in a perfectly competitive market, and, as we explain below, it is close to the fee that almost all commentators agree actually does prevail in at least some segment of the mutual fund market.⁸⁷ So long as an investor can locate even one fund charging fees close to marginal cost, activism cannot produce more benefit than switching. If activism is even slightly costlier than switching (and it almost always is), no one will become active.

The second condition (that the net benefit of activism must exceed the net benefit of exiting) is particularly likely to fail with respect to fee liability, because the *Jones* standard that controls fee liability actually requires plaintiffs to prove the failure of the second condition. One of the six factors in the *Gartenberg* standard adopted by *Jones* assesses fees in other funds and grants recovery only if the fees charged by funds similar to the one in question are lower. In other words, shareholders are likely to win a section 36(b) suit only if they can show that exiting offered greater benefits than did fee liability (or, to put it directly, that the second condition for activism fails).

There remains one final difficulty to sort out with respect to the operation of the two conditions for activism with respect to fee liability (as distinct from voting). The foregoing analysis has taken the perspective of an investor who wants to invest today and hold shares until some point in the future. Fee

86. You cannot make money by charging less for a product than what it costs to provide it.

87. See *infra* text accompanying notes 92-99.

liability, however, allows investors not only to reduce fees in the future but also to recover fees paid in the past.⁸⁸ We can think of two kinds of investors who might use fee liability to recover fees paid in the past. The first of these kinds of investors is unlikely; the second is an unintended artifact of poor statutory design (as well as being somewhat unlikely).

The first kind of investor initially invests with the belief that a fund's fees are competitive, realizes at some later date that the fees are excessive, and then commences a lawsuit to recover the excessive portion of the fees paid in the past. This is the archetypal investor that section 36(b) was designed to protect. The problem is that this kind of investor is highly unlikely to exist. The only plausible reason that the investor would have landed in the high-fee fund in the first place rather than in some lower-fee alternative is that the investor is unsophisticated and lacks time, money, knowledge, and professional advice. But this very same lack of time, money, knowledge, and professional advice will also prevent the investor from bringing a lawsuit. If an investor lacks the know-how to move her money to a cheaper fund, how is she going to launch a protracted lawsuit and meaningfully supervise her lawyers? And even if this investor could gain some understanding of her legal rights and bring a lawsuit, the benefits of such a suit would be small, since this investor is by assumption an unsophisticated investor with little money at stake and therefore little to gain from litigation.

The other kind of past-fee-motivated litigant is an undesirable artifact of a mismatch between exit rights and the way in which excessive fee recoveries are distributed. As we explain below, section 36(b) requires recoveries to go only to funds themselves, and not to investors.⁸⁹ Since section 36(b) allows recovery of excessive fees paid after a date one year prior to the commencement of a lawsuit, some investors might invest in a fund and then immediately commence a suit to recover fees paid in the year leading up to the lawsuit. The new investors can do this even though they did not actually pay any portion of the past fees being sought.

We explain in more detail below why this state of affairs is undesirable and why share pricing does not eliminate this possibility. But we note here that this fee recovery structure does not directly incentivize the bringing of fee lawsuits because it bears no relationship to the amount of effort put forth in pursuing a suit. Indeed, *any investor* who times an investment correctly can arbitrage a

88. Section 36(b) does not formally empower judges to enter injunctions dictating fees charged after a judgment, but a judgment or settlement about fees charged in the past will almost always have implications for fees charged in the future.

89. See *infra* Section III.C.

litigation recovery. Any investor could simply find out when a settlement or recovery would be received by a fund in a fee lawsuit, invest in the fund one day prior to the reception of the recovery, and then redeem one day later at the higher NAV that reflects the fund's reception of the recovery. Such an investor could walk away with a big chunk of the recovery without having taken any significant risk, without having done anything to pursue the litigation, and without having paid any portion of the fees being recovered.

This second kind of past-fee-motivated litigant is also unlikely, in addition to being undesirable, because the rewards of this kind of litigation even to large shareholder plaintiffs are low. Recoveries are uncertain (no litigant has ever won a verdict in such a case)⁹⁰ and small (section 36(b) limits recoveries only to the excessive portion of fees and only to fees paid in the period beginning one year prior to the commencement of a suit).⁹¹ Investors are therefore unlikely ever to bring a lawsuit.

D. *The Benefits of Exiting*

An additional element of the exit/activism decision for investors in high-fee funds is the benefit obtainable by switching to a lower-fee fund. The lower the fee obtainable by switching, the more likely an investor is to choose exit over voting or fee litigation.

The key point to bear in mind is that switching is more appealing than activism so long as *even one fund* with a similar investing style and similarly competent managers charges a low enough fee to make switching appealing. The possibility that *many* or *most* funds do not charge competitive fees may be a serious public policy problem. But so long as at least some other portion of the market charges fees at or even moderately above competitive levels, no individual investor will choose to become active.

Although there is considerable dispute about whether all or most funds charge fees near the competitive level, it is widely recognized that *at least some* funds charge fees near competitive levels. The argument that *most* funds charge

90. See JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 1211 (3d ed. 2001); James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 WASH. U. L.Q. 907, 923 (2005); Freeman & Brown, *supra* note 11, at 645-47. The American Funds family recently won a bench trial in a section 36(b) case, with the plaintiffs taking nothing on their claims. *In re Am. Mut. Funds Fee Litig.*, No. 04-5593, 2009 WL 5215755 (C.D. Cal. Dec. 28, 2009).

91. We concede that the smallness and uncertainty of recoveries are not mechanical products of exit and could be remedied by revising section 36(b), but they presently amount to just one more reason why litigation by actual plaintiffs is unlikely.

competitive fees has been made most persuasively by John Coates and Glenn Hubbard in an influential recent article.⁹² They present very compelling evidence to suggest that “[c]oncentration and barriers to entry are low, actual entry [by new funds] is common and continuous, pricing exhibits no dominant long-term trend, and market shares fluctuate significantly [among funds].”⁹³

One criticism of Coates and Hubbard’s view that we take very seriously is that although most of the mutual fund market may be competitive, at least some portion of it is not. Critics commonly cite as an example S&P 500 index funds. There are dozens of such funds in existence, and even though they seem to offer indistinguishable services, the fees that they charge differ widely from each other.⁹⁴ This phenomenon is often cited as an indication that some funds charge fees above marginal cost and that some subset of investors is therefore being overcharged.⁹⁵

There are various explanations for this phenomenon, some of them consistent with the view that the market is competitive, some of them not.⁹⁶ Our point, however, is that it does not matter which of these explanations is correct, because even the commentators most critical of competition concede that *at least some* funds charge highly competitive fees and that finding these funds is not hard. Returning to the S&P 500 fund example, even though some funds charge fees as high as 0.7%, Vanguard and Fidelity, two of the largest adviser complexes, both run S&P 500 funds that as of this writing had fees of less than 0.2%.⁹⁷ The Vanguard and Fidelity funds are not hard to find: they do extensive advertising and have extensive web presences, and they clearly compete against each other directly. The dynamic is similar in other investment style categories.

92. Coates & Hubbard, *supra* note 61.

93. *Id.* at 153.

94. Hortaçsu & Syverson, *supra* note 68; Mahoney, *supra* note 11, at 169-71.

95. E.g., PETER J. WALLISON & ROBERT E. LITAN, *COMPETITIVE EQUITY: A BETTER WAY TO ORGANIZE MUTUAL FUNDS* (2007).

96. E.g., James J. Choi, David Laibson & Brigitte C. Madrian, *Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds*, 23 *REV. FIN. STUD.* 1405 (2010); Susan E. K. Christoffersen & David K. Musto, *Demand Curves and the Pricing of Money Management*, 15 *REV. FIN. STUD.* 1499 (2002); Coates & Hubbard, *supra* note 61; Javier Gil-Bazo & Pablo Ruiz-Verdú, *The Relation Between Price and Performance in the Mutual Fund Industry*, 64 *J. FIN.* 2153 (2009); Javier Gil-Bazo & Pablo Ruiz-Verdú, *When Cheaper Is Better: Fee Determination in the Market for Equity Mutual Funds*, 67 *J. ECON. BEHAV. & ORG.* 871 (2008); Hortaçsu & Syverson, *supra* note 68.

97. FINRA Mutual Fund Analyzer, <http://apps.finra.org/fundanalyzer/1/fa.aspx> (last visited Sept. 7, 2010).

The only skeptics who claim that the *entire* mutual fund market is uncompetitive are those who focus on a different kind of competition. These critics focus on competition among advisers for advisory contracts rather than on competition among funds for investors. Because boards always renew existing advisory contracts, there is said to be no competition among advisers for advisory contracts. The *Gartenberg* opinion made this argument,⁹⁸ as have some law review articles.⁹⁹

Competition among advisers for advisory contracts, however, is not important independently of competition among funds for investors. A simple example will illustrate. Imagine that the competition among funds for investors was vigorously competitive and also that mutual funds did not have boards of directors at all. In this example, investors would receive less protection from boards than they would under even the most skeptical set of views about boards' passivity, since boards would not even exist. But even in this example, investors would be fine, because their fees, by assumption, would be set in a vigorously competitive market. Investors in this example would be like consumers of auto tires, breakfast cereal, or any number of other products whose prices are set by vigorously competitive market forces and not by consumer-representative boards.

The only rebuttal is to dispute the terms of this example and say that competition among funds for investors is not actually vigorous. But then we are back to where we started: what matters is competition among funds for investors, not competition among advisers for advisory contracts.

E. The Costs of Exiting

The benefits of moving to a lower-fee fund must be offset against the cost of finding such a fund and implementing the switch. These include both searching and switching costs. It turns out that, for investors for whom these costs are high, the costs of activism are higher.

1. Switching Costs

Switching costs can be identified fairly precisely. They include load and redemption fees, restrictions in 401(k) plans, and taxes. Though load and redemption fees may have been an important obstacle in the past, they are not a serious concern presently. Investors can easily avoid these fees simply by

98. *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 929 (2d Cir. 1982).

99. See, e.g., Freeman & Brown, *supra* note 11.

choosing funds that do not charge them. Funds charging either kind of fee are a minority of all funds, and most funds that do charge such fees sell multiple share classes, some of which do not charge such fees.¹⁰⁰ Additionally, back-end load fees usually phase out over a period of a few years, and front-end load fees do not directly influence exit decisions, since money paid in a front-end load is a sunk cost and is irrelevant to future decisions.

Another potential obstacle to switching is the structure of 401(k) plans. These plans are tax-favored accounts set up by employers through which employees often invest in mutual funds. Employees' choices may be limited in these arrangements, because employees can usually only select funds offered by one or two service providers chosen by their employers. Exit still dominates voting and litigation even for investors in 401(k) plans, however, because the costs of voting and litigating against funds held in 401(k) plans are particularly high and the benefits are particularly low. The tax code restricts participation in these plans to individuals and to small amounts of money—currently a maximum of \$15,500 per year. These small individual investors are the least likely investors to become active because they encounter the standard collective action problem of corporate governance most severely. Moreover, even though switching costs are high, they are not impossibly high: employees can ask their employers to switch providers or expand choices.¹⁰¹

Taxes are the final source of switching costs because redemption is a realization event for capital gains tax purposes. There are a few reasons why taxes do not make activism appealing. First, unlike ordinary companies, mutual funds are required by tax law to distribute capital gains and ordinary income annually, so unrealized capital gains generally constitute a small portion of mutual funds' share prices at any given moment.¹⁰² Second, a very large portion of mutual fund shares is held in tax-exempt retirement accounts, for

100. Only 35% of assets in U.S. domestic equity funds were in front-end load funds in 1999, and the proportion was steadily declining. Brad M. Barber, Terrance Odean & Lu Zheng, *Out of Sight, Out of Mind: The Effect of Expenses on Mutual Fund Flows*, 78 J. BUS. 2095, 2095 (2005). Average load fees have declined significantly since 1980, and no-load funds have grown much more quickly than front-end load funds since 2002. Funds with redemption fees have experienced net outflows every year since 2003. INV. CO. INST., *supra* note 2, at 77 fig.5.13. Many redemption fees apply only to shares held for very short periods and are charged only as a way of discouraging abusive quick-trading arbitrage schemes. Eric Zitzewitz, *Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds*, 19 J.L. ECON. & ORG. 245 (2003).

101. They can also sue their employers and the mutual fund managers who administer 401(k) plans under § 404 of ERISA, which imposes a prudent man standard of care and loyalty. 29 U.S.C. § 1104 (2006); *see, e.g.*, *Braden v. Wal-Mart Stores, Inc.*, 588 F.3d 585 (8th Cir. 2009).

102. Barclay et al., *supra* note 78; Coates & Hubbard, *supra* note 61, at 199.

which tax realization is not an issue. Third, the taxes that might come from unrealized gains that have not yet been distributed are an issue only for investors who have been invested in a particular fund for a long time. They are not an issue if money is being invested for the first time or if it is being switched out of a fund after only a brief period. Fourth, even an investor who is motivated by tax considerations to stay and become active will be unlikely to succeed in her activism. For the reasons just described, many unsatisfied investors will not be prevented by tax considerations from leaving for better funds. So when a tax-motivated investor begins leading a revolt, a large portion of her potential allies will already have left for better funds, making a vote very difficult to win.¹⁰³ Fifth, the tax cost is only the cost of realizing gains early, since the taxes ultimately have to be paid one way or another. Sixth, even if taxes make switching somewhat costly, we must remember that activism is costly too. Our point is not that switching is costless but rather that the relative costs of switching and activism almost always favor switching. Finally, we know of no significant fee- or performance-related shareholder activism in any open-end mutual fund since 1940. Even if it is possible to imagine extreme scenarios in which taxes motivate shareholders to become active, such scenarios have never become reality.

2. Search Costs

Now we turn to search costs. By search costs, we mean the effort, time, and financial understanding required to locate a low-fee fund. For investors who pay attention to and understand their funds or who have hired professional advisers, search costs are very low. Most funds now have substantial presences on the Internet. Various news and information sources, such as Morningstar, make comparison-shopping easy.

Search costs may be high for some subset of investors, however, because these investors may lack the time, financial sophistication, or motivation to pay attention to their funds or to make sound investing decisions. For these investors, even getting on the Internet and switching to a lower-fee fund may be prohibitively difficult. There is now a large empirical literature demonstrating that many mutual fund investors—from business school students to middle-income families to low-income families—tend to neglect their investments or to weigh the wrong factors in choosing funds.¹⁰⁴

103. See *supra* Section II.C; *infra* Section III.A.

104. See, e.g., Gordon J. Alexander, Jonathan D. Jones & Peter J. Nigro, *Mutual Fund Shareholders: Characteristics, Investor Knowledge, and Sources of Information*, 7 FIN. SERVS. REV.

Search costs do not make activism appealing even for investors for whom these costs are high, however, because the same lack of resources and sophistication that makes searching costly also makes activism costly. If an investor lacks the know-how to go online and move her money to Vanguard, how is she going to launch a proxy campaign?

F. Evidence on Shareholder Involvement in Activism

Although high-quality data about shareholders' use of voting and fee litigation are not available, anecdotal evidence and the available data strongly suggest that in practice exit is almost always more appealing to shareholders than voting and fee litigation. Indeed, while activism in ordinary public companies is uncommon, it is unheard of in mutual funds.

1. Voting

It is widely understood in the mutual fund industry that shareholders very rarely vote (although the reasons are poorly understood).¹⁰⁵ Statutes and regulations, rather than contracts, are therefore the sources of almost all voting in mutual funds.

We know of no shareholder-initiated takeovers (either hostile or friendly), despite the fact that open-end mutual funds rarely adopt defensive measures such as poison pills. We know of no instances in which shareholders initiated a vote on any fundamental matter. Management is almost never opposed when votes are required. We know of only a handful of instances in which director elections or votes involving a change in managers were contested, and only one in which managers lost.¹⁰⁶ None of these votes was contested by

301 (1998); Choi et al., *supra* note 96; Michael J. Cooper, Huseyin Gulen & P. Raghavendra Rau, *Changing Names with Style: Mutual Fund Name Changes and Their Effects on Fund Flows*, 60 J. FIN. 2825 (2005); Don A. Moore et al., *Positive Illusions and Forecasting Errors in Mutual Fund Investment Decisions*, 79 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 95 (1999); Christopher J. Malloy & Ning Zhu, *Mutual Fund Choices and Investor Demographics*, (Mar. 16, 2004) (unpublished manuscript, on file with authors).

105. See, e.g., INV. CO. INST., COSTS OF ELIMINATING DISCRETIONARY BROKER VOTING ON UNCONTESTED ELECTIONS OF INVESTMENT COMPANY DIRECTORS (Dec. 18, 2006), available at http://www.ici.org/pdf/wht_broker_voting.pdf.

106. Independent directors of the Yacktman Fund in 1998 fought a public proxy battle with the fund's adviser, and shareholders ultimately approved a proposal by the adviser to remove the independent directors (the directors did not formally attempt to terminate the contract with the adviser). Paul H. Dykstra & Paulita Pike-Bokhari, *The Yacktman Battle: Manager Bites Watchdogs*, INV. LAW., Nov./Dec. 1998, at 1. The board of the Navellier Funds in 1997

shareholders—they involved only disputes between managers and directors. We know of very few instances in which fee increases have been successfully opposed.¹⁰⁷ The only votes in mutual funds that are ever contested by shareholders involve social issue proposals under Rule 14a-8 that have nothing to do with fees or returns.¹⁰⁸

It is very expensive to obtain quorums when votes are required. For non-routine matters, in which New York Stock Exchange (NYSE) rules do not allow brokers to vote shares that they hold for clients, most of the time quorums cannot be obtained on the first try, and three or more adjournments are often necessary, frequently with three or more resolicitations for each adjournment.¹⁰⁹ This is why the mutual fund industry successfully lobbied for an exemption from the new NYSE rule prohibiting broker voting in uncontested director elections.¹¹⁰

attempted to change managers and was defeated by shareholder vote. *Navellier v. Sletten*, 262 F.3d 923, 933 (9th Cir. 2001). The Japan Fund changed managers in 2002. Media sources suggested that the board fired the managers, but our conversations with industry professionals suggest that the managers may have simply walked away from the fund. Chuck Jaffe, *Japan Fund Shift Shows Who's Boss*, STAR-LEDGER (Newark), Nov. 27, 2003, at B6; Ian McDonald, *Japan Fund's Board Stages a Revolt—Directors Ask Shareholders To Approve Severing Ties with Deutsche Bank*, WALL ST. J., July 15, 2002, at C17.

107. In 1991 the shareholders of six T. Rowe Price funds voted on fees that would have applied upon redemption to any shareholder who redeemed less than six or twelve months after purchasing shares. Four funds approved the new fee, and two rejected it. Carole Gould, *Mixed Reviews on Redemption Fees*, N.Y. TIMES, May 12, 1991, at F14. Arguably, shareholders are more motivated to vote on redemption fees than initial load fees or continuous fees, since redemption fees uniquely impinge on the freedom of exit.
108. A group called Investors Against Genocide initiated proposals in funds in Fidelity, Vanguard, TIAA-CREF, T. Rowe Price, and other complexes to prohibit investing in countries and companies involved in genocide. Daisy Maxey, *Drop in Voting Adds to Costs*, WALL ST. J., May 19, 2008, at C12; MUTUAL FUNDS WITH SHAREHOLDER PROPOSALS FOR GENOCIDE-FREE INVESTING, <http://investorsagainstgenocide.net/shareholderhelp> (last visited Sept. 7, 2010). These proposals generally received little support and participation. Investors Against Genocide initiated proposals in twenty-one Fidelity funds in 2008, for example, and after three separate votes, the proposals did not obtain a quorum in seven funds and failed with less than 30% in thirteen funds. *Id.*
109. INV. CO. INST., *supra* note 105, at 11-13; Maxey, *supra* note 108. The ICI's data do not distinguish open-end and closed-end funds.
110. See Order Approving Proposed Rule Change, as Modified by Amendment No. 4, To Amend NYSE Rule 452 and Corresponding Listed Company Manual Section 402.08, 74 Fed. Reg. 33,293 (July 1, 2009), available at <http://www.sec.gov/rules/sro/nyse/2009/34-60215.pdf>; INV. CO. INST., *supra* note 105.

2. *Fee Liability*

Our claims about section 36(b) litigation are based on theory and on the preliminary results of an empirical study of fee liability which we have drafted in working paper form and which we intend to publish separately from this Article.¹¹¹ This will be the first empirical study of excessive fee liability. Our study includes all or almost all lawsuits filed under section 36(b) since 2000.

We can say with some degree of confidence that plaintiffs have won very few – if any – verdicts in mutual fund fee litigation.¹¹² It does appear, however, that there have been a significant number of settlements, and litigation under section 36(b) is not uncommon.

Anecdotal impressions from published opinions, conversations with practicing lawyers, and the evidence from our data set suggest strongly that plaintiffs' lawyers play a dominant role in initiating and running the great majority of section 36(b) suits. The vast majority of cases since 2000 were initiated by particular coalitions of plaintiffs' firms and involved the same standard set of claims and allegations.¹¹³ The *Jones* case, for example, was one of about a dozen complaints that a group of plaintiffs' lawyers led by two South Carolina law firms brought within months of each other. The law firms advertised extensively in search of potential plaintiffs.¹¹⁴ There have been only a handful of institutional plaintiffs in cases against open-end funds that center on excessive fees since 2000, and none of these plaintiffs appears to have played any significant role in the lawsuits.¹¹⁵

It also appears that many section 36(b) claims originate in complaints motivated primarily by matters other than fees, with the section 36(b) claims getting tossed in for good measure. For example, the litigation over the Reserve Primary Fund, a money market fund that collapsed during the recent financial crisis as a result of bad investments in Lehman Brothers debt, included section 36(b) claims even though the real issue in the suit was the collapse of the fund for reasons unrelated to management fees.¹¹⁶

111. Curtis & Morley, *supra* note 69.

112. See *supra* note 90 and accompanying text.

113. Curtis & Morley, *supra* note 69.

114. See, e.g., Exhibit List of Defendant at 4, Exhibits 2001-2007, *Baker v. Am. Century Inv. Mgmt., Inc.*, No. 04-4039-CV-C-ODS, (W.D. Mo. July 3, 2006); *Attention Investment Fund Investors (Advertisement)*, POST-TRIBUNE (Jefferson City, Mo.), Mar. 15, 2004, at 6.

115. Curtis & Morley, *supra* note 69.

116. Consolidated Class Action Complaint, *In re Reserve Primary Fund Sec. & Derivative Class Action Litig.*, No. 08-CV-8060-PGG (S.D.N.Y. Jan. 5, 2010).

3. Boards

Shareholders do not meaningfully elect or lobby boards of directors for the same reasons that they do not vote. We know of only one instance in which a director election was contested, and it involved an attempt by managers to remove directors who accused the managers of misconduct.¹¹⁷

There is very little evidence of boards challenging fund managers over any significant issue. Although a couple of academic articles have suggested otherwise, we are certain that only a handful of boards have ever fired a fund's managers.¹¹⁸ The many empirical studies on mutual fund board independence do not contradict these anecdotal impressions.¹¹⁹ The results of these studies have been mixed, with some studies finding evidence that greater board independence is associated with better outcomes and some studies finding no such evidence. The SEC compiled a summary of this literature in 2006 and concluded that "[b]road cross-sectional analysis reveals little consistent

117. The managers won, which is surely not the result that most advocates of mutual fund governance would have desired. See Dykstra & Pike-Bokhari, *supra* note 106.

118. Camelia Kuhnen has collected data suggesting that nearly 30% of funds changed managers at least once between 1993 and 2002 and that nearly 16% changed managers in 2001 alone. Camelia M. Kuhnen, *Dynamic Contracting in the Mutual Fund Industry* 15, 38 tbl.4 (Feb. 15, 2005) (unpublished manuscript), available at <http://ssrn.com/abstract=687530>. Kuhnen does not attempt to distinguish among the different reasons why managers change, but apparently assumes that every change is attributable to boards firing managers. *E.g.*, *id.* at 14, 15, 23-26. Similarly Ajay Khorana, Peter Tufano, and Lei Wedge analyze a significant (albeit much smaller) number of mergers between funds with different managers and assume that all or at least a significant portion of these mergers are initiated by target fund boards who are dissatisfied with their funds' managers and want to get rid of them. Ajay Khorana, Peter Tufano & Lei Wedge, *Board Structure, Mergers, and Shareholder Wealth: A Study of the Mutual Fund Industry*, 85 J. FIN. ECON. 571, 573, 596 (2007). It is simply not plausible, however, to think that management change initiates with boards—at least not with the frequency these authors describe. Because shareholders have to vote on management changes, genuine conflict between boards and managers would inevitably leave traces in the public record. Our conversations with mutual fund industry professionals, however, have turned up no memories of any significant instances of board-manager conflict or board-initiated change other than the Navellier and Yackman funds, with respect to which there is tremendous collective memory and awareness in the industry. See *supra* note 106. Neither Kuhnen nor Khorana, Tufano, and Wedge supply any anecdotal evidence that any of the instances in their samples involved actual conflict between managers and boards, and we strongly doubt whether there are more than a few such instances in their samples (if indeed there are any). The better explanation for the management changes in these data, therefore, is that managers initiate the changes and boards simply rubber-stamp them. The real motivation for management changes is that one set of managers effectively sells a fund to another set of managers.

119. See *supra* note 70 and accompanying text.

evidence that board composition *is related* to lower fees and higher returns for fund shareholders.”¹²⁰

In any event, evidence on board independence is not very useful for our purposes. The most serious problem is that it is impossible to compare funds that have boards to funds that do not, since all funds are required to have boards. The evidence on whether boards ought to be independent, in other words, does not say much about whether boards ought to exist at all. Additionally, the inability of any study on board independence to address endogeneity problems makes it difficult to draw causal inferences even about the impact of independence. In other words, even if we observe a statistical connection between board independence and fees, it would be impossible to know whether board independence causes funds to have lower fees or whether some unobserved factor that causes some funds to have more independent boards also causes those funds to have lower fees.¹²¹

G. Contrast with Ordinary Companies and Closed-End Funds

The incentives for activism in ordinary companies and closed-end funds are much greater than in mutual funds. For shareholders in closed-end funds and ordinary companies, the choice between exit and activism comes down simply to a direct comparison of the costs and benefits of each, since switching is not an option. This direct comparison is also more favorable in ordinary companies than in mutual funds, because current shareholders in ordinary companies enjoy the full present value of activism, not just the value that accrues while they hold the company’s shares.

To be sure, the benefits of activism rarely outweigh the costs in large public ordinary companies with dispersed shareholders, and that is why we see so little shareholder activism in these companies. But the reasons for investors’ passivity in mutual funds and ordinary companies are different. Ordinary company investors are often passive because their stakes in these companies are too small to make activism worthwhile. Where the benefits of activism are particularly high or where shareholders hold large stakes in their companies, we can imagine and even occasionally observe contested votes, lobbying of directors, takeovers, and shareholder litigation that is actually initiated and controlled by shareholders rather than by plaintiffs’ lawyers. We cannot imagine, let alone observe, such activism in mutual funds.

120. See SEC Literature Review, *supra* note 70, at 1.

121. See, e.g., Khorana et al., *supra* note 118.

Closed-end funds provide an even stronger illustration of the importance of exit. The regulation of governance and of fee liability is virtually identical in closed- and open-end funds, and closed-end funds are widely believed to have ownership patterns similar to those of open-end funds. But unlike open-end funds, closed-end funds experience contested votes frequently. Indeed, closed-end funds are constantly at risk of being torn apart by activists. Most closed-end funds' shares trade at prices that are lower than the shares' NAV.¹²² Arbitrageurs can therefore make money by forcing a closed-end fund to liquidate and redeem shares at NAV.¹²³ This is why, unlike open-end funds, which generally have no anti-takeover measures, closed-end funds typically arm themselves with a variety of anti-takeover measures.¹²⁴ There is also activism for more conventional purposes in closed-end funds, although we cannot say much, unfortunately, about its frequency, other than to say that anecdotal evidence suggests that it is more common than activism in open-end funds.

III. HARMFUL INTERACTIONS BETWEEN EXIT, VOICE, AND FEE LIABILITY

Exit does not just limit the usefulness of voice and liability; it also interacts with them to generate three types of costs. One is direct. Voting, boards, and fee litigation all cost money, and voting costs even more money in mutual funds than in ordinary companies because of the way in which it interacts with exit. Another cost involves lost opportunities. Voting, boards, and fee liability have distracted Congress and the SEC from more effective solutions to real problems. A third type of cost involves harmful and unintended distortions that the interaction of exit, voice, and fee liability produces in the way in which mutual funds operate. In this Part, we explore all three of these sets of costs, with primary focus on the way in which exit distorts the operation of voice and fee liability.

122. This has long been the central puzzle in the study of closed-end funds. See, e.g., Elroy Dimson & Carolina Minio-Kozerski, *Closed-End Funds: A Survey*, FIN. MKTS., INSTITUTIONS & INSTRUMENTS, May 1999, at 1-2; Charles M. C. Lee, Andrei Shleifer & Richard H. Thaler, *Anomalies: Closed-End Mutual Funds*, J. ECON. PERSP., Fall 1990, at 153-54.

123. Michael Bradley et al., *Activist Arbitrage: A Study of Open-Ending Attempts of Closed-End Funds*, 95 J. FIN. ECON. 1 (2010).

124. See Andrew J. Donohue, Dir., Div. of Inv. Mgmt., SEC, Keynote Address at the Independent Directors Council Investment Company Directors Conference (Nov. 12, 2009), available at <http://www.sec.gov/news/speech/2009/spch111209ajd.htm>.

A. *Voting*

Exit makes the direct costs of voting in mutual funds unusually high, because mutual fund shareholders have even less reason to vote than shareholders of ordinary companies. As we explain above, obtaining minimum quorums is extremely costly; multiple readjournments and resolicitations are the norm.¹²⁵ The cost for mailing a single proxy averages \$4.37 in matters in which broker voting is not allowed and \$1.85 in matters in which broker voting is allowed.¹²⁶ Given mutual funds' size and dispersed ownership, these costs add up rapidly. One fund complex in a study of voting costs published by the Investment Company Institute spent about \$20 million on a single proxy effort.¹²⁷

Additionally, voting and exit interact to prevent even the most independent boards from firing managers or driving hard bargains on fees.¹²⁸ If a board decides to change a mutual fund's managers, the ICA requires shareholders to vote on the change. This would be unusual even in an ordinary company. The net effect of this requirement is analogous to a provision protecting a specific CEO's tenure in an ordinary company's charter, which would require a shareholder vote to change.

But while a shareholder vote requirement would make firing a manager very difficult in an ordinary corporation, it makes firing a manager virtually impossible in a mutual fund. In an ordinary corporation, voting obstructs change by imposing direct costs—votes have to be obtained and counted—and by making outcomes uncertain. It does the same in a mutual fund, and it also combines with exit to create a kind of selection effect. Any investor who thinks that the current managers are performing poorly or that fees are too high in a mutual fund will not invest in the fund or, if she is already invested, will make the change herself by redeeming her shares and investing with a better manager. At no point in a fund's existence will it ever have a majority of investors who think managers or fees could be significantly improved. Investors either will approve of the management and fees or will be too apathetic to vote. Votes on management changes, therefore, are strongly biased in favor of current management.

125. INV. CO. INST., *supra* note 105, at 11 fig.7.

126. *Id.* at 17 tbl.1.

127. *Id.* at 17.

128. To be sure, these are not the only reasons why boards do not fire managers. Other reasons include boards' lack of independence from managers and the great difficulty of finding and working with new managers once the old managers have been fired. Birdthistle, *supra* note 11, at 1409-11.

Ordinary companies do not experience this selection effect. It is true that only shareholders who value an ordinary company's shares more than the market does will hold them. But a shareholder does not have to like management more than the market does or more than the relevant alternatives, in order to value a company's shares more than the market does. An ordinary company shareholder might value a company's shares more than the market does because she thinks that if she buys the shares, she has a better chance of using voting to replace the current management than the marginal market buyer does. This is the logic of many corporate acquisitions and private equity deals. Or an investor might have greater faith in the management than the market does but still believe that the company would be even better under alternative management.

The combination of the ICA's voting requirement and this unusual selection effect in mutual funds has consequences for every aspect of boards' functioning; negotiating fees, operating policies, and restrictions on conflict-of-interest transactions are challenging for a board that cannot credibly threaten to walk away from a fund manager.

The desire to avoid shareholder votes on fee changes has also produced the so-called "fee cap-and-waiver" system. Shareholders have to vote on increases in the basic management fee, although not on certain other classes of fees. When a fund is first started and before its shares are sold to the public, therefore, both boards and inside shareholders approve a basic management fee higher than what management actually intends to charge. Management then sets the actual management fee somewhere below the authorized limit based on market conditions. Once the shares have been distributed to the general public, management retains the option of increasing actual fees up to the authorized limit without the hassle of a shareholder vote.

Advisers avoid scaring off shareholders with the high authorized management fees by signing separate agreements with funds that cap the funds' total expense ratios, which include brokerage, custody, and other fees, as well as basic management fees. Fees and expenses other than basic management fees are generally not subject to shareholder voting; after the fund has been offered to the public, boards and managers can change the expense ratio caps annually or more frequently without having to hold shareholder votes. The total expense ratios that managers actually charge are often less than the amounts that boards authorize under the fee caps. Data indicate that a large majority of money market funds use some variant of this cap-and-waiver

system,¹²⁹ and anecdotal evidence suggests that a very large percentage of other funds do so as well.

The harm in this practice is not that it removes boards or shareholders from the fee-setting process. The harm is that this practice prevents shareholders from receiving notice of changes in fees. So long as an increase in management fees does not take the fees above the formal caps, managers are not obligated to say anything to shareholders about the increase. While the formal fee cap protects shareholders from fee increases in excess of the cap, the lack of notice means that shareholders are less likely to be aware of the fees that they are being charged than they would be if there were no shareholder voting in mutual funds.

Additionally, this practice makes fee disclosure complicated and difficult for investors to understand. Authorized fees are often buried deep in attachments to prospectuses and at any given time a mutual fund might be disclosing, in various locations, as many as four different versions of the same fees.¹³⁰ Indeed, the cap-and-waiver system has apparently confused even many financial economists. To our knowledge, none of the many empirical studies of the relationship between mutual fund board composition and fees has recognized that the fees that funds charge are not the ones that boards actually set.¹³¹

B. Boards

In this Section, we first consider how the dominance of exit casts doubt on mutual fund boards' ability to benefit investors. We then examine ways in which the dominance of exit may cause boards to harm investors.

1. Doubtful Benefits

The commonly accepted explanation for boards' inactivity in mutual funds is that boards are initially appointed by managers and that their independence is co-opted in various ways. We do not disagree with this view. Our analysis

129. Susan E. K. Christoffersen, *Why Do Money Fund Managers Voluntarily Waive Their Fees?*, 56 J. FIN. 1117, 1120 (2001).

130. These fees typically include the fee approved by the board, the fee that management intends to charge at the time the prospectus is printed, the fee negotiated in a separate contract with the board, and the fee that management actually charges at any given moment.

131. It is unclear what this ought to mean for empirical studies. But the fact that none of these studies even mention the problem suggests to us that their authors are not aware of it and therefore that the format of fee disclosure is genuinely confusing.

suggests, however, that the dominance of exit would also undermine the effectiveness of even truly independent boards.

The primary reason was already given above: voting requirements make it virtually impossible for boards to fire managers. Another reason is that because investors have no reason to vote for mutual fund directors, directors are effectively unelected. This has a number of important consequences for the desirability and effectiveness of mutual fund boards.

First, there is little reason to prefer mutual fund directors' judgment over managers' judgment on general strategy questions that do not involve direct managerial conflicts of interest. In ordinary companies, directors retain ultimate management authority and prevail in disagreements with managers about general strategy primarily because directors are elected. But mutual funds boards' authority cannot be rationalized this way. The only reason to prefer mutual fund directors' judgment over managers' judgment is that some directors are independent of managers. But this rationale is completely unconvincing with respect to directors who are not independent. And although it is somewhat convincing with respect to independent directors' responsibilities for conflict-of-interest issues, it is not convincing with respect to general matters not involving conflicts of interest, such as portfolio allocation and borrowing. Why should directors make decisions about optimal borrowing and risk levels, for example, just because the directors are independent? Auditors are even more independent, but no one would suggest trusting auditors with such decisions. Indeed, managers are arguably more accountable to shareholders on strategy than directors are precisely because managers are interested—their fees are tied directly to shareholders' willingness to invest.

A related problem is that directors lack motivation to use their authority, even if they can manage to overcome the obstacles to using it described above. No director is ever installed by shareholders and charged with fulfilling a shareholder-friendly agenda, and no director ever faces the threat of discipline through the election process.

Directors might be motivated by the threat of enforcement by the SEC or other authorities. Enforcement actions, however, can be effective only against clear misconduct and not against fuzzy market-based judgments such as whether a fund has struck the optimal balance between risk and return.

Directors may also be motivated by a sense of duty. Indeed, we believe that the overwhelming majority of mutual fund directors are conscientious and sincere advocates for investors' interests. To the extent that mutual fund boards benefit investors, it is because directors often feel and act upon a strong sense of duty to shareholders.

But managers' influence over the selection of funds' independent directors¹³² ensures that even conscientious and hard-working directors are always either redundant or ineffective. The reason, to put it simply, is that only good managers hire good directors. The bad managers who might actually benefit from good directors will deliberately choose not to hire them. And in any case, boards' negotiating power is so restricted that even highly motivated directors cannot produce much change.

Setting aside all of the reasons that we have given to doubt boards' authority, desirability, and motivation, it is not clear just what problem boards are intended to solve. In operating companies, shareholders must act collectively to intervene in firm governance in order to protect their collective investment. The high cost of acting collectively on every issue makes it necessary to delegate direct oversight responsibilities to a board of directors that represents shareholders as a consequence of having been elected. But in mutual funds, the collective action problem is much more limited. Exit decisions are unilateral.

Boards may have a role in ensuring funds' compliance and in monitoring technical and complicated matters. We will explore this issue in more detail in Part V. The trouble, as we will explain, is that boards evolved into this compliance-focused role over time and were never consciously or coherently designed to perform it.

2. *Significant Harms*

We now turn to considering how the interaction between exit and boards has harmed shareholders. One problem is that boards may be used to dismiss derivative litigation as permitted by state law.¹³³ Derivative litigation is sometimes desirable in mutual funds, such as when it attempts to recover damages for fraud. Exit is not a possible remedy for most fraud, since by definition fraud is not disclosed early enough to make exit prior to the fraud possible. To the extent that boards have been used as tools to prevent such litigation, they have been harmful.

The larger harm done by boards, however, has been indirect: boards have created an enormous distraction. There are many people who inaccurately view boards as saviors. In recent years, the SEC has placed greater and greater

132. See *supra* notes 25-27 and accompanying text.

133. See, e.g., *Burks v. Lasker*, 441 U.S. 471 (1979). Donald Langevoort has similarly criticized allowing boards to dismiss derivative litigation on the ground that boards are ineffective. Langevoort, *supra* note 60.

emphasis on boards' independence and has vested them with greater and greater responsibilities for monitoring managers.¹³⁴ This is unfortunate, because there is little reason to believe boards can effectively perform these functions.

Opposite those who view boards as saviors are those who view boards as villains. Angst over boards' failure to negotiate fees has provided the political and administrative motivation for a great deal of regulation with dubious value. The most important example is section 36(b), which Congress added to the ICA in 1970 after being impressed by studies by the SEC and the Wharton School suggesting that boards were insufficiently involved in setting fees.¹³⁵ The concern about boards' role in fee-setting was then extended to judicial doctrine on section 36(b) by *Gartenberg* and now by *Jones*. Both of these cases set the standard for section 36(b) liability by express reference to the fee that would have been negotiated at arm's length by a hypothetically independent board. *Gartenberg* and *Jones* also make the independence and conscientiousness of a fund's board one of the list of factors to be evaluated in assessing a fee's reasonability.¹³⁶ This is unfortunate, because boards' failure to get involved in fee-setting is an inevitable consequence of exit rights. The hypothetically independent board called for by *Gartenberg* and *Jones* is a purely fictional character whose real-life actions can only be imagined.

C. Fee Liability

Exit produces several harmful and unintended distortions in the way in which fee lawsuits operate. Although these distortions may not eliminate the value of fee lawsuits entirely, they do diminish the value of fee lawsuits and create important problems that would not exist in the absence of exit.

The primary distortion is that the agency conflicts between lawyers and shareholders that have been documented in ordinary class action litigation are particularly acute in mutual funds.¹³⁷ Indeed, the *mere existence* of many of the

134. See *supra* notes 73-75 and accompanying text.

135. SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 89-2337, at 12 (1966), available at <http://sechistorical.org/museum/papers/1960/>; WHARTON SCH. OF FIN. & COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 87-2274, at 28-36 (1962).

136. See *Jones v. Harris Assocs. L.P.*, 130 S. Ct. 1418, 1428-30 (2010); Johnson, *supra* note 67, at 519.

137. John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class*

lawyer-client relationships in high-fee funds is evidence of serious agency conflicts. In many cases, any lawyer who genuinely sought the welfare of her clients would not allow them to stand around paying high fees while waiting for litigation to reach resolution. She would tell her clients to get out and invest elsewhere. By getting out, they would give up the right to recover in the litigation, but the outcomes of section 36(b) cases are sufficiently uncertain and small that it is rarely worth paying high fees while the litigation is in progress just to maintain the possibility of recovery. In any event, shareholders can participate in a recovery by exiting at the time when the suit is commenced and then investing again one day prior to the recovery.

One way in which agency conflicts manifest themselves is that excessive fee lawsuits are unlikely to target small funds and small fund families, even though these funds and families are likely to have the most egregious fees.¹³⁸ Both intuition and empirical evidence suggest that fund size is negatively related to fee rates, since many investors leave in response to high fees.¹³⁹ But because plaintiffs' attorneys' compensation is a function of total recoveries, and total recoveries are a function of both fee rates and total assets under management, lawyers may prefer to target large, moderate-fee funds and families rather than small funds and families whose fee rates are more clearly abusive. Because *Gartenberg* (and now *Jones*) maintained the possibility that even funds charging fees at prevailing market rates might be liable, suits against large, moderate-fee funds are quite tempting to plaintiffs' lawyers. The early results of our empirical study are consistent with this intuition.¹⁴⁰

In addition to giving plaintiffs' lawyers free reign in section 36(b) suits, the interaction of exit and section 36(b) produces several unintended distortions. The first is that recovery often goes to investors who did not pay the excessive fees at issue and does not go to investors who did. According to the text of section 36(b), suits can be brought only on behalf of a fund and recovery goes only to the fund itself, so that functionally (though not formally) section 36(b) suits are similar to derivative suits.¹⁴¹ Fees paid as far back as one year prior to

Actions and Derivative Litigation: Economic Analysis and Recommendations for Reform, 58 U. CHI. L. REV. 1 (1991).

138. For a similar argument about the incentives of plaintiffs' lawyers in section 36(b) cases, see Henderson, *supra* note 61, at 14.

139. See, e.g., Coates & Hubbard, *supra* note 61.

140. Curtis & Morley, *supra* note 69.

141. Section 36(b) suits are formally distinct from derivative suits because funds themselves cannot bring the suits (only investors and the SEC can). *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 535 & n.11 (1984). Section 36(b) suits are therefore not subject to state law board-demand requirements or dismissal by boards.

the commencement of the suit can be recovered. However, fees are paid based on the amount of time an investor spends in a fund. This means, for example, that an investor who enters a fund more than one year prior to the commencement of a suit and exits one day before the suit is concluded gets no recovery, even though she has paid all of the fees that ultimately will be recovered. An investor who enters the fund one day prior to the recovery benefits even though she has paid none of the recovered fees. This problem applies to any litigation recovery that goes to a fund rather than to investors, not just to section 36(b) recoveries.

A related distortion is that if an investor leaves a high-fee fund, she forfeits her ability to recover past excessive fees. Thus the prospect of recovering under section 36(b) not only diminishes investors' incentive to search for lower-fee funds by creating alternatives to doing so but actually *affirmatively discourages* investors from switching even if they have already located a lower-fee fund.

Recoveries in derivative suits in operating companies are not distorted in this way because operating company shares are priced in expectation of future lawsuit outcomes. Suppose that the CFO of an operating company engages in a fraudulent transaction that nets him \$10 million in ill-gotten gains. When the news of this malfeasance hits the market, the price of the company's stock will drop, but not by \$10 million, because the company's stock price will include the value of future litigation against the CFO, discounted for the probability that the company will actually collect it and the cost of collecting. Shareholders who were harmed by the fraud will therefore receive the full expected present value of the potential recovery even if they sell their shares before the recovery is received. The price of a mutual fund's shares in such a scenario would not adjust this way, since it must be tied to the shares' NAV. In fact, shares in such a mutual fund would be underpriced if expected litigation recoveries are taken into account, since the value of a prospective recovery would not be reflected in the price.

A third distortion is that exit combines with section 36(b) to reward the plaintiffs who had the best alternatives to paying high fees. The question we would ask section 36(b) plaintiffs is: "If the fees in your fund were so unreasonable, why didn't you move to a new fund?" Ordinary company shareholders would have a good answer to this question: when something unexpected and negative happens in an ordinary company, the price of the shares drops immediately, making selling unappealing. Mutual fund investors have no such excuse.

The only way in which a plaintiff can explain the decision not to move to a new mutual fund is to argue that other funds' fees were too high as well. But the *Gartenberg/Jones* standard includes as one of its factors an assessment of fee levels prevailing among similar funds. The lower the fees charged by other

funds, the more likely a plaintiff is to prevail. In other words, *Gartenberg* and *Jones* give the greatest rewards to the plaintiffs whose answers to our question – why didn't you move to another fund? – are the least compelling.

The reason for this strange result, of course, is that *Gartenberg* and *Jones* wanted to protect the investors who did not initiate litigation and who did not understand that better options were available. Investors in the funds that charge fees at greatest divergence from competitive market levels are the investors most in need of protection. But because the plaintiffs who actually bring these suits have to prove the existence of better funds, these plaintiffs demonstrate implicitly an awareness of those better funds. Nevertheless these plaintiffs must remain invested in the high-fee fund in order to retain standing to press the suit. The *Gartenberg/Jones* standard thus puts the plaintiffs who actually bring these suits in the absurd position of arguing that they should be rewarded for choosing to pay high fees *precisely because they could freely choose to pay lower fees*.

Exit also makes fraud-on-the-market theories of loss causation inapplicable to mutual funds because it ties mutual fund share prices to NAVs.¹⁴² This is irrelevant to excessive fee cases, but it makes establishing damages in fraud cases very difficult.

There is one other quirk of mutual fund litigation that is also worth noting (even though it is not a direct product of exit): ordinary securities class action litigation often has been criticized on the ground that recoveries simply shift assets around among diversified investors and that the actual perpetrators of wrongdoing are unaffected.¹⁴³ Litigation between managers and shareholders of mutual funds typically has no such problem because managers are legally distinct from their funds and recoveries are often sought (and in section 36(b) suits *must* be sought) from managers, rather than from funds.

IV. EXIT'S AMBIGUOUS CONSEQUENCES

Commentary on mutual funds generally treats exit as purely a good thing. There is debate about the *extent* of the good that exit does (many commentators believe that its beneficial effects are limited), but exit is rarely thought to have any negative consequences. Because of the way in which exit undermines voice and liability, however, its net effect on some investors is

142. David M. Geffen, *A Shaky Future for Securities Act Claims Against Mutual Funds*, 37 SEC. REG. L.J. 20, 24-25 (2009).

143. See, e.g., John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1556-58 (2006).

actually ambiguous. Exit solves some problems and aggravates others. We take no position regarding whether exit is ultimately helpful or harmful to shareholders *on balance*. But we nevertheless wish to stress that assessing exit's net effect involves a balance of both good and bad elements.

For investors who use exit effectively, it is helpful because it eliminates the unpleasant choice between living with the consequences of bad management and spending the great resources required to act collectively through voice and liability to reform management. Investors who are unhappy with management can make an individual and unilateral decision to leave.

For the unsophisticated investors who lack the financial understanding or other resources necessary to exit effectively, however, exit is a mixed blessing. The chief downside of exit for investors who do not use it effectively is that it prevents these investors from free-riding on activism by large and sophisticated investors. In an ordinary company, large shareholders displeased with management may agitate for change that benefits all of the company's shareholders, including the small and unsophisticated ones. Unsophisticated investors in poorly performing mutual funds cannot expect such a rescue.

Of course, exit benefits even unsophisticated investors who do not use it by fostering product-market style competition. In order to attract sophisticated investors who are sensitive to fees and returns, many funds may offer competitive fees and returns to *all* investors, even those who are not sensitive to fees and returns.

The value of this competition may be limited, however, by some funds' ability to discriminate between sophisticated and unsophisticated investors. Managers may do this, for example, by creating separate funds or share classes with very high initial investment requirements that appeal primarily to institutional investors and by offering large clients separately managed accounts not subject to the ICA. The fact that these institutional funds always charge lower fees than retail funds does not necessarily indicate that retail investors are being overcharged,¹⁴⁴ but the existence of these institutional funds does indicate the possibility that competition for sophisticated investors may not benefit unsophisticated investors.¹⁴⁵

144. Institutional funds may charge lower fees because they are cheaper to manage. See Coates & Hubbard, *supra* note 61, at 184-87. Additionally, institutional funds charge less than retail funds almost by definition. Since institutional investors can choose between retail and institutional funds, an institutional fund charging more than a retail fund has no reason to exist.

145. See Birdthistle, *supra* note 50, at 75. The segmentation of the market is probably not complete, because institutional investors may invest in retail funds.

Another potential source of price discrimination may come from mutual fund investors' well-documented tendency to neglect their investments after they have initially made them. Managers of funds that have built up large investor bases over time might find it more profitable to charge their existing investors high fees (since a large segment of these investors is unlikely to leave in response to the fees) than to maintain low fees to compete for new and sophisticated investors.¹⁴⁶

Regression evidence by Khorana and Servaes¹⁴⁷ and by Coates and Hubbard¹⁴⁸ suggesting that market share is negatively related to fees over time is not necessarily inconsistent with the existence of price discrimination. This regression evidence indicates only that some (perhaps even most) funds compete on price, but not that all funds do. Indeed, even Coates and Hubbard would likely acknowledge that at least some segment of the mutual fund market is not competitive.

V. POLICY PROPOSALS

A. *A Shift in Regulatory Style*

To the extent that regulation is necessary, it should apply automatically without shareholder action or should encourage investors to exit more efficiently. In other words, mutual funds call for the same regulatory approach that applies to consumer products. Even if voting, boards, and fee liability might be said to achieve some benefit, those same benefits can be achieved more effectively and at lower cost by product-style regulation that does not rely on shareholder action. Our claim, in short, is that “[a]nything you can do, I can do better.”¹⁴⁹

If, for example, it was believed that the price of certain auto tires was too high or the quality was too low, the sensible solution would not be to allow tire consumers to sue for excessive prices or to empower them to set prices and quality by vote. Rather, the solution would be to regulate quality directly and

146. For empirical evidence and a theoretical model of mutual fund fee competition to support this intuition, see Christoffersen & Musto, *supra* note 96, and Gil-Bazo & Ruiz-Verdú, *supra* note 96. This intuition is also consistent with models developed to explain multiple equilibria in product markets with heterogeneous consumers. See Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387 (1983).

147. Khorana & Servaes, *supra* note 68.

148. Coates & Hubbard, *supra* note 61, at 221-22 tbl.A4.

149. IRVING BERLIN ET AL., *ANNIE GET YOUR GUN* 174 (1967).

to encourage price competition. We propose something similar for mutual funds. The analogy gains further traction from the fact that mutual fund regulation and consumer product regulation are motivated by similar concerns (such as safety, fraud, limits in buyer sophistication, concentrations of market power, and high search costs), while corporate governance regulation is motivated largely by a concern that is irrelevant in mutual funds (the high cost of collective action).

We wish to stress that in advocating a shift from corporate governance-style regulation to product-style regulation, we are not taking a position on the *degree* or *amount* of regulation that is appropriate for mutual funds. Rather, our claim is about the *form* that regulation should take when it is thought to be appropriate. In other words, we generally express no opinion about whether regulation is necessary and say simply that whenever regulation is necessary, it should be implemented in the manner that we propose.¹⁵⁰ This pose of neutrality is not a dodge; it is part of our contribution. It allows us to say that voting, boards, and fee liability are a bad idea *regardless of whether the mutual fund market is competitive and regardless of whether extensive regulation is necessary.*

B. Voting

Of the three categories of shareholder rights we have treated here—voting, boards, and fee liability—the case for eliminating voting is clearly the strongest. Without investor participation, voting cannot achieve its central purpose: to aggregate investors' preferences. Whatever other benefits voting may be said to achieve are therefore ancillary and are not unique to voting. They could be achieved more precisely by mechanisms that apply without shareholder action.

For example, voting is said to be useful because it forces funds to convey information through the mailing of proxy statements.¹⁵¹ But the cap-and-waiver system produced by voting actually prevents investors from receiving notice of changes in fees.¹⁵² And if conveying information is the goal, then regulation should just require funds to convey information. Funds could simply send informational documents without all of the voting-related paraphernalia. Purely informational documents would incur some, but not all

150. Of course, we do have opinions about whether and to what extent regulation is actually necessary, and these opinions are informed by our foregoing insight about how exit's net effect on investors is ambiguous. But we save for future research the task of commenting on the optimal extent of product-style regulation in mutual funds.

151. SEC HALF CENTURY REPORT, *supra* note 14, at 273.

152. See *supra* notes 129–131 and accompanying text.

of the costs that proxies now generate. Purely informational documents would not incur any of the costs associated with the actual vote collection process, which are unusually large in mutual funds because of the difficulty of getting the participation necessary for minimum quorums.¹⁵³

Voting is also said to be useful because it prevents funds from changing policies that can only be changed by shareholder vote. But preventing change is very different from sorting the changes that investors favor from the changes that they do not favor. It also is doubtful whether preventing change is always good. And even if preventing change is a good goal, voting is a bad way to achieve it. Voting is expensive and permits and prohibits changes thoughtlessly and haphazardly. If prohibiting change is the goal, then regulation should just prohibit change or should impose automatic conditions to screen desirable changes from undesirable ones.

C. Boards

The case for eliminating boards' role in setting fees and strategy (as distinct from their role in monitoring compliance) is also clear. Boards are not shareholder representatives and they lack the ability, motivation, and economic mandate to become involved in highly market-sensitive matters. Independence alone is not a qualification for setting fees and strategy. Auditors are more independent than boards are. And yet no one would suggest having auditors set fees and strategy. So why should boards do it? The answer cannot be that boards are elected, because they are not elected in any meaningful sense.

We concede that things are less clear with respect to boards' role in monitoring compliance.¹⁵⁴ Boards are capable of functioning autonomously without shareholder participation, and it is plausible to think that boards might monitor compliance for the same reasons that it is plausible to think that auditors might monitor compliance. We therefore concede that one could reasonably believe that boards provide some benefits through their compliance-monitoring function.

We nevertheless propose to eliminate boards entirely because we believe that even if boards generate some benefits by monitoring compliance, there are better and more direct ways of achieving those same benefits.

153. See *supra* notes 109-110 and accompanying text.

154. For a summary of the technical and compliance matters for which boards are now responsible, see the background portion on boards in Subsection I.A.2. In short, boards review a wide range of matters that involve conflicts of interest, highly technical compliance issues, or both. These include, for example, purchases of securities from affiliates of managers and the setting of policies for valuing illiquid portfolio securities.

One possible alternative to board review is simply to rely on new or existing forms of direct regulation. For the most part, board review is already merely an adjunct to direct regulation.¹⁵⁵ Boards are required, for example, to review a fund's purchase of newly issued securities if an affiliate of the fund's adviser is a member of the syndicate underwriting the securities.¹⁵⁶ But the rule governing these transactions also requires the securities to be purchased from a member of the syndicate who is not an affiliate of the adviser and imposes conditions on the price paid and quantity purchased. It is doubtful whether board review does anything that these pricing and purchase conditions do not do on their own. Indeed, the pricing and purchase conditions reflect a tacit acknowledgement by the SEC that board review is inadequate. Where necessary, the SEC could increase direct regulation and enforcement to compensate for boards' absence.

If direct regulation is thought to be inadequate on its own and independent review by some party other than the SEC is thought to be necessary, then boards should be replaced with professional compliance monitors. We noted above that the reason that it is plausible to think of unelected boards monitoring compliance is that it is plausible to think of unelected auditors or similar unelected professionals monitoring compliance. Why, then, should we not just have auditors or similar professionals monitor compliance? There is no need to use boards to approximate the operation of professional monitors when professional monitors are better suited to the task.

Professional compliance monitors already play an important role in mutual funds. The SEC recently began requiring both funds and advisers to employ Chief Compliance Officers (CCO).¹⁵⁷ These are full-time professionals whose job is to review and test compliance procedures. Additionally, boards already partly professionalize their compliance review functions by hiring consultants, such as Lipper, Morningstar, and Strategic Insight, to advise them on compliance issues.

There is nothing boards can do that CCOs could not do better. CCOs have more time and greater professional expertise. CCOs are at least as independent as boards are. It is true that CCOs are effectively employees of advisers, but so

155. This type of regulation is common as a result of the fact that the ICA prohibits outright many practices that have subsequently been permitted by rule and are now commonplace in the mutual fund industry. See generally Tamar Frankel, *The Scope and Jurisprudence of the Investment Management Regulation*, 83 WASH. U. L.Q. 939 (2005) (describing investment company regulation's tendency toward absolute statutory prohibitions tempered by administrative exemptions).

156. 17 C.F.R. § 270.10f-3 (2009).

157. 17 C.F.R. § 270.38a-1.

are board members since they are not elected by shareholders. Of course, firing a board member is hard, but firing a CCO is also hard and it could be made even harder. Board members also do not have any unique liability that CCOs could not have. Most mutual funds are organized as statutory business trusts, not as corporations, and the extent of fiduciary liability for directors in these organizations is unclear.¹⁵⁸

If one really believes that CCOs are insufficiently independent or that they need some independent body to which they can report, then perhaps the solution is to require funds to hire truly independent and professionally certified compliance monitors employed by outside organizations that specialize in compliance monitoring. We have in mind something similar to auditors. The independent consulting companies such as Lipper, Morningstar, and Strategic Insight that already consult on compliance issues could perform this role, as could debt-rating organizations, or the kinds of professionals who now provide fairness opinions to public company boards. Peter Wallison and Robert Litan have similarly suggested in a recent book that the trustees of a mutual fund could perform this monitoring role.¹⁵⁹ We agree with the spirit of Wallison and Litan's proposal, although we think their understanding of mutual fund governance is seriously flawed.¹⁶⁰

Critics will say that if advisers make hiring decisions about outside professional compliance review organizations and CCOs, those organizations

158. See Sitkoff, *supra* note 45.

159. WALLISON & LITAN, *supra* note 95.

160. Wallison and Litan believe that directors are *too powerful*, and that they keep fees *artificially high*. Boards are allegedly engaged in a "cost-plus"-style rate-setting process, which they use to force advisers to charge higher fees than the advisers would otherwise charge. *Id.* at 89. This argument makes little sense, because (a) directors are in fact powerless since they are unelected and incapable of firing advisers, and (b) advisers are free to charge fees below those set by their boards. In fact, under the cap-and-waiver system described above, most advisers actually do charge fees lower than the fees their boards have approved. See *supra* note 129 and accompanying text. The only evidence that Wallison and Litan offer in support of their unusual view of directors' influence is the divergence in fees among seemingly similar funds. Many coherent explanations have been offered for this phenomenon from many sides of the debate about market competition. See *supra* note 96 and accompanying text. But Wallison and Litan do not engage these more coherent explanations and do not articulate why boards' alleged role in forcing managers to charge high fees is the real cause of this phenomenon. A softer version of Wallison and Litan's argument might say that boards' involvement in the fee-setting process helps to insulate managers from *Jones*-style liability under section 36(b) and therefore leads indirectly to higher fees. But this cannot be the cause of the mutual fund market's alleged problems. Every other product we can think of is even more insulated from *Jones*-style liability than mutual funds are, since no other product market is even subject to such liability. And in any event, the fees that boards set bear little relationship to the fees that advisers actually charge.

and CCOs will be vulnerable to advisers' influence. But this same criticism applies with even greater force to independent board members.

Professional compliance monitors offer many advantages over independent directors. The most important are their specialized expertise, independence, and greater motivation to develop and protect their reputations. The direct costs of professional compliance reviewers might also be comparable to the direct costs of elected boards, since conscientious boards already hire professional compliance consultants. Outside professional compliance reviewers could also use economies of scale to manage the costs of reviewing technical matters.

D. Fee Liability

We begin with a simple proposal for reforming all mutual fund litigation and then turn to proposals specific to fee litigation under section 36(b). Our proposal for all mutual fund litigation is that, as a general rule, recovery in lawsuits alleging some harm to a mutual fund or its shareholders, including section 36(b) suits, should go first to the individual shareholders who brought the suit or to the class of investors who held shares in a fund at the time when the fund experienced the loss at issue. Then, if these investors fail to claim their portion of the recovery, the recovery should go to the fund itself. Recoveries are already commonly paid this way in cases involving fraud or misconduct under headings other than section 36(b).¹⁶¹ The reason for reforming recoveries in this way appears above: giving recovery to a fund rewards only investors who hold shares at the time the recovery is received, regardless of whether they held shares in the fund at the time the loss at issue occurred.

Now we turn to section 36(b). We concede that *Jones*-style liability is capable of functioning autonomously without shareholder participation. Moreover, one could accept our argument about shareholders' unwillingness to participate in *Jones*-style claims and still reasonably believe that plaintiffs'

161. The Wells Fargo family of funds, for example, recently settled litigation over an alleged brokerage kickback scheme. The plaintiffs alleged violation of both ICA section 36(b) and various general anti-fraud laws, including Exchange Act Rule 10b-5. The settlement included both a payment to the affected funds in consideration of the section 36(b) claims and a payment directly to a class of investors who bought shares during a specified period of time in consideration of the general anti-fraud claims. Stipulation of Settlement at 10-12, *Siemers v. Wells Fargo & Co.*, No. 05-04518 (N.D. Cal. July 5, 2007); Consolidated Amended Class Action Complaint for Violation of the Federal Securities Laws and for Violation of the Investment Company Act, *Siemers v. Wells Fargo & Co.*, No. 05-04518 (N.D. Cal. Apr. 11, 2006).

lawyers generate some benefit for investors by bringing these lawsuits without investors' participation.

We nevertheless propose limiting liability under section 36(b) to cases involving fraud or some other kind of clear misconduct or misleading disclosure. We argue, in short, that even if *Jones*-style liability generates some value without shareholder participation, this value is too limited to justify the costs of this kind of litigation. Moreover, there are better and more direct ways of achieving the same goals as *Jones*-style liability.

We propose retaining section 36(b) as a source of liability for fraud, misconduct, or inadequate disclosure (but not for fees that are simply alleged to be excessive), because by definition fraud is something that investors do not know about, and investors cannot use exit to respond to information that they do not know about. Investors therefore might actually use section 36(b) in cases involving fraud or inadequate disclosure. Indeed, one of the many unintended consequences of *Gartenberg*'s and *Jones*'s unhealthy obsession with fee levels is that some courts have actually dismissed arguably legitimate fraud claims under section 36(b) on the ground that section 36(b) is only about the simple excessiveness of fees and offers no remedy for fraud or misconduct.¹⁶² This is troublesome because section 36(b) may be the only private right of action in the ICA,¹⁶³ and it offers important procedural advantages relative to other sources of fraud liability outside of the ICA.

Fraud-based liability is consistent with our consumer product analogy. Product liability focuses not on price (as in the *Jones* and *Gartenberg* standards), but on negligence, fraud, and misrepresentations. Note also that this is essentially the standard proposed by Judge Easterbrook in his Seventh Circuit opinion in *Jones*.¹⁶⁴

We would eliminate *Jones*' more extensive version of section 36(b) liability both for conventional reasons and for reasons driven uniquely by our insights about exit rights. The conventional reasons rest on a straightforward comparison of the costs and benefits of this kind of liability.¹⁶⁵ The costs are substantial. Even though victories at trial are unlikely, settlements have occurred in cases litigated under the *Gartenberg* standard simply because the

162. See, e.g., *In re Oppenheimer Funds Fees Litig.*, 419 F. Supp. 2d 593 (S.D.N.Y.), *reconsidered*, 426 F. Supp. 2d 157 (S.D.N.Y. 2006).

163. *Olmsted v. Pruco Life Ins. Co.*, 283 F.3d 429 (2d Cir. 2002).

164. *Jones v. Harris Assocs. L.P. (Jones I)*, 527 F.3d 627, 632 (7th Cir. 2008). Easterbrook suggested that extremely high fees may trigger liability but only because they are *evidence* of misconduct in the setting of fees. *Id.*

165. For a good exploration of many of these costs and benefits, see Henderson, *supra* note 61.

accompanying costs of litigation and discovery are very high and are borne disproportionately by defendants. The *Gartenberg/Jones* standard is unclear and complicated and it requires the analysis of a great deal of sensitive evidence, almost all of it in the hands of defendants. Plaintiffs therefore bear far fewer costs than defendants and can credibly threaten to push litigation forward even with very little chance of prevailing at trial.

Additionally, the benefits of *Jones*-style liability are limited. It is a poor “deterrence” against high fees. Damages include only disgorgement of the excessive portion of fees. An adviser can therefore be no worse off as a result of having tried to charge excessive fees than it would have been if it had charged only reasonable fees. Furthermore, only fees going back one year prior to the commencement of a suit are recoverable. And there has never been a verdict for a plaintiff in a pure section 36(b) case.¹⁶⁶

Our insights about exit rights further strengthen this conventional case against *Jones*-style liability in a number of ways. Most important, our insights about exit and about mutual funds’ similarity to products give us the perspective to see just how extraordinary *Jones*-style liability is. Imperfections are common in products markets, as is regulation to correct them. Yet we cannot think of a similar form of liability in any other product market. Private litigation over price levels in product markets is generally reserved only for monopoly and unconscionability, neither of which is required by the *Jones* standard. Where price competition is thought to be inadequate in product markets, regulation almost always acts directly, through means such as antitrust regulations and direct price caps, rather than through vague standards of consumer price liability.¹⁶⁷

Since the overwhelming weight of experience in the regulation of product markets disfavors *Jones*-style liability, the burden of proof ought to be on the proponents of this liability to demonstrate some set of benefits that it can achieve for mutual funds but not also for cars, cosmetics, computers, insurance, and other complicated consumer products. The markets for all of these products are surely imperfect for many of the same reasons that the mutual fund market is allegedly imperfect. But no one seems to be suggesting a vague standard of consumer price liability for these other product markets. Why, then, should we have such liability for mutual funds?

166. COX ET AL., *supra* note 90, at 1211.

167. *Gartenberg*-style liability also appears extraordinary if we compare mutual funds to ordinary companies because litigation over executive compensation in ordinary companies generally must allege fraud or misconduct in the setting of compensation—not merely that compensation is outside of the range of what is reasonable.

Additionally, our insight about exit suggests that investors' total lack of incentive to join fee lawsuits causes fee lawsuits to be even more completely driven by plaintiffs' lawyers than conventional class actions are. We can therefore say that agency conflicts between lawyers and their clients even more seriously diminish the value of *Jones*-style liability than has been previously supposed. The most important consequence of these conflicts is that plaintiffs' lawyers have very little reason to target the smallest funds and families, which are the most likely to charge egregiously excessive fees.

Our insight about exit also allows us to envision more effective approaches by seeking analogies in the regulation of other products. If price regulation is truly necessary, then the most straightforward solution would simply be an honest-to-goodness price cap enforceable by the government. Such a cap would have to be clearer than the *Jones* standard or else the government would probably not enforce it, but there may be a variety of ways to set such a standard.¹⁶⁸ Perhaps it could be a function of the fees charged by comparable funds. For example, S&P 500 index funds could be prohibited from charging more than some fixed multiple of the median fee charged by other S&P 500 index funds or the minimum fee charged by an S&P 500 index fund of roughly comparable size. Setting a fee cap as a function of the fees charged by other funds would prevent the fee cap from becoming a rallying point and would ensure that it always bears some reasonable relationship to prevailing market rates.

A clear price cap enforceable by the government would be much more effective than *Jones*-style liability. It would generate less meritless litigation than *Jones*-style liability, would be more likely to target small funds and families that have high fees, and would have a strong deterrent effect against funds that crossed the threshold. Indeed, Congress probably adopted section 36(b) rather than a real price cap precisely because it knew that a real price cap would have been more effective than section 36(b).

We wish to make it clear that for the purposes of this paper *we reserve judgment about whether such a price cap is actually necessary*. We mention it simply to show that whatever benefits fee liability may be said to achieve, product-style regulation can achieve more effectively.

We can also imagine less intrusive alternatives than fee liability and price caps for addressing investors' lack of sophistication. For example, regulation could attempt to improve investors' understanding. The SEC and the

¹⁶⁸. Note that the SEC already has authority to bring suits under section 36(b). To our knowledge, the SEC has never brought such a suit, probably because the *Gartenberg* standard and the SEC's mandate for enforcement are unclear.

Investment Company Institute already post basic explanations of the fundamentals of mutual fund investing on their web sites.¹⁶⁹ Perhaps investors could be required to scroll through one of these explanations and check a box at the end before they are allowed to invest in funds with fees more than a certain number of standard deviations above the mean for funds with similar investing styles.

We could also imagine more “Nudge”-style regulation of disclosures to prompt better decisionmaking by investors.¹⁷⁰ Evidence on the SEC’s recent simplified prospectus effort is not encouraging, unfortunately.¹⁷¹ But perhaps more imaginative measures are necessary. Funds could be required to disclose the average fees charged by the ten funds in other complexes with portfolios most similar to the fund in question.¹⁷² Or funds could be required to put notices or some other demarcation in prospectuses next to fees that are more than a certain distance from the mean fees charged by funds with similar investing styles or portfolios. Other reforms of the way in which fees are disclosed could easily be imagined.¹⁷³

VI. THE PERSISTENCE OF VOTING, BOARDS, AND FEE LIABILITY

If voting, boards, and fee liability are so inappropriate in mutual funds, why do they exist? The answer, unfortunately, is that they exist precisely because they fail. Their failure benefits various constituencies who have the power to thwart reform.

Voting and boards first came into existence through a combination of historical accident and astute political maneuvering by the SEC. Closed-end funds comprised a much larger segment of the industry’s total assets in 1940

169. INV. CO. INST., A GUIDE TO UNDERSTANDING MUTUAL FUNDS, http://www.ici.org/pdf/bro_understanding_mfs_p.pdf; SEC, INVEST WISELY: AN INTRODUCTION TO MUTUAL FUNDS, <http://www.sec.gov/investor/pubs/inwsmf.htm> (last visited Sept. 8, 2010).

170. RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS (2d ed. 2009). Sunstein and Thaler’s suggestions regarding the presentation of utility bills might be particularly useful. *Id.* at 259.

171. John Beshears et al., *How Does Simplified Disclosure Affect Individuals’ Mutual Fund Choices?* 3 (Nat’l Bureau of Econ. Research, Working Paper No. 14,859, 2009), available at <http://www.nber.org/papers/w14859.pdf>.

172. Since funds must publicly disclose their portfolios and these disclosures are already compiled into databases maintained by Thomson West and the Center for Research in Securities Prices, discerning portfolio similarity would not be hard. For one possible model of portfolio similarity, see Wahal & Wang, *supra* note 68.

173. See, e.g., Cox & Payne, *supra* note 90.

than they do now. Just as we would predict, few open-end funds in 1940 allowed voting, although many closed-end funds did.¹⁷⁴ Similarly, as we would predict, closed-end funds made no objection to the SEC's proposal to require funds to have elected boards, but open-end funds lobbied hard against it.¹⁷⁵ Ultimately, open-end funds gave up their opposition to voting requirements only because the SEC agreed to a grandfather exemption for funds then in existence that did not have shareholder voting.¹⁷⁶

Voting, boards, and fee liability continue to exist because their failure benefits various constituencies. Voting benefits managers by producing the cap-and-waiver system, which obscures fees and eliminates the obligation to disclose changes in fees. Boards benefit managers by dismissing meritorious derivative litigation over fraud and other matters. Additionally, managers know very well that boards' effectiveness is limited, so they may cultivate regulators' faith in boards as a way of convincing them that more invasive (and more effective) regulation is unnecessary.

Boards benefit the SEC by allowing it to shift enforcement costs to the industry. The SEC treats enforcement by boards as a kind of substitute for SEC enforcement. Additionally, boards' failures have a directly self-reinforcing quality at the SEC; each time boards have failed to protect the industry from scandal, the SEC has tried to bring boards to life by injecting them with additional responsibilities and independence requirements.

Voting and boards also have friends among board members, lawyers, and proxy solicitors for reasons that have to do with voting and boards' failures. Mutual fund board membership is a great job precisely because there are no shareholder activists or elections to worry about and because management makes all of the important strategic decisions. Voting is highly profitable for proxy solicitors and lawyers because shareholders' unwillingness to vote

174. In 1940, the open-end fund industry was dominated by three large Boston-based funds: Massachusetts Investors Trust, Incorporated Investors, and State Street Investment Corporation. See John D. Morley, *The Origins of Investment Management Regulation 1936-1942*, at 17-18 (Mar. 11, 2010) (unpublished working paper, on file with authors). Prior to the late 1930s none of these funds allowed shareholder voting. Natalie R. Grow, *The "Boston-Type Open-End Fund" – Development of a National Financial Institution: 1924-1940*, at 76-77, 171, 536 (Apr. 30, 1977) (unpublished Ph.D. dissertation, Harvard University).

175. *Investment Trusts and Investment Companies: Hearing Before the Subcomm. on Securities and Exchange of the S. Comm. on Banking and Currency*, 76th Cong. 488, 502, 1055 (1940) (statements of Merrill Griswold, Chairman of Massachusetts Investors Trust, and Arthur H. Bunker, Executive Vice President of Lehman Corporation).

176. Investment Company Act of 1940 § 16(c), 15 U.S.C. § 80a-16(c) (2006).

necessitates extensive proxy solicitation to meet minimum quorum requirements.

Fee liability also owes its existence to its own failures and the failures of voting and boards. Fee liability was added to the ICA in 1970. Congress probably adopted it instead of a direct price cap because a cap would have done too much to disrupt the status quo and limit fees. The strangely vague “fiduciary duty” language of section 36(b) and the section’s elaborate disguise as a form of shareholder litigation reflect an attempt by Congress to punt the issue to the courts and to create the illusion of action while essentially maintaining the status quo. Additionally, the drive for price regulation in 1970 had its roots at least partly in reports by the SEC and the Wharton School alleging that boards failed to get actively involved in setting fees (a failure that in our view was inevitable).¹⁷⁷

CONCLUSION

The reforms that we suggest would modernize and streamline mutual fund regulation, making it less expensive for sophisticated investors and more effective for unsophisticated investors by acknowledging that no investors ever participate in governance or fee litigation. Funds should be regulated in the same manner as products. Rules should apply directly, without investors’ participation, or should encourage investors to exit effectively.

The failure of voting, boards, and fee liability has created a cloud of scandal around the mutual fund industry that refuses to go away. The scandal arises from the sense that advisers are somehow responsible for this failure. In our opinion, however, the real scandal is not that voting, boards, and fee liability have failed. It is that so many people have perpetuated for so long the illusion that they might someday succeed.

177. See *supra* note 135 and accompanying text.