Federal Misgovernance of Mutual Funds

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Introduction

As Congress enacts another round of financial regulation in response to the most recent financial crisis, it is worth evaluating where we have been. An appropriate occasion for this evaluation is the Supreme Court's recent decision in *Jones v. Harris Associates*,[1] where the Court had to contend with the structure of the Investment Company Act—crafted in 1940 and revised in 1970 to deal with the financial circumstances of the 1920s and 1960s, respectively—in light of the vastly different financial marketplace of 2010. *Jones* should serve as a warning against the dangers of federal regulation of firms' structure and governance.

Jones interpreted section 36(b) of the Investment Company Act of 1940, which provides that ''the 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'' from the investment company or its investors.[2] The section also authorizes an action by the Securities and Exchange Commission or an investor in the fund against the investment adviser, among others, for breach of fiduciary duty as to this compensation.[3]

Since 1982, most federal courts applying section 36(b) have purported to apply the standard set forth in *Gartenberg v. Merrill Lynch Asset Management, Inc.*:

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[1] 559 U.S. ___, 130 S. Ct. 1418 (2010).

[2] 15 U.S.C. § 80a-35(b) (2006).

[3] *Id.*

> To be guilty of a violation of § 36(b). . . the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining.[4]

When *Jones* reached the U.S. Court of Appeals for the Seventh Circuit, Judge Frank Easterbrook's panel opinion affirmed summary judgment for the defendant investment adviser.[5] Noting that ''judicial price-setting does not accompany fiduciary duties'' and the existence of vigorous competition among mutual funds, the court disapproved *Gartenberg* and articulated a new test:

> A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation. The trustees (and in the end investors, who vote with their feet and dollars), rather than a judge or jury, determine how much advisory services are worth.[6]

The Seventh Circuit's denial of rehearing *en banc* prompted a sharp dissent from Judge Richard Posner, writing for four colleagues:

> The panel bases its rejection of *Gartenberg* mainly on an economic analysis that is ripe for reexamination on the basis of growing indications that executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation. . . . Competition in product and capital markets can't be counted on to solve the problem because the same structure of incentives operates on all large corporations and similar entities, including mutual funds.[7]

The Supreme Court, faced with a circuit split and two prominent market-oriented jurists' disagreement about the nature of the mutual fund market, took the bait and granted certiorari. The unanimous opinion by Justice Samuel Alito endorsed *Gartenberg* and vacated

[4] 694 F.2d 923, 928 (2d Cir. 1982). For citations and analysis of decisions applying *Gartenberg* see Lyman Johnson, A Fresh Look at Director ''Independence'': Mutual Fund Fee Litigation and *Gartenberg* at Twenty-Five, 61 Vand. L. Rev. 497, 538-42 (2008).

[5] Jones v. Harris Assocs., 527 F.3d 627, 635 (7th Cir. 2008).

[6] *Id.* at 632–33.

[7] Jones v. Harris Assocs., 537 F.3d 728, 730 (7th Cir. 2008).

and remanded the Seventh Circuit decision, concluding that the Easterbrook-Posner debate ''regarding today's mutual fund market is a matter for Congress, not the courts.''[8]

Justice Alito was correct that the issue in *Jones* is properly for Congress to decide. However, the issue reaches beyond the viability of the market for mutual funds to the federal role in regulating the structure of business. The problems highlighted in section 36(b) litigation do not stem from inadequate enforcement of investment advisers' fiduciary duty in setting fees, but rather from the very existence of this duty and the corporate structure from which it springs. Moreover, the perpetuation of this dysfunctional structure points to its even more basic problem of being embedded in a federal law that lacks state corporate law's safety valve of interstate competition and experimentation.

Part I of this article discusses the background of *Jones v. Harris Associates*, placing the case in the context of the statutory scheme and the pre-*Jones* litigation. This part shows that the section 36(b) fiduciary duty has served the interests of investment advisers and trial lawyers more than those of investors.

Part II links the problems with the fiduciary duty applied in *Jones* to mutual funds' corporate structure established in the original ICA. This structure conflicts with investors' right to cash out of open-end mutual funds at will. The redemption right renders the whole panoply of corporate shareholder-protection devices, particularly fiduciary duties, not only unnecessary but even counterproductive. Mutual fund investors buy a product rather than investing in a firm, and the law should treat investors accordingly.

Part III asks where to go from here, and takes a deeper look at the problems that led to *Jones.* The ICA's dysfunctional mutual fund governance regime could have been sustained only by a federal law, which lacks the competitive discipline that applies to state regulation of firms' internal governance. Federal regulation of financial markets should stick to the model established in the early 1930s for the original federal securities laws in which states establish governance structures and federal law requires firms to disclose these structures and other facts to investors. Whether or not disclosure is adequate to support a fully efficient market for mutual funds, the history of

[8] Jones, 130 S. Ct. at 1431.

mutual fund regulation shows that federal constraints on firms' governance are no solution.

I. The ''Fiduciary Duty'' Problem in Mutual Funds

The basic problems involved in *Jones* begin with the section 36(b) ''fiduciary duty'' the case was applying. Unlike traditional fiduciary duties, which have evolved through centuries of case law to meet firms' needs, section 36(b) used fiduciary duties as a makeshift political compromise. This part begins by placing fiduciary duties in a theoretical perspective. It then discusses the legislative history of the section 36(b) fiduciary duty and the duty's evolution through *Gartenberg* and *Jones.*

A. The Theory of Fiduciary Duties

Courts have interpreted the term ''fiduciary duty'' in many different professions (from doctors to corporate directors) to refer to a broad constellation of duties, including loyalty, care, the amorphous category of ''good faith,'' and maintaining confidences. One leading commentator despaired of ''confusion and uncertainty in applying the fiduciary principle to disparate fact situations.''[9]

Perhaps the most famous judicial expression of fiduciary duties is by Justice Benjamin Cardozo in *Meinhard v. Salmon*:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the ''disintegrating erosion'' of particular exceptions [citation omitted]. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.[10]

[9] J.C. Shepherd, The Law of Fiduciaries 7 (1981).

[10] 164 N.E. 545, 546 (N.Y. 1928).

Justice Cardozo accurately describes the fiduciary duty as one of unselfishness. This insight helps define the situations in which the duty should rise. Given the extraordinary nature of a fiduciary duty in a commercial economy that generally assumes self-seeking behavior, we would expect this duty to arise only in extraordinary circumstances—specifically, where the beneficiary delegates to the fiduciary broad power that is not amenable to alternative disciplinary mechanisms.[11] The duty is not justified simply because one party to a transaction relies on another's expertise as long as the empowered party is subject to enough constraints that an intense duty of unselfishness is unnecessary. For example, fiduciary duties usually are unnecessary in general partnerships—the form of business involved in *Meinhard*—unless, as in that case, one partner functions as the manager.

Strong policy concerns justify excluding from the fiduciary category many situations where duties might seem necessary to protect a vulnerable party. Fiduciary duties are best seen as only one of several devices intended to control ''agency costs''—that is, the costs of an owner's delegating discretion to manage her property. These duties may be costly because judges are poor business managers and judicial scrutiny can interfere with other aspects of parties' contracts. The parties need not incur these costs where market and reputational constraints and other governance devices are effective to constrain cheating. Fiduciary duties entail judicial intervention only as a last resort, and only to the limited extent of keeping the fiduciary from extracting selfish gain from the beneficiary.

The publicly held corporation illustrates when fiduciary duties are justified. Here, dispersed and rationally apathetic investors lack practicable ways to fully control managerial conduct. Although investors can sell their shares, the sale price reflects any mismanagement. Shareholders can vote, but small holders cannot easily coordinate and lack incentives to become well-informed. Accordingly, directors of publicly held firms are accountable for unauthorized self-interested transactions. Managers' disinterested conduct is left to discipline by capital markets, shareholder voting, and board supervision.

[11] See Larry E. Ribstein, Are Partners Fiduciaries?, 2005 U. Ill. L. Rev. 209.

Bringing the discussion closer to the issue in *Jones,* managerial compensation, including investment adviser fees, generally is not governed by the *default* fiduciary duties discussed above because fiduciaries commonly opt out of default duties and bargain over compensation. Corporate-type firms bargain through a board of directors or other managers who are subject to fiduciary rules requiring disinterested conduct. (Part II considers whether these constraints are appropriate for mutual funds.)

Finally, it is worth emphasizing that fiduciary duties traditionally emerge from state common law. Accordingly, fiduciary duties arising in federal statutes like section 36(b) raise special problems of meshing state fiduciary law with the specific aims of the federal statute.

B. Mutual Fund Governance under the Investment Company Act

The ''fiduciary duty'' in section 36(b) results from the corporate structure of mutual funds Congress imposed in the ICA, which in turn borrowed heavily from the industry as it existed in 1940. Analysis of the duty therefore must begin with the history of the mutual fund industry.

The investment companies formed in the 1920s were mostly ''closed-end'' funds, meaning their size and shares were fixed at birth. Investors could exit such funds only by finding somebody to buy their shares. Few pre-1940 mutual funds were ''open-end'' like the one in *Jones,* which continually sold new shares and let investors cash out by redeeming their shares from the fund.[12]

The most important feature of the mutual funds of the 1920s and early 1930s for present purposes is the typical, though not universal, corporate structure of the closed-end funds that dominated the early mutual fund industry. Because promoters established these funds mainly to earn fees from selling securities, they were unconcerned with devising the most efficient structure for managing money.[13] Mutual funds' corporate structure was never inevitable. Investment companies established in the United Kingdom since the 1800s have

[12] For a discussion of the pre-1930 mutual fund industry outlining the nature and roles of closed- and open-end funds, see Peter J. Wallison & Robert E. Litan, Competitive Equity: A Better Way to Organize Mutual Funds, 24–27 (2007).

[13] See *id.* at 25.

not used a corporate form,[14] and some U.S. funds as of the time of the ICA were organized as common-law trusts. When it came time to establish a regulatory structure for the investment company industry, Congress might have followed the disclosure approach that it had used in the Securities Act of 1933 and the Securities Exchange Act of 1934 and left firms' structure for the market to decide. Instead, Congress imposed the corporate-type structure that many funds used at the time.

There was little basis in 1940 for believing that the corporate structure was appropriate for mutual funds given the industry's limited history from the end of the 1920s stock market boom. In particular, Congress had had little opportunity to analyze the corporation's suitability for open-end funds which were only a small part of the industry in 1940. As we will see, the ICA's mandatory corporate structure was particularly inappropriate for open-end funds because of investors' power to cash out at will. The 1940 Act exempted the trusts that existed as of 1940,[15] and prevented further structural development of the industry thereafter.[16]

C. The Section 36(b) Fiduciary Duty

Since the ICA initially lacked an express fiduciary remedy, investors sued fund directors in state court. The courts applied a ''waste'' standard that made it virtually impossible for plaintiffs to win a challenge.[17] Opposition to the ICA regulatory structure began developing in the early 1960s. A report by the Wharton School in 1962 suggested that investment advisers were pocketing the fruits of increasing scale economies, abetted by inadequate competition among investment advisers.[18] There ensued eight years of legislative

[14] *Id.* at 24. This difference between the United States and the United Kingdom partly reflects the generally different roles played by the corporate form in the two countries. Larry E. Ribstein, The Rise of the Uncorporation 65–94 (2010).

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

[16] See Wallison & Litan, *supra* note 12, at 24–25.

[17] See, e.g., Saxe v. Brady, 184 A.2d 602 (Del. Ch. 1962).

[18] Wharton Sch. of Fin. & Commerce, A Study of Mutual Funds, H.R. Rep. No. 87-2274, at 1 (1962).

proposals and bargaining between the SEC and the Investment Company Institute, the industry group that represented, and still represents, a vast majority of the industry.[19]

The Wharton report initially recommended subjecting fees to judicial review for reasonableness. The ICI opposed such rate regulation. A 1967 Wharton conference produced the compromise of imposing a fiduciary obligation on the adviser.[20] A 1968 Senate bill added a rebuttable presumption of reasonableness of fee agreements approved by shareholder and independent director vote.[21] The following year the ICI and the SEC agreed to key elements of the final version of section 36(b)—a fiduciary duty, with the burden on the plaintiff to prove a breach.[22]

Several elements of the final version of section 36(b) suggest that the so-called fiduciary duty, on which Congress placed so much weight, was not really a fiduciary duty at all in the sense discussed in Part I.A. First, the subsection imposes the duty not on the fund's board, which technically exercised the control that is fundamental to fiduciary duties, but rather on the adviser with whom the board is contracting.[23] The subsection states that ''the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services,''[24] and ''no damages or other relief shall be granted against any person other than the recipient of such compensation or payments.''[25] Second, the section avoids imputing misconduct to the investment adviser for receiving excessive fees by providing that no judicial finding of a breach of fiduciary duty under the subsection is a basis for violation of or remedies under other specified sections of the

[19] For general reviews of the legislative history summarized below, see William P. Rogers & James N. Benedict, Market Fund Management Fees: How Much Is Too Much?, 57 N.Y.U. L. Rev. 1059 (1982); Amy Yeung & Kristen J. Freeman, *Gartenberg*, *Jones*, and the Meaning of Fiduciary: A Legislative Investigation of Section 36(b), 35 Del. J. Corp. L. (forthcoming 2010), available at http://ssrn.com/abstract=1557349.

[20] See The Mutual Fund Management Fee, 115 U. Pa. L. Rev. 726 (1967) (conference transcript).

[21] S. 3724, 90th Cong. § 8(d) (1968).

[22] See Yeung & Freeman, *supra* note 19, at 26-27. 23 15 U.S.C. § 80a-35(b) (2006).

[23] 15 U.S.C. § 80a-25(b) (2006).

[24] *Id.*

[25] *Id.* § 35(b)(3).

securities laws.[26] Third, section 36(b) provides that ''the plaintiff shall have the burden of proving a breach of fiduciary duty'' although the strict prohibition against self-dealing and the presumed information asymmetry between the fiduciary and the beneficiary support imposing the burden of proof on the fiduciary.[27]

Section 36(b) was born to fail. Given fund directors' practical difficulty of firing the investment adviser that established the fund, as well as the close relationship between advisers and boards,[28] a court cannot realistically assume that the fee was negotiated by a fully disinterested board.[29] Yet the fiduciary duty added in 1970 was too weak to provide the discipline such boards needed. This set the stage for the 40 years of litigation to follow.

D. Post-36(b) Litigation and the Gartenberg *Standard*

The previous section shows that section 36(b)'s fiduciary duty was conceived as a political compromise, in contrast to the carefully constrained functional role of fiduciary duties that developed under the common law. Congress did not fully consider how much judicial supervision was justified given the overall structure of mutual funds, or even what the structure of mutual funds should be. Moreover, it is unlikely that Congress or anyone else had a clear idea of what the fiduciary duty might entail. The courts were left to work out the details.

The Second Circuit's articulation of the *Gartenberg* standard established an equilibrium that survived for 30 years until Judge Easterbrook provoked a reevaluation.[30] The equilibrium was tenuous because the standard was never clear. The rule seems to stress the size of the fee—that is, whether it is disproportionate to the services rendered. This is at odds with section 36(b)'s legislative history discussed above, which shows that Congress adopted the fiduciary duty approach as a way to avoid rate regulation. The *Gartenberg* test arguably can be squared with this history by interpreting the

[26] *Id.* § 35(b)(6).

[27] *Id.* § 35(b)(1).

[28] See Camelia M. Kuhnen, Business Networks, Corporate Governance, and Contracting in the Mutual Fund Industry, 64 J. Fin. 2185 (2009) (finding connections between fund directors and advisers that cause them to hire one another).

[29] See Johnson, *supra* note 4.

[30] Jones v. Harris Assocs., 527 F.3d 627 (7th Cir. 2008).

standard as using the size of the fee only as circumstantial evidence of the board's independence and the existence of ''arm's-length bargaining.''[31] However, the court's use of ''and'' separates the ''disproportionate'' and ''arm's-length bargaining'' aspects of the test.[32] Moreover, *Gartenberg* admits consideration of other factors, including the amount and role of funds' competition for investors and the process of approving the fees.[33] Courts accordingly have significant leeway under *Gartenberg* as to what factors to emphasize.[34]

Gartenberg's ''so disproportionately large'' standard coupled with its placement of the burden of proof on the plaintiff has proved an insuperable hurdle for plaintiffs. Not one has won at trial in hundreds of post-*Gartenberg* cases.[35] Nevertheless, the cases are still costly. Todd Henderson's study of 36(b) litigation estimates that cases applying the *Gartenberg* standard ''likely involved over 1600 lawyers filing nearly 1000 motions and about 1500 legal briefs, and generating over 1400 judicial orders,'' that defendants' total costs in cases tried post-*Gartenberg* are about $1.3 billion, and that cases filed and settled before a written judicial opinion cost defendants an additional $21.6 billion for a total post-*Gartenberg* cost of $23 billion.[36] Despite these costs, section 36(b) litigation probably has little effect on investment adviser behavior. The amounts work out to a litigation ''tax'' of about $125,000 per year for each of 8,000 mutual funds, which may not be a large enough portion of the investment advisers' revenue to motivate them to significantly change their practices.[37]

[31] Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928 (2d Cir. 1982).

[32] *Id.;* See Yeung & Freeman, *supra* note 19, at 34 n.203.

[33] 694 F.2d 923, 929–30. See John C. Coates IV & R. Glenn Hubbard, Competition in the Mutual Fund Industry: Evidence and Implications for Policy, 33 J. Corp. L. 151, 209-10 (2007). However, courts have given evidence of the extent of market competition little or no weight. *Id.* at 209 n.207.

[34] For a critical analysis of *Gartenberg* and its flawed economic understanding, see Br. for Cato Institute as Amicus Curiae Supporting Resp't 27-31, Jones v. Harris Assocs., 559 U.S. ____, 130 S. Ct. 1418 (2010) (No. 08-586), available at http://www.cato.org/pub display.php?pub id=10508.

[35] Johnson, *supra* note 4, at 500, 519; James D. Cox & John W. Payne, Mutual Fund Expense Disclosures; A Behavior Perspective, 83 Wash. U. L. Q. 907, 923 (2005).

[36] M. Todd Henderson, Justifying Jones, U. Chi. L. Rev. (forthcoming) (Univ. of Chi. Law Sch. John M. Olin L. & Econ., Working Paper No. 491 at 12, 2009), available at http://ssrn.com/abstract=1499410.

[37] *Id.* at 13 & n.42.

Moreover, Henderson reports conversations with fund board members indicating that they ignore litigation risk in management decisions because they view the incidence and cost of litigation as unrelated to the merits of individual cases.[38]

This system's biggest beneficiaries are plaintiffs' lawyers, who collect from settlements even without any wins at trial. Indeed, then-leading plaintiffs' lawyer Abe Pomerantz had a seat at the table when section 36(b) was being drafted.[39] Plaintiffs' lawyers can extract at least some of defendants' avoided discovery costs in settlement, particularly if the case survives a motion to dismiss or summary judgment.

Investment advisers might seem to have a significant incentive to fight this ''tax'' by banding together to fight the suits, thereby raising plaintiffs' costs. They can easily coordinate over litigation or a political fix because almost all of them are members of the ICI. Why do they not press for more judicial supervision of settlements, or for a statutory amendment that eliminates or sharply restricts litigation? One potential reason is that mutual fund advisers might rather pay a litigation tax and agree to ''prophylactic'' settlements prescribing breakpoints in fees than risk the rate regulation the fiduciary duty was intended to avoid.[40]

Other interest groups also have reason to support, or at least not oppose, the current regulatory structure and the fiduciary litigation that flows from it. The SEC gets to use fund boards to maintain at least the appearance of regulation, without actually having to devote more of its limited budget to actively policing fees at thousands of mutual funds.[41] Lawyers and others get to serve on these boards,

[38] *Id.* at 13-14.

[39] Yeung & Freeman, *supra* note 19, at 19 n.100.

[40] See Henderson, supra note 36, at 20-21 (noting that mutual funds would prefer a small litigation tax to focusing political attention on the problem of adviser pay); John Morley & Quinn Curtis, Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds, Yale L.J. (forthcoming) (Yale L. & Econ. Res. Paper No. 403 at 66, 2010), available at http://ssrn.com/abstract=1547162 (noting that investment companies might prefer to ''cultivate regulators' faith in boards as a way of convincing them that more invasive regulation is unnecessary'').

[41] See John C. Coates IV, Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis, 1 J. Legal Analysis 591, 629 (2009) (noting that the SEC would rather spend its limited budget on enforcement of existing law than on reform).

legal academics get to work as litigation experts and consultants, and Congress avoids revisiting a regulatory tangle on which it spent eight years in the 1960s. Sophisticated investors have little reason to protest because they can easily choose and exit funds, including hedge funds and other vehicles. The only relevant group that does not seem to be accounted for in this regulatory process is the unsophisticated investors for whose benefit the ICA supposedly was enacted.

E. Jones v. Harris Associates: *Seventh Circuit*

It was left to Judge Easterbrook and his Seventh Circuit panel to cast doubt on the *Gartenberg* equilibrium. *Jones* involved fees paid by Oakmark Fund to its adviser, Harris Associates. Plaintiff investors argued for rejection of *Gartenberg* because this test would wrongly emphasize the fees paid by similar funds (a test Harris probably would pass) over one that compared Oakmark's fees with those Harris charged its unaffiliated institutional clients (which Harris might flunk).[42]

Faced squarely with the issue of *Gartenberg*'s validity, Judge Easterbrook threw out the test and replaced it with one that was even less friendly to plaintiffs. Easterbrook reasoned that ''just as plaintiffs are skeptical of *Gartenberg* because it relies too heavily on markets, we are skeptical about *Gartenberg* because it relies too little on markets.''[43] Rather than worrying about the fund board's control over the adviser's fees or the difference between fund and institutional fees, Easterbrook emphasized the apparently vigorous competition among fund companies for investors.[44] Since returns depend on fees, he said, ''mutual funds have a powerful reason to keep [fees] low unless higher fees are associated with higher return on investment.''[45] Firms must cater at least to ''sophisticated investors who . . . create a competitive pressure that protects the rest.''[46]

Consistent with his emphasis on markets, Judge Easterbrook rejected the idea that section 36(b)'s fiduciary duty required fees to

[42] Jones, 527 F.3d at 631.

[43] *Id.* at 632.

[44] *Id.* at 633.

[45] *Id.* at 632.

[46] *Id.* at 634 (citing Alan Schwartz & Louis Wilde, Imperfect Information in Markets for Contract Terms, 69 Va. L. Rev. 1387 (1983)).

''be 'reasonable' in relation to a judicially created standard.''[47] Rather, he said:

> A fiduciary duty differs from rate regulation. A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation. The trustees (and in the end investors, who vote with their feet and dollars), rather than a judge or jury, determine how much advisory services are worth.[48]

The federal securities laws help ensure full disclosure, and no one complained about disclosure. Judge Easterbrook also found support in the rules for corporations and attorneys' fees, where there is also no reasonableness review because markets constrain executive and attorney compensation just as they do the compensation of fund advisers.[49]

Although Judge Easterbrook emphasized competition in the market for mutual funds, there is reason to believe that he was actually more concerned with the problem of excessive litigation under *Gartenberg* discussed above.[50] Easterbrook noted that ''regulating advisory fees through litigation is unlikely to do more good than harm,''[51] and that even imperfect markets ''remain superior to a 'just price' system administered by the judiciary. However weak competition may be at weeding out errors, the judicial process is worse—for judges can't be turned out of office or have their salaries cut if they display poor business judgment.''[52]

Todd Henderson explains *Jones* primarily in light of this concern with the judicial process.[53] Skepticism with judicial review could explain why Easterbrook swept away the *Gartenberg* multi-factor standard, rather than merely tinkering with it.

Judge Easterbrook's description of mutual fund markets may be more a response to plaintiffs' emphasis on Congress's supposed

[47] Jones, 527 F.3d at 632.

[48] *Id.*

[49] *Id.* at 633.

[50] See Henderson, *supra* note 36, at 6.

[51] 527 F.3d at 634 (citing Coates & Hubbard, *supra* note 33).

[52] *Id.* at 633.

[53] Henderson, *supra* note 36.

concern with the market of the late 1960s than positive support for a limited fiduciary duty. Easterbrook noted plaintiffs' position

> that because many members of Congress deemed competition inadequate (and regulation essential) in 1970, we must act as if competition remains weak today. Why? Congress did not enact its members' *beliefs;* it enacted a text. A text authorizing the SEC or the judiciary to set rates would be binding no matter how market conditions change. Section 36(b) does not create a rate-regulation mechanism, and plaintiffs' proposal to create such a mechanism in 2008 cannot be justified by suppositions about the market conditions of 1970.[54]

Easterbrook thus stressed that Congress did not, in fact, enact rate regulation—whatever market conditions may have been in 1970. He only secondarily observed that, even if those conditions might once have informed congressional intent, they have changed.

While Judge Easterbrook had ample justification for rejecting *Gartenberg,* problems with his analysis undermined his ability to establish a post-*Gartenberg* equilibrium. First, limiting the rule to disclosure essentially assumes that the fund or its investors are directly negotiating the fee in their own interests. Corporate law requires approval by disinterested directors. This leaves an opening for critics to argue that a stricter rule is necessary for mutual funds given the effective lack of arm's length bargaining between funds and advisers.[55]

Second, Easterbrook's tight constraint on liability has a loophole:

> 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—for example, if a university's board of trustees decides to pay the president $50 million a year, when no other president of a comparable institution receives more than $2 million—but no court would inquire whether a salary normal among similar institutions is excessive.''[56]

[54] 527 F.3d at 633 (emphasis in original).

[55] See Johnson, *supra* note 4.

[56] 527 F.3d at 632.

Thus, in *Jones* as in *Gartenberg,* the amount of the fee can circumstantially indicate breach of the board's duty. The difference between the cases lies mainly in Easterbrook's emphasis on evidence of clear wrongdoing and his willingness to accept a ''salary normal among similar institutions'' to show the absence of wrongdoing. Because charging a ''normal'' fee helps insulate the adviser from liability, this test facilitates a kind of rate regulation by the industry. Although this addresses Easterbrook's concern with excessive litigation by enabling the development of a clear and predictable rule, it hamstrings free-wheeling competition by advisers. Indeed, we will see below that this problem inheres in having boards set fees subject to judicial review.

Third, Judge Easterbrook's discussion of the market for mutual funds created an unfortunate sideshow to his argument based on legislative intent. The market was a hard sell in 2009 given the financial crisis and mounting skepticism concerning executive compensation. This enabled critics of the market for mutual funds to turn the sideshow into the main event.

Judge Posner, dissenting from the court's denial of rehearing en banc, argued that ''[t]he panel bases its rejection of *Gartenberg* mainly on an economic analysis that is ripe for reexamination on the basis of growing indications that executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation.''[57] Posner then cites a host of articles critical of corporate executive compensation by everybody from Lucian Bebchuk to Ben Stein,[58] concluding that ''[c]ompetition in product and capital markets can't be counted on to solve the problem because the same structure of incentives operates on all large corporations and similar entities, including mutual funds.''[59]

Posner also emphasized the deficiencies in mutual funds' hiring of advisers, citing evidence of favoritism and networks and the absence of arm's-length bargaining.[60] Because advisers face a real market for pension funds and other institutional clients, Posner suggested that this market provides a better standard than the suspect

[57] Jones, 537 F.3d at 730.

[58] *Id.*

[59] *Id.*

[60] *Id.* at 730-31.

market for mutual fund fees.[61] Posner concluded that ''the one-sided character of the panel's analysis,'' together with the issue's importance and the circuit split, warranted hearing the case *en banc*.[62]

The circuit split resulting from Judge Easterbrook's rejection of *Gartenberg*, plus the sharp disagreement between two leading market-oriented jurists, made it almost inevitable that the Supreme Court would take the case. If Easterbrook hoped this would lead to the adoption of a less litigation-friendly standard, he was disappointed.

F. Jones v. Harris Associates: *Supreme Court*

The Court's unanimous opinion authored by Justice Alito rejected the Easterbrook rule and accepted *Gartenberg*'s ''basic formulation of what 36(b) requires.''[63] This is not surprising given the fact that both parties and virtually all of the amici rejected Easterbrook's approach and endorsed *Gartenberg*. The Court's opinion found support in a famous Supreme Court corporate case involving the fiduciary duties of controlling shareholders, which looked for the ''earmarks of an arm's-length bargain,'' holding that ''this formulation expresses the meaning of the phrase 'fiduciary duty' in §36(b).''[64]

Although the Supreme Court seems to adopt the *Gartenberg* rule and reject the Easterbrook test, it actually endorses a new rule that, like Easterbrook's rule, reflects concern with the open-ended way the courts had applied *Gartenberg* and the litigation costs resulting from that approach. The Court warns that the *Gartenberg* standard ''does not call for judicial second-guessing of informed board decisions,'' at least in the sense of ''precise calculation of fees representative of arm's-length bargaining.''[65] Justice Clarence Thomas's concurring opinion reinforces this point, calling attention to the above language and the Court's emphasis on the ''degree of deference that is due a board's decision to approve an adviser's fees.''[66] Thus,

[61] *Id.* at 731-32.

[62] *Id.* at 732-33.

[63] Jones v. Harris Assocs., 130 S. Ct. 1418, 1426 (2010).

[64] *Id.* at 1427 (citing Pepper v. Litton, 308 U.S. 295, 306-07 (1939)).

[65] *Id.* at 1430. This is consistent with Alito's concern with litigation costs as a federal appeals judge. See Larry E. Ribstein, Justice Alito on Business, Forbes.com, Jan. 13, 2006, http://www.forbes.com/2006/01/13/alito-ribstein-comentary-cx_lr_0116alito.html.

[66] Jones, 130 S. Ct. at 1431 (Thomas, J., concurring).

according to Justice Thomas, the Court did *not* ''endorse the '*Gartenberg* standard''' and ''does not countenance the free-ranging judicial 'fairness' review of fees that *Gartenberg* could be read to authorize.''[67]

Despite the Court's recognition of the need for deference to board decisions, the continued existence of an open-ended, multi-factor standard left lower courts with significant freedom to question those decisions, thereby generating litigation, settlements, and attorneys' fee awards. While plaintiffs probably still cannot win at trial, which should please investment advisers, they can at least still sue and thereby purchase a lottery ticket that can get them a share of defendants' discovery costs. Faced with a motion to dismiss or for summary judgment, a judge can employ either the board-discretion-burden-on-plaintiff approach and grant the motion or the possibly-disproportionate-non-arm's-length approach and deny it. The Supreme Court's rejection of the Easterbrook rule, if not its reasoning, could make courts reluctant to accept compliance with industry standards as a safe harbor. *Jones*'s only effect may be to reduce defendants' chances of actually losing at trial compared with prior law, and thereby increase their freedom to charge what the market will bear subject to section 36(b)'s litigation tax.

Although the Supreme Court's resolution in *Jones* is not ideal, the Court cannot do much more. The basic problem with section 36(b) is the corporate governance structure Congress has imposed on open-end mutual funds. Given the corporate framework's unsuitability in this context, it should not be surprising that the courts have not been able to turn the statute into something that works in the real world.

II. The Mismatch of Corporate Governance and Investor Exit

A basic problem with regulation of mutual funds under the Investment Company Act is Congress's assumption that mutual funds should be governed like corporations. This assumption is faulty because mutual funds lack the critical corporate feature of ''capital lock-in,'' or rules that protect managers' control of the cash from investors' reach.[68] The corporate structure was designed to deal with

[67] *Id.* at 1431 (majority opinion).

[68] See Margaret M. Blair, Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century, 51 UCLA L. Rev. 387 (2003).

the far-flung business enterprises created during the Industrial Revolution to coordinate the production and sale of products.[69] This task required giving control of the firm's resources and investors' money to the firm's managers. Unlike typical partnership-based firms, corporate shareholders could not unilaterally dissolve the firm or otherwise take their money out.[70] Managers' power over corporate resources necessitates mechanisms ensuring the managers' accountability to investors in exercising this power, including investors' power to vote, sell their shares, and sue for breach of fiduciary duty.

Given corporations' importance to industrial development, it may be easy to forget that the corporate form is not the only feasible structure for organizing even large-scale businesses. What I have called ''uncorporate'' business forms—including general or limited partnership and limited liability companies—provide for a lower level of ''capital lock-in'' by promising to repurchase investors' shares, dissolve under certain circumstances or at a particular time, or regularly distribute cash to investors.[71] These devices apply the discipline of the capital markets by effectively forcing managers to induce current owners to keep their cash in the firm, or to continually raise cash from outside investors. Unlike corporate shareholders, who are generally limited to selling their shares for a value that reflects the buyer's continued exposure to the firm's current management, uncorporate owners have some ability to free their cash from managers' control. A corporate shareholder, by contrast, can accomplish this only by taking control of the company in which he owns shares and replacing its managers. The choice between corporate and uncorporate forms involves an overall meshing of provisions. It may make little sense for a firm to both forgo the benefits of corporate-type capital lock-in by adopting the uncorporate form and incurring the costs of corporate-type accountability, particularly including voting and fiduciary duties.

This background enables a full appreciation of the difference between a mutual fund and a corporation. An open-end mutual

[69] See generally Alfred D. Chandler Jr., The Visible Hand: The Managerial Revolution in American Business (1977).

[70] For an analysis of this corporate feature and comparison with partnerships, see Ribstein, *supra* note 14, at 65–94.

[71] See *id.* at 15-38.

fund is the extreme form of an uncorporation, or what might be called an un-uncorporation. Unlike partners or limited liability company (LLC) members, who can sell only at particular times or on certain conditions, mutual fund investors' redemption rights usually are subject to few restrictions.[72] Thus, while some uncorporations, such as hedge funds organized as limited partnerships, need some corporate-type protections, mutual fund investors do not because they have the ultimate power to discipline managers by simply removing capital from managers they do not like whenever they want. Accordingly, it has been said that, ''[f]rom an economic perspective, the protection of redeemable shares is arguably more important in supporting competition than any other aspect of the current legal framework.''[73] The protection provided by the right of exit accordingly eliminates the need not only for fiduciary duties but also for the board itself.[74] The price investors pay for this accountability is managers' inability to engage in long-term enterprise building because the firm's cash can fly away at any minute. But this is a small price in an open-end mutual fund whose main objective is achieving portfolio diversification rather than long-term asset management.

A possible response to the argument that mutual funds can dispense with corporate accountability mechanisms is that this may leave unsophisticated mutual fund investors who do not take advantage of their exit right even worse off than unsophisticated corporate shareholders. Unlike in corporations, sophisticated mutual fund investors have little interest in changing the management of their mutual funds on behalf of all the investors because the sophisticates

[72] This observation is subject to potential exit costs from taxes or back-end ''load'' fees. However, for many investors these costs are low or minimal. The contrast between open-end mutual funds and other unincorporated business entities suggests that the regulatory distinction between mutual funds and hedge funds is backwards. While mutual funds are subject to detailed requirements regarding the board of directors, see 15 U.S.C. § 80a-10 (2006)), and shareholder voting, *id.* § 80a-13, there are no such requirements for domestic hedge funds. However, since hedge fund limited partners normally are subject to restrictions on withdrawal, they arguably should have more governance rights than mutual fund investors, rather than fewer.

[73] Coates & Hubbard, *supra* note 33, at 162 (noting that it is corporate-type capital lock-in that creates a need for a ''mediating hierarch'' who can watch out for locked-in investors).

[74] See Morley & Curtis, *supra* note 40.

can cash out whenever they want.[75] However, even if the ''left behind'' investors need some protection from high fees, fiduciary duties are not the answer. For the same reason that sophisticated investors have no incentive to help the unsophisticated investors by changing the fund's management, they have no incentive to use their fiduciary rights to fix the fund's fees.[76] Plaintiffs' lawyers step into the role of the unsophisticated shareholders' ''protectors'' in bringing derivative suits, but without the potential for discipline that large shareholders bring to corporate securities class actions.[77]

The problems with the mutual fund derivative suit under section 36(b) were analyzed in a Delaware state court action involving a hedge fund organized as a Delaware limited partnership that was not subject to section 36(b).[78] The partnership invested in publicly traded securities and revalued the limited partners' capital accounts daily. The limited partners sued the general partner for over-withdrawing its capital account. Although actions devaluing the partnership's assets normally would give rise to a derivative claim on behalf of the partnership, the court characterized the suit as a direct action on behalf of the individual partners. The court reasoned ''that the operation and function of the Fund as specified in the Agreement diverge so radically from the traditional corporate model that the claims made in the complaint must be brought as direct claims.''[79] Specifically, that because the partners redeem their shares rather than sell them, the court noted devaluation of partnership assets

[75] See 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, 1031 (2005).

[76] See Morley & Curtis, *supra* note 40. This is not necessarily to say that unsophisticated mutual fund investors are not injured or that they should not be able to sue for deception or outright theft. Rather, the point here is that fiduciary litigation is ineffective to deal with excessive fund fees, the specific problem addressed by section 36(b).

[77] Supervision of litigation by large shareholders has been regarded as a possible solution to the problem of improvident securities class actions. See Elliott Weiss & John S. Beckerman, Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions, 104 Yale L.J. 2053 (1995). This article spurred the ''lead plaintiff'' provision of the Private Securities Litigation Reform Act of 1995. See 15 U.S.C. § 78u- 4(a)(3) (2006).

[78] Anglo Am. Sec. Fund, L.P. v. S.R. Global Int'l Fund, L.P, 829 A.2d 143 (Del. Ch. 2003).

[79] *Id.* at 152.

affects only current partners and not later partners.[80] Moreover, later partners would get a windfall if the partnership were to recover damages after the partners' admission on account of a pre-admission injury. Therefore, said the court, ''[c]haracterizing the plaintiffs' claims as derivative would thus have the perverse effect of denying standing (and therefore recovery) to parties who were actually injured by the challenged transactions while granting ultimate recovery (and therefore a windfall) to parties who were not.''[81] In other words, because the limited partnership functioned like an open-end mutual fund, a remedy on behalf of the fund was inappropriate.

In short, given open-end funds' redemption right, Georgetown University law professor Donald Langevoort is correct in describing mutual funds as ''products—no different, really, from health care, insurance, bank deposits, residential real estate, and other important settings where consumers are often less than diligent.''[82] University of Pennsylvania law professor Jill Fisch also argues for the product analogy.[83] It arguably follows that consumers of mutual fund products no more need the protection of directors than do consumers of other products.

The mutual fund governance structure that the ICA imposes on mutual funds is not only the wrong way to protect mutual fund investors, but it levies an additional cost in deterring competition among investment advisers. The corporate governance model, including empowering the board to protect mutual fund investors, necessarily entails judicial supervision of directors via fiduciary duties. Since the adviser establishes and finances the fund, it is unrealistic to expect the adviser–fund director relationship to be purely arm's-length,[84] and therefore the fund board to be disinterested.[85] Accordingly, the board's existence necessarily creates a conflict, which in turn requires judicial oversight. However, courts,

[80] *Id.*

[81] *Id.* at 153.

[82] Langevoort, *supra* note 75, at 1037.

[83] Jill E. Fisch, Rethinking the Regulation of Securities Intermediaries, 158 U. Pa. L. Rev. (forthcoming 2010) (Univ. of Pa. Law Sch. Inst. for L. & Econ., Research Paper No. 10-04), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1573768##.

[84] See Wallison & Litan, *supra* note 12, at 14 (noting that the adviser expects control because it sets up the fund).

[85] See Johnson, *supra* note 4 (questioning the disinterest of independent fund directors who are considered ''independent'' under current law).

wary of their ability to second-guess board decisions, necessarily look for some benchmark to apply, such as the funds' costs,[86] or the industry norms. Fund managers then might rather hew to the benchmark than look for profits in new efficiencies that the courts might force them to disgorge.

Langevoort laments that mutual fund advisers and directors have adopted the ''ideology of consumer sovereignty'' and so feel less obligated to act as real fiduciaries.[87] He accordingly suggests making the duty more fiduciary-like, including by tightening the standards for dismissing derivative claims, thereby encouraging the development of more fiduciary-like norms of investment adviser and mutual fund director conduct. But, like it or not, mutual funds are fundamentally like products given investors' exit rights, as Langevoort himself recognizes.[88] Applying the fiduciary duty to what seem to be ordinary market transactions therefore might have little effect on behavior and might even weaken fiduciary norms by confusing them with consumer norms.[89]

The lesson of the above discussion is that the courts cannot fix the section 36(b) duty simply by changing the standard because the problems with the duty are inherent in Congress's misbegotten imposition of a corporate governance structure on open-end mutual funds. Congress added the fiduciary duty when it became obvious that directors and other corporate trappings could not adequately protect investors. Loosening the standard would ignore the conflict built into the board's role in mutual fund governance. Tightening the standard would impose still more costly judicial supervision and constraints on competition that are unnecessary in light of investors' ability to exit mutual funds. The only viable solution is to dismantle the corporate governance structure in the Investment Company Act.

III. The Deeper Problem with Federal Regulation of Mutual Funds

We have seen that the basic problem in *Jones* lies not with the courts' approach to applying section 36(b) but with the statute the

[86] See Wallison & Litan, *supra* note 12, at 76–80.

[87] Langevoort, *supra* note 75, at 1019.

[88] See *supra* text accompanying note 75.

[89] See generally Larry E. Ribstein, Law v. Trust, 81 B.U. L. Rev. 553 (2001) (analyzing the law's effect on social norms).

courts had to apply. The problem lies deeper than section 36(b)'s fiduciary duty, which itself responded to the Investment Company Act's dysfunctional corporate governance structure. This part suggests that the problem goes even deeper than the particular governance structure Congress imposed on mutual funds, encompassing the entire concept of federal regulation of mutual funds' internal governance. Congress should stick with what the federal government does best in financial regulation—giving investors the facts and letting them decide where to invest. Even if disclosure does not fully protect investors, the alternative of federally mandating governance structure is doomed to costly failure, as the sad history of *Jones* has shown.

A. State vs. Federal Regulation of Governance

Critics of captive boards and empty duties in mutual funds[90] should ask how such dysfunction could arise in what ''may be the most heavily regulated sector of the financial services industry.''[91] The federal government did not just happen to get mutual fund regulation wrong in 1940 and 1970, but it continues to err as long as it attempts to regulate the internal governance structure of mutual funds or, for that matter, any business associations.

The problem is not that Congress is particularly error-prone, but that it lacks the error-correction mechanism inherent in the state market for internal governance of firms. In the absence of federal regulation of governance structure, states could provide various structures from which investment companies could choose. States' ability to provide choice and experimentation derives from the ''internal affairs'' choice of law rule, which ensures that each firm's choice of state law is enforced wherever its place of business and investors are located.[92] This rule enables firms to choose the law that best fits their needs. States can develop a broad menu of firms that evolves over time to meet changing business needs. Investment funds can experiment with different structures that, for example, trade off investor exit rights with investor voice and fiduciary litigation, and provide for different types of compensation. States can

[90] See Wallison & Litan, *supra* note 12; Morley & Curtis, *supra* note 40.

[91] Coates & Hubbard, *supra* note 33, at 162.

[92] See generally, Larry E. Ribstein & Erin Ann O'Hara, Corporations and the Market for Law, 2008 U. Ill. L. Rev. 661.

compete regarding not only the substance of their laws but also their legal infrastructures of courts, legal rules, and lawyers. Moreover, investment companies themselves can experiment with variations within general state statutory frameworks.

The flexibility, variation, and experimentation facilitated by the state system are necessary for the efficient governance of firms. A business association statute entails choosing provisions from a broad range of potential alternatives and assembling them into a coherent whole.[93] We have seen that the basic problem with federally dictated mutual fund governance is that investor redemption rights do not mesh well with the corporate trappings of boards, voting, and fiduciary duties. Legislatures must also decide, among other things, which terms are default rules and which are mandatory, the choices they will offer investors, and which types of firms to design terms for. No single legislature has enough information to get this right even at the time the statute is passed. Also, legislation necessarily is produced by contending interest groups rather than by disinterested lawgivers determined to maximize social welfare. And even if a legislature did come up with the right law as of the time of enactment, the business world changes rapidly. Accordingly, it is critical for competing jurisdictions to be able to fix mistakes and adapt to changing times.

The federal system's dynamic quality has been particularly evident with respect to the evolution of business associations.[94] U.S. law initially offered firms the choice between the corporate form designed for large, often publicly traded firms, and the partnership form for small firms. Tax and other laws and the evolving nature of firms have complicated these choices. The states provided new organizational forms, and firms' choices changed over time. During the mid-20th century the dominant business form for smaller firms was the closely held corporation. The LLC rapidly emerged from obscurity over 20 years and by the 2000s began to replace the corporate form for closely held firms.

To be sure, there is no guarantee that optimal business forms and state laws ultimately will dominate under a state system. States might cater to fund sponsors by designing structures that attract

[93] See generally, Ribstein, *supra* note 14, at 15–38.

[94] See *id.* at 39–136 (tracing this evolution).

funds, fees, and business for local lawyers.[95] Also, investment advisers might favor structures such as corporate boards and fiduciary duties that provide the appearance but not, as we have seen, the reality of discipline. Unsophisticated mutual fund investors may pay little attention to organizational form or applicable law. Accordingly, a state system may end up as a ''race to the bottom,'' toward laxity rather than reasonable regulation.

However, before concluding from these undesirable possibilities that a mandatory federal regime is better than a state system, it is important to consider the former's defects. Imperfect competition may be better than no competition at all. The ICA locked mutual fund governance into the model that had developed in the nascent mutual fund industry during the 1920s despite numerous major changes in the investment industry since 1940, including the rise of open-end funds and significantly increased competition. Instead of 51 jurisdictions enacting new or revised laws from which investment companies could choose, the evolutionary process was left to a single modestly funded agency, the Securities and Exchange Commission, which has viewed its own power narrowly.[96] Although funds are technically formed under and governed by state law (mainly Delaware, Maryland, and Massachusetts),[97] the corporate structure built into the ICA constricts the range within which state laws can compete. Federal regulation is interpreted exclusively by federal courts throughout the country with only rare intervention by the Supreme Court. This system subjects mutual funds to different standards across the circuits, applied haphazardly based on where plaintiffs' lawyers choose to litigate. Changing financial regulation requires moving proposals through the cumbersome federal legislative process, and generally occurs in the panicked atmosphere of a financial bust.[98]

[95] See Langevoort, *supra* note 75, at 1036.

[96] Coates, *supra* note 40, at 627.

[97] For discussions of competing state structures for mutual funds, see John H. Langbein, The Secret Life of the Trust: The Trust as an Instrument of Commerce, 107 Yale L.J. 165, 187-88 (1997); Robert H. Sitkoff, Trust as ''Uncorporation'': A Research Agenda, 2005 U. Ill. L. Rev. 31. See also Wallace Wen Yeu Wang, Corporate versus Contractual Mutual Funds: An Evolution of Structure and Governance, 69 Wash. L. Rev. 927 (1994) (providing an international comparison between the U.S. ''corporate'' approach to mutual fund governance and the ''contractual'' approach in other countries).

[98] See Larry E. Ribstein, Bubble Laws, 40 Hous. L. Rev. 77 (2003).

Congress, the courts, and the SEC—no matter how wise, informed, and well meaning they are—cannot create a dynamic system comparable to the market for state law. Accordingly, efforts to fix federal law will inevitably fall short. For example, Peter Wallison and Robert Litan propose a new structure they call a ''managed investment trust,'' an actively managed version of the unit investment trusts that antedated the Investment Company Act.[99] This is a move in the right direction under this article's approach because it would eliminate the board, which is an unnecessary corporate trapping. However, the dysfunction in the existing mutual fund structures created by Congress would remain. Moreover, adding one more choice would not alone create a dynamic system that can keep any structure updated to current business developments.

B. The Appropriate Scope of Federal Regulation: Beyond Disclosure

Beyond regulation of the governance of investment companies such as mutual funds, there is still arguably a role for the federal regulation of disclosure. This is essentially the approach taken by the federal securities laws. As William O. Douglas, chair of the SEC before serving on the Supreme Court, said of the Securities Act of 1933: ''All the Act pretends to do is to require the 'truth about securities' at the time of issue, and to impose a penalty for failure to tell the truth. Once it is told, the matter is left to the investor.''[100]

The main argument against relying on disclosure for mutual funds is that it may not fix what some believe to be a fundamentally defective market for investment adviser fees.[101] To some extent, the problem is that many investors are inexperienced or unsophisticated and therefore are suckers for advertising or the manipulation of disclosures. There is evidence, for example, that high fees actually

[99] Wallison & Litan, *supra* note 12, at 99-120.

[100] William O. Douglas & George E. Bates, The Federal Securities Act of 1933, 43 Yale L.J. 171, 171 (1933).

[101] For arguments critical of the market for investment adviser fees, see William A. Birdthistle, Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence, 2010 U. Ill. L. Rev. 61; Alan R. Palmiter & Ahmed E. Taha, Mutual Fund Investors: Divergent Profiles, 2008 Colum. Bus. L. Rev. 934; Br. of Robert Litan, Joseph Mason & Ian Ayers as Amici Curiae Supporting Pet'rs, Jones v. Harris Assocs., 559 U.S. ___, 130 S. Ct. 1418 (2010) (No. 08-586), 2009 WL 1759017.

correlate with bad performance,[102] and that investors with below-average financial literacy feel overwhelmed by the information required to choose funds and are attracted to high-cost advertised and broker-sold funds.[103] One leading study shows that investors avoid front-end load fees or commissions but are not less likely to buy funds with higher expenses and are actually *more* likely to buy funds with higher marketing expenses, suggesting that they are sensitive to advertising and to more salient fees but are not otherwise very sophisticated about fees.[104] More experienced mutual fund investors are less likely to pay front-end loads than first-time buyers, but even these investors do not avoid high operating expenses. Mutual fund advisers apparently have figured all this out, since over the last 40 years operating expenses generally have increased while funds have tended to drop or lower front-end load fees.

Problems in the mutual fund market may not be limited to unsophisticated investors. Professors James Choi, David Laibson, and Brigitte Madrian conducted an experiment of mutual fund purchases by Harvard staff members, Wharton MBA students, and college students recruited on the Harvard campus.[105] The staff members were overwhelmingly college educated, and 60 percent also had graduate school education. The MBA and undergraduate subjects reported average SAT scores in the 98th and 99th percentiles, respectively, and all three groups had above-average financial literacy. The subjects were told to invest in S&P 500 Index funds; were given the funds' prospectuses, which disclosed fees; and were rewarded for maximizing the returns on their portfolios, which meant reducing expenses since the returns were based on the same index. The subjects generally failed to minimize fees.[106] Only the MBAs thought

[102] See Mark M. Carhart, On the Persistence in Mutual Fund Performance, 52 J. Fin. 57 (1997); Javier Gil-Bazo & Pablo Ruiz-Verdú, The Relation between Price and Performance in the Mutual Fund Industry, 64 J. Fin. 2153 (2009) (modeling how this result can occur even with competition).

[103] John A. Haslem, Why Does Mutual Fund Advertising Work? Some Complementary Evidence (July 1, 2009) (unpublished, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id = 1428620) (summarizing studies).

[104] Brad M. Barber, Terrance Odean & Lu Zheng, Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows, 78 J. Bus. 2095 (2005).

[105] 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).

[106] *Id.* at 1407.

fees mattered most to their decisions, and even they did not choose significantly lower-fee funds than the college students. The subjects emphasized annualized returns of the fund—although prospectus returns were not comparable across funds—and relying on returns caused subjects to pay higher expenses.

A different picture of mutual fund fees arguably emerges from examining the overall structure of competition in the mutual fund market. Professors John Coates and R. Glenn Hubbard note the vast increase in the size of the mutual fund industry since the 1960s and summarize evidence consistent with competition in the industry.[107] They explain contrary evidence by such factors as differences in investor search costs and changes in how funds are distributed, including through mutual fund supermarkets, which are more convenient but costly to maintain.[108]

Part of the difficulty of reconciling this evidence is trying to determine what mutual fund investors want. As Coates and Hubbard discuss, some funds cost more than others because investors value their services, such as one-stop-shopping and easy exchange. Also, even if higher costs do not buy better service, they may serve as a bond to protect investors.[109] This reasonably assumes that investors are looking mainly for safety and reasonable returns rather than the highest possible returns. Since investors cannot easily determine safety and the likelihood of mismanagement from publicly available information, they would want advisers to have a lot of profits to lose if they do cheat. The bonding theory complicates any determination of when fund fees are too high.

There is a further question of whether any problems with the mutual fund market are distinct from those affecting consumer markets generally. For example, Florencia Marotta-Wurgler examines the extent to which consumers read online software contracts.[110]

[107] Coates & Hubbard, *supra* note 33, at 173-84.

[108] *Id.* at 184-201.

[109] See Benjamin Klein & Keith B. Leffler, The Role of Market Forces in Assuring Contractual Performance, 89 J. Pol. Econ. 615 (1981); D. Bruce Johnsen, Myths about Mutual Fund Fees: Economic Insights on Jones v. Harris (George Mason Univ. L. & Econ. Research Paper Series No. 09–49, 2009), available at http://ssrn.com/abstract=1483862.

[110] Florencia Marotta-Wurgler, Does Disclosure Matter? (March 16, 2010) (working paper, on file with author).

Strikingly, consumers tend not to read these contracts even when the internet makes them readily available; they are no more likely to read more accessible contracts or ones with more one-sided terms. If mutual funds should be regulated despite thousands of competitors and very low industry concentration,[111] this implies a need to increase regulation of all consumer markets.

Even if there really is something wrong with the mutual fund industry, the problem may lie in the regulation of the industry rather than in the market. This has at least superficial plausibility given the already quite detailed regulation of mutual funds.[112] Thus, Wallison and Litan observe the ''paradox'' of dispersion in pricing in a seemingly competitive industry that should exhibit more convergence as consumers find the best values.[113] As discussed above, the culprit may be the benchmarking inherent in fiduciary litigation. This hypothesis is supported by the fact that fee dispersion shows up much more in the United States than in the United Kingdom, where the consumers are likely similar to those in the United States but the regulation does not require mutual funds to adopt a corporate structure.

Better-designed disclosure regulation conceivably could address at least some of the problems in the market for mutual funds. For example, Fisch recommends an approach in which funds must explain their departure from a federally prescribed menu.[114] Perhaps there is some justification for specific substantive regulations such as debt limits and redemption rules. However, federally prescribed regulation of the *governance* of mutual funds is likely to lead to even worse mistakes than consumers would make under a disclosure-only regime. Indeed, future-Justice Douglas made this point in his defense of the securities laws.[115] The costs of mandating a particular governance structure for mutual funds, and of specifically adjudicating a ''fiduciary duty'' within that structure, have been high. Even if Congress initially took the right approach, the market evolved

[111] See Wallison & Litan, *supra* note 12, at 48 (noting that while a concentrated industry has an Herfindahl-Hirschman Index of over 1000, the mutual fund industry's HHI is only 400).

[112] See *id.* at 75.

[113] *Id.* at 48.

[114] Fisch, *supra* note 83, at 105-117.

[115] Douglas & Bates, *supra* note 100, at 171-73.

enough over time to render that approach obsolete. Yet Congress lacks the will to deregulate financial structures, the SEC lacks the resources and power to make adequate modifications, and the courts can do no more than tinker around the margins. Moreover, it is important to keep in mind that Congress, the SEC, and the federal courts are subject to the same sorts of heuristic errors as investors.[116]

Conversely, even if the laboratory of state law is defective and subject to interest-group capture, it can hardly be much worse than what Congress has done with investment companies. At least there is always an opportunity for some state to create a structure that would better suit modern needs than that crafted in the 1930s and 1960s. A vibrant market populated by self-interested investors at least stands some chance of fixing errors, while Congress and federal agencies are not subject to the same corrective pressures.

Conclusion

The central problem in *Jones v. Harris Associates* is not the issue that confronted the Court—that is, whether to adopt the *Gartenberg* standard for applying the fiduciary duty in section 36(b)—but instead the whole regulatory structure that gave rise to this duty. Judge Easterbrook addressed the problem but could not fix it without actually rewriting the Act. The Supreme Court's decision, while recognizing the problem with litigation under existing regulation, basically leaves things just as they were before *Jones.* The only effective fix is for Congress to scrap the existing approach of imposing a corporate governance model on decidedly non corporate mutual funds. More generally, *Jones* should stand as a lesson of the dangers of federal regulation of the governance of firms. *Jones*'s most important words, therefore, may be Justice Alito's closing comment that the relevant debate ''is a matter for Congress, not the courts.''[117]

It might seem quixotic to advocate scaling back federal financial regulation given the recent expansionary trend. Indeed, as part of its massive financial reform law, Congress authorized the SEC to establish a new fiduciary duty for brokers and dealers in selling

[116] See Stephen J. Choi & A.C. Pritchard, Behavioral Economics and the SEC, 56 Stan. L. Rev. 1 (2003).

[117] Jones, 130 S. Ct. at 1431.

securities.[118] This new duty could generate at least as much uncertainty and litigation as the fiduciary duty at issue in *Jones v. Harris.*

However, in the long run Congress will have to confront the fact that U.S. financial regulation must compete with regulations around the world, such as those in Luxembourg, with respect to mutual funds.[119] Also, no regulator can hope to keep pace with the market's endless inventiveness. Numerous investment vehicles already compete with mutual funds, including common trusts, separately managed accounts, and exchange-traded funds.[120] Continuing with misguided legislation in an unresponsive system ultimately will drive investment dollars to these competitors. The result may be a flow of investments out of the United States or to investment forms that leave investors even worse off than they are in mutual funds.

The United States has an inherent advantage over other countries: a robust federal system that provides an internal laboratory for refining regulation. The most promising regulatory path for the United States is to build on that system rather than slowly dismantling it.

[118] See Dodd-Frank Wall Street Reform and Consumer Protection Act, (H.R. 4173) §913(g). See also, Statement of Larry E. Ribstein, United States Senate Committee on the Judiciary, Subcommittee on Crime and Drugs, Hearing on ''Wall Street and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations,'' May 4, 2010, http://judiciary.senate.gov/pdf/10-05-04RibsteinsTestimony.pdf (criticizing proposal to impose fiduciary duties on investment bankers with criminal sanctions for breach).

[119] See Coates, *supra* note 40, at 654-55.

[120] See Wallison & Litan, *supra* note 12, at 51-60.

United States Senate

Committee on the Judiciary

Subcommittee on Crime and Drugs

HEARING ON

"WALL STREET AND FIDUCIARY DUTIES: CAN JAIL TIME SERVE AS AN ADEQUATE DETERRENT FOR WILLFUL VIOLATIONS"

MAY 4, 2010

STATEMENT OF LARRY E. RIBSTEIN, MILDRED VAN VOORHIS JONES CHAIR, UNIVERSITY OF ILLINOIS COLLEGE OF LAW.

Chairman Specter, Ranking Member Graham, and distinguished members of the Committee:

Thank you for the invitation to testify today. My name is Larry E. Ribstein. I am Associate Dean for Research and Mildred Van Voorhis Jones Chair, University of Illinois College of Law. I have taught and written extensively in the areas of corporate and securities law for 35 years. Among my main current areas of research are the law and theory of fiduciary duties and corporate criminal liability. A more complete biography is appended to this testimony.

My testimony focuses on two issues raised by this hearing. First, to what extent should investment bankers have fiduciary duties to investors? Second, should there be criminal liability for willful breach of these duties?

To summarize my conclusions, these duties are the wrong tool for dealing with any problems that might exist in the investment banking industry. Based on my analysis and research concerning the nature and function of fiduciary duties,[1] fiduciary duties are an amorphous concept which courts and commentators have applied in many different forms to many different types of conduct. Applying these duties to investment bankers would cast a potentially wide net over not only bad conduct but also conduct that should be viewed as clearly legitimate. Moreover, even under a narrow view of these duties, they are inappropriate for most aspects of investment banking. These problems with fiduciary duties would be significantly exacerbated by imposing criminal liability for their breach.

I. THE AMORPHOUS NATURE OF FIDUCIARY DUTIES

"Fiduciary duty" is one of the most amorphous concepts in the law. The concept has been developed through centuries of case law. Part of the problem is that courts and commentators have used fiduciary language to describe duties in a bewildering variety of circumstances ranging from seemingly straightforward contractual relationships between franchisees and franchisors[2] to professional relationships of dependence such as between patients

[1] *See* Larry E. Ribstein, *Are Partners Fiduciaries?* 2005 U. ILL. L. REV. 209.

[2] Harold Brown, *Franchising: A Fiduciary Relationship*, 49 Tex. L. Rev. 650 (1971).

and doctors[3] and pharmacists and customers.[4] J.C. Shepherd, a leading commentator, despairs of "confusion and uncertainty in applying the fiduciary principle to disparate fact situations."[5] As discussed in the following sections, numerous questions arise concerning the definition of fiduciary duties.

A. DUTY OF CARE

A fiduciary duty may or may not include a duty of care as distinguished from one to refrain from stealing or outright cheating. The two types of conduct are similar in that a careless fiduciary in effect cheats on her obligation of devoted service. However, a strict duty to devote time to the beneficiary's business would have no natural limit. Thus, Shepherd notes that "the duty of care has absolutely no necessary connection with fiduciary relationships."[6]

B. GOOD FAITH

A fiduciary duty differs from the implied covenant of good faith and fair dealing courts have generally applied to contractual relationships. In most types of commercial relationships, arguably including many of those in the investment banking business, the parties operate at arm's length and expect to be able to bargain on their own behalf and serve their own interests as long as they do so in good faith.[7]

The duty to bargain in good faith is illustrated by the leading case of *Katz v. Oak Industries, Inc.*,[8] involving a corporation's duties to holders of its debt securities. Delaware Chancellor Allen held that "[t]he terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to its bondholders. . . [I]f courts are to provide protection against such enhanced risk, they will require either legislative direction to do so or the negotiation of indenture provisions designed to afford such protection." The court further determined the corporation's duty by asking whether it is

> clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith--had they thought to negotiate with respect to that matter. If the answer to this question is yes, then, in my opinion, a court is justified in concluding that such act constitutes a breach of the implied covenant of good faith.[9]

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[3] Marc A. Rodwin, *Strains in the Fiduciary Metaphor: Divided Physician Loyalties and Obligations in a Changing Health Care System*, 21 Am. J.L. & Med. 241, 247-48 (1995)

[4] *Anonymous v. CVS Corp.*, 728 N.Y.S.2d 333, 336-39 (N.Y. Sup. Ct. 2001).

[5] J.C. Shepherd, LAW OF FIDUCIARIES 7 (1981).

[6] *Id.* at 49.

[7] *See, e.g.*, John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 Colum. L. Rev. 1618, 1658 (1989) (noting that "a contracting party may seek to advance his own interests in good faith").

[8] 508 A.2d 873, 879 (Del. Ch. 1986).

[9] Id. at 880.

In other words, the implied covenant of good faith is to be determined by examining the terms of the parties' contract. This raises the question of when the contract provides the limits of the parties' duties and when the court should add a default fiduciary duty to the express contract.

C. CONFIDENTIAL RELATIONSHIPS

A fiduciary duty differs from a "confidential relationship" which involves the entrustment of information by one party to another. A federal case illustrates this difference. *United States v. Chestman*[10] held that a broker was not liable for insider trading based on his client's alleged misappropriation of information from the client's wife because the husband and wife did not have a fiduciary relationship breach of which was necessary to find misappropriation. The court made clear that it meant that there was no fiduciary duty in the specific sense of an expectation of confidentiality arising from "repeated disclosure of business secrets between family members."[11] Even viewing fiduciary duties from this same narrow perspective, a dissenting judge disagreed as to their application, basing an expectation of confidentiality on shared control within a family corporation. Importantly for present purposes, even if the parties had a duty to maintain confidentiality of information, they would not necessarily have had other fiduciary duties, including the core fiduciary duty of unselfish conduct discussed below.

D. UNEQUAL POSITION

A fiduciary duty cannot be based solely on disparities between the parties of sophistication, information or bargaining power. Where the problem is simply disparity of bargaining power, the appropriate remedy is to refuse to enforce the contract between the parties on the ground that it is unconscionable, rather than to enforce the contract and add a fiduciary duty to it. A broad fiduciary duty may not be appropriate even if one party is more sophisticated or informed than the other. For example, in *Burdett v. Miller*,[12] although Judge Richard Posner held that an accountant who held himself out as a financial advisor was a fiduciary under the facts of the specific case, he was careful to note that "we do not mean to suggest that every expert is automatically a fiduciary." Rather, he reasoned that a fiduciary duty was justified under the particular facts of the case because the accountant

> cultivated a relation of trust with [the client] over a period of years, holding himself out as an expert in a field (investments) in which she was inexperienced and unsophisticated. He knew that she took his advice uncritically and unquestioningly and that she sought no "second opinion" or even--until the end, when at last her suspicions were aroused--any documentary confirmation of the investments to which he steered her.[13]

In other words, even where there is a clear disparity between the parties as to expertise and sophistication, courts will impose a fiduciary duty only after analyzing the precise nature of the

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[10] 947 F.2d 551 (2d Cir. 1991).

[11] Id. at 569.

[12] 957 F.2d 1375, 1381 (7th Cir. 1992).

[13] *Id.*

client's reliance on the alleged fiduciary. The relationship in *Burdett* obviously differs from the arm's length relationships between sophisticated parties that are common in investment banking.

II. APPROPRIATE APPLICATION OF FIDUCIARY DUTIES

Although the courts have used fiduciary language to describe many types of duties in a wide variety of situations, closer examination of the cases and consideration of underlying theory suggests that only one type of case is appropriate for the application of fiduciary duties in the strict sense of the term – that is, a situation in which the owner of property delegates open-ended management power over the property to a manager or fiduciary. This specific situation justifies requiring the entrusted party to refrain from self-interested conduct.

The most famous description of this duty is that of Justice Cardozo in *Meinhard v. Salmon*[14]:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions (citation omitted). Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

As Justice Cardozo indicates, it is necessary to distinguish relationships in the "workaday world" in which "[m]any forms of conduct permissible . . . for those acting at arm's length" from relationships in which the parties are "bound by fiduciary ties" and forbidden from engaging in this ordinary commercial conduct. Delegating power to manage a business, as Meinhard did to Salmon, is such a situation. The beneficiary of the duty wants and expects the fiduciary to maximize the value of her property. However, the delegation of power means the beneficiary has little ability to force the fiduciary to perform or even to determine whether the fiduciary has performed adequately.[15]

The law's response in this situation is to empower the courts to supervise the fiduciary through the imposition of the fiduciary duty. However, courts are not in much better position than the beneficiary to determine whether the fiduciary has performed adequately. After all, courts are not business experts and a courtroom is not a good place to analyze business decisions.

Fiduciary duties address these problems by subjecting fiduciaries, at least in the absence of contrary agreement, to a duty under which "thought of self was to be renounced, however hard the abnegation," in Justice Cardozo's words. This means fiduciaries have a legal duty to forego

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[14] 164 N.E. 545, 546 (N.Y. 1928).

[15] See Robert Cooter & Bradley J. Friedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences,* 66 N.Y.U. L. Rev. 1045 (1991).

any gain from the relationship except perhaps for some reasonable compensation. This clear-cut remedy saves courts from having to fully evaluate how well the fiduciary performed while significantly reducing the fiduciary's motive to cheat the beneficiary.

The problem with this remedy, as Justice Cardozo suggests, is that it is quite harsh and remote from conduct generally expected in the commercial world. It is accordingly necessary to carefully define the relationships in which the harsh fiduciary remedy is appropriate. Otherwise, imposing the default fiduciary duty may either unnecessarily require parties to incur the costs of contracting around the duty, or cause them to avoid potentially valuable relationships because the fiduciary duty makes the relationship too costly. Examples of relationships involving fiduciary-like delegation of control over property include the trustee-beneficiary relationship in a trust and the relationship between a manager and a publicly held corporation. On the other hand, a stringent fiduciary duty is unnecessary when an owner has significant ability to control or supervise the agent's conduct through other means.

As indicated above, fiduciary duties are appropriately viewed as "default" duties in the sense that they are subject to the parties' contrary agreement. This qualification is necessary because the wide variation in contractual relationships makes it impossible for courts or legislators to design a duty or set of duties that precisely fit all contexts. In particular, contracts differ across the critical dimension of the amount of control property owners delegate to managers, and therefore the extent to which fiduciary duties are necessary. Also, the parties may want to provide for exceptions to the strict duty of unselfishness to enable them, for example, to engage in particular types of business outside the duty. Even if a particular state law purports to impose a mandatory fiduciary duty, the parties may be able in effect to contract out of the duty by contracting for the application of another state's law. Moreover, the parties have flexibility to contractually define their relationships so that they are not "fiduciary" in nature.

III. STATE VS. FEDERAL LAW

Fiduciary duties are predominantly a matter of *state* law. State courts, or federal courts applying state law, have defined these duties and the situations in which they arise case by case over hundreds of years. There is no general federal common law on which courts can draw to determine when fiduciary duties should be applied, the precise nature of default fiduciary duties, or the interpretation or enforcement of contracts varying the default rules. Rather, to the extent fiduciary duties arise under federal law they do so under specific statutes. Courts applying these statutes must decide which elements of or approaches to fiduciary law to borrow from the states, and how to adapt this large body of law to suit the objectives of the federal statute at issue.

An example of the problems raised by federal fiduciary duties is Section 36(b),[16] added to the Investment Company Act in 1970 and recently interpreted by the Supreme Court in *Jones v. Harris*.[17] This section provides that the 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" from the investment company or its investors. This provision forced the federal courts to develop for the first time a "fiduciary duty" for mutual

[16] 15 U.S.C. § 80a-35(b).

[17] 2010 WL 1189560 (S. Ct. March 30, 2010).

fund investment advisers. Although the federal courts ultimately converged on the Second Circuit standard for applying the Section 36(b) duty articulated in *Gartenberg v. Merrill Lynch Asset Management, Inc.*,[18] the resulting litigation produced much smoke in terms of litigation costs without a single plaintiff victory at trial.[19] The Supreme Court in *Jones* ultimately vacated the Seventh Circuit's rejection of *Gartenberg*, but according to a concurring opinion did not "endorse the "*Gartenberg* standard" and "does not countenance the free-ranging judicial 'fairness' review of fees that *Gartenberg* could be read to authorize."[20] Thus, forty years after Congress added the "fiduciary duty" to the Investment Company Act, there is still no clear standard that meaningfully constrains mutual fund adviser fees.

The difficulties with a fiduciary duty under federal law reflect the broader problem of imposing inflexible, one-size-fits-all mandatory duties of any kind under the federal securities laws. These laws must keep pace with dynamic and constantly evolving financial markets. Congress recognized the limitations of the securities laws when it enacted the first federal securities statute, the Securities Act of 1933. In the words of William O. Douglas, chair of the SEC before serving on the Supreme Court, "[a]ll the Act pretends to do is to require the "truth about securities" at the time of issue, and to impose a penalty for failure to tell the truth. Once it is told, the matter is left to the investor."[21] A disclosure duty can adjust to myriad new structures and mechanisms by simply requiring firms to tell the truth about them. By contrast, enacting a new substantive obligation such as a fiduciary duty freezes this obligation into place, perhaps for decades as with Section 36(b). Although the SEC can promulgate new rules and exceptions, it is ultimately limited by the statute. There is therefore only so much the SEC can do to mitigate the problems created by statutory imposition of a mandatory fiduciary duty that is inappropriate for many situations to which it is being applied.

IV. APPLICATION TO INVESTMENT BANKING

The application of a mandatory fiduciary duty to investment bankers would be inappropriate for several reasons under the above analysis.

First, a general "fiduciary duty" applicable to a broad range of investment banker dealings would leave significant uncertainty as to the nature of the duties in each specific context. As discussed above, courts and commentators have applied the fiduciary concept to a wide variety of relationships and to embrace a number of different duties in those relationships, including due care, good faith, confidentiality and absence of self dealing. Thus, a prominent commentator has noted that "the fiduciary duty principle, both generally and in the context of

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[18] 694 F.2d 923, 928 (2d Cir. 1982).

[19] *See* M. Todd Henderson, *Justifying Jones* (November 10, 2009), forthcoming University of Chicago Law Review, U of Chicago Law & Economics, Olin Working Paper No. 491, available at http://ssrn.com/abstract=1499410.

[20] 2010 WL 1189560 at 12.

[21] William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 171 (1933).

investment advice providers, is too amorphous to serve as a standard setter."[22] Among the many questions posed by the creation of a new fiduciary duty are:

(1) What types of conflicts of interest are permissible (particularly including whether investment bankers can participate in market-making, which inherently involves positions on both sides of the market)?

(2) What types of compensation investment bankers are entitled to earn?

(3) When are contracts waiving fiduciary duties, including those entered into by investment bankers' sophisticated clients, enforceable?

(4) Is disclosure of conflicts alone sufficient to avoid a fiduciary duty?

(5) What types of information must the fiduciary disclose?

(6) How material must omitted information be to trigger liability?

(7) To whom is the fiduciary duty owed (that is, to the issuers that are the investment bankers' clients, the issuers' shareholders, or the market as a whole)?

(8) What are the remedies for breach?

Second, the above analysis shows that a fiduciary duty in the properly narrow sense of refraining from self-dealing would be inappropriate in most investment banking situations. Although investment bankers may be delegated discretion by the customer, this rarely is the sort of complete delegation that justifies imposing what Justice Cardozo called "the punctilio of an honor the most sensitive." If the situation clearly does not call for such a duty, the courts would have to invent the appropriate duty out of a whole cloth without the benefit of contractual adjustment of statutory default rules as under state law.

In most, if not all, investment banking situations, disclosure duties are sufficient without resorting to inventing a new investment banker fiduciary duty. For example, in the situation alleged in the SEC's recent complaint against Goldman, Sachs & Co, Goldman was said to have "structured and marketed" a security to investors, particularly including a bank (IKB). To the extent there was any fiduciary-type delegation of discretion, it was to the collateral manager, ACA, which is not a defendant in the case and has not been accused of wrongdoing. Rather, the alleged wrongdoing in the case is Goldman's failure to disclose John Paulson's role in selecting the reference portfolio for the security. The SEC alleged violations of antifraud provisions in existing securities statutes arising from Goldman's incomplete disclosures regarding the portfolio selection process. If the facts are as alleged and the non-disclosures are material, Goldman may be held liable under existing law and no new fiduciary duty is necessary to create an obligation to disclose. On the other hand, if Goldman did not breach an existing duty to disclose material facts, there is no apparent justification for holding Goldman liable under *any* theory, including a

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[22] Barbara Black, *Fiduciary Duty, Professionalism and Investment Advice* at 3 (March 28, 2010), University of Cincinnati Public Law Research Paper, http://ssrn.com/abstract=1579719.

fiduciary theory. This is true whether or not Goldman can be deemed to have an interest that conflicts with that of its customer.

In short, simply imposing an ill-defined "fiduciary duty" would result in massive uncertainty. Moreover, in the absence of a classic fiduciary relationship discussed above involving complete delegation of control, the parties should be able to act self-interestedly just as they do in general commercial dealings, subject to the contractual covenant of good faith and fair dealing. Where a contracting party is deemed to require protection, the federal securities laws generally should provide that protection through mandatory disclosure or antifraud rules.

Under some circumstances investment bankers might be subjected to new professional duties beyond pure disclosure. However, for the reasons discussed above, any such new duty should be articulated in detail and should not be imposed as part of a general fiduciary duty. The current version of the Restoring American Financial Stability Act calls for the SEC to study existing standards of care for broker-dealers and investment advisers who provide personalized investment advice and recommend securities to retail customers. This call for study reflects the fact that there is currently no well-developed set of federal fiduciary duties for either investment advisers or broker-dealers even in their dealings with retail customers. Clearly such additional study would be even more necessary before imposing new federal fiduciary duties in connection with investment bankers' advice at the wholesale level.

Finally, the arguments against fiduciary duties apply regardless of the nature of the security or instrument being sold. These instruments might involve new types of risks that customers do not well understand or create systemic risks that the dealer and customer do not internalize. More disclosure may be appropriate. However, a vague or inappropriate fiduciary duty would still not be the right way to deal with the situation. The broad application of strict fiduciary duties might discourage legitimate conduct. Conversely, the vagueness and ambiguity of the fiduciary duty might lead courts to permit conduct that should be forbidden, perhaps without appropriate disclosures.

Whatever problems Congress might find to exist in investment banking, fiduciary duties are the wrong tool for dealing with the problems.

V. CRIMINAL PENALTIES EXACERBATE THE PROBLEMS OF FIDUCIARY DUTIES

The above analysis of fiduciary duties applies irrespective of the nature of the remedy applied to breach of the duty. However, the application of criminal penalties significantly exacerbates the problems of applying inherently vague and ambiguous fiduciary duties. This is so even if criminal penalties are attached only to "willful" violations, since it is necessary to define what behavior is being engaged in "willfully." Some of these additional problems from criminal liability for fiduciary breach are discussed in the following sections.

A. VAGUENESS

As stated in Senator Specter's press release announcing this hearing, "a jail sentence is enormously different" from a mere civil liability or fine. The Fifth Amendment of our Constitution recognizes this difference by seeking to ensure that defendants are alerted to the precise nature of conduct that triggers criminal punishment. Although vague laws are always a concern, they are particularly problematic when they result in jail terms.

As discussed above, courts have applied fiduciary duties to many types of conduct. Unless the statute prescribing such duties is very clear, it will leave courts wide discretion in deciding what situations give rise to fiduciary duties and what those duties entail. Even if the statute precisely describes the situations to which the duty applies, this still may leave a lot of ambiguity, particularly if the duty applies outside the traditional range of fiduciary relationships. For example, Congress articulated the fiduciary duty under Section 36(b) of the Investment Company Act applied in *Jones v. Harris* to apply solely to investment advisers' role in setting their compensation. Yet despite this definition, the statute triggered decades of costly and fruitless litigation.

B. DETERRENCE

The press release and remarks on the Senate floor announcing this hearing emphasize that "criminal prosecutions are an effective deterrent." This may be true in general, but the effectiveness of criminal penalties depends on the conduct that is sought to be deterred being precisely defined in the statute. As discussed above, fiduciary duties have been used quite broadly to refer to a wide variety of conduct of obligations.

One effect of using criminal fiduciary duties to deter investment banker misconduct is that the vagueness of these duties may actually result in *less* deterrence of misconduct than would be accomplished by more precise remedies. This was noted in the 19th century by Jeremy Bentham, who argued that common law crimes failed to achieve effective deterrence. He called these crimes "dog law" because, similar to the way dogs perceived discipline by their owners, the judges made up crimes as they went along without adequately notifying potential miscreants of what conduct to avoid. A broad new fiduciary duty for investment bankers could fall into this category because, like common law crimes, courts would develop it a case at a time.

Under-deterrence also may result from the difficulty of proving criminal liability. Prosecutors may find it difficult to win cases under a willfulness standard and the criminal standard of proof beyond a reasonable doubt. This is particularly so if courts and prosecutors are wary of the social consequences of applying new fiduciary standards in a criminal context. For example, only a couple of criminal backdating prosecutions ultimately were successful despite reports of potentially very widespread misrepresentations, and although these cases involved conventional disclosure violations rather than a new and untried federal fiduciary duty. As a result, a new criminal fiduciary duty could divert prosecutorial resources from their more effective use in deterring conventional fraud to a lower-value pursuit of elusive criminal penalties.

In addition to the problem of under-deterring bad behavior, fiduciary duties may over-deter by threatening punishment even of socially valuable behavior. Given the seriousness of criminal prosecution, legitimate firms seeking profits over the long haul will give a very wide berth to behavior that poses even the slightest risk of putting them out of business or sending the individual employees to jail. This is clearly true for securities firms for which criminal prosecution might be a death sentence. Thus, the fact that civil remedies may be, as Senator

Specter noted, merely a “cost of doing business” is actually a good thing to the extent that it avoids this over-deterrence effect of criminal penalties.

Over-deterrence may impose significant costs on society by inhibiting innovation. Firms may stick to the most established practices and financial instruments for which fiduciary standards have been well-developed in order to avoid liability risks through behavior whose risks are uncertain. Although new financial instruments and practices have inflicted harm on the market, they have also significantly added to the markets’ liquidity and efficiency.

Some over-deterrence may be worth getting rid of socially costly behavior by irresponsible firms. However, these bad firms bent on destructive behavior may not be much deterred by the threat of new criminal penalties from breach of fiduciary duties. Irresponsible firms likely already are committing criminal fraud by lying about what they are doing.

At the same time, broad criminal liability for fiduciary breach might even turn good firms into criminals. A legitimate firm might unwittingly find that it may have committed a crime by possibly having breached a new fiduciary duty. The firm then might have an incentive to cover up its offense by committing criminal fraud. In other words, vague laws pose a risk of entangling firms in a web of guilt not unlike what enveloped the hapless protagonist of Kafka’s *The Trial.*

C. ABUSE OF PROSECUTORIAL POWER

Broad criminal liability for breach of fiduciary duty could have the perverse effect of encouraging abuse of prosecutorial power. That is not to say that abuse of prosecutorial power is a widespread problem in society. Most prosecutors are honest and operate with great integrity. However, even the smallest increased risk of prosecutorial misconduct can be a serious social problem given the importance of an honest criminal justice system. Criminal penalties for corporate misconduct give rise to highly politicized trials in which the stakes for the prosecutors for their jobs and future careers are particularly high. At the same time, the high standard of proof required for a criminal conviction increases the prosecutors’ incentive to cheat.

While a new corporate criminal liability increases prosecutors’ incentive to cheat, criminal liability for breach of fiduciary duty gives them a powerful new weapon that is subject to potential abuse. Again in the backdating cases, judges dismissed trials and even threw out convictions in the face of evidence of prosecutorial misconduct, including threatening potential defense witnesses. Broad and vague criminal penalties for breach of fiduciary duty increase the range of threats prosecutors can make even against defendants and potential witnesses who reasonably believe their conduct was legitimate. For example, prosecutors might be able to increase their chances of success by using the threat of a fiduciary duty prosecution to get firms facing possible shut-down to put pressure on their employees to cooperate with prosecutors.

VI. CONCLUSION

Any proposal to impose new fiduciary duties on investment banking firms, and particularly one for criminal penalties for breach of any such duties, is very likely to be ill-advised, and should be adopted only after extensive study that takes into account the significant potential costs and risks discussed above. Such new duties and penalties almost certainly will have little or no effect in decreasing the level of fraud in the investment banking industry or reducing systemic risk in securities markets. On the contrary, these penalties may even increase risk and fraud by deterring efficient practices in the securities industry and reducing effective discipline of fraudulent behavior. Clearly in light of these potential dangers, new fiduciary duties and penalties require the most careful and extensive deliberation.

BIOGRAPHY

Professor Larry E. Ribstein is the Mildred Van Voorhis Jones Chair in Law, the Associate Dean for Research and Co-Director of the Program in Business Law and Policy at the University of Illinois College of Law. He is a graduate of the Johns Hopkins University and the University of Chicago Law School. In addition to full-time appointments in the law schools of University of Illinois, George Mason University and Mercer University he has visited at the law schools of the University of Texas, New York University, Washington University, Southern Methodist University and St. Louis University.

Professor Ribstein has taught business associations and securities law for 35 years. He is the author of leading treatises on limited liability companies (*Ribstein & Keatinge on Limited Liability Companies*) and partnership law (*Bromberg & Ribstein on Partnerships*), as well as two business associations casebooks (Ribstein & Lipshaw, *Unincorporated Business Entities,* 4th edition 2009 and Ribstein & Letsou, *Business Associations, 4th edition, 2003*). His books also include *The Sarbanes-Oxley Debacle* and *The Constitution and the Corporation* (both with Henry Butler), *The Law Market* (2009, with Erin O'Hara), *The Rise of the Uncorporation* (2010) and *The Economics of Federalism* (with Kobayashi). From 1998-2001 he was co-editor of the *Supreme Court Economic Review*.

Ribstein has written or co-authored approximately 150 articles on subjects including corporate, securities and partnership law, constitutional law, bankruptcy, film, the internet, family law, professional ethics and licensing, uniform laws, choice of law and jurisdictional competition.