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).
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).
Federal Misgovernance of Mutual Funds

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.”

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.”

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.

10 164 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. 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.

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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

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13 See id. at 25.
not used a corporate form, 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, and prevented further structural development of the industry thereafter.

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. 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. 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).
16 See Wallison & Litan, supra note 12, at 24–25.
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

²¹ S. 3724, 90th Cong. § 8(d) (1968).
²⁴ Id.
²⁵ Id. § 35(b)(3).
Federal Misgovernance of Mutual Funds

securities laws.\textsuperscript{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.\textsuperscript{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,\textsuperscript{28} a court cannot realistically assume that the fee was negotiated by a fully disinterested board.\textsuperscript{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.\textsuperscript{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

\textsuperscript{26} Id. § 35(b)(6).

\textsuperscript{27} Id. § 35(b)(1).

\textsuperscript{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).

\textsuperscript{29} See Johnson, supra note 4.

\textsuperscript{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.” However, the court’s use of “and” separates the “disproportionate” and “arm’s-length bargaining” aspects of the test. Moreover, Gartenberg admits consideration of other factors, including the amount and role of funds’ competition for investors and the process of approving the fees. Courts accordingly have significant leeway under Gartenberg as to what factors to emphasize.

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. 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. 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.

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.
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).
Cato Supreme Court Review

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)).
Federal Misgovernance of Mutual Funds

‘be ‘reasonable’ in relation to a judicially created standard.’” 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.

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.

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. Easterbrook noted that “regulating advisory fees through litigation is unlikely to do more good than harm,” 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.”

Todd Henderson explains Jones primarily in light of this concern with the judicial process. 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

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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 hampers 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.” Posner then cites a host of articles critical of corporate executive compensation by everybody from Lucian Bebchuk to Ben Stein, 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.”

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. 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. 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.

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.” 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).”

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.” 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.” Thus,

61 Id. at 731-32.
62 Id. at 732-33.
64 Id. at 1427 (citing Pepper v. Litton, 308 U.S. 295, 306-07 (1939)).
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).
the far-flung business enterprises created during the Industrial Revolu-
tion to coordinate the production and sale of products.\textsuperscript{69} This task
required giving control of the firm’s resources and investors’ money
to the firm’s managers. Unlike typical partnership-based firms, cor-
porate shareholders could not unilaterally dissolve the firm or other-
wise take their money out.\textsuperscript{70} Managers’ power over corporate
resources necessitates mechanisms ensuring the managers’ account-
ability 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.\textsuperscript{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 manage-
ment, uncorporate owners have some ability to free their cash from
managers’ control. A corporate shareholder, by contrast, can accom-
plish 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

\textsuperscript{69} See generally Alfred D. Chandler Jr., The Visible Hand: The Managerial Revolution

\textsuperscript{70} For an analysis of this corporate feature and comparison with partnerships, see
Ribstein, supra note 14, at 65–94.

\textsuperscript{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. 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.”

The protection provided by the right of exit accordingly eliminates the need not only for fiduciary duties but also for the board itself. 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. 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. 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.

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). 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.” Specifically, that because the partners redeem their shares rather than sell them, the court noted devaluation of partnership assets

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).
79 Id. at 152.
Federal Misgovernance of Mutual Funds

affects only current partners and not later partners.\footnote{Id.} 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.”\footnote{Id. at 153.} 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.”\footnote{Langevoort, supra note 75, at 1037.} University of Pennsylvania law professor Jill Fisch also argues for the product analogy.\footnote{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##.} 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,\footnote{See Wallison & Litan, supra note 12, at 14 (noting that the adviser expects control because it sets up the fund).} and therefore the fund board to be disinterested.\footnote{See Johnson, supra note 4 (questioning the disinterest of independent fund directors who are considered “independent” under current law).} Accordingly, the board’s existence necessarily creates a conflict, which in turn requires judicial oversight. However, courts,
wary of their ability to second-guess board decisions, necessarily look for some benchmark to apply, such as the funds’ costs, 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. 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. 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.

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.
Federal Misgovernance of Mutual Funds

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 should ask how such dysfunction could arise in what “may be the most heavily regulated sector of the financial services industry.” 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. 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.
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. 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. 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

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93 See generally, Ribstein, supra note 14, at 15–38.
94 See id. at 39–136 (tracing this evolution).
Federal Misgovernance of Mutual Funds

funds, fees, and business for local lawyers.\textsuperscript{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.\textsuperscript{96} Although funds are technically formed under and governed by state law (mainly Delaware, Maryland, and Massachusetts),\textsuperscript{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.\textsuperscript{98}

\textsuperscript{95} See Langevoort, supra note 75, at 1036.
\textsuperscript{96} Coates, supra note 40, at 627.
\textsuperscript{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. 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.”

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. 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

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99 Wallison & Litan, supra note 12, at 99-120.
correlate with bad performance, 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. 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. 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. 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. Only the MBAs thought

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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. 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.

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. 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.

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107 Coates & Hubbard, supra note 33, at 173-84.
108 Id. at 184-201.
Federal Misgovernance of Mutual Funds

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.\textsuperscript{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.

\section*{Conclusion}

The central problem in \textit{Jones v. Harris Associates} is not the issue that confronted the Court—that is, whether to adopt the \textit{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 \textit{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, \textit{Jones} should stand as a lesson of the dangers of federal regulation of the governance of firms. \textit{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.”\textsuperscript{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


\textsuperscript{117} Jones, 130 S. Ct. at 1431.
Federal Misgovernance of Mutual Funds

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. 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. 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.

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

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