

**NEW DIRECTIONS FOR MUTUAL FUND GOVERNANCE IN CANADA:
INVESTOR PROTECTION FROM EXCESSIVE FEES AND EXPENSES**

SEAN MCFARLAND

A DISSERTATION SUBMITTED TO OSGOODE HALL LAW SCHOOL AND THE
FACULTY OF GRADUATE STUDIES
IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE DEGREE OF
DOCTOR OF PHILOSOPHY

OSGOODE HALL LAW SCHOOL
YORK UNIVERSITY,
TORONTO, ONTARIO

MAY 2013

**NEW DIRECTIONS FOR MUTUAL FUND GOVERNANCE IN CANADA:
INVESTOR PROTECTION FROM EXCESSIVE FEES AND EXPENSES**

by **Sean McFarland**

a dissertation submitted to the Faculty of Graduate Studies of York University in partial fulfillment of the requirements for the degree of

DOCTOR OF PHILOSOPHY

©

Permission has been granted to: a) YORK UNIVERSITY LIBRARIES to lend or sell copies of this dissertation in paper, microform or electronic formats, and b) LIBRARY AND ARCHIVES CANADA to reproduce, lend, distribute, or sell copies of this dissertation anywhere in the world in microform, paper or electronic formats *and* to authorize or procure the reproduction, loan, distribution or sale of copies of this dissertation anywhere in the world in microform, paper or electronic formats.

The author reserves other publication rights, and neither the dissertation nor extensive extracts from it may be printed or otherwise reproduced without the author's written permission.

**NEW DIRECTIONS FOR MUTUAL FUND GOVERNANCE IN CANADA:
INVESTOR PROTECTION FROM EXCESSIVE FEES AND EXPENSES**

by Sean McFarland

By virtue of submitting this document electronically, the author certifies that this is a true electronic equivalent of the copy of the dissertation approved by York University for the award of the degree. No alteration of the content has occurred and if there are any minor variations in formatting, they are as a result of the conversion to Adobe Acrobat format (or similar software application).

Examination Committee Members:

1. Poonam Puri
2. Liora Salter
3. Anita Anand
4. Allan Hutchinson
5. Thaddius Hwong
6. Faisal Bhabha

ABSTRACT

Canadian investors pay among the highest expenses and advisory fees worldwide. There is currently no mechanism in the existing Canadian mutual fund governance regime to protect investors against excessive advisory fees. Recent changes to the Canadian securities regulatory framework were precipitated by the mutual fund scandal in Canada and the United States that involved late trading and market timing and involved introduction of national instruments for enhancing disclosure and the introduction of an independent review committee focussed upon conflicts of interest. While the existing disclosure mechanism in Canada is appropriate, it is not effective because investors do not fully understand the information being disclosed. An enhanced program of public involvement, participation and education should be conducted in Canada to enhance investor protection such that disclosure is an effective governance mechanism. This program should include increased involvement and participation of investors in the development and implementation of mutual governance mechanism in Canada. The Independent Review Committee falls short of the governance agency contemplated by the Canadian securities regulators' Concept Proposal and recommendations in the related reports commissioned by these agencies. I recommend a fund board as an appropriate mutual governance agency for Canada, which should have a fiduciary duty for investor protection from excessive mutual fund expenses and fees.

DEDICATION

I would like to dedicate this dissertation to my wife Gabriele Guderjahn, my son Liam McFarland, my mother Jacqueline Waring and my father Ron McFarland.

ACKNOWLEDGEMENTS

I would like to thank my Supervisor Poonam Puri for her faith, encouragement and direction in completing this dissertation. I would like to thank Liora Salter for her part in completion in my doctorate from admission, research and analysis through to defence. I would further like to thank Allan Hutchinson, Thaddius Hwong, Anita Anand and Faisal Bhabha for participating in the examination committee for my defence. I would like to thank my mother for her part in my early interest in law. I would like to thank Kam Dutt for her expertise and assistance in preparing this document when she attended OSgoode Law School.

I would like to thank my wife Gabriele Guderjahn and my son Liam McFarland for their love and support during my doctorate and the completion of this dissertation.

CONTENTS

ABSTRACT	IV
DEDICATION	V
ACKNOWLEDGEMENTS	VI
CONTENTS	VII
LIST OF TABLES	IX
1.0 INTRODUCTION	1
1.1 APPROACH AND METHODOLOGY	2
2.0 HISTORY, EVOLUTION AND STRUCTURE OF MUTUAL FUNDS	6
2.2 THE NORTH AMERICAN MUTUAL FUND MARKET	10
2.3 IMPORTANCE OF MUTUAL FUNDS IN NORTH AMERICA	14
2.4 GLOBAL CONTEXT OF MUTUAL FUND INDUSTRY	22
2.5 GLOBAL FUND INDUSTRY	27
2.6 MUTUAL FUND PERFORMANCE	32
2.7 MUTUAL FUND SCANDALS	55
2.8 DISCUSSION	63
3.0 CANADIAN MUTUAL FUND REGULATORY REGIME	67
3.1 GLOBAL CONTEXT	67
3.2 FORMATIVE DEVELOPMENTS IN THE DISCLOSURE MECHANISM IN CANADA	70
3.3 1969 CCMF REPORT	75
3.4 CURRENT CANADIAN MUTUAL FUND GOVERNANCE REGIME	84
3.4.1 2004 Comments on Proposed National Instrument 81-106	94
3.4.2 Proxy Voting Disclosure for Securities Held	94
3.4.3 2004 Comments Concerning Mutual Fund Proxy Voting Disclosure	95
3.4.4 Requirement to Establish Policies and Procedures	97
3.4.5 Proxy Voting Record	98
3.4.6 Discussion	106
3.5 NATIONAL INSTRUMENT 81-107, INDEPENDENT REVIEW COMMITTEE FOR MUTUAL FUNDS	124
3.5.1 Independent Review Committee (IRC)	124
3.5.2 Conflicts of Interest	137
3.5.3 Inter-fund Trades	146
3.5.4 Changes to the Mutual Fund	147
3.6 FUNCTION OF INDEPENDENT REVIEW COMMITTEE (IRC)	153
3.7 COMPARISON OF THE IRC WITH THE 'GOVERNANCE AGENCY' IN THE CONCEPT PROPOSAL	159
3.8 COMPLIANCE PLANS	166

3.9	POINT OF SCALE DISCLOSURE FOR MUTUAL FUNDS (POS PROJECT)	167
3.10	EDUCATION AND PUBLIC INVOLVEMENT OF RETAIL INVESTORS	194
3.11	DISCUSSION	202
4.0	UNITED STATES MUTUAL FUND GOVERNANCE	215
4.1	THE INVESTMENT COMPANY ACT OF 1940	216
4.2	LATE TRADING AND MARKET TIMING	219
4.3	SEC RESPONSE TO MUTUAL FUND SCANDALS	224
4.4	THE SEC'S NEW RULES	235
4.5	UNITED STATES FUND BOARDS	247
4.6	DIRECTOR INDEPENDENCE IN MUTUAL FUND BOARDS	260
4.6.1	Criteria for Non Interested Directors in the United States	272
4.6.2	Board Independence and Performance	277
4.7	FIDUCIARY DUTIES OF INVESTMENT COMPANY DIRECTORS	290
4.8	MUTUAL FUND INVESTOR PROFILES	302
4.8.1	ICI SURVEY	302
4.8.2	SEC PORTRAYAL	312
4.8.3	ACADEMIC PROFILE	314
4.9	MUTUAL FUND DISCLOSURE AND ADVERTISING	330
4.9.1	Streamlined Disclosure	332
4.9.2	Standardized Disclosure	337
4.9.3	Fund Advertising	342
4.10	DISCUSSION	349
5.0	MUTUAL FUND FEES AND EXPENSES RATIOS	357
5.1	GLOBAL CONTEXT	357
5.2	MORNINGSTAR REPORTS	372
5.3	COMPARATIVE ANALYSIS OF MUTUAL FEES AND EXPENSES CANADA AND THE UNITED STATES	377
5.3.1	Evaluation of Potential Causes of Higher MERs in Canada	382
5.4	GAO STUDY OF DISCLOSURE OF MUTUAL FUND FEES	390
5.5	COMPARISON OF MUTUAL FUND AND PENSION FUND ADVISORY FEES	405
5.6	EXCESSIVE MUTUAL FUND FEES	412
5.7	MUTUAL FUND ECONOMIES OF SCALE	429
5.8	EXCESSIVE FEE LITIGATION IN U.S. COURTS	450
5.9	PRICE COMPETITION	482
5.10	FUND INDUSTRY LACKS CLEAR DISCLOSURE	492
5.11	U.S. FIDUCIARY DUTY APPLICABLE TO MUTUAL FUND MANAGERS	517
5.12	CONTROLLING ADVISORY FEES	541
5.13	DISCUSSION	547
6.0	CONCLUSIONS AND RECOMMENDATIONS	554
6.1	CONCLUSIONS	554
6.2	RECOMMENDATIONS	562
APPENDIX A - GLOBAL COMPARISON OF TOTAL EXPENSE RATIOS FOR FIXED INCOME, MONEY MARKET AND EQUITY FUNDS		565

APPENDIX B - SUMMARY OF GLOBAL FUND PROSPECTUS PRACTICES IN THE MUTUAL FUND INDUSTRY	566
---	------------

LIST OF TABLES

Table 1 - Mutual Fund Expense Ratios in 1967

Table 2 - The Most Expensive Funds in the World are Canadian

Table 3a - Global Ranking of TER by Country in 2009 Morningstar Study Report

Table 3b - Canada's Grade in 2011 Morningstar Study

Table 4 - Comparison of Canadian and United States Equity Mutual Funds in Ruckman
Study

Table 5 - Comparison of the MER in Canada and the U.S. by Fund type in Ruckman
Study

Table 6 - Comparison of Operating Expense Ratios in Freeman and Brown and ICI
Studies

Table 7 - Comparison of Weighted Average Operating, Advisory, and Administrative
Expense Ratios from Freeman and Brown Study

Table 8 - Comparison of Public Pension and Mutual Fund Investment Advisory Fees
from Freeman and Brown Study

1.0 INTRODUCTION

In this dissertation I demonstrate that while Canadians pay amongst the highest expenses and advisory fees worldwide, there is currently not an effective mechanism for protection of investors from excessive fees in Canada. Based on my analyses, I argue that the recent changes in mutual fund governance in Canada were in response to mutual fund scandals in both Canada and the United States and surprisingly did not address investor protection from high advisory fees. I conclude that investor protection from excessive advisory fees must be introduced in the Canadian mutual fund governance framework, in particular since Canadians pay high expenses and advisory fees in both a North American and global context.

My analysis of the Canadian mutual fund governance leads me to conclude that the introduction of the independent review committee in Canada has fallen short of the ‘governance agency’ envisioned in the Canadian securities regulators’ Concept Proposal. Following my analysis of mutual fund governance in the United States, I recommend that Canada adopt a mutual fund board. Unlike in the United States, I argue that this should not include a super majority of independent directors and an independent chair.

I conclude that the disclosure mechanism in Canada, while technically sound, is not effective because investors do not fully understand the information being disclosed. To address this weakness, I suggest that increased public education of investors be incorporated in the Canadian mutual fund governance framework. I recommend that

enhanced investor involvement and participation be implemented in the future development of mutual fund governance in Canada. I recommend, based on my analysis of United States governance and litigation of excessive fee challenges in the courts, that the fiduciary duty of this fund board include a fiduciary duty to protect investors from excessive advisory fees. This dissertation constitutes new and important research as the question of advisory fees was not studied or addressed during the recent mutual fund reforms in Canada, or the United States, since the focus was directed upon the mutual fund scandals. It represents significant and critical work, since Canadians pay among the highest mutual fund fees in the world and changes to the mutual fund governance regime are required to protect investors from excessive advisory fees and expenses.

1.1 APPROACH AND METHODOLOGY

There have been recent changes to the mutual fund governance in both Canada and the United States. Within both countries this has involved sweeping regulatory reform. A primary driver for these reforms in both countries was the highly publicized mutual fund scandals and corporate governance scandals such as Enron. The regulatory agencies in Canada and the United States responded with new rules focussed upon conflicts of interest to prevent future scandals and provide improved investor protection. In Canada this has included a new national instrument for disclosure to investors and a new national instrument requiring an Independent Review Committee (IRC) which is focused on conflicts of interest. In the United States, new rules were proposed and introduced by the Securities and Exchange Commission (SEC) that focus upon director

independence and an independent chair of the fund board. This dissertation analyzes both mutual fund governance regimes and assesses their effectiveness for mutual fund investor protection. This dissertation concludes with a discussion of key findings and directions for enhancement of investor protection in Canadian mutual fund governance.

The general research area for this dissertation is mutual fund governance utilizing a comparative fund governance approach. The objective is to analyze the changes in the mutual fund governance regime in Canada in relation to those in the United States in an international context and to utilize this analysis to contribute to the development of an improved mutual fund governance regime in Canada. This dissertation is a practical application of legal principles in Canada and the United States. As a result, the conclusions and recommendations are practical in nature rather than a highly theoretical and abstract exposition of legal principles. The application utilizes a comparative corporate governance approach, while drawing upon the literature of law and economics and literature pertaining to mutual fund performance. A primary focus is placed upon investor protection. In the context of the mutual fund industry, investor protection relates to conflicts of interests where fund managers and advisors place their own interests and those of their shareholders above the interests of the mutual fund investors. This is of particular concern, as discussed in this dissertation, due to the structure of the mutual fund industry which creates an inherent conflict of interest between the fund manager and/or advisor, where they may seek to maximize their financial returns at the expense of the investors of their mutual funds.

As discussed in this dissertation, this conflict of interest has been manifested historically in late trading and market timing activities associated with mutual scandals. This conflict of interest has been and is being manifested in high mutual fund expenses and fees being charged to mutual fund investors, which is a primary focus of this dissertation. Investor protection in the context of the mutual fund industry is multi faceted and relates to development of regulatory mechanisms, such as disclosure, as well as providing education to investors to ensure that they understand the regulations and the information that is being disclosed. As such regulators need to work with industry and investors to determine what information needs to be disclosed. Accordingly, investor protection in the mutual fund industry involves an inter relationship between regulators, fund managers and advisors, and investors. Canadian mutual fund investors are threatened by the basic structures and practices of the mutual fund industry in Canada, which create embedded conflicts of interests on the part of fund managers and advisors that lead to the diminution of investors' investments often without investors understanding or even knowing why or how. Investor protection means changing those structures to expose conflicts of interest, and empower investors through better regulation and education. In the context of this thesis it also means investor protection from high expenses and fees for mutual funds which has previously not been the focus of investor protection in Canada.

Initially, I conducted an extensive review of relevant literature on international fund governance. A decision was made to proceed with a comparative analysis of mutual fund governance in Canadian and United States due to the close relation between the

mutual fund markets and the comparable governance regimes. The methodology involved review and analysis of existing literature in fund governance and corporate governance. A comparative analysis of fund governance was conducted on governance of the mutual fund industry in North America. The literature on mutual fund governance was obtained using the Lexis/Nexis Database, and the resources at the Osgoode Hall Law Library and other libraries. Internet searches were performed using multiple search engines to search for topics related to mutual fund governance and corporate governance, including governance agencies such as fund boards. The literature review and Internet searches included international materials on mutual fund governance including those available from the Canadian securities regulators and Securities and Exchange Commission (SEC) in the United States. The results of the literature review were used to conduct an evaluation of the mutual fund regime of the United States and Canada and develop conclusions for future direction of the mutual fund regime in Canada. The thesis draws upon the literature review, analysis and group discussions that I experienced in the study groups in the graduate program at Osgoode Hall Law School. Although these may not be explicitly referred to these are woven into the fabric of this dissertation. A final draft of the dissertation was submitted in October 18, 2012, which represents the 'cut-off' date for the research, analysis, conclusions and recommendations.

An overview is provided of the history of the investment companies, the global context of the mutual fund industry, the North American mutual fund market and the importance of mutual funds in North America. A discussion of the mutual fund performance is provided including the persistence of long term performance and whether

fund managers are able to increase performance and justify higher fees. A discussion and analysis of global total expense ratios is provided which includes a comparison and ranking of Canada and the United States with other countries. A comparison of the management expense ratios in Canada and the United States is then performed.

An evaluation of the changes in the Canadian mutual fund regulatory regime is conducted which is focussed upon the introduction of the disclosure mechanism and the independent review committee. This is followed by a critical evaluation of mutual fund governance in the United States, focussing upon the introduction of rules for independent director chairs of fund boards, as well as investor protection in the courts. An analysis of fees is performed to determine if mutual investors in Canada and the United States are paying excessively high advisory fees and whether there is adequate investor protection in place to prevent this. Finally, a discussion of the key findings and conclusions is provided followed by suggestions and recommendations for future directions in the evolution of Canadian mutual fund governance to enhance investor protection.

2.0 HISTORY, EVOLUTION AND STRUCTURE OF MUTUAL FUNDS

2.1 INVESTMENT COMPANY REGULATION BACKGROUND AND HISTORY

The investment company concept dates to Europe in the late 1700s, when a Dutch merchant and broker invited subscriptions from investors to form a trust to provide an opportunity to diversify for small investors with limited means¹. This trust was created by

¹ Goetzmann, W.N., & K. Geert Rouwenhorst (2005). *The Origins of Value*, Oxford University Press, New York, 254 p.

Abraham van Ketwich and was called the Eendragt Maakt Magt. It sold 2,000 shares to subscribers whose funds would be collectively invested in bonds issued by foreign governments and banks and in plantation loans in the West Indies². The sponsor was paid a fee of 0.5 percent of the subscriptions plus an annual fee. An annual accounting was required, and the sponsor was monitored by two independent trustees³.

The Societe Generale de Belgique, a Belgium trust originally created in 1822 by King William of the Netherlands, was another collective investment enterprise that initially invested in foreign government loans and later in commercial businesses⁴. A decade or so later, the Societe Generale Pour Favoriser l'Industrie Nationale Des Pays-Bas, initially a Belgian firm, converted loans to defaulting businesses into stocks of those firms and later sold the stock into the public market. That enterprise formed another investment trust with the Rothschilds in 1836 called the Societe Des S Capitalistes Reunis Dans un But de Mutualite Industrielle, which held shares in various companies⁵. The Societe Generale de Credit Mobilier was organized in France in 1852 to supply new enterprises with banking facilities⁶.

Investment companies became popular in London in the 1860s. They operated as limited liability companies upon the enactment of the English Companies Act in 1862.

² Ibid.

³ Ibid. at 254, 257.

⁴ Harwood, E.C., & R. L. Blair, (1942). *Investment Trusts and Funds from The Investor's Point of View*, American Institute for Economic Research, p. 102, Grayson, T.J., (1928). *Investment Trusts Their Origin, Development and Operation*, John Wiley and Sons, New York.

⁵ Cameron, R., (1961). *France and The Economic Development of Europe*, 147-48, 2d Ed.

⁶ Markham, J. W., (2002). *A Financial History of The United States*, pp. 322-23, M.E. Sharpe Inc., United States.

Their numbers included the London Financial Association and the International Financial Society, which pooled small investors' funds and provided management. Investment trust companies were formed in London in the 1870s as a mechanism for the purchase of American corporate securities. Typically, an English investment trust would set aside one half percent of the first £500,000 of capital and one quarter percent above that amount for expenses. This included payments to directors. In 1886 there were twelve investment trusts that were trading.

A mutual fund pools multiple investors' money into a single investment portfolio created and managed by a fund management company⁷. Investors who purchase shares of the fund, typically organized as a separate corporation or trust, are entitled to the proportionate return from the assets held by the fund. Thus, the investors do not own the fund assets directly, but rather own pieces of the mutual fund. Investors in open-end funds (the most prevalent form) have the right to withdraw their investment at any time at a price determined by the fund's net asset value, as opposed to a closed-ended fund where investors do not have this option. Mutual funds vary considerably, including in the types of financial assets held, their investment objectives and strategies, and their fees and expenses-all of which are set forth in a fund's prospectus.

⁷ For a description of the basic characteristics of mutual funds, see SEC, *Invest Wisely: An Introduction to Mutual Funds*, <http://sec.gov/investor/pubs/inwsmf.htm> (hereinafter SEC, *Invest Wisely*)

Mutual funds emerged in the second half of the 18th century in the Netherland, Europe⁸. Following the financial crisis of 1772 – 1773, a trust named Eendragt Maakt Magt-the maxim of the Dutch Republic, “Unity Creates Strength” was formed 1774 by the Dutch merchant and broker Abraham van Ketwich⁹. The aim of this fund was to provide small investors with an opportunity to diversify risk spreading by investing in Austria, Germany, Denmark, Spain, Sweden, Russia and some colonial plantations in Central and South America. The administrator of this fund was to receive a commission of 0.5 percent at the founding of the trust, plus an annual compensation of 100 guilders per class, which translates into an annual management fee of 0.2 percent of class¹⁰. This mutual fund was followed by the creation of a few other mutual funds and most of the fortunes of these are linked to the fortunes of their predominant investments – plantation loans in West India¹¹. In addition, in the 1780s and 1790s investment trusts emerged with the objective on speculation on the future credit of the United States¹². The first investment trust outside of the Netherlands was founded in 1868 in London and is the Foreign and Colonial Government Trust¹³ on the London Stock Exchange.

⁸ Rouwenhorst, K. Geert (2004). *The origins of mutual funds*, Yale ICF Working Paper No. 04-48, p. 1, Retrieved from <http://ssrn.co/abstract=636146>.

⁹ Rouwenhorst, 2004, p.1.

¹⁰ Rouwenhorst, 2004, p. 7.

¹¹ Rouwenhorst, 2004, p. 11.

¹² Rouwenhorst, 2004, p. 12.

¹³ Rouwenhorst, 2004, p. 16.

2.2 THE NORTH AMERICAN MUTUAL FUND MARKET

The model for American investment companies is the English investment trust. There were however, some collective investment schemes in America that predated those ventures. The Massachusetts Hospital Life Insurance Company (MHLIC) for example, was originally chartered in 1818 as an insurance company. It soon began to operate somewhat similar to a trust company. The funds deposited, however, were commingled as opposed to being maintained as separate trusts, similar to a modern investment trust.

The United States Mortgage Company that was organized in New York in 1871 and the New York Stock Trust that was formed in 1890 were also investment trusts established in America. The Boston Personal Property Trust that was formed in 1893 was a collective investment fund that invested in a diversified group of securities.

The popularization of the investment company as a medium for investment in a diversified portfolio of securities, particularly common stocks, began only in the early 1920's. The American investment trusts in the 1920s differed from the British investment trusts by the fact that the latter took long-term positions in securities and did not actively trade their portfolios. At this time, investment companies were then promoted as a way for small investors to diversify their security holdings. The investment companies provided expertise in the management of the investors' funds. This investment medium was thought to provide investors with the opportunity of investing small amounts in a large number of securities, diversified according to undertaking, geographical location, and type of security.

During the 1920's the type of investment company which was almost exclusively organized was the closed-end management investment company with funds being raised through common and preferred stock offerings and bond issues. The American investment trusts of the 1920s were founded on the basis of return on capital rather than investment return. The Investment Bankers Association successfully advocated that the term "investment company" should be substituted for investment trust, to reflect that investment trusts were often speculative enterprises, with the latter term connoting a more conservative investment approach.

Regulatory efforts to deal with the speculative operations of investment companies were fitful at best and New York authorities warned that the investment trusts were being used to defraud investors. An attempt to adopt legislation in 1927 to regulate the investment trusts failed in New York. While California, Utah and other states did adopt some regulations, they had no effect on the growing number of investment companies.

The investment companies sold their shares to the public as a means to diversify their investments. The investment trusts however commonly acquired concentrated holdings in particular industries, thereby subjecting the investors to the very risk that they were attempting to avoid in a diversified portfolio. A New York deputy attorney general charged that investment companies were merely blind pools engaging in speculation since shareholders did not know what stocks management were selecting for investment. Many of the investment companies gave shareholders only a general description of their investment strategies.

There were many abuses of investment trusts by investment companies. Self-dealing was common and investment companies often changed their trading strategies without informing their shareholders. Sponsors of investment trusts retained warrants that allowed them to profit from the investment trust with no risk. The investment trusts were often used as a place to dump securities underwritten by their sponsors for investment banking clients. The investment trusts often raised funds through bond sales that gained leverage through buying stocks on margin, which was highly speculative for investors.

A burgeoning of investment trusts occurred in America before the Stock Market Crash of 1929. Approximately 140 investment companies were formed between 1921 and 1926. By 1924, over \$75 million had been invested in investment companies, up from less than \$15 million in the prior year. In 1925, investment trusts holdings doubled to \$150 million. A new investment company was being created every other day in 1928, with total assets of investment companies over \$1 billion. By 1929 investment companies were being created at the rate of almost one a day. The assets of investments companies rose to over \$3 billion in 1929.

Between those two years, the number of investment company shareholders increased from 55,000 to over 500,000. Almost all of these enterprises in the early 1920's were "closed-end" investment companies that invested in securities rather than producing a product or service. They operated like any other corporations in the distribution and sale of their securities and investors bought and sold shares in investment companies through a secondary market after the initial distribution of the shares.

Open-end mutual funds, which dominate the market today, were not created until 1924, but did not become significant before 1927. The first open-end mutual fund was the Massachusetts Investors Trust that was created by Edward G. Leffler in Boston. George Putnam formed another open-end fund, Incorporated Investors, in 1925. The State Street Investment Corporation, which was originally formed in 1924, became an open-end company in 1927.

Open-ended mutual funds allowed shareholders to have their shares redeemed at any time upon giving a specified notice with the redemption based on the net asset value (NAV) of the shares minus a charge. These mutual funds continually offered and redeemed their own shares. Owners of mutual funds purchased and sold their ownership interests from and to the mutual fund instead of a secondary trading market based on the NAV of the fund's shares as calculated at the end of the day on which a redemption or purchase order is received.

During the 1890s investment trusts were introduced into the United States¹⁴. Most of these early investment funds were closed-end funds, meaning issuing a fixed number of shares. The United Founders Corp. and the American Founders Corp. were the largest investment trusts operating in the 1920s¹⁵. This changed on March 21, 1924¹⁶. In 1928,

¹⁴ Rouwenhorst, 2004, p. 17.

¹⁵ The price of American Founders Corp. stock dropped from \$30 to 38 cents. The stock of the United Founders Corp. fell from a high of over \$75 to 25 cents a share. Goldman Sachs Trading Corporation, was trading at \$1.75 per share in 1932, down from a high of \$326. A Blue Ridge Corporation, experienced a drop in its share from a high of \$100 to 63 cents. Assets of the Kidder, Peabody investment companies declined in value from \$85 million to \$20 million.

¹⁶ IFIC, (2011). Trends in mutual fund investing, accessed at: http://www.ici.org/research/stats/trends/trends_03_11.

the MIT fund went public and later on became known as MFS Investment Management, when the Massachusetts Investors Trusts became the first U.S. mutual fund with an open-end capitalization¹⁷, meaning continuous issue and redemption of shares by the investment company at a price that is proportional to the value of the underlying investment portfolio. The original assets of \$50,000 grew to \$392,000 over the first year. In Canada, the first Canadian Investment Fund Ltd. (CIF) was established in 1932, it changed its name to Spectrum United Canadian Investment Fund in November 1996 and since August 2002 is known as CI Canadian Investment Fund¹⁸.

2.3 IMPORTANCE OF MUTUAL FUNDS IN NORTH AMERICA

There has been a significant growth in mutual fund industry in recent years. In 1982 the Canadian mutual fund industry consisted of an estimated 578,000 mutual fund accounts with an estimated \$4.1 billion of assets under management¹⁹. While in 2003, the industry had total assets under management of \$439 billion, with 1,887 mutual funds and 52.1 million accounts²⁰. There have been increased efforts by the Canadian and Ontario securities regulators to more effectively regulate the mutual fund industry during this growth.

¹⁷ Rouwenhorst, 2004, p. 17.

¹⁸ Investment Company Institute, (2011). The Investment Funds Institute of Canada. Accessed at <http://www.ific.ca>

¹⁹ Johnston, D. and K.D.Rockwell, (2003). *Canadian Securities Regulation*. LexisNexis Inc., 3rd Ed., Canada, p. 292.

²⁰ Investment Company Institute Website, accessed at: <<http://www.ific.ca/eng/frames.asp?11=Statistics>>

Mutual fund sales grew strongly in Canada in the 1990s correlated to a decrease in interest rates. During the time from December 1990 to December 2001 the assets under management grew from \$25 billion to \$426 billion, an increase of 1,700 percent²¹, and by the end of 2009 had grown to approximately \$600 billion. At that time, these assets were managed in about 1,800 different mutual funds held in more than 50 million unit holder accounts.²² In the U.S., as of December 2010, the total net assets of mutual funds were US\$ 11,820.7 billion²³.

The number of mutual funds in the U.S. grew from less than 600 funds to more than 8100 funds between 1980 and 2006²⁴. During this time the assets managed by mutual funds in the U.S. expanded from \$135 billion to more than \$10.5 trillion²⁵. During the last 25 years mutual funds have achieved acceptance as a means of investing in securities, including funding for retirement. In 2006 mutual fund shares were held by nearly half of all U.S. households and mutual funds held almost one-fourth of all the total financial assets in U.S. households. Governance of mutual fund companies and regulation of the mutual fund industry is important given that a large number of North American population relies on mutual funds for investment in securities. Should their confidence in mutual funds be negatively impacted, this could result in negative impacts

²¹ Investment Company Institute, Ibid., 2011.

²² Ibid.

²³ Investment Company Institute, (2012). *Investment Company Factbook*, accessed at: www.ici.org/pdf/2012-factbook.pdf

²⁴ Investment Company Institute, (2007). *Investment Company Factbook*, 93 (47th ed. 2007), accessed at: <http://www.icifactbook.org>

²⁵ Ibid.

through the reduction in investment in securities and associated impacts within financial capital markets.

As of the end of 2007, U.S. mutual funds held USD \$12 trillion in assets²⁶ and 24% of all outstanding equity of U.S. public companies²⁷. Investors have a great number of funds to choose from, totalling 8,752 funds as of the end of 2007²⁸. Although no single fund family dominates the mutual fund market, the five largest fund families controlled 38% of the industry's total assets²⁹. Some fund families, such as Fidelity Investments and the Vanguard Group, offered more than a hundred funds³⁰.

Ownership of mutual funds is widespread. Of the 116 million households in the United States, almost 51 million (or 44%) own mutual funds, far more than hold individual stocks and bonds³¹. Also, most households that own mutual funds have moderate income and wealth. The median household income of mutual fund investors is USD\$74,000³². Two-thirds of households that own mutual funds have incomes of less

²⁶ Investment Company Institute, (2008). *Investment Company Factbook*, accessed at: http://www.icifactbook.org/pdf/2008_factbook.pdf

²⁷ Ibid. at 11, fig.1.4.

²⁸ Ibid. at 15, fig.1.8.

²⁹ Ibid. at 21, fig.2.2.

³⁰ Vanguard Funds Overview, accessed at <https://personal.vanguard.com/us/FundsStocksOverview?Entry=Homeoffer01> (listing of current Vanguard funds); All Fidelity Funds Daily Pricing, <http://personal.fidelity.com/products/funds/framesets/daily-prices-frame.shtml?refpr=zffdfp03> (last visited Dec. 3, 2008) (listing current Fidelity funds):

³¹ Investment Company Institute, *ICI Research Fundamentals: Trends In Ownership Of Mutual Funds In The United States* 2 fig.1 (Nov. 2007), accessed at: <http://www.ici.org/pdf/fm-v16n5.pdf>.

³² Investment Company Institute, *Profile of Mutual Fund Shareholders*, 6 fig.1.3 (Spring 2008), accessed at: <http://www.ici.org/stats/res/rptprofile08.pdf>.

than \$100,000, and 26% have incomes below USD \$50,000³³. In addition, fund-owning households have median total financial assets of only USD \$175,000 and a median of USD \$100,000 invested in mutual funds³⁴.

Mutual fund ownership has become widespread largely because mutual funds have become a primary way that Americans save for retirement. Employers have increasingly switched from providing traditional pension plans, with defined benefit plans, to providing defined-contribution retirement plans, such as 401(k) plans. In defined-contribution plans, employers may make contributions to their employees' retirement accounts, but the employees themselves choose how to invest these contributions³⁵. Typically, mutual funds are among the investment options available to the employees.

As of March 2008, U.S. retirement assets totaled USD \$17.1 trillion³⁶ constituting 38% of all household financial assets in the U.S.³⁷. About USD \$4.3 trillion (25%) of retirement assets were in defined-contribution plans³⁸, and about half of the assets in these plans (USD \$2.2 trillion) were invested in mutual funds³⁹. In contrast, in 1992, only

³³ Ibid.

³⁴ Investment Company Institute, 2008 *Factbook*, supra note 26, at 71, fig.6.2.

³⁵ Lowenstein, R., The end of pensions?, N.Y. Times. (Oct. 30, 2005), at Sec.6.

³⁶ Investment Company Institute, (2008). *Research fundamentals: The U.S. retirement market, first quarter* at 2, fig.1 accessed at: <http://www.ici.org/pdf/retmrkt-update.pdf>

³⁷ Ibid., p.3, fig. 2.

³⁸ Ibid., p. 11, fig. A1.

³⁹ Ibid., p. 23, fig. A15.

USD \$184 billion of assets in defined-contribution plans were invested in mutual funds⁴⁰. In other words, defined-contribution plans' assets invested in mutual funds have increased almost twelve-fold, growing almost 18% annually, over fifteen years.

Mutual fund assets in Individual Retirement Accounts (IRAs) have experienced similar growth. As of March 2008, IRAs constituted an estimated USD \$4.5 trillion, or 27%, of all retirement assets⁴¹. Nearly half of IRA assets (USD \$2.1 trillion) were invested in mutual funds⁴². By comparison, in 1992, only USD \$233 billion of IRA assets were invested in mutual funds⁴³. In other words, mutual fund assets invested in IRAs have increased nine-fold, growing almost 16% annually, over the last fifteen years⁴⁴. Primarily as a result of the rapid growth of mutual fund investments in defined-contribution plans and IRAs, mutual funds' total share of retirement assets increased from 8% at the end of 1992 to 25% in March 2008⁴⁵. Mutual funds now constitute a quarter of America's retirement savings.

Although in 2008 the greatest portion of mutual fund assets (44%) were held in

⁴⁰ Ibid.

⁴¹ Ibid., p.11, fig. A1.

⁴² Ibid., at 12, fig. A2.

⁴³ Ibid.

⁴⁴ A significant portion of IRAs originate in employer-sponsored retirement plans that are "rolled over" into IRAs when the employee leaves an employer. For example, in 2004-the most recent year for which data is available-traditional IRAs received approximately \$214.9 billion in rollovers but only \$12.6 billion in other contributions. Ibid. at 6 fig.7.

⁴⁵ Ibid., p.11-13, fig. A1-A3. In addition to being in defined-contribution plans and IRAs, retirement assets are in annuities, government pension plans, and private defined benefit plans (private pension plans). Ibid., at 2 fig. 1.

tax-deferred retirement accounts, such as IRAs and defined-contribution plans, most mutual fund assets are held elsewhere⁴⁶. Other mutual fund assets were in taxable accounts held by households (37%), taxable accounts held by non-households (12%), and tax-exempt funds (7%)⁴⁷. Investors, however, undoubtedly consider some of these other mutual fund assets as retirement savings too. Limits on the amount investors can contribute annually to tax-deferred accounts mean that some retirement savings are invested outside of tax-deferred accounts⁴⁸.

Half of mutual fund holdings in 2008 were in equity funds, with most of the rest divided between money market funds (29%) and bond funds (15%)⁴⁹. Equities tend to have higher returns in the long run, but greater risk in the short run, than bonds and money market securities⁵⁰. Lifecycle funds, a relatively new segment of private retirement savings, allow investors to delegate asset allocation decisions to the fund manager. A lifecycle fund blends particular asset types (such as stocks and bonds) to match investors' risk tolerance and investment horizon, shifting the fund's asset mix over time in light of the investors' retirement target date. Although growing by 61% from the end of 2006 to USD \$185 billion as of March 2008, these funds still constituted only

⁴⁶ Investment Company Institute, *2008 Factbook*, supra note 26, at 23, fig.2.4.

⁴⁷ Ibid.

⁴⁸ For example, in 2007, most people were permitted to contribute no more than \$15,500 each year to defined-contribution plans and \$5,000 to an IRA. Internal Revenue Serv., Publication 525: Taxable and Nontaxable INCOME 8 (2007), available at <http://www.irs.gov/pub/irs-pdf/p525.pdf>; Internal Revenue Serv., Publication 590: Individual Retirement Accounts 11, 59 (2007), available at <http://www.irs.gov/pub/irs-pdf/p590.pdf>

⁴⁹ ICI Statistics & Research, *Trends in Mutual Fund Investing* (June 2008), http://www.ici.org/stats/mf/arctrends/trends_06_08.html

⁵⁰ Siegel, J.J., (2008). *Stocks for the Long Run*, 12-18, 24-27 (4th ed. 2008).

approximately 1% of retirement assets⁵¹.

Mutual funds enjoy wide acceptance by investors as they provide their shareholders with the service to diversify investment risk, to manage investments professionally, and are redeemable securities. In summary, the North America population relies upon mutual funds. Ownership of mutual funds has become widespread, with almost half of American households owning them. These funds constitute a significant portion of the retirement system. As a result, understanding fund investors' characteristics, especially their knowledge, financial sophistication, and how they choose among mutual funds, is essential to understanding and safeguarding this system.

While the total assets of mutual funds show a steady increase over time, management and operating expenses of these funds changed considerably over time. Initially, trustees who managed the funds were paid by a minor portion of the income the trust generated⁵², and if the fund did not produce any income, then there were no fees⁵³. Soon the initial 6 percent compensation was reduced to 5 percent of the income and further down to 3.35 percent in the 1940s⁵⁴. This was further reduced to 0.4 percent in 1949 and by the 1960s the annual expense ratio had dropped to 0.19 percent of net assets⁵⁵. Today the expense ratio is mostly more than 2 percent⁵⁶ of net assets. The annual

⁵¹ ICI, Research Fundamentals, supra note 36 p. at 10 fig.13 & 11 fig. A1.

⁵² Lowenstein, L., (2008). *The Investor's Dilemma: How Mutual Funds are Betraying Your Trust and What To Do About It*, Wiley, New Jersey, United States, 250p., p.13.

⁵³ Ibid.

⁵⁴ Ibid.

⁵⁵ Ibid.

expense ratio reflects expenses paid by investors to advisors and managers no matter how well or poorly the fund performs. Hence, the question arises whether the investors are receiving the benefits of increased total assets while paying higher fees.

In Canada, mutual funds are an important investment vehicle with current (August 2012) total assets under management (AUM) of \$811.7 billion, accounting for 30% of Canadian's financial wealth⁵⁷. In 2012 net sales were \$26.6 billion and in August 2012 the net sales were \$2.29 billion representing an increase from August 2011 of \$33.1 billion or 4.3%. The Canadian mutual fund industry currently employs more than 90,000 workers⁵⁸. Since the mutual fund industry is so important to Canada, for investors and for the economy, I conclude that it is important that the Canadian securities regulations provide adequate investor protection through a regulatory regime that contributes to the continued growth of the industry.

When mutual funds were initiated in North America, they were characterized by low management expenses and management fees. The growth of the mutual fund industry, discussed in the subsequent section, was accompanied by an increase in management fees and expenses. It would be expected that the fees and expenses ratios would not continually increase due to economies of scale in managing increased assets.

⁵⁶ Ibid.

⁵⁷ IFIC, *Industry Overview*, August, 2012, accessed at: [www: http://www.ific.ca](http://www.ific.ca)

⁵⁸ IFIC, *Our Industry*, accessed at: <https://www.ific.ca/Content/Content.aspx?id=152>

2.4 GLOBAL CONTEXT OF MUTUAL FUND INDUSTRY

There has been a rapid growth of the global mutual fund industry over the past few decades. The mutual fund industry is among the most successful recent financial developments, with the median national fund industry being only 22 years in age. In total, mutual funds holds assets worth \$11.7 trillion or 13.8 percent of the estimate of the “primary securities” that funds can hold. Despite this growth in the fund industry globally, academic studies of mutual funds have been restricted to a relatively small number of countries for example; almost all the research has focused on the US, with the exception of a few studies of national fund markets⁵⁹. U.S. funds comprise only 15 percent of the number of funds available globally and 60 percent of the world’s fund assets in 2001⁶⁰. The nation which has the second largest fund industry in terms of fund assets is Luxembourg with 6.5 percent of world mutual fund assets. France and Korea offer the second largest number of mutual funds available worldwide which each account for 13% of the world total.

In most countries, there is a recognizable “mutual fund” style of intermediation characterized by a transparent investment vehicle with identifiable assets with the value of the fund marked-to-market on a regular (usually daily) basis and reflected in the NAV of the fund, and with new shares created or redeemed upon demand. In some countries, the industry is a significant component of the national economic landscape, but in others,

⁵⁹ Khorana, A., H. Servaes, & P. Tufano, (2005). Explaining the size of the mutual fund industry around the world, *Journal of Financial Economics*, 78, 145-185. See also, for example, Bams and Otten (2002), Blake and Timmermann (1998), Brown, Goetzmann, et al. (2001), Cai, Chan, and Yamada (1997), Dahlquist, Engstrom, and Soderlind (2000), and Dermine and Roller (1992).

⁶⁰ Investment Company Institute, *2001 Mutual Fund Factbook*, pp. 100, 101., accessed at: www.ici.org

it is a more recent innovation. In some countries, the industry is over a century old but in other countries, it is small or nonexistent. The age of a nation's fund industry, however, is unlikely to explain why this type of financial intermediation has captured a larger share of the nation's primary assets in some countries than in others considering the recent rapid growth of the industry.

There are different types of hypotheses to explain the difference in the financial development of mutual funds. One set of hypotheses, in the literature on law and economics, suggests that laws and regulations can generally explain differences in the pace of financial development. Applying this logic to the fund industry, it would be expected that the fund industry would prosper when laws and regulations make this sort of investment attractive to investors, for example by protecting investor rights. "Supply-side" hypotheses focus on competitive dynamics to explain different adoption rates, for example, a concentrated banking sector could plausibly encourage or discourage the formation of a strong fund industry. "Demand-side" hypotheses focus on characteristics of the potential buyers of mutual funds in terms of, for example, their degree of wealth and education, to account for these differences. It might be expected that more economically prosperous and sophisticated economies would be ones where the innovation would be adopted more quickly relative to the older forms of investing. The characteristics of the country's securities trading environment may also be relevant, since the production technology available to fund promoters can influence the attractiveness of the ultimate investment vehicle.

Khorana et al ⁶¹ studied a combination of fundamental economic and regulatory factors to explain where this innovation has flourished. The authors collected data for 56 nations and measured the size of each country's mutual fund industry relative to the country's assets in "primary" domestic securities which includes equities, bonds, and bank loans. The size of national fund industry assets relative to each country's GDP and population is also reported. Equity and bond funds were measured separately from the industry as a whole, since certain hypotheses apply only to one of the two subsectors. The authors then analyzed the cross sectional differences in the size of national fund industries in 2001, as well as the size and growth of national industries over a five year window from 1996 to 2001.

The mutual fund industry held 17% of the nation's primary financial assets, on average, with a median of 4% for the countries in their sample. Khorana et al indicated that this large difference between the mean and median is largely driven by two national "outliers"; the so-called "offshore" fund industries in Luxembourg and Ireland hold assets that are 484% and 82% of their country's primary assets⁶². The inclusion of these countries in analyses can produce misleading results, and hence, they analyzed the drivers of the fund industry for the remainder of the countries and separately discuss the factors driving the growth of the two offshore locations.

⁶¹ Khorana, Servaes & Tufano, *supra* note 59.

⁶² The term "offshore" is loosely used in practice to describe financial centers which domicile fund complexes and sell funds in other countries. Some of these are indeed physically "off-shore" such as Bermuda, Cayman Islands, Guernsey and Jersey.

Laws and regulation for “on-shore” industries were found by Khorana et al to be related to a more robust mutual fund sector, one that controls a larger fraction of the nation’s primary securities. The authors found that, in general, countries with nations with more stringent regulatory approval and disclosure requirements for funds tend to have a larger fund industry which suggests that stronger regulation that specifically protects fund investors may be beneficial to the fund industry⁶³. The authors further found that for equity funds, the enforcement of insider trading rules has an adverse effect on the size of the mutual fund industry. They suggest that this is consistent with the view that failure to enforce these rules discourages investors from purchasing equities directly and encourages them to rely on professional intermediaries like funds.

In the context of supply-side factors, Khorana et al evaluate characteristics of the financial sector that would influence the speed of adoption of mutual funds and examine the effect of bank concentration, restrictions placed on banks to enter the securities business, the number of distribution channels available for funds, the presence of an explicit deposit insurance system for banks and the time and cost to set up a new fund⁶⁴. The authors found that nations that restrict banks from entering the securities business have smaller equity fund sectors, while countries with a more concentrated banking industry have smaller bond fund sectors, while countries where barriers to entry are higher have smaller fund industries; in particular, the costs required to set up a new fund are negatively related to industry size.

⁶³ Ibid.

⁶⁴ Ibid.

In the context of demand-side factors, Khorana et al⁶⁵ found that wealthier countries, measured by GDP per capita, and countries with a more educated population have larger mutual fund industries, which is particularly pronounced for the equity funds, and may require a higher level of investor sophistication. The age of the national fund industry is also positively related to its size and recent growth rate. Mutual funds also hold more national assets in countries where a larger fraction of pension plans are defined contribution plans. Internet penetration is also positively related to the size of the mutual fund sector. The authors suggest that these results in combination indicate that mutual funds thrive in more developed economies⁶⁶.

The ability of Khorana et al to draw sharp conclusions that distinguish among these various hypotheses is hampered by the high correlation among a number of the independent variables in their sample. For example, the correlation of GDP per capita with education levels and judicial systems quality are .62 and .89, respectively. These authors suggested that it appears that the fund industry is stronger in countries that are more economically developed (as measured by variables such as education and per capita GDP) and have stronger legal systems.

I note that Canada is one of the wealthier countries in the study, with a more educated population and a large mutual fund industry. It also has a well developed equity

⁶⁵ Ibid.

⁶⁶ Ibid.

fund market which suggests the need for a higher level of investor sophistication to understand the investment options as noted above.

2.5 GLOBAL FUND INDUSTRY

The 2005 study by Khorana et al⁶⁷ provides background on the mutual fund industry worldwide. Mutual funds are open-end pooled investment vehicles that invest in transferable securities that are bought and redeemed at the fund's NAV and are available globally. The two major forms of mutual funds are U.S. open-end funds and European Undertakings for Collective Investments in Transferable Securities (UCITS). The term "mutual fund" in this discussion excludes other investment products such as hedge funds, closed-end funds, trusts, and exchange traded funds. Many funds have fund classes, with varied management fees, expense ratios, or loads; for example classes differ in the U.S. based on the mix of upfront, on-going, and back-end distribution charges. The basic unit of observation is therefore a fund class.

The nationality of a fund class is associated with the fund's *domicile* which represents the country in which the fund is legally organized. The only funds registered for sale in a closed fund economy, such as the United States or Canada, are those that are domiciled in the country. In Europe, however, it is very common for a fund to be domiciled in one country, but offered for sale in other countries as well. Many funds are domiciled in offshore fund markets, but then offered for sale in six or several countries.

⁶⁷ Khorana, Servaes & Tufano, *supra* note 59.

Any fund has a single country of domicile, but may have multiple countries of sale or registration.

At the end of 2001, the worldwide mutual fund industry held \$11.7 trillion in assets⁶⁸. The \$11.7 trillion of world fund assets were held in 55,026 open-end funds, with a median number of 285 funds per country⁶⁹. The U.S. had the largest fund industry with respect to the share of assets held, and was also the largest with respect to the number of mutual funds with 8,307 funds at the end of 2001. France and Korea were second and third with 7,144 and 7,117 funds respectively. There were over 55,000 different financial products in this industry⁷⁰.

Over the period from 1996 to 2001, the ratio of fund industry size to GDP⁷¹ increased by 7.9 percentage points on average with a Canadian median of 5.1 percentage points. The countries' fund industries have grown at different rates⁷². The slowest growth over the 1996-2001 period, being -0.9 percentage points, was in Japan and the fastest was 26.6 percentage points in South Korea⁷³. The total size of the equity mutual fund industry is similar to that of the bond industry (including money market funds)⁷⁴. At the end of 2001, worldwide equity and bond fund assets stood at \$5,925 billion and

⁶⁸ Khorana, Servaes & Tufano, (2005). *supra* note 59.

⁶⁹ *Ibid.*

⁷⁰ *Ibid.*

⁷¹ Khorana, Servaes & Tufano, (2005). *supra* note 59.

⁷² *Ibid.*

⁷³ *Ibid.*

⁷⁴ *Ibid.*

\$5,415 billion respectively, with median country assets of \$8.9 billion and \$13.7 billion across the two sectors⁷⁵.

The countries with the largest portfolio of the industry in 2001 were the U.S. (60 percent), Luxembourg (6.5 percent) France (6.1 percent), Italy (3.1 percent) and Japan (2.9 percent). Countries with very small fund industries include Bangladesh, Romania, and Sri Lanka. In addition, Khorana et al⁷⁶ identified five countries with no fund sector: Algeria, Burma, Libya, United Arab Emirates and Yugoslavia. Median assets under management as a function of the country's GDP are 9 percent with a high of 3991 percent for Luxembourg, followed by Ireland with 186 percent and a low of 0.011 percent for Bangladesh (after excluding the countries with zero mutual fund assets)⁷⁷.

With respect to assets, Canada had a median GDP of 38 percent under management relative to the global level of primary securities. The fund industry held 4 percent of all primary securities in the median country, with Luxembourg once again at the high end with 485 percent, followed by Ireland with 82 percent⁷⁸. The average mutual fund asset per capita was \$31,890. Median equity mutual fund assets (including balanced fund assets, stand at 11 percent (mean is 56 percent), as a percentage of the total domestic equity market capitalization of the host country. Bond and money market funds accounted for 6 percent of the domiciled country's primary fixed income investments in

⁷⁵ Ibid.

⁷⁶ Ibid.

⁷⁷ Ibid.

⁷⁸ Ibid.

the median country (mean of 17 percent). This suggests that funds have been more successful worldwide in capturing a share of equity assets than of bond assets.

Favorable banking and tax laws have led to a transformation of Luxembourg into a major center for offshore mutual funds. This growth was partly fueled in 1992 when the German government began to levy a 25% withholding tax on interest on investment assets and bank deposits which led to a movement of capital to Luxembourg-based fund management subsidiaries of German banks. The status of Luxembourg as a tax haven has been further augmented by the country's strict bank secrecy laws, which are one of the strictest in Europe. According to Khorana et al⁷⁹ the success of Ireland has been driven by the establishment of an International Financial Services Center (IFSC) in Dublin which provided significant incentives to fund operators in the form of a reduced tax of 10 percent on income earned for specific types of servicing and financing operations. The harmonization of regulations permitting funds to be sold throughout Europe facilitated the growth of these centralized hubs as well as access to skilled workforces to administer fund operations.

The results of the Khorana et al⁸⁰ study corroborate the findings from the law and economics literature that countries' rules and norms affect financial development. Strong legal and regulatory factors in particular were found to have a positive impact on the size of the mutual fund industry, especially fund industry regulations addressing the process

⁷⁹ Ibid.

⁸⁰ Ibid.

approving fund starts, mandating fee and performance disclosures, and handling conflicts of interest between the fund management company and fund shareholders. The findings also indicate that countries that more vigilantly protect fund shareholders' interests have larger industries. The study results further indicate that while protecting mutual fund investors helps the industry, protecting individual equity investors apparently does not help the fund industry. The failure to enforce insider trading laws was found to have a positive effect on the size of the equity fund industry, which the authors suggest is perhaps because fund investors are less confident of trading on their own against better-informed insiders.

The authors conclude that it appears that mutual funds are "advanced" financial products, in that they flourish in more developed economies; for example, the fund industry is larger where per capita GDP is higher. Investor wealth and education have a positive impact on fund industry size at least for equity funds. In addition, fund size increases with time, related to the age of the fund industry in the countries. The results further indicate that the fund sector is larger in countries where a greater proportion of pension funds are of the defined contribution type. The fund sector is smaller when it requires greater effort to set up a fund, measured by dollars or time. The equity fund sector was also noted to be smaller in countries where banks are restricted from entering the fund management business.

The results of this study are particularly pertinent to Canada as countries that more vigilantly protect fund shareholders interests have larger fund industries. This

implies that to achieve growth in Canada's mutual fund industry, mutual fund governance should focus upon investor protection. The study indicates that the areas that contribute to this are especially industry regulations that address approving fund starts, mandating fee and performance disclosure and dealing with conflicts of interests between the fund management company and fund shareholders.

2.6 MUTUAL FUND PERFORMANCE

Close authored one of the first academic articles on mutual funds⁸¹. He examined data on assets under management from 1940 to 1950 and found that closed-end funds were surpassed by open-end funds by the end of 1943 and that open-end funds had three times the assets of closed-end funds by the end of 1950. Close examined the structural differences between open-end and closed-end to account for the rapid growth of open-end funds in comparison to closed-end funds. He argued that the high growth in open-end funds was related primarily to the sale effort associated with these funds which well compensated through loads. Close analyzed the actual performance of sample of open-end and closed-end funds and found that from January 1937 to December 1946, the main net asset value returns earned by closed-end fund managers exceeded those of open-end fund managers.

⁸¹ Close, J., (1952). Investment companies: closed-end versus open-end, *Harvard Business Review*, 29, 79-88.

Brown and Vickers⁸² evaluated the rates of portfolio turnover, the measurement of performance results and the impact of trading activity in the mutual fund market from 1953 to 1958. The main conclusion of Brown and Vickers is that fund portfolio turnover ratio was not associated with variations in performance and that the fund portfolio activity influenced market prices. It should be recognized that while the turnover is not directly related to performance it does not mean that it does not detract from returns to investors through increased trading costs passed on as expenses.

An early evaluation of the performance of mutual funds utilizing portfolio theory was conducted by Sharpe.⁸³ The author reasons that there may be significant differences in fund returns given the selection of various priced securities, with different volatility and risk. Sharpe found considerable performance variability in a sample of 34 open-end mutual funds over a period from 1954 to 1963. He attributed this variability to being transitory, due to excessive expenditure by the funds, or differences in management skills.

Treynor and Mazury evaluated the expectation of investors that managers anticipate market movement through a test of the historical success of mutual funds in anticipating major moves in the market⁸⁴. The authors analyzed the rates of return for 57 funds from 1953 to 1962 to determine if the volatility of the funds is higher in years when

⁸² Brown, F. & D. Vickers, (1963). Mutual fund portfolio activity, performance and market impact. *The Journal of Finance*, 18, 377-391.

⁸³ Sharpe, W., (1966). Mutual fund performance, *The Journal of Business*, 39, 119-138.

⁸⁴ Treynor, J. & K. Mazury, (1966). Can mutual funds outguess the market? *Harvard Business Review*, 44, 31-136.

the market does well in comparison to years when the market does poorly. The authors conclude that no managers outguessed the market and that managers should not be held responsible for failing to see changes in market direction. The results of this case study also bring into question whether fund managers are justified in charging higher fees if they are not outperforming the market, an argument continuing to be put forward today.

Jensen completed the first study to measure the performance of mutual funds through a model that statistically measured fund performance in comparison to a benchmark⁸⁵. Jensen used mutual funds in the period from 1945-1964 and relative to returns on the S&P 500 index to represent the market. The analysis indicated that the funds on average earned 1.1% less than they should have earned relative to their level of systemic risk and that on average the mutual funds did not produce returns sufficient to offset their research expenses and management fees. Further, he found that there was little evidence that any fund in the sample did better than random chance. As such, at this early date of mutual fund development, there was an indication that high management fees were not justifiable on the basis of increased fund performance.

Carlson provided an assessment of mutual fund performance in the period from 1948-1967⁸⁶. The results of the study indicated that past performance has little predictive value for future performance and that net returns during the period were not influenced

⁸⁵ Jensen, M., (1968). The performance of mutual funds in the period 1945-1964, *The Journal of Finance*, 23, 389-4116.

⁸⁶ Carlson, P., (1970). Aggregate performance of mutual funds, 1948-1967, *Journal of Finance and Quantitative Analysis*.

by fund size or expense ratios, and that fund performance is positively related to availability of new cash resources, through fund flows, for investment. As such, the study findings do not support the notion that investors should pay more management fees to fund managers with high performing mutual funds since this is no prediction of future performance and there was no correlation between expense ratios and performance.

An evaluation of mutual fund performance for 123 mutual funds from 1960-1969 relative to objectives was conducted by McDonald⁸⁷. He found that the slope of the graphed performance line was not significantly different than the stock market line for the 10 year period. McDonald concludes that the sample data indicates that mutual funds do not perform significantly different overall than the market. This brings into question the actual value that investors receive from mutual fund managers with higher management fees and administrative expenses. It should be recognized that these conclusions were arrived early in the development of mutual fund regulations (e.g., pre-1980).

A study of mutual fund performance relative to benchmarks was conducted by Lehman and Modest⁸⁸. The authors analyzed the measurement of whether managers possess superior skills in stock selection and market timing. They concluded that the choice of a benchmark portfolio may significantly impact performance results and is a

⁸⁷ McDonald, J., (1974). Objectives and performance of mutual funds, 1960-1969, *Journal of Financial and Quantitative Analysis*, 311-333.

⁸⁸ Lehman, B., & D. Modest, (1987). Mutual fund performance evaluation: A comparison of benchmarks and benchmark comparisons, *The Journal of Finance*, 112, 233-265.

critical initial step in measuring the performance of a mutual fund. Accordingly, the determination of whether funds out perform market and whether this is due to the fund managers skills is a complex determination that is dependent upon the benchmark selected and may not be readily comprehensible by average investors.

In 1989, Grinblatt and Titman published an evaluation of mutual fund performance based on actual returns and gross portfolio returns, in comparison to previous studies which analyzed the actual returns to mutual fund investors⁸⁹. The results of this study include the finding that abnormal gross returns are inversely related to fund size resulting in actual net returns that are unrelated to asset value. The findings also indicate that on average actual returns do not show positive abnormal results while gross returns of both growth and aggressive growth funds are significant on average. The authors conclude that abnormal investor returns are eliminated, while superior performance may exist among growth funds, aggressive growth funds and smaller funds. These funds have the highest expenses which eliminate abnormal investor returns. As a result, investors are not able to benefit from the fund manager's skills by purchasing mutual funds in their portfolio.

In 1993, Grinblatt and Titman conducted additional analyses on the set of mutual funds used in their 1989 study with a new measure of portfolio performance⁹⁰. The

⁸⁹ Grinblatt, M. & S. Titman, (1989). Mutual fund performance: An analysis of quarterly portfolio holdings. *The Journal of Business*, 62, 393-416.

⁹⁰ Grinblatt, M. & S. Titman, (1993). Performance measurement without benchmarks: An examination of mutual fund returns. *The Journal of Business*, 66, 47-68.

authors found that performance measures are considerably different than those from the three benchmarks in their 1989 study. They concluded that abnormal performance can be seen in the aggressive growth category but that this does not mean that investors can achieve superior returns by investing in mutual funds because transaction costs and fund expenses dissipate abnormal positive investment returns.

The short-run persistence of mutual fund performance from 1974 – 1988 was evaluated by Hendricks et al for a sample of 165 no-load growth equity funds⁹¹. The authors found short-run performance persistence for four quarters followed by a reversal. The authors attributed these results to several possible reasons, including: superior managers being bid away once they build a track record; new funds flow to successful performers leading to a bloated organization with fewer good investment ideas per invested dollar; manager drive becoming diminished once their reputation is established; and, manager sensitivity being restricted to short term performance and salaries and fees rise in response to successes. Regardless of the net losses for the short-run performance, the study results do not support higher management fees for mutual fund managers on the basis of delivering superior sustained performance.

In contrast, the study by Goetzman and Ibbotson involving a “winner repeat” hypothesis found support for higher performing mutual funds repeating higher performance, based on data from 728 mutual funds from 1976-1988, considering one-

⁹¹ Hendricks, D., J. Patel, & R. Leckhauser, (1993). Hot hands in mutual funds: Short-run persistence of relative performance, 1974-1988, *The Journal of Finance*, 43, 93-130.

year, two-year and monthly gross and risk-adjusted returns⁹². A study by Makiel examined every diversified equity mutual fund sold to the public for the 1971-1991 period to evaluate their performance⁹³. He found that some persistence in mutual fund performance existed during the earlier decade (1971-1981) but this was not maintained during the second decade (1981-1991), suggesting that while persistence may have existed during the 1970's, many investors may not have benefited due to high load charges of up to 8% of asset value. He further found a strong significant negative relationship between a fund's total expense ratio and its net performance. Makiel concluded that funds have tended to under perform the market both before and after all reported expenses except for loads. The findings of Makiel's study therefore do not support the concept that investors pay more expenses to fund manager for superior returns, in fact the reserve appears to be true. Further this does not support the justification for fund managers charging higher management fees to its investors under the promise that they will receive higher returns.

An analysis of the persistence of mutual fund performance was conducted by Brown and Goetzman for the period 1976-1988⁹⁴. The results of the analysis indicate that 1,304 past winners was repeat winners; 1,237 past losers were repeat losers and 1936 funds reserve roles and therefore a majority of funds have persistent performance. The

⁹² Goetzman, W., & R. Ibbotson, (1994). Do winners repeat? Patterns in mutual fund behavior, *The Journal of Portfolio Management*, Winter, 9-18.

⁹³ Makeil, B., (1995). Returns from investing in equity mutual funds: 1971-1991, *The Journal of Finance*, 50, 549-572.

⁹⁴ Brown, S., & W. Goetzmann, (1995). Performance Persistence, *The Journal of Finance*, 50, 679-698.

authors indicated, however, that persistence was not found to be a result of a winning management style each year. The authors found that absolute repeat winners and repeat losers follow approximately the same trend as those of relative repeat winners and losers. The authors interpret the analytical results to indicate that performance persistence is more likely due to repeat losers than to repeat winners, and that poor performance is the strongest predictor of closure.

Kahn and Rudd analyze whether historical performance predicts future performance using a style analysis approach, which stratifies funds to analyze their performance relative to a set of style indices, in contrast to single index approach that was used in previous studies⁹⁵. The study results show no evidence of persistence among fixed-income funds. The authors conclude that investors need to consider information other than historical performance to select the funds for their investments. This supports the results of previous studies that utilized a single index model.

A study of performance of mutual fund in changing economic conditions and mutual fund strategy was conducted by Ferson and Schadt⁹⁶. The results indicate that risk exposure changes in response to publicly available information on the economy, based on a sample of 67 mutual funds from 1968-1990. According to Ferson and Schadt, traditional unconditional models of performance evaluation incorporate unexpected

⁹⁵ Kahn, R., & A. Rudd, (1995). Does historical performance predict future performance? *Financial Analyst's Journal*, 51, 43-52.

⁹⁶ Ferson, W., & R. Schadt, (1996). Measuring fund strategy and performance in changing economic conditions, *The Journal of Finance*, 51, 425-461.

returns in their models. If expected return risks vary over time, however, then this approach would likely be unreliable. Conditional models allow estimation of time varying systematic risk (betas), as managers of active portfolios are likely to shift their bets on the market to incorporate information concerning changing market conditions. The results of this model produce different performance evaluation results than traditional unconditional models. The study results illustrate the difficulty in estimating the performance of mutual funds and hence the related difficulties in assessing the performance of mutual fund managers. Without a reliable methodology for assessing mutual fund performance it is difficult to determine whether a manager's fees are appropriate.

Ferson and Warther⁹⁷, like Ferson and Schadt⁹⁸ put forward that the traditional unconditional model ignores common dependencies between mutual fund systemic risk (betas) and expected market returns. The author's study results show that funds do not routinely under perform the S&P 500 index on a risk-adjusted basis using conditional models, in contrast to the results using unconditional models. Instead, as would be expected in an efficient market the performance is neutral.

⁹⁷ Ferson, W., & V. Warther, (1996). Evaluating fund performance in a dynamic market, *Financial Analysis Journal*, 52, 20 – 28.

⁹⁸ Ibid.

Based on an analysis of 270 funds from 1985 – 1994, Gruber found that mutual funds underperformed the market by 1.94% per year⁹⁹. He found that for a single index model the underperformance was 1.56% per year and with a four index model the underperformance was 0.65% per year. All three of these approaches result in mutual funds underperforming the market. These calls into question the value of actively managed funds and whether managers are justified in charging high fees for funds that underperform the market.

A study by Cathart of fund performance persistence was conducted using 1,892 equity funds from 1962 - 1993¹⁰⁰. The study results indicate only slight evidence that any mutual fund managers beat the market and that most funds under perform by the amount of their expenses. These results raise the question of the justification for mutual fund managers charging higher expenses given that these expenses essentially subtract from performance resulting in the same or lower than market performance.

A study of mutual fund managers security – selection, market timing capabilities, and performance persistence prior to and after the 1987 crash was performed by Volkman¹⁰¹. The study results indicate that fund managers demonstrate significant perverse timing ability, with a negative correlation between fund's timing and selectivity

⁹⁹ Gruber, M., (1996). Another puzzle, the growth in actively managed mutual funds, *The Journal of Finance*, 51, 783 – 810.

¹⁰⁰ Carhart, M., (1997). On persistence in mutual fund performance, *The Journal of Finance*, 52, 57 – 82.

¹⁰¹ Volkman, D., (1999). Market volatility and perverse timing performance of mutual fund managers, *The Journal of Financial Research*, 22, 449 – 470.

performance, which suggests that managers focus on the one source of performance to the detriment of another source.

A study of the relationship between the probability of fund closure and their return performance was conducted by Lund et al using samples of 973 terminated funds and 1,402 surviving funds from U.K. open-ended funds (unit trusts) during the period from 1972-1995¹⁰². The authors found different reasons why funds were terminated such as: never reaching critical mass in market capitalization; merging a poorly performing fund with a similar, more successful fund in the same family; merging a poorly performing fund to improve family group performance overall. Accordingly, the relationship between termination and performance adds another level of complexity to the evaluation of the performance of mutual funds and mutual fund managers.

An assessment of the effects of fund size upon fund performance was completed by Indro et al¹⁰³. The authors noted that growth in assets can be beneficial since larger transaction volume lowers brokerage commission, and economies of scale can impact other costs such as data, research, and administrative expenses. Analysis of data from 683 funds from the period 1993 to 1995 shows that three year returns increase as fund size increases, with larger funds having lower expense ratios and lower turnovers. The authors concluded that there are diminishing marginal returns from increasing total assets

¹⁰² Lund, A., A. Timmerman, & D. Blake, (1999). The hazards of mutual fund underperformance: A cox regression analysis. *Journal of Empirical Finance*, 6, 121-152.

¹⁰³ Indro, D., C. Jiang, M. Hiu, & W. Lee, (1999). Mutual fund performance. Does size matter?, *Financial Analyst's Journal*, 55, 74-77.

under management. It is not clear how the costs were calculated that would allow a reliable estimated of returns relative to assets under management.

Warmer conducted a study to answer the simple question “Do mutual fund managers who actively trade stocks add value?”¹⁰⁴ The study results indicate that mutual funds on average hold stocks that outperform characteristic benchmarks by 71 basis points per year, which roughly equals the sum of the combined expenses and transaction costs. The results further indicate that funds select stocks that outperform common benchmark by 71 basis points per year, but the average net fund returns is lower than the CRSP index. Further, the author found that there to be a 2.3% difference between the returns of stock holdings relative to the net return, with approximately 7% attributable to lower average returns for the non stock holding component of the portfolio and the remaining 1.6% split between expense ratios and transaction costs. The study results also indicate that mutual funds with high turnovers have higher end transactions but also hold stocks with higher average returns compared to low turnover funds and a portion of the higher returns for the high turnover funds is due to the stock picking skills of the manager. The author concluded that overall actively managed funds outperform the Vanguard 500 index on a net return basis.

A number of studies have found that stock selection ability persists over periods as short as one year and that although funds generate on average negative abnormal

¹⁰⁴ Warmer, R. (2000). Mutual fund performance: An empirical decomposition into stock-picking talent, style, transactions costs, and expenses. *Journal of Finance*, 55, 1655-1695.

returns performance persists. Persistence studies include those by Hendricks, Patel and Zeckhauser¹⁰⁵, Goetzmann and Ibbotson¹⁰⁶, Brown and Goetzmann¹⁰⁷, Grinblatt, et al¹⁰⁸, Gruber¹⁰⁹, Carhart¹¹⁰, Daniel et al¹¹¹, Nofsinger and Sias¹¹² and Wermers¹¹³. While most of these articles attribute this persistence at least in part to fund manager skill, Grinblatt et al and Carhart, however, both attribute this to the effects of momentum. After including momentum in his model, Carhart found that persistence largely disappeared, except amongst the lowest performers, where it remains from persistently high expenses¹¹⁴.

Investors may use past performance as an expectation of future performance as one of the considerations in making their investment decisions¹¹⁵ and studies have examined the use of past performance as a criteria for selected mutual funds. Hendricks

¹⁰⁵ Hendricks, D., J. Patel, & R. Zeckhauser, (1993). Hot hands in mutual funds: Short term persistence of performance, 1974-1988. *Journal of Finance*, 48, 93-130.

¹⁰⁶ Goetzmann W., & R. Ibbotson, (1994). Do winners repeat? Patterns in mutual fund performance. *Journal of Portfolio Management*, 20, pp. 9-18.

¹⁰⁷ Brown S., & W. Goetzman, (1995). Performance persistence. *Journal of Finance*, 50, pp. 679-698.

¹⁰⁸ Grinblatt, M., S. Titman, & R. Werner, (1995). Momentum investing strategies, portfolio performance and herding: A study of mutual fund behaviour. *American Economic Review*, 85, pp. 1088-1105.

¹⁰⁹ Gruber, M., (1996). Another puzzle: The growth in activity managed mutual funds. *Journal of Finance*, 51, 873-810.

¹¹⁰ Carhart, M., (1997). On persistence in mutual fund performance. *Journal of Finance*, 52, pp. 57-82.

¹¹¹ Daniel, K., M. Grinblatt, S. Titman, & R. Werners, (1997). Measuring mutual fund performance with characteristic-based benchmarks. *Journal of Finance*, 52, pp. 1035-1058.

¹¹² Nofsinger J., & R. Sian, (1999). Herding and feedback trading by individual and institutional investors. *Journal of Finance*, 54, pp. 2263-2295.

¹¹³ Werners, R., (1999). Mutual fund holding and impact on stock prices. *Journal of Finance*, 54, pp. 581-622

¹¹⁴ Carhart, supra note 110.

¹¹⁵ Guetzman W.N., & R.G Ibbutson, (1994). Do winners repeat? Patterns in mutual behaviour. *The Journal of Portfolio Management*, 20, Winter 1994, pp. 9-18.

et al found that mutual funds which performed well continued to perform well in the near term¹¹⁶. Grinblatt and Titman found a positive persistence in mutual fund performance¹¹⁷.

Studies by Brown and Goetzman¹¹⁸ and Makiel¹¹⁹ provide evidence of performance persistence in mutual funds. However, it is widely acknowledged that the past performance is not a guarantee of future performance. Droms and Walker¹²⁰ found that load funds generally underperformed no-load funds on a risk-adjusted basis for the period 1985-1990. Grinblatt and Titman found a significant positive relationship between sales load and the performance of 279 equity mutual for the period 1975-1984¹²¹. Proponents of 12b-1 fees contend that payment of distribution fees to selling agents out of the fund's assets provide an incentive to brokers to sell these funds that may increase the performance of the fund due to growth and possible economies of scale. Studies by Ferris and Chance¹²² and McCleod and Malhotta¹²³ concluded that 12b-1

¹¹⁶ Hendricks, J. Patel, & R. Zelkehauser, (1993). Hot hand in mutual fund short-run persistence of relative persistence of relative performance 1974-1988. *The Journal of Finance*, 48(1), March 1993 pp. 93-130.

¹¹⁷ Grinblatt, M., & S. Titman, (1992). The persistence of mutual fund performance. *The Journal of Finance*, 47(5), December 1992, pp. 1977-1984.

¹¹⁸ Brown, S.J., & W.N. Goetzman, (1995). Performance persistence. *The Journal of Finance*, 50(2), June 1995, pp. 679-698

¹¹⁹ Makiel, B. G., (1995). Returns from investing in equity mutual funds. 1971-1991. *The Journal of Finance*, 50(2), June 1995, pp. 549-572.

¹²⁰ Droms, W.G., & D.A. Walker, (1994). Investment performance of international mutual funds. *The Journal of Financial Research*, 17(1), Spring 1994, pp. 1-14.

¹²¹ Grinblatt, M., & S. Titman, (1994). A study of monthly fund returns and performance evaluation techniques. *Journal of Financial and Quantitative Analysis*, 29(3), September 1994, pp. 419-444.

¹²² Ferris, S. P., & D. M. Chance, (1987). The effect of 12b-1 plans on mutual fund expense ratios: A note. *The Journal of Finance*, 42(4), September 1987.

¹²³ McCleod, R.W., & D.K. Malhotta, (1994). A re-examination of the effect of 12b-1 plans on mutual fund expense ratio. *The Journal of Financial Research*, 17(2), Summer 1994, pp. 231-240.

charges are deadweight costs to shareholders and do not add any economic value to the fund. Ippolito found that funds with higher expense ratios earn sufficiently high enough rates of return to warrant the higher charges¹²⁴. Apap and Griffin examined the impact of sales charges 12b-1 fees and expense ratios on equity mutual fund performance¹²⁵. The authors found no significant relationship between sales charges and abnormal or total returns, and did not support the findings of Droms and Walker¹²⁶ who found that load funds generally underperform no load funds, or Grinblatt and Titman¹²⁷ who found that a significant positive relationship exists between sales charges and performance. Apap and Griffin concluded that the results of their study add evidence to the growing body of evidence that sales charges will not enhance investor performance.

Bollen and Bussen conducted a comprehensive analysis of short-term persistence in mutual fund performance based on daily returns of 230 mutual funds¹²⁸. The authors concluded that “superior performance is a short-lived phenomenon that is observable only when funds are evaluated several times a year”¹²⁹. Bollen and Bussen further concluded that “Although our findings are statistically significant, and are robust to a battery of diagnostic tests, the economic significance of persistence in abnormal returns is

¹²⁴ Ippolito, R.A., (1989). Efficiency with costly information: A study of mutual fund performance 1965-1984. *The Quarterly Journal of Economics*, 104(1), February 1989, pp. 1-23.

¹²⁵ Apap, A., & J.M. Griffin, (1998). The impact of expenses on equity mutual fund performance. *Journal of Financial Planning*, 11, February 1998, pp. 76-81.

¹²⁶ Ibid.

¹²⁷ Ibid.

¹²⁸ Bollen, N.P.B., & J.A. Bussen, (2004). Short-term persistence in mutual fund performance. *The Review of Financial Studies*, 18(2), pp. 569-597.

¹²⁹ Ibid.

questionable. After taking into account transaction costs and taxes investors may generate superior returns by following a naïve buy and hold approach rather than a performance-chasing strategy, even if short-term persistence is predictable.”¹³⁰

Kosowski et al evaluate the performance of the United States mutual fund industry during the 1975 to 2002 period to determine if there is evidence for the performance persistence of superior managers¹³¹. The authors’ findings provide an indication that the performance of the best and worst managers is not due solely to luck and that there is some limited degree of persistence among growth-oriented funds but not among income-oriented funds. The authors did not provide a comparison of performance versus fees. Therefore, there is no indication as to whether investors are paying high fees for these mutual funds that had strong performance or those with weak performance. Accordingly, there is no indication as to whether investors are paying high fees for performance or non-performance.

Ianotta and Navone conducted an analysis of the factors affecting the cross-section of mutual fund fee dispersion¹³². Carthart¹³³ had previously shown that the performance of U.S. equity mutual funds shows that their price dispersion is not explained by the ex-post performance of the portfolio. He showed that differences in

¹³⁰ Ibid., p. 595

¹³¹ Kosowski, R., A. Timmerman, R. Wermers, & H. White, (2006). Can mutual fund “stars” really pick stocks? New evidence from a bootstrap analysis. *The Journal of Finance*, LXI(6), December 2006, 2551-2595.

¹³² Ianotta, G., & M. Navone, (2012). The cross-section of mutual fund fee dispersion. *Journal of Banking and Finance* 36, pp. 846 – 856.

¹³³ Carthart, *supra* note 100.

expenses explain most of the variation in after-expense performance, suggesting that there is no positive relationship between the expense ratio and the gross performance of the portfolio. Gil-Bazo and Ruiz-Verdu' show a negative relationship between gross performance and expenses¹³⁴.

Hortaçsu and Syverson found that for a large sample of growth and income funds the correlation between fees and performance is not significantly different from zero¹³⁵. Fund managers with greater stock selection ability should be able to charge more for their services¹³⁶. If mutual fund managers have different investment abilities then some degree of fee dispersion would be expected¹³⁷. Also, economic theory suggests that heterogeneity of clienteles and production functions can generate price dispersion¹³⁸. Price dispersion may occur when agents differ in their ability to make economical decisions in the market place¹³⁹. A study by Stahl analyzed investors with different degrees of ability to search among sellers for better prices and determined that when

¹³⁴ Gil-Bazo, J., & P. Ruiz-Verdu', (2009). The relation between price and performance in the mutual fund industry. *Journal of Finance*, 64(5), pp. 2153 – 2183.

¹³⁵ Hortaçsu, A., & C. Syverson, (2004). Product differentiations, search costs, and competition in the mutual fund industry: A case study of S & P 500 index funds. *Quarterly Journal of Economics*, 119, C27, 403 – 456.

¹³⁶ Chevalier, J., & G. Ellison, (1999). Are some mutual fund managers better than others? Cross-sectional patterns in behavior and performance. *Journal of Finance*, 54(3), pp. 875 – 899.

¹³⁷ Gil-Bazo, J., & P. Ruiz-Verdu', supra note 134.

¹³⁸ Salop S., Iannotta & Navone, supra note 132.

¹³⁹ Salop, S., & J. Stiglitz, (1977). Bargains and ripoffs: A model of monopolistically competitive price dispersion. *Review of Economics Studies*, 44(3), 493 – 510.

buyers are assumed to be identical, price dispersion can arise from heterogeneity among producers¹⁴⁰.

Price dispersion can exist when firms have marginal heterogeneous marginal costs. Iannotta and Navone¹⁴¹ evaluate the effects of price dispersion in the mutual fund industry as a function of variables that are commonly used to explain the price of investment services. Past performance is used to proxy the ability of a fund manager, a likely source of heterogeneity among funds. Fund fees, however, should reflect investors' expectations with respect to future performance. For example, if an investor believes that a fund manager is particularly good, then they may be willing to pay a higher fee. Investors often make an assessment of fund managerial ability based on past performance of mutual funds¹⁴². Iannotta and Navone concluded that fee dispersion in the mutual funds is related to heterogeneity of products such as past performance and other characteristics of the fund. The authors further found that fee dispersion decreases with fund size and age as well as the amount of assets under management of the investment company, and is lower for funds that charge marketing and distribution fees. The authors concluded that the study results are consistent with the premise that search costs can generate fee dispersion.

¹⁴⁰ Stahl, D, (1989). Oligopolistic pricing with sequential consumer search. *American Economic Review* 79(4), pp. 700–712.

¹⁴¹ Iannotta and Navone, supra note 132.

¹⁴² Berk, J., & R. Green, (2004). Mutual fund flows and performance in rational markets. *Journal of Political Economy* 112(6), pp. 1269 – 1295; Huang, J., K. Wei & H. Yan, (2007). Participation costs and the sensitivity of fund flows to past performance. *Journal of Finance*, 62(3), pp. 1273 – 1311.

Tufano and Sevick evaluated the relationship of the fees charged to shareholders and board structure in the United States mutual fund industry¹⁴³. This study involved a database of the independent directors of the funds offered by the 50 fund sponsors with the largest assets at the end of 1992, which offered 1,587 open-end mutual funds and accounting for 69% of all U.S. open-end mutual fund assets and 37% of all open-end mutual funds available at that time¹⁴⁴. The authors interpreted the study results to provide evidence of economies of scale at the fund level with fees inversely related to fund size. There is a positive relationship evident in the study between fund age and fees, suggesting that funds with greater experience charge higher fees. There is little evidence in the study results that the fund fees are related to fund performance over the prior twelve months. The authors also concluded that larger boards with less independent directors tend to charge shareholders significantly higher fees, while smaller boards that have a lower fraction of independent directors charge investors lower fees. The authors caution, however, that these finds do not necessarily indicate that board structure effects fees and that this may be due to other factors such as fund sponsors with certain fee targets selecting different types of boards.

The agency conflict between fund management companies and shareholders has been extensively studied¹⁴⁵. Massa examines how the structure of the mutual fund

¹⁴³ Tufano, P., & M. Sevick, (1997). Board structure and fee-setting in the U.S. mutual fund industry. *Journal of Financial Economics*, 46, pp. 321 – 355.

¹⁴⁴ Ibid.

¹⁴⁵ Brown, K., W. Harlow & L. Starts, (1996). Of tournaments and temptations: An analysis of managerial incentives in the mutual fund industry. *Journal of Finance*, 51, pp. 85-110; Chevalier, J., & G. Ellison, (1997). Risk taking by mutual fund as a response to incentives. *Journal of Political Economy*, 105, 1167-

industry influences mutual fund behaviours¹⁴⁶. Ferris and Yan conducted a study of the effects of fund management form on the level of agency costs within mutual funds, based on a comprehensive sample of mutual fund and fund families from 1992-2004¹⁴⁷. Researchers¹⁴⁸ and industry critics¹⁴⁹ both agree that the mutual fund scandals during the early 2000s in the United States can be viewed in the context of agency conflict between the fund management company and fund shareholders. The root of this agency conflict is that the shareholders seek highly risk-adjusted returns at low cost, while the fund management company seeks to maximize the amount of assets under management and the associated management fees¹⁵⁰.

Ferris and Yan¹⁵¹ argued that fund management companies with a short term focus, emphasize new term profits over long term value creation and are more likely to adopt strategies that increase their fee revenue but conflict with the interest of shareholders. In contrast, the authors suggested that fund management companies that adopt a longer term focus are likely to employ strategies, that decrease long-term fee

1200; Tufano, P., & M. Serick, (1997). Board structure and fee-setting in the mutual fund industry. *Journal of Financial Economics*, 46, pp. 321-355; Mahoney, P., (2004). Manager – investor conflicts in mutual funds. *Journal of Economic prospectus*, 18, pp. 161-182; Gispard, M. J., M. Massa & P. Matos, (2006). Favouritism in mutual fund families? Evidence on strategic cross-fund subsidization. *Journal at Finance*, 61, pp. 73-104.

¹⁴⁶ Massa, M., (2003). How do family strategies affect performance when performance maximization is not the day game in town? *Journal of Financial Economics*, 67, pp. 249-304.

¹⁴⁷ Ferris, S.P., & X. Yan, (2009). Agency costs, governance and organizational forms: Evidence from the mutual fund industry. *Journal of Banking and Finance*, 33, pp. 619-626.

¹⁴⁸ Mahoney, P., (2004). Manager-investor conflicts in mutual funds. *Journal of Economics Perspectives*, 18, pp. 161-182.

¹⁴⁹ Bogle, J., (2005). *The Battle for the Soul of Capitalism*, Yale University Press.

¹⁵⁰ Ferris and Yan, *supra* note 147.

¹⁵¹ *Ibid.*

revenue due to lower fund performance and investor cash flow, and instead focus on maximizing fund performance. The authors reasoned that the interest of fund shareholders is better aligned with fund management companies that adopt long term strategies than these that adopt short term strategies.

Ferris and Yan found strong evidence in their study that funds managed by public fund companies charge higher fees than those managed by private fund companies, and funds of public fund families significantly underperform funds of private fund families. The authors concluded that “collectively, those findings suggest that agency costs are higher in mutual fund managed by public fund companies.”¹⁵² They noted that their results are consistent with the agency conflict between the fund management company and fund shareholders, being more acute for public management companies because of their shorter-term focus.

Barber et al conducted a study on the effects of expenses on U.S. equity fund flows during the period of 1970-1999¹⁵³. The authors focussed on changes in how investors respond to various mutual fund expenses such as front-end load fees, commissions and operating expenses. The authors argued that over time the investors have become increasingly aware of and averse to mutual fund costs and have learned to avoid high front-end load and commission costs and high operating expenses. They noted that all else being equal mutual fund investors prefer to pay lower fees to mutual fund

¹⁵² Ibid, p. 619

¹⁵³ Barber, B. M., T. Oden, & L. Zheng, (2005). Out of sight, out of mind; the effects of expenses on mutual fund flows. *Journal of Business*, 78, a (G), pp 2095-2119.

companies. The authors further found that on average, any negative effect on fund flows are more than offset with the expenditure on marketing, while non marketing expenses reduce fund flows. The authors also recognized that investor knowledge has increased; they state in conclusion that “investors would benefit from greater understanding awareness of mutual fund expenses. While educating investors is a complex and multifaceted task, our results support the GAO’s recommendation that one step in that process could be for mutual funds to disclose to investors the actual dollar amount of fees paid. Expenses that remain out of sight are likely to remain out of mind”¹⁵⁴.

Early research on mutual fund performance by Treynor¹⁵⁵ and Jensen¹⁵⁶ found that mutual fund performance net of expenses was worse than what investors can earn by a naïve buy and hold strategy. Studies in the 1970’s by Williamson¹⁵⁷, McDonald¹⁵⁸ and Crenshaw¹⁵⁹ found that mutual fund managers were able to justify their charges. Other studies in the 1980’s by Kon and Jen¹⁶⁰, Merton¹⁶¹, Woerhide¹⁶², Veit and Cheney¹⁶³,

¹⁵⁴ Ibid., p. 2118 (the authors statement refers to a recommendation by GAO (the General Authority Office), that mutual fund expenses in dollar amounts rather than as percentages.).

¹⁵⁵ Treynor, How to rate management investment funds. *Harvard Business Review*, 44, 131-136.

¹⁵⁶ Jensen, M., (1968). The performance of mutual funds in the period of 1945-1964. *The Journal of Finance*, 42, 167-247.

¹⁵⁷ Williamson, P., (1972). Measurement and forecasting of mutual fund performance: Choosing an investment strategy. *Financial analysis Journal* 28, 78-84.

¹⁵⁸ McDonald, J., (1974). Objectives and performances of mutual funds, 1960-1969. *Journal of Financial Quantitative Analysis*, 9, 311-332.

¹⁵⁹ Crenshaw., (1977). The evaluation of investment performance. *Journal of Business*, 41, 462-485.

¹⁶⁰ Kon. S., & F. Jen. (1979). The investment performance of mutual funds: an empirical investigation of timing, selectivity, and market efficiency. *Journal of Business*, 52, 263-289.

¹⁶¹ Merton, R., (1992). On market timing and investment performance an equilibrium theory of value for market forecasts. *Journal of Business* 54, 363-406.

Alexander et al¹⁶⁴, Kon¹⁶⁵, Chang and Lewellen¹⁶⁶, Ferri et al¹⁶⁷, Hendriksson¹⁶⁸, and in the 1990's by Lee and Rahman¹⁶⁹, found that a limited number of fund managers have market timing selectivity expertise.

Ferris and Chance¹⁷⁰, Chance and Ferris¹⁷¹ and McLeod and Malhotra¹⁷² found that 12b-1 plans increase funds' expense ratios and concluded that 12b-1 fees are dead weight costs that should be avoided. Dellva and Olson conducted a study to investigate the relationship between front-end load charges, deferred sales charges, redemption fees, and 12b-1 fees on total fund expense and risk adjusted performance¹⁷³. In particular the

¹⁶² Woerhide, W., (1982). Investor responses to suggested criteria for the selection of mutual funds. *Journal of Financial Quantitative Analysis* 17, 129-137.

¹⁶³ Veit, E., & J. Cheney, (1982). Are mutual fund market times?, *The Journal of Portfolio Management*, 9, 35-42.

¹⁶⁴ Alexander, G., G. Benson & C. Eger (1982). Timing decisions and the behavior of mutual fund systems risk. *Journal at Financial and Quantitative Analysis*, 17, 579-602.

¹⁶⁵ Kon, S., (1983). The market timing performance of mutual fund managers. *Journal of Business*, 56, pp 323-347.

¹⁶⁶ Chang, E., & and W. Lewellen, (1984). Market timing and mutual fund investment performance. *Journal of Business*, 57, pp. 57-72.

¹⁶⁷ Ferri, M., H. Oberhelman, & R. Roenfeldt. (1984). Market timing and mutual fund portfolio composition. *The Journal of Financial Research* 7, pp. 143-150.

¹⁶⁸ Hendriksson, R., (1984). Market timing and mutual fund performance: an empirical investigation. *Journal of Business*, 57, pp 73-96.

¹⁶⁹ Lee, C., & S. Rahman, (1990). Market timing, selectively, and mutual fund performance; an empirical investigation. *Journal of Business* 63, pp. 261-278; Lee, C., & S. Rahman, (1991). New evidence on timing and security selection skill of mutual fund managers. *The Journal of Portfolio Management*, 18, 80-83.

¹⁷⁰ Ferris, S., & D. Chance. (1987). The effects of 12b-1 a note. *The Journal of Finance*, 42, 1077-1082.

¹⁷¹ Chance, D., & S. Ferris, (1991). Mutual fund distribution fees: an empirical analysis of the impact of deregulation. *Journal of Finance Services Research*, 5, pp 25-42.

¹⁷² McLeod, R., & D. Malhotra, (1994). A re-examination of the effect of 12b-1 plans on mutual fund expense ratios. *The Journal of Financial Research*, 17, pp. 231-240.

¹⁷³ Dellva, W. L., & G. T. Olson, (1998). The relationship between mutual fund fees and expenses and their effects on performance. *The Financial Review*, 33, February 1998, pp. 85-104.

authors sought to determine if there is any fundamental difference in the various types of fees with respect to expense ratios, and mutual fund performance. The authors conclude that 12b-1 fees, deferred sales charges, and redemption fees increase expenses and only a limited number of funds with these fees earn risk adjusted return that can justify them. The authors noted that investors should not select funds with front-end loads, 12b-1 fees, deferred sales charges, and redemption fees.

2.7 MUTUAL FUND SCANDALS

Widespread publicity was given financial scandals occurring in the United States after the market downturn in 2000. Eliot Spitzer's charges against prominent financial analysts resulted in a \$1.4 billion settlement with the firms where they worked made headlines. Spitzer charged Edward J. Stern and the hedge fund that he managed, Canary Capital Partners, LLC, with improper market timing and late trading in shares of the Strong mutual fund complex. To settle these charges, Canary Capital Partners was required to pay \$40 million, while Bear Stearns also agreed to pay \$250 million to the New York Stock Exchange and the SEC to settle late trading charges in its mutual funds. Subsequently, Spitzer brought several other suits against mutual funds for allowing or engaging in market timing and late trading that resulted large fines and media exposure¹⁷⁴.

The SEC and Spitzer were to obtain settlements totalling over \$4.25 billion in penalties, disgorgement and reduced mutual fund fees by the end of 2005, despite their

¹⁷⁴ Markham, S. J., (2006). A Financial History of Modern Corporate Scandals, from Enron to Reform, 400-434

lack of success in Court¹⁷⁵. In 2006, Prudential Financial Inc. agreed to pay \$600 million and admitted to criminal fraud under a deferred prosecution agreement, and agreed to pay \$52 million to settle market timing claims and to cut fees by \$25 million. Additional discussion regarding mutual fund scandals in the United States is provided in the analysis of the SEC response to the scandal through the development of new rules.

In 2004, the question facing mutual fund companies was how the scandal would affect Canadian investors. The OSC responded to the U.S. scandal by requesting that mutual fund companies in Ontario to respond whether they had sufficient procedures in place to prevent late trading and market timing by distributing a questionnaire to them. The main response of the Canadian mutual fund industry to the mutual fund scandals in the United States was that timings were different in Canada which had better safeguards and that investors were protected against abuse, with an industry spokesman stating that Canadians “should be encouraged by the differences in the systems procedures and structure of our markets”¹⁷⁶.

A U.S. economist, Eric Zitzewitz of Stanford University, who helped New York State Attorney General Eliot Spitzer probe the mutual fund industry in the United States indicated in 2003 that there was evidence of similar trading problems occurring in Canada, stating “I believe that there is a problem in Canada it may not be as big as in the

¹⁷⁵ Bloomberg News, (2006, July 25). Money manager agrees to settle regulators' market-timing case, *N.Y. Times*, at C1.

¹⁷⁶ McFarland, J., (2004, June 22). Mutual fund abuse in Canada needs prompt action. *Globe and Mail*, available at: <http://www.theglobeandmail.com/report-onbusiness/mutual-fund-abuse-in-Canada-needs...>

U.S. but some of these revelations will start to come out about Canadian funds.”¹⁷⁷ Eric Pelletier, a spokesman for the OSC, explained that OSC official had consulted with Mr. Zitzewitz regarding his study but that his Canadian sample was not sufficient to draw any conclusions from. He also indicated that the OSC was conducting its own review of data and that OSC officials suggested that Canadian funds were not as open to abuse as those in the U.S., and suggested regulations to further inform and educate investors of the regulations in place.

An article by Reuters in 2003¹⁷⁸ warned against comparing apples with oranges in assessing the impact of a U.S. mutual fund scandal on Canada’s much smaller mutual fund industry. The article indicates that analysts did not expect Canada to experience the problems to the extent experienced in the United States. Canadian analysis indicated that because of the mutual fund sector in Canada was \$320 billion U.S. (\$429 billion CAN) versus \$7 trillion in the U.S., late trading practices in Canada would be identified quickly. However, the analysis did indicate that investor confidence was an issue¹⁷⁹.

In the United States a correlation has not been demonstrated between introduction of independent directors and chairs in the United States and the detections and reduction of late trading and market timing. For this reason, I don’t suggest that Canada introduce

¹⁷⁷ McCarthy, S., (2003, November 24). Mutual funds abuses found in Canada, *The Global and Mail*.

¹⁷⁸ Bay St., (2003, November 9). Week Ahead, Canada braces for fund scandal fallout, Reuters.

¹⁷⁹ Q & A: On the Pricewaterhouse Coopers mutual fund survey restoring lost confidence – insights from the industry, available at <http://www.pwc.com/ca/en/investment-management/q-a-mutual-fund-survey-restoring-/0...>

independent directors and chairs to address late trading and market timing activities. There has been no indication that independent directors increase firms' performance and there are suggestions that this may detract from performance. In Canada, the securities regulators introduced the IRC to address conflicts of interest. There was no supporting studies to indicate whether the IRC would be able to detect late trading or market timing which is a highly statistical and mathematical process. Therefore, there is no indication that independent directors and chairs of the IRC would be an effective governance mechanism for late trading and market timing. Similarly, the mechanism of independent directors and chairs in the United States and the IRC were not purposely developed as a governance mechanism for excessive advisory fees.

The mutual fund scandals in the United States prompted action of the part of the OSC to determine whether mutual fund trading abuses were occurring in Canada. This included broadly targeted the industry with a questionnaire test to select mutual fund companies asking them what policies and procedures they had in place to deal with buy and sell orders that come into the firm after the normal 4 PM cut off time. OSC spokesmen Eric Pelletier stated, "We believe that we don't have the same level of problem in the Canadian industry as we've seen emerging in the United States."¹⁸⁰

Although the OSC did not believe that the market timing abuses were occurring in Canada, they were concerned with the effect that this perception would have on investor

¹⁸⁰ Howlett, K., & C. Leitch, U.S. fund scandal prompts OSC move, sends questionnaire on trading abuses, *Globe advisor.com*, accessed at: <https://secure.globeadvisor.com/servlet/articlenews/story1gam/20031104/REFUNDSO4>

confidence. As stated by Pelletier, spokesman for the OSC, "We have no evidence that these abuse practices are taking place in our market, ...but we need to bolster the market"¹⁸¹. There was also a concern of the effect of the U.S. scandals on Canadian investors expressed by Canadian mutual fund companies. A discussion of whether the mutual fund scandals in the U.S. were occurring in Canada was provided by Dan Hallett of the *Globe and Mail* who stated "I am not aware of any Canadian Firm participating in the types of activities in which a handful of U.S. fund companies have been alleged to have participated."¹⁸²

There was considerable controversy as to whether the settlements against AGF Fund, and IAG Investment Management Inc. were sufficient. The restitution payments from these firms totalled USD\$156.5 million, while fund managers and other short term traders realized USD\$301 million in profits representing about half of the losses to investors¹⁸³ and their gross management fees totalled USD\$17.3 million dollars.

The scandal resurfaced with Law Firm Rochon Genova LLP seeking class action status for a lawsuit against the fund companies that agreed in December 2004 and March 2005 to pay a total of USD\$205.6 to investors¹⁸⁴. The fund companies' response was that

¹⁸¹ Ibid.

¹⁸² Mutual fund insight by Hallett, D., Mutual fund scandal, is U.S. experience in Canada? *Globe and Mail* advisor, accessed at: <https://secure.globeadvisor.com/education/insight/article.html/?/education/insight/200309...>

¹⁸³ Mutual fund insight by Hallett, D., Fund companies settle, Restitution payments half of losses, *GlobalAdvisors.com*, accessed at: <http://secure.globeadvisor.com/education/insight/article.html/?/education/insight/2004/12...>

¹⁸⁴ Hallett, D., (2009, October 12). Market-timing losses in dispute, *Morningstar Investor Insight*, 12-10-09, accessed at: <http://cawidgets.morningstar.ca/Article/Template/PrintArticle.htm>.

they had made restitution. The plaintiffs' lawyers disagreed arguing that more should be paid to investors. A key argument of the lawsuit is that hedge funds were allowed to trade frequently without being charged the short term trading fees which are typically levied. The lawsuit also asserts that short-term trading fees were charged at that time to all other investors. The litigation against the five fund companies is related to the total losses to investors. Eric Zitzewitz, an economics professor at Stanford University, estimated that the losses to Canadian investors resulting from the market timing to be from \$300 million to \$800 million. The lower end to this range is comparable to what the OSC calculated and was used as a basis for the lawsuit.¹⁸⁵

In an article in the Globe and Mail, Dan Hallet states: "The OSC's decision to obtain settlements against five fund firms reflects its goal of protecting market rather than punishing a wrongdoer"¹⁸⁶. In this sense, I suggest that the OSC's intent may have been to 'make an example' of these five firms, as a way of discouraging market timing and late trading in the Canadian mutual fund industry. The OSC, however, did not undertake any disciplinary measures against the fund companies mentioned in the brokerage firm settlements. TD Waterhouse Canada Inc. was penalized for facilitating rapid trading in an equity fund under two pooled funds managed by a separate advisor. The settlement with RBC Dominion Securities Inc. confirmed that some of the market timing trades that it facilitated occurred in its affiliated RBC fund family and yet the fund company

¹⁸⁵ Ibid.

¹⁸⁶ Ibid.

affiliated of the bank-owned brokerages were not subject to punitive measures¹⁸⁷. The regulators also appeared to ignore the adverse impact from frequent trading by money market funds upon investors¹⁸⁸.

There was concern that market timers would detract from investor confidence and as a result some companies sought determine how to deter market timers from participating in their funds. Sian Burgess, senior vice president and general counsel at Mackenzie Financial Corp. Stated: "We do think that there are measures that the industry as a whole can adopt to dramatically reduce the inappropriate short-term trading opportunities. We think an industry-wide response to this is crucial"¹⁸⁹.

William Hollands, chief executive officer of CI Fund Management Inc. indicated that managers are no longer allowing any client to trade in and out in under 30 days, since with respect to market timing "The public perception right now is that this is a negative"¹⁹⁰. Jonathan Hartman, vice president of business development at RBC Asset Management Inc., Canada's largest mutual fund manager at that time, indicated that RBC was considering imposing a short-term trading fee. David Goodman, president of Dynamic Mutual Funds Ltd., indicated that his firm charges a 2 percent fee for short-term trading as it wants to do business only with long-term investors.

¹⁸⁷ Ibid.

¹⁸⁸ Ibid.

¹⁸⁹ Howlett, K., (2004, June 21). In-and-out-traders unwelcome, firms says, *Globeinvestor.com*, accessed at: <http://www.globeinvestor.com/servlet/ArticleNews/story/GAM/20040621/RFUNDSFID2/>

¹⁹⁰ Ibid.

Howlett ¹⁹¹ indicated that the Report on Business found that fund companies had mixed results in keeping market timers out of their funds and that rapid in-and-out trading took place in dozens of international funds managed by Canadian companies over a four year period. According to Karen Howlett, "Investors have no way of knowing whether their mutual funds contain tell tale signs of market timing activity"¹⁹². The investment fund industry association IFIC restricts free access of its reports containing detailed fund statistics to mutual fund companies and for everyone else charges a significant fee.

Stephan Erlichman indicated that reforms were needed in Canada to ensure that the industry acts in the best interests of the investors and that there was a lack of independent governing bodies in Canada to oversee mutual funds to monitor their operations¹⁹³. In 2003, Erlichman recommended that funds be required to have compliance plans. At the time of the mutual fund scandals, the requirement for compliance plans had not yet been adopted in Canada. Erlichman stated "I continue to believe that my recommendation for mandatory compliance plans is an important one for Canada. We will wait and see what the [regulators] do in response in regard to this issue"

¹⁹¹ Ibid.

¹⁹² Howlett, K., (2004, June 21). Spotting signs of market timing tough for the ordinary investor, *Globeadvisor.com*, accessed at: <http://secure.globeadvisor.com/servlet/ArticleNews/story/gam/200440621/RFUNDSS21>

¹⁹³ Howlett, K., (2004, January 1). Funds under microscope in wake of U.S. scandal, *Globe and Mail.com*, accessed at: <http://www.investorvoice.ca/PI/S33.htm>

¹⁹⁴. As will be discussed later the Independent Review Committee was put in place to monitor conflicts of interest.

Karen Howlett, referring to the IRC, noted “The Ontario Securities Commission hinted in November that it plans to introduce a watered-down version of Erlichman’s recommendations on January 9, it will introduce new governance rules requiring funds to set up committees, rather than full boards of directors, to monitor conflict of interest. The OSC said the committees will not have the power to overrule fund managers nor would managers be required to abide by the committees decisions.”¹⁹⁵

2.8 DISCUSSION

The results of the evaluation of mutual funds have identified key findings with regard to the mutual fund performance based on my literature review and analysis. Firstly, I recognize that these studies have not identified a relationship between sustained high past performance and future high performance. I conclude on the basis of my analysis that there is therefore no reason why investors should pay higher fees for mutual fund advisors on the basis of past performance if this does not relate to the current performance that they are receiving, or future performance. I further conclude from my analysis of this literature that the studies have also shown that high advisory fees detract from performance and actually may result in performance that is lower than market benchmarks. I conclude based on the literature review that there is no justification for

¹⁹⁴ Karen Howlett, Ibid.

¹⁹⁵ Karen Howlett, Funds under microscope in wake of U.S. Scandal, *supra* at note 193.

investors paying high fees to advisors on the basis of persistent performance. The results of the literature review above indicate that 12b-1 fees and sales loads do not enhance performance. Based on these studies, I suggest that there is some uncertainty as to whether trailer commissions in Canada will increase mutual fund performance and add value to investors. A study of whether trailer commissions increases the performance of Canadian mutual fund investments should be conducted by the securities regulators to determine whether these charges should be permitted in the future. This is, of course, of particular importance since Canadians pay among the highest mutual fund expenses globally and trailer fees are a significant contributor to these high expenses. Mutual fund expenses and fees are discussed in Section 5.

There are competing loyalties for both mutual fund managers and corporations that offer proprietary mutual funds. As will be discussed, this inherent conflict of interest in the mutual fund industry results in a conflict for fund managers in maximizing the returns through increases in their fees which typically results in decreasing returns to their shareholders, versus decreasing their fees which will decrease their returns and increase the returns to their mutual fund shareholders (unitholders). Boards of the mutual fund companies also are subject to these competing loyalties since they too are responsible for the success of the fund manager and compensation to the unit holders of their funds.

The question also arises as to whether the board would favour the returns to shareholders through an increase in the stock price or provide dividends which would

tend to stimulate additional investment in the corporation or an increase in the price of the mutual fund which would tend to stimulate decreased investment in the fund. It may be expected that the board's first responsibility, in the vast majority of the cases, would be to its corporate shareholders. It is this responsibility to provide a financial return to both its fund management corporation and the mutual fund unit holders that creates a potential conflict of interest. Investors may be unaware of the potential conflicts of interest of their fund managers of providing financial returns to the mutual fund unit holders and the shareholders of the corporation. Potential conflict of interest also extend to banks since major banks also provide mutual fund management and offer proprietary mutual funds and are responsible to both their shareholders and the unit holders of their mutual funds.

The mutual fund scandals during the early 2000s in the United States can be viewed in the context of agency conflict between the fund management company and fund shareholders. The root of this conflict agency is that the shareholders deserve highly risk-adjusted returns at low cost, while the fund management company deserves to maximize the amount of assets under management and the associated management fees.

My review of the mutual fund scandals that occurred in the United States indicates that these were related to late trading and market timing and that they received wide media attention. These mutual fund scandals had a broad impact in Canada as well among U.S. securities regulators, the mutual fund industry and investors. My evaluation of the literature and media releases at the time of the scandals has indicated that there was

considerable concern as to the effect of these scandals upon investor confidence and investing activities in both Canada and the United States. Accordingly, maintaining and restoring investor confidence became a focus of the regulatory agencies. I suggest that this was a key driver in the initiation of the governance mechanisms involving director and chair independence in the United States, as well as the IRC in Canada.

The results of my analysis of the mutual fund scandals in Canada and the U.S. indicate that the two markets experienced different degrees of late trading and market timing issues, with greater issues in the U.S. due largely to the size of the market. The scale of the issue alone would suggest that Canada would not need to introduce the same degree of measures to prevent market abuses. The actions taken by the OSC may have been in response to the action taken by regulators in the United States. In addition, both of the scandals precipitated changes in mutual fund governance in Canada and the United States and these were manifested differently in the two countries.

The mutual fund scandals created public concern and a decline in investor confidence which prompted securities regulators and the mutual fund industry to reduce these concerns and increase investor confidence. Prior to the mutual scandals in the U.S. very few people in Canada knew what the term late trading meant, but during the ongoing scandal in the United this was read about in Canada on a daily basis. This public concern in Canada and the U.S. was a key driver for regulatory change in the mutual fund governance regime in both countries. I suggest, based on review and interpretation of the literature, that the mutual fund scandals could have focussed the Canadian securities

regulators on responding to the mutual fund scandals that were occurring at that time rather than addressing the high fees in Canada.

3.0 CANADIAN MUTUAL FUND REGULATORY REGIME

3.1 GLOBAL CONTEXT

An analysis of the Canadian mutual fund regulatory regimes in the context of global practices in disclosure in the mutual fund industry was conducted based on research by Morningstar and provided in their 2009 and 2011 reports (results relevant to fees are discussed in Section 5 and global disclosure practises are summarized in Appendix A). I identify two key findings in this study pertaining to the Canadian mutual fund governance regime. Firstly, Canada was the only country in the Morningstar studies to receive a failing grade of F with respect to fees, due to the high total expense ratio associated with Canadian mutual funds. Secondly, Canada received an “A” in the area of transparency in the prospectus and shareholder report in the Morningstar studies which noted that Canadian funds are required to publish a simplified prospectus that has a standard format and is more clear and easier for the average investor to read. The methods of disclosure also appear to be consistent between Canada and the other countries in the Morningstar studies in that most of these countries require a prospectus and annual or semi-annual reports to shareholders. The Morningstar studies gained widespread media attention and discussion and received strong criticism from the

Canadian mutual fund industry.¹⁹⁶ The criticisms were aimed at the selection of funds that were used in the study but the industry, however, did not provide a study to specifically rebut the Morningstar studies.

My assessment of the results of the Morningstar studies leads me to conclude that Canada has high total expense ratios in a global context. The regulations in each of the countries surveyed require that the total expense ratio is disclosed (with the exception of one). Investors are not able to determine the relationship between the actual trading cost and the fees to determine if increased fees are related to increased costs or increased profits for fund managers because these costs are bundled within the total expense ratio. As such it is not possible to determine whether the high total expense ratio in Canada is due to high advisory fees, high profits captured by the fund manager or advisor, or other factors. Even if the excess fees were not related to increased profit to the fund managers, this could also be due to costs associated with inefficiencies such as excessive turnover in stock in the fund portfolio resulting from ineffective selection of stocks by fund managers requiring them to turnover or “churn” to generate an adequate return to the fund’s unit holders.

While the Morningstar studies indicate that Canada has among the highest expense ratios in the world, the root causes are not clear since the costs are bundled in the expense ratio. I therefore suggest that a gap in the current Canadian regulatory

¹⁹⁶ Rekenthaler, J.K., M. Swartzentruber & C.S. Tsai, (2009). *Morningstar Global Fund Experience*, Morningstar Fund Research, May 2009 (2009 Morningstar Report); Alpert, B.N., & J.K. Rekenthaler, (2011). *Morningstar Global Fund Investor Experience*, March 2011 (2011 Morningstar Report).

framework for mutual funds is that there is no requirement for disclosing the unbundled costs associated with advisory fees, administrative costs and trading costs such that investors can evaluate the costs that they are paying. Currently, in Canada, this is bundled within the MER. A transparency issue is that brokerage costs may report back to the fund manager and appear as a cost, while it is actually income, without having this properly disclosed to investors. These costs could be significant for instance, for those funds that have high turnover rates if they churn more of their portfolio per year. Therefore disclosure of turnover rates would be beneficial for shareholders. It is noted that disclosure of turnover is not required in many of the countries included in the Morningstar studies.

I note that an evaluation of whether the disclosure documents are actually read by shareholders is not provided in the Morningstar studies. In Canada, there has been no published survey by the OSC, or the mutual fund industry as to whether investors are reading the prospectus and shareholder reports. Further, there is no indication based on feedback from investors as to whether this information is what shareholders need and is written and organized in a way that they can understand. In addition, I raise the question as to whether investors have been properly educated to understand the information in the disclosure documents. This is discussed further in the public education, involvement and participation section of this dissertation.

3.2 FORMATIVE DEVELOPMENTS IN THE DISCLOSURE MECHANISM IN CANADA

I conducted a review and historical evaluation of the development of disclosure as a mechanism for corporate governance based on a review of historical information from OSC bulletins and more recent academic studies.

The emphasis on disclosure in Canadian securities legislation can be traced to the Urquart Report¹⁹⁷; where it was recommended as a mechanism to increase investment in Ontario's capital markets. Disclosure was considered in the Urquart Report to be a means of fraud prevention and a viable alternative to increasing sanctions for promotion of fraudulent securities prior to the formation of the Securities Act in 1945. The disclosure of corporate information to shareholders played a prominent role in company law legislation following the Urquart Report.

After the enhancement of the Securities Act in 1945, an administrative agency was provided with the power to enforce the distribution of information to prospective investors as part of the primary distribution. Section 49 of the 1945 Securities Act involved providing the investor with all the material and facts so that the investor could make up their own mind whether or not to invest. Following 1945, disclosure became a central tenet in Ontario securities legislation. The perspective on disclosure at that time was that the individual was to make up their own mind on the merits of an investment based on the assumption the disclosure requirement ensured that all material information

¹⁹⁷ Condon, M., (1998). *Making Disclosure: Ideas and Interests in Ontario Securities Regulation*, Toronto: University of Toronto Press, p.82.

was provided to potential investors. An early OSC bulletin stated “The frames of the Act credited the average individual with sufficient horse-sense to be able to decide whether or not a security should be bought providing he was in possession of the material facts regarding that security”¹⁹⁸. The OSC provided the perspective that disclosure provides full protection for the inexperienced individual investor so that they make the effort to understand the details of the investment opportunity.

I suggest that the OSC viewed the responsibility to rest with the individual investor and not with the agency, which was to make no recommendation to the public on the investment. Further, I note that the agency related the protection offered to be for the average individual and that the agency did not give consideration as to whether the investor had sufficient knowledge to reliably make this decision. It was also not considered whether the agency should play a role in investor education and to arm investors with the knowledge to make decisions based on the disclosed information. At the very root of the disclosure, there was a fundamental assumption or belief that investors would understand the information that was being provided to them under disclosure requirements. I further suggest that it also assumed that investors would know where to find this information and would actually take the time to read it.

Condon¹⁹⁹ notes that “in the securities law context, a disclosure orientation is often contrasted by regulators with a ‘merit-based’ philosophy that would examine the

¹⁹⁸ Ontario Securities Commission Bulletin, (1949, March). B5.

¹⁹⁹ Condon, *supra* note 97, p. 41.

substance of a proposed distribution, in the sense of its potential for financial success, beyond the adequacy of the information provided”. I note that, in choosing a direction of ‘disclosure’, rather than a merit-based approach, the agency was moving away a role of involving the public and turning more to a role of an agency that stipulates what information should be disclosed with a stated view that “the Ontario purchaser of securities has access to *all* the facts – after that well, it’s his dollar”²⁰⁰. It is also clear that the agency had moved away from its previous role in fraud protection, in placing an emphasis upon disclosure to investors.

The disclosure of information was equated with investor protection in an OSC Bulletin in 1949, where it was described as “the cornerstone of current securities legislation”²⁰¹. In addition, the bulletin mentioned a reason for the emphasis upon disclosure legislation was the increasing population in Ontario and consequent expansion into financing. The bulletin noted that the time has long since passed when a small number of investors or speculators might have obtained first-hand information regarding any particular venture, as well as first-hand information regarding persons engaged in the sale of promotional issues²⁰². In the 1950’s, there was some movement beyond disclosure being confirmed in the initial prospectus in the acknowledgement that pro forma balance sheets may be required to reflect any material financial changes beyond the balance sheet

²⁰⁰ Ibid.

²⁰¹ Ontario Securities Commission Bulletin, (1994, May). B3.

²⁰² Ibid.

in the original perspectives. It was, however, not until the Securities Act was passed in 1966 that provisions for disclosure beyond the initial prospectus were put in place²⁰³.

The Kimber Report associated disclosure with achievement of public confidence, yet indicated that the current provisions were inadequate and that improvements should be made. The presentation of this Act occurred after the compilation of the Windfall Report. In the Windfall Report disclosure was associated public protection while in the Porter report it was associated with investor protection. I note that although there were various positive attributes on the perceived benefits of disclosure, it is not clear if there was a widespread knowledge amongst investors concerning this legislation and whether they had sufficient knowledge to understand this information and whether they in fact utilized this disclosure information in their investment decisions. The Kimber Report was a central core to the 1966 Securities Bill, and this bill was drafted by four of the lawyers and the accountant who had served on the Kimber Committee who were retained by the Attorney General for this purpose. The Attorney General introduced the 1966 Securities Bill as representing the consolidation of the major recommendations of the Kimber Committee. The 1966 Securities Bill incorporated a central tenet of the Kimber report which was that inadequate disclosure was the root cause in the deficiencies. In the first reading of the Corporations Bill, the provincial secretary used this as its 'base principle'²⁰⁴. In 1967 the OSC announced that it had adopted a new standard of disclosure for sales finance companies and stated: "The normal business of sales finance

²⁰³ The drafting of the 1966 Act began after the Kimber report was tabled in the house.

²⁰⁴ Condon, *supra* note 197, p.82.

companies is dealing in commercial paper rather than a product, making it imperative that certain information is available in addition to that normally required by other types of companies. Without this, the investing public will not have proper information to assess the financial position of the company”²⁰⁵.

The final report of the Five Year Committee chaired by Purdy Crawford, referred to as the “Crawford Report”, included a proposal that would it make it easier to fire fund managers and that all mutual funds be required to have some form of independent governance body. The Crawford Report recommended that an independent governance body would represent the interest of fund investors by monitoring fees and expenses charged to unit holders.²⁰⁶ Former Ontario finance minister Janet Ecker tabled the committee’s report in the legislature. She indicated at that time that the government would set up a select committee of the legislature to review the entire report. The select committee, however, did not get appointed before the provincial elections. The new government did not proceed with the select committee to which would have involved an evaluation of an independent governance body that would represent the interests of fund investors by monitoring fees and expenses charged to mutual fund investors.

Disclosure as a corporate governance mechanism has strong roots in the securities regulation. I suggest that these historical developments influenced the selection of disclosure as a primary mechanism for mutual fund governance in Canada.

²⁰⁵ Ontario Securities Commission Bulletin, (1967, January). B6, 1998, p.10, Condon, *supra* note 197.

²⁰⁶ Ontario Ministry of Finance, (2003) *Five Year Review Report – Reviewing the Securities Act*. Ontario Ministry of Finance

3.3 1969 CCMF REPORT

The CCMF (Canadian Committee on Mutual Funds) study report²⁰⁷, released in 1969, indicated that the prevailing level of management fees and sales charges in Canada was attributable to adoption of the pattern in the United States, since the first mutual funds organized in Canada followed the practices that were established first in the United States, and that the patterns that they established have endured ever since in Canada. The committee indicated that this was, in a large part, attributable to the policies of securities makers that were reluctant to accept prospectuses for filing if they contained higher fees than the prevailing rate. At that time, the policies of securities administrators on levels of management fees and sales charges were for the most part unwritten, although well known to the mutual fund industry. The prevailing levels of management fees could not be easily described since at that time management fees were considered alone or together with either management expenses. The management fees could be increased by the allocation of management expenses to the mutual fund, which made comparison of management fees between mutual funds difficult.

A summary of the management fees and management expenses paid by mutual funds in 1967 is summarized in Table 1 below. These data indicate that the MER ranged from 2% to 0.75% depending on the assets under management.

²⁰⁷ *Report of the Canadian Committee on Mutual Funds and Investment Contracts*, (1969). Provincial and Federal Study, (CCMF Report). Ottawa, Queens Printer.

Table 1 – Mutual Fund Expense Ratios in 1967

Assets Under Management	Expense Ratio
Up to \$1,000,000	2%
\$1,000,000 up to \$3,000,000	1.75%
\$3,000,000 up to \$5,000,000	1.5%
\$5,000,000 up to \$10,000,000	1.25%
\$10,000,000 up to \$100,000,000	1%
\$100,000,000 and over	0.75%

Source: CCMF Study, supra note 207.

In February 1968, the Ontario Securities Commission adopted a policy to recognize the relationship between management fees and management expenses, and to ensure that economies of scale are reflected in the management fee. This policy is provided below:

Pending the policy which may be developed as a result of the studies now being conducted by the Canadian Mutual Fund Committee, all mutual funds are advised that the maximum management fees and other expenses which may be charged against the assets of the fund, expressed as a percentage of the net assets under administration.

This policy will be applied to all new funds whose securities are for the first time the subject of the filing and all funds making an annual refilling or making a new filing. Within the limits and percentages set out above, sliding scale or incentive management fees will be accepted. It is again emphasized that the maximum

percentage is to include not only the management fee chargeable but also all other expenses.

A supplementary interpretative release was published by the OSC in January 1969 to clarify this policy²⁰⁸. The release clarifies that the lower percentage limits on the higher dollar amount are not intended to determine total compensation. A mutual fund with \$1,500,000 total net assets, for instance, at that time could pay up to 2 percent for management fees and expenses on the first 1,000,000 and 1.75% on the remaining \$500,000. The committee noted that there is not a difference in sought versus unsought market segments and largely attribute this to the low degree of importance of fees to the Canadian purchases. At the time of the CCMF study, there were sales charges in the order of more than 8 percent and this was more significant to mutual fund purchasers than an annual management fee of 0.5 percent, and as a result there was little pressure to reduce management fees even in the commodity (shopping goods) segment of the market.

The committee indicated that differences between the rules of the various administrators account for the variance in management fees and expenses for the industry as a whole²⁰⁹. According to the committee, the variance is explained by the greater variance in management expense ratios that is due to the concentration of the administrative component of management expenses rather than management fees. The commission further noted that the reason that the prevailing level of management fees did

²⁰⁸ Ontario Securities Commission Bulletin, (1969, January), 6.

²⁰⁹ Ibid., p. 320.

not increase following the policy ruling made by the Ontario Securities Commission is attributable to reluctance on the part of the existing organizations to increase their management fees. The committee believed this reluctance was because an increase would require notification of shareholders which would draw management fees to their attention and would attract unfavourable attention from securities administrators.

The committee was not able to decide on whether the prevailing levels of management fees and sales charges were too high or too low, based on the submissions that they received as part of the study. The committee suggested that one approach to arriving at this decision could be through an analysis of profit levels of management and distribution companies. The authors noted that this information is often difficult to obtain accurately since this involves a separation of expenses attributable to the mutual funds from these attributable to other activities of management and distributing and it would be necessary to frequently check upon which expenses were appropriate and which were not. Although not specifically addressed in this dissertation, I note that this would also require accounting guidelines and standards to be developed that were consistent across the industry.

Another potential approach noted by the committee would be to decide what levels of management fees and sales charges are necessary to enable the distribution and management companies to function properly. This would, however, first require an identification of these relevant functions and then determine how costly these are. The committee notes that this determination would be difficult for sales charges, since these

are used to compensate sales activity and the costs vary against sales levels. These are examples that the committee noted prevented it from reaching a conclusion on the appropriate level of management fees and sales charges, which led the committee to a conclusion that a substitute should be found for the existing regulatory structure in this aspect of industry operations. The committee concluded: "In our opinion, the only effective way to control the levels of sales charges and management fees would be through the operation of competition in these areas at the consumer level"²¹⁰. From the committee's perspective, this will occur only if and when there is an ability and willingness among mutual fund investors to compare sales charges and management fees before making purchase decisions. The committee indicates that this can be brought about only through the use of techniques to provide purchasers with information as to the implications of the factors that differentiate mutual funds, together with the willingness and the ability to make use of that information²¹¹.

According to the committee, there are two preconditions to this development of competition in sales charge levels. The first prediction is the existence of ability and willingness among mutual fund investors to compare sales charges before making a decision²¹². Without this, distribution would not be motivated to reduce sales charges and salesman will not be motivated to reduce their portion of sales charges and brokers and salesman will not be motivated to reduce their portion of sales charges. The second

²¹⁰ Ibid., Section 10.28, p. 3245.

²¹¹ Ibid.

²¹² Ibid., Section 2.38, p. 49.

precondition relates to the second type of competition between sales outlets and a particular mutual fund. If they are motivated by consumer pressure to reduce sales charges, they must have the ability to reduce their sales charges for the purchases for this comparison to develop. The CCMF committee concluded the first precondition is unsatisfied for a large portion of the mutual fund market and that the second precondition is also not satisfied due to the policies of distribution²¹³.

The mechanism that the CCMF proposed to the control management fees in the mutual fund industry is competition. The committee recommended that appropriate measures be instituted to disseminate and require dissemination of information concerning the relative merits of mutual fund, in order to encourage the development of a higher degree of competition at the consumer level for the levels of sales charges and management fees. The CCMF committee further recommended that appropriate measures be instituted to avoid undue increases in the level of sales charges and management fees until effective competition developed as a result of their recommendations. In order to increase competition, the committee indicates that potential purchasers must become more knowledgeable to distinguish between fees in investment options.

At the time of the CCMF study, sales charges were traditionally disclosed as a percentage of the amount paid by the purchaser, rather than amount invested in the mutual fund. The CCMF indicated that they received numerous suggestions that sales

²¹³ Refer to section to 2.52 to 2.57 of CCMF report for details.

charges should be disclosed as a percentage of the amount invested in the mutual fund, rather than as a percentage of the amount paid by the purchaser, for the reason that this disclosure would facilitate comparisons with stock exchange commission rates. The committee decided against this since they believed that most mutual fund purchasers decide on a particular dollar amount rather than on a particular number of shares or units. The committee indicated that the purchaser could more easily calculate the portion of the payment which will be contained in the sales charges and if the rate is stated as a percentage of the amount paid for the purchaser.

This practice was consistent with the practice in the United States which at that time stated sales charges as a percentage of the amount paid by the purchaser²¹⁴. The committee reasoned that a consistency between Canada and the United States disclosure of sales charges would avoid confusion if were to read material concerning United Sales charges by Canadian mutual fund investors. As previously discussed, management fees may be increased through the allocation of management expense to the mutual fund rather than the management company. Due to the relationship between management fees and other management expenses, disclosure of management fees on a comparable basis is more difficult. The committee therefore indicated that "it is essential that a system of disclosure designed to encourage comparisons among mutual funds include provision for management fees and expense comparisons on a basis that will not be affected by the allocation of expenses between mutual fund and management company"²¹⁵. Today, more

²¹⁴ See also recommendation 3, *Ibid.*, p.33.

²¹⁵ *Ibid.*, p. 331.

than 40 years later, this vision has not fully become a reality, since the management fees are not disclosed in detail between the mutual fund and the fund manager.

The committee considered whether it would prescribe by statute a basis for the allocation of expenses between management and the distribution company and the mutual fund, and “concluded that such a requirement would be unduly onerous”²¹⁶. The committee indicated that instead the focus for purposes of disclosure should be upon the management expense ratio, and stated:

“This ratio should be calculated for any year by aggregating the management expenses (which would include all expenses except brokerage fees and other fees incurred in the completion of transitions and income taxes) of the mutual fund for that year and expressing the result as a proportion of average total net assets for the year. Average total net assets should be the average of the total net assets of the mutual fund on all days upon which net asset value per share unit was completed. The information so provided will furnish a more valid basis for comparison among mutual fund than do management fee rates standing along. It, rather than the management fee, should be the subject of emphasis in prospectuses and sales literature”²¹⁷.

²¹⁶ Ibid.

²¹⁷ Ibid., p. 332, see also recommendation 4, Ibid, p. 334.

The above statement of the committee expresses the root of today's current disclosure of management fees and management fees as a percentage of total net assets that is currently utilized in the industry. While this was a positive development from a disclosure standpoint, the opinion expressed by the committee was that there should not be a requirement for disclosure of management and distribution costs and fees and this has led to the current situation where the mutual fund managers are not required to disclose the expenses related to the distribution versus the funds. Accordingly, this approach has contributed to the current practice of not disclosing trailer fees as part of the management expense ratio. As previously discussed Canadian mutual fund managers are considered to charge the highest management fees for mutual funds worldwide, and it is interpreted that trailer fees are a contributing factor to these high fees.

It is suggested that the current regulation of management fees in the Canadian mutual fund industry have a component of path dependency originating from the recommendations of the CCMF study and prevailing practices at the time of this study. The committee further recommended that the knowledge necessary for the comparison of mutual funds should be communicated to the potential purchasers through the mechanisms of salesmen distributing the content of material, educational programs financed by the government, through press, and other communications meetings. Notably, the provincial and federal governments did not embark upon the investor education program contemplated by the CCMF study.

The committee recommended “that the financial press should be encouraged to prepare comparative analysis of the mutual funds which reflect the quality of investment management, sales charges, management fees and other relevant factors in order to enable purchasers to base their selections on adequate comparisons, if the financial process fails to prepare such analysis, the task is sufficiently important to justify its performance by government”,²¹⁸.

Although financial press currently does publish some of this information, it does not for instance publish information that “properly reflects the quality of investment management and this is also not published by the government”. It is clear that the degree of disclosure by the financial press recommended by the CCMF has not materialized and it may have not been realistic in retrospect for the committee to have expected this to develop into an effective mechanism for disclosure. Further, the federal and provincial governments have not supplied the level of investor education programs recommended by the CCMF study (refer to Section 3.10).

3.4 CURRENT CANADIAN MUTUAL FUND GOVERNANCE REGIME

The Canadian Securities Administrators (CSA) has been moving towards the creation of fund governance regime for all publicly offered mutual funds in Canada, to ensure that investors maintain their confidence in the mutual fund industry. The mutual

²¹⁸ Ibid., p. 333.

fund industry is very important for Canadian investors and comprises a significant portion of their retirement funds, and the CSA recognize that the buoyancy of Canadian capital markets depends upon investor confidence in this industry. The CSA's efforts towards creation of a mutual fund regime and instilling confidence in Canadian investors have been accompanied by numerous scandals in the mutual fund industry in the United States²¹⁹ beginning in 2003, including late trading and market timing²²⁰. The need for a conflict of interest regime in mutual fund governance in Canada has been underscored by recent events in the mutual fund industry within the United States²²¹. In addition, the CSA has initiated a three-stage mutual fund trading practices probe²²², largely in response to the U.S. scandals. The market probe resulted in identification of abusive practices in five large Canadian mutual fund companies, further underscoring the need for improved fund governance, with a settlement of \$205.6 Million²²³.

In 2002, the Ontario Securities Commission (OSC) released Concept Proposal 81-402 *Striking a New Balance: A Framework for Regulating Mutual Funds and their*

²¹⁹ Donaldson, W.H., (2004, January 7). U.S. Securities and Exchange Commission, Speech by SEC Chairman: *America's Need for Vigilant Mutual Fund Directors*, accessed at: www.sec.gov.on.ca.

²¹⁹ Rule 0-1(a) (7).

²²⁰ Maich, S., (2005, January 31). Personal finance, *MacCleans, Mutual Misery*, accessed at: www.macleans.ca.

²²¹ Howlett, K., (2004, December 14). OSC rapped for not being tougher, available at: www.globeadvisor.com

²²² Ontario Securities Commission, (2004). *Annual Report*, accessed at: <http://www.osc.gov.on.ca/About/AnnualRpt/2004/mdtl.html>.

²²³ Ontario Securities Commission, (2005). *OSC Approves Distribution Plan for \$205.6 Million Fund Probe Settlement*, News Release, June 30, 2005, accessed at: http://www.osc.gov.on.ca/About/NewsRelease/2005/nr_20050630_osc-distribution-plans.jsp.

Managers (the 'Concept Proposal')²²⁴. The Concept Proposal was prepared in light of other background reports commissioned by the Canadian CSA²²⁵. The initial background report to the Concept Proposal for National Instrument 81-402 was *Regulatory Strategies for the Mid-90s-Recommendations for Regulating Investment Funds in Canada* (the 'Stromberg Report')²²⁶ released in 1995. The *Stromberg Report: An Industry Perspective* (the 'Steering Group Report') was prepared by the Industry Funds Steering Group comprised of industry participants formed at the request of the OSC, on behalf of the CSA to consider the implementation of the recommendations contained in the Stromberg Report and was released in 1996²²⁷. In 1998, Glorianne Stromberg released a second report for the Office of Consumer Affairs, Industry Canada entitled *Investment Funds in Canada and Consumer Protection-Strategies for the Millenium*²²⁸ that focused on consumer protection in the fund industry.

In 2000, the CSA commissioned Stephen Erlichman to prepare a report on how it could improve fund governance, which he presented in *Making it Mutual: Aligning the*

²²⁴ Ontario Securities Commission, (2002). *Concept Proposal 81-402, Striking a new balance: A framework for regulating mutual funds and their managers, Concept Proposal of the Canadian Securities Administrators*, March 1, 2002, available at: www.osc.gov.on.ca.

²²⁵ Ontario Securities Commission, (2002). *The Canadian + Mutual Fund Industry: Its Experience With and Attitudes Toward Mutual Fund Regulation, A Background Research Report to Concept Proposal 81 - 402 of the Canadian Securities Administrators*, Prepared by Ontario Securities Commission, March 2002, available at: www.osc.gov.on.ca.

²²⁶ Stromberg G., (1995). *Regulatory strategies for the mid-'90s: Recommendations for regulating investment funds in Canada*. Toronto, accessed at: www.osc.gov.on.ca.

²²⁷ Ontario Securities Commission, The Investment Funds Steering Group, (1996, November). *The Stromberg Report: An Industry Perspective*, prepared for the Canadian securities administrators, accessed at: www.osc.gov.on.ca

²²⁸ Stromberg, G., (1998). *Investment Funds in Canada and Consumer Protection-Strategies for the Millenium, a Review*. Office of consumer affairs, Industry Canada, accessed at: www.strategis.ic.gc.ca

Interests of Investors and Managers-Recommendations for a Mutual Fund Governance Regime for Canada (the ‘Erlichman Report’) in 2000.²²⁹ In 2002, the OSC published the background legal paper *Trust Law Implications of Proposed Regulatory Reform of Mutual Fund Governance* (the ‘Stevens Report’)²³⁰. These reports drew upon the 1969 Report of the Canadian Committee on Mutual Funds and Investment Contracts (the ‘CCMF Report’)²³¹, and the 1974 proposal for Mutual Fund Law for Canada (the ‘1974 Proposal’)²³². In May 2003, the Five Year Review Committee, created by the Minister of Finance of Ontario, released its final report on its securities law review²³³, which recommended that the OSC and CSA introduce a requirement for all publicly offered mutual funds to establish and maintain an independent governance body which led to the further development of the Concept Proposal.

The framework of the Concept Proposal involves a new fund governance regime to ensure independent oversight of mutual fund managers and to minimize conflicts of interest.²³⁴ The CSA indicated that the Concept Proposal set out a system of fund

²²⁹ Erlichman, S., (2000). *Making it Mutual: Aligning the Interests of Investors and Managers: Recommendations for a Mutual Fund Governance Regime in Canada*, (June 2000), Ontario Securities Commission, accessed at: www.osc.gov.on.ca.

²³⁰ Stevens, D.P., (2002). *Trust Law Implications of Proposed Regulatory Reform of Mutual Fund Governance Structure: A Background Research Report to Concept Proposal 81-402 of the Canadian Securities Administrators* accessed at: www.osc.gov.on.ca.

²³¹ *Report of the Canadian Committee on Mutual Funds and Investment Contracts*, Provincial and Federal study, (1969). Ottawa: Queens Printer.

²³² Baillie, J.C., & W.M.H. Grover, (1974). *Consumer and Corporate Affairs: Proposals for a Canada Mutual Funds Law, I & II*. Ottawa: Information Canada.

²³³ Ontario Securities Commission. *The Five Year Review Committee Final Report: Reviewing the securities act*, prepared by the five year review committee to the Minister of Finance, available at www.osc.gov.on.ca

²³⁴ Ontario Securities Commission Bulletin 469, accessed at: www.osc.gov.on.ca

governance which would oversee all of the fund manager's activities through a 'governance agency' defined as "A governing body, that is independent of the mutual fund manager, will supervise that manager's management of its funds and will act to ensure those mutual funds are managed in the best interests of investors. This governing body will act solely in the best interests of investors and will be largely free from conflicts of interest"²³⁵. For a mutual fund structured as a corporation, the Concept Proposal indicates that its board of directors will be that fund's agency. For mutual funds structured as trusts, the Concept Proposal indicates that a board of individual trustees, a registered trust company, and a board of governors would qualify as a governance agency.

The investment fund industry in Canada is currently regulated by a series of National Instruments²³⁶. Two of the major National Instruments were proposed following the Concept Proposal: National Instrument 81-106 (NI 81-106) Investment Fund Continuous Disclosure, and National Instrument 81-107 (NI 81-107) Independent Review Committees which is focussed on conflicts of interest. These two National Instruments are central to the development of a mutual fund governance regime in Canada and have been highly controversial. For example, following the introduction of NI 81-107 in 2004 Elizabeth Church writes:

²³⁵ Concept Proposal, *supra* at note 224.

²³⁶ Accessed at: http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/rrn_part8_index.jsp

“When Canada’s securities agencies unveiled a new approach to regulating mutual fund companies two years ago, the effort was geared to providing more protection for investors. But somewhere along the way from conception to reality, that spirit of reform got lost. This January, the Canadian Securities Administrators (CSA) finally released their new rules for the mutual fund industry and their former “stand-up-for investors” attitude was nowhere in site. Gone were several investor-friendly measures that had been in the sweeping 2002 proposal-measures that had been debated in Canada for the better part of four decades. The missing reforms included the requirement for an independent committee or board to oversee fund operations and the mandatory registration for fund managers to ensure better protection for investors. Instead of beefing up investors’ rights, the new regulations talk about promoting investor protection “while fostering market efficiency” – a nod to industry complaints that the original reform proposals were too costly and cumbersome. Plans to force funds to set up independent boards were abandoned. In their place, the rules call for independent committees to monitor conflicts of interest. But these new committees would have no power to stop a transaction. They could only require the manager to make the objections public”²³⁷.

²³⁷ Church, E., (2004, June 22). Who’s standing up for the investor? Watered-down rules table in January call into question whose side the regulators are on. *The Globe and Mail*, accessed at:

These and other changes to the mutual fund regulatory regime stood in stark contrast to the actions that the U.S. regulators were taking to toughen governance standards for the mutual fund industry in response to the abusive practices previously mentioned. Some other observers were shocked to see proposals so clearly favour the industry given the timing and history of the debate. For instance, Purdy Crawford, Chair of the Five Year Review Committee that reviewed the Securities Act in 2001, characterized this framework as “a very watered down regulatory regime for the governance of mutual funds in Canada”²³⁸.

An evaluation of National Instrument 81-106 and National Instrument 81-107 will be conducted to determine if they provide adequate fund governance, as contemplated, for example, by the Concept Proposal. A secondary purpose is to identify a potential alternative governance regime, when it became clear that these Instruments would not alone provide adequate governance, and that the CSA has not yet proposed a governance agency as contemplated in the sweeping reforms of the Concept Proposal.

As will be shown in the following, the introduction of mutual fund proxy voting disclosure provides a cost effective means of deterring fund managers from voting against the best interests of their shareholders. However, the deterrence of conflicts of interest by disclosure of proxy voting records is limited, since investors will likely not request or read the proxy voting lists. In addition, proxy voting disclosure will not assist

<https://secure.globeadvisor/servlet/ArticleNew/story/gam/20040622/RFUND22>

²³⁸ Gray, J., (2004, September 13- September 26). It's not mutual. *Canadian Business*, 77(18), p. 27.

investors with day to day decision-making concerning their mutual funds. As will be further shown, the introduction of the Independent Review Committee under the current proposal for NI 81-107 will provide positive benefits for regulation at conflicts of interest. However, the role of the IRC is relatively narrow in comparison with the governance agency contemplated in the Concept Proposal. I will explore fund boards as a potential alternative model for a governance agency for Canadian mutual funds. I will further examine the composition of United States board, with respect to the independence of board members, and whether this would influence financial performance of the funds or the board's ability to regulate conflicts of interests and excessive expenses and advisory fees.

4.4 NATIONAL INSTRUMENT 81-106 INVESTMENT FUND CONTINUOUS DISCLOSURE

Disclosure of mutual funds is based on the same principles as disclosure other areas of securities regulation²³⁹, including the principle that investors should have access to all relevant information in making their investment decisions. Disclosure in the mutual fund industry is subject to National Instrument 81-101 *Mutual Fund Prospectus Disclosure*²⁴⁰, which requires mutual funds to provide details concerning fund governance disclosure. In an international context, corporate governance has been

²³⁹ MacIntosh, J.G., & C.C. Nicholls, (2002). *Securities Law*, Irwin Law Inc. Canada.

²⁴⁰ Ontario Securities Commission, *National instrument 81-101, 22OSCB (Supp. 2), form 81-101F1 and form 81-101F2* [referred to as the SP and AIF form respectively], accessed at: <http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/rule_20040116_81-101_ni.jsp>

addressed in the recent OECD report entitled “Principles of Corporate Governance”, which addresses proxy voting, indicating that “a corporate governance framework should ensure that proxies are voted in accordance with the direction of the proxy holder and that disclosure is provided in relation to how proxies will be voted”²⁴¹. Further, shareholders’ right to vote on basic fundamental issues is recognized by law in virtually all the OECD jurisdictions²⁴².

The CSA believes that investors have a fundamental right to know how their fund manager has voted proxies, and that the transparency of voting information would facilitate accountability on the part of fund managers in voting proxies in the best interests of the fund shareholders. The intent of the proposed National Instrument 81-106 *Investment Fund Continuous Disclosure*, is to promote transparency with respect to proxy voting. Under this proposed Instrument, all public investment funds, not just public mutual funds, are subject to national uniform rules providing for a continuous disclosure regime that has been tailored to investment funds. Existing rules that apply only to mutual funds were updated to reflect current industry practices and broadened to apply to other investment funds as appropriate.

On September 20, 2002 the CSA issued an initial draft of proposed National Instrument 81-106 *Investment Fund Continuous Disclosure* (the Rule), Form 81-106F

²⁴¹ Accessed at: <<http://www.oecd.org/dataoecd/32/18/31557724.pdf>>

²⁴² Hertig G., (2004). Convergence of Substantive Law and Convergence of Enforcement: A comparison; in Gordon, J. N. & Roe, M.J. eds., (2004). *Convergence and Persistence in Corporate Governance*, Cambridge University Press, 1st Ed. United Kingdom, p. 336.

Contents of Annual and Interim Management Report of Fund Performance (the Form), Companion Policy 81-106CP (the Policy)²⁴³. The Rule and the Form together are referred to as the proposed Instrument. An initial Notice and Request for Comments was issued on September 20, 2002²⁴⁴. A total of 56 comments were received²⁴⁵. The CSA provided a response to these comments in the Request for Comment for the revised proposed Instrument²⁴⁶.

The CSA also commissioned COMPAS to conduct an opinion survey for the proposed instrument in May 2003 to provide information for the preparation of a revised proposed Instrument²⁴⁷. The COMPAS report indicated that when investors were asked whether they would like to receive reports about the way that their mutual funds cast their votes, 21% indicated interest in knowing how their funds cast their votes on all issues, 48% indicated interest in knowing how their funds vote on major issues and 24% stated that funds should be free not to report how they vote. The CSA is requiring in the proposed Instrument that funds disclose 100% of their proxy votes to security holders.

²⁴³ Ontario Securities Commission, accessed at:
<http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/rule_20020920_81-106_pr.jsp>

²⁴⁴ Ontario Securities Commission, accessed at:
<http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/rule_20020920_81-106_roc.jsp>

²⁴⁵ Ontario Securities Commission, accessed at:
<http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/rule_20021217_81_106_comments.jsp>

²⁴⁶ Supra note, 244.

²⁴⁷ COMPAS, (2003, May). *Final report for Ontario Securities Commission, National Instrument, 81-106*, accessed at: <http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/rule_20040528_81-106_survey-rpt-en.pdf>

3.4.1 2004 Comments on Proposed National Instrument 81-106

The CSA released a revised version of the proposed National Instrument 81-106 on May 28, 2004 which incorporated the comments received on the initial survey and the results of the COMPAS survey²⁴⁸. A Notice and Request for Comments for the proposed Instrument was also issued on May 28, 2004 with a deadline of July 27, 2004²⁴⁹. The CSA provided a description of material changes to the 2002 proposal in Appendix A and responses to the comments on the 2002 proposal in Appendix B. A total of 32 comments were received²⁵⁰.

3.4.2 Proxy Voting Disclosure for Securities Held

NI 81-106 requires that the investment fund establish procedures and policies for determining whether and how to vote on any matter for which the investment fund receives proxy materials for a meeting of security holders of an issuer. Part 10 of the proposed Instrument, entitled “Proxy Voting Disclosure for Securities Held”, addresses proxy voting disclosure for investment funds as follows:

- *Section 10.1, Application*, holds that this applies only to an investment fund that is a reporting issuer;

²⁴⁸ Ontario Securities Commission, accessed at:
<http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/rule_20040528_81-106_pro-ni-ifcd.jsp>

²⁴⁹ Ontario Securities Commission. *Notice and request for comment-changes to proposed national instrument 81-106 investment fund continuous disclosure, form 81-106F1 and companion policy 81-106CP investment fund continuous disclosure (second publication) and related amendments*, accessed at:
<http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/rule_20040528_81-106_not-rfc-changes-pro-ni.pdf>

²⁵⁰ Ontario Securities Commission, accessed at
<http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/rule_20040628_81-106_comments.jsp>

- *Section 10.2, Requirement to Establish Policies and Procedures*, requires the establishment of policies and procedures for a an investment fund for proxy voting;
- *Section 10.3, Proxy Voting Record*, requires that an investment fund must maintain a proxy voting record; and
- *Section 10.4, Preparation and Availability of Proxy Voting Record*, addresses the preparation and availability of a proxy voting record.

Section 10.4 (1) requires that an investment fund prepare a proxy voting record on an annual basis for the period ending on June 30 of each calendar year. Section 10.4(2) requires the delivery of a fund's proxy voting record upon request to any client, and requires managers to create a record (under Section 10.3) on a fund-by-fund basis showing what proxies were received and how they were voted. Section 10.4(2) requires that the fund must deliver or send a copy of the fund's proxy voting policies and procedures, and proxy voting record, upon request, free of charge, to any security holder of the fund not more than 60 days after the end of the period to which the proxy voting record pertains.

3.4.3 2004 Comments Concerning Mutual Fund Proxy Voting Disclosure

Some of the comments on NI 81-106 offered strong support for mutual fund proxy voting disclosure. For example, the proposed instrument has received strong

support from the Social Investment Organization (hereinafter 'SIO'), that represents the socially responsible investment industry in Canada, which "commends the CSA for its proposed policy and rule with regard to proxy voting as outlined in NI 81-106 and 81-106CP"²⁵¹. The Ethical Funds Company (hereinafter 'Ethical Funds') provided the following supportive comment:

"The Ethical Funds Company believes that proxy voting disclosure is a fiduciary obligation owed by mutual funds to their unit holders. More broadly, proxy voting disclosure across the industry would help ensure that mutual funds are supporting corporate governance practices that are consistent with the best interests of investors, stock markets, and the public. Mandatory proxy voting disclosure is a crucial step toward ensuring that mutual funds and pension funds become part of a process of encouraging improved corporate governance practices and restoring investor confidence in our corporations and capital markets"²⁵².

Specific issues associated with the requirements for establishing policies and procedures, maintenance of a proxy voting record and the preparation and availability of a proxy voting record are discussed below.

²⁵¹ Ellman, E., (2004, July 23). Social Investment Organization, RE: Proposed National Instrument 81-106 investment fund continuous disclosure.

²⁵² Walker, R., (2004, July 27). The Ethical Funds Company, SRI policy and research, RE: National Instrument 81-106 and mutual fund proxy voting disclosure.

3.4.4 Requirement to Establish Policies and Procedures

There was broad support in the comments for the provision of policies and procedure for proxy voting to investors. However, issues were raised concerning the requirement to provide these policies and procedure on a fund-by-fund basis. It was noted by Borden Ladner Gervais LLP²⁵³ (hereinafter ‘BLG’) that managers of investment funds will each have policies and procedures applicable to all the investment funds they manage, but that each fund typically does not have its own policies and procedures. It was suggested that the policies and procedures for proxy voting should instead be provided on a manager-by-manager basis, rather than on a fund-by-fund basis, to be consistent with the existing structure of mutual funds.

Commentators noted that they already have an obligation to act in the best interests of the unit holders of their funds, which includes exercising the voting rights attached to securities held, and as such the proposed Instrument would not change their current proxy voting policies and procedures. Many of the commentators supported the requirement for written policies and procedures. For example, the RBC Financial and Asset Management Groups (hereinafter ‘RBC AM’) support the requirements to “have and to publish proxy voting policies and procedures”²⁵⁴. The AIC Group of Funds (hereinafter ‘AIC’) also supports the requirement of written policies and procedures

²⁵³ Borden Ladner Gervais Investment Management Group, (2004, July 28). RE: Proposed national instrument 81-106 investment fund continuous disclosure and proposed related amendments to national and local instruments-Comments of Borden Ladner Gervais.

²⁵⁴ Lalji, R. S., & F. Lippa, (2004, July 26). RBC Financial & Law Group & RBC Asset Management Inc. RE: Proposed National Instrument 81-106 – investment fund continuous disclosure.

designed to ensure that proxies are voted in the best interests of the fund shareholders²⁵⁵.

In summary, all of the commentators appeared to accept the requirements for disclosure of written policies and procedures for proxy voting.

3.4.5 Proxy Voting Record

Significant concerns were expressed amongst the commentators with respect to the requirements to maintain and provide proxy voting records under Sections 10.3 and 10.4 of the proposed Instrument. The comments reflect a perceived lack of investor demand and BMO Nesbitt Burns and BMO Harris Investment Management Inc. (hereinafter BMO) for example state that “Since we see very little demand for this information by investors, we are strongly opposed to the requirement to compile, maintain and deliver a proxy voting record”²⁵⁶. Similarly, AIC notes that “there has not in our experience been a demand for disclosure of actual proxy vote cast -on any matters, let alone routine matters – and the cost involved in meeting this requirement is anticipated to be substantial and will ultimately be borne by the fund security holders.”²⁵⁷ Only 1.38% of the Investors Group Inc. (hereinafter Investors Group) have actually requested that they be sent their fund’s 2003 Annual Report and “they have never

²⁵⁵ McDougall, J. I. The AIC Group of Funds. RE: Submissions in response to request for comments-changes to proposed National Instrument 81-106, its companion policy and form 81-106F.

²⁵⁶ Stefankiewicz, C., (2004, July 27). BMO Nesbitt Burns. RE: Prosposed national instrument 81-106-investment fund continuous disclosure-comments of BMO Nesbitt Burns.; Ian Niven, R., (2004, July 27). NBMO Harris Private Banking, RE: Prosposed national instrument 81-106-investment fund continuous disclosure-comments of BMO Harris Investment Management Inc.

²⁵⁷ AIC supra note 255, p. 24.

received a single request for the proxy voting results for any of their funds”²⁵⁸. Hence, actual experience suggests that proxy voting result will not be in large demand by investors. A legal commentator noted that “The mandating of the disclosure of a fund’s proxy voting record appears to be far less valuable than the disclosure of privileges and procedures because of the irrelevancy of most, if not all, of the information to the investor”²⁵⁹.

The Investment Funds Institute of Canada²⁶⁰ (hereinafter IFIC) comments indicated that the experience of the majority of its members, which are primarily fund managers, has and continues to demonstrate that the overwhelming majority of their investors do not request information that is available upon request. The IFIC therefore believes that the effort and cost required to compile and make the proxy record available to a minority of interested investors is not justifiable. A minority of IFIC members believe that the compilation and provision of a proxy voting record to investors is a necessary part of a fund manager’s fiduciary duty. For example, the Small Investor Protection Association (hereinafter SIPA) believes that shareholders have the right to know how their proxy shares are being voted and that the vote is consistent with the best

²⁵⁸ Wright, W.T., (2004, July 27). Investors Group Inc. Canadian Securities Administrators proposed National Instrument 81-106-investment fund continuous disclosure.

²⁵⁹ Stewart, B. D., (2004). Article disclosure of the irrelevant? – Impact of the SEC’s final proxy voting disclosure rules, 9 *Fordham Journal of Corporate and Financial Law*, 233.

²⁶⁰ Murray, J. W., (2004, August 4). The Investment Funds Institute of Canada. Regulation and corporate affairs, RE: Changes to proposed national instrument 81-106-investment fund continuous disclosure.

interests of the fund and that the new rules will make mutual funds more transparent in their proxy policies and on their voting records²⁶¹.

The Guardian Group of Funds (hereinafter Guardian Group) recommends that the CSA should remove the requirement for delivery of proxy voting reporting, since they believe that “additional costs will be passed on to the unit holders without any appreciable benefit accruing to them”²⁶². However, the experience of Ethical Funds, which conducts proxy voting disclosure, contravenes this view since it indicates that historically its MERs were below industry average for the majority of its funds and concludes that “Cost is not a barrier to proxy voting disclosure”²⁶³.

In its present form, the proposed Instrument requires reporting on the proxy votes cast at both general meetings and special meetings, regardless of the importance of matters that are put to a vote. Desjardins Trust (hereinafter Desjardins) suggested that proxy voting disclosure should be changed to apply only to special meetings of unit holders having voting rights at these meetings, and not to statutory annual meetings and in particular shareholder general meetings²⁶⁴. This would entail amendment of the

²⁶¹ Small Investor Protection Association (SIPA), Ken Kivenko, Chair, Advisory Committee and Stan Buell, President, Subject: CSA National Instrument 81-106 Investment Fund Continuous Disclosure, July 27 2004.

²⁶² Guardian Group of Funds, Steven P. Rostowsky, Chief Financial Officer and Chief Compliance Officer, Re: Changes to Proposed National Instrument 81-106 Investment Fund Continuous Disclosure – Comments of Guardian Group of Funds Ltd.

²⁶³ Ethical Funds, *supra* note 252.

²⁶⁴ Desjardins Trust Louis Chartrain, Attorney, Assistant Secretary. Re: Changes to proposed National Instrument 81-106 (Investment Fund Continuous Disclosure), Appendix 81-106A1 and the companion policy to National Instrument 81-106 (Investment Fund Continuous Disclosure) (second publication), July 27, 2004.

Section 10.3 of the proposed instrument to apply only to special meetings or to general meetings when the investment fund exercises its voting rights against a recommendation of management. BMO suggested that if funds are required to prepare and maintain a proxy voting record, the proposed Instrument should be narrowed to votes where the fund opposed management's recommendation.

It was suggested that if the CSA maintains the requirement for a Proxy Voting Report in the proposed Instrument, that it be restricted to reporting only votes where the portfolio manager deviated from the fund's proxy voting policy or in circumstances where the fund voted against the recommendations of the issuer's management. For example, the Investors Group states "In view of the requirement to provide a summary of the fund's proxy voting policies and procedures, it would make sense to report only those instances where a fund deviated from the policy, or voted against management, if any disclosure at all is required"²⁶⁵. Some commentators suggested that reporting be subdivided into routine and non-routine matters and that only the non-routine matters are voted upon. However, another view was expressed that it is highly unlikely that security holders are interested in voting on 'routine matters'.

Other commentators do not support filtering of proxy votes between routine and non-routine matters, since most of the existing proxy voting services do not have this type of filter making the process manual, which would be both time consuming and expensive. AGF, for example, supports the CSA's position that filtering proxy

²⁶⁵ Investors Group, *supra* at note 258.

information between routine and non-routine matters is not necessarily beneficial due to the time and cost involved in setting up this type of system²⁶⁶. Commentators believe that investors wish to delegate responsibilities for managing their fund to professionals. For example, AGF states that they “believe that investors purchase the professional management services that are available to them through investment in mutual funds precisely because they wish to have investment management, proxy voting, and other issues addressed for them.”²⁶⁷

Mackenzie Mutual Funds (hereinafter Mackenzie) indicates that it does not believe that the disclosure of proxy voting on individual securities will provide useful information to most investors²⁶⁸. AGF believes that investors will have sufficient information to make their investment decisions if the policies and procedures are summarized in the annual information form and available to investors upon request. TD Asset Management (‘TD AM’) states that “We agree that investors should be entitled to information if desired but would prefer being able to deal with individual requests rather than producing unwieldy records that investors may ultimately never want access to.”²⁶⁹

²⁶⁶ AGF Management Limited, Canadian Securities Administrators (“CSA”), Judy Goldring, Proposed National Instrument, 81-106 (“NI 81-106”) Investment Fund Continuous Disclosure, July 27, 2004.

²⁶⁷ Ibid.

²⁶⁸ Mackenzie Mutual Funds, W. Sian B. Brown Senior Vice President and General Counsel, Ann Savege Senior Vice President and Chief Financial Officer, Funds and Venkrat Kannan Vice-President, Fund Administration, Re: Proposed National Instrument 81-106 and Companion Policy 81-106CP Investment Fund Continuous Disclosure and Form 81-106F1 Contents of Annual and Interim Management Reports of Fund Performance and the Related Amendments to National Instrument 81-101, National Instrument 81-102 and National Instrument 13-101, July 27, 2004.

²⁶⁹ TD Asset Management, Steve Geist, President TD Mutual Funds, Re: Request for comments on Proposed National Instrument 81-106 (“NI-106”), Companion Policy 81-106P and Form 81-106F1 (collectively referred to as the “Proposals”), July 27, 2004.

The proposed Instrument imposes the requirement on the investment fund, and hence the management company, to establish policies and procedures for voting by proxy and maintaining a proxy voting file. However, some of the funds are administered by external advisors, such as the Guardian Group which has 99% of their assets under management advised by external professional portfolio advisors under the terms of an Investment Management Agreement (IMA), which gives the portfolio advisors the responsibility for voting proxies pertaining to the portfolios that they manage.

The Investors Group noted that compilation of proxy voting record into a consolidated record could be difficult where external portfolio advisors are involved who vote independently of the manager, especially on routine matters when they follow the fund's proxy voting policy. It may be more appropriate for some funds that investment advisors are subject to the proxy voting requirements in the proposed Instrument. For example, Desjardins states: "We believe that the exercise of voting rights by proxy for securities held is completely in line with the mandate of investment advisors. They are the ones who are or should be best informed to exercise such voting rights in the best interest of the investment fund. We therefore submit that the advisors and associate investment advisors should bear the requirements of Part 10 of the Instrument"²⁷⁰. Additional support was provided by AGF which stated that "proxy voting is a part of the

²⁷⁰ Desjardins, *supra* note 264.

management process that is best dealt with by portfolio advisors, not mutual fund managers”²⁷¹.

Many of the commentators are not convinced that potential benefit of providing the detailed proxy record outweigh the costs to investors of producing it. BMO indicated, that it does not believe that a record of proxy voting is widely desired by Canadian investors, and that the preparation, maintenance and delivery of the proxy voting records would involve considerable time and expense due to its size and scope and would be difficult and costly to complete²⁷². The Investors Group “strongly oppose the requirement in s. 10.3 that each fund compile and publish its Proxy Voting Record because this would entail a huge and costly commitment of time and effort, the usefulness of this information is questionable, and we do not perceive any appreciable demand for this information.”²⁷³ The Investor’s Group indicated that for their organization, with about 140 funds, preparation of proxy voting record would require a summary of a total of 1,400 meetings; for a fund with the minimum required ten holdings that it would be required to report on.

The requirement for producing proxy voting records on a fund-by-fund basis is a major concern amongst the commentators, since these are currently organized largely on an issuer-by-issuer basis. Concerns were expressed that maintaining and providing a proxy voting record on a fund-by-fund basis would be expensive, and it is argued that it

²⁷¹ AGF, *supra* note 266.

²⁷² BMO *supra* note 256.

²⁷³ Investors Group, *supra* note 258.

is easier for the advisor to produce a proxy voting record at much lower cost and will provide essentially the same information. RBC for example states:

“The section of proposed NI 81-106 with which RBC AM has significant concerns is the requirement to publish proxy voting records on a fund-by-fund basis. RBC AM currently maintains its proxy voting records on an issuer-by-issuer basis because like most advisors, it generally exercises all of its funds’ proxies for one issuer in the same manner. The requirement under proposed section 10.3, to create and maintain a proxy voting record on a fund-by-fund basis, would be very expensive to produce.”²⁷⁴

In RBC’s view, the CSA has not provided rationale or a basis for selecting the proxy voting records to be dealt with on a fund-by-fund basis. Several commentators believe that the cost of proxy voting disclosure exceeds the benefits given the low perceived demand for proxy information in the past, and AGF for example indicates that they believe the cost to all security holders of providing the proxy voting record exceeds the benefits of providing this information to a few that are interested in the results. The Investors Group further states that “mutual funds should not be forced to bear the costs of providing information that the vast majority of their security holders do not wish to receive²⁷⁵. Proxy voting reporting under Section 10.4 is expected by the fund managers to result in increased effort and cost particularly if required on a per-fund basis as opposed to

²⁷⁴ RBC, *supra* note 254.

²⁷⁵ Investors Group, *supra* note 258.

requiring this on a per manager basis or per investment advisor basis.” RBC also indicates that a proxy voting record is easier for an advisor to produce and maintain and will provide unit holders with substantially the same information at a much lower cost.

IFIC, which represents the investment fund industry, encouraged the CSA not to make the provision proxy voting records mandatory in the proposed Instrument stating: “We encourage the CSA not to render the compiling of a proxy voting record or the requirements of section 10.4(2) as they pertain to the delivery of the record, mandatory”²⁷⁶.

IFIC indicated that this approach would acknowledge the experience of the majority of its members, while providing those members with the option to revisit and amend their practices to best accommodate investor demand for proxy voting results, should these demands change with time. IFIC further indicated that this approach would also not hinder its members that currently provide proxy voting information from continuing to do so, and permit them to determine how to best collect, compile and distribute this information to investors.

3.4.6 Discussion

The SIO believed that by permitting investment funds to post their proxy policies and records on the web, the CSA would provide the option for mutual funds to set up a low-cost disclosure system. The SIO recommended that investment funds be given the

²⁷⁶ IFIC, *supra* note 260.

option of providing written copies of the proxy policies and records on request by security holders, or to provide these documents on their websites and referring security holders to the web for this information. Ethical Funds currently discloses proxy voting policy, procedures and results on its website²⁷⁷. It discloses its proxy voting policies on its website in advance of the proxy voting season and the annual publication of this document is accompanied by a media release. The unit holders are informed about proxy voting policies through its prospectus and semi-annual and annual reports, with actual proxy voting activity disclosed on the website. Using this approach, the company is able to provide its voting intentions several days before each company's annual general meeting. The proxy voting record is able to be sorted by visitors to the Ethical Funds website by company name or by annual company meeting date.

Ethical Funds found that this approach meets their unit holders needs in a cost effective manner and believes that its web-based approach provides a superior level of disclosure to unit holders at a lower cost than that proposed by the CSA. Ethical Funds suggests that the CSA allow mutual fund companies to comply with disclosure requirements using this method. Modifying the Instrument to allow for the use of websites for provision of proxy voting records could address much of the concerns expressed by fund managers concerning the provision of proxy voting records.

The SEC recognized the advantages of positioning of proxy records on websites. In preparation of SEC's final rule of Proxy Voting Policies and Proxy Voting Records for

²⁷⁷ <http://www.ethicalfunds.com/do_the_right_thing/sri/shareholder_action/proxy_voting.asp>

Registered Management Investment Companies, the SEC modified its original rule to specifically permit investment funds to provide their voting records via the web.²⁷⁸ This modification was undertaken to address concerns that the proposals would require funds with large numbers of holdings to produce lengthy proxy voting spreadsheets and to send them in paper copy to investors who request them, comparable to the concerns expressed in the comments concerning the proposed instrument in Canada. Under the SEC's final rule, unit holders may obtain a copy of the voting record without charge upon request through the fund's website, or through the SEC's website.

In Canada, the Ontario Teachers Pension Board and the Ontario Municipal Retirement System also post their votes on their website.²⁷⁹ The Canada Pension Plan Investment Board uses a system put in place by Institutional Shareholder Services to publicly report its shareholder votes²⁸⁰. The Internet promises to make shareholder voting a more frequently used and powerful tool for corporate management²⁸¹. In addition, transparency and disclosure on the Internet may be necessary for Canadian funds to effectively compete in global capital markets²⁸². By providing this web-based option to mutual funds, the CSA would create a low-cost disclosure method to provide an

²⁷⁸ <<http://www.sec.gov/rules/final/33-8188.htm>>

²⁷⁹ SIO, *supra* note 251.

²⁸⁰ *Ibid.*

²⁸¹ Cole, D. R., (2001). E-proxies for sale? corporate vote-buying in the Internet age, 76 *Washington Law Review* 793, July 2001.

²⁸² Sarra, J., (2001). Convergence Versus Divergence, Global Corporate Governance at the Crossroads: Governance Norms, Capital Markets & OECD Principles for Corporate Governance, 33 *Ottawa Law Review* 177.

up-to-date source of information on proxy policies and votes to facilitate their integration within global capital markets.

Fund managers and portfolio advisors must vote proxies on behalf of an investment fund in a manner that is consistent with the best interests of the fund and the security holders²⁸³. Mandatory disclosure may result in development of potential conflicts of interests. For example, mutual funds commonly receive investments through retirement plans that are offered by companies in which the funds invest. Accordingly, fund managers may not want to vote against management of companies that hold funds in employee retirement plans, even though this may be in the best interests of the participants in the plan.

Mutual funds have traditionally followed the so called “Wall Street Rule” which involves voting routinely with management. In the U.S., the SEC found that mutual funds prior to the 1970s almost universally exercised voting authority in accordance with the Wall Street Rule and “rarely participate in corporate governance.”²⁸⁴ The practice of voting with management has continued to persist and a legal commentator has recently remarked, for instance, that “while managers of most large fund groups carefully review corporate proxies, they endorse the proposals of corporate management almost without

²⁸³ Sonthalia, R., (2004). Shareholder Voting on All Stock Option Plans: An Unnecessary and Unwise Proposition, April, 2004, 51 *UCLA Law Review* 1203.

²⁸⁴ Palmiter, A.R. (2002). Mutual fund voting for portfolio shares: why not disclose?, 23 *Cardozo Law Review* 1419, March 2002.

exception.”²⁸⁵ In the past, when dissatisfied with managerial performance, institutional investors typically sold their stock rather than actively participating in corporate governance²⁸⁶. Mutual funds continue to be considered as passive participants in corporate governance, since fund managers have not been activists in voting against management initiatives, voting for other shareholders’ proposals, or proposing corporate reforms. However, this passive role is changing and mutual funds are beginning to play a stronger role in voting and governance. Investors may potentially find disclosure of proxy voting policies and results relevant which may serve to stimulate their interest and lead to increased investor participation in corporate governance.

There has been considerable attention paid to the role of institutional investors in corporate governance, such as by Bernard advocating increased involvement of shareholders in director nominations and voting²⁸⁷, and three papers by Black advocating increased participation in corporate decision-making by institutional investors with large but non-controlling holdings²⁸⁸. Camara has recently argued that the ability of directors to bundle decisions cannot justify shareholder initiative and that there is no other reason to expect that an increased power of shareholder intervention would overcome the

²⁸⁵ Bogle, J.C. (2004). Re-mutualizing the mutual fund industry--the alpha and the omega, 45 *Boston College Law Review* 391, March, 2004.

²⁸⁶ Bernard, J. W. (1990). Shareholder access to the proxy revisited, 40 *Catholic University Law Review* 37, Fall, 1990.

²⁸⁷ J.W. Bernard, *supra* at 75; Bernard, J. W., (1991). Institutional investors and the new corporate governance, *North Carolina Law Review*, 69, 1135, 1149.

²⁸⁸ Black, B.S., (1991). The value of institutional investor monitoring: the empirical evidence, 39, *UCLA Law Review*, 895; Black, B.S., (1990). Shareholder Passivity Reexamined, *Michigan Law Review*, 520; Black, B.S. (1992). Agents watching agents: the promise of institutional investor voice, *UCLA Law Review*, 39, 811.

existing problems with shareholder voting as a corporate control mechanism²⁸⁹, stating that “Effective shareholder voting cannot be justified as increasing shareholder wealth.”²⁹⁰ A dissenting view has been put forward by Bebchuk who argues that shareholders should be able to act on at least certain important categories of corporate decisions on their own initiative.²⁹¹ As such, there are dissenting views concerning the efficacy of shareholder participation in voting. The rules for proxy voting disclosure in NI 81-106 allow for an effective means for shareholders of mutual funds to know how proxies were voted on their behalf.

Mutual fund managers tend to be short-term investors, with a focus on short-terms returns, and they are rewarded by the total value assets under management and not fund performance. Hence their primary incentive is to increase fund assets with little incentive to participate, by proxy voting, in the long-term corporate governance of the companies in their fund portfolios. Mutual funds have an incentive to avoid becoming activist through proxy voting since most activism is not financially reimbursed and any resultant gains in fund performance are shared with competing mutual funds. In addition, mutual funds may adopt a ‘free rider’ approach on the activism of pension funds, without the risks and costs associated with activism.

²⁸⁹Camara K.A.D., (2004) Shareholder voting and the bundling problem in corporate law, *Wisconsin Law Review*, 1425, 1428, 1453-54.

²⁹⁰Camara K.A.D., (2005). Classifying institutional investors, *Iowa Journal of Corporation Law*, 219, Winter 2005.

²⁹¹ Bebchuk., L., (2005). The case for increasing shareholder power, *Harvard Law Review*, 118, 833, 836.

Mandatory disclosure could discourage funds from voting against management of portfolio companies, since there will be a record of their voting, which can be accessed by management, for fear of reprisal from the portfolio companies. Such reprisal could, for example, involve withholding of company information required by the funds, or influencing the holdings of mutual funds in the company's retirement plan. In this sense, disclosure of mutual fund voting records may serve to deter meaningful participation in corporate governance through proxy voting. Disclosure of mutual fund proxy voting results may result in activism for those who wish to establish notoriety, which has occurred for pension funds²⁹². Mandatory disclosure of proxy voting records could result in voting for notoriety or political agenda, which could become particularly problematic should the voting power become concentrated in large fund families or proxy service companies. Fund voting that is motivated by private or political agenda could detract from the maximization of value for shareholders. The greater transparency resulting from disclosure may serve to reduce the effectiveness of mutual funds as corporate monitors through 'behind the scenes' lobbying and secret balloting²⁹³. Adoption of confidential voting, however, has no significant effect on voting outcomes, and does not affect firms' stock performance, based on empirical evidence²⁹⁴. Hence, there is not likely to be an affect on a fund performance resulting from public disclosure of mutual fund proxy voting results.

²⁹² Palmiter, *supra* note 284.

²⁹³ Fisch, J.E., (1993). From legitimacy to logic: reconstructing proxy regulation, 46 *Vanderbilt Law Review* 1129, October 1993.

²⁹⁴ Romano, R., (2003). Does confidential proxy voting matter? 32 *Journal of Legal Studies* 465, June 2003.

A potential for conflict of interest could arise when a fund manager seeks to manage the retirement plan assets of a company whose securities are also held by the fund. In these circumstances, disclosure of proxy voting records could stimulate the fund manager to vote with management of the portfolio company to avoid potential reprisals associated with the companies not recommending the funds for company retirement plans. The requirement for a manager to disclose its proxy voting record could put the manager in a position of conflict. For instance, a fund manager may decide to vote against a management proposal that it believes is not in the best interests of fund investors, while continuing to need the cooperation of management of the corporation in order to carry out its due diligence on the corporation as part of its portfolio function.

There is a potential for mandatory disclosure of proxy voting results to inhibit proxy voting since voters will not want their views publicly known. There is also a potential for increased 'grandstanding' by voters who want to be publicly recognized²⁹⁵. Further, mutual fund managers may not want to become known as activists, through proxy voting records, which could alienate portfolio companies and investors. Fund managers may not want to risk good relationships with corporations in their portfolio by voting publicly against management, in the event that the portfolio company would deny access to corporate information that is critical for competitiveness and success of their funds with the increased focus associated with transparency, created by disclosure of proxy

²⁹⁵ Palmiter, *supra* note 284.

voting, results may motivate mutual fund managers to pursue politically activist roles that do not relate directly to financial performance of the fund.

Mandatory disclosure of proxy voting results may cause mutual funds to base voting on considerations of business with portfolio companies rather than on the best interests of shareholders. Mandatory disclosure may influence mutual fund managers to vote with management since the voting will be publicly available and they would not want to risk reprisal from portfolio companies. Further, fund managers may wish to be publicly seen to be voting with management of portfolio companies to show their alliance and gain support and cooperation. In addition, fund managers may fear that portfolio company management may direct employees with investments in their mutual funds, within their company retirement funds, to other less activist funds if they are perceived to be voting against management. Therefore, disclosure could provide a public record of this and perhaps dissuade fund managers from voting against management and instead continue to follow the "Wall Street Rule".

The lack of a disclosure mandate for mutual fund voting has been justified in the past based on the belief that funds are subject to market forces that legitimize the voting of portfolio shares²⁹⁶. However, financial results, not the disclosure of voting or governance policies, appear to matter most to investors²⁹⁷. Further, rational apathy of investors and their perceptions that the efforts will not materialize into financial returns

²⁹⁶ Buxbaum, R.M., (1991). Institutional owners and corporate managers: a comparative perspective, 57 *Brooklyn Law Review* 1, 47.

²⁹⁷ Palmiter, *supra* note 284.

also discourages discipline by market forces. In addition, funds that adopt high-cost or ineffective voting and corporate governance policies seem to be largely immune to market discipline²⁹⁸. As such, the market forces do not appear to be sufficient to justify lack of disclosure of proxy voting for mutual funds. Accordingly, the CSA's proposal for proxy voting disclosure is considered to be appropriate.

Institutional activism has steadily grown in the U.S. since the mid 1980s²⁹⁹, and capital markets have experienced a shift over the last decade from participants consisting primarily of household investors to one made up primarily of institutional investors including mutual funds and pension funds³⁰⁰. The Canadian mutual fund industry has a potential for substantial influence upon the companies in which it invests with more than \$450 billion in assets under management³⁰¹. Some institutional investors, in recent years, have sought to use this influence to challenge traditional patterns of corporate governance, claiming that new patterns of decision making will result in enhanced corporate performance³⁰². Recently, there has been an increase in the engagement in corporate governance activities by institutional investors, including proxy proposals and negotiating with management, with a goal of improving corporate performance, although

²⁹⁸ Ibid.

²⁹⁹ O'Sullivan M.A., (2001). *Contests for Corporate Control Corporate Governance and Economic Performance in the United States and Germany*, Oxford Press, 1st Ed., United States, pp. 177-178.

³⁰⁰ Ibid.

³⁰¹ IFIC, supra note 260.

³⁰² Bernard, J.W.J., (1991). Institutional investors and the new corporate governance, 69 *North Carolina Law Review* 1135 June, 1991.

empirical research indicates that such activism may have little or no effect on targeted firms' financial performance³⁰³.

Mutual fund proxy voting disclosure will encourage activism of institutional investors, by providing a mechanism by which shareholders can have meaningful participation in corporate governance. Mandatory disclosure of voting policies and procedures will provide a more uniform approach to identification of issues. This could promote consistency in the identification of issues, reducing sporadic releases of issues by some funds while others choose to remain silent. In addition, funds that identify issues may be less likely to be singled out as alarmist and receive reprisals from the companies that they invest in. However, requiring all mutual funds to vote proxies or actively monitor corporate governance may be inappropriately encouraging uniformity³⁰⁴.

Mutual funds are currently rated on a number of different criteria such as fund performance and expense ratios. In the future, mutual funds may be rated with respect to non-financial measures, such as activism and corporate governance based on proxy voting results. The ability for investors to actively participate in corporate governance of funds by proxy voting may provide these funds with a competitive advantage over those funds that rely only on financial performance for shareholder returns.

³⁰³ Romano, R., (2001). Less is more: making institutional investor activism a valuable mechanism of corporate governance, 18 *Yale Journal on Regulation* 174, Summer 2001.

³⁰⁴ Larson, J., (2004). Institutional Investors, Corporate Governance and Proxy Voting Disclosure in: Puri, P. & J. Larson, (2004). *Corporate Governance and Securities Regulations in the 21st Century*, Lexis Nexis, Canada Inc. Butterworth, May 2004, pp. 181-215

In 2003, the United States SEC adopted a new rule entitled "Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies"³⁰⁵. This rule requires mutual funds to disclose the policies and procedures they use to vote proxies and make the results of the proxy voting available to shareholders. The SEC indicated that the required disclosure of a fund's proxy voting policies and actual votes is intended to enable shareholders to monitor their funds' involvement in the governance activities of portfolio companies which, in turn, will encourage funds to become more engaged in portfolio company governance activities³⁰⁶. The SEC rule is premised on the belief that poor governance practices contributed to a series of accounting failures which subsequently had a negative impact on public confidence in capital markets.

The investment fund industry objected to the rules introduced by the SEC in 2003 claiming that it would be expensive, but record comments in favour of the proposal led to its approval by all but one of the SEC Commissioners³⁰⁷. The SEC's expectation is that increased shareholder activity with respect to mutual funds through proxy voting disclosure can have a potential "dramatic impact on shareholder value" and the value of capital market investors at large. The SEC also asserts that disclosure of proxy voting activities could "illuminate potential conflicts of interest and discourage voting that is

³⁰⁵ SEC, 17 CFR Parts 239, 249, 270, and 274; Release No. 5 33-8188, 34-47304, IC-25922; File No. 57-36-02; RIN 3235-A164; available at: <<http://www.sec.gov/rules/final/33-8188.htm>>

³⁰⁶ <<http://www.sec.gov/cgi-bin/txt-srch-sec?text=proxy+investment+fund+proxy+voting#section1>>

³⁰⁷ Monks R.A.G. & N. Minow, (2004). *Corporate Governance*, Blackwell Publishing, 3rd Ed., United Kingdom, p.132.

inconsistent with fund shareholders' best interests". Hence, there are potential benefits of enhancing investor confidence associated with mandatory proxy voting disclosure within Canada.

Mutual fund proxy voting provides a means to deter mutual fund advisors from conflicts of interests arising from fund managers voting against the best interests of their security holders. In the U.S. the SEC describes its rationale for the mutual fund proxy voting regulations "to prevent material conflicts of interests from affecting the manner in which advisors vote client proxies"³⁰⁸. The new proxy voting disclosure rules developed by the SEC in the United States, adopted in 2003, specifically require mutual funds to disclose their proxy voting procedures, as well as their actual votes on specific proposals. There are conflicting views concerning their effectiveness. Stewart indicates that they provide no practical benefit to investors in their investment decision-making process, while imposing onerous and costly obligations on funds and their advisors³⁰⁹. Nicholson indicates that "proxy voting disclosure is a relatively simple and cost-efficient way to deter mutual fund advisors from voting against their clients' best interests"³¹⁰.

³⁰⁸ *Proxy voting by Investment Advisors*, 68 Fed. Reg. 6585 (Feb. 7, 2003). *Disclosure of Proxy Voting Records by Management Companies*, 368 Fed. Re. 6564 (Feb 7, 2003).

³⁰⁹ Stewart, B. D., (2000). Disclosure of the irrelevant? – impact of the SEC's final proxy voting disclosure rules, *Fordham Journal of Corporate and Financial Law*, 9, 133.

³¹⁰ Nicholson, H.A., (2004). Securities law: proxies pull mutual funds into sunlight: mandatory disclosure of proxy voting records, 57 *Oklahoma Law Review* 687, Fall 2004).

The new SEC regulations addressing disclosure are similar to those proposed by the SEC in 1978³¹¹. The SEC's 1978 proposal did require that funds disclose the number of times they voted for and against management but did not require the disclosure of the actual votes. In the U.S., the SEC indicates that voting investment fund advisors have a fiduciary duty to vote in the best interests of the investors. The SEC indicated that proxy voting disclosure was required to instill confidence in investors, which may lead to an increase in shareholder value³¹².

The impetus behind the new SEC regulations for proxy voting disclosure in the U.S. came from fund management companies that advocated for shareholder activism³¹³. The fund managers that were proponents of disclosure argued that the disclosure of the proxy votes will mitigate the conflict of interest present when a mutual fund votes proxies a company for when it also manages assets; increase the seriousness with which fund managers vote; and will deter managers from unilaterally "rubber stamping" management decisions. Although the ICI supported the requirement that mutual funds adopt policies and procedures for conducting their proxy voting it strongly opposed the requirement that mutual funds disclose their actual votes on each proposal³¹⁴. The situation in the U.S.

³¹¹ *Proposed Rules Relating to Shareholder Communications, Shareholder Participation in the "Corporate Electoral Process and Corporate Governance Securities Exchange Act*, Release No. 14, 970, 1978 SEC Lexis 1127 (July 18, 1978).

³¹² *Proxy Voting by Investment Advisors*, 17 C.F.R. & 275.206 (4)-6 (2003); *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, 17 C.F.R 270.3061-4.

³¹³ Nicholson, *supra* note 310.

³¹⁴ Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (2002), at <http://www.sec.gov/rules/proposed/S73602/cstyle1.htm>

mirrored that in Canada, in which IFIC supported the adaptation of policies and procedures for proxy voting, but strongly objected to the requirement for provision of proxy voting records. This is to be expected since the CSA was essentially following suit with regard to the basic framework of the U.S. proxy voting regulations.

Under the SEC regulations, mutual funds must disclose the name of the company, identify information on the security voted, provide a brief description of the matter voted on and the proposing party, state whether the fund voted on the matter, disclose how the fund voted and detail and whether this vote was in favour of, or against, management's position³¹⁵. The SEC, however, decided not to require a fund to disclose when its vote was inconsistent with its stated policies. The TIAA-CREF, a large pension fund-insurance company, commented that individual investors would find this information more valuable than the disclosure of individual votes³¹⁶. In addition, the TIAA-CREF argued against the disclosure of actual votes because of the concern that disclosure may jeopardize its use of the vote to negotiate with the management of portfolio companies, and instead proposed a summary disclosure that would group votes by type and report in the aggregate³¹⁷. The information required by the SEC proxy voting disclosure regulation adds very little to an investor's resources for making an informed decision

³¹⁵ *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, 68 Fed. Reg. 6564 (Feb. 7, 2003).

³¹⁶ Comment Letter from Peter. C. Clapman, Senior Vice President and Chief Counsel, Corporate Governance, Teachers Insurance and Annuity Association of America College Retirement and Equities Fund, to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 6, 2002) at <http://www.sec.gov/rules/proposed/S73602/pcclapman1.htm>

³¹⁷ *Ibid.*

about the quality of fund management. For instance a record of a yes or no vote on a proposal provides little information as to why a fund voted that way³¹⁸.

Conflicts of interest within the mutual fund industry present a challenge to regulators where no disclosure rules exist to control unethical or illegal behaviour. Before the proxy disclosure rules, financial markets relied largely on competitive forces to determine optimal levels of disclosure. Theorists postulated that if disclosure is worthwhile to investors the firm can profit by providing it³¹⁹. Although the disclosure of proxy voting rules may not directly benefit individual investors, investors will benefit from the impacts of the SEC regulations upon mutual funds³²⁰. Disclosure may deter conflicts of interest, since fund managers may find possible benefits from a failure to disclose or from a failure to vote proxies in a client's best interests outweigh any potential loss of revenue or reputation, particularly when mutual funds face little chance of being caught³²¹.

Mutual Fund managers could also use proxy voting record disclosure to demonstrate their alliance by publicly voting with management at the expense of voting in shareholders' interests, as well as potential issues of using proxy voting record disclosure to gain notoriety or for potential agendas. Despite these issues there are significant opportunities for mutual fund proxy disclosure to contribute to corporate

³¹⁸ Ibid.

³¹⁹ Nicholson, *supra* note 310.

³²⁰ Ibid.

³²¹ Ibid.

governance by increased shareholder involvement in the proxy voting process. In the event that the requirement for provision of proxy voting records is retained in the final Instrument, the CSA should consider allowing the mutual fund industry to compile and publish proxy voting records on a manager-by-manager basis, or advisor-by-advisor basis, rather than the more costly fund-by-fund basis. This will minimize the potential for unnecessary costs that would ultimately be passed on to investors in the form of management fees and therefore, mutual fund proxy disclosure has the potential to enhance corporate governance in Canada.

In summary, the responses from the Investment Fund Industry to the CSA's Request for Comments on the proposed Instrument indicated a general acceptance of the requirement to provide written policies and procedures for mutual fund proxy voting disclosure. The comments identified several significant issues with respect to maintaining and providing a proxy voting record. Firstly, the proposed Instrument requires that the proxy voting records be organized and maintained on a per-fund basis, while currently they appear to be organized primarily on a manager-by-manager basis based on the comments received. The industry comments indicate that the requirement to provide the proxy voting reports upon request is anticipated to be time-consuming and costly. Industry perception is that this is not appropriate from a cost-benefit perspective since there is anticipated to be a low demand for proxy voting records from investors. The IFIC, which represents the investment fund industry has encouraged the CSA to not to require mandatory disclosure and provision of proxy voting records. Additional issues associated with disclosure of proxy voting records include reprisal from portfolio

companies for mutual funds that vote against management, which could influence funds to vote with management.

The CSA released the revised NI 81-106 on March 11, 2005 indicating that “After considering the comments received, we revised the Instrument and CP. However, as these changes are not material, we are not republishing the Instrument or CP for further comment period”³²². NI 81-106 received ministered approval on May 2, 2005³²³. The only changes to the rules for proxy voting disclosure (Part 10 of the Instrument) were the addition of a requirement for investment funds that have a website to post their proxy voting records. Accordingly, the other issues previously discussed with respect to the September 2002 and May 2004 drafts of the Instrument persist. The SEC has included posting of proxy voting records on web sites in its final rule for proxy voting disclosure in the United States and there are examples of successful use of web-based proxy voting disclosure in Canada. Posting of proxy voting records on websites, is permitted in the U.S. instead of providing these in paper form, to avoid the need to issue lengthy paper copies and to reduce costs. The final Instrument instead provides a duplication of efforts, since the fund managers will now be required to provide paper proxy voting records and post them on their websites.

³²² Available at: www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/rule_20050311_81-106_ni-05cb2810-supp.pdf.

³²³ *Notice of Ministerial Approval of National Instrument 81-106 Investment Fund Continuous Disclosure and Ontario Securities Commission Rule 81-101 Implementing National Instrument 81-106 Investment Fund Continuous Disclosure and Related Amendments*, accessed at: http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/rule_20050603_81-106_not-if-cont-disc.jsp

3.5 NATIONAL INSTRUMENT 81-107, INDEPENDENT REVIEW COMMITTEE FOR MUTUAL FUNDS

In January 2004, the Ontario Securities Commission (OSC) released proposed National Instrument 81-107–*Independent Review Committee for Mutual Funds*³²⁴ (hereinafter the “Instrument”) for comment. The Instrument introduces a mandatory fund governance regime focussed on conflicts of interest. Under the proposed Instrument, conflicts of interest would be regulated through a principle-based governance regime rather than restrictive rules. This proposed Instrument is intended to regulate all publicly offered mutual funds in Canada, including mutual funds investing in equities, bonds, income securities, money market instruments, balanced funds, index funds, mortgage funds, fund of funds, and commodity pools. A total of 43 comment letters were received in response to the CSA’s Request for Comment³²⁵ and posted on the website³²⁶.

3.5.1 Independent Review Committee (IRC)

Mutual fund managers are required, under Section 2 of the Instrument, to establish an Independent Review Committee (‘IRC’) for each of its funds or groups of its mutual funds. The IRC would act independently of the fund manager and the trustee for mutual funds structured as trusts, and independently of the board of directors for mutual funds structured as corporations. The IRC must have at least three members (Section 2.3

³²⁴ *Proposed National Instrument 81-107 Independent Review Committee for Mutual Funds*, accessed at: www.osc.gov.on.ca

³²⁵ *Request for Comments Request for Comment Proposed National Instrument 81-107 Independent Review Committee for Mutual Funds*, Prepared by the Canadian Securities Administrators, available at www.osc.gov.on.ca

³²⁶ Comments available at: www.osc.gov.on.ca

of Instrument). The Instrument does not mandate a specific legal structure for an IRC and a manager may use for the independent review committee individuals appointed as trustees for the mutual funds, the board of directors or a special committee of the board of directors, a committee of individuals each of whom is independent from the manager. The commentary in Section 2.1 of the Instrument indicates that a manager may establish a separate IRC for each group of funds or that more than one manager may use the same IRC.

The IRC must be independent from the fund manager under the criteria of the Instrument which indicates that a person will not be independent if he or she has a 'direct or indirect' relationship with the fund manager, the mutual fund manager, or an entity related to the fund manager. The Instrument defines a 'direct or indirect relationship' as any relationship that a reasonable person might consider to interfere with the exercise of the member's independent judgement concerning conflicts of interest facing the fund manager. A 'cooling off' period of at least three years is required for any material relationships that may affect an individual's independence.

The manager must appoint the first members of the IRC (Section 2.2 of the Instrument) and the IRC must appoint replacement members to fill any vacancies on the committee (Section 2.3 of the Instrument). A number of commentators were in agreement that the manager should appoint the initial members, but indicated that they believed the manager should also be involved in the replacement of committee members,

such that the managers retain some control over the composition of the committee³²⁷. It was suggested that the Instrument be amended such that managers are involved in the replacement of members of the IRC, and that vacancies on the IRC should only be filled by the mutual consent of the manager and the IRC³²⁸. Alternatively, it was suggested that the fund manager be responsible for the appointment and compensation of IRC members upon the recommendation of IRC members³²⁹. It was suggested that the fund manager should appoint all IRC members and not just initial members, given that the responsibility for acting in the best interests of the fund ultimately lies with the fund manager³³⁰.

A term for IRC members of not less than 2 years and more than 5 years is indicated in Section 2.3 of the Instrument. It was suggested that the term should be extended such that experienced members could remain on the committee, rather the requirement for replacement with less experienced members after 5 years³³¹. There was a concern expressed that IRC members could be in place not for successive terms since

³²⁷ Edgar Legzdins, BMO Mutual Funds, Re: Proposed National Instrument 81-107-Independent Review Committee ("IRC") for Mutual Funds, April 8, 2004.

³²⁸ W.T. Wright, Investors Group Inc., Re: Canadian Securities Administrators ("CSA") Proposed National Instrument 81-107 Independent Review Committee for Mutual Funds, April 8, 2004.

³²⁹ BMO, *supra* note 256.

³³⁰ John W. Murray, The Investment Funds Institute of Canada, Re: Canadian Securities Administrations Proposed National Instrument 81-107 – Independent Review Committee for Mutual Funds, April 8, 2004.

³³¹ W. Sian Brown, MacKenzie Mutual Funds, Re: Proposed National Instrument 81-107 –Independent Review Committee, May 2, 2004.

IRC members are compensated by the mutual fund. It was recommended that the CSA allow IRC members to sit for consecutive terms³³².

The commentary indicates that the manager should not have the authority to remove a member, such that the member can perform their functions freely. The IRC members could be removed from office by a vote of the other members of the IRC, or by a majority vote if security holders at a special meeting called for that purpose by the manager. It was suggested by one commentator that the independence of the IRC would not be compromised if the fund manager and the IRC appoint and remove members jointly if this were to be necessary to ensure the smooth operation and continuity of the IRC³³³.

Every member of the IRC must be independent with respect to the criteria in Section 2.4(1) of the Instrument. A member of the IRC would be deemed as not independent if they have a material 'direct or indirect' relationship with the manager, mutual fund, or an entity related to the manager (Section 2.4(3) of the Instrument). The commentary indicates that directors or special committee of the board will be considered to have a 'material relationship' with the manager. The board of directors or committee of the board of directors will not be considered independent under the Instrument, since

³³² IFIC, *supra* note 260.

³³³ Robert F. MacLellan, TD Asset Management, Re: Request for Comments by the Canadian Securities Administrators ("CSA") on Proposed Instrument 81-107 – Independent Review Committee for Mutual Funds (The Instrument) April 8, 2004.

these individuals have a duty to act in the best interest of the fund manager which could interfere with their independent judgment.

Section 2.4 of the Instrument defines persons that would not be considered independent to include a person who has accepted, directly or indirectly, at any time during the past 3 years, any consulting, advisory, or other compensatory fee from the manager. The commentary defines a person to be not independent who is, or whose family member is, or has been at any time during the previous three years an officer, director or employee of the manager, the mutual fund or an entity related to the manager. Further, the commentary further defines ‘indirect acceptance’ by a person of any consulting, advisory, or other compensatory fee to include a family member, that provides professional services (e.g., accounting, consulting, legal, investment banking, portfolio management, back office or financial advisory services) to the manager or the mutual fund, or any company related to the manager in which the person is a partner, member or executive officer.

Many of the commentators indicated that the proposed definition of independence for IRC members is too restrictive. For instance, it was suggested that employees or fund managers that are family members should not taint the eligibility of a prospective IRC member³³⁴. It was suggested that while it may be appropriate to deem IRC members, with a family member who is a director or an officer of such entities to be ‘not

³³⁴ Don S. Panchuk, Philips Hager and North Investment Management Ltd., Re: Proposed National Instrument 81-107 – Independent Review Committee for Mutual Funds (“IRC”), April 8, 2004.

independent', the inclusion of low level employees in the deeming provisions goes too far³³⁵.

Directors of an entity related to the manager, according to the commentary to Section 2.4, cannot act as the independent review committee since those directors will be considered to have a material relationship with the manager. The definition of 'independence' in Section 2.4 of the Instrument would not allow independent directors of a fund manager to sit on the IRC, which would preclude many directors with experience in this role. As such, the initial members of an IRC will likely not have any direct mutual fund experience, if the proposed Instrument is introduced in its current form. Experienced members would also be beneficial since they could provide leadership and guidance to less experienced members to facilitate their development. An IRC comprised solely of members with no previous experience may take a significant amount of time to train³³⁶. Several commentators urged the CSA to allow for the inclusion of a minority of IRC members who are not independent of management, since they believe, based on their experience, that more effective decisions will be made with a management representative as a full participating member of the IRC. Further, it was suggested that by heightening the liability of some members of management to consider conflicts of interest as part of the IRC, those members will have an innate interest in ensuring these issues are properly resolved.

³³⁵ IFIC, *supra* note 260.

³³⁶ MacKenzie, *supra* note 268.

It was suggested that the proposed ‘cooling off’ period of 3 years (Commentary 4) is too long, and would unnecessarily disqualify otherwise qualified persons from sitting on the IRC, and that a period of 1 to 2 years would be sufficient³³⁷. It was suggested that the Instrument should define independence in a less onerous and restrictive manner, since many individuals could be excluded by the definition of independence in Commentary 4³³⁸. It was further suggested that there are challenges associated with the recruitment of qualified persons for the IRC, given Canada’s relatively small population, and even smaller class of financially literate individuals³³⁹. There was a strong agreement among the commentators that the definition of ‘independent’ in subsections 2.4(2) and 2.4(3) of the Instrument is overly restrictive. The CSA Instrument should consider the amendment of the Instrument with a less restrictive definition, which could include a shorter cooling off period, and amendment of the definition of ‘indirect acceptance’ to exclude family members, or to include only family members of senior personnel in the fund manager.

It is noted in the Instrument (Section 2.4) that Commentary 4 to Section 2.4 parallels the proposed Multilateral Instrument 52-110 *Audit Committees*, but is tailored to mutual funds. The highly restrictive nature of the definition of independence for the IRC may reflect its derivation from the criteria for an audit committee and this degree of independence may not be appropriate for an independent review committee. It was

³³⁷ BMO, *supra* note 256.

³³⁸ *Ibid.*

³³⁹ IFIC, *supra* note 260.

questioned whether the concept of independence of audit committees is appropriate for an IRC³⁴⁰.

Guideline 3 of ‘The Corporate Governance Guidelines for Building High Performance Boards’, published by the Canadian Coalition for Good Governance (CCGG)³⁴¹, indicates that a board of directors should, at a minimum, have a majority of directors, which are independent of management and have no material relationship with the company. Hence, the CCGG recommends, under the best practice guideline, that board membership be comprised of two-thirds of independent directors. Hence, the criterion for 100 percent independence for the members of an IRC is inconsistent with best practices for Canadian corporate governance. The Dey Report provided a definition for unrelated directors³⁴². The Concept Proposal stated:

“Stephen Erlichman recommends that we base our definition of independence on the Dey Report’s definition of “unrelated directors”. We agree with this recommendation. Thus, a member of a governance agency of a mutual fund will be independent of the fund manager if he or she is free from any interest and any business relationships which could, or could

³⁴⁰ IFIC, *supra* note 260.

³⁴¹ Accessed at: <http://www.ccg.com>

³⁴² Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada. *Where were the Directors? Guidelines for Improved Corporate Governance in Canada* (December 1994). Chair: P. Dey.

reasonably be perceived to, materially influence the member's oversight of the mutual fund manager's management of the mutual fund”³⁴³.

It is not clear why the CSA adopted the highly restrictive definition of independence for the IRC, based on the independence criteria of an audit committee, rather than for instance that of the Dey Report or the Canadian Corporate Governance Guidelines. The CSA should reconsider the incorporation of the definition of ‘unrelated’ in the Dey Report within the Instrument.

The CSA should also reconsider the requirement for a majority instead of all members of a governance agency being independent. The Concept Proposal states:

“Notwithstanding the arguments in favour of requiring all members of a mutual fund governance agency to be independent, we believe that equally valid reasons exist for fund manager representatives to be members of a governance agency. These representatives will be expected to bring the perspective of the fund manager to the governance agency, including their insights into the business of the fund manager”³⁴⁴.

Given this view expressed in the Concept Proposal, it is unclear why the CSA did not include a provision for representatives of a fund manager on the IRC, and instead specified a requirement for 100 percent independence for the IRC.

³⁴³ Concept Proposal, *supra* note 224.

³⁴⁴ *Ibid.*

The United States SEC recently proposed amendments which would require that 75 percent of the members of a board of directors of a registered mutual fund be independent in order for the fund to be able to rely on certain exemptions from the SEC's rules regarding serious conflicts of interest. The new SEC criterion, for a minimum three person board, is two independent members. The CSA should consider adopting a similar approach which for an IRC of three members would require only two-thirds of the minimum three-person IRC committee to be independent, rather than the currently proposed requirement for 100 percent independence.

Section 2.7 of the proposed Instrument provides an IRC authority to set the compensation of its members and engage and compensate independent advisors. The ability of an IRC to set compensation for themselves directly from the funds puts the IRC in a conflict of interest with the funds³⁴⁵. To avoid the potential for conflicts of interest, the compensation of the IRC should be set jointly with the fund manager³⁴⁶, rather than the IRC setting its own compensation. The amount of compensation set by the IRC for its members by subject to mandatory disclosure in a fund's continuous disclosure documents³⁴⁷. The CSA should re-evaluate the concept of the IRC setting its own compensation levels and amend the Instrument to the extent that it ensure that it would not place committee members in a conflict of interest position.

³⁴⁵ BMO, *supra* note 256.

³⁴⁶ MacKenzie, *supra* note 268.

³⁴⁷ IFIC, *supra* note 260.

There was general concern expressed by many commentators that there is no statutory limitation of liability for IRC members, as outlined in Section 2.8 of the Instrument. An area of concern with respect to the lack of limitation of liability is that this would deter prospective IRC members, which would further limit an already small pool of potential committee members³⁴⁸. The protection of liability of members of an IRC is considered to be necessary for recruitment of qualified persons that do not fear the consequences of either challenging or supporting the mutual fund manager's position³⁴⁹. It was suggested that there should be monetary limits on the liability of IRC members³⁵⁰. The Instrument could be amended to indicate that IRC members are protected by the 'business judgement rule', since the standard of care set out in Section 2.6 may not provide adequate protection for an IRC member³⁵¹.

Section 2.11 of the Instrument specifies that a mutual fund must disclose, in its prospectus and in its periodic disclosure document reports, the written charter of the independent review committee or another appropriate charter, the identity and experience of the independent review committee member, and any changes in membership of the independent review committee for each disclosure in the relevant period³⁵². The disclosure requirements further include "any instances where the manager did not follow

³⁴⁸ John Moulson, CIBC, Re: Canadian Securities Administrators ("CSA") Proposed National Instrument 81-107-Independent Review Committee for Mutual Funds ("NI 81-107"), April 26, 2004.

³⁴⁹ Ibid.

³⁵⁰ Ibid.

³⁵¹ Securities Law Subcommittee, Business Law Section, Ontario Bar Association, Re: Request for Comment on Proposed National Instrument 81-107 Independent Review Committee For Mutual Funds, April 14, 2004.

³⁵² Subsection 2(a), NI 81-107.

a recommendation of the Independent Review Committee, the general nature of the recommendations and reasons for not following the recommendations for each disclosure in the relevant period”³⁵³. The Instrument further specifies that, for each disclosure in the relevant period, the mutual fund must disclose any report of the independent review committee that it directs the manager to incorporate into the prospectus or periodic disclosure reports of the mutual fund.

The commentary to Section 2.11 of the Instrument indicates that the disclosure requirements in the Instrument assume that proposed NI 81-106 *Investment Fund Continuous Disclosure* is in force. The terms “prospectus” in NI 81-107 refers to disclosure in a point of sale document, currently a simplified prospectus and annual information form. The phrase “periodic continuous disclosure reports” refers to the documents in NI 81-106. The commentary states: “Section 2.11 and the commentary recognize that disclosure of any instances where the manager did not follow a recommendation of the independent review committee is a practical and realistic method of moderating disputes”. It was recommended by one commentator that there should be a materiality threshold regarding the disclosure of instances where the manager and IRC disagree³⁵⁴. Under current changes to securities legislation, the prospectuses will only be distributed to individuals that request it. Regulators, through exemption orders and proposed rule changes, no longer require these documents to be given to investors unless

³⁵³ Subsection 2(b), NI 81-107.

³⁵⁴ TDAM, *supra* note 269.

they expressly ask for them³⁵⁵. Therefore, it is highly likely that many security holders will not be aware of instances where the manager did not follow the recommendation of the IRC. The Small Investors Protection Agency (SIPA) recognized these limitations and provided an objection that while disclosure is expected to take the place of regulatory sanctions, the proposed Instrument requires investors expressively request these disclosure materials or find them on a website³⁵⁶.

While emphasis should be placed upon the importance of disclosure, it should not be assumed that disclosure coupled with the availability of the right to redeem will provide adequate continuing scrutiny over the management of mutual funds. Underlying reasons for this include the lack of required ability and knowledge for review of management's activities by mutual fund security holders in order to make an informed decision as to whether to redeem, and that few security holders spend the time and effort necessary to complete a review of materials sent to them to ensure management was paying proper attention to its responsibilities³⁵⁷. Disclosure of disagreements or concerns in a prospectus or an annual report is not likely to be an effective remedy, since for the most part disclosure will probably 'come too late' and may not be specific enough to be of much use to investors³⁵⁸.

³⁵⁵ Glorianne Stromberg, Re: Proposed National Instrument 81-107-Independent Review Committee for Mutual Funds, April 8, 2004.

³⁵⁶ Ken Kivenko, Robert Kyle, Stan Buell, SIPA Inc., Subject: CSA National Instrument 81-107 (NI81-107) Independent Review Committee for Mutual Funds, April 6, 2004.

³⁵⁷ CCMF Report *supra* note 122.

³⁵⁸ Glorianne Stromberg, *supra* note 355.

3.5.2 Conflicts of Interest

Part 3 of the Instrument focuses upon the review of all conflicts of interest between the fund manager's own commercial, and business interests, and its fiduciary duty to manage its mutual funds in the best interests of those funds and its security holders. The Instrument retains the central principle of Canadian mutual fund regulation which is that the fund manager has the responsibility and accountability for managing its mutual funds in accordance with its fiduciary responsibilities³⁵⁹. A standard of care is imposed on the IRC by the Instrument to act honestly and in good faith, in the best interests of the mutual fund and to exercise the degree of care, diligence and skill that a reasonably prudent person would expect in the circumstances³⁶⁰. The disclosure requirements include any instances where the manager did not follow a recommendation of the Independent Review Committee, the general nature of the recommendation and the reasons for not following the recommendation.

Subsection 3.1(1) of the Instrument indicates that the manager must refer a matter to the mutual fund's IRC for its review and recommendation before taking any action, if a reasonable person would question whether the manager has a conflict of interest in relation to its management of the mutual fund. Subsection 3(2) of the Instrument sets out particular circumstances where the CSA believes that a reasonable person would question whether the manager has a conflict of interest. This subsection indicates that a manager

³⁵⁹ R.A. Cowdery and J.E. Hall, Borden Ladner Gervais LLP, *Recent Developments in Investment Funds & Asset Management*, 2004, accessed at: www.lexexpert.ca

³⁶⁰ CSA Request for Comment, *supra* note 325, p. 2

is considered to have a conflict of interest where either the manager or an entity related to the manager has an interest in the matter that is different from, or conflicts with, the best interests of the mutual fund. An entity is considered to be related to the manager if it is a person that can direct or cause the direction of the management and policies of the manager, other than the IRC of the mutual fund, or an affiliate, associate or subsidiary of the manager.

Subsection 3.2(1) of the Instrument describes matters that a manager must refer to a mutual fund's independent review committee for its recommendation before taking any action. Subsection 3.2(3) of the Instrument specifies that the mutual fund must also send a notice to all security holders at least 60 days before the effective date of the change that contains sufficient information to enable the security holder to make an informed decision about whether to continue to hold securities of the mutual fund, describes the free transfer right (paragraph 3.2(3)(c)), and is sent to the security holders and filed with the securities regulatory authority or regulator. The mutual fund must also include a summary of the recommendations of the IRC with the notice (paragraph 3.2(3)(b)) and allow the security holder to redeem securities of that mutual fund and purchase securities of another mutual fund managed by the manager without the payment of any fee (paragraph 3.2(3)(c)).

The reorganization will require referral to the IRC if the transfer of assets or the transaction results in the mutual fund's security holders becoming security holders in another mutual fund; and acquisition of assets from another mutual fund, if the fund

continues, or the transaction results in the security holders becoming security holders in the mutual fund or a significant change to the mutual fund. This will not require notification to the security holders and filing with the regulator under subsection 3.2(3). The commentary indicates that Section 3.2 does replace the timely disclosure documents required by securities regulation in proposed NI 81-106 *Investment Fund Continuous Disclosure*, which establishes the obligations of a manager and a mutual fund to make timely disclosure of a significant or material change to the mutual fund.

Prior to proceeding with a change to the basis of the calculation of a fee or expense, or introduction of a new fee or expense (subsection 3.2(1)1), the mutual fund must obtain approval of its security holders in accordance with NI 81-102 *Mutual Funds*, and include with the notice of meeting sent in accordance with NI 81-102 a summary of the IRC's recommendation. These fundamental changes are essentially the same as those required by Part 5 of NI 81-102, such as changes to the fundamental investment objectives of a mutual fund or proposed increase in fees. The fund manager may implement most fundamental changes, such as changes in auditors, after it has considered the IRC's recommendations and given security holders 60 days advance notice of the change. However, the fund manager must obtain security holder approval before implementing a fundamental change to investment objectives or fees.

One commentator noted the inclusion of business conflicts in Commentary 4 on Section 3.1 of the Instrument goes beyond related-party transactions and self dealing

provisions that are currently prohibited in securities regulation³⁶¹. It was further suggested that business conflicts be removed from the Instrument, or at a minimum only require fund managers to adopt policies on certain items such as allocating mutual funds in a fund family and soft dollar transactions. In addition, it was indicated that greater certainty of appropriate referrals to the IRC could be created by providing a more exhaustive list of potential matters that should be referred to the IRC to provide guidance to fund managers. It was also suggested that there should be a materiality threshold regarding the disclosure of instances where a manager and IRC disagree, with disclosure confined to situations with a material conflict of interest. The Instrument should acknowledge that there will be situations where there is a potential conflict between the interests of the manager and the security holders, but the rules to the mutual funds are so insignificant that it would be inefficient to submit a proposal to the IRC³⁶².

Conflicts of interest, as defined in the Instrument, are where a manager “has an interest in the matter that is different from, or conflicts with the best interest of the mutual fund.” This wording could result in any matter that is different from the best interest of the mutual fund being referred to the IRC rather than those matters that are material and have the potential to represent a conflict of interest. One commentator indicated “that only matters which a reasonable person would believe would result in a material conflict with the best interests of the mutual fund should be reviewed by the committee.”³⁶³

³⁶¹ Philips, Hager and North, *supra* note 334.

³⁶² Securities Law Subcommittee, Ontario Bar Association, *supra* note 351.

³⁶³ Robert G. Wepler, Elliot & Page, Re: NI 81-107, April 8, 2004.

Objections were raised that the IRC will not have the power to overrule fund managers nor will the manager be required to abide by the committee's decision, and the Instrument instead relies upon the threat of disclosure as a deterrent for conflicts of interest³⁶⁴.

It was noted by several commentators that the definition of conflict of interest in Section 3.1(2) of the Instrument is "too broad", since by definition a manager will generally have interests that are "different from" the best interests of the mutual fund. Concerns were expressed that the IRC's conflict of interests mandate as proposed is too broad³⁶⁵, and that too many matters might constitute conflicts of interests that would require the manager to refer the issue to the IRC³⁶⁶. The broad scope of the IRC's responsibilities, and specifically the conflict of interest in Section 3.1(2), could impede the IRC exercising their role³⁶⁷. One commentator noted that almost any issue has the potential to require a review by the IRC in financial institutions where the fund manager has a related portfolio advisor, underwriter and back office service provider³⁶⁸. It was suggested by several commentators that because of the broad definition for conflicts of interest it should be left up to the IRC to determine what constitutes a conflict for that

³⁶⁴ SIPA, *supra* note 261.

³⁶⁵ TDAM, *supra* note 269.

³⁶⁶ Joe Yassi, Primerica, Re: Canadian Securities Administrators Proposed National Instrument 81-107 Independent Review Committee for Mutual Funds (IRC), April 8, 2004.

³⁶⁷ J.C. Massar, Capital International Asset Management (Canada) Inc., Re: Canadian Securities Administrators ("CSA") Proposed National Instrument 81-107 Independent Review Committee for Mutual Funds ("IRC"), April 6, 2004

³⁶⁸ BMO, *supra* note 256.

specific organization and what situations should be referred to it for recommendation³⁶⁹. This determination would be specific to the organizational structure of the fund manager and its business relationships. It was also suggested that a more proactive role for an IRC, involving review of transactions referred to it by a fund manager in accordance with its pre-approved policies would be appropriate³⁷⁰. There was a suggestion that the Instrument should clearly establish the situations where an IRC can approve a general policy for the manager's action, providing that it monitors the manager's compliance with that policy³⁷¹.

The commentary to Section 3.1 of the Instrument indicates that 'business conflicts' would include situations where the manager may be motivated to favour one mutual fund over another mutual fund. The definition of 'business conflicts' in the Instrument is extremely broad, which could lead to uncertainty³⁷². The inclusion of business conflicts on the proposed instrument as matters to be referred to the IRC is inappropriate. Requirements for a fund manager to adopt policies on matters included in Section 3.1 as business conflicts would then have to be reviewed and approved by the IRC³⁷³. It has also be suggested that more guidance be given in the Instrument on the conflicts of interests to be referred to the IRC, and in particular, that the Instrument refer to "material" conflicts with a distinction of the term "material" to assist in avoiding

³⁶⁹ Ibid.

³⁷⁰ IFIC, *supra* note 260.

³⁷¹ Securities Law Subcommittee, Ontario Bar Association, *supra* note 351.

³⁷² Primerica, *supra* note 366.

³⁷³ IFIC, *supra* note 260.

lengthy checklists and standard of reports which appear to hamper existing fund boards³⁷⁴.

It was suggested by several commentators that the most effective and efficient means for the IRC to fulfill its responsibilities would be reviewing and approving the fund manager's policies and procedures in relation to conflicts of interest and related party transactions in advance. The IRC would thereafter receive quarterly reports and/or presentations by senior management to enable the IRC to satisfy itself that the fund manager is in compliance with these policies and procedures. It was further suggested that the Instrument make greater reference to the manager having policies in place that are approved by the IRC to address conflicts of interests and receiving regular reports on compliance with these policies rather than approving every transaction³⁷⁵.

Following the introduction of the Instrument the CSA intends to repeal the regulatory restrictions contained in the various provincial securities acts and NI 81-102 that address self-dealing and conflicts of interest and effectively replace these with the discretion of the IRC. The Instrument, however, fails to clearly identify the existing restrictions that will be repealed³⁷⁶. Certain changes that currently require an investor vote in NI 81-102, would then be referable to the IRC, and advance notice of the change would replace the ability of an investor to vote. There were strong concerns expressed by

³⁷⁴ MacKenzie, *supra* note 268.

³⁷⁵ *Ibid.*

³⁷⁶ IFIC, *supra* note 260.

investors and investor protections agencies, with respect to the removal of these regulatory restrictions, associated with the introduction of the Instrument.

There were numerous concerns expressed in the comments that the Instrument would increase costs to the fund managers, which would ultimately be passed onto investors as expenses to the mutual funds. There were also concerns that these expenses would detract from the ability of the mutual fund to be competitive. It was questioned as to whether the establishment of an IRC improves governance sufficiently to offset the costs for the benefit of such unit holders³⁷⁷. For example, a concern was expressed that it would not be in the best interests of the security holders to hold costly meetings with the IRC for approval of ongoing administrative matters, since these charges result in an increase in charges for the security holder³⁷⁸. Approval of security holders must be obtained at a meeting in accordance with NI 81-102 before proceeding with the changes outlined in Section 3.2(1) of the Instrument, which was perceived to be a requirement that would add to the costs³⁷⁹. The CSA should consider elimination of either the security holders meeting, or the IRC meeting, in order to reduce duplication of costs if the IRC is to have the ability to subsequently influence the outcome of a security holders meeting.

Smaller fund managers who are less likely to be related to financial services providers, and thus have fewer legal conflicts, will be less likely to benefit from the

³⁷⁷ Steve Rostowsky, Gaurdian Group of Funds (GGOF), Re: Canadian Securities Administrators ("CSA"), Proposed National Instrument 81-107 – Independent Review Committee Mutual Funds ("IRC"), April 8, 2004.

³⁷⁸ TDAM, *supra* note 269.

³⁷⁹ TDAM, *Ibid*.

IRC³⁸⁰. The CSA have indicated that the repeal of regulatory restrictions on related party transactions will result in a decreased need to take matters to a vote of a fund's security holders, which will translate into significant savings to the mutual fund industry³⁸¹. However, this cost reduction would only occur if the regulatory on restrictions on related-party transactions are actually repealed. It was further suggested that the cumulative impact of mounting cost pressures will result in higher costs to investors and only serve to reduce the overall competitiveness of the industry³⁸².

Investors in many funds already pay for the services provided by a fund board of directors or a fund board of governors³⁸³. Hence, there would be an unnecessary duplication of costs for some investors by requiring the creation of a separate IRC when its functions are already being fulfilled by an existing body³⁸⁴. IFIC indicates that a significant cost savings and reduction of redundancy in function could be achieved by adopting a different definition of independence, and by allowing an IRC to be created from, and not in addition to, a board of directors or board of governors where these already exist in a fund complex.

³⁸⁰ IFIC, *supra* note 260.

³⁸¹ CSA Request for Comments, *supra* note 325.

³⁸² IFIC, *supra* note 260.

³⁸³ *Ibid.*

³⁸⁴ GGOF, *supra* note 377.

3.5.3 Inter-fund Trades

The Instrument would allow a mutual fund to trade securities to a related mutual fund, including a related pool fund, providing that certain requirements are met. Inter-fund trading is currently prohibited by securities legislation³⁸⁵. Section 3.3 generally follows the framework for inter-fund trading established in U.S. legislation, which has proven to operate successfully³⁸⁶. Section 3.3 (1) of the Instrument indicates that a mutual fund must not purchase or sell securities from or to a mutual fund managed by the same manager, or from or to a pooled fund managed by the same manager (engage in inter-fund trades) unless the manager of the mutual fund refers the matter to the IRC for its recommendation. The commentary indicates that this section is not intended to apply to securities issued by a mutual fund that are purchased by another fund within the same fund family. An inter-fund trade made in accordance with subsection 3.3(1) is exempt from the provisions of NI 21-101 *Marketplace Operation* and Section 6.1 and Part 8 of NI 23-101 *Trading Rules*.

Several commentators indicated that it is not clear if referral of inter-fund trades must be done on case-by-case basis or whether the fund manager can refer a general inter-fund trading policy to the IRC for its recommendations. Concern was expressed that clause 3.3(1) may be interpreted to require the IRC to review and make a

³⁸⁵ Borden Ladner Gervais LLP, Proposed National Instrument 81-107 Independent Review Committee for Mutual Funds-Comments of Borden Ladner Gervais LLP, April 16, 2004.

³⁸⁶ Martin Guest, Fidelity Investments Canada Limited, April 8, 2004.

recommendation for each inter fund trade³⁸⁷. It was suggested by a commentator that the IRC review inter-fund trades ‘after the fact’ in the same manner as the purchase of securities of related parties are reviewed. The involvement of the IRC was also suggested to be redundant since compliance with the Instrument should suffice, given all the requirements relating to inter-fund trades (Section 3.3(1) (a) – (d))³⁸⁸. Rather than reviewing and specific approving each inter-fund trades which would be impractical, it was suggested that the IRC adopt policies and receive regular reports on inter-fund trading including material exceptions to the policies³⁸⁹.

3.5.4 Changes to the Mutual Fund

Under Section 3.2 of the Instrument, fundamental changes to the investment objectives of a fund or fund manager would have to be brought to the IRC for approval. Under the Instrument certain changes to the fund mandate or its selection of an auditor which currently require an investor vote under NI 81-102 (referred to as ‘fundamental changes’) would be referable to the IRC. Many of these changes are expected to be routine in nature and the provisions should apply only where the changes constitute a conflicts of interest³⁹⁰. Section 3.2 of the Instrument requires that sub-clauses 3.2(1) 1 and 3 be referred to the IRC for consideration prior to being approved by security holders at a meeting called for this purpose. Objections were raised since the IRC will not have

³⁸⁷ Karen J. Fisher, Scotia Securities Inc., Re: Proposed National Instrument 81-107, April 6, 2004.

³⁸⁸ GGOF, supra note 377.

³⁸⁹ MacKenzie, supra note 268.

³⁹⁰ David L. Yu and Luda Rittenhouse, Association for Investment Management Research (AIMR), Re: Request for Comment – Proposed National Instrument 81-107 – Independent Review Committee for Mutual Funds, April 6, 2004.

the power to overrule fund managers, nor will manager be required to abide by the Committee's decision³⁹¹.

The Small Investor Protection Association (SIPA) indicates that the certain time-proven investor protection prohibitions will be removed with examples of transactions that will no longer be prohibited including principal trading, lending money to related parties, buying securities of related parties and buying securities of underwritten by an affiliated dealer while in primary distribution³⁹². IFIC notes that many mutual funds have some form of governance structure in place, such as a board of directors for a corporate mutual fund, or a board of governors, board of trustees, or advisory board for other types of funds³⁹³. The goals of the IRC may be met through governing bodies that are in place, to the extent that they already exist as part of the reporting structure of a fund complex, which can allow the IRC to be implemented in such a manner as to provide a contribution to investor protection without duplication in function or costs³⁹⁴.

IFIC does not believe that the mandatory imposition is necessarily the best or most practical way to achieve enhanced investor protection, and urge the CSA to allow and confirm that having an IRC as a sub-committee of an existing governance body is an acceptable alternative³⁹⁵. Tradex Management Inc. (TMI) has a Board of Directors

³⁹¹ SIPA, *supra* note 261.

³⁹² SIPA, *Ibid.*

³⁹³ IFIC, *supra* note 260.

³⁹⁴ IFIC, *Ibid.*

³⁹⁵ IFIC, *Ibid.*

structure for its mutual funds which centers on a governance framework with a strong independent board of directors which it believes is superior to the IRC which would handle only conflicts of interests³⁹⁶. TMI recommended that an exemption be made in the Instrument such that independent members of the Board of Directors of a mutual fund management company would be allowed to sit in an Independent Review Committee provided that a certain minimum standards are met.

Some mutual fund managers indicated that the CSA has strengthened the credibility of the IRC by a more focused mandate which should permit an IRC to bring better analysis to investor protection, and are of the view that a narrowed focus for the IRC is appropriate³⁹⁷. Other commentators indicated that implementing a regime such as the Instrument is appropriate provided that it is coupled with a roll back of appropriate existing prescriptive regulations³⁹⁸. There was also support from the legal profession for the scaling back of the original mutual fund governance proposals to permit the gradual introduction of practical rules³⁹⁹. Some mutual fund managers have serious concerns

³⁹⁶ John S. Rayu and Robert C. White, Tradex Management Inc., April 7, 2004.

³⁹⁷ Fidelity, *supra* note 386.

³⁹⁸ Gerry Rocchi, Barclays Global Investors Canada Limited, Re: Canadian Securities Administrators Proposed National Instrument 81-107 – Independent Review Committee for Mutual Funds, April 5, 2004.

³⁹⁹ Securities Law Subcommittee, Business Law Section, Ontario Bar Association, Re: Request for Comment on Proposed National Instrument 81-107 Independent Review Committee For Mutual Funds, April 14, 2004.

about the Instrument and believe that it will not promote investor protection and inhibit market efficiency⁴⁰⁰.

Other commentators were opposed to the Instrument since they felt that investor protection will be undermined by self dealing and other related party transactions⁴⁰¹. According to Glorianne Stromberg, there are two fundamental problems with the CSA proposals:

“The first relates to the proposal to repeal the existing provisions that govern conflicts of interest. The second relates the proposal to replace these provisions with a requirement that mutual funds have an independent review committee whose function will be to consider transactions involving conflicts of interest but with no real power to constrain or otherwise limit or influence the transactions”⁴⁰².

An opinion was expressed by an investment manager that:

“It is my hope that the draft version of 81-107 is not approved as proposed since it would represent an effective deregulation in my opinion”⁴⁰³. “I

⁴⁰⁰ Patrick Walsh, SEI Investments Canada Company, Comment Letter: Proposed National Instrument 81-107 Independent Review Committee for Mutual Funds, March 31, 2004.

⁴⁰¹ Lillian Morgethau, CARP, Re: Proposed National Instrument 81-107 Independent Review Committee for Mutual Funds, June 17, 2004.

⁴⁰² Glorianne Stromberg, Re: Proposed National Instrument 81-107-Independent Review Committee for Mutual Funds, April 8, 2004.

⁴⁰³ Dan Hallett & Associates Inc., Re: Proposed NI81-107, May 12, 2004.

think that 81-107 needs to go back to the drawing board. Ironically, some fund companies feel that it goes too far in tying their hands while investor activists think it actually waters down the existing regime. I would lean closer to the latter camp.”⁴⁰⁴

In her review of the Instrument Glorianne Stromberg concluded: “Neither investors nor the fund industry will be well-served by implementing NI 81-107. I recommend that it be withdrawn.”⁴⁰⁵ SIPA fully supports the comments made by Glorianne Stromberg in her article in the Toronto Star entitled “Proposed mutual fund rules are ‘dangerous’ to the investors”⁴⁰⁶, and urge the CSA to include her in its deliberations⁴⁰⁷.

SIPA indicates that previous studies, including the Stromberg reports and the Five Year Review of the Ontario Securities Act, recommended more robust investor protecting structures have been largely discounted in the Instrument to satisfy industry participants and not investor protection⁴⁰⁸. SIPA indicates that, if the Instrument is adopted, Canadian mutual fund investors will have significantly less protection than their counterparts in the U.S. through recent SEC regulatory changes. In the view of SIPA, the Instrument removes many of the existing rules that have made mutual funds a safe investment for

⁴⁰⁴ Dan Hallett, 2004. Proposed Investor Protection Law Needs Work IRCs Lack Real Authority, accessed at: www.globeadvisor.com

⁴⁰⁵ Stromberg, *supra* note 402.

⁴⁰⁶ Toronto Star, March 21, 2004.

⁴⁰⁷ SIPA, *supra* note 261.

⁴⁰⁸ SIPA, *Ibid*.

small investors and replaces them with weak governance. For these reasons SIPA states “NI 81-107 is not in the public interest and we recommended that it be replaced with fund governance as recommended in the Concept Proposal.”⁴⁰⁹

Significant concerns have been raised from investor protection groups, investors and other commentators on the Instrument particularly with respect to the proposed removal of investor protection legislation and replacement of this with the function of the IRC. For example, Glorianne Stromberg stated:

“The CSA proposals (contained in National Instrument 81-107 which was published for comment in January 2004) are akin to revoking the rules of the road and leaving it to individual users of the road to set their own rules. The resulting chaos and injuries could be catastrophic. The CSA’s unstated expectation that fund managers and their independent review committees (IRCs) will start with the existing rules and build on them is pathetic in its naïveté. The approval of a toothless, inexperienced IRC is hardly a substitute for statutory prohibition and regulatory oversight.”⁴¹⁰

⁴⁰⁹ SIPA, *Ibid.*

⁴¹⁰ Glorianne Stromberg, A wake-up call to the fund industry, *Investment Executive*, Wednesday, February 18, 2004.

3.6 FUNCTION OF INDEPENDENT REVIEW COMMITTEE (IRC)

On May 25, 2005 the CSA released a revised version of the proposed Instrument renamed *Independent Review Committees for Investment Funds*⁴¹¹. The new name reflects the CSA's proposal to expand the applicability of the Proposed Rule from conventional mutual funds only to all publicly offered investment funds. The revised Instrument applies to all publicly offered investment funds which includes mutual funds, commodity pools, scholarship plans, labour sponsored or venture capital funds, and closed-end funds and mutual funds that are listed and posted for trading on a stock exchange or quoted on as over-the-counter market.

The CSA states:⁴¹²

“The Proposed Rule contemplates imposing a minimum, consistent standard of governance for publicly offered investment funds. Currently, there is no requirement that an investment fund have a governance body. Under the proposed Rule, every investment fund that is a reporting issue must have an IRC to oversee all conflict of interest matters – not just those subject to prohibitions of restrictions in securities legislation – faced by the fund manager in the operation of the investment fund”.

⁴¹¹ Accessed at: http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/rule_20050527_81-107_supplement.pdf

⁴¹² (2005) 028 OSCB (Supp-2), May 28, 2005.

The CSA indicated they expect that this Instrument will contribute to more efficient Canadian capital markets, by permitting fund managers to engage in certain types of conflict of interest transactions without prior regulatory approval, provided that the IRC approves.

The Instrument addresses two main types of conflicts of interest. The first of these is business or operational conflicts faced by fund managers which are conflicts of interest relating to the operation by the manager of its funds that are not specifically regulated under securities legislation except through general duties of care imposed on the fund manager. The second of these is structural conflicts faced by the fund managers, which are conflicts of interest that result from proposed transactions by the manager with related entities of the manager, fund or portfolio manager currently prohibited or restricted by the conflict of interest and self dealing provisions in securities legislation.

In the 2004 proposal, the CSA proposed to remove the requirement for security holder approval for all changes contemplated under Section 5.1 of N1 81-102, except for a change in the mutual funds investment objectives and increases in the charges to the mutual fund or its security holders. The 2005 proposal maintained the requirement for security holder approvals which is a positive change from the perspective of investor protection. The 2004 proposal involved the replacement of the existing conflict of interest and self-dealing prohibitions and restrictions in securities legislation with the introduction of IRC review. In the comments accompanying the revised May 2005 Instrument, the CSA states:

“there was mutual fund industry support for the introduction of independent oversight by the IRC”,.....”Investors and investor advocates unanimously urged us not to replace existing conflict of interest and self-dealing prohibitions in securities legislation with an IRC whose recommendations were non-binding”. They told us that the IRC’s lack of “teeth” would render it ineffective in being a check and balance on a fund manager’s conflicts of interest”.

Through the IRC, the CSA retains the conflict of interest and self-dealing prohibitions and restrictions in securities legislation. The Instrument includes a fiduciary duty and standard of care for the manager of an investment fund, similar to duties imposed upon the manager of a mutual fund in most Canadian provinces, based on a review of potential liability of IRC members⁴¹³. The Instrument requires that the fund manager must appoint the IRC within six months of the rule coming into force. This Instrument provides strict criteria for independence and contains a stipulation that members of a manager’s board of directors are unlikely to be considered to be independent.

The Instrument provides exemptions from the provisions in the proposed Instrument and NI 81-102 that preclude certain specified transactions, provided that the

⁴¹³ Letter from Davies, Ward Phillips Vineberg LLP to Susan Silma and Rhonda Goldberg, Ontario Securities Commission, Subject Proposed National Instrument 81-107, May 2, 2005 available at: http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/rule_20050502_81-107_memorandum.pdf

fund manager has received the approval of the IRC to proceed. The transactions include: inter-fund trading, transactions in securities at related issues, and purchases of securities underwritten by related underwriters. Under the Instrument, a fund manager must also receive IRC approval under Part 5 of N1 81-102 to proceed with a change of auditor of the mutual fund, and a reorganization or transfer of assets of the mutual fund to a mutual fund managed by the same fund manager or an affiliate.

The IRC is required to monitor and assess the adequacy and effectiveness of the fund manager's written policies and procedures related to conflict of interest matters and the fund manager's compliance with the IRC's instructions on these matters. The proposal also gives the IRC the authority to communicate directly with the securities regulatory authorities. The CSA indicates that this is intended to encourage members of the IRC to inform the regulator of any concerns, including concerns about a fund manager not referring conflict of interest matters to the IRC that are otherwise required to be reported by securities legislation. In addition, the Instrument gives the IRC authority to require the fund manager to notify security holders of the fund manager's decision at least 30 days before the effective date of the action.

The Instrument places assessment and reporting requirements on the IRC. The IRC must assess the adequacy and effectiveness of the following, on at least an annual basis: (i) the manager's written policies and procedures, (ii) any standing instructions on conflict of interests matters it has provided to the manager, (iii) the manager's and the investment' fund's compliance with any conditions imposed by the IRC in a

recommendation or approval it has provided to the manager, (iv) its performance as a committee and the contribution of each of its members based on the criteria set out in the rule.

The IRC must prepare and deliver to the manager a written report of the regular IRC assessment that include: (i) any breaches of the manager's policies and procedures, (ii) any breaches of a condition imposed by the IRC in a recommendation or approval delivered to the manager, (iii) recommendations for any changes the IRC considers should be made to the manager's policies and procedures.

The IRC is required by the Instrument to prepare a report to security holders of the investment fund on its activities for the financial year. This report is to include: (i) a description of any known instance when the manager proceeded to act in a conflict of interest matter referred to the IRC for which the IRC did not give a positive recommendation, (ii) a description of each known instance where the manager proceeded to act in a conflict of interest matter but did not meet a condition imposed by the IRC in its recommendation or approval, (iii) the identity of each IRC member active at the time of the report, any changes to the composition or membership of the IRC, and the aggregate compensation paid to the IRC including any expenses or compensation outside the recommendations of the manager. The IRC is required to maintain records of its current written charter, meeting minutes, and written reports provided to its or made by it and copies of material. The Instrument further requires the IRC to report an investment fund's principal securities regulator all instances where the manager proceeded to act in a

conflict of interests matter but did not meet a condition imposed by securities legislation or the IRC in its approval.

The Instrument indicates that a manager may not proceed with a proposal action without the approval of an IRC, if the action is (i) an inter-fund trade, (ii) a transaction in securities of a related issuer (related issuer transaction), or (iii) investment in a class of securities of an issuer underwritten by an entity related to the manager (related underwriter transaction). Following receipt of IRC approval, the transaction must be completed in accordance with the requirements set out in the rule, or the requirements of an amended Part IV of NI 81-102 for an inter-fund trade or related issuer transaction. The transaction will then be exempt from the conflict of interest or self-dealing prohibition of securities legislation that would otherwise apply to the transaction provided that IRC approval is obtained.

The Instrument requires that an IRC must provide the manager with a recommendation which the fund manager must consider before proceeding, for any other proposed course of action that a reasonable person would consider represents a conflict of interest for the manager. The IRC's recommendation must be based on its view that the proposed course of action will achieve a fair and reasonable result for the investment fund. The IRC has the authority to require the manager to notify security holders of a managers' decision to proceed against an IRC recommendation. The proposal specifies that this notification must be sent to security holders at least thirty days before the effective day of the proposed action.

The CSA did not repeal existing investor protection legislation contained in the various provincial security acts and replace these with the discretion of the IRC, fund managers must receive approval before proceeding with related issues and related underwriter transactions, the IRC has the authority to stop certain transactions and the IRC has more authority and responsibilities. These changes are positive with respect to dealing with conflict of interest and enhancing investor protection.

3.7 COMPARISON OF THE IRC WITH THE 'GOVERNANCE AGENCY' IN THE CONCEPT PROPOSAL

The role of the IRC in the 2005 proposal for NI 81-107 is much narrower than the governance agency described in the Concept Proposal. The CSA indicated:

“Our decision to narrow the role of the IRC in the Proposed Rule came largely in response to public comment. The respondents to the Concept proposal asked us not to cast the role of the IRC too broadly. They were concerned that by asking the IRC to oversee management, we would effectively dilute the manager’s role”⁴¹⁴.

The CSA requested comments as to “whether the Proposal would result in mutual funds being monitored by a governance agency that a. effectively oversees the management of the mutual funds b. has real power and real teeth and c. adds value for investors”⁴¹⁵. By reducing the role of governance agency or IRC to dealing with conflicts

⁴¹⁴ Request for Comment 81-107, supra note 325, p. 2.

⁴¹⁵ Request for Comment, 81-107 supra note 325, p. 2.

of interests only the Instrument, in Part 3, removes important protection for the mutual fund investor set out in Section 5 of the Concept Proposal. As noted by an investment manager “By doing this, NI 81-107 fails to meet the tests outlines above a., b., and c.”⁴¹⁶

An article published in October 2003 stated that the head of the OSC’s Investment Funds Group indicated that the fund governance project changed course because the mutual fund industry was so vigorously opposed to the Concept Proposal⁴¹⁷. OSC staff were questioned whether their approach to governance should be revised given the U.S. scandals, but concluded that it was more important to get their current proposal implemented rather than rethink the entire project. Stephen Erlichman stated:

“If the October 2003 article quoting the head of the OSC’s Investment Funds Group is accurate, then industry pressure (rather than belief in what is the right answer) has resulted in the CSA’s proposal for a much less robust independent review committee as they key element in a Canadian mutual fund governance regime in NI 81-107 compared to the suggestions in the earlier concept proposal”⁴¹⁸.

⁴¹⁶ Michael A. Meighen, On behalf of the Independent Governors of the Cundill Funds, Re: Proposed National Instrument 81-107, April 5, 2004.

⁴¹⁷ Stephen Erlichman, 2004., Current legal developments in the mutual fund industry: abuses and governance, The Law Society of Canada Special Lectures, accessed at: [http://www.fasken.com/web/fmdwebsite.nsf/AllDoc/DE819E66A44AC73F85256F16005A0C92/\\$File/CURRENT_LEGAL_DEVELOPMENTS.PDF](http://www.fasken.com/web/fmdwebsite.nsf/AllDoc/DE819E66A44AC73F85256F16005A0C92/$File/CURRENT_LEGAL_DEVELOPMENTS.PDF);

⁴¹⁸ Erlichman, supra note 417.

Further, Rebecca Cowdery, formerly of the OSC, has indicated that a strong push back from the mutual fund industry led regulators to put aside many of the ideas outlined in the sweeping 2002 proposal⁴¹⁹. The difficulties associated with achieving consensus from the 13 different securities regulators across Canada “is another possible reason for backing down from the Concept Proposal”⁴²⁰. For instance, the British Columbia Securities Commission clearly stated in its deregulation proposals that it was against mandating any independence governance body for mutual funds, despite the fact that the British Columbia Securities Commission was a member of the CSA which brought forward the Concept Proposal around the same time as British Columbia’s deregulation proposal, and the Concept Proposal did recommend an independent governance body⁴²¹.

The Concept Proposal stated the role of the governance agency to be as follows:

“The role of the governance agency will be to oversee the actions of the mutual fund manager in managing its mutual funds to see that it acts in the best interests of investors. The governance agency’s role will be to *supervise* – it will not micro-manage the day-to-day management of the mutual funds”⁴²².

⁴¹⁹ Elizabeth Church, *supra* note 237.

⁴²⁰ *Ibid.*

⁴²¹ *Ibid.*

⁴²² Concept Proposal, *supra* note 224, p. 5

The role of the IRC is clearly considerably narrower than that initially contemplated in the Concept Proposal. The CSA “strongly” encourages consideration of a “broader mandate” for IRC’s. The CSA state that they expect fund governance to “evolve” with time and that IRCs provide “a flexible platform for future regulatory reform.” A fund board structure may be a more appropriate mechanism than an IRC for the CSA to expand mutual fund governance in the future and should be considered as an alternative to the IRC in the Instrument. The CSA could also consider the incorporation of the proposed role of the IRC within the broader framework of a fund board. The Stromberg Report recommended that Investment funds should be required to have an independent board stating:

“Investment funds should be required to have an independent board. The fact that tax laws have encouraged the use of structures other than corporations to constitute investment funds should not, in my opinion, eliminate the basic governance mechanisms reflected in a corporate structure”⁴²³.

The term “independent board” in the Stromberg Report is defined as a board of directors or an advisory committee or other entity with equivalent duties and responsibilities to those of a board of directors of a corporation, which board, in either case, is comprised of persons, the majority of whom are “unrelated persons”⁴²⁴. The term

⁴²³ Stromberg Report, *supra* note 226, p. 49.

⁴²⁴ Stromberg Report, *Ibid.*, p. 158.

“unrelated persons” refers to persons who are free from relationships and other interests who could or could be reasonably perceived to materially interfere with the exercise of judgment in the best interests of the investment fund”⁴²⁵. The Stromberg Report indicates that the board of directors should consist of at least five persons, a majority of whom are “unrelated persons” within the meaning of the term as used in the Dey Report. The Stromberg Report indicated that the board would be responsible for dealing with conflicts of interests as expressed in the following:

“In view of the fact that it is impractical for each situation involving a conflict of interest to be referred to security holders for approval, it is essential that there be an independent body whose sole focus is the interests of the investment fund and its security holders, since it is impractical for each situation involving a conflict of interest to be referred to security holders for approval.”⁴²⁶

The report of the Steering Group, formed to consider the implementation of the recommendations in the Stromberg Report, clearly agreed with the recommendation for independent boards in the Stromberg Report and stated: “We agree with the Stromberg Report recommendation that investment funds be required to have an independent board, board of governors or advisory committee with equivalent duties and responsibilities to

⁴²⁵ Stromberg Report, Ibid.

⁴²⁶ Stromberg Report, Ibid., p. 154.

those of the board of directors of a corporation”⁴²⁷. The Steering Group Report indicated that each fund family should have a board of at least five members, the majority of whom are independent of the manager and an audit committee comprised entirely of independent members of the board. A board member would be “independent” if he or she were free of relationships and other relationships which could reasonably be perceived by a security holder to materially interfere with the exercise of judgement in the best interests of the funds. The Steering Group Report recommended the following: “The Canadian Securities Administrators should develop requirements for fund managers to create boards and audit committees to oversee the affairs of managed funds within fund families and articulate the duties and responsibilities of such boards”⁴²⁸.

The Erlichman Report, which was commissioned by the CSA to assist with the development of the Concept Proposal, recommended the establishment of a corporate style board for mutual funds in the following: “if the CSA conclude that they should mandate one specific form of governance regime at this time I recommend that each mutual fund should have a corporate style board (of directors, governors or trustees, as the case may be)”⁴²⁹. The Erlichman Report indicates that it is more appropriate to have a separate board for each mutual fund rather than one board for the entire mutual fund complex or the entire fund family, in order to create a simple and coherent structure. According to the Erlichman Report, the board should have the general responsibility to

⁴²⁷ Steering Group Report, *supra* note 227, p. 6.

⁴²⁸ Steering Group Report, *Ibid.*, p. 56.

⁴²⁹ Erlichman Report, *supra* note 229, p. 164.

supervise the management of the business and affairs of the mutual fund in order that decisions affecting the mutual fund are made in the best interests of the security holders of the mutual fund⁴³⁰. It is recommended in the Erlichman Report that a mutual fund board should consist of at least three individuals, of whom a majority, and preferably at least two-thirds, are independent of the manager. The Erlichman report indicated that the definition of what constitutes an “independent” member should be modelled on the Dey Report’s definition of “unrelated director”⁴³¹.

It is suggested in the Erlichman Report⁴³² that independent members of the board initially be selected and appointed by the manager, and thereafter the independent members would be appointed by the full board, and not by the manager nor by the independent directors alone. In the case of a corporate mutual fund they would be elected by the fund’s shareholders as required by the fund’s governing corporate statute. It is further suggested in the Erlichman Report that for both trusts and corporate structures, the appointment of the independent members would be based on the recommendations of a nominating committee comprised of at least a majority of directors who are independent of the manager.

There have been several criticisms levied against the use of corporate style board for mutual fund governance regimes, which include the potential hindrance of a mutual fund board on the operations of a mutual fund complex. The Erlichman Report indicates

⁴³⁰ Erlichman Report, Ibid., p. 166.

⁴³¹ Erlichman Report, Ibid., p. 187.

⁴³² Erlichman Report, Ibid., p. 165.

that it is possible for a mutual fund organization to design an effective and efficient board which will not hinder the mutual fund complex.

3.8 COMPLIANCE PLANS

The Erlichman Report recommends that “Each mutual fund in existence today should be required to have a compliance plan, which is filed with the CSA. Adopting a compliance plan should be a condition precedent for a new mutual fund to be permitted to offer its securities to the public”⁴³³. A compliance plan is a means of assuring that a mutual fund is being operated in the best interests of the security holders⁴³⁴. A compliance plan sets out the measures that the manager and the governance body will apply in managing or supervising the management of the mutual fund to ensure compliance with applicable laws and the constating documents of the mutual fund, and includes conflicts of interest provisions. A compliance plan will cover more matters than the compliance reports required by Part 12 of National Instrument 81-102⁴³⁵.

The Erlichman Report indicated that “...whatever the form of corporate governance regime that results from these recommendations, I believe it is important that the manager, with the input of the governance body, prepares a compliance plan for each mutual fund”⁴³⁶. The CSA has not included a compliance plan in its mutual fund governance system as recommended in the Erlichman Report to date. Without a reliable

⁴³³ Erlichman Report, *supra* at 13, p. 193.

⁴³⁴ Erlichman Report, *Ibid.*, p. 191.

⁴³⁵ Erlichman Report, *Ibid.*

⁴³⁶ Erlichmann Report, *Ibid.*

compliance plan, it will be difficult for IRCs to determine whether the fund managers are in compliance with conflict of interest guidelines.

Erichman indicated that in the SEC adopted a rule in requiring U.S. mutual funds to have comprehensive compliance policies and procedures as well as to have a chief compliance officer accountable to the fund board of directors⁴³⁷. Erlichman noted that the SEC adopted this rule three years after the recommendation in the Erlichman Report that mutual fund managers in Canada be required to adopt compliance plans for the mutual funds they manage and that to date Canadian mutual funds still do not have this requirement⁴³⁸. Erlichman recommended that even if the CSA proceed with the independent review committee set out in NI 81-107, the CSA should reread and implement the recommendation in the Erlichman Report requiring the adoption of compliance plans⁴³⁹.

3.9 POINT OF SCALE DISCLOSURE FOR MUTUAL FUNDS (POS PROJECT)

The Point of Sale (POS) project is a continuation of the development of mutual fund governance to provide investors with more meaningful and effective prospectus disclosure of mutual funds and segregated funds⁴⁴⁰. The CSA published proposed rule amendments aimed at implementing all of the elements of the point of sale

⁴³⁷ Erlichman, *supra* note 417.

⁴³⁸ *Ibid.*

⁴³⁹ *Ibid.*

⁴⁴⁰ Framework 81 – 406 Point of Sale Disclosure for Mutual Funds and Segregated Funds(the Framework), Published by the Joint Forum of Financial Market Regulators on October 24, 2008.

disclosure regime set out in the Framework on June 19, 2009. On June 19, 2009, the CSA published proposed amendments to National Instrument 81 – 101 *Mutual Fund Prospectus Disclosure*, its Forms and Companion Policy (collectively, in this Section the Instrument), aimed at providing investors with more meaningful and effective disclosure. The Instrument was the first step in implementing the point of sale disclosure framework published in October 2008 by the Joint Forum of Financial Market Regulators (the Joint Forum), which includes the CSA. Under the framework, investors would receive key information about a mutual fund at a time that is relevant to their investment decision⁴⁴¹.

The OSC believes that the disclosure required by the Instrument would provide investors with the opportunity to make more informed investment decisions by giving investors key information about a mutual fund, in language they can easily understand, at a time that is relevant to their investment decision. The *Fund Facts* document is designed to give investors key information about a mutual fund, in language they can easily understand, at a time that is relevant to their investment decision. The *Fund Facts* document is central to the new prospectus disclosure regime. It is in plain language, will be no more than two pages and highlights the potential benefits, risks and the costs of investing in a mutual fund. Investors would generally receive a Fund Facts when they buy a fund for the first time (at or before the “point of sale”).

⁴⁴¹ CSA Staff Notice 81-319 – *Status Report on the Implementation of Point of Sale Disclosure for Mutual Funds*, Canadian Securities Administrators Staff Notice 81, 319, Status Report on the Implementation of Point of Sale Disclosure for Mutual Funds, (2010) 33 oscb 5449. June 18, 2010.

The comment period closed on October 17, 2009 and 54 comment letters on the Instrument were received which were posted on the Ontario Securities Commission website at www.osc.gov.on.ca. Copies are also available from any CSA member. The comments show that stakeholders generally agree with the benefits of providing investors with a more meaningful and simplified form of disclosure, and support the *Fund Facts* as a way of providing concise, plain language information that describes key elements of the mutual fund under consideration. However, the OSC also received significant comments related to operational and compliance concerns with point of sale delivery for mutual funds. A large number of commenters also asked the CSA to implement a point of sale disclosure regime for other types of publicly offered investment funds and other securities at the same time.

After consideration of the comments received on the 2009 Proposal, the CSA concluded to proceed with a staged implementation of the Framework⁴⁴². The CSA is proceeding with a staged implementation of the project that will provide the opportunity to continue to consult with stakeholders and to consider the applicability of the point of sale regime for mutual funds to other types of publicly offered investment funds, with the possible outcome of implementing a point of sale delivery requirement at the same time for all comparable investment fund products. Stage 1 of the POS Project was completed on October 6, 2010 when the CSA published amendments to National Instrument 81 –

⁴⁴² *CSA Staff Notice 81-0319 Status Report on the Implementation of Point of Sale Disclosure for Mutual Funds*, published on June 16, 2010.

101 *Mutual Fund Prospectus Disclosure* to require the preparation, filing and posting of the *Fund Facts*.

As of January 1, 2011, mutual fund companies in Canada are required to prepare and file a Fund Facts for each class or series of each of their mutual funds and to post the *Fund Facts* to their website⁴⁴³. In addition, they must deliver the *Fund Facts* to investors free of charge upon request.

On August 12, 2011, the OSC published for comment proposed amendments to the National Instrument 81 – 101 *Mutual Fund Prospectus Disclosure*, to allow the delivery of the Fund Facts instead of the simplified prospectus to satisfy current prospectus delivery requirements. This comment period ended on November 10, 2011. On June 21, 2012, the OSC published for second comment changes to the proposed amendments which focus primarily on the presentation of risk in the Fund Facts. Under the proposed rules investment firms would have to disclose the following in annual client statements under new rules proposed by securities regulators:

- total amount, in dollars, that a dealer or advisor was paid for advice and products sold;
- returns, in dollars and percentage terms, for a client's investments in the current year, and longer periods;
- some commissions on bonds.

⁴⁴³ OSC, *Investment Funds – Point of Sale Disclosure for Mutual Funds (POS Project)*, http://www.osc.gov.on.ca/en/InvestmentFunds_point-of-sale_index.htm

The comment period was open until September 6, 2012. A total of 32 comments were received. The response from the OSC Investor Advisory Panel⁴⁴⁴ was supportive of the POS project stating. “We would like to begin by reiterating our strong support for the point-of-sale (POS) initiative. Ontario investors need clear and meaningful disclosure about their investments at the time they are making their purchase decision. We appreciate the efforts that are being made to improve the Fund Facts document and move forward quickly with the POS delivery regime.”⁴⁴⁵ With regard to fee disclosure, the panel stated: “The Panel is pleased to see the addition of clearer and more definitive language regarding the payment of trailing commissions to dealers/advisors which takes into account our earlier feedback to the CSA. While we appreciate the inclusion of language alerting investors that such commission payments may give rise to conflict of interest on behalf of dealer representatives, we think that the CSA could go further in this respect. Other jurisdictions such as Australia and United Kingdom have completely banned the payment of such commissions to financial services representatives on the grounds that these payments are wholly incompatible with the provision of unbiased, independent investment advice to consumers. It is misleading to suggest that trailing commissions “may” create a conflict of interest, when, in fact, they do.”⁴⁴⁶

⁴⁴⁴ OSC Investor Advisory Panel, Re: Implementation of Stage 2 of Point of Sale Disclosure for Mutual Funds – Proposed Amendments to NI 81-101 Mutual Fund Prospectus Disclosure, Form 81-101F3 Contents of Fund Facts Document and Companion Policy 81-101CP Mutual Fund Prospectus Disclosure – 2nd Request for comments, September 6, 2012.

⁴⁴⁵ Ibid.

⁴⁴⁶ Ibid.

RBC Global Asset Management Inc. provided comments on Stage 2 point of sale disclosure practices⁴⁴⁷. With respect to the OSC's statement: "Adding a requirement to confirm whether trailing commissions are paid and disclosure of any potential conflicts arising from the payment of trailing commissions".⁴⁴⁸ RBC replied "We are confused as to why trailing commissions have been singled out for this type of disclosure, since the placement of any investment for commission or fees could presumably have the same influence."⁴⁴⁹ It may seem surprising to see this comment from RBC employee it must have seen the study results and media exposure that indicated Canadians have the highest MERs worldwide and that trailer fees are a significant contributor to this situation. However, RBC raises a valid point that other areas of commissions and fees are also important and should be evaluated as part of total expenses expressed in the MER.

The Federation of Mutual Fund Dealers represent 30 dealer firms with over 114 billion of assets under management and 17,000 licensed advisors that provide services to more than 3.5 million Canadian investors. As they are the recipients of trailer fees, their position on the proposed point of sale rule is important in understanding industry perspective. The Federation of Mutual Fund Dealers provided a comment on the

⁴⁴⁷ RBC Global Asset Management Inc., RE: Request for comments – Implementation of Stage 2 of Point of Sale Disclosure for Mutual Funds – Proposed Amendments of National Instrument 81-101 Mutual Fund Prospectus Disclosure ("NI 81-101"), Form 81-101F3 and Companion Policy 81-101CP and Consequential Amendments (2nd Publication) (the "Proposed Amendments"), September 6, 2012.

⁴⁴⁸ RBC, Ibid.

⁴⁴⁹ RBC, Ibid.

disclosure of trailing commissions⁴⁵⁰. Their primary concerns related to the costs of the disclosure were:

“In this section you say “We acknowledge the potential costs to industry, but believe that informing the investing public is worth this cost.” This seems a rather dismissive statement given the concerns expressed by industry participants who commented previously. Our own letter addresses these concerns under the heading Disclosure Duplication, Cost Burden & the Consultative Process in Appendix A attached. In addition we believe that this statement does not satisfy (at the very least) the Ontario Securities Commissions obligations under s.143.2 (1)7 of the *Ontario Securities Act* which requires that the published notice of a proposed rule must include “A description of the anticipated costs and benefits of the proposed rule. We believe that it would be contrary to the public interest not to conduct this quantitative analysis. We also believe that the investing public would be astounded as the costs versus the information being delivered. Dealers have already, and continue, to re-engineer their systems to deliver quarterly statements efficiently, with fund facts to come, and they will have to re-engineer again to deliver this annual statement with the proposed expanded disclosure.” This further

⁴⁵⁰ Federation of Mutual Fund Dealers, RE: Notice and Request for comment on proposed Amendments to National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations and to Companion Policy 31-103CP Registration Requirements, Exemptions and Ongoing Registrant Obligations June 14, 2012 (2nd Publication) Cost Disclosure, Performance Reporting and Client Statement, September 7th, 2012.

contributes to an unlevel playing field for e.g. the banks and exempt market dealers and it is unfair to continue to disadvantage the mutual fund dealer industry.”⁴⁵¹

Steven Kelman questions the benefit that investors will receive from the disclosure of the dollars that investors paid for trailer fees and the accompanying descriptive statement of these fees.⁴⁵² His article describes the types of services that are expected to be provided to investors for this fee, which in some cases never transpire, while in other cases the advisors earn their trailer fees by providing investment advice to their clients. The issue arises when investors are charged for services they don’t receive, and the advisors receive this profit at the expense of investors. Kelman states, “Of course dealers and fund companies may argue that it’s the fund management company’s money that is paid to the dealer and not the investor’s. I disagree. You should consider the trailer fee your money because if you are dissatisfied with the service you receive and move your account to another dealer or to another advisor within the same firm, the trailer moves with your account to compensate your advisor for the after-sales services you may or may not receive.”⁴⁵³

Ms. De Laurentiis, the President and CEO of IFIC was questioned referring to the proposed POS rules that would require investment firms of all types to disclose the dollar

⁴⁵¹ Ibid.

⁴⁵² Steven L. Kelman, How much did your advisors earn in trailer fees from your accounts last year? August 17, 2012, Investor Insight, assessed at: <http://cawidgets.morningstar.ca/ArticleTemplate/printArticle.htm>

⁴⁵³ Ibid.

amount of fees paid by investors, and their personalized rates of return. Ms. De Laurentiis stated “We’re totally supportive of both these points. We think it’s important for the investor to understand what they’re paying for a product they’re buying, and then how the product is serving them”⁴⁵⁴. She further noted that at a certain point the costs to investors exceeds the benefits, indicating that is the case with the proposed disclosure rules, and stated “it’s a lot of information, and we are not really sure it’s going to deliver value.”⁴⁵⁵

A large component of the advisory fee is related to trailing commissions that are paid to advisors that sell their products and designed to compensate advisors for ongoing client service. Current fund industry documents explain the trailing commission in terms of the percentage of assets invested in a fund which is typically approximately 1 percent for an equity fund and 0.5 percent for a bond fund. Ms. De Laurentiis believes that this current level of disclosure provides a sufficient level of detail stating, “We think it gets to the point, which is informing investors. It gives them the information they need to say [to an advisor], by the way, tell me more about what you’re being paid”⁴⁵⁶. The proposed disclosure rules, under the POS project, would require fund companies to show the amount of trailing fees paid by investors expressed in terms of dollars. The data, under the proposed format, would be provided on an annual client statement new report of personalized returns since the account was established. This is an improvement for the

⁴⁵⁴ Ibid.

⁴⁵⁵ Ibid.

⁴⁵⁶ Ibid.

firms that show only how much the account has changed since the last statement, while the same for others show the change since its exception⁴⁵⁷.

A recent article by Rob Carrick in the *Globe and Mail* evaluated whether the extra costs of fees related to full disclosure was ‘worth the added cost’ to investors. In his opinion, “when it comes to how our money as investors is being spent and being managed by the financial industry it’s worth paying more to know more”.⁴⁵⁸ In Britain, regulators banned financial advisors from accepting commissions on mutual funds and other financial products⁴⁵⁹. Canadian investor advocates, however, are sceptical that the trailer fees will be banned. According to Ermenno Piscutto, Executive director of the Canadian Foundation for Advancement of Investors Rights (FAIR), this model could come to Canada if there were regulators with “Fire in their belly, and a mission to improve investor protection.... But the pace of investor – protection reforms in this country is frustrating and painfully slow”.⁴⁶⁰

Mr. Piscutto further stated “Canadian regulators should emulate Britain’s move in getting rid of continuing trailer fees that advisers receive when keeping their clients in a mutual fund. The client is essentially paying these fees, but is not aware they are paying

⁴⁵⁷ e.g., TD Canada Trust, www.tdcanadatrust.com

⁴⁵⁸ Rob Carrick, Investing Fees: Full Disclosure is worth the added cost, September 12, 2012, *The Globe and Mail*, accessed at: <http://www.theglobeandmail.com/globe-investor/personal-finance/investing-fees-full-disc...>

⁴⁵⁹ Ibid.

⁴⁶⁰ Shirley Won, Canada unlikely to see ban on fund commissions, *The Globe and Mail*, April 1, 2010, accessed at: <http://www.theglobeandmail.com/globe-investor/funds-and-etfs/funds/canada-unlikely-to....>

these fees”.⁴⁶¹ Glorianne Stromberg has stated “Paying that trailing commission substantially cuts down on the investors reasonably expected return so it has made mutual funds a very expensive way of investing”.⁴⁶² She further suggested that it will be hard for Canadian regulators to ignore Britain’s initiative given that other countries are also looking at this.

Ken Kivenko, an investor advocate, likes what Britain has done, but doubts that a similar ban will occur in Canada, stating: “It would take real leadership...to make it happen, and he’d be up against the banks, the mutual fund companies, the big insurance companies. I just don’t see anyone like that. The distribution system for mutual funds is based on embedded commissions”.⁴⁶³ I note that banning of trailer commissions is not included as part of the most recent disclosure mechanism proposal that was submitted for comment in June 12, 2012 which is very significant since these fees are a significant factor in the high expenses paid by Canadian mutual fund investors. Instead, the proposal simply calls for disclosing whether the fund expenses include trailer fees.

In a 2003 article by Rob Carrick in the Globe and Mail Rob Carrick previously stated: “Trailer fees are a major reason why MERs are as high as they are, which means they deserve a lot more scrutiny than they usually get. In fact, the debate over high MERs is almost as much about trailer fees as it is about the fund industry’s gluttonous

⁴⁶¹ Ibid.

⁴⁶² Ibid.

⁴⁶³ Ibid.

tendencies when it comes to fees of all kinds.”⁴⁶⁴ Carrick observed that “The average Canadian equity fund MER is a strikingly high 2.7 per cent, which means 2.7 per cent of the fund’s assets go to cover expenses. It also means that if the average fund grossed 2.7 per cent in a year, the reported return to unit holders would be nil. MERs reflect all kinds of expenses, including manager salaries, research, distribution and marketing efforts and the cost of staging promotional golf tournaments. Trailer fees are a huge component as well. In fact, if you eliminated the cost of trailer fees and DSC commissions from that average Canadian equity fund, you’d get the MER down to something in the area of a slim, trim 1.7 per cent or possibly even a little less. Don’t read this as a criticism of trailer fees per se. Advisers deserve to be paid for continued customer care. The question is how much?”⁴⁶⁵

Trailer fees, or trailing commissions, are tied to the value of client accounts and paid to advisors, monthly, quarterly or annually. Under the POS project trailer fees are disclosed in the Fund Facts document and summary prospectuses as a percentage of an investor’s holding in a given fund. For a fund sold with an upfront commission, which typically ranges from zero to 5 percent of the investment, the trailer fee will be as much as 1 percent annually in most cases. When an investor buys a deferred sales charge fund, then the trailer is typically as much as five percent. Under this proposal the trailer fees would be expressed in dollar terms. I note that these trailer fees are typically paid to

⁴⁶⁴ Rob Carrick, Hope you’re getting great service from the financial advisor or dealer that sold you your mutual funds. After all, you’re paying for it. *The Globe and Mail*, July 10, 2003, accessed at: GlobeandMail.com

⁴⁶⁵ Ibid.

advisors regardless of the performance of the fund. They may also be related to personal commission where advisor sales staff receive a sales commission based on how much product they sell, while the more product they sell the more trailing commissions they receive. The Fund Facts format simply expresses a charge that is levied upon investors in dollar terms. It does not provide investors any assurance to investors that they are receiving value for this fee.

In a recent article, Rob Carrick indicates that the point of sale issued in (June 2012) proposals “include a requirement for the entire financial industry that investors be shown the dollar amount of fees paid for products and advice, and that they be shown how their investments have performed in both dollar and percentage amounts. Having this information in hand would provide a huge lift to financial literacy by causing investors to think more critically about what they own, what they pay, what services they receive and how much they get in returns. Trailing commissions are a particularly important aspect of all this because they are associated with mutual funds, a mass marketing investing product.”⁴⁶⁶

Glorianne Stromberg noted in the Stromberg Report at that time there was no check on whether the investors were receiving the services that they paid for in the trailer fees, stating “no one monitors whether in fact these services have been provided.”⁴⁶⁷ She

⁴⁶⁶ Rob Carrick, Shedding light on a hidden mutual fund fee, *The Globe and Mail*, June 29, 2012, <http://www.theglobeandmail.com/globe-investor/personal-finance/shedding-light-on-a-hidden-mutual-fund-fee/article4382237/>

⁴⁶⁷ Stromberg Report, supra note 226.

also noted that “these fees may also be a factor in a sales representative not recommending a change in the clients portfolio when it would be in the client’s interest to make this change.”⁴⁶⁸ The Stromberg Report also recommended that the mutual fund industry voluntarily end the payment of these fees⁴⁶⁹. I note that the current POS project only involves the disclosure of the trailer fees and not monitoring of whether investors are receiving the value for services that they are paying for in trailer fees. Therefore, this concern has not been addressed in the current POS project and proposed (June 2012) revisions.

While the public may not understand trailer fees, I suggest that this may not be the only issue with associated with their high levels. I suggest that an attitude from dealers and advisors (if this exists) that these fees are their money and not investor’s money could also contribute to the current situation where their fees are charged to investors, and investors are largely not even aware of what they are, let alone that they pay for them as part of their management expenses. However, this viewpoint assumes that trailer fees should not be banned as in the U.K. or “voluntarily” stopped by the mutual fund industry as recommended by Glorianne Stromberg. It also assumes investors are receiving value for the trailer fees, which has not been demonstrated by the mutual fund industry, Canadian securities regulators, or in published academic studies.

⁴⁶⁸ Ibid.

⁴⁶⁹ Ibid.

In both the U.K. and Australia, regulators have banned the commission model. In Canada, the trend is towards maintaining the fee-based model and the commission, but requiring disclosure of the expense ratios and breaking out the trailer fees which are currently bundled with the management expenses. Rather than letting the market sort itself out, Canadian regulators could institute a process to facilitate industry with providing a set of fees and services instead of having advisors receive trailer fees from the account that they were attached to, although this simplifies the situation for advisors.

My recommendation is that trailer fees not be banned in Canada, as in the U.K., assuming that they can be well regulated, until it has been demonstrated that they do not add value for investors. For example, studies have found that 12b- fees in the United States are a deadweight cost to investors. From my perspective, 'well regulated' does not simply mean disclosing the dollar value that investors are paying in trailer fees on a one page, double-sided Fund Fact document. For instance, the MERs (which include trailer fees) were disclosed to investors and Canadian mutual fund investors still paid among the highest mutual fees globally. As such, simple disclosure does not appear to be an effective regulatory mechanism for fees in the mutual fund industry.

Disclosure could be an effective mechanism for regulation of conflicts of interest, but it is currently not an effective mechanism for regulation of expenses and fees based on the current level of fees paid by Canadian investors. As the current proposal under the POS project is disclosure in a simpler 'Fund Facts' format and the desired outcome is that investors will be aware of how much they pay, this will provide them with adequate

background to make their investment decisions. I suggest that the format change alone will not be enough to make investors sufficiently aware of the relevance of these values as they will not have the context for comparison of whether these are appropriate.

If an individual investor compares MERs or trailer fees with an industry that is high in a North American or global context, then the levels that the individual is paying may seem appropriate to them, when in fact the entire industry has a high average level. I therefore conclude that regulations should be developed to control the levels of fees and expenses in Canada. This could include setting maximum levels for expenses in fees, which could involve a comparison with pension funds. This could also involve benchmarking fund types such as index funds as a base, and the funds could be scaled up based on the actual services delivered to investors. Consideration could also be given to advisors submitting invoices for their actual services, with backup, and these costs could then be passed on to investors, instead of by the straight percentage fee levied today regardless of the advisors' actual activities. This regulatory approach could operate in addition to the point of sale process, since it would not be in conflict with the disclosure mechanism.

A fundamental factor underlying the issues being experienced with advisory fees is establishing an appropriate compensation model. On the one hand investors desire their fees to be as low as possible, and on the other hand advisors deserve to be appropriately compensated for their services. The main options for independent financial advisors are fee-based, compensation-based or a hybrid of these two options. One article

states, “Trailer fees tend to be ‘sticky’, meaning that an advisor buying the book continues receiving them, potentially raising the value of the book. This simplifies matters for the advisor.”⁴⁷⁰ While this may simplify things for the advisor, this is clearly not the goal, particularly if it means that investors are paying for services that they do not receive. Accordingly, a process should be worked out that produces an appropriate charge to investors based on the value of services that they receive, rather than a blanket charge to all investors regardless of whether they are receiving value for their trailer fees.

The trailer fee has historically been bundled within the MER and not visible to investors. As Dale Jackson states, “The MER is subtracted from the fund’s total return before it is posted. Mutual fund companies are required to display the MER prominently when providing performance details. However, one detail tucked away within the MER is the trailer fee – the portion that goes toward paying the person who sells you the fund, which in most cases is the financial advisor. The amount of trailer fees varies between companies, which raises conflicts of interests, such as whether the advisor is recommending the fund to an investor because it is a good investment, or because they receive higher trailer fees. Glorianne Stromberg indicates that providing incentives for financial advisors is creating a situation where “the system doesn’t allow them to act for anything but their own self interests.”⁴⁷¹

⁴⁷⁰ Al Emid, Fees vs. Commission not clear cut., January 25, 2011, <http://www.advisor.ca/news/industry-news/fee-vs-commission-not-clear-cut-13241>

⁴⁷¹ Dale Jackson, High MERs needn’t be a dirty little secret. Fund fees can add up. But sometimes, you get what you pay for., *The Globe and Mail*, <http://www.theglobeandmail.com/partners/free/rrsp2007/mf-mer.html>

From this perspective, disclosure of trailer fees in the POS project is a positive step, although the question remains whether they should be allowed to continue and if so, how should they be regulated to add value to investors along with the other fees. This situation needs to be resolved, since trailer fees make up a large portion of the compensation of fund managers and advisors. As expressed by Rob Carrick, “Mutual fund companies pay the trailer out of the money they charge investors who own their products. Fact is trailing commissions account for the biggest chunk of fund fees. If an equity fund had a management expense ratio at 2 percent, then the trailing commission could account for up to half of that amount.”⁴⁷²

An effective mechanism for investor protection would ensure that investors are getting value for their money. The proposed approach of disclosure under the point of sale project simply requires that fund managers disclose the trailer fee and not whether they receive value or even that they receive services for the fee that they pay. They only receive a potboiler statement of what a trailer fee is.

With respect to value I should also point out that investors will pay for the ‘Fund Facts’ disclosure document in the end as part of their MER. As stated by Jon Cockerline, director of policy and research at the Investment Funds Institute of Canada, concerning the disclosure of trailer fees, “We feel it’s an unnecessary and unwarranted requirement.

⁴⁷² Rob Carrick, *supra* note 466.

It probably isn't that relevant to investors, and yet it's going to cost the industry a fairly large amount of money. Investors will incur the costs in the end."⁴⁷³

There have also been actions on high mutual fund fees in Canada by the federal government. As stated in an article by the Canadian Press, "Last year, Federal Finance Minister Jim Flaherty took on credit cards and forced long overdue changes (though interest rates didn't budge). Now, he's taken a bead on the mutual fund industry, prompted by FAIR Canada, the Canadian Foundation for the Advancement of Investor Rights. The issue is fees."⁴⁷⁴ Flaherty asked the Senate Council to look into why Canadians pay so much for mutual funds. As such this push to look into mutual fund fees includes the Finance Minister of the Federal Government. Referring to Flaherty, Kilpatrick further states that "As with credit card interest, he may not be willing or able to force a cut in costs, but simply requiring transparency will give Canadians the critical information they need to comparison shop for mutual funds and decide if we are getting what we pay for."⁴⁷⁵ This comment is consistent of the focus of the point of sale project upon disclosure.

Disclosure alone, however, will not allow investors to 'comparison shop' if they read the disclosure documents and choose to shop on the basis of fee expenses, which they have not largely done to date. The disclosure document does provide some of the critical information for performance. I note that the current proposal for point of sale

⁴⁷³ Ibid.

⁴⁷⁴ Sean Kilpatrick, Ottawa tackles high mutual fund fees. *The Canadian Press*, October 9, 2011.

⁴⁷⁵ Ibid.

includes what I consider to be one of the most important metrics – the relationship of fees to performance. Investors should be able to understand how well the fund is performing relative to the fees they are paying, which is not readily apparent in ‘Fund Facts’. Although all investors across the country could theoretically do their own ratio analysis, this should more appropriately be done as part of the disclosure document.

The point of sale process also does not address the economies of scale of the mutual fund industry. As previously discussed, as mutual fund assets under management increase, the expenses per unit asset should decrease due to economies of scale. There is a perceived issue that these cost savings are not being passed on to consumers. One way to accomplish this is to set a scaled ceiling for expenses and fees, with increased assets under management. Passing on economies of scale to investors has not been addressed thus far. I recommend that this be addressed as part of a comprehensive investor protection strategy.

The *Summary of Changes to the 2011 Proposal and Issues for Comment* of the June 2012 document described the key changes made to the 2011 Proposal and identified specific issues for comment in text boxes related to specific changes that were made (in Appendix B of document). The document indicates that “Many of the changes respond to investor advocate comments relating to the presentation of risk in the Fund Facts.”⁴⁷⁶ I point out, however, that there were only a limited number of investor responses, consisting of two professional investor advocates. While the OSC may have addressed

⁴⁷⁶ June 2012 document Appendix B.

these comments, I suggest that the greater issue is that it did not generate broad public participation and as such may have not have a representative understanding as to whether the point of sale disclosure mechanism is appropriate for investors.

The securities regulators further state “We have made a number of revisions to the content of the Fund Facts. The changes respond to investor advocate comments to provide greater detail or clarity to the disclosure, specifically regarding the presentation of risk and performance.”⁴⁷⁷ Again, the comments of the securities regulators may give the impression that there were numerous responses from the public when there the responses from the public were limited to two professional investor advocates.

The changes to Fund Facts in the 2012 version included the following:

- recognized and publicly available identification codes for the class or series of the mutual fund are required to be disclosed on the top of the first page.
- background was added on the history and relative size of the class or series of the mutual fund in Quick Facts (e.g., related separate headings were created for the ‘Date fund started’ and Date class/series started’.
- the percentage of each holding was added to the list of Top 10 investments to provide a greater sense of the fund's concentration risk in a particular investment.

⁴⁷⁷ Ibid.

- stronger warning language was mandated concerning the risks of investing in mutual funds.
- an explanation was included about the risk scale and the relationship between risk and losses (i.e. higher returns typically result in greater chances of losses).

The June 2012 document indicates what feedback is sought: “The proposed explanatory text included above the risk scale is based on the assumption that fund managers use risk classification methodologies based on measures of market volatility, such as standard deviation. We seek feedback on whether the proposed text will assist investors in understanding how to interpret the risk scale in the Fund Facts, and whether the explanation is compatible with the risk classification methodologies used by fund managers.”⁴⁷⁸

I raise the question as to whether the CSA will believe that it has the feedback that it sought if only two investor advocates and no members of the general public have formally responded. Further given that this limited response is the case, will the CSA then change its approach from a ‘comment and response’ format to a format that engages the public more such as focus groups, town hall meetings, etc.? It should be stressed that if the CSA is seeking feedback and then does not receive the feedback from the public that it desires-then in fact it is putting forward a rule designed for the public without public input. It is hard to imagine how a disclosure document could be developed for the

⁴⁷⁸ Ibid.

public without the appropriate level of public input, yet this was the case for the 2011 stage of the project and the CSA adopted the same approach for the 2012 process. I also note that the request for feedback does not include input on whether any additional items should be added to Fund Facts related to fees and expenses. The public was not provided with any background information on advisory fees or expenses based on academic studies or regulatory experiences in the United States associated with the introduction of the requirement for a streamlined prospectus. Instead, the public was asked to comment on this document without any advance public education. Moreover there was no evaluation of public awareness of the public comment process, that is, how many investors were even aware of the project and the opportunity to comment.

A requirement was added to include a list of no more than four main risks of the fund, while continuing to direct investors to the simplified prospectus for a more detailed discussion of a fund's specific risks. The Canadian securities regulators explain that the intent of the proposed requirement to list the fund's main risks under the heading "What are the risks of this fund?" is to highlight for investors some of the specific risk factors that may impact the fund's returns. In an effort to avoid lengthy boilerplate disclosure, I am proposing to limit the list to no more than four risk factors, as identified by the fund manager, and to not allow any narrative description of those risks.

The Canadian securities regulators sought feedback on whether the proposed inclusion of the fund's main risks will assist investors in better understanding the risks associated with investing in the fund. In particular, they invite feedback on how they

could ensure that “such descriptions convey meaningful information to investors while remaining short, simple and in plain language”⁴⁷⁹. Investors have until September 2012 to provide comments. If there are no comments from the public, other than investors advocates, I suggest that this process be halted and a meaningful form of public participation be implemented such that the public has meaningful involvement in the development of the disclosure mechanism being designed for their use.

A comparison has been added in the June 2012 document to the mutual fund's performance with a lower risk investment, specifically the one-year Guaranteed Investment Certificate (GIC). The Canadian securities regulators are proposing to compare the fund's performance to a benchmark of a one-year GIC, to assist investors in assessing the performance of the fund relative to its associated risk. This comparison is intended to highlight the risk of investing in a fund by illustrating how a fund may have a higher return than a GIC in some years, but its return will generally vary from year to year and may sometimes lose money. They seek feedback as to whether there are other appropriate benchmarks to illustrate this comparison.

I suggest that while a GIC could be a viable comparison, a more appropriate comparison would be market indices since the expenses charged by mutual fund companies may result in them underperforming the market conditions (as previously discussed), while a GIC typically has a very low rate of return for investors with very low risk, and therefore this would be a very low performance bar for mutual funds to clear. I

⁴⁷⁹ Ibid.

suggest that the risk-return profile would be very different between mutual funds and GICs and therefore this benchmark would not be appropriate. Since the comments to the proposed disclosure mechanism are largely from industry, it may be expected that the comments from industry will be very supportive of a comparison with a GIC index since this is a relatively low performance bar. I suggest, instead of or in addition to a GIC benchmark, that an index fund benchmark be adopted since this represents a clearer portrayal of market performance prior to the deduction of performance by the applications of expenses including advisory fees.

The CSA added a requirement for the worst 3 month return to be added to the performance section of Fund Facts with the intent of better informing investors about the possible loss of investing in the fund. I suggest that this is essentially a meaningless metric, since 'past performance is no guarantee of future performance' and there is a possibility that the future performance could be lower than the three month low particularly for relatively new funds. I suggest that this metric could be misleading to investors and should be removed.

A requirement was added to confirm whether trailing commissions are paid. A requirement for a statement was also added regarding the potential conflicts arising from the payment of trailing commissions. I believe that this requirement falls far short of what is needed for effective disclosure for an investor protection mechanism since this simply requires a disclosure of whether they are paid and not the magnitude of the trailer fees. As previously discussed, trailer fees are a significant factor in why Canadian investors

pay among the highest mutual fund expenses in the world (discussed further in Section 5). A requirement should be added for disclosure of the actual dollar amount of the trailer fees that the individual investor is paying each year, and the percentage that the trailer fees detract from the overall performance return to investors.

The time frame for certain information disclosed in the Fund Facts from 30 days to 45 days to allow greater flexibility for mutual fund companies to comply with the disclosure requirements. I note that this change is beneficial for fund managers but not beneficial for investors since they may be receiving this information up to 4 to 6 weeks later than in the previous version of this disclosure mechanism.

The Canadian securities regulators added a cross-reference in the brochure "Understanding Mutual Funds" which is available on the website of the Canadian Securities Administrators.⁴⁸⁰ While a link to a brochure on a website is a step toward investor education, this does not go far enough toward a comprehensive program of public education, participation and involvement.

The proposed POS rules are a step forward for the disclosure mechanism at governance in Canada from the stand point of disclosing key financial information in a content and format that is relevant to investors – the actual costs in dollars that they pay their mutual funds and advisor for their services. I suggest that this is not enough, on its own, for an investment disclosure mechanism but must also involve an increased amount

⁴⁸⁰ www.securities-administrators.ca.

of public education such that investors can understand use and the information being disclosed. This is discussed in the section of public involvement, participation and education (Section 3.10). Further, there must also be an effective governance agency, with decision-making authority and 'real teeth' that can act in the best interests of mutual fund shareholders when the disclosed information indicates that the fees are excessive, such as a fund board. A discussion of a 'governance agency' is discussed under the Canadian mutual fund regulation and is in place in the United States mutual fund governance framework. In my interpretation, the POS project is a compromise position, since rather than banning trailer fees, the securities regulators are allowing fund advisors to change these fees continuously as long as their existence, but not the amount, is disclosed to advisors.

I conclude, based on the preceding analyses, that the Point of Sale (POS) disclosure mechanism is not an effective mechanism for investor protection as proposed. It completely ignores the fundamental issue that Canadian investors pay among the highest mutual fund expenses globally, and fails to address this issue in the current version of the rule. As this is a fundamental starting point for the development of a rule that protects Canadian investors from the current state of the high expenses and fees, I recommend that the current process of the rule and that the process be reinitiated from the beginning to ensure that an effective disclosure mechanism is developed to contribute to investor protection from high fees and expenses.

3.10 EDUCATION AND PUBLIC INVOLVEMENT OF RETAIL INVESTORS

In order to evaluate the effectiveness of current public education and involvement of retail investors in the Canadian mutual fund regime I conducted an extensive literature review. The results of this review identified a study by Julia Black that was commissioned by the Canadian Securities Regulators which is a focal point of this analysis since it is a recent study focussed specifically on this subject by a world recognized expert in corporate governance that has not yet been utilized for the development of mutual fund governance in Canada.

The Task Force to Modernize Securities Regulation in Canada commissioned Julia Black to undertake a research study that was prompted by an awareness that retail investors often do not have the same economic incentives or opportunities as institutional investors to monitor public companies and their management, and lack effective communication channels with regulators, making it more difficult for their views and interests to be given proper weight in consideration of different regulatory options. This task force focussed on the four largest Securities Commissions (Ontario, British Columbia, Alberta and Quebec) and the three regulatory organizations, including the Mutual Fund Dealers Association (as well as the Investment Dealers Association and Market Regulation Services Inc.).

The results of this study are provided in the report entitled “Involving Consumers in Securities Regulation”⁴⁸¹. This report examines how securities regulators in Canada

⁴⁸¹ Black, J., (2006). *Research Study Involving Consumers in Securities Regulation*, June 23, 2006.

and the U.K. currently involve retail investors and determine their interests in designing regulation and comments upon: current methods of involving and determining the interests of retail investors; alternative methods that may have been considered and rejected; and the views of regulators, consumer representatives on advisory panels and consumer advocates as to the effectiveness of the current system as a method for eliciting comment and contribution on and toward prospective policies from the retail sector.

Consumer awareness of the securities regulatory system is low in both Canada⁴⁸² and the U.K.⁴⁸³. In the U.K., most consumers get their information concerning financial products from firms' marketing literature and very few seek advice from regulators or are aware that it is available⁴⁸⁴. In addition there is little awareness of what the regulators actually do. For instance, in the U.K., the results of research by the National Consumers Council found that most consumers see regulators as a body for receiving complaints rather than decision making for their sector.

Effective retail consumer involvement, according to Black, improves the democratic accountability of the regulator, builds trust and confidence, widens the range of information on which decisions can be based, and leads to a better quality of decision making. As such there are significant advantages to effective consumer involvement in the development of the Canadian mutual fund governance regime. Black indicates that consumer involvement in the regulatory process takes the four forms of: information;

⁴⁸² OSC, *Stakeholder Satisfaction Survey*, Wave 3, Final Report, Toronto, 2004.

⁴⁸³ *Awareness of the FSA*, CRPR, 39, London, 2005.

⁴⁸⁴ FSA, *Levels of Financial Capability in the U.K.: Results of a Baseline Survey*, London (2006).

education; consultation; and, participation. Black further notes that these form a pyramid where as the degree of active engagement increases, the number of consumers decreases along with the opportunities for engagement. For example, opportunities for information and education are open and available to more consumers than consultative and participative processes. According to Black, consumers and the wider public can be involved through any of the four forms.

The current consultation through notice and comment processes in the development of Canadian securities regulation, according to Black, offers the potential for involvement, but on its own does not provide a real opportunity. She indicates that “commenting on proposed changes to securities laws requires a level of interest, knowledge and time that most consumers simply do not have.” The securities regulators have indicated that although numbers are not kept, there is a low level of consumer responses to consultations, usually in single figures⁴⁸⁵. This is consistent with the low levels of public involvement in providing comments on the draft national instruments for mutual fund regulation in Canada.

There are also weak levels of satisfaction with and low readership of reports that have been provided as part of the development of the proposed national instruments for mutual fund regulation. For example, a Compass survey found weak levels of satisfaction

⁴⁸⁵ Black, *supra* note 481, p. 572.

with the reports that were being provided under the regulatory requirements for proposed National Instrument 81-106 with low levels of readership⁴⁸⁶.

The launch of the Fair Dealing Model by the OSC in 2002 utilized an interactive website that used animation software to bring client-advisor relations to virtual life, including enactments of virtual investor-advisor interactions, examples of how advisors could deliver their services and provided documents that firms could use in the new relationships, and a sample document for investors outlining the expectations for services they could receive and fees they would pay. The site received 10,000 hits and although a relatively small proportion of individuals submitted comments, 20 percent of these were from individual investors⁴⁸⁷. This number of responses is more than the number of persons that responded to proposed National Instrument as part of the comment process. It is also considerably more than would formally respond to the formal consultation processes⁴⁸⁸. The more usual method for piloting has been to use focus groups⁴⁸⁹. The Alberta Securities Commission utilized focus groups discussions on proposed changes to the prospectus and exemption rules⁴⁹⁰. It should be noted that most of this research to date has been associated with the Fair Dealing initiative.

⁴⁸⁶ Compas, *National Instrument 81-106: Final Report for the Ontario Securities Commission*, May 2003.

⁴⁸⁷ *OSC Annual Report, 2003-2004*.

⁴⁸⁸ Black, *supra* note 481, p. 590.

⁴⁸⁹ *Ibid.*

⁴⁹⁰ *National Instrument 52-109, MI 52-111*.

In 2002, the OSC, together with the BCSC, commissioned a Compas survey to conduct research into consumer's understanding concerning the financial and non-financial aspects of an investment fund, with a focus on continuous fund disclosure and mutual fund reporting. The survey asked questions concerning the ideal form of content with respect to content, formatting and frequency, and evaluated how changes in reporting could affect behaviour. Other projects that the CSA utilized for focus groups include the registration reform project and the mutual fund point of sale project. The point of sale project is a CSA and Joint Forum of Financial Markets Regulators project, with the CSA component of the project being led by the OSC and the BCSC. The disclosures were tested at locations across Canada in order to determine if there were regional differences to be taken into account. The proposals of the SRO rule committee on the registration reform project were tested using focus groups, which is the first time that any of the SROs used focus groups for this type of research. Despite these localized attempts at involving the public for research purposes, there remains a low level of public involvement in rule development across the Canadian mutual fund regulatory system.

The BCSC conducted research into the victims of the Enron mortgage scam in 2005 in order to determine how investors had been fooled by this scam for so long⁴⁹¹. Again, these actions initially involved research. The results of this research, however, resulted in improvements to investor education, to reduce susceptibility to scams, which is an addition mechanism for public involvement beyond research.

⁴⁹¹ Neil Boyd, Enron Mortgage Study, April 2005, Vancouver, accessed at: http://www.bcsc.bc.ca/uploadedFiles/Enron_Research_Study.pdf

Canadian securities regulators have also engaged in research on the impact of securities regulation of the behaviour of investors and firms. The ASC and BCSC's Capital Market Project evaluated the introduction of broader exemptions for the issuance of securities targeted at small and medium sized issuers. The Commissions consulted with industry through focus groups and information sessions to obtain views and comments directly. The use of the exemptions was monitored by the ASC and BCSC after it was released in order to determine if there was an increase in percentage of capital raised by small and medium sized firms.

The following provides brief tests as to the degree of consumer involvement in the CSA program associated with the development of the Canadian mutual fund governance regime. The information available to consumers during the development of the Canadian mutual fund governance regime was passive and limited to reports posted on the CSA website and did not include outreaching for public education. As such, this program did not include even the basic elements of consumer involvement. There was a consultation process in this program, however, the design of this encouraged participation almost solely from the mutual fund industry which lobbied in their interest. Accordingly, this consultation process was counterproductive for consumer involvement. Although the program did include an opportunity for the public to provide comments on the proposed regulation, there was not an opportunity for the public to take an active role in the process such as sitting on advisory boards as consumer representatives.

The main methods used by U.K., Australian and Canadian securities regulators, according to Black, are notice and comment processes⁴⁹². This was the primary process for comments on proposed national instruments 81-106 and 81-107. Public meetings and more focussed consultations with groups of investors through focus group research are common in the U.K. and Australia⁴⁹³. In Canada, only one regulator has held an open public meeting specifically for retail investors to air their views (the Ontario Securities Commission's Investor Town Hall). Focus groups have been held in the U.K., Australia and Canada. However, there have been no focus groups associated with the introduction of national instruments in Canada, based on the information published on the CSA and OSC websites.

There is active participation in investor advisory committees and consumer panels in the U.K. and Australian securities regulation, and more recently within Canada. Consumer representatives have been introduced and included by two Canadian regulators, the RS and the OSC, in their committee structures. The RS has invited an academic to serve on its main policy group advisory committed to give a retail investor's perspective. The OSC has created the OSC Investor Advisory Committee (IAC). Based on my review of mutual fund governance, this has not been put in place for mutual funds to date. I suggest that this advisory committee would be beneficial for mutual funds and should be established to enhance public involvement. I further suggest that Canadian security regulators should include consumer representatives in their committee structures

⁴⁹² Supra note 481, p. 554.

⁴⁹³ Black, supra note 481.

for mutual fund regulation in order to foster public participation and involvement as is being undertaken elsewhere.

Regulators have been experimenting with alternative forms of active participation such as citizen's juries and other deliberative panels, which Black notes are an increasing feature of health, bio-technology and environmental regulation⁴⁹⁴. For these approaches, the participants are provided with an education on the subject matter and how to communicate and present on formal policy procedures, and this is fed into the regulatory development process. Again, this is much more consumer focussed than the approach used in the past to develop mutual fund governance regulation in Canada.

Alternate forms of active participation, such as citizen's juries and deliberative panel approaches have not been employed in securities regulation in Canada. I suggest there is an opportunity to adopt best practices from other industries into securities and mutual fund governance in Canada. Black⁴⁹⁵ states "there is no real, coherent, national, well-resourced consumer voice representing the interests of all Canadian retail investors in securities regulation." She notes that this is in contrast to the practice in Australia, the U.K. and the EU⁴⁹⁶. In Canada, there are few advocacy groups even though there are many active and committed consumer advocates⁴⁹⁷.

⁴⁹⁴Black, supra note 481, p.555.

⁴⁹⁵ Black, supra note 481.

⁴⁹⁶ Ibid.

⁴⁹⁷ Ibid.

In her report, Black⁴⁹⁸ stresses the importance of embedding consumer interest in regulatory decision making and states that in Canada “regulators are recognizing that engagement with retail investors can be valuable and are starting to seek active ways of achieving it. Some of these initiatives are in their infancy, and many regulators are unsure as to which strategies are likely to be the most effective”⁴⁹⁹. Black indicates that the first step is the break down of involvement into the four main modes⁵⁰⁰ and that the next stage is recognizing that each mode of involvement serves a different purpose with different advantages and disadvantages, and that selecting which of these to target would depend upon the objectives. I recommend that public involvement in the development of the regulatory framework for mutual funds in Canada consider the framework suggested by Black of information, education, consultation and participation to better embed consumer’s interests in regulatory decision-making.

3.11 DISCUSSION

It is my conclusion, based on my review of the process for the national instruments as part of the literature review for this dissertation, that the development of the regulatory framework for mutual fund governance has not had adequate public involvement and has been limited to largely request for comments on the Concept Proposal and proposed national instruments. My literature review of the public comment process associated with the introduction of national instruments has indicated that the

⁴⁹⁸ Ibid., p. 555.

⁴⁹⁹ Ibid., p. 556.

⁵⁰⁰ 1) information 2) education 3) consultation 4) participation

responses to the requests for comments were largely from mutual fund industry companies, which dominated the process, and not strong public involvement.

I suggest that an improved public consultation processes for the creation of national instruments for the mutual fund governance regime in Canada would include public meetings and focus groups in addition to the existing notice and comments processes. This would serve, for example, to offset the dominance of industry in the comment process in the development of previous national instruments and provide an improved medium for the voice of the public. Public participation has been weak in the development of national instruments for mutual funds, except for some participation from investors in focus groups, for example, as part of the POS project.

In her report Black states “knowing what investors need means involving them, and being involved with them.”⁵⁰¹ It is my perspective, based on my evaluation, that one of the primary outcomes of the lack of meaningful public involvement is that the Canadian securities regulators do not fully know and understand what protection investors need, and as a result it is not possible for them to effectively fulfill their mandate. Further, according to Black “consumers are usually only vaguely aware of the existence of securities regulation and rules, or the regulator that created them, let alone the content of the rules themselves. ... The consumer, however, is usually only vaguely aware of the existence of these rules, or indeed of the regulator who formed them, let

⁵⁰¹ Black, *supra* note 481, p. 564.

alone their specific content.”⁵⁰² As such, there needs to be increased investor awareness of both the Canadian regulator and regulations.

In my opinion, the above calls into question the effectiveness of the national instruments for the regulation of mutual funds in Canada. I suggest that since the securities regulators have not achieved meaningful public involvement and were therefore not aware of what is required for investor protection; how can there be certainty that the rules for disclosure or the independent review committee are effective for investor protection? Moreover, I submit the question: how can Canadian securities regulators be certain that investors are aware of these regulations and the level of protection afforded to them if they do not fully understand investors’ knowledge or needs? One means of establishing the level of awareness of mutual fund investors’ knowledge of regulation and avenues for their protection would be the completion of a public survey, which has not been conducted to date, based on published information. Without this level of protection, it calls into question how the Canadian securities regulators could believe that they can complete proper due diligence to determine whether the public was aware of the securities regulations and the specific rules which have been put in place for their protection.

Regulators need to take proactive steps with the public given that few investors actively involve themselves in securities regulation, to achieve their involvement and understand what investor protection is required. I maintain that this clearly has not been

⁵⁰² Ibid., p. 565.

achieved to date through the development of the concept proposal and the subsequent national instruments, as previously discussed. It also brings into question how Canadian securities regulators can serve the public interest without having effective public involvement, or knowing what the public requires for investor protection. Black⁵⁰³ indicates that this involves “being consulted on the rules, policies and practices or the regulator” and “active participation in the rule making and implementation of the regulatory system”. It could be argued that there was a public consultation process since there was the opportunity for public comment on proposed national instruments. However, there was not active participation in this process as evidenced by the low number of responses from the public. For instance, in the public comment process for the Point of Sale (POS) project, of the 54 comments, there were none from the public and only two from persons representing retail investors.

It is currently assumed that mutual fund ‘investors will vote with their feet’ and that this affords a degree of market protection. The question arises with regard to this assumption is whether investors have sufficient knowledge to vote with their feet, particularly when they have not been educated by securities regulators through a public involvement program. In addition, relying on investors ‘voting with their feet’ by exiting the fund is not an effective mechanism for corporate governance.

⁵⁰³ Ibid., p. 565.

The results of multiple surveys by financial regulators in Canada, and elsewhere, show a low degree of awareness of the regulator amongst the public⁵⁰⁴. From this I interpret that not only are the Canadian public not receiving meaningful involvement in the development of regulations, or public education, most are not even aware of the regulator. This is also common to other countries, as a survey by the Financial Services Authority in the U.K. found that 43 percent of people who had bought an FSA-regulated product were not aware that a financial product existed⁵⁰⁵, despite the fact that there are numerous benefits to involving consumers⁵⁰⁶.

Consumer involvement in the mutual fund regulation should be a continuum from information, to education, to consultation, to participation. In practice, this has largely been comprised of 'information-giving' where consumers receive one-way communications from the regulator, (e.g., reports, information of website and bulletins) and have limited opportunity to participate, which has largely consisted on the opportunity to comment on draft national instruments. Further, my evaluation of the proposed national instruments, previously discussed in this chapter, is that there has not been an opportunity for consumers to be involved in the development of mutual fund regulation at an early stage of this process such that their needs are fully understood, prior to the development of the regulation.

⁵⁰⁴ Ibid.

⁵⁰⁵ FSA, 2005, *Awareness of the FSA*, CRPR 39, London.

⁵⁰⁶ National Consumers Council, *Involving Consumers: Everyone Benefits* (London, 2001), accessed at: <http://www.ncc.U.K./involvingconsumers/index.htm#invcon>.

Education is becoming increasingly important for financial regulators in Australia, the U.K. as well as Canada⁵⁰⁷. In practice information and education are interrelated prerequisites for public consultation and participation. People cannot contribute effectively to the regulatory process without the requisite knowledge concerning both the regulatory system and the financial market. As such, from my perspective, it is not a surprise that the degree of public involvement in the development of the Canadian national instruments for mutual funds was so low-since I submit that they did not have the requisite knowledge to participate in the process, as the opportunity was not provided by the securities regulator. Therefore, I hold that public education is an important component of engaging the public in the mutual fund investor protection, which is in the public interest and should be an important part of the future framework for mutual fund governance in Canada. I conclude that effective and meaningful public education has not been part of the development of the mutual fund governance regime in Canada to date, based on my analysis carried out as part of this dissertation. I recommend that that enhanced public education should be introduced as part of the future development of the Canadian mutual fund governance regime to improve investor protection.

Consultation involving a dialogue between the public and the regulator provides a mechanism through which the public can give their responses to policy proposals being developed by securities regulators. Black⁵⁰⁸ indicates that these may involve: public

⁵⁰⁷ Black, *supra* note 481 p. 566.

⁵⁰⁸ *Ibid.*, p. 567.

notice and comment and consultation papers; questionnaires and opinion surveys; public meetings; toll-free telephone lines; targeted briefings; web-based questionnaires/comment facilities; focus groups; multi-stakeholder negotiations; and, web-based reference groups⁵⁰⁹. The consultation program for the development of mutual fund national instruments in Canada included primarily notice and comment process and not the other potential avenues. Clearly, the securities regulators should consider the involvement of the other consultation practices to improve public consultation in the development of an effective framework for mutual fund governance in Canada.

Public participation is a more active and direct form of involvement than consultation which involves consumers or consumer organizations being directly engaged with the policy making processes of defining the issues, setting the agenda and shaping the policy debate to assist with government decision-making. Some of the methods include: participation by consumer representatives in consumer panels, committees or other forums that advise or comment on regulators work; consumer or multi-stakeholder workshops; citizen's juries; consensus conferences and web-based reference groups⁵¹⁰. Black notes that relatively few countries have begun to explore these forms of public participation in securities regulation. As such, there is an opportunity for Canada to take a leadership role in these areas.

⁵⁰⁹ OECD, *Citizens as Partners: Information, Consultation and Public Participation in Policy Making*, Paris 2001.

⁵¹⁰ Black, *supra* note 481, p. 567

An enhanced public participation program will assist securities regulators in protecting the public since they will not know how to best protect investors unless they have information and are educated with respect to the consumers' knowledge, skills behaviours and needs. In order for this to occur, consumers will need to be educated so that they can participate meaningfully in the process. This knowledge will allow securities regulators to shape the strategies for ensuring meaningful consultation and participation.

Being involved, accordingly to Black⁵¹¹ includes "receiving information or education from regulators, either directly or indirectly"... "being consulted on the rules, policies and practices of the regulator". Black's study is relevant to the mutual fund governance regime established in Canada as this was ostensibly a public process but was dominated by mutual fund industry with very little feedback from private citizens and the public in general as previously discussed. As Black states: "Knowing what investors need means involving them and being involved with them"⁵¹².

Black points out that all securities regulators considered in her report have the mandate to protect investors but that without knowing what protection that investors need it is not possible to fulfill that mandate effectively. In the case of the development of the mutual fund governance regime, such as NI 81-107, I suggest that there was inadequate stakeholder consultation, and as a result the securities regulators were not fully aware of

⁵¹¹ Ibid., p. 565.

⁵¹² Ibid., p. 564.

the protection that investors need. It follows that the rules that were constructed using the approach do not fully protect investors as they were made without being fully aware of the protection that they need.

Black indicates that few citizens actively involve themselves in securities regulation; regulators need to take proactive steps to engage with them. Black states “As many regulators are recognizing, this means doing far more than following the traditional practices of basic information provision and paper-based notice and comment processes”⁵¹³. As previously indicated, the public process in the development of the mutual governance regime (e.g., NI 81-107) utilized a traditional process involving paper-based notice and public comment. Based on Black’s assessment, the regulators must do far more to reach citizens as few actively involve themselves in securities regulation.

Based on the preceding analysis I conclude that retail investors should be more involved in the development of a mutual fund governance regime for Canada. I further conclude that retail investors have a low level of knowledge of the mutual fund industry including the fees that they pay to their advisors. I suggest that this is a key reason why disclosure is currently not an effective mechanism of fund governance in Canada, since investors are not sufficiently knowledgeable about their investments to understand the information that is being disclosed. I further suggest that the Point of Sale (POS) project will not achieve the desired results for mutual fund governance since simplification of

⁵¹³ Ibid.

information alone will not provide investors with an understanding of the fees that they are paying relative to other fees in Canada, the United States and internationally. In order for disclosure to be effective as a governance mechanism and for the POS project to achieve the desired results, I conclude that there must be increased public education. Further, I conclude that there must be improved public involvement and participation in the development of the Canadian mutual fund regime, in order to develop a governance mechanism that will meet the needs of retail investors.

The Canadian mutual fund governance regime was revised, in part, in response to mutual fund scandals in the United States, as well as late trading and market timing scandals in Canada that received widespread attention from the media and general public. As with the SEC in the United States, there was pressure upon the Canadian Securities Regulators to respond to these scandals by introducing new legislation that would prevent scandals resulting from conflict of interest. The result was the development and implementation of the main mechanisms of the Canadian mutual fund governance regime which are disclosure (under the newly developed National Instrument 81-106) and the Independent Review Committee (IRC) (under the newly developed National Instrument 81-107).

In my review of the information provided by the OSC or CSA, I have not found any reference to a mandate for the IRC to address high excessive advisory fees. I therefore conclude that this mandate does not exist. My analysis of mutual fund expense ratios and advisory fees demonstrated that Canadian mutual fund investors pay the

highest mutual fund expenses in the world and more than fifty percent more than the United States in a North American context. I therefore conclude that the IRC does not protect investors against excessively high advisory fees, even though this is what I believe to be one of the most significant issues in mutual fund governance in Canada that translates into billions of dollars annually being taken from the pockets of Canadian investors and put into the pockets of mutual fund management companies and advisors.

I suggest that high expense ratios and advisory fees in Canada could have been addressed in the mandate of the IRC since this relates to the inherent conflict of interest discussed in the history and structure of mutual funds where the advisor has a responsibility to maximize the financial returns to both the mutual fund company and its shareholders. Conflicts of interest, as defined in National Instrument 81-107, are where a manager "has an interest in the matter that is different from, or conflicts with the best interest of the mutual fund." However, this does not explicitly refer to excessive advisory fees. I conclude that excess advisory fees are not being addressed by the IRC since this is not referred to in the Instrument.

As previously discussed, high expense ratios and advisory fees are not being addressed by the disclosure mechanism since there is an insufficient investor knowledge and comparison with relevant benchmarks, and the costs are bundled and not disclosed in such a way that sophisticated retail investors could make a reliable determination of whether the fees are in fact excessive. Based on this identified gap in investor protection, I recommend that the Canadian mutual fund governance regime be enhanced to include a

regulatory mechanism to address high expense ratios and excessive advisory fees. This mechanism could involve a mandate for an expanded mandate for the IRC to include high expense ratios and excessive advisory fees.

It is clear from my analysis of the Morningstar Reports of 2009 and 2011 that Canada has very high expense ratios, which is likely due largely to the trailer fees which result in increased advisory fees. The high mutual fund expenses and fees, like the market timing and late trading scandals, have received broad media attention as well. The Canadian Securities regulators, however, have not created a mechanism to protect investors from these high fees. Like the early OSC regulation previously discussed, the securities regulators prefer to leave it to the investor to decide whether the expenses are too high and to 'vote with their feet'. Canada received a high rating in the Morningstar study for transparency and disclosure, largely because of the prospectus and the delivery of this to investors. The disclosure mechanism is being modified to provide a simplified Fund Facts document to investors within two days after the purchase and the Prospectus, only upon request, and accordingly the rating may actually have been lower with the new disclosure mechanism in place.

The existing mechanism of disclosure would not be an effective vehicle for addressing the high expenses and advisory fees, such as trailer fees, since this involves only the disclosure of the bundled expense ratios and not data that would allow a determination of the actual advisory fees. In addition, the rule only requires that the expense ratio is disclosed without relevant benchmark data. Even if Canadian benchmark

data was disclosed this would not be appropriate since this would involve comparison against other expense ratios that are amongst the highest in the world. Benchmarks comprised of expense ratios and advisory fees would be more appropriate for investors such that they are no longer locked into to an insular comparison. The IRC is focussed upon conflicts of interest and its mandate currently does not involve high advisory fees although these could be construed to result from the inherent conflict of interest between managers seeking to maximize their own returns at the expense of their investors. Accordingly, there is currently no effective investor protection mechanism for the high mutual fund expenses and fees in Canada.

There needs to be a greater public involvement in the development of the Canadian mutual fund governance regime in the future. In the past, this has been limited to public comment on proposed rules and the public has not participated much in this and may not have been sufficiently knowledgeable to do so. The securities regulators should consider the recommendations in the report by Julia Black, which they commissioned but have not yet acted upon. A public involvement, participation and education program should be developed that is linked with the development of mutual fund boards in Canada. This should include more meaningful participation of investors in the rule development instead of the request for comments. This would allow the development of a fund board that would address investor's needs and be appropriate for their capabilities, since they were involved in the development process.

The results of my analysis of the literature lead me to conclude that the independent review committee falls short of the governance agency in the Concept Proposal. I further conclude that a fund board may be the most appropriate mechanism for fund governance and investor protection. In order to understand the required evolution of the mutual fund governance regime, I undertook an evaluation of fund governance in the United States. The fund governance regime includes independent directors, such as that contemplated as the 'governance agency', in the Erlichman and Stromberg reports. Funds boards in the United States are discussed in Section 4 of this dissertation.

4.0 UNITED STATES MUTUAL FUND GOVERNANCE

I undertook a comparative analysis of mutual fund governance in the United States from a number of perspectives to assist with the evaluation of the strengths and issues with mutual fund governance in Canada, and to determine if there were potential practices in the United States that could be adopted in Canada to enhance investor protection. This comparison is relevant in particular from a number of perspectives. It is relevant from the standpoint of mutual fund fees since the analysis in this dissertation has demonstrated that advisory fees in United States are fifty percent lower than those in Canada (see Section 5) and there may be a reason for this from a governance perspective. Unlike Canada, the United States does include investor protection for excessive advisory fees in the regulatory regime. As will be discussed in this chapter there have been several challenges on excessive mutual fund fees in United States courts which are analysed to

evaluate their implications for mutual fund governance in Canada. Further the mutual fund governance regulations in the United States were modified in response to mutual fund scandals that occurred in North America generally and these developed differently in the two countries. It is relevant also from the perspective that the governance agency that was recommended by the Erlichman Study for Canada mutual fund governance was a fund board, comparable to that which was adopted in the United States, in contrast to the more limited IRC which was ultimately implemented in Canada. As discussed in the following the United States moved to a focus on director independence for fund board directors and chairman that was highly controversial and analysis of this was conducted in order to evaluate whether Canada should also include this in its governance regime.

My following analysis of mutual fund governance in the United States was based on a comprehensive review of United States regulations, releases by the SEC, the ICI and other bodies, proceedings of hearings and commissions, academic literature, documentation from courts concerning litigation on excessive fees, as well as public media sources.

4.1 THE INVESTMENT COMPANY ACT OF 1940

Investment companies were regulated under a piece of New Deal legislation that arose from the Stock Market Crash of 1929 and the subsequent Great Depression. A study by the SEC of the operations of investment companies was authorized by the Public Utilities Holding Company Act of 1935. The SEC investigation, which discovered a number of abuses, resulted in the passage of the Investment Company Act of 1940.

The Investment Company Act of 1940 originated in response to congressional concern that the Securities Act of 1933⁵¹⁴, and the Securities Exchange Act of 1934⁵¹⁵, were inadequate for protection of the purchasers of investment company securities⁵¹⁶. Congress directed the SEC to study the structures, practices, and problems of investment companies with a view toward proposing further legislation. After four years of study of the industry, the Investment Trust Study was published with recommendations of legislation to address the problems and issues and abuses it identified in this study. The Investment Company Act of 1940 was adopted following congressional consideration.

The act also regulates the election of directors to the board of investment companies⁵¹⁷. Specifically, the Investment Company Act requires that at least forty percent of investment company board of directors be independent outside directors⁵¹⁸. The requirement for outside directors was expanded to a majority requirement by the SEC in 2001⁵¹⁹. That requirement for a majority outside directors was added through the back door by the SEC by requiring such a board for investment companies become eligible for exemptions from SEC conflict of interest rules⁵²⁰.

⁵¹⁴ 48 Stat. 74, 15 U.S.C. § 77a et seq.

⁵¹⁵ 48 Stat. 881, 15 U.S.C. § 78a et seq.

⁵¹⁶ § 30 of the Public Utility Holding Company Act, 49 Stat. 837, 15 U.S.C. § 79z-4

⁵¹⁷ ICA, Ibid., § 80a-16(a).

⁵¹⁸ ICA, Ibid., § 80a-10(a). 15 U.S.C. § 80a-15(f)(1)(A) (2000).

⁵¹⁹ *Role of Independent Directors of Investment Companies*, 66 Fed. Reg. 3,734, 3,736 (Jan. 16, 2001) (codified at 17 C.F.R. pts. 239, 240, 270, and 274).

⁵²⁰ Exemptions permit mutual funds with majority outside directors to purchase securities in an initial public offering in which an affiliated broker-dealer is acting as an underwriter; permit the use of fund assets to pay distribution expenses; allow securities transactions between a fund and another client of the fund's advisor; and permit funds to issue multiple classes of voting stock as well as other items.

The SEC also used its exemption authority as a stick for creating other governance requirements including how board meetings are to be conducted⁵²¹. This pervasive regulation is considered to be justified on the ground that unlike most business organizations, mutual funds are typically organized and operated by an investment advisor that is responsible for the day-to-day operations of the fund⁵²².

Investment advisors generally organize and manage investment companies pursuant to a contractual arrangement with the company. The advisor selects the company's investment portfolio and supervises it in return for a management fee. The investment advisor is typically separate and distinct from the fund that it advises, with a primary responsibility and loyalty to its own shareholders. The external management of mutual funds, however, presents inherent conflicts of interest and potential for abuses since external management must seek to maximize the return for both its firm and its shareholders⁵²³.

As the Supreme Court has noted:

“Congress consciously chose to address the conflict-of-interest problem through the Act's independent-directors section, rather than through more drastic remedies such as complete disaffiliation of the companies from their advisers or compulsory internalization of the management function” Congress' purpose in structuring the Act as it did is clear. It "was designed to place the unaffiliated

⁵²¹ See, e.g., 17 C.F.R. § 270.15a-4(b)(1)(ii) (2006).

⁵²² *Role of Independent Directors of Investment Companies*, 66 Fed. Reg., supra note 519, at 3,736.

⁵²³ *Role of Independent Directors of Investment Companies*, 66 Fed. Reg., supra note 519, at 3,736.

directors in the role of 'independent watchdogs,'" who would "furnish an independent check upon the management" of investment companies⁵²⁴.

This "watchdog" control was chosen in preference to the more direct controls on behaviour exemplified by the options not adopted. When by 1970 it appeared that the "affiliated person" provision of the 1940 Act might not be adequately restraining conflicts of interest, Congress turned not to direct controls, but rather to stiffening the requirement of independence as the way to "remedy the act's deficiencies." Without question, "[the] function of these provisions with respect to unaffiliated directors [was] to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs."⁵²⁵

The role of investment advisors was deemed so sensitive that another statute was layered on top of the regulation of mutual funds-by the Investment Advisers Act of 1940. That act imposes a registration requirement, imposes books and records and disclosure regulations and places limits on the fees that may be charged by the advisor.

4.2 LATE TRADING AND MARKET TIMING

Mutual funds were not really the target of the Investment Company Act of 1940 since they were simply too young to have played any significant role in the abuses that led to that legislation. However, mutual funds became increasingly popular beginning in the 1940s and soon replaced the closed-end fund as the investment vehicle of choice for

⁵²⁴ *Burks v. Lasker*, 441 U.S. 471, 483-84 (1979).

⁵²⁵ *Ibid.*

most individual investors. By 1970, some 360 mutual funds held \$47 billion in assets in the United States⁵²⁶.

In the early 2000's, there were about 8,000 mutual funds holding almost \$7 trillion in assets for ninety-five million investors⁵²⁷. However, the bursting of the market bubble in 2000 resulted in a sharp drop in the NAV of equity based mutual funds and mutual funds trading equities experienced a \$1.4 trillion drop in the value of their assets between 2000 and 2002. This reduction in NAV was due largely a reduction in portfolio values, resulting from the drop in stock prices during the downturn, which caused many investors to pull their assets out of long term mutual funds. The number of redemptions from such mutual funds increased from an annual rate of 21.7% in 1999 to 27.9% in 2002.

Mutual funds began to allow market timing and late trading by hedge funds in order to compete against other investment opportunities. The SEC sought to regulate market timing and late trading in 1968 when it enacted a "forward pricing" rule⁵²⁸. This rule required redemptions and purchases to be priced after receipt of the order from the customer generally using the closing price for the stocks that were set at the end of that trading day⁵²⁹. There were other concerns with using mutual funds for quick in-an-out-trading seeking short-term profits through market timing. The SEC had long sought to

⁵²⁶ Investment Company Institute, 2004 *Mutual Fund Fact Book*, (2004), accessed at: <http://www.ici.org/pdf/2004factbook.pdf>.

⁵²⁷ Ibid.

⁵²⁸ 44 Fed. Reg. 29,644, 29,647 (May 22, 1979) (codified at 17 C.F.R. § 270.22c-l(a).)

⁵²⁹ Ward, D. (2005). Protecting mutual funds from market-timing profiteers: forward pricing international fund shares, 56 *Hastings Law Journal* 585, 589.

prevent mutual fund salesmen from recommending market timing in mutual funds to retail customers because sales loads, and time and place disadvantages, made such trading unsuitable for them. The SEC thus prohibited the practice of "switching" mutual fund investors in and out of different mutual funds in order to generate commissions. Such transactions were usually accompanied by promises of short-term profits from trading opportunities that sought to anticipate favourable market moves and make quick-in-and-out profits⁵³⁰. It was possible for a knowledgeable investor to purchase shares in a rising market at the current price with the advance information that the next day's price would be higher. He could thus be guaranteed an immediate appreciation in the market value of his investment.

Timing transactions in mutual funds by professional traders was not viewed by the SEC to be a matter of concern since the professionals could look after themselves or the investors whose money they were managing⁵³¹. Further, the restriction on buying and selling mutual fund shares at their net asset value was a practical barrier to market timing even by professional traders. Nevertheless, during the 1980s, there were some fifty money managers who specialized in market timing mutual funds for even small investors in amounts as low as \$2,000⁵³². These market timers charged fees of two percent or more on assets under management, which was in addition to any mutual fund sales loads.

⁵³⁰ *United States v. Nat'l Ass'n of Sec. Dealers, Inc.*, 422 U.S. 694, 707 (1975).

⁵³¹ See generally Markham, J. W. (1995) *Protecting the Institutional Investor-Jungle Predator or Shorn Lamb?* 12 *Yale Journal on Regulation*, 345 (describing SEC views toward institutional investors).

⁵³² J. L. Reid, Choosing tactics in the war against risk, 17 *Money* 83, 83.

Money Magazine conducted a study in 1988 of the five-year performance of market timing by mutual fund money managers. It found, for example, that clients of J.D. Reynolds Co. experienced compound returns of more than twenty percent. Most market timing managers were not that successful, but two-thirds of those managers did better than the Lipper mutual fund average. They were particularly successful in preserving investor capital during market downturns. However, these earlier market timers were not over night arbitrageurs like those involved in the Spitzer-generated scandals. For example, J.D. Reynolds Co. engaged in less than four market timing transactions per year⁵³³. This was because the goal of the market timers in the 1980s was to move investment funds between equity and fixed income funds in anticipation of changes between those two markets. For example, if interest rates were expected to increase and equities to decline, the market timer would move money out of stocks and into bonds⁵³⁴. These market timers were not popular with mutual fund sponsors because when market-timing money managers move millions of dollars at a time in or out of funds, as they often do, they force mutual fund managers to buy or sell large blocks of stock at inopportune moments⁵³⁵.

Some no load mutual funds (a mutual fund that does not charge an investment management fee) sought to discourage market timers by limiting the number of switches that an investor could make, so the market timers moved to load funds which charged management fees and were less likely to impose such restrictions because of the incentive

⁵³³ Ibid.

⁵³⁴ Ibid.

⁵³⁵ Ibid.

of those fees. That was only a temporary solution. Market timers became more active during the 1990s⁵³⁶, and created issues for mutual funds that had to deal with their liquidations. Some mutual funds imposed redemption fees on traders engaged in market timing in order to discourage such activity. Those fees had been allowed by the SEC, up to two percent, since 1979⁵³⁷. The number of funds imposing such fees increased substantially in the 1990s when the market run up was encouraging day trading and other speculative trading⁵³⁸. Some mutual funds threatened to suspend the redemption privileges of traders engaged in market timing. "Fair value pricing" was also used to discourage market timers in international funds that presented arbitrage opportunities because foreign markets might still be open when NAV was computed. Fair value pricing sought to set a fair price on foreign holdings at the close of trading in the United States in order to reduce those arbitrage opportunities.

These attempts at curbing market timing were described in mutual fund prospectuses. To an outside viewer of those disclosures, it appeared that the mutual funds were opposed to market timers because they were disruptive and harmful to the funds. As the new century began, however, a new market timer appeared-the hedge fund that found a way to entice mutual funds into welcoming their trading.

⁵³⁶ Tim Quinson, Market-timers fiddle around with fund assets, *News & Record* (Greensboro)

⁵³⁷ See Robert McGough, Junk funds believe it's time to strike back at 'timers', *Wall Street Journal*.

⁵³⁸ See Tim Quinson, Mutual funds install fees to deter those who cash out quickly, *Dallas Morning News*.

4.3 SEC RESPONSE TO MUTUAL FUND SCANDALS

The investigation enforcement action against mutual fund market timing and late trading scandals initiated by New York Attorney General Eliot Spitzer in 2003 led to settlements from industry participants that totalled over \$4.25 billion⁵³⁹. Spitzer's actions however were considered to be controversial and thought to undercut the role of the Securities and Exchange Commission (SEC), since it had been given primary and widespread regulatory authority over mutual funds in the Investment Company Act of 1940⁵⁴⁰.

Earlier Spitzer prosecutions of financial analyst conflicts on Wall Street and by accounting scandals at Enron and elsewhere had embarrassed the SEC⁵⁴¹. In those scandals, the entities had all been under the jurisdiction of the SEC who had done nothing to identify or prevent this. The actions taken by Spitzer in response to the mutual funds made the SEC appear ineffective. In response to the growing perception of its ineffectiveness and related concerns, the SEC imposed additional regulations on mutual funds, including a requirement to increase the number of outside directors on their boards and split the role of chairman and chief executive. Hence, from the outset, the introduction of the requirements for independent directors and chairperson was reactionary in response to perceptions concerning its effectiveness, as opposed to

⁵³⁹ Bullard M. E., (2006). The mutual fund as a firm: frequent trading, fund arbitrage and the SEC's response to the mutual fund scandal, 42 *Houston Law Review*. 1271; Bullard, M.E., (2005). Insider trading in mutual funds, 84 *Oregon Law Review* 821; Hurst, T. R., (2005). The unfinished business of mutual fund reform, 26 *Pace Law Review* 133.

⁵⁴⁰ Pub. L. No. 76-768, 54 Stat. 789 (1940) (codified at 15 U.S.C. §§ 80a-1 to 80a-64 (2000)).

⁵⁴¹ Markham J. W., (2006). Mutual fund scandals – a comparative analysis of the role of corporate governance in the regulation of investments. 3 *Hastings Business Law Journal* 67 2006-2007.

comprehensive studies that indicted that this would be an effective mutual fund governance regime.

The actions taken by the SEC at this time were highly publicized subject to discussion. Critics argued that there was no evidence indicating that this requirement would have prevented the mutual fund scandals or assured better performance. Further, these new corporate governance rules⁵⁴² that were introduced by the SEC were struck down twice by the District of Columbia Court.

The SEC's proposals were in response to regulatory actions by Spitzer and a regulatory scheme for mutual funds under the Investment Company Act of 1940, including requirements for outside directors that already existed. The question, therefore, is whether the requirement for independent directors and chairman actually increases investor protection. There is a perception that these restrictions provided little or no protection to mutual fund shareholders and that the corporate governance model for mutual funds simply has failed. This raises the issue of whether the governance structures recently introduced for mutual funds in Canada by CSA are effective in providing shareholder protection. It further raises the question of whether there are other governance structures for mutual funds which would afford more effective investor protection⁵⁴³.

⁵⁴² Chamber of Commerce of the United States v. SEC, 412 F.3d 133, 142 (D.C. Cir. 2005) and Chamber of Commerce of the United States v. SEC, 443 F.3d 890, 909 (D.C. Cir. 2006).

⁵⁴³ Joint study by the American Enterprise Institute for Public Policy ("AEI") and the Brookings Institute. See Ronald A. Cass & Henry G. Mann, SEC a la Donaldson, Wall Street Journal, July 1, 2005, at A8, accessed at: <http://www.aei-brookings.org/policy/page.php?id=220>.

Widespread publicity was given to the actions of New York Attorney General Eliot Spitzer associated with the financial scandals occurring after the market downturn in 2000. His charges against prominent financial analysts that resulted in a massive \$1.4 billion settlement with the firms where they worked made headlines. Spitzer charged Edward J. Stern and the hedge fund that he managed, Canary Capital Partners, LLC, with improper market timing and late trading in shares of the Strong mutual fund complex.

To settle these charges, Canary Capital Partners was required to pay \$40 million, part of which was to be used for restitution to mutual fund investors and Edward Stern also agreed not to trade in mutual funds or manage any public investment funds for ten years. Bear Stearns also agreed to pay \$250 million to the New York stock Exchange and the SEC to settle late trading charges in its mutual funds. Subsequently, Spitzer brought several other suits against mutual funds for allowing or engaging in market timing and late trading that resulted in large fines and media exposure⁵⁴⁴. After gaining exposure from these charges, Spitzer ran for the governorship in New York.

The charges filed by Spitzer created controversy since it was not clear why a state attorney general was seeking to regulate mutual funds that were under the regulatory control of the SEC. More controversy resulted from Spitzer's actions to regulate mutual funds by requiring them to reduce their fees as part of their market timing and late trading settlements. Previously, those fees had been regulated under the Investment Company Act by NASD under oversight of the SEC as mandated by Congress. The NASD Rules

⁵⁴⁴ See Markham J., (2006). *A Financial History of Modern Corporate Scandals, from Enron to Reform*, 400-434.

of Fair Practice place a ceiling on the 'sales load,' or the sales commission, for transactions in shares of open-end companies that an NASD member may charge to investors. The limits placed on mutual fund sales loads are in sharp contrast to the free competition with regard to brokers' commissions generally. The ceiling on sales loads is in accordance with Investment Company Act section 22(b)'s mandate that the price allowed by NASD rules 'shall not include an excessive sales load but shall allow for reasonable compensation for sales personnel, broker-dealers, and underwriters and for reasonable sales loads to investors.' Under these rules a fund is limited to a maximum sales charge of 7.25 percent, subject to mandatory quantity discounts, unless it offers additional services which in the aggregate carry a maximum additional 1.25 percentage point value.

Spitzer ignored the NASD rules and created his own public utility regulatory program governed solely by his personal views on what constitutes appropriate fees. Spitzer received further criticism for 'criminalizing' what were common business practices, since market timing in mutual funds was occurring prior to and at the time of his actions. The SEC's reputation had been tarnished by the accounting scandals at Enron Corp. and several telecoms, such as WorldCom Inc despite its authority, regulations and reputation as an aggressive regulator. The SEC had failed to prevent or detect those problems. In fact, the SEC had read about market timing and late trading scandals in the press before becoming involved. Spitzer added to the increasing public perception of the SEC's incompetence by charges against the financial analysts that were also regulated by the SEC and by the late trading and market timing scandals. Spitzer even disparaged the

SEC and other federal agencies, stating that they had been so "beaten down" and "neutered" and diminished that they had been "rendered incapable of fulfilling their fundamental mandate" and that they had "been sapped of the desire to regulate"⁵⁴⁵. In an effort to maintain and regain credibility, the SEC filed its own suits for late trading and market timing, often in parallel with Spitzer.

The SEC's charges on market timing, however, were somewhat hesitant. For example, the SEC indicated that market timing was not "illegal per se"⁵⁴⁶ but argued that it could be detrimental to investors. The SEC indicated that the market timing could damage the mutual fund because (a) it can dilute the value of their shares if the market timer is exploiting pricing inefficiencies, (b) it can disrupt the management of the mutual fund's investment portfolio, and (c) it can cause the targeted mutual fund to incur costs borne by other shareholders to accommodate the market timer's frequent buying and selling of shares⁵⁴⁷. With regard to late trading, the SEC was more emphatic about late trading, charging that such "trading violates Rule 22c-1(a) under the Investment Company Act"⁵⁴⁸ and defrauds innocent shareholders in those mutual funds by giving to the late

⁵⁴⁵ Hannah Bergman, Spitzer: is OCC blocking N. Y.'s probe of lenders, *American Banker* (May 19, 2005).

⁵⁴⁶ *Mutual Fund Redemption Fees*, 70 Fed. Reg. 13,328, 13,330 (Mar. 18, 2005) (codified at 17 C.F.R. pl. 270); *Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings*, 68 Fed. Reg. 70,402, 70,404 (Dec. 17) (codified at 17 C.F.R. pts. 239 and 274).

⁵⁴⁷ In re Strong Capital Mgmt., Inc., Securities Exchange Act Release No. 49,741, Investment Company Act Release No. 26,448, 2004 SEC Lexis 1044 (May 20, 2004).

⁵⁴⁸ Rule 22c-1(a) states in part that: "No registered investment company issuing any redeemable security, no person designated in such issuer's prospectus as authorized to consummate transactions in any such security, and no principal underwriter of, or dealer in, any such security shall sell, redeem, or repurchase any such security except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security". 17 C.F.R. § 270.22c-1 (2006).

trader an advantage not available to other shareholders, and harms shareholders when late trading dilutes the value of their shares⁵⁴⁹.

The SEC's actions against market timers and late traders, however, were encountering resistance in the courts. For example, in *SEC v. Pimco Advisors Fund Management, LLC*,⁵⁵⁰ a federal district court dismissed the SEC's fraud claims involving Canary Capital's late trading and market timing. The court stated that the market timing agreement with Canary, standing alone, could not be considered per se a fraudulent device intended to defraud investors. The court recognized that SEC did not allege, nor could it, that market timing practices are per se illegal, since many individual and institutional investors, as part of not uncommon investment strategies, continue to attempt to time markets with varying degrees of success⁵⁵¹.

In another action, a federal district court dismissed SEC charges against two senior executives at Columbia Funds Distributors, Inc. who had allowed market timing in mutual funds that were being sold under prospectuses which stated that such trading was barred by the mutual fund. The court stated that "market timing arrangements are not the kind of sham transactions which have been held to qualify as schemes to defraud⁵⁵². The SEC subsequently revised its action to charge that investors were misled by fund

⁵⁴⁹ In re Theodore Charles Sihpol III, Securities Act Release No. 8624, Securities Exchange Act Release No. 52,591, Investment Company Act of 1940 Release No. 27113, 2005 SEC LEXIS 2633 (Oct. 12, 2005).

⁵⁵⁰ *SEC v. PIMCO Advisors Fund Mgmt. LLC*, 341 F. Supp. 2d 454 (S.D.N.Y. 2004).

⁵⁵¹ *Ibid.*

⁵⁵² *SEC v. Tambone*, 417 F. Supp. 2d 127, 136 (D. Mass. 2006).

prospectuses that claimed the funds were hostile to market timing⁵⁵³. A survey by the Investment Company Institute found that most investors did not read their mutual fund prospectuses and those that did were focused on other issues.

In another case, a federal district court dismissed aiding and abetting charges brought by the SEC over market timing. However, that court and two other district courts allowed fraud claims against defendants who had used subterfuges and deceptive devices to avoid mutual fund restrictions on such activity. The SEC and Spitzer were to obtain settlements totalling over \$4.25 billion in penalties, disgorgement and reduced mutual fund fees by the end of 2005, despite their lack of success in Court⁵⁵⁴. The SEC also began adopting proposed regulations that its staff thought would prevent market timing and late trading, which was less than successful. One failed proposal by the SEC to regulate mutual fund late trading was the adoption of a rule requiring a "hard close" of mutual funds that would prevent the filling of any purchase or redemption requests after 4:00 p.m., with orders received after that time having to be filled at the close of the next day. This proposed approach was considered to be too complex. Another failed proposal required mandatory redemption fees⁵⁵⁵ when the SEC adopted a rule that 'allowed' but did not 'require' a two percent redemption fee⁵⁵⁶. Other rules proposed by the SEC were

⁵⁵³ *SEC Again Charges Former Execs in Columbia Funds Market Timing Case*, 38 FED. SEC. REG. & L. REP. (BNA) 920 (May 29, 2006). *Most Mutual Fund Investors Ignore Prospectuses*, ICI Survey Finds, 38 FED. SEC. REG. & L. REP. (BNA) 927 (May 29, 2006).

⁵⁵⁴ Bloomberg News, Money manager agrees to settle regulators' market-timing case, *N.Y. Times*, July 25, 2006, at C1.

⁵⁵⁵ *Mandatory Redemption Fees for Redeemable Fund Securities*, 69 Fed. Reg. 11,762, 11,763 (Mar. 11, 2004) (codified at 17 C.F.R. pt. 270).

⁵⁵⁶ *Mutual Fund Redemption Fees*, 70 Fed. Reg. 13,328, 13,330 (Mar. 18, 2005) (codified at 17 C.F.R. pt. 270).

adopted⁵⁵⁷ such as requirement for required mutual funds to disclose the effects of market timing⁵⁵⁸.

In 2006, the SEC adopted rule amendments requiring mutual fund boards to consider whether to impose a fee of up to two percent on redemptions within seven days of the purchase⁵⁵⁹. Those amendments required mutual funds to enter into agreements with broker-dealers holding shares on behalf of other investors in omnibus accounts. Those agreements must allow the mutual funds to access information about transactions in those accounts in order to enforce restrictions on late trading and market timings⁵⁶⁰. In 2006, Prudential Financial Inc. agreed to pay \$600 million and admitted to criminal fraud under a deferred prosecution agreement; and agreed to pay \$52 million to settle market timing claims and to cut fees by \$25 million.

Another rule required broker-dealers to give mutual funds access to information on trading in omnibus accounts that hold funds of several customers so that the mutual funds could determine if market timing was occurring in those accounts⁵⁶¹. The rule adopted by the SEC that required the chairman of mutual fund boards to be independent

⁵⁵⁷ SEC v. Gann, No. 3:05-CV-0063-L, 2006 U.S. Dist. LEXIS 9955, at *23 (N.D. Tex. Mar. 13, 2006). See also SEC v. Druffuer, 353 F. Supp. 2d 141, 153 (D. Mass. 2005); SEC v. JB Oxford Holdings, Inc., No. CV-04-07084, 2004 U.S. Dist. LEXIS 29494, *23 (C.D. Cal. Nov. 9, 2004).

⁵⁵⁸ *Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings*, 69 Fed. Reg. 22,300, 22,301 (Apr. 23, 2004) (codified at 17 C.F.R. pt. 239, 274).

⁵⁵⁹ 71 Fed. Reg. 58257 (Oct. 3, 2006).

⁵⁶⁰ *Ibid.*

⁵⁶¹ Markham, J. W. (2006). Mutual fund scandals, 3 *Hastings Business Law Journal* 95 2006-2007 Fall 2006 95.

from the chief executive officer and increased the majority requirement for outside directors to seventy-five percent was highly controversial.

The SEC had long pursued efforts to increase participation by outside directors in public corporations as a check on management excesses, although there was no evidence that such a corporate governance structure was more efficient or provided greater shareholder protection. The requirement for independent directors was common for corporate reformists over the last quarter century, which was magnified following the Enron Corp. scandal. The ensuing corporate reform resulted in the New York Stock Exchange ('NYSE') and Nasdaq requiring that at least a majority of the board of directors of their listed companies be composed of outside directors and that nominating and compensating committees be composed entirely of such directors⁵⁶².

Audit committees at public companies had been required since 1977 to be composed entirely of outside directors; however that requirement did nothing to check the audit-based scandals at Enron and elsewhere that arose after the market downturn in 2000⁵⁶³. There was also no empirical evidence to support requirements for boards with a majority of outside directors. Despite the lack of evidence for the effectiveness of independent boards, this requirement was adopted by the SEC for mutual funds.

⁵⁶² See N.Y. stock exchange NYSE listed company manual § 303(A)(.01), (.04) (2004), accessed at: <http://www.nyse.com/RegulationFrameset.html?nyseref=http%3A%2F%2Fwww.nyse.com/audience/listedcompanies.html&displayPage=about%2Flist%2F1022221393251.html>; NAT'L Assoc. of SEC. Dealers, Nasd Manual, Marketplace Rule 4350 (2006), accessed at: <http://nasd.com/linet.com/nasd/display/display.html?rbid=189&elementId=1159000635>.

⁵⁶³ Cunningham, L. A., (2003). The Sarbanes-Oxley yawn: heavy rhetoric, light reform (and it just might work), 35 *Connecticut Law Review* 915, 947.

The boards of directors at Enron and WorldCom, for instance, as well as other scandals were comprised of large percentages of prominent outside directors who were unable to do anything to prevent the problems at those companies. The requirement for a majority of outside directors that was already in place did nothing to prevent the late trading or market timing scandals. Several other mutual funds scandals emerged in the wake of the late trading and market timing cases involving "shelf space" payments to sales staff to prefer one mutual fund over another in their recommendations to customers; failure to disclose breakpoints (commission discounts based on the size of the investment); and lavish entertainment provided to investment advisors as an incentive to direct mutual fund trades to broker-dealers⁵⁶⁴.

Edward Jones paid \$75 million to settle claims that it was sharing revenues with a group of mutual funds in 2004 and another \$127 million in 2006 over shelf space payments⁵⁶⁵. Morgan Stanley agreed to pay the SEC \$50 million to settle charges in connection with its sale of mutual funds, which included directing customers to mutual funds based on commissions paid for those funds, instead of the appropriateness of the investment for the customer. Certain "preferred" funds paid higher commissions to Morgan Stanley registered representatives as an incentive to push those products. The Morgan Stanley sales force was failing to disclose "at the point of sale" that its Class B

⁵⁶⁴ See for example: In re PA Fund Mgmt. LLP, Securities Exchange Act Release No. 50384, Investment Company Act Release No. 26598, 2004 SEC LEXIS 2085 (Sep. 15, 2004); In re Mass. Fin. Services Co., Investment Advisors Act of 1940 Release No. 2224, Investment Company Act Release No. 26409, 2004 SEC LEXIS 734 (Mar. 31, 2004); In re Rudney Associates, Inc., Investment Advisors Act of 1940 Release No. 2300, 2004 SEC LEXIS 2147 (Sep. 21, 2004).

⁵⁶⁵ Edward Jones agrees to settle 9 lawsuits, *Wall Street Journal*, Sept. 1, 2006, at C2.

mutual shares of certain of its proprietary funds charged higher fees for large transactions⁵⁶⁶. However, the Sixth Circuit Court dismissed class action claims against Morgan Stanley for this conduct, finding no duty to disclose⁵⁶⁷.

Congress required the SEC to provide justification⁵⁶⁸ for their proposed requirement for splitting the role of chairman and chief executive officer at mutual funds. The SEC did not provide this justification and instead it passed the independent chairman and seventy-five percent outside director rule by a 3-2 vote⁵⁶⁹. The SEC mutual fund governance rule was then challenged by the U.S. Chamber of Commerce and was set aside by the District of Columbia Court of Appeals. This court concluded that the SEC had the authority to adopt such a proposal, but held that the SEC had not adequately considered its costs or available alternatives⁵⁷⁰.

In response, the SEC reintroduced the same rule one week after it was stricken down, without waiting for the mandate of the Court of Appeals. The re-passage of the rule was approved once again over the dissenting votes of two Republican commissioners, one of whom apologized to the Court of Appeals for the majority's high-handed approach⁵⁷¹. This action could have been because SEC chairman William

⁵⁶⁶ In re Morgan Stanley DW Inc., Securities Act Release No. 8339, Securities Exchange Act Release No. 48789, 2003 SEC LEXIS 2732 (Nov. 17, 2003).

⁵⁶⁷ *Benzon v. Morgan Stanley Distribs., Inc.*, 420 F.3d 598, 614 (6th Cir. 2005).

⁵⁶⁸ *Consolidated Appropriations Act*, 2005, Pub. L. No. 108-447, 118 Stat. 2,809, 2,910 (2004).

⁵⁶⁹ *Investment Company Governance*, 69 Fed. Reg. at 46,390.

⁵⁷⁰ *Chamber of Commerce vs. US.*, 412 F.3d at 136.

⁵⁷¹ *Investment Company Governance*, 70 Fed. Reg. 39,390, 39,398 (July 7, 2005) (codified at 17 C.F.R. pt. 270).

Donaldson was leaving the SEC and there would no longer be a majority of activist commissioners focusing on the rule. That act set off a storm of controversy and did even further damage to the already tarnished reputation of the SEC⁵⁷².

The new rule was challenged and was set aside once again by the Court of Appeals⁵⁷³. The Court held that the SEC should have sought public comment before adopting the rule so quickly after the Court's prior ruling. The Court did stay its judgment for ninety days in order to allow the SEC to seek public comment, which the agency did.

In 2006, a Harvard Business School study by Tufano et al⁵⁷⁴ revealed that mutual funds were still wrongly pricing their mutual fund assets, which was publicized in media causing more embarrassment to the SEC⁵⁷⁵. The Tufano et al study found that, while most mutual funds calculated NAV by using the closing price on the day of the pricing, they applied that value to the shares held on the previous day. That could result in substantial differences in pricing, depending on market conditions.

4.4 THE SEC'S NEW RULES

The response of the SEC to the mutual fund scandals may have relieved some of the public pressure on the SEC to act since they may be perceived as at least "doing

⁵⁷² Ibid.

⁵⁷³ Chamber of Commerce of the United States v. SEC, 443 F.3d 890, 909 (D.C. Cir. 2006).

⁵⁷⁴ Tufano, P., M. Quinn & R. Taliaferro (2006). Live Prices and stale quantities: T+1 accounting and mutual fund mispricing, at 24 (March 13, 2006), available at <http://papers.ssrn.com/sol3/papers.cfm?abstract-id=881615>.

⁵⁷⁵ Mark Hulbert, Uh-Oh. Something else is stale at mutual funds, *N.Y. Times*, Feb. 12, 2006, at B6.

something”⁵⁷⁶. The SEC’s position was that the current mutual fund industry problem was addressed by the new rules by augmenting the accountability of the investment advisor to the independent directors and independent chair, thus decreasing abusive and illegal practise. It is not clear whether this would include the activities associated with the mutual fund scandals, such as late trading, as this has not been indicated the SEC. Some proponents of the New Rules have indicated that eighty percent of the boards had inside chairs at the time of the scandals, suggesting that this demonstrates the need for change. The use of this statistic is misleading; however, since approximately 80 percent of all fund firms have interested chairpersons suggesting only that funds with inside chairs are involved in the scandals, while in fact they represent the majority of firms. The SEC cited this questionable comparison by not comparing equivalent proportion of firms with inside and independent chairs.

There are potential advantages to independent chairs minimizing potential conflicts of interest associated with the inherent conflicts of interest faced by fund managers of maximizing their financial returns and those of their investors, while maximizing returns to the mutual fund investors. At the same time, an inside chair offers several advantages through their familiarity with the fund and may accordingly be more aware of potential conflicts of interest than an independent chair, for instance an

⁵⁷⁶ Eckerle, S.T., (2007). Three strikes you’re out: the effect and controversies of the SEC’s attempted mandate for greater independence of mutual fund boards, 40 *Indiana Law Review* 149 p. 163.

dissenting commissioners noted that a common feature of the mutual fund scandals is that boards were not told of the formal or informal arrangements permitting market timing⁵⁷⁷.

The New Rules may also not prevent future mutual fund scandals that have involved mutual funds working with entities that are subject to the exemptive New Rules.⁵⁷⁸ For example, many of the mutual fund scandals that created the impetus for the New Rules involved hedge fund advisors that have participated in the late trading and market timing of mutual funds⁵⁷⁹. The hedge fund advisors reportedly agreed with mutual fund managers to overlook prohibitions and restrictions on market timing in order for the investment advisor to receive sticky assets, which occur when hedge fund advisors deposit assets into other funds managed by a mutual fund advisor which resulted in the exploitation of mutual fund shareholders⁵⁸⁰. The SEC has stated that almost forty hedge funds and at least eighty-seven hedge fund advisors have been involved in mutual fund scandals or were under investigation with these scandals⁵⁸¹.

The SEC's New Rules added additional oversight to only those transactions that are covered by the exemptive rules, such as the rule (Rule 17a-7) that allows a mutual fund to conduct securities transactions with other mutual funds that have common officers, directors, or investment advisors with the approval of a majority of independent

⁵⁷⁷ *Infra* note 587, Dissent of Glassman and Atkins.

⁵⁷⁸ *Chamber I*, 412 F.3d 133, 140-41 (D.C. Cir. 2005).

⁵⁷⁹ Registration Under the Advisors Act of Certain Hedge Fund Advisors, 69 Fed. Reg. 72,054, 72,056 (Sec. and Exch. Comm'n, Dec. 10, 2004).

⁵⁸⁰ *Ibid.*, pg 30 at 72, 056 – 057.

⁵⁸¹ Registration Under the Advisors Act of Certain Hedge Fund Advisors, 69 Fed. Reg., *supra* note 579, at 71, 057.

directors⁵⁸². The question arises as to whether the mutual fund scandals are effectively addressed by the additional requirement for majority of independent directors and an independent chairman given that these scandals could occur outside of their mandate. The same question arises with respect to the effectiveness of the IRC in Canada, particularly since it is focussed upon conflicts of interest.

In the mutual fund scandal involving the hedge fund Canary Capital Partners (Canary), and its investment advisor Canary Investment Management, LLC⁵⁸³, Canary was able to participate in late trading and market timing, by working with numerous mutual funds, resulting in mutual fund shareholders losing millions of dollars, with fund managers receiving significant management fees and Canary reaping tens of millions of dollars⁵⁸⁴. In one instance Canary worked with one of the largest mutual fund managers in the U.S. Federated Investors, and after 6 months Canary received \$1.6 billion in market timing transactions⁵⁸⁵. While hedge funds such as Canary would not have been able to conduct these illegal activities with the participation of mutual fund chairman and independent directors, the expected enhanced oversight provided by 'independence' may

⁵⁸² Rule 71a-7, 17C.F.R., 270, 17a-7(2005).

⁵⁸³ *Registration Under the Advisors Act of Certain Hedge Fund Advisors*, Investment Advisors Act of 1940 Release No. 2266, 2004 WL 1636422, pp. 5-6 (proposed July 20, 2004).

⁵⁸⁴ *Ibid.*

⁵⁸⁵ *In re Federated Inv. Mgmt. Co., Federated Sec. Corp. and Federated S'holder Serv. Co.*, Investment Advisors Act of 1940 Release.

not be sufficient to prevent these scandals in the future, without the effective regulation of hedge funds with regard to their trading practice with mutual funds⁵⁸⁶.

The SEC regulations in 2001, less than 2 years before the SEC adopted the New Rules, already required that a board of directors consisted of a majority of independent directors⁵⁸⁷. When adopting this requirement in 2001, the SEC stated that a majority of independent directors is able under state law to permit the independent directors to control the funds corporate machinery, to elect officers of the fund, soliciting proxies, holding meetings and have a more meaningful influence on fund management and represent shareholders from a position of strength⁵⁸⁸.

Further under the 2001 SEC amendments, a majority of independent directors could require an independent chair if they believed that this would protect the best interest of shareholders. The requirement in the New Rules conflicts with the independent directors' authority to elect a chair of their choice by imposing the requirement for an independent chair. In addition, if there were a requirement for a super-majority of independent directors, the independent chair requirement may not be necessary since a super-majority of independent directors could elect an independent chair without the SEC regulations. Further, a super-majority could determine the outcome of a matter put to a board vote and could control all aspects of the board process.

⁵⁸⁶ With hedge fund regulations being outside the scope of this dissertation.

⁵⁸⁷ U.S.C. & 80a-10 (2000) at 35; *Investment Company Governance*, 69 Fed. Reg. 46, 378, 46, 390 (Sec. and Exch. Comm'n (August 2, 2004) (dissent of Glassman and Atkins).

⁵⁸⁸ *Ibid.*, p.391

The SEC believes that even with a super-majority of independent directors the board may not feel sufficiently empowered to override the election of an independent chair if this means overriding the objections of the fund management company⁵⁸⁹. In their opening position the U.S. Chamber of Commerce indicated that the proposal New Rules would provide independent directors with less power than they previously had and would prevent them from making decisions that are in the best interests of investors.

The SEC in its New Rules did not focus upon the fiduciary duty of directors. The SEC did also not undertake sufficient studies to determine the effect of independence upon fund governance⁵⁹⁰. They stated that the data they have relating to the correlation between fund performance and an independent chair is inconclusive⁵⁹¹.

A study was commissioned by Fidelity in response to the expressed interest of the SEC for empirical data on performance for funds with affiliated chairs, and produced in a report commonly referred to as the “Bobroff Mack Report”⁵⁹². This report indicates that, using Morningstar’s fund rankings, funds with affiliated chairs rank on average in the 58th percentile while funds with independent chair rank on average in the 53rd percentile⁵⁹³. The report therefore indicates that there is a negative correlation between independently chaired funds and fund performance. This study further indicated that there

⁵⁸⁹ Supra note 519.

⁵⁹⁰ *Chamber II*, 443 F.3d 890, 905 (D.C. Cir. 2006)

⁵⁹¹ Report in Accordance with the Consolidated Appropriations Act, supra note 568 p. 5

⁵⁹² Bobroff, G. H. & T. H. Mack, (2004). Assessing the significance of mutual fund board independent chairs, a study for Fidelity Investments. (Mar.10, 2004), <http://www.sec.gov/rules/proposed/7034/fidelity031804.htm>

⁵⁹³ Ibid.

is no correlation between the lower expenses and performance⁵⁹⁴. The SEC did not use the Bobroff Mack Report in the development or adopting release of the New Rules⁵⁹⁵. The SEC stated that the Bobroff Mack Report only evaluated the past performance that an independent chair had on past fund performance and not future performance⁵⁹⁶.

A study by Hermalin and Weisbach found that boards with more independent directors are likely to have lower fees⁵⁹⁷. A comparison between the relationship between director independence and fund performance is hampered by the varying assumptions on “how performance is measured, which expenses should be included, what time period should be examined, and which funds should be examined.”⁵⁹⁸ Further, the authors indicate that there is a lack of information concerning the nature of conflict of interest between a mutual fund investment advisor and shareholders. There are also varying assumptions on how performance is measured, which expenses should be included, what time period should be examined”⁵⁹⁹.

The SEC noted that another analyst found that funds with independent chairman performed slightly better than funds with affiliated chairs using the same statistics; with the results attributed to varying analytical methods and sample selections. The SEC did

⁵⁹⁴ Ibid.

⁵⁹⁵ Chamber of Commerce V. Sec. and Exch. Comm’n, 412 F.3d 133 (D.C. Cir. 2005) (NO. 04-1300).

⁵⁹⁶ Ibid.

⁵⁹⁷ Hermalin, B.E & M. S. Weisbach, (2003). Board of directors as an endogenously determined institution: a survey of the economic Literature, Federal Reserve Bank of N.Y., *Economic Policy Review* 8 (April 2003).

⁵⁹⁸ Report in Accordance with the Consolidated Appropriations Act, supra note 568, p.159 – 160.

⁵⁹⁹ Ibid., p. 159 – 160.

indicate that the purpose of the New Rules was not to increase fund performance. The SEC however did not note that the study results failed to show a definitive positive correlation between independence and increased fund performance. They insisted that there should be an increase fund compliance and a decrease in transactions that involve a conflict of interest⁶⁰⁰.

In *Chamber I* the Chamber of Commerce brought the issue of the Report and the need for empirical studies before the DC Circuit⁶⁰¹. The Court indicated that while empirical data was not required for the SEC to justify a rule-making action although this may have allowed it to more readily demonstrate that it satisfied its obligations under the APA⁶⁰².

Ruder opines that a comprehensive and statistically sound empirical study of the correlation between independent chairs and fund performance would most likely have helped the SEC in justifying the New Rules⁶⁰³. The SEC also did not possess empirical data linking chair independence to a favourable compliance record⁶⁰⁴. The SEC indicated that this empirical evidence was impossible to analyze because there was no clear method

⁶⁰⁰ Ibid., p. 182.

⁶⁰¹ *Chamber I*, supra at note 578.

⁶⁰² Ibid.

⁶⁰³ Ibid.

⁶⁰⁴ Ibid.

for measuring the quality of compliance by the funds and their advisors, particularly since enforcement actions represent only one indication of compliance⁶⁰⁵.

The SEC has brought enforcement actions for compliance issues against mutual funds with the corporate structure proposed by the New Rules. Some of these funds had independent chairs and several of them were involved in enforcement actions involving market timing abuses⁶⁰⁶, which included Bank of America, Banc One and Putnam Investment Management⁶⁰⁷. In an action by the SEC against Banc One, the board of Banc One consisted of seventy-five percent independent directors continuously during the period when the abuse was occurring. The action involved Banc One allegedly committing numerous illegal and abusive actions that resulted in illegal conflicts of interest, which involved market timing transactions with hedge fund advisors, failure to charge the hedge fund advisors redemption fees and improper disclosure of confidential information⁶⁰⁸.

In other instances independent directors have also been implicated in enforcement actions by the SEC for failing to meet their legal duties. For instance the SEC implicated independent directors of abusive and illegal activities while serving on the boards of

⁶⁰⁵ Report in Accordance with Consolidated Appropriations Act, *supra* note 568, p. 183.

⁶⁰⁶ Glassman Statement, *supra* note 587.

⁶⁰⁷ Atkins Statement, *supra* note 587.

⁶⁰⁸ *Ibid*.

Monetta Financial Services, Parnassus Investments and Rockies Fund, Inc.⁶⁰⁹ resulting in a violation of the APA.

In their adoption of the New Rules, the SEC did not consider the disclosure alternative that the two dissenting commissioners (Glassman and Atkins) raised⁶¹⁰. This disclosure alternative would require mandatory disclosure of whether the Chair of the board is independent or affiliated with the management company, allowing investors choose a fund based on their perceived importance of an independent chair⁶¹¹.

The SEC is not required to analyze every alternative when proposing a new rule although they are required to analyze alternatives that are not uncommon or frivolous⁶¹². Initially, the SEC claimed that it did not need to analyze the disclosure alternative because Congress rejected a purely disclosure-based approach to the ICA. In *Chamber I*, however, the D.C. Circuit Court rejected this argument since Congress does require extensive consideration of disclosure for many matters concerning investment companies. For example, the ICI requires mutual funds to provide extensive disclosures including filing a registration statement with the SEC, sending semi-annual reports to investors and making all documents publicly available⁶¹³.

⁶⁰⁹ Report in Accordance with the Consolidated Appropriations Act, supra note 568, p. 32, n.44.

⁶¹⁰ *Chamber I* 412 F.3d, p. 144 – 145.

⁶¹¹ Investment Company Governance, 69 Fed. Reg. 46, 378, 46, 393 (Securities and Exchange Commission, Aug. 2 2004).

⁶¹² *Chamber I*, 412 F.3d, p. 144 – 145.

⁶¹³ *Chamber I*, 412 F.3d

The SEC, on remand, reconsidered and rejected the disclosure alternative⁶¹⁴. The SEC indicated that they believed that the disclosure of whether the chair was independent would not adequately protect investors from inherent conflicts of interest that arise from the relationship between the shareholders and investment advisor⁶¹⁵. The rationale provided by the SEC for this perspective was that disclosure alone is not sufficient to prevent investment advisors and the management company from putting their own interests ahead of the shareholders by engaging in self-dealing, or abusive or illegal transactions⁶¹⁶. The SEC's rejection of the disclosure alternative was also based on their perception of investor's lack of knowledge about the complexity of the inherent conflicts of interest in mutual funds⁶¹⁷. The SEC further indicated that disclosure of a management-affiliated chair would not achieve the benefits of the new rules, such as increased oversight by the board of directors⁶¹⁸. The SEC argued in the response to the remand that in order to make the disclosure of an independent or management-affiliated chair meaningful, the investor would have to first need to understand the significance and impact that these two options for a chair can have on board and management oversight and that without this information investors cannot make the proper decisions concerning the disclosed information⁶¹⁹.

⁶¹⁴ Investment Company Governance, 70 Fed. Reg. 39, 390, 39, 396 – 397 (Securities and Exchange Commission, July 7, 2005).

⁶¹⁵ Ibid.

⁶¹⁶ Ibid., p. 39, 397

⁶¹⁷ Ibid.

⁶¹⁸ Ibid.

⁶¹⁹ Investment Company Governance, 70 Fed. Reg. at 39, 397 (response to remand), *supra* note 587.

Commissioners Glassman and Atkins, however, indicated that they believed that the SEC's reconsideration of the disclosure alternative was inadequate⁶²⁰. The statements in their dissent point out a procedural error by the SEC in that the SEC did not initially seek public comment on the disclosure alternative and therefore there was very little public comment to ascertain whether others, including investors, and mutual funds, believed the disclosure option to be a viable alternative⁶²¹.

In *Chamber I*, the Circuit also instructed the SEC to use its expertise and best judgement to examine and evaluate the disclosure alternative⁶²². The SEC, however, did not ask either Commissioner Glassman or Atkins to comment on or analyze the disclosure alternative⁶²³. It should be emphasized that the SEC proposed the alternative yet the members of the SEC that proposed the New Rules did not engage the dissenting members on its merits despite being instructed to evaluate this alternative by the D.C. Circuit.

There are several advantages to this disclosure alternative. Disclosure to shareholders by investment advisors would increase shareholders trust in the management and investment advisor instead of causing the shareholder to be more sceptical and

⁶²⁰ Dissent of Glassman and Atkins, Investment Company Governance, 70 Fed. Reg. at 39, 390 (response to remand), supra note 587.

⁶²¹ Ibid. at 39, 404, dissent of Glassman.

⁶²² *Chamber I*, supra at note 578.

⁶²³ Dissent of Glassman and Atkins (response to remand), supra note 587.

cautious⁶²⁴. Many investors are ignorant about basic investment decisions and educating investors is one of the best ways to foster investor protection⁶²⁵.

4.5 UNITED STATES FUND BOARDS

Independent directors play a vital role in the U.S. under the Investment Company Act of 1940 (the “1940 Act”). This role was summarized by the Supreme Court of the United States as follows: “Congress’ purpose is structuring the 1940 Act as it did is clear. It was designed to place the unaffiliated directors in the role of “independent watchdogs”, who would furnish an independent check upon the management of investment companies. In short, the structure and purpose of the 1940 Act indicate that Congress entrusted to the independent directors of investment companies, exercising the authority granted to them by state law, the primary responsibility for looking after the funds shareholders”⁶²⁶.

Over the last 20 years the SEC has increasingly come to rely upon independent directors of investment companies to monitor fund operations and exercise their judgement in conflict of interest situations. The SEC Division of Investment Management provided a report to the SEC in 1990 with the following recommendations concerning independent directors: 1) The minimum proportion of independent directors on investment company boards should be increased from 40 percent to a majority; 2)

⁶²⁴ Black, B and J. Gross, (2005). The elusive balance between investor protection and wealth creation, 26 *Pace Law Review* 27, 37, (2005).

⁶²⁵ Ibid.

⁶²⁶ Supreme Court of the United States, *Burks V. Lasker* 441 U.S. 471, 484-85 (1979), (citations omitted).

independent director vacancies should be filled by the remaining independent directors; and 3) independent directors should be given the authority to terminate advisory contracts⁶²⁷. In their report “Protecting Investors”, the Division of Investment Management stated “We believe that the investment company governance system works best when the functions required of independent directors are performed by individuals who are truly independent. Measures that enhance the independence of independent directors, if they can be taken without undue expense, are consequently desirable.”⁶²⁸

In the U.S., in order to be independent, a director must not be an “interested person” as defined under Section 2(a) (19) of the 1940 Act to include: (i) certain categories of persons with interests of the investment company, (ii) persons with any beneficial or legal interest in securities issued by the investment advisor or principal underwriter or their control persons, (iii) a registered broker-dealer executing transactions involving the investment company or a related entity, (iv) persons loaning money or other property to the investment company or a related entity, and (v) legal counsel for the advisor or principal underwriter. The term “interested person” includes persons with close familial or substantial financial or certain professional relationships with management. The ICI best practices report⁶²⁹ entitled “Enhancing a Culture of Independence and Effectiveness” recommends that former officers or directors of an

⁶²⁷ *Protecting Investors: A Half Century of Investment Company Regulation*, SEC Staff Report, Fed. Sec. L. (CCH), Report 1504, Extra Edition, May 29, 1992, at xvii, 251-289 (May 1, 1992).

⁶²⁸ *Ibid.*

⁶²⁹ Investment Company Institute, *Enhancing a Culture of Independence and Effectiveness*, June 24, 1999. Accessed at: <http://www.ici.org>

investment company's investment, advisor, principal underwriter or related entities not serve as a fund director. The SEC in the final rule, entitled "Role of Independent Directors of Investment Companies"⁶³⁰, indicate that in most cases, the investment advisor is separate and distinct from the fund it advises, with primary responsibilities and loyalty to its own shareholders, and that the 'external management' of mutual funds "presents inherent conflicts of interest and potential for abuses".

The SEC currently relies upon independent directors to oversee the funds activities and protect the interests of the shareholders. The independent directors are expected to investigate mistakes violations of law, or conflicts of interest occur, independent directors are expected to investigate the matter on behalf of the fund and resolve the problem with the advisor or other responsible service providers.

Perhaps the greatest obstacle to effective governance of mutual funds in the U.S. is the prevailing but misguided attitude in American corporate culture that unaffiliated directors who are strongly supportive of management are thereby being truly supportive of shareholders⁶³¹. This attitude appears too widespread even among mutual fund directors, probably because many of them have served on other corporate boards, or have been senior corporate executives⁶³². This creates a mindset that is difficult to modify when an individual is appointed to serve on a mutual fund board, where the key

⁶³⁰ 17 CFR Parts 239, 240, 270 and 274, effective February 15, 2001.

⁶³¹ Grove, D.L., (2002). *The Critical Role of Independent Directors of Mutual Funds*, Management Practice, New York, New York. 61p.

⁶³² Tate, S., (2002). The role of independent directors of mutual funds; accessed at: <http://cyber.law.harvard.edu/rfilpapers/role.pdf>

difference is that the fund advisor serves a different set of shareholders than does the independent director⁶³³.

Grove notes that the major difference between mutual fund boards and other boards is that in most business corporations, both the members of management and the members of the board of directors each serve the identical set of shareholders so there is not an inherent structural conflict between the interests of each of them. With respect to mutual funds, there can be no presumption that whatever is the advisors' best interest will necessarily be beneficial to the funds shareholders, because the representatives of the investment management company have to be concerned with promoting their own interests to the full extent that the law and competitive conditions permit⁶³⁴. This creates a potential conflict of interest for managers of mutual funds to act in their own interests and those of their shareholder, rather than the mutual fund unitholders⁶³⁵. In the U.S. this has been addressed by giving independent directors of mutual funds the responsibility by law to advance and protect the interests of the mutual fund's unitholders⁶³⁶.

In the United States, public policy with respect to mutual funds is based on an implicit but correct assumption that fund shareholders need some special protection against an inherent temptation of advisors to maximize their own profits, and pay little

⁶³³ Tibbets, S.D., (2004). Scared straight: An argument for a new cause of action to enforce mutual fund director independence transactions, *Tennessee Journal of Business Law*, 5, 377, Spring 2004.

⁶³⁴ Ibid.

⁶³⁵ Ibid.

⁶³⁶ Ibid.

attention to the best interests of the fund shareholders than competition for their savings requires⁶³⁷. That protection is supposed to be provided by directors who are truly independent, capable and diligent in performing their duties⁶³⁸.

The American Bar Association's "Fund Director's Guidebook" recommends that changes in outside affiliations should be reviewed to help ensure that an independent director does not inadvertently become an interested person of the fund or otherwise become disqualified⁶³⁹. The Investment Company Institute (ICI) best practices report recommends that independent directors complete, on an annual basis, a questionnaire on business, financial and family relationships, if any, with the advisor, principal underwriter, or other service providers and their affiliates⁶⁴⁰.

Fund directors are responsible for overseeing generally the fund's investment performance and monitoring investment practices⁶⁴¹. These activities are not part of the proposed role of the IRC and as such without the requirement for a fund board, mutual investors in Canada would not receive the benefit of having mandated fund boards to having an oversight role concerning investment performance and investment practices that investors receive in the U.S. In the U.S., although independent directors of fund boards are required to act as 'watchdogs' for the shareholders, they are not expected to

⁶³⁷ Grove, *supra* at 631, p. 37.

⁶³⁸ *Ibid.*

⁶³⁹ American Bar Association (2003). *Fund Director's Guidebook*. Federal Regulation of Securities Committee, American Bar Association, 2nd ed., United States, 113p.

⁶⁴⁰ ICI, *supra* note 629.

⁶⁴¹ ABA, *Fund Directors Guidebook*, p. 59, *supra* note 639.

discover compliance failures on their own initiatives, and instead may satisfy their responsibility by monitoring the adequacy of management's internal controls and compliance programs⁶⁴². These responsibilities are heightened where conflicts of interest exist, or other problems are identified, and the task of monitoring compliance involving the advisor or other affiliated persons of the fund falls primarily on the independent directors with guidance from their legal counsel⁶⁴³.

In January 2004, the SEC in the U.S. proposed amendments to improve the governance standards of investment companies⁶⁴⁴. According to the SEC, these amendments provide for greater independence of fund boards for funds that rely on exemptive rules that allow funds to engage in transactions that otherwise be prohibited under the Investment Company Act, and present conflicts of interest between the fund and its management company⁶⁴⁵. These amendments were proposed, after a series of enforcement actions involving late trading of mutual fund shares, appropriate market timing activities and misuse of public information concerning fund portfolios⁶⁴⁶. The SEC indicates that "the significant overhaul" of the composition and workings of fund boards is intended to establish, without ambiguity, the dominant role of independent

⁶⁴² ABA, *Fund Directors Guidebook*, supra note 639.

⁶⁴³ Ibid.

⁶⁴⁴ Securities and Exchange Commission 17 CFR 270, Release No. IC-2650; File No. S7-03-04, RIN 3235-AJ05, Investment Company Governance, accessed at: www.sec.gov

⁶⁴⁵ Ibid.

⁶⁴⁶ Ibid.

directors on a fund's board. Independent directors will set the board agenda as well as have the power to control the outcome of board votes⁶⁴⁷.

Fund compliance matters are now required (rule 38a-1), which the SEC believes will allow fund boards to be better able to fulfill their responsibilities. The SEC recently adopted a rule that created the position of fund chief compliance officer, who reports directly to the fund board on compliance matters. This rule is complemented by the SEC's proposed fund governance standards by placing fund boards in a better position to demand that management adhere to the highest of compliance standards⁶⁴⁸. The SEC's proposed rules also reflect broader concerns with the governance of mutual funds. The Investment Company Act and the SEC's rules place a high reliance on fund board with independent directors to manage the conflicts of interest that advisors have with funds that they manage. The SEC have expressed the view that the best way to ensure that funds obtain fair and reasonable fees is through "a marketplace of vigorous, independent and diligent mutual fund boards, coupled with fully informed investors who are armed with complete, easy-to-digest disclosure about the fees paid and the services rendered"⁶⁴⁹.

The U.S. fund governance standards are that at least 75 percent of the directors of the fund must be independent directors or, if the fund board has only three directors, all

⁶⁴⁷ Paul F. Roy Director, Division of Investment Management U.S. Securities & Exchange Commission, Testimony concerning the Securities and Exchange Commission's recent regulatory actions to protect mutual fund investors, March 10, 2004, available at www.sec.gov.on

⁶⁴⁸ William H. Donaldson, U.S. Securities and Exchange Commission, Speech by SEC Chairman: America's need for vigilant mutual fund directors, January 7, 2004, accessed at: www.sec.gov.on.ca

⁶⁴⁹ Ibid.

but one of the directors must be independent directors⁶⁵⁰. The board must perform a self-assessment at least once annually, and the independent directors must be authorized to hire their own staff. Under the amendments, any fund that relies on the exemptive rule must have a board of directors whose independent directors constitute at least 75 percent of the board or, if the fund has only three directors, all but one of the directors must be independent⁶⁵¹.

The SEC is introducing an additional amendment that requires any fund that relies on an exemptive rule to have a chairman of its board who is an independent director. The SEC “believe that a fund board is in a better position to protect the better interests of the fund, and to fulfill the board’s obligations under the Act and the exemptive rules, when its chairman does not have the conflicts of interest inherent in the role of an executive of the fund advisor⁶⁵². This amendment received broad support from investors and investor groups which expressed the view that an independent chairman would provide many benefits, including better protection of fund shareholders. The SEC noted that while not a guarantee that all conflicts of interest will be resolved in the best interests of the shareholders, a board composed of an independent chairman and a super-majority of independent directors is more likely to be an effective check on management, particularly

⁶⁵⁰ Rule 0-1(a) (7).

⁶⁵¹ Ibid.

⁶⁵² Securities and Exchange Commission 17 CFR 270, p. 8, *supra* note 644.

since so much of the board's responsibility involves policing the management company's conflicts of interest⁶⁵³.

The Investment Company Institute (ICI), an industry organization for mutual funds in the U.S. is supportive of the new SEC fund governance rules with the exception of the requirements for an independent chairman and criterion for 75 percent of the directors to be independent⁶⁵⁴. With respect to the requirement for an independent chairman, the ICI believes that the selection of an appropriate person to serve as the chairman of the board is, and should continue to be, left to the judgement of the directors and not mandated by law. The ICI notes that the SEC proposal is inconsistent with the responsibility of the directors to provide oversight on fund operations since they are not permitted to select their own chairman. The ICI argues that the requirement for an independent chairman is not necessary since fund boards are required to have a majority of independent directors and are therefore in a position to select the most appropriate person, independent or not, to serve as chairman. The ICI further argued that a chairman could potentially deprive funds and their boards of the most highly qualified candidate for the position of chairman. In this respect, the SEC rules may detract from mutual fund governance by preventing qualified persons who are not deemed independent from serving as chairman.

⁶⁵³ 15 U.S.C. 80a-15f.

⁶⁵⁴ Investment Company Institute, Letter to Mr. Jonathon Katz, Secretary, Securities and Exchange Commission, Re: Investment Company Governance File No. S7-03-04, March 10, 2004. accessed at: www.ici.org.statements.

With respect to the SEC's requirement that 75 percent of directors be independent, the ICI has indicated that "there is no empirical evidence to suggest that mandating a seventy-five percent supermajority would even marginally enhance the authority or effectiveness of the independent directors"⁶⁵⁵. The ICI urged that the required supermajority of independent directors be two-thirds rather than 75 percent. The U.S. Chamber of Commerce filed a lawsuit in August 2005 that would require the SEC to overturn the rule that 75 percent of a mutual fund's board of directors of the fund's management company be composed of directors that are independent and that the board's chairman must also be independent. The lawsuit filed by the U.S. Chamber of Commerce alleged that the SEC did not provide evidence supporting the need for a new governance rule, and sought an order that requirements for an independent chairman and 75 percent independent director composition is unlawful and that the SEC be prohibited from implementing and enforcing the requirement⁶⁵⁶. The case was considered on April 15, 2005 before the U.S. Court of Appeals for the District of Columbia circuit.

The U.S. Chamber of Commerce sued the SEC for introducing the rule requiring an independent chairman for mutual fund boards. The decision of the U.S. Court of Appeals for the District of Columbia indicated that while the SEC had the authority to adopt the rule requiring an independent chairman, it didn't adequately consider the costs it would impose on mutual funds and failed to fully consider the costs it would impose on

⁶⁵⁵ Investment Company Institute, *U.S. Chamber of Commerce Lawsuit Challenges New Governance Requirements*, February 5, 2005, accessed at: www.ici.org/issues

⁶⁵⁶ U.S. Chamber of Commerce, *U.S. Chamber of Commerce v. SEC Mutual Fund "Governance" Litigation*, accessed at: www.uschamberinfo

mutual funds and failed to fully consider an alternative to requiring an independent chairman⁶⁵⁷. On June 28, 2005, the SEC scheduled a vote for the following day to readopt the rule⁶⁵⁸. Mr. Donaldson chair of the SEC indicated that the reason it was bringing the measure to a vote less than a week after the court ruling and the day before his departure from the SEC as chair, since not doing so would “throw the future of this rule making into uncertain limbo until a new chairman is confirmed.”⁶⁵⁹ On June 29, 2005, the SEC by a contentious 3-2 vote reaffirmed the rules that require mutual funds to have an independent chairman and 75 percent independent directors⁶⁶⁰.

The vote followed a June 29, 2005 public meeting, where the SEC provided estimates of the costs the rules would impose and stated its conclusion that the benefits of the rules outweigh the costs⁶⁶¹. In response to these actions, on July 26, 2005, the U.S. Chamber of Commerce filed a new petition for review in the Court of Appeals⁶⁶². There was also an alternative proposal for disclosure of chair independence, which Mr. Donaldson denied would protect investors from conflicts of interests⁶⁶³. At present, the SEC rule requiring an independent chairman and 75 percent of independent directors on

⁶⁵⁷ Michael Schroeder, Karen Damato and Deborah Soloman. Court orders SEC to review mutual fund governance rule, *The Wall Street Journal*, June 22, 2005.

⁶⁵⁸ Deborah Soloman. Moving the market: Donaldson's finale draws uproar; departing SEC head sets vote for mutual fund rule on the day before his exit, *The Wall Street Journal*, June 28, 2005.

⁶⁵⁹ Stephen Taub. Donaldson: The Last Agenda, CFO.com, Boston: June 30, 2005.

⁶⁶⁰ Baker and Hostetler, LLP. Despite departing SEC Chairman's last minute manoeuvre, future of governance remains unclear, July 2005, available at www.bakerlaw.com

⁶⁶¹ Ibid.

⁶⁶² U.S. Chamber of Commerce, Chamber files motion to stay SEC mutual fund rule, Tuesday July 26, 2005; available at: www.uschamber.com

⁶⁶³ Ronald A. Cass and Henry Manne. SEC a la Donaldson. *Wall Street Journal* (Eastern Edition), July 1, 2005.

fund boards remains uncertain. This decision will have a significant impact on the future structure of fund boards and upon fund governance in the United States.

In 1999, the SEC Chairman Arthur Levitt held a roundtable in Washington D.C. on the role of independent investment company directors, in order to appreciate what their appropriate and specific responsibilities should be⁶⁶⁴. After the roundtable chairman Levitt announced that the SEC would consider certain regulatory proposals to enhance their effectiveness⁶⁶⁵. At the same time that he made this announcement, the ICI (Investment Company Institute) announced the creation of an advisory group on best practices for fund directors, which created comprehensive best practices for fund directors⁶⁶⁶. The SEC rejected the requirement for a super-majority of independent directors, proposed by the ICI, stating “We are rejecting this because it would change the dynamic of board decision-making in favour of the interests of investors.”⁶⁶⁷

In the United States, guidelines adopted by the Council of Institutional Investors (CII) call for at least 2/3 of a company’s directors to be independent and guidelines adopted by the California Public Employees Retirement System (CalPERS) and by the

⁶⁶⁴ SEC, SEC roundtable on the role of independent company directors, Washington D.C, February 23-24, 1999, accessed at: www.sec.gov

⁶⁶⁵ Arthur Levitt, SEC Chairman, Keeping faith with the shareholder interest, strengthening the role of independent directors of mutual funds, Remarks at Mutual Fund Conference, Palm Springs, CA, accessed at: <http://www.sec.gov/news/speeches/spch259.htm>. (March 22, 1999).

⁶⁶⁶ ICI, Report on the advisory group on best practices for fund directors, enhancing a culture of independence and effectiveness, The Investment Company Institute, June 24, 1999, accessed at: www.ici.org

⁶⁶⁷ SEC, *Role of Independent Directors of Investment Companies*, Exchange Act Release No. 33-7754, 70 SEC Docket (CCH) 1867 (Oct. 14, 1999).

National Association of Corporate Directors call for boards to have a “substantial majority” of independent directors. The requirements for a majority of directors rather than complete 100 percent independence as in the United States are similar to the practice in the United Kingdom. In the United Kingdom, the principal recommendations of the Cadbury Committee in the UK are (i) the positions of chairman and CEO should be separated, with the board chairman monitoring the performance of management; (ii) firms should have at least three non-executive directors, at least two of whom should have no financial or other ties with management; and (iii) each board should have an audit committee composed entirely of non-executive directors, with a majority of independent non-executive directors⁶⁶⁸.

The Committee for the Promotion of Non-Executive Directors (PRO NED) was established by the Bank of England and other major financial institutions to encourage companies to hire more independent directors and to serve as a clearing house for director candidates. PRO NED does not recommend complete independence for directors but rather ‘independent non-executive directors’. The CSA indicate that the IRC is to be comprised at 100 percent independent members. This requirement differs from practices for fund boards in the United States and the United Kingdom⁶⁶⁹.

⁶⁶⁸ Committee on the Financial Aspects of Corporate Governance (Cadbury Committee), *Report of the Committee on the Financial Aspects of Corporate Governance*, December 1, 1992, (Cadbury Report.).

⁶⁶⁹ Black, B.S. & J.C. Coffee, Jr., (1994). Hail Britannia?: institutional behaviour under limited regulation, *Michigan Law Review*, 92, 1997.

Gilson and Kraakman advocated the creation of a pool of trained professional directors by institutional investors⁶⁷⁰. Stephen Howard questions why there is no organization for independent directors or a national association for independent directors of investment companies⁶⁷¹. Howard proposes the establishment of a national association for independent directors of investment companies (NAID) in the United States. At present there is an Institute for Corporate Directors⁶⁷² in Canada, but not a corresponding institute for fund directors, and there is no training offered by or sponsored by regulatory authorities.

4.6 DIRECTOR INDEPENDENCE IN MUTUAL FUND BOARDS

An analysis of director and chair independence was conducted to evaluate the effectiveness of this governance regime and whether this would be beneficial for Canada in addition to or instead of the current IRC. As will be discussed, the introduction of the director and chair independence in the United States was initiated to address conflicts of interest associated with mutual fund scandals that received wide media attention and not to address high advisory fees. Given that the advisory fees in the United States are significantly less than those in Canada, it is not expected that the United States governance regime should focus on developing regulations to ensure investor protection from high advisory fees. At the same time, it is not enough for Canada to follow the

⁶⁷⁰ Gilson, R.J. & R. Kraakman, (1991). Reinventing the outside director: an agenda for institutional investors, *Stanford Law Review*, 43, 45.

⁶⁷¹ Howard, S.R., (2001). Mutual fund regulation in the next millenium, Symposium Article: A National Association for Independent Directors of Investment Companies: A Supplement to Current SEC Proposals, 44 *New York Law School Review*, 535.

⁶⁷² Refer to <http://www.icd.ca>

United States' lead in developing a mutual fund governance regime that is focussed upon conflicts of interest as was the case with the introduction of the IRC in Canada.

The principal federal statute governing mutual funds in the United States is the Investment Company Act⁶⁷³. The managers of the securities portfolios of mutual funds and other investment companies are investment advisors under the Investment Advisors Act and subject to that Act⁶⁷⁴. The Securities Act and the Securities Exchange Act apply to mutual funds because the funds issue securities that are offered and sold to investors⁶⁷⁵.

U.S. Congress re-examined the statutory criteria for the status of director in 1970 and concluded that the criteria that were adopted in 1940 were not providing adequate protection to the shareholders of investment companies⁶⁷⁶. A revised framework was put in place in 1970 which is still in place today after having undergone only minor modifications. Today, the board of a registered investment company is required by the Act to have no less than 40 percent of its seats filled by independent directors, as under the original 1940 legislation. In 1970, U.S. Congress introduced the concept of an "interested person" into section 2(a)(19) of the Act, which distinguished interested

⁶⁷³ *Investment Company Act*, 15 U.S.C.A., 80a-1 to -64 (West 1997 & Supp. 2007).

⁶⁷⁴ 15 U.S.C.A. 80-2(a)(11), -3(a) (West 1997 & Supp. 2007).

⁶⁷⁵ 15 U.S.C. 80a-24 (2000); 15 U.S.C. 77a to 77z-3 (2000 & Supp. V 2005); 15 U.S.C. 78a to 78mm (2000 & Supp. V 2005).

⁶⁷⁶ Senate Committee On Banking and Currency, *Investment Company Amendments Act of 1969*, S. Rep. No. 91-184, at 32 (1st Sess. 1969); Committee On Interstate and Foreign Commerce, *Investment Company Amendments Act of 1970*, H. Rep. No. 91-1382, at 13-14 (2nd Sess. 1970).

directors from independent directors and is the foundation of the current structure of investment company boards in the U.S.

In 2001 the SEC focused its attention on corporate governance of boards of directors of mutual funds⁶⁷⁷. The SEC required funds to have more seats on the board filled by independent directors to exceed the minimum percentage of independent directors specified in the Investment Company Act. The Act distinguishes between “interested” and “non-interested” directors, where non-interested directors, who are independent, hold at least 40 percent of the seats on the board of a registered investment company⁶⁷⁸. Mutual funds that have used any of the ten rules established by the Securities and Exchange Commission to gain an exemption from the mandate of the Act have been required to fill a majority of the seats on their boards with independent directors and to assign the responsibility for selecting and nominating the independent directors solely to the independent directors since 2002⁶⁷⁹. Nine out of ten funds in the U.S. were estimated to be covered by this requirement since the rules were widespread⁶⁸⁰. The ten rules that were designated relate to activities that the Commission concluded involve inescapable conflicts of interest between the fund and its management⁶⁸¹.

⁶⁷⁷ *Role of Independent Directors of Investment Companies*, Investment Company Release No. IC-24816, 66 Fed. Reg. 3734 (Jan. 16, 2001).

⁶⁷⁸ U.S.C. 80-10(a) (2000).

⁶⁷⁹ *Role of Independent Directors of Investment Companies*, Investment Company Act Release No. IC-24816, 66 Fed. Reg. 3734, January 16, 2001.

⁶⁸⁰ *Ibid.*

⁶⁸¹ *Ibid.*, p. 3736.

In 2004, the Commission made a further increase to the required percentage of seats on investment company boards for independent directors, under this unproven assumption. This decision for a new policy, narrowly passed by a split vote of the commissioners, required that a fund that relies on any of the ten rules to avoid breaching the Act would be required to place independent directors on three out of every four seats on its boards, and if the fund had a board with just three members, at least two directors would need to be independent⁶⁸². This proposed requirement would thereby raise the percentage of independent directors from 50% to 75% for the fund having four or more directors. Further, the chairman of this board would also need to be an independent director. This policy could not be implemented without the Commission receiving and assessing additional evidence on the cost and requirements to investment companies, pursuant to a court decision⁶⁸³. The Commission requested comments and evidence relevant to the proposed requirements with a submission date of August 2006⁶⁸⁴.

A comparable board majority requirement was the subject of an SEC Investment Management Division proposal put forward in 1992, years prior to the 2001 rule requiring independent directors⁶⁸⁵. It was well known to the SEC that the majority of mutual fund boards had independent directors in practice in 1992, for example, the SEC's staff proposed that the Commission require by regulation that a majority of fund directors

⁶⁸² Release No. IC-26520, at 46.

⁶⁸³ *Chamber of Commerce v. Sec. & Exch. Comm'n* 443 F.3d 890 (D.C. Cir. 2006).

⁶⁸⁴ *Investment Company Governance*, Investment Company Act Release no. IC-27395, 71 Fed. Reg. 35, 366 (June 19, 2006).

⁶⁸⁵ Protecting Investors Report, at 266-67.

be independent, and noted that this change would be minor because "many, if not most major investment company complexes already have boards with independent majorities"⁶⁸⁶. In the mid 1990s, legislation was pending in U.S. Congress that would require that a majority of fund directors be independent. An industry participant, supporting the legislation, noted that Investment Company Institute data indicate that "nearly all funds have a populate funds' nominating committee"⁶⁸⁷. All of the many funds with Rule 12b-1 plans already are required to have self-nominating independent directors⁶⁸⁸.

The independent legal counsel requirement requires that independent directors assure themselves that a lawyer they hire has no ties to fund service providers that would be likely "to adversely affect the [lawyer's] professional judgment, in providing legal representation."⁶⁸⁹ This requirement does not represent a significant change since any lawyer whose exercise of professional judgment on behalf of fund directors would likely be adversely affected by ties to another client would have a disabling conflict of interest under well-understood legal ethics rules.

The fund industry itself has proposed a set of "best practices" for fund directors that go well beyond the SEC's new requirements, underscoring the lack of effective

⁶⁸⁶ SEC Division of Investment Management, *Protecting investors: a half century of Investment Company Act regulation*, (1992).

⁶⁸⁷ American Bar Association, *Fund Directors' Guidebook*, 229,247-48 (1996).

⁶⁸⁸ *Ibid.*, p. 254.

⁶⁸⁹ *Role of Independent Directors of Investment Companies*, Investment Company Act Release No. 24816 (Jan. 2, 2001), 2001 WL 6738 (SEC), *supra* note 679.

regulation that has been introduced by the SEC⁶⁹⁰. For example, the ICI group recommended that at least two-thirds of the directors of all investment companies be independent directors (the SEC required merely a majority). The ICI Advisory Group also recommended that:

- "Former officers or directors of a fund's investment advisor, principal underwriter or certain of their affiliates not serve as independent directors of the fund"⁶⁹¹.
- "Independent directors be selected and nominated by the incumbent independent directors"⁶⁹².
- "Independent directors establish the appropriate compensation for serving on fund boards"⁶⁹³.
- "Fund directors invest in funds on whose boards they serve"⁶⁹⁴.
- "Independent directors have qualified investment company counsel who is independent from the investment advisor and the fund's other service providers; and that independent directors have express authority to consult with the fund's independent auditors or other experts, as appropriate, when faced with issues that they believe require special expertise"⁶⁹⁵.

⁶⁹⁰ ICI advisory group report, *supra* note p. 215.

⁶⁹¹ *Ibid.*, p. 23.

⁶⁹² *Ibid.*, p. 25.

⁶⁹³ *Ibid.*, p. 27.

⁶⁹⁴ *Ibid.*, p. 28.

⁶⁹⁵ *Ibid.*, p. 29.

- "Independent directors complete on an annual basis a questionnaire on business, financial and family relationships, if any, with the advisor, principal underwriter, other service providers and their affiliates"⁶⁹⁶.
- "Independent directors meet separately from management in connection with their consideration of the fund's advisory and underwriting contracts and otherwise as they deem appropriate"⁶⁹⁷.
- "Independent directors designate one or more 'lead' independent directors"⁶⁹⁸.
- "Fund boards obtain directors' and officers' errors and omissions insurance coverage and/or indemnification from the fund that is adequate to ensure the independence and effectiveness of independent directors"⁶⁹⁹.
- "Investment company boards of directors generally are organized either as a unitary board for all the funds in a complex, or as cluster boards for groups of funds within a complex, rather than as separate boards for each individual fund"⁷⁰⁰.
- "Fund boards adopt policies on retirement of directors"⁷⁰¹.
- "Fund directors evaluate periodically the board's effectiveness"⁷⁰². "New fund directors receive appropriate orientation and fund directors keep abreast of industry

⁶⁹⁶ Ibid., p. 32.

⁶⁹⁷ Ibid., p. 35.

⁶⁹⁸ Ibid., p. 36.

⁶⁹⁹ Ibid., p. 36.

⁷⁰⁰ Ibid., p. 38.

⁷⁰¹ Ibid., p. 40.

⁷⁰² Ibid.

and regulatory developments"⁷⁰³.

- Investment company boards establish Audit Committees composed entirely of independent directors; that the committee meet with the fund's independent auditors at least once a year outside the presence of management representatives; that the committee secure from the auditor an annual representation of its independence from management; and that the committee have a written charter spelling out its duties and powers⁷⁰⁴.

Many, if not most funds already had a majority of directors who were supposed to be independent of the external advisor to keep fees and expenses in line prior to the introduction of the new SEAC legislation concerning director independence. For example, as early as 1999, an ICI advisory group report stated that "The vast majority of fund boards today consist of a majority of independent directors"⁷⁰⁵. In many cases, funds' independent directors already majority of independent directors," with the result that "the proposed statutory revisions would be largely superfluous."⁷⁰⁶ A study analyzing the makeup of fund boards for the industry's 50 largest fund sponsors found in 1992 that 71% of the seats on the sampled fund boards were held by independent directors, with the average independent director sitting on sixteen board seats within

⁷⁰³ Ibid., pp. ii-iv.

⁷⁰⁴ Ibid., p. 33.

⁷⁰⁵ Investment Company Institute, *Report of the Advisory Group on Best Practices for Fund Directors*, (June 1999).

⁷⁰⁶ Investment Company Act Amendments of 1995: Hearing on H.R. 1495 Before the Subcommittee on Telecommunication and Finance of the House Committee On Commerce, 104th Cong. 75,78 (1995) (statement of Paul G. Haaga, Jr., Senior Vice President and Director, Capital Research and Management Company).

the sponsor's complex⁷⁰⁷. The study found that "funds whose boards have a larger fraction of independent directors tend to charge investors lower fees"⁷⁰⁸. It also found "some evidence that funds whose independent directors are paid relatively larger directors' fees approve higher shareholder fees than those directors who are paid less"⁷⁰⁹.

The Director of the SEC's Division of Investment Management, testifying before Congress in 1995, noted that the requirement that fund independent directors be nominated and selected by the other independent directors "is a type of arrangement that is used in many fund complexes today."⁷¹⁰ The mutual fund industry's "best practices" proposals have been attacked as simply calling for conduct that, for the most part, already is the industry norm⁷¹¹. The SEC's rulemaking failed to demand that funds separately and specifically identify what the advisor charges for the most crucial of all fund services: investment advice. The SEC had shown any interest publicly in calling specifically for fund independent directors to inquire whether fund managers sell advisory services to others and, if so, on what terms.

⁷⁰⁷ Tufano and Sevic, *supra* note 143, pp. 331-34.

⁷⁰⁸ *Ibid.*, p. 348.

⁷⁰⁹ *Ibid.*, p. 353.

⁷¹⁰ Investment Company Act Amendments of 1995: Hearing on H.R. 1495 Before the Subcommittee on Telecommunication and Finance, 104th Cong 30 (1995) (Statement of Barry P. Barbash, Director, SEC Division of Investment Management).

⁷¹¹ See Barker, *supra* note 122, reporting on a study of the top 10 complexes, accounting for 46% of the industry's assets.

The Investment Company Act specifies the nature of an investment company, which it defines as an entity that (i) issues securities to its investors and that (ii) employs, or proposes to employ, the assets received from investors to engage in the business of seeking profit from securities issues by other entities⁷¹². Accordingly, an investment company issues securities of its own and holds a portfolio of securities of other issuers, and if securities are absent at either point, an investment company does not exist under the Investment Company Act⁷¹³. The Investment Company Act is silent on the nature of a 'mutual fund'. A mutual fund in the securities industry in the U.S. is generally regarded as an investment company (i) that publicly sells the securities that it issues (ii) that when requested by investors holding its securities, redeems these securities, and (iii) that manages the securities in its portfolio⁷¹⁴. Therefore, a mutual fund in the U.S. is an investment company. Further, mutual funds and investment companies are almost coextensive since the net assets of mutual funds constitute about 93% of the net assets of investment companies.

The Investment Company Act considers a 'director' to be "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated, including any natural person who is a member

⁷¹² 15 U.S.C. 80a-3(a) 2000.

⁷¹³ see also Bradford, C.S. 1999. Expanding the Investment Company Act: The SEC's manipulation of the definition of Security, 60 *Ohio State Law Journal* 1995).

⁷¹⁴ 15 U.S.C. 80a-4(3), -5(a) (2000).

of a board of trustees of a management company created as a common law trust”⁷¹⁵. The Investment Company Act classifies directors as either interested or as non-interested.

Actions that have been taken by the SEC and Congress to regulate the composition of fund boards are explored by Barnett⁷¹⁶. In particular, he evaluates measures that have been implemented and a measure that has been proposed by the SEC to further increase the percentage of directors who are independent and reduce the percentage of directors who are interested. He examines the basic assumption inherent in the SEC and the Investment Company Act as to whether independent directors are beneficial to fund investors. According to Barnett, effective regulation of investment advisors is important in order to create public investor confidence⁷¹⁷. He suggests that current measures to regulate investment company boards have largely a sociological basis and in particular that they benefit society by their social productivity⁷¹⁸.

Conventional wisdom, according to Barnett⁷¹⁹, dictates that independent (non interested) directors are essential to protecting investment company shareholders from financial exploitation and staff at the SEC have described independent directors as fulfilling a critical role in preventing actions that take advantage of investment company

⁷¹⁵ 15 U.S.C.80a-4(3), -5(a) (2000).

⁷¹⁶ Barnett, L.D., (2007). The regulation of mutual fund boards of directors: financial protection or social productivity?, 16 *Journal of Law & Policy* 489, 2007-2008, 16, pp. 542-549.

⁷¹⁷ Barnett, L.D., (2007). Law as symbol: appearances in the regulation of investment advisors and attorneys, 55 *Cleveland State Law Review*.

⁷¹⁸ Barnett, L.D., (2006). Social productivity, law and the regulation of conflicts of interest in the investment industry, 3 *Cardozo Public Law Policy & Ethics Journal* 793.

⁷¹⁹ Barnett, *supra* note 716.

shareholders⁷²⁰. One court has characterized independent directors as performing a ‘vital function’ in safeguarding shareholders⁷²¹. The rationale for this position is that interested directors of an investment company will not be consistently fair to the shareholders of the company. Misgivings about interested directors seem to be a result, of the apparent belief of U.S. Congress and the SEC that because the interested directors are involved in certain types of situations that are personally important to them and/or to other persons have ties to them, the interested directors possess an incentive to sacrifice the goals of the shareholders when dealing with matters which implicate these situations⁷²². This reflects the view of the Court in *Burks v. Lasker* where the Court writes that the welfare of shareholders was “entrusted” by Congress to the non interested directors⁷²³ which implies that Congress did not trust the interested directors to prevent the exploitation of shareholders.

The Investment Company Act is very specific as to when a director is considered as independent, and the criteria have changed since the Act was enacted in 1940. The Act originally prohibited an entity that was required to register with the Commission as an independent investment company⁷²⁴ from filling more than 60% of the seats on its board of directors with persons who were an investment advisor to the fund, affiliated with an

⁷²⁰ *Interpretive Matters Concerning Independent Directors of Investment Companies*, Investment Company Release No. IC-24083, 64 Fed. Reg. 59, 877, (Nov. 3 1999).

⁷²¹ *Papilsky v. Berndt*, No. 71 Civ. 2534, 1976 U.S. Dist. LEXIS 14442, at p. 43 (S.D.N.Y. June 24, 1976

⁷²² *Barnett*, supra note 718, p. 495.

⁷²³ *Burks v. Lasker*, 441 U.S. 471, 485 (1979).

⁷²⁴ *Investment Company Act of 1940*, ch. 686 3, 6, 7 54 Stat. 789, 797, 802 (1940); 15 U.S.C. 80a-3 (2000 & Supp. V. 2005); and 15 U.S.C. 80a-6, -7 (2000).

investment advisor to the fund, or an officer or employee in the investment company⁷²⁵. Any director that was not in the preceding categories was considered to be independent⁷²⁶. The Act makes the concept of the affiliation a key factor in the status of the director, and considers affiliation to exist between two person when (i) at least 5% of the voting securities of one person are directly or indirectly owned by or can be voted by the other person, (ii) one of the persons directly or indirectly controls or is controlled by the other or is, along with the other person, controlled by a third person, or (iii) one person is currently an “officer, director, partner, copartner, or employee” of the other person or, if the other person is an investment company, is currently its investment adviser”⁷²⁷. There was later legislation put in place that changed the role of affiliation in determining whether a director is independent.

4.6.1 Criteria for Non Interested Directors in the United States

One of the two central premises for protection of shareholders in Canadian mutual fund regulation is the regulation of conflicts of interest by an independent IRC. In contrast, the United States employs an approach which involves protection of shareholders through ‘non-interested’ directors.

⁷²⁵ *Investment Company Act of 1940*, CH 686, 10(a), 54 Stat. 789, 806 (1940).

⁷²⁶ Senate Communication on Banking and Currency, *Investment Company Act of 1940 and Investment Advisors Act of 1940*, S. Rep. No. Rep. No. 76-1775 at 14 (3d sess. 1940).

⁷²⁷ *Investment Company Act of 1940*, ch. 686 2(a)(3), 54 Stat. 789, 791 (1940) (codified at 15 U.S.C. 80a-2(a)(3) (2000)).

According to *Burks v. Lasker*⁷²⁸ “Congress entrusted to the independent directors of investment companies...the primary responsibility for looking after the interest of the fund’s shareholders”. In the United States, a director of an investment company, including an mutual fund, is barred from having had a ‘material business relationship’ or a ‘material professional relationship’ with specified parties during the last two fiscal years of the company under Section 2(a)(19) of the Act.

Accordingly to Section 2(a) (19) of the Act, a maximum of 60 percent of directors of a registered investment company can be “interested” in the company⁷²⁹. A person is not considered to be independent with respect to the Act if they have direct or indirect ties to an investment advisor⁷³⁰ or principal underwriter for the company⁷³¹. The criteria for being ‘interested’ were those that were believed to provide the opportunity to create a potential motivation for the person to act against the interests of the investment company and its shareholders in favour of i) the person themselves and ii) another individual or entity that have ties to this person. The ties that are included in Section 2(a)(19) are those that would be likely to create a significant temptation for the director to disadvantage the investment company and shareholders in favour of i) the person or ii) an individual or entity having ties to the person, given the congressional goal of preventing harm to the shareholders of investment companies.

⁷²⁸ 441 U.S. 471, 485 (1979).

⁷²⁹ 15 U.S.C. & 80a-10(a) (2000) Section 10(d) does allow more than 60 percent of a qualifying investment company to be interested.

⁷³⁰ Defined in section 2(a)(20) of the Act.

⁷³¹ Defined in section 2(a)(29) of the Act.

The main concern of the Act is with conflicts of interest⁷³². In mandating directors of registered investment companies to be non-interested persons, Congress was attempting to protect society as a whole, and the responsibility of independent directors to deal with conflicts of interest became a central tenet of the Act to protect shareholders from the damaging effects of these conflicts⁷³³. Congress intended independent directors to, as stated by the U.S. Supreme Court to fulfill “the role of ‘independent watchdogs’, who would ‘furnish and independent check upon management’ of investment companies”⁷³⁴.

Section 2(a)(19) of the Act also specifies the circumstances when a person is ‘interested’. Subsection B of the Act specifies the types of situations that make a person interested in an investment advisor or principal underwriter for the investment company. Any person that is interested in an investment company pursuant to this subsection will be considered to be ‘interested’ in the investment company⁷³⁵. The specific circumstances in which a person is interested in an investment advisor or principal underwriter are indicated below:

⁷³² *Role of Independent Directors of Investment Companies*, Investment Company Act Release No. IC-24082, 64 Fed. Reg. 59, 826, 59, 827 (Nov.3, 1999).

⁷³³ *Personal Investment Activities of Investment Company Personnel and Codes of Ethics of Investment Companies and their Investment Advisors and Principal Underwriters*, Investment Company.

⁷³⁴ *Burks v. Lasker*, 441 U.S. 471, 484 (1979).

⁷³⁵ 15 U.S.C. & 80a-2(a)(19)(A)(iii)(2000).

- when a person is affiliated with the investment advisor or principal underwriter⁷³⁶ or has certain types of kinship ties to a person to someone that is affiliated⁷³⁷.
- when a person is aware of having a direct or indirect beneficial interest in a security that has been issued by the investment advisor, by the principal underwriter, or by a party controlling either of them⁷³⁸.
- is a partner or employee of a person that has served as legal counsel for the investment advisor or principal underwriter at any time since the beginning of the last two completed fiscal years of the investment company⁷³⁹.
- when a person is, or is affiliated with, a person that during the previous six months, executed securities transactions or distributed securities for, had principal transactions with, or extended a loan to, inter alia, an investment company served by the investment advisor or principal underwriter⁷⁴⁰.
- when Commission has issued an order to designating the individual as interested because at any time since the start of the last two completed fiscal years of the investment company, the individual has “a material business or professional

⁷³⁶ 15 U.S.C. & 80a-2(a)(19)(B)(i)(2000).

⁷³⁷ 15 U.S.C. & 80a-2(a)(19)(B)(ii)(2000). Includes individuals that are related as spouses, as parent and child, as siblings, as child and spouse of a parent and of the child, or as parent and spouse of the child of the parent.

⁷³⁸ 15 U.S.C. & 80a-2(a)(19)(B)(iii)(2000).

⁷³⁹ 15 U.S.C. & 80a-2(a)(19)(B)(iv)(2000).

⁷⁴⁰ 15 U.S.C. & 80a-2(a)(19)(B)(v),(2000); 15 U.S.C. & 80a-2(a)(19)(B)(vi) (Supplement V 2005).

relationship” with the investment advisor or principal underwriter or with the principal executive officer.⁷⁴¹

Subsection A specifies the circumstances when an interest is considered to exist within the investment company itself⁷⁴². The clauses in Subsection A parallel those in Subsection B with one exception. In Subsection A person’s interest in an investment company does not arise through a beneficial interest in a security issued by the company unless 5% of the voting securities of the company are owned or controlled, or can be voted, by the person whose status is in question. Such a person in the United States would be affiliated with the investment company⁷⁴³, and a person affiliated with an investment company through holdings or control of voting securities would also be considered to be ‘interested’ in the company⁷⁴⁴. However, a person knowingly holding a beneficial interest in a security that is issued by the investment advisor or principal underwriter for an investment company, or by a person controlling the investment advisor or principal underwriter, is considered to be interested in the investment company, and any quantity of such a security is sufficient to make the holder interested in the company⁷⁴⁵.

In summary, the Investment Company Act requires an investment company that must be registered with the Securities and Exchange Commission to fill at least (i.e. a

⁷⁴¹ 15 U.S.C. & 80a-2(a)(19)(B)(vii) (Supplement V 2005).

⁷⁴² 15 U.S.C. & 80a-2(a) (19) (2000 & Supp. V 2005).

⁷⁴³ 15 U.S.C. & 80 80a-2a(3)(A)(2000).

⁷⁴⁴ 15 U.S.C. & 80a-2(a)(19)(A)(i)(2000).

⁷⁴⁵ 15 U.S.C. & 80-2(a)(19)(A)(iii), 80a-2(a)(19)(B)(iii) (2000).

minimum) 40% of the seats on its board with directors who do not possess any of the ties listed in this Act that would cause them to be 'interested', and hence be deemed to be independent. The criteria for independence of non-interested directors is very similar to that for the IRC in Canada, as discussed in the chapter on Canadian fund governance, since Canada was able to review and incorporate this into its national instrument, as the United States criteria was published first.

4.6.2 Board Independence and Performance

A United States style of fund board could be a potential governance agency for fund governance in Canada as set out in the Concept Proposal and recommended by Stromberg and Erlichman. The following provides an assessment of the board independence and performance to determine whether there is a preferred structure for a fund board composition.

Corporate boards have undergone gradual but dramatic change over the last thirty years, with respect to the proportion of outside, inside and independent directors. During the 1960s, most boards had a majority of inside directors. In the 1980s there was an increasing proportion of majority independent boards reflecting the belief that and the appointment of independent directors would reduce management's influence in the boardroom⁷⁴⁶. During the 1990s there was an increasing focus on whether more inside directors or independent directors on boards led to increased performance for

⁷⁴⁶ Brudney, V., (1982). The independent director: heavenly city or Potemkin Village?, 95 *Harvard Law Review*, 597, 597-607.

shareholders. The conflicting views on the relationship between board independence and performance were expressed by one researcher during the late 1990s as follows:

“Conventional wisdom holds that control by independent directors leads to higher returns for companies because such directors are less likely than inside directors to take self-interested actions. Academics have devoted much time to the study of whether this conventional wisdom is true. But only one thing is clear. The answer is unclear.”⁷⁴⁷

Today, almost all boards have a majority (usually a large majority) of outside directors, modern boards almost always have a majority of independent directors, and an increasing number have only one or two inside directors⁷⁴⁸. This pattern reflects the conventional wisdom that the board’s principal task is to monitor management and only independent directors can be effective monitors, while in contrast, an insider board is seen as a device for management entrenchment⁷⁴⁹.

One of the most cited academic research papers on this is a study by Milstein and MacAvoy which focused on the relationship between board structure and corporate performance in large, widely held corporations⁷⁵⁰. The authors found that well-governed

⁷⁴⁷ Chandler, W. B., III., (1999). On the Instructiveness of insiders, independents, and institutional investors, *University of Cincinnati Law Review*, 67, 1083.

⁷⁴⁸ Hamilton, R.W. (2000). Corporate governance in America 1950 – 2000: major changes but uncertain benefits, *Iowa Journal of Corporate Law*, 25, 349, Winter, 2000.

⁷⁴⁹ Ibid.

⁷⁵⁰ Milstein, I. & P. MacAvoy, (1998). Active boards of directors and performance of the large publicly traded corporations, *Columbia Law Journal*, June 1998, 1283-1322.

companies out-performed the non well-governed companies by about 7 percent over a period of five years when performance was measured in terms of changes in share prices.

Other studies suggest that companies with majority independent boards do not perform better than companies with majority insider boards. The results of a study of the effectiveness of inside versus independent directors indicate that two of the seven boards studied show a positive correlation between outside directors and firm performance, one shows a negative correlation, three show no correlation, and one appears to produce two opposite results depending upon the criteria used to measure them.⁷⁵¹ Some of the boards in this study however do show a statistically significant relationship between the percentage of outside directors on a board and shareholder wealth with respect to overall performance⁷⁵².

Another view has been expressed that "there is no statistical evidence of a relationship between corporate performance and proportion of outside directors on the board."⁷⁵³ It has been suggested that one reason why increasing board independence may not lead to improved performance is that having a reasonable number, if not a majority, of inside directors could add value, and that an optimal board contains a mix of inside, independent, and perhaps also affiliated directors who bring different skills and

⁷⁵¹ Lin, L., (1992). The effectiveness of outside directors as a corporate governance mechanism: theories and evidence, *Northwestern University Law Review*, 90, 898, 968.

⁷⁵² Ibid.

⁷⁵³ Amoako-Adu & B.F. Smith (1995). In R.J. Daniels and R. Morck, eds., *Corporate Decision-Making in Canada*, University of Calgary Press, 1995, Calgary, p. 413.

knowledge to the board⁷⁵⁴. These and other studies have been used to put forward the view that further reforms on board independence are unwarranted from the perspective of increasing returns to shareholders.

Klein indicates that no study paper to date has been able to find an association between board composition and firm performance on a day-to-day basis⁷⁵⁵. However Klein found relationships between the percentage of inside directors on finance and investment committees and accounting and stock market performance measures, with firms significantly increasing inside director representatives on the finance and investment committees experiencing significantly higher stock returns and return on investments than firms decreasing the percentage of inside directors of these committees. These findings suggest that inside directors provide valuable information to boards about the firm's long term financial decisions⁷⁵⁶.

Bhagat and Black conducted a study of 205 firms to determine whether independent directors or inside directors are "better" in the sense of attaining maximum firm performance and growth⁷⁵⁷. They found a consistent negative correlation between the number of outside directors on the board and the financial performance of the firm. They further found that the proportion of independent directors on a company's board, or

⁷⁵⁴ Baysinger, B. & H. Butler, (1985). Corporate governance and the board of directors: performance effects of changes in board composition. 1 *Journal of Law, Economics & Organization* 101.

⁷⁵⁵ Klein, A., (1998). Firm performance and board committee structure, *Journal of Law and Economics*, 41, 275.

⁷⁵⁶ Ibid.

⁷⁵⁷ Bhagat, S. & B. Black, (1999). The uncertain relationship between board composition and firm performance, *Business Law*, 54, 921.

whether the company has a majority-independent board, has no statistically significant effect on performance⁷⁵⁸. Bhagat and Black state that “in large public companies, there is no convincing evidence that greater board independence correlates with greater firm profitability or faster growth. In particular, there is no empirical support for current proposals that firms should have a “supermajority independent boards”⁷⁵⁹. The authors indicate that their primary finding is that companies with larger numbers of inside board members performed better than those with more independent directors. Bhagat and Black further suggest that conventional wisdom may be wrong and that inside directors are valuable to firm performance since inside directors have more specific knowledge of running the corporation⁷⁶⁰. Black further indicates that evidence that governance practices matter is scarce, and that when affects are found, they are economically small—often only a percent or two⁷⁶¹. Sonnenfeld also did not recognize a significant relationship between board independence and performance stating “in research that I have been doing with Sanjay Bhagat at Colorado and Dick Wittink of Yale on 1500 public companies we are finding no support for a relationship between structural dimensions of board governance and company performance⁷⁶².” An additional study by Bhagat and Black

⁷⁵⁸ Ibid.

⁷⁵⁹ Ibid.

⁷⁶⁰ Ibid.

⁷⁶¹ Black, B. (2001). Does corporate governance matter? a crude test using Russian data, *University of Pennsylvania Law Review*, 149, 2131, June 2001.

⁷⁶² Sonnenfeld, J.A., (2004). Good governance and the misleading myths of bad metrics, *Academy of Management Executive* 18:1, 108-113.

further indicates that there appears to be a non-correlation between board independence and financial performance⁷⁶³.

Black indicates independent directors are preconditions for strong securities markets which can facilitate economic growth⁷⁶⁴. Black notes that while there is no conclusive relationship between board performance and board independence, there is support for board independence being effective for oversight and monitoring conflicts of interest⁷⁶⁵. In summary, the research to date clearly indicates that there is no significant correlation between board independence and firm performance. In addition, there is an indication that the presence of insiders on some areas of boards may lead to increased performance.

Further, there is some support that independence is effective for oversight and monitoring of conflicts of interest. However, boards with independent members may not consistently be effective with oversight and monitoring of conflicts of interest. Monks and Minnow for example state:

“Independent directors were meant to be a means to an end. It was thought that informed, intelligent and wise directors, of proven integrity, bound by a fiduciary standard, would effectively oversee management. Being

⁷⁶³ For example, S. Bhagat, & B. Black, (2002). The non-correlation between board independence and long-term firm performance, 27 *Journal of Corporation Law*, 231, 233.

⁷⁶⁴ Black B.S., (2001). The legal and institutional preconditions for strong securities markets. *UCLA Law Review*, 48, 781.

⁷⁶⁵ Ibid.

outsiders, they wouldn't face the conflicts that, say, the chief operating officer might face, reluctant to criticize his boss and in no position to call for his ouster. The idea proved to be a mirage. Independence is an intangible concept. Outsiders cannot be guaranteed to be independent, anymore than insiders can be assumed to be deferential."....Directors do not become independent just because they have no economic ties beyond their job as a director."⁷⁶⁶

Despite the apparent non correlation between board independence and performance, by 2001, an estimated seventy-five percent of companies listed on the New York Stock Exchange (NYSE) or Nasdaq Stock Market (NASDAQ) had responded to shareholder's activist calls and populated their boards with a majority of independent directors.⁷⁶⁷ However, after Enron and other major scandals occurred, it became apparent that the introduction of independent directors alone was insufficient to curtail managerial misconduct. There are numerous examples where a highly independent board hasn't prevented large-scale wealth destruction. Hence, it is clear that the presence of a majority of independent directors on boards, alone, is not enough to prevent conflicts of interest from occurring.

⁷⁶⁶ Monks, R.A. & N. Minow, (2004). *Corporate Governance*, Blackwell Publishing, 3rd Ed., United States, 564p.

⁷⁶⁷ Investor Responsibility Research Centre, IRRRC data guides new listing rules for NYSE (March 7, 2002), at <http://www.irc.org/company106062002.html>

Leblanc and Gillies in their study of corporate governance in the boardroom indicate that board structure is not as important as board processes for effective governance stating:

“All the research, slim as it is, indicates that the structural characteristics of a board, i.e., the number of outside directors, the number of independent directors, the separation of the position of chair and chief executive officer, the independence of directors, et al., really make little or no difference in general board performance when performance is in terms of corporate financial performance. And there is no evidence to indicate that it matters, one way or another, in terms of the capacity of boards of directors to better perform their oversight duties. In short, therefore, although the evidence is far from being conclusive, it appears that over the years the requirement that a majority of directors be independent, while nominally changing the structure of boards to more outside directors, has had little impact on characteristic features of board members. In fact, there is some evidence-anecdotal, observational and otherwise-to suggest that it did not have much impact on creating actual independence within boards”⁷⁶⁸.

⁷⁶⁸ Leblanc, R. & J. Gillies (2005). *Inside the Boardroom: How Boards Really Work and the Coming Revolution of Corporate Governance*. John Wiley & Sons, Canada, 314p., p. 133.

The Toronto Stock Exchange Committee on Corporate Governance in Canada in 2000 also recognized that there may be a preoccupation with the structure of boards with respect to the number of independent directors rather than whether the board functions independently stating:

“Structure over substance: The committee noted that many boards did respond positively to the Report. There is concern, however, that the response of a number of corporations may have been more structural and more procedural than substantive. The Report contains guidelines which propose structures for governance systems which establish boards of directors independent of management boards which implement the guidelines may achieve structural independence, but structuring boards in this way is only part of the answer. Boards must function independently⁷⁶⁹.”

This assessment of board independence has indicated that there is no clear relationship between board independence and board performance, and that it appears that insiders may add value to shareholders in some committees of boards. Further, a board structure with a majority of independent board members is being utilized for fund boards in the U.S. as specified by the Investment Company Act, recommended by the Investment Company Institute (ICI), accepted by CalPERS, one of the most active institutional investors in the US, and utilized in the United Kingdom. It is also the

⁷⁶⁹ The TSX and Institute for Corporate Directors, (2001). *The State of Corporate Governance in Canada*.

recommended structure by the Canadian Coalition for Good Governance. Hence, should the CSA decide adopt fund boards as a governance agency, as contemplated in the Concept Proposal, they should utilize a structure consisting of both independent and inside directors, with a majority of independent directors, but not a structure with complete (100 percent) independence. The CSA should also re-examine the effectiveness of having a requirement of 100 percent independence for the IRC, as opposed to a majority of independent members.

A study by Ding and Wermers concluded from regression analysis on mutual fund performance that “board independence is not an important influence in ongoing fund performance”⁷⁷⁰ This study on the effectiveness of independent directors indicated that their financial performance of domestic stock mutual funds increased with the size of the board, and therefore with the number of independent directors, but was unrelated to the percentage of board seats held by independent directors⁷⁷¹. Palmiter, however, questioned whether the relationship between the number of independent directors and fund performance was due to the status of directors under Section 2(a)19 of the Act. Palmiter further indicated that if there was an effect whether it was sufficiently large to be of practical consequence was uncertain⁷⁷².

⁷⁷⁰ Ding, B., & R. Wermers, (2005). Mutual fund performance and governance structure: the role of portfolio managers and boards of directors, Dec. 9 2005. Available at <http://ssrn.com/abstract+687273>

⁷⁷¹ Ibid.

⁷⁷² A. R., (2006). The mutual fund board: a failed experiment in regulatory outsourcing, 1 *Brooklyn Journal of Corporate, Financial & Commercial Law* 165, 200.

The results of another study by Meschke indicated that the percentage of board positions held by independent directors was not clearly related to the performance of funds whose portfolios consisted of debt securities⁷⁷³. In this study the financial performance of mutual funds that invested in equity securities was weakly and inversely related to the percentage of board seats occupied by independent directors, and that as a result fund performance declined somewhat as the fraction of independent directors rose. Based on the results of the Ding and Wermers and Meschke studies, it is uncertain whether mutual fund shareholders financially benefit from independent directors.

Tufano and Sevick studied the board of directors of mutual funds, with a focus on independent directors, in the 50 largest fund sponsors in 1992⁷⁷⁴. The authors found that funds with smaller boards and a higher percentage of independent directors tend to negotiate and approve lower fees. They also found that independent directors who receive higher compensation approve higher shareholder fees than those that are less well compensated.

Del Guercio et al evaluated board structure and director independence in closed-end investment companies⁷⁷⁵. The authors found that smaller boards and boards with a higher percentage of independent directors are more effective and that there is an

⁷⁷³ Meschke, F. (2007). An empirical examination of mutual fund boards. 17-18, 33-34, University of Minnesota, Twin Cities, Carlson School of Management, Working Paper, Mar. 15, 2007.

⁷⁷⁴ Tufano, P. & M. Sevick, (1997). Board structure and fee-setting in the mutual fund industry. *Journal of Financial Economics*, 46, 321-355.

⁷⁷⁵ Del Guercio, D., L. Dann & M. Patch, (2003). Governance and boards of directors in closed-end investment companies, *Journal of Financial Economics*, 69, pp. 111-152.

association between board structure and the fund's willingness to undertake activities favourable to shareholder value.

Ding and Wermers found that boards with a greater number of independent directors are associated with better performance and a higher likelihood of replacing underperforming portfolio managers⁷⁷⁶. The authors conclude that board structure, as measured by its degree of independence, is an important determinant of fund governance quality with regard to director ownership. Chen et al found ownership patterns consistent with the hypothesis that directors tend to own shares in the funds that they oversee when the benefit is expected to be high and other control mechanisms are not in place⁷⁷⁷. Cremers et al found that director's ownership stakes are positively related to fund performance, noting that this relationship holds for independent directors but is stronger for non-independent directors⁷⁷⁸. Meschke examined a sample of 169 boards to determine whether their structures are related to fund fees and performance⁷⁷⁹. He found lower fees to be associated with independent directors with higher ownership and lower compensation.

Ferris and Yan evaluated whether independent directors matter in mutual fund governance, in response to the changes in requirements by the SEC for a mutual fund

⁷⁷⁶ Ding, B. & R. Wermers, (2005). Mutual fund governance performance and governance structure: The role of portfolio managers and boards of directors, Working paper, University of Maryland.

⁷⁷⁷ Chen, Q., I. Goldstein & W. Jiang, (2006). Director's ownership in the U.S. mutual fund industry, Working Paper, Duke University.

⁷⁷⁸ Cremers, M., J. Driessen, P. Maenhout & D. Weinbaum, (2005). Does Skin the game matter? Director incentives and governance in the mutual fund industry, Working Paper, Tale University.

⁷⁷⁹ Meschke, *supra* at note 773.

board to be comprised of at least 75% independent directors that was prompted by scandals involving late trading, market timing and other trading abuses⁷⁸⁰. Using a large sample of mutual fund families for 2002, the authors found neither the probability of a fund scandal nor overall fund performance is related to either chair or board independence, stating “we fail to find, however, that either the proportion of independent directors or the presence of an independent chairman is related to the probability of a fund scandal.”⁷⁸¹ I suggest that the implication of the results of this study of mutual fund governance is that a requirement is not necessary for a supermajority of independent directors of a mutual fund board and an independent chair.

The authors also evaluate that relationship between board characteristics and fund fees, concluding: “Again, we find no evidence that those measures of fund governance of most interest to the SEC’s current reform efforts are associated with lower fees. Specifically, we observe no evidence that funds with a higher percentage of independent directors or independent chairman charge lower fees. We also find no evidence that board or chair independence is significantly related to fund performance or fund turnover.”

Ferris and Yan indicate that their study results “question, however the usefulness of recent SEC proposals for mutual funds to have independent chairmen accompanied by a board that is at least 75% independent. Contrary to the arguments made in support of

⁷⁸⁰ Ferris, S. P. & X. S. Yan, (2007). Do independent directors and chairmen matter? The role of boards of directors in mutual fund governance, *Journal of Corporate Finance*, 13, pp. 392-420.

⁷⁸¹ Ibid.

these proposed changes, we find that board and chairman independence are generally insignificant factors in explaining the level of fund fees or the likelihood of a fund scandal”⁷⁸². The authors further conclude that this result is consistent with the argument of Pichhadze⁷⁸³ that in response to a crisis, regulators often adopt new rules regardless of their effectiveness.

4.7 FIDUCIARY DUTIES OF INVESTMENT COMPANY DIRECTORS

Current law in the United States assumes that there is an unacceptable probability that ‘interested directors’ will financially abuse the fund’s investors. The established view suggests that shareholders will be financially injured by interested directors more frequently than independent directors because interested directors are subject to inherent conflicts of interest from exposure to situations where their goals and the goals of shareholders differ. It should be recognized, however, that the established view appears to not assume that the interested directors of a fund act for their own benefit in all situations where the goals of the interested directors diverge from the goals of the fund’s investors⁷⁸⁴. Rather, the established view appears to assume that interested directors act for their own benefit in a significant and unacceptable proportion of situations that involve this divergence⁷⁸⁵. Stout⁷⁸⁶ suggests that, from social and behavioural science

⁷⁸² Ibid., p.417.

⁷⁸³ Pischadze, A. (2006). Mutual fund governance reforms: a commentary, *Banking and Finance Law Review*, 17, pp. 67 – 95.

⁷⁸⁴ Barnett, supra note 716, p. 506, n. 75.

⁷⁸⁵ Ibid.

⁷⁸⁶ Stout, L. A., (2003). On the proper motives of corporate directors (or why you don’t want to invite homo economicus to join your board), 28 *Delaware Journal of Corporate Law* 1.

research, directors frequently, and perhaps typically, act for the benefit of others. The premise of the Act, therefore, is that interested directors are seen to be inclined to act in ways that favour them or persons linked to them and instances of exploitation of shareholders by interested are thought to originate and result from selfishness.

From this perspective, the lack of directors in the Canadian mutual fund governance regime may be inferred to be positive since the interested (non independent) directors under this interpretation could be expected to act in their own interests or in the interests of those 'related' to them. On the other hand, mutual funds in Canada have boards of directors under existing conditions, and therefore applying this rationale, it could be inferred that some of the existing mutual fund directors in Canada are acting out of selfishness. However, there have been no supporting studies to support the premise that all directors act out of selfishness, or that they in fact do not act out of self interest. This lack of data is a fundamental issue with mutual fund governance in North America, since in the United States the SEC has adopted to regulate governance using directors, including the concept of independence through 'non-interested' directors, without supporting studies to demonstrate that they will be effective or monitoring and analysis to verify that they are effective in practice. In Canada the CSA decided to move forward with the IRC without supporting studies to demonstrate that this would be effective, or any subsequent published studies, to date, to verify that they are effective.

The potential for conflicts of interests do exist for interested directors of investment companies. Barnett⁷⁸⁷ questions whether “the assumption should be made that these conflicts render interested directors an actual or probable menace to the investors of the companies.” In the United States, state law has a clear set of fiduciary duties for the directors of entities, including investment companies, and that the duties are imposed upon all directors, whether they are interested or independent. In Canada, there are specific regulations that govern the behaviours of directors, which include corporations that act as fund managers for mutual funds. From this perspective, the Canadian mutual fund regime relies upon the corporate governance rules for directors for Canadian corporations while providing an extra mechanism for proactive detection of conflicts of interest by the IRC.

Under the Investment Company Act in the United States, the structure of an investment company (e.g., business trust or limited partnership) it is not relevant whether the person is a director, because under the definition of “director” in the Act, persons are directors if their functions “with respect to any organization, whether incorporated or unincorporated” are “similar” to those of the director of a corporation⁷⁸⁸. This definition is not confined to a person on the board of a corporation but extends to a general partner of an investment company that is a limited partnership and to a trustee of an investment company that is a business trust.

⁷⁸⁷ Ibid., p. 507.

⁷⁸⁸ 15 U.S.C. & 80a-2(a)(12) (2000).

The U.S. Supreme Court of Delaware clearly indicates that directors are deemed to be fiduciaries in its statement: "The fiduciary nature of a corporate office is immutable. As this court stated long ago: Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its shareholders..."⁷⁸⁹. Directors are therefore required to demonstrate good faith and fairness in their dealings where they have a financial, business or other personal interest which does not impact the corporation or all stockholders generally⁷⁹⁰. The failure of a director to fulfill a fiduciary duty results in director being liable for damages that stem from the failure⁷⁹¹. While the potential for liability is assumed to shape the conduct of directors for the benefit of the public, the fact that the duties apply to interested directors seems to be overlooked⁷⁹².

Barnett notes that the duties of interested directors that are expressed in doctrines of law may have no actual influence on the behaviour of directors and be simply words, since interested directors may work in their own immediate goals regardless of the principles embodied in law⁷⁹³. He reasons that doctrines of law as widespread and prominent as the fiduciary duties of directors exist because they reflect the character of

⁷⁸⁹ Integrated Resources, Inc., SEC No-Action Letter, 1979 WL 14861, at *1 (June 1, 1979); Sheldon A. Jones et al., *The Massachusetts Business Trust and Registered Investment Companies*, 13 Del. J. Corp. 421, 435 n.91 451 (1988).

⁷⁹⁰ *Mills Acquisition Co. V. Macmillan, Inc.* 559 A.2d 1261, 1280 (Del. 1989).

⁷⁹¹ Franklin A. Gevurtz, *Corporation Law*, p. 301 301, 2000.

⁷⁹² Barnett *supra* note 716, p. 508.

⁷⁹³ *Ibid.*

the society in which the law is embedded and endorse behaviours and values needed by the system⁷⁹⁴.

A review of the fiduciary duties of directors in the context of investment companies is provided by Barnett⁷⁹⁵ beginning with the duty of care and the duty of loyalty, followed by consideration of the requirement of state law that the directors of an entity act in good faith. While corporations and limited partnerships are popular arenas for examining director duties, business trusts appears not to be, and thus comments in particular on the duties of the directors of business trusts (i.e., trustees). For mutual funds, the law on business trusts in Delaware and Massachusetts is of primary importance because business trusts seem normally to be established under the law of one of these states⁷⁹⁶. In states that have decided the issue, the directors of a business trust are generally deemed to have a fiduciary relationship to the holders of beneficial interests in the trust, and state courts have generally analogized the duties of trustees of business trusts to those of directors of corporations⁷⁹⁷. The fiduciary relationship includes both a duty of care and a duty of loyalty⁷⁹⁸. The Delaware statute on business trusts, however, allows the document that governs a business trust to alter or remove fiduciary duties of a trustee, recognizing that the document cannot “eliminate the implied contractual covenant

⁷⁹⁴ Ibid.

⁷⁹⁵ Ibid.

⁷⁹⁶ Haas, J. J. & S. R. Howard, (2002). The Heartlands Funds’ receivership and its implications for independent mutual fund directors, 51 *Emory Law Journal* 153, 200 n. 232.

⁷⁹⁷ William K. & W. K. Sjostrom, (2005). Tapping the reservoir: mutual fund litigation under Section 36(a) of the Investment Company Act of 1940, *Kansas Law Review*, 251, 274.

⁷⁹⁸ Laby, A. B., (2004). Resolving conflicts of duty in fiduciary relationships, 54 *American University Law Review* 75, 80.

of good faith and fair dealing”⁷⁹⁹. The current wording of the section became effective on August 1, 2006⁸⁰⁰ although it was not likely that that Delaware courts would allow a trustee of a business trust to escape these obligations⁸⁰¹. The trustee of a business trust in Delaware is therefore subject to the requirements of good faith and fairness that are inherent in the central role of director⁸⁰². The obligations of care and loyalty are therefore further applicable to the directors of every investment company having a board of directors regardless of whether the company is structured as a corporation, a limited partnership, or a business trust.

Members of an investment company board in the United States are subject to three obligations: duty, loyalty and good faith and at least the first two of these are fiduciary in nature. These three obligations, which are embedded in state law, *apply to all directors of all investment companies*. Accordingly, the three obligations apply to the interested directors of investment companies. The test determining whether a fiduciary duty has been breached is the same for all directors and state law offers no safe haven for investment company directors and directors, who are interested as well as directors who are not interested, are treated alike under Section 2(a)(19) of the Investment Company Act. As such, under state law interested directors should not differ from independent

⁷⁹⁹ Del. Code. Ann. Tit. 12 & 3806(c) (Lexis).

⁸⁰⁰ 75 Del. Laws 418 (2006), accessed at: <http://legis.delaware.gov>

⁸⁰¹ Frankel, T., (2001). The Delaware Business Trust Act failure as the new corporate law, 23 *Cardozo Law Review* 325, 332.

⁸⁰² Barnett, *supra* note 716.

directors in the degree to which they protect investment company shareholders from financial abuse⁸⁰³.

Barnett considers “federal law governing mutual funds to be grounded on scepticism regarding the willingness or ability of interested directors to safeguard fund investors from financial abuse.”⁸⁰⁴ He indicates that this scepticism exists despite the explicit recognition that state law contains fiduciary duties for directors and that interested directors are subject to the same duties as independent directors. He reasons that under state law, the care and loyalty to which interested directors perform their tasks as directors must match that of independent directors and given this parity, the scepticism directed at interested directors is illogical. Barnett⁸⁰⁵ further indicates that this logical inconsistency is accompanied by the belief that the prevalence of interested directors on fund boards substantially affects the investment returns on mutual funds. He suggests that “it is at least plausible, and may indeed be probable, that the relationship between board composition and fund performance is weak or non-existent.”⁸⁰⁶

According to Barnett⁸⁰⁷, if it were to be postulated that the status of directors under Section 2(a)(19) of the Act do not pose the economic threat to the funds and their shareholders, and do not pose the economic threat to shareholders that is commonly

⁸⁰³ Barnett, *supra* note 716.

⁸⁰⁴ *Ibid.*, p. 534.

⁸⁰⁵ *Ibid.*, p. 234.

⁸⁰⁶ *Ibid.*, p. 234.

⁸⁰⁷ *Ibid.*

assumed, then two questions must be answered. The first question is “what advantages to accrue to society from the congressionally established maximum percentage of interested directors on fund boards and from the actions of the Securities and Exchange Commission to reduce this percentage?” Barnett suggests that the first question “implicates the macro logical proposition that (i) the concepts and doctrines dominant in the institution of law facilitate the operation of the society in which they exist and ii) when these concepts and doctrines hinder the social system, they are abandoned and replaced by concepts and doctrines that strengthen the social order”⁸⁰⁸. This two part proposition, according to Barnett⁸⁰⁹, leads to the conclusion that if interested directors have no appreciable effect on the profitability of investment fund shares, existing law on the percentage of interested directors on fund boards arose because it benefits the social system in some other ways”. He suggests that this was to instil trust, as “The functioning of a social system is improved by the creation and preservation of trust, and the legislative history of the act discloses that it was adopted to promote trust in entities that are vehicles for collective investments in securities so that the entities would contribute to the growth of the United States economy.”⁸¹⁰ Barnett supports this suggestion by his assertion that even though a concern with trust is rarely made explicit or stressed in court opinions and Commission releases, “Congress evidently had an underlying sociological

⁸⁰⁸ Barnett, *supra* note 716, p. 535

⁸⁰⁹ *Ibid.*, p. 235.

⁸¹⁰ *Ibid.*, p. 535.

purpose in limiting the percentage of investment company board seats held by interested fund directors.”⁸¹¹

Barnett indicates that symbols are for maintaining and improving the operation of groups⁸¹², and in regulating investment company boards of directors, federal legislation seems to be inescapably symbolic⁸¹³. From this perspective, both the IRC in Canada and independent directors in the US may be symbols of protection to investors that help protect the reputation through the perception that they are part of a regulated industry and that there is governmental concern with the welfare of investors. A fundamental question that must be addressed is whether regulatory approaches that do not impose a maximum percentage of board seats held by interested directors benefit society as much as, or more than, regulatory approaches that do.

The criteria for ‘independence’ for the IRC in Canada and being ‘non-interested’ for directors in the United States are comparable. A primary reason for this may have been that the Canadian regulators ‘borrowed’ the criteria of being ‘interested’ from the United States regulation and applied this to the development of the criteria of ‘independence’ for the IRC in Canadian regulation. As such, the understanding of the

⁸¹¹ Ibid., p. 535.

⁸¹² Barnett, L. D., (2007). The roots of law, 15 *American University Journal of Gender Social Policy & the Law* 613, 615, 636-37, 672; Barnett, L. D., (2007). Law as symbol: appearances in the regulation of investment advisors and attorneys, 55 *Cleveland State Law Review*, 289, 290, 294-95, 302-03, 330-31, 2007.

⁸¹³ Barnett, the roots of law, *supra* note 812, p. 536.

criteria for being 'interested' in the United States is of particular to understanding Canadian regulations and the level of protection afforded by the IRC.

The primary limitations of both concepts are that it focuses on the protection of shareholders, through regulation of conflicts of interest only. This is important when the mutual fund managers decrease the return to the unit holders of the mutual fund in order to increase the return to the shareholders of the mutual fund manager. In these circumstances, there would not be a perceived conflict of interest in the protection of the shareholders of the mutual fund and the neither the independent IRC in Canada, nor the non-interested directors in the United States, would perceive this as a conflict of interest as it is in favour of 'shareholders'. On the other hand, the unit holders of the mutual fund are disadvantaged with the decrease in the return on their mutual funds fund investment, at the expense of the return to the shareholders of the mutual fund manager. Therefore, the current mutual fund regulation does not address the inherent conflict of interest that is at the heart of the mutual fund industry. An evolution of the mutual fund governance regime should include a regulation to protect unit holders of mutual funds from this inherent conflict of interest. This should include a public consultation process that would involve understanding of mutual fund unit holders of their returns, which would dictate the level of regulation required.

According to Barnett⁸¹⁴ law in general serves the social system in which it exists: law is formulated to meet the needs and endorse the values of society and that the Investment Company Act is illustrative of this. In creating the Investment Company Act of 1940, Congress recognized the potential of investment companies to contribute to the economic growth of the United States and sought explicitly through the Act to raise the level of confidence that could be placed in investment companies by investors, and in particular those having relatively small amounts of money to buy securities⁸¹⁵. This goal was comparable to the goal of establishing the Securities and Exchange Act since “Congress enacted the 1933 and 1934 Acts to promote investor confidence in the United States securities markets and thereby to encourage the investment necessary for capital formation, economic growth and job creation”⁸¹⁶. In seeking to restore and maintain the trust of Americans in the financial institution of their society would have also served to improve the reputation of the institution, through creating a set of rules for these companies to follow.

Barnett notes that the societal function of the Investment Company Act was illustrated by the scandal that occurred in 2003 in the United States that involved a number of investment companies for fund families⁸¹⁷. The Securities and Exchange

⁸¹⁴ Barnett, L.D., (2005). When is a mutual fund director independent? The unexplored role of professional relationships Under Section 2(2)(19) of the Investment Company Act. 4 *Depaul Business & Commercial Law Journal* 155 2005-2006.

⁸¹⁵ Senate Committee on Banking and Currency, Investment Company Act of 1940, S.Rep. No. 76-1775, at 5 (3d Sess. 1940).

⁸¹⁶ Senate Committee on Banking, Housing and Urban Affairs, Private Securities Litigation Reform Act of 1995, S. Rep. No. 104-98, at 4 (1995), as reprinted in 1995 U.S.C.C.A.N. 679, 683).

⁸¹⁷ Morningstar Fund Investor, Fund families under investigation, April 2005, at 17.

Commission imposed civil sanctions on parties responsible for the violations of the Act and adopted new rules under the Act to better prevent or control future incidents⁸¹⁸. Barnett suggests that the negative impact of the scandal on the public image of the mutual fund industry was apparently offset to a large degree by other factors⁸¹⁹. A survey of investors found that three out of four respondents indicated that they had not altered their mutual fund investment plans because of recent mutual fund scandals and only one out of eight respondents had shifted into other types of investments⁸²⁰. He further suggests⁸²¹ that the failure of the scandal to have a substantial effect on investors was probably attributable to in part to a widespread belief in the adequacy of existing information applicable to investment companies, the fact that very few investment companies were implicated in the scandal, and because the SEC responded sanctions on funds that violated that Act and further responded by bolstering the Act. Barnett further reasons that without the Investment Company Act there would likely be widespread doubts about the Investment Industry, and suggests that these doubts would “appreciably reduce the number of investors in investment companies” and that this Act, along with the authority of the SEC to enforce it, provides investors with the basis for assuming that companies will operate in an “evenhanded manner”⁸²². He further states that this assumption “is a

⁸¹⁸ *Investment Company Governance*, 69 U.S.C. 80a-37, 80a-41 (2000 & Supp. II 2002).

⁸¹⁹ see Investment Company Institute, *Shareholder Sentiment of the Mutual Fund Industry, Fundamentals*, Oct. 2004, at 1, 3-4, available at www.ici.org/stats/res/fm-v14n7.pdf

⁸²⁰ Technometrica Institute of Policy & Polling, Roper Center Public Opinion Online, Dec. 1-7. 2003, available at LEXIS accession no.044175 Public Opinion Location Library or Public Opinion.

⁸²¹ Barnett, *supra* note 814, p. 159.

⁸²² Palmiter, A. R., & A.E. Taha, (2008). Mutual fund investors: divergent profiles, *Columbia Business Law Review* 934 p. 160-161.

necessary condition for investment companies to be trusted by the public, and it thereby helps to supply the societal foundation that the companies require to be an important vehicle for finance”⁸²³.

4.8 MUTUAL FUND INVESTOR PROFILES

Palmiter and Taha examine the profiles of mutual fund investors presented by the mutual fund industry in the United States⁸²⁴. They present three profiles of the mutual fund investor: one put forward by the mutual fund industry, another assumed by the SEC, and another identified by the academic finance literature.

4.8.1 ICI SURVEY

In 2006 the ICI undertook a comprehensive study to identify the information needs of mutual fund investors and the sources from which they obtain that information⁸²⁵. The study consisted of in-home interviews of 737 randomly-selected mutual fund investors who had bought, outside of a work-related retirement plan, a stock, bond, or hybrid fund that they did not own prior to 2001⁸²⁶. The study excluded mutual fund investors who purchased only money market funds, who had only added to an already-owned fund, or who had purchased funds only through a 401(k) or similar work-

⁸²³ Ibid., p. 161.

⁸²⁴ Ibid.

⁸²⁵ Investment Company Institute, *Understanding Investor Preferences for Mutual Fund Information*, (Aug. 2006), accessed at: <http://ici.org/pdf/rpt-06-inv-prefs-full.pdf> (ICI, Investor Preferences).

⁸²⁶ Ibid., p. 1. The survey was conducted by an independent research firm.

related plan⁸²⁷.

According to the ICI a "key finding" of the survey, is that investors "consider a wide range of information before purchasing mutual fund shares [and] most frequently review or ask questions about a fund's fees and expenses and its historical performance"⁸²⁸. Of those surveyed 74% responded that they review a fund's fees and expenses before investing⁸²⁹, the second most reviewed information is the fund's 'historical performance', which 69% of surveyed investors stated they review, and the third is the 'fund risks', which 61% of the respondents indicated they review⁸³⁰.

A second key finding of the ICI survey was that "[s]hareholders consult a variety of sources for mutual fund information before and after purchasing shares, and one of these sources is usually a professional financial advisor as shareholders primarily turn to advisers for assistance in understanding and interpreting fund information."⁸³¹ Investors responded that they consulted an average of three sources before buying a fund⁸³². Financial advisors were, by far, investors' most consulted source of information, with 73% of those surveyed reporting that they consulted professional financial advisors before buying a mutual fund⁸³³. The next most consulted sources were 'fund company or

⁸²⁷ Ibid. p. 1, n.2

⁸²⁸ Ibid. p. 1

⁸²⁹ Ibid. p. 3, fig. 1

⁸³⁰ Ibid.

⁸³¹ Ibid., p. 1.

⁸³² Ibid., p. 4, fig. 2.

⁸³³ Ibid.

other websites' (46%) and 'friends, family, or business associates' (40%)⁸³⁴.

Palmiter and Taha⁸³⁵ indicate that the ICI survey paints a very favorable portrait of mutual fund investors in that according to the survey, investors obtain essential fund information, such as costs, returns, and risks, and they usually are assisted by professional financial advisors before choosing a mutual fund. Palmiter and Taha⁸³⁶ reason that if this profile is accurate, it suggests that investors have the acumen and knowledge to provide market discipline over mutual funds.

Palmiter and Taha⁸³⁷ suggest that the ICI survey may be of limited value since it includes only surveyed investors who own funds outside of employer-sponsored plans, thus missing a large and growing number of fund investors who only own funds inside such plans. Further, most of the surveyed investors reported using financial advisors, a resource often unavailable with employer-sponsored plans⁸³⁸. Moreover, the survey relied upon investors to accurately self-report their own behavior in face-to-face interviews and respondents predictably may have given what they saw as the right answer, not necessarily the truthful one⁸³⁹. For example, an investor who admits to buying a fund without examining its fees and expenses (the price for investing in the fund) is admitting

⁸³⁴ Ibid.

⁸³⁵ Ibid.

⁸³⁶ Ibid., p. 948.

⁸³⁷ Ibid., p. 948.

⁸³⁸ Ibid., p. 948.

⁸³⁹ Ibid., p. 948.

to buying a service without considering the price⁸⁴⁰. It is well-known that survey respondents often lie to avoid embarrassing themselves⁸⁴¹.

The ICI has also explicitly and implicitly profiled mutual fund investors in other publications and in statements by its officials. As the national trade association for the mutual fund industry, the ICI regularly sends comment letters to the SEC regarding proposed mutual fund rules. Before the SEC adopts new regulations of mutual funds, it seeks public input. The SEC publishes the proposed regulation in the Federal Register and asks the public to comment on the proposal. The SEC typically responds in the Federal Register to these comments and sometimes even modifies or retracts the proposal in light of the comments. As such the ICI comments are considered by the SEC as part of its rule making. The comment letters often state or reflect the ICI's view of mutual fund investors. The ICI has portrayed investors as having available, and utilizing, a great deal of information about funds when making their fund choices. The statements and comment letters of the ICI present a portrait of mutual fund investors who place great emphasis on fund fees and expenses when choosing among mutual funds, thus creating a competitive fund market that disciplines the industry.

The ICI frequently asserts that investors search for funds with low fees and

⁸⁴⁰ Ibid., p. 948.

⁸⁴¹ See for example, Carl Bialik, When it comes to donations, polls don't tell the whole story, *Wall Street Journal Online*, Feb. 11, 2005, <http://online.wsj.com/public/article/SB110806528683351584.html?mod=blogs> (discussing examples of when survey respondents have lied and quoting Jeffrey M. Jones, managing editor of the Gallup Poll, as explaining that "the [survey] interview is a social experience As would be the case in a cocktail party or at a job interview, you want to give a good impression of yourself.")

expenses as evidence of investors' preference for low fees and expenses and the ICI has pointed out that investors are heavily invested in lower-cost funds⁸⁴². The ICI stated that "[more than three-quarters of stock and bond fund assets are invested in funds charging below-average operational and management expenses in its study of competition in the mutual fund industry."⁸⁴³ A 2005 ICI study described a 25-year trend of declining fund fees and expenses where the ICI study found that investors paid on average 113 basis points⁸⁴⁴ to invest in stock funds, 90 basis points for bond funds, and 41 basis points for money market funds-the lowest cost levels for each class of fund in more than 25 years⁸⁴⁵.

According to Palmiter and Taha⁸⁴⁶, the ICI regularly claims that cost-sensitive investors impose a strong market discipline on mutual funds. In a recent publication on competition in the mutual fund industry the ICI stated that "[t]he 90 million fund shareholders' demand for investment performance and services at a competitive level of fees and expenses continuously impacts mutual funds."⁸⁴⁷ The ICI has also indicated that "[i]ncreased investor demand for low-cost funds accounted for more than half of the

⁸⁴² Statement by Paul Schott Stevens, President, Investment Company Institute, ICI Welcomes Efforts to Improve 401(k) Disclosure (Mar. 7, 2007), http://www.ici.org/statements/nr/2007/07_news_401k_hrg.html#TopOfPage

⁸⁴³ Investment Company Institute, *Research Commentary: Competition in the Mutual Fund Business*, 1 (2006), accessed at: <http://www.ici.org/stats/res/rc-competition.pdf> (ICI, Competition).

⁸⁴⁴ A basis point is 0.01% of the fund's assets. Thus, paying 113 basis points on a \$10,000 investment costs an investor \$113 annually.

⁸⁴⁵ Investment Company Institute, *Fees and Expenses of Mutual Funds*, 2005 at 1-2 & fig.1 (2006), accessed at: <http://www.ici.org/statements/fundamentals/fm-v15n4.pdf> (ICI, Fees & Expenses).

⁸⁴⁶ *Ibid.*, p. 951

⁸⁴⁷ ICI, Competition, *supra* note 843, p. 1.

decline in the asset-weighted average expense ratio [in 2005]”.⁸⁴⁸ According to the ICI, mutual funds compete vigorously to keep costs low, since the performance figures reported by the fund, and the total value of an investor's mutual fund account, are provided after all fees and expenses have been deducted.

ICI officials have also made strong statements on how the market disciplines the mutual fund industry. For instance, John Murphy, the General Membership Meeting Chairman of the ICI, recently stated that: “The free market still reigns as the most powerful source of accountability. Market competition offers a strict, comprehensive, and daily form of discipline. The score on funds is printed in the paper and on the Internet every day. Mutual fund managers know that unhappy investors are never more than a phone call or mouse click away from switching to another provider.”⁸⁴⁹

While indicating that there is investor demand for lower-cost funds the ICI has not encouraged investors to invest in such funds. For example, an online mutual fund primer sponsored by the ICI Education Foundation and the National Urban League is silent about the effect of costs (such as loads and expenses) on fund returns⁸⁵⁰. Instead, fund investors are urged to focus on “time in the market” rather than “timing the

⁸⁴⁸ ICI, Fees and Expenses, *supra* note 845, p.1. See also, Investment Company Institute, a Guide to Understanding Mutual Funds 23 (2007), accessed at: <http://www.ici.org/pdf/brounderstanding-mfs-p.pdf>

⁸⁴⁹ John V. Murphy, Gen. Membership Meeting Chairman, Welcoming remarks at the Investment Company Institute's 2006 general membership meeting (May 17, 2006), accessed at: http://www.ici.org/statements/remarks/06_gmm-murphy-spch.html#TopOfPage.

⁸⁵⁰ Investment Company Institute Education Foundation and National Urban League, *Investing for Success*, <http://www.ici.org/introduction/index.html>. In the 230 pages of the online primer, the terms “fees” and “expenses” do not appear except with respect to college costs, and the terms “12b-1” and “loads” are not mentioned at all.

market.”⁸⁵¹ The primer points out that annual stock market returns have averaged 11% from 1926 to 2004, but does not indicate how much less mutual fund investors have received because of the drag of fund fees and expenses⁸⁵². Other ICI educational materials mention fees and expenses but do not encourage investors to seek out low-cost funds. For example, the ICI has published an educational brochure entitled ‘A Guide to Understanding Mutual Funds’⁸⁵³. Some of the information in the brochure is written in a question-and-answer format. In response to the question "Should Fund Fees Affect Your Decision?" the ICI responds only that:

“If two funds were identical, except for the fees and expenses they charge, the lower-cost fund would be a better option. But rarely, if ever, are funds identical. For example, stock funds typically cost more than bond and money market funds, but stock funds historically have provided a significantly higher return-even after expenses are deducted. Even different types of stock funds, U.S. or foreign, typically vary in cost. In short, there are many factors that affect the fees and expenses a fund charges. Only after weighing all of the relative benefits of different funds, including an analysis of their costs, can you decide if owning a particular fund is acceptable to you. A fund with higher costs may make more money for you, even after accounting for the costs you pay, than a fund with a

⁸⁵¹ Ibid.

⁸⁵² Ibid.

⁸⁵³ ICI, Fees and Expenses, *supra* note 845.

lower cost. The opposite may also be true.”⁸⁵⁴

ICI officials have also credited as a source of market discipline the great amount of information about funds available to investors⁸⁵⁵. They claim that this information allows investors to compare funds, forcing funds to compete for investors⁸⁵⁶. The ICI also believes that most investors are receiving too much information about funds. The ICI has therefore, supported actions by the SEC to reduce, summarize, and standardize the information in fund prospectuses⁸⁵⁷ and to simplify the language used in disclosure documents so that investors can better understand them⁸⁵⁸. The ICI has further supported

⁸⁵⁴ Ibid., at 26. Another ICI educational brochure gives a very similar answer to the same question except that it begins its answer with "Yes. Fund fees are one of many important elements that should be considered when you are making a decision about whether to purchase a particular fund." Investment Company Institute, *Frequently Asked Questions About Mutual Fund Fees* 11 (2007), accessed at: http://www.ici.org/pdf/mf_fee_faqs.pdf.

⁸⁵⁵ See, e.g., Paul Schott Stevens, President, Investment Company Institute, Address at the Investment Company Institute Gen. Membership Meeting (May 17, 2006), (transcript accessed at: http://www.ici.org/issues/tax/arc-leg/06_gmm-stevens-spch.html) ("If mutual funds have succeeded, it is because they rest on strong regulatory and market disciplines-the high standard of fiduciary duty the law justly demands of fund managers, the abundant information funds must supply to their investors, the fiercely competitive environment in which funds operate, and the resulting scrutiny to which they are subject.")

⁸⁵⁶ Murphy, *supra* note 849 ("Mutual funds are arguably the most scrutinized, regulated, and transparent products in financial history. Our industry features a large number of firms, all competing for investors' loyalty. Barriers to entry are low and information to compare competing products is widely available.")

⁸⁵⁷ See, Letter from Paul Schott Stevens, Senior Vice President & Gen. Counsel, Investment Company Institute, to Jonathan G. Katz, Sec'y, Sec. & Exch. Comm'n (June 9, 1997), accessed at: http://www.ici.org/statements/cmltr/97_sec_formnlacom.html supporting the SEC's proposal to require the prospectus to contain a standardized risk/return summary because the ICI "believe[s] the summary will assist investors both in understanding the key features of a particular fund and in comparing different funds"). In addition, the ICI has supported changes to the prospectus "to minimize potential investor confusion and to avoid unnecessary clutter." Ibid.

⁸⁵⁸ For example, the ICI supported the SEC's requiring that the risk/return summary be written in "plain English." *Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Fund Costs and Distribution Practices*: Before the S. Comm. on Banking, Housing, and Urban Affairs, 108th Cong. 32 (Mar. 31, 2004) (statement of Paul G. Haaga, Jr., Chairman, Investment Company Institute), available at http://banking.senate.gov/public/_files/haaga/pdf. In addition, the ICI recommended that the SEC require that, in drafting a fund profile, "mutual funds, to the extent possible, use language that

efforts of the SEC to create even more basic disclosure documents, such as fund profiles⁸⁵⁹.

The ICI supported these disclosure reforms because it believed that investors are more likely to read and understand simplified and standardized information⁸⁶⁰ and the ICI has called for even simpler disclosure than was as adopted by the SEC⁸⁶¹. The ICI's President Paul Schott Stevens, suggested that investors receive "something like a quick-start guide [similar to what is provided with some electronic equipment] when they buy fund shares"⁸⁶². This guide would be a "clear, concise document that highlights the key information that a fund buyer wants and needs, in an easy-to-understand form."⁸⁶³

a typical investor would understand and avoid the use of technical terms and the relegation of critical information to footnotes." (see note 859).

⁸⁵⁹ Ibid., Letter from Paul Schott Stevens, Senior Vice President & Gen. Counsel, Investment Company Institute, to Barry P. Barbash, Dir., Div. of Inv. Mgmt., Sec. & Exch. Comm'n (May 20, 1996), available at http://www.ici.org/statements/cmltr/96_sec-profile-prospcom2.html [hereinafter Stevens-Barbash Letter] (stating that ICI and mutual fund complexes' research found that "substantially more shareholders are likely to actually read the profile prospectus than the traditional prospectus because the profile provides the information they need more succinctly, in a way they can more readily understand, and in a format they can more easily use.")

⁸⁶⁰ Letter from Paul Schott Stevens, Senior Vice President & Gen. Counsel, Investment Company Institute, to Jonathan G. Katz, Sec'y, Sec. & Exch. Comm'n (June 9, 1997), accessed at: http://www.ici.org/statements/cmltr/97_sec_fund-profile-com.html ("By adopting the profile, the Commission would address the clear need for a fund disclosure document that many more of today's sixty-three million fund shareholders actually will read and use in making investment decisions.")

⁸⁶¹ Paul Schott Stevens, President, Investment Company Institute, Remarks at The National Press Club: Revolution in Real Time: Using the Internet to Inform Investors Better (Feb. 14, 2006) (transcript accessed at: http://www.ici.org/statements/remarks/06_npcstevens_spch.html#TopOfPage) ("There is widespread agreement that today's disclosure system is not optimal from the fund investor's perspective. Most investors seek information that is clear and concise. They value quality, not quantity.")

⁸⁶² Paul Schott Stevens, President, Investment Company Institute, ICI President's Remarks at the Mutual Funds and Investment Management Conference: When You Come to a Fork in the Road, Take It: Improving Financial Regulation in America (Mar. 26, 2007) (transcript accessed at: <http://www.ici.org/statements/remarks/07mfimstevens-spch.html>).

⁸⁶³ Ibid.

The ICI, however, has opposed disclosure reforms where investors are able to obtain the information from other sources. For example, the ICI supported the National Association of Securities Dealers' ("NASD") proposal to require disclosure of fund expense ratios in performance advertisements⁸⁶⁴. It did not, however oppose disclosure reform for the actual dollar amount of expenses that would be incurred by a fund investor. The ICI argued that:

“Fund advertisements are not intended to be the exclusive source for investors of information about the fund, which is why all advertisements under Rule 482 are required to encourage potential investors to read the fund's prospectus carefully before investing and include information about how an investor may obtain the prospectus”⁸⁶⁵.

The ICI has assumed that investors will read cautionary disclosures placed in television advertisements. Thus, in letters to both the SEC and the Municipal Securities Rulemaking Board, the ICI advocated for disclosures required in television ads to be permitted to appear in text on the screen rather than being spoken⁸⁶⁶.

⁸⁶⁴ A performance advertisement is a mutual fund advertisement that presents a fund's historical returns.

⁸⁶⁵ Letter from Dorothy M. Donohue, Assoc. Counsel, Investment Company Institute, to Barbara Z. Sweeney, Office of the Corp. Sec'y, Nat'l Assoc. Sec. Dealers (Jan. 23, 2004), accessed at: http://www.ici.org/statements/cmltr/04_nasd_ad_disclosecom.html#TopOfPage (footnote omitted).

⁸⁶⁶ Letter from Amy B.R. Lancellotta, Senior Counsel, Investment Company Institute, to Jonathan G. Katz, Sec'y, Sec. & Exch. Comm'n (July 31, 2002), accessed at: http://www.ici.org/statements/cmltr/02secfund_advertcom.html#TopOfPage ("[With respect to television advertisements, we recommend that the Commission clarify that such disclosures need not be provided orally and that, instead, they may be provided in written text on the television screen.]); Letter from Dorothy M. Donohue, Assoc. Counsel, Investment Company Institute, to Ernesto A. Lanza, Senior Assoc. Gen. Counsel, Mun. Sec. Rulemaking

In summary, the ICI portrays mutual fund investors as investors who diligently seek out and digest important information about fund expenses, performance, and risks before investing. The ICI's position is that, as a result, investors create pressure on funds to lower expenses and achieve high returns. The ICI's profile of fund investors describes them as investors who, on their own or with the assistance of financial advisors, impose sufficient market discipline on the mutual fund industry⁸⁶⁷. The ICI's portrayal of investors has been provided to the SEC as part of their development regulations for the mutual fund industry. The ICI warns that many investors will only read and understand disclosures that are concise and clear. It has not been established based on a similar survey whether the Canadian investors fit the ICI's portrayal of fund investors.

4.8.2 SEC PORTRAYAL

The SEC also paints a portrait of fund investors that implies a well-functioning mutual fund market⁸⁶⁸. The SEC shares the industry view expressed through the ICI, that fund investors consider a variety of important information before investing⁸⁶⁹. The SEC also agrees with the ICI that fund investors can become confused by complex information about mutual funds and can therefore benefit from having information in a

Bd., (Sept. 22, 2006), available at http://www.ici.org/statements/cmltr/06_msrbadsc.com.html#TopOfPage ("We also strongly support permitting the required information to be provided in an abbreviated manner and permitting a portion of the disclosure to be provided on the screen (rather than spoken) for television advertisements.")

⁸⁶⁷ See also Investment Company Institute, (1997). *Understanding Shareholders' Use of Information and Advisors*, 3 (1997), accessed at: http://www.ici.org/statements/res/arc-dis/rpt_undstdshare.pdf

⁸⁶⁸ Palmiter and Taha; supra note 822, p. 956.

⁸⁶⁹ Palmiter and Taha, supra note 822.

concise, readable, and standardized form. Unlike the industry, however, the SEC has specific concerns about investor sophistication, and whether fund investors pay insufficient attention to fund fees and expenses and too much attention to past returns. The agency's solution, however, is generally more and better disclosure. Expressing the SEC's view, then SEC Chairman Arthur Levitt testified before Congress that "[t]he Commission should not be the arbiter of the appropriate level of fund fees. Whether fund fees are too high or too low is a question that we believe must be answered by competition in the marketplace, not by government intervention."⁸⁷⁰

The underlying premise of the Investment Act of 1940 is that regulations are required for investor protection since that fund investors cannot fend for themselves. The SEC has now assumed that informed demand-side market forces from investors are sufficient to discipline any supply-side excesses from the mutual fund industry. The question arises as to whether these investors are sufficiently informed or active to discipline the market using disclosed information. This question is also relevant for discipline of the Canadian mutual fund industry, since there is a belief that market regulation can be achieved through a disclosure mechanism. Recent attempts by the SEC to directly educate fund investors also reveal some awareness of investors' limitations. The SEC's investor profile is influenced significantly by industry comments and studies,

⁸⁷⁰ *Transparency in the United States Debt Market and Mutual Fund Fees and Expenses*: Hearings Before the H. Subcomm. on Finance and Hazardous Materials, Comm. on Commerce, (1998) (Transparency Hearings) (statement of Arthur Levitt, Chairman, SEC), available at <http://www.sec.gov/news/testimony/testarchive/1998/tsty1398.htm>. See also U.S. Gen. Accounting Office (GAO), *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition*, 7 (2000) (GAO, Mutual Fund Fees) ("Regulators rely on competition to be a primary means of influencing the fees that mutual fund advisors charge.").

and nearly oblivious to the findings of the academic literature on fund investor behavior.

4.8.3 ACADEMIC PROFILE

An extensive body of studies of investor behavior, conducted primarily by finance professors indicates that fund investors are “largely lost”⁸⁷¹. The findings of these finance studies indicate that investors are mostly ignorant of the basic characteristics of the funds that they own and that they regularly buy funds based on strong past performance. Further, investors pay insufficient attention to fund costs and are also unaware of their funds' riskiness, despite there being little correlation between high past and future returns.

Palmiter and Taha⁸⁷² indicate that mutual fund investors on the whole seem unable to perform the disciplining role that the industry says they do and that the SEC believes they can do. Investors in mutual funds have chosen to delegate management of their investment to a professional. But fund investors still must choose in which funds to invest. This section describes the findings of the academic literature and contrasts the investor profile that this literature reveals with the profiles advanced by the ICI and the SEC.

Most fund investors do not know even the basic characteristics of the mutual funds they own, based on the results of academic studies. A broad survey in 1991 found that mutual fund investors are “in general uninformed regarding the nature of their

⁸⁷¹ Palmiter and Taha, *supra* note 822.

⁸⁷² *Ibid.*

investments.”⁸⁷³ For instance, the results of the telephone survey of almost 3400 households that invest in mutual funds indicated that 72% of the respondents did not know whether their primary fund invests in domestic or international securities, and 75% did not know whether the fund invests in equity or fixed income securities. Even the ICI’s own survey conducted in 2006⁸⁷⁴ is consistent with these findings. Only 57% of investors that responded to an ICI survey indicated that they review the types of securities held by the fund before investing and only 40% said they review the fund’s investment objectives⁸⁷⁵. In the Capon, Fitzsimons and Prince’s survey, 39% of the respondents to the survey said they did not know whether their primary mutual fund had a load⁸⁷⁶. In a survey, sponsored by the SEC and the Office of the Comptroller of the Currency, of 2000 mutual fund investors, 57% admitted to not knowing the expense ratio of their primary fund even at the time they purchased it⁸⁷⁷. In this survey, 58% of respondents indicated that they reviewed a fund’s NAV before investing. A fund’s NAV, however does not indicate the fund’s merit and should be irrelevant to rational investors as the NAV is simply the value of the fund’s holdings divided by the number of fund shares outstanding. A fund can arbitrarily change its NAV for example by splitting its shares⁸⁷⁸. The survey

⁸⁷³ Capon, N., G. J. Fitzsimons & R. A. Prince, (1996). An individual level analysis of the mutual fund investment decision, 10 *Journal of Financial Services Research* 59, 77.

⁸⁷⁴ ICI, Investor Preferences, supra note 825.

⁸⁷⁵ ICI, Investor Preferences, Ibid., at 3, figure 1.

⁸⁷⁶ Capon et al., supra note 873, at 68.

⁸⁷⁷ Alexander, G. J., J. D. Jones & P. J. Nigro, (1998). Mutual fund shareholders: characteristics, investor knowledge, and sources of information, 7 *Financial Services Review* 301, 309 tbl.5.

⁸⁷⁸ The high percentage of investors who claim to consider the NAV also might be evidence that investors did not answer the ICI survey honestly. As discussed above, some investors might falsely claim to survey takers that they consider certain factors (such as NAV) before investing because they believe that good investors consider these factors. See ICI, Investor Preferences, supra note 874, at 10 fig.6. Even if investors

therefore revealed basic investor ignorance even about how mutual funds work. The respondents answers suggest that they are not financially sophisticated enough to realize that the NAV should be irrelevant to an investor. Again, it is not clear how the SEC and ICI believe that investors can regulate the market through disclosure of fund information.

Academic studies also suggest that fund investors generally are not aware of fund risks and do not take them seriously⁸⁷⁹. The results of a number of academic studies of investor behavior contradict the findings of the ICI survey which indicated that 61% of respondents reported reviewing a fund's risks before investing, making "fund risks" the third most reviewed information by investors⁸⁸⁰. Academic studies further indicate that fund investors consistently show a lack of understanding of and indifference to risk. One academic survey indicated that the majority of fund investors were not using standard measures of risk, such as beta⁸⁸¹ or the standard deviation of the fund's returns, in evaluating a fund⁸⁸². In another academic study, fund investors were asked to choose among hypothetical stock mutual funds differing in up to the following six characteristics: (1) the fund company's name; (2) the fund's load; (3) the fund's

are lying about considering a fund's NAV. The respondents' answer that they are not financially sophisticated enough to realize that the NAV should be irrelevant to an investor.

⁸⁷⁹ This conclusion is also shared by professionals who work with investors, for example, Jones, M.A., V. P. Lesseig, & T. I. Smythe, (2005). Financial advisors and mutual fund selection, 18 *Journal of Financial Planning* 64, 68 ("The consensus among most academics and practitioners is that individual investors largely ignore risk as a decision factor.").

⁸⁸⁰ ICI, Investor Preferences, *supra* note 825, at 3 fig.1.

⁸⁸¹ Beta is a measure of the correlation of a fund's returns with the stock market's returns, Carney, W. J. (2005). *Corporate Finance: Principles and Practice* 105-08.

⁸⁸² See for example, Guercio, D. & P. A. Tkac, (2002). The determinants of the flow of funds of managed portfolios: mutual funds vs. pension funds, 37 *Journal of Financial & Quantitative Analysis*, 523, 528 (2002) (noting that a survey of investors found that only 14% "said they use standard deviation to measure risk, 10% use beta, and only 4% use an alpha or Sharpe measure").

annual management fee; (4) the fund's return during the previous year; (5) the fund's average annual return during the previous ten years; and (6) the fund's beta⁸⁸³. In fact, the results of this study found that a fund's beta was the least important characteristic to investors where in fact it is more important than the funds previous returns which received a higher number of selections⁸⁸⁴.

Tracking error is a measure of diversifiable risk. A fund has less tracking error if its returns more closely match those of a relevant market benchmark. Mutual Fund investors, however, seem indifferent to tracking error in the selection of mutual funds⁸⁸⁵. Pension funds, which are run by managers who generally are much more sophisticated than most mutual fund investors, put less money in mutual funds with greater tracking error⁸⁸⁶. Del Guercio and Tkac examined fund flows into a large sample of equity mutual funds managed by a total of 483 fund managers in 352 different fund families⁸⁸⁷. They found that fund flow is not negatively related to the fund's tracking error. Instead of depending on the measure of fund flow used, they found that tracking error either had a statistically insignificant effect on fund flow or a statistically significant positive effect on fund flow⁸⁸⁸. Since tracking error is a measure of diversifiable risk, its lack of negative influence on fund flows is interpreted to indicate that mutual fund investors do not pay

⁸⁸³ Wilcox, R. T., (2003). Bargain hunting or star gazing? Investors' preferences for stock mutual funds, 76 *Journal of Business* 645, 648.

⁸⁸⁴ Ibid., p. 650, Fig.1.

⁸⁸⁵ Del Guercio & Tkac, *supra* note 882 161, at 525.

⁸⁸⁶ Del Guercio & Tkac, Ibid.

⁸⁸⁷ Ibid., at 533.

⁸⁸⁸ Ibid., at 539.

attention to whether a fund reduces even diversifiable risk. This suggests that mutual fund investors are not sophisticated with respect to diversifiable risks in their selection of funds.

Many investors use published fund ratings or rankings from third parties such as those from Morningstar that often incorporate some measure of risk even though they do not carefully consider a fund's risk. A survey by the ICI found that 35% of investors review a fund's rating from a mutual fund rating service before purchasing the fund, and of these 19% call it "very important" with respect to their final decision to invest⁸⁸⁹. Thus, perception of risk may be considered by investors' behavior⁸⁹⁰. However, reliance on third-party advice does not appear to increase investors' sensitivity to fund risk. While there is a positive relationship between flow and funds' risk-adjusted returns, it is not as strong as the relationship between flow and non-adjusted returns⁸⁹¹. In general, fund investors do not seem to understand or take into account fund risk and that they ignore standard measures of fund risk and risk does not have a substantial impact on their choice of funds. Fund investors tend to focus on past returns rather than risk despite the central tenet of investing that past performance is no guarantee for future performance.

Fund investors pay too little attention to fund fees and expenses, particularly the regular costs that funds incur, such as management fees; and studies of the actual

⁸⁸⁹ ICI, *Investor Preferences*, supra note 825, at 10 fig.6.

⁸⁹⁰ Del Guercio & Tkac, supra note 882, at 525 (finding evidence that the positive relationship between fund flow and Jensen's alpha—a risk-adjusted performance measure—is due to a high correlation between Jensen's alpha and "widely available summary performance measures, such as Morningstar's star rating").

⁸⁹¹ *Ibid.*

knowledge and behavior of investors show that fund fees and expenses matter little to many investors⁸⁹². In contrast, 74% of the respondents in the ICI survey indicated that they review fund fees and expenses before investing, with this being the most commonly reviewed information⁸⁹³. In a survey, sponsored by the SEC and the Office of the Comptroller, of 2000 randomly-selected mutual fund investors, only 19% of those surveyed could give even an estimate of the expenses of their largest mutual fund holding⁸⁹⁴. Only 43% of respondents claimed to have known the fund's expenses at the time they first purchased it⁸⁹⁵.

Wallison and Litan surveyed mutual fund investors and asked them to rate (on a scale of one to ten) how informed they were about their own mutual fund investments⁸⁹⁶. Only 21% of those investors rated their knowledge highly (eight or above), while fewer than 10% of even that self-described knowledgeable subgroup "knew even approximately what they were paying as an advisory fee."⁸⁹⁷ An academic survey of mutual fund investors⁸⁹⁸ asked them to rate the importance of nine particular factors in choosing a

⁸⁹² Palmiter and Taha, *supra* note 822.

⁸⁹³ ICI, *Investor Preferences*, *supra* note 825, p. 3, fig.1.

⁸⁹⁴ Gordon et al, *supra* note 873, 301, 309 tbl.5 (1998).

⁸⁹⁵ *Ibid.*

⁸⁹⁶ Wallison, P. J. & R. E. Litan, (2007). *Competitive Equity: a Better Way to Organize Mutual Funds*. 72-73.

⁸⁹⁷ *Registration Form Used by Open-End Management Investment Companies*, 62 Fed. Reg. at 10,900 ("The prospectus is intended to provide information about matters of fundamental importance to most investors."); *Registration Form Used by Open-End Management Investment Companies*, 63 Fed. Reg. 13,916, 13,919 (Mar. 28, 1998) (to be codified at 17 C.F.R. pt. 230, 232, 239, 240, 270, 274) ("Funds should limit disclosure in prospectuses generally to information that is necessary for an average or typical investor to make an investment decision.")

⁸⁹⁸ Capon et al, *supra* note 873.

mutual fund⁸⁹⁹. The ratings could range from one ("not at all important") to five ("extremely important"). The respondents gave management fees an average rating of only 2.28, thus ranking it only fifth among the nine factors⁹⁰⁰. An academic study by Wilcox asked fund investors to choose among hypothetical stock mutual funds that differed in up to six characteristics⁹⁰¹. Investors chose the fund's management fee as the fourth most important factor, ahead only of the fund's load and its beta⁹⁰². The results of these studies indicate that fund investors pay little attention to fund fees and expenses, and are in contrast to those of the ICI survey.

A possible reason for the discrepancy is the difference in the questions asked. The ICI survey asked whether the investor "reviewed" a fund's fees and expenses before investing, while the Capon et al survey and the Wilcox study asked how "important" the fund's fees were to the investor in choosing a fund. Accordingly, investors could review a fund's fees before investing, yet not give them much weight and be consistent with the survey results. However, as noted by Palmiter and Taha⁹⁰³, this difference would not reconcile the ICI survey's findings with the finding of the SEC survey which indicated that less than half of investors knew their largest fund's expenses when they purchased

⁸⁹⁹ Ibid.

⁹⁰⁰ Id. The other factors were, in order of decreasing importance, the fund's investment performance track record, fund manager reputation, number of funds in the family, responsiveness to inquiries, investment management style, additional features (checking, brokerage), confidentiality, and community service/charity record. Ibid.

⁹⁰¹ Wilcox, *supra* note 883, p. 649, tbl.1.

⁹⁰² Ibid., p. 650, fig.1. The other fund characteristics were the fund company's name, the fund's return during the previous year, and the fund's return during the previous ten years.

⁹⁰³ Palmiter and Taha, *supra* note 822.

the fund. Regardless, the results of the studies indicate that investors do not place weight on fees in their selection of mutual funds even if they do review them first in a cursory manner. The above surveys generally show that most investors are unaware of their funds' expense ratios and that expenses do not greatly affect their fund choices. There is evidence that some fund investors do care about expenses in making investment decision. The studies have mixed results as to whether funds with lower expenses receive more flow overall.

Barber, Odean, and Zheng's examination of diversified U.S. equity mutual funds from 1970 to 1999, examined the mutual fund purchases and sales made by customers of a large discount broker from 1991 to 1996. They found "at best, no relation between operating expenses and flows and, at worst, a perverse positive relation between expenses and flows for large funds."⁹⁰⁴ It was found that the operating expenses of the purchased funds were generally higher than those of the funds that were sold, indicating that investors do not switch funds to reduce the expenses they are paying⁹⁰⁵.

Sirri and Tufano, in a study of equity mutual funds⁹⁰⁶ from 1971-1990 found that reductions in expenses have a strong positive effect on flow, but also found that increases in expenses have a marginally significant positive effect on flow as well. Other studies found that investor demand for mutual funds is elastic with respect to fund expenses-that

⁹⁰⁴ Barber, B. B., T. Odean & L. Zheng, (2005). Out of sight, out of mind: the effects of expenses on mutual fund flows, 78 *Journal of Business* 2095, 2107.

⁹⁰⁵ Ibid., p. 2116

⁹⁰⁶ Sirri, E. R., & P. Tufano, (1998). Costly search and mutual fund flows, 53 *Journal of Finance* 1589, 1606-07 tbl.IV, 1612.

is, overall, fund investors are sensitive to expenses⁹⁰⁷. Additionally, a study found a negative relationship between flows and a fund family's average expense ratio, as opposed to the expense ratios of particular funds in the family⁹⁰⁸. Another study found that lower expenses resulted in higher market share for a fund family only if the family already had high expenses; expenses did not affect the market share if the fund family had low expenses⁹⁰⁹. One study found that the elasticity has been increasing recently, suggesting that investors may be becoming more sensitive to expenses⁹¹⁰.

The mutual fund industry has large economies of scale and the size of funds and fund families has grown dramatically. Academic studies and other research find that as mutual fund assets grow, mutual fund advisors experience operational efficiencies or economies of scale that would allow them to reduce their funds' expense ratios. Coates and Hubbard⁹¹¹ observe that studies have failed to find consistently that expense ratios have declined in recent decades⁹¹². A SEC study in 2000 found that the weighted average

⁹⁰⁷ Zhang, A. (2007). Mutual fund expense ratios in market equilibrium, (July 20, 2007) (unpublished manuscript, available at <http://ssrn.com/abstract=1010544>).

⁹⁰⁸ Gallaher, S., R. Kaniel & L. Starks, (2006). Madison Avenue meets Wall Street: mutual fund families, competition and advertising (Jan. 2006) (unpublished manuscript, available at <http://ssrn.com/abstract=879775>).

⁹⁰⁹ Ajay Khorana & Henri Servaes, (2004). Conflicts of interest and competition in the mutual fund industry (July 2004) (unpublished manuscript, available at <http://ssrn.com/abstract=240596>).

⁹¹⁰ Zhang, *supra* note 907 p. 21.

⁹¹¹ Coates, J. C. IV & R. G. Hubbard, (2007). Competition in the mutual fund industry: evidence and implications for policy, 33 *Journal of Corporation Law* 151.

⁹¹² Coates & Hubbard, *Ibid.*, at 175, tbl.6; GAO, Mutual Fund Fees, *supra* note 870, at 9 ("Academic studies and other research find that as mutual fund assets grow, mutual fund advisors experience operational efficiencies or economies of scale that would allow them to reduce their funds' expense ratios.")

expense ratio for equity and bond funds rose from 0.73% in 1979 to 0.94% in 1999⁹¹³. This suggests that investors seem not to have had a great disciplining effect on expenses despite the ease with which fund investors may move from one fund to another.

The studies examined by Coates and Hubbard⁹¹⁴ came to mixed results with respect to overall fund costs (loads and expenses), although noting a decline in total investor costs. The overall costs to fund investors declined from the 1970s to the 1990s when loads are added to operating expense ratios (not taking into account trading costs). Khorana and Servaes, for example, found that total costs (calculated as the weighted average expense ratio plus one-seventh of front-and back-end loads) fell from 1.40% in 1979 to 1.19% in 1998⁹¹⁵. Another study found that weighted average total costs for S&P 500 index funds rose from 0.27% in 1995 to 0.32% in 2000⁹¹⁶. Another study⁹¹⁷ found that 12b-1 fees rose from 0.14% in 1993 to 0.20% in 1999. These studies do not reach uniform conclusions on whether mutual fund costs have declined as the industry has grown. Thus, Coates and Hubbard's thesis that the mutual fund market is competitive because fund investors can and do move to lower-cost funds is not supported by much of the evidence they cite. Although investors have moved away from funds that charge loads they have not exercised the same discipline with respect to ongoing management

⁹¹³ SEC, Division of Investment management, Report on Mutual Fund Fees and Expenses, at § III(c)(2), accessed at: <http://www.sec.gov/news/studies/feestudy.htm>

⁹¹⁴ Coates and Hubbard, *supra* at 911.

⁹¹⁵ Khorana & Servaes, *supra* note 909 p. 19

⁹¹⁶ Hortaqsu, A. & C. Syverson, (2004). Product differentiation, search costs, and competition in the mutual fund industry: a case study of S&P 500 Index Funds, *Quarterly Journal of Economics* 403, 409 tbl.2.

⁹¹⁷ Barber et al., *supra* note 904 pp. 2108-10.

expenses and 12b-1 fees. That is, there may be price competition with respect to highly-salient loads, but competition is much weaker with respect to less visible, ongoing fund costs.

Index funds are funds that attempt to match, rather than beat, the returns of a particular market index, such as the S&P 500⁹¹⁸. The management fees of index funds can be very low since, unlike actively managed funds, they need not incur stock-picking research expenses, since they buy a portfolio of stocks that track the reference index⁹¹⁹. Index funds also buy and sell securities far less often than most actively managed funds, resulting in much lower transaction costs related to turnover⁹²⁰. As a result, the expenses of index funds are generally lower than those of actively managed funds.

The growth of index funds over the past thirty years provides evidence that a subset of investors is sensitive to fund expenses⁹²¹. The growth of index funds may reflect the increasing attention to the benefits of index funds in popular financial media, which indicated that generally outperform actively managed funds. For example, popular publications such as Money magazine and the "Getting Going" column in The Wall Street Journal have frequently touted the wisdom of buying index funds⁹²². This media

⁹¹⁸ Tamar Frankel & Ann Taylor Schwing, (2008).The regulation of money managers: mutual funds and advisors § 31.02 [j]

⁹¹⁹ Malkiel, B.G., (2007). *A Random Walk Down Wall Street*, 9th ed.

⁹²⁰ Ibid.

⁹²¹ Ibid., p. 359

⁹²² See, e.g., Penelope Wang & Walter Updegrave, Funds for the long run, Money, Feb. 1, 2008, at 69 (recommending that "index funds are the ideal foundation for your core portfolio"); Jonathan Clements,

message appears to be getting through to some investors based on the growth of index funds.

For example, index funds first became available in 1976, and by 1999 they grew to hold 10% of equity mutual fund assets⁹²³. The market share of index funds, however, has remained stable since then⁹²⁴ and popularity of index funds has therefore reached a plateau. This small market share of these indicates that cost-sensitive investors remain a weak market force, at best⁹²⁵. The existence of index funds indicates that some investors are sensitive to fund expenses. In contrast, the continued success of high-cost index funds further suggests that many investors continue to disregard fund expenses. A study by Elton, Gruber and Busse of flows into different S&P 500 index funds from 1996 to 2001, for example, found that investors were not moving away from high-expense index funds. Instead, it found that "a large amount of new cash flow goes to the poorest-performing funds."⁹²⁶

Although an investor might buy a high-cost actively-managed fund believing that the fund manager's stock-picking skills will more than compensate for the higher expenses, buying a high-cost index fund makes little sense. Index funds do not attempt to

Getting going, Wall Street Journal, Feb. 16, 2005, at D1 (noting that index funds regularly outperform most actively managed funds).

⁹²³ Bogle, J.C., (2007). Reflections on "toward common sense and common ground?", 33 *Journal of Corporation Law* 31, 34.

⁹²⁴ Ibid.

⁹²⁵ Palmiter and Taha, *supra* note 822.

⁹²⁶ Elton, E.J., M.J. Gruber, and J.A. Busse, (2004). Are investors rational? Choices among index funds, *Journal of Finance*, Vol. 59, No. 1, February 2004.

pick high-performing securities but rather just track the performance of a specific market index and an index fund manager's stock-picking skill is irrelevant. A rational index fund investor should buy the index fund that has the lowest expense ratio because all index funds hold essentially the same securities. This is evidenced by the fact that index funds typically out-perform actively managed funds. Therefore, the continued success of mutual funds with high fees indicates that investors are not sensitive to high fees, since these typically produce lower yields than index funds which are well advertised. Additionally, this indicates that mutual fund investors have not significantly disciplined the market with respect to management fees.

According to academic literature the SEC and the fund management industry, through its trade association the ICI, portrays fund investors as diligent and fairly sophisticated. The authors note that the ICI indicates that investors consider relevant fund characteristics, including fund fees and expenses, and consult multiple sources of information before choosing a mutual fund. The ICI regularly states in its public statements, that mutual funds operate in a highly competitive market driven by millions of investors clamoring for low fees and high performance and this comparison serves to regulate the market⁹²⁷. The ICI further indicates that to assist investors in choosing among funds, the industry supports providing investors with simplified and standardized

⁹²⁷ Ibid.

disclosure of information about funds⁹²⁸.

The SEC believes that investors greatly benefit from simplified and standardized disclosure similar to the position of the ICI⁹²⁹. The SEC has expressed concern that some investors pay too little attention to fund fees and expenses while paying too much attention to past returns⁹³⁰. The SEC has taken some limited and cautious steps to better educate and inform investors about how to make fund choices. Palmiter and Taha⁹³¹ hold that the SEC, in its regulatory policy, paints a portrait of mutual fund investors similar to that of the ICI. The SEC claims that investors consider much relevant information before investing in a fund.

According to Palmiter and Taha⁹³², the academic literature over the last decade paints a much less favorable portrait of fund investors than the ICI or SEC. Empirical studies of actual investor behavior-studies, conducted mostly by finance professors, find that fund investors generally are uninformed and lack financial sophistication. The portrayal in academic literature is in stark contrast to the portrayal of investors by the ICI and SEC. These academic studies find that most fund investors are unaware of the investment objectives, composition, and risks of their funds⁹³³. These academic studies further find that most investors are also ignorant of the level of fees and expenses charged

⁹²⁸ Ibid.

⁹²⁹ Ibid.

⁹³⁰ Ibid.

⁹³¹ Ibid.

⁹³² Ibid.

⁹³³ Ibid.

by their funds, and these costs are often not a significant factor in their fund choices⁹³⁴. Most fund investors instead base their purchase decisions on funds past performance, despite little evidence that high past returns predicts high future returns. In addition, although many investors use financial advisors, little evidence exists that the advisors help investors to make better fund choices⁹³⁵.

The ICI and the SEC, accordingly to Palmiter and Taha, barely acknowledge the existence of this large body of academic research. Although the ICI has sometimes sought to refute some specific academic findings, it is generally silent with respect to these studies⁹³⁶. The SEC has also generally disregarded the academic literature on investors⁹³⁷. Instead SEC rulemaking releases often cite to ICI research and comment letters, particularly with respect to the information needs of fund investors⁹³⁸.

Palmiter and Taha note that there is overwhelming evidence of investors' limitations and of their inability to protect their own interests, lending support to a key premise of the 1940 Act regulatory regime. This evidence, however, is disregarded by the industry that purports to serve fund investors and by the regulator charged with responding to market failure. The authors state that "Although the industry trumpets the "fiercely competitive" market in which it operates and the SEC extols the virtues of

⁹³⁴ Ibid.

⁹³⁵ Ibid

⁹³⁶ Ibid.

⁹³⁷ Ibid.

⁹³⁸ Ibid.

competition, the evidence shows that fund investors lack the knowledge and financial sophistication to sufficiently discipline the mutual fund industry.”⁹³⁹ The authors argue that policymakers should pay greater attention to fund investors' ignorance and limitations. The authors further argue that recent efforts by the SEC to educate investors and to improve mutual fund disclosure fail to recognize the extent of investors' limitations. The authors conclude that these efforts are unlikely to significantly improve investors' ability to pursue their own interests and, in doing so, to provide important market discipline over mutual funds.

Regulation of the mutual fund industry, according to the Palmiter and Taha⁹⁴⁰, has been strongly influenced by the portrayal of investors by the ICI and SEC as sophisticated and informed, and capable of both using disclosed financial information to assist in their investment decisions and disciplining the mutual fund industry. The ICI often provides input regarding the regulation of mutual funds to Congress, the SEC, and other regulatory organizations as part of its role as national trade association of the U.S. mutual fund industry. The ICI has consistently maintained that the mutual fund industry is highly competitive, with fund choices, services, and fees determined by a robust market of sophisticated and informed mutual fund investors. The ICI has asserted that fund investors seek out and examine important fund information before investing, including the fund's investment objectives, fees and expenses, historical performance and risks, based on the results of a 2006 ICI-sponsored survey of investors who had

⁹³⁹ Ibid.

⁹⁴⁰ Ibid.

purchased mutual funds outside of retirement plans. This survey portrays mutual fund investors as generally knowledgeable and well-advised, leaving little need for greater regulation of the industry.

In its publications, speeches by its officials, and comments to the SEC, the ICI has regularly supported simplifying and standardizing required disclosure by mutual funds and that implicit in these statements is some recognition of investors' limitations⁹⁴¹. Profiles of U.S. mutual fund investors have been developed based on survey results from the ICI. While there has been no comparable survey conducted in Canada, the ICI survey can be used to shed light on mutual fund investors in Canada which operate within a comparable industry with comparable regulatory requirements.

4.9 MUTUAL FUND DISCLOSURE AND ADVERTISING

The intention of the SEC is that the fund prospectus be the primary source of information for investors choosing a fund, as expressed by its statement "The Commission regards the prospectus as an investor's primary source of information about a fund."⁹⁴² By law in the United States, a prospective fund investor must be provided with a fund's prospectus before or at the time that the investor purchases fund shares⁹⁴³. The SEC requires that fund advertisements explicitly direct investors to the prospectus,

⁹⁴¹ Palmiter and Taha, *supra* note 822.

⁹⁴² *Registration Form Used by Open-End Management Investment Companies*, 62 Fed. Reg. 10,898, 10,900 (Mar. 10, 1997) (to be codified at 17 C.F.R. pt. 230, 239, 270, 274) ("The Commission regards the prospectus as an investor's primary source of information about a fund."); see also, SEC, *Invest Wisely*, *supra* note 1 ("The prospectus is the fund's selling document. ")

⁹⁴³ Securities Act of 1933 § 5(b)(2), 15 U.S.C. § 77e(b)(2) (2006).

and must explain that the prospectus contains information about the fund, identify where investors can obtain the prospectus, and warn that "the prospectus should be read carefully before investing."⁹⁴⁴

The SEC further recognizes that investors vary in sophistication and as such seek different types and amounts of information before buying a mutual fund⁹⁴⁵. Different investors prefer different amounts of information before making an investment decision and use different types and amounts of materials in determining whether to invest in funds. The target audience for the prospectus, in the view of the SEC, is the typical investor⁹⁴⁶. The prospectus is intended to provide information about matters of fundamental importance to most investors. It is the SEC's position that funds should limit disclosure in prospectuses generally to information that is necessary for an average or typical investor to make an investment decision. The required content of the disclosures in the prospectus therefore reflect the SEC's view of the abilities and limitations of the typical mutual fund investor. It is the position of the Palmiter and

⁹⁴⁴ *Amendments to Investment Company Advertising Rules*, 68 Fed. Reg. 57,760, 57,777 (Oct. 6, 2003) (to be codified at 17 C.F.R. pt. 230,239,270, 274).

⁹⁴⁵ *Registration Form Used by Open-End Management Investment Companies*, 62 Fed. Reg. at 10,900 ("Different investors prefer different amounts of information before making an investment decision, and regulatory requirements should not foreclose options that respond to prospective investors' information needs."); *New Disclosure Option for Open-End Management Investment Companies*, 63 Fed. Reg. 13,968, 13,970 (Mar. 23, 1998) (codified at 17 C.F.R. pt. 230, 270) ("Different investors desire and use different types and amounts of materials in determining whether to invest in funds.")

⁹⁴⁶ *Registration Form Used by Open-End Management Investment Companies*, 62 Fed. Reg. at 10,900 ("The prospectus is intended to provide information about matters of fundamental importance to most investors."); *Registration Form Used by Open-End Management Investment Companies*, 63 Fed. Reg. 13,916, 13,919 (Mar. 28, 1998) (codified at 17 C.F.R. pt. 230, 232, 239, 240, 270, 274) ("Funds should limit disclosure in prospectuses generally to information that is necessary for an average or typical investor to make an investment decision.")

Taha⁹⁴⁷ that the simplified form and content of the prospectus suggests that most investors are not capable of understanding sophisticated information and hence must not be sophisticated.

4.9.1 Streamlined Disclosure

The SEC has simplified the prospectus strategy that this fits with the knowledge of investors and only provides fundamental information. The SEC has acknowledged that most investors "may not be sophisticated in legal or financial matters"⁹⁴⁸ and has recognized that most investors are less likely to read a prospectus that is difficult to understand⁹⁴⁹. The SEC has therefore tried to simplify the prospectus to be less technical and easier to read for investors as expressed in their goal to streamline prospectus disclosure requirements to focus on essential information about a particular fund and make the prospectus less technical and easier to read⁹⁵⁰.

The SEC has endeavored to make the prospectus more accessible to fund investors by moving more complicated and detailed information out of the prospectus to another document. The SEC adopted a two-part disclosure format in 1983 under which investors receive a simplified prospectus designed to contain essential information about a fund. Investors can also obtain a Statement of Additional Information (SAI) that

⁹⁴⁷ Palmiter and Taha, *supra* note 822.

⁹⁴⁸ SEC, *Form N-1A*, at General Instruction C(1)(b), accessed at: <http://www.sec.gov/about/forms/formn-1a.pdf>

⁹⁴⁹ *Registration Form Used by Open-End Management Investment Companies*, 62 Fed. Reg. at 10,900 ("A prospectus ...is not useful to investors if it is in a form that discourages investors from reading it.").

⁹⁵⁰ *Ibid.*

contains "more extensive information and detailed discussions of matters included in the prospectus upon request"⁹⁵¹. The SEC intended the prospectus to include only fund information that would be used by "typical or average investors" and the Statement of Additional Information to contain information of interest only to "sophisticated investors"⁹⁵². Therefore, the contents of the prospectus reflect the SEC's view of what information is useful to the "typical" mutual fund investor⁹⁵³ which states the prospectus disclosure requirements are intended to elicit information for an average or typical investor who may not be sophisticated in legal or financial matters⁹⁵⁴.

The SEC docs does not require the prospectus to provide any comparative information on performance, loads, fees, expenses or portfolio turnover except for the returns of an "appropriate" market index. Fund investors must search elsewhere for how a particular fund compares to others and the prospectus has to suggest any sources such as Morningstar for comparative information⁹⁵⁵. The SEC instead assumes fund investors can determine how a fund's performance and costs compare to those of other funds. Given the lack of information on the management of expenses and other pertinent information, such as performance, in the prospectus it is highly questionable as to

⁹⁵¹ Ibid. at 10, 899.

⁹⁵² *Registration Form Used by Open-End Management Investment Companies*, 63 Fed. Reg. 13,916, 13,917.

⁹⁵³ SEC, *Form N-1A*, supra note 948, at General Instruction C(1)(b). ("The prospectus disclosure requirements .. are intended to elicit information for an average or typical investor who may not be sophisticated in legal or financial matters.").

⁹⁵⁴ Ibid. at Items 2, 4.

⁹⁵⁵ Morningstar, Inc. compiles detailed information about particular mutual funds and other securities. Data accessed at: <http://www.morningstar.com>.

whether disclosure in this media could afford a significant degree of market protection.

The SEC does not require that the prospectus educates investors about diversification, long-term returns of various asset classes risk, or the relationship of risk and return. By not requiring such information in the prospectus, the SEC is at least implicitly assuming that most investors already know or do not need this information, or that it would not be understood by them. Alternatively, it may be interpreted that undecided investors remain uneducated and in this case, not be able to effectively regulate the market through disclosure, since they would not be able to understand the disclosed information.

The SEC's rules regarding fund profiles offer additional insight into what the SEC perceives as the information needs of most investors. In 1998 the SEC amended its rules to allow investors to buy mutual fund shares without having first received a prospectus, providing that they had received a fund profile in advance⁹⁵⁶. The SEC required that the fund profile summarize the key information that is contained within the prospectus and must contain specific information concerning the fund fees and expenses.

When the SEC proposed the fund profile, it received several suggestions from third parties that additional information such as information on portfolio holdings,

⁹⁵⁶ An investor who bought the fund on the basis of the profile, however, is still required to receive the prospectus with the confirmation of their purchase. *New Disclosure Option for Open-End Management Investment Companies*, 63 Fed. Reg. 13,968.

investment style, and risk measures also be required in the profile⁹⁵⁷. While acknowledging the information might be "of interest to some fund investors," the SEC rejected its inclusion as "not necessarily essential information for the average or typical investor."⁹⁵⁸ Again, this is an indication that the SEC did not consider fund data that would be routinely used by fund managers as suitable for average investors.

The SEC proposed in November 2007 to "provide investors with streamlined disclosure of key mutual fund information at the front of the statutory prospectus, in a standardized order that facilitates comparisons across funds as part of its effort to improve the disclosure that fund investors receive."⁹⁵⁹ The SEC proposed that the risk/return summary currently at the front of mutual fund prospectuses be the "centerpiece" of the new summary section. The summary section would contain the following information about the fund, in a fixed order⁹⁶⁰:

- costs (including a fee table and an example)
- principal investment strategies, risks, and performance (including the current risk/return bar chart and a table showing the fund's past performance and the volatility of its returns)

⁹⁵⁷ The suggested additional information included "a fund's top ten portfolio holdings; an investment style box; additional measures of risk; and financial highlights." *New Disclosure Option for Open-End Management Investment Companies*, 63 Fed. Reg. 13,968, 13,972.

⁹⁵⁸ *Ibid.*

⁹⁵⁹ *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies*, 72 Fed. Reg. 67,790, 67,793 (Nov. 30, 2007) (codified at 17 C.F.R. pt. 230, 232, 239, 274).

⁹⁶⁰ *Ibid.*, pp. 67,794-95.

- information regarding the purchase and sale of fund shares
- information about taxes resulting from fund
- distributions of financial intermediary compensation⁹⁶¹.

Some modifications were made to the risk/return summary to "address concerns that investors do not understand that they pay ongoing costs every year when they invest in mutual funds."⁹⁶² In the current risk/return summary for example, the heading "Annual Fund Operating Expenses" in the fee table is followed by the parenthetical "expenses that are deducted from Fund assets." The revised summary section would replace that statement with the more understandable words "ongoing expenses that you pay each year as a percentage of the value of your investment."⁹⁶³ The requirements for costs do require a fee table and the turnover of the portfolio through purchase and sale of funds shares. It also requires the disclosure of distribution to financial intermediaries such as sales agents.

In addition, the SEC's proposal would replace the fund profile with a Summary Prospectus that contains the same information (in the same order) that would be in the

⁹⁶¹ Investors are warned that if they purchased their fund shares through an intermediary and that intermediary receives compensation for the sale of the shares, that compensation may bias the intermediary's advice to the investor. *Ibid.* at 67,798.

⁹⁶² *Ibid.*, pp. 67,795.

⁹⁶³ *Ibid.*

new summary section of the full, statutory prospectus⁹⁶⁴. Investors are permitted by the SEC to buy a fund after having received just the Summary Prospectus, as long as the statutory prospectus is available online⁹⁶⁵. While this revision does draw the investor's attention to the expenses, it does not provide guidelines to the investor for selecting funds. In addition, the disclosure of these parameters is at the prospectus stage and there is not continuous disclosure of these to mutual investors.

The SEC like the ICI believes that a variety of information is important to most mutual fund investors. Like the ICI, the SEC also believes that if investors are provided with too much information they are unlikely to read it. Accordingly, the SEC has adopted measures to summarize and reduce the information that investors receive in certain disclosure documents. It is of note that the SEC has not provided any substantiation to their belief that investors would not read additional information. Further, it assumes that all investors are same in their abilities to understand financial information.

4.9.2 Standardized Disclosure

The SEC believes that a standardized format of information, as well as its substance, is important to investors. It believes in particular that fund investors are more likely to understand clear, concise, and standardized disclosure of information in plain

⁹⁶⁴ Ibid., pp. 67,800.

⁹⁶⁵ If requested by an investor, the fund would also have to send a copy of full, statutory prospectus by regular mail or email. Ibid. at 67,792.

English or in graphical or tabular form⁹⁶⁶. As a result, the prospectus and fund profile are required to contain much summarized information in standardized tables and graphs.

The SEC for example, has required the fund prospectus to include a fee table itemizing all fees and expenses in a uniform way since 1988 since it believes this can be understood easily and facilitates comparison among funds⁹⁶⁷. This requirement arose from the SEC's concern that investors could be confused if the increasing variety of sales loads and other fund distribution arrangements were not uniformly presented⁹⁶⁸. The fee table must also be accompanied by a listing of the dollar amount of fees and expenses that investors would pay over one, three, five, and ten year periods if they invested \$10,000 in the fund and received a 5% annual return⁹⁶⁹. The prospectus must also contain a standardized graph and table of the fund's historical returns. A bar chart must show the fund's annual returns during each of the last ten calendar years. In addition, the fund's average annual returns over the previous one, five, and ten calendar years must be presented in the table⁹⁷⁰. The table must also show the returns of an appropriate broad-

⁹⁶⁶ *Registration Form Used by Open-End Management Investment Companies*, 62 Fed. Reg. at 10,900 (stating "Investors have expressed a strong preference for summary information about funds in a standard format.").

⁹⁶⁷ SEC, Fees and Expenses Report, *supra* note 913, § II(A)(2) (2000). The table itemizes front and back-end loads, management fees, 12b-1 fees, and other fees and expenses. SEC Form N-1A, *supra* note 948, at Item 3.

⁹⁶⁸ SEC Fees and Expenses Report, *supra* note 913, at § II(A)(2).

⁹⁶⁹ SEC Form N-1A, *supra* note 948, at Item 3.

⁹⁷⁰ The fund's returns before taxes, returns after taxes on distributions, and returns after taxes on distributions and sale of fund shares must each be presented in the table. *Ibid.*, at Item 2.

based securities market index for the same periods⁹⁷¹.

According to the SEC, this bar chart and table serve multiple purposes. First, they help inform investors about the fund's past returns, in absolute terms and relative to an appropriate index. Standardizing the presentation of past returns also facilitates investor comparison of the returns of other mutual funds-subject to the boilerplate caution that "the Fund's past performance (before and after taxes) is not necessarily an indication of how the Fund will perform in the future."⁹⁷² The SEC also seeks to have the prospectus convey the volatility of the fund's returns. The prospectus is therefore required to include an explanation of how the bar chart and table of the fund's past returns that illustrate:

"the variability of the Fund's returns (e.g., by stating that the information provides some indication of the risks of investing in the Fund by showing changes in the Fund's performance from year to year and by showing how the Fund's average annual returns for one, five, and ten years compare with those of a broad measure of market performance)."⁹⁷³

In 1998, the SEC initiated a requirement for the front part of prospectuses to include a risk/return summary, which is intended to function as executive summary of key information about the fund⁹⁷⁴. The summary includes the fund's investment

⁹⁷¹ Ibid.

⁹⁷² Ibid.

⁹⁷³ Ibid.

⁹⁷⁴ Transparency Hearings, *supra* note 870 (statement of Arthur Levitt).

objectives or goals, its principal investment strategies, the fee table, and the bar chart and table showing past returns⁹⁷⁵. The SEC's belief that investors are more likely to read prominently placed information reflected by the placement of the summary at the beginning of the prospectus⁹⁷⁶. Recognizing that comparing funds can be difficult, the SEC has strived to make the information in the current disclosure documents more accessible to investors. In June 2007, the SEC allowed mutual funds to file information in the risk/return summary of their prospectuses as interactive electronic data. Investors are able to access this information using software and compare it across different mutual funds much more quickly than if they had to collect the data from traditional prospectuses⁹⁷⁷.

The SEC has specifically stated that investors are more likely to understand disclosure documents written in plain English⁹⁷⁸. In 1998, to make prospectuses and fund profiles easier for investors to understand, the SEC adopted a "Plain English Rule," which explicitly requires that a prospectus's cover page, risk/return summary, and risk

⁹⁷⁵ SEC, Form N-1A, *supra* note 948, at Item 2.

⁹⁷⁶ Transparency Hearings, *supra* note 870 (statement of Arthur Levitt) (requiring the fee table to be in the risk/return summary and stating that this "reflects the Commission's commitment to promoting investors' access to fee information as a basis for a fund investment decision").

⁹⁷⁷ Rachel McTague, R. (2007). *Mutual Funds: SEC to Allow Use of Interactive Data By Mutual Funds to Submit Risk/Return Info*, 39 Securities Regulation & Law Report 986 (June 25, 2007) (stating that information filed as interactive data "will be tagged using eXtensible Business Reporting Language, or XBRL, so that it can be manipulated through the use of software tools to cull out specified information, such as cost data, for example.")

⁹⁷⁸ SEC, *Plain English Disclosure*, 63 Fed. Reg. 6,370, 6,371 (Feb. 6, 1998) (codified at 17 C.F.R. pt. 228, 229, 230, 239, 274). ("Preparing documents in plain English increases investors' understanding and helps them make informed investment decisions."). See also, SEC, *A Plain English Handbook: How to Create Clear SEC Disclosure Documents*, 3 (Aug. 1998), accessed at: <http://www.sec.gov/pdf/handbook.pdf> (Plain English Handbook) (stating that "The benefits of plain English abound. Investors will be more likely to understand what they are buying and to make informed judgments about whether they should hold or sell their investments.")

factors section be written in "plain English"⁹⁷⁹. The SEC summarized the plain English rule as requiring that, in these sections of the prospectus, issuers use "short sentences; definite, concrete, everyday language; active voice; tabular presentation of complex information; no legal or business jargon; and no multiple negatives" and requiring that these sections be designed "to make them inviting to the reader."⁹⁸⁰ To assist with issuers complying with the new rule, the SEC also produced an 83-page 'Plain English Handbook' with specific guidelines on how to write in plain English⁹⁸¹. The fact that SEC is requiring plain English suggests a view of their investors as not highly sophisticated. It is not clear how this requirement is consistent with their view of mutual fund investors as being sophisticated.

The content requirements of the prospectus and fund profile reflect the SEC's views regarding which fund characteristics are pertinent to the majority of mutual fund investors and largely mirror those of the ICI. The SEC's requirements regarding the format of the information also reflect the SEC's belief, shared by the ICI, that how the information is presented affects whether investors will read and understand it, leading to the adoption of standardized disclosure formats and plain English rules.

The SEC has not ensured that it is really helping investors understand their fund investment choices despite its awareness of investors' difficulties in processing

⁹⁷⁹ Although the plain English requirement applies only to certain parts of the prospectus, the entire prospectus is required to be "clear, concise, and understandable." *Plain English Disclosure*, 63 Fed. Reg. 6,370, 6,371.

⁹⁸⁰ *Ibid.* at 6,370.

⁹⁸¹ See *Plain English Handbook*, *supra* note 978.

information. In the 1998 prospectus disclosure rulemaking, for example, the SEC acknowledged that an ICI survey found that about half of fund investors do not read a fund's prospectus before investing⁹⁸². However, the SEC has not conducted a follow-up study on whether fund investors are reading or understanding the new streamlined prospectuses. As a result, the SEC opinions on what disclosure investors require remain unconfirmed.

4.9.3 Fund Advertising

Mutual fund advertisements are also an important source of information for investors. In fact, investors invest more in heavily advertised funds. This suggests that investors do not make these purchase decisions as much upon fund data as upon advertising, further suggesting that, as a whole, mutual fund investors are not sophisticated investors. This in turn would suggest that these unsophisticated investors would not be capable of disciplining or regulating the market through a disclosure mechanism. The SEC's rules regarding the content and form of fund advertisements, like its rules regarding prospectus and profile disclosures, reveal the agency's view of fund investors. Again, these suggest that the SEC, in practice treats mutual fund investors as unsophisticated.

The advertising rules require that fund advertisements advise investors "to consider the investment objectives, risks, and charges and expenses of the investment

⁹⁸² *Registration Form Used by Open-End Management Investment Companies*, 63 Fed. Reg. 13,916, 13,917 n.5.

company carefully before investing.”⁹⁸³ The SEC advertising rules also reflect a concern that mutual fund investors may be strongly influenced by past performance and closely regulates advertising of past returns, which mutual funds with strong records commonly promote despite a lack of evidence that strong past returns predict strong future returns. The SEC’s concerns arose during the 1999 and 2000 stock mutual boom when many funds had very high performance and engaged in advertising campaigns to market their funds based on their past performance⁹⁸⁴. For example, the SEC amended its rules governing advertisements that contain performance data in 2003 indicating that amendments “address our concern that some funds, when advertising their performance, may resort to techniques that create unrealistic investor expectations or may mislead potential investors.”⁹⁸⁵

The SEC rules mandate that the advertisements must include a legend stating that:

“past performance does not guarantee future results; that the investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost; and that current performance may be lower or higher than the

⁹⁸³ 17 C.F.R. § 230.482(b)(1)(i) (2008).

⁹⁸⁴ *Ibid.*, pp. 57,760.

⁹⁸⁵ The amendments were intended to ensure that performance advertisements contain current returns data and that fund advertisements include improved narrative information and present explanatory information more prominently. See Amendments to Investment Company Advertising Rules, 68 Fed. Reg. 57,760, 57,763.

performance data quoted.”⁹⁸⁶

The SEC requires that performance information in advertisements be standardized, and prescribes how past returns must be calculated⁹⁸⁷. It also prescribes the time periods for reporting.⁹⁸⁸ The SEC further prescribes that the advertisement must list “a toll-free or collect telephone number or a website where an investor may obtain performance data current to the most recent month-end, unless the advertisement includes this information.”⁹⁸⁹ The intent of the SEC regulations is to ensure that advertised fund returns accurately reflect their historical returns, to minimize the opportunity for fund managers to mislead investors by selectively advertising fund performance only for periods of high fund performance⁹⁹⁰. In addition, by standardizing how returns are calculated and the time periods for which they must be reported, these regulations facilitate investor comparison of different funds' returns⁹⁹¹.

The SEC's regulation of advertisements reflects strong concerns about decision-making. The SEC's encouragement to investors to scrutinize key fund characteristics may

⁹⁸⁶ 17 C.F.R. § 230.482(b)(3)(i) (2008). Advertisements need not use this exact language; any wording that “clearly communicates” this information is sufficient. Amendments to Investment Company Advertising Rules, 68 Fed. Reg. 57,760, 57,765.

⁹⁸⁷ The rules regarding how to calculate past returns in advertisements are identical to those regarding how past returns must be calculated in the prospectus. See 17 C.F.R. § 230.482(d) (2008).

⁹⁸⁸ The advertisements must report annual returns for one, five and ten years, current to the most recent quarter. 17 C.F.R. § 230.482(d)(3)-(4) (2008). Advertisements may also include other historical return measures, but these other measures may only supplement-not replace-the required measures. 17 C.F.R. § 230.482(d)(5) (2008).

⁹⁸⁹ 17 C.F.R. § 230.482(b)(3)(i) (2008).

⁹⁹⁰ *Amendments to Investment Company Advertising Rules*, 68 Fed. Reg. 57,760, 57,765 (Oct. 6, 2003).

⁹⁹¹ *Ibid.* pp. 57,768.

reflect its perception of the abilities of investors for selecting and purchasing mutual funds and worry that investors will not do so. The SEC warns investors not to plan an overemphasis upon performance, suggests a belief that investors may do so. The SEC also place and requires standardized data of past performance, facilitating investor comparison of the performance of different funds. The advertising regulations may not reflect the SEC's view of the "typical" or "average" investor unlike its prospectus and profile regulations. Advertisements commonly viewed by audiences which have not reviewed information about mutual fund investment and particular mutual funds, and may be not financially sophisticated investors. The SEC's advertising regulations like its prospectus regulations are largely based on the agency's unsupported perceptions of the needs of fund investors. For example, although the SEC requires advertisements to warn that past returns do not guarantee future returns, there is no indication that the SEC has ever examined whether these warnings are effective⁹⁹².

The SEC has also to directly educate fund investors in addition to the requirement for mutual fund companies to provide investors with specific information and warnings in prospectuses, profiles, and advertisements. Further, the SEC has also indicated that it has an "important" role to play in this regard⁹⁹³ and a 2000 study by the SEC's Division of Investment Management recommended that it continue its program to improve investor "financial literacy" regarding mutual funds including their costs⁹⁹⁴ that it develop

⁹⁹² Palmiter and Taha, *supra* note 822

⁹⁹³ SEC Fees and Expenses Report, *supra* note 845, at § IV(A)(1)

⁹⁹⁴ *Ibid.*

educational materials to help investors understand how to use any new fee disclosures⁹⁹⁵.

As part of its investor program, the SEC has developed some very basic materials that suggest that the SEC recognizes that mutual fund investors are prone to certain investing mistakes. These materials like the advertising regulations that reflect the agency's concern that investors overweight past fund returns. A document on the SEC website, *Invest Wisely: An Introduction to Mutual Funds*, gives investors a basic introduction to mutual funds and a stern warning (in plain English) against relying on past returns:

"Past performance is not a reliable indicator of future performance. So don't be dazzled by last year's high returns A fund's past performance is not as important as you might think. Advertisements, rankings, and ratings often emphasize how well a fund has performed in the past. But studies show that the future is often different. This year's "number one" fund can easily become next year's below average fund."⁹⁹⁶

Another example, another document on the SEC's website addresses the same concern. *Mutual Fund Investing: Look at More Than a Fund's Past Performance*, warns investors:

"You can't open a newspaper or read a magazine without seeing ads

⁹⁹⁵ Ibid. at § I(B)(2)(a).

⁹⁹⁶ SEC, *Invest Wisely*, accessed at: <http://www.sec.gov/investor/pubs/inwsmf.htm>

promoting the stellar performance of "hot" mutual funds. But past performance is not as important as you may think, especially the short-term performance of relatively new or small funds. As with any investment, a fund's past performance is no guarantee of its future success. Over the long-term, the success (or failure) of your investment in a fund also will depend on [other] factorsSo, look at more than the fund's past performance when making your investment decisions."⁹⁹⁷

It is not clear how the SEC believes that the same investors that require this basic level of education and warnings are capable of disciplining the market through disclosure. Concerns are expressed in SEC's educational materials indicate concern that some investors do not pay enough attention to fund fees and expenses⁹⁹⁸. Investors who are choosing a mutual fund are encouraged to give significant weight to costs⁹⁹⁹. These materials describe the different types of fees and expenses, encourage investors to review these carefully, scrutinize the fees and expenses charged by funds they are considering, and warn investors that even small differences in fees can translate into large differences in returns over time¹⁰⁰⁰.

⁹⁹⁷ SEC, Mutual Fund Investing: look at more than a fund's past performance, accessed at: <http://sec.gov/investor/pubs/mfperform.htm>

⁹⁹⁸ SEC, Invest Wisely, *supra* note 996

⁹⁹⁹ *Ibid.*

¹⁰⁰⁰ SEC, Invest Wisely, *supra* note 996; see also Securities And Exchange Commission, Calculating Mutual Fund Fees and Expenses, <http://sec.gov/investor/tools/mfcc/mfcc-int.htm> (last visited Dec. 3, 2008) (SEC, Calculating Fees) (stating "Fees and expenses are an important consideration in selecting a mutual fund because these charges lower your returns."); SEC, Invest Wisely, *supra* note 996 (stating "It is important that you understand [mutual fund fees and expenses] because they lower your returns.") ("For

The SEC even provides an example of the effect over twenty years of a 1% annual difference in expenses on a hypothetical \$10,000 investment. It should be noted, however, that this information is not required in fund prospectuses, profiles, or advertisements. The SEC website contains a "Mutual Fund Cost Calculator" and a link to the NASD's 'Mutual Fund Expense Analyzer'¹⁰⁰¹ to help investors compare the costs of different mutual funds and understand the impact of costs over time. It should be stressed again that neither of these tools is required to be mentioned in fund prospectuses, profiles, or advertisements.

The SEC's website also encourages investors to consider to other basic fund characteristics, such as the fund's risks and investment strategy, how the fund fits with the investor's own risk tolerance, long-term investment strategies, and diversified investment portfolio. It does not however, like the prospectus explain how investors should develop investment strategies or what represents a diversified portfolio. Since this information is contained only on the SEC investor education website, the information would only be limited to these individuals that visit the website. Again, it is not clear how the SEC believes it can educate investors broadly enough simply by placing materials on its website in order to provide them with sufficient skills to discipline the market through the review of disclosure information and the subsequent actions.

example, if you invested \$10,000 in a fund that produced a 10% annual return before expenses and had annual operating expenses of 1.5%, then after 20 years you would have roughly \$49,725. But if the fund had expenses of only 0.5%, then you would end up with \$60,858 -an 18% difference.")

¹⁰⁰¹ SEC, Calculating Fees, *supra* note 1000.

The educational materials indicate that the agency believes that some investors need to be reminded not to overweight a fund's past returns and not to underweight other fund characteristics such as fees and expenses, risk, and investment objectives and strategies. These beliefs are comparable to those expressed in the educational materials. The intended audience of the educational material on the SEC's website is unclear as is the case with the advertising regulations. Much of the information is very basic, and titles such as "An Introduction to Mutual Funds" suggest that it either targets new investors or that the typical investor is unsophisticated. Whichever the case, the SEC has indicated elsewhere that most investors may need to be reminded to make fully-informed investment decisions suggesting that they view most investors as unsophisticated¹⁰⁰². In addition, the profile of the investor to whom the SEC's educational materials is directed is significantly less favorable than the investor profile presented by the fund industry. In this sense the SEC's perception of the target audience appears to be new or unsophisticated investors in contrast to its assertion that mutual fund investors are sophisticated.

4.10 DISCUSSION

In the United States, the prevailing approach to regulating mutual fund boards reflects a lack of confidence in interested directors. However, the same situation is clearly

¹⁰⁰² See, e.g., SEC Fees and Expenses Report, *supra* note 845, § II(B)(2) (stating that the SEC "continues to be concerned ... that the typical investor [is] not using all of the resources that are available in considering investments in mutual funds"); *Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies*, 69 Fed. Reg. 11,244, 11,245 (Mar. 9, 2004) (codified at 17 C.F.R. pt. 210, 239, 249, 270, 274) (stating "The degree to which investors understand mutual fund fees and expenses remains a source of concern.").

not the case in Canada. For instance, the Canadian securities regulators opted for acceptance of the existing board structure for mutual fund boards rather than requiring an increased number or proportion of interested directors, in marked contrast to the situation in the United States. In addition, there was no commentary provided as to the rationale for why interested directors on fund boards were not utilized as in the U.S., or whether this was considered as an option for Canada.

The results of the above studies lead me to conclude that there is a potential for mutual fund Managers and investment advisors with independent boards to be more effective and more responsive to adding value to shareholders. At the same time, there appears to be a higher level of mutual fund ownership associated with boards with higher director ownership. The underlying belief of the Commission was that the independent directors, with a majority of seats on the board of a fund that relies on any of the rules, would be able to control the fund's "corporate machinery" and to have a more meaningful influence on fund management and represent shareholders from a position of strength¹⁰⁰³. This 'control of corporate machinery' could include election of officers of the fund, calling meetings, soliciting proxies and taking other actions without the consent of the investment advisor¹⁰⁰⁴.

I suggest that this 'control of corporate machinery' is not within the scope of the IRC in Canada. I further suggest that the current solution for mutual fund governance in

¹⁰⁰³ Ibid.

¹⁰⁰⁴ Ibid.

Canada, the IRC, does not have the breadth of scope for influence and control of mutual fund boards in the United States, since the IRC has a comparatively narrow role focussed on conflicts of interest. Although there are significant limitations to the effectiveness of fund boards in the United States, my perspective is that the Canadian solution of the IRC can be considered to fall significantly short of the desired state. The legislation in the United States includes a section in the Investment Company Act that addresses excessive advisory fees and as will be discussed this relates to the fiduciary duty of independent directors of fund boards. There is no such requirement for the IRC in Canada and as such they are much more limited in their scope for addressing excessive advisory fees which is a limitation and omission, or gap, in the Canadian mutual fund governance regime.

The question arises as to whether investors actually received significant protection from the SEC rule that independent directors form a majority of the membership of fund boards. According to the Commission, the answer to this question appears to be that they did not, since few funds had boards with membership that was altered by this requirement¹⁰⁰⁵. I note, however, that this perspective of the Commission would not pertain to a fund board that did not have the requisite majority of independent directors in place. In Canada, where there is not a majority of independent directors in place, there could be improved protection to investors provided through a fund board. I have found, however, that there is a general lack of research on whether independent directors provide protection to shareholders. This is expressed by the Barnett statement that

¹⁰⁰⁵ *Role of Independent Directors of Investment Companies*, Investment Company Release No. IC-24082, 64 Fed. Reg. 59, 826, 59827, November 3, 1999.

“Unfortunately, there is a dearth of rigorous social science research on whether, and the extent to which, fund shareholders benefit from independent directors, from any particular number or percentage of independent directors, or from a requirement that independent directors be chosen by independent directors.”¹⁰⁰⁶

My review of the academic literature indicates that board independence may detract from fund performance since the directors and the chair are at least initially less familiar with the operations. In this sense, the introduction of the IRC may be beneficial for Canada from the perspective that this does not require the directors or chair to be independent and hence preclude the potential detraction in fund performance, or susceptibility to conflicts of interest, associated with independent directors and chairs of fund boards. As will be discussed in the subsequent section there are also potential disadvantages associated with the adoption of the IRC approach instead of the United States fund board approach to mutual fund governance associated with a fiduciary duty to protect investors against excessive advisory fees.

The SEC’s decision to create a requirement for a super majority of independent directors on mutual fund boards predated their results of academic studies. It is not known if these studies had been completed whether this would have changed the Commission’s decision. It should be further noted that the Commission’s decision was made in apparent absence of supporting information to indicate that the presence of a majority of independent directors would increase the financial performance of the mutual

¹⁰⁰⁶ Barnett, *supra* at note 716, p. 504.

funds. As Barnett¹⁰⁰⁷ noted, “the Commission adopted the requirements that independent directors constitute a majority of an investment company board and nominate the independent directors because the requirements *seemed* desirable under an ‘unproven assumption’ that independent directors are key to protecting mutual fund shareholders”.

I note that there are broad parallels between the procedures utilized by the CSA to require the mutual fund boards in Canada to utilize an IRC and the Commission in the United States requiring mutual fund boards to utilize independent directors. Firstly, both of these organizations introduced these ‘solutions’ without clear evidence that these measures would be effective. In the case of the CSA, the results of studies commissioned by this organization recommended U.S. style fund boards (e.g., the Erlichman report) which they chose to ignore in favour of the IRC. In the case of the SEC, this organization required independent directors without supporting studies indicating that they were effective.

The SEC’s streamlined prospectus may be an improvement over the Fund Facts document in Canada as it contains the information that is necessary for investors without oversimplifying this information. For instance, the summary prospectus contains the same information as the summary information in the statutory prospectus. In addition, the prospectus is provided to investors, unlike the mutual fund prospectus in Canada that is provided to investors only upon request. The SEC allows investors to buy a fund as long as the statutory prospectus is on-line. In Canada, it will be possible under the

¹⁰⁰⁷ Ibid, p. 505.

proposed POS program for investors to purchase the shares and then receive the Fund Facts within 2 days.

I believe that this proposed approach to POS provides less investor protection than allowing investors to read the documentation prior to purchase, such as posting the disclosure documents online as in the United States. In addition, I believe the approach of the United States to be beneficial where the summary statement is the source as the summary section of the statutory prospectus. These improvements to streamline the United States disclosure process could and should be made in Canada. I suggest that Fund Facts in the POS program could be linked, through a similar approach to the U.S., such that it also appears in the summary prospectus in identified format documents such that they are consistent.

The SEC has not considered a comprehensive program for investor education such that investors would be better able to understand the material contained in the prospectus. This should be completed in Canada, as previously discussed. The Canadian prospectus could also adopt the SEC's approach on prominent placement of key information at the beginning of the prospectus as well as the requirement for 'plain English' and supporting materials, and the risk-return summary.

The Canadian regulatory regime has not yet dealt with fund advertising as has been accomplished in the United States. Investors appear to base their investment decisions as much upon advertising as upon actual performance, since they invest more in

heavily advertised funds and this advertising may be misleading to investors to encourage sales. As such, it is important for the Canadian Securities regulators to consider regulating fund advertising as in the U.S., which is not currently being conducted, to the same extent, in Canada. These should include reference to the key message that 'past performance is not guarantee of future performance', particularly considering the lack of persistence of positive fund performance (discussed on Section 2). The SEC has made efforts at investor education through its publications. However, like Canada, the SEC has not created the level of investor participation or involvement discussed by Julia Black in her report to Canadian Securities regulators¹⁰⁰⁸.

The fund industry portrays fund investors as making informed decisions. The SEC portrays them as needing only to be reminded to pay appropriate attention to important fund characteristics, while the academic literature finds fund investors ill-prepared to choose among funds. Both the SEC and the industry also place emphasis upon the role of investors in disciplining the market.

The SEC appears to have adopted the New Rules for directors and chair independence on fund boards in response to public pressure during the mutual fund scandals of 2002-2003 that involved late trading and market timing that received broad media and public attention. These rules were not intended to address excess mutual fund advisory fees. Instead, the SEC intends to address excessive advisory fees under Section

¹⁰⁰⁸ Black, *supra* at 481.

36(b) of the Investment Company Act focussed on the fiduciary duty of directors. It is not appropriate for Canada to pursue the New Rules related to director and chair independence on mutual funds for excessive fees since this is not their intended purpose.

There has not been a single successful fee litigation case in United State courts under Section 36(b) of the Investment Company Act. If Canada is to adopt a mechanism for excessive advisory fee challenges, it must address the deficiencies of the U.S. mechanism. Based on my analysis of litigation in the United States courts, the deficiencies are that the appropriate financial information are not disclosed and as such it is not possible for plaintiffs to demonstrate that these fees are excessive. There is also not a specific methodology for evaluating advisory fees to determine if they are excessive, resulting in widely different estimates of advisory fees and profitability between the plaintiff's investors and defendant advisors.

Therefore, in order for excessive fee regulation to be effective in Canada, there must be a requirement that the correct information to be disclosed and a standardized methodology for reliably determining advisory fees and profitability for evaluation of excessive advisory fees. The existing prospectus and proposed fund facts disclosure document could be evaluated and modified such that the appropriate financial information is provided.

There should also be a regulatory mechanism for excessive fee litigation in Canadian courts. Based on my analyses of U.S. regulation and litigation, I conclude that

the most appropriate mechanism is through the fiduciary duty of directors to ensure that the fees of their mutual fund advisors are not excessive. This approach does not require changing the current focus of the IRC on conflicts of interest. I recommend that this mechanism be developed and should be implemented by securities regulators. The process for development and implementation should involve public involvement and participation where the public becomes involved in the development of the regulation. In addition an effective public awareness program should be developed to ensure investors are fully aware of the regulation and how the regulator can utilize it. A public education program should be developed to inform investors of excessive fees to assist them with decision making.

5.0 MUTUAL FUND FEES AND EXPENSES RATIOS

5.1 GLOBAL CONTEXT

Ajay Khorana, Henri Servaes and Peter Tufano (Khorana et al) developed a database for almost 47,000 mutual funds sold in 18 countries. The authors' primary goal was to explain differences in funds sold in many jurisdictions. They focussed on three metrics: management fees; total expense ratios (i.e. MERs); and, total shareholder costs (i.e. MERs plus annualized loads). The results of the study were provided in a preliminary research paper entitled "Mutual Fund Fees Around the World"¹⁰⁰⁹.

¹⁰⁰⁹ Khorana, A., H. Servaes & P. Tufano, Mutual fund fees around the world, July 18, 2007, accessed at: <http://ssrn.com/abstract=901023>.

The authors¹⁰¹⁰ examined global management fees, total expense ratios, and total shareholder costs (which include load charges). They found that fees vary substantially across funds and from country to country. To explain these differences, they considered fund, sponsor, and national characteristics. They found that fees differ by investment objectives; larger funds and fund complexes charge lower fees; while fees are higher for funds distributed in more countries and funds domiciled in certain offshore locations. They further found that substantial cross-country differences persist even after controlling for these variables, which they argue can be explained by a variety of factors, the most robust of which is that fund fees are lower in countries with stronger investor protection.

From an investor's perspective, mutual fund fees are the price paid for investment management, distribution and other services and from a financial service firm perspective, they generate revenue. From both perspectives fees are important¹⁰¹¹. In general, higher fees detract from investment performance¹⁰¹² while increasing fund companies' profitability. Increasing public attention is being paid to fund fees in the U.S., Canada, and elsewhere. Recent legal settlements in the U.S. have resulted in fee reductions, and a number of lawsuits allege that fund managers and fund trustees breached their fiduciary duties by approving fees to retail investors that are excessive¹⁰¹³. In order to assess whether a particular country's fees are too high, its fees must be put

¹⁰¹⁰ Ibid.

¹⁰¹¹ Investment Company Institute, 2006, *Investment Company Fact Book* (<http://www.icifactbook.org/>).

¹⁰¹² Carhart, M. M., (1997). On Persistence in mutual fund performance, *Journal of Finance* 52, 57-82.

¹⁰¹³ Sean Murphy, 2005, Mutual funds under scrutiny: an overview of recent litigation, *Securities Litigation & Regulation*.

into global perspective. Khorana et al¹⁰¹⁴ provided this global perspective by studying the mutual fund fees charged to investors in 18 countries in 2002. Their sample is comprised of 46,580 mutual fund classes with assets in excess of \$10 trillion, representing about 86% of the \$11.3 trillion in funds sold worldwide in 2002.

The Khorana et al study found that mutual fund fees vary around the globe and relate these fee differences to fund, sponsor (fund complex), and national characteristics. In 2002, the asset-weighted average expense ratio for equity funds worldwide was 1.29%, ranging from 1.05% in Belgium and 1.11% in the US to 1.92% in Italy and 2.56%, while in Canada fee variation at the fund level is even more pronounced. The Khorana et al study found that fees differ by objective type (e.g., equities versus money market), by clientele type (e.g., institutional versus retail) and with various measures of fund and sponsor scale. After controlling for these factors, Khorana et al found that there are differences across countries, which relate to varying regulation, supply and demand¹⁰¹⁵. Some countries have stronger legal systems and regulations that more explicitly protect investor rights, some countries house larger industries while some countries have wealthier and more educated populations. European nations have typically open borders, enabling foreign fund promoters to more easily sell funds in many countries. In contrast, some countries, such as the United States or Canada, effectively close their borders to funds domiciled in other countries.

¹⁰¹⁴ Ibid.

¹⁰¹⁵ Ibid.

There is a relatively small literature on the expenses charged for fund management in mutual fund fees, particularly outside of the United States¹⁰¹⁶. This literature typically focuses upon on one or a few countries in each study. Baumol, Goldfeld, Gordon, and Koehn¹⁰¹⁷ document economies of scale in the U.S. mutual fund industry. Otten and Bams¹⁰¹⁸ found a negative influence of fees on European mutual fund performance in five countries (i.e., France, Italy, Germany, Netherlands, and the UK). Franks, Schaefer, and Staunton¹⁰¹⁹ compared the direct regulatory costs for the investment management industry across three countries and found that the costs in the UK are twice as high as in the U.S. and four times as high as in France. Ruckman¹⁰²⁰ compared fees in the U.S. and Canada and found that Canadian funds are considerably more expensive.

The research methodology of Khorana et al is designed to analyze cross-sectional national differences in fees¹⁰²¹. Fund fees vary across investment objectives, with larger funds and fund complexes charging lower fees, along with index funds, funds of funds, and certain funds selling cross-nationally. Funds selling to institutions and larger

¹⁰¹⁶ Reporter 10 (21); Andrew Caffrey, Lawsuits challenge unequal fund fees; Fidelity, Putnam among defendants, *The Boston Globe*, August 18, 2004.

¹⁰¹⁷ Baumol, W. J., S. M. Goldfeld, L. A. Gordon, and M. F. Koehn, 1980, *The Economics of Mutual Fund Markets: Competition versus Regulation*, Kluwer Academic, Boston, MA.

¹⁰¹⁸ Otten, R., & D. Bams, (2002). European mutual fund performance, *European Financial Management* 8, 75-101.

¹⁰¹⁹ Franks, J. R., S. M. Schaefer, & M. D. Staunton, 1998, The direct and compliance costs of financial regulation, *Journal of Banking and Finance*, 21, 1547-1572.

¹⁰²⁰ Ruckman, K., (2003). Expense ratios in North American mutual funds, *Canadian Journal of Economics*, 36, 192-223.

¹⁰²¹ Khorana et al, supra note 1009.

accounts have lower fees. In contrast, fees are higher for funds distributed in more countries, funds domiciled in offshore locations, and funds sold by fund management companies whose ultimate parent is domiciled abroad¹⁰²². After controlling for these variables the Khorana et al study found substantial cross-country differences, with the remaining differences associated with a variety of factors. The most significant of these factors is that stronger investor protection is associated with lower mutual fund fees, and this effect is stronger for fund-specific rules than for general measures of judicial quality. For instance, rules that govern conflicts of interest between investors and investment managers are associated with lower management fees. As a result, it may be expected that Canada could have lower management fees if it has strong, high quality regulations for governing conflicts of interest in the mutual fund industry. Certain fees are also lower when funds are domiciled in countries with an older fund industry. Presumably, this would include the UK, the U.S. and Canada which would also be expected not to lower fees in Canada. Management fees are lower in wealthier countries with more educated populations, where there is either little concentration in the banking industry or where banks are prohibited from entering the securities business.

Khorana et al¹⁰²³ used global fund data from multiple sources to analyze mutual fund fees consisting of 77,449 fund-class/country pairs¹⁰²⁴. A classification was

¹⁰²² Ibid.

¹⁰²³ Ibid.

¹⁰²⁴ For funds from Australia, Canada, Japan, and the US, data was obtained from Morningstar. For funds elsewhere data was obtained from Morningstar research plus, Lipper Fitzrovia and Financial Research Corporation. Lipper Fitzrovia is a leading purveyor of European Total Expense Ratio (TER) data and gathers data from the funds' annual reports on management fees and expense ratios for funds domiciled in

developed scheme where the funds were divided into 10 broad categories.¹⁰²⁵ Each category was then further divided along two dimensions: (a) region of investment e.g. country, region or global) and (b) a more detailed investment objective (e.g., small cap stocks or high-yield bonds). Using the narrowest objective classification, there were a total of 122 different investment objectives in the sample.

For each fund, Khorana et al¹⁰²⁶ collected information on the minimum initial investment required and the age of the fund. The total sample consisted of 77,449 fund-class/country observations (represented by 46,580 unique fund classes). Fund fees were examined and measured by Khorana et al¹⁰²⁷ in three ways. Management fees represent the charges levied each year by funds for management services, which always include investment management services, but may also include payments for administration and distribution¹⁰²⁸. In Australia and Canada, management fees also include Goods and Services Taxes (GST). A more expansive and more commonly reported definition of fees is a fund's expense ratio (in the U.S.) or total expense ratio or TER (in Europe).

Austria, Belgium, Denmark, Finland, France, Germany, Italy, the Netherlands, Norway, Spain, Sweden, Switzerland, the United Kingdom, as well as the offshore market consists of funds domiciled in Luxembourg and Dublin, both of which are hubs for fund distribution across Europe as well as other 'Island offshore' locations. The final database employed is from Financial Research Corporation (FRC) which tracks US money market funds that are not available in Morningstar's US database.

¹⁰²⁵ Alternative Investments, Balanced, Bonds & Cash, Bonds, Convertible Bonds, Equities, Mortgage Backed Securities, Money Market, Real Estate and Other/Not classified. Equities form the largest category with 42,066 country/fund class observations, followed by Bonds with 17,243 observations, and Balanced with 9,699

¹⁰²⁶ Ibid.

¹⁰²⁷ Ibid.

¹⁰²⁸ There may be other implicit fees in the form of higher transaction costs incurred by investment managers or underperformance, but these would be captured in a fund's gross return and not in any traditional measure of fees or costs.

This category of fees is broader than just management fees, and includes all annual expenses levied by a fund on its investors, covering investment management, administration, servicing, transfer agency, audit, legal, etc.¹⁰²⁹ However, TERs exclude certain distribution fees, such as front-end or back-end loads, as well as annual fees charged by distributors that are separate from the fund charges (e.g., fees for participation in a wrap program). The measure of total shareholder charges (TSC) includes the expense ratio plus annualized loads. Because loads are paid when entering or exiting the fund, the authors divided these loads over the investor's holding period, which allowed them to compute the appropriate back-end load, if any, given a five year holding period¹⁰³⁰.

Khorana et al¹⁰³¹ report the value-weighted average levels of these three types of fees by country for all funds as well as for bond and equity funds. On a value-weighted basis, using any of the three fee measures, funds domiciled and sold in Canada cost considerably more than those elsewhere, such as the United States. Mean management

¹⁰²⁹ Lipper Fitzrovia uses the following definition of TERs: "The Lipper Fitzrovia Total Expense Ratio (TER) represents the drag on fund performance caused by all annual operating costs (including administration/share registration, trustee/custody, audit and legal fees), not just the basic annual management charge." Morningstar uses this comparable definition: "The expense ratio typically includes the following types of fees: accounting, administrator, advisor, auditor, board of directors, custodial, distribution (12b-1), legal, organizational, professional, registration, Shareholder reporting, sub-advisor, and transfer agency. The expense ratio does not reflect the fund's brokerage costs or any investor sales charges."

¹⁰³⁰ Khorana et. al defined total shareholder cost (TSC) as: Total Shareholder Cost = TER + initial load/5 + back-end load at five years/5. Khorana et al have fewer observations on the TSC because data on loads are only available from Morningstar. Their five-year holding period estimate is admittedly ad hoc, since data is not available on actual holding periods and does not include any non-load charges levied by the distribution channel. Investors may not pay stated load charges because distributors may offer rebates or reduced loads for large investments (break points).

¹⁰³¹ Ibid.

fees for equity funds are 62 basis points in the United States versus 196 basis points in Canada, while TERs are 111 basis points in the United States and 256 basis points in Canada. The results of the Khorana et al study indicate that Canada has the highest mutual fund management fees of any country and considerably higher than those in the United States.

Canada has the highest average management fees after correcting for fund and fund family characteristics. Generally, the most expensive countries have fees three to four times higher than the least expensive countries. Fees may be highest for equities, followed by balanced, bond and money market funds respectively¹⁰³².

Recent studies have shown that countries differ markedly in the extent to which their laws protect investors from conflicts of interest. Regulation, in particular investor protection provisions, may hold fees¹⁰³³. The quality of the legal system has a potential influence on fees as discussed by La Porta, Lopez-de-Silanes, Shleifer, and Vishny¹⁰³⁴, who measured fees relative to the efficiency of the judicial system, rule of law, corruption, risk of expropriation, and risk of contract repudiation. These variables are constructed such that higher values imply a higher quality legal system. A positive and statistically significant relation has been documented between various measures of

¹⁰³² Khorana et al, supra note 1009. Tufano, P., & M. Sevic, (1997). Board structure and fee-setting in the U.S. mutual fund industry, *Journal of Financial Economics*, 46, 321-355.

¹⁰³³ Fink, M., 1998, Improving price competition for mutual funds and bonds, Statement before the Subcommittee on Finance and Hazardous Materials, Committee on Commerce, United States House of Representatives, September 29, (available online at: www.ici.org/statements).

¹⁰³⁴ La Porta, R., F. Lopez-de-Silanes, A. Shleifer, & R. W. Vishny, (1998). Law and finance, *Journal of Political Economy*, 106, 1113-1155.

stock market development, and measures of minority shareholder protection against self-dealing by controlling shareholders¹⁰³⁵.

Fees and expenses eat away fund performance, and it is important to determine whether fees are reasonable and encourage the fund industry to lower them when they are not. The typical front-end load that investors pay after negotiation is between 2.00% and 3.99%. Investors in China, Italy, Netherlands, Spain, and Taiwan enjoy a lower front-end load, but investors in Canada and Hong Kong typically pay higher loads.

The authors found that the typical expense ratios for fixed-income, money market, and equity funds are from 0.76% to 1.00%, 0.40% to 0.89%, and 1.50% to 1.99%, respectively. For fixed-income funds, investors in Australia, China, and the United States enjoy lower expense ratios, while Canada, Hong Kong, New Zealand, Singapore, Taiwan, and the United Kingdom have higher ratios. For money market funds, expense ratios are lower for Japan, Netherlands, Singapore, and Taiwan, and they are more than 0.90% in Australia and Spain. For equity funds, the U.S. is the only country with an expense ratio lower than 1.00%, and investors in Australia, China, and New Zealand have expense ratios between 1.00% and 1.49%. Investors in Canada and Japan typically pay between 2.00% and 2.50% for equity funds.

The Khorana et al study paper concludes among other things that Canadian mutual funds are by far the most expensive in the developed world. The authors found that Canadian

¹⁰³⁵ Djankov, S., R. La Porta, F. Lopez-de-Silanes, & A. Shleifer, (2008). The law and economics of self dealing, *Journal of Financial Economics*.

mutual funds had an average MER of 2.68% per annum. In comparison, the paper indicates that fees in United States were at an average of 1.42% per year at the end of 2002¹⁰³⁶.

Khorana, Servaes and Tufano¹⁰³⁷ study the relationship between the extent of fund-specific regulation and the levels of fees and analyze the laws and regulations of the country where the fund is domiciled and where it is offered for sale. The authors found that nations whose laws protect fund investors better have larger fund industries. To measure fund-specific investment the authors' projection used data from KPMG in a 2002 report¹⁰³⁸. In addition, the authors determined the procedures in place to prevent conflicts of interest between the fund management company and fund investors. European fund associations have argued that the smaller scale of fund markets in Europe can explain their higher fees. However, it could also reflect investor preferences for low fee funds.

Mark Warywoda, at that time a quantitative analyst at Morningstar Canada, indicated that the average MER of Canadian mutual funds at that time was 2.44%. This is comparable to the value in the Khorana et al report. Dan Hallett, at that time a financial analyst at the Globe and Mail commenting on the Khorana et al study, stated "No doubt, management fees and other expenses charged by Canadian mutual funds are

¹⁰³⁶ Khorana et al, supra note 1009.

¹⁰³⁷ Khorana, A., H. Servaes, and P. Tufano, (2005). Explaining the size of the mutual fund industry around the world, *Journal of Financial Economics*, 78, 145-185.

¹⁰³⁸ International Organization of Securities Commissions (IOSCO), (2002). *Performance Presentation Standards for Collective Investment Schemes*.

high. Further, roughly half of a fund's management fees (about 40% of MER) are paid to financial advisers and their dealers. Conversely, U.S. funds are very cheap if measured on a dollar weighted basis, Canadian MERs are about double the sub – 1% fees of U.S. funds (before controlling for fund type and advisory fees)."¹⁰³⁹.

The issues expressed in the past with high management fees persist to the present that a governance mechanism from investor protection from excessive fees is required in Canada. An article in the Financial Post by Jonathan Chevreau discusses the debate on MERs in Canada¹⁰⁴⁰. He notes that, despite the concerns, in 2011 there was still \$773 billion in mutual funds according to the Investment Funds Institute of Canada (IFIC), while the amount of exchange-traded funds is approximately \$49 billion representing only 6% of the total. He interprets this to reflect the lack of price sensitivity of Canadian mutual fund investors.

An article by Jonathan Chevreau in the Financial Post attributes the high mutual fund fees to advisor compensation associated with trailer fees stating: "A big reason Canada's mutual fund fees are so high is advisor compensation. Typically 1% of a 2.5%

¹⁰³⁹ Dan Hallet, Are Canadian fees excessive? Paper calls Canadian funds most expensive by far, *The Globe and Mail*, accessed at: <https://secure.globeadvisors.com/education/insight/article.html?/education/insight/200609...>

¹⁰⁴⁰ Jonathan Chevreau, MER debate: Mutual fund industry stands its ground, *Financial Post*, accessed at: <http://business.financialpost.com/2011/12/06/mer-debate-mutual-fund-industry-stands-its....>

fund management expense ratio (MER) is chewed up in so-called trailer fees. These go to advisors for ongoing service, or simply to keep clients invested”¹⁰⁴¹.

Pouliot notes that mutual fund fees reduce mutual fund returns by 25% to 33% representing approximately \$23 billion to \$46 billion out of a total \$2.3 trillion of assets under management¹⁰⁴². Referring to the study ‘Mutual Fund Fees Around the World’, updated in 2007 he noted that, for management and administration fees, Canadian pay on average \$2.56 per \$100 invested every year, while by comparison in the United States investors pay \$1.11 for the same amount. Based on a \$100 investment on an average, equity funds and bonds are 74% to 92% more expensive than anywhere else in the world (see Table 2).

¹⁰⁴¹ Jonathan Chevreau, Fund trailer fees entrenched, *Financial Post*, accessed at: <http://financialpost.com/opinion/story.html?id=4966c04f-05-d0-446d-8ac-6bb4182...>

¹⁰⁴² R. Pouliot, Quiet leakage, *CA Magazine*, November 2007 ip. 22-33.

Table 2-The Most Expensive Funds in the World are Canadian

	Expected Returns (stocks)	Equity Fund fees	Fees as % of Expected returns	Expected returns (bonds)	Bond Fund fees	Fees as % of Expected returns
Canada	9.70%	2.56%	26.4%	5.00	1.79%	35.8%
Switzerland	7.60	1.54	20.3	5.10	0.97	19.0
Netherlands	9.00	1.61	17.9	4.10	1.01	24.6
Germany	9.70	1.47	15.2	2.80	0.91	32.5
Italy	12.00	1.79	14.9	6.70	1.06	15.8
Sweden	11.60	1.68	14.5	6.20	1.07	17.3
United Kingdom	10.10	1.42	14.1	5.40	1.02	18.9
France	12.10	1.49	12.3	6.80	0.96	14.1
United States	10.10	1.11	11.0	4.80	0.78	16.3
Australia	11.90	1.17	9.8	5.20	0.63	12.1
Global average	10.38	1.58	15.6	5.21	1.02	20.6
Average excluding Canada	10.46	1.48	14.4	5.23	0.93	19.0
Comparison with average excluding Canada	7.2%	73.5%	82.9%	-4.5%	91.6%	88.9%
Comparison with United States	27.6%	66.2%	30.2%	-2.0%	84.5%	88.2%

Source: Pouliot, note 1042.

Compared with the United States the difference in expenses is approximately 130% in both cases¹⁰⁴³. With respect to equity funds fees make up 25% of potential returns which with 83% more than the average in the other niche countries (refer to Table 2). As noted by Pouliot, "One dollar out every 100 dollars may not seem like much, but the amount becomes astronomical when we consider that Canadians hold \$750 billion in long term mutual funds. If we factor in close of the half a percent point of annual underperformance of Canadian funds due to higher transaction costs and a less liquid

¹⁰⁴³ Ibid.

market compared with nine industrialized nations Canadian investors are paying \$10 billion a year. More were troubling is that the majority of Canadians are unaware at the fees.”¹⁰⁴⁴

An article by Janet McFarland and Rob Carrick states “Canadians have invested billions of dollars in mutual funds that charge fees that eat up much or all of their returns” an exclusive Report on Business analyses shows. The ROB review of many Canada’s most popular mutual funds shows that management expenses—the built-in fees that are automatically deducted from the price of each mutual fund before the value is published—can often obliterate most of a fund’s returns. The ROB review found that at least \$32.7 billion is invested in funds in Canada that lost money for investors over the five years to March 31, 2004, even though the fund companies made tens of millions of dollars in revenue from the fees. Another \$21-billion-plus is invested in funds where more than half of the gross returns of the fund went to pay fees, the ROB analysis shows.”¹⁰⁴⁵

The Globe’s review analyzed 615 mutual funds in the major equity, bond and balanced categories to determine the value investors receive for the fees they pay to their fund companies. The measuring was done using the Fee-to-Performance indicator, which calculates how much of a fund’s gross returns are used by a fund company to cover costs

¹⁰⁴⁴ Ibid, p. 24.

¹⁰⁴⁵ Janet McFarland and Rob Carrick, The fee crunch: Not all investors get value for money, Thursday, June 24, 2004, [Globeadvisor.com](https://secureglobeadvisor.com/servlet/ArticleNews/story/gam/20040624/RFUNDS524), accessed at: <https://secureglobeadvisor.com/servlet/ArticleNews/story/gam/20040624/RFUNDS524>

ranging from manager salaries and research to commissions for dealers and advisors who sell funds¹⁰⁴⁶. The summary of this article states “Many investors are surprised at how much they pay in fees to their mutual fund company and who gets the money. An ROB investigation shows that there is often no relationship between mutual fund fees and performance and that many investors pay handsomely for poor returns. That’s one reason why mutual funds have profited even as returns have stagnated or fallen.”¹⁰⁴⁷ The median value score for all funds in all categories was 25, which indicates that about 25 percent of returns were used to cover fees.

Investor advocates point out that data on MERs and performance demonstrates why it is so important for investors to understand the fees that they pay for the funds that they own. For example: Ken Kivenko, a spokesman for the Small Investor Protection Association, said at that time that many surveys have found that a majority of mutual fund investors don’t realize that they pay any fees at all because they are built into the costs¹⁰⁴⁸. He further indicated that he felt it was surprising that some mutual funds tend to attract billions of dollars despite their uncompetitive fees, and attribute this to investors not knowing what they were buying and although the MER is disclosed in the fund prospectus many investors did not read this due to its length¹⁰⁴⁹.

¹⁰⁴⁶ Janet McFarland and Rob Carrick, Fee-to-performance value indicator measures impact of company’s MERs, Helps show how badly returns are hit. *Globe and Mail* accessed at: <http://golbeinvestor.com/servlet/ArticleNews/story/gam/20040624/RFUNDSMER...>

¹⁰⁴⁷ Ibid.

¹⁰⁴⁸ Ibid.

¹⁰⁴⁹ Ibid.

Kivenko believes that the mutual fund industry should publish specific dollar information on investors' accounts, and not just the current percentages, so that investors know what they are paying in terms of dollars. He further believes that investors won't pay attention to the MER until they know how much they are paying personally every year¹⁰⁵⁰. In 2003, the president of Fundamentals Research Corp, who did his own study on management expense ratios of Canadian equity funds, stated "what's interesting to me is that in most products, the more you pay, the more you get with these funds, it appears that this is not the case."¹⁰⁵¹

5.2 MORNINGSTAR REPORTS

Morningstar conducted evaluations of the global mutual fund industry in 2009¹⁰⁵² and 2011¹⁰⁵³. A ranking of the countries evaluated by Morningstar on the basis of the total expense ratios in the 2009 report is summarized from lowest to highest expense ratios in Table 3a.

¹⁰⁵⁰ Ibid.

¹⁰⁵¹ Ibid.

¹⁰⁵² J.K. Rekenthaler, M. Swartzentruber and C.S. Tsai, (2009). *Morningstar Global Fund Experience 2009*, Morningstar Fund Research, May 2009 (2009 Morningstar Report).

¹⁰⁵³ B.N. Alpert and J.K. Rekenthaler, (2011). *Morningstar Global Fund Investor Experience 2011*, March 2011 (2011 Morningstar Report).

Table 3a - Global Ranking of TER by Country in 2009 Morningstar Study Report

Ranking	Country
A	US, China
B	Netherlands, Australia, Italy, France, Germany, Japan, New Zealand, Switzerland
C	Taiwan, Spain, Singapore, U.K.
D	Hong Kong
F	Canada

Note: Ranking, from lowest (A) to highest (F) TER; Source: 2009 Morningstar Report, supra note 1052)

As indicated above, in the 2009 Morningstar study Canada received the lowest ranking and a failing grade of F due to its high fees for fixed income and equity funds, which are the highest of all the countries. The Morningstar report¹⁰⁵⁴ states “Canada’s failing grade in fees is the lowest grade received in any of the surveyed areas.” In comparison, the United States has the highest ranking (along with China) for their lowest TER.

The 2009 Morningstar report indicates that Canadian investors do not pay much attention to fees and that Canadians are comfortable with the fees because they do not know how much the fees actually should be¹⁰⁵⁵. In addition, assets tend to flow into

¹⁰⁵⁴ 2009 Morningstar Report, supra note 1052, p.28.

¹⁰⁵⁵ 2009 Morningstar Report, supra note 1052, p.26.

funds with average or higher fees because Canadian investors use financial advisors to help them make their decisions¹⁰⁵⁶. In Canada, advisors direct clients to funds that pay better trailer fees, and since the trailer fees are indicated in the MER, the result is that assets flow into higher fees¹⁰⁵⁷.

High fees were the primary reason why Canada received a failing grade in the 2011 Morningstar global mutual fund study. As indicated below, Canada also received a failing grade on fund fees in the 2009 study. The 2011 study ranked 22 countries in comparison to the 16 countries ranked in the 2009 study. Canada was the only country to receive a failing grade of “F” for fees and expenses (TER) in the 2011 study as was the case for the 2009 study. Italy which was the second worst with a “D” grade was the only other country that did not receive at least a “C” grade for its TER (fees and expenses).

The study’s discussion of Canadian fund fees includes point-by-point rebuttals to criticism of the 2009 study by the Canadian mutual fund industry. A criticism by mutual fund industry executives on the 2009 Morningstar report, including Joanne De Laurentiis the president of the Investment Funds Institute of Canada, contended that the Morningstar fund fee comparisons were “apples to oranges” because of major differences between Canadian pricing structures and those of other countries. The differences that were cited by the industry including the bundling of advisor compensation into the management fees of Canadian funds, lower front end commissions charged in Canada, federal and

¹⁰⁵⁶ Ibid.

¹⁰⁵⁷ Ruckman, K., (2003). Expense ratios of North American mutual funds, *Canadian Journal of Economics*, Vol. 36, No. 1 February 2003.

provincial taxes push up management expenses ratios (MERs), and greater transparency in the reporting of expenses in Canada.

The primary authors of the 2011 Morningstar report, Reckenthaler and Alpert, indicate in rebuttal of industry contentions that in the 2011 study with rare exception, every country pays for distribution costs out their funds expense ratios with regard to load structures. The Morningstar study indicates that the load structure in Canada is broadly similar to the global average. Funds with front-end sales charge are in the minority, and in many countries as well these charges can and will be negotiated to lower levels than stated in the prospectus. The authors of the Morningstar study noted that high taxes in Canada were a contributing factor to the high MERs in Canada, but that this did not affect the global rating by country and added that many European funds are also subject to value-added taxes. With regard to the transparency of fund expenses, the report indicated that Canadian disclosure of fund fees and expenses is not materially different to that of the other 21 countries studied.

There were positive aspects to Canada's rating. Canada received a grade of "A" for its sales and media practices, since preferential compensation for sales of particular funds are highly regulated and there is frequent media coverage including mention of high fees and the merits of long term investing. Canada received a "B" rating for disclosure and received favourable mention for its five year disclosure of the fund's expenses history and monetary illustration of each fund's cost.

Overall, Canada received a grade of “C+” which ranked in a tie with France, Germany, Japan, and the United Kingdom. The high overall grades of “A” were awarded to the United States and Singapore, which were the only two countries to receive this grade. The results with respect to expenses are the same as in 2009 where Canada also received a failing grade. The grades of Canada in the 2011 study are provided in Table 3b below:

Table 3b - Canada’s Grade in 2011 Morningstar Study

CATEGORY	GRADE
OVERALL GRADE	C+
REGULATION AND TAXATION	D
DISCLOSURE	B+
FEES AND EXPENSES	F
SALES AND MEDIA	A

Source: 2011 Morningstar Report, *supra* note 1053.

The 2011 Morningstar study report states “At a deceptively normal looking C+, Canada’s overall grade hides major strengths and weaknesses. Positively for investors, sales and media practices are excellent and disclosure is very good. Unfortunately, these benefits are counter balanced by steep taxes and the highest fund costs found in this survey.”¹⁰⁵⁸ With regards to taxation, the study referred to Canada’s high taxes on fund management fees. This includes GST in five provinces, and the harmonized sales tax (HST) which combines the GST with a provincial tax in the five provinces, and in

¹⁰⁵⁸ Ibid.

Ontario this “resulted in the tax on fund fees soaring to 13%, up from 5% when only GST was applicable.”¹⁰⁵⁹

5.3 COMPARATIVE ANALYSIS OF MUTUAL FEES AND EXPENSES CANADA AND THE UNITED STATES

I conducted a comparative analysis of the management expense ratios, which are the fees and costs paid by mutual fund investors, between Canada and the United States¹⁰⁶⁰. The results of this literature analysis indicate that the average Canadian management expense ratio (MER) is consistently higher than those paid by mutual fund investors in the United States, which translates into billions of dollars of additional costs paid by Canadian mutual fund investors. I then investigate why MERs are higher in Canada than in the United States in order to evaluate if these are associated with issues within the Canadian mutual fund governance regime as well as any areas for improvement.

In order to conduct a comparative analysis of mutual fund fees and costs between Canada and the United States, I conducted an extensive literature review. This review identified a comprehensive study by Ruckman that specifically analyzed the expense ratios of North American mutual funds.

The total value of the American mutual fund industry is over 14 times larger than

¹⁰⁵⁹ Rudy Luvko, A failing grade (again) on fees, *Morningstar Fund Watch*, accessed at: <http://cawidgets.morningstar.ca/ArticleTemplet/printArticle.htm>

¹⁰⁶⁰ K. Ruckman, (2003). Expense ratios of North American mutual Funds, *Canadian Journal of Economics*, Vol. 36, No. 1 February 2003.

that of Canada.¹⁰⁶¹ There are almost four times as many funds in the U.S. than in Canada, and the average fund size in the United States is about three and a half times larger than in Canada. There is however a significant difference between the mean MER in the two markets. Both countries define a MER as the ratio of a fund's total costs to total assets and report it as a percentage. It is the sum of management fees (these are company profits and fees to fund managers if contracted out), operating expenses, distribution fees and commissions to sellers. MER is regarded as the price of a mutual fund even though it is paid on continual basis by netting-out returns. The mean Canadian MER is about 50% higher than the mean MER in the United States.

If Canada had a relatively small proportion of funds in lower MER fund types, the difference in the over-all average MER could be simply explained. Ruckman's comparison of the distribution of MERs for all fund types for both Canada and the United States demonstrates that the mean is not a misleading indicator of the whole distribution, and that every fund type has the Canadian distribution of MERs at a higher level than that of the United States. A comparison of the different fund types, in Canada and the United States, along with their descriptive statistics are shown on Table 4. A comparison of the MERs between Canada and the U.S. is provided in Table 5.

¹⁰⁶¹ Ibid.

TABLE 4 - Comparison of Canadian and United States Equity Mutual Funds in Ruckman Study

Country	Total Assets (\$US billion)	Number of funds	Mean fund size (\$US million)	Mean MER (%)	Mean 3-year annualized return (%)
US	2.926	5,749	509.1	1.5	13.92
Canada	203	1,455	140.0	2.29	9.28
US – Canada Ratio Analysis					
US: Canada ratio	14.41	3.95	3.64	0.66	1.5

Source: Ruckman, supra note 1060

TABLE 5 - Comparison of the MER in Canada and the U.S. by Fund type in Ruckman Study

Category	Fund Type	Country	Mean MER (%)	Mean fund size (\$USmil)	Mean 3-year return (%)	Fund type's share of country's total market (%)	Mean market share of fund in fund type (%)
Domestic	Balanced	US	1.33	450	14.61	9.87	0.155
		Canada	2.16	203	9.77	24.52	0.406
	Blend	US	1.26	949	21.95	30.51	0.106
		Canada	2.15	168	9.64	19.41	0.423
	Value	US	1.36	848	17.66	19.22	0.150
		Canada	2.03	240	13.13	12.13	0.970
	Growth	US	1.49	668	22.19	16.47	0.138
		Canada	2.43	195	13.95	2.30	4.166
	Specialty	US	1.65	239	11.02	4.40	0.185
		Canada	2.50	57	-8.39	2.12	1.315
	Small-cap	US	1.53	206	12.84	4.75	0.148
		Canada	2.77	78	4.53	3.62	1.052
Foreign	Global	US	1.66	302	6.59	14.30	0.072
		Canada	2.39	125	7.77	24.27	0.252
	Emerging	US	2.13	78	-10.82	0.48	0.549
		Canada	2.82	28	-7.82	0.70	1.923
U.S.-invested Canadian Funds		Canada	2.15	98	22.26	11.03	0.437

Source: Ruckman, supra note 1060

For every fund type, the mean MER in the United States is lower than the mean Canadian MER in Canada and the United States mean fund size is larger than the Canadian mean fund size. There is a large variation of mean fund size differences ranging

from about twice as large (Balanced funds) to five and a half times larger (Blend funds). At the time of the Ruckman study, Canada had a higher proportion of foreign oriented funds (24%) compared with that of the United States (15%), while the United States had a higher proportion of Growth funds and Canada has relatively more balanced funds. The mean market share of funds in each category is the inverse of the number of funds. Ruckman indicates that this accounts for the difference in fund type size, while it proxies the degree of competition. Canada's Growth funds on average have a large market share within that category (4.17%), while U.S. Growth funds have on average a very small market share (0.14%)¹⁰⁶². The difference between average market shares in Canada and the United States for other fund types is less dramatic but always positive, suggesting that there is less competition in Canada in every fund type¹⁰⁶³.

The results of the Ruckman study indicate that the average Canadian management expense ratio (MER) is consistently over 50% higher than its American counterpart. The results of the Ruckman study demonstrate that the average Canadian management expense ratio (MER), the fee paid by mutual fund investors, is consistently more than 50% higher than those paid by mutual fund investors in the United States. The Investments in the Canadian mutual fund market by the end of 2001 totaled \$CDN 450 billion or 84% of the amount of money invested in guaranteed investment certificates, chequing and savings accounts combined. If Canadian investors paid the same average

¹⁰⁶² Ibid.

¹⁰⁶³ Ibid.

MER as U.S. investors in 2001, they would have saved over \$CDN 4 billion¹⁰⁶⁴.

5.3.1 Evaluation of Potential Causes of Higher MERs in Canada

I conducted an evaluation of the potential reasons why MERs are higher in Canada than in the United States based on the work of Ruckman¹⁰⁶⁵. Historically, the two most common explanations for the discrepancy in MERs are that Canadian funds do not take advantage of economies of scale and have fewer rival funds. Canadian regulations do not allow United States residents to purchase Canadian-owned mutual funds or U.S.-owned mutual funds to be sold to Canadians unless they are registered with a provincial commission. These regulations essentially segregate the Canadian and U.S. mutual fund markets. This segregation may create a potential monopolistic competition structure where Canadian mutual funds could charge premium fees for 'expenses'. The results of an economic model developed by Ruckman determines the extent to which these two common explanations account for the difference in MERs and reveals the mark-up in Canadian MERs that remains unexplained.

The results of Ruckman model show that differences in fund sizes, intensity of competition and measurable fund attributes account for about 24% of the Canadian MER mark-up¹⁰⁶⁶. The Canadian MERs are even higher than the monopolistic competition model would predict, which suggests that the mark-up is due to either monopoly power

¹⁰⁶⁴ Ibid.

¹⁰⁶⁵ Ibid.

¹⁰⁶⁶ Ibid.

beyond that allowed by monopolistic competition or a difference in accepted distribution practices. In addition, using the United States market as a base, the number of Canadian mutual funds predicted by the model can be calculated using the estimated parameters. The predicted number of Canadian funds in Ruckman's model is very close to the actual number of funds and is shown to be closer than the simpler form of monopolistic competition that does not allow for heterogeneous funds.

Carhart¹⁰⁶⁷ concludes that the three fund characteristics, MERs, transaction costs, and turnover rates, explain almost all the persistence in returns. Grinblatt and Titman¹⁰⁶⁸ suggest that turnover rate is significantly related to the ability of the fund managers to earn abnormal returns.¹⁰⁶⁹ Tufano and Sevick¹⁰⁷⁰ connect board of director characteristics with fund fees and determine that smaller boards and boards with a larger fraction of independent members approve lower fees. Ruckman's paper differs from the existing literature because it attempts to explain mutual fund fees by utilizing a monopolistic competition model. Previous authors have recognized the importance of economies of scale and other fund-specific variables in explaining mutual fund performance.

Experts in the Canadian mutual fund industry often attribute the high Canadian

¹⁰⁶⁷Carhart, *supra* note 100

¹⁰⁶⁸Grinblatt and Titman, *supra* note 87.

¹⁰⁶⁹There are also a number of studies in which the determinants of mutual fund fees are examined in a purely empirical context. Trzcinka and Zweig (1990) and Malhotra and McLeod (1997) conclude that funds with 12b-1 fees have larger MERs. Malhotra and McLeod (1997) also determine that economies of scale have a significant role in mutual funds fees. There is also a set of studies linking the form of fund manager compensation with fund performance. Significant contributors include: Brown, Harlow, and Starks (1996) and Berkowitz and Kotowitz (1993).

¹⁰⁷⁰Tufano and Sevick, *supra* note 143.

MERs to the following five factors: i) there are a larger number of index funds in the United States that traditionally have much lower MERs that push down the mean MER ii) higher marketing costs in Canada caused by typical load structure, iii) higher costs in Canada due to higher trailer fees; iv) the larger average fund size in the U.S. leads to economies of scale; v) the average size of families of funds in Canada is smaller than in the U.S., which does not allow Canada to take advantage of economies of scale.

Ruckman examined the effects of competition on MERs in Canada. According to Ruckman, the basic monopolistic competition framework has a large number of firms producing and selling goods that are close substitutes, allowing each firm a degree of monopoly over the sale of its own product. In equilibrium, a firm's average cost depends on the size of the market and the number of firms in the industry: the more firms there are in the industry, the higher is a firm's average cost. Even though there is free entry in the market, there can be a short-run equilibrium involving profits in the long-run, this model however, has each firm earning zero economic profits, charging a price equal to average cost and, compared with perfect competition, operating at excess capacity. Ruckman concludes based on the results of an economic model that the monopolistic competition model has been shown to be an acceptable representation of the mutual fund industry in North America. Ruckman notes however that using its framework, it remains to be shown to what extent the different attributes of the funds and fund types and markets can explain the difference in MERs. Ruckman's analysis further indicates that a larger sized fund should have a lower MER because of economies of scale.

Malhotra and McLeod¹⁰⁷¹ find that a 100% increase in the size of the mean U.S. equity fund for 1993 would decrease its MER by 7.3 basis points. They note that the data set used in Ruckman's paper includes Canadian funds, and that a doubling of the mean fund's assets would decrease its MER by more than 22 basis points. Malhotra and McLeod¹⁰⁷² do not include the inverse of number of funds (the variable accounting for different competition in different fund types between countries) which accounts for part of the discrepancy. A doubling of the mean fund size in the Ruckman study would decrease its MER by 12 basis points, bringing the economies of scale effect closer to Malhotra and McLeod's findings¹⁰⁷³.

As funds increase in size, there should be economies of scale that allow a decrease in the MER. The results of Ruckman's analysis indicate that an older fund will have a higher MER. This result confirms a conclusion of Tufano and Sevick¹⁰⁷⁴ who found that older funds tend to charge higher MERs. As explained earlier, funds with loads tend to have inflated MERs and the strong positive sign of the coefficient corroborates this interpretation. Funds with many family members appear to have lower MERs because of economies of scale. Index funds have lower MERs because they require less research expense.

Ruckman's analysis shows that even after accounting for the smaller average fund

¹⁰⁷¹ Ibid.

¹⁰⁷² Ibid.

¹⁰⁷³ Ibid.

¹⁰⁷⁴ Tufano and Sevick, *supra* note 143 p. 347.

size of the Canadian companies and difference in competition, there is still a significant unexplained average mark-up in Canadian equity MERs. The unexplained mark-up is estimated to be an average of 65 basis points or 76% of the Canadian mark-up¹⁰⁷⁵.

Ruckman concludes that economies of scale contribute to the difference in MERs between the two countries (Canada and the U.S.) and accounts for more than 14% of the difference in MERs¹⁰⁷⁶. She considers the difference in competition between the two markets to be a comparatively minor factor in accounting for the difference in MERs. In all cases, however, the unexplained Canadian mark-up is significant and does not appear to be due largely to marginal cost difference.

The results of the Ruckman study further indicate that the more funds in a fund type the smaller the market share each fund in that fund type will have. The estimation predicts that the higher a fund's MER is over its fund type's average MER, the lower will be its market share in that fund type. The estimated significances suggest that the competition effect is stronger than the effect of an above average MER in determining market share.

Older funds were found in the Ruckman study to have larger market shares. This could be because of confidence instilled in consumers or simply because they have had a longer time to build a clientele. Funds with better than average returns have larger market

¹⁰⁷⁵ Ibid.

¹⁰⁷⁶ Ibid.

shares. Funds that are associated with larger families are predicted to have larger market shares. This is most likely because mutual fund consumers may look to purchase funds that allow them to switch costless among funds in the same family.

Ruckman concludes that her model fits the North American data well, and its estimation determines the extent to which the two common explanations account for the discrepancy in MERs. However the difference in fund sizes, degree of competition, and measurable fund attributes are determined to explain about only 24% of the Canadian mark-up¹⁰⁷⁷ and therefore there are other factors that may be influencing the differences in MER.

Trailer fees in Canada are anecdotally thought to be twice as large as 12b-1 fees in the United States. Trailer/12b-1 fees are a marginal cost according to Ruckman and can account for only up to one – third of the difference in MERs¹⁰⁷⁸. A significant difference in costs, such as labor costs, would influence a difference in MERs between the two markets. This was not investigated by Ruckman as there are no available data on cost factors. Lastly, Canadian investors buy rear-loaded funds four times as often as front-loaded funds, whereas U.S. investors buy them equally as often. Ruckman notes that this remains a feasible but as of yet immeasurable reason for part of the difference in MERs.

¹⁰⁷⁷ Ibid.

¹⁰⁷⁸ Ibid.

The majority of the fund management companies are privately owned, or owned by financial entities, such as insurance companies or commercial banks. There are some that are publicly traded that allow for an analysis of financial returns. For the private companies, this information is not made public through disclosure requirements and fees are commonly bundled together with administrative costs. Therefore, a detailed analysis of the root causes for the high fees in Canada is not possible without the disclosure of this information in a standardized format to allow for comparison between companies and fund classes.

I suggest that there also should be a consistent framework introduced for reporting of the breakdown of fees and costs such that a determination could be made of why the fees in Canada are so high in comparison with the rest of the world. Based on my review of the literature, I conclude that trailer fees are a significant reason why the advisory fees are high in Canada and therefore this evaluation should focus upon trailer fees and ensure that there is effective control on these to prevent investors from paying excessively high fees. I also suggest that there should also be a communication to Canadian investors as to the fees that they pay relative to other benchmarks. From my perspective, this is underscored by the current situation of Canadian investors being largely unaware that they pay the highest fees mutual fund fees globally, since in my opinion, in all practicality, they are not able to search out and read detailed studies such as the Ruckman or Morningstar studies.

Mutual fund management is a scalable business, since the fees increase with the

assets under management and as such the costs do not increase in parallel. Instead, the costs tend to increase less than the revenues due to economics of scale resulting in higher profitability with progressively higher revenues, since the profit margin (profit per dollar of revenues) increases. Currently, based on my review of the literature and regulatory framework there is no information that is publicly available which will allow Canadian investors to understand whether they would benefit from reduced fees associated with economies of the scale.

The current mutual fund regulatory regime in Canada is based on the premise that investors will “vote their feet” when they believe that their mutual fund fees are too high which acts as a mechanism of investor protection and control upon fees through competition. As noted by Qian¹⁰⁷⁹, however, investors’ “voting with their feet” is not an effective corporate governance mechanism. There is also a belief that and that they will not purchase mutual funds with fees that are too high. The results of studies on investors behavior and fund flows, however, indicate that they will purchase funds with high fees if these funds have exhibited recent high performance¹⁰⁸⁰.

These mechanisms also assume that investors are knowledgeable about their investments and have the necessary time and resources to monitor these to provide them with sufficient information to make this choice. The most obvious evidence for this is

¹⁰⁷⁹ Meijian Qian, Is ‘voting with your feet’ an effective corporate governance mechanism?, *Journal of Corporate Finance* 17 (2011), pp. 45-61.

¹⁰⁸⁰ Alexander, G. J., J. D. Jones, & P. J. Nigro, Mutual fund shareholders: characteristics, investor knowledge, and sources of information, *Financial Services Review* 7 (1998), pp. 301-316.

that investors are continuing to invest in mutual funds despite the very high fees in Canada. Additionally, the recent growth of exchange traded funds (ETFs) with low fees which mimic the portfolio composition of stock market indices is an indication that investors are becoming more sensitive about high fees.

5.4 GAO STUDY OF DISCLOSURE OF MUTUAL FUND FEES

In 2003, the General Accounting Office (GAO) in the United States published a study focused upon the disclosure of mutual fund fees and related purchases¹⁰⁸¹. The GAO study reviewed how mutual funds disclose their fees, related trading costs, and options for improving these disclosures. The study also reviewed changes in how mutual funds pay for the sale of fund shares and how the changes in these practices are affecting investors. The GAO study noted that a reason for this study was that fees and other costs that investors pay for their mutual fund shares can significantly affect their returns. An additional reason for the study was there were questions raised as to whether the disclosures of mutual fund fees and other practices are sufficiently transparent.

The GAO study found that while mutual funds disclose considerable information concerning their costs to investors, the specific amount of fees and expenses paid by each mutual fund investor were disclosed as a percentage of fund assets, while most other financial services disclose the actual costs to the purchaser in dollar terms. The GAO report noted that other disclosures could increase the transparency of these fees, such as

¹⁰⁸¹ GAO, Mutual Funds, Greater Transparency needed in Disclosures to Investors, United States General Accounting Office Report to Congressional Requesters, Report GAO-03-763, June 2003. Accessed at: www.gao.gov/cgi-bin/getrpt?GAO-03-763.

providing existing investors with the specific amounts of the expenses paid or by placing fee-related disclosures in the quarterly account statements that investors receive.

The disclosure regulations at the time of the GAO study were recognized by regulators to be in need of augmentation. The GAO study results also indicated that brokerage commissions and other trading costs are also incurred by mutual funds when they buy and sell securities but these costs are not prominently disclosed to investors. The GAO report noted that SEC proposed requiring mutual funds to disclose additional fee-related information, but these would not provide investors with a specific dollar amount of fees paid on their shares, and these disclosures to be provided in the document would not generally be considered to be the most interest to investors. It was recognized in the GAO study that while mutual funds have boards of directors that are responsible for reviewing the fees that fund investors are charged; some study participants questioned whether the directors have been effective in overseeing these fees.

Industry observers noted that “the process that fund directors are required to follow under the law fails to produce sufficient actions to minimize fees.”¹⁰⁸² Some participants suggested that fund directors should be required to seek competitive bids from other investment advisors. At the same time industry participants noted that this may not result in lower costs and lower fees for investors and indicated that directors could strive to lower fees through other approaches such as requiring investment advisors to charge progressively lower fees as the fund assets grow.

¹⁰⁸² Ibid. p. 39.

Disclosure of 12b-1 Fees

In 2000, a SEC report recommended that rule 12b-1 be modified to create changes in the way funds were being marketed. One of the areas of concern in the United States arose when a SEC rule, Rule 12b-1, was adopted in 1980 that allowed mutual funds to be using fund assets to pay for distribution expenses. This included payment for marketing expenses and compensation for financial intermediaries that sell fund shares. Concern arose as to whether funds with 12b-1 fees are more costly to investors. Concerns were also raised in particular whether disclosure mechanisms that were in place at that time were sufficiently transparent to allow investors to understand the extent to which their own broker-dealer receives these payments.

Revenue Sharing

A distribution practice that became common and a concern in the United States is revenue sharing which involves investment advisors making additional payments to broker-dealers that distribute their fund shares. One of the principle concerns with revenue sharing is whether the broker dealers that are receiving payments to promote certain funds represent a conflict of interest where sales creates representatives recommended to investors what the investment funds instruct firms to recommend as opposed to being the fund that best meets investors needs.

Soft Dollar Arrangements

Soft dollar arrangements involve investment advisors of mutual funds using part of their brokerage commissions to pay broker dealers that execute trades on the fund's behalf to obtain research and brokerage services that could potentially benefit fund investors, but at the same time increase the costs of the funds to investors. An example of this is investment advisor being paid for market research by a broker dealer in a soft dollar arrangement. These costs could be passed on to investors in the form of fees or expenses or bundled costs.

Concerns have been raised about the potential conflict of interest that could arise should fund advisors use investment advisors largely or solely for the soft dollar services rather than for their value to investors. Additional concerns were raised as to whether investment advisors would trade excessively in order to achieve soft dollars. An early evolution by the SEC in 1998 found issues associated with the use of soft dollars by investment advisors. The SEC did not take actions specifically on the recommendations for disclosure although it improved investor's understanding of the use of soft dollars by their investment advisors. I note that it is important that investors fully understand fees related to their mutual fund investment and their advisors and the costs they are paying in order to create competition in the mutual fund market place. Competition in the mutual fund industry is in the public interest as it will serve to contribute to regulating investment advisor fees.

A study conducted by GAO indicated that the average fees charged by 77 of the largest stock and bond mutual funds declined between 1990 and 1998¹⁰⁸³. In this report GAO concluded that mutual funds compete for investment dollars primarily on their performance rather than on the price of their service expressed in their fees. In 2003, an updating of this study by GAO found that the average for the same group of funds had increased which if concluded was due in part to some funds paying higher management fees to their investment advisors to reflect performance¹⁰⁸⁴.

GAO noted in their 2003 report¹⁰⁸⁵ that, at that time, mutual funds disclosed information about their fees as a percentage of their assets whereas most other financial services disclose their costs in dollar forms. The SEC has proposed alternatives for disclosure of mutual fund fees, however, these have been countered by the mutual fund industry by indicating that these disclosures would result in additional costs and that the benefits of these disclosures have not been determined. The brokerage commission and other costs that are incurred by mutual funds when they buy or sell securities were also not routinely or explicitly disclosed to investors at that time. I suggest that the focus of the SEC during and after the period of mutual fund scandals in the early 2000s was upon introducing additional requirements for independent directors and a chairman to address the scandals and not requirements for additional disclosure of fees and expenses.

¹⁰⁸³ GAO, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition*, GAO/GGD-00-126 (Washington, D.C., June 7, 2000).

¹⁰⁸⁴ U.S. General Accounting Office, *Mutual Funds: Information on Trends and Their Related Disclosure*, GAO-03-55-IT (Washington, D.C.: March 12, 2003).

¹⁰⁸⁵ GAO Report GAO-03-763.

At the time of the 2003 GAO study, all mutual funds in the United States were required to provide investors with disclosures about the fund in a written prospectus provided to investors when they initially purchase shares. According to SEC rules, the prospectus was required to include a fee table that contained information concerning operating expenses, sales charges and other fees that investors will pay for holding shares in that fund. This table must provide disclosure information concerning charges paid directly by shareholders out of their investment such as front or back end sales loads, and recurring charges deducted from fund assets, holding management fees and distribution fees, as well as other expenses charged to shareholders. The funds operating expense ratio is also reported, which represents the fees deducted from the fund's assets expressed as percentage of fund assets.

The 2003 GAO report noted that unlike many other financial products, mutual funds do not provide the exact dollar amounts of fees that individual investors pay while they hold the investment. Although mutual funds provide information about their fees in percentage terms and in dollar terms using hypothetical examples, they do not provide investors with information about the specific dollar amounts of fees that have been deducted from their shares.

The SEC released proposed rule amendments, which include a requirement that mutual funds make additional disclosures about their expenses in annual and semi annual

reports to be prepared by mutual funds¹⁰⁸⁶. The SEC proposed that mutual funds be required to disclose the cost *in dollars* of an investment of \$10,000 with the fund's actual return and expenses. The SEC also proposed that mutual funds further be required to disclose the cost in dollars of \$10,000 investment that earned a standardized return of 5 percent, based upon the funds actual expenses.

There were several advantages to the SEC's proposed alternative disclosures. The new disclosures would provide investors with additional information concerning the fees that they pay for their mutual fund investments and would allow for investors to compare across mutual funds in dollar terms. The limitation to this proposed approach is that it still would not be specific to investor's amount balances or the number of shares that they owned. A disadvantage to the proposed additional disclosures is semi-annual shareholder reports rather quarterly statements which are generally considered to be the most valuable for investors since they show investors the number of shares owned and the value of their fund. As such, the SEC's proposed disclosures could have been less effective in increasing investor awareness and increasing price competition in the mutual fund industry. Nevertheless, the SEC proposed approval of the proposed disclosures processes in their December 2002 proposal. The SEC proposal received a wide range of comments, most of which were in support of the proposed requirement to include a dollar cost associated with a \$10,000 investment.

¹⁰⁸⁶ SEC, *Shareholder Reports and Quarterly Portfolio Disclosure*, Securities and Exchange Commission Release No. 5 33-81-64; 34-47023; 1C-2587068 Dec. 18, 2002.

Investor-Specific Dollar Fee Disclosure

GAO provided an alternative for disclosing mutual fund fees involving specific disclosure of the actual dollar amount in fees paid by each investor. GAO noted that this disclosure would make mutual funds comparable to other financial product services such as stock transactions through a broker or banks. In its June 2000 report GAO reasoned that since other financial services such as brokerage and banks compete on the basis of price, if mutual funds were to include similar specific dollar disclosures then investors would be reminded that they pay fees for investing in mutual funds and then additional competition being funds would result. GAO had also received an opinion from an attorney specializing in mutual fund law requiring mutual funds to disclose the dollar amount in fee in investor account statements would likely encourage investment advisors to compete on the basis of fees. GAO believed that this disclosure could also stimulate new entrants to the mutual fund industry that would find their funds attractive on the basis of low costs, similar to the manner in which low-cost discount broker-dealers entered the securities industry.

There was not, however, universal acceptance that the GAO's suggested approach would be beneficial. For instance, only six of fifteen financial advisors selected for interviews by GAO believed that specific dollar disclosure of mutual fund fees would provide additional benefit to investors. The remaining nine advisors interviewed did not think that specific dollar disclosures of fees would provide much additional benefit since they believed that the factor that most investors consider more than others is the overall

net performance of the fund. A variety of concerns were also raised by industry officials regarding the requirements for specific dollar disclosures suggested by GAO. For example, one officer indicated that this would inform investors how much they were paying in fees but not provide the appropriate context to allow for comparison with charges for other funds and would therefore not stimulate competition.

It was recognized by GAO that while the total costs of providing investor specific dollar fee disclosures could be significant, this may not represent a large expenditure on a per-investor basis. The Investment Company Institute (IFIC) commissioned study from an accounting firm to survey mutual fund companies about the costs of these investor-specific disclosures¹⁰⁸⁷. The results of this study concluded that the total costs for the survey respondents to implement investor-specific dollar disclosure in shareholder account statements would be more than \$200 million, with annual compliance costs of \$66 million. It should be noted that this estimate did not include the reportedly significant costs associated with third-party financial institutions which have mutual fund accounts for shareholders. The annual compliance costs were estimated to be more than \$66 million. This would amount to approximately \$1 dollar per investor account for the initial investment and \$0.35 per account for the annual costs according to GAO estimation.

Cost estimates were also obtained by GAO from transfer agents, who maintain shareholder account records and process share purchases and redemptions that provide

¹⁰⁸⁷ See GAO Report GAO-03-551T for a summary of results.

services for approximately one-third of the total 240 million accounts globally. These transfer agents estimated that they would incur estimated one-time development costs of between \$1.5 and \$3 million to revise their system to accept and maintain account expertise data for specific individual investors, with estimated annual data processing expenses of \$0.15 to \$0.30 per account¹⁰⁸⁸. These annual costs represent about 1 percent of the administrative costs estimated to be from \$18 to \$23 per annum. There would also be costs incurred by funds to modify their web sites to provide investors with their specific account expense information. While this information could benefit investors and be desired by them, it could potentially be cost sensitive.

The results of a survey of more than 500 of its investor clients by a broker dealer found that almost 90 percent of the survey respondents indicated that specific dollar disclosures would be useful or very useful, while only 14 percent indicated that they would be very or somewhat likely to pay for this information¹⁰⁸⁹. The SEC and industry participants indicated that before requiring mutual funds broker-dealers and other account intermediaries to compile and provide investor specific information to modify their system at their cost, additional information and the price of a security before it is sale. Investors may also not pay commissions when broker-dealers are compensated based on the spread between buying and selling prices of securities.

Brokerage Commissions

¹⁰⁸⁸ Ibid.

¹⁰⁸⁹ GAO Report, GAO/GGD-00-126, p.178, June 2000.

Mutual funds incur trading costs that affect investor's returns such as brokerage commissions, mark-ups or spreads. Brokerage commissions are not required to be disclosed specifically to investors and this disclosure does not typically occur in the mutual fund industry. These brokerage commissions add significantly to investor costs and other trading costs and therefore should be disclosed. For example, the estimated size of brokerage commissions paid by mutual funds range from 0.15 percent to 0.50 percent of fund assets¹⁰⁹⁰.

The results of academic studies in the 1990's found that the brokerage commissions amounted to approximately 0.3 percent of mutual funds' total assets¹⁰⁹¹. One of these studies that included more than 1,100 stock and bond funds found that brokerage commissions averaged 0.31 percent of fund assets¹⁰⁹². One of these academic studies estimated that mutual funds pay brokerage commissions amounting to \$0.06 per share traded¹⁰⁹³. In contrast, at that time (mid 1990's) investors could trade for as little as \$0.02 per share, which represents a \$0.04 percent differential from the average cost of brokerage commissions identified by this study. This study estimated that 66 percent of this total amount per share was attributable to charges for soft dollar research from the broker dealer. In the United States fund managers are permitted to engage in soft dollar arrangements under provision in Section 28 (e) of the Securities Exchange Act of 1934.

¹⁰⁹⁰ GAO Report GAO - 03 -763, p. 17.

¹⁰⁹¹ Fortin, R., & S. Michelson, (1998). Mutual fund trading costs, *Journal of Investing*, Spring 1998.

¹⁰⁹² Ibid.

¹⁰⁹³ Livingston, M., & E. S. O'Neal, (1996). Mutual Fund Brokerage Commissions, *Journal of Financial Research*, Summer 1996, Vol. XIX, pp. 273-292.

In the adoption of this section, Congress acknowledged the service provided by broker dealers managers by producing and distributing investment research to fund managers and allowed fund managers to use commission dollars paid by managed accounts to acquire research. Accordingly, soft dollar arrangements are permitted in the United States although their specific costs are not specifically disclosed to investors.

Brokerage commission costs are not disclosed in documents sent to investors in the United States. The SEC required mutual funds to disclose the amount of brokerage paid in the Statement of Additional Information (SAI). The SEC requires funds to disclose the aggregate amount of brokerage commissions paid during its 3 most recent fiscal years in the SAI. If there is any material difference from the most recent fiscal years brokerage commissions paid in comparison with the previous 2 fiscal years, then this material difference must be explained. Mutual funds may also trade costs that offer investors' returns, in addition to the expenses incorporated within the expense ratio¹⁰⁹⁴. These costs include commissions paid by investors to broker-dealers when they trade securities on the behalf of a mutual fund.

The SAIs, however, are not required to be sent periodically to a fund's shareholders and instead are filed with the SEC annually and sent to investors upon request. It should be recognised that the amount disclosed in the SAI does not include other trading costs such as spreads. One of the academic studies noted that since all expenses and reducing fund returns, then the significant trading costs including brokerage

¹⁰⁹⁴ The funds total annual operating expenses as a percentage of fund assets.

commissions be disclosed directly to investors rather than only to SEC and made available upon request¹⁰⁹⁵ have called for mutual funds to be required to include their trading costs including brokerage commissions either in their expense rates or separately disclose their expense ratios¹⁰⁹⁶. An investor advocate reasoned that funds would likely seek to reduce their broker commissions if they were required to disclose them as part of their expenses. It was also suggested that competition among funds usually results in them attempting to improve their performance in the area that is being disclosed. I suggest that it is not clear, however, if this is actually the case since management expense ratios are disclosed and lowering of these does not appear to have occurred due to competition amongst funds.

There have been concerns raised regarding disclosure of brokerage commissions. One concern was that requiring funds to include brokerage commissions would not result in the provision of comparable information to investors due to differences in fund composition and the securities upon which the brokerage commissions are paid, such as securities listed on the NASDAQ where the broker-dealers are typically compensated on the basis of spread rather than sales commissions. Further, bond transactions are subject to mark-ups and not commissions. As such, there could be difficulties directly comparing costs between categories, although this would not affect comparison within categories.

¹⁰⁹⁵ M. Livingston and E. S. O'Neal, *supra* note 1093.

¹⁰⁹⁶ GAO Report GAO, 03-55 IT.

The ICI indicated that costs of trading, inclusive of brokerage commissions, are included as part of the initial value of purchased securities which is used to calculate the change in value when it is sold and that as such trading costs are included in funds' performance returns¹⁰⁹⁷. I should note that while the ICI's asserts that brokerage commissions are included in performance returns, this does not provide these costs separately for investors to consider. The SEC has indicated to GAO that directors are expected to oversee their funds brokerage arrangements and oversee their funds transactions to ensure that there are good trade executions¹⁰⁹⁸, that these directors have a fiduciary obligation to ensure that the level of brokerage commissions, and other trading costs are being managed in the fund investors best interest¹⁰⁹⁹.

Mutual fund boards of directors in the United States have a responsibility to protect shareholder interests and independent directors have a special responsibility to protect investor interests. Independent directors, however, could do more to assert their influence to reduce fees charged by fund advisors. In the United States, the Investment Company Act (ICA) requires that a majority of independent directors separately approve the contracts with the investment advisor that will manage the fund's portfolio and the entity that will distribute the fund's shares as well other administrative service arrangements. In the United States, independent directors are responsible for whether the service contract is in the best interest of the fund and its shareholders, that the services

¹⁰⁹⁷ GAO Report GAO-03-55IT.

¹⁰⁹⁸ Ibid.

¹⁰⁹⁹ Ibid., p. 20.

are of a nature and quality at least equal to the same or similar services provided by independent third parties, and that the fees for these services are reasonable in comparison to the fees charged for the same nature and quality¹¹⁰⁰. Further, independent directors in the United States have specific duties and responsibilities to approve the investment advisory contract between the fund and the investment advisor and fees that will be charged on an annual basis¹¹⁰¹.

In the United States, SEC staff from the SEC's Office of Compliance Inspections and Examinations conduct examinations of mutual funds and their advisors including review of minutes from past board meetings to ensure that the directors were provided with relevant information and utilized this as part of their decision making process. Independent directors in the United States have been criticized for not using their positions effectively to reduce fees. In part, these criticisms could arise from the process for the annual contracts which may serve to keep fees at their current levels by comparing fees with industry averages. In addition, board members are typically not required to ensure that fees are as low as possible but rather to be written in a range of reasonableness. The directors are also hampered by the outcomes of court cases that found that comparison of mutual fund fee to other funds, such as pension fund fees, was inappropriate¹¹⁰².

¹¹⁰⁰ GAO Report No. GAO – 03-763, p21.

¹¹⁰¹ Under Section 15 of Investment Company Act.

¹¹⁰² Freeman, J. P., & S.L. Brown, (2001). Mutual fund advisory fees: The cost of conflicts of interest, 26 *Journal of Corporation Law* 609.

A potential approach for increasing the effectiveness of boards in lowering fees for investors is to have fund directors obtain competitive bids for funds' advisory contracts. This approach is routine for pension funds, which may seek new investment advisors every 2 to 3 years. This approach could contribute to the fact that pension funds' fees are 2 to 3 time less on average than mutual fund investment according to a Treasury Department Official¹¹⁰³.

Investment advisors in the United States also have a fiduciary duty to the fund regarding the fees that they receive and to authorize actions by shareholders and the SEC against the advisors for breach of this duty¹¹⁰⁴. The framework was developed by the U.S. courts for determining whether an investment advisor has breached its duty is the *Gartenberg* test established by the second circuit Court of Appeals decisions, where the court set forth factors relevant to determining whether an advisor's fee is excessive¹¹⁰⁵.

5.5 COMPARISON OF MUTUAL FUND AND PENSION FUND ADVISORY FEES

Freeman and Brown¹¹⁰⁶ found that the average mutual fund advisory fee is twice as large as a pension fund advisory fee, with the average mutual fund paying 56 basis points compared to¹¹⁰⁷ 28 basis points for pension funds. Freeman and Brown found that the main reason for lower pension advisory fees was essentially that pension funds

¹¹⁰³ GAO Report GAO – 03-763 .

¹¹⁰⁴ Under Section 36(b) of the Investment Company Act.

¹¹⁰⁵ *Gartenberg v Merrill Lynch Asset Management Inc.* 528 F. supp 1038 (S.D.N.Y. 1981), aff'd, 694 F. 2d923 (2dCir 1982) cert. denied, 461 V. S. 906 (1983).

¹¹⁰⁶ Freeman and Brown, supra note 1102.

¹¹⁰⁷ Ibid.

operate in a market with arm's length bargaining due to the separation of the fund and investment advisors. In contrast, the mutual fund industry has argued that the cost differential is due to the services and required costs in the mutual fund industry. Both the SEC and ICI indicate that investment advisors for mutual funds provide many other services than advisors of pension funds and that the higher advisory fees for mutual fund advisors compensate them for these additional services which may include 'around the clock' customer service, preparation of account statements and shareholder communications, and compilation of annual tax information for the funds investors. An additional reason could be that commonly mutual funds have thousands of accounts requiring management from customer service and record keeping, while pension funds have one large institutional account.

Industry participants have also indicated that mutual fund shareholders would likely not expect that their fund's board would change investment advisors. In their view investors often select their funds because of the reputation of a particular investment advisor, and therefore would not be supportive of their board changing fund managers. Industry participants have also indicated that it is not necessary for fund boards to change investment advisors since investors are able to redeem their shares and change advisors if they are unhappy with the advisor and/or their fund performance. Pension funds, in contrast, are unable to move their pension fund investments if they are unhappy with their existing fund advisor or fund performance, since decisions concerning the selection and hiring of advisors are made by the pension fund administrators.

In practice, very few mutual funds change their investment advisors. For instance, in the 2001 GAO report¹¹⁰⁸ it was noted that less than 10 funds changed their investment advisor within the previous 15 years. There are various reasons proposed to account for this. One of these is the switching costs that are incurred when funds change investment advisors. An additional reason is the logistics associated with the change in the United States, which is not confined to the board of directors but also requires to shareholders of the fund to vote to approve the change following the filing of a proxy statement by the board.

Arguments have been advanced by the fund industry against mutual fund boards sending their advisory service contracts for bid, indicating that this may not yield the anticipated cost savings and may in fact increase costs. Industry staff have indicated that their companies will not likely bid on contracts for mutual fund assets at the same rate that they bid on pension fund assets since their costs to manage mutual fund assets would be higher. One reason for this is that mutual fund assets are accumulated over time from many investors, while pension fund assets are offered to investment advisors in a large pre-existing pool. In addition, there are administrative costs associated with managing multiple mutual fund investors in contrast to a single pension fund pool. As such a comparison between pension fund fees and mutual fund fees may not be appropriate contrary to the views of Freeman and Brown¹¹⁰⁹.

¹¹⁰⁸ General Accounting Office, GAO Report GAO – 03-763.

¹¹⁰⁹ Freeman and Brown, supra note 1102.

Birdthistle¹¹¹⁰ analyzed allegations of malfeasance in the investment management industry, such as market timing, late-trading and reward sharing. He stated “to explain the common source of these irregularities by forecasting upon a train they share the practice of investment advisors capitalizing upon their management influence to increase assets under management in order to generate greater fees from these assets”¹¹¹¹. Birdthistle argues that this malfeasance can best be understood as a “camouflaged extraction of compensation from fund shareholders.”¹¹¹² Further, Birdthistle concludes that the regulatory reforms related to director independence proposed and adopted in 2003-2004 “are, and will continue to be, inadequate to the task of vitiating the influence of investment advisors and the conflicts of interest that currently pervert those advisor incentives to the detriment of shareholders.”¹¹¹³

A fundamental basis for camouflaged extraction of shareholders value, according to the Birdthistle, is that investment advisors are typically rewarded and commonly ranked based on the amounts of assets that they manage. He further notes that since the advisors’ fees are a direct function of the assets that they manage the metric is also an easy proxy for their success. While for an increase in every new dollar of assets an advisor may realize a penny or two, these profits become significant once the assets under management increase to billions of dollars providing a strong incentive for advisors

¹¹¹⁰ Birdthistle, W.A. (2006). Compensating power: an analysis of rents and rewards in the mutual fund industry, 80 *Tulane Law Review*, 1401, 2005-2006.

¹¹¹¹ *Ibid.*, p. 1401.

¹¹¹² *Ibid.*, p. 1404.

¹¹¹³ *Ibid.*, p. 1404.

to maximize profits by increasing assets under management. Birdthistle indicates that based on his analysis “A dynamic shared by many of the mutual fund irregularities of the past two and half years is the choice by culpable advisers to increase assets under their management at the expense of shareholders interests.”¹¹¹⁴ He recognized that increases in assets under management can potentially translate into economies of scale on transactions costs that can be shared in the form of reduced costs to investors. However, this may not have occurred in practice since as noted by Birdthistle “One of the in practises that recently came to light involves investment advisors failing to honour these breakpoints and not giving shareholders appropriate discounts.”¹¹¹⁵

Birdthistle argues that the industry’s faults can be found in the idiosyncratic structure of mutual fund, a structure that exacerbates the ability of managers to wield substantial power and use that power to extract rents both overtly and surreptitiously from shareholders¹¹¹⁶. The structure and incentive compensation of mutual funds creates the potential for conflict of interest by advisors, managers and brokers¹¹¹⁷. According to Birdthistle it is the structure of mutual funds that creates the potential for abuse.

An important part of this structure is where the funds are managed by an external investment advisor under an agreement to manage the fund in exchange for a fee

¹¹¹⁴ Ibid., p. 1452.

¹¹¹⁵ Ibid., p. 1452, note 226.

¹¹¹⁶ Ibid., p. 1409.

¹¹¹⁷ See for example Mahoney, P. G., (2004). Manager-investor conflicts in mutual funds, 18 *Journal of Economic Perspectives*.

calculated as a percentage of the assets under management. This results in a potential conflict of interest when an investment advisor maximizes their profits at the expense of fund shareholders. Theoretically, a fund board is able to protect the fund shareholders from this conflict of interest by terminating the contract of the investment advisor. This protection however rarely occurs in practice. One reason for this is that fund boards terminating the advisor could have a negative effect on the fund, since advisors who selected the fund because of the investment advisor could leave the fund. There would also be additional costs associated with the termination of an advisor and hiring of a new advisor as well as adverse publicity for the fund which could negatively impact the fund through reduced investment. These constraints would exist whether or not the fund board was comprised of independent directors. As such, the rules introduced in the United States requiring a majority of independent directors would not bolster the main remedy available to fund boards in response to conflict of interest the 'termination' of investment advisors' contracts.

Mutual fund advisors do engage in some activities to lower fees. One of these is that advisors commonly establish management fee "breakpoints" based on the level of fund assets or performance. These breakpoints decrease the level of management fees as asset levels grow through reduction of the investment advisors fee for the additional assets above the levels set in the breakpoint. Directors could also require performance clauses in an advisory contract that would reduce an investment advisor's fees if the performance of the fund did not exceed a specified industry benchmark.

In February 1999, the SEC held a forum on the role of independent directors of mutual fund directors to consider ways for improving mutual fund governance. The ICI created the Advisory Group on Best Practices at the same time, which recommended best practices used by fund boards to enhance the independence and effectiveness of mutual fund directors and recommended that all fund boards adopt them. These ICI recommendations included having independent directors constitute at least two thirds of the fund's board and independent directors select and nominate their independent directors.

The SEC's proposed rule amendments, which were recommended by the ICI, intended to reaffirm and enhance the role of independent directors in protecting fund investors, and were adopted in January 2001. These amendments required almost all funds to have a majority of independent directors on their boards and to have their independent directors select and nominate their independent directors, and that legal counsel for independent directors also is independent¹¹¹⁸. I note that these rules were in place prior to the mutual fund scandals that occurred in 2002 and 2003 which provided the impetus of the SEC's rule changes for director and chair independence.

One of the three key recommendations of the GAO report involving the disclosure to fund investors was as follows: "To promote greater awareness and competition among the mutual funds on the basis of their fees, we recommend that the SEC increase the

¹¹¹⁸ Securities and Exchange Commission, (2001). *Role of Independent Directors of Investment Companies*, Securities and Exchange Commission Release Nos. 33-7932; 3443786; IC-248/6 (Jan. 2, 2001).

transparency of the fees and practices that relate to mutual funds by ... considering the benefits of additional disclosure relative to mutual fund fees, including requiring more information in mutual fund account statements about the fees investors pay”¹¹¹⁹.

5.6 EXCESSIVE MUTUAL FUND FEES

Claims of excessive fees in equity mutual funds first arose in the 1950s and 1960s. The SEC contracted the Wharton School of Finance and Commerce to conduct a study of the mutual fund industry, in response to complaints about the fund industry, commonly referred to as “The Wharton Report”¹¹²⁰. The Wharton Report concluded that mutual fund assets grew substantially in the 1950s, providing lower cost through economies of scale, while the shareholder fees remained relatively constant at 0.5% of assets for most mutual funds¹¹²¹. The Wharton Report also concluded that investment fees were lower for non mutual fund clients where advisors were easily fired in contrast to mutual funds where they were not¹¹²². The report concluded that competition had not been substantially operative in fixing the advisory fee rates paid by the mutual funds¹¹²³.

¹¹¹⁹ General Accounting Office, GAO report GAO-03-763, *Greater Transparency Needed in Disclosure to Investors*, pp.56-57.

¹¹²⁰ Wharton School of Finance and Commerce, (1962). *A Study of Mutual Funds*, H.R. R&P. No. 87-2274, 1962. (Wharton Report)

¹¹²¹ *Ibid.*, p.28.

¹¹²² *Ibid.*, at 29.

¹¹²³ *Ibid.*, at 494.

The report attributed this to be because lower costs from economies of scale had not led to lower fees and because advisors did not compete for retail mutual fund contracts¹¹²⁴.

The SEC issued a report in 1966¹¹²⁵ that concluded that competition among mutual funds was absent¹¹²⁶. In addition SEC concluded that, at that time, the ICA and related SEC regulations did not protect investors from excessive fees¹¹²⁷. The Senate then issued a report which was largely related to discussion and interpretation of the Wharton Report and the SEC report. The reports served as background and context for Congress to amend the ICA in 1970. The Federal courts began to quote from the SEC's report in order to interpret the ICA, including the conclusion the competition did not constrain advisory fees. An example of this is *Fox v. Reich & Tang, Inc.* It was stated that the 1966 SEC Report found that "no evidence existed to demonstrate a willingness on the part of advisors to provide services at a 'reasonable' rate"¹¹²⁸. The conclusion that competition does not constrain advisory fees was further adopted by subsequent courts. For example, in *Gartenberg v. Merrill Lynch Asset Mgmt. Inc.*¹¹²⁹ the courts stated that

¹¹²⁴ *Ibid.*, at 493-494.

¹¹²⁵ SEC, *Public Policy Implications of Investment Company Growth*, H. R. Report No.1 89-2337, p. 2.3 (1966).

¹¹²⁶ *Ibid.*, p.12

¹¹²⁷ *Ibid.*, p. viii

¹¹²⁸ 692 F. 2d 250, 257 (1982).

¹¹²⁹ *Gartenberg I*, 694 F.2d 923,932 (2d Cir. 1982).

outside forces do not seem to affect Merrill Lynch's fees. In *Kalish v. Franklin Advisors, Inc.*¹¹³⁰ previous decisions of the court that considered advisory fees were discussed.

The perceived conflict of interest with investment advisors is central to the issue of excessive fees. For example a fund's board of directors typically contracts out all or most services to an investment advisor (it may retain administrative services in house). The fees that an advisor charges a fund for its advisory services require approval by the board of directors. This structure creates the primary conflict of interest since the advisor has an incentive to maximize its profits by charging the highest possible fees for services, while the funds' shareholders prefer the lowest fees possible in order to maximize the funds' returns. A common position of fund industry critics has been that since the fund advisors essentially control the fee approval process since they are not at significant risk of being fired or replaced by the mutual fund's board of directors.

The board of directors rarely fire advisors or put their contracts up for bid although there may be pressure on them to increase performance for both shareholders of the fund manager and the mutual fund units resulting in a potential agency conflict of interest¹¹³¹. Directors, however, can and do pressure advisors to replace poorly performing portfolio managers and may be fired¹¹³². Investors, however, have the

¹¹³⁰ 742 F. Supp. 1222, 1238 (S.D. N.Y. 1990).

¹¹³¹ Tufano, P., & M. Sevik, (1997). Board structure and fee-setting in the U.S. mutual fund industry, 46 *Journal of Financial Economics* 325; Dillon, C., (2006). Do you get what you pay for? A look at the high fees and low protections of mutual funds, *Columbia Business Law Review* 281.

¹¹³² Khorana, A. (1996). Top management turnover: an empirical investigation of mutual fund managers, 40 *Journal of Financial Economics* 403.

contractual right to collectively fire advisors through the proper process but do not exercise their rights. Hence, the absence or low degree of competitive regulation is the result of investors not exercising their rights and relates to investor education and behaviour. There is a perception that since fund boards do not shop around, they are beholden to advisors and that they do not attempt to negotiate competitive fees for fund shareholders.

There is a view that fee competition may be strong in the institutional fund market but weak in the mutual fund market as institutional investors may fire advisors since, for example, it is simpler for a single institutional investor to fire an advisor than for hundreds or thousands of mutual fund investors to align and fire a mutual fund advisor. There is also a view expressed that since fund fee levels have either remained constant or increased economies of scale are not being passed on to investors which implies that competition is not serving to regulate fee levels. For instance, Freeman and Brown indicate that to the extent economies of scale exist, they are being captured by the funds advisors and not the fund themselves¹¹³³.

The difference in the advisory fees for similar funds is also interpreted to indicate that competition is not effective as a constraint on advisory fees¹¹³⁴. It has been suggested that investors sacrifice efficiency for education and as a result are ineffective at constraining advisory fees since they are not sufficiently sophisticated to create a

¹¹³³ Freeman and Brown *supra* note 1102.

¹¹³⁴ Elton, E. J., (2004). Are investors rational? Choices among index funds, *Journal of Finance* 261.

competitive environment. There are several mechanisms that have been put forward as contributing to creating competition that could constrain mutual fund fees. The first of these is where the shares are redeemable shares¹¹³⁵ which are important for investors since the shares may be redeemed at any time of net asset value less sales charges or redemption. The ability for shareholders to redeem shares is the contracts between shareholders and their mutual funds¹¹³⁶ which include restrictions embedded within prospective and advisory contracts.

Coates and Hubbard¹¹³⁷ indicate that “the simple mechanism of redeemable shares is perhaps the most important aspect of fund regulation” and “From 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 mechanism for facilitating competition is that it allows investors to quickly and easily switch to another fund that they find more desirable, such as for instance switching from a fund with higher fees to a fund with lower fees. What Coates and Hubbard fail to mention, however, is that the capacity for redeemable shares to create competition based on funds’ fees is dependant upon investor knowledge and their vigilance of mutual fund fees. The typical portrait of a mutual fund investor is one that does not closely monitor mutual fund

¹¹³⁵ Schonfield, V. E., & T.M.J. Kerwing, (1993). Organization of Mutual Funds, 49 *Business Law* 107, 112.

¹¹³⁶ Deli, D.N., (2002). Mutual fund advisory contracts: an empirical investigation, 57 *Journal of Finance* 109, 122.

¹¹³⁷ Coates and Hubbard, *supra* note 911, p. 162.

fees. As such, while redeemable shares could be important for creating competition on a theoretical basis, this would not be considered to occur in reality.

The mutual fund industry in the United States was experiencing a condition of net redemptions in the early 1970s, which meant that it was contracting in size. For example, between February 1972 and July 1974, Investment Company Institute-member (ICI) funds suffered net redemptions in twenty-six out of thirty months¹¹³⁸. In response, the Securities and Exchange Commission (SEC) embarked upon a study analyzing the problems in the mutual fund industry including the net redemption conditions. From that starting point, the SEC moved to loosen restrictions on fund marketing in order to foster a more competitive environment¹¹³⁹. As part of this study, the SEC's Division of Investment Management Regulation conducted hearings into the state of mutual fund marketing. In its report on mutual fund distribution, the Division stated:

"The hearings confirmed that the mutual fund industry is faced with a disrupted marketing system. Record sales of earlier years have given way to net redemptions; competing products have made substantial inroads; fund managers have diversified into other fields; and the fund industry, which in many cases has operated at a distribution deficit, has allowed its relationship with small broker-dealers to deteriorate, while it has become increasingly dependent for sales upon large broker-dealers to whom mutual fund

¹¹³⁸ SEC, Division of Investment Management, *Mutual Fund Distribution and Section 22(d) of the Investment Company Act of 1940*, 19 (1974).

¹¹³⁹ *Ibid.*, pp. 10-11, 84-135.

shares are a relatively unimportant source of income.”¹¹⁴⁰

The report further noted that the: “industry is not prospering with the marketing strategy which was so successful in past years. Hence, changes in the pattern of fund distribution seem inevitable....”¹¹⁴¹ The 1974 SEC report noted that cash management funds were a “relatively new phenomenon”, accounting “for a significant portion of industry sales and a growing portion of industry assets,” and that, “but for the rapid growth of these funds, the industry as a whole would be in a net redemption position.”¹¹⁴²

These cash management funds were a major factor in the industry's subsequent resurgence, due to the flood of money into the industry's money market funds, as investors chased high yields during the mid-to-late 1970s and into the 1980s¹¹⁴³. A significant change in fund distribution resulted from the SEC's 1980 promulgation of rule 12b-1, which enabled funds to pass on distribution costs directly to fund shareholders¹¹⁴⁴. Rule 12b-1 fees provide a mechanism by which pricing, fees, and distribution could be modified by allowing conditional deferred sales loads. This provided an incentive for investors to purchase mutual funds and the increased sales volumes provided an incentive for small distributors to sell mutual funds, which provided a renewed interest in comparison to their previous waning interest during the 1970s.

¹¹⁴⁰ Ibid., p. 9

¹¹⁴¹ Ibid., p. 43

¹¹⁴² Division of Investment Management, *supra* note 1138, at 129, n.1.

¹¹⁴³ See McCue, L. (1982). Is deposit insurance necessary?, *American Banker*, Apr. 15, 1982, at 14 (discussing the success of money market mutual funds).

¹¹⁴⁴ 17 C.F.R. § 270.12b-1 (1999).

Though its rulemaking enabled this change, this appears to be unintentional as the SEC did not anticipate that this transformation would occur. Glenn et al.¹¹⁴⁵ state "[T]he major result of Rule 12b-1, the development of the widespread appearance of contingent deferred sales charges beginning in 1981, was clearly unanticipated by the Commission when it adopted Rule 12b-1." Although this appears to have been unintentional, this change resulted in a rejuvenation of the mutual fund industry in the United States and a rejuvenation of the distribution from small broker-dealers.

The popular press began to focus attention on the industry's fee structure and the perceived inadequacy of mutual fund governance. There were strong opinions voiced that high fees did not tend to translate into higher fund performance. For example one publication stated "Several leading mutual fund analysts and critics are also making the case that not only do higher fees not mean better performance, often the opposite is true."¹¹⁴⁶ There were also questions raised about the value of the higher fees that investors were receiving and one article stated "It's not a hard and fast rule, but the more a fund costs, the less you can expect from your investment."¹¹⁴⁷ Another writer indicated that the higher fees may in fact be negatively affecting investors since according to studies conducted separately by the SEC and Princeton University, "investors lose roughly 2 percentage points in return for every one percentage point they

¹¹⁴⁵ Quoted in Freeman and Brown, *supra* note 1102, p. 610, n2.

¹¹⁴⁶ Longo, T., (1998). Days of rejoicing: congress is finally starting to look into why mutual fund fees keep rising, *Financial Planning*, Nov. 1, 1998, at 1.

¹¹⁴⁷ J. Clements, Hint: managers are only as smart as the expenses they charge, *Wall Street Journal*, July 6, 1999, at R1.

pay in annual expenses."¹¹⁴⁸

There was a growing recognition that, while there were increasing economies of scale, these cost savings were not being passed on to investors. For example, an article in *Business Week* stated "Since 1984, Morningstar reports show that the average cost of actively run no-load U.S. stock funds fell less than 100, even as their assets multiplied 32 times. Vast economies of scale benefited mutual-fund companies not investors."¹¹⁴⁹ An article in *FORBES* indicated "The dirty secret of the business is that the more you manage, the more profit you make-but the less able you are to serve your shareholders. In businesses size is an advantage. In mutual funds it is an advantage only to the sponsor, not to the customer."¹¹⁵⁰ There were also doubts expressed that the industry was responding appropriately to investors. An article in *Wall Street* stated "Is the industry rising to the challenge? Is it doing all it can to clearly and simply explain how much investors are paying in fees and expenses?"¹¹⁵¹ The increasingly higher fees also called into question the ability of independent directors to manage these. An article in *Business Week*, for example, stated "If expenses are too high, it's the independent directors who have failed."¹¹⁵² Doubts about fund directors were also expressed in another financial publication which stated "It isn't hard to find examples of fund directors who are tolerant

¹¹⁴⁸ R. Simon, Avoid stock and bond funds with high expenses, *Buffalo News*, Mar. 6, 1995, at 10.

¹¹⁴⁹ R. Barker, High fund fees have got to go, *Business Week*, Aug. 16, 1999, at 122.

¹¹⁵⁰ T. Easton, The fund industry's dirty secret: big is not beautiful, *Forbes*, Aug. 24, 1998, at 116, 117.

¹¹⁵¹ C. Gasparino, Some say more could be done to clarify fees, *Wall Street Journal*, May 20, 1998, at C1.

¹¹⁵² R. Barker, Fund fees are rising. Who's to blame?, *Business Week*, Oct 26, 1998, at 162.

of high fees, bad performance or both.”¹¹⁵³

It was also noted that the fees in mutual funds are high relative to pension funds.¹¹⁵⁴ An article in MONEY indicated that mutual fund shareholders "pay nearly twice as much as institutional investors for money management, even excluding any additional front- or back-end sales charges."¹¹⁵⁵ For example, an article in Business Week noted allegations that the amount of assets under management in the Fidelity fund complex jumped from \$36 billion to \$373 billion from 1985 to 1995 without economies of size being shared with investors, while management fees were increased from 1.085% of assets under management to 1.146% of assets, which yielded the management company an extra \$288 million in revenue¹¹⁵⁶. The actions of the SEC in the early 2000s in fact may have been a response to the issues being raised publicly about fund directors which were fueled in part by the issues associated with increases in management fees. Scholarly articles published by finance academics have criticized board-approved 12b-1 fees paid by fund shareholders. Apap and Griffith, for example, opine that for funds with investment objectives of long-term growth, growth and current income, and equity income, 12b-1 fees do not add to fund's performance¹¹⁵⁷. Ferris and Chance describe

¹¹⁵³ S. T. Goldberg, Where are fund directors when we need them?, *Kiplinger's Financial Magazine*, Apr. 1997, at 111.

¹¹⁵⁴ J. M. Laderman, Are fund managers carving themselves too fat a slice, *Business Week*, Mar. 23, 1992, at 78.

¹¹⁵⁵ R. Simon, How funds get rich at your expense, *Money*, Feb. 1995, at 130.

¹¹⁵⁶ G. Smith, Why fund fees are so high, *Business Week*, Nov. 30, 1998, at 126.

¹¹⁵⁷ Apap, A. & J. M. Griffith, (1998). The impact of expenses on mutual fund performance, *Journal of Financial Planning* 76.

12b-1 fees as "a dead-weight cost."¹¹⁵⁸ Mcleod and Malhotra extend this further stating that 12b-1 fees are "a dead weight cost" to shareholders that has been increasing over time¹¹⁵⁹.

Law review commentators offer uncomplimentary evaluations of those who control fund management and policies, including dealing with conflicts of interest¹¹⁶⁰. The SEC has weighed in, questioning "whether changes are needed in the current system"¹¹⁶¹ as part of its examination of mutual fund governance. In January 2001, the SEC amended various exceptive rules in an effort to "enhance director independence and effectiveness"¹¹⁶², however, the issue of oversight of management fees was not addressed as part of this process, despite the attention paid to this in popular press and scholarly articles during the preceding period of the mid to late 1990s.

The U.S. government itself has also recognized the concerns over management fees. A General Accounting Office (GAO) report noted that academics have voiced the following concerns about fee levels in the fund industry as to "whether competition, fund disclosures, and mutual fund directors are sufficiently affecting the level of fees."¹¹⁶³

¹¹⁵⁸ Ferris, S. P. & D. M. Chance, (1987). The effect of 12b-1 plans on mutual fund expense ratios: a note, 42 *Journal of Finance* 1077, 1082.

¹¹⁵⁹ Mcleod, R.W. & O.K. Malhotra,(1994). A re-examination of the effect of 12b-J plans on mutual fund expense ratios, *Journal of Financial Research* 231,239

¹¹⁶⁰ King, S.S., (1998). Note, Mutual Funds: solving the shortcomings of the independent director response to advisory self-dealing through use of the undue influence standard, 98 *Columbia Law Review* 4.

¹¹⁶¹ Ibid.

¹¹⁶² Role of Independent Directors of Investment Companies, *supra* note 1118.

¹¹⁶³ U. S.General Accounting Office (GAO), (2000). *Mutual Fund Fees Additional Disclosure Could Encourage Price Competition*.

The GAO report noted that "some studies or analyses that looked at the trend in mutual fund fees found that fees had been rising"¹¹⁶⁴. The GAO report further acknowledges "that the information currently provided does not sufficiently make investors aware of the level of fees they pay."¹¹⁶⁵ The GAO report further reiterates concerns that in fact "the directors' activities may be keeping fees at higher levels because of [a] focus on maintaining fees within the range of other funds."¹¹⁶⁶ It was also recognized in the report concerns that "funds do not compete primarily on the basis of their operating expense fees."¹¹⁶⁷

The General Accounting Office also issued a detailed report finding that mutual funds generally do not attempt to compete on the basis of costs (i.e., price competition is muted). An early objective of the SEC was to spur innovations to "set the stage for retail price competition" within the industry¹¹⁶⁸. This goal is certainly beneficial since competition is in investors' best interests since, in the absence of competition, costs increase, resulting in decreased performance. The question then becomes whether the desired state of price competition has been achieved such that it may benefit investors.

Amy Amott, an editor with Morningstar stated "Most fund companies don't even attempt to point to strong performance as a rationale for higher fees. "Rather, they

¹¹⁶⁴ Ibid., p. 47.

¹¹⁶⁵ Ibid., p. 7.

¹¹⁶⁶ Ibid., p. 8.

¹¹⁶⁷ Ibid., at 62; In addition, this report noted that academic researchers [and others] saw problems with the fee disclosures" made by mutual funds GAO report *supra* note 1163.

¹¹⁶⁸ Division of Investment Management, *supra* note 1138, p. v.

typically justify increases in their management fees by pointing to the average for similar funds. This argument can only lead to an upward spiral in costs: As more funds raise their fees to bring there in line with the averages, the averages go up, more funds raise their fee and so on."¹¹⁶⁹

A former SEC chairman has stated that "[n]o issuer of securities is subject to more detailed regulation than a mutual fund. However, it must be asked who this regulation is working for- the mutual fund industry or the investors?"¹¹⁷⁰ Freeman and Brown stated "Unfortunately[...] decades of SEC-commissioned studies, rule-making, and jawboning have led to a system that, for the most part, works beautifully for those who sell funds to the public, or sell services to funds, but much less admirably for the industry's investors."¹¹⁷¹

John C. Bogle the founder of Vanguard Funds observed that most proxies seeking shareholder approval of fee hikes "suggest that, after long consideration, the fund's directors have approved the fee increase requested by the management company, since the fund's rates were below industry norms."¹¹⁷² Competition could also result in upward increases in fees within the industry in response to fee hikes by key industry players. For example, upward movement in advisory fees provides a valid reason for other advisors to hike their fee rates. As a result fund revenues could be expected to boom. This could be

¹¹⁶⁹ Stem, *supra* note p.73.

¹¹⁷⁰ Division of Investment Management, *supra* note 1138, p. v.

¹¹⁷¹ Freeman and Brown, *supra* note 1102, p. 613.

¹¹⁷² Bogle, J. C. (1994). *Bogle on Mutual Funds*, Dell, 352p.

one of the causes of the rise in fund expense ratios for the most popular funds. For the 10 best-selling average annual expense ratios funds are reportedly running at 0.93% of fund assets, up from 0.7% from the previous year and 0.73% in 1998¹¹⁷³. For its part, the ICI takes a dim view of the notion that fund directors increase advisory fees to keep up with rates levied at other funds¹¹⁷⁴. Of course the fact that applicable legal standards ought to prevent such action does not mean it does not occur, it means only that if the behaviour does go on it may well be illegal.

Despite all of the concerns expressed over management fees, the SEC did not develop a mutual fund governance system to address this. Specifically, there was no regulation developed in the United States to govern management fee ratios or increases. There were also no guidelines for directors to deal with management fees. This included a lack of rules, policies or guidelines for independent directors with respect to management fees. The U.S. government adopted the approach of relying upon market pressures and competition to regulate mutual fund fees, combined with a disclosure mechanism.

Similarly, there were no regulations developed in Canada to address management fees and although there was not as much written on management fees in Canada, there

¹¹⁷³ See Christopher Oster. Fees? You mean mutual funds have fees?, *Wall Street Journal*, July 14, 2000, at A1.

¹¹⁷⁴ See Letter from Matthew P. Fink, President, Investment Company Institute, to Thomas J. McCool, Director, Financial Institutions and Market Issues, U.S. General Accounting Office 2 (May 3, 2000), (arguing that the perspective that this goes on "is contradicted directly by the applicable legal standards governing the work of directors").

appears to be a similar underlying approach to a reliance upon 'the market' to regulate pressures. Further, as in the United States, there was no specific rule, policies or guidelines for directors to manage mutual fund fees. As such, both in the Canada and the United States, the primary point of contention-management fees-was not incorporated in the mutual fund governance regime. Instead, this was left to the market, investors, and competition to control.

Freeman and Brown¹¹⁷⁵ examine whether the chief product that shareholders buy when they invest in mutual funds-professional investment advice-is being systematically overpriced by fund managers, with an emphasis placed upon advisory fees that are imposed on equity mutual funds. There is an inherent conflict of interest within the fund management structure, which relies upon external management. As explained by the Vanguard Group's founder, John C. Bogle, mutual funds "Are operated by external management companies which seek to earn high returns for fund investors, to be sure, but seek at the same time to earn the highest possible returns for themselves."¹¹⁷⁶ Freeman and Brown explain how the mutual fund industry's unique management structure accounts for the perception of lack of price competition in the delivery of management advice perceived by the industry's detractors. Freeman and Brown¹¹⁷⁷ also examined whether economies of scale exist for the delivery of investment management services to equity fund shareholders. They also question whether economies of scale, if

¹¹⁷⁵ Freeman and Brown, *supra* note 1102.

¹¹⁷⁶ See Schonfeld, V.E. & T.M.J. Kerwin, (1993). Organization of a mutual fund, 49 *Business Law* 107.

¹¹⁷⁷ Freeman and Brown, *supra* note 1102.

they exist, are being shared fairly with the funds' owners by the funds' agents, the investment advisors. Freeman and Brown also study causes for the current state, including the industry's statutory scheme, the quality of the SEC's regulatory efforts, and the reception given fund critics by the courts. Lastly Freeman and Brown provide a proposal for changing the present competitive environment in which fund advisory fees are set, disclosed, and evaluated.

When it enacted the Investment Company Act of 1940 Congress took a position favoring shareholders since it was aware of the inherent conflict existing between the fund's shareholders and the external advisors, as expressed in the following statement:

"The national public interest and the interest of investors are adversely affected ... when investment companies are organized, operated and managed in the interest of investment advisors, rather than in the interest of shareholders. . . or when investment companies are not subject to adequate independent scrutiny."¹¹⁷⁸

Congress imposed a requirement in the Investment Company Act of 1940 that at least forty percent of a fund board needs to be composed of directors, ostensibly independent of the investment advisor, to protect fund shareholders from self-dealing¹¹⁷⁹.

¹¹⁷⁸ Ibid., p. 614.

¹¹⁷⁹ *Role of Independent Directors of Investment Companies*, Securities Act Release No. 33-7754, Fed. Sec. L. Rep. (CCH) 86,212, at 82,451 (Oct 14,1999), quoting from Division of Investment Management, SEC, *Protecting Investors: A Half Century of Investment Company Regulation*, 251 (1992). (SEC Protecting Investors)

These special directors were subsequently referred to as "independent watchdogs" by the United States Supreme Court¹¹⁸⁰ who are charged with the responsibility of protecting fund shareholders. It is the duty of the directors serving on an independent committee to approve only a transaction that is in the best interests of the public shareholders, and to say no to any transaction that is not fair to those shareholders and is not the best transaction available¹¹⁸¹.

As excessively high fees would not be considered to be in the best interests of the public shareholders, it would follow that directors should say no to these. In practice, while independent fund directors have the right to demand advisory or distribution fee cuts or to fire the fund's advisor or underwriter, those rights are virtually never exercised¹¹⁸². As stated by Renberg in *Barron's* "[Fund] directors have seldom booted an investment advisor, no matter how lousy a fund's performance."¹¹⁸³ As an example in the leading fund industry management fee case of *Gartenberg v. Merrill Lynch Asset Management, Inc.*, the Second Circuit specifically referred to "the existence in most cases of an unseverable relationship between the advisor-manager and the fund it services."¹¹⁸⁴

¹¹⁸⁰ *Burks v. Lasker*, 441 U.S. 471, 484 (1979).

¹¹⁸¹ *Kahn v. Lynch Communications Sys., Inc.*, 638 A.2d 1110, 1119 (Del. 1994) (quoting *In re First Boston, Inc. Shareholder Litig.*, C.A. 10338, 1990 WL 78836, at *15-16 (June 7, 1990).

¹¹⁸² e.g., Werner Renberg, Sixth men or fifth wheels: do fund directors earn their paychecks, *Barron's*, August 12 1991 at M14.

¹¹⁸³ *Ibid.*, at M13.

¹¹⁸⁴ 694 F.2d 923 (2d Cir. 1982).

The fund advisor's de facto control over the fund's board can lead to high profit margins and a high price for the advisory office should the advisor wish to sell out at some point. The conflict also leads to the risk that well-understood obligations owed by the board to investors are not performed. A 1997 article cited only three instances in which a fund board replaced the fund manager against the manager's wishes, noting that the "board virtually never selects a sponsor other than the initial firm who established the fund and selected its initial board members. Instead of looking out for the interests of shareholders, one legal scholar has stated that instead the chief oversight function performed by a normal board of directors in this country is 'overseeing management's dedication to the polestar of profit maximization.'"¹¹⁸⁵

5.7 MUTUAL FUND ECONOMIES OF SCALE

Economies of scale in the mutual fund industry occur when there is an inverse relationship between assets under management and the operating expense ratios¹¹⁸⁶. Operating expense ratios refer to the value of operating expenses divided by average fund assets, which in the United States is defined by the Investment Company Institute (ICI), the fund industry's trade group, as advisory expenses plus administrative expenses (excluding 12b-1 fees)¹¹⁸⁷.

There have been doubts expressed concerning the existence of economies of scale

¹¹⁸⁵ Millstein, I. M., (1997). The responsible board, 52 *Business Law* 407,409.

¹¹⁸⁶ John Rea et al., Operating expense ratios, assets and economies of scale in equity mutual funds, Investment Company Institute Perspective, Dec. 1999, at 1.

¹¹⁸⁷ Ibid.

that arise as fund assets under management increase and this has been referred to as "folklore"¹¹⁸⁸ as well an item about which "no plaintiff has been able to produce evidence."¹¹⁸⁹ One would expect that fund expenses on average would have decreased in response to the explosive growth of the industry. If there have been economies of scale in the mutual fund industry these savings have apparently not been passed on to investors in the form of reduced fees. For example, the average equity fund's expense ratio has more than doubled from 1950 to 2000 and between 1980 and 1998. The average equity fund's annual expense ratio increased from 1.1% to 1.57%.¹¹⁹⁰

The concept of economies of scale is that as the number or volume of a product or services increases, the total costs do not increase as quickly as output and therefore average costs per unit of product or service decreases as output increases. The economies of scale typically arise from distributing the fixed costs among more units of production thereby lowering the fixed cost per unit. With respect to advisory services, the portfolio management process has high fixed costs (e.g. offices, computers, salaries, etc.) and very low variable costs. This is recognized as the SEC staff which noted: "Most observers believe that portfolio management is the fund cost with the greatest economies."¹¹⁹¹ A previous SEC staff report concluded that "a portfolio manager can manage \$10 million

¹¹⁸⁸ Baumol, W.J., S.M. Goldfeld, L.A. Gordon & M.F. Koehn, (1990). *The Economics of Mutual Fund Markets: Competition versus Regulation*, at 87, Boston: Kluwer.

¹¹⁸⁹ Ibid.

¹¹⁹⁰ Bogle, J. C. (2000). Mutual funds at the Millennium: fund directors and fund myths. Accessed at: http://www.vanguard.com/bogle_sitelmayis2000.html (May, 2000).

¹¹⁹¹ SEC Report On Mutual Fund Fees and Expenses, *supra* note 845.

nearly as easily as \$100 million."¹¹⁹² While advisory services are subject to economies of scale, the fund's advisor may or may not decide to pass along the resultant savings to investors in the form of reduced fees. Economies of scale in the mutual fund industry arise when assets under management increase. If economies of scale exist due to an increase in assets under management then the benefits of increased scale accrue to the manager in the form of increased profits, unless these are passed onto investors in the form of reduced fees. The report by GAO's on price competition in the fund industry found that 64% of fund portfolio growth is due to portfolio appreciation¹¹⁹³. This appreciation benefits investment advisors who garner increased fees from the general increase in market prices with no commensurate efforts on their part.

The operating expense ratio consists of management and administrative expenses born by shareholders divided by the fund's net assets; it does not include distribution costs, such as sales loads. It should be noted that 12b-1 fees paid by many U.S. fund shareholders were excluded from the 'operating expenses' definition. The omission was justified by the study's authors on the basis that the payments are mainly used "to compensate sales professionals for advice and assistance given to buyers of fund shares."¹¹⁹⁴ In litigation, the payments have been justified on the ground that they are assessed "not only to encourage growth, but also to stimulate improved shareholder

¹¹⁹² SEC Protecting Investors Report, *supra* note 1179, p. 256 n.12.

¹¹⁹³ GAO Report on price competition, *supra* note 1083, p. 9.

¹¹⁹⁴ *Ibid.*, p. 1

service."¹¹⁹⁵

According to a study published by the ICI, the operating expense ratio for all equity funds, using a sales-weighted average, rose 15% from 1980 to 1997¹¹⁹⁶ during a time of strong asset growth for the industry. As an example of this growth, the average size of the 100 largest funds in existence in 1997 that were also in existence in 1980 increased from \$282 million to 55.8 billion¹¹⁹⁷. A SEC staff study indicated that funds' weighted average expense ratio rose nearly 30% between 1979 and 1999¹¹⁹⁸, with an increase of more than a 20% increase for equity funds¹¹⁹⁹. Another study found that the cost of ownership for the industry's lowest priced equity funds rose by 19% between 1980 and 1997¹²⁰⁰.

Another report on equity fund expenses shows that between 1981 and 1997, average equity fund expenses grew from 0.97% of net assets to 1.55%, with this 50% increase occurring over a period in which fund equity assets rose from \$40 billion to \$2.8 trillion¹²⁰¹. Annual costs paid by fund shareholders during the same period increased from \$320 million to \$34 billion. It is accepted today that economies of scale

¹¹⁹⁵ *Krinsk v. Fund Asset Mgmt., Inc.*, 715 F. Supp. 472,490 n.37 (S.D.N.Y. 1988). (Included as operating expenses for purposes of the study were such items as custodial and transfer agent fees). Rea and Reid., note 1196, p. 5.

¹¹⁹⁶ John D. Rea & Brian K. Reid, Trends in the ownership cost of equity of mutual funds, Investment Company Institute Perspective, Nov. 1998, p. 12.

¹¹⁹⁷ *Ibid.*, p.13.

¹¹⁹⁸ SEC Report on Mutual Fund Fees and Expenses, *supra* note 845 at tbl. 2.

¹¹⁹⁹ *Ibid.* at tbl. 9.

¹²⁰⁰ Rea and Reid., *supra* note 1196, p. 9.

¹²⁰¹ Bogle, *supra* note 1190, p. 320.

exist in the fund industry. Since economies of scale exist it would not be expected that there be a two order of magnitude increase in costs associated with a seventy times increase in assets. It is clear that the cost savings associated with the increase in assets was not passed onto the shareholders, and instead they may have been retained in the form of profits to the fund manager. It should be noted that if the average expense ratio has simply remained constant, rather than decreasing if the cost savings were translated into reduced fees, the fund investors would have paid billions less in fees annually.

The existence of economies of scale has been admitted in SEC filings made by fund managers¹²⁰². Economies of scale are also implicit within the fund industry's frequent use of fee rates that decrease as assets under management increase. The existence of fee breakpoints in the fund industry has been viewed as "One piece of evidence for the existence of economies in portfolio management". The breakpoint pricing system has been explained as follows:

“Many funds employ a declining rate structure in which the percentage fee rate decreases in steps or at designated breakpoints as assets increase. . . . The declining rate schedule reflects the expectation that cost efficiencies or scale economies will be realized in the management and administration of the fund's portfolio and operations as the fund grows”.

¹²⁰² Freeman, J.P., (1978). The use of mutual fund assets to pay monitoring costs, 9 *Loyola University of Chicago Law Journal* 533, 554-55 nl.

Fund industry investment managers may cite economies of scale as justification for business decisions. Though the ICI, however, has not specifically discussed economies of scale in advisory fees. Bogle, an experienced and credible member of the mutual fund industry has indicated that "there are staggering economies of scale in portfolio management and research."¹²⁰³

Economies of scale are also viewed by legal commentators as a fact of life in the fund industry. For example, Schonfeld and Kirwin state that "Mutual funds offer advantages that other investment vehicles may not, including diversification, economies of scale, and professional management."¹²⁰⁴ There was also a general consensus reached by GAO's investigators that fund operations benefit from economies of scale, and that there is strong evidence that economies of scale exist. The GAO report stated:

"Industry officials we interviewed ... generally agreed that mutual fund operations experience economies of scale. An official at a money management firm whose customers invest in mutual funds told us that mutual fund advisors' operations are subject to large economies of scale, and additional investor inflows result in little additional cost. Officials of the fund advisors we interviewed also agreed that their operations experienced economies of scale"¹²⁰⁵.

¹²⁰³ Bogle, *supra* note 1190, p. 321.

¹²⁰⁴ Schonfeld & Kerwin, *supra* note 1192, p. 107.

¹²⁰⁵ GAO Report, *supra* note 1083, p. 34.

In a GAO report, the agency reported that as much as 64% of mutual fund asset growth is due to the appreciation of portfolio securities to new investors which is costless in contrast to growth from share sales. The GAO agency found that, for at least the previous five years to the study publication, operating profits of eighteen publicly-held fund advisory companies had grown as a percentage of revenues, although its analysis of operating efficiencies was reportedly limited by the lack of cost data available for fund advisors¹²⁰⁶.

The GAO found that a sample of the industry's largest funds that experienced asset growth of at least 500% from 1990 to 1998. Specifically the GAO found that among the industry's 77 largest funds, of the 51 that experienced asset growth of at least 500% from 1990 to 1998, 38 reduced their expense ratios by at least 10%; of the remaining 13 funds, 1 reduced their expense ratios by less than 10%, and 6 either had not changed their fees or had raised them¹²⁰⁷. Accordingly, these data indicate that more than one quarter of the funds in the study either raised their expense ratios or failed to reduce them.

The fund industry data indicates that there are economies of scale in the mutual fund industry. Studies by the ICI, though never focusing on advisory fees in isolation, generally confirm the existence of economies of scale within the industry. A 1998 ICI study found economies of scale to exist for individual equity funds¹²⁰⁸. Another ICI study, based on sample of 2260 funds that focused on fund operating expenses "suggests

¹²⁰⁶ Ibid., pp. 9-11.

¹²⁰⁷ GAO Report, *supra* note 1083, pp. 11-12.

¹²⁰⁸ Ibid., pp. 9-11.

the presence of economies of scale as equity fund assets grow¹²⁰⁹. The ICI's operating expense study, however, did not specifically address the effect of economies of scale on advisory fees, which is to be expected given that this organization represents the industry and would not want to draw attention to the potential for lowering of fees due to economies of scale. The ICI instead bundled advisory fees and administrative fees, including custodial fees, legal and accounting fees, and transfer agent fees (excluding 12b-1 fees). The ICI study found that the ratio of bundled costs to fund assets, the 'operating expense ratio', did decline as the size of the fund size increased¹²¹⁰ which supports the conclusion that economies of scale exist (since the total costs decline relative to assets).

To verify the ICI's analysis, Freeman and Brown¹²¹¹ used the Morningstar Principia Pro database compilation for October 1999 for domestic equity funds. The final sample consisted of 2161 actively managed, non institutional funds consisting of 1090 single class funds and 1071 multiclass funds which contained 3302 sub-funds. The ICI analysis used simple average operating expense ratios to aggregate multiclass funds within ranges of fund size. For comparison purposes, Freeman and Brown initially used simple averages, but since weighted averages are considered to be superior for this purpose and they were used as the principal data in the authors' analyses. A comparison of the operating expenses in the Freeman and Brown and ICI studies is provided in Table

¹²⁰⁹ Rea and Reid, *supra* note 1196, p. 2.

¹²¹⁰ Rea and Reid *supra* note 1196, pp. 2, 15.

¹²¹¹ Freeman and Brown, *supra* note 1102.

6.

Table 6 - Comparison of Operating Expense Ratios in Freeman and Brown and ICI Studies

	ICI Study			Freeman and Brown Study	
Fund Size (\$MM)	Number of Funds	Simple/ Average/ Operating/ Expense Ratios/(Basis Points)	Number of Funds	Simple/ Average/ Operating/ Expense Ratios/(Basis Points)	Weighted/Average/ Operating/ Expense Ratios/(Basis Points)
<\$250	1,451	147	1,295	129	114
\$250-\$500	261	116	272	103	104
\$500-\$1,000	20 4	109	228	98	98
\$1,000-\$5,000	26 5	94	274	89	85
>\$5,000	79	72	92	68	63
Overall	2,260		2,161	114	75

Source: Freeman and Brown, supra note 1102.

It is expected that economies of scale will cause average operating expense ratios to decline as fund size increases, and both the ICI and Freeman and Brown studies show that this is the case. The left-hand column in Table 6 is the ICI breakdown by the size of fund. The results of the ICI study show that as fund assets increase from under \$250 million to greater than \$5 billion the operating expense ratio declines from 147 basis points to 72 basis points. Similarly, operating expense ratios obtained from Morningstar exhibited a similar decline from 129 to 68 basis points.

The weighted average operating expense ratios are shown on the right-hand

column of Table 6. These weighted average operating expense ratios also decline as asset size increases, although the decline is not as pronounced as with the simple average values. The ICI study bundled different costs into one overall 'operating ratio' and did not distinguish or examine the differences between advisory and administrative expenses. After confirming the essential equivalence of the Morningstar and ICI results, Freeman and Brown decomposed operating expense ratios into advisory and administrative expense ratios, while maintaining the ICI asset groupings and categories. The results of this analysis are presented in Table 7.

Table 7 - Comparison of Weighted Average Operating, Advisory, and Administrative Expense Ratios from Freeman and Brown Study

Fund Size \$MM	Number of Funds	Average Fund Size (\$mm)	Weighted Average Operating Expense (Basis Points)	Weighted Average Advisory Expense Ratios (Basis Points)	Weighted Average Administrative Expense Ratios (Basis Points)
<\$250	1,295	\$77	114	71	43
\$250- \$500mm	272	\$355	104	71	33
\$500- \$1,000mm	228	\$715	98	67	30
\$1,000- \$5,000mm	274	\$2,163	85	61	24
>\$5,000mm	92	\$14,520	63	46	17
Overall	2,161	\$1,058	75	54	21

Source: Freeman and Brown, *supra* note 1102.

The third column of Table 7 shows the average size of the fund in each group. There are large numbers (1295) of relatively small funds, with an average fund in the

less than \$250 million range having \$77 million in assets. There are relatively small numbers (92) of very large funds (average assets of \$14.5 billion). Thus, the distribution of fund size exhibits an extreme negative skew. The largest funds (greater than \$5 billion) average more than \$14 billion, almost seven times larger than the next largest grouping (\$1 to \$5 billion) and almost 200 times the average fund in the less than \$250 million range.

The weighted average operating expense ratios decline by approximately 45% from the smallest to the largest funds (from 114 to 63 basis points). However, the decline is not uniform for advisory and administrative fees. There is a 60% decrease in administrative fees, from 43 to 17 basis points. This decline is relatively smooth and linear. In comparison, there is only a 35% decline in advisory fees, from 71 to 46 basis points including the smallest to the largest funds. Up to approximately a \$1 billion fund size advisory fees remain at about 70 basis points. An increase in the average fund size in large funds, from \$715 million to \$14.5 billion, results in only a 31% decrease in advisory fees. Therefore, greater economies of scale are being passed on to the fund shareholders from administrative fees than advisory fees, particularly in the larger funds where economies of scale would be expected to be the greatest.

The ICI approach of combining the two different advisory and administrative fee types has not shown to represent the difference in economies of scale. It should be noted that this should not be taken to imply that the ICI has sought to conceal this since there is no specified way for it to do so. The SEC has not defined 'investment advisory

fees' and has not required separate reporting for that item. The SEC itself has indicated that it is not able to determine directly whether economies of scale exist for advisory fees¹²¹². The data of Freeman and Brown is consistent with that of the ICI in demonstrating economies of scale in operating expense ratios exist in the mutual fund industry. In general mutual fund operating expense ratios tend to decline steadily as fund size increases, and this decline is greater for administrative than advisory fee levels. According to Freeman and Brown the analyses suggest that fund advisors are reluctant to fully share economies of scale with fund shareholders when negotiating the terms of advisory fee contracts, and conclude that this reluctance depletes shareholder wealth.

It should also be recognized that these economies of scale are not as large for advisory fees as for administrative wealth. The ICI's position is that price competition is strong in the fund industry, with economies of scale existing and being properly shared by the advisor with fund shareholders. However, the ICI's position is supported by selectively presented data since it deals with a lumped decrease in administrative and advisory fees. Rea and Reid¹²¹³ argued on behalf of the ICI that funds' operating expense ratios consisting of advisory and administrative fees lumped together, have generally tended to decline with significant asset growth. The ICI study does not analyze the fees charged for investment advice, while Freeman and Brown's analysis separates advisory fees and administrative fees. Freeman and Brown¹²¹⁴, conclude that it is evident that

¹²¹² Report On Mutual Fund Fees and Expenses, *supra* note 845.

¹²¹³ Rea and Reid, *supra* note 1196.

¹²¹⁴ Freeman and Brown, *supra* note 1102.

economies of scale in the provision of advisory services are, for the most part, not being shared with fund shareholders.

It becomes apparent that the primary potential conflict of interest, the opportunity for fund managers to enrich themselves at the expense of their mutual fund unit holders, is in fact occurring on a large scale in the United States mutual fund industry. This is not being addressed in the current mutual fund governance regime in the United States, which professes to address conflicts of interest and yet has missed this fundamental conflict of interest that occurs on a massive scale, totaling \$2 billion that is being taken by the investment advisors and not passed on to investors. This conflict of interest is exacerbated by the lack of requirement by United States securities regulators for specific reporting of the investment advisor's fees but instead allowing these to be lumped into operating expenses and reported as expense ratios. Further, based on the findings of Freeman and Brown it is clear that the incentive for fund managers is to increase the total assets under management, since this will allow a greater capture of the percentage of investment advisor fees of the total operating expenses, while passing on the administrative cost savings from economies of scale to investors.

The principal decline is the cost of delivering shareholder administrative services relative to total net assets⁷⁹. GAO found that 64% of equity firm growth was due to the appreciation in value of portfolio securities. The ratio of administrative expenses to total fund assets has tended to decrease as funds have become larger due to economies of scale and as such passing these cost savings on to the investors has had no significant

direct costs to fund managers.

Freeman and Brown's data indicates that economies of scale for advisory services in the mutual fund market likely exist. To the extent that they do exist, it appears these are not being passed on to investors through reductions in management fees, or increases in unit prices, but instead being captured by mainly by the funds' advisors. Regulation of management fees cannot not be left to the market; since price competition is weak in the mutual fund advisory services marketplace, as consumers are not price conscious. As Bogle stated: "Price competition is ... defined by the actions of producers, not the actions of consumers. Thus, price competition is not 'intense' in the fund industry; it is barely alive."¹²¹⁵ Therefore, no matter how hard the fund advisors try to create price competition on advisory fees through their systems, or the government to its systems, these efforts will prove futile as long as consumers have the current mindset. From the advisors perspective, there is no better time to capture the economies of scale in advisory fees rather than pass these on to investors, since investors are not aware of this since these are not broken out by advisors in disclosure information. In fact, there is not a requirement by U.S. securities regulators for disclosure of this information or even a proposed methodology of how this information could be calculated and presented.

Morningstar mutual fund analysts started warning investors that the fund industry was ratcheting up fees, especially management fees, to dangerous levels forcing people to pay

¹²¹⁵ Ibid.

premium prices for what is in essence a commodity. John Rekenthaler, the group's director of research, indicates that "it has become pretty clear that over time funds with lower expense ratios outperform those with higher ratios"...¹²¹⁶ The management process is essentially the same for pension funds and mutual funds. The portfolio ownership structure alone of a pension fund versus mutual fund should not result in portfolio management costs being higher or lower for either.

There are very different fee structures for equity portfolio investment advisory services purchased by public pension funds on the free market in comparison to the same type of services purchased by investor-owned mutual funds. This disparity has little recent attention although it has been studied in the past. A study conducted by the Wharton School of Finance and Commerce for the SEC, nearly forty years ago, determined that where fund advisors had outside advisory clients, there was a "tendency for systematically higher advisory fee rates to be charged to open-end [mutual fund] clients."¹²¹⁷ The Wharton Report attributed the disparity in fee structures to fund advisors' relative ability to capitalize on the inherent conflict of interest in the funds' management structures and convert it into the power to set prices. The primary reason for the differences in rates charged to open-end companies and other clients is as follows. With respect to fees charged to open-end companies, in theory the fees are established by negotiations between independent representatives of separate legal entities, and

¹²¹⁶ Freeman and Brown, *supra* note 1102, p. 627.

¹²¹⁷ Wharton School of Finance & Commerce, (1962). *A Study of Mutual Funds* (Wharton Report).

approved by democratic vote of the shareholders, while in practice they are typically fixed by essentially the same persons who receive the fees-the investment advisors. With regard to the other clients a procedure in negotiating a fee is to arrive at a fixed fee which is mutually acceptable. This suggests that competitive factors which tend to influence rates charged to other clients have not been substantially operative in fixing the advisory fee rates paid by mutual funds. It also suggests that in the mutual fund industry there is less pressure to reach a mutually acceptable fee than in the pension fund industry.

The Wharton Report identified 54 investment advisors with both mutual fund clients and other clients. Of this sample, fee rates charged the mutual fund clients were at least 50% higher in 39 out of the 54 cases, 200% higher in 24 of the cases, and 500% or higher in 9 of the cases¹²¹⁸. These analytical results clearly indicate that mutual fund investment advisors charge higher fee rates than comparative advisors.

The disparity between advisory services in free market versus fund market pricing was recognized decades ago by the SEC. In its detailed report submitted to Congress in 1966¹²¹⁹, the SEC revisited the Wharton School's findings and stated the "Wharton Report's conclusions correspond to those reached by the more intensive examination of selected mutual funds and mutual fund complexes made by the

¹²¹⁸ Ibid.

¹²¹⁹ Securities and Exchange Commission, (1966). *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 89-2337.

Commission's staff."¹²²⁰ The SEC, however, has consistently ignored these pricing disparities since it recognized them four decades ago, and the pronounced, continuous increase in fund advisory fee levels and revenues has continued.

Freeman and Brown verified whether the advisory fee pricing disparities found in the Wharton Report and the 'Public Policy Implications to Investment Growth report continued to exist. They sent questionnaires concerning portfolio management fees to the 100 largest public pension funds listed in the January 25, 1999 edition of 'Pensions and Investments'. The questionnaire asked pension fund staff for information on fees that were paid to their pension fund's external portfolio investment managers the previous year. The authors received responses from 36 funds that provided usable data which comprised total assets of \$754 billion and averaged \$21 billion per fund. The funds were broadly diversified across asset classes and for comparison purposes, the evaluation included only actively managed domestic equity portfolios. A total of 220 individual actively managed portfolios were identified, totaling \$97.5 billion in assets, ranging in size from \$15 million to \$4.8 billion, with an average portfolio size of \$443 million.

To enable a direct comparison of advisory fees between mutual fund and pension fund portfolios, Freeman and Brown restricted the mutual fund sample to those funds with financial characteristics closest to those of the pension fund sample, representing a final sample consisting of 1,343 funds of which 659 were single class funds and 684 were multiclass funds representing a total of 118 sub-funds. Table 8 from Freeman and

¹²²⁰ Ibid.

Brown compares investment advisory fees for public pension funds and actively managed domestic equity mutual funds.

Table 8 - Comparison of Public Pension and Mutual Fund Investment Advisory Fees

	Public Pension Funds		Mutual Funds	
	Average Portfolio Size	Weighted Average's Advisory Fee	Average Fund Size	Weighted Average's Adv. Fee
Decile	\$mm	(Basis Pts)	\$mm	(Basis Pts)
1	36	60	24	77
2	79	57	47	77
3	130	49	76	75
4	194	42	121	74
5	257	37	185	73
6	327	42	284	71
7	437	33	454	73
8	579	28	759	69
9	842	22	1,527	66
10	1,550	20	9,666	50
Overall	443	28	1,318	56

Source: Freeman and Brown, supra note 1102.

As indicated in Table 8, overall the investment advisory fees are twice as large for mutual funds as they are for pension funds even though the average actively managed domestic equity mutual fund in the sample was nearly three times as large as the average actively managed equity pension portfolio.

Freeman and Brown compared the mutual and pension fund fees on the basis of decile ranking of the respective samples by asset size and then splitting the sample into ten segments with the same number of portfolios/funds in each respective segment. This

resulted in a sample of 22 portfolios in each pension fund decile, with 135 mutual funds in the first three mutual fund deciles, and 134 funds in the remaining deciles.

In the first decile of fund asset size (smallest funds), the advisory fees are roughly comparable, with mutual fund owners paying 77 basis points for an average fund size of \$24 million and pension fund owners paying 60 basis points for an average portfolio of \$36 million. Pension fund advisory fees decrease as portfolio size increases from 60 basis points for the smallest portfolios with an average asset size of \$36 million to 20 basis points for the largest fund with an average asset size of \$1.55 billion. Freeman and Brown interpret this trend to indicate that “The competitive nature of the market for investment advisory services to public pension funds forces fees to decline as asset size increases, essentially reflecting economies of scale in the money management business.”¹²²¹

There is no comparable decline in fees with increasing asset size for the mutual funds, with the average fee comparable through the first seven deciles and consistently greater than 70 basis points. There is a decrease in fees above a fund size approximately \$750 million, although this decrease is not as pronounced as for pension portfolios. For example, while average fund size in the largest decile is approximately \$10 billion, the weighted average advisory fees decline to only 50 basis points.

It should be noted that the average mutual fund portfolio is \$1.3 billion, about

¹²²¹ Freeman and Brown, *supra* note 1102, p. 632.

three times greater than the average pension portfolio of \$443 million. Moreover, the average mutual fund portfolio is approximately six times larger than the average pension portfolio in the largest deciles of portfolios/funds. A comparison of pension and mutual fund portfolios on a comparable size basis indicates an even larger differential in investment advisory fees between pension and mutual funds. For comparison purposes, Freeman and Brown removed the largest mutual funds from consideration, such that the size of the average mutual fund was calibrated to be \$443 million and identical to the average pension portfolio. On this standardized size basis, the weighted average mutual fund advisory fees were 67 basis points, more than double the 28 basis points for pension portfolios.

Freeman and Brown also undertook a comparison of mutual fund and pension fund fees through regression analysis¹²²². This technique was applied to compare the differential responsiveness of pension and mutual fund advisory fees to increases in fund size. The results of the regression analyses indicate that both advisory fees decline as the log of assets under management increases but the slope coefficient for the slope decline for the pension fund regression is three times greater than the mutual fund regression. Freeman and Brown conclude that this reflects that pension fund fees are three times more sensitive to assets under management than mutual fund fees. Based on the analysis by Freeman and Brown, public pension fund portfolio managers receive

¹²²² It also provides the means of controlling for the extreme negative skew in the distribution of fund size. The authors employed a standard technique used in studies of economies of scale is to use a log transformation on the nonlinear (skewed) variable. See Latzko, D. A., (1999). Economies of scale in mutual fund administration, 22 *Journal of Financial Research* 331.

lower fees for a greater commitment of funds under management than their mutual fund counterparts.

The authors conclude that "the chief reason for substantial advisory fee level differences between equity pension fund portfolio managers and equity mutual fund portfolio managers is that advisory fees in the pension field are subject to a marketplace where arm's-length bargaining occurs. As a rule, [mutual] fund shareholders neither benefit from arm's-length bargaining nor from prices that approximate those that arm's-length bargaining would yield were it the norm."¹²²³

ICI President Matthew Fink, contends that "competition is working effectively in the interests of investors."¹²²⁴ The GAO issued a detailed report finding that mutual funds generally do not attempt to compete with each other on the basis of costs and that price competition is muted¹²²⁵. The report observed that "most economists view competition in the mutual fund industry as imperfect."¹²²⁶ Freeman and Brown hold that the fund industry is "over-regulated and under-policed" and operates in a dysfunctional competitive system. Part of the underlying reason for this, according to Freeman and Brown, is the absence of a strong corrective influence arising in part by the fact that those in control of an industry that can afford lawyers, lobbyists, and public relations

¹²²³ Freeman and Brown, *supra* note 1102, p. 634.

¹²²⁴ Improving Price Competition, *supra* note 1174 (Statement of Matthew P. Fink, President, Investment Company Institute).

¹²²⁵ GAO Report, *supra* note 1083 pp. 62-65.

¹²²⁶ *Ibid.*, p. 64.

specialists, as well as having the ICI at their disposal, to argue against major reform proposals.

Mr. Fink opines that the mutual fund industry may be competitive with respect to performance rather than advisory fees. The GAO report stated:

“Although thousands of mutual funds compete actively for investor dollars, competition in the mutual fund industry may not be strongly influencing fee levels because fund advisors generally compete on the basis of performance (measured by returns net of fees) or services provided rather than on the basis of the fees they charge”¹²²⁷.

Although fund sales may be competitive on the basis of performance, this does not necessarily mean that fund governance is regulated by competition.

5.8 EXCESSIVE FEE LITIGATION IN U.S. COURTS

Before the inclusion of Section 36(b) in the Investment Company Act in 1970 a shareholder could legally challenge an investment advisor's fee only through an allegation of excessive fees. The standard for excessively high fees required plaintiffs to demonstrate that the advisor's services were of such a low value relative to the fees that “no person of ordinary, sound business judgement would deem their services to be worth what the fund had paid for them.”¹²²⁸ In enacting Section 36 (b) Congress rejected this

¹²²⁷ Ibid. p. 7.

¹²²⁸ *Saxe V. Brady*, 184 A.2d 602, 611 (De. Ch. 1962).

standard indicating that it was “unduly restrictive.”¹²²⁹ When considering excessive fee lawsuits, following the enactment of Section 36(b), the courts held that the statute incorporated the common law concept of fiduciary duty¹²³⁰. This standard involved an evaluation of fairness of the advisor’s fee under ‘traditional equitable standards’¹²³¹. The burden of proof was placed upon the plaintiff shareholder to demonstrate that the advisory fee was unfair to the company and its shareholders.

In the United States Section 36(b) case law safeguards the status quo of Section 36 (b) of the Investment Company Act of 1940 and has been the focal point of fund industry advisory fee litigation. This section provides a mechanism for a cause of action to attack fund fee payments subject to the following several limitations: (1) plaintiffs are not entitled to a jury trial; (2) only shareholders or the SEC have standing to sue (the fund may not sue for wrongs inflicted on it, as in a common law derivative suit); (3) plaintiffs have the burden of proof, meaning that self-dealing fiduciaries are relieved of the burden of proving fairness; (4) damages are not recoverable for any period prior to one year before the action was instituted; (5) recovery is limited to actual damages resulting from the breach of fiduciary duty and may not exceed the amount of the payments received by such recipient from the investment company or its security holders; and (6) federal courts have exclusive jurisdiction.

¹²²⁹ S. Rep. No. 91-184 at 5 (as reprinted in 1970 V.S.C.C.A.N. 4897, 4901).

¹²³⁰ Savino, A. G., (1980). Note, mutual fund advisory fees – too much too little, 48 *Fordham Law Review* 530, 543-544 & nn. 115 – 116.

¹²³¹ *Galfand V. Chestnutt Corp.*, 545 F. 2d 807, 812 n.12 (2) C.V. 1976).

The seminal case interpreting Section 36(b) is *Gartenberg v. Merrill Lynch Asset Management, Inc.*,¹²³² which involved a suit brought by shareholders of Merrill Lynch Ready Assets Trust money market mutual fund, the trust's assets had increased dramatically from \$428 million to more than \$19 billion between 1977 and 1981, during which time the fund's management fee increased from \$1.6 million to \$39 million. In *Gartenberg* the court stated "The court must consider the 'nature, quality and extent' of the services to the fund in relation to the fee paid by the fund." The plaintiffs contended that the fund was realizing cost savings through economies of size generated by the increase in revenue, which was being captured and by the fund's advisor in the form of higher profits and not passed on to the fund's shareholders. The plaintiffs claimed that the cash should have been passed on to shareholders in the form of lower costs and higher net investment returns¹²³³. The district court dismissed the fund shareholders' claims. The Second Circuit affirmed the district court's decision and articulated the following precepts adopted by subsequent courts in section 36(b) cases commonly referred to as the 'Gartenberg test':

"To be guilty of a violation of § 36(b) ... the advisor-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. . . . To make this determination all pertinent facts must be weighed"¹²³⁴. In determining whether the

¹²³² 694 F.2d 923 (2d Cir. 1982).

¹²³³ *Ibid.*, p. 928.

¹²³⁴ *Ibid.* pp. 928-29.

foregoing standard is met, the following factors need to be weighed: (a) the nature and quality of services provided to fund shareholders; (b) the profitability of the fund to the advisor-manager; (c) fall-out benefits; (d) economies of scale; (e) comparative fee structures; and (f) the independence and conscientiousness of the trustees¹²³⁵. Though rates charged by other advisor-managers are a factor to be taken into account in evaluating reasonableness, the normally "unseverable relationship between the advisor-manager and the fund it services tends to weaken the weight to be given to rates charged by advisors of other similar funds."¹²³⁶

The court held that argument that the lower fees charged by investment advisors to large pension funds should be used as a criterion for determining fair advisory fees for money market funds was rejected by the court.¹²³⁷ The court justified its ruling on this point on the grounds that "[t]he nature and extent of the services required by each type of fund differ sharply [T]he pension fund does not face the myriad of daily purchases and redemptions throughout the nation which must be handled by the Fund, in which a purchaser may invest for only a few days."¹²³⁸

In *Gartenberg*, the United States District Court, for the Southern District of New York, held that, although Merrill Lynch's advisory fee was irrefutably high, the plaintiffs failed to show that it represented anything more than a reasonable relationship to the

¹²³⁵ Ibid. pp. 929-32.

¹²³⁶ Ibid p. 929.

¹²³⁷ Ibid., p. 930, n.3.

¹²³⁸ Ibid., p. 930.

services provided by Merrill Lynch¹²³⁹. The court also noted that the fund's explosive growth had required Merrill Lynch to provide costlier facilities and increased the cost of processing redemption orders. This interpretation, however, is at odds with the expected cost savings due to economies of scale arising from this growth, which would offset these costs. The court found in the favour of Merrill Lynch noting that there was a significant amount of documentary material and the board engaged in significant deliberations before approving the advisory contract.

The Second Circuit Court of Appeals affirmed that the district court's dismissal, indicating the standard that courts would later apply in Section 36(b) actions for the subsequent 25 years. The court concluded that arms length bargaining for mutual fund advisory contracts did not occur in the market based on review legislative history of Section 36(b). The court therefore held that the test of whether an advisor's fee violated his Section 36(b) fiduciary duty was "essentially whether the fee schedule represents[ed] a charge within the range of what would have been negotiated at arm's-length in light of all the surrounding circumstances."¹²⁴⁰ The court concluded that the plaintiffs failed to carry their burden of establishing a breach of fiduciary duty¹²⁴¹. The court also rejected the plaintiffs' argument that the court should consider the lower fees that Merrill Lynch had charged to its pension fund clients as a criterion for evaluating mutual fund advisory fees.

¹²³⁹ *Gartenberg*, 528 F. Supp. p. 1068.

¹²⁴⁰ *Ibid.*

¹²⁴¹ *Gartenberg*, 694 F. 2d p. 933.

There have been numerous criticisms at the court's decision and rationale in *Gartenberg*. For example, legal commentators have argued that courts manipulate the *Gartenberg* factors such that they effectively prevent recovery by plaintiff shareholders, without creating liability on the part of the defendant advisors, resulting in an insurmountable burden of proof placed upon plaintiffs in Section 36(b) actions. Freeman et al state "the federal fiduciary standard applied in Section 36(b) cases under *Gartenberg* is an infirm and warped legal standard requiring scrutiny of hidden or essentially undiscoverable data that, even if found, are subject to wildly different interpretation by well paid and highly-credentialed experts."¹²⁴²

One of the *Gartenberg* factors requires courts to evaluate the nature and quality of the services provided by the advisor in evaluation the size of an advisory fee¹²⁴³. Courts often equate above average yields with high quality advisory services and if, for instance, the fund has experienced above average yields then the courts weigh the quality of the service as a factor in upholding the advisory fee. In *Krinsk*, for example, the court noted that the fund experienced yields in comparison with other funds and suggested that these higher yields resulted from the advisor's research and trading strategies¹²⁴⁴. However, this does not hold true if the fund experienced below average returns. For example, in *Migdal* the court refused to permit discovery in a Section 36(b) action when the plaintiffs

¹²⁴² Freeman, J. P., S.L. Brown, & S. Pomerantz, (2008). Mutual fund advisory fees: new evidence and a fair fiduciary test, 61 *Oklahoma Law Review* 83 p. 139.

¹²⁴³ *Gartenberg*, 694 F. 2d p. 930, *Krinsk*, 875 F. 2d p. 409.

¹²⁴⁴ *Krinsk V. Fund Asset Mgmt., Inc.*, 715F Supp. 472, 488-89 (S.D.N.Y. 1988).

alleged that the fund had underperformed¹²⁴⁵. In *Migdal V. Rowe Price-Fleming Int'l* the plaintiffs in the Section 36(b) action alleged that the investment advisors fee was excessive in relation to poor performance of the mutual fund. The Fourth Circuit Court refused to accept the plaintiff's argument that investment advisory services had less value than similar services provided to a fund with superior performance¹²⁴⁶.

The court noted that investors assumed some risk that their investments would not perform up to expectations. The issue with potential manipulation arises with respect to its different treatment of high and low yield funds. As stated by Colin Davis¹²⁴⁷ “the *Gartenberg* factors allow for significant judicial manipulation – a court can minimize the importance of those factors that would appear to weigh against the investment advisor in order to reach the courts desired result”. The Fourth Court of Appeals was concerned that allowing plaintiffs to proceed to discovery on only a demonstration of underperformance in fund yield would “make it possible for other plaintiffs to state a claim in limitless actions filed under Section 36(b).”¹²⁴⁸ A concern has been expressed that a court could apply the same analysis to a case where the plaintiff submitted evidence on other components of the *Gartenberg* test¹²⁴⁹.

¹²⁴⁵ *Migdal V. Rowe Price-Fleming Int'l, Inc.* 248-F. 3d 321, 327-328 (4th Cir. 2001).

¹²⁴⁶ *Ibid.*

¹²⁴⁷ Davis, C. B., (2010). Nudging mutual fund fees downward: using default rules to combat excessive advisory fees, 47 *San Diego Law Review* 185 (March 2010) p. 208.

¹²⁴⁸ *Ibid.*, p. 328.

¹²⁴⁹ *Ibid.*, p. 208.

A common criticism of the Gartenberg test is that profitability cannot be calculated by investors because advisors do not provide the critical information. Freeman and Brown¹²⁵⁰ state “profitability is difficult to calculate for starters, because it is tough to obtain the raw data necessary to make the calculations ... To even start profitability analysis, a plaintiff must marshal evidence the SEC does not have and says it cannot obtain it”.

In *Jones v. Harris Associates, L.P. (Harris Associates)*¹²⁵¹ the plaintiffs filed a lawsuit against the investment advisor alleging that the advisor had received such a disproportionately large fee in comparison to the value of its services as to constitute a breach of fiduciary duty under Section 36(b). The U.S. district court considered the Gartenberg factors and concluded that the advisor’s fee was within an acceptable range. The district court based on its decision on four main factors: 1) advisor’s charges were comparable to those charged by similar funds that were managed by other companies 2) the advisor disclosed all relevant information to the funds trustees who approved their fee 3) the fund’s fee schedule contained breakpoints resulting from regulation with the trustees, and 4) the funds performed well during the period of claimed damages¹²⁵². The Seventh Circuit Court of Appeals affirmed the district court’s decision but on different grounds and rejected the approach of the Gartenberg test for Section 36(b) litigation¹²⁵³.

¹²⁵⁰ Freeman and Brown, *supra* note 1102, p. 131.

¹²⁵¹ *Jones V. Harris Associates, L.P.*, No. 04C 8305, 2007 WL 627640 at *1-3 N.D. 111. Feb. 27, 2007, *aff’d*, 527 F3d 627 (7th Cir. 2008), *cert. Granted*, 129 S. Ct. 1579 (2009)

¹²⁵² *Ibid.*, p. 8.

¹²⁵³ *Ibid.*, p. 632.

The court concluded that the ‘Gartenberg Standard’ relied too little on the role of markets in regulating advisory fees¹²⁵⁴. The court indicated that the mutual fund market had grown significantly since the amendments in 1970, stating “Section 36(b) does not create a rate – regulation mechanism, and the plaintiff’s proposal to create such a mechanism in 2008 cannot be justified by market conditions of 1970. A lot has happened in the last 38 years.”¹²⁵⁵ The court posited that the size and structure of the mutual fund market to facilitate competition, driving down the prices of advisory services. The court further suggested that even if sparse competition for mutual fund advisory contracts failed to regulate advisory fees, shareholders ability to cheaply and easily move their money to another fund charging lower fees creates an incentive for investment advisors to keep their rates comparatively low. The court declined to review the advisory fees and held that the responsibility to regulate advisory fees belonged to “the trustees (and in the end investors, who vote with their feet and dollars), rather than a judge or jury.”¹²⁵⁶

The Court’s decision will serve to make it even more difficult for the previous shareholders to recover excessive fees since it firmly places the responsibility away from the courts and upon the trustees or investors¹²⁵⁷. The courts approach in *Harris* may also provide even greater protection to mutual fund advisors who charge fees comparable to those charged by other advisors in the market even if they were all excessive. This was

¹²⁵⁴ *Harris Associates*, 527 F.3d 627.

¹²⁵⁵ *Ibid.*, pp. 633-634.

¹²⁵⁶ *Ibid.*, p. 632.

¹²⁵⁷ See Colin Davis, *supra* note 1247, p. 210.

recognized by the dissenting judge in the Court of Appeals who stated “The governing structure that enables mutual fund advisors to charge exorbitant fees is industry-wide, so the panels comparability approach would if widely followed allow those fees to become the industry floor.”¹²⁵⁸ No plaintiff to date has successfully met the *Gartenberg* test. One of the issues is that plaintiffs have had the burden of proving that fees extracted from a given fund are “unreasonably unreasonable.” This term was coined by Judge Henry Friendly in discussing the role of courts in reviewing fund fee cases as follows: “There is a common law liability of directors for waste, and while a plaintiff who seeks to prevail on that score may have to show that the fee is not merely unreasonable but unreasonably unreasonable, a court still has the job of comparing what has been done with what has been received.”¹²⁵⁹

A primary problem has been investors' inability to generate the data needed to discharge their burden of proof. This is related both to the lack of available information on fund costs and fees as discussed elsewhere in this thesis. The plaintiffs' attempted to demonstrate unreasonableness through a comparison with rates of other fund managers. This was rejected by the court on the ground that fees charged by other advisors have little relevance because advisors do not bid against each other in an effort to gain more fund assets to manage¹²⁶⁰. The outcome was that the *Gartenberg* plaintiffs failed to prove

¹²⁵⁸ *Jones V. Harris Associates. L.P.*, 537 F.3d 728, 732 (7th Cir. 2008) (Posner J., dissenting).

¹²⁵⁹ Investment Company Act Amendments of 1967: Hearing on H.R. 9510 and H.R. 9511 Before the Subcommittee on Commerce and Finance, 90th Cong. 610 (1967) (statement of Judge Henry J. Friendly, U.S. Appeals Court., N.Y., N.Y.).

¹²⁶⁰ 694 F.2d, p. 929.

either the presence of economies of scale or the advisor's failure to share them with the fund¹²⁶¹. In *Gartenberg*, the court was considering a comparison with pension fund fee data to challenge the fee levels in a money market fund. It would be expected that the court's ruling on admissibility may have no force in a case involving a direct comparison between fees of equity pension funds and equity mutual funds.

Freeman and Brown¹²⁶² disagree with the district court's suggestions in *Gartenberg* that the principal factor to be considered in evaluating a fee's fairness is the price charged by other similar advisors to funds managed by them, and that the "price charged by advisors to those funds establishes the free and open market level for fiduciary compensation," that the "market price ... serves as a standard to test the fairness of the investment advisory fee," and that a fee is fair if it "is in harmony with the broad and prevailing market choice available to the investor."¹²⁶³ Freeman and Brown contend that competition between money market funds for shareholder business does not support an inference that competition must therefore also exist between advisor-managers for fund business and that "The former may be vigorous even though the latter is virtually non-existent. Each is governed by different forces. Reliance on prevailing industry advisory fees will not satisfy § 36(b)."¹²⁶⁴

¹²⁶¹ 694 F.2d, p. 931.

¹²⁶² Freeman and Brown, *supra* note 1102.

¹²⁶³ *Ibid.*

¹²⁶⁴ *Ibid.*, p.3.

In *Kalish v. Franklin Advisors, Inc.*¹²⁶⁵ the district court dismissed fiduciary duty claims against the defendant fund investment advisor, holding that it was improper to compare the profitability of fund managers to earnings elsewhere in the financial services area, stating: "[T]o the extent that comparisons are probative at all, a mutual fund advisor-manager must be compared with members of an appropriate universe: advisor-managers of similar funds"¹²⁶⁶. The fund in *Kalish* invested in GNMA securities but the court essentially held that the designation "similar funds" required disregarding evidence drawn from comparison with Vanguard group's low-cost GNMA fund. The court indicated that any comparison with Vanguard is "seriously flawed."¹²⁶⁷ The distinguishing factors according to the court were that the Vanguard funds were unique due to their internal management and their tendency to furnish "corporate management, administrative, shareholder accounting, marketing and distribution services" on an "at-cost" basis¹²⁶⁸ even though Vanguard's GNMA fund, like Franklin's, was managed by an external investment advisor. The court focused on factors that distinguished Vanguard funds as unique¹²⁶⁹.

The court attributed the low advisory fee (0.03%) charged by Wellington Management Company, the Vanguard GNMA fund's external advisor, as attributable to

¹²⁶⁵ 742 F. Supp. 1222 (S.D.N.Y. 1990).

¹²⁶⁶ *Ibid.*, p. 1237.

¹²⁶⁷ *Ibid.*, p. 1250.

¹²⁶⁸ *Kalish*, 742 F. Supp. p. 1231.

¹²⁶⁹ *Ibid.*

the "the great buying power possessed by the Vanguard group."¹²⁷⁰ The court did not address the possibility that the lower fees were due to aggressive and effective bargaining by Vanguard to serve its shareholders' interests. The court in *Kalish* also implied that Wellington had cut its fees for Vanguard's GNMA fund in an effort to win advisory contracts for other Vanguard funds¹²⁷¹. The court therefore ignored the potential that the lower fees were the result of competitive behaviour by the external manager. Accordingly, it is highly unlikely that the court will compare low fees in well managed competitive companies during court challenges for high fees. As a result, the U.S. courts cannot be expected to serve to contribute to maintaining lower mutual fund advisory fees and would only, at best, address exorbitant fees¹²⁷². Like *Gartenberg*, each court dealt with actions under Section 36(b) on advisory fee levels assessed against shareholders of money market mutual funds. The district courts found in favour of the industry defence arguments.

The court in *Krinsk* dismissed a fiduciary duty claim against Merrill Lynch, advisor to CMA Money Fund, under section 36(b)¹²⁷³, and also dismissed a proxy claim under 14a-9¹²⁷⁴. The court in *Krinsk* made a number of significant rulings considering *Gartenberg*. The court held that plaintiffs would not be permitted to prove that the fund's

¹²⁷⁰ Ibid.

¹²⁷¹ Ibid.

¹²⁷² Both *Krinsk v. Fund Asset Management, Inc.* 715 F. Supp. 472 (S.D.N.Y. 1988). And *Schuyt v. T.Rowe Price Prime Reserve Fund, Inc.* 663 F. Supp. 962 (S.D.N.Y. 1987), *aftd*, 835 F.2d 45 (2d Cir. 1987), *cert. Denied*, 485 U.S. 1034.

¹²⁷³ *Krinsk*, 715 F. Supp. At 502-03.

¹²⁷⁴ Ibid., p. 1.

performance, which the advisor touted as being "at or near the top of money market funds"¹²⁷⁵, was actually inferior when analyzed on a "risk-adjusted" basis taking into account the portfolio's volatility. The court rejected the "concept of 'risk-adjusted' return as a standard of fund performance measurement, noting that the SEC did not require risk-adjusted performance ratings. In *Krinsk*, the courts received three expert reports on the issue of the advisor's profitability. The expert for the plaintiffs testified that the CMA fund generated pre-tax profits for Merrill Lynch with a pre-tax return on revenues of 28.5% on \$47.5 million of revenue. In contrast, Merrill Lynch's chief expert reported a loss of \$77 million and a negative profitability percentage of 55.8%.¹²⁷⁶ The court stated Merrill Lynch's average annual profitability for 1984 to 1986 according to the plaintiff was 40.4%. The defendants' expert estimated average profitability for the same period to be 32.7% and stated "it is safe to say that fee based profits fall somewhere in the range between the [two] positions"¹²⁷⁷ without information to support this conclusion. After consideration of both sides' presentation on profitability, the court concluded that a weighted average of pre-tax profitability over the three-year test period "would probably fall in a range from at least a few percentage points greater than 0% to perhaps as much as 33%."¹²⁷⁸ Essentially, the court was left to guess what the advisory fee netted the fund's advisor, due to its uncertainty concerning the profitability of the advisory contract.

¹²⁷⁵ *Ibid.*, p. 487.

¹²⁷⁶ *Ibid.*, p. 489.

¹²⁷⁷ *Ibid.*, p. 494.

¹²⁷⁸ *Krinsk*, 715 F. Supp. p. 494.

The court in *Krinsk* found the plaintiffs unable to quantify fall-out benefits accruing to Merrill Lynch arising from (i) commission profits from trades in the CMA program securities account; (ii) margin interest; (iii) management fees derived from funds other than the Fund within the CMA program; (iv) earnings from sales of products and services outside the program, but sold to fund customers; and (v) profits earned by affiliates who transact business with the fund¹²⁷⁹. Similarly, in *Courtenberg*, plaintiffs were not able to demonstrate that the advisor benefited from economies of scale, since they did not quantify the existence and magnitude of any economies of scale¹²⁸⁰. The court held that it is not enough to show that costs decreased as the fund increased in size; or that the unit cost of providing management services directly to the fund decreases as the fund grows, but "the per unit cost of servicing Fund shareholders does not."¹²⁸¹ The court found that money market fund shareholders "tend to transfer money in and out of their funds on a regular basis," with per unit processing costs remaining constant, and not varying with the size of the fund or the number of accounts¹²⁸².

As the Gartenberg test requires that the fund's directors weigh "the profitability of the fund to the advisor manager", the inability of the defence to coherently advance a profitability number does not reflect well upon its argument or the directors' discharge of

¹²⁷⁹ *Krinsk*, 715 F. Supp. At 494. The lack of success by the plaintiff in quantifying the above resulted in them having no way to show that the advisory fee was unreasonably high. The plaintiff was not able to demonstrate that they contributed to the. *Ibid.*, pp. 494- 96.

¹²⁸⁰ *Ibid.*

¹²⁸¹ *Ibid.*

¹²⁸² *Ibid.*

their investigative duties¹²⁸³. It would be expected that the fund's directors, in their presentation would present an understandable representation of profitability. It would also be expected that the court, in their decision, would also demonstrate a clear understanding of the advisory contract's profitability. The onus is on the plaintiff to win a case by alleging and proving a breach of fiduciary duty rooted in an unfair compensation charge. However, it appears that the burden of proof upon the plaintiff is so pronounced that the defence is not required to produce a coherent argument.

As the result the Plaintiffs' issue in *Krinsk* was a lack of solid proof and thus mirrored the problems encountered in *Gartenberg* and *Kalish*. The court in *Krinsk* evaluated comparable expense ratios in a way that was highly favourable to the defence, as in *Gartenberg* and *Kalish*. The court opined that expense ratios for stand-alone money market funds were less relevant than for other brokerage money management accounts and citing *Gartenberg*, stated that that comparison with those funds was of "limited value due to the lack of competition among advisors for fund business."¹²⁸⁴ The court concluded that the CMA Fund expense ratio placed it in the "middle range" among similar funds.

In *Krinsk*, the court heard the fact that, over and above its charging a level of costs placing it in the middle of its peer group, fund advisor Merrill Lynch retained an additional \$65 million on an annual fee it levied against each of its one million CMA

¹²⁸³ *Krinsk*, 875 F.2d p. 409, citing *Gartenberg*, 694 F.2d, pp. 929-30.

¹²⁸⁴ *Ibid.*

investors which it found to be irrelevant¹²⁸⁵. The "irrelevant" annual fee paid by the fund's shareholders alone generated enormous revenue for Merrill Lynch, which in fact exceeded the total amount of the fund's advisory fee, which was \$64 million in 1985¹²⁸⁶. The court's justification for essentially ignoring the additional \$65 million item was that the fee was mandatory for all Merrill Lynch CMA shareholders having cash management accounts regardless of whether they used the CMA fund or not. The court viewed the payment as "a reasonable means by which to seek to hedge against the entrepreneurial risk incurred in setting up and maintaining the CMA."¹²⁸⁷

In *Schuyt v. T. Rowe Price Prime Reserve Fund, Inc. (Schuyt)* the fund had undergone a ten-fold growth over three years. The advisor's pre-tax profit margin had increased from 57% for the first nine months of 1979¹²⁸⁸ to 59.1% for the entire year, to 66.8% for 1980 and to 77.3% for 1981¹²⁸⁹. It should be noted that in *Schuyt* the courts approved the directors' behaviour based on the *Gartenberg* factors. At the same time, the court faulted the plaintiff's experts for failing to address them in detail, while provided a favourable assessment of the directors' behaviour. Specifically, the court approved of the formulation of directors' duties by the lawyer who served as independent counsel to the fund's independent directors, stating: "The basic test is whether the directors can satisfy themselves that the information that is available provides a reasonable basis for judgment

¹²⁸⁵ Krinsk, 715 F. Supp., p. 497-98.

¹²⁸⁶ Ibid., p. 479.

¹²⁸⁷ Ibid., p. 498.

¹²⁸⁸ Ibid., p. 968.

¹²⁸⁹ *Schuyt*, 663 F. Supp. p. 979.

that the benefits of the economies of scale are, in fact, shared by the advisor with the Fund."¹²⁹⁰

The court rejected the efforts by the plaintiff's experts to show excessiveness by comparing the advisory fee to the fees they charged "to its private counsel accounts and fees charged by others for performing different types of services."¹²⁹¹ The court recognized that other funds' fee schedules were relevant and "significant to economies of scale"¹²⁹² and it faulted the plaintiff's expert for failing to correlate the nature of the services provided in different settings¹²⁹³.

Schuyt can be read to leave the door open to a proof of excessiveness built in part on evidence of fees charged by the advisor in other venues. The court also rejected use of fee rates used by banks and trust companies in rendering advisory services outside the fund industry, finding such services "unrelated to the advisory services at issue in this case" and ineligible for consideration under *Gartenberg*¹²⁹⁴. The court in *Schuyt* dismissed the idea that advisory fees charged outside the fund industry could furnish helpful guidance, contending, as did the appellate court in *Gartenberg*, that managers in other venues are not required to cope with processing numerous purchases and redemptions each day. In so holding, the court cited *Gartenberg* for the proposition that

¹²⁹⁰ *Schuyt*, 663 F. Supp. At 969 n.20 (quoting Exhibit AL, at II).

¹²⁹¹ *Ibid.*, pp. 973, n.38.

¹²⁹² *Ibid.*, pp. 972, n.34.

¹²⁹³ *Ibid.*, pp. 973-74, n.38.

¹²⁹⁴ *Ibid.*, p. 974, n.38.

"fee rates of advisors to non-mutual fund clients should not be used as criterion for determining fairness of mutual fund fees because advisors to other types of entities perform services that do not involve a myriad of daily purchases and redemptions."¹²⁹⁵ The court in *Schuyt* later explained that, "due to the unique nature of the services provided by money market advisors and the industry, the Court finds there were no fee schedules from the competitive market that could have appropriately guided the directors."¹²⁹⁶

It is true that daily shareholder redemptions do add costs to mutual fund administration, and the redemption feature distinguishes mutual funds from other professionally managed investment portfolios, such as pension and endowment funds. However, the costs associated with the characteristics that make mutual funds unique tend to be nominal and realized as administrative expenses.

The plaintiff's allegations in *Schuyt* also included a charge that the fund's shareholders had been misled, due to a failure to disclose to them in proxy solicitation information concerning the profitability of the advisory contract to the advisor, in violation of Rule 14a-9 under the Securities Exchange Act of 1934¹²⁹⁷. The court held that, from the standpoint of the fund's shareholders, information disclosing the advisory contract's profitability to the advisor was immaterial as a matter of law¹²⁹⁸. The court

¹²⁹⁵ Ibid.

¹²⁹⁶ Ibid., pp. 983-84.

¹²⁹⁷ *Schuyt*, 663 F. Supp. p. 989.

¹²⁹⁸ Ibid.

found "that the omitted profitability information is neither accurate nor significant enough to influence the vote of investors" ... ¹²⁹⁹ It was the court's opinion that "a reasonable shareholder would not consider profitability information on important when voting on the investment advisory agreement."¹³⁰⁰ The court justified its immateriality ruling on the ground that the SEC did not require disclosure and lacked proof that "such profitability information is commonly provided in proxy statements by others in the money market industry."¹³⁰¹ Accordingly, the basis of the court's ruling of immateriality is the SEC's lack of requirements for the justification of the lack of disclosure of the profitability of the investment advisor to investors. There is a lack of supporting information for the court's opinion that a reasonable shareholder would not consider the profitability of an advisor when selecting an advisor. It would stand to reason that in fact an investor would consider this information to be very important since increases in the advisor's profit decrease the investor's profit. In short, on the crucial issue of disclosure to fund shareholders about the dollars paid for advisory services, the SEC tolerates, and thus abets, nondisclosure or, at best, weak, generalized disclosure.

In fact, the court applied an improper test since, in a 14a-9 case, the materiality test is not whether the omitted fact would cause an investor to change his or her vote and the voting decision need not be altered¹³⁰². Rather, it is only necessary that there be a

¹²⁹⁹ Ibid., p. 990.

¹³⁰⁰ Ibid.

¹³⁰¹ Ibid.

¹³⁰² Freeman and Brown, *supra* note 1102; TSC Indus., Inc. V. Northway, line., 426 U.S. 438, 44849 (1976).

substantial likelihood that a reasonable investor would consider the fact important¹³⁰³. The court also made a significant error in its dismissal of the need for disclosure on the grounds that the profitability information that would have been provided to investors concerning the advisory contract which was inaccurate. This also meant that both the advisor and the fund directors were using and relying on inaccurate profitability data. It can be expected that a reasonable shareholder surely could have viewed the reliance of the directors and advisors upon inaccurate information as significant, particularly since the court found that the advisor's pre-tax profit margin was 77%. The Second Circuit affirmed the lower court's ruling in *Schuyt* only two days after it was argued, "substantially for the reasons stated in Judge Ward's thorough opinion" without detailed discussion¹³⁰⁴.

There are several problems with the application of the *Gartenberg* reasonableness test. As stated by Freeman and Brown it "is unexceptionable in theory; in practice, it is a failure."¹³⁰⁵ The starting point of the reasonableness test is fair as it is essentially a demand that fees be equivalent to those resulting from "arm's-length bargaining." The next part of the test also appears to be fair as it demands that among the factors that "are to be considered" are "comparative fee structures."¹³⁰⁶ Issues arise with the subsequent part as the post-*Gartenberg* courts have improperly denied the relevance of advisory fee structures actually set by arm's-length bargaining as in the pension fund advisory fees.

¹³⁰³ *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 835 F.2d 45, 46 (2d Cir. 1987).

¹³⁰⁴ *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 835 F.2d 45, 46 (2d Cir. 1987).

¹³⁰⁵ Freeman and Brown, *supra* note 1102, p. 651.

¹³⁰⁶ Krinsk, 875 F.2d at 409.

Low-cost fee structures charged by other funds, such as Vanguard's, have been considered to be essentially irrelevant since lower advisory prices are not available to the fund because fund advisors refuse to compete against each other for advisory business¹³⁰⁷. According to Freeman and Brown¹³⁰⁸, the "Misapplication of the *Gartenberg* criteria has led to a 'tilted playing field'". The absence of a competitive market has not become a reason for enhanced scrutiny, but a justification for fitting the judiciary with blinders."

In *Kalish* the court's refusal to consider a comparison with the low fees of the Vanguard group is exemplary of the judiciary's refusal to consider and learn from free market pricing patterns. The exclusion of a comparison with the fees of Vanguard was not warranted since it competes directly with all other funds for investors' money and its pricing structure is particularly relevant and important because its low cost provides a yardstick for measuring the reasonableness of other funds' fee structures. It was illogical that the rationale for the courts exclusion of a comparison was that they are not relevant as they are a low cost provider which is necessary to include for a proper benchmarking as part of reasonableness test. As Freeman and Brown¹³⁰⁹ state: "To say that Vanguard's fee schedules are irrelevant just because the Vanguard managers, like most other corporate managers in the economy, operate with an eye single to their shareholders' interests, only calls attention to the peculiarity of the fund industry's default management

¹³⁰⁷ Freeman and Brown, *supra* note 1102.

¹³⁰⁸ *Ibid.*, p. 651.

¹³⁰⁹ Freeman and Brown, *supra* note 1102, p. 651.

structure.”

It is also inappropriate for the courts to hold that fee levels charged by pension funds' external advisors have no relevance to mutual fund advisory services. A basis of the *Gartenberg* test is that free market pricing or "arm's-length bargaining" is relevant to the examination of fees under Section 36(b), and then all relevant evidence on fees should be collected and analyzed including pension fund fees. This is particularly relevant for example considering that investors may have a choice in whether to invest in their pension fund or in mutual funds, such as within a retirement fund. However, a comparison should include prices set in the free market for the same commodity, including, for example, by Vanguard funds, pension funds, endowment funds, or other institutional investors. It is not appropriate improper to interpret *Gartenberg* as barring comparison with these other investments. In *Gartenberg* the court held that the pension fund advisory fee data was irrelevant to the claim only because the fund in question was a money market fund. The court almost certainly would have allowed the comparison if it were a bond or equity fund.

It also was not appropriate for the courts applying the *Gartenberg* test to consider analogies with fee structures in other investment vehicles to be irrelevant since analogies to establish fairness by fiduciaries can play a major role in addressing misconduct in the securities field. Experts testifying in individual brokerage account turnover ('churning') cases today, for example, are permitted to support their opinions with turnover rate data

drawn from mutual fund prospectuses using accepted practices¹³¹⁰.

Argument by analogy has also been accepted in areas of related securities law such as excessive markups. As an example, in *Grandon v. Merrill Lynch & Co.*¹³¹¹ (*Merrill Lynch*), the Second Circuit did not reject the argument by analogy when considering markup limits on equity securities and in their decision held that the plaintiffs had stated a cause of action based on alleged excessive, undisclosed markups for municipal securities. In *Merrill Lynch*, the court held that investors are entitled to be informed when the prices charged them are not reasonably related to prices charged in "an open and competitive market."¹³¹² This is relevant to the disclosure of mutual fund fees since mutual fund shareholders do not deserve less disclosure than investors trading municipal securities. Fund advisors who charge mutual fund shareholders excessive prices for advisory services should be dealt with in the same manner as those who charge fees to other institutions in other markets, such as pension funds and municipal securities. Further, the duty of full disclosure espoused in *Merrill Lynch* with respect to bond market pricing also becomes a duty in fund advisory fee litigation.

The major issue for plaintiffs in every fully litigated fund advisory fee case, under Section 36(b) in the United States, involving charging unreasonable fee levels has been the court's position that there is a lack of accurate supporting data. The burden of proof in

¹³¹⁰ Winslow, D. A. & S. C. Anderson, (1990). A model for determining the excessive trading element in churning claims, 68 *North Carolina Law Review* 327.

¹³¹¹ 147 F.3d 184 (2d Cir. 1998).

¹³¹² *Ibid.*, pp. 189-90.

these cases has been upon the plaintiffs. In 1967 Congress considered the introduction of legislation to address issues with fund fee levels. At this time Congress did consider placing the burden of showing that the fees were not excessive on the fund manager and away from the investor. Professor Ernest Folk testified that saddling plaintiffs with the burden of showing that fees are excessive unduly favours management since fund shareholders do not have access to the required data relevant to the quality of the services, economies of scale, or the value of all benefits received by the advisor.¹³¹³ Congress decided not to shift the burden of proving fairness to the advisor from the shareholder and this decision was therefore a root cause for the subsequent decisions in *Gartenberg*, *Schuyt*, *Kalish*, and *Krinsk*, which placed the burden of proof on the investor which has insufficient data to prove that the fees were excessive. For example, the Second Circuit in *Gartenberg* explicitly called attention to the plaintiffs' failure of proof:

“Our affordance is not a holding that the fee contract between the Fund and the Manager is fair and reasonable. We merely conclude that on these record appellants failed to prove by a preponderance of the evidence a breach of fiduciary duty. Whether a violation of § 36(b) might be established through more probative evidence... must therefore remain a matter of speculation¹³¹⁴.

¹³¹³ Investment Company Act Amendments of 1967: Hearing before the Subcomm. On Commerce and Fin. Of the Comm. On Interstate and Foreign Commerce, 90th Congo 801 (1967) (statement of Ernest Folk, Professor of Law, University of North Carolina).

¹³¹⁴ *Gartenberg*, 694 F.2d p. 933.

Freeman and Brown¹³¹⁵ hold that a misinterpretation of *Gartenberg*, by subsequent courts, has unfairly hindered attacks on excessive fund fees, which has contributed to shift in focus away from excessive compensation claims in fund litigation.

The absence of quality data still presents problems for those willing to question the status quo. A study by GAO was unable to determine the extent to which mutual fund advisors experienced economies of scale because information on the costs and profitability of most fund advisors was not generally publicly available¹³¹⁶. In general, fund managers have the favored litigation position in fee cases, since their opponents are not privy to the crucial data needed to show abusive behavior prior to litigation and they do not have the burden of justifying their behavior.

Three of the four cases, including *Gartenberg*, *Krinsk*, and *Schuyt* concerned money market fund advisory fees and thus are easily distinguishable from an equity fund advisory fee case. The GAO reports indicates that price competition or sensitivity to operating cost levels is most evident in the money market and bond fund segments, to the extent that they exist in the fund industry.¹³¹⁷ *Kalish* dealt with a bond fund. Another money market fund case that has been litigated is *Meyer v. Oppenheimer*¹³¹⁸ (*Meyer*). The leading advisory fee cases to date did not involve equity funds. As a result, the courts have not yet considered the comparisons that can be made with the pension fund industry

¹³¹⁵ Freeman and Brown, *supra* note 1102.

¹³¹⁶ GAO Report, *supra* note 1083p. 33.

¹³¹⁷ GAO Report, *supra* note 1083 pp. 62-63.

¹³¹⁸ 609 F. Supp. 380.

where prices are notably lower for equity advisory services than in the mutual fund industry.

*Meyer*¹³¹⁹ was initiated as an action under Section 36(b) attacking advisory fees charged against the Daily Cash Accumulation Fund, which was settled¹³²⁰. The fund board subsequently adopted a Rule 12b-1 plan that caused certain costs to be shifted to fund shareholders which previously had been borne by brokerage firms distributing the fund. This change was attacked under Section 36(b) and other theories as a violation of the terms of the settlement agreement, and that charge ultimately was rejected. The Section 36(b) claim in *Meyer* failed due to a lack of proof as in the other Section 36(b) cases¹³²¹. The Second Circuit expressly recommended that, on remand, the district court invite comment from the SEC.¹³²² However when it was subsequently invited to comment, the SEC declined to participate¹³²³. *Meyer* thus was litigated more like a lawsuit alleging breach of a settlement agreement capping compensation and less like a full-scale advisory fee case.

The fiduciary duty has failed to protect mutual fund investors in practice in the United States as retail mutual fund clients continue to pay investment advisors substantially higher fees than institutional clients, yet no court has ever found that an

¹³¹⁹ 609 F. Supp. 380, (S.O.N.Y. 1984), rev'd, 764 F.2d 76 (2d Cir, 1985).

¹³²⁰ *Meyer*, 609 F. Supp. pp. 381-82.

¹³²¹ *Ibid.*, pp. 680-81.

¹³²² *Meyer*, 764 F.2d, p. 85.

¹³²³ *Meyer*, 691 F. Supp. pp. 680-81.

investment advisor breached its fiduciary duty to shareholders. The SEC has never brought suit against an investment advisor for breach of fiduciary duty regarding fees, and shareholders have lost every suit that they brought¹³²⁴. Cox et al in their review of the Gartenberg test stated “Plaintiffs are still seeking to achieve their first victory under section 36(b).”¹³²⁵ Lyman Johnson’s evaluation of the Gartenberg test after 25 years stated “The most remarkable statistic under section 36(b) is that, thirty-seven years after its enactment and twenty-five years after Gartenberg, no investor had obtained a verdict against an investment advisor.”¹³²⁶

Harris Associates,¹³²⁷ utilizing the application of *Gartenberg* standard, created a circuit split. The court, in an opinion authored by Judge Easterbrook, expressed scepticism about *Gartenberg* “because it relies too little on the markets.”¹³²⁸ In a strong dissent from the denial on the rehearing, Judge Posner argued that the panel’s decision was based primarily on “economic analysis that is ripe for re-examination.”¹³²⁹ This disagreement between two judges that are prominent in the field of law and economics highlighted the uncertainty surrounding the appropriate fiduciary duty for mutual fund

¹³²⁴ Ibid.

¹³²⁵ Cox J. D., & J. W. Payne, (2005). Mutual fund expense disclosure: a behavioural perspective, 83 *Washington University Law Quarterly* 907, 914, 923.

¹³²⁶ Johnson, L., (2008). A freshlook at director “independence”: mutual fund fee litigation and Gartenberg at twenty-five, 61 *Vanderbilt Law Review* 4947, 519.

¹³²⁷ *Jones V. Harris Associates*, 527 F.3d 627 (7th Cir. 2008).

¹³²⁸ Ibid. at 632.

¹³²⁹ *Harris Associates*, 5, 537 F.3d. at 729 (Judge Posner dissenting).

excessive fee cases¹³³⁰. In March 2009, the Supreme Court granted certiorari in *Harris Associates* to address that uncertainty¹³³¹.

In *Harris Associates*, decided in May 2008, Chief Judge Easterbrook provided an opinion which disapproved the *Gartenberg* approach¹³³². *Harris Associates* is the only appellate opinion that rejected *Gartenberg*. In this case the plaintiff shareholders claimed that the advisor's fees were excessive. The plaintiffs applied the factors of the *Gartenberg* test, although they requested that the court consider whether the *Gartenberg* test should be uncritically accepted and applied¹³³³. They pointed out two "serious flaws" with the *Gartenberg* standard:

- 1) *Gartenberg* fails to recognize the immaturity of recent fund performance; and
- 2) *Gartenberg* understates the fiduciary standard and should instead be a reasonableness standard.

The plaintiffs also disagreed with district court's application of the comparative fee structure factor¹³³⁴ arguing that they were set incestuously¹³³⁵. Specifically, the district

¹³³⁰ E. D. Johnson, (2009) *The Fiduciary Duty in Excessive Fee Cases*, Duke Law Journal Vol. 59:145.

¹³³¹ *Jones V. Harris*, 1295. ct. 1579 (2009).

¹³³² *Jones V. Harris Assoc.*, 527 F.3d 627, 632 (7th Cir. 2008).

¹³³³ Brief and Required short Appendix of Plaintiffs – Appellants at 33, *Jones V. Harris Assocs.*, No. 07-1624)7th Cir.2008), 2007 WL1582568.

¹³³⁴ *Ibid.*, at 37.

¹³³⁵ *Ibid.*, *Jones V. Harris Assocs.*, 527 F.3d 627, 631 (7th Cir. 2008).

court did not allow the comparison to institutional investors, which the plaintiffs argued was the best example of a fee negotiated at arm's length¹³³⁶.

The Seventh Circuit Court did not uncritically accept and apply *Gartenberg* as the plaintiffs requested. The court believed that *Gartenberg* relied too little on markets and rejected the *Gartenberg* standard. The plaintiffs' reasonableness test states "Section 36(b) does not require that the fees be 'reasonable' in relation to a judicially created standard. It says instead that the advisor has a fiduciary duty."¹³³⁷ The Seventh Circuit Court stated that a "fiduciary must make full disclosure but it is not subject to a cap on compensation"¹³³⁸. The court qualified this standard for unusual fees stating "it is possible to imagine compensation so unusual that a court will infer that deceit must have occurred or that the persons responsible for (the) decision have abdicated..."¹³³⁹.

Chief Judge Easterbrook relied largely on a market approach, assuming that the markets were efficient and regulated by competition, referring to a paper by Coates and Hubbard¹³⁴⁰. Judge Easterbrook's approach also relies upon the assumption of self-regulating markets through competition in the Coates and Hubbard paper¹³⁴¹. Easterbrook emphasized that the Coates and Hubbard study found that "investors can and

¹³³⁶ Plaintiff's brief, *supra* note 1333 at 27.

¹³³⁷ *Harris Assocs.*, 527 F.3d at 632.

¹³³⁸ *Harris Associates*, 527 F.3d at 632.

¹³³⁹ *Ibid.*

¹³⁴⁰ Coates and Hubbard, *supra* note 911.

¹³⁴¹ *Ibid.*

do protect their interests by shopping, and the regulating advisory fees through litigation is unlikely to do more good than harm.”¹³⁴²

In particular, Judge Easterbrook was concerned that Section 36(b)’s fiduciary duty not be interpreted a means of rate regulation, stating “Section 36(b) does not create a rate-regulation mechanism. Judicial price-setting does not accompany fiduciary duties and Section 36(b) does not call for a departure from this norm.”¹³⁴³ He instead declared that securities laws “work largely by requiring disclosure and then allowing price to be set by competition in which investors make their own choices.”¹³⁴⁴ He also disregarded comparisons between institutional and captive funds¹³⁴⁵.

Judge Posner, in his dissent, advocated for examining the fee differences between institutional investors and retail investors and rejected the argument that boards protect investors and referred to mutual funds in the context of executive compensation. Posner did not agree with Judge Easterbrook with respect to boards and noted that boards that contain CEOs have feeble incentives to police compensation. He also referred to the negative effect of the director incentive structure on competition. Judge Posner was very concerned with the price differential between what he termed the ‘captive’ plaintiffs of mutual funds and investors of independent funds. He noted that the mutual fund investors pay twice as much as independent funds. Posner indicated that while he

¹³⁴² Supra note 1339.. at 634, Citing Coates and Hubbard, supra at 911.

¹³⁴³ Ibid. at 633.

¹³⁴⁴ Ibid. at 635.

¹³⁴⁵ Ibid. at 632.

strongly rejected the process, the “outcome of the case may be correct”¹³⁴⁶. He argued that the Seventh Circuit should have heard the case for three reasons: The panel’s analysis was one-sided, the issue was a very important to the mutual fund industry and its decision created a circuit split¹³⁴⁷. The public fundamental disagreement between two pillars of the law and economics community drew media attention¹³⁴⁸. This disagreement and public controversy created uncertainty in the fiduciary standard in excessive fee cases¹³⁴⁹. As expressed in the Ropes & Gray statement: “The immediate consequences of the *Harris* opinion are difficult to predict.”¹³⁵⁰ In March 2009, the Supreme Court granted certiorari¹³⁵¹, as previously indicated.

Emily Johnson¹³⁵² proposed a modification of the fifth *Gartenberg* factor, ‘comparative fee structures’, to include a comparison between retail fund fees and institutional fees, in order to provide the protection that Congress intended for shareholders. She indicates that this would broaden the fiduciary analysis under *Gartenberg*. In addition, Johnson states that “eliminating the profitability factor would incentivize investment advisors to reduce fees by allowing them to reap the rewards of

¹³⁴⁶ Ibid. at 732.

¹³⁴⁷ Ibid.

¹³⁴⁸ Floyd Norris, The supremes will decide which economics makes legal sense, *N.Y. Times*, March 9, 2009, accessed at: <http://norris.blogs.nytimes.com/2009/03/09/the-supreme's-will-decide-which-economics-makes-legal-sense/>. J. Floyd Norris, Judges in dispute over mutual funds, *N.Y. Times*, August 15, 2008, at C3 accesses at: <http://www.nytimes.com/2008/08/16/business/16place.html>

¹³⁴⁹ Johnson, E. D., (2009). The fiduciary duty in excessive fee cases, *Duke Law Journal* 59:145.

¹³⁵⁰ Ropes & Gray, Appeals court rejects mutual fund excessive fee claims, adopting new standard for evaluation of fees, Ropes & Gray, May 20, 2008, accessed at: <http://www.ropesgray.com/litigationalert>

¹³⁵¹ *Jones V. Harris Assocs.*, 129 S. Ct. 1579 (2009).

¹³⁵² Johnson, *supra* note 1349.

fee reductions.”¹³⁵³ Section 36(b) does not require the investment advisor to charge the lowest possible fee but rather only a fair fee. Therefore, if an investment advisor can derive a high profit with fair fees, then they should not be punished in court under the *Gartenberg* test for doing so. Retail investors and institutional investors in the United States are unlikely to realize savings associated with a fee analysis that is extended to include both institutional investors’ fees in addition to retail investor fees. Under the current *Gartenberg* test, if there were any cost savings that would increase the advisor’s profit, the board could take these away during the next negotiation or have this work against advisors in court when applying the test. Accordingly, there is currently no incentive for investment advisors to lower fees with respect to the *Gartenberg* framework.

It should be noted that there may be other incentives for advisors to lower fees, such as increasing fund flows by attracting more investments that would serve to increase the assets under management, which would result in overall increased profits. Increased economies of scale associated with increased assets under management would also result in increased profit margin which could be retained with lower fees to mutual fund unit holders. The regulatory framework should not discourage lower fees for shareholders.

5.9 PRICE COMPETITION

A General Accounting Office (GAO) study examined price competition in the fund industry and concluded that "competition in the mutual fund industry is not

¹³⁵³ Ibid., pp. 180-181.

generally price-based.”¹³⁵⁴ Freeman and Brown¹³⁵⁵ hold that while SEC regulation can be detailed and complex, it has not generated any sign of intra-industry competition on the part of equity fund advisors and that while fund managers compete for new sales, this is done in ways designed to shelter high fee levels from price-cutting pressures. Freeman and Brown hold that there is no proof that fee ranges within the fund industry, which lacks arm's-length dealing, are too close to the fee rates that the same advisory firms charge elsewhere when selling investment advisory services in the free market.

Government regulation is not stringent when it comes to advisory fee levels. In the United States, the SEC has a role to facilitate competitive forces to bring fund advisory fees down to levels that are fair to investors but according to Freeman and Brown “so far it has been missing in action.”¹³⁵⁶ For example, the SEC could take an amicus position and endorse the relevance of comparative cost data in advisory fee litigation but it has yet not done so. For instance, in *Meyer v. Oppenheimer Management Corp.*¹³⁵⁷ (*Meyer*), the SEC expressly refused the district court's invitation to weigh in with its views. In the course of the 1967 Senate Hearings into fund industry governance, as early as 1967, Professor Paul Samuelson stated his conclusion “that in the past competition has not served to bring down management fees to a minimal competitive level”, and he suggested that “the SEC should be required to help the courts as a friend of the court in deciding on what has constituted adequate performance and proper

¹³⁵⁴ GAO Report, *supra* note 1083 p. 96.

¹³⁵⁵ Freeman and Brown, *supra* note 1102.

¹³⁵⁶ Freeman and Brown, *supra* note 1102, p. 656.

¹³⁵⁷ 609 F. Supp. 380 (S.D.N.Y. 1984), *rev'd*, 764 F.2d 76, 80-81 (2d Cir. 1985).

remuneration.”¹³⁵⁸ Similarly, the CSA in Canada has not yet promoted competition in mutual funds to ensure fair fees for investors. This could be a contributing factor to the high mutual fund fees in Canada noted by the Morningstar reports¹³⁵⁹.

The SEC has also not introduced legislation to ensure that advisors identify, quantify, and justify price differences between the prices they charge the funds that they manage compared to advisory fees paid by other customers. Rather, in the opinion of Freeman and Brown, “it has studiously avoided calling for frank, detailed disclosure of advisors' profitability in fund proxy statements.”¹³⁶⁰ The SEC has also not required that fund sponsors describe in detail, how they profit from their services on fund-by-fund, fund complex, or portfolio bases to investors and the public and has considered and rejected adding a proxy disclosure requirement that shareholders be given an ‘adviser balance sheet’. In addition, the SEC has not introduced a specific reporting requirement for funds to report separately what they pay for advisory service, in order to better foster comparative fee analyses by fund directors, shareholders, and industry observers. This oversight led to the SEC staff admitting that it could not directly analyze the cost of providing portfolio management services “because the data are unavailable.”

Both the Wharton Report, that was prepared for the SEC, and the Public Policy Report, written by the SEC, recognized the need for comparative data when they

¹³⁵⁸ Mutual Fund Legislation of 1967: Hearing Before the Senate Committee On Banking and Currency, 90th Congress 354 (1967), statement of Prof. Paul Samuelson, quoted from Freeman and Brown, 2003, p. 256).

¹³⁵⁹ Morningstar reports, *supra* note 196.

¹³⁶⁰ Freeman and Brown, *supra* note 1102.

focused on comparative fee structures and both studies highlighted the disparity between advisory fee rates in the fund industry and elsewhere in the economy. The comparative cost disparities are large, and they have been deemed worthy of note by the SEC and the Wharton report authors, not to mention the experts who testify in fund fee litigation. Given this context and the SEC's expressed interest in fostering a more competitive environment, the reason for its lack of response in requiring specific accounting of fee charges is unclear.

This leads to the question of why the SEC has not made fee rate differences a priority or a focus for its regulation and rather than aggressively pushing the fund industry in a direction that would to force boards to confront noncompetitive fee levels. The SEC has instead been engaged in rulemaking that reinforces current practices and the status quo of advisory fee rates. For instance, rather than tackle high advisory fee rates in mutual funds head on the SEC promulgated a rule of a majority of independent directors on mutual fund boards that was adopted after a roundtable deliberation of current fund issues¹³⁶¹. This rule mandates what is already a *de facto* standard by requiring nearly all fund boards and nominating committees to have a majority of independent directors.

One of the fund directors' fundamental responsibilities is to ensure that the bills submitted for services furnished to fund shareholders are accurate and reflect fair pricing.

¹³⁶¹ *Role of Independent Directors of Investment Companies*, Investment Company Act Release No. 24816 (Jan. 2, 2001). 2001 WL 6738 (SEC).

However, for fund directors to properly exercise this oversight function, they need to know the prices of comparable advisory services in the free market and then consider those prices in deciding the fairness of bills presented by the fund's advisor for equivalent services. The current SEC regulation does not stipulate the public provision of this information. The Gartenberg test¹³⁶² explicitly requires this comparison. For example, in *Krinsk*¹³⁶³ the court cited *Gartenberg* for the proposition that comparative fee structures should be weighed by fund boards when determining whether the Section 36(b) reasonableness standard has been met.

The SEC, however, has not yet specifically called for fund directors to make such a comparative analysis although this is clearly required by the Gartenberg test which is the primary test in the U.S. courts for a challenge on excessive advisory fees²²⁴. The SEC has paved the way for judicial findings by failing to require uniform reporting of crucial cost data and by refusing to demand that fund advisors make public sufficient financial data to enable interested observers to calculate the profitability of advisory contracts. For instance in *Schuyt*, the ISS have stated that "The recommendations from the ICI Advisory Group on Best Practices for Fund Directors amounted to "a good beginning, but certainly not enough" and Richard Ferlauto the Director of Proxy Voter Services stated "It was less than half a step even."¹³⁶⁴ Profitability information is immaterial as a matter of law. However, fund directors need and deserve detailed cost and profitability

¹³⁶² *Gartenberg*, 694 F.2d pp. 929-30.

¹³⁶³ *Krinsk v. Fund Management, Inc.*, 875 F.2d 404. p. 409 (1989).

¹³⁶⁴ ISS take on ICI over best practices proposals, *Fund Action*, July 12, 1999, p. 1.

disclosure in order to fulfill their oversight role¹³⁶⁵.

The public also requires this information to make informed decisions about their choice of funds. The SEC's lack of action in requiring this information to be provided by use for directors and investors is in direct conflict with its objective goal on investor protection through directors and the mechanism of disclosure as a means of enhancing competition. For instance, SEC Chairman Arthur Levitt testified before Congress in 1998 that:

“Historically, Congress and the Commission have taken a three-pronged approach to investor protection. First, reduce conflicts of interest that could result in excessive charges. Second, require that mutual fund fees be fully disclosed so that investors can make informed decisions. And third, let market competition, not government intervention, answer the question of whether any mutual fund's fees are too high or low. The Commission remains vigilant on behalf of investors in its oversight of mutual fund fees and expenses¹³⁶⁶.”

The absence of comparative cost and profitability data makes it virtually impossible for shareholders bringing Section 36(b) suits to sustain the burden of proving

¹³⁶⁵ For a discussion of the relationship between effective corporate governance and financial disclosure, see Lowenstein, L., (1996). Financial transparency and corporate governance: you manage what you measure, 96 *Columbia Law Review* 1335.

¹³⁶⁶ Improving Price Competition, *supra* note 1174 (statement of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission), accessed at: <http://www.sec.gov/news/testimony/testarchivell9981tsty1398.htm>.

that fees are excessive. These data are essential to evaluate whether fees are excessive under the Gartenberg test, which takes into account the profitability of the fund to the advisor-manager, economies of scale, and comparative fee structures¹³⁶⁷. Action by the SEC to mandate disclosure allowing calculation of advisory profits would assist with effective corporate governance by allowing directors to compare advisory fees with industry benchmarks and possess the data necessary to effectively negotiate advisory fees with investment advisors. These data would also allow disclosure to be a more effective mechanism for fund governance by providing the information needed for investors to make informed choices in selecting funds and remaining within funds including the ability to 'vote with their feet' and exit funds.

The requirement for public disclosure of these data, which may be considered by the industry to be proprietary, could be justifiable from the perspective that the inherent conflict of interest resulting from the mutual fund industry's management structure does not afford fund shareholders sufficient protection. In addition, those fund managers that utilize external management should carry with it the requirement that the service providers are subject to more disclosure of their costs and profits than is common for those who deal through arm's-length transactions. The SEC's continued allowance of fund managers to not provide the required advisory fee information and profitability data that is required for investor protection through a disclosure mechanism impedes investor protection. Put simply there can be no effective corporate governance through disclosure

¹³⁶⁷ *Gartenberg*, 694 F.2d 929-30.

if the relevant and required data is not disclosed.

Outside prices qualify under the Gartenberg test as when the fund's board makes its fair price determination, "all pertinent facts must be weighed"...¹³⁶⁸ and industry advisory fee data would be considered to be "pertinent facts". Further, significant price discrepancies are not just "pertinent facts," assuming approximately equivalent levels of service, but instead represent "material facts"¹³⁶⁹.

Disclosure of these data is justifiable from the standpoint that it will be used to facilitate a reduction in advisory fees that will directly enhance fund shareholders' returns. This is evident by the fact that higher fees detract directly from investor profits. According to the GAO, for example, various studies have also documented the impact of fees on investors' returns by finding that funds with lower fees tended to be among the better performing funds¹³⁷⁰. There is also no indication that funds with higher advisory fees outperform funds with lower fees.

There is also no rationale that fund shareholders should not overpay for the securities that are purchased and held in their funds' portfolios or for advisory services. The SEC will need to require fund directors collect, analyze and weigh comparative

¹³⁶⁸ *Gartenberg*, 694 F.2d p. 929.

¹³⁶⁹ A fact is material in the pertinent US legal framework if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision. *TSC Indus., Inc. V, Northway, Inc.*, 426 U.S. 438,449 (1976). The Court explained in *TSC* that to fulfill the materiality requirements "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." (*Ibid.*)

¹³⁷⁰ GAO Report, *supra* note 1083 p. 28.

prices used by the fund's advisor, or its affiliates, to bill for advisory services if shareholders are to experience the effects of competitive pressure on advisory fees. This is contemplated in the Gartenberg test which calls for the "profitability of the fund to the advisor"¹³⁷¹ to be studied in order that the price for advice paid by the fund to its advisory be equivalent to "the product of arm's-length bargaining..."¹³⁷²

The SEC could and should require the scrutiny of comparative fee data by fund directors, since this will facilitate increased investor protection through a more effective mechanism of fee disclosure. The ABA in its Fund Directors' Guidebook¹³⁷³ like the SEC, ignores the absence of other advisory fee data and suggests instead that directors undertake "a comparative analysis of expense ratios of, and advisory fees paid by, similar funds."¹³⁷⁴

The bargaining position of independent fund directors would be strengthened by an improved knowledge of the prices charged for advisory services by their fund's advisor compared to its other clients, for example. It should be recognized, however, that there is more to comparison of advisory services than price and that differences in services rendered, to the extent they exist, need to be understood and taken into account by directors and shareholders. Accordingly, a standardized framework for this comparison would be helpful to allow directors and shareholders to compare these data

¹³⁷¹ *Krinsk*, 875 F.2d p. 409.

¹³⁷² *Gartenberg*, 694 F.2d p. 929.

¹³⁷³ ABA, *Fund Director's Guidebook*, Third Edition, ISBN 978-1-59031-510-1.

¹³⁷⁴ *Ibid.*, pp. 249-50.

across funds. These services could be quantified in financial terms by the fund's advisor for the benefit of independent directors and shareholders. These data would also provide independent fund directors with a means to verify the profitability values issued to them by the advisor.

The SEC's *Report on Mutual Fund Fees and Expenses* stated that "although expense ratios are important, it can be misleading to focus on one number without identifying key factors that influence that number."¹³⁷⁵ The investment advisory fee is a key component of expense ratios for actively managed funds, since it reflects the price charged for investment advice rendered to the fund. However the SEC, to date, has not prescribed a uniform reporting requirement for that key item, a shortcoming reflected in the staff's report on fees and expenses. This report presents the staff's finding that it was unable to analyze directly the cost of providing portfolio management services because "the data are unavailable." The report used management fees as a proxy for the missing advisory fee data, a substitution the staff admitted was far from perfect since management fees "often pay for other services as well."¹³⁷⁶

The SEC's latest rulemaking effort focused on director independence rather than the issue of excessive advisory fees that is known to detract from investor performance. There is a widely held view that the director independence rules will not increase investor protection significantly, since it essentially largely mandated existing industry

¹³⁷⁵ Report on Mutual Fund Fees, supra note 845.

¹³⁷⁶ Ibid.

practices. To better address the issue of fee gouging of investors, in the specific context of the mutual fund industry, the SEC could have instead addressed the definition of the term "investment advisory fee", and required that it be reported throughout the fund industry on a consistent basis.

5.10 FUND INDUSTRY LACKS CLEAR DISCLOSURE

The ICI's Matthew Fink indicated "clear disclosure" as a hallmark of the fund industry's "near textbook example of a competitive market structure" when defending the fund industry¹³⁷⁷. However, the GAO found its analysis of overall industry profitability stymied due to "the unavailability of comprehensive financial and cost information."¹³⁷⁸ A fund shareholder who for instance seeks "clear disclosure" of the advisor's comprehensive financial and cost information referred to by GAO will not find this in the fund prospectus. They will also not find this information available at the fund management offices or available for inspection at the SEC, at any other government agency.

In 1995, the Chairman of a House committee considering fund legislation in 1995 offered this appraisal: "Mutual fund shareholders are beset by a confusing array of fees. Investment advisory fees, service fees, distribution fees, all of these fees can make it very

¹³⁷⁷ See Improving Price Competition, supra note 1174, at 79 (statement of Matthew P. Fink, President, Investment Company Institute).

¹³⁷⁸ GAO Report, supra note 1083 p. 6.

difficult for investors to compare one fund against another."¹³⁷⁹ Another industry observer has concluded "Investors have a hard time determining what they are paying and an even more difficult time determining what they are getting. Some fees are hidden and many fees are charged in a complicated fashion."¹³⁸⁰

A 1995 study commissioned by the SEC and the Office of the Comptroller of the Currency found that fund prospectuses were the single most widely used information resource consulted by investors¹³⁸¹. Those same widely used fund prospectuses mentioned in this study have been criticized for tending to "obscure rather than illuminate what a fund is doing. " noting that "While mutual fund companies are catering directly to bankers and sales clerks, mutual fund prospectuses appear intelligible to only bankers and securities lawyers."¹³⁸²

The SEC's Division of Investment Management published a *Report on Mutual Fund Fees and Expenses* which stated: "Through the Commission's disclosure efforts, mutual fund fee information is readily available to investors in an understandable, easy-to-use format in the new mutual fund prospectuses"¹³⁸³.

¹³⁷⁹ Investment Company Act Amendments of 1995: Hearing on H.R. 1495 before the Subcommittee on Telecommunications and Finance, 104th Cong. 2 (1995) (statement of Hon. Jack Fields, Chairman of Subcommittee on Telecommunications and Finance).

¹³⁸⁰ Improving Price Competition, *supra* note 1174, at 50 (statement of Charles Trzcinka, Professor of Finance, State University of New York at Buffalo).

¹³⁸¹ Robertson, R. A., (1999). In search of the perfect mutual fund prospectus, 54 *Business Law*, 461, 472

¹³⁸² *Ibid.*, p. 475.

¹³⁸³ Report on Mutual Fund Fees and Expenses, *supra* note 845.

This perspective conflicts with the view of the GAO:

“Investors have a hard time determining how much they are paying and an even more difficult time determining what they are getting. Some fees are hidden and many fees are charged in a complicated fashion. At best, the total fee can be estimated from the disclosure of most funds but if an investor decides to estimate fees, it is very difficult to compare portfolios of risky securities. There are limitations in applying all measures of risk and there is a lack of uniformity in their application.”¹³⁸⁴ Professor Trzcinka's findings stated in *Improving Price Competition*, are as follows:

“Total expenses paid by investors have not fallen over the past decade and probably have risen. There is no relationship between the level of expense ratios and risk-adjusted performance except that large expense ratios substantially reduce performance. There is no evidence that managed mutual funds have performed better than funds that simply try to match an index or a combination of indices. There is little evidence of persistence of good performance. There is stronger evidence of persistence of poor performance. Good performance is rewarded by investors; poor performance is ignored except when the poor performance is extreme. Information available to

¹³⁸⁴ *Improving Price Competition*, supra note 1174 p. 50.

investors on mutual fund portfolio management is poor.”¹³⁸⁵

Many of Professor Trzcinka's views were echoed at the hearings by witness Harold Evensky, a certified financial planner who (as noted in *Improving Price Competition*) stated:

“In the aggregate the fund industry is ethical and professional, however there are numerous problems. Most seem to be related to the industry's shift from a focus on trusteeship to a focus on asset gathering and distribution. More specifically, these problems include a misperception of the role of the fund vis-a-vis the investor, inadequate supervision by the funds' independent trustees, poor disclosure, inadequate communications and a long bull market. The combination of these factors results in poorly informed investors making bad decisions about investing in funds that often do not deliver the benefits reasonably expected of competition and economies of scale.”

It is currently difficult for investors to understand fee information since some funds mix administrative and advisory fees together, which makes it essentially not possible for investors to separate advisory fees for comparison purposes. This difficulty extends to fund directors who would not be able to break out the advisory fees based on published information and therefore they cannot accurately compare fee levels between funds.

¹³⁸⁵ *Improving Price Competition*, supra note 1174, p. 62

In *Krinsk* the fund's independent directors themselves were not even able to explain what was covered by the separate advisory and administrative fees they approved. One of the directors testified that the administrative fees and advisory fees offset the costs of the program as a whole and actually stated "if you can tell me exactly what is paying for what, you're a better man than I."¹³⁸⁶ Another director explained that looking at a component of the overall CMA fee structure "as though it was a stand-alone piece, was trying to unscramble an omelet."¹³⁸⁷ These comments come from paid mutual directors that were presumably represented by competent counsel, and were delivered as testimony made under oath in multi-million dollar fund fee litigation. This example of fund directors that are testifying in an excessive fee confessing ignorance about fees they have approved confirms that "clear disclosure" in the fund industry, as professed by the SEC and ICI, simply is not a reality in practice.

The SEC claims in its fees and expenses report that its regulatory scheme generates for fund shareholders "mutual fund fee information in an understandable, easy to-use format."¹³⁸⁸ However, at the same time the SEC indicated that it was unable to "analyze directly the cost of providing portfolio management services to a mutual fund in order to determine whether economies exist (because the data are unavailable)."¹³⁸⁹

The Gartenberg test for reasonableness requires that fund directors bargain

¹³⁸⁶ *Krinsk*, 715 F.Supp. p. 481.

¹³⁸⁷ *Ibid.*

¹³⁸⁸ SEC Report on Mutual Fund Fees and Expenses, *supra* note 845.

¹³⁸⁹ *Ibid.*

effectively with service providers at arm's-length over "the nature and quality of the services" provided.¹³⁹⁰ The test further requires that fund directors make determinations as to "economies of scale" and "comparative fee structures"¹³⁹¹. Total fund expenses generally include investment advisory services, administration and operations, shareholder account maintenance, marketing and distribution, custodian's fee, auditing fee, state taxes, shareholders' reports, annual meetings and proxy costs and directors' fees and expenses. It is therefore difficult, or not possible, for individual investors, or directors, to unbundle these aggregate costs and calculate advisory fees.

The question arises as to how fund shareholders or directors can understand the mutual fund advisory fees and whether economies exist in the provision of portfolio management services if the responsible body of the federal government in the U.S., the SEC, is not able to understand this. This issue is heightened by the requirement for fund shareholders to 'vote with their feet' and exit funds or directors to negotiate appropriate fee levels with investment advisors when the SEC itself cannot. A question further arises as to how the SEC and courts make the determination of whether fees are excessive, or expect fund shareholders or directors to place any reliance upon their own calculations.

The SEC has not required that clear, useful data on advisory fees for mutual funds be generated to assist fund directors in making the comparisons necessary to perform their fiduciary duties by ensuring that appropriate fee levels are set with the

¹³⁹⁰ Krinsk, 875 F.2d p. 409.

¹³⁹¹ Ibid.

investment advisor for the fund that they oversee. A fund director who has no understanding of the costs associated with different fund services for the fund they oversee or comparable funds, as in *Krinsk*, cannot negotiate appropriate fee levels effectively on behalf of investors.

The SEC staff itself was unable to determine directly whether there are economies of scale in the provision of fund advisory services "because the data are unavailable"¹³⁹². Given the complexity of the services and finances that vary between funds and are dependent on the fund's specific fee structure, it is not surprising if there is confusion over fund fees by directors and individual investors. It is not clear how the SEC expects fund directors to perform their oversight role if they are not provided with appropriate information on industry advisory fee levels. It would be expected that investors lack high quality disclosure about fund expenses, if their fund directors are unable to understand or explain fund fees.

The GAO study found that advisory fee profitability data is not accessible to investors or government investigators such as the GAO itself. Specifically, the GAO's detailed study of fund costs was inhibited because the researchers were "unable to determine the extent to which mutual fund advisors experienced ... economies of scale because information on the costs and profitability of most fund advisors was not generally publicly available."¹³⁹³ The SEC has not mandated that fund sponsors break

¹³⁹² Report on Mutual Fund Fees and Expenses, *supra* note 845.

¹³⁹³ GAO Report, *supra* note 1083 at 33.

out clearly, on a uniform basis, different types of expenses. Also, the courts have not allowed comparative cost disclosure in suits challenging excessive advisory fees. Seventy years after the enactment of the Investment Company Act of 1940, the fund industry does not have an effective check on excessive advisory fees. Both the SEC and the courts have allowed advisors to charge prices, in some cases, that are not competitive in the industry. The lack of disclosure of pertinent financial information contributes to this lack of check on fund advisory fees, since fund directors are not able to gauge whether or not the advisory fees charged to their funds are competitive or constitute unfair pricing for the fund investors.

The GAO did not consider disclosure to be sufficient, and recommended an individualized approach to disclosure. The GAO recommended that funds essentially present investors each quarter with itemized statements showing not just account holdings and activities but also an itemized statement of the expenses paid by the shareholder over the period¹³⁹⁴. The GAO also recommended, as an alternative, disclosures allowing investors to estimate fee charges for their accounts¹³⁹⁵. The GAO found the fund industry's failure to account to fund shareholders for the costs incurred in their accounts to be counter to the norm in the financial services industry. The GAO report states:

"After they have invested, fund shareholders are not provided the

¹³⁹⁴ GAO Report, *supra* note 1083 pp. 7-8

¹³⁹⁵ *Ibid.*, p. 14.

specific dollar cost of the mutual fund investments they have made. For example, mutual fund investors generally receive quarterly statements detailing their mutual fund accounts. These statements usually indicate the beginning and ending number of shares and the total dollar value of shares in each mutual fund owned. They do not show the dollar amount of operating expense fees that were deducted from the value of these shares during the previous quarter. This contrasts with most other financial products or services, such as bank accounts or brokerage services, for which customer fees are generally disclosed in specific dollar amounts."¹³⁹⁶

GAO's plan is directed at driving home to individual shareholders the size of the bill each individual fund investor pays for fund services. The GAO's approach addresses a disclosure problem revealed by case law under Section 36(b), namely, that investors seem to be indifferent to fee levels because of the seeming insignificance of fee levels to individual investors. In *Schuyt*¹³⁹⁷, the proposition is noted as a key reason why "fund competition for shareholder business does not lead to similar competition between advisors for fund business is the relative insignificance of the advisor's fee to each shareholder."¹³⁹⁸ The GAO's objective in its individualized approach aims to accomplish two goals: to encourage investors to evaluate more accurately the quality of services for which they pay fees and to encourage service providers to emphasize price

¹³⁹⁶ GAO Report, *supra* note 1083 p. 13.

¹³⁹⁷ *Schuyt*, 663 F. Supp. pp. 973, 974. With approval from Gartenberg, 694 F.2d p. 929.

¹³⁹⁸ *Schuyt*, 663 F. Supp. pp. 973, 974.

in their sales efforts¹³⁹⁹.

The Director of the SEC's Investment Management Division announced that both he and SEC Chairman Arthur Levitt believed that personalized disclosure for fund investors is a good idea, one that may work better¹⁴⁰⁰. The SEC's Division of Investment management, in its 'Report on Mutual Fund Fees and Expenses', endorsed a form of dollar disclosure comparable advocated by the GAO. The staffs plan would "require fund shareholder reports to include a table that shows the cost in dollars associated with an investment of a standardized amount (e.g., \$10,000) that deemed the fund's actual return for the period and incurred the fund's actual expenses for the period."¹⁴⁰¹ The staff's endorsement is a step in the right direction. It will be interesting now to see what action, if any, the Commission itself is willing to take in order to bring some form of the GAO's proposal to realization.

To facilitate comparative cost disclosures, the SEC would need to require financial reporting on a standardized basis such that the categories of expenses are comparable on an industry-wide basis. Currently, some funds blend administrative costs into the advisory fee. This bundling does not allow for detailed comparisons and analyses by investors or by SEC staff. In addition, investment advisors in the U.S. are currently not required to disclose the expenses that they charge to other mutual fund clients and to pension fund clients. If the investment advisors were required to provide

¹³⁹⁹ GAO REPORT, *supra* note 1083 p. 17.

¹⁴⁰⁰ Witmer, *supra* note pp. 1006-07.

¹⁴⁰¹ SEC Report on Mutual Fund Fees and Expenses, *supra* note 845.

this disclosure then a comparison could be made as part of the determination of whether mutual fund fees are excessive. The investment advisors could be required to justify why they are not charging the same expenses to the captive funds that they are charging to non-captive mutual funds and to pension funds in the free market. The question arises as to why should the expenses should be higher to a mutual fund investor in a fiduciary relationship with an advisor than the costs of these services in the free market.

The SEC has a responsibility to fund investors to ensure that the data is disclosed that will allow them to make investment decisions and to exercise their rights of protection under excessive fee challenges in court. This data should be disclosed so that it can be reviewed and analyzed independent fund directors, government agencies, the media, and academics. The standardization of the format of this disclosed data would allow for comparisons that could facilitate competition on the basis of expenses and fees.

Fund advisors in the U.S. are benefitting from the complex bundled fee structure disclosure format since this does not allow investors to compare the expenses with other funds on the free market or to win court challenges for excessive fees and this has been the case since the Wharton Report. There is a perception that some fund advisors may cite their below-industry standard fee levels as a justification for fee hikes with fees therefore continuing to increase²⁷⁶. The ICI could identify excessive fee levels, since they could obtain this data; however, they are unlikely to do so since they represent the fund industry. The ICI has not demonstrated action involving the promotion of the interests of fund shareholders at the expense of fund sponsors²⁷⁷. For instance, the ICI

has not indicated that economies of scale for advisory services are not being shared with fund shareholders and has instead published studies defending industry. The ICI has bundled advisory fees with other operating costs in order to support the fund managers' assertion that fund shareholders are benefitting from economies of scale. Accordingly, industry associations that represent the mutual fund industry, such as the ICI, are not effective mechanisms for protecting shareholders' own financial interests, since they represent the industry. The SEC has not provided a requirement for industry to properly disclose fees to investors as they bundled within expenses that include operating costs and are not required to be provided in a standardized disclosure format. The SEC therefore bears some responsibility for the lack of investor protection from excessive fees resulting from the inaction with respect to mandating disclosure of unbundled costs to investors in a standardized format.

The GAO Report notes:

“Critics have also indicated that the legal standards applicable to directors' oversight of fees are flawed. One factor that directors consider is how their fund's fee compares to those charged by other similar funds. However, a private money manager stated that directors have no basis, therefore, for seeking a lower fee if their fund is charging fees similar to those of other funds. An industry analyst indicated that basing a fund's fees on those charged by similar funds results in fees being higher than necessary. He stated

that although it is a safe way to set fees, in light of the *Gartenberg* standards, such practices do not contribute to lower fees.”¹⁴⁰²

The Investment Company Act of 1940 states that "the national public interest and the interest of investors is adversely affected... when investment companies are organized, operated, or managed ... in the interest of investment advisors" and not in the interest of fund shareholders.”¹⁴⁰³ The Act was written "to mitigate and, so far as is feasible, to eliminate these conditions.”¹⁴⁰⁴

The first comprehensive study of the fund industry following enactment of the Investment Company Act, the Wharton Report, established that "the advisory fee rates ... charged other clients [by mutual fund investment advisors] are significantly lower than those paid by open-end [mutual fund] companies.”¹⁴⁰⁵ The conclusions of the Wharton Report remain relevant today as demonstrated by the excessive fee challenges in U.S. Courts. Courts that have applied *Gartenberg* to disallow the use of comparative fee structures in advisory fee litigation have deprived complaining shareholders of one of their most important sources of data. This application of *Gartenberg* permitted fund advisors to compare fee schedules which are lower than the competitors to justify fee hikes, which in turn allows others competitors to point to the newly increased fee increases to justify their own increases, resulting in a leap frog effect.

¹⁴⁰² GAO REPORT, supra note 1083 p. 94.

¹⁴⁰³ Investment Company Act of 1940 § 1(b)(2), 15 U.S.C.A. § 80a-l(b)(2) (West Supp. 1999).

¹⁴⁰⁴ Ibid., § 80a-l(b)(2).

¹⁴⁰⁵ Wharton Report, supra note, p. 485.

The application of *Gartenberg* to the outcome of future court challenges for excessive fees will be weakest for actively managed equity funds since almost all of the fully litigated cases have involved money market funds, which are a different form of investment vehicle than equity or pension fund portfolios¹⁴⁰⁶. Further the fully litigated cases have not involved equity fund advisory fees, where fee comparisons between equity pension managers and equity fund managers can be most difficult. Future excessive fee challenges will provide fund advisors an opportunity to explain why picking a stock for a mutual fund equity portfolio should be much more expensive to the customer than picking the same stock for a pension fund equity portfolio.

The difference between prices charged for advisory services versus prices charged elsewhere in the market for those same services represents the bill paid by fund shareholders for the costs of the advisory conflict of interest in the mutual fund industry. Fund industry cost data reviewed and developed by Freeman and Brown suggest that equity fund management fees on the whole are around 25 basis points higher than they need to be in order to furnish fund advisors with fair and reasonable compensation and fund shareholders with the same quality of service. According to Freeman and Brown¹⁴⁰⁷, for an equity fund asset base of \$3.5 trillion "this translates into equity mutual fund shareholders being overcharged to the tune of nearly \$9 billion-plus annually-a staggering number-nearly reaching the price tag that the tobacco companies agreed to pay each year as part of their landmark "global settlement" with 46 states' attorneys

¹⁴⁰⁶ Freeman and Brown, *supra* note 1102.

¹⁴⁰⁷ *Ibid.*

general announced in November of 1998.”¹⁴⁰⁸

The SEC has not yet appeared to recognize that evidence shows that fund advisory fee levels are too high, which in part may have been caused by its decision not to require disclosure requirements designed to allow for fee comparisons. The SEC does have the mandate and the power to require funds to adhere to a uniform accounting and reporting system. It has, however, not yet required this fee data in a form that is easily understandable to the public or able to be used for court challenges. According to Freeman and Brown the SEC’s inaction “has allowed fee categories and prices to become scrambled and thus distorted or concealed.”¹⁴⁰⁹

The SEC’s inaction may also be perceived as an acceptance or endorsement of the current state. This inaction also has provided the mutual fund industry with an advantage for excessive fee challenges as investors have not possessed the information required for court challenges. The SEC’s inaction and silence on excessive fees may also be perceived to lend credibility to defense claims of the mutual fund industry in fund litigation. The mutual fund industry defendants have, for example, successfully argued that positions of plaintiffs challenging the fee levels in the fund industry are not credible since there was no violation of a mandatory SEC requirement. In *Krinsk*, for instance, the court rejected plaintiff’s assertion that performance should be evaluated on a risk-adjusted basis because performance-adjusted ratings were not required by the SEC. In

¹⁴⁰⁸ Ibid.

¹⁴⁰⁹ Ibid.

another mutual fund case, the court did not consider a broker's concealment that the recommended house fund had a high expense ratio relative to competing funds to be actionable, noting that plaintiffs had presented "no precedent or SEC ruling that requires this comparison"¹⁴¹⁰.

Independent directors on mutual fund board in the U.S. should demand that advisors identify and quantify what they charge for rendering investment advice since they need this information to perform their role regardless of whether the SEC mandates the public disclosure of this information. With this data directors are better able to fulfill their responsibility under *Gartenberg* to reach sound conclusions on such important matters as advisor profitability, economies of scale, and comparative fee structures. The SEC staff's *'Report on Mutual Fund Fees and Expenses'* states that "the current regulatory framework would be enhanced by independent directors who more closely monitor fund fees and expense."¹⁴¹¹ The SEC has not supported fund directors by not requiring that mutual fund advisors to provide comparable cost data, which should be rectified to allow directors to protect shareholders interest with respect to ensuring that the fees that they pay are comparable with the appropriate benchmarks.

Fund directors must able to gather information about comparable funds, and also about the fees charged by the fund's advisor for advisory services provided to other mutual fund and non mutual fund clients. Mutual fund advisors in the U.S. should be

¹⁴¹⁰ *Krinsk*, supra note 1391.

¹⁴¹¹ Freeman and Brown, supra note 1102.

required to describe how their services differ between their captive and free market investors and be able to justify price disparities to directors and to courts during litigation concerning excessive fees. The U.S. courts should also allow evidence of regarding comparable pricing behavior on fund cases. The court cases on excessive mutual fund fees have not had the required data for comparison to allow for a determination of whether the fees were reasonable. Given that the onus is on the plaintiffs to demonstrate that the fees are not reasonable, they have been placed at a disadvantage in excessive fee cases. Fund industry cases are beset with conflicts of interest that call for careful, reasoned, thorough analysis. The appropriate data should be available for investors, including comparable data, so that they and the courts can evaluate whether the fund fee levels are excessive.

Former SEC Chairman Arthur Levitt testified before a House Subcommittee that “The largest mutual funds pay money management advisory fees that are more than twice those paid by pension funds.”¹⁴¹² Levitt further argued “It is essential that investment company boards be required to solicit competitive bids from those who wish to undertake the management function. Furthermore, boards should justify to their ‘bosses’, the fund shareholders, why they chose a particular investment advisor and each year should demonstrate that they have aggressively and competitively negotiated management fees.”¹⁴¹³

¹⁴¹² Mutual funds: who’s looking out for investors? Hearing before the Subcommittee on Capital Markets, 108th Cong. 48 (2003), statement of Arthur Levitt, Chairman, Securities Exchange Commission.

¹⁴¹³ Ibid.

Coates and Hubbard¹⁴¹⁴ argue that since mutual funds operate in a free market and excessive fees do not exist in competitive markets, mutual funds do not have excessive fees. Coates and Hubbard dismissed the Wharton Report's comparative fee analysis as being superficial and being "primitive and misleading."¹⁴¹⁵ They further dismissed the PPI Study as simply accepting the findings of the Wharton Report. Both the Wharton Report and the SEC's PPI Study are rejected by Coates and Hubbard as being "old school" and outdated. Coates and Hubbard dismissed the arguments of Freeman and Brown based on their opinion that pension fund advisory costs cannot be compared with those of mutual funds, which they maintain amounts to a meaningless 'apples to oranges' comparison. The basis of Coates and Hubbard's opinion is that "mutual funds report different costs in the same category of expenses, since fees sometimes include administrative and costs other than pure portfolio management."¹⁴¹⁶ Secondly, they contend that differences in liquidity do not allow for appropriate comparison between mutual fund and pension fund fees¹⁴¹⁷.

The PPI Study also did not simply accept the findings of the Wharton Report as asserted by Coates and Hubbard. Based on its study of new and different data, the SEC determined mutual funds pay far more for advisory services than pension funds. The SEC report further indicates that competition between advisors does not exist in the mutual

¹⁴¹⁴ Coates, J. C., & R. Glenn Hubbard, (2007). Competition in the mutual fund industry: evidence and implications for policy, 33 *Journal of Corporation Law* 151.

¹⁴¹⁵ Ibid., p. 156.

¹⁴¹⁶ Coates & Hubbard, Ibid., p. 186-187.

¹⁴¹⁷ Ibid., p. 188.

fund industry and found instead that mutual funds are formed by persons who hope to profit from providing management services to them¹⁴¹⁸. Once retained by a fund, the managers of the funds seldom compete between one another for the advisory contracts¹⁴¹⁹.

According to Freeman et al the affects of commingling of expenses does exist and does prevent a true 'apples to apples' comparison. Coates and Hubbard indicate that the problem of size exaggerates the impact and ignore the efforts of Freeman and Brown to adjust for expense commingling¹⁴²⁰. Freeman et al further note that "Coates and Hubbard ignores the pure apples - to - apples data that does exist supporting central thesis of Freeman and Brown's that fee gouging is rampant within the fund industry"¹⁴²¹ and cite a 2004 Senate Subcommittee hearing examining excessive fees in the mutual fund industry to support this. At this hearing then New York Attorney General Eliot Spitzer testified that he had asked for the "best apples to apples comparison for identical services" from the advisor Putnam Investments¹⁴²² and that he was provided data showing that the same advisors mutual fund investors were charged 40% more advisory services than the advisor's institutional clients. This example shows that in this instance mutual fund investors paid \$290 million (40% more) in advisory fees than they would have paid if they had been charged the rate that the advisor charged the institutional clients.

¹⁴¹⁸ PPI Study, *supra* note p. 127.

¹⁴¹⁹ *Ibid.*, p. 128.

¹⁴²⁰ Freeman et al, *supra* note 1242 p. 109.

¹⁴²¹ *Ibid.*, p. 110.

¹⁴²² Oversight Hearing on Mutual Funds (testimony of Eliot L. Spitzer, N.Y. Attorney General).

An additional example cited by Freeman et al is that 'The Alliance Premier Growth Fund' in 2002 paid total advisory, distribution, and administrative expense of \$198 million, which included an advisory fee of \$88 million to the fund's sponsor Alliance Capital¹⁴²³. The advisory fee exceeds 90 bps, based on average assets above \$9.1 billion¹⁴²⁴. At about the same time Alliance was managing the Vanguard U.S. growth fund for 11 bps, a \$107 billion portfolio for the Minnesota State Board of Investment for 20 bps, a \$730 million equities portfolio for the Missouri Retirement System for 18.5 bps and a \$975 million for 10 bps¹⁴²⁵.

The difference between the management fees for the pension and mutual funds cannot be justified, according to Freeman et al,¹⁴²⁶ to reflect expense commingling since the advisory fees were separate from administrative and operational fees in the certified shareholder report. The fee differential can also not be justified by differences in personnel or services since Alliance Capital has stated that its institutional accounts and mutual fund accounts managed by the same investment professionals. Further, the prospective for the management company's institutional accounts and its growth fund shared substantially the same investment objectives and policies with essentially the same investment strategies and techniques, with different clients sharing nearly identical composition of investment holdings and related weightings.

¹⁴²³ Ibid.

¹⁴²⁴ Ibid.

¹⁴²⁵ Ibid.

¹⁴²⁶ Ibid.

Alliance Capital was paid less than approximately \$88 million annually while the pension plan customers paid less than \$1 million for essentially the same advice from the same advisors, which represents a price differential of 88 times for this example. This and other examples led Freeman et al to state “price competition for advisory services in the fund market is not robust, it is on life support, if it can be said to exist at all. The point is this proof of price gouging in the fund portfolio management business is finable and has been found.”¹⁴²⁷ One of the issues in evaluating excessive mutual fund fees and price gouging is that the SEC has allowed mutual funds to commingle expenses which obscure the actual advisory fees. This issue could be addressed through the introduction of a regulation to prevent commingling of advisory expenses with other expenses, such as the amount that investors pay for investment advice.

The difference in advisory fees between mutual funds and pension funds is commonly attributed to differences in liquidity since mutual funds are constantly selling and redeeming shares while pension funds hold the shares for long periods of time resulting in higher advisory fees for mutual funds. For example, Coates and Hubbard cite a liquidity factor¹⁴²⁸ to justify the differences in mutual fund and pension fund and pension fund advisory fees. As noted by Freeman et al¹⁴²⁹ while Coates and Hubbard conduct an economic analysis they do not quantify the differences in the liquidity factor, and they do not cite any authoritative source for the significance of this liquidity factor.

¹⁴²⁷ Ibid., p. 112.

¹⁴²⁸ Coates – Hubbard, *supra* note 911.

¹⁴²⁹ Freeman et al, *supra* note 1242.

The ICI indicated that the true cost of managing a mutual fund portfolio is 31 bps on a weighted average basis¹⁴³⁰ which led it to a conclusion that mutual fund and pension fund plans pay like fees for like portfolio management services¹⁴³¹. The ICI also has stated that “mutual fund sub advisors and pension plan investment managers charge investment advisory fees that are virtually identical.”¹⁴³² This position is at odds with the Coates – Hubbard liquidity factor since the ICI position implies that the advisory services for mutual funds and pension funds are similar since they are “virtually identical”, as stated in their press release. Freeman and Brown¹⁴³³ have shown how the top 10% largest mutual funds held assets of \$9.7 billion with a 50 bps fee level, while the largest pension funds held assets of \$1.55 billion. Even accounting for the size difference these data indicate that mutual fund managers are paid approximately 15 times more than for managing the largest pension funds.

The weighted average expense ratio for the mutual fund industry’s equity index funds has been estimated to be 25 bps, which represents the true cost, on a weighted average basis, of performing all administrative and distribution services. Portfolio management is not included as a significant cost component. Freeman et al reason that if the average cost of advisory services is approximately 30 bps, then the weighted average cost of the typical actively managed equity mutual fund would be approximately 55 bps (30 bps for management plus 25 bps for the remainder). As a comparison, Freeman and

¹⁴³⁰ Ibid.

¹⁴³¹ Ibid., p. 17.

¹⁴³² Freeman and Brown, *supra* note 1102

¹⁴³³ Ibid.

Brown¹⁴³⁴ estimated advisory fees for equity mutual funds to be approximately 56 bps. They further note that by comparison the fees for actively managed equity funds are 112 bps, more than twice the 55 bps value. Freeman et al conclude that the cost difference between operating an equity index fund (25 bps) and a typical managed equity fund (112 bps) is 87 bps¹⁴³⁵. Freeman et al adjusted the 87 bps down by 25 bps to account for 12b-1 fees, resulting in a difference of 62 bps, and note that this is comparable to the average advisory fee of 59 bps for the 500 largest actively managed equity funds. The authors conclude that 62 bps reflects the cost of the portfolio advisory services since advisory services are the only expenses that equity funds pay and index funds do not pay, except for 12b-1 fees which have been adjusted for. This value of 62 bps is more than double the value of 30 bps which the ICI represents, and Coates and Hubbard accept, as the true cost of managing equity fund portfolios.

The approximate 30 bps gap between the typical advisory fee for managed equity mutual funds and the sub-advisors' typical fee of approximately 30 bps, according to Freeman et al, cannot be accounted for by the presence of hidden non-advisory expense items being imbedded in the advisory fee but, rather, it confirms that mutual fund directors are grossly overpaying for fund advisory services, and gives some idea of the enormity of fund advisors' advisory profits. This position is counter to that of the ICI which contends that sub-advisory costs represent the true cost of providing portfolio management advice to mutual funds, with the difference being average fund sub-advisory

¹⁴³⁴ Ibid.

¹⁴³⁵ Ibid.

costs of around 30 bps and average advisory fees of around 60 bps being explained by hidden non-advisory expenses buried in the advisory fee and not reported separately.

Major administrative expenses when itemized separately total only 21 bps on average¹⁴³⁶. Therefore, for the ICI and Coates and Hubbard to be correct in arguing that hidden expenses explain the difference between fund advisory fees on the one hand, and sub-advisory and pension advisory fees on the other, there would have to be approximately 30 bps of additional administrative costs in fund advisory fees. This amounts to more than the average total level of identified and scheduled administrative fees reported by mutual funds to the SEC¹⁴³⁷. For the contention of the ICI and Coates – Hubbard to be credible, there would have to be such a large number of separate administrative costs that when combined they would exceed the administrative costs that are accounted for and disclosed which is not tenable. It may be argued that in all of corporate finance, no securities issuers are subject to more intensive regulation than mutual funds, yet this regulation has failed to curb excessive fees and protect investors. Part of the root cause of this must rest with the SEC since it is charged with regulating the mutual fund industry.

The SEC stated: “While we can all applaud fair and reasonable fees, we think the best way to ensure them is a marketplace of vigorous, independent, and diligent mutual fund boards coupled with fully-informed investors who are armed with complete, easy-

¹⁴³⁶ Freeman and Brown, *supra* note 1102 p. 624, Table 2.

¹⁴³⁷ Freeman et al, *supra* note 1242 p.121, note 131.

to-digest disclosure about the fees paid and the services rendered.”¹⁴³⁸ The SEC, however, has not fulfilled its goal of “fair and reasonable fees”. The SEC has not bought a single action against excessive portfolio management fees under Section 36(b) of the Investment Company Act. The question also arises as to whether the SEC director independence rules have resulted in “a marketplace of vigorous, independent and diligent mutual fund boards”. Additionally, it is questionable whether investors are “fully informed” and “armed with complete, easy to digest disclosure about the fees paid and the services rendered”. One of the specific philosophies of the establishment of the SEC is “that the SEC should ensure that companies provide full and fair disclosure”¹⁴³⁹. However, a view was expressed at a subcommittee hearing in 2003, prior to many of the SEC’s disclosure reforms, that “mutual funds have constructed a system where the costs are practically invisible”¹⁴⁴⁰.

The SEC has not required disclosure of costs or advisory fees for funds to date; this has impeded investor protection since it has not provided adequate data for investors to make a viable challenge under Section 36(b) of the Investment Company Act. Further, the lack of disclosure on advisory fees does not facilitate price competition since investors are not able to adequately distinguish between funds based on costs and price relative to services provided. Further, the high profitability of the firms providing the

¹⁴³⁸ SEC Press Release: Alliance Capital Management will pay record \$250 million and make significant governance and compliance reforms to settle SEC charges (Dec. 18, 2003).

¹⁴³⁹ Henry, H. T. C., (2000). Faith and magic: investor beliefs and government neutrality, 78 *Texas Law Review* 777, 838.

¹⁴⁴⁰ *Mutual Fund Industry Practices and Their Effect on Individual Investors*: Hearing before the Subcommittee on Capital Markets, 108th Cong. 157 2003; prepared statement of Gary Gensler, former Undersecretary for Domestic Finance, Department of the Treasury.

services is not required to be disclosed. For example, the market returns for five large publicly traded fund sponsors averaged 26.1% compared to an average return of 12.4% over matched periods for the S&P 500¹⁴⁴¹. Further, a capitalization-weighted index of a sample of twenty-nine publicly traded fund sponsors had a compound average return of 27.8% from 1982 to 2006¹⁴⁴².

5.11 U.S. FIDUCIARY DUTY APPLICABLE TO MUTUAL FUND MANAGERS

The fiduciary duty law in the U.S. that is applicable to mutual fund managers is focussed upon one statute, Section 36(b) of the Investment Company Act (ICA)¹⁴⁴³. Following enactment of the ICA there was a lack of any “mechanism by which the fairness of management contracts could be tested in court”¹⁴⁴⁴. The decision of congress to add Section 36(b) was based on the results of the PPI study that economies of scale resulting from the growth in mutual fund assets during the 1950s and 1960s were not being shared fairly with fund shareholders¹⁴⁴⁵. An express civil liability provision was added¹⁴⁴⁶ in response to the congressional finding¹⁴⁴⁷ that “the forces arms-length

¹⁴⁴¹ Freeman et al, supra note 1242 Table, 1.

¹⁴⁴² Freeman et al, supra note 1242, n. 28.

¹⁴⁴³ 15 U. S. C. § 80a-35(b) (2000),

¹⁴⁴⁴ S. Rep. No. 91-189, at 5(1970), as reprinted in 1970 U. S. C. C. A. N. 4897, 4901,

¹⁴⁴⁵ PPI Study, supra note pp. 10-12.

¹⁴⁴⁶ Ibid.

¹⁴⁴⁷ Ibid.

bargaining does not work in the mutual fund industry in the same manner as they in other sectors of the American economy”¹⁴⁴⁸.

Section 36(b) provides that “the investment advisor of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services” and it empowers security holders to bring civil actions if investment advisors breach their fiduciary duties “in respect of such compensation or payments paid”¹⁴⁴⁹. Prior to the amendment of the ICA in 1970, mutual fund fees were evaluated on the basis of a “waste test” in state courts. This “waste test” was widely regarded as being very difficult to satisfy since it required to plaintiff to demonstrate that the transaction that was being challenged was one that no reasonable person could view as representing a fair exchange¹⁴⁵⁰. In order to win the “waste test” in a state court, the defendant needed only to show that “any reasonable person might conclude that the deal made no sense”¹⁴⁵¹. Congress recognized that the burden placed on the plaintiff was too large and decided to create a statute to lower this burden. Congress specifically indicated that “because market forces are not likely to operate as effectively” the test was unduly restrictive and needed to be relaxed¹⁴⁵².

Gartenberg has set the standard for how Section 36(b) is interpreted and applied. This case was the first major fund industry fee case tried to a verdict in which the trial

¹⁴⁴⁸ S. Rep. No. 91-184, p. 5.

¹⁴⁴⁹ 15 U. S. C. § 80a-35(b).

¹⁴⁵⁰ *Steiner V. Meyerson*, Civ. A. No. 13139, 1995 WL 441999, at *1 (Del. Ch. July 19, 1995).

¹⁴⁵¹ *Ibid.*

¹⁴⁵² S. Rep. No. 91-184, p. 5.

judge set a very high threshold for proof. The Second Circuit's affirmance of the results used the "Gartenberg factors" as the primary test for mutual fund fee litigation. Unfortunately, the Gartenberg test has resulted in Section 36(b) not providing the appropriate level of investor protection. Freeman et al state: "The Gartenberg factors have destroyed the promise held out by congress in 1970 when it presented Section 36(b) to fund shareholders as a fiduciary duty enforcement weapon. Despite stratospheric fees and resultant advisor profitability, to date, no complaining shareholder has ever won a lawsuit contesting mutual fund payouts under Section 36(b)."¹⁴⁵³

Gartenberg involved a challenge for excessive fees for Merrill Lynch's Ready Asset Trust money market mutual fund, which at the time (late 1981) was "by far the largest money market fund in existence"¹⁴⁵⁴ which increased by \$100 million in assets to more than \$19 billion in assets "in just a few years"¹⁴⁵⁵. The plaintiffs challenged the advisory fee they paid to Merrill Lynch for its rapidly growing fund to be excessive. At that time the fund had over 1.1 million shareholders serviced through Merrill Lynch's 400 local branch offices, with thousands of account executives with support staff to process more than 30,000 share orders daily¹⁴⁵⁶. The complex cost accounting resulted in a potential range in profitability of more 38% to financial losses¹⁴⁵⁷.

¹⁴⁵³ Freeman et al, supra note 1242, p. 126.

¹⁴⁵⁴ *Gartenberg*, 528 F. Supp. p.1042.

¹⁴⁵⁵ Ibid.

¹⁴⁵⁶ *Gartenberg*, 528 F. Supp. pp. 1040, 1041.

¹⁴⁵⁷ *Gartenberg*, 694 F. 2d p. 926.

The focus of the district court was upon evaluating whether a fiduciary breach had occurred and noted, that under Section 36(b), the advisors conduct is to “be governed by the ‘duty of uncompromising fidelity’ and undivided loyalty”¹⁴⁵⁸ and that advisors must function “with an eye single to the best interests of the beneficiaries.”¹⁴⁵⁹ The court also noted fair dealing is mandatory when the advisor deals with the fund regarding fees. The court noted that the investment advisor owes a duty of full disclosure to the trustees, and shareholders of the fund, and even when full disclosure has been made the courts must subject the transaction to rigorous scrutiny for fairness. The court stated that the essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm’s length bargain. These statements by the courts are considered to be consistent with the legislative intent of Section 36(b)¹⁴⁶⁰.

A significant issue when arose when the court held that Section 36(b) requires proof of unfairness in consideration to the “nature, quality and extent” of the services provided to the fund relative to the fee¹⁴⁶¹. The court also held that proof of unfairness should also involve due consideration of “the money market fund industry practice and level of management fees”¹⁴⁶². It is this consideration that is an issue for investors, since Section 36(b) was created specifically because the mutual fund industry could not be relied upon to deliver fair pricing due to the inherent conflict of interest in its

¹⁴⁵⁸ *Gartenberg*, 528 F. Supp. p. 1047 (citing *Galfand V. Chestnut*, 545 F. 2d 807, 809, 811 (2d Cir. 1976)).

¹⁴⁵⁹ *Ibid.*, citing *Rosenfeld V. Black*, 445 F. 2d 1337, 1342 (2d Cir. 1971).

¹⁴⁶⁰ *Freeman et al*, supra note 1242 p. 128.

¹⁴⁶¹ Quoting *Pepper V. Litton*, 308 U.S. 295, 306-07 (1939).

¹⁴⁶² *Gartenberg V. Merrill Lynch Asset Mgmt. Inc.* 694 F. 2d 923, 927 (2d Cir. 1982).

management structure. By involving a consideration of industry practice and level of management fees, the court has essentially created a benchmark for the prevalent high to excessive levels of fees.

The court also held that proof of unfairness should also involve a consideration of “the money market fund industry practice and level of management fees”¹⁴⁶³. It is this consideration that is an issue for investors since Section 36 (b) was created specifically because the mutual funds industry could not be relied upon to deliver fair pricing due to the inherent conflict of interest in its management structure. By involving a consideration of industry practice and level of management fees, the court has essentially created a benchmark for the prevalent high to excessive levels of fees. The lower court stated that “The market price – freely available and competitively set – serves as a standard to the investment advisory fee...”¹⁴⁶⁴. The issue with the courts statement is that this assumes that the market is competitively set which has not been reliability established. The issue with this application of the *Gartenberg* test is that if the comparison is made against other funds that also have excessive fees, the entire industry is characterized as having excessive fees.

According to the Freeman et al¹⁴⁶⁵, mutual fund fees are not competitively regulated. Accepting that this is the case the existing regulation of mutual fund fees is not effective. Benchmarks of fees allowed Merrill Lynch to defend its high fees based on

¹⁴⁶³ *Gartenberg V. Merrill Lynch Asset Mgmt. Inc.* 694 F. 2d 923, 927 (2d C. 1982).

¹⁴⁶⁴ *Gartenberg*, 528 F. Supp note? p. 1067.

¹⁴⁶⁵ *Freeman et al*, supra note 1242, Part 1.

inappropriate benchmarks. In their appeal, the plaintiffs in *Gartenberg* attempted to convince the court that while the fairness standard related to a market price that was tied to a market price that was freely available and competitively set, the market price was not actually competitively set and that this comparison bore no relationship to actual market conditions¹⁴⁶⁶. The second circuit court did recognize the existence of an ‘unseverable relationship’ between the advisor manager and the fund it provides services to, but stopped short of recognizing the ‘no-bid’ nature of industry fund price associated with this relationship.

The appellate court rejected the plaintiffs argument and held that in a *Gartenberg* test, the plaintiff must demonstrate that “the advisor” manager [charges] a fee that is so large that it bears no reasonable relationship to services rendered and could not have been the product of arms length bargaining¹⁴⁶⁷. This interpretation introduced a de facto waste requirement, which was the proof threshold that Congress had sought to eliminate through the introduction of Section 36(b).

The second circuit also rejected the plaintiff’s argument that comparison with fees charged by pension funds was an accepted “criterion for determining fair advisory fees for money market funds”¹⁴⁶⁸. The court opined that pension funds do not “face the myriad of daily purchases and redemptions throughout the nation which must be handled

¹⁴⁶⁶ *Gartenberg*, 694 F. 2d p. 929.

¹⁴⁶⁷ *Ibid.*, p. 28.

¹⁴⁶⁸ *Ibid.*, p. 930, note 3.

by the fund in which purchaser may invest for only a few days”¹⁴⁶⁹. Freeman et al state “the Gartenberg courts greatest failing was its refusal to accept that the pricing of investment advisory service offered in the free market provides a legitimate and helpful guidepost for evaluating such services in the fund market¹⁴⁷⁰ and provide three reasons “why the court’s refusal to consider this comparative data made no sense”¹⁴⁷¹.

The first of these reasons is that the cost of servicing accounts, including purchases and redemptions, is an administrative cost and not a cost associated with portfolio management. The focus in fund cases is on portfolio advisory services and not on the administrative cost associated with purchases and redemptions which the *Gartenberg* court focussed on. Secondly, the additional advisory portfolio costs associated with the share purchases and redemptions could have been quantified. The third mistake, according to Freeman et al, is that in *Gartenberg* the court refused to admit corporate free market data which resulted in the advisory fees of the mutual fund industry not being compared to ‘free market data’ of pension advisory funds.

A manager of a large mutual fund does not manage all of the inflows and outflows, but instead the total of the inflows and outflows, contrary to the indication from the court of appeals. The issue with the application of the Gartenberg factors by shareholders is that it cannot be compared to pension fund data, but instead only data from other pension funds which may, or likely have, comparable issues with high

¹⁴⁶⁹ Ibid.

¹⁴⁷⁰ Freeman et al, supra note 1242, p. 129.

¹⁴⁷¹ Ibid.

advisory fees since this is an industry – wide phenomena. Additionally, the shareholders did not have access to cost and price data, as this is typically not disclosed, since this has not been mandated by the SEC and when it is disclosed it is often bundled together and mixed with other data such that it has not been possible to use this for the *Gartenberg* test. As such, shareholders do not possess the data to make a legal challenge on excessive advisory fees in the courts through the only available legal mechanism provided to them.

With respect to determination of the funds profitability for the advisor (factor 2 of the *Gartenberg* test), it is difficult to obtain the raw data concerning the cost of servicing the fund from the mutual fund manager, since they tend not to disclose this information. In addition, there are not uniform accounting standards for cost allocation for calculating profitability in mutual funds, resulting in any calculations being susceptible to dispute, even if pristine cost data was available. For example the analysis at the experts in *Gartenberg* resulted in a range of profit margins from 38% financial losses¹⁴⁷². In *Krinsk* the Merrill Lynch management account generated a pre-tax profit of \$47.5 million and a pre-tax return of 28.5%¹⁴⁷³. In contrast Merrill Lynch's chief expert reported a loss of \$77 million and a negative profitability of 55.8% for the same period¹⁴⁷⁴. The plaintiff's expert determined the average annual profitability of the fee contract to the advisor was 40.4%, in comparison to the estimate from the export of Merrill Lynch of minus 32.7%

¹⁴⁷² *Gartenberg*, 694 F. 2d p. 926.

¹⁴⁷³ *Krinsk*, V. Fund Asset Mgmt., Inc. 715 F. Supp 472, 489 (S.D.N.Y), aff'd, 875 F. 2d (2nd Cir, 1989).

¹⁴⁷⁴ *Ibid.*, table from Merrill Lynch's expert.

over the same period¹⁴⁷⁵. After hearing the evidence from the plaintiff and defendant the court concluded that a weighted average pre-tax profitability over the three-year test period “would probably fall in a range from at least a few percentage profits greater than 0% to perhaps as much as 33%.”¹⁴⁷⁶

The court in *Krinsk* was clearly not able to make a reliable determination of profitability factor (factors) for the Gartenberg test based on detailed analysis by the experts for the plaintiffs and defendant. In *Schuyt*, the court found that the calculation of the advisor’s cost of servicing the captive fund to be a “virtually impossible task”¹⁴⁷⁷. The advisor’s pre-tax profit was very high, exceeding 77%¹⁴⁷⁸. The court however also held that the advisors profit did not need to be disclosed to investors because profitability was not a material fact¹⁴⁷⁹. Based on the plaintiff’s experience in *Krinsk* and *Schuyt* it will be very difficult for plaintiffs to meet the profitability factor in the *Gartenberg* test. As such, realistically this test is not a viable remedy for shareholders in excessive fee challenges given that the lack of available data and uncertainty in the calculations will limit their success in the debate which would undoubtedly ensure with the defence since the burden of proof is placed upon the plaintiff. It is also not clear why the plaintiff should be required to prove the advisor’s profitability for an excessive fee challenge.

¹⁴⁷⁵ Ibid., p. 494.

¹⁴⁷⁶ Ibid.

¹⁴⁷⁷ *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp. 962,978 (S.D.N.Y. 1987), aff’d 835 F. 2d 45 (2d Cir. 1987).

¹⁴⁷⁸ Ibid.

¹⁴⁷⁹ Ibid., p. 990.

This is particularly problematic since the advisors cost data is typically confidential and when discussed is difficult for third parties to analyze and reach values.

Economies of scale are recognized to exist in the mutual fund industry. As one industry expert stated “the economics of scale in the mutual fund industry are truly staggering”¹⁴⁸⁰. The economy of scale factor (factor 3 in Gartenberg test) has also been proven to be very difficult to analyze in *Gartenberg*. In order to prove that economics of scale exist and have been captured by the advisor as unfairly high profits, the plaintiff has to have access to the appropriate cost and profitability data. The relevant cost data is difficult to obtain because even if the direct expenses for portfolio management were available, which is the most easily calculated cost information, cost for the advisory function, which excludes administration and distribution costs, would still require allocating an appropriate share of the advisory fees to indirect cost, including overhead costs.

Even the SEC has experienced issues with obtaining this information. SEC report on mutual fund fees in 2000 indicated that it was unable to “manage directly the cost of providing portfolio management services to a mutual fund in order to determine whether economies exist because the data are unavailable”¹⁴⁸¹. Accordingly, how can plaintiffs be expected to obtain and calculate the required information if the SEC cannot with its staff of lawyers, economics and mutual fund experts who have expressed that they are not able

¹⁴⁸⁰ Bogle *supra* note 149, p. 417.

¹⁴⁸¹ SEC, Division of Investment Management, *Report on Mutual Fund Fees and Expenses*, (2000), accessed at: <http://www.sec.gov/news/studies/feestudy.htm>

to locate adequate data on costs that would allow them to analyze whether economies of scale in the fund industry exist because they do not have access to industry cost concerning the portfolio management function. Therefore, it would be expected that plaintiffs would not be able to obtain and calculate this data to satisfy this requirement in an excessive fee challenge. For this reason, Freeman et al contend that courts must permit plaintiffs to use free market comparables and state "Without use of such comparators, Section 36(b), plaintiffs are doomed."¹⁴⁸²

In *Harris Associates*¹⁴⁸³ the court permitted the admission that the advisors of institutional clients were charged fees that were less than half of those charged to the captive funds. This evidence, for example, established that if the advisor had charged the Oakmark Funds in accordance with the fee schedule for institutional clients, the advisory fee would have dropped from 88 bps to less than 36 bps, which would have resulted in savings to the Oakmark Fund Shareholders of more than \$33 million annually. For the Oakmark Equity and Income Fund, the advisory fees would have dropped from 73 bps to less than 26 bps, resulting in annual savings to fund shareholders of \$37 million annually. Therefore, the advisors received more than \$70 million more in fees than if the shareholders for those two funds alone were charged the same fees as in their institutional fee schedule. The court in granting judgement in favour of the defendants, held that the advisors had a range of fees and that the institutional clients within the lower part of the range with the higher fees simply part of the upper range and therefore this was proper.

¹⁴⁸² Freeman et al, supra note 1242 p. 142, n. 226.

¹⁴⁸³ Jones V. Harris Associates L.P., No. 1:04-CV-08305, 2007 WL 627640 (N.D. 111. Feb 27, 2007).

Again, the interpretation of the court appeared to revolve around whether fees were so excessive as to constitute a breach of fiduciary duty.

The court, in *Harris Associates*, also failed to recognize that the evidence indicated that it was less expensive for the advisor in Oakmark to service its mutual fund clients than its institutional clients. Accordingly, the advisor in Oakmark was charging its mutual fund shareholders more than twice as much as its institutional clients, even though these services were cheaper to deliver than to its institutional clients.

In *Ameriprise*¹⁴⁸⁴ the plaintiffs provided evidence indicating that the advisor charged advisory fees to its captive mutual funds that were nearly twice as much as they would have been had the advisor used the fee schedules that it adhered to when selling portfolio management services in the open market¹⁴⁸⁵. The Ameriprise court, following *Harris Associates*, held that the lower advisory fees for institutional clients established the low end of the range rather than being excessive and found in favour of the defendant.

The approach of the court in both *Harris Associates* and *Ameriprise*, fund investors will likely not be able to win a Section 36(b) fee challenge for excessive advisory fees through comparison with lower institutional fees as the court will simply continue to hold that institutional fees simply represent the lower range of fees, even if evidence is presented to demonstrate that the costs to the advisors are less for institutional clients than for mutual fund clients. The approach in *Harris Associates* and *Ameriprise*

¹⁴⁸⁴ *Gallus V. Ameriprise Financial, Inc.* 497 F. 2d 974 (D. Minn. 2007).

¹⁴⁸⁵ *Ibid.*

underscores the U.S. Courts refusal to admit comparative price data into evidence. Without allowing comparative data, it is difficult to understand how the courts would be able to determine whether the advisory fees are “excessive” relative to the market.

In addition, both Davis¹⁴⁸⁶ and Freeman and Brown¹⁴⁸⁷ indicated how fund managers sometimes sell their services on the open market and then overcharge their own captive funds for the same services. Directors of captive funds have the responsibility to ensure that their shareholders are not being overcharged for services relative to the open market. In particular they should ensure that their advisors are not charging investors in their captive funds more than they are charging investors in the free market. Directors could, for example, apply the “most favoured nation” concept for fee fund pricing of Freeman and Brown¹⁴⁸⁸ where the mutual fund investors and pension fund investors pay the lower of the two advisory fee rates. In order to justify higher rates for mutual fund investors, the advisors would have to justify higher costs. This framework would place the onus on advisors to justify higher fees for mutual fund investors, rather than having investors seek a Section 36(b) remedy which likely would not prove to be successful.

Congress and the SEC had attempted to regulate mutual fund advisory fees under Section 36(b) of the Investment Company Act of 1940. Section 36(b) imposes places a fiduciary duty on the investment advisor with respect to payments that they receive from the fund in exchange for advisory services. This regulation has resulted in substantial

¹⁴⁸⁶ Supra note 1247, Table, 3.

¹⁴⁸⁷ Supra note 1102, pp. 635-635.

¹⁴⁸⁸ Freeman and Brown, supra note 1102.

litigation, the vast majority of which resulted in decisions that upheld the fees that were being challenged. For example the lawsuits that occurred in the mid-late 2000's in the U.S. resulted in multiple rulings in favour of the investment advisor while the plaintiffs were not successful in court and did not receive any public settlement requiring the return of advisory fees¹⁴⁸⁹.

While Congress granted shareholders of investment companies a private right of action as a means of enforcing fiduciary duty of an investment advisor to a fund shareholder, this mechanism has not been effective in practice. Freeman et al stated that "Section 36(b) is important in practice. Because of the impractical proof standard for succeeding in a 36(b) lawsuit, no plaintiff has ever won a fee case brought under Section 36(b)."¹⁴⁹⁰ To date, no plaintiff has successfully demonstrated a breach of this duty under the Gartenberg standard used by the majority of the courts to evaluate excessive fee claims. The replacement standard proposed by the Seventh Circuit Court of Appeals¹⁴⁹¹ is also not favourable toward investors. The court stated that "The trustees (and in the end upon investors who vote with their feet and dollars), other than a judge or jury, determine how much advisory services are worth". It also relies upon a comparison with

¹⁴⁸⁹ Carroll, J. R., & D. S. Clancy, (2008). Excessive fee lawsuits, *National Law Journal*, May 26a, 2008 at 12.

¹⁴⁹⁰ Freeman, J. P., S. L. Brown & S. Pomerantz (2008). Mutual fund advisory fees: new evidence and a fair fiduciary test, 61 *Oklahoma Law Review* 83, 86.

¹⁴⁹¹ See *Jones V. Harris Associates. L.P.*, 527 F. 3d 627, 632 (7th Cir. 2008).

other mutual fund fees in a market which academic papers¹⁴⁹² have indicated lacks a sufficient degree of competition to affect mutual fund fee prices.

In the end, this is not ‘investor protection’ since it essentially pushes the responsible back upon the investor to exit the fund. The Seventh Circuit Court of Appeals in *Harris Associates* indicated that it would find that an investment advisor had breached its fiduciary of duty only if it charged an advisory fee so unusual that the court might infer “deceit must have occurred”¹⁴⁹³. The court in *Harris Associates*¹⁴⁹⁴ further acknowledged that a “mutual fund cannot, as a practical matter sever its relationship with the advisor”. As such, the court thereby assumed that investment protection for fees would be practically available to shareholders through the mechanism of a fund board terminating the investment advisor. Section 36(a) of the Act authorizes the SEC to bring civil actions against mutual fund board members who “engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct”¹⁴⁹⁵. A mutual fund’s board of directors does not receive any benefit from an excessively high advisory fee. Accordingly, the shareholders do not have a viable cause of action against the fund’s boards of directors that approve excessive advisory fee contracts. As such, there is a lack of the incentive for fund directors to fulfill their fiduciary duty to fund shareholders to bargain at arms length with the investment advisors during the approval of the investment contract. Further, mutual fund directors typically do not hold a high value of shares in

¹⁴⁹² See for example, Freeman and Brown, *supra* note 1102.

¹⁴⁹³ *Ibid.*

¹⁴⁹⁴ *Ibid.*

¹⁴⁹⁵ U S V.S.C 80a-35(a) (2006).

the funds they oversee and therefore do not have a personal financial incentive to ensure that the advisors fees are kept in check¹⁴⁹⁶.

In the mid-1960's, the SEC concluded that mandated disclosure, disinterested directors and other controls could not adequately protect investors from excessive advisory fees. For example in 1966, the SEC stated: "The disclosure requirements for the Federal Securities laws ... [are] a less effective constraint on manager's compensation in this industry.... additional regulatory provisions for advisory fees ... which mainly require approval of advisory contracts by shareholders and unaffiliated directors, have rarely operated to provide fund shareholders with an adequate share of the economies of size in many cases"¹⁴⁹⁷.

In response to these concerns, Congress amended the Investment Company Act in 1970 to add section 36(b)¹⁴⁹⁸ which places a fiduciary duty upon the investment advisors of SEC-registered companies to protect mutual fund shareholders from fee gouging¹⁴⁹⁹. This section forbids investment advisors from charging and collecting excessive advisory fees relative to the services that they provide¹⁵⁰⁰. The statute that provides fund shareholders with a right of action against the investment advisor is U.S.C. 80a – 35(b). In *Nuveem* the court stated "[Section] 36(b) provided shareholders with an express cause

¹⁴⁹⁶ Lowenstein, *supra* note p. 76.

¹⁴⁹⁷ SEC, *Public Policy Implications of Investment Growth*, H.R. Report No. 89-2337, p. 12 (1966).

¹⁴⁹⁸ *Investment Company Amendments Act of 1970*, Pub. L. No. 91-547, 84 Stat. 1413.

¹⁴⁹⁹ U.S.C.. 80a-35(b) (2006).

¹⁵⁰⁰ Hazen, J. L. S., (2009). *The Law of Securities Regulation*, 6th ed.

of action against the investment advisor that by – passed demand on the directors”¹⁵⁰¹. The burden of proof is placed upon the plaintiff in this section for providing a breach of fiduciary duty¹⁵⁰². The statute directs courts to defer to the investment company board’s approval of the advisory contract to the extent warranted¹⁵⁰³. Section 35(b) does not provide specific standards or guidelines for evaluating the size of the advisor’s fee.

U.S. Congress recognized that investment advisors appeared to charge advisory fees that were not in proportion to the value of the services rendered, based on the findings of the Wharton Report¹⁵⁰⁴. The SEC authorized the University of Pennsylvania to conduct a study of the mutual fund market¹⁵⁰⁵. The Wharton Report also pointed out that the management structure created an opportunity for investment advisors to charge higher than warranted fees¹⁵⁰⁶. The Wharton report put forward that the close relationship between fund directors and investment advisors reduced the efficiency of arms length negotiations and prevented competitive market forces from creating downward pressure on advisory fees. The basis for this finding was a survey questionnaire distributed to 163 investment advisors with mutual fund clients, which indicated that mutual fund investors paid higher advisory fees than the advisors of other

¹⁵⁰¹ Citing *Daily Income Ins. Fund, Inc. v. Fox* 446 U.S. 523,535 (1984).

¹⁵⁰² U.S.C 80a – 35(b)(1).

¹⁵⁰³ *Ibid.* 80a – 35b (2).

¹⁵⁰⁴ Wharton School of Finance and Commerce, *A Study of Mutual Funds*, H. R. Rep. 87-2274 1962.

¹⁵⁰⁵ SEC, *Public Policy Implications of Investment Company Growth*, H. R. Report No.1 89-2337, p. 2.3 (1966).

¹⁵⁰⁶ *Ibid.*

clients¹⁵⁰⁷. Almost half of the advisors (twenty-four of fifty-four) with both mutual fund and non mutual fund clients charged their fund clients two or more times as much as they did their non-mutual fund clients.

The Wharton Report also indicated that even though economies of scale emerged as mutual fund assets increased, resulting in lower costs per shareholder, investment advisors did not pass on these savings to shareholders¹⁵⁰⁸. The SEC, in 1966 largely adopted the conclusions of the Wharton report which recommended that U.S. Congress amend the Investment Company Act in order to impose a standard of reasonableness on fees received by the investment advisors. Specifically, the SEC report recommendations provide that “all compensation received by any person affiliated with a registered investment company... for services furnished the investment company be reasonable”¹⁵⁰⁹.

The intent of the SEC was that this limitation would be applicable to investment advisor's compensation and the compensation of directors, trustees and underwriters. In 1970 Congress enacted Section 36(b) which imposed a fiduciary duty on an investment advisor rather than the reasonableness standard proposed by the SEC. The rationale for this decision is expressed in the following statement: “[Y]our committee has decided that there is an adequate basis to delete the express statutory requirement of reasonableness and substitute a different method of testing management compensation. This bill states that the mutual fund investment advisor has a specific ‘fiduciary duty’ in respect to

¹⁵⁰⁷ Ibid.

¹⁵⁰⁸ Wharton Report, Ibid., pp. 28.29.

¹⁵⁰⁹ H.R. REP. No. 89 – 2337, p. 13.

management fee compensation”¹⁵¹⁰. The 1970 amendments to the Investment Company Act only imposed a fiduciary duty on investment advisors and did not include the reasonableness requirement proposed by SEC. It should be recognized that this change in the proposed Section 36 (b) was a result of objection by the mutual fund industry to the proposed reasonableness requirement¹⁵¹¹. Bills failed to gain passage that would imposed the SEC’s proposed reasonable test, through amendment to the Investment Company Act, failed to gain passage¹⁵¹².

As a result, there is no test for reasonableness included within the Investment Company Act. The interpretation of Section 36(b) by U.S. Courts has therefore focused on the evaluation of a breach of fiduciary duty. Accordingly, the courts have been particularly focused on advisory fees that were so excessive that they constitute a breach of fiduciary duty. Therefore the courts have refused to consider whether the fees are ‘reasonable’. The U.S. courts interpretation of the legislative history has been that the legislative history appears to have been that the rejection of the SEC proposal implied that the version of Section 36(b) that Congress enacted involves something other than an assessment of ‘reasonableness’ of advisory fees, which relates to director responsibility (i.e., a breach of fiduciary duty by the investment advisor). For example, in *Gartenberg*, the court stated “[The] legislative history of 36(b) indicates that the substitution of the term ‘fiduciary duty’ for ‘reasonable’ while possibly intended to modify the standard

¹⁵¹⁰ S. Rep. No. 91 – 184, at 6 (1969).

¹⁵¹¹ *Gartenberg v. Merrill Lynch Asset Mgmt. Inc.*, 694 F. 2d 923, 928 92d Cir. (1982).

¹⁵¹² SEC, 3724 90th Cong. (1968) S. 1659, 90th Cong. (1967) HR 9511 90th Cong (1967), H.R. 9510, 90th Cong. 91967).

somewhat, was a more semantical than substantive compromise, shifting the focus slightly from the fund directors to the conduct of the investment adviser manager”¹⁵¹³. From this point forward, there has been no attempt by the U.S. courts to regulate mutual fund advisory fees, other than where they relate to a breach of fiduciary duty. There is a significant difference between the fees that investment advisors charge to pension fund clients and those that the same advisors charge to mutual fund clients¹⁵¹⁴.

An example of this is the advisory fees paid by CalPERS (California Public Employees Retirement System, which is one of the few pension funds that discloses the advisory fee that it paid. In 2002, CalPERS paid three advisory firms an average of 0.08% of net assets to manage three portfolios with an average size of \$720 million¹⁵¹⁵. The same three advisory firms charged an average of 0.61% of net assets to manage three mutual funds with similar portfolios and an average of \$12 billion in net assets during same period¹⁵¹⁶. Freeman and Brown¹⁵¹⁷ provide additional examples of higher advisory fees for mutual funds than pension funds. This situation is somewhat counter intuitive since it may be expected that larger mutual fund portfolios have greater economies of scale and therefore lower advisory fees than smaller pension funds.

¹⁵¹³ *Gartenberg*, 694 F. 2d p. 928.

¹⁵¹⁴ Freeman, J. P. & S. L. Brown, (2001). Mutual fund advisory fees: the costs of conflicts of interest, 26 *Journal of Corporation Law* 609, 627-36.

¹⁵¹⁵ Bogle, J. C., (2006). *The Battle for the Soul of Capitalism*, Yale University Press.

¹⁵¹⁶ *Ibid*.

¹⁵¹⁷ Freeman and Brown, *supra* note 1102.

The Wharton Report indicates that holders of open-end companies do not require individual portfolio attention, as other clients usually do, so that a single quarterly compilation of portfolio holdings, for example, is all that is required for the aggregate of shareholders, whether they 'be a dozen or a million'. The characteristic of investment companies suggest a greater likelihood of the emergence of economies of scale and lower costs with increases in asset size than where clients must be catered to on a more individualized basis¹⁵¹⁸.

There have been a number of hypotheses put forward to account for the difference between mutual fund and pension fund advisory fees. The most common justification for higher advisory fees for mutual funds is that the mutual funds are more expensive to manage because their advisors hold assets in liquid investment vehicles that allow frequent redemptions and high sales¹⁵¹⁹. Another common hypothesis is that investment advisors must provide services to hundreds or thousands of individual investors whereas the pension funds commonly deal with a single investor (e.g., a single pension fund client team as opposed to a magnitude of investors).

In Section 36(b) challenges, plaintiffs have drawn attention to the difference between the mutual fund advisory fee that they were paying and the lower pension fund charged by the same investment advisor as evidence for the 'unreasonableness' of the

¹⁵¹⁸ Wharton School of Finance and Commerce, *A Study of Mutual Funds*, H.R. R&P. No. 87-2274, 1962. (Wharton Report) p. 492.

¹⁵¹⁹ Freeman and Brown, *supra* note 1102, p. 113-114 this "liquidity factor" is not visible or quantifiable in the real world.

mutual fund advisory fee. For example in *Harris Associates*¹⁵²⁰ the court stated the plaintiffs “insist that we must compare Harris’s fees not to those charged to funds run by managers other than Harris but rather to those charged to institutional clients. In *Stringliabotti*¹⁵²¹ the plaintiffs were mutual fund holders who issued a claim under Section 36(b) by demonstrating that the defendant-advisor charged a lower fee for the provision of similar services to a state pension fund. There has been some recognition by the courts of the validity of arguments from mutual fund investors that they pay higher fees to the advisor than the advisor charges its institutional pension fund clients. For example in *Ameriprise* the court stated “indeed, the argument for comparing mutual fund advisory fees with the fees charged to institutional accounts is particularly strong in this case because the investment advice may have been essentially the same for both accounts”¹⁵²². The response from the mutual fund industry to allegations that it is overcharging its mutual fund clients relative to its pension fund clients is that the costs are higher for mutual fund clients compared to pension fund clients and hence the cost are higher fees are higher to compensate for this. This explanation has been accepted by a U.S. court. In *Harris*, the court, persuaded by the argument of the defence stated:

“Harris Associates charges a lower percentage of assets to other clients, but this does not imply that it must be charging too much to the Oakmark funds. Different clients call for different combinations of time. Pension funds have low (and predictable)

¹⁵²⁰ Jones V Harris Assoc. L.P., No. 04C 8305, 2007 WL 627640, at *8 (N. D. 111. Feb 27, 2007).

¹⁵²¹ Stringliabatti V. Franklin Res., M. Inc. No. C04-9=00883 S1, 2005 WL 645529 p. 34.

¹⁵²² Gallus V. Ameriprice Fin., Inc., 561 F. 3d 816, 824 8th Cir. 2009.

turnover of assets. Mutual funds may grow or shrink quickly and must hold some assets in high-liquidity instruments to facilitate redemptions that complicate an advisor's tasks¹⁵²³. These arguments, however, are at odds with on statements from the ICI (Investment Company Institute) mutual fund industry advisory group has put forward that the actual cost of providing management and advisory services to a mutual fund is comparable to the cost of providing management services to a pension fund"¹⁵²⁴. In addition, Freeman and Brown¹⁵²⁵ state "There is no evidence that managers of public pension fund equity portfolios are paid less than equity [mutual] fund managers because they do less work or perform at a lower level."¹⁵²⁶

There are numerous potential causes for excessive mutual fund fees that operate singly or in combination¹⁵²⁷. Colin Davis states "The disparity between mutual fund and pension fund advisory fees cannot be solved by pointing to a single discrete issue; rather, a confluence of factors has allowed investment advisors to charge fees to their mutual clients representing several times what they charge to their pension fund clients for essentially the same services"¹⁵²⁸. The higher fees charged by mutual funds advisors is partially due to the advisor board relationship. Close ties between mutual fund boards of directors and investment advisors correlate with higher advisory fees, since boards may

¹⁵²³ Harris Associates, 527 F. 3d p. 63.

¹⁵²⁴ Collins, S. (2003). *The Expenses of Defined Benefit Pension Plans and Mutual Funds*, Investment Company Institute Perspective, Dec 2003, at 8, <http://www.ici.org/pdf/per09-06.pdf>

¹⁵²⁵ Freeman and Brown, *supra* note 1102, p. 634.

¹⁵²⁶ Harris, *supra* note 1524.

¹⁵²⁷ Bogle, *supra* note 149.

¹⁵²⁸ Davis, C. B., (2010). Nudging mutual fund fees downward: using default rules to combat excessive advisory fees, *San Diego Law Review*, Vol. 47, 185.

monitor advisors less closely, which may negatively affect fund performance¹⁵²⁹. Bogle¹⁵³⁰ also indicates that when independent directors do not negotiate with the investment advisor at arm's length on behalf of the fund, this may lead to higher advisory fees and higher profit margins for the investment advisor.

The lower fees for pension funds than for mutual funds may be partially attributable to mutual funds captive contract with their advisor – manager, where pension funds obtain this on the open market. In this regard, Freeman et al¹⁵³¹ state, referencing mutual funds “Because the fund market features prices drawn from negotiation where one party (the fund) is under compulsions to buy from only one supplier (the advisor), mutual fund fees negotiated between captive funds and their advisor, whether considered individually or collectively, cannot reflect fair market value”.

Johnson provided a revaluation of the fiduciary in mutual fund excessive fee cases in the United States.¹⁵³² She states “Congress imposed a fiduciary duty regarding compensation on investment advisors by adding Section 36 (b) to the Investment Company Act of 1940. Legislations intended this fiduciary duty to protect mutual fund investors from excessive management fees. It has failed. Mutual fund investors continue

¹⁵²⁹ Kuhen, C. M. (2009). Business networks, corporate governance and contracting in the mutual fund industry, 64 *Journal of Finance*, at 2185, 2219.

¹⁵³⁰ Bogle, *supra* note 149.

¹⁵³¹ Freeman, J. P., S.L. Brown & S. Pomerantz, (2008). Mutual Fund Advisory Fees New Evidence and a Fair fiduciary duty test 61 *Oklahoma Law Review* 83, 86

¹⁵³² E.D. Johnson, *supra* note 1352.

to pay significantly higher fees than institutional investors for the same money management services.”¹⁵³³

In *Harris Associates*, decided in 2008, the Seventh circuit broke with the *Gartenberg* precedent. There was strong dissent between the two judges which heightened the uncertainty concerning the appropriate fiduciary standard for the mutual fund excessive fee cases in the United States. The Supreme Court heard *Harris Associates* and upheld the decision of the Seventh Circuit. Johnson argues that neither the traditional *Gartenberg* standard nor the market-based *Harris Associates* standard adequately protects investors.

Johnson recommends that the court should maintain but modify the *Gartenberg* standard to further the goal of congress. Her recommended modification is that the *Gartenberg* tests allow comparisons to institutional investors’ fees and eliminate profit penalties. She believes that this incorporates market forces into the fiduciary duty standard by introducing a proxy for fairness and encourages efficiency. She rejects, however, *Harris Associates* reliance on the market that incorporates market forces into the fiduciary duty standard by introducing a proxy for fairness.

5.12 CONTROLLING ADVISORY FEES

There is a perspective that competition in the mutual fund market has not protected investors from excessive advisory fees¹⁵³⁴. Review of mutual funds suggests

¹⁵³³ Johnson, *Ibid.*, p. 145.

¹⁵³⁴ See for example Freeman and Brown, *supra* note 1102.

that there is considerable price dispersion despite a general lack of differentiation amongst products and services¹⁵³⁵. If the mutual fund were truly competitive, less price dispersion would be expected since advisory services would tend to cluster around a mean value since advisors could not charge advisory fees that were much higher than the cost of providing portfolio management services¹⁵³⁶.

Michael Porter writes “Competition in an industry continually works to drive down the rate of return, or the return that would be earned by the economists “perfectly competitive” industry. This competitive floor, or “free market” return is approximated by the yield on long-term government securities adjusted upward by the risk of capital loss”¹⁵³⁷. The high price dispersion in the mutual fund industry suggests that the prices in the industry are not strongly governed by competition or the price would have been driven down to the competitive floor. Further, the high profits in the mutual industry suggest that the prices have not been driven down to a competitive floor. If the price for retails investors was governed strongly by competition, it would have been driven to a common a common rate of risk adjusted return.

Davis¹⁵³⁸ suggests the application of a penalty default mechanism in advisory contracts as a mechanism for controlling advisory fees. This penalty default, Davis

¹⁵³⁵ Bogle, *supra* note 149.

¹⁵³⁶ Wallison, P. J., & R. E. Litam, (2007). *Competitive Equity: A Better Way to Organize Mutual Funds*, The AEI Press.

¹⁵³⁷ Porter, M. E., (1980). *Competitive Strategy Techniques for Analyzing Industries and Competitors*, The Free Press, New York, United States, p. 5.

¹⁵³⁸ Davis, *supra* note 1247.

posits, would force advisors to negotiate with independent directors of mutual funds in order to avoid a contract with low fees. Further, by requiring investment advisors to negotiate with mutual fund directors, for a penalty default rule will compel advisors to disclose fee related information that they have generally not disclosed to date. Freeman and Brown ¹⁵³⁹ have noted that investment advisory firms have generally refused to produce data concerning the costs associated with providing their services which makes it virtually impossible to evaluate their profitability. The Investment Company Act requires that investment advisors provide independent directors whatever information that they require in order to evaluate the advisory service. In practice, however, they have been reluctant to provide information related to their costs.

Davis¹⁵⁴⁰ also indicates that a penalty default rule set against the investment advisor will result in the desired state of arm's length bargaining, which does not exist in the majority of mutual fund boardrooms, by forcing an investment advisor to reach a negotiated fee structure with the independent directors of a mutual fund. Davis suggests that a statutory – mandated or rule-mandated low level of advisory fee would give the investment advisor no choice to come to the bargaining table to negotiate with the mutual funds independent directors. In order to avoid the default rule, according to Davis, also increases the likelihood that the advisor will offer concessions with regard to its fee structure to avoid the default outcome of low fees.

¹⁵³⁹Freeman and Brown, *supra* note 1102, p. 131.

¹⁵⁴⁰ Davis, *supra* note 1247.

Davis suggests that the SEC could require the advisors or independent directors to justify and agree upon any departure from the default, and if the advisor refuses to do so then the default level of advisory fees will be set, resulting in lower advisory fees for the shareholders¹⁵⁴¹. The default penalty mechanism, proposed by Davis involves benchmarking to establish the default advisory fees at a level that is unfavourable for advisors, which would force advisors to produce cost information to justify high level of fees.

Freeman and Brown¹⁵⁴² proposed that the SEC use its rulemaking authority to grant mutual fund shareholders a 'most favoured nations' treatment, which would forbid investment advisors from charging more for portfolio services than they charge pension funds and other institutional investors for comparable services. The SEC did not adopt Freeman and Browns proposal. Freeman et al subsequently urged its adoption, stating "The time has come for fund directors to demand that fund advisors give shareholders a 'most featured nations' treatment for advisory fees."¹⁵⁴³

Davis¹⁵⁴⁴ proposes that the SEC convert Freeman and Brown's "most favoured nations" pricing policy into a penalty default rule. Under this regime each investment advisor would have their own default determined by the amount the advisor charges institutional investors for its advisory services. Again, this would stimulate disclosure

¹⁵⁴¹ Ibid.

¹⁵⁴² Freeman and Brown, *supra* note 1102 p. 661.

¹⁵⁴³ Freeman et al, *supra* note 1242, p. 150.

¹⁵⁴⁴ Davis, *supra* note 1247.

since investment advisors would need to provide additional cost information to demonstrate why they could not provide comparable investment advice for the same price that they charge institutional investors. In addition, investment advisors would presumably need to produce profitability as well as cost data to justify why managing mutual fund portfolios requires higher advisory fees than pension fund portfolios. The penalty default mechanism proposed by Davis would also encourage the more informed investment advisor party to reveal information to the less informed investor party which would facilitate increased investor knowledge. Davis further suggests that the SEC could require the mutual fund prospectors to include discussion of any decision that constitutes a departure from the default.

In the United States, a mutual fund prospectus must include:

- the nature, extent, and quality of services to be provided by the investment advisors;
- the investment performance of the fund and the investment advisor;
- the costs of the services to be provided and the profits to be realized by the investment advisor and its affiliates from the relationship with the fund;
- the extent to which economies of scale would be realized as the fund grows;

- whether fee levels reflect those economies of scale for the benefits of fund investors¹⁵⁴⁵.

These criteria are consistent with *Gartenberg* analyses by the U.S. Courts¹⁵⁴⁶. A further advantage of the penalty default mechanisms is that it encourages cooperation between the mutual fund's independent directors and investment advisors. This mechanism does also not involve the SEC acting directly to regulate advisory fee rates. Specifically, Congress in Section 36(b), indicated that it did not decide to regulate mutual fund advisory fees, stating "[Section 36(b)] is not intended to introduce general concepts of rate regulations as applied to public entities"¹⁵⁴⁷. Instead, it was envisioned by Congress that the mutual fund independent directors regulate the fees that advisors may charge. In *Burks V. Laster*¹⁵⁴⁸ the court stated "Congress[s] purpose in structuring the [Investment Company] Act as it did is clear. It was designed to place the unaffiliated directors in the role of independent watchdogs, who would furnish an independent check upon the management of investment companies. Palmiter also indicated that Congress delegated the negotiation of advisory fees to mutual funds' board of directors."¹⁵⁴⁹ Ford argues that new cooperative governance models of regulation can shift traditional

¹⁵⁴⁵ *Disclosure Regarding Approval of Investment Company Contracts by Directors of Investment Companies*, Investment Company Act Release No. 26,486 Fed. Sec. L. Rep. (CCH) 87,332, at 80, 632 (June 23, 2004).

¹⁵⁴⁶ See *Krinsk v. Fund Asset Management Inc.*, 875 F. 2d 404, 409, 2d cir. 1989) citing *Gartenberg v. Merrill Lynch Asset Management* 694 F.2d 923, 929-30 (2d Cir. 1982).

¹⁵⁴⁷ S.Rep. No. 91-184, at 6 (1969).

¹⁵⁴⁸ 441 U.S. 471, 484 (1979).

¹⁵⁴⁹ Palmiter, A. R., (2006). The mutual fund board: a failed experiment in regulatory outsourcing, 1 *Brooklyn Journal Corporate Financial & Commercial Law* 165, 165.

adversarial processes to collaborative reform¹⁵⁵⁰. The penalty default mechanism would serve to honour the degree of interaction and potentially cooperation between mutual fund advisors and boards of directors. It should be recognized that these mechanisms would continue to be subject to the affects of directors being close to mutual fund advisors and approving higher fees than at arm's length bargaining due to a close relationship.

5.13 DISCUSSION

Canada has notoriously high management expense ratios. Canadian MERs also include trailer fees which are fairly specific to the Canadian market. These trailer fees 'cover' the expense and commissions for the professional advisor. Trailer fees are a significant contributor to the higher fees in Canada. The direction of Canadian investors to funds with higher trailer fees may be considered to be a result of advisors seeking to maximize their fees, since there is no indication that higher fund fees produce higher financial returns for mutual fund unit holders. Clearly, fees are an important area for regulation in the mutual fund industry, which has not been adequately addressed in Canada to date. Although Canada has the highest expense ratios globally this was not addressed as part of the recent regulatory changes in Canadian mutual fund governance. The preceding analysis has clearly demonstrated that Canada has among the highest fees and expenses globally. Therefore, the development of a mechanism for investor protection within the Canadian mutual fund governance regime is warranted.

¹⁵⁵⁰ Ford, C. L., (2005). Toward a new model for securities law enforcement, 57 *Administrative Law Review* 757, 821-822.

At the time of mutual fund scandals there was concern over the fees that investors pay for their mutual funds and whether they were receiving value for their money. Without the result of analysis in the Globe and Mail ROB report, investors would not have known that an average 25 percent of their total returns were used to cover advisory fees. The reason that this is significant is that it demonstrates that there were issues with high fees at the time of the mutual fund scandals and that this should have become a focus for Canadian regulators in order to create rules for investor protection from excessive advisory fees. Instead, the Canadian regulators focussed on addressing conflicts of interest through the introduction of an independent review committee rather than a governance body that could protect investors from excessive fees and expenses.

I note that while Canadian securities regulators did introduce additional disclosure mechanisms these simply disclosed management expense ratios and not, for instance, the amount of investor returns that were consumed by advisory fees. Further, this eventually culminated in a simplified document that provided limited information to investors and allowed mutual funds to provide this after investors purchased the mutual funds. I suggest that Canadian securities regulators were focussed on addressing the issues of the time associated with the mutual fund scandals, related to late trading and market timing rather than excessive fees, resulting in a gap in investor protection in the Canadian mutual fund governance regime.

The results of my analysis of excessive fee litigation in United States indicate that there has not been a successful action by the plaintiff, with one case resulting in a

settlement. The primary issue with the actions has been that the onus is on the plaintiff to prove that the fees are excessive and that this constitutes a breach of fiduciary duty. The difficulty with the plaintiff proving this is that there is not standardized methodology for the calculation of advisory fees as a portion of the expense and no standardized methodology for determination of profitability. In addition, the plaintiffs are not able to accurately calculate these values because this information is not disclosed, since the SEC has no requirements for its disclosure. Accordingly, there is no way that the plaintiffs or their experts would be able to demonstrate that the advisory fees were too high since they would not have the required data to do so, while the fund manager or investment advisor has this data available to justify that its fees were not excessive. The end result is that the Investment Company Act, the primary means for action by investors in excessive fee litigation in the United States is essentially non functional with respect to being a remedy for excessive fees in U.S. courts.

The responses of the SEC to the mutual fund scandals resulted in the introduction of the requirements for independence to address conflicts of interest associated with late trading and market timing activities, and not excessive fees and did not involve a modification for investor protection against excessive advisory fees.

There is currently no comparable mechanism in Canada comparable to Section 36(b) of the Investment Company Act that would allow for investors to launch an excessive fee challenge. This should be rectified since it is inadequate investor protection not to have a legal mechanism for investor protraction from excessive advisory fees. In

addition, Canadian securities regulatory should require the disclosure of the information that would allow for a determination of excessive advisory fees that would prevent the issues associated with plaintiffs not being able to demonstrate that their advisory fees were excessive as has been experienced in the United States.

The fiduciary duty of directors on mutual fund company boards in Canada should be extended to include a fiduciary duty to their unit holders that fees are not excessively high. This should include a comparison of fees between retail investors and institutional investors to ensure that retail investor fees are not excessively high in comparison. Further, this fee comparison could involve a 'penalty default mechanism' or a 'most favoured nations approach' where investors pay the lowest of the fees in a comparison within fund classes.

The results of my comparative analysis support the results of the analysis of global mutual fund expenses, based on the results of the Morningstar study, which indicate that Canadians pay among the highest mutual fund expenses globally. From these analyses I conclude that Canadian mutual fund investors pay among the highest expenses globally and significantly more on average than investors in the United States.

I suggest that there is another possible reason that the MERs are higher in Canada than in the United States. I suggest that there is a potential that Canadian fund advisors are simply charging higher fees thereby achieving higher profits. Without a correlation between costs and profits with fees and expense ratios it is not possible to discount this. I therefore recommend that a detailed study is conducted by Canadian securities regulators to determine why Canadians pay

the highest advisory fees in the world¹⁵⁵¹ and introduce investor protection measures to ensure that Canadians no longer pay advisory fees that may be considered to be excessively high. The current regulatory regime for mutual fund governance relies largely upon disclosure as a governance mechanism. This governance mechanism is not effective since the outcome is that mutual fund investors in Canada pay among the highest fees in the world and roughly fifty percent more than investors in the United States in a comparable segment of the North American mutual fund industry. Accordingly, a focus must be placed by the securities regulators upon developing an investor protection governance mechanism for the high mutual fund expenses in Canada. It should be recognized that disclosure and education on its own will not address conflicts of interest in the Canadian mutual fund industry will not mitigate against improper motives, practices and unjust enrichment. It is recommended in this dissertation that a fund board with a fiduciary duty to investors should be established to address conflicts of interest related to high expenses and fees.

The recent revisions to the Canadian mutual fund governance regime focused on the IRC and centered on addressing conflicts of influence rather than high investment advisory fees. In addition, the IRC has significantly less scope and power than independent directors in the U.S. since it is focused solely upon conflicts of interest. As such, the Canadian IRC governance mechanism has significantly less 'teeth' than its U.S. counterpart. Canada should adopt a fund board style of corporate governance mechanism for the mutual fund industry comparable to that in the United States.

¹⁵⁵¹ Of the companies in the Morningstar study.

The SEC received a leadership obligation from Congress when the Investment Company Act of 1940 was enacted. The SEC has the ability to assume leadership and exercise its authority to initiate price competition by improving the degree and quality of mutual fund fee disclosure. In Canada, there is not a comparable regulation to Section 36(b). If such a regulation were to be introduced it would be important to provide for a comparative framework to allow for a determination of what represent an "excessive fee" relative to the range of fees in the free market. This could be the "most favored nation" concept of Freeman and Brown to ensure that mutual fund investors receive fair advisory fees.

I recommend that the securities regulators develop a framework that protects shareholders from excessive management fees, by imposing a fiduciary duty regarding compensation on investment advisors, comparable to Section 36 (b) to the Investment Company Act. Canadian securities regulators should also provide a framework for calculating whether fees are excessive, in court challenges, including the provision of required information in order to avoid the pitfalls experienced in the United States that resulted in a lack of investor protection under the Gartenberg test. I suggest that it is an appropriate role for securities regulators to set the allowable trailer or maximum expense levels given that Canadian mutual fund investors pay the among the highest expenses globally. This has not occurred in the United States and Congress explicitly rejected the regulation of the expenses and fees using a reasonableness test and instead placed a fiduciary duty upon advisors. I do suggest, however, that it is appropriate for Canadian

Securities regulators to introduce a requirement for fund boards for investor protection, comparable to the fund boards in place within the United States.

I recommend that the fiduciary duty of independent directors should be extended to include excessive advisory fees and not simply having this as a primary mechanism to excessive fee challenges as in the United States. I recommend that fund board be established in Canada similar to those established in the United States and that the fiduciary duty of independent directors in these boards includes assurance that the mutual fund investors are not paying excessive advisory fees. I also recommend that the fiduciary standard in Canada be adopted by directors of fund boards to protect investors from excessive advisory fees. Firstly, a fund board governance mechanism must be adopted by mutual fund companies as in the United States, with a majority of independent directors. I recommend that a comparison be made with the fees paid by institutional investors in a determination of whether mutual fund fees are excessive in the event of a court challenge in Canada.

High trailer fees are significant contributor to the high expenses paid by Canadian mutual fund investors and could represent as much as 1 percent of the MER. I therefore recommend that Canadian securities regulators place an appropriate cap on trailer fees in the Canadian mutual fund governance regime. It is recognized that there is currently insufficient information to place a reliable cap on trailer fees and that an appropriate cap would require a comprehensive study as part of a program involving Canadian securities regulator, mutual fund industry participants, the public and other parties such as the legal

scholars and professionals. An appropriate fee cap should be set at a level which allows the required services to be provided to investors while at the same time not over charging investors or charging investors for services they do not receive. The fee cap should be utilized to set a cap on the expenses paid by Canadian mutual fund investors.

6.0 CONCLUSIONS AND RECOMMENDATIONS

The following conclusions and recommendations are provided based on the results of my dissertation.

6.1 CONCLUSIONS

- 1) Mutual funds are an important investment vehicle for Canadians and represent an area of employment for many workers. In 2012 the net sales were \$2.29 billion and year-to-date net sales were \$26.6 billion. The total assets under management for August were \$811. 7 billion and account for 30% of Canadian's financial wealth. The Canadian mutual fund industry is continuing to grow and from August 2011 to August 2012, the total assets increased by \$33.1 billion or 4.3%. The mutual fund industry is also a significant source of employment in Canada, currently employing more than 90,000 workers. Since the mutual fund industry is so important to Canada, it is important that the Canadian securities regulations provide adequate investor protection and ensure the continued growth of the industry.

- 2) Recent changes in mutual fund governance in Canada, involving enhanced disclosure and the requirement for an Independent Review Committee (IRC), were initiated in response to mutual fund scandals in both Canada and the United States and did not address investor protection from high advisory fees. Investor protection from excessive advisory fees must be introduced in the Canadian mutual fund governance framework, in particular since Canadians pay high expenses and advisory fees in a global context and in a North American context.
- 3) The existing disclosure mechanism under NI 81-106 in Canada is not effective because investors do not fully understand the information being disclosed. The root cause for this is that an effective program of public involvement, participation and education has not yet been implemented in Canada. Investors have not had meaningful involvement in the development of the new rules other than the public comment process on draft rules which they did not actively participate in as evidenced, for example, by the low public participation in the Point of Sale process. As a result, disclosure is an effective governance mechanism for investor protection. In addition, disclosure is not a substitute for a legal mechanism for excessive fees challenges such as that in place within the United States under the Investment Company Act.
- 4) The Independent Review Committee (IRC) falls short of the governance agency contemplated by the Canadian securities regulators' Concept Proposal and recommendations in the related reports commissioned by these agencies. This was

clearly articulated during the development of the proposed rule, by the public and the media. Gloria Stromberg and Stephen Erlichman who both recommended a fund board such as that in place within the United States. Despite these strong negative comments the Canadian securities regulators decided to adopt and implement the IRC. The mutual fund industry was largely in favour of the IRC, as would be expected, since this did not require modification of the board with independent directors as was occurring in the United States that could have an impact on management, but rather a relatively small committee with no authority and “no teeth”.

- 5) The IRC has no decision-making authority and can only bring possible conflicts of interest to the attention of the board and the board then makes a decision on their course of action. The conflict of interest is required to be disclosed, but this is not done in a way that it receives attention from investors. As such it is an ineffective governance agency in comparison to fund boards, such as those in the United States, which have decision-making authority.
- 6) Canadian investors pay among the highest expenses worldwide based on the results of numerous studies. The magnitude of these high expenses is exemplified by Canada receiving a failing grade in global rankings of mutual fund industries- the only country to do so. Canadian investors were paying amongst the highest expenses worldwide at the time of the mutual fund scandals and Canadian securities regulators chose not to pursue this at the time, focussing instead upon

disclosure and conflicts of interest. Securities regulators are now attempting to address high fees through a disclosure approach as part of the Point of Sale project, but in the interim 5 years or more, investors have continued to pay the highest mutual fund fees in the world detracting significantly from their investments.

- 7) Academic studies have not identified a definitive relationship between sustained high past performance and future high performance. It stands to reason that there is therefore no reason why investors should pay consistently higher advisory fees on the basis of past performance, if this does not relate to the current performance that they are receiving, or to future performance. Further, high expenses and associated advisory fees detract from performance and actually may result in performance that is lower than stock market benchmarks. I conclude based on the literature review that there is no justification for Canadian investors paying high fees to advisors on the basis of persistent performance.
- 8) Despite the fact that Canadians pay among the highest expenses in the world, there is currently not a mechanism in the existing Canadian mutual fund governance regime to protect investors from excessively high advisory fees. One of the significant contributing factors to these high expenses is 'trailer fees' which are designed to compensate advisors for their services. These trailer fees are estimated to account for a significant portion of expenses charged to Canadian mutual fund investors.

- 9) There has been no evaluation to date by Canadian securities regulators as to whether the use of trailer fees adds value to investors. In the United States, comparable 12b-1 fees do not enhance performance and Canadian trailer fees have been estimated to be roughly double 12b-1 fees. I suggest that there is at least some uncertainty as to whether trailer commissions in Canada will increase mutual fund performance and add value to investors and that Canadian securities regulators should undertake a study to determine if trailer fees should be permitted and if so at what levels. This is, of course, of particular importance since Canadians pay among the highest mutual fund expenses globally and trailer fees are a significant contributor to these high expenses. In the United Kingdom, trailer fees have been banned and it is not clear why this is not being considered in Canada.
- 10) While Canadians pay amongst the highest expenses and advisory fees worldwide, there is currently not an effective mechanism for protection from excessive fees in Canada. There is currently a proposal underway as part of the Point of Sale process that would require the disclosure document *Fund Facts* to disclose key financial metrics. The information in this disclosure document was largely previously provided in the prospectus and the main advantage to the investors may be that it is a simplified format. It should be recognized that this simplified format is actually a disadvantage for those investors that would prefer more detailed information than is in the prospectus. Under the current Point of Sale process, the fund manager is no longer required to deliver the prospectus to the

investor, but instead provide this to the securities regulators who will retain this on file, and the prospectus is available to the investor upon request. This process results in one more step of distance of investors from key information on the mutual fund.

- 11) The Point of Sale (POS) process favours industry because they do not have to provide the prospectus to investors 'up front' at the time of sale and as a result favourable comments on this process were received from industry during the comment period. In addition, the *Fund Facts* document is not required to be provided at the point of sale, but instead only within 48 hours after the sale, and investors have are therefore not actually entitled to point of sale disclosure. There is concern from investor advocates that investors are in fact losing their rights to point of sale disclosure and the onus would be on investors to cancel the transaction following the purchase rather than possess a right to cancel the sale. The mutual fund industry is in favour of this process since it places the onus on the investor to cancel and removes their previous rights to have the sale cancelled.
- 12) It is not clear how securities regulators expect investors to make informed investment decisions using the proposed POS process if they are receiving the relevant fund information after the sale. Given that this proposed process no longer involves point of sale disclosure, but rather allows for disclosure the program, if adopted as is, may be more appropriately entitled the "non point of sale disclosure" program so that investors are aware of what they are giving up if

this regulation is adopted as proposed, and to ensure that the title accurately describes the actual process. This process also places the onus on investors to read, absorb and understand the information in a relatively short time after the sale and then if they choose not to proceed with the purchase, they must cancel the order.

- 13) The proposed Point of Sale disclosure mechanism is not an effective mechanism for investor protection as proposed. It does not adequately address the fundamental issue that Canadian investors pay among the highest mutual fund expenses globally, and fails to address this issue in the current version of the rule. Additionally, the current Point of Sale (POS) proposal includes allowance of trailer fees which are a contributing factor to the Canadian investors paying the highest expenses worldwide. As this is a fundamental starting point for the development of a rule that protects Canadian investors from the current state of the high expenses and fees, I recommend that the current process of the rule be reinitiated from the beginning to ensure that an effective disclosure mechanism is developed to contribute to investor protection from high fees and expenses.

- 14) The disclosure mechanism in Canada, while technically sound, is not effective because investors do not fully understand the information being disclosed and because they were not actively involved as part of a public participation program in the development of the rules. The root cause for this is the lack of an effective public education, public involvement and public participation program. The

responsibility of public involvement and participation in the development of rules, such as national instruments, rests squarely on the shoulders of Canadian securities regulators who have a responsibility to the public in this regard. The proposed national instruments 81-106 and 81-107 and the Point of Sale (POS) project have all been characterized by a low degree of public involvement for example limited to a request for comment process with a low number of public responses. Instead of recognizing this lack of public involvement and participation and taking steps to rectify this, the securities regulators forged ahead with the program leaving the public largely uninvolved and unaware.

15) A fund board should be implemented in the Canadian mutual fund industry, comparable to the fund boards in the United States. This fund board would have a fiduciary duty to act in the mutual fund investors' best interests and represent a primary mechanism for investor protection against high expenses and fees. The fund board could be established independently from the IRC or be structured to include the IRC.

16) The development of the regulatory framework for mutual fund governance has not had adequate public consultation and has been limited to largely request for comments on the Concept Proposal and proposed national instruments. Responses to the requests for comments were largely from industry mutual fund companies, which dominated the process, and not strong public involvement. The Canadian mutual fund governance regime could be enhanced through the

development of public involvement, participation and education programs that are linked, with more meaningful participation of investors in the rule development instead of responding the request for comments.

6.2 RECOMMENDATIONS

- 1) A 'fund board' governance mechanism should be adopted as a 'governance agency' for the Canadian mutual fund industry, comparable to fund boards in the United States. I further recommend that this fund board be comprised of a majority of independent directors.
- 2) The fund board that I recommend be established in Canada, should have a fiduciary duty for investor protection from excessive mutual fund expenses and fees, comparable to that in the United States in Section 36 (b) of the Investment Company Act of 1940. The fiduciary duty should be extended to include investor protection from excessively high fees and expenses.
- 3) Canadian securities regulators should provide a framework for calculating whether fees are excessive, in court challenges, including the provision of required information in order to avoid the pitfalls associated with the inability of the plaintiff to prove that fees are excessive, as experienced in the United States, that resulted in a lack of investor protection since there has been only a single case where the plaintiff investor was successful in an excessive fee challenge.

- 4) A comparison with pension fund fees should be permitted when evaluating whether mutual fund fees are excessive. This could involve a 'penalty default mechanism' or a "most favoured nation" approach to ensure that retail mutual fund investors receive fair advisory fees in comparison with institutional investors.
- 5) A study of whether the use of trailer fees increase the performance of Canadian mutual fund investments should be conducted by the securities regulators to determine whether these charges should be permitted in the future.
- 6) Consideration should be given to banning trailer fees in Canada, as has recently been done in the United Kingdom, should the results of the above recommended study indicate that they detract from performance and do not provide value to mutual fund investors.
- 7) The current process of the development of the Point of Sale (POS) process should be suspended and reinitiated from the beginning, since this has not had sufficient public participation and involvement, to ensure that an effective disclosure mechanism is developed that will ensure investor protection from high fees and expenses.
- 8) An appropriate cap on mutual fund expenses and fees should be established by the Canadian securities regulators to protect investors from high fees and expenses,

based on a comprehensive study as part of program involving the mutual fund industry, the public and other relevant stakeholders.

- 9) An enhanced program of public involvement, participation and education should be conducted in Canada to enhance investor protection such that disclosure is an effective governance mechanism. This program should include increased involvement and participation of investors in the development and implementation of mutual governance mechanisms such that it meets their needs.

**APPENDIX A - GLOBAL COMPARISON OF TOTAL EXPENSE RATIOS FOR
FIXED INCOME, MONEY MARKET AND EQUITY FUNDS.**

	Fixed Income (%)	Total Expense Ratio (TER) Money Market (%)	Equity (%)
Australia	< 0.75	0.90 – 1.29	1.00 – 1.49
Canada	1.25 – 1.49	0.40 – 0.89	2.00 – 2.50
China	< 0.75	0.40 – 0.89	1.00 – 1.49
France	0.75 – 0.99	0.40 – 0.89	1.00 – 1.49
Germany	0.75 – 0.99	0.40 – 0.89	1.50 – 1.99
Hong Kong	1.25 – 1.49	0.40 – 0.89	1.50 – 1.99
Italy	0.75 – 0.99	0.40 – 0.89	1.50 – 1.99
Japan	0.75 – 0.99	< 0.40	2.00 – 2.50
Netherlands	0.75 – 0.99	< 0.40	1.50 – 1.99
New Zealand	1.00 – 1.24	0.40 – 0.89	1.00 – 1.49
Singapore	1.25 – 1.49	< 0.49	1.50 – 1.99
Spain	0.75 – 0.99	0.90 – 1.29	1.50 – 1.99
Switzerland	0.75 – 0.99	0.40 – 0.89	1.50 – 1.99
Taiwan	1.25 – 1.49	< 0.40	1.50 – 1.99
United Kingdom	1.00 – 1.25	0.40 – 0.89	1.50 – 1.99
United States	< 0.75	0.40 – 0.89	< 1.00

Note: Source: Global Fund Investor Experience Morningstar Fund Research, May 2009

APPENDIX B - SUMMARY OF GLOBAL FUND PROSPECTUS PRACTICES IN THE MUTUAL FUND INDUSTRY

Australia	In Australia, a fund investor must be provided a prospectus before a fund purchase. Fund companies are required to publish a full prospectus but are not obligated to provide a simplified version. Some companies voluntarily provide a simplified prospectus, and there is a broad movement in the industry to consider this mandate. There is a comprehensive list of fees in the fund's Product Disclosure Statement (PDS). A numerical example that illustrates the total expenses an investor could expect to pay on an investment is available. The standardized example is based on a balance of \$50,000 and a \$5,000 contribution during the year. The contribution fee (for example, \$0 to \$200) and the management fee (for example, \$800) are shown, and a total amount is provided. The ASIC <i>Disclosure of Fees and Charges for Superannuation and Managed Investment Products</i> guideline requires uniform representation of fees and expenses with the intention of allowing investors to easily compare one fund to another. In regard to portfolio-manager information, the manager name and tenure are not listed in the prospectus.
-----------	---

Canada	After an investor agrees to buy a mutual fund, he or she must be supplied a simplified prospectus within two business days. The simplified prospectus is more concise and easier to read than the complete prospectus. The simplified prospectus contains information on the fund company, fees and expenses, optional services, investor-related information, and specific information on the fund, including objective and strategies, top 10 holdings, distribution policy, financial highlights, past performance, and risk. The content of the simplified prospectus is standardized so an investor can easily compare funds. In addition, funds are required to publish a more detailed prospectus that contains the financial statements of the mutual funds. A fund's prospectus and Management Report of Fund Performance (MRFP) outline the management expense ratio (MER), the day-to-day expense of managing the fund. MERs are reported as all-inclusive, meaning all fees, costs, and sales taxes are reported as the fund's total MER. In addition, the MRFP contains the MERs for the past five years. Brokerage commissions and other trading fees are not included in the MER; however, these costs are reported as a trading expense ratio, which can be found in the MRFP. The trading expense ratio is the total commission and other portfolio transaction costs expressed as an annualized percentage of daily average net assets during the period of the annual
--------	--

	report. The CSA requires all mutual funds to publish standardized fee disclosures in the prospectus. This includes a numerical example that illustrates the total expenses that an investor can expect to pay on an investment. Portfolio-manager information can be found in the Annual Information Form (AIF), a supplemental document to the prospectus. The portfolio manager's name is always published, and sometimes the tenure of the portfolio manager will also be available. AIFs are available on SEDAR.
China	In China, fund companies are required to publish both a simplified and a full prospectus, and fund investors must be provided one of these documents before they can make a purchase. The simplified prospectus is somewhat simpler than the full prospectus, but it is still long and difficult to read. In both the simplified and full prospectuses there is a comprehensive list of fees. A numerical example that illustrates the total expenses an investor could expect to pay on an investment is not available in the simplified or full prospectus. There is no uniform fee disclosure that would allow an investor to easily compare one prospectus to another. In regard to portfolio-manager information, fund companies are required to disclose the manager name

	and tenure in the prospectus. Also disclosed are the manager's education and brief biography.
France	In France, funds are required to publish a comprehensive prospectus as well as a simplified one. Prospectuses are available on a centralized Web site run by the AMF. The simplified prospectus has two parts: Part A – a “legal” section that describes legal aspects and operations; and part B – a “statistics” section that provides quantified data about the performance, fees and charges, portfolio turnover, and proportions of transactions carried out with companies in the same group. In France, funds can elect to use a “free-form” simplified prospectus. This must be made available to all investors and should be a simple investment strategy in which exposure to different types of risks is stable and the risk profile is easy to understand. The free form has the same requirements as the regular simplified prospectus but allows for flexibility in the placement of sections and the naming of headings. Per the AMF, the free-form simplified prospectus must be: clear and balanced; contain no advertising or pure marketing material; and the information must be equivalent to the mandated requirements for the simplified prospectus. The comprehensive prospectus and the simplified prospectus

	contain a complete listing of fees and sales charges. There is, however, no numerical example that illustrates the total expenses that an investor could expect to pay on an investment. There are percentages available but no dollar value example. Portfolio-manager information and tenure are not available in any of the required publications. Performance is considered to be part of a team-managed environment, so the publication of individual manager names is not encouraged.
Germany	In Germany, fund investors must be provided a simplified prospectus before they can make a purchase. The fund must also provide a full prospectus to the investor if requested. In the simplified prospectus, there is a comprehensive list of fees. However, the calculation of the total expense ratio (TER) can vary from fund company to fund company. The fund may publish TER including performance fees or excluding performance fees. A numerical example that illustrates the total expenses an investor could expect to pay on an investment is not available in either the simplified or full prospectus. The BVI requires members to publish TER figures, but many international fund shops operating in Germany have not joined the BVI. Because of the lack of standardization in the calculation of TER, there

	is no uniform fee disclosure that would allow an investor to easily compare one prospectus to another. In addition, no disclosure of historical TER is required. In the past, funds were required to calculate a transaction cost ratio. This was a ratio between the costs of the purchase and sale of the fund assets and the net asset value. Currently, the transaction cost ratio is no longer a requirement. Now the requirement is that the fund company applies adequate measures to avoid discriminating against investor interests by transaction costs. Therefore, no trading cost information is available to the investor. In regard to portfolio-manager information, there is no consistency in the availability of manager name and tenure; nor are there any requirements that this information be published.
Hong Kong	In Hong Kong, the regulation does not require that sale of mutual funds be accompanied by an offering document (prospectus) if a specific subset of the required disclosures in an offering document is provided. Fund companies are required to publish an offering document but are not obligated to provide an abridged version. There is a comprehensive list of fees. A numerical example that illustrates the total expenses an investor could expect to pay on an investment is not available. There is no uniform presentation of fees and

	expenses that would allow an investor to easily compare one prospectus to another. In regard to portfolio-manager information, the manager's name and tenure are not available.
Italy	In Italy the prospectus is divided into three parts. The first part contains all the generic data about the fund, the strategy, benchmark, and current costs. The second part contains all the historical data, including costs and fees paid by the fund as well as the risk associated with the fund; returns; and portfolio turnover. The third part contains other information on the fund. Fund companies in Italy are required, in addition to publishing a full prospectus, to publish a simplified version. The simplified prospectus consists of part one and part two of the full prospectus. Consob requires all mutual funds to publish standardized fee disclosure in the prospectus. This includes a numerical example that illustrates the total expenses that an investor can expect to pay on an investment. Portfolio-manager information is not readily available in Italy. Only the chief investment officer will be listed in the prospectus. There are no regulatory requirements for disclosing portfolio managers.
Japan	In Japan, the regulation requires that distributing companies and mutual funds deliver a prospectus to investors in advance or at the same time as

	the sale of mutual funds. Fund companies are required to publish a full prospectus and an abridged version, but the abridged version is lengthy and difficult to read. There is a comprehensive list of fees in the prospectus. A numerical example that illustrates the total expenses an investor could expect to pay on an investment is not available. There is uniform presentation of fees and expenses, and an investor can easily compare one prospectus to another. In regard to portfolio-manager information, the managers' names and tenures are not available.
Netherlands	The AFM follows the directives of the European Parliament and of the Council in regard to information contained in prospectuses as well as the format. In addition to offering a full prospectus, funds in the Netherlands must also make a simplified version available. The simplified prospectus is around four pages long and should be less complicated and easier to read than the full prospectus. The prospectus includes a comprehensive list of fees. Fee disclosure is uniform so one can easily compare the fees of one fund to another. The prospectus does not include a numerical example that illustrates

	the total expenses that an investor could expect to pay on an investment. Portfolio-manager information is not available in any disclosure documents in the Netherlands. Both prospectus and shortened prospectus are available on Web sites from fund distributors as well as asset managers.
New Zealand	In New Zealand, fund companies are required to publish both an investment statement (simplified prospectus) and a prospectus. A fund investor must be provided an investment statement before a fund purchase, and the prospectus must be made available upon request. There is a comprehensive list of fees. A numerical example that illustrates the total expenses an investor could expect to pay on an investment is not generally available. There is no uniform representation of fees and expenses. However, all investment statements and prospectuses have “How Much Do I Pay” and “What Are the Charges” sections that clearly outline the entry/exit fees, switching fees, management fee, and trustee fee. Investors can make comparisons across funds even though the information is not presented in a standardized format. In regard to portfolio-manager information, the manager name and tenure are not listed in the prospectus or the

	investment statement.
Singapore	In Singapore, the regulation requires that sale of mutual funds be accompanied by an abridged or full prospectus. Fund companies publish both abridged and full versions of the prospectus, and the abridged document is significantly easier to read and shorter than the full version. There is a comprehensive list of fees, but a numerical example that illustrates the total expenses an investor could expect to pay on an investment is not available. There is no uniform presentation of fees and expenses that would allow an investor to easily compare one prospectus to another. In regard to portfolio-manager information, the manager's name and tenure are not available.
Spain	Funds in Spain are required to publish a complete prospectus whose contents are prescribed by law and must be filed with the CNMV. In addition, funds must publish a simplified version of the prospectus, which is a shorter, easier-to-read version of the complete prospectus. All fees, their amounts and conditions, are to be published in both versions of the prospectus. The fee disclosure is presented in a uniform manner that allows for easy comparison of fees from one prospectus to another. In the case of funds that have historical data available, sometimes a

	quarterly report will be produced that will include information on the fund's past performance and the fund's total expense ratio (TER). The TER includes management and custody fees, external expenses, and other operating expenses. However, this data is not available in the prospectus. In addition, the CNMV publishes TER figures for every Spanish fund on a quarterly basis. There is no numerical example in the prospectus that illustrates the total expenses an investor could expect to pay on an investment.
Switzerland	In Switzerland, the fund company is required to publish a prospectus as well as a simplified prospectus. The simplified prospectus should be concise and easy for the average investor to understand. The prospectus must contain any costs or fees itemized according to those costs charged to the investor and those that are applied to the fund assets. The fee disclosure is standardized, allowing for easy comparison between one prospectus and another. The prospectus does not contain a numerical example that illustrates the total expense that an investor could expect to pay on an investment. Sometimes names and tenures of the portfolio managers are included in the prospectus. Portfolio-manager names are required to be published in the annual report.

Taiwan	In Taiwan, a fund investor must be provided a prospectus before a fund purchase. Fund companies are required to publish a full prospectus but are not obligated to provide an abridged version. However, it is common practice for fund companies to provide an abridged prospectus. There is a comprehensive list of fees in the prospectus, but this list could be expressed in broad categories and may not always itemize miscellaneous costs. A numerical example that illustrates the total expenses an investor could expect to pay on an investment is not available. There is uniform presentation of fees and expenses, and an investor can easily compare one prospectus to another. In regard to portfolio-manager information, the manager's name is listed in the prospectus, but the manager's tenure is not always available.
United Kingdom	The FSA requires funds to publish both a complete prospectus and a simplified version. For UCITS funds, the latter is known as the simplified prospectus, which is a point-of-sale document that is a good summary of the longer prospectus. The FSA spells out in detail the contents of the simplified prospectus, based largely on the specifications in the UCITS directive. Non-UCITS funds may elect to publish a KFD in lieu of a simplified prospectus. In regard to fees, the following information is required for the

	simplified prospectus per the FSA Handbook: disclosure of the TER; disclosure of the expected cost structure; all entry and exit commissions and other expenses to be paid directly by the investor; an indication of all other costs not included in the TER, including disclosure of transaction costs; the portfolio turnover ratio (following a standard calculation set by the FSA); and an indication of the existence of fee-sharing agreements and soft commissions. Fee disclosure is fairly standardized, but the fees can be found in various locations within the prospectus and simplified prospectus, making comparison from one fund company to another difficult. Non-UCITS funds may elect to use the KFD, which does not require the disclosure of a TER. Instead, the KFD requires a “Reduction in Yield” section, which projects the reduction in an assumed level of return over various periods after deducting all up-front and deferred charges as well as ongoing operating costs. Manager name and manager tenure are not available in the prospectus, simplified prospectus, or KFD for U.K. funds. In addition, there is no requirement in the U.K. to notify an investor when there is a manager change.
--	--

United States	The prospectus must be filed with the SEC. The required contents of the prospectus include the following: • Investment strategy – describes the fund’s strategy, risk, and what policies can be changed without share holder approval. • Fees – including sales charges, management fees, and 12b-1 fees. • Performance – three-, five-, and 10-year returns and calendar-year returns. • Management – fund’s investment advisors and the basis for compensation and the names of the fund’s portfolio manager and tenure. A fund may organize the prospectus in any manner it sees fit. However, a few items, including the summary of fund investments, risks, and performance, and the fund’s fee table, may not be preceded with anything other than the cover page or the table of contents
---------------	---

Note: Source, Global Fund Investor Experience, Morningstar Fund Research, May 2009,

APPENDIX 2

Summary of Global Disclosure Practices in the Mutual Fund Industry

Australia	Mutual funds are not required to publish a full and complete disclosure of the portfolio holdings, and fund companies rarely provide this information voluntarily. A soft dollar arrangement is one in which the fund trades with a brokerage firm in exchange for free research, hardware, software, or even non-research-related favors such as entertainment. Soft dollar arrangement is an accepted practice in Australia, and funds with these arrangements are required to disclose them. The regulation in Australia requires that all expenses be disclosed in the Product Disclosure Statement (PDS) and the Periodic Statements. These reports provide the current total expense ratio but do not contain ratios for past years. The cost of trading securities is not disclosed to investors.
Canada	Twice a year the fund is required to publish its financial statement and full portfolio holdings via the annual and semi-annual reports. Annual financial statements must be filed on or before the 90th day after an investment fund's most recently completed financial year-end.

	In addition, a fund must prepare quarterly portfolio disclosure of its top 25 holdings. The portfolio disclosure must be posted on the fund's Web site within 60 days after the quarter end. In regard to soft dollar practices, fund advisors must disclose the "total client brokerage commissions paid by the client during the period reported on," per the CSA. This disclosure is required at least annually. Canadian investment advisors typically buy third-party research through soft dollar arrangements. The MFRP includes disclosure of trading costs and total expense ratios for the last five years.
China	Twice a year the fund is required to publish a full and complete disclosure of the portfolio holdings. The semi-annual report is published within 60 days of the end of the first half of the year, and the annual report is published within 90 days after year-end. In regard to soft dollar practices, there are no disclosure requirements. Soft dollar practices are common in China; each investment manager honors his/her preferred broker for research or entertainment. The calculation of total expense ratio (TER) is not standardized, and funds are not required to show the history of TER next to the current-year figures in the shareholder reports. The dollar amount associated with costs of trading securities within the portfolio is disclosed to

	investors in the semi-annual and annual reports; however, it takes a knowledgeable reader to find this information so it is not easily accessible.
France	Portfolio holdings are disclosed with the annual report, which is published within four months from the end of the period. Only simplified breakdowns of assets are provided, though an investor may request complete portfolio holdings. When an investor requests the complete holdings, the fund company has eight days to comply. In France, the fund is required to publish a total expense ratio (TER), a fund's aggregate expense (excluding transaction costs) as a proportion of assets under management, expressed as a percentage. The fund is not required to publish a historical presentation of the TER. Additionally, transaction costs are disclosed in the prospectus, but are not easy to locate.
Germany	Twice a year the fund is required to publish a full and complete disclosure of the portfolio holdings. The semi-annual report is published within two months of the end of the period, and the annual report is published within four months of the fiscal year-end. In regard to soft dollar practices, there are no disclosure

	requirements. Soft dollar practices are popular in Germany; each investment manager honors his/her preferred broker for research.
Hong Kong	Mutual funds are required to publish a full and complete disclosure of the portfolio holdings in the annual and semi-annual reports. The annual report is published within four months of the end of the fiscal year, and the semi-annual report within two months after the end of the period. Funds are also required to publish movements in holdings since the end of the last accounting period, and the Code allows the manager to determine the most appropriate method of illustrating these movements taking into consideration the nature of the fund. Examples include holdings-movement disclosure by security, sector, country, or security type. A soft dollar arrangement is one in which the fund trades with a brokerage firm in exchange for free research, hardware, software, or even no research-related favors such as entertainment. In the case of Hong Kong, the Code restricts the use to cases where there is demonstrable benefit to shareholders and reasonable execution and brokerage rates. Payments for travel, accommodation, entertainment, and general administrative expenses are not allowed. Disclosure is required in the offering document and annual reports.

	The regulation in Hong Kong requires that all expenses be disclosed in the annual and semi-annual reports. These reports provide the current total expense ratio but do not contain ratios for past years. The cost of trading securities is not disclosed to investors.
Italy	Portfolio holdings are disclosed to investors via the semi-annual and annual reports. In both reports the fund company has to show the portfolios; however, the law requires that the fund publish only the first 50 holdings. Only if the holdings after the 50th represent more than 0.5% of the assets is the fund company required to publish the complete holdings. Full and complete disclosure to Banca d'Italia is required once a year. In Italy there are no soft dollar arrangements (instances where a fund sends trades to a brokerage firm because that brokerage firm will provide free services or tools). The total expense ratio (TER) can be found in the prospectus and is defined as a ratio between operating costs borne by the fund and average asset under management. The operating costs charged on the fund assets include the management fees, administrative costs, bank fees (the fees paid to the bank which acts as the custodian of the fund's assets), distribution fees and other operating expenses. TERs are also published

	in the fund's annual report along with three years worth of TER history if available. Trading costs are not available in any of the fund's required publications. In some cases, the media or fund analyst will try to estimate the trading costs by starting with the turnover ratio of each fund portfolio.
Japan	Mutual funds are required to publish a full and complete disclosure of the portfolio holdings in the annual report. Additionally, some quarterly and monthly dividend funds publish this information twice a year. The annual report is ordinarily published within three months of the end of the fiscal year, and the semi-annual report within three months of the end of the period; however, there is no chronological requirement. A soft dollar arrangement is one in which the fund trades with a brokerage firm in exchange for free research, hardware, software, or even no research-related favors such as entertainment. In Japan, soft dollar arrangements do not exist. The regulation in Japan requires that all expenses be disclosed in the annual and semi-annual reports. These reports provide the current total expense ratio but do not contain ratios for past years. It is common

	practice for mutual funds to disclose the cost of trading securities to investors in the semi-annual and annual reports, expressed in amount format. This information is easily accessible.
Netherlands	In the Netherlands, the fund company is required to publish portfolio holdings twice a year via semi-annual and annual reports. The annual report must be made available within four months of the fiscal year-end of the fund, and full disclosure is required. For the semi-annual report, only partial disclosure is required. There is no consistency to how funds publish their holdings. Some fund companies will publish single share class information whereas others will publish regional or valuation information. In regard to soft dollar practices, fund advisors must disclose these types of arrangements. The typical soft dollar arrangement in the Netherlands is with third-party research. However, even though it is compulsory to disclose these arrangements, in the majority of these instances the fund company will state that it cannot quantify the value of the research it receives. In the Netherlands, the annual report is required to include a total expense ratio (TER) history. It is one of only five countries in the survey that require presentation of historical TER. Trading costs are

	not available in any of the fund's required publications.
New Zealand	Mutual funds are not required to publish a full and complete disclosure of the portfolio holdings, and fund companies rarely provide this information voluntarily. Soft dollar arrangements, in which the fund trades with a brokerage firm in exchange for free research, hardware, software, or even no research-related favors such as entertainment, are an accepted practice in New Zealand. Funds with these arrangements are required to disclose them. The regulation in New Zealand requires that all expenses be disclosed. The prospectus provides the current total expense ratio (TER), but does not contain ratios for past years. The cost of trading securities is not disclosed to investors.
Singapore	Mutual funds are not required to publish a full and complete disclosure of the portfolio holdings in the annual report; however in practice, all funds include this information in the annual report and many do so in the semi-annual report as well. The annual report is published within three months of the end of the fiscal year.

	In regard to soft dollar practices, the CIS Code restricts the use and requires the disclosure of soft dollars received from each broker in the semi-annual and annual reports. A soft dollar arrangement is one in which the fund trades with a brokerage firm in exchange for free research, hardware, software, or even no research-related favors such as entertainment. In the case of Singapore, the CIS Code restricts the use of these practices as follows: “ The manager should not receive soft dollars in the management of the scheme unless the following requirements are met: The soft dollars received can reasonably be expected to assist in the manager’s provision of investment advice or related services to the scheme; ii) transactions are executed on the best available terms, taking into account the market at the time for transactions of the kind and size concerned; and iii) the manager does not enter into unnecessary trades in order to achieve a sufficient volume of transactions to qualify for soft dollars. The receipt of goods and services such as travel, accommodation and entertainment do not fall within the definition of “soft dollars” and is therefore prohibited.” The regulation in Singapore requires that all expenses be disclosed. The CIS Code requires that the annual and
--	--

	semi-annual reports show the total expense ratio (TER) for the period under review and a year ago. The cost of trading securities is not disclosed to investors.
Spain	A fund's complete portfolio holdings are published on a quarterly basis (with a three- to four-month lag) via the CNMV's Web site. With regard to soft dollar practices, there is no disclosure in Spain; however, the use of soft dollars is not a common way of conducting business. The regulation in Spain requires that all expenses be disclosed in the annual and semi-annual reports. These reports provide the current total expense ratio but do not contain ratios for past years. The cost of trading securities is not disclosed to investors.
Switzerland	In Switzerland, the fund company is required to provide full and complete disclosure of portfolio holdings twice a year via the annual and semi-annual reports. With regard to soft dollar practices, there is no disclosure in Switzerland. In Switzerland, the fund is required to publish a total expense ratio (TER). TER is the costs and commission charged on the management of

	the fund. It is calculated as a ratio of total operating expenses over the average net assets of the fund. Total operating expenses include commission charged by fund management, commission charged by the custodian, and other expenses (such as administration costs, portfolio management costs, and distribution costs). The TER is to be calculated over a 12-month period at the close of the annual report and the semi-annual report. The TER is to be calculated including performance-related fees and excluding performance-related fees. Disclosure of historical TER's is not required. Trading cost information (the cost associated with trading securities) is not available to investors; however, a portfolio turnover ratio (PTR) is a required calculation. The PTR is disclosed to provide insight into the additional costs incurred by a fund when buying and selling securities. The PTR is to be calculated over a 12-month period at the close of the annual report and the semi-annual report.
Taiwan	Mutual funds are required to publish a full and complete disclosure of the portfolio holdings in the annual report. It is common practice for equity funds to publish this information quarterly and bond funds semi-annually. The annual report is published within three months of the end of the fiscal year.

	Soft dollar arrangements, in which the fund trades with a brokerage firm in exchange for free research, hardware, software, or even no research-related favors such as entertainment, do not exist in Taiwan. The <i>Self-Regulatory Code of SITCA</i> stipulates that members have written agreements with security brokers stating that kickbacks of commission charges and other interests from security brokers cannot be accepted. The regulation in Taiwan requires that all expenses be disclosed in the annual report. These reports do not contain expense ratios for past years. The cost of trading securities is disclosed to investors in the annual report and is easily accessible. In addition, on a monthly basis, a list of the top five brokerage firms the fund uses is disclosed, and brokerage fees paid to these firms are expressed in both dollar amounts and as percentages of the total brokerage fee.
United Kingdom	In regard to portfolio holdings, a fund company is required to disclose this information twice a year via long-form reports. Funds are required to file a “long-form” report to the regulator (the FSA) and are only required to send this version to shareholders if requested. Although fund companies may send the long-form report to investors by default, many elect to send a “short-form” report, which omits many things

	including the complete portfolio holdings. Prior to 2007, TERs were not required to be disclosed. The FSA, in keeping with the UCITS directive, now requires TER to be included in the simplified prospectus. The simplified prospectus is required of UCITS funds, but non-UCITS funds may elect to publish a KFD instead. The TER is not required to be disclosed in the KFD. Instead, an alternative "Reduction in Yield" table is provided. The FSA defines the TER as "the ratio of the scheme's total operating costs to its average net assets." The TER is to be calculated at least once a year. For specific purposes, it may also be calculated for other time periods. Therefore, there is no required disclosure of the history of the TER. The FSA does state that the simplified prospectus should include a clear reference to an information source where the investor may obtain previous years'/periods' TER figures. Trading cost information is available to investors but is usually buried in the notes section of the prospectus. There is no standardization of trading cost information so fund companies each tend to present this information in their own way.
United States	Sometimes included in the trading costs mutual funds pay to brokerage firms are goods and services not directly related to the trade of a

	security. The fund firms pay for these goods and services through “soft dollars,” or inflated brokerage commissions. For example, a fund company may receive equity research from the brokerage firm as part of its per-share trading fee. The SEC’s stance toward soft dollars is that such payments are permissible as long as the services provided are lawful and appropriate to portfolio-manager performance. Soft dollar arrangements are to be disclosed in the prospectus. As mandated by the SEC, the expense ratio is defined as total operating expenses divided by average total assets. The components of the expense ratio are: 12b-1 fees, management fees, and other operating expenses. The 12b-1 fees represent the annual charge deducted from fund assets to pay for distribution and marketing costs. Management fees represent the annual charge to pay the fund’s management. The TER history is included in this disclosure for comparison. Trading costs are not available in any of the fund’s required publications.
--	--

Note: Source, Global Fund Investor Experience, Morningstar Fund Research, May 2009,

APPENDIX 3

Summary of Global Shareholder Report Practices in the Mutual Fund Industry.

Australia	In Australia, fund companies must publish annual reports. The annual report must be audited by an auditor that is not associated with the asset-management company and published within three months after the fiscal year ends. Fund companies are not required to publish a section on management's discussion of fund performance in the annual report, but it is common practice for funds to provide a performance discussion in a separate format. The detail of this discussion is generally quite basic and could be improved.
Canada	In Canada, a fund is obligated to make its financials available via semiannual and annual reports. These reports are available on the SEDAR Web site. Fund management is required to publish a section on management's discussion of fund performance within the MRFP. The MRFP is an industry wide requirement of securities regulators to supplement the annual and semiannual financial statements of mutual funds. It is released quarterly.

China	As required by the <i>Administrative Measures on Information Disclosure for Securities Investment Funds</i> (CSRC Decree No. 19), the fund manager must complete the annual report and publish the context of the report on the Web sites and the summary of the report in the designated newspaper within 90 days after the end of each year. The financial and accounting report of the annual report must be audited by an independent organization. The semiannual report must be completed and published within 60 days after the end of the first half of each year, and the quarterly report within 15 days after the end of each quarter. In case significant events concerning the fund occur (for example, replacement of fund manager and custodian), an interim report is to be published within two days. Fund companies are required to publish a section on management's discussion of fund performance. These commentaries of the fund's performance are often meaningful and considered to be an important means of communication to shareholders.
France	In France, funds are required to publish both annual and semiannual reports. The semiannual report must include condensed financial statements for the previous half-year, an activity report, and the auditors' report on the limited audit of the financial statements.

	The annual report must include financial statements, as well as a statement that the financial statements have been prepared in accordance with generally accepted accounting principles; a description of any risk or uncertainty; and the auditors' report. In addition a section on management's discussions of fund performance is required.
Germany	In Germany, fund companies must publish annual and semiannual reports that have been audited by an independent third party. These reports must be made available through the Electronic Federal Gazette. Fund companies are not required by law to publish a section on management's discussion of fund performance. However, some funds will publish some commentary that discusses the fund's performance.
Hong Kong	In Hong Kong, fund companies must publish semiannual and annual reports. The annual report must be audited by an auditor that is not associated with the asset-management company. The annual report must be made available within four months after the fiscal year ends, and the semiannual report is required to be published within two months after the period ends. Fund companies are not required to publish a section on the

	management's comments on fund performance in shareholder reports. Not many funds voluntarily provide this information.
Italy	In Italy, a fund is obligated to make its financials available via semiannual reports published within three months from the end of the period and annual reports published within two months from the end of the year. These reports are available on Consob's Web site. Fund management is required to publish a section on management's discussion of fund performance. This is to be published in both the semiannual and annual reports and is sent to Consob to publish on its Web site. The discussion is usually written by the chief investment officer and describes what has happened throughout the year with explanations of the market's impact on the fund's performance.
Japan	In Japan, fund companies must publish semiannual and annual securities reports. The annual report must be audited by an auditor that is not associated with the asset-management company. The annual report must be made available within three months after the fiscal year ends, and the semiannual report must be published within three months after the period ends.

	Fund companies are required to publish a section on the management's comments on fund performance in annual and semiannual reports.
Netherlands	Investment firms are required to provide the AFM with an annual report within four months of the end of the financial year. The report must be reviewed by an independent auditor. The auditor should issue a statement certifying that the report represents a true and fair picture. Access to these reports can be difficult. Most companies make annual and semiannual reports available on their Web sites. There is no central database where an investor can go to find annual report filings. Some fund companies will include a section on management's discussion of the fund's performance, but it is not a requirement. These discussions tend to be fairly generic.
New Zealand	In New Zealand, fund companies must publish annual and semiannual reports. The annual report must be audited by an auditor that is not associated with the asset-management company. Although not required, it is a common practice for fund companies in New Zealand to publish discussions on funds' performance. The detail of this discussion is generally quite basic, however, and could

	be improved.
Singapore	In Singapore, fund companies must publish semiannual and annual reports. The annual report must be audited by an auditor that is not associated with the asset-management company. The annual report must be made available within three months after the fiscal year ends, and the semiannual report is required to be published within two months after the period ends. Fund companies are required to publish a section on the management's comments on fund performance in shareholder reports.
Spain	Funds are required to publish both annual and semiannual reports. The annual report is required to be audited by an independent organization. Fund management is required to publish a section on management's discussion of fund performance as part of the annual and semiannual reports.
Switzerland	The fund company is required to publish an annual report within four months of the financial year-end. Per the IFA, the annual report must contain the following:

- | | |
|--|---|
| | <ul style="list-style-type: none">• Annual audited financial statements• The number of redeemed, newly issued, and outstanding units• Inventory of the assets of the fund• List of sales and purchases• Depositories• Portfolio-manager names• A discussion of economic issues by fund management (discussion of fund performance is not required)• Auditor's report |
|--|---|

The fund company is also required to publish semiannual reports within two months following the end of the first half of the financial year. The semiannual report is to contain the following:

- | | |
|--|--|
| | <ul style="list-style-type: none">• Unaudited financial statements• The number of redeemed, newly issued, and outstanding units |
|--|--|

	• Inventory of the assets of the fund • List of sales and purchases Semiannual and annual reports are to be submitted to the Supervisory Authority, which will keep the report accessible to investors for 10 years.
Taiwan	In Taiwan, fund companies must publish annual and semiannual reports. The annual report must be audited by a certified CPA that is not affiliated with the fund company. The annual report must be filed with the FSC within two months of the conclusion of the fiscal year, and it must be audited and made available to investors within three months after the fiscal year ends. Although not required, it is a common practice for funds to publish a quarterly report. Fund companies are required to publish a section on the management's comments on fund performance in the annual report.
United Kingdom	In the U.K., fund management companies must publish both an annual and a semiannual report. The fund must publish an annual report within four months after the end of the annual accounting period, and a semiannual report within two months after the end of each half-yearly

	accounting period. The annual report should contain the audited annual financial statements. Per the FSA, the following items should be included in the annual report: a statement of total return; a statement of movements in shareholders' funds; a portfolio statement; a balance sheet; a summary of material portfolio changes; a statement of the material accounting policies used in preparing the financial statements; further details in notes to the financial statements; and a distribution table. The semiannual report should be prepared using the same accounting policies and format as the annual report; however, financial statements are not required to be audited. The annual and semiannual reports are required to be made available to shareholders free of charge. A management discussion section is required as part of these reports. These discussions tend to be a macro discussion of what went on in the economy.
United States	The SEC requires funds to distribute both annual and semiannual reports. These reports disclose the financial conditions of the fund as well as the fund's portfolio holdings. Annual reports must be audited by an independent auditor.

	In addition, the SEC requires that funds provide a numerical example showing the cost of expenses. The example presents the cost in dollars of a \$10,000 investment earning a hypothetical 5% return annually. This requirement was intended to provide investors with a basis for comparing the level of current expenses across different fund options. In addition, the SEC requires funds to include a section from management that discusses the fund's performance and the factors that have materially affected the fund's performance during the fiscal year. The discussion should include the investment strategies employed by the fund's investment advisor.
--	---