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Advisory Fees: Evolving Theories

by Tamar Frankel

The theories on which mutual fund advisers' fiduciary and advisory fees are based have evolved over time. They were changed to justify different public policy approaches and reflect different perceptions of the relationships between advisers and investors. Three theories have developed on the subject and yet another is percolating currently. The familiar context in which these theories arose is revisited to clarify their development.

Mutual Funds Are Allowed to Outsource Their Entire Management to Independent Contractors, That Is, to Advisers

This unique feature was permitted by Congress in the Investment Company Act of 1940[1] regulating investment companies (funds), even though courts have not allowed corporations and other financial institutions, such as insurance companies, to adopt such a structure.[2] Much in fund management can be duplicated, and could therefore be efficiently concentrated in the advisers' hands to reduce the costs. Advisers serve funds under contracts, subject to significant fiduciary duties commensurate with the nature of their advisory services. Included in this regime is the regulation of advisory fees.

The Measure of Advisory Fees to Mutual Funds Tells Part of the Story

Traditionally, advisers charge a percentage of the value of the assets under their management. This is the measure of fees usually charged by trustees. Three main justifications can be offered for this fee standard. First, the fee aligns the interests of the trustee and the beneficiaries, as both benefit from increased value of the assets. Second, the fee provides the trustees with an incentive to increase the value of trust assets and consequently, their own fees as well. Third, those who manage larger amounts of assets should be compensated for bearing heavier responsibilities and exposed to greater liabilities. Therefore, more assets under management justify higher dollar amounts in fees.

Similar rationales apply to the managers of mutual funds. But there are significant differences between mutual fund managers and trustees. First, trustees are usually vested with a fixed amount of trust assets and can enlarge the amount of assets under management only or mainly by increasing the value of these assets. Thus, their interests and those of the beneficiaries are far more aligned. In contrast, fund managers can enlarge the amounts under management not only by performance, but also by causing the funds to issue and sell more shares. To be sure, performance helps sell fund shares. But an aggressive sales force can do wonders in marketing the shares of a fund that is not necessarily leading in performance. As the saying goes "mutual fund shares are sold, not bought." In fact, an aggressive sales force can increase the amount of fund assets and the advisers' fees by more than mere performance would. The sale of one share increases the assets under management by close to 100 percent of the price (minus distribution costs, if any). Net increase of a fund share by performance hardly ever does.

Second, as compared to trustees, open-end fund managers are subject to greater pressures to increase the amount of assets under management. Once a trust is established, trustees are fairly secure in their posi-

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tions and can be replaced only in very special circumstances. Trust assets are distributed according to a predetermined scheme and often subject to the discretion of the trustees, not the beneficiaries. As compared to trustees, managements of closed-end funds are exposed to somewhat greater pressures. Dissatisfied shareholders of closed-end funds can sell their shares, thereby depressing the share market prices. But the same fund assets remain under management, and the advisory fees are calculated as a percentage of these assets, not as a percentage of the share prices. The funds may have difficulty in raising additional capital. But that is all.

In contrast to both private trusts and closed-end funds, mutual funds that issue redeemable securities are exposed to the dangers of "net redemption," and consequent shrinking assets. Redemption effects a partial liquidation of the funds' assets, unless new shares are sold to compensate for the amount representing the redeemed shares. Therefore, to avoid liquidation by redemption open-end funds must rely on a sales force at least as much as on their advisers' performance. In fact, one could view the operation of these mutual funds as a joint venture of fund managers and fund distributors. The services of both result in increasing assets under management, and the services of salespersons can result in a greater increase of fund assets.

The dual source of advisory fees became clear during the 1990s. Underwriters who saw the tremendous rise of fund assets and advisory fees began to press advisers for more than a one-time commission. After all, advisers obtained fees continuously from the money that the underwriters provided them, while the underwriters and their brokers received a one-time payment. Underwriters asserted that their contribution was ongoing as well. Without marketing, the best adviser is unlikely to attract investors or assets to manage. Hence underwriters demanded a share of the management fees derived from the money that they brought the adviser.

This demand and the arrangements that followed demonstrate the very different vision and rationale for the fees of mutual fund advisers as compared with the fees of trustees. The ability to increase the assets under management not only by advertising but by selling shares through a huge experienced sales force allows for increasing significantly the amounts that the managers collect at lower costs, even if they reduce the fees to investors. It is not surprising that banks, which engaged in the trust business for so long, sought the power to advertise managerial expertise as advisers to mutual funds. Significantly, the bone of contention between the banks and fund industry was the right to advertise investment management services.

Being Fiduciaries, Advisers Are Prohibited from Charging Excessive Fees.[3] But What Does This Prohibition Mean, and under What Circumstances Would Fees Become Excessive?

Advisers, who function as outsourced operating managers, have been analogized to corporate directors and officers. The analogy did not help clarify the fee measure to which advisers were entitled and the limits of the fees, because courts have not clearly determined the test for excessive fees of corporate directors and officers. Some courts followed the test of "corporate waste," that is, excessive fees constitute amounts that "shock the conscience,"[4] and others followed the measure of "reasonable relationship to the services rendered."[5]

Under both measures, however, it seemed clear that advisers who were ready to allocate a portion of their fees for distributing fund shares were charging excessive fees. If they used a portion of the fees for purposes unrelated to advisory services, they were obviously willing to accept a lesser amount for the performance of advisory services. This interpretation and reasoning barred advisers from financing the distribution of their funds' shares.[6] Any payment advisers would make to underwriters and brokers would constitute proof that the advisers could and did perform their advisory services for less, and therefore charged excessive fees.

Then, in the Mid-1970s a New Theory Emerged, Converting Personal Advisory Services into the Business of Advisory Services

The theory transformed the image of personal advisory services into the image of a business of providing advisory services. If advisers were engaged in the *business* of offering advisory services, advisers would be entitled to profits, like any other business. This theory enabled advisers to charge investors advisory fees and use a portion of the fees to finance the distribution of their funds' shares. The fees were not considered excessive because the profit portion could be used as the advisers wished. As the business image of advisers took hold, advisers not only used part of their fees but also borrowed to finance the distribution of their funds' shares. Such borrowing was at times secured by a pledge of future advisory fees. Even though the 1940 Act permits funds to terminate the advisory contract by a 60 days notice, without penalty,[7] for various reasons funds very rarely did so. Therefore, borrowing to pay brokers could be guaranteed by the almost certain flow of income from the

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increased fees that these sales would bring. Higher management fees resulting from an increased volume of assets could also be ascertained, and provide a source of repaying the loans.

Sales of Their Funds' Shares Poses for Advisers Internal Conflicts. In Addition, the Advisers' Incentives Diverge from Those of the Sales Force

As to redemption, advisers are interested in increasing the redemption fees to reduce the investors' incentives to redeem, but the law prohibits imposing significant costs upon redemption, thus undermining the redemption promise.[8] Initially, redemption dampened brokers' incentives to distribute redeemable securities because they could charge a load only on the sales, but not on the redemptions. However, the brokers' "loss" of future sales load on redemption has justified a higher initial load on redeemable shares. This compensation provided incentives for greater sales pressures, because, viewed as an initial sales load, it is obviously attractive. Losses of future commissions can be compensated by immediate higher payments and hope for higher future volume. Therefore, the sale of redeemable shares on these terms remained attractive to the sales force, and was preferred or at least competitive with the sale of non-redeemable shares.

A Higher Initial Sales Load Presents a Double-Edged Sword for Advisers

An initial charge of a sales load may deter investors from investing in the first place. On this score, advisers are interested in lowering the initial sales load, or even eliminating it altogether. Yet, while high sales load may deter investors from buying redeemable securities, a high initial load may deter investors from redeeming, if they intend to reinvest the proceeds in other redeemable securities. In addition, the advisers are interested in increasing the sale of the funds' shares, and that requires paying higher commissions to the sales force.

After investors committed their money to a particular fund, the interests of the advisers and distributors could diverge as well. Distributors are interested in turnover, while the advisers are interested in stable invested assets and money in their funds. However, so long as advisers were not allowed to finance the sale of fund shares these conflicts and divergence remained dormant.

New Theoretical Basis That Allowed Advisers to Finance the Sale of Funds' Shares Transferred the Control over the Terms of Clients' Payments of Sales Loads from the Underwriters and Brokers to the Advisers

It enabled the advisers to separate the payment terms to the brokers from the payment terms of the shareholders.

Brokers do not extend credit to customers' payment of the sales load. They need the money, and have no incentives to provide credit. But advisers have such an incentive. Now they could pay brokers for the sales, and then determine how much and when investors will repay as the sales load.[9] Because the advisers were just as interested in giving investors an incentive to keep their money in the funds as they were in distributing new shares, advisers offered investors deferred sales loads as incentives. Loads were not charged when investors bought the shares, and became painfully chargeable only on redemption. Yet they classified as sales load and not prohibitive redemption fees. Annual reductions of sales loads sweetened investors' lingering in the funds. Brokers were paid, investors were drawn to invest and avoid redemptions, and advisory fees grew with the assets under management.

The New Theory Brought With It Mounting Financing Pressures on Advisers, As They Borrowed More to Pay Brokers for Ever-Increasing Sales of Fund Shares, on the One Hand, and Required Them to Bear the Cost of Waiving or Deferring the Sales Load Payments by Investors, on the Other Hand

As advisers' financing pressures rose, they sought relief. This relief materialized in the form of Rule 12b-1,[10] which allows the *funds* to pay for distribution of their shares and the increase in assets.

Rule 12b-1 Is Grounded in Yet Another Theory of Funds, That Is, the Mutual Funds as Businesses, and Their Shareholders As the Promoters of the Businesses

Not only are advisers the operators of these businesses, but in this evolutionary stage, the funds themselves are viewed as businesses. The theory is that,

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under certain circumstances, the *shareholders* would benefit from spending their investment money on distributing their funds' shares, presumably, similar to the benefits that investors in any operating company would gain from distributing the company's products to consumers. In the funds' case the main product constitutes the advisory services and the pooling arrangement. The benefits would be especially high, so the argument goes, when the funds are small (either because they shrank for many possible reasons, or because they were newly established). Small funds are more costly for investors because they do not maximize economies of scale.

A number of situations can be examined under this theory. One is that the investors should cover the seed money needed to establish mutual funds. Under the first theory examined, the theory that required advisory fees to be reasonably related to the services rendered, advisory fees could not cover the cost of establishing the funds. This principle holds also under the second theory, under which the advisers are deemed to engage in businesses. Seed money constitutes their promotional costs rather than the costs of the shareholders.

But if advisers are managing the business conducted by the funds, there should be no objection to the funds bearing the costs of establishing their business. The low economies of scale suffered by small funds should be borne by them and their shareholders. Presumably, the adviser could be justified in collecting higher fees regardless of the funds' sizes, and charging the higher transaction costs that are incurred because of the funds' small size.

While economies of scale may benefit investors, larger assets under management greatly benefit the advisers. Thus, even if the amount of benefits differs, economies of scale benefit both parties. Further, the rationale of Rule 12b-1 does not apply only to start-ups but to any fund at any stage, including funds that may experience shrinking through "net redemption" because of poor performance of the advisers. The funds could also shrink because market prices have fallen. In addition, the assumption seemed to be that happy and prosperous advisers make for happy and prosperous fund shareholders. At some point this may be correct. If advisers are in financial difficulties the shareholders may indeed suffer losses, being virtually locked into the services of failing advisers. But if there are no limits to the advisers' needs to be happy it is not clear whether their interests identify with those of the shareholders.

Rule 12b-1 is a mechanism by which shareholders pay every year to save money at the initial stage of the investment. However, while the amounts investors annually pay are clear and precise, their savings, which related to economies of scale, are not. These savings are more speculative. It is doubtful whether a business plan to spend money on growth for the purpose of saving costs rather than increasing profits will be considered reasonable.

The Image of Mutual Funds As Businesses Has Far-Reaching Consequences

If funds are indeed independent enterprises and not investors' money that are pooled for the limited purpose of management, subject to specific directives, then the funds take a life of their own and an existence far separate from that of the shareholders. The advisers will attain power that they do not now possess. For example, like any corporate enterprise, advisers may determine to contribute funds' assets to charities, up to reasonable amounts. They may donate funds' assets to political campaigns, if in the advisers' opinions, the shareholders and the funds may benefit from the donations. The advisers may decide to increase the costs to the funds by offering added services. To be sure, the shareholders of such funds can liquidate part of the funds by redemption and invest in competing funds. But investors' mobility suffers a time lag, and fund competition is not perfect. In the meanwhile the power of fund managers, that is, the board of directors and the advisers' discretion and authority will expand beyond what is acceptable today. The foundations of such a view are laid in the rationale of Rule 12b-1, of viewing the *funds as businesses.*

Rule 12b-1 also Makes Inroads into the Regulatory Model of Controlling Conflict of Interest Transactions

The decision on whether to charge Rule 12b-1 fees is vested with the board of directors, and the Rule provided for a higher percentage of independent directors than is required in the 1940 Act. The board must make a finding that charging of the fees is beneficial to the shareholders. The model for the Rule seems to be corporate law that allows disinterested directors to permit conflict of interest transactions between insiders and the corporation. This Rule deviates from the basic model of section 17 of the 1940 Act,[11] which requires an exemption by the Commission for such conflicts of interest.

To be sure, exemptive rules that transfer power to the independent members of the board of directors have increased in the last 30 years. But the transfer was limited by conditions that are more precise than those provided in corporate law, and the conditions

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imposed to ensure the independence of the directors are stricter. Yet the movement is worth noting. On the one hand, the SEC's enforcement and investigation resources have not matched the enormous growth of mutual funds. In addition, government involvement in the business affairs of the funds has become more publicly distasteful. Therefore, the mode of regulating mutual funds has been moving to disclosure for some time. Notwithstanding the requirement of approval by the disinterested directors, which reduced the formal power of advisers over the funds, Rule 12b-1 fees were adopted in about 70 percent of the funds, including more than 600 funds that had over $1 billion in assets.[12]

In fact, when one fund closed its doors to investors, it continued to charge Rule 12b-1 fees, justifying the charges by the additional services that it offered investors and by the fact that the adviser had yet to repay the loans it took to pay brokers for prior sales. It seems that both the 12b-1 fees and additional money, including borrowed money, were channeled to distribute mutual fund shares. The financing of the sales became a business expense of the fund and indirectly its shareholders. In addition, the funds' business was managed short-term. The advisers offered added advances to distributors of funds' shares in order to increase fund assets as much as possible as soon as possible, and these advances were to be recouped from future Rule 12b-1 payments. Thus, even when distributions ceased, the funds continued to pay. Although these were not clearly obligations, it seems that whenever the advisers borrowed, the borrowing became liabilities of the funds to be paid from a designated source, that is, Rule 12b-1 charges.

Recent events cast a shadow of doubt on the very justification for Rule 12b-1. It is reasonable to assume that the charges under the Rule would be used when fund assets are shrinking and the need to maintain efficient economies of scale is greatest. Paradoxically, it seems that in today's shrinking fund sizes, advisers are not increasing their reliance on Rule 12b-1 fees but reducing, waiving or even eliminating them. Advisers may perceive rightly that in the current environment investors are examining carefully the charges and are less inclined to be generous. In fact, fee reductions serve as advertising. According to a study of the Investment Company Institute, charges to investors in mutual funds have fallen from the 1980s to the year 1998, and were further reduced in the year 2001. In 1980s the charges amounted to 2.26 percent; in 2001 they amounted to 1.28 percent. The overall costs were affected by lower distribution costs, as no-load funds became more popular, and load funds reduced or waived the loads for tax-deferred plans, which have grown significantly.[13] This is the time to show investors that their costs of holding mutual funds have been reduced. Rather than using Rule 12b-1 to finance aggressive sales, advisers rightly manifest care and participation in investors' losses.

How do advisers solve the problem of the inefficient size of funds? They do so by selling fund assets, or consolidating and merging funds, and by changing their investment policies. This development suggests that the rationale for Rule 12b-1 even for small funds is quite weak. For large funds, especially funds that are so large as to lose flexibility for a quick recomposition of their portfolio, the rationale is seriously questionable. Directors should not be driven to give opinions and make decisions based on unconvincing holdings and findings.

In Light of Rule 12b-1's Past Experience and the Cost of Fund Distribution, the Current Reality Suggests That Advisory Fees and Distribution Expenses Should Be Guided by Yet a Different Theory, Reflecting Investors' Attitudes

I speculate that investors and regulators do not care about how the funds' performance is achieved, whether through effective management or rising market "bubbles." They assume, and perhaps we all should, that investors will not buy securities when performance is low, for whatever reason, and will rush to buy securities when performance is high, for whatever reason. Therefore, investors should be informed about the aggregate amount that they are charged for the shares, and especially *the net amount that is due to them.*[14] This speculation suggests that we should *measure the fees by the amounts of investors' gain, not by the relationship of the fees to the services.*

When the markets bubble and investors are gaining, most investors do not seem to object to charges of high fees, and advisers need not compete on the fees and expenses. When the markets crash and prices plummet, investors pay far greater attention to fees and charges, and advisers tend to reduce the fees accordingly. Advisers seem to share the fortunes of their shareholders. The higher the funds' performance, regardless of whether it is attributed to the market bubble, to the advisers' prescience, or to aggressive sales, the higher the fees can be. Lean years for investors are likely to bring lean years for advisers. The question for the industry is whether investors remember how much they paid in the good years and resent advisers who charged what investors

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determined later to be too much. That is a business decision, which advisers and fund boards can answer better than regulators.

Thus, reality seems to conflict with theory. Theoretically, regardless of performance and sales efforts, regulators should guard against excessive advisory fees. In addition, if performance and sales come easily, in rising markets, fees should not be increased. and yet regulators seem to tolerate a questionably high level of fees. When market prices fall, performance is harder to achieve and sales are difficult, regulators look at advisory and distribution fees with jaundiced eyes. I speculate that the regulatory attitude reflects the investors' attitude. Further, the industry responds to the attitude of investors the same way as well, offering to share in the investors' fortunes.

One of the Main Justifications for Rule 12b-1 Fees and Their Continuation Was Investors' Consent

When the markets prices were rising, advisers argued that investors do not complain about the Rule 12b-1 fees. The fees were clearly disclosed, and investors accepted them, presumably understanding what they were paying and for what. Investors in mutual funds have the choice to exit, if not costlessly then at least at low cost. However, the assumptions that investors obtain clear information about the fees may not necessarily be accurate. Consequently, the SEC's staff latest report proposed rules that would standardize and simplify the disclosure to investors and demonstrate the effect of Rule 12b-1 fees on their investments.[15]

Disclosure Is a Condition Leading to Another Metamorphosis of Theory That Might Help Address the Fee Problem. Let Advisers Price Their Offered Services As Commodities

Suppose we can isolate the dangers that advisers pose for investors in terms of possible misappropriation and breach of trust, and ensure through regulation of the custody and verification of the advisory statements, standardization of the share offerings, and other fiduciary duties to ensure that investors receive what they were promised. The fees and expenses that investors are charged can then be separated from these other obligations and treated differently.

Regulation of Management Fees and Distribution Expenses Should Reflect Investors' Attitudes. If Advisers Sell Their Services As Commodities, They Will Set the Price of Their Services by the Markets, and Are Likely to Share With Investors Their Fortunes, Similar to Contingency Fees of the Litigation Bar

This rationale mirrors market reality and investors sentiments but contradicts all other theories on which the fees and expenses of the fiduciary advisers can charge. We can find rationale for this reflection of reality by recognizing that it harks back to the justification of trustee fees: Charging a percentage of the assets as an incentive to enhance performance of the assets. Just as trust assets reflect market conditions, so do fund assets. Advisers gain more because they can increase their fees (not performance) by financing the sale of the funds' shares and increasing assets under management. They can finance the sale of shares when their fees are high—in good times, and must reduce their costs in bad times.

At an April 2002 Meeting of Lawyers and the Industry with Members of the SEC Staff, Leaders Among the Lawyers Suggested That the Time Has Come to Eliminate the 1940 Act

The changes touched the fundamental theoretical basis of the 1940 Act rather than merely the provisions of particular rules. For example, it was suggested that shareholders receive information about the price of the shares and not any breakdown of the costs and benefits of the advisers. This proposal assimilates mutual fund shares with any other commodity. It also was suggested that section 17 of the 1940 Act be eliminated as irrelevant to the shareholders. So long as they receive information about the price, they should not care whether the advisers benefit by conflicts or not.

The Proposal Does Not Distinguish Between the Payment Due to Advisers for Their Services—the Contractual Part of the Arrangement—and Amounts Handed over to the Advisers for the Sole Purpose of Managing the Money for the Benefit of the Investors—the Fiduciary Part of the Arrangement

The fiduciary duties appended to the advisory fees were based on the assumption that indirectly advisers determine the fees by representing both the investors and their own interests. In today's market reality this assumption may be too strong. It may be argued that

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with respect to advisory fees and expenses, investors are interested in comparing advisory fees and charges, and can make the decision on whether to pay higher or lower price depending on the resulting performance of the portfolios. With respect to management of their money investors need protection from mismanagement, conflicts of interests, embezzlement and abuse of trust. That is because advisers are vested with investors' money for the sole purpose of performing their advisory services more efficiently. They are holding other people's money and have no right to benefit from it. Investors cannot monitor and enforce the advisers' obligations and need both the law and law enforcement to protect their assets. Advisers need the law as well to establish their trustworthiness.

It should be made clear that the proposed commodification in this article applies not to the investors' money but to the advisers' fees. If they are indeed operating a business of outsourced managers, and if they are charging fees for the services, then all these fees together constitute the consideration paid in exchange for their services. The fiduciary duties of these advisers remain outside the contract intact because investors are unlikely to hand over their money to managers that would view entrusted money as their own. If investors have the slightest suspicion that their trustees help themselves to their money, in any form, investors will protect themselves by avoiding these advisers. Disclosure is not effective in these situations because investors are helpless to verify the statement and enforce the promises of the advisers. Therefore, fiduciary duties must be strictly enforced. Even if the fiduciaries operate a business, and there is no escape from the conclusion that they do, and even if they offer mass-produced services, they are holding other people's money, and as such must be trustworthy.

Further, there is no conflict between a combination of fiduciary duties and contract. Advisory fees paid for their service belong to the advisers, so long as the investors rather than the advisers determine the level of these fees. In such a case there is no need to impose fiduciary duties on advisers with respect to the fees, but money vested in the advisers for the benefit of the investors must be governed by strict fiduciary rules.

What Theories Should We Apply Today to Advisers and Their Advisory Fees?

First, external advisers operate a business, and as such they are entitled to advertise their business and to make profits. However, like the operators of any business, advisers are subject to the regulatory constraints of their business. In the case of advisers their business is the rendering of fiduciary services. Just as people who manage restaurants are regulated with respect to cleanliness, so advisers who offer trust services are regulated with respect to their handling of other people's money. So long as they obtain power over other people's money in order to facilitate their services of managing other people's money, advisers must be regulated as fiduciaries, and very strictly so.

Second, as to their fees, the relationship between investors and advisers is contractual, assuming that investors obtain information that allows them to determine and choose advisers. The market prices for advisory services can be determined by competition among advisers, subject to clear and imposed standardized disclosure rules. Advisory fees may then reflect the fortunes of the investors.

Third, mutual funds should not be viewed as businesses but as aggregates of persons seeking mass-produced services from the advisers. *Shares of mutual funds are not commodities*, and are closer to representing services of fiduciary duties rather than shares of corporations engaged in operating various businesses. Hence, the theoretical foundation of Rule 12b-1 is flawed.

Enter a New Structure: The Exchange-Traded Funds

Why they made their appearance in the mid-1990s I do not know. But their emergence is significant to the evolution of Rule 12b-1 fees, to advisory fees, and to share distribution costs and their allocation. Most of all, they may signal an era that retreats to pre-1930s fund structures, this time under the protection of federal regulation. Advisers sought a Rule 12b-1 arrangement for closed-end funds, but failed to convince the SEC to grant such a rule. As open-end funds grew beyond any expectations, some of the growth was attributable to Rule 12b-1 fees. Discussions about limiting the impact of the Rule usually ended with a shrug: the industry was based on the availability of these fees and any attempt to change the status quo was doomed to failure.

Yet the industry continued to search for a way to finance the distribution of closed-end fund shares. These funds have two great advantages for advisers. First, they offer non-redeemable shares and do not expose advisers to the threat of a "run," that is, liquidation by shareholder redemption. Second, the shares are traded only through brokers, both on sale and on purchase and their commissions are paid by the investors up front.

Exchange-traded funds offer a number of benefits for the shareholders. For years the price of closed-end funds shares did not match the pro-rata net asset value that the shares represented. Thus, if the net asset value was $100 per share, the price of the shares in the market could be $85 and sometimes,

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even lower. There were many explanations for this discount. One was that the underwriting of the shares, which usually costs 7 percent of the invested amount, reduces the value of the assets by that amount, and the price fell accordingly. Hence no one wished to buy the shares at the public offering. Another explanation was that investors calculated the costs of liquidating the funds that would be required in order to reach the assets. Yet another explanation was that investors suspected conflict of interest transactions, and discounted the share prices for the losses they presumably caused. Whatever the reasons, the discounts persisted.

Then in the mid-1990s, advisers devised an ingenious solution to return to the closed-end fund structure, the structure that was most popular in the 1920s. The solution is ingenious because it has resolved a number of problems. First, it resolved the problem of the discounted price, and enabled these funds to maintain their net asset value. Second, the solution was not effected by government fiat and regulation but by the market actors, acting to their advantage. The structure offers large underwriters another avenue of distributing shares to small investors through mutual funds. At the same time the underwriters act as arbitrageurs whenever the small-denomination-traded shares fall below the net asset value. For investors the funds offer the advantage of liquidity, instantaneous pricing, and the ability to sell at a particular known price, and at the same time maintenance of the net asset value. Exchange-traded funds are growing and are likely to grow because, among other reasons, both advisers and brokers are interested in selling them and stock exchanges are interested in accommodating their trades. As they take hold, managed exchange-traded funds are likely to become the major new investment tools. Advisers would then obtain management fees, cease to be concerned about redemptions, and be assured of an energetic distribution force.

The fourth-stage theory concerning advisory fees and sales load may be most suitable to this new investment vehicle. Fiduciary law will govern management and advisory services. Broker dealer regulation will govern the manner of distribution and trading of these securities. Advisory fees and brokerage commissions will be regulated separately, encouraging investors through supporting disclosure regulation to determine the advisory fees they agree to pay, and in all likelihood, these will follow investors' fortunes in the markets.

Notes

1. 15 U.S.C. § 80a-1 to -64 (2000); 15 U.S.C. § 80a-15 (2000); 2 Tamar Frankel & Ann Taylor Schwing, The Regulation of Money Managers § 12.01, at 12-5 to 12-6 (2001 & Supp. 2002).

2. *See* Sherman & Ellis, Inc. v. Ind. Mut. Cas. Co., 41 F.2d 588 (7th Cir. 1930).

3. 15 U.S.C. § 80a-35(b) (2000).

4. *See* Saxe v. Brady, 184 A.2d 602, 611 (1962); 2 Tamar Frankel & Ann Taylor Schwing, The Regulation of Money Managers § 12.03[C], at 12-76 (2001).

5. *See* 2 Tamar Frankel & Ann Taylor Schwing, The Regulation of Money Managers § 12.03[D], at 12-82 to 12-84 (2001 & Supp. 2002) (citing authorities).

6. The received wisdom was that funds may not finance the distribution of their shares. Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 10,252 (May 23, 1978), 43 Fed. Reg. 23,589 (May 31, 1978). An adviser also would be barred from causing the funds to do so. 4 Tamar Frankel & Ann Taylor Schwing, The Regulation of Money Managers § 27.04[B], at 27-104 (2001); *see* 15 U.S.C. § 80a-47(a) (2000) (prohibiting any person from performing an act by means of another person which would be a violation of the Act by such person).

7. 15 U.S.C. § 80a-15(a) (2000).

8. *See* 15 U.S.C. § 80a-2(a)(32) (stating that holder of redeemable security "is entitled . . . to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof").

9. Insurance companies have incentives similar to those of advisers. They provide credit to potential customers to cover the payment of the premiums. Premiums for the first three years are usually handed over to the sales personnel.

10. 17 C.F.R. § 270.12b-1 (2002).

11. 15 U.S.C. § 80a-17 (2000).

12. Beth Piskora, "12b-1 Fees a Rip-Off," *N.Y. Post*, July 21, 2002, at 31.

13. Julie Huynh, "Funds Have Continued to Trim Fees; Silver Lining to Slump; Stock Funds Cost 1.28% a year, Down from 1.35% in 1998, 2.26% in 1980," *Investor's Bus. Daily*, Oct. 10, 2002, LEXIS, News Library, Curnws File.

14. If we agree that the courts and the regulators are not the optimal decisionmakers on the precise level of amounts charged to fund investors directly or through the fund, then the decision must lie with the investors. They need information. One type of information relates to the performance of the fund, which is credited and debited pro rata on each share. That has been achieved, but not entirely. The other type is information that relates to the particular investor, and concerns the amount which the investor paid for the share, the tax implications on the investor's own fortune, and the impact of service-related expenses on the investor. One solution to this personalized information is to provide the impact of Rule 12b-1 payments on hypothetical investments, as proposed recently by the staff. Another is to offer investors a service for a competitive payment, in which I suspect many investors will be interested. The information may reduce the claims of performance now offered by funds, but may keep investors in the funds longer.

15. Div. of Inv. Mgmt., U.S. Sec. & Exch. Comm'n, Report on Mutual Fund Fees and Expenses, *http://www.sec.gov/news/studies/feestudy.htm* (2000); *see also* Disclosure of Mutual Fund After-Tax Returns, Investment Company Act Release No. 24,832 (Jan. 18, 2001), 66 Fed. Reg. 9002 (Feb. 5, 2001) (requiring disclosure to investors of the true gain or loss of their investments including income taxes that they might have paid).

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