

Tinker, Tailor, Mutual Fund Adviser . . .

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The U.S. Court of Appeals has instructed the SEC to revisit its controversial rule that mutual fund boards be run by independent chairmen and include 75% independent directors. The motivation for the rule, mandated in 2004, was a desire to strengthen mutual fund governance following the trading scandals of the previous year. While the future of this regulation is being decided, however, it may now be a good time to focus on more fundamental issues about the broader structure and scope of mutual fund regulation.

The rationale for the regulation of these entities is that open-end mutual funds are fundamentally similar to corporations -- but very different from service-providers such as lawyers or automotive technicians. From an economic point of view, nothing could be further from the truth.

The Investment Company Act of 1940 assembles the regulatory structure for mutual funds on the traditional corporate model, establishing a board of directors as the monitor of fund adviser actions and fees. The 2004 SEC rules on fund governance echo the spirit of Sarbanes-Oxley by highlighting the role of independent directors on the board. Is this model appropriate?

Corporate boards typically provide strategic expertise and monitor management. A mutual fund board, however, doesn't provide strategic expertise, since it is the fund advisers who are the experts on portfolio management and strategy. As a monitor, a corporate board exists to deter CEOs and other top managers from taking actions that harm investors: In the extreme case, stockholders can lose their investment if the management is incompetent and drives the stock price to zero. But mutual fund advisers have fewer opportunities to harm fund investors, and investors can do much more to protect themselves and discipline management than in a typical corporation.

That's because the value of a mutual fund share depends neither on what other market participants are willing to pay for it nor on anyone's expectations of future fund performance; it depends, rather, on the current value of the securities held by the fund. Investors can redeem their shares at this net asset value. This implies that market concerns about adviser ability or ethics cannot drive the value of investors' shares to zero. Fund investors thus have much less potential to be harmed than traditional corporate shareholders. Investors can also protect their assets and discipline managers via individual, non-coordinated redemption of fund shares. This withdrawal directly affects fund adviser revenue through fees, typically based on assets under management.

Historically, setting fees has been the primary role ascribed to mutual fund boards. Since they are wholly owned by investors, it follows that paying fees out of mutual fund assets amounts to spending shareholders' money. The board is positioned as a watchdog and proposed rule changes are often motivated by a regulatory desire to reduce fee levels. But this view of fees is fundamentally at odds with the economic reality of the mutual fund marketplace. Most investors

view themselves not as owners but as customers; thus mutual fund advisers are best viewed as service-providers not fundamentally different from lawyers.

So why all the regulatory attention? We don't concern ourselves with the prices individuals pay to have their wills drafted or their cars repaired. Nor are prices hidden: The fees investors pay for portfolio management, record-keeping, advice and all of the other bundled services are fully observable both explicitly, if an investor chooses to look for them, and implicitly, in the net return earned on shares owned. Indeed, investors in a mutual fund can compare the services they receive, net of the fee paid, with those offered by other funds or alternative investment vehicles.

It is of course true that advisers would prefer to receive a higher price for their services and investors would like to pay a lower one. But these preferences prevail in all market interactions; mutual fund fees in the marketplace are equilibrium agreements, like the price of an oil change. For that matter, why are fund boards even involved in setting fees? Since the price for fund services is observable, there is no agency problem here with "hidden actions" on the part of the fund adviser that could be deterred through close monitoring.

A common argument for the involvement of independent fund boards in setting fees is that "unsophisticated" individual investors need to be protected; fund investors need a board because they cannot adequately evaluate an investment opportunity. This argument is unsatisfying. Individuals make many decisions that are as complicated as investing, including which car to buy, what cancer treatment to undergo, and whom to marry. Is investing so different that investors cannot know what is best for them?

Putting philosophy aside, we might instead ask whether the characterization of today's fund investor as passive and unsophisticated is accurate. Investors' reaction in the immediate aftermath of the market-timing scandals of 2003 is evidence that it is not. Firms implicated in the scandal experienced economically significant asset outflows in the five months following the discovery of improper trading. Among those most hard hit were Putnam, Janus and Invesco (AIM), with net outflows from equity and fixed-income mutual funds of \$24 billion, \$12 billion and \$6 billion, respectively. Not surprisingly, these assets flowed to fund families with clean records, such as Vanguard, Fidelity and American.

From an economic point of view, as my research has shown, the rationale for regulating open-end mutual funds based on the corporate governance model is not well-grounded. We must focus on the service-oriented nature of the mutual fund product, and on the competitive pressures exerted by investors. At the least, there is reason to consider removing board oversight of fees. We might even contemplate eliminating the legal mandate to have mutual fund boards at all. These are not new suggestions -- but it is time to give them another hearing.

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