

TAMAR FRANKEL\*

## How Did We Get Into This Mess?

### INTRODUCTION

HOW DID MUTUAL FUNDS AND THEIR ADVISERS GET INTO THIS MESS? It is impossible to offer a clear answer to this question. Proving causation is generally very difficult. We can examine, however, what has changed in the past thirty years and draw our own conclusions. This Article lists a number of changes that have occurred in the past thirty years and focuses on one change in particular. These changes point to altered theories, categories, images, and ways in which we interpret and approach the law. The conceptual substitutions that have occurred offer the justifications for the evolving attitudes, behavior, and laws. Almost every practical change was brought about by an underlying fundamental substitution in the culture of professional advisory services. These changes took years to develop and came to fruition in the 1990s. It may well be that this is how we got into this mess. This Article offers a short outline of the problems and includes an excerpt from my book, *Trust and Honesty, America's Business Culture at a Crossroad*.<sup>1</sup>

#### A. *From a profession and fiduciary service to a business*

During the past thirty years, the view of the professions has changed and has become equated with business.<sup>2</sup> This transformation occurred not only in advisory services but also in the fields of law and medicine. The change has had profound effects. The difference between professions and businesses is substantive by emphasis. It has its roots in the Middle Ages. First and foremost, professionals offer a public service. That is why, historically, professionals did not compete with each other; they complemented each other. They united in the objective of serving society. To be sure, professionals had to charge for their services. Maximizing profits, however, was not their main objective. In contrast, the objective of business is to make money and maximize profits. That is why businesses compete and are in fact encouraged, and sometimes required, to compete. And that is fine, too.

A number of consequences follow from the view of professionals as businesspersons and their services as businesses. First, professionals, like businesspersons, put far more emphasis on profits. Second, the main client of professionals is no longer

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1. TAMAR FRANKEL, *TRUST AND HONESTY, AMERICA'S BUSINESS CULTURE AT A CROSSROAD* (2006).

2. Tamar Frankel, *Advisory Fees: Evolving Theories*, *INVESTMENT LAWYER*, Feb. 2003, at 22–24.

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the public, but rather those who seek legal advice for a fee. Third, like businesspersons, professionals compete among themselves for paying clients. Fourth, professional services are viewed mostly as commodities. Thus, investment advisers have become the sellers of commodities. Each of these changes merits an observation.

### *i. The transformation of professions into businesses*

Profit has become the main emphasis for professionals. After all, how can lawyers manage an office of more than a thousand lawyers without producing revenues and controlling costs? How can one create additional offices in the United States—and perhaps around the globe—without pressing for revenues? How can one recruit talent without paying more than what others offer? How can one find new clients without paying those who steer clients in one's direction? The argument is that professionals must act like businesspersons or they would not survive. The argument is that "everyone does it" and if you don't, you will not survive.

If that is the conclusion with respect to lawyers, it is doubly true with respect to advisers who offer investment advice to mutual funds. Not only do they advise the funds, but they also establish and promote the "client" funds. Not only do they invest significant amounts in promoting the funds, but they also must invest heavily in maintaining the infrastructure of the funds. Not only must they do that, but they must ensure that the funds are not depleted by redemptions—they must make sure they continue to bring in clients. Therefore, lawyers and investment advisers operate businesses. Advisers to mutual funds must view their services as businesses because they are taking the risks of businesspersons.

Viewing the operations of investment advisers as businesses also changed the view of the fees they may charge. These fees were no longer limited to the value of the services. They could now include profits, like any other business. That brought with it the permission to do with the profits what they wanted. Before the transformation, advisers who used their fees to pay the sellers of the fund shares were considered to have overcharged. After all, they were willing to provide the services for less—i.e., their charges minus the amounts they paid the sellers of the shares. Now, however, they were entitled to profits. As a result, they could do with the money as they wished.

The transformation of investment advisory operations into businesses did not stop with the advisers. The transformation also touched the funds themselves. Funds no longer consist of investors' money, pooled for economies of scale, diversification, and the services of expert managers. They are the advisers' businesses, like operating corporations. If the funds were businesses, the funds should bear the cost of selling their shares. This transformation opened the door to Rule 12b-1 and to

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fees that are higher than the cost of managing the clients' or funds' portfolios.<sup>3</sup> This image change, however, was not complete. The rationale for Rule 12b-1 was still tied to the image of funds as investors' money pooled for economies of scale and diversification and expert managers. Although the language and history of the rule demonstrates this image, in practice, advisers have viewed the funds as corporations. Moreover, although investors believe that the shares represent money that belongs to them, at least some managers speak in terms of money that has been "borrowed" from investors to manage.

Viewing investment advisers as businesses legitimized paying them not only fees for their services, but also profits based on or related to those fees. If they were selling a commodity instead of providing a service, they were more likely to be entitled to profits on top of services. Besides, if they are selling a commodity, it is no one's business to inquire how much the manufacturing of the commodity cost them. If they are astute businesspersons and can manage the funds at a low cost, why should they share the savings with the clients? Once the right to profit was established, there was free money that was not linked to the value of the service advisers offered. The measure of the fees must change to how much the market will bear. If investors are willing to pay the price, and if they can shop for service, as they do for shoes, the measure of fairness disappears. Even though the assumption was that investors do not evaluate fees, but focus on performance, there are studies that suggest that they do factor in fees. Therefore, advisory services can indeed be priced in the same way shoes are priced. The fairness of the price is not an issue.

In addition, advisers could do with the profits what they liked. Thus, the door was opened to fees that are, by definition, higher than advisory fees. That view opened the door to advisers' payments to brokers for selling fund shares. This led to where we are today, that is, "revenue sharing." This move has now been discovered to be a "mess," and it converts the professional, who services the public first and aims at payment later, to a business person, who aims at profits, puts a dent in the culture of self-limitation, and shifts the burden of protection to the investor.

*ii. The main client of professionals has been replaced.*

It is no longer the public but the clients who seek legal or investment advice. In the past thirty years, the public-service aspect of professionals has taken second place. Interestingly, this transformation took place not when the lawyers and advisers were earning less, but when both professional groups' profits were higher than ever. The 1990s, for example, were heralded as the "golden era" of the Bar. Investment advisers have never earned as much as they did during this period when the money and assets under their management in mutual funds and other vehicles exceeded

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3. See 17 C.F.R. § 270.12b-1 (2005) (providing that it is unlawful for "any registered open-end management investment company . . . to act as a distributor of securities of which it is the issuer, except through an underwriter").

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that of most banks. In the mutual fund heyday, assets exceeded \$12 billion. In 2005, assets were about \$8 billion, and the money continues to pour in. At this time, however, professionals have been acting more like businesspersons pursuing business objectives. In the past thirty years, “revenues at the top 100 firms quintupled to \$38 billion, while profits quadrupled to \$13.5 billion.”<sup>4</sup> It might be that if lawyers and advisers had not acted like businesspersons, they would not have reached the “golden age.” Yet the fact that the “golden age” ended in a mess leaves the door open to another interpretation.

*iii. Professionals have been competing among themselves for clients.*

When the Supreme Court struck down the fixed rates that lawyers were charging, the assumption was that competition among lawyers would reduce the fees they charged and increase information about the quality of their work. This prediction, however, has not come to fruition. The lawyers’ charges have not fallen. It is unclear whether there is increased information about the quality of their work or whether it has risen. In fact, the pressures to profit and the justifications for acting in a businesslike manner may have led to deterioration in the quality of lawyers’ services.

The advisers’ fees and charges did not fall but rose. In addition, competition did not contribute more information about the quality of their work. That is not surprising. Clients and beneficiaries cannot properly and continuously evaluate the quality of their lawyers or money managers. One reason is that many clients are not experts. Additionally, even experts may wish to devote their time to other pursuits and leave the tasks to other experts. Our society is built on specialization, not on the idea that every person does all.

*iv. If professionals are merely selling services, the services can be viewed as commodities.*

It is not surprising that the transformation of professionals into businesspersons brought a change in how professional services were valued. As commodities, they could be evaluated not by the proficiency of the service providers, but by the results they produced. The emphasis shifted from the way the professionals provided the services to what they ultimately brought to the clients—performance.

Professionals, however, cannot ensure results. No matter how hard professionals try or how well they perform, the results are not within their control. The lawyer’s client may be found guilty regardless of a brilliant defense. The physician’s patient may die despite receiving the best available treatment. Market prices may unexpectedly fall regardless of the money manager’s talent and expertise. This is one reason

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4. Aric Press & Susan Beck, *Almost a Revolution*, AM. LAW., May 2004, at 76, 78.

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for imposing professional fiduciary duties: The quality of these professionals' services and their honesty cannot be judged by the results of the services.

Nonetheless, the distinction between the sellers of cars and the sellers of legal advice or investment advice has been disappearing. The pressures to produce results, no matter how, sharpened the conflict between the interests of professionals and their clients. Not surprisingly, these pressures led to professional attempts to cut corners and even seek competitive advantages by leveraging the law, if not violating it. This brings a competitive advantage—at least until the other competitors discover the leverage and copy it. Then, the advantage disappears and the professional must find other inventive loopholes or exemptions.

The advertising of securities and investment advice is more limited by regulation than that of other commodities. Nonetheless, these regulations have been relaxed. First, in evaluating whether the advisory fees were excessive, the Second Circuit has allowed performance of the adviser to be considered.<sup>5</sup> This consideration brought with it many problems and opened the door to misleading statements. Performance is hard to define and costly to ascertain. If an adviser claims that it is number one under the CFA Institute, it would be difficult for the client to find out whether that was so. To do that, the client would have to examine the adviser's books.

Limitations on advertising led to investment "products" designed for sale. These are even harder to identify and verify than claims about performance. The historical sales pressure to produce more securities for sale and management brought about the revival of "fund of funds." Regulators prohibited this structure after they consistently discovered abuses of the form. Allowed again, it led to the manufacture of additional shares based on the same portfolio. Before 1940, this practice produced an enormous number of shares based on the same issuer or few issuers. The structure produced multiple management fees, multiple transaction costs (in each tier), and opportunities by controlling shareholders to force the managers of the funds to invest in particular investments under the threat of redeeming the shares the controlling shareholders held.<sup>6</sup> During the 1990s, the SEC and then Congress again allowed "fund of funds." To be sure, they prohibited the old abuses, such as multiple fees. They allowed two layers of funds only within a fund's complex, managed by the same adviser.<sup>7</sup> The assumption was that an adviser would not harm the interests of one fund that it manages in order to enrich those of another. Advisers may, however, be interested in cross-subsidizing funds to show performance, even in poorly managed funds. Advisers may wish to charge different fees to institu-

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5. See *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 929-30 (2d Cir. 1982) (stating that "the nature and quality of the service" are a factor in determining whether a fee is excessive); *Krinsk v. Fund Asset Mgmt., Inc.*, 875 F.2d 404, 409-10 (2d Cir. 1989) (following *Gartenberg*; noting fund performance in determining that factor weighs against excessive fee).

6. See, e.g., *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 978-81 (2d Cir. 1975); see also CHARLES RAW ET AL., DO YOU SINCERELY WANT TO BE RICH?: THE FULL STORY OF BERNARD CORNFELD AND IOS 83-94 (1971).

7. See 15 U.S.C. § 80a-12(d)(1)(G) (2000).

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tional investors for the same service and investment in the same fund they offer public investors. The institutions can bargain better than individual shareholders, and the shareholders are not informed about the difference. Therefore, the structure produced new unfair treatment of the shareholders.

### *B. The conversion of professions into business services was accompanied by a vision of fiduciaries as salespersons.*

Related to the first shift in investment advisory service is the move of advisers from investment management toward the position of salespersons.<sup>8</sup> If not directly, then indirectly, advisers are mainly concerned with sales. Even though advisers ask for the investors' trust, they are also acting to sell their services. The pressure to sell brings a number of implications.

The pressure to sell leads to designing investment management "products" to attract buyers,<sup>9</sup> and it causes the manufacture of shares for sale, as happened in the days before the 1940 Act.<sup>10</sup> Pressure to sell blurs the line between a fiduciary who imposes limits on himself and a salesperson who seeks to maximize the benefits for himself on the assumption that the buyer will take care of himself. The adviser is no longer acting for the sole benefit of the mutual fund shareholders. He is acting in his own interests, and the shareholders should take care of their own interests. This is the posture of a contract. Fiduciary relationships have been watered down, if they have not disappeared altogether.

The image of adviser as salesperson does not escape the investor's notice. Trust in their adviser deteriorates with the realization that the advisers focus on sales and not on performance for the fund shareholders.

For the advisers, however, the new image carries lesser responsibilities. If they violated their duties or breached their promises, they are less likely to be viewed as abusers of the trust that was imposed on them, but rather as contract parties that broke their contract. A very different stigma is attached to this behavior. After all, it is clear that a salesperson tends to his own interests. If he considers the interests of the customer, it is only to entice the customer to buy what the salesperson offers. That is no secret. Therefore, the customer must fend for himself, ask questions, and shop around.

### *C. Relaxing legal prohibitions without accompanying controls*

During the past thirty years, the size of mutual funds increased tremendously. With this increase came the need for new arrangements. For example, thousands of par-

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8. See Tamar Frankel, *The Seventh Circuit Decision in Wsol v. Fiduciary Management Associates and the Amendment to Rule 12b-1*, INVESTMENT LAWYER, Aug. 2004, at 11.

9. See Paul F. Roye, Remarks at the American Law Institute/American Bar Association Investment Company Regulation and Compliance Conference: The Exciting World of Investment Company Regulation (June 14, 2001), available at <http://www.sec.gov/news/speech/spch500.htm>.

10. JOHN KENNETH GALBRAITH, THE GREAT CRASH, 1929 46-65 (6th ed. 1988).

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ticipants in 401(k) plans made frequent investments in the funds. Insurance companies added their thousands of investors in variable insurance contracts and policies. These enormous numbers conflicted with the closed-circle regulatory structure that ensured the integrity of the purchase and redemption prices of mutual fund shares, and prevented insiders from manipulating the prices and diluting the value of the remaining shares.

Permitting investors in 401(k) plans and insurance contracts to place their orders just before 4:00 p.m. (EST), as all investors could, had to be allowed in order to collate all these orders and produce a number for the funds' portfolio managers. Thus, the strict 4:00 p.m. deadline was relaxed to three or even four hours after the cutoff. No additional controls were imposed on the advisers of the funds, and no limits were imposed on delegating the receipt and collation of the orders and ensuring that the timing would not be manipulated.

In addition, foreign funds that held shares traded in foreign markets after the closing of the New York Stock Exchange were allowed to adjust the price of the shares when justified by special events. Control was left to the boards of directors. Consequently, the door was opened to market timing with all its glorious permutations. Regulators allowed this flexibility based on a certain assumption. Because market timing reduces the value of the portfolio and because the fund advisers' fees are linked to the value of the portfolios, the advisers' interests are identified with those of the remaining shareholders. Hence, the fund advisers will find ways to reduce the adverse effects of market timing without the need for regulatory intervention. In sum, the market would take care of the problem. After all, shareholders are entitled to redeem their shares and the liquidity of the shares is valuable for many reasons. But this assumption proved wrong. We have relaxed strict legal limitations and allowed fiduciaries greater discretion. That discretion, coupled with competition, was abused.

*D. Ignoring the law on the books*

An area in which everyone ignored the law on the books and regulators did nothing about it was Rule 12b-1. The constraints and limits of the rule were ignored. Investors received added services. Arguably, if the investors do not like it, they can leave by selling or redeeming their securities. That was a caveat emptor approach and perhaps a waiver of the main requirements of Rule 12b-1. Such an attitude to the law undermines not only the particular rule, which was ignored, but the attitude toward other rules as well.

We ignored violations of clear legal directives on the books. Rule 12b-1 provided directors with discretion, subject to restrictions. The restrictions were ignored, and no one did anything about it. That not only allowed for abuse of Rule 12b-1 but also brought disrespect for other rules and the law. Ignoring, and even condoning, violations of the rule's limits invites disdain for other legal limitations and cynicism

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about the law generally. This fits well with a cost-benefit analysis of violating the law.

### *E. From standards to specific rules*

During the past thirty years we have slowly moved from standards and principles to specific rules. The approach that emerged was that “whatever is not prohibited or required is permitted.” The search from the vague area that was not addressed specifically led, for example, to unfair treatment of clients in the allocation of IPOs. The principle of fairness has been lost in the myriad of pages of rules. We have changed the way we interpret the law. In the name of efficiency, we demanded specificity. To be sure, it provided more efficiency for the fiduciaries. But it made enforcement of the legitimate limitations on fiduciaries much more inefficient. We are paying the costs of these “efficiencies” today.

No wonder we got into this mess.

The following excerpt from the draft of my book, *Trust and Honesty, America's Business Culture at a Crossroad*,<sup>11</sup> elaborates on this topic (footnotes omitted).

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*The movement from fiduciaries to contract parties, from professions to businesses, was accompanied by changes in the way the law is interpreted.* The rules concerning the distribution and sale of securities offer an example. To raise money from public investors (“public offering”) a corporation must file a statement (registration statement) with the SEC. The statement contains information about the corporation and the securities (stock, bonds) that it offers. The government officials then review the materials and may require additional information. When they are satisfied, they will declare the registration “effective,” and the securities may then be offered and sold to the public. Part of this registration statement becomes the “prospectus,” which is offered to public investors with the stock. But if the investors are sophisticated, the corporation can offer them its securities in a nonpublic distribution, or “private placement.” The corporation must then offer these investors adequate information but bypass the registration with the government. Instead, it just sends the government a notice and a copy of the documents that it offers to the investors. How does one decide when a distribution is a “public offering” and when a distribution is a “private placement”?

In the 1953 case of *SEC v. Ralston Purina Company* the Supreme Court offered guidelines and a list of factors to define “private placement.” It emphasized that those who are offered securities in a private placement must be sophisticated and have access to information that would have been included in the registration statement. A later, 1977 case, *Doran v. Petroleum Management Corporation*, provided a

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11. See Frankel, *supra* note 1 at 146–49.

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more detailed list, including the number of the persons who were offered the stock, their financial situations, their knowledge of the corporation's business, and access to information about the corporation.

*The pressures arose to turn the list of factors into detailed rules.* The SEC published regulation D, which detailed with specificity who are sophisticated investors, and how a private offering is to be made. Specific rules seem more efficient because they are presumably clearer. But experience has shown that specific rules are not necessarily clearer. The more specific they are, the more questions of interpretations they can raise. . . . There are now volumes about regulation D on private placement. Specific rules are assumed to be fairer. After all, people ought to know what is permitted and what is not. The government should tell people *precisely* what to do and *precisely* what not to do. Otherwise, people ought to be free to act or not to act as they please.

This approach may be reasonable for tax and criminal laws. In fiduciary law, this approach raises serious problems, precisely because of the precision that it advocates. No rule can list all that is prohibited to fiduciaries, even if the rule filled the Library of Congress. When fiduciaries have broad discretion, such as managing large corporations and billions of dollars in financial assets, there are always ambiguous and new situations, which abusers of trust can interpret their way. They can construe the law narrowly: What the rules do not specifically say, the rules do not cover. This is a hostile view of the law as an intruder on the trusted persons' freedom to exercise their powers. Another interpretation would inquire into the purpose of the rule, ask how reasonable people would explain it, and impose a broader or narrower interpretation accordingly, depending on the danger of abuse. This is a view of the law as a protector of trust and the public good.

It may be argued that specific rules limit discretion and standards broaden discretion. That may be inaccurate in many areas. As Frederick Schauer points out, specific rules are not as specific as they seem and standards are not as broad as they seem. But for fiduciaries specific rules can be used to broaden discretion, not narrow it. And standards can be used to limit their discretion.

*A strictly literal interpretation of a rule can drain it of its spirit and subvert its goal.* The proponents of precise rules strive to free trusted persons from legal constraints as much as possible. Under the banner of the rule of law, they wave the flag of market freedom. This approach allows for easy manipulation. If a law prohibits corporate officers from buying corporate real estate, but does not mention leases, then the officers may acquire leases—that is, even though the purpose of the law was to prohibit corporate officers from sitting on both sides of any bargain as representatives of the corporation and as representatives of their own interests. Or if the prohibition mentions leases but does not mention loans, then corporate officers may borrow from the corporation. If borrowing is prohibited, but no mention is made of using corporate power to obtain business opportunities that should belong to the corporation, then such use would be permitted. And if the rule does

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not describe with precision and prohibit the manner in which top officers of Enron managed seemingly independent entities that in fact held Enron's assets, the actions would be permitted. . . .

An example of a literal reading is instructive. The SEC reached a settlement that disqualified a corporate officer from sitting on a board of directors of a "corporation" for five years. Literally, the settlement did not disqualify this person from serving as director on the board of a not-for-profit corporation, or perhaps as trustee on the board of a large trust. It may well be that the settlement was truly limited to corporations, and that the officer was not disqualified from sitting on the boards of other types of entities. But suppose the spirit of the settlement meant full disqualification. In such a case, the interpreters would include in the term "corporation" similar large organizations. After all, the message of this disqualification was that this officer, who was in charge of a large corporation in which accounting frauds have occurred, should not be allowed to manage similarly large organizations. A literal interpretation of the settlement emptied it of its substance. In fact, it could make a mockery of the settlement, as this officer could head a large not-for-profit corporation during the disqualification period.

A literal, precise interpretation of a rule invites trusted persons and their lawyers to search for ways to "con the law," that is, escape a rule without openly breaking it. An interpretation of the spirit of the rule invites trusted people and their lawyers to search the gray area around the rule to avoid entering the gray area and breaking the rule. One approach leads lawyers to look for an escape route from the law; the other posits them as the law's gatekeepers, inducing their clients to halt at the gate. Following the literal meaning of a rule can eliminate and subvert its spirit and meaning. Using gimmicks based on literal meaning can protect or even promote fraud.

The experience in the accounting area is similar. . . . The staff of the SEC reached the conclusion that a literal interpretation of the detailed rules is inadequate. It recommended that these accounting rules be interpreted in light of the principles on which the rules are based, and the purposes for which the rules were enacted. A staff report concluded that interpretations based on *rules only* or *principles only* do not provide optimal results. . . .

Legal imprecision sends a message to trusted persons, "When in doubt, don't do it!" Rules that increase the legal risks (uncertainty) for trusted people produce a self-enforcing mechanism that keeps trusted people from coming too close to the forbidden boundary. . . .

But would this idea not backfire? After all, imprecise rules may give the fiduciaries room for maneuvering and for justifying undesirable activities. The answer depends on how the law is interpreted. If the purpose of the rules is examined instead of their literal meaning, then the situations that violate the purpose of the rules will be prohibited even if the situations are not specified.

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CONCLUSION

In sum, we moved from a profession and fiduciary service to a business, and from advisers to salespersons. We relaxed legal prohibitions without accompanying controls, ignored the law on the books, and moved from standards to specific rules. Uncertainty is a powerful enforcement mechanism, which we have discarded too readily. To be sure, trusted people ought to know what is required of them. I doubt whether advisers are ignorant of that. But when they wish to innovate, and when they “push the envelope,” they ought to be more sensitive to the boundaries.

