The Seventh Circuit Decision in \textit{Wsol v. Fiduciary Management Associates} and the Amendment to Rule 12b-1

by Tamar Frankel

On February 24, 2004, the Securities and Exchange Commission proposed an amendment to Rule 12b-1. In essence, the rule prohibits mutual funds that have adopted a 12b-1 plan from exchanging brokerage business of their portfolios for the distribution of the funds’ shares. In its summary of the rule the Commission wrote: “The proposed amendments are designed to end a practice that is fraught with conflicts of interest and may be harmful to funds and fund shareholders.”

A decision by the Seventh Circuit in 2001 highlights the importance and relevance of the rule. More importantly, the decision demonstrates a basic difference between the view of the Securities and Exchange Commission and the Court on who owns the benefits from allocating portfolio brokerage business. Most importantly, the decision brings home the fundamental difference between the views of the SEC and the Court on the meaning of fiduciary duties.

The Case

This is the story of \textit{Wsol v. Fiduciary Management Associates}.

Fiduciary Management Associates (FMA) was a registered investment adviser that managed large portfolios, usually of institutional investors, such as pension funds. As other advisers, its fees were calculated as a percentage of the assets under management. Therefore, obtaining large amounts for management was attractive to FMA, and the competition for these clients was (and still is) very fierce. As investment manager, FMA had the power to allocate lucrative brokerage business. Brokers were willing (and still are) to offer deep discounts to obtain the business, and were eager to please FMA in order to become its choice.

To solicit advisory business, FMA employed a sharp salesman whose main compensation was based on a percentage of the business he brought (FMA Employee). FMA Employee had previous contacts with brokers (Introducing Brokers). These brokers had close connections to large financial institutions. These brokers helped FMA Employee obtain business for FMA.

The driving force of such exchanges seemed to be FMA Employee. Although he denied the responsibility for allocating brokerage business to brokers that did not provide adequate research (as required by Section 28(c) of the Securities Exchange Act of 1934), he pressed his FMA superiors hard for such allocations. And he succeeded. In less than two years, FMA Employee earned significant commissions for bringing business to his employer, including the business of the Teamsters Pension Fund (Teamsters Plan), while FMA allocated brokerage business to Introducing Brokers, qualified or not.

An Introducing Broker and FMA Employee made a deal. FMA Employee would secure for Introducing Broker brokerage business at $.06 a share. Introducing Broker would secure for FMA Employee large investment management business. To deliver on his part of the deal, Introducing Broker bribed two trustees of Teamsters Plan. The bribe was effective, and FMA obtained the management of approximately $260 million of Teamsters Plan’s portfolio. Thus, the trail led from the bribed trustees to Introducing Broker, from Introducing Broker to FMA Employee, and from FMA Employee to FMA.

One of Teamsters Plan’s trustees sued FMA for breach of its fiduciary duty of care. The trustee argued that FMA negligently facilitated the bribe of the Plan’s trustees. After all, it was the deal with

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FMA Employee that tempted Introducing Broker to bribe Teamsters Plan’s trustees. The lower court held that FMA was not responsible for the bribe. Teamsters Plan’s trustees appealed, and the Seventh Circuit affirmed. Thus far, there is nothing unique in the story. FMA would not necessarily be responsible for the actions of an independent Introducing Broker. FMA Employee may have tempted Introducing Broker, but not necessarily actually help him to bribe the trustees of a would-be client.

The Great Innovative Rationale

Judge Posner, writing for the Seventh Circuit, did not base the decision on the failure of the plaintiff to prove that FMA breached its fiduciary duty of care to Teamsters Plan. The decision was based on entirely different grounds. The new grounds related to the remedies that Teamsters Plan could assert. The FMA exchange of brokerage business of the clients’ portfolios for new business from Teamsters Plan did not, in the Court’s opinion, entitle the Plan to any remedy.

The decision started not with the wrong done by the defendants, but with the remedies available to the plaintiff. The Court restated the well-known rules on the remedies for breach of “fiduciary duty” as follows: “The plaintiffs [Plan and its trustees] cannot prevail unless the breach of fiduciary duty either imposed a loss on the [Teamsters] plan or generated a profit for FMA ‘through the use of assets of the plan’ by FMA.” If the transaction between FMA Employee and Introducing Broker did not harm Teamsters Plan, wrote the Court, Teamsters Plan is not entitled to a remedy of damages. If the transaction did not benefit FMA, Teamsters Plan is not entitled to the remedy of accounting for the fiduciary’s profits.

There is nothing unique or interesting in this restatement of the law except its starting point. It certainly is the case that the remedies for a breach of “fiduciary duty” include damages for harm to the beneficiary and/or accounting for the ill-gotten gains of the fiduciary.

But then comes the most astounding part of the decision. It was no longer relevant whether FMA breached its fiduciary duty of care by offering a tempting deal to Introducing Broker through its Employee. In effect, the Court said: “Even if FMA breached its fiduciary duty, Teamsters Plan would have no remedy in a court of law; at least it would not receive a remedy in the Seventh Circuit.” “[S]urprising as this may seem, the shady operation [of Introducing Broker] appears to have given the fund [Teamsters Plan] all the benefits it would have received had FMA either retained a reputable soliciting broker or dealt directly with the executing brokers. In either case, [Teamsters Plan] would have paid 6 cents a share per trade; that is the standard fee and there is no proof that FMA could have obtained comparable trading services for less.” That is what everyone was paying, almost without exception, stated the Court. Since Teamsters Plan can expect to be charged the market price, said the Court, the Plan was not harmed. It received “best execution” and paid competitive commission rates.

The deal of FMA Employee and Introducing Brokers and the bribing of Teamsters Plan’s trustees did not benefit FMA, continued the Court. To be sure, FMA was paid. Not because of the introduction or the bribe, but because of the services, which it rendered Teamsters Plan, and it earned fair and square. Therefore, surprising as this may seem, FMA did not benefit, and had no ill-gotten profits. Hence, the Teamsters Plan had no remedy of accounting.

This is the kind of arrangement for which there are no remedies to the client, Teamsters Plan, even if FMA breached its fiduciary duties, that is, even if it was careless in allowing its employee to induce another to bribe the trustees of future clients. That is OK, so long as the future client, which has become a client by virtue of the bribe of its trustees, is not harmed, and FMA does not profit. The keys to this decision are the Court’s interpretations of “harm” and “profit.”

Understanding the Decision

The Meaning of Benefit to FMA

One key to understanding the Court’s decision is its interpretation of the concept of “benefit” to FMA. The fees paid to FMA, said the Court, were in exchange for FMA’s hard work of managing $260 million of Teamsters Plan. No other benefits ensued from the arrangement between its Employee and Introducing Broker.

The Court erred twice in stating that FMA did not benefit from the exchange of brokerage business for these “introductions.” In fact, FMA received two kinds of benefits from this exchange.

1. The benefit of getting new business in a competitive environment. Under the Court’s new theory there is no benefit to fiduciaries (and presumably to anyone else) from gaining new business. That is wrong. Getting new business in a competitive environment is not free. It is valuable and quantifiable. What Introducing Broker did for FMA was to convince the Teamsters Plan trustees to transfer to it $260 million for FMA’s management. That, in and by itself, was a benefit. It is difficult to ignore the fact
that advisers vie for business, and getting the business per se is valuable to them. Even people who knew nothing about economics and business might guess that getting the business is valuable, or else advertising, referrals and other means of getting business are waste. Therefore, if that benefit of new business was gained wrongfully, by breach of fiduciary duties, FMA should account for its benefits to Teamsters Plan.

2. Paying for new valuable business with misappropriated assets is wrong. In this case, FMA did not pay for new business with its own money. It paid for the new business with its clients' assets in a roundabout way. The fees that FMA received for its services belonged to it. But the benefits from the power over the clients' money did not belong to it. It was not given to FMA in trust to use only for the benefit of its clients. Fiduciaries may not use the control of the clients' assets for the fiduciaries' own benefit. This is the principle under the Employee Retirement Income Security Act (ERISA),* the Investment Advisers Act of 1940, the Investment Company Act of 1940, banking laws, corporate laws, partnership laws, and general principles of fiduciary law. When fiduciaries take advantage of this type of power for their own benefit (or for the benefit of others than the beneficiaries), the fiduciaries are deemed to have misappropriated the assets of their beneficiaries.

Investment advisers have the power to choose the brokers that execute the clients' portfolio transactions. This business is lucrative for brokers; they prefer orders for a large number of shares. Reputable brokerage firms are willing to offer discounts for such a business. The discounts from $.06 a share can range from $.03 to $.04 a share. By law, the clients are entitled to the discounts. In other words, the clients should be charged $.02 to $.03 a share. But some advisers pressed brokers to charge the clients $.06 per share for executing these transactions and pay the advisers the discount, that is, $.03 per share. In fact, this is straightforward bribery of the advisers and is prohibited by law.

However, advisers are allowed under Section 28(e) of the Securities Exchange Act of 1934 to gain some benefit from brokers to whom they allocated business. These "soft dollar" arrangements do not include helping advisers gain new business by advertising or introductions or in any other form. Thus, advisers who allocate brokerage business of their clients' portfolios for "introductions" of new clients are violating the law. If FMA allocated clients' brokerage business in exchange for new business for itself, it violated its duties and had to account for its benefits. These benefits can be calculated either as the profits that FMA reaped from the new business or, at least repay the cost that FMA "saved" in obtaining the new business.

In this case this is precisely what FMA did. It paid for new business with misappropriated assets that belonged to clients—the clients' brokerage business (valuable to brokers in a competitive environment). FMA benefited from the introduction to the tune of $260 million in new business. But it did not pay for the new business with its own money. Rather, it paid for the new business by allocating the business to Introducing Broker.

The payment of $.06 a share, which the Court believed was the market price that "everyone" was paying for, contained the discount, which Introducing Broker received. In fact, very reputable firms (not Introducing Broker) executed the transactions for the discounted rate. The arrangement hid the payment to Introducing Broker that ran from Teamsters Plan and other clients in exchange for new business to FMA. Thus, "surprising as this may seem" the Court was right. FMA benefited from the exchange by gaining new business and used its clients' assets to gain.

Harm to the Teamsters Plan, the Client

In the Court's opinion there is only one "market price" of $.06 a share. Had the issue been before the Court, and had evidence been heard, the Court would have discovered that there is no one market price for executing large transactions, and that some expert brokers are very happy to offer the service for $.02 to $.03 a share. As described, it is the "shady operation" that absorbed the difference between the "market price" and the true discounted price for large share transactions. Presumably, because the issue was not before the Court, this piece of information was not before it. In fact, Teamsters Plan was charged at least twice the true brokerage market price for its portfolio transactions.

It seems that the Court may have anticipated the possible discount, since the Court mentions that Teamsters Plan received consideration in lieu of discount. If Teamsters Plan paid less than $.06 per share (for example, if itself had chosen the broker), the Plan would not have received the "guaranteed best execution" that [shady] Introducing Broker had promised. This argument is wrong on the merit.

The benefits that Introducing Broker received cannot and should not be deemed to be compensation for "guaranteeing best execution." Not only is it doubtful whether this broker's guarantee that the judges call "shady" could be worth anything. In addition, FMA was paid for choosing (guaranteeing) the best executing broker. If someone else performed, for an additional charge, the brokers' eval-

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uation and choice then FMA charged Teamsters Plan for services it has not rendered, and the amount must be repaid to the Plan. 3 If no other party performs the service, then FMA has charged Teamsters Plan twice for the same service and must return the excess amount.

The Court subsumed fiduciary relationship into a contract relationship. It seems that in the Court's opinion Teamsters Plan "bought" FMA services under a contract including the power to choose brokers who charge "market price," whatever that may be. That is inaccurate. FMA acted for the Plan. It was bound to obtain the best execution at the best price. In this case, FMA caused the client to be charged about double the brokerage and recouped the difference for itself—by providing it to Introducing Broker.

The Implications of the Decision

The Court’s Strategy: Eliminate the Remedies

The decision is not a frontal attack on fiduciary duties. It emasculates the duties in a roundabout way. The strategy of the Court is to eliminate the remedies for wrongful behavior of a fiduciary, and thereby eliminate the duty without touching it. The Court does not negate the violations. On the contrary! It expressly declares a possible violation, which is not accompanied by a remedy. In my book of rules, if there is no remedy, there are no duties or prohibitions. Not so in the book of the Seventh Circuit’s rules. After eliminating the remedies, it applies principles of arm’s length contract to the duties of fiduciaries with respect to entrusted property. Out comes an entirely different regime for brokers, investment managers; a regime to gladden their hearts.

Court Reached the Same Decision by Introducing a Different and Broad Theory

The entire discussion in this case offers different reasons for the same result that was reached by the lower court. The rationale for the decision is gratuitously broad. The Court does not deal with FMA’s liability for its employee’s deals with a crooked broker. Instead it holds that the issue is irrelevant since in any case, even if the bribe was linked to FMA, the client had no remedy. This rationale may be interpreted to apply to the agreement between FMA Employee and the broker, regardless of how the broker managed to deliver its promised new advisory business. In any case, says the Court, the client was not harmed and FMA did not benefit. Therefore, no remedy is available to the client. Gone are the fiduciary duties that used to exist in such cases.

How Does a Court with So Many Illustrious Scholars and Experts in Economics Make So Many Obvious Mistakes?

It may be the ideology that the whole world is a market and all relationships are contracts. The investors “buy” management and execution of orders. They should not complain if they pay the “market price” to brokers. Like contract terms, which should be imputed to the parties, this Court believed that investors should rationally expect the adviser from whom they buy the services to pay the market price of brokerage. Although the Court does not expressly say so, if a particular broker is ready to perform the services for less, that difference belongs to the adviser, not to the investors. After all, the seller of shoes sells at the market price, regardless of how much the seller profits from the transaction. If he finds leather at a lower price, the difference belongs to the shoe seller.

The contract model leads the Court astray. Following contract law the Court assumes that had the clients been asked, they would have consented to the payment of “market price” commissions. While conceding to the remedy of constructive trust and accounting for profits, the Court adopts the contract interpretation and avoids this remedy as well by declaring no benefits to FMA. The test under fiduciary law is not whether the price that fiduciaries pay on behalf of the beneficiary is the market price. The test is whether the fiduciaries benefited from the arrangement.

There is no better example of corruption that breeds corruption than this case. It starts with FMA Employee who promises brokers brokerage business (whether they execute it themselves or sell the business rights to others) in exchange for referrals. It ends with bribing the pension fund trustees into granting FMA the advisory business. A court should control its urge to surprise and foment arguments to further an ideology that on reflection can be very dangerous. These ideas can be an admirable subject for debates. But they do not belong in a court decision that affects millions of people and our financial system as a whole.

More surprising is the fact that the whole discussion and its convoluted analysis need not have taken place. The subject of the complaint was not misappropriation of vested powers by FMA, but its lack of care in preventing temptation of bribery by FMA Employee. None of the discussion was necessary to reach the conclusion that FMA was not liable in this case because of the remoteness of the bribe from FMA or FMA Employee’s arrangement with the briber. Instead, the Court’s discussion suggests that even if the bribing was more closely related to FMA,
it would not be liable because Teamsters Plan was not harmed—a wrong conclusion—and FMA did not gain—another wrong conclusion.

The implications of this decision and its voluntary and unnecessary propositions are chilling. They should be keeping judges awake at night, if their life savings were invested in pension funds subject to ERISA and managed by advisers subject to the Investment Advisers Act of 1940. “Shady fiduciaries” in breach of their duties should pay attention. They can certainly make use of this case.22

Need for a Different Jurisprudence

Among the Court’s justifications for seeing no wrong in the exchange of “introductions” for the allocation of clients’ brokerage business at “market price” were the NASD Rule and the SEC opinion that allocating brokerage business to brokers who bring assets under management to the adviser is not objectionable. I assume that these statements were made so that advisers will not feel compelled to avoid allocating brokerage business to friendly broker dealers. There is recognition that long-term relationships are beneficial to the parties and should not be discouraged.

But the jurisprudence of the past twenty years viewed these words differently. Rather than examine the rationale for the opinion and rule the Court looked to the dictionary meaning. The specific language allows such an exchange, regardless of the circumstances. This jurisprudence of requiring specific prohibition is fine for criminal offenses, and perhaps for tax law. But in the case of fiduciaries such a specificity approach invites precisely the actions that have been discovered during the past three years. Whatever is not specifically spelled out as prohibited is permitted. Ambiguity is interpreted as permissive.

Today, when investors are wondering whether the securities markets and their infrastructure are safe for keeping their life savings, the case of the Seventh Circuit presents a warning. It is not surprising that the discoveries of the past three years led the Commission to “plug” the holes by additional specific prohibitions. The Commission had to make it clear that these arrangements are not permitted because the use of brokerage business is an asset of the shareholders of the funds and not the asset of the adviser. The discount which the broker is willing to offer belongs to the shareholders of the funds and not to the adviser. Therefore, the arrangements by which excess commissions are used to pay for distribution costs is prohibited.23

The new myriad of rules, as specific as they might be, are not likely to prevent abuses unless the rules are interpreted less literally, and unless the interpretations take into account the problems that they were intended to resolve. To be sure, under this approach the meaning and limits of the rules will be less clear. It will lead to gray areas. The approach will expose fiduciaries to more risk. It will prevent fiduciaries from engaging in activities that may be legal and not prohibited. It will be inefficient because the fiduciaries will not be able to profit from legal arrangements. But such somewhat vague rules will be very efficient to prevent abuse.

What the economy will lose by precluding legitimate profitable business, the economy will gain by preventing abuse of fiduciary duties. The costs of enforcing such duties far outweigh the profit losses of fiduciaries as a result of ambiguities.24 Thus, together with the specific prohibitions on particular actions, I hope that the Commission will introduce the old approach of adding a focus on the purposes of the rules and what they were designed to achieve.

NOTES


5. For this proposition the Judge cites section 1109(a) of the Employee Retirement Income Security Act. See 266 F.3d at 656 (citing 29 U.S.C. § 1109(a) (1994)).

6. Wsol at 657.

7. Id. at 658.

8. The Court itself recognizes that FMA could hire an honest solicitor for new business (and presumably pay the solicitor). See id. at 657.


13. See Gramm-Leach-Bliley Act, Pub. L. No. 106-102, §§ 211-
225, 113 Stat. 1338, 1396–1402 (codified in scattered sections of 15 U.S.C.) (subjecting banks that advise mutual funds to the same regulatory scheme as other advisers to mutual funds).

14. See William Meade Fletcher, Fletcher Cyclopaedia of the Law of Private Corporations § 840, at 198–199 (perm. ed. rev. 2002) (noting that state statutes generally provide that "officers and directors stand in a fiduciary relation to the corporation").


16. Under these principles, brokers may not pay advisers for brokerage business. It is a breach of fiduciary duties for advisers to receive such payment in cash or soft dollars. There is only one exception to this rule under Section 28(e) of the Securities Exchange Act of 1934. Advisers may receive benefits in the form of research. 15 U.S.C. § 78bb(e) (2000). Introduction to clients and bringing advisory business to the advisers are not included in the exception. Under principles of fiduciary law, both state and federal laws, no benefit may be given to advisers in connection with the exercise of their functions, including allocation of brokerage business.


18. I assume that the decision in this case does not exclude soft dollars from the prohibition on kickbacks or bribes. I believe that the court was unaware of the existence of a vast soft dollar market in brokerage business and its limitations or misunderstood the nature of this market, which is described below.

19. In this case, FMA received the management of $650 million. The management fees for such amount and the net profits from the management business can easily be calculated and their present value determined.

20. That is why Introducing Broker was eager to exchange, so eager to perform its part of the deal that it bribed the trustees of Teamsters Fund to obtain the advisory business for FMA.

21. Introducing Broker, who received the $0.04 difference between the amounts $0.06 paid by FMA's clients, and the $0.02 received by the executing broker, was not charged with performing this task, and should not have performed it.

