The Relationship Between the Investment Advisor and the Mutual Fund: Too Close for Comfort

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I. INTRODUCTION

Mutual funds have a unique corporate structure. Unlike conventional corporations, almost all mutual funds are externally managed.¹ The mutual fund generally contracts out the "principal management functions to a separate company, an investment adviser, which is paid an advisory fee, almost always a percentage of the fund's net assets."² The principal function of the investment adviser is portfolio management, but often the adviser also provides all administrative services for the fund.³

Usually the people who organize mutual funds also act as the investment adviser.⁴ Often, these same people are elected to the board of directors of the fund, enabling them to control the decisions of the fund.⁵ "Hence, while the fund and its adviser are theoretically two separate entities, with the fund contracting out to the adviser for certain services, it is the adviser that dominates the fund."⁶ The conflicts of interest inherent in this relationship are obvious, blending the duties of corporate directors, independent money managers, and investment advisers. This consanguinity does not lend itself to easy dissection or characterization, causing commentators to label it anomalous⁷ and incestuous.⁸ However, the kinship between the fund and the

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³. 1966 SEC Report, supra note 1, at 84-87, 90-91. "Since most mutual funds have no staffs of their own, the non-advisory services they require are performed in varying degrees by their investment advisers . . ." Id. at 90. A survey of 100 mutual funds to determine the extent to which the advisers pay for non-advisory services revealed:
   a) 88% of the advisers paid all the salaries and compensation of the fund's officers;
   b) 85% of the advisers paid for the office rental;
   c) 81% of the advisers paid for all the clerical and bookkeeping services. Id. at 91.
⁶. Cornell Note, supra note 5, at 631. "At the time of the Wharton study (1958-62), for example, the Wharton Report found that 89% of the funds it studied, or 94.4% of all mutual fund assets, were under the control of advisory groups with no substantial ownership interest in the fund itself." Id. at 631-32 n.26.
investment adviser\textsuperscript{9} has been recognized by both Congress\textsuperscript{10} and the courts\textsuperscript{11} as fiduciary in nature. This recognition only opens the door to judicial scrutiny. The obligations arising from the relationship and the consequences flowing from a breach of the adviser's duties pose more intricate problems.\textsuperscript{12}

This Note will examine the nature of the fiduciary relationship between the investment adviser and the mutual fund and assess standards\textsuperscript{13} to be used in determining whether the adviser has breached its obligations. It will then discuss several problems stemming\textsuperscript{14} from this unique relationship and analyze the effect of recent legislation adopted to solve these problems.

II. FIDUCIARY DUTY AND ADVISORY CONTRACT FEE: A BUILT-IN CONFLICT OF INTEREST

Although not completely analogous, the fiduciary relationship between mutual fund and adviser closely parallels that of a corporation and its directors.\textsuperscript{15} This is so since the adviser commonly exerts a dominant influence on the fund's board and is often a member of such board. This analogy also permits the advisory contract to be viewed as an interested director contract, and brings into play the problems of corporations (the fund and the adviser) with common directors. Finally, the adviser's fee can be scrutinized from the standpoint of directors fixing their own compensation.

Generally, corporate fiduciary duties require no less than good faith and fair dealing.\textsuperscript{16} The fiduciary duties of a corporate director are usually expressed in terms of a duty to exercise due care and a duty of individual loyalty.


9. There is an inherent conflict of interest in this relationship, especially in regard to the advisory fee. Rottenberg, supra note 2, at 312.

10. 15 U.S.C. § 80a-35 (a, b) (1970). "It is certainly not breaking any new legal ground to state that the investment adviser . . . owes a fiduciary duty to the fund and to the public shareholders who are the owners of the fund." 1967 Senate Hearings, supra note 5, at 10.

11. See, e.g., SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191 (1963); Rosenfeld v. Black, 445 F.2d 1337, 1342, 1348 (2d Cir. 1971), petition for cert. dismissed, 409 U.S. 802 (1972). "While a new § 36 (b) expressly declares that 'the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment advisor,' the context makes plain that Congress did not mean this to be the only fiduciary duty of investment advisers." Id. at 1348.


13. See notes 42-68 infra and accompanying text.

14. See notes 77-103, 148-55 infra and accompanying text.

15. Cornell Note, supra note 5, at 641-42; see 1967 Senate Hearings, supra note 5, at 210 (statement by Senator McIntyre) (urged the use of corporate fiduciary principles in developing standards for the mutual fund industry); SEC v. Insurance Sec., Inc., 254 F.2d 642, 650 (9th Cir.), cert. denied, 358 U.S. 823 (1958) (corporate fiduciary standards used to define investment adviser's relationship to fund).

to the corporate interest. Included in the concept of corporate loyalty is "a duty to avoid conflicts of interest or self-dealing." Directors owe a duty of undivided loyalty as their actions should only be influenced by considerations of the corporate welfare. This principle prevents the fiduciary from making a profit at the expense of the corporation. Nevertheless, it has not been so strictly applied as to exclude all possibilities of personal gain or benefit by the director.

When a director has a conflict of interest in a corporate transaction, there has been a split of authority as to whether the contract is voidable. The more recent cases tend to apply a fairness test. Given that a conflict of interest exists, the inquiry involves whether "the transaction carries the earmarks of an arm's length bargain," and whether there is a reasonable balance between the benefits and the burdens. The director owes a duty of full disclosure, since "he must give to the corporation . . . all the relevant and material information he possesses or can obtain on the subject of the transaction." Such transactions are subject to rigorous judicial scrutiny. Whenever the fairness of a transaction involving a conflict of interest is challenged the burden is usually placed upon those who seek to uphold the transaction, subject to state statutory schemes.

17. M. Feuer, Personal Liabilities of Corporate Officers and Directors 28 (2d ed. 1974) [hereinafter cited as Feuer].
18. Henn, supra note 16, § 236; Feuer, supra note 17, at 40. But cf. "[A] director or officer, besides his corporate activities, has personal interests to advance. Hence, too strict an application of the rule of undivided loyalty would tend to restrict freedom of enterprise and to discourage competent men from serving . . . ." Henn, supra note 16, § 236 at 459-60.
21. Feuer, supra note 17, at 41.
22. A three way split exists. The contract has been held to be "voidable on the basis of the conflicting interest alone, on the basis of the conflicting interest plus the additional element of fraud or bad faith, or on the basis of the conflicting interest plus the additional factor of unfairness to the corporation." Henn, supra note 16, § 238 at 466-67 (footnotes omitted).
26. Feuer, supra note 17, at 47.
28. Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 599 (1912). The burden of proof has consistently been imposed upon the party seeking to enforce the transaction to show it was fair. See, e.g., Pepper v. Litton, 308 U.S. 295, 306 (1939); Backus v. Finkelstein, 23 F.2d 357, 364 (D. Minn. 1927); Voss Oil Co. v. Voss, 367 P. 2d 977, 979 (Wyo. 1962); Henn, supra note 16, § 238, at 467; Feuer, supra note 17, at 43.
The most apparent conflict of interest for the investment adviser involves the determination of the advisory fee. Both the Wharton Report and the 1966 SEC Report on mutual funds indicated that tighter controls than were originally included in the Investment Company Act of 1940 were needed to protect the interests of the shareholders. Early challenges to excessive advisory fees, decided under either state or federal law, were unsuccessful. The courts rejected the application of the traditional fairness test, and instead treated the cases as ratification cases, placing the burden on plaintiff to prove that the fees were so excessive as to constitute waste of corporate assets. Plaintiff was required to show that the fees were so out of proportion to the value of services rendered as to be "unconscionable." In 1966, the SEC recommended that the standard of reasonableness should be applied in advisory fee cases. The mutual fund industry was opposed to the enactment of an express standard of reasonableness and succeeded in

30. Between 1959 and 1966 over 50 actions were commenced against investment advisers. These suits involved mainly the advisory fee. 1966 SEC Report, supra note 1, at 132.
32. See note 1 supra.
34. Wharton Report, supra note 31, at 33-34, 64; 1966 SEC report, supra note 1, at 75, 142-43.
35. Acampora v. Birkland, 220 F. Supp. 527 (D. Colo. 1963) (applying federal law); Saxe v. Brady, 40 Del. Ch. 474, 184 A.2d 602 (1962) (applying state law); Meiselman v. Eberstadt, 39 Del. Ch. 563, 170 A.2d 720 (1961) (applying state law). These are the only fully litigated cases in this area. The 1966 SEC report noted that "in most cases settlements were reached which provided for some reduction in advisory fees to be charged in future years." 1966 SEC Report, supra note 1, at 133. In each of the fully litigated cases it was "held that the plaintiffs had failed to prove the fees legally excessive . . . ." Id.
36. "When the stockholders ratify a transaction, the interested parties are relieved of the burden of proving the fairness of the transaction. The burden then falls on the objecting stockholders to convince the court that no person of ordinary, sound business judgment would be expected to entertain the view that the consideration was a fair exchange for the value which was given." Saxe v. Brady, 40 Del. Ch. 474, 481, 184 A.2d 602, 610 (1962).
39. 1966 SEC Report, supra note 1, at 143-47. "[T]he standard of reasonableness [should] be applied in the light of all relevant factors, including the fees paid for comparable services by other financial institutions . . . ; the nature and quality of the services provided; all benefits directly or indirectly received by persons affiliated with an investment company and their affiliated persons by virtue of their relationship with an investment company . . . ." Id. at 144.
40. 1967 Senate Hearings, supra note 5, at 192 (Statement on Behalf of the Investment Company Institute, Joseph E. Welch, Member of Executive Committee and Chairman of Federal Legislation Committee). "We agree, of course, that management fees should be reasonable. We
blocking passage of the bill. Four years later, Congress enacted the Investment Company Amendments Act of 1970, which provided that "the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation ...."

Under this Act it became clear that advisory fee cases would not be treated as ratification cases, but rather as fiduciary cases involving a conflict of interest. While the traditional common law approach to cases involving conflicts of interest and abuses of fiduciary relationships was to place the burden of demonstrating the fairness of the transaction on the investment adviser, section 35(b)(1) appears to impose the burden of proving a breach of fiduciary duty on the plaintiff.

It has been argued that the statute does not have to be construed so as to place the burden on plaintiff to establish that the transaction is unfair by a clear preponderance of the evidence. Instead, the courts could use the same approach taken in some corporate fiduciary cases. Plaintiff would have a duty to state a prima facie case demonstrating some unfairness, at which point the burden would shift to defendant to demonstrate the fairness of the transaction. This would appear to be the better construction of the rule. If the courts reject this interpretation and place the full burden on the plaintiff, the effectiveness of this section to protect the rights of shareholders will be believe they are reasonable and will continue to be so. Why, then, are we opposed to this SEC proposal? We are opposed, first, because we believe it is unnecessary and, secondly, because it is dangerous not only to our industry but to the investing public whom we serve. . . . " Id.

44. Id. § 80a-35b(2) (1970), as amended by Act of Dec. 14, 1970, Pub. L. No. 91-547, 84 Stat. 1413. "In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances." Id.
46. See notes 22-29 supra and accompanying text.
47. 15 U.S.C. § 80a-35(b), as amended by Act of Dec. 14, 1970, Pub. L. No. 91-547, 84 Stat. 1413. "It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty." Id.
48. Cornell Note, supra note 5, at 645.
50. Cornell Note, supra note 5, at 647.
diminished. Plaintiff would usually be unable to meet this higher burden of proof and therefore could not effectively challenge the contract between the fund and the investment adviser. It was the difficult, almost impossible, standard established in the earlier cases\(^1\) that prompted Congress to enact the new section 35. However, it appears that the courts will place a heavier burden on plaintiff than the mere establishment of a prima facie case of unfairness.\(^2\)

Section 35 does not indicate what factors are to be used in determining the fairness of the transaction. Section 35 (b)(2) provides only that approval by the board of directors or ratification by the shareholders should be given such consideration as is deemed appropriate. In light of the control that the investment adviser has over the board of directors and the proxy machinery, it is unlikely that the courts will give this factor much weight.\(^3\)

The legislative history indicates that when an action is brought for breach of fiduciary duty against the investment adviser regarding compensation received by him the court should look at all facts, including all services rendered to the fund, all compensation received, and the compensation paid by other mutual funds for similar services.\(^4\)

To ensure that the negotiations between the fund and the adviser are fair and approximate arm's-length negotiations, the investment adviser has a duty to disclose all relevant information.\(^5\) Failure to disclose such information will be strong evidence of a breach of fiduciary duty.\(^6\)

\(^1\) See notes 33-36 supra and accompanying text.

\(^2\) In Galfand v. Chestnutt, 402 F. Supp. 1318 (S.D.N.Y. 1975), the court does not clearly state which party has the burden of proof. The court cited the traditional corporate fiduciary cases, stating that "such transactions will be upheld only if, after subjecting them to rigid judicial scrutiny, they are found to be fair." Id. at 1328. In all these cited cases, the burden was on the party seeking to sustain the transaction. See note 28 supra and accompanying text. The court also cited Rosenfeld v. Black, 445 F.2d 1337 (2d Cir. 1971), petition for cert. dismissed, 409 U.S. 802 (1972). Rosenfeld dealt with another aspect of breach of fiduciary relationship by the investment adviser. 402 F. Supp. at 1328. However, in Rosenfeld the burden was on the defendant to demonstrate the fairness of the transaction.

Though Galfand does not speak in terms of burden of proof, it appears to take a middle position between requiring plaintiff to show a breach of fiduciary duty by a clear preponderance of the evidence and the prima facie standard suggested. 402 F. Supp. at 1326. But see 3 U.S. Code Cong. & Ad. News 4910 (1970). "The section makes it explicit that . . . plaintiff has the burden of proving to the satisfaction of the court that the defendant has committed a breach of fiduciary duty." Id.

\(^3\) See notes 4-6 supra and accompanying text; Galfand v. Chestnutt, 402 F. Supp. 1318, 1328 (S.D.N.Y. 1975) (ratification of the advisory contract by the board without the benefit of full disclosure, was the basis on which the court found a breach of fiduciary duty).


\(^6\) Galfand v. Chestnutt, 402 F. Supp. 1318, 1324-29 (S.D.N.Y. 1975). The failure of the investment adviser to present to the Board of Directors all relevant information, including the financial position of the investment adviser, the decrease in value of the stock portfolio, and
In evaluating the fairness of the transaction, the court can look to see if the "deliberations of the directors were a matter of substance or a mere formality." The directors must evaluate both the benefits and the burdens to the fund for the absence of such deliberation will be evidence that the transaction was unfair and therefore voidable by the court. However, the court is not authorized "to substitute its business judgement for that of the mutual fund's board of directors in the area of management fees."

The court in determining the fairness of the advisory fee, should take into consideration the size of the mutual fund and the growth of the net assets of the fund. The advisory fee is usually related to the net assets of the fund, so that as the assets increase so does the advisory fee. "It is generally recognized, however, that increases in the assets of a fund do not lead to a commensurate increase in the cost of furnishing it with investment advice and other managerial services." However, most advisory fees do not decline proportionally as net assets increase. A failure by the investment adviser to inform the board of directors of the proportional decrease in cost that occurs when net assets rise could possibly be grounds for finding a breach of fiduciary duty.

In determining whether costs are fair, the courts may also wish to consider the expense of providing similar services by an internally managed mutual fund. Though internally managed funds are the exception in the mutual fund industry, an analysis of their costs shows that their management fees are significantly lower than those incurred by externally managed funds. How-

detailed description of increased cost was the basis on which the court found the advisory contract to be unenforceable.

57. Galfand v. Chestnutt, 402 F. Supp. 1318, 1326 (S.D.N.Y. 1975). "The desire to improve [the investment adviser's] profits was, perhaps, not 'improper motivation' of the interested directors here, but to do so without full disclosure and discussion of [the investment adviser's] financial condition . . . was inappropriate." Id. at 1328.

58. See note 25 supra and accompanying text.

59. Galfand v. Chestnutt, 402 F. Supp. 1318, 1326-28 (S.D.N.Y. 1975). The failure of the board to consider the relation between the benefit received by the fund and the increased burden imposed by the higher advisory fee was strong indication that the transaction did not have the characteristics of arm's length negotiation. There was some evidence that the investment adviser offered a unique service and that his rising cost threatened his business, but the court concluded that this contention was unsupported. Id. at 1327-28.

60. 1970 News, supra note 41, at 4902.

61. See note 2 supra and accompanying text.

62. 1966 SEC Report, supra note 1, at 94. "It is now almost axiomatic in the trust business that operating costs decline proportionately as the size of a trust increases." Id. (testimony of M. Griswold).

63. Id. at 97-98.

64. Id. at 102.

65. Id. at 103-08. Both of these factors, decrease in costs due to increase in net assets and comparing costs of internally managed funds, were suggested by the SEC as part of the "reasonableness test" in the 1967 legislative recommendation. Congress, however, did not adopt the reasonableness test, but instead enacted a standard based on fiduciary principles. The SEC stated its opinion that the fiduciary standard was an "even more effective method than its original proposal to test the reasonableness of mutual fund management fees." SEC Memorandum on
ever, use of this comparison might suggest that most external management fees are excessive. Finally, the courts could consider the relative performance of the stock portfolio as compared to the performance of other mutual fund portfolios.66

Conscientious judicial attention to these factors may well be the only protection afforded to mutual fund shareholders in a marketplace which lacks the competitive forces necessary to achieve the same protection. "Such competitive forces . . . have not in fact existed in the mutual fund industry with respect to advisory fees. Instead, a sellers' market exists in which the investment adviser wearing one hat, sets his own fee, and wearing his other hat collects it. . . .

... In the absence of competition or arm's-length bargaining, the basic fiduciary obligation of fairness must serve as an effective substitute."67

III. SALE OF THE INVESTMENT ADVISER

Another frequently litigated area connected with mutual funds concerns the impact of the fiduciary relationship when the person who controls the investment adviser sells or transfers his interest. The problem arises when the compensation the adviser receives exceeds the book value of the assets of the management organization.68 The higher price is paid to the adviser because of his ability to ensure that the fund will engage the new adviser.69

The acceptance of these succession fees creates a potential conflict of interest for the investment adviser; while he has an interest in obtaining the highest price for himself, he also has a duty to the mutual fund to select the best available management successor.70

The Investment Company Act of 1940 provided that the adviser's contract is automatically terminated if assigned.71 Therefore any contract between the

H.R. 11995, Hearings on H.R. 11995 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong., 1st Sess., ser. 91-33, pt. 1 at 138-39 (1969). Therefore, the use of these standards should be appropriate under the fairness test.

66. This comparison was suggested in Cornell Note, supra note 5, at 650. By employing this comparison, the negotiations between the adviser and the fund would more closely approximate arm's length negotiations. This would encourage a competitive element which has been conspicuously missing in the mutual fund industry.

67. 1967 Senate Hearings, supra note 5, at 10.

68. "While the management organization may have some tangible assets, by far its most valuable asset is its control of the fund." 1966 SEC Report, supra note 1, at 149.

69. "The prices paid in these transactions invariably reflect an expectation that the buyers will be able to succeed to the sellers' control relationship with the fund. These prices usually have been far in excess of book value of the property transferred and represent a capitalization of anticipated future earnings that can be realized only from the continuance of that relationship." Id. at 150-51.

70. See 1966 SEC Report, supra note 1, at 14, 151. See also Note, Fiduciary Requirements and the Succession Fee Upon the Change of Mutual Fund Advisers, 85 Harv. L. Rev. 655, 656 (1972).

new adviser and the fund would have to be approved by the shareholders, theoretically providing them with direct protection of their interest. In practice, however, the outgoing adviser usually dominates the board of directors of the fund and controls the proxy machinery. He is thus routinely able to assure approval of his successor by the stockholders.

When a profit is made from the sale of the adviser, the problem arises as to whether it is the outgoing adviser or the fund that is entitled to the profit. As a fiduciary, the fund may be entitled to all profits from the sale of the fiduciary office. However, since it was the investment adviser who organized the fund and took the initial risks, he would seemingly be entitled to receive compensation for his entrepreneurial skills in successfully organizing the fund. This problem has been considered in litigation and in new federal legislation.

In SEC v. Insurance Securities, Inc., the court rejected the contention that sale of the investment adviser, in excess of book value, constituted "gross misconduct" and "gross abuse of trust," thus rejecting the allegation that the sale involved a breach of fiduciary duty. Though the court recognized that a fiduciary cannot profit from the sale of his office, this principle was deemed inapplicable because, under 15 U.S.C. § 80a-15(a)(4) the shift in control of the investment adviser automatically terminated the service contract. Therefore, the profits received could not be said to represent compensation for the sale of fiduciary office. The only protection that Congress intended was approval by the stockholders of any subsequent contract.

72. Id. § 80a-15(a).
73. "In the Commission's experience, shareholder approval of a sale of management organization has been readily obtained. The Commission knows of no instance where fund shareholders have rejected a new advisory contract proposed by their managers in connection with a sale by them of the management organization." 1966 SEC Report, supra note 1, at 150.
74. Under basic fiduciary principles all profits from the sale of fiduciary office goes to the cestui qui trust. See Rosenfeld v. Black, 445 F.2d 1337, 1343 (2d Cir. 1971).
76. Unlike corporations, the fund may not offer shares of the fund to the investment adviser at a discount in compensation for services rendered. 15 U.S.C. §§ 80a-22(g), 80b-5(l) (1970).
77. 254 F.2d 642 (9th Cir.), cert. denied, 358 U.S. 823 (1958).
78. Id. at 651.
79. Id. at 650.
80. Id.
81. Id.
82. Id. The decision was criticized by the SEC in its 1966 Report on Public Policy Implications of Investment Company Growth. "However unrealistic this conclusion may appear in the light of the ability of the retiring management to use the proxy machinery to insure the installation of its self-chosen successors, application of the strict common-law principle might well be unfair insofar as it denies to the retiring management any compensation for the elements of value in the relationship which they may have built up over the years." 1966 SEC Report, supra note 1, at 152.
83. 254 F.2d at 651.
Thirteen years later, in *Rosenfeld v. Black*, the Second Circuit held that realizing profits as a result of the transfer of the investment adviser was a breach of fiduciary duty. The court found that the sale of control of the investment adviser came within the well-established equitable principle that a fiduciary may not sell or transfer such an office for personal gain. Further, the ratification by the stockholders will "not save a fiduciary from accountability. . . ." The court rejected the contention that section 15 was the only protection envisioned by Congress. "The purpose of § 15 was to furnish the added protection of approval of a new adviser by a majority of the stockholders, not to withdraw safeguards already afforded by equity."

In distinguishing *Insurance Securities*, the court pointed to a change in section 36 since that earlier decision. The new standard was based on fiduciary duty, not on a "gross abuse of trust." Finally the court, after examining the legislative history, refused to endorse the contention that Congress intended an investment adviser to profit from the sale of his advisory position. The practical result of *Rosenfeld* was to create uncertainty as to the proper distribution of funds from the sale of the investment adviser. The decision was criticized for depriving the owner of the investment adviser of any possible gain from the organization of new mutual funds. After the *Rosenfeld* decision, "lawsuits were brought attacking at least 22 transactions involving the sale of substantial interest[s] in management companies." Few of the lawsuits were ever fully litigated—many were settled—though some of these decisions indicated in dictum that *Rosenfeld*

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84. 445 F.2d 1337 (2d Cir. 1971).
85. Id. at 1342-43.
86. Id. at 1342.
87. Id.
88. Id. at 1343.
90. 445 F.2d at 1344.
91. Id. at 1344-45 (footnote omitted).
92. Id. at 1345-46 n.12.
93. Id. at 1346-48.
94. Id. at 1347-48. On remand the court approved a settlement in which the adviser would pay one million dollars for the release of all claims. 336 F. Supp. 84 (S.D.N.Y. 1972). The court found that the maximum recovery for plaintiff, if successful, would have been three million dollars. Id. at 90. In determining the reasonableness of the settlement, the court looked to "the strength of the case for plaintiffs on the merits, balanced against the amount offered in settlement." Id. at 87. Therefore, the court found the million dollar settlement was reasonable. Id. at 90.
96. 1975 Hearings, supra note 75, at 372.
97. Id.; see, e.g., Newman v. Stein, 464 F.2d 689 (2d Cir.), cert. denied, 409 U.S. 1039
was controlling law. A few courts have rejected the rationale of the Rosenfeld decision, on the ground that it misinterpreted Congressional intent.

Section 28 of the Securities Acts Amendments of 1975 amended section 15 of the Investment Company Act of 1940. It clarifies the law in light of Rosenfeld by removing the uncertainty surrounding the transfer of the investment adviser. The amendment makes clear that an investment adviser can make a profit on the sale of its business provided certain conditions are met. "These conditions are designed to prevent any unfair burden from being imposed on the investment company in connection with such a transaction.

The new section 15(f)(1) provides that an investment adviser may receive any amount or benefit from the sale of securities or other business interest which results in an assignment of the advisory contract with the investment company, provided two conditions are met. It is the assign-
The first condition is that for three years after the transfer at least 75 percent of the board of directors of the investment company must not be interested in either the new or outgoing investment adviser. The purpose of this provision is to insulate the board from the control of the investment adviser. The advisory contract must be renewed every year, so that when the initial contract of the new adviser expires, the board will be independent and able to make an arm's-length decision on whether to continue with the same investment adviser. To ensure the independence of the board of directors, section 16 of the Investment Company Act of 1940 was also amended as to the procedure for filling vacancies on the board of directors. The section provides that when such a vacancy occurs and must be filled by a non-interested person, that person must be selected and proposed for election by a majority of directors not interested in the investment adviser and the new director must be elected by the holders of outstanding voting securities. The obvious purpose of this section is to ensure that the new director, even though non-interested in the investment adviser, is also not under its influence.

The second condition is that no unfair burden to the investment company may occur as a result of the transaction. The Act provides that an unfair burden includes any arrangement for compensation, within two years after

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108. "Any direct or indirect transfer or hypothecation of a contract or chose in action by the assignor, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor...." 15 U.S.C. § 80a-2(a)(4) (1970). "As assignment ordinarily occurs as a result of a transfer of a controlling block of the adviser's or corporate trustee's stock, but, as indicated by the definition, it may also be accomplished indirectly by a sale of assets or other means." Legislative History, supra note 103, at 318.


110. The rule is different when a corporate trustee is involved. See Legislative History, supra note 103, at 317-18.

111. The term "interested person" is defined in 15 U.S.C. § 80a-2(a)(19) (1970). This definition is referred to in the new section (f)(2). Normally 60 percent of the board of directors are permitted to be interested in the investment adviser. 15 U.S.C. § 80a-10(a) (1970). However an open-ended, no-load fund may have a board of directors where all members except one are interested in the investment adviser. 15 U.S.C. § 80a-10(d) (1970).


113. The initial SEC proposal was to have a five year period, but this section of the bill was amended by a bill proposed by Senator Williams. See Markham, supra note 95, at 76-79.


115. It was suggested that an even better solution to the problem would be to require the board not only to be independent for two years after the transfer, but also to be composed of members of which 75 percent are uninterested in the investment adviser six months before the new advisory contract is approved. Sterrett, Reward for Mutual Fund Sponsor Entrepreneurial Risk, 58 Cornell L. Rev. 195, 256 (1973) [hereinafter cited as Sterrett].


117. See notes 104-109 supra and accompanying text.

118. 15 U.S.C.A. § 80a-16(b) (Supp. 1976); see Sterrett, supra note 115, at 252-53.

the transaction occurs, in which the investment adviser receives or is entitled to receive direct or indirect compensation from the sale of securities or property either to, from, or on behalf of the company.\textsuperscript{120} This does not include bona fide ordinary compensation received as principal underwriter or compensation for bona fide investment advisory or other services.\textsuperscript{121} "Such a burden could arise, for example where the transaction involves an arrangement entitling an interested person of an investment adviser to receive brokerage commissions for executing the investment company's portfolio transactions."\textsuperscript{122}

This unfair burden provision is similar to one suggested by the SEC in 1966.\textsuperscript{123} Under the original provision, liability would result upon a showing of a likelihood of harm.\textsuperscript{124} In the new legislation, there would seem to be a less stringent standard, since liability attaches when an unfair burden is imposed. The standard in the 1966 SEC recommendation was "additional burdens"\textsuperscript{125} while the new standard is "unfair burden." It has been suggested that this evidenced the Congressional belief "that certain types of burdens caused by a change in advisers should be borne by mutual fund shareholders."\textsuperscript{126}

To protect the funds further from the negative effect of such a transaction, Congress amended section 15. The new section now makes it unlawful for the board of directors of the investment company, in connection with its evaluation of the terms of the advisory contract, to consider the purchase price which the incoming adviser has paid.\textsuperscript{127} Its clear purpose is to prevent the adviser from attempting to recoup part of his succession fee by obtaining a higher management fee.

The bill also provides for a number of situations where the 75 percent rule is inapplicable.\textsuperscript{128} "[W]here the successor investment adviser has under management a substantially larger amount of assets than its predecessor adviser, the Commission must take the discrepancy in size of assets into consideration in determining whether or to what extent an application for exemption from the requirements of subsection 15(f)(1)(A), 75 percent disinterested directors, should be granted."\textsuperscript{129}

The same provision is used when the transfer of the adviser results from a merger or other consolidation of investment advisers with substantial dis-
crepancies in assets. The purpose of these sections is "to permit the Commission to deal flexibly with situations in which the requirements of subsection (f)(1)(A) might pose an unnecessary obstacle to the completion of a transfer of a small investment company management or organization to a substantially larger one."

Finally, section 15(f)(1)(A) does not apply when the transfer of the adviser results either (i) from selling the stock to the public—provided there is no change in the identity of the person who controls the investment adviser—or, (ii) from transferring to a person affiliated with the adviser—provided that the transferee is a natural person who owned in aggregate more than 25 percent of the voting securities for a period of six months prior to the transfer. The motivation behind this section is to differentiate situations in which there is a new adviser from those in which there is a transfer of ownership of a continuing adviser. The restriction of placing no "unfair burden" on the fund is still appropriate in those situations which are excepted or partially excepted from the 75 percent rule.

IV. BROKERAGE COMMISSIONS: GIVE-UPS TO PAY-UPS

The external management structure of mutual funds has also given rise to litigation involving the use of brokerage dollars paid directly by the mutual fund, for research costs of the investment adviser. Prior to May 1975, brokerage commissions charged for executing transactions were governed by a minimum commission rate schedule. This commission was based on a certain percentage of the price of the stock. These fixed-commission rates "failed to take any account of the economies of scale in executing large transactions." The result was that a broker executing a large volume transaction could make "a profit on substantially less than the minimum commission rate." This created a situation where brokers who were com-

131. CCH Annot., supra note 105, ¶ 48,330, at 37,148.
134. This distinction was first suggested in an attempt to limit the scope of the Rosenfeld decision. It was argued that Rosenfeld only "involved a succession by a new investment adviser . . . ." 1975 Hearings, supra note 75, at 372 (emphasis omitted).
135. CCH Annot., supra note 105, ¶ 48,330.
136. 1966 SEC Report, supra note 1, at 156.
137. The minimum commission on a sale of 10,000 shares of a particular stock was 100 times the minimum commission on the sale of 100 shares of the same stock, assuming that the price per share is the same. See Note, The Use of Brokerage Commissions to Promote Mutual Fund Sales: Time to Give Up the "Give-Up", 68 Colum. L. Rev. 334, 336 (1968) [hereinafter cited as Give-Up].
138. "In December 1968, the NYSE altered the commission schedule to allow a volume discount on transactions in excess of 1,000 shares. However, the volume discount was not large enough to fully reflect the economies of scale." Legislative History, supra note 103, at 239.
139. Id.
140. Give-Up, supra note 137, at 336.
peting for mutual fund execution were willing to "give-up" part of their commission to other brokers, as provided for by the rules of various exchanges. The practice was for the investment adviser to use the give-up dollars to stimulate sales of shares of the fund and to obtain additional research information. The adviser would direct the give-up to brokers who qualified under exchange rules and provided necessary services, either sales or research, even though the services were not connected with the particular execution. The potential for abusing the customer-directed give-up was apparent, and the SEC recommended in 1966 that the practice be discontinued. However, the practice lasted until 1975, although it was attacked in litigation.

In Moses v. Burgin, a shareholder of a mutual fund brought an action claiming that the fund could recapture a portion of the commissions given-up, thus reducing the brokerage cost to the fund and that the failure to do so was a breach of fiduciary duty. Defendants contended that even if recapture were practical, "the directors still had a right to choose between recapture of the give-ups for [the] Fund's direct benefit, and awarding them to brokers for its indirect benefit. [The court held], however, that if recovery was freely available to [the] Fund, the directors had no such choice."

The court found that the fund could possibly have recovered the give-ups, and the failure to

141. "A broker who surrenders a portion of his commission to another is said to 'give up' the surrendered portion. 'Give-ups' are of two kinds. One kind, the traditional correspondent relationship, involves a division of compensation where there has been an actual division of labor among two or more brokers in the handling of a particular transaction." 1966 SEC Report, supra note 1, at 169. "The other kind of give-up is directed by the customer rather than arranged by the executing broker and is paid to a broker who has nothing to do with the transaction. In the typical customer-directed give-up, the customer places an order with a broker on condition that even though he will handle the entire transaction he will pay cash amounting to a portion of his commission to one or more other brokers . . . ." Id. at 170. In this Note, "give-up" will refer to a customer directed "give-up," which was extensively used by the funds.

142. The percentage that the broker was willing to "give-up" was usually between 50-70 percent of his total commission. 1966 SEC Report, supra note 1, at 170; Give-Up, supra note 137, at 336.

143. The NYSE rule generally provided that the give-up could only be directed to other NYSE brokers. Regional exchange rules provided that a give-up could be distributed to any broker who qualified under NASD rules. 1966 SEC Report, supra note 1, at 170-71.

144. 1966 SEC Report, supra note 1, at 164-65; Give-Up, supra note 137, at 337-38.

145. 1966 SEC Report, supra note 1, at 164.

146. Id. at 185-86.


149. Id. at 371.

150. 445 F.2d at 374.

151. Id. at 375-76. In this case the investment adviser also had a wholly owned subsidiary that was an underwriter. The underwriter could qualify under NASD or as a broker, and
fully disclose this possibility to the disinterested directors was grounds for liability.\footnote{152} In Fogel v. Chestnutt,\footnote{153} a similar action was brought for the failure to recapture broker give-ups. The district court accepted the principle "that defendants were under a duty by all proper means to secure for Fund the return of excess brokerage commissions. It [was] not shown [however] that defendants could have properly secured any return for Fund."\footnote{154} The court recognized the conflict of interest created by using give-ups to stimulate sales. The fund's dollars were used to stimulate sales by directing the excess commission dollars to brokers who had rendered sales services. This resulted in higher fees for the adviser because the sales increased the net assets of the fund. The court found, however, that this practice did not harm the fund, because under no circumstances could the fund secure a rebate.\footnote{155}

After concluding that recapture of give-ups was against public policy,\footnote{156} the court stated that "[c]ivil liability can scarcely be imposed for failing to do what it would have been contrary to public policy for the defendants to do."\footnote{157} Finally, it was found that defendants had fully disclosed the use of give-ups,\footnote{158} and therefore had not breached their fiduciary duty.

The Second Circuit reversed this decision.\footnote{159} The court recognized that the "investment adviser is 'under a duty of full disclosure of information to . . . unaffiliated directors in every area where there was even a possible conflict of interest between their interests and the interests of the fund. . . .'"\footnote{160} The information supplied must be " 'effective' " in informing the disinterested director of the possible alternatives.\footnote{161} The court held that although there was some discussion of the possibility of recapture of give-ups, this did not constitute effective communication of the problem.\footnote{162} The court rejected defendant's contention that liability should not be imposed because the course chosen was based on reasonable business judgment and most probably would have been followed even with full disclosure.\footnote{163} The court went on to state, therefore could qualify for "give-ups" on the regional exchanges. The "give-up" directed to the underwriter could be used to decrease the fund's operating expense.

\footnote{152} Id. at 377-79, 384.


\footnote{154} 383 F. Supp. at 920.

\footnote{155} Id. at 917.

\footnote{156} The court cited various proposals by the NYSE and the SEC to eliminate "give-ups." Id. at 918.

\footnote{157} Id. at 921.

\footnote{158} Id. at 919. The court also went on to distinguish the Moses decision on the grounds that Moses was decided before the SEC proposal was adopted and also the factual situation of the defendants was different. In Moses, defendants' control of the underwriter provided a practical means of recapture. Id. at 921.

\footnote{159} Fogel v. Chestnutt, 533 F.2d 731 (2d Cir. 1975).

\footnote{160} Id. at 745.

\footnote{161} Id. at 745 n.13.

\footnote{162} Id. at 747-49.

\footnote{163} Id. at 750.
however, that if recapture was impossible or illegal then there would be no liability. \(^{164}\) The court rejected the district court's findings and held that recapture of some brokerage commissions was possible either through membership, by the adviser or affiliate, in either the National Association of Security Dealers or the Philadelphia-Baltimore-Washington Exchange. \(^{165}\) Finally, the court found that the recapture of give-ups did not violate the anti-rebate rules and therefore was not illegal. \(^{166}\)

The recapture of give-ups has become a less important question as various exchanges have changed their rules to limit customer-directed give-ups. \(^{167}\) The later court decisions have been concerned more with the question of full disclosure. If the adviser informed the board of directors of the business alternatives, there was no breach of fiduciary duty. \(^{168}\)

Perhaps the shareholder would have been more successful had he brought a derivative action against the investment adviser for failure to disclose the benefits the adviser had received as a result of give-ups he had directed. \(^{169}\) If the adviser received free services, ordinarily payable from his advisory fee, the fund could be entitled to a refund. Failure to disclose this might be a breach of the adviser's fiduciary duty \(^{170}\) and of his duty to give the board of directors all relevant information. \(^{171}\)

On May 1, 1975, the minimum fixed commission rates were replaced by a competitive rate system. \(^{172}\) Funds, through their advisers, can now negotiate the commission rate with the broker and receive the appropriate discount depending on the size of the transaction. In the past, the conflict of interest was created because the adviser used the excess in the fixed commission rate to purchase services other than execution, including investment research. \(^{173}\) A new conflict of interest has arisen with the advent of competitive commission rates, since the adviser must determine what constitutes fair compensation. \(^{174}\)

The problem for the investment adviser is whether, as a fiduciary, it will

\(^{164}\) Id.

\(^{165}\) Id. at 750-52.

\(^{166}\) Id. at 752-55.

\(^{167}\) "Give-ups' were abolished by a rule of the NYSE effective December 5, 1968. Recapture of commissions or a portion thereof, however, was permissible in other respects until adoption of Article IX, Section 7(k) of the Constitution of the NYSE on January 29, 1973, and of the present Rule 318 of the NYSE on February 1, 1973. Similar rules have now been adopted by the AMEX and various regional exchanges." See Tannenbaum v. Zeller, 399 F. Supp. 945, 949 (S.D.N.Y. 1975).


\(^{172}\) SEC Reg. 19b-3(a), 17 C.F.R. § 240.19b-3(a) (1976).

\(^{173}\) Legislative History, supra note 103, at 239.

\(^{174}\) Legislative History, supra note 103, at 242-43. This problem is particularly acute when the adviser controls the broker and as a result there is no arm's length negotiation possible on commission rates.
always be required to get the lowest commission rates for portfolio transactions. If so, it cannot use a broker who provides research services because the charge would include research as well as execution costs. The possibility that the adviser would not be allowed to "pay-up" for research services caused concern in the brokerage industry.

In response to this, Congress amended section 28 of the Securities Exchange Act of 1934. The new section 28(e)(1) provides that it is not a breach of fiduciary duty for the investment adviser to pay excess commissions for research services, if it determined in good faith that such a commission was reasonable. The reasonableness would be determined by the value of the brokerage and research services provided, viewed in terms of the particular transaction or "the fiduciary's overall responsibilities with respect to the accounts over which he exercises investment direction. It is thus unnecessary for the money manager to show that specific services benefited specific accounts." The provisions are to supersede state common law or any other federal or state law in effect at the time of the enactment of the 1975 Act.

It is also provided that the adviser must disclose the policies and practices affecting the commission. The extent of the disclosure will be determined by the appropriate regulatory agency. The "standards [should] evolve in light of the 'public interest and the protection of the investors.'"

The result of this legislation is to allow the adviser to continue to "pay-up" for additional research with brokerage commission dollars. Beyond the legal questions involved there are practical considerations. The advisory fee is based on providing portfolio management. If the fund pays excess brokerage commissions for research, the fund is in essence paying for the same thing twice. This double payment should be taken into consideration when the adviser renegotiates its advisory fee.

V. CONCLUSION

With the passage of the Securities Acts Amendments, Congress has attempted to solve the problems arising from the unique relationship of the investment adviser and the mutual fund. It is now clear that the owners of

175. Id. at 248; 1975 Hearings, supra note 75, at 202 (statement of Ray Garret, Jr., Chairman, SEC).
179. Legislative History, supra note 103, at 248.
182. There also exist practical considerations for brokerage firms. A number of the larger firms have intimated that they will unbundle their commission rates, i.e., charge separately for execution and for research. This unbundling could seriously threaten the already precarious position of smaller brokerage houses. The collapse of the small brokerage firms could affect the amount of investment research available to all investors.
the investment adviser are entitled to profit from the sale or transfer of the adviser. However, Congress has been careful to establish safeguards to protect the interest of the shareholders of the fund. Future litigation in this area will certainly center on what constitutes an unfair burden on the fund. The legislation leaves this term essentially undefined. However, any arrangement which entitles the new adviser to higher brokerage commissions than were received by the old adviser places an unfair burden on the fund. The type of compensation the new adviser may receive is limited by the new provisions of the law. The courts must determine what constitutes bona fide ordinary compensation; what are bona fide investment advisory services; and what are the other services that the adviser can contract with the fund to perform without placing an undue burden on the fund.

In determining the standards, courts should consider that Congress enacted this legislation in reaction to court decisions that prohibited the retention of profit by the owners of the adviser from its sale or transfer. Further, the language of the new legislation appears to take a position allowing some burden to be placed on the fund to facilitate the sale, in contrast to the original proposals made by the SEC in 1966.

In the area of brokerage commissions, the new law expressly provides that it is not a breach of the investment adviser's fiduciary duty to pay higher commissions for stock execution. The adviser's conduct must, however, be reasonable and he is under a duty to disclose fully his policies and practices concerning the commission. This duty of full disclosure should allow the independent members of the fund's board of directors to correctly evaluate the services rendered by the adviser.

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