Reward for Mutual Fund Sponsor Entrepreneurial Risk

James K. Sterrett II

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REWARD FOR MUTUAL FUND SPONSOR ENTREPRENEURIAL RISK*

James K. Sterrett II†

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* This article was prepared while the author was a Fellow at the University of Pennsylvania Law School Center for Study of Financial Institutions. Many of the considerations with which the piece deals were discussed at a roundtable held at the Center and attended by practitioners, mutual fund executives, and representatives of the SEC. The author gratefully acknowledges the suggestions of Robert H. Mundheim, Director of the Center. The views here expressed are those of the author alone and do not necessarily reflect the views of Professor Mundheim.

† Member of the California Bar. A.B. 1968, California State University, San Diego; J.D. 1971, University of California, Berkeley.
The investment company industry was surprised and alarmed to learn from the Second Circuit in *Rosenfeld v. Black*\(^1\) that mutual fund investment advisers may not profit from the transfer of the management of a mutual fund. Advisers generally organize, promote, and, through the control of the proxy machinery, control the funds they manage. Consequently, some members of the industry regarded funds as belonging to their respective advisers, and, in effect, permitted those advisers to transfer freely their advisory relationship for whatever price the market would bear. This feeling had support in sales of adviser corporation stock at substantial amounts over book value and at very high price-to-earnings ratios. *Rosenfeld* laid to rest this popular notion and specifically held that an adviser cannot be paid for the use of its influence, the proxy machinery, or its fiduciary position in effectuating the selection and appointment of a successor adviser. But *Rosenfeld* has potentially greater implications. Read in its broadest sense, the decision could be interpreted as an attempt to prohibit completely the realization of reward for the entrepreneurial risk taken by an investment adviser.

In American corporate enterprise, entrepreneurial risk is rewarded in the form of capital appreciation in the worth of corporate shares. These shares represent an ownership interest in the entrepreneur’s business venture. Entrepreneurs often acquire this ownership interest in their enterprise at a cost lower than that paid by their capitalist counterparts who invest the initial seed money.\(^2\) For example, by

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\(^1\) 445 F.2d 1337 (2d Cir. 1971).

\(^2\) Seed money investors are sometimes considered entrepreneurs. Throughout this article, however, the economic distinction between an entrepreneur and a capitalist is observed. Of course, in any one instance a promoter may be serving in both capacities. In reference to reward for entrepreneurial risk, the reader should keep in mind the distinction between
issuance of "cheap stock," entrepreneurs share in the success of their efforts without large initial capital outlays. Mutual funds, however, by their very nature, cannot properly offer a similar opportunity to their organizers and sponsors. The funds stand ready to redeem or repurchase their own shares upon the demand of the owner at the net asset value of the owner's share. The issuance of cheap stock would have the effect of reallocating proportionate equitable ownership and diminishing the net asset value of the public shareholders' interest. This would theoretically occur in all corporations, of course, but shareholders of industrial companies, whose shares are traded in a secondary market and are not callable at the option of the owner, do not generally experience an immediate market devaluation of their holdings. In corporations which are operating concerns, the liquidation or net asset value of each share is not a major market consideration. Mutual fund shares are not traded in a secondary market, however, and their value is always directly related to the market value of the fund's portfolio. The Investment Company Act of 1940 prohibits cheap stock in mutual funds partially for this reason. This aspect of mutual funds, which denies sponsors an inexpensive equity interest, has been a major factor in the emergence of mutual funds as the predominant form of investment company.

Abuses of control abounded in the investment company industry prior to the enactment of the 1940 legislation. The mutual fund

an entrepreneur's profit and a capitalist's interest, however uncertain the rate of return. See generally J. SCHRUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT (R. Opie transl. 1934); MANNE, IN DEFENSE OF INSIDER TRADING, 44 HARV. BUS. REV., NOV.-DEC. 1966, at 113, 116-18.

3 No mutual fund shares may be sold at less than the "current public offering price" described in a prospectus. The baseline of that price must be the "current net asset value" of the fund. Investment Company Act of 1940, § 22(a)(1), 15 U.S.C. § 80a-22(a)(1) (1970) [hereinafter cited as "the 1940 Act" or "the Act"]; Section 22(g), 15 U.S.C. § 80a-22(g) (1970), requires that shares be sold only in exchange for cash or securities, except in cases of reorganization or dividend distribution to security holders. Finally, § 18(d), 15 U.S.C. § 80a-18(d) (1970), prohibits the issuance of warrants or options except on a ratable basis to existing shareholders. The SEC has permitted employees of advisory companies to purchase shares in funds managed by their employers without paying a sales charge. To this extent, they are allowed to purchase cheap stock. However, reallocation of equitable ownership, i.e., public subsidization of adviser personnel, would not occur, since net asset value would still determine each shareholder's interest. See In re Counselors Inv. Fund, Inc., Investment Co. Act Release No. 2700, [1957-1961 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 76,580, at 80,249 (1958); In re Dow Theory Inv. Fund, Inc., Investment Co. Act Release No. 2894, 38 S.E.C. 286 (1958); 17 C.F.R. § 270.22d-1(h) (1972).

features of available liquidity and freedom from market discounts, which provide greater security for shareholders, attracted the bulk of post-1929 investment company investors. In order to continue to profit from their entrepreneurial efforts, advisers organizing mutual funds after the crash created funds as separate corporate entities with no management of their own and then contracted with them for investment advice and administrative services. As the assets of mutual funds grew through sales promotion or capital accretion, the management fees, which typically are structured to some extent as a percentage of assets under management, correspondingly increased. The management contracts themselves became valuable commodities, allowing the advisers to capitalize upon their promotional success and thereby to benefit from their entrepreneurial efforts.

The investigations of the SEC in the late 1930's, however, revealed that management contracts were often sold to successors who lacked the experience or competence of the original advisers, upon whose names and reputations the shareholders had originally relied. Moreover, purchasers were frequently prompted to pay large amounts for these contracts with the promise not only of earning the attendant management fees, but also of using the pooled monies for their own purposes. Congress responded with the 1940 Act, which in relevant part requires that all investment company management contracts automatically terminate upon purported assignment or upon the sale of a controlling block of stock in the adviser. In addition, the award of a new contract following such a termination must be approved initially by the unaffiliated directors and shareholders of a fund. Nevertheless, advisers generally perform all aspects of portfolio management and

5 Jaretzki, supra note 4, at 306-07.
6 SEC 1940 Report 1918-25. These management contracts often had terms which could extend up to 20 years at the sponsor's option. Id. at 1921.
7 Id. at 1918-36.
8 The investigations resulted in the SEC 1940 Report.
11 The Act defines "assignment" to include the transfer of a controlling block of adviser stock. Id. § 2(a)(4), 15 U.S.C. § 80a-2(a)(4) (1970). This transaction would accomplish the same practical result as an outright transfer because by gaining control of the management company the purchaser can appoint its own personnel and institute its own investment policies.
12 Id. §§ 15(a), (c), 15 U.S.C. §§ 80a-15(a), (c) (1970).
administrative operation, leaving shareholders little opportunity to refuse the successor chosen by the retiring adviser or his principals, since rejection would leave the fund without management of any kind. Thus, despite the provisions of the 1940 Act, retiring advisers have been able to derive entrepreneurial reward much like an entrepreneur does in a conventionally formed, internally managed corporation through his sale of corporate shares. Moreover, at least twenty advisory companies have “gone public,” often permitting their principals to reap enormous entrepreneurial profits without abdicating control of the management company and the funds it manages and, at the same time, allowing them to continue to receive generous salaries as the management company’s officers.

By denying the adviser profit from a transfer of its advisory duties, Rosenfeld may, therefore, eliminate an important source of entrepreneurial reward for organizers and promoters of mutual funds. The proscription could, moreover, be directed at all entrepreneurial reward, regardless of its source, since the reward of entrepreneurial effort in the mutual fund context must be accomplished through the direct or indirect use of the control an adviser has over a fund. Thus, the decision has important implications for the sale of stock in investment advisory companies, in both private negotiated transactions and public offerings, and, perhaps more significantly, for the determination of the composition, the structure, and ultimately the size of management fees.

The denial of entrepreneurial reward suggested by a broad reading of Rosenfeld comes at a time when other avenues of income for advisers are being eliminated or threatened. The 1970 Amendments to the 1940 Act impose a more stringent standard upon mutual fund advisers with regard to the amount of compensation they may legally derive from their advisory relationships. The 1940 Act now imposes upon advisers a fiduciary duty with regard to management fees and

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other material compensation payments, replacing the lax corporate waste standard developed at common law with one of reasonableness.\textsuperscript{17} This new standard will subject all management compensation, including brokerage commissions and underwriter fees, to closer judicial scrutiny.

Immediately prior to the \textit{Rosenfeld} pronouncement, the First Circuit held, in \textit{Moses v. Burgin},\textsuperscript{18} that advisers must present to mutual fund independent directors the possibility of establishing broker-dealer affiliates for the purpose of recapturing brokerage commissions on behalf of the funds. Under \textit{Moses}, independent directors, acting within the proper exercise of their business judgment, cannot refuse to recapture commissions whenever brokerage recapture through affiliates, or otherwise, is possible. \textit{Moses} does permit independent directors to weigh the risks attendant to establishing a brokerage operation, and, if they conclude that the financial savings are outweighed by those risks, to forego creation of an affiliate.\textsuperscript{19} By condemning the use of brokerage on the adviser's behalf, \textit{Moses} also appears to prohibit advisers from allocating brokerage to reward other broker-dealers for selling shares of the funds the adviser manages. The SEC has embraced this position.\textsuperscript{20} Some industry representatives, however, have expressed the fear that this reduction in financial incentive to sell mutual fund


There has been some question as to whether the fiduciary standard requires a reasonableness test. See Baris, \textit{Mutual Fund Legislation}, 4 Rev. SEC. REG. 977 (1971). SEC staff members are sure that it does: "The legislative history thus supports the position that the fiduciary duty standard and the test of reasonableness are the same in substance." Freedman & Rosenblatt, \textit{Duties to Mutual Funds}, 4 Rev. SEC. REG. 937, 940 (1971).


\textsuperscript{19} A SEC opinion, however, suggests that if an affiliate of the adviser in such a case continues to handle fund brokerage, the profits of the affiliate must be taken into account by independent directors in management fee negotiations. \textit{In re First Multifund of America, Inc., Investment Co. Act Release No. 6700, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,209, at 80,600 (1971). If the profits are offset dollar for dollar against the management fee, the practical effect would be similar to the establishment of a fund affiliate. See generally Wyckoff, \textit{Recapture of Fund Brokerage}, 4 Rev. SEC. REG. 847 (1971).} The advent of negotiated rates is also materially diminishing the revenue formerly available to mutual fund advisers. See generally Note, \textit{Fiduciary Requirements and the Succession Fee upon the Change of Mutual Fund Advisers}, 85 Harv. L. Rev. 655 (1972).

shares will materially reduce sales of such shares, for, as the maxim goes, mutual fund shares are sold, not bought. Since sales directly affect the size of mutual funds, management fees will likewise be affected.

Furthermore, for the first time since the enactment of the 1940 Act, the mutual fund industry is experiencing a prolonged period of net redemptions, i.e., more money is being taken out of mutual funds through the redemption of fund shares than new sales bring in. Since management fees are at least in part related to the size of the funds advisers manage, advisory compensation is on the average diminishing.

*Rosenfeld* has caused great concern among industry observers; the opinion has been claimed to have created a "new and fundamental crisis" which "threatens to rock the mutual fund industry at its very foundation," and which will lead "to a major restructuring of the [mutual] fund industry." Lawyers have been left with grave uncertainties as to the rights and duties of the parties involved in a transfer of advisory duties or in a sale of a controlling block of adviser stock. Some transactions have been consummated on the advice of legal counsel that *Rosenfeld* was inapplicable, but others have either been aborted, forcing advisory personnel to remain in their present management positions for economic reasons, or have been carried out only after it has been arranged for the fund, not the adviser, to receive payment for the successor's opportunity to manage the fund.

In response both to the uncertainty of the respective rights and obligations of parties to a transfer or sale, and to the apparent denial

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22 Lenzer, *You Can't Sell a Mutual Fund—Or Can You?*, 5 INSTITUTIONAL INVESTOR, Nov. 1971, at 44.


24 In such cases, of course, the proxy statement submitted to stockholders in connection with the approval of a new advisory contract with the successor advisor must discuss the legal problems arising from the decision and indicate counsel's opinion as to the non-applicability of the decision to the transaction.

A. Mostoff, *supra* note 20, at 53.


**CONTROL OF MUTUAL FUND MANAGEMENT COMPANY**

Sought for cash by principals well known in financial community. Should at least break even with approx. $5-8 Million under management. Geographic location no problem, but should be relocatable to Southern California.

Wall St. J., May 4, 1972, at 21, col. 6 (eastern ed.).

26 See note 248 infra.
of "the same kind of opportunity for profit in capital value that you get in other businesses," the SEC has drafted legislation, S. 4071, designed to make continuation of the advisory relationship between a successor adviser and a fund dependent upon proven performance and service. This effect is to be accomplished by requiring a board, comprised of at least seventy-five percent totally independent directors, to govern the fund's management for at least three years following the sale of control of the management company or of the advisory position. The SEC has theorized that, under the proposal, any consideration an adviser can derive upon the assignment of an advisory contract would be limited because the purchaser would not be ensured of automatic succession to the advisory position.

This article will analyze the two chief means of rewarding mutual fund sponsor entrepreneurial risk: management fees and succession fees. It will examine what a succession fee is and why it is paid by a successor to its predecessor adviser. Through an analysis of Rosenfeld, the article will attempt to articulate, as the Rosenfeld court failed to do, the reasons why only a complete prohibition of succession fees will provide sufficient shareholder protection. The effect of the proscription of succession fees on transfers in the form of sales of control of management companies will also be considered. The article will argue for the continued allowance of entrepreneurial reward, suggesting, however, that entrepreneurial reward be paid as a component of periodic management fees. Finally, the adoption of S. 4071 is urged, but only after several alterations are made.

I
THE SUCCESSION FEE

A succession fee is the payment an incoming adviser makes to the departing one for the opportunity to advise the mutual fund. It can be in the form of an outright payment of money, stock, or other

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29 The SEC hopes that any consideration an adviser can derive upon an effectual assignment of an advisory contract would be limited by the natural market factors which come into play when the purchaser is not ensured automatic succession to and continuation of the advisory position. Letter from SEC Chairman William J. Casey to Senator Harrison A. Williams, Jr., reprinted in BNA SEC. REG. & L. REP., No. 146, April 5, 1972, at 1-1 [hereinafter cited as Casey Letter]. See also Address by A. Sydney Herlong, Jr., Current Developments for Investment Companies, Investment Company Institute, Washington, D.C., May 18, 1972, at 9-12 (on file at the Cornell Law Review) [hereinafter cited as Herlong].
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property. Alternatively, when the new adviser takes control of the former adviser's institutional entity through a purchase of controlling shares, a purchase of the assets, or a merger, a succession fee can take the form of a premium above the price that would otherwise be paid if the advisory relationship were not attendant to such a purchase. It is important, therefore, prior to a discussion of the legal rules governing succession fees, to understand both the nature of the opportunity a succession fee purchases, and, in view of the fact that a mutual fund has its own board of directors which can theoretically contract for advisory services with any responsible organization, why it must presently be paid to an outgoing adviser and not to a fund.

A. The Opportunity

There are two primary reasons why a prospective adviser might pay for the opportunity to manage a mutual fund. First, the business has potential to produce enormous management fees and high profit margins. Second, since investment company clients never discontinue the management relationship, there is no risk of loss of the position. Management fees are generally based upon a percentage of the assets under management. As a fund grows, either through additional sales or capital accretion, so does the management fee. The cost of managing a fund, however, does not generally increase proportionately with its assets. Although it may be too simple to say that "it costs no more in research effort to buy 100 shares of stock than 1,000," significant economies of scale do exist in mutual fund management. Thus, as assets

30 For a discussion of this characteristic of mutual funds, which largely results from the manner in which independent directors discharge their duties, see notes 43-54 and accompanying text infra.

31 There are three basic forms of mutual fund management fees: (1) a fixed percentage of fund net asset value, (2) a percentage of net asset value scaled down for increased assets, and (3) a percentage of net asset value supplemented by a bonus or penalty determined by portfolio performance relative to an objective market measure, such as the Standard & Poor's or the Dow Jones industrial averages. Glazer, A Study of Mutual Fund Complexes, 119 U. Pa. L. Rev. 205, 259-60 (1970). There is no requirement that management fees be based on a percentage of assets under management. For a suggestion of a flat fee, see Mundheim, Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds, 115 U. Pa. L. Rev. 1058, 1067 (1967).


33 "[I]t would cost little more or no more to manage and domicile [an investment] company of $30,000,000 capital than one of $3,000,000." SEC 1940 Report 1385 (statement of W. Thorold, controlling stockholder, Federated Management Corp.; see Wharton School of Finance and Commerce, A Study of Mutual Funds, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 29 (1962) [hereinafter cited as Wharton Report]; Mundheim, supra note 31, at 1065.
increase, advisers' profit margins grow at a proportionately faster rate. In especially large funds the profit becomes immense.  

These massive fees obviously compensate advisers for more than mere management and portfolio advice. In 1966 eleven investment companies had internal management, i.e., fund-hired personnel ran the investment company.  

The SEC found that on the average the cost of management services in these companies was significantly lower than that found in funds which have institutionally distinct management companies.  

The extra margin of profit must be justified, then, if at all, as a reward for the initial entrepreneurial risk each adviser takes when it first organizes a fund and as repayment of the losses experienced until the fund reaches an asset level sufficient to be self-supporting.

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34 For example, the industry's largest adviser, Investors Diversified Services (IDS), earned a profit of $17,786,000 on total income of $39,073,000 in the fiscal year ending June 1965. SEC 1966 Report 122. This resulted in a profit margin of over 45%, Id. Other more efficient advisers with smaller total profits had even higher profit margins, with the maximum over 68%, Id.

In the late 1950's and the 1960's, over 50 lawsuits were instituted challenging the propriety of these enormous fees. For a comprehensive survey, see Eisenberg & Phillips, Mutual Fund Litigation—New Frontiers for the Investment Company Act, 62 Colum. L. Rev. 73 (1962). The aftermath of the litigation is briefly summarized in Note, supra note 17, at 633-37. Most suits ended in settlement, with advisers agreeing to some reduction in the fee as the assets under management increased. Often this meant that the industry's most common rate, .5%, was reduced to .4% and in some cases to .3% on the assets above certain break points. For example, Investors Mutual Fund, the largest fund in the IDS complex, presently pays a graduated scale of fees beginning with .5% on the first $250 million of average net assets and ending with .3% on all assets in excess of $1,750 million. In 1970, Investors Mutual had $2,508,101,830 in assets and paid IDS $7,975,205 in net fees for an effective rate of roughly .32%. Prospectus, Investors Mutual, Inc., Jan. 13, 1973, at 5.

In addition, many advisers have affiliate broker-dealer organizations which execute large portions of their funds' brokerage, despite the specter of the Moses case. See Moses v. Burgin, 445 F.2d 1337 (2d Cir. 1971). Although the level of a fixed commission rate is declining and many institutional size orders are not as profitable as before, significant amounts of profit still exist for advisers. The absence of a fixed commission rate may also increase the nominal size of management fees. Some advisers faced with both the difficult conflicts of interest situation, in which they must in effect bargain with themselves for appropriate brokerage charges, and the declining profits from this source, are insisting that trades above the fixed level be executed at their cost, but that management fees be increased to reflect this loss. The effect then of negotiated rates may be merely to "visualize" the total amount of management compensation, not to reduce it.

35 SEC 1966 Report 102. Subsequently, the MIT-MIGS complex of Boston, formerly the largest internally run group of funds, externalized management.

36 Id. at 102-11.

At present, however, no mutual fund delineates the portion of the fee the adviser earns as payment for entrepreneurial risk or initial losses. As a result, when an adviser arranges a transfer to a new adviser, the fee rate remains the same; the successor will receive fees compensating it for an entrepreneurial risk it never took. The selling adviser will, of course, compute its sale price as a capitalization of future profits. This may permit the seller in effect to be rewarded twice for its promotional talents. It also changes the position of the adviser of the fund from that of entrepreneur to that of capitalist.

By determining its sale price from a capitalization of future profits, the retiring adviser can demand a sum at least equal to the present value of those profits, less the present value of potential market value of the successor's or its principals' personal services. Without more, a successor would do as well in the labor market; there would be no reason to risk its capital. The possibility of deriving additional compensation sufficient to assure both a return of its capital investment and a reasonable rate of interest must exist. An optimistic adviser, believing it can develop the opportunity and increase profits, will take the risk. Several avenues are open to a confident adviser who wishes to achieve a higher return.

First, a prospective adviser may believe that it can manage the mutual fund more efficiently than its predecessor. Greater efficiency will reduce cost, and, if all else remains the same, the successor's net income will be greater than that of its predecessor. For example, an adviser managing several funds with a total asset base sufficient to permit a high profit operation may be able to take another fund into its complex at a low marginal increase in operating expenses, producing larger profits on that fund's management fee than an adviser which managed only that one fund could produce.

A prospective adviser may also believe that it can manage mutual funds more effectively than its predecessor and thereby achieve better performance. Superior investment performance often results in profits not only for the shareholders but also for advisers. Unrealized capital gains and realized earnings (which are often reinvested by shareholders) enlarge management fees because they are generally structured as a percentage of assets under management. A growing number of advisory contracts have performance incentive clauses which permit advisers to earn a proportionately larger percentage when investment results are better, on a risk adjusted basis, than a given market indicator or standard, such as the Dow Jones industrial average. Superior performance is especially attractive to prospective mutual fund in-
vestors. While empirical supporting data is still inconclusive, many mutual fund sponsors believe the strongest selling point they can have is good performance.\textsuperscript{38}

Still another reason prospective advisers are willing to pay succession fees is to avoid the risk of organizing and promoting a fund to a similar size.\textsuperscript{39} Not all mutual fund sponsors starting new funds are successful. One industry observer estimates that only one out of every five sponsors ever makes a profit, principally because sponsors are unable to amass enough assets under management to produce a management fee sufficient to cover operating costs.\textsuperscript{40}

Thus, a prospective adviser desirous of entering the industry is faced with two alternatives: organizing and promoting a new fund, or paying a succession fee to manage a previously established one. In making its decision, it will have to compare the costs of each course of action. In organizing a new fund, it may be able to estimate with relative certainty the fixed capital costs; however, it must also value the promotional time and effort needed to organize the underwriting and management operations and the sales team or network. Additionally, until the assets accumulate to a self-supporting size, operating losses must be absorbed. A proper cost estimate must include the considerable risk of failing ever to reach a profitable asset level. To the prospective adviser that believes its forte is not promotion but management and financial analysis, the opportunity of taking over an established fund and foregoing the entrepreneurial risks absorbed by its predecessor will be worth a great deal.\textsuperscript{41}

\textsuperscript{38} The best recent example of the value of performance is the T. Rowe Price complex. For the last several years the funds managed by the Rowe Price management company have consistently been leaders in risk-adjusted performance. Despite being no-load funds, which means that no salesman is paid to sell fund shares, the three Price funds garnered 14% of the total gross sales of the 1,000 funds in the industry in 1971. Bleakley, \textit{How Persistence Has Paid Off For T. Rowe Price}, 6 \textit{INSTITUTIONAL INVESTOR}, April 1972, at 60. See also Robertson & Falk, \textit{A Baltimore Firm's Winning "Philosophy": T. Rowe Price's Private Business}, 85 \textit{FORTUNE}, April 1972, at 137. Even more spectacularly, the same three funds had over 50% of the industry's net sales for the same period (id.), indicating that performance not only aids new sales, but also deters satisfied investors from redeeming shares.

\textsuperscript{39} The advantages to an insurance company of purchasing, instead of developing, a mutual fund management company are considered in Huard, \textit{supra} note 25, at 1203-05.

\textsuperscript{40} "We would guess that as much as 80% of the individual management companies operate at a break-even point or at a loss." Arthur Lipper, president of the Arthur Lipper Corp., which surveys the mutual fund industry, \textit{quoted in Can They Survive?}, \textit{FORBES}, Dec. 1, 1971, at 87.

\textsuperscript{41} Both the prospective adviser that cannot offer investors good investment analysis and the present adviser that, due to substandard performance, has been unable to accumulate enough assets under management to be profitable and has thus stifled investor enthusiasm, will view the chance to succeed to an established fund as a favorable oppor-
Finally, an unscrupulous adviser might pay a succession fee in order to obtain the opportunity to loot a fund or otherwise to use the assets on its own behalf. Misuse of a fund’s assets can be accomplished in subtle ways, most of which are specifically proscribed by the Act. Unfortunately, some prospective advisers may not be deterred by these prohibitions.

The prospective adviser that believes it can serve the shareholders of a fund more efficiently and effectively than the present management should be encouraged to do so, even if its decision is motivated by a business judgment to forego the entrepreneurial risk of promotion. The shareholders of an organized fund want the best investment management available; an adviser’s promotional abilities are of relatively little importance to the shareholders. Once a self-supporting asset level is reached, many observers, including the SEC, believe that “existing shareholders . . . derive little or no benefit from the sale of new shares.”

Those prospective advisers that wish to purchase an advisory relationship either because they are incapable of developing one themselves or because they plan to use the acquired fund’s portfolio for their own benefit should not be permitted the opportunity, despite the societal interest in rewarding the retiring adviser for developing the investment vehicle through its entrepreneurial talents.

B. Payment to the Predecessor

The backbone of the 1940 Act is the requirement of independent directors on every investment company board of directors. Prior to 1940, most advisers would staff boards of directors which they organized with men from their own company. In this manner advisers were able to control all corporate decisions of their funds and to “negotiate” very favorable contractual terms. In recognition of the fact that such relationships lacked any semblance of arm’s-length bargaining and provided few safeguards for investors, the Act requires that forty-per-

42 Examples of how this may be done include churning, i.e., excessively trading the portfolio through a brokerage affiliate in order to earn unduly large brokerage fees, and investing in companies in which the adviser is interested, either as an underwriter, shareholder, or lender.

43 For example, § 17(a), 15 U.S.C. § 80a-17(a) (1970), prohibits self-dealing on the part of advisers or their personnel.

44 SEC, Statement on the Future Structure of the Securities Market, supra note 20, at 7. See also SEC 1966 Report 263; Mundheim, supra note 31, at 1069.


cent of the boards of most mutual funds consist of persons unaffiliated with their advisers.47

Unfortunately, the regulatory scheme has not provided the arm’s-length bargaining envisioned by Congress. In a comprehensive study of mutual fund independent directors, William Nutt, then a Fellow at the University of Pennsylvania Law School Center for Study of Financial Institutions, found that in practice the annual meetings at which advisory contracts are renewed bear “few of the earmarks of arm’s-length bargaining. . . . Contract renewal is not a bid-and-ask proposition.”48 Instead, Nutt concluded, an adviser simply presents a complete contract, including a management fee provision, and the independent directors acquiesce in its terms. He found no instances of directors shopping for another management company with a better performance record or lower fee; no director surveyed suggested that a board or any independent director should as much as contact other advisers to ascertain the price of comparable services.49

Nutt’s study confirms earlier suspicions that independent directors do not view their role as that of a bargaining adversary of the adviser. Instead, they see themselves as watchdogs for only the most egregious adviser misconduct. This attitude reflects the dual nature of the director-adviser relationship in the mutual fund industry. Most independent directors are selected by the adviser; they are not, after all, “self-appointed strangers.”50 Shareholders must formally elect an adviser’s choice of director, but, in practice, the adviser’s power to place the name of a director on the proxy statement is “tantamount to appointment.”51 Independent directors are keenly aware that they owe their tenure to the adviser.52


The original purpose of the requirement was to establish at least a modicum of arm’s-length bargaining between a fund and an adviser, thereby protecting the fund shareholders from self-interested overreaching on the part of an adviser. On especially important issues, such as management contract award and renewal, the Act further mandates that a majority of the independent members agree, effectually requiring boards to be totally independent for decision making purposes. See 1940 Act § 15(c), 15 U.S.C. § 80a-15(c) (1970).

48 Nutt, supra note 47, at 222-23.

49 Id. at 223.


51 Nutt, supra note 47, at 216; see SEC 1966 REPORT 129.

52 While some independent boards have begun to assume more responsibility in the
Moreover, new directors are usually oriented to their duties by representatives of the adviser. They are often not fully briefed by the other independent directors or fund counsel, may fail to recognize the significant conflicts of interest inherent in the dual entity structure. Thus, independent directors place unwarranted trust in adviser officials.

Finally, because mutual fund investors tend to select a particular fund on the basis of its adviser's reputation rather than on the basis of the fund's intrinsic qualities, many independent directors feel that the shareholder purchases what is essentially an individual contract with the adviser and that the appropriate solution to poor performance or inadequate service is redemption by the shareholder, not a change in advisers or contractual relations by a fund. This concept, often labelled the "shell theory" because it reduces a fund to a mere legal "shell," has been advanced by some legal commentators as the appropriate model for legal rights and obligations in a mutual fund. But the 1940 Act and the 1970 Amendments reject this suggestion. The requirements that the advisory contract be written and that it describe all compensation to be paid a management company, that the contract be

The pooling of assets, whatever the form used to accomplish it, has only convenience and economy as its motive and intended to have only convenience and economy as its effects.

Rights, expectations, obligations, performance, all the palpable realities of fund operation, flow into the mold only with sales of fund shares. Each sale of the Fund's shares is the creation of another contract—the Fund's contract with the investor. This is the "real" contract.
terminable without penalty by the board or shareholders on sixty days notice,\textsuperscript{59} that the initial contract award be approved by a majority of both the independent directors and the shareholders,\textsuperscript{60} and that continuance of the contract be annually reviewed by a majority of independent directors,\textsuperscript{61} indicate that Congress did not intend the fund to be merely an institutionallorication.\textsuperscript{62}

The prevailing permissive attitude on the part of independent directors results in the virtual certainty that a mutual fund will annually renew its advisory contract with the present adviser, regardless of prolonged dismal performance or high management fees: "Changes in investment advisers have almost always occurred only with the cooperation (or at best acquiescence) of the existing adviser."\textsuperscript{63} For a prospective or competing adviser to assume managerial responsibilities of an existing fund, it must convince the fund's adviser, not its independent directors, of the benefits of such a change. Naturally this is most often done with financial persuasions, namely, a succession fee.

The Act does provide that a majority of the shareholders can terminate an advisory relationship.\textsuperscript{64} Thus, at least theoretically, an adviser eager to manage a fund could take its case directly to the shareholders, bypassing an unreceptive board. Most mutual funds, however, have a large and widespread body of shareholders. The expense of a proxy fight would be considerable, perhaps not significantly

\textsuperscript{60} Id. §§ 15(a), (c), 15 U.S.C. §§ 80a-15(a), (c) (1970).
\textsuperscript{61} Id. §§ 15(b)(1), (c), 15 U.S.C. §§ 80a-15(b)(1), (c) (1970).
\textsuperscript{62} The fact that the 1970 Amendments deem advisers fiduciaries, at least with respect to management compensation (see note 17 supra), could be interpreted as a move toward the shell theory, because the existence of the separate fund entity no longer supports the legal fiction that its presence establishes sufficient check upon the adviser to dispel the need for the typical legal responsibilities incumbent upon those entrusted with other people's money.

But while Congress placed heavier statutory burdens on advisers, it also strengthened the role of independent directors. They are now required to "request and evaluate" all information that may be reasonably necessary to evaluate the terms of a management contract. 1940 Act § 15(c), 15 U.S.C. § 80a-15(c) (1970), as amended, 84 Stat. 1413. For an analysis of this duty, see Nutt, supra note 47, at 195-96. Moreover, the directors must now personally attend the meeting called for contract award or renewal. Id. Thus, the Amendments do not abandon the concept of an interposed entity providing real safeguards against adviser overreaching. It is more likely that the characterization of advisers as fiduciaries merely reflects "a legislative judgment that the fund's independent directors do not normally deal at arm's-length with the investment adviser," and not a judgment that their existence is meaningless. Mundheim & Nutt, The Independent Directors of Mutual Funds, [Vol. 58:195]
less than the succession fee demanded by the adviser. Moreover, the results would be unpredictable. Since most mutual fund shareholders base their investment upon the reputation of an adviser and choose mutual funds for the very purpose of leaving the management of their money to someone else, they would be loath to take an active role in the business matters of a fund, particularly to change the identity of its adviser. 65

Since both independent directors and shareholders acquiesce in management recommendations, advisers not only can be assured of their retention by the fund, but can also virtually guarantee acceptance of their chosen successor by the respective groups. Thus, when a successor pays a succession fee to a retiring adviser, that fee represents not only an inducement for the current adviser to step down, but also assures that the succession will be approved by the fund and that the successor will be able to maintain the advisory relationship at its pleasure.

True independence on the part of unaffiliated directors would, of course, eliminate these factors. If upon the retirement of an adviser competitive bids were sought and applicants were reviewed not only on the basis of the price of their services but on their past performance records, the directors could secure for a fund the premium an adviser now receives for recommending a particular successor. If a successor were willing to pay an adviser for the opportunity to succeed as adviser to the fund, "it would in all likelihood [be] willing to make the same concession to the fund." 66 This concession could take the form of reduced future management fees or a lump sum payment upon engagement, whichever a board believed to be more advantageous. 67

This industry pattern, in which advisers effectively determine their tenure and successors, does not result solely from the failure of independent directors to fulfill their directorial responsibilities. There are practical reasons which may justify choosing a present adviser over

65 This is not to suggest that redemption is the only appropriate means of expressing dissatisfaction with advisory services which the law will recognize. It merely demonstrates that shareholders, who unlike directors are not in a position to closely evaluate the reasons for poor adviser performance, are more likely to redeem than to wait for (or promote) a proxy fight in order to secure new investment management.
66 Nutt, supra note 47, at 245.
67 This would, however, still leave the possibility that an adviser would demand a fee for voluntarily quitting the relationship from an optimistic adviser willing to take its chances. But if the selection procedure used by a board were extensive, the amount paid by any one prospective successor would probably be small, reflecting the small chance of selection from a potentially large pool of possible successors. This would reduce the degree to which a new adviser must recoup its initial "capital investment," and would result in even lower fees or more extensive services.
possible competitors. First, the current adviser is a tested and seasoned entity. During the course of the relationship, an adviser and its team will become familiar to the board, permitting smooth working conditions. Second, the fund may be a part of a complex of funds. Fund complexes can provide several advantages, principally related to economies of scale, efficient use of specialized personnel, and coordinated sales. If the other funds do not wish to switch advisers, a fund would have to leave the complex and forego these advantages.\(^6\)

A change in advisers over the opposition of the existing adviser might result in a disruptive adjustment period for the fund.\(^6\) Unless a successor were picked without an existing adviser's knowledge and the chosen adviser was available to assume duties immediately, a fund would be faced with having a less than enthusiastic adviser at the helm during the interim. Furthermore, since a departing adviser may be entitled to sixty days of management fees, a board may be reluctant to have a successor begin immediately because of the duplication of compensation.

Investment advisers typically perform many services other than portfolio management, such as administration of shareholder accounts and sales of fund shares. A board might find that a potential adviser which has an excellent past performance record is not organized to provide these additional services. Moreover, some advisers have engaged in the questionable practice of providing in their respective management contracts that the adviser will maintain all of a fund's records and files.\(^7\)

Finally, one board of directors has implied that industry members will presently negotiate only with mutual fund advisers, not with the funds they manage. In a proxy statement sent to shareholders of the approximately sixty-six million dollar Ivy Fund, recommending the approval of the sale of its adviser Studley, Shupert & Co., Inc. to Fidelity Corporation for five million dollars worth of Fidelity stock, the board

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\(^6\) See Mundheim & Nutt, supra note 62, at 22.  
\(^6\) SEC 1966 REPORT 129.  
\(^7\) Id., at 131.

In one notable incident, the independent board of the Investors Mutual Fund, known for being truly independent, is reported to have actually investigated the possibilities of finding a new adviser because its adviser, IDS, was providing management which resulted in sustained below average performance. The board found, however, that under the advisory contract IDS had exclusive control of the Fund's records. Making the switch would have been an administrative nightmare because IDS could, as a practical matter, seriously hamper the Fund's exercise of its state-created, unqualified right of access to the records. Despite dissatisfaction with the services of IDS, the board decided to continue the advisory relationship.
stated that the independent directors "doubt[ed] that another respectable and competent investment manager would pay the Fund a premium for being retained as the Fund's investment adviser." Unless the Ivy Fund independent directors detected a conspiracy in the industry to discourage direct bargaining with mutual fund boards, the basis for the statement seems questionable. Investment advisers, in intense competition for pension and employee benefits and endowment fund accounts, regularly make concessions to those funds in order to win advisory contracts.

It may well be that some established management companies are hesitant to negotiate directly with fund directors because they wish to discourage active shopping by fund boards. They may believe that such negotiations and the possible subsequent shift in advisers could become a precedent for the industry, leading to the widespread adoption of competitive bidding for investment company clients. Thus, advisers may resist the temptation to increase their immediate revenues for fear of establishing price and performance competition throughout the industry, thus ultimately weakening their own secure position as advisers to funds presently under their management.

C. The Mutual Dependency of Price and Quality

Some commentators have suggested that the proper resolution of problems posed by succession fees can be found by focusing solely on the amount of management fees paid by shareholders through their funds. They argue that "if the fees being received are excessive, then the price received by the sellers of stock in the investment adviser is really a capitalization of the unconscionable profits being taken from the investment company, and therefore in equity it belongs to the investment company shareholders." Implicit is the notion that if the fees meet the statutory standards, a succession fee would be proper, regardless of its size. But the seller under this rule would be free to select a successor, not on the basis of the candidate's expertise or competence, but on the basis of his own financial interest. These commentators further suggest that "corporate democracy" demands that

71 Proxy Statement, Ivy Fund, Inc., March 29, 1972, at 13. Ivy Fund had paid $334,577 for management and advisory services in 1971, and the proposed contract following the sale would have made no change in the fee.

72 Despite the possible presence of these fears, the Ivy Fund directors probably could have found one tested adviser which did not share such inhibitions. If not, and if the reluctance of the industry were inexplicable on other grounds, the Ivy Fund directors might well have investigated the possibilities of judicial remedy under the antitrust laws.


74 Id.
shareholder approval operate as the sole assurance of the quality of a successor adviser. This ignores the fact that shareholders have no real choice in such a vote. Even if they did, they could not be expected to have the time or resources to become fully informed of the nominee's abilities. Although the fact that shareholders do invest primarily to secure a particular adviser's management may be sufficient to deter independent directors from recommending a switch except in cases of prolonged substandard performance or egregious adviser misconduct, that consideration is not relevant when the adviser is voluntarily leaving. The successor it recommends need not be accorded the same deference. Moreover, the commentators' suggestions ignore the fact that an adviser which receives only reasonable management fees can still demand a premium, either for relinquishing its position, assured award of a new contract with the successor, or transferring a profitable relationship the tenure of which is determinable by the transferee. The mere payment of a premium will economically force the successor either to cut costs and services or to charge more than mere management would warrant. Even if the fees were within the statutory standard, the shareholders will eventually pay the succession fee. Analysis cannot focus solely on management fees, but must consider both the price that shareholders must pay for advisory services and the quality of the investment management they receive.

Consideration of the quality of adviser performance is not an onerous burden on either independent directors or reviewing courts. First, without the ability to discontinue an advisory relationship, independent directors are unable to bargain effectively on advisory fee matters. Both price and quality are necessarily mutually dependent; one cannot be properly determined in the absence of the other.

Second, from a philosophical standpoint no essential difference exists between providing protection for shareholders for the quality of services they receive and providing similar safeguards for the cost of those services. The alternatives of redemption and corporate democracy, while necessary, both suffer from limitations that make them unsatisfactory as the sole protections. In view of the ultimate effect on a mutual fund shareholder's investment, it seems more appropriate to provide safeguards against poor performance than against management fees, which are, economically speaking, relatively insignificant.

75 Id. See also Lobell, supra note 56. Rottenberg chronicles the mutual fund industry's argument along these lines in opposition to the 1970 Amendments. See Rottenberg, supra note 17, at 337-43.
76 SEC 1966 REPORT 131.
to each shareholder's investment. Performance is the risk investors take in all investments, but a mutual fund shareholder should not have to assume the risk of inattentive or incompetent investment advisory services.

Finally, the fact that a shareholder has knowingly invested in a fund which has had poor performance in the past, or would vote to approve a management contract with an untested or substandard successor, does not necessarily mandate that he assume the investment risk of continued poor performance from that adviser. Management fee rates are disclosed to all investors, but the shareholder has not been left to fend for himself. Congress has recognized that as a practical matter the sole shareholder bargaining tool is redemption, which when coupled with reinvestment is often much costlier than switching corporate stock. The situation is no different with performance of an adviser-recommended successor. In all three cases, Congress has interposed independent directors to represent the interests of the shareholders.\(^7\)

Determination of independent directors' duties in these situations, however, is difficult. No court has ever held that independent directors were remiss in not seeking new management, because, for example, the present adviser's performance was so poor that it would be unreasonable to continue the relationship. No court has ever suggested that an adviser-selected successor lacked sufficient qualifications to justify a business judgment to recommend the award of a new contract. Nor has any court ever suggested that independent directors entertain bids from several potential advisers upon the voluntary departure of a former adviser.

Nutt suggests, in perhaps the boldest statement to date, that independent directors should "contact other investment advisory houses and solicit competing offers to manage the fund's portfolio."\(^8\) However, he recommends that this be done only as a "last resort" when they become convinced that a present adviser offers no chance for good performance.\(^9\) A desire on the part of independent directors to secure lower cost services would not be sufficient under this view. Indeed, Nutt cautions that "[a]s fiduciaries, the directors have no obligation to bargain for the least expensive investment advisory services for the fund."\(^10\)

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\(^7\) See note 47 supra.

\(^8\) Nutt, supra note 47, at 250.

\(^9\) Id.

\(^10\) Id.
These suggestions acknowledge the practical edge present advisers enjoy over potential competitors for the advisory position, and adopt it as the appropriate legal standard by which to judge director actions. Under Nutt's view, independent directors should act only as watchdogs for egregious adviser misconduct, not as bargaining representatives of the shareholders. Without the freedom to terminate the management fee negotiations and to look elsewhere for similar services, independent directors lack the most essential element of arm's-length bargaining.

This position takes too narrow a view of the appropriate scope of independent director action. Recognition of common industry practices does not mandate their enshrinement in a statutory scheme. Indeed, the 1940 Act suggests otherwise. If Congress contemplated independent directors acting only as policemen for outright fraud or looting, it could have permitted interested directors numerically to control board decisions in all situations. But Congress clearly did not envision such a limited role for independent directors. In those situations which are fraught with adviser self-interest, the Act states that only independent directors have the power to act.81 Interested directors have no vote at all.

Because advisers control the proxy machinery of their funds, independent directors generally must be satisfactory to advisers. It is reasonable to assume that Congress recognized that advisers would be able to hold veto power over the selection of independent directors. But this does not mean that Congress also instituted all the procedural safeguards in the Act merely to have them become ritualistic incantations for rubber-stamp independent directors. Using the widespread industry reality of adviser domination as the legal model for independent director duties credits Congress with the enactment of mere surplusage which operates to reward advisers for the creation and maintenance of an overly friendly and timid board.

Only one court has recognized the active role contemplated for independent directors by the Act. It stated that independent directors have an affirmative duty to switch advisers if the present one is failing to provide services ordinarily supplied by other advisers, resulting in higher costs to the fund. That decision was Rosenfeld v. Black.82

II

Rosenfeld v. Black

The case arose in an unusual factual setting. Most transfers of mutual fund management responsibilities are accomplished by a sale of stock in the advisory organization. Management companies with other sources of revenue often incorporate subsidiaries to contract with investment company clients. Lazard Freres & Co. did not, however, incorporate a subsidiary to manage the fund it created in 1958, the Lazard Fund. Lazard is a highly reputed Wall Street investment banker. The revenue received from its advisory position was only a small percentage of its total income. Thus, when Lazard decided that it would be in the best interest of the Fund to have another adviser assume command, a sale of Lazard's shares would have been inappropriate to accomplish a transfer only of the advisory position.

Lazard had selected a wholly-owned subsidiary of Dun & Bradstreet, Inc., Moody's Investors Service, Inc., to assume management. Moody's had never before advised a mutual fund or operated a distribution system, but it did manage over four billion dollars in assets for other clients. Moody's formed a new mutual fund, Moody's Capital Fund, and capitalized it with the statutory minimum, 100,000 dollars.\(^{83}\) Moody's Advisers and Distributors, Inc., a wholly-owned subsidiary, was organized to manage the Capital Fund under a management contract virtually identical to the Lazard contract. The succession was to be accomplished by a merger of the Lazard Fund into the new Capital Fund.

In a collateral agreement Lazard promised not to re-enter the investment company business for at least five years. It also undertook several obligations with regard to facilitating the transfer, such as providing research and administrative aid and making a partner available for consultation. As consideration for these undertakings Lazard was to receive 75,000 shares of Dun & Bradstreet common stock. Despite the ostensibly independent character of these obligations, the agreement was expressly conditioned on the approval of the merger and new advisory contract by the shareholders. The market value of the stock at the time of the merger was approximately forty dollars a share.

Lazard solicited proxies for the special meeting. The vote was structured so that a vote for the merger, which was recommended by

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Lazard, would also approve the new management contract with Moody's. The shareholders approved the transaction.

Plaintiff Rosenfeld, a Fund shareholder, charged that the collateral agreement was a sham and that the Dun & Bradstreet stock was actually paid for by Lazard's selection of Moody's as a successor and by the use of the proxy machinery to secure the merger and management agreement for Moody's Advisers and Distributors, Inc. The gravamen of the complaint was that the transaction was, in essence, a sale of Lazard's fiduciary office—a practice long prohibited by general equitable principles.\[84\]

The district court\[85\] dismissed the complaint relying heavily on a Ninth Circuit opinion, SEC v. Insurance Securities, Inc. (ISI),\[86\] which held that the sale of fiduciary office rule does not apply to investment advisers. The Second Circuit reversed. In doing so it negated the much criticized rationale of the ISI case which dealt with the exclusivity of the 1940 Act and its mechanical operation rather than with an analysis of the sale of fiduciary office rule or an appraisal of the rule's appropriateness with regard to mutual fund advisers and shareholders.

The Rosenfeld opinion's consideration of the fiduciary office rule is so terse that at first blush it may appear that the Second Circuit, despite reaching a position diametrically opposed to that reached in ISI, was similarly unconcerned with the intrinsic merits of the fiduciary office rule in the mutual fund context. A closer examination reveals, however, that the court may have considered the consequences of its holding more fully than some industry representatives have appreciated. The following analysis will suggest that the decision is the necessary result of Chief Judge Friendly's rejection of the popular notion that contract award and renewal, made possible by the docility of independent directors in the mutual fund industry, is akin to a property right of mutual fund advisers. The heart of the decision is a simple syllogism which might be stated as follows:

A fiduciary is prohibited from transferring its office for personal profit.
As an investment adviser, Lazard is a fiduciary.
Therefore, Lazard may not profit from the transfer of its investment advisory position.

A. The Investment Adviser as Fiduciary

In holding that Lazard, as the investment adviser to a mutual fund, had fiduciary responsibilities to the fund it managed, the court

\[84\] See notes 87-93 and accompanying text infra.
\[86\] 254 F.2d 642 (9th Cir.), cert. denied, 358 U.S. 823 (1958).
followed the established legal principle that whenever a dominant party has discretionary control over the assets of another, and the parties' relationship is founded on reliance and trust of that other party, a fiduciary relationship exists. Although few courts had ever specifically held that an adviser to a mutual fund was a fiduciary, the extension of fiduciary duties to such an adviser had been foreshadowed and came as no surprise.

B. The Sale of Office Rule

The recognition that an investment adviser assumes a fiduciary status does not necessarily mandate the application of the sale of office rule, since the stringency of fiduciary obligations varies as the context demands.

The equitable principle prohibiting profit from the transfer of a fiduciary position has been applied in numerous situations, but different courts have applied it on different theoretical bases. Some courts consider the rule as only one version of the prohibition against the diversion of proper opportunities for beneficiaries by fiduciaries to their own benefit. Other courts apply the principle in an attempt to keep beneficiary costs at a lower level. Still others enforce the standard because they believe that profiteering on the part of the fiduciary amounts to a taking of trust assets. Finally, some courts use the rule

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88 See, e.g., Brown v. Bullock, 294 F.2d 415 (2d Cir. 1961); SEC v. Insurance Securities, Inc., 254 F.2d 642 (9th Cir.), cert. denied, 358 U.S. 823 (1958); Aldred Inv. Trust v. SEC, 151 F.2d 254 (1st Cir. 1945); cf. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 190 (1963); Herpich v. Wallace, 430 F.2d 792, 816 (6th Cir. 1970): "Like the earlier statutes, the Investment Company Act was meant to provide another step toward a return to the understanding that those who manage other people's money are trustees acting for others." See also Greene, Fiduciary Standards of Conduct Under the Investment Company Act of 1940, 28 Geo. Wash. L. Rev. 266, 272-76 (1959).
89 See, e.g., Bent v. Priest, 86 Mo. 475 (1885) (corporate officers); Sauerhering v. Rueping, 197 Wis. 407, 119 N.W. 184 (1909) (officers of mutual insurance company). In another case involving the officer of a mutual life insurance company, the court noted that "[i]f the succession was worth $125,000 in the market, the sale (if it were lawful) should have been made by the directors for the benefit of the owners of the business, not of [the officer]." Moulton v. Field, 179 F. 673, 675 (7th Cir. 1910). But see Note, Mutual Funds and the Investment Company Advisory Contract, 50 Va. L. Rev. 141, 167 (1964) (questioning applicability of diversion of corporate opportunity doctrine to advisers).
90 See, e.g., Eddy v. Capron, 4 R.I. 394, 397 (1856) (port physician):
The services performed under such appointments are paid for by salary or fees, presumed to be adjusted by law to the precise point of adequate remuneration for them. Any premium paid to obtain the office, other than that which the law establishes or regulates, interferes with this adjustment, and tempts to peculation, overcharges, and frauds, in the effort to restore the balance thus disturbed.
91 See, e.g., Aughey v. Windrem, 137 Iowa 315, 114 N.W. 1047 (1908) (guardian); Ellicott v. Chamberlin, 88 N.J. Eq. 604 (1884); Porter v. Healy, 244 Pa. 427, 91 A. 428 (1914).
as a prophylactic to ensure that the selection of a successor will be based solely upon the informed and objective judgment of the departing fiduciary. Chief Judge Friendly relied primarily upon this last rationale to support the imposition of the rule:

A fiduciary endeavoring to influence the selection of a successor must do so with an eye single to the best interests of the beneficiaries. Experience has taught that, no matter how high-minded a particular fiduciary may be, the only certain way to insure full compliance with that duty is to eliminate any possibility of personal gain.

C. Alternative Rules

Unfortunately, the Rosenfeld opinion does not explore why such a stringent fiduciary standard is necessary to guarantee a satisfactory selection. No examples of poor selection are given. Perhaps a com-

(corporate directors); Bowers v. Bowers, 26 Pa. 74 (1856) (administrator); T.F. Pagel Lumber Co. v. Webster, 231 Wis. 222, 285 N.W. 739 (1939) (corporate president). Contra, Basset v. Miller, 8 Md. 548 (1855) (contract for relinquishment of administration of estate upheld; court supervision of appointment of successor adequate protection).


The court did not even refer to the instant case, despite the benefit of hindsight which showed that the Fund suffered badly under the direction of Moody's. See Lenzner, Under New Management: From Lazard Freres to Moody's to Smith Barney, 52 BARRON'S, April 10, 1972, at 9.
mon sense understanding of human nature is reason enough for the application of the rule; when conflicts of interest develop, most resolutions, consciously or not, are probably made in favor of financial self-interest. The court, however, should perhaps have investigated possible alternatives, if only to demonstrate that no other rule would provide a different result from the sale of office rule, except those which give a retiring adviser an economic incentive to choose the least desirable candidate.

1. *Rebuttable Presumption of Influence*

An alternative rule, within traditional fiduciary analysis, would permit the defendant in a challenged transaction case to prove that its selection was uninfluenced by the compensation it received from the chosen successor. This would relax the presumption of improper motive, which the sale of office rule necessarily creates, from an absolute to a rebuttable presumption. Presumably, one way the burden could be met would be to demonstrate that the successor was the best in the industry. At first blush it would seem that such a showing would be sufficient evidence to rebut the presumption of improper motive because it would either necessarily imply that the interest of the fund was the uppermost criterion for selection, or prove that the fund could not possibly have received a better adviser, regardless of the circumstances surrounding the selection process. But this alternative fails in several respects.

First, objective, qualitative standards for measuring services rendered by investment advisers have not yet been widely accepted. If portfolio performance were the sole criterion, many administrative and managerial qualities and services necessary to mutual fund operation would be left unjudged. Economists are not in agreement that any one method of evaluation measures each adviser fairly. Many complex variables, such as overall portfolio risk, investment objectives, and total funds under management, make comparison of even performance difficult. Given present methods, any analysis would inevitably turn on subjective criteria, and the search for the best adviser would be reduced to a value judgment.

But even assuming that economic theorists were able to refine the comparative process to their universal satisfaction or that a court was willing to submit the judgment to a jury, an interpretation would have to be made as to whether the standard could be met only by a

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showing that the selected successor was the foremost candidate in the industry or simply that it was the best potential adviser willing to pay the succession price demanded by the departing adviser. The second interpretation would permit the retiring adviser to choose the highest bidder, regardless of its qualifications, since it could raise the price of succession until only a single candidate remained. The effect would be to provide no safeguard for the selection process at all.

The first interpretation, requiring a showing that the nominee was the best possible adviser, regardless of its willingness to pay the desired price, would be the preferable alternative if it were not construed to require the premier adviser in the industry despite that particular adviser's inability to assume the proffered position. A rule which required the defendant to meet such an absolute standard would use as its determinates factors unrelated to the conduct of the departing adviser, and thus would overshoot its objective. A showing that potential advisers thought to be superior to the eventual nominee could not assume the position for reasons unrelated to the succession fee should be sufficient to qualify the final choice as the best available.9

Another possible method of meeting the burden of proof required of a defendant under a rebuttable presumption of influence rule would be not to focus on the quality of the nominee, but to demonstrate that the selection process itself was free from influence. It might be an impossible task, given the proper skepticism of the judiciary evidenced by the Rosenfeld court, to justify the selection process unless, as one commentator recommends, the selection was made by someone other than the retiring adviser. To avoid suspicion that the amount of succession fees offered by the candidates influenced the selection process, this commentator suggests that "the adviser might wish to entrust to the fund's independent directors the entire task of evaluating and settling upon a successor."97 Presumably the scheme envisioned would begin with the adviser informing the independent directors of its desire to discontinue its advisory duties. The independent directors, without aid or guidance from the adviser, would then scout or survey the potential successors, choose the one most appealing, and leave the bargaining of the succession fee to the two parties. This suggestion, however, overlooks several considerations.

96 This interpretation, however, would not produce a different result than the sale of office rule. A legal standard that required the best adviser to be selected regardless of the succession fee it was willing or able to pay would permit such an adviser to refuse to pay any fee at all. Such a rule, much like the Rosenfeld decision, would deprive the retiring adviser of a succession fee.

97 Note, supra note 19, at 666.
First, as a fiduciary to a fund, an adviser has the duty to seek the appointment of a worthy successor. Fiduciaries are not released from all responsibilities upon resignation. They are obligated to take steps to ensure the smooth transfer of their position to the best available successor. This principle seems particularly appropriate in the mutual fund context where nearly all assets are highly liquid and potentially volatile investment securities, funds are completely dependent upon external management for day-to-day operations, and independent directors typically spend less than one full day a month considering their respective funds' affairs. Advisers are far more familiar with the industry and the attributes of a successful investment adviser than independent directors who often only have personal knowledge of the adviser of their own fund.

Second, courts have traditionally applied the same basic rule to situations in which fiduciaries merely resign and, ostensibly at least, take no part in the selection of a successor, and to those in which influence is overtly exerted. Thus, the law has been rigid in prohibiting fiduciaries, including corporate directors and officers, from resigning at the instance of pecuniary gain. This stringent rule may stem from a persistent belief that subtle or covert influence will be exercised to install the payor.

Finally, even if the successor is selected by uninfluenced, independent directors, no incentive remains for the payment of a succession fee, other than to secure the retirement of the present adviser. The identity of the recipient is irrelevant to the successor, as long as it secures the opportunity to assume the advisory position with its attendant management fees. Should independent directors be free to choose the successor, they would then be in a position to demand the succession fee, in the form of either lower future management fees or a lump sum payment, for the benefit of the fund. Any payment to the adviser would deprive the fund of that amount. Viewed in this manner, the payment of a succession fee to the departing adviser would be a conscious bribe on the part of the independent directors to induce the adviser to sever contractual relations, a step which the 1940 Act allows on an ex parte basis to investment companies.

Adoption of this alternative, and thus permitting advisers to rebut

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100 See text accompanying notes 85-86 supra.
the presumption of influence, would not produce results significantly different from the absolute prophylactic applied by the Second Circuit in *Rosenfeld*. Such a standard might, in fact, create additional problems if advisers sought to avoid some of their duties while attempting to meet the burden of proof.

2. **Probability of Harm**

Courts have developed, primarily in cases dealing with sales of controlling shares of corporate stock, another fiduciary standard which subjects corporate fiduciaries to liability only if the circumstances surrounding a transfer of the fiduciary position would have put a reasonable man on notice that the buyers might use corporate assets for their own benefit.  

This rule does not operate as a prophylactic, but requires that the beneficiary, *i.e.*, the corporation or minority shareholder, first be placed in danger of harm.  

In 1966 the SEC recommended that a similar rule, designed especially for the unique structure of the investment company industry, be enacted to apply to sales of management contracts or control. Specifically, the Commission recommended that the Act be amended to prohibit such a transfer "if the sale, or any express or implied understanding in connection with the sale, is likely to impose additional burdens on the investment company or to limit its freedom of future action."  

Expressly contemplated were transfers in which purchasers were to pay for the opportunity, at least in part, by directing fund

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102 As a practical matter, of course, in most of the cases in which the standard was imposed actual financial harm did follow the transfer. Courts applying the rule do not focus on the mere existence of a succession fee or control premium, but consider the size of such a payment as one of the factors which would arouse suspicion in the mind of a reasonable man. One case found the premium alone enough to put the sellers on notice. Gerdes v. Reynolds, 28 N.Y.S.2d 622, 658, *referee's report confirmed*, 30 N.Y.S.2d 755 (Sup. Ct. 1941) (investment company). If the succession fee could probably not be recouped within a reasonable period of time from either any proper accouterments of control or an increased value in the corporate shares due to improved management, the rule would hold the seller liable for any harm resulting from the transfer. In some cases the measure of damages would be the profits made by the seller. See Perlman v. Feldmann, 154 F. Supp. 496 (D. Conn. 1957), on remand from 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955). See also Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 506 (1965); Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1 (1956).

103 SEC 1966 REPOX 152. The actual text of the legislative proposal was similar. See H.R. 9510, 90th Cong., 1st Sess. § 15(a) (1967).
brokerage to the seller or by forcing the fund to employ the seller or its principals on particularly favorable terms.\textsuperscript{104} Significantly, the SEC stated that management compensation levels were within the scope of the additional burdens test; instead, the Commission felt that its simultaneously proposed test of reasonableness for management compensation (later enacted in the 1970 Amendments under the alternate rubric of fiduciary duty\textsuperscript{105}) would adequately police subsequent management fees.\textsuperscript{106} But, apparently unaware of the conceptual difficulties posed by these necessarily self-contradictory positions, the SEC further proposed that the amount of the succession fee be disregarded in any determination of the reasonableness of the subsequent management compensation fee.\textsuperscript{107}

The SEC proposal overlooked the fact that succession fees, which the Commission was then able to recognize represented a capitalization of future management fees, are themselves a form of management compensation. Upon the enactment of the 1970 Amendments, this was acknowledged, and the additional burdens test applicable only to succession fees was deleted. Correspondingly, the standard of fiduciary duty was applied to the determination of all management compensation.

The language of the amendment imposing the new statutory duty “with respect to the receipt of compensation for services, or of payments of a material nature, paid by [a] registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser,”\textsuperscript{108} however, might be read to exclude succession fees, because the successor, not the fund, makes the direct payment. But the fund and its shareholders eventually will pay the amount through the management fee paid to the successor.\textsuperscript{109} Moreover, the legislative history makes it clear that the scope of the statutory fiduciary duty was not meant to be so artificially restricted.\textsuperscript{110}

\textsuperscript{104} SEC 1966 REPORT 153.
\textsuperscript{106} Cf. note 75 and accompanying text supra.
\textsuperscript{107} SEC 1966 REPORT 153.
\textsuperscript{109} See text following note 75 supra.
\textsuperscript{110} The senate committee report on the Amendments stated the reasons for deleting the additional burdens test and for the use of one standard for both management and succession fees:

This section of [the Amendments] would have added a new section . . . to deal with problems raised by the transfer of management organizations. However, this bill imposes a standard of reasonableness over management compensation and extends the Commission’s power to seek court injunctions against breaches of fiduciary duty involving personal misconduct. Your committee, therefore, believes that this provision . . . is unnecessary. A breach of fiduciary duty involving personal misconduct in connection with the transfer of a management organiza-
Thus, the statutory fiduciary duty does apply to succession fees; the payment to the retiring adviser operates merely as a prepayment by the incoming successor of the management fees to be paid to it by the fund in the future.¹¹¹

Focusing solely on the likelihood that a fund would be harmed by a change in advisers, the 1966 SEC proposal provided little safeguard for the quality of the successor selected by the departing adviser. It does not seem reasonable to credit the SEC with the creation of a rule that did not contemplate any standard for the selection of the successor, but implicit in the approval of the payment of any succession fee at all is the notion that a selection standard be based, at most, only on minimum qualifications. This is a necessary implication because if the adviser were required to select the best available candidate, no fee would be paid except at the instance of improper adviser domination. Moreover, since the liability standard proposed by the SEC nominally hinged on potential harm to the fund, the criteria for judgment of the fitness of a successor would probably be reduced to the integrity of the nominee, not its investment advisory qualifications, short of a record of irresponsible or reckless management. An adviser which consistently performed below the industry or market average indices would not be eliminated from the list of potential successors. Thus, the proposal would have not only given complete freedom to the departing adviser to select a mediocre successor, but would have provided a financial incentive to do so, since the poorer the performance record of the candidate, the more attractive the opportunity to assume management of an established fund should seem and the more it should be willing to pay. Adoption of this alternative rule by the Rosenfeld court would have permitted, if not encouraged, the selection of the least desirable advisers.

D. **Chief Judge Friendly's Role for Independent Directors**

By summarily rejecting alternative fiduciary standards that would have the effect in the mutual fund context of rewarding lawyers for dominating the decisions of independent directors, the Second Circuit

¹¹¹ Lipton, *supra* note 23, at 855.
appears to be preserving, not abandoning, the concept of independent directors. In this sense, the opinion exhibits a most sensitive judicial understanding of the delicate role such directors are required to fill. By placing the onus of selecting the successor on the adviser, the court relieved independent directors of a judgment which would subject them to great pressure from their respective investment advisers. The court apparently recognized that in the absence of the absolute liability test, independent directors would be faced in every transfer transaction with enormous liability should they acquiesce in the award of a new contract to the adviser-chosen candidate and permit the departing adviser to receive a succession fee without at least demanding a similar concession from the successor on behalf of the fund.

Despite helping to protect the integrity of the independent director regulatory scheme by removing from the realm of independent director action a determination sure to be fraught with sharp conflicts of interest and large stakes, Chief Judge Friendly made it clear that he does not envision a more limited role for the directors. Indeed, he suggested that they must be ready to initiate affirmative action to discontinue contractual relations when present advisers' services put their funds at a disadvantage compared with others in the industry.112 By requiring independent directors to exercise the full bargaining power at their command, Friendly answered the argument that the imposition of the sale of office rule would economically force old or disinterested advisers to remain in their advisory positions to the detriment of the funds they manage.

When Lazard began the Lazard Fund, an initial offering of shares garnered an asset base of 114 million dollars. But Lazard did not have its own captive sales force and apparently was reluctant to organize a distribution network using independent broker-dealers. Thus, the Fund did not have a continuous sale of its shares to the public. A second offering, although initially contemplated, did not materialize, so by virtue of occasional redemptions without offset by sales, the assets dwindled to 85 million dollars in eight years. Without the incoming cash produced by continuous sales, investments must be liquidated once the cash cushion maintained by most funds is exhausted by redemptions. Often this may force the sale of portfolio positions at inopportune moments.113 Apparently for this reason, and perhaps others

112 445 F.2d at 1347 n.14.
such as a rising expense ratio, Lazard decided that the Fund would be better served if it contracted with another management company which could offer the possibility of an ongoing sales program. The independent directors were apparently told of Lazard's conclusion that it was not serving the Fund's interest by remaining as the investment adviser, because they approved of Lazard approaching Moody's to negotiate the succession.

Lazard's actions were quite typical; advisers unilaterally determine both when to pursue the possibility of transferring the advisory position and whom to consider as a successor.114 Chief Judge Friendly challenged "the implication that it is solely up to the adviser to decide whether he will retire from that position in favor of a more effective manager."115 He cited those sections of the 1940 Act which require annual renewal of the advisory contract by a vote of the independent directors and permit termination of the contract by either the shareholders or the board without penalty upon sixty days notice116 as evidence that Congress did not intend to afford only advisers the power or the duty to make such decisions. Moreover, he reminded independent directors that despite the prevalence of adviser domination, their actions are judged separately and that they are "amenable to suit if they discharge their annual approval function in a merely perfunctory fashion."117 Turning to the Rosenfeld facts, he noted that the 1970 Amendments obligate directors to "request and evaluate" all information necessary to make an intelligent and informed decision whether to renew a management contract.118 Thus, he determined that "if Lazard was convinced that its unwillingness to engage in continuous sales was detrimental to the Fund, and the independent directors believed this, they would have an affirmative responsibility to seek out a successor."119

Rosenfeld was not governed by the 1970 Amendments; the effec-

114 See notes 43-54, 63 and accompanying text supra.

115 445 F.2d at 1347 n.14.


118 445 F.2d at 1347 n.14.

119 Id.
tive date of their enactment postdated both the decision and its factual setting. If they had been applicable, however, this largely overlooked aspect of the decision could well have become the crux of the holding. Arising as it did, the case gave the court an opportunity to warn independent directors of the full reach of their duties. The thrust of Friendly's remarks is clear: independent directors now have the duty to consider annually obtaining management elsewhere, and, if it is apparent that a switch in advisers will result in less harm or better performance, they will be held accountable for failing to initiate steps to implement such a switch. The decision must be based on a business judgment, of course, and the factors favoring retention considered above must be taken into account in the determination. But the independent director's allegiance must be to the shareholders and must not have been altered by personal or social ties with the adviser. The expectations of shareholders who purchase a particular fund's shares in order to obtain the financial management of the adviser must be given great weight, but as soon as it appears that considerations of sales loads or personal tax consequences, rather than shareholder satisfaction with performance or services, are preventing redemption, then independent directors must act on the shareholders' behalf to secure new management.

III

THE SALE OF CONTROL OF MANAGEMENT COMPANIES

Some commentators have interpreted Rosenfeld v. Black to prohibit the receipt by shareholders of a management company of any

\footnote{But see Lipton, supra note 23, at 856: "The next big surprise could be a suit premised on failure to make new advisory arrangements where the investment performance of the original adviser was poor for a substantial period."}

\footnote{Cf. Mundheim & Nutt, supra note 62, at 10: "An independent director cannot successfully perform his role unless he recognizes that his sole loyalty must be to the shareholders of the fund."}

\footnote{Sales loads normally consume about 8%-9% of a shareholder's investment. SEC 1966 Report 204. There is generally no redemption fee, but a switch to another mutual fund which charges a sales load would be an investment cost to the shareholder. No-load funds are becoming increasingly popular with mutual fund investors. A number of load funds are switching to no-load status in recognition of the new, better-educated mutual fund shareholder. See Wall St. J., Aug. 3, 1972, at 1, col. 5 (eastern ed.). In a no-load fund, sales charges would not be a consideration for independent directors. The absence of a load may permit retention of an adviser in a situation where were the fund a load fund reasonable business judgment would preclude its retention. But even no-load fund directors must remember that each shareholder may suffer adverse tax consequences, insofar as a change in advisers by a shareholder causes him to realize a gain or loss. On the other hand, a change of advisers by a fund does not.}
payment in excess of the book value of the company upon the sale of a controlling block of stock.\footnote{E.g., Keeffe, "Undivided Loyalty" Prescribed for Mutual Fund Managers, 58 A.B.A.J. 209 (1972).} This was the proposition urged by the SEC, but not adopted by the Ninth Circuit, in the ISI case.\footnote{For the thought that the court intentionally ignored the duties created by the Act and the realities of the case before it, see Simpson, I(b), or not I(b), . . . ? Recognition of Legislative Intent in Judicial Interpretation of Investment Company Act of 1940, 40 Geo. Wash. L. Rev. 890, 898-99 & n.49 (1972).} The Second Circuit, while distinguishing ISI on a technical point, rejected the rationale of that decision. This may have led the commentators to conclude that Chief Judge Friendly embraced the position urged by the SEC in that case. But the unusual facts of Rosenfeld did not permit him to address the question directly. It is necessary then to apply the Rosenfeld analysis, which concentrates on the price and quality of the services the fund will likely receive from a successor, to the sale of controlling shares of management companies.\footnote{At least one court has not followed Rosenfeld. Kukman v. Baum, [Current Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,602 (N.D. Ill. July 9, 1972), held that the prophylactic sale of office rule had not been incorporated into the Act. Instead, argued the court, Congress in 1970 intentionally declined to alter the result of ISI. See text accompanying note 155 infra. For similar arguments, see Note, Mutual Control-Transfer Profits: Congress, the SEC, and Rosenfeld v. Black, 58 Va. L. Rev. 371, 394-406 (1972).} The following discussion will demonstrate that Rosenfeld does not mandate adoption of the SEC position in ISI. It is helpful first to review the historical developments of the law in this area and to contrast the reasoning of ISI and Rosenfeld.

\section*{A. Prelude to ISI}

The first interpretation of the effect of the 1940 Act on the legality of the sale of controlling shares in a management company was an opinion by SEC General Counsel Chester Lane in 1942.\footnote{Investment Act Release No. 354, CCH Fed. Sec. L. Serv. ¶ 75,281 (1942).} The owner of a controlling block of stock sought Commission approval of a transaction in which a successor would pay him for the opportunity to assume management of a mutual fund. Four alternate scenarios were discussed, perhaps in an attempt by the SEC to demonstrate that the form of the transaction would not be determinative of the governing rule. In each instance the ultimate economic effect would be identical to an assignment of the advisory contract, which, of course, would have been inoperative under the Act. The four plans were: (1) sale of the controlling block of stock of the advisory company; (2) resignation by the current management and the subsequent award of a new contract to the chosen successor by the management-controlled board; (3) merger
of the retiring and successor management companies; and (f) delegation of management duties, without a concomitant assignment of management fees, to the successor for a given period of time.

Lane opined that each of the four alternatives was violative of the Act and of the common law fiduciary duties incorporated in it. He invoked section 15(d) which provides for the termination of management contracts upon purported assignment. Since section 2(d)(4) defines "assignment" to include any transfer of a controlling block of stock in the adviser company or the indirect transfer of the contract, he reasoned that by "[l]ooking through the form of the alternative proposals" the transaction would be violative of the Act. This broad reading of the Act was mandated by the legislative history, which he found to contain "a clear Congressional intention to prevent all trafficking in investment advisory contracts and to prevent an investment adviser from transferring his fiduciary obligations by turning over the management of the stockholders' money to a different person." Thus, he interpreted those provisions which proscribe transfers of advisory contracts to prohibit all transactions which accomplish the same practical result.

The opinion, however, did not rest solely on these sections of the Act. Lane regarded the legal status of mutual fund investment advisers as similar to that of fiduciaries, such as trustees and corporate executives, and reasoned that the sale of office rule would likewise be applicable. He decided that regardless of its orchestration the proposed transaction would breach such fiduciary duty. This SEC opinion remained the sole statement of the "law" for fourteen years.

B. The ISI Case

In 1956 the SEC decided that a transaction involving Insurance Securities, Inc. (ISI), warranted its intervention. The Ninth Circuit, however, rejected the rationale of the Lane opinion. Specifically, it

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128 Id. § 80a-2(d)(4) (1970).
130 Id.
131 Industry adherence to its commands, however, was not unanimous. In April 1949, Bertin C. Gamble sold to the Allegheny Corporation 57% of the voting stock of IDS, which then managed three funds. Investors Diversified Servs., Inc., 50 S.E.C. 278 (1949). The staff of the Commission charged, in part, that the sale of the stock violated § 36. The Commission, however, was more concerned with other issues at the time, and upon receiving assurance that the boards of directors of the funds would consider the possibility of litigation did not press the point. Naturally no litigation ever resulted.
held that the sellers of a controlling block of stock in an advisory company do not violate the Act or any other fiduciary duty by receiving a price in excess of the book value of the stock. Given the carte blanche provided by this decision, many principal shareholders sold their interests; in other cases, management company stock, often without voting power, was sold to the public. 133

Four men founded ISI and its captive fund in 1938. By 1955 the fund had accumulated assets of 215 million dollars, producing a management fee of almost five million dollars for ISI. The management company had no other business. On February 1, 1956, the founders entered into a plan to sell 68,000 of their total 88,000 shares to a small group of purchasers at fifty dollars a share, against a book value of only $1.81. Another thirteen percent of the total 166,000 shares was to be purchased from other shareholders.

The sale was carefully arranged. The transfer of the shares was spread over a five month period ending July 1, 1956. The contract of sale, however, called for consummation prior to an August 15 shareholders' meeting. The meeting was held in order to re-award the management contract which would be terminated by the sale of the controlling block of stock of the management company. The proxy machinery was still controlled by the ISI founders and the proxy statement indicated that ISI "favored the reinstatement." The contract award was approved by the shareholders and the sale was completed.

The Ninth Circuit, affirming the district court, dismissed the complaint for failure to state a claim. In doing so, it apparently relied on two alternative holdings. Unlike Lane, the court ignored the extensive SEC 1940 Report. 134 Instead, it looked only to the brief House 135 and Senate 136 reports for its review of the legislative history. Those reports, as well as one of the stated purposes of the 1940 Act, 137 disclosed, the court felt, that the only problem with which Congress was concerned was change of investment company management without shareholder consent, not profiteering by those who participate in the transfer. 138

133 SEC, 26TH ANNUAL REPORT 181 (1960).
134 See note 4, supra; cf. Tolins, supra note 4, at 91: "There should be some safeguard against the sale of control and the election of a new board of directors without any notification whatsoever to the shareholders. Even with notice, control is not properly the subject of a sale."
138 The pertinent problem with which Congress was asked to deal was not the
Since shareholder approval was obtained, ISI's duties were fulfilled. Moreover, the court reasoned that since Congress specifically addressed itself to this problem, it intended the statutory provisions to be exclusive. Thus, the SEC charge that everything over book value of the stock sold amounted to a bribe for the sale of the fiduciary relationship was held not actionable under the Act nor justification for relief under common law. Alternatively, the court held that in the event that the Act's provisions for shareholder consent were not the exclusive remedy envisioned by Congress, any fiduciary duty ISI owed to the fund was derived from the contractual relationship between the two. Since the sale of the controlling block of stock automatically terminated the contract by operation of sections 15(a)(4) and 2(a)(4), the fiduciary office was vacated. Thus, since ISI had no office to sell, the rule was inapplicable.

1. Exclusivity of Specific Provisions of the Act

Lazard, the defendant in *Rosenfeld*, also advanced these arguments, but went one step further, suggesting that since shareholder approval was obtained, the sale transaction was actually *authorized* by the Act. Congress should be credited, however, with the intent to provide real, substantive safeguards for investment company investors when it required their approval to effectuate changes in management. Although history demonstrates that the existence of this theoretical veto has never resulted in its actual employment, it seems likely that these provisions were intended to provide more than merely the form of disclosure which proxy solicitation would produce, since the basic thrust of the Act was to provide extensive federal regulation, not simply disclosure. Indeed, it is probable that by prohibiting the assignment of management contracts, Congress believed it would prevent all trafficking in mutual fund control, and, a fortiori, any “prof-

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excess price received for the sale of a controlling interest in the stock of investment advisors. Rather, it was the transfer of control of investment advisors exercising management functions, or their assignment of the service contract to others, without the consent of the investors, regardless of the consideration received therefor.

254 F.2d at 651.

140 Id. § 80a-2(a)(4) (1970).
141 Brief for Appellees at 12-38.
142 Studies completed prior to the enactment of the Act may have forewarned the legislature of this ineffectiveness. For example, two commentators warned of the inefficacy of shareholder self-protection. See A. Berle & G. Means, *The Modern Corporation and Private Property* 277-87 (1932).
143 See Tolins, *supra* note 4, *passim.*
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iteering from such sales. The numerous impediments to meaningful shareholder participation and the ready acquiescence of independent directors, of course, permit the economic equivalent of such sales to be easily arranged, making the protection of such provisions illusory and defeating the legislative expectation. The Ninth Circuit’s limitation of shareholder safeguards to those specifically enumerated in the Act, therefore, frustrated rather than promoted the purpose of the legislation.

Friendly, on the other hand, tacitly adopted Rosenfeld’s argument that section 15(a) was intended to reallocate corporate decision making by removing from directors the sole power to approve the effectual assignment of management contracts, instead of withdrawing safeguards already afforded by equity. Having concluded that the statute’s provisions were not meant to be exclusive, the court was faced with three alternatives in applying the appropriate equitable principles: (1) to hold that the applicable rule must be found in the law of the state in which the federal forum is located under the Erie doctrine; (2) to hold that section 36, then prohibiting “gross abuse of trust,” implicitly incorporated existing fiduciary duties into the Act; or (3) to hold that the appropriate principles were impliedly incorporated into section 15(a)(4) itself.

The court did not consider the second possibility. Obviously the language of section 36 implied that persons subject to the 1940 Act were obliged to adhere to some residuary fiduciary principles not enumerated in specific provisions. Indeed, the 1942 SEC opinion interpreted section 36 as embracing the sale of office rule. Courts have been loath to stigmatize businessmen as guilty of a “gross abuse of

144 Note, Protecting the Interests of Mutual-Fund Investors in Sales of Management-Corporation Control (Or, Policing the Traffic in Other People’s Money), 68 YALE L.J. 113, 131 (1958).
146 445 F.2d at 1344-45.
150 See text accompanying notes 126-30 supra.
but if the bald sale of a fiduciary position of which the court found Lazard guilty amounts to a breach of trust somewhere short of the highly reprehensible conduct meant by “gross abuse,” the Act would not seem to provide a remedy.\textsuperscript{162}

The first alternative also received scant attention from the court. The opinion did note that reliance on a state-created claim would produce the same result as the court’s solution, because Rosenfeld also charged that the proxy statements used to procure shareholder approval were deficient and misleading, affording sufficient basis for pendent federal jurisdiction. But its rejection of this alternative was premised entirely on its justification for holding that the sale of fiduciary office rule was impliedly incorporated into section 15(a). There was a consideration, left unmentioned by the court but of practical consequence, which may have provided additional reason for rejection of this theory. Despite the court’s apparent confidence, it is not at all clear that New York, the source of applicable common law, had adopted the sale of office rule. While relevant New York law is somewhat confused, at least one case has refused to apply the rule to the seriatim resignation of corporate directors pursuant to a sale of corporate control.\textsuperscript{163} Perhaps Friendly recognized this when he cited as support for his holding the beneficial effect of providing uniform fiduciary standards for all investment advisers, regardless of the vagaries of local law.

Possibly to avoid the undesirable attributes of these two alternatives, Friendly ingeniously held that when Congress extended the opportunity to approve or to veto successor advisers to shareholders, it must have also intended that the proxy machinery be used only in a

\textsuperscript{161} 445 F.2d at 1346.

\textsuperscript{162} Congressional recognition of judicial reluctance to invoke this standard resulted in the moderation of the language to “a breach of fiduciary duty involving personal misconduct” in the 1970 Amendments. Although the new, broader standard was not yet effective, the contents of the legislation were well known to the court. Perhaps the court accomplished a judicial acceleration of the effective date of the lesser standard; however, this would seem a highly suspect purpose for its holding, particularly given that the broader standard applies only to actions brought by the Commission. Nevertheless, the potential illegitimacy of the reasoning employed is buttressed by rumors which emanated from the court’s chambers following the release of the clerk’s copy of the opinion and prior to the publication of the official version to the effect that the court was seriously considering removing the language exonerating Lazard of a “gross abuse of trust.” Whatever the reason for the court’s failure to apply § 36 as it then stood, this defect has been strongly criticized. See, e.g., Note, supra note 125, at 394-406.

\textsuperscript{163} Barnes v. Brown, 80 N.Y. 527 (1880); cf. Essex Universal Corp. v. Yates, 305 F.2d 572 (2d Cir. 1962).
manner that precludes influence on the adviser's recommendations which may conflict with the best interests of the shareholders:

When Congress, in § 15(a), required shareholder approval of any new advisory contract, it must have meant an approval uninfluenced by any improper motivations on the part of the outgoing adviser-fiduciary . . . . [I]t is . . . unthinkable that if a particular state had chosen not to recognize the rule of equity here in question Congress would have sanctioned an investment adviser's profiting from using his influence in securing stockholder approval of the appointment of a successor.\textsuperscript{154}

One court has expressly disagreed with this reasoning and held, as ISI did, that no cause of action lies when a mutual fund adviser sells its advisory position. In \textit{Kukman v. Baum},\textsuperscript{155} a federal district court in Chicago found that Congress meant to adopt the ISI construction of the Act when it failed to amend section 15(a) in the 1970 Amendments. This holding implies, of course, the untenable conclusion that through its inaction Congress intended to change the purpose of the Act from providing more extensive protection for mutual fund shareholders to eliminating the safeguards they enjoyed at common law prior to its enactment.

2. \textit{Mechanical Operation of the Act}

Lazard also argued, based on the second alternative holding of ISI, that even if the provisions of the 1940 Act were not exclusive, the sale of office rule had no application to investment advisers because the sale of a controlling block of stock in an adviser (or the purported assignment of a management contract) automatically terminated the contractual relationship between an adviser and a fund. While conceptually clever, this argument rests on a faulty understanding of fiduciary relationships. The implicit notion that fiduciary duties are incumbent only upon one who is contractually obligated to another is erroneous: "A fiduciary is a person who undertakes to act in the interest of another person. It is immaterial whether the undertaking is in the form of a contract."\textsuperscript{156} Mutual fund sponsors create and operate funds in such a manner that the shareholders are reliant upon the sponsor's external management and administration. A momentary hiatus in the contractual relationship produced by the unilateral action of an adviser does not diminish this necessary reliance. By holding that a sponsor can escape its fiduciary duties by acting in the very manner

\textsuperscript{154} 445 F.2d at 1345.
\textsuperscript{156} Scott, supra note 87, at 540.
that Congress sought to prevent, the Ninth Circuit perverted the legislative purpose of the termination provisions and ignored established fiduciary principles.

Further, the ISI court apparently misunderstood the principle to mean literally what its name states, i.e., that there be a “sale” of fiduciary office. Except in unusual circumstances, the rule only has effect in situations where a fiduciary does not have the power literally to sell its position, simply because most fiduciary positions cannot be unilaterally transferred by the fiduciary. For example, no corporate executive can assign his office. A trustee, executor, or guardian cannot, absent authorization in the dispositive instrument, appoint a successor, nor can an attorney sell his practice.157 In each case, the consent of the company, beneficiary, or client must be secured. Of course, the recommendation of the retiring fiduciary will in most cases convince the board or shareholders to elect the nominee, the court or the beneficiary to appoint the recommended successor, and the client to hire the purchaser. In recognition of this, the sale of office rule seeks to prohibit both the resignation and the use of a trusted position to influence selection at the instance of personal profit. Thus, Friendly recognized that the clever rationale of the ISI decision “proves too much,” and made short shrift of Lazard’s contentions:

The role of Lazard, an organizer of the Fund[,] and its practical control of the proxy machinery used to recommend the approval of Moody’s A & D as new adviser, made it quite as active and influential as a corporate president who recommends a successor to his board of directors, or a trustee who puts the name of a successor before a judge. Indeed, the very fact of nonassignability demonstrates that any payment made to the outgoing adviser by his successor in these circumstances over and above the value of any continuing services represents consideration not for lawful assignment of the contract—which is prohibited—but primarily for the use of influence in securing stockholder approval of the successor who expects to profit from the post.158

3. Summary

The Ninth Circuit’s use of reasoning premised on misinterpretations of congressional intent and misconceptions of the common law’s treatment of fiduciary relationships may have been prompted by its reluctance to reach the same result that an application of the corporate asset theory of corporate control would produce. Considerable judicial

158 445 F.2d at 1344.
dissatisfaction\textsuperscript{159} with the corporate asset theory has been evidenced since Berle and Means\textsuperscript{160} advanced the concept forty years ago. But objection to a questionable theory does not necessarily require a rejection of its result. The Second Circuit better understood the dilemma and realized that independent reasons, particularly the protection of shareholder interests, mandated the result reached. Thus, the court dismissed Lazard's protests that the sale of fiduciary office rule deprives it of an asset which not only rightfully belongs to it, but which is properly alienated at its leisure:

It is wholly immaterial that the prospect of receiving future management fees if it had continued as an adviser would have been an asset of Lazard rather than of the Fund; the same would be true of a trustee's right to receive future commissions or a corporate president's right to receive future salary and other benefits.\textsuperscript{161}

Whatever the reasons for the ISI court's use of such a rationale, its holding that a retiring investment adviser retains no fiduciary duty to the fund it abandons has been repudiated both by the 1970 Amendments, which recognize a duty to the fund with respect to the receipt of all management compensation,\textsuperscript{162} and by the superior reasoning of Rosenfeld. Its demise gives occasion for a fresh look at these duties in the sale of a controlling block of stock in an adviser. At the same time, by recognizing the need for fiduciary standards when the right to management fees is being transferred, Rosenfeld provides the focal point for our consideration. Its concern with the price and quality of subsequent services afforded mutual funds following such a transfer will be the guiding principle in the following analysis.

C. The Rosenfeld Analysis Applied

Sitting as a review court, the Second Circuit could not determine as a matter of fact whether the undertakings of Lazard were a sham to conceal what Rosenfeld contended was the true purpose, the sale of the advisory position. The holding, therefore, was necessarily limited to a determination that if the various covenants were a sham, as the plaintiff alleged, a cause of action was stated. The case was remanded to the district court for such a finding.\textsuperscript{163} The court of appeals did not, however, instruct the trial court how to make such a determination. Pre-
sumably the court would follow familiar, albeit criticized, examples, such as valuing the undertakings and subtracting this amount from the total consideration. Regardless of how the determination is made, the thrust of the holding strongly suggests that where more than merely a management contract is transferred, the seller can receive compensation for all other objects of worth.\textsuperscript{164} For example, if a management company were being transferred by means of a sale of its assets, the sellers could properly receive compensation for all the tangible assets sold. Similarly, where the transfer takes place through a sale of stock, the value of the proportional amount of the company's tangible assets that bears the same relationship as the quantity of stock sold does to the total management company stock outstanding can be properly paid to the sellers.\textsuperscript{166} But operating companies have more assets than their books and tables. Intangible assets, such as goodwill or going concern value, have a real market value. Nevertheless, the mere characterization of an element of worth as an asset does not end the analysis. As one court, faced with a challenge to a transfer similar to that in \textit{ISI}, has recognized that "[i]f there was payment for sale of control of [a mutual fund], it cannot legally be justified as payment for an element of value belonging to the [management company] stock."\textsuperscript{166} Thus, it must be determined which of these conceptual assets can be sold consistent with the \textit{Rosenfeld} prophylactic analysis.

1. \textit{Goodwill}

In 1966, with the publication of its mutual fund report, the SEC retreated from its earlier position on changes of management company control. Despite expressing continued dissatisfaction with the \textit{ISI} decision and recognizing that significant danger existed to mutual fund investor interests from management self-interest, the Commission nevertheless drew the new conclusion that the application of the sale of office rule would deny retiring management any compensation for the elements of value in the relationship [with the fund] which they may have built up over the years... [and thus that] existing management might be reluctant to surrender that relationship and to provide the fund with new and possibly more effective management.\textsuperscript{167}

\textsuperscript{164} Cf. Butowsky, \textit{supra} note 110, at 764.

\textsuperscript{165} This was, of course, admitted even by the SEC in \textit{ISI}, although the Commission also contended that the proper measure of those assets was their book value.


\textsuperscript{167} SEC 1966 \textit{REPORT} 152.
The defendant in *Rosenfeld* argued that this amounted to explicit acknowledgment by the SEC that goodwill was an asset of the adviser which might properly be sold. While Friendly never specifically addressed this argument, his analysis, of course, impliedly rejects it.

The SEC's suggestion is premised on the notion that because of the psychological and practical impediments to effective arm's-length bargaining by independent directors, most changes of management are initiated by advisers, not by the fund. Making a value judgment that it is better to permit the seller to bargain with whomever it wants for whatever price it can obtain than economically to lock the adviser into the relationship, the suggestion capitulates to the commanding position many advisers have constructed through the appointment of friendly directors and the placement of administrative machinery in their own, rather than a fund's, corporate entity. But *Rosenfeld* was not ready to accept this frustration of the purposes of the Act. Apparently realizing that the SEC position anomalously rewards advisers exercising a lesser standard of care for their initial disregard for the standards originally envisioned by the Act, the court rejected the implication that an adviser should be accorded unlimited discretion in the determination of its own tenure.

The concern of the court for the prophylactic effect the deprivation of personal gain would have on the selection of a successor clearly runs counter to the mutual fund report proposal. In balancing the two competing interests—reward for entrepreneurial achievement and protection of the price and quality of investment advice for investors—the court apparently believed the latter to be more important. Indeed, the court seems to suggest that, unlike other industries where the fiduciary principle need not be applied so stringently (because the interests of management and the investing public do not clash so forcefully and the cost of investment liquidation is not so great), economic incentives have no proper place in the retirement and selection process. Thus, the bargaining process itself is the root evil at which the rule was directed.

Finally, the assumption that the relationship between an adviser and a fund is the product of mutual goodwill generated and built up over the years is without basis. Goodwill is generally defined as the value of the probability of continued business or patronage. Yet, in the mutual fund industry, the expectancy of the continuance of the relationship is not derived from mutual business respect and admir-
tion as it is in industries where dealing is on an arm's-length basis. It is produced, instead, by the power the adviser exercises over the fund. The probability—if indeed it is not a certainty—of annual contract renewal is just as great at the inception of the relationship as it is many years later. It is improper to consider the expectancy of renewal to be "built up." It is this self-created control of the business decisions of a fund that permits the seller to bargain for a price that reflects a capitalization of future income, without any discount for the possibility of loss of patronage. Thus, goodwill is not an asset for which an adviser can be paid.

Failure to recognize the unique relationship between an adviser and a mutual fund can result in misguided judicial approval of the sale of goodwill. An example is the case of *Krieger v. Anderson.* Suing derivatively in a Delaware state court on behalf of a fund, a shareholder charged that the sale of the stock of the fund's investment adviser at a price reflecting a capitalization rate of approximately thirty-seven times annual earnings was a sale of its fiduciary office and the usurpation of a corporate opportunity of the fund. The trial court summarized the plaintiff's argument as follows:

> The fair value of the stock where a sale of "control" shares of a management company is involved is tested by the price a willing buyer and a willing seller would reach; since such a sale would terminate the management contract, a willing buyer would not be willing to pay anything approximating its value in the hands of the seller unless he was assured of renewal of the management contract; therefore, payment of the difference is evidence of payment for improper action taken to insure the renewal of the service contracts.

*Rosenfeld,* of course, accepted this line of reasoning, agreeing that the automatic termination of the management contract merely underscored the use of influence and proxy machinery by the retiring adviser. On appeal, however, the *Krieger* court rejected these arguments on two grounds. One demonstrates the court's misunderstanding of the adviser-fund relationship, which is typified by the lack of arm's-length bargaining. The other illustrates the court's misconception of the respective interests of an adviser and the shareholders of a fund in the growth of the fund's size through sales.

The defendant shareholders argued that if they received only a "fair" price for their shares, their fiduciary duty to the fund could not

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170 40 Del. Ch. at 153, 177 A.2d at 204.
have been breached. In a masterstroke of artful advocacy, they urged that a fair price would be the same price that minority shareholders not selling a controlling block would receive. The plaintiff, Krieger, was forced to concede that noncontrol shares of other advisory companies were generally selling at prices reflecting a price-earnings ratio similar to that received by the defendants. He argued, however, that control shares would have a lower value than noncontrol shares, because upon their sale the contract-severing provisions of the Act became operative. He suggested that the difference between the purchase price and a deflated value which control shares should enjoy was in fact the premium for control and use of the proxy machinery that the fund should recover.

The court acknowledged that permitting control shares to be valued equally with noncontrol shares allowed the seller to receive consideration for the value of the expectancy of contract renewal. Nevertheless, since the sale price was the same as the current market price for individual shares, the court reasoned that nothing could have been paid specifically for the use of the proxy machinery in order to secure renewal, and, accordingly, that there could be no violation of the sale of office rule. The court failed to consider, however, that the market price of individual shares probably reflected the marketplace expectation that annual renewal was a certainty because of the dominance of the adviser. Hence it endorsed the illicit peddling of fiduciary influence merely because the practice had become commonplace. Consideration should have been given to the fact that even the price of noncontrol shares reflected a premium for control of the fund, since the ongoing contractual relationship would continue without regard to the provisions of the Act enabling the fund to terminate the relationship when conditions would properly warrant.

In a cogent review of this problem, an eminent securities law practitioner has suggested that goodwill should be marketable when it can be demonstrated “to the independent directors of the fund that the fund is receiving a benefit commensurate with the value of the expectancy payment to the retiring adviser.” Another commentator also believes that in a sale transaction where there is continuity of management, such as when “the former chief executive officer of the adviser, its portfolio managers, research analysts, and administrative personnel continue to serve the [fund] after the transaction,” the Rosenfeld rationale will not be violated because “the directors can exercise sound business judgment in approving a fee that is not reduced by the amount

171 Lipton, supra note 23, at 855-56.
in the excess of the tangible asset value plus the value of the adviser's organization absent the contract received by the selling shareholders.\textsuperscript{172}

White \textit{v. Auerbach}\textsuperscript{173} apparently followed this second suggestion sub silentio, using the term "human assets." In ruling on the reasonableness of a settlement offer made by defendant sellers, the district court subtracted the estimated value of the skills and abilities of a key management executive and other personnel who were retained by the purchasing adviser from the total payment in determining the amount paid for the fiduciary office.

The fallacy in such reasoning is that in foregoing a fee reduction or the receipt of a premium the fund is paying for a benefit the Act allows it to obtain for free. It should make no difference whether the successor is a newcomer or merely the same management company under new ownership. By directing the value of that benefit to themselves, the defendant controlling shareholders in \textit{Krieger}, as the plaintiff charged, usurped a business opportunity properly belonging only to the fund.

The 1940 Act is not concerned with changes of either adviser personnel or names. Its protective mechanisms are activated only when changes occur in advisory company control. This implicit awareness that important policies and investment philosophy can be changed by new owners without a change in personnel militates for the use of a similar standard whether the advisory organization personnel remain essentially the same or whether a totally new adviser succeeds to the position.

The second ground for the \textit{Krieger} decision was best expressed in the opinion of the Supreme Court of Delaware:

\[\text{[W]e observe that the approval of plaintiff's contention would lead to an anomalous result. Owners of stock of a management company who have built up the value of their shares through the years by the exercise of business ability and good judgment are forbidden ever to reap the reward of their labor. In other words, they can never sell the shares for what they are really worth. This conclusion offends one's sense of fairness. If overriding considerations of public policy requires [sic] a curb on the right of owners of management contracts to realize the full value of their assets, it is for Congress to say so.}\textsuperscript{174}\]

Despite the smug implication that Congress would never pass a law

\textsuperscript{172} Nutt, \textit{supra} note 47, at 245.
\textsuperscript{174} 40 Del. Ch. at 367-68, 182 A.2d at 910.
that would offend the Delaware court's system of values, the 1940 Act stands as evidence that Congress apparently has. The court's objections are more properly addressed to those provisions of the Act which deny cheap stock to mutual fund promoters and permit mutual funds to cancel advisory contracts without penalty, rather than to the plaintiff's interpretation of the latter's operation. In answer to the protests of the court that Kreiger's arguments would prohibit owners of management contracts from realizing their full value, the Act specifically proscribes the indirect assignment of management contracts and warns that tenure is at best guaranteed for only sixty days. The 1940 Act rejects the implication that mutual fund management contracts are vendible capital assets in the hands of advisers; Kreiger was correct in demonstrating to the court that they have no true alienable worth.

More important, the court misunderstands the nature of management fees and overlooks the conflicts of interest they present. Investment company investors, unlike their counterparts in industrial concerns, do not always share the same interests as management in the growth of their companies' assets. The value to management of a freely marketable contract would be largely dependent upon the size of the management fee it produces. But since the amount of assets under management can be increased either by capital accretion or by sales, the fee operates to reward sales as well as performance. Under Kreiger or ISI, the worth of a management company's shares would reflect in large part the ability of the sponsor to mount an effective sales campaign. Data are inconclusive, but most industry observers do not believe that the large size of a fund necessarily benefits individual shareholders. Although sufficient assets are needed to meet investment objectives, such as portfolio diversity, economic theorists believe that no material diversification benefit accompanies ownership of more than twenty securities. Also, brokerage costs per invested dollar are likely to decrease with growth, because greater funds permit larger positions in any one issue. Some economists believe, however, that many funds are so large that meaningful portfolio positions are impossible; investment is required in too many different securities, effectively removing discretionary judgment and reducing the fund to an unmanaged pool at the mercy of general market conditions. Moreover, liquidity is dif-

176 SEC 1966 REPORT 263. This finding was questioned in SEC, INSTITUTIONAL INVESTORS STUDY REPORT, H.R. Doc. No. 64, 92d Cong., 1st Sess. pt. 8, at 31 (1971). The latter report noted "the lack of a significant relationship between fund size or advisory complex size and fund performance." Id.
ficult to obtain without severe market fluctuations disadvantageous to
the fund because each portfolio position is so relatively large that its
disposition (and occasionally acquisition) disrupts normal supply and
demand levels. Block traders and third market makers have developed
remarkable talent in facilitating these trades, but they charge handsome
premiums for their services. Thus, the sale of shares may be more im-
portant to the interests of the adviser than to those of the shareholders.
The Krieger rationale improperly rewards advisers for efforts which
may have in fact retarded the performance of the fund and harmed the
shareholders.

2. Voluntary Shareholder Renewal

It has also been suggested that while the sale of office rule properly
prohibits profiting from the use of influence, sellers of management
company stock should be permitted to receive a sales price that reflects
the value of "the chance that the investors [will] voluntarily reinstate
the contract." This theory argues that if the services of the manage-
ment company had been satisfactory and the sale changed only the
ownership of the adviser, not its personnel, then shareholders would
most likely continue the relationship. Since no investor expectations
would be frustrated, payment for "that portion fairly attributable to
the anticipated earnings of an organization capable of performing valu-
able services" would properly reward the sellers for the full value of
their assets without exposing shareholders to possible harm.

This theory would appear to give desirable deference to the fact
that investors choose a particular mutual fund primarily on the basis
of the reputation of the adviser. Moreover, if the theory were extended
to newly constituted advisers, as it theoretically can be, it would reward
retiring principals who select the best successors obtainable, since the
chance that well-informed shareholders would vote to renew the con-
tract would increase with the quality of the buyers. The argument,
however, rests on the untenable assumption that shareholders can exer-
cise concerted, well-reasoned control over the renewal procedure. The
practical impediments to effective shareholder democracy are over-
whelming. Shareholder approval of any candidate nominated is almost
a certainty. If a court were to determine the chances of renewal realis-
tically, the resulting reduction in the sales price would be infinitesimal.
Moreover, the effect of such a determination would be to give undue
meaning to the ritual of shareholder ratification, a result Congress

177 Note, supra note 144, at 129 (emphasis added).
178 Id. at 130.
specifically sought to prevent in the 1970 Amendments.\textsuperscript{179} Realizing that the power to place the successor's name on the proxy is tantamount to approval, \textit{Rosenfeld} rejected this approach and triggered adviser liability, in part, upon the use of the proxy machinery. It held that shareholder ratification would be effective only if shareholders were informed that they were entitled to the profit and that the vote must be unanimous to bind the fund.\textsuperscript{180} On the other hand, if a court were to recognize these obstacles to independent shareholder judgment, it would be forced to predict what a hypothetical body of intelligent, informed shareholders would do in a similar case.

Perhaps similar considerations have persuaded courts to apply the sale of office rule in situations where fiduciaries merely resign at the instance of personal gain and have not sought to influence the selection of their successor. Whatever the merits in other circumstances, in the mutual fund context such application properly recognizes the power that control of the proxy machinery carries and obviates the need for proof of specific examples of the use of influence on fund directors.

\textit{Rosenfeld}, however, phrased the duty in conditional terms, possibly implying that had Lazard remained aloof during the selection and approval process, it could have received whatever succession fee it could negotiate. The court, however, was skeptical that such a situation would ever arise:

\begin{quotation}
It will be time to deal with the unlikely case where the adviser retires or the controlling stockholder sells his interest in the advisory company at a profit but scrupulously avoids any involvement with the required approval of the new contract, when it arises.\textsuperscript{181}
\end{quotation}

While the bargaining position of the retiring adviser is substantially reduced when it does not control the selection process, such a case, or at least the staging of such a case, is not so unlikely as the court believes. Commentators and practitioners have suggested that selling shareholders

\textsuperscript{179} Prior to the 1970 Amendments, courts in effect held that shareholder approval of a contract award removed any fiduciary duty of an adviser with regard to management compensation. \textit{See, e.g.,} Saxe v. Brady, 40 Del. Ch. 474, 184 A.2d 602 (1962). \textit{See also Hearings, supra} note 55, at 608 (remarks of Chief Judge Friendly: shareholder voting provided no protection against adviser overreaching). Congress added § 36b(2) to provide that approval of management contracts by shareholders "shall be given such consideration by the court as is deemed appropriate under all the circumstances." This was intended to make ratification only one of many factors to consider—not controlling as earlier courts had held, S. \textit{Rep.} No. 184, 91st Cong., 1st Sess. 15-16 (1969). Now "it is unlikely that courts will give much weight to ratification as a determinant of fairness." \textit{Note, supra} note 17, at 648.

\textsuperscript{180} 445 F.2d at 1343.

\textsuperscript{181} \textit{Id.} at 1347 n.13.
may avoid liability if they play no role in settling upon a successor.\footnote{182 See Lenzer, supra note 22, at 44; Note, supra note 97, at 666.} But these suggestions ignore the fiduciary duty of the adviser to make its disinterested recommendations to the independent directors. To permit the sellers to receive a price which includes the hypothetical value of voluntary renewal, regardless of their role, would leave the same opportunities for abuse that \textit{Rosenfeld} sought to eliminate and would undercut the purpose and principles of the fiduciary obligations the opinion imposed.

3. \textit{Ex-Fund Going Concern Value}

Analytically, the denial of the value of either goodwill or the chance of voluntary shareholder renewal to selling management company shareholders, and, ultimately the sale of office rule, are in part the products of the equitable prohibition against a fiduciary profiteering from its relationship with its beneficiary. It follows that it would be entirely proper for the selling shareholders to be compensated for the value of the management company without the mutual fund relationship. In some cases this will include the value of a firm’s goodwill in other capacities, such as investment banking or underwriting, but in many instances it will be limited to the worth of an operating management organization capable of advising other mutual funds not presently under management and similar pools of investment assets, such as endowment and employee benefit funds. This element of worth will be called ex-fund going concern value.

The logic of this analysis with regard to the value of an adviser’s goodwill in businesses other than investment management can be tested if we alter the facts of \textit{Rosenfeld} slightly. Suppose that instead of Lazard withdrawing from the management relationship, the principal owners decided to sell their controlling interest in the entire company. Since Lazard had not formed a subsidiary to manage the Fund, such a sale would have triggered the termination of the advisory contract. But Lazard derived only a small portion of its total revenues from the advisory relationship. To prohibit the selling shareholders from receiving more than the tangible net asset value of the firm would be to deprive them of the value of intangible assets which are in no way connected with the operation and management of the fund, a result neither required nor contemplated under \textit{Rosenfeld}.

Even those advisers that have no business other than advising

\footnote{183 See text following note 82 supra.}
mutual funds have value as a going concern distinct from their relationship with funds presently under management. A history of proven performance and low-expense ratios can make an adviser quite attractive to an investment pool looking for new or improved management. Competition for pension and retirement fund advisory contracts is currently quite intense, and, unlike the mutual fund situation, advisers are frequently changed.\footnote{Several large pools have begun hiring two or more advisers to manage their funds. See Rohrer, \textit{Everybody Wants to Split—But How Are They Going About It?}, 5 \textit{Institutional Investor}, Aug. 1971, at 64; \textit{A Splitting Sampler: How 40 Major Companies Spread the Money Around}, id., Oct. 1971, at 69. The better performing advisers are then rewarded by the allocation of a larger proportion of the assets to their control, thus raising their management fee. Unsatisfactory performers are fired if their service does not improve with fewer assets under management. Even The Common Fund, a college endowment fund, has begun to screen prospective advisers and select multiple managers. See Address by J. Meck, \textit{The Selection of Investment Managers for The Common Fund}, Donaldson, Lufkin and Jenrette Endowment Conference, New York City, May 1971.}

The fact that competing mutual fund advisers are presently unable successfully to bid for and win management contracts, replacing other sponsors, should not diminish ex-fund going concern value. Courts must distinguish between the actual and the ideal practices in the industry. A court in agreement with \textit{Rosenfeld}'s rejection of the current edge which advisers enjoy as a legal model might well approve a larger allocation of value for this component than the marketplace would otherwise assign to it.\footnote{Ex-fund going concern value should also include a recognition of the successful public offerings of new mutual funds. Such offerings have become more common in recent years. In the \textit{Rosenfeld} case, for example, the Lazard Fund amassed $115 million in assets without the benefit of an ongoing sales program. Several years ago Jerry Tsai was able to assemble assets totaling close to $300 million in the public offering of his Manhattan Fund. The weak market of the last few years has not foreclosed this marketing technique. Recently, Massachusetts Financial Services, which normally employs Vance, Sanders & Company for continuous underwriting and sales, has used Merrill Lynch, Pierce, Fenner & Smith, Inc. for the initial public offering of two new mutual funds. Merrill Lynch delivered over $300 million in new assets. An established name in investment management may be able to use this technique and duplicate these results. Ex-fund going concern value should properly reflect these possibilities. }

Allocation for this element of worth should be restricted, however, by two considerations. First, compensation for ex-fund going concern value is only proper where the purchaser acquires the benefit of the adviser's name, personnel, and organization. When a key management
officer does not continue to serve after the sale or does so only in a limited capacity, such as a consultant, or when the name recognition factor of the company is lost, as, for example, in a transaction staged as a merger, the evaluation of this component should reflect such loss.\textsuperscript{186}

Second, when an advisory organization manages a complex of mutual funds, care must be taken not to permit the selling shareholders to profit from the effectual assignment of management contracts with the other funds comprising the complex. Allocation of the value of the renewal of advisory contracts with other funds would reward the sellers for the use of proxy machinery to secure shareholder approval. Moreover, since the danger of adviser domination would exist in each fund, particularly where independent directors sit across the complex,\textsuperscript{187} serving on each board, the need for a prophylactic rule to protect the integrity of the Act would be as great as in a single fund evaluating the overall goodwill of its adviser. The evaluation of ex-fund going concern value, therefore, should not reflect consideration of other investment company clients then under contract.

4. \textit{Summary of the Rosenfeld Analysis}

The net effect of \textit{Rosenfeld} is to deny promoters any opportunity for the receipt of entrepreneurial reward for promotional efforts in developing new investment vehicles in the form of investment companies, at least when they withdraw from their role as sponsor and investment adviser or sell control of the advisory company. Receipt of compensation equivalent to the value of the advisory organization they have developed is permitted, but this cannot reflect the relationship of the advisory company to the mutual funds it has sponsored or come to manage. This result will undoubtedly further one avowed purpose of the 1940 Act, which was to discourage the creation of investment companies for quick profit rather than for long term management.\textsuperscript{188} Since the only remaining avenue for earning entrepreneurial reward is the management fee, prospective promoters may be reluctant to sponsor new funds unless they feel that they are prepared to undertake a long term

\textsuperscript{186} In the \textit{Rosenfeld} situation, Moody's was promised the services of an economic consultant for five years and the best efforts of Lazard "to induce certain persons presently performing services for the [Fund] to similarly perform for Moody's Capital Fund." 445 F.2d at 1839-40. While Lazard should receive the worth of these individual covenants, nothing resembling an ongoing organization changed ownership. Payment designated for going concern value, therefore, would have been improper.

\textsuperscript{187} Cf. Glazer, \textit{supra} note 81, \textit{passim}.

\textsuperscript{188} See, e.g., \textit{Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency}, 76th Cong., 3d Sess. 252-54 (1940) (remarks of D. Schenker, SEC counsel).
The entrepreneur who is content to recoup the investment of his time and effort over a lengthy period, however, may find that even this source of entrepreneurial reward will be denied if performance as an adviser does not merit his retention.

Left unsettled are the procedures to be used to evaluate the largely hypothetical and speculative ex-fund going concern value of an adviser. The difficulties presented are formidable—perhaps so incapable of precise solution given the current state of techniques of financial appraisal that the SEC and Senator Harrison Williams devised S. 4071, at least in part, to avoid the need for such an appraisal by removing some of the incentive for paying a succession fee.

IV

S. 4071: THE NEWEST LEGISLATIVE PROPOSAL

The recently proposed S. 4071 would specifically permit an adviser or its shareholders to receive a succession fee if two requirements were met. First, S. 4071 requires that at least seventy-five percent of the governing board of a mutual fund consist of independent directors for a period of three years following a sale. Second, a sale transaction must not impose "an unfair burden" on a fund. The bill would exempt a transaction in which an adviser "goes public," selling its shares to unrelated investors and retaining the individuals in actual control of the adviser. A final provision, though not a condition to the approval of receipt of a succession fee, may potentially be the most important facet of the bill. This provision would prohibit the new, post-sale board from considering the succession fee paid by a new adviser in its evaluation of the terms of the management contract. Undoubtedly, the bill,

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189 This hesitancy may become an absolute deterrent given the high percentage of initial failure for promotion efforts. See notes 39-40 and accompanying text supra.

190 See note 28 and accompanying text supra.

191 92d Cong., 2d Sess. (1972) [hereinafter cited as SEC Reform Bill]. The bill was introduced in the Senate on October 9, 1972, by Senator Williams on behalf of the SEC. See 118 Cong. Rec. S91 (daily ed. Oct. 9, 1972) (statement of Senator Williams); Speech by Senator Williams before the Securities Industry Ass'n, Sept. 7, 1972, reprinted in BNA Sec. Reg. & L. Rep., No. 108, Sept. 13, 1972, at D-1. The bill, entitled the Securities Act of 1973, was introduced, in part, as a replacement for S. 3681, 92d Cong., 2d Sess. (1972), which had been introduced in Congress on June 7, 1972, by Senator Williams. Since the Commission is presently taking a "no comment" position, it is unlikely that the SEC will protest its own alterations of the original text which are found in S. 4071.

192 SEC Reform Bill § 5 (proposed addition to 15 U.S.C. § 80a-15 (1970)).

193 Id.

194 Id.

195 Id. § 6 (proposed addition to 15 U.S.C. § 80a-15(c) (1970)).
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if enacted, would provide some protection for both mutual fund shareholders and advisers; however, in order for the bill to fully accomplish its objectives, it must be clarified and amended in several respects.

A. Principally Disinterested Boards

S. 4071 is the second bill drafted by the SEC dealing with succession fees to be introduced in Congress. The first, S. 3681,\(^{106}\) closely parallels the present proposal in approach; the latter, however, incorporates several changes, one of which deals with the composition of mutual fund boards of directors. S. 3681 called for a fund to have a wholly disinterested board for a period of five years following a sale.\(^{107}\) SEC Commissioner Sydney Herlong stated that the purpose of S. 3681 was to prevent an investment adviser or its shareholders from receiving any succession payment "reflecting the certainty of succession to and assurance of continuation of the investment advisory contract."\(^{97}\) That bill was to reduce the amount paid in excess of the worth of an adviser without regard for its mutual fund advisory position by requiring a totally independent board which would presumably be resistant to improper adviser influence.\(^{100}\) Thus, a successor "would have to bargain with the investment company at arm's length"; continuation of advisory relationships would be dependent upon proven performance and service.\(^{200}\) The SEC did believe that sellers should "be able to receive some payment reflecting the real going concern value of the adviser."\(^{201}\)

This provision in S. 3681 met with much criticism from representatives of the mutual fund industry who felt it was "an unduly harsh restriction, and could result in additional costs to the funds because of the need to hire new people not connected with the management company."\(^{202}\) Apparently recognizing that stiff opposition on this one point could endanger the many other reform measures included in the bill, Senator Williams, who introduced the bill in Congress, softened the requirements. Significantly, however, he did not change the framework of the original proposal or its intended effect.

The Act has always provided that for advisory contract award and

\(^{106}\) 92d Cong., 2d Sess. § 1 (1972).

\(^{107}\) Id. § 3 (proposed addition to 15 U.S.C. 80a-16 (1970)).

\(^{100}\) Herlong 11.

\(^{97}\) Id. at 12.

renewal only the votes of independent directors have any effect.\textsuperscript{203} True, directors were previously permitted to "avoid responsibility for approving a disadvantageous advisory contract by leaving the approval to a majority of the outstanding shares,"\textsuperscript{204} but with the enactment of the 1970 Amendments, the Act mandates that such determinations be made by the independent board members in person at a meeting called for that purpose.\textsuperscript{205} Thus, for contract award and renewal all mutual fund boards in effect are now wholly disinterested, and, in theory at least, a successor must bargain at arm's-length with the independent members of a mixed board. This aspect of S. 4071 demonstrates a recognition that unaffiliated directors of forty percent independent, bifurcated boards presently do not provide such bargaining on behalf of mutual fund investors.

The SEC has previously recognized that independent directors do not always perform the extensive role seemingly provided for them in the 1940 Act.\textsuperscript{206} For example, during congressional consideration of the 1970 Amendments, an industry trade group proposed an alternative to the statutory imposition of a fiduciary duty on advisers which would have increased the required number of independent directors on an average board from forty percent to at least a majority. The SEC rejected this enforcement method. A member of the Commission staff commented that "by relying upon measures to strengthen the number and the independence of the unaffiliated directors, the industry was propagating the myth that unaffiliated directors have served as an effective control over advisory fees."\textsuperscript{207} Neither the bill, Senator Williams, nor the SEC, however, make clear why the cure for this ill is to be a larger dose of the same tonic. The only objective result of a change to principally independent boards would be the theoretical removal of proxy control from advisers. This might permit independent directors to oppose adviser practices without fear of being removed from the slate of nominees at re-election time.

Another change required by S. 4071 may be intended to eliminate a major influence on the outlook of independent directors. In the investment company industry, advisers generally make (or at least can veto) the selection of independent directors. As one prominent securities lawyer noted: "[T]he men who need to be watched pick the watchdogs

\begin{footnotesize}
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\item \textsuperscript{203} 1940 Act § 15(c), 15 U.S.C. 80a-15(c) (1970).
\item \textsuperscript{204} Rosenfeld v. Black, 445 F.2d 1337, 1347 n.14 (2d Cir. 1971).
\item \textsuperscript{206} See Hearings, supra note 55, at 674-80 (statement of M. Cohen, Chairman, SEC).
\item \textsuperscript{207} Id. at 46.
\end{itemize}
\end{footnotesize}
to watch them." S. 4071 requires that only the independent directors pick the successors to ousted interested directors. Of course, there is no guarantee that nominally independent directors who were selected by an adviser are going to choose men who will serve solely in the interests of fund investors. Indeed, this may by the unlikely case.

Independent directors who prior to succession acceded as a matter of course to other adviser demands would probably honor recommendations of new board members made by a seller or buyer. Moreover, those directors brought onto the board by a departing adviser may desire to retire from the board rather than to attempt to establish a working relationship with a new and foreign organization. S. 4071 clearly contemplates close monitoring and continual evaluation of the performance of a new adviser in the years immediately following a succession, perhaps requiring more time-consuming work than a director may have come to expect. Furthermore, even those directors who have maintained their independence, but who anticipate leaving the board upon a transfer, could be expected to look to a successor for suggestions for nominees in order to provide directors familiar with its personnel, organization, and operations, since little continuity of board membership would be maintained.

Despite the existence of boards comprised primarily of unaffiliated persons, the development of directors’ psychological independence would probably require either adviser assistance or a lengthy working-out period in which identification with adviser interests gradually diminishes as boards evolve away from direct adviser selection. Since it is in an adviser’s interest to maintain a board sympathetic to its interests, many funds may not receive the necessary sponsor assistance. However, some of the most successful and respected advisers in the industry have voluntarily divorced themselves from the selection process for independent board members, leaving the entire task to unaffiliated directors. Some successors may develop truly independent attitudes, but in the majority of cases the evolutionary process to true independence would probably take longer than the three year period provided in S. 4071. If, as seems likely, an adviser is still able to influence director nomination after the statutory period, the bill would permit it to install its representatives on the board and to gain absolute control of the proxy machinery.

209 SEC Reform Bill § 7 (proposed amendment of 15 U.S.C. § 80a-16 (1970)).
210 Id. § 5 (proposed addition to 15 U.S.C. § 80a-15 (1970)).
Even if S. 4071 does produce truly independent boards and fund control of proxy machinery, it cannot police the quality of successors in the very sale transactions which trigger its operation. A new adviser, unlike new directors, is not required to be selected and nominated solely by unaffiliated members of the board. Nor must a newly constituted board be elected prior to board consideration of a successor. According to Commissioner Herlong, the legislation contemplates that "the new adviser [will] be initially approved by the outgoing board."\textsuperscript{211} This mechanical flaw casts grave doubt on the ability of the proposal even theoretically to accomplish its goal of eliminating any payment reflecting certainty of succession, since installation of a new, less interested board would come only after a successor had been approved by the old board, and the outgoing adviser (still in control of the proxy machinery) had solicited shareholder approval. Thus, a retiring adviser could exert as much influence in the operative sale transaction after adoption of the bill as it is presently able to do.

The rationale offered by the SEC for requiring more independent directors does not explain why such directors are considered necessary only after succession. If, as Commissioner Herlong has stated, the principal purpose for removing interested directors and replacing them with unaffiliated persons is to provide arm's-length bargaining, it would be equally appropriate to mandate such bargaining throughout the existence of a fund, since management compensation is paid during this entire period. There is one explanation that may justify this otherwise anomalous result. When a mutual fund investor selects a particular fund, he does so primarily to secure the investment management skills of the adviser of that fund.\textsuperscript{212} In a very real sense, he seeks only a personal relationship with that one adviser. The investment risk he willingly assumes is justified by his trust in the talents of his chosen adviser. As long as that original adviser remains, the investor will be subject only to risks typical of most investments. If he becomes disenchanted with portfolio performance, he may redeem his investment and seek out another adviser (although in load funds at costs somewhat higher than in direct common stock investment). Senator Williams and the SEC may believe that in such an instance an investor should be satisfied, except in cases of egregious adviser misconduct, to rely solely on redemption to obtain new investment management, since an adviser's interest in remaining in the relationship that it created in order

\textsuperscript{211} Herlong 10.

\textsuperscript{212} Both proponents and critics of the shell theory agree on this. See Lobell, supra note 56, 70 YALE L.J. at 1260-62; Nutt, supra note 47, at 232; WHARTON REPORT 343-44.
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to earn entrepreneurial reward outweighs the interest of the investor in obtaining a low cost change.

On the other hand, when an adviser retires from the relationship on its own initiative, the mutual fund shareholder, unlike the investment adviser's individual client, must unwillingly incur both the costs of a sales load and possible tax consequences that would accompany a switch to another adviser if he is dissatisfied with the retiring adviser-selected successor. True, he does have the right to vote against a recommended successor or (should it come to pass) a competitor adviser, but he must accept the candidate selected by a majority of his peers. The nature of his investment is thus materially changed from reliance on his personal choice of investment manager to reliance on the board of directors of the investment vehicle to which he is wed to ensure that he receives the best possible portfolio performance. In other words, as long as the adviser he chose manages his money, he should bear the risk of his selection, but when that adviser leaves and his investment expectations are disappointed, his investment risk is changed and his interest becomes solely a maximization of return. Thus, he is entitled to receive closer and disinterested scrutiny of an adviser from the board which can more easily seek new management in the event of substandard performance.

This rationale, though appealing, does adopt much of the reasoning of the shell theory which has so often been rejected by the SEC and Congress. That theory undermines the bargaining position of fund directors by removing their principal bargaining tool with regard to management fees—the power to terminate the relationship. The 1970 Amendments, however, placed new duties on independent directors to police the compensation advisers receive. Adoption of this rationale would undercut the purpose of those Amendments. Moreover, if this rationale were the basis of S. 4071, the bill would have the curious effect of changing the duties of directors in situations with which it does not purport to deal. It would be anomalous to change the role of independent directors in pre-transfer situations with an amendment dealing only with post-transfer periods. Furthermore, the bill would operate with only the roughest form of justice for successor advisers. Those investors who purchased fund shares for three years following succession in order to obtain the successor's services will receive more than they bargained for—the investment management of their choice and a primarily independent board capable of arm's-length bargaining.

Finally, it is inconsistent with the rationale proffered to allow a

213 See notes 57-62 and accompanying text supra.
retiring adviser to select a successor. An investment adviser would not be able to force an individual client to place his portfolio with another adviser chosen by it, nor could it assign its personal investment advisory contract. It is conceivable, however, that the drafters of S. 4071 believe that the adviser would be prohibited from taking any role in the selection of a successor. Rosenfeld reasoned that when the legislature required shareholder approval of new advisers it must have meant approval uninfluenced by financial self-interest on the part of a retiring adviser which is in control of the proxy machinery. The drafters may have intended Rosenfeld’s holding to be left unchanged by S. 4071, permitting an outgoing adviser to receive a succession fee only if it allows independent members of an outgoing mixed board to select a new adviser as well as new directors. That additional requirement, however, would appear to contravene the bill’s express approval of a succession fee (albeit solely upon the simultaneous institution of a wholly disinterested board and the absence of an unfair burden imposed on a fund). Moreover, abstention from the selection process may be in violation of the fiduciary duties an adviser owes to a fund. If the drafters intend the bill to change these common law duties, specific indication should be made in the amendment.

A better method of preventing unbridled adviser selection would be to alter the bill to mandate the installation of a principally independent board prior to a succession. If proposed subsection 15(f)(1) required that, in addition to three years following an effectual assignment of an advisory contract, the board of a fund be staffed principally with unaffiliated persons six months prior to a succession, absolute control of the proxy machinery would be removed from a retiring adviser, preventing it, at least theoretically, from being able to guarantee succession for the candidate of its choice and thus bargaining for that guarantee’s worth. Six months should provide the new board with sufficient time to scan the industry, survey past performance records, receive bids, and conduct interviews with prospective successors. With this change, a succession fee would be reduced (except for ex-fund going concern and tangible asset value in a sale of stock) to merely a “suggestion fee.”

214 The amendment would not visibly alter § 15(a), 15 U.S.C. § 80a-15(a) (1970), the provision held by Rosenfeld to incorporate the equitable proscription against personal gain. 215 445 F.2d at 1344. 216 SEC Reform Bill § 5 (proposed addition to 15 U.S.C. § 80a-15 (1970)). 217 Of course, the new board could choose not to solicit the outgoing adviser’s counsel, but if it did, the difference in market value between a suggestion and a succession fee would lie in the extent to which new boards in fact exercised independent judgment. The
This characteristic of S. 4071 which permits advisers to present new, principally disinterested boards with new advisers as a *fait accompli*, together with the express approval of the receipt by sellers of "any amount of benefit" in connection with transfers, appears to contemplate the abolition of any standard of quality (other than honesty) for an adviser's choice of a successor. Freedom to bargain for the highest price obtainable and to choose the identity of a successor presumes no duty to select the best candidate; conceivably, an outgoing adviser could select a complete novice whose integrity was impeccable. Admittedly, the 1940 Act would permit discontinuation of the advisory relationship by a new board in such a case. But since the purpose of the bill is to make continuation of the relationship dependent upon performance, it is likely that the bill contemplates that once installed, a successor will be given an opportunity to prove itself. In order to provide a fair trial period, a board would have to wait at least three or four years to evaluate properly the portfolio performance. Thus, in bargaining for the succession fee, an outgoing adviser could ignore the short notice termination provisions of the Act and demand an amount reflecting the present value of the anticipated profits for the trial period without any discount for the possibility of loss of the position.

In sum, the independent director facet of S. 4071, as presently written, would not prevent an outgoing adviser from demanding payment for guaranteeing the succession to an advisory position and the present value of the profits from the first few years of the relationship. Nor would the bill prevent an adviser from selecting the highest bidder rather than the best potential successor. At best, it would only operate to limit slightly the amount of consideration a successor is willing to pay, since after the trial period negotiations with a new, principally independent board might carry a higher degree of risk of termination or unfavorable terms than those with a conventionally comprised board. The success of even this limited result would depend in large part upon advisers assisting, against their own self-interest, in the development of truly independent boards.

development of a pattern of strict adherence to the choice of retiring sponsors would force courts to require financial appraisal and allocation to separate the ex-fund worth of the adviser and the price of its influence. Should boards demonstrate a pattern of independence, however, courts may not wish to bother with such guesswork, despite the fact that an adviser may be selling its influence, since the amount which would be allocated to this component would be minimal.

B. Publicly Held Advisers

Certain dangers inherent in a negotiated sale of advisory company control are not present in a public sale of stock. Fund shareholders are not subject to being placed in the hands of the highest bidding succession candidate. The effective management of their investment will remain under the direction of the same personnel they selected. Even when key executives do leave an adviser simultaneously with a public sale, their replacements will have probably gained their positions by prowess rather than purchase—often through internal promotion. If the only object of mutual fund shareholder protection were the quality of investment management, public sales of advisory company stock might well be permitted to go unregulated, as S. 4071 would allow in a provision not included in its predecessor, S. 3681.

However, whether management identity is changed or not, sellers of advisory company stock always capitalize on the company's advisory relationship. The selling price of such stock, of course, will be greatly influenced by the profitability of the adviser. Selling stock to outsider shareholders puts new pressures upon adviser principals to maximize profits. Public shareholders will be interested in the best return possible on their investment, rather than in the welfare of fund shareholders. As Chief Judge Friendly has recognized, in such a case "the price paid for the stock would inevitably figure in any efforts to reduce the management fee." Principals will assume new fiduciary duties to these public shareholders. Those who may have been willing to forego certain cost saving moves or higher fees when they were sole owners may now be under new legal duties to refrain no longer from maximizing profits. Furthermore, principals who plan to sell more of their own adviser stock may be tempted to maintain the market price of the stock at high levels by delivering large dividends to adviser shareholders at the expense of a fund. Finally, principals who have retained little voting stock may fear a proxy fight from adviser shareholders and a consequent loss of their executive positions. The cost of investment management may be adversely affected when adviser stock is sold to the public. That provision of S. 4071 which would exclude public sales of adviser stock from the Act should be deleted from the bill.

Even without the enactment of such an exemption clause, a question remains as to the applicability of the present provisions of the 1940 Act which govern management contract assignments. Should manage-

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220 SEC Reform Bill § 2 (proposed addition to 15 U.S.C. § 78k (1970)).
222 SEC Reform Bill § 2 (proposed addition to 15 U.S.C. § 78k (1970)).
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ment company stock be sold, the Act demands that a "controlling block" be transferred before the advisory contract is considered "assigned," and the advisory relationship is thus automatically severed. Shareholders, therefore, need not be solicited nor do independent directors need to vote in order for the relationship to be continued when less than a controlling block is transferred.

An interpretive problem arises. When stock of a company previously closely-held is sold, even in large amounts, to widely dispersed and unrelated public investors, control of the issuer can be maintained by those in control of the proxy machinery at the time of the sale. In Newman v. Stein, the voting stock of the Dreyfus Corp., investment adviser to Dreyfus Fund, Inc., was sold publicly by its principal shareholders; yet, the chief operative officers and management personnel were able to continue in command of the company. The selling shareholders of Dreyfus were subsequently sued derivatively by a fund shareholder who relied on Rosenfeld charging, inter alia, that the sale of stock constituted a sale of fiduciary office, and who sought recovery of the profits derived from the sale. Rosenfeld incorporated the equitable principle requiring abnegation of personal profit in the transfer of a fiduciary position into section 15(a). Since that provision is applicable only when a sale of adviser stock constitutes a transfer of a controlling block, arguably at issue was whether a controlling block was sold at all. Curiously, the Act does not define "controlling block." Courts and commentators, however, have generally thought the Act's definition of "control" related directly to this provision. "Control" is defined as the "power to exercise a controlling influence over the management or policies of a company." Without more, the Act would not appear to be operative and the Rosenfeld rule would be inapplicable in the Newman case, since practical control was retained by the same principals. But the Act further provides that an owner of twenty-five percent or more of voting stock of a company shall be presumed to have control of that company. The contrary presumption applies to the owner of

227 See, e.g., Phillips v. SEC, 388 F.2d 964 (2d Cir. 1968).
228 See, e.g., Comment, Termination of Management Contracts Under the Investment Company Act of 1940, 63 Colum. L. Rev. 733, 739 (1963).
230 Id.
less than this percentage. The trial and appellate courts both ignored the issue. The sale of Dreyfus stock clearly did constitute transfer of a block in excess of twenty-five percent of its voting securities. The purchaser, however, did not receive a "controlling block," nor did any one purchaser or related group of buyers receive a twenty-five percent block. Thus, not only was the presumption of control arguably not met, but, in fact, no control changed hands.

The result reached in the *Newman* case is a desirable one. The contract termination provisions of the Act, and hence the sale of fiduciary office rule, should apply to public sales of adviser stock. The theory apparently relied upon to suggest such a rule in both the *Newman* case and the Act, however, is questionable. A transfer of control does not necessarily occur simply because more than twenty-five percent of an adviser's voting stock is sold. In order for control to change hands, the buyer must receive a controlling block of stock. Indeed, it is quite conceivable that a purchaser could acquire a "controlling block" through several sales, none of which was itself substantial. As long as control is the trigger for contract severance, courts should focus on what the purchaser received rather than what the vendor sold.

The Act should be amended so that transactions such as the Dreyfus sale do trigger its operative provisions. The presence or absence of a transfer of control should not be the determinative factor. Instead, the mere sale of adviser stock should be the sole trigger of *Rosenfeld* or S. 4071 liability. Formulation of an amendment incorporating this objective, however, is complicated by the desirability of certain sales within management. Many transfers between controlling shareholders or executives would be innocuous or would actually benefit a fund. Sales which permit a greater number of management personnel to share in the profits of an adviser may stimulate more active interest in the performance of the fund an adviser manages.

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231 While these presumptions are rebuttable, evidence must be initially presented to the SEC for its determination. The sellers in *Newman* apparently did not solicit the Commission to challenge the statutory presumption of control; instead, they sought shareholder and director approval of the transaction and renewal of the advisory contract. If the court or the parties believed the sale constituted a transaction triggering the Act because the selling group no longer held 25%, they improperly allowed the Act's rebuttable presumption to contradict the realities of the transaction. It would seem that the presumptions are rebuttable for just this kind of case.

232 Despite the obvious difference in results, the trial court, nevertheless, assumed that "[t]he facts here are essentially similar to those in [ISI]." [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. at 91,720.

233 Cf. Lipton, *supra* note 23, at 855-56 (ownership limited to key adviser employees benefits fund).

ting this alignment of work and reward would suggest allowing some internal shifting of equitable ownership. This method of transfer, on the other hand, should not be used by founding principals to capitalize on the advisory relationship. When they withdraw, entrepreneurial risk must no longer be rewarded. If their successor principals have paid a succession fee, resistance to a proper reduction in management fees can be expected. In order to balance these competing interests, S. 4071, in addition to those alternatives detailed above, should be modified to amend section 2(a)(4) of the Act to define "assignment" to include any sale of adviser stock (voting or nonvoting) to persons other than those actively engaged in management. In contrast to sales to outsiders, the regulation of internal sales of adviser stock should focus on the amount transferred, not the amount received, since the danger lies in selling shareholders capitalizing their rights to future fees. Thus, in addition to the general transfer of control definition, all sales of stock by insiders in excess of a fixed amount, say ten percent, should be included in the statutory definition of "assignment."

Many advisers are already publicly held. The marketplace, as Krieger v. Anderson, 40 Del. Ch. 363, 182 A.2d 907 (Sup. Ct.), aff'g 40 Del. Ch. 151, 177 A.2d 203 (1962), on rehearing from 40 Del. Ch. 61, 173 A.2d 626 (1961). demonstrates, values advisory company stock, often in the face of disclosure of the short guaranteed duration of management contracts, presuming contractual relationships with funds will continue indefinitely. In this sense, the sales price of all publicly traded advisory company stock includes a succession fee. Should independent directors of funds whose advisers have gone public lower advisory fees now that those funds' founders have reaped their entrepreneurial reward? The burden of such a reduction would fall not on a successor which has purchased an advisory position, as it would in a negotiated transfer, but on the public shareholders of the adviser. A reduction in management fee rates would severely decrease the market value of these shareholders' stock, because almost the entire entrepreneurial reward profit stream would be eliminated. It would be possible to derive profit only as a reward for outstanding performance and efficient service. Little incentive would exist to provide a return on the succession fee the public shareholders paid. Despite this harsh result, as between the two innocent groups, adviser shareholders and fund shareholders, the mutual fund investors have the better of the equities.

First, adviser shareholders have been put on notice in their prospectuses that the continued right to profits from advisory relationships is not certain. Admittedly, many prospectuses probably have not warned
that the management fees the issuer earns may drop as a result of the immediate sale. However, if this was a misleading disclosure, adviser shareholders should have recourse against the sellers.

Second, even assuming that public purchasers of advisory stock could not be expected to anticipate a lowering of management fees, the adviser shareholders should bear the loss since they took the action which created the problem. This loss (despite once appearing very remote) is part of their investment risk.

To ameliorate this harsh result, adviser shareholders may argue that to the extent a fund recovers the seller's profits from a sale through litigation, the advisory fees should remain at their previous levels. This may seem an equitable solution, but it would impose undesirable financing costs on fund shareholders. Since sellers would likely be liable to purchasers and to the funds they formerly managed, it seems better to let adviser shareholders seek restitution from their vendors with priority to the sellers' assets. Mutual fund directors should ignore any such recovery in their calculation of management fees.

C. Payment of Entrepreneurial Reward

Two provisions in S. 4071, one prohibiting the imposition of burdens on mutual funds and the other regulating the post-sale management fee, may together dictate that entrepreneurial reward be paid only through management fees.

1. Unfair Burden

The principally disinterested board provision attempts only to insert some of the economic effects of arm's-length bargaining into transfers of advisory positions; it does not purport to regulate any other aspect of such sales. Accordingly, the drafters apparently considered a residuary fiduciary standard necessary. In order for sellers to receive a succession fee, S. 4071 would further require that a sale transaction not impose an "unfair burden" on a fund. Commissioner Herlong has explained that "unfair burden" is to be defined by the 1966 Mutual Fund Report. That report discussed proposed subsection 15(g) which was eventually deleted from the 1970 Amendments. Subsection 15(g), would have prohibited transfers which had terms likely to impose additional burdens. "Additional burdens" were specifically thought to include agreements to direct fund brokerage to the seller's broker.

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236 SEC Reform Bill § 5 (proposed addition to 15 U.S.C. § 80a-15 (1970)).
237 Herlong 10.
238 SEC 1966 REPORT 152-53.
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affiliates; S. 4071 expressly defines “unfair burden” to include similar agreements. But neither of these definitions is meant to be exclusive. The scope of the phrase “unfair burden” is uncertain; on its face it does not necessarily share the identity with subsection 15(g) that Commissioner Herlong suggests.

First, unlike the 1966 proposal, S. 4071 contains no language suggesting that liability hinges only on a showing of potential harm. While subsection 15(g) would have prohibited any transaction “likely” to cause harm, the new proposal requires only that “there is not imposed an unfair burden.” Thus, recovery under the new proposal may be conditioned upon the occurrence of actual harm to a fund. The unfair burden requirement, however, does extend to “any express or implied terms, conditions, or understandings” with respect to a sale. In light of Commissioner Herlong’s remarks suggesting that the two standards were intended to be similar, a court might reasonably consider a sale agreement containing terms which were likely to harm a fund to be the kind of risk that imposes an unfair burden on a mutual fund. In doing so, of course, the court would be attributing the error of very sloppy draftsmanship to the drafters. The absence of such language more probably suggests that liability was not meant to result from an anticipatory showing of harm and that actual injury must be demonstrated to establish a violation.

A second possible difference between the 1966 recommendation and S. 4071 is the nature of the burden or burdens that must result from the sale to create grounds for liability. The Commission’s change from “additional” to “unfair” may signify that here too a less rigorous standard of care may now be contemplated. The natural import of “additional” suggests that the 1966 test would have made unlawful sales which would impose any new burden or cost on a mutual fund; in contrast, S. 4071 would seem to permit a seller or buyer to impose “fair” costs on a fund. In other words, enactment of the new bill would evidence congressional belief that certain types of burdens caused by a change in advisers should be borne by mutual fund shareholders.

239 Id. at 153.
241 The Investment Company Institute proposed a draft that would have subjected parties to the sale of an advisory position to liability only when the transfer imposed an “undue burden” on a mutual fund. For the text of the draft, see Newman v. Stein, 464 F.2d 689 (2d Cir. 1972). Chairman Casey stated that the SEC has “trouble with the approach taken by the [Investment Company Institute proposal] because of the difficulties we see in determining what constitutes an unfair burden.” Casey Letter. Nevertheless, the phrase was used in the SEC draft.
Finally, the change to the singular “burden” in S. 4071 from the plural “burdens” in subsection 15(g) may indicate that the fairness of the transaction is to be judged on the basis of its overall effect, permitting burdens to be offset by benefits; in subsection 15(g) each potential cost or injury was occasion for liability. Unfortunately, the new proposal does not indicate, nor has the SEC suggested, what types of burdens or what costs could permissibly be placed on mutual funds by sellers or buyers of advisory positions. The proper interpretation of this provision will probably depend in large part on the method to be used for board determination of the reasonableness of management compensation.

2. Subsequent Fee

In ascertaining the role of the unfair burden provision, another provision of S. 4071 must be considered. That provision regulates not the sale itself, but the post-sale board evaluation of the terms of a management contract with a successor. As an amendment to section 15(c) of the Act, it would make unlawful the consideration by mutual fund directors of any succession fee paid an adviser with regard to their evaluation of an advisory contract. This provision is apparently intended to have two interrelated effects on the deliberations of a board. First, directors are not to feel bound to retain an unsuccessful successor so that it can recoup its succession fee. More important, board members are not to consider the size of a succession fee as a relevant factor in negotiations with respect to the management fee.

3. Incremental Review of Management Compensation

In practice, the effect of these two parts of S. 4071 is largely determined by the method independent directors must now use to evaluate management compensation. The 1970 Amendments considered the method for such determination. Prior to enactment of the Amendments, advisers and directors attempted to justify, and courts often upheld, fee rates, in part because the particular fee in question did not deviate substantially from prevailing rates in the industry. One purpose of the Amendments was to reject the circular reasoning of such an approach and to require that the reasonableness of each management fee be judged in relation to its own particular circumstances. Directors are now obliged

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243 Id. § 6 (proposed addition to 15 U.S.C. § 80a-15(c) (1970)).
244 See Rottenberg, supra note 17, at 325-33; Note, supra note 17, at 633-36. Chancellor Seitz noted that a court was unlikely to find that all the funds in the industry were paying unreasonable fees. Saxe v. Brady, 40 Del. Ch. 474, 488-89, 184 A.2d 602, 611-12 (1962).
"to request and evaluate" all information necessary to judge the reasonableness of management compensation. The original version of the Amendments included a nonexclusive list of items deemed necessary to such a determination.245 The version eventually enacted did not contain that list, but the purpose of the Amendments—to require an incremental review of each component of a fee—was not changed. True, it is unlikely that many boards presently break down the management fee for consideration. No mutual fund prospectus, for example, explains for what service or risk each management fee dollar is awarded. Without dissection and independent evaluation of each component, however, intelligent review is impossible, and fees paid without regard to such an evaluation are suspect.246

S. 4071 deems the capital investment a successor makes in a succession fee to be an improper factor or component for board members to consider. If they used an incremental review of each component of a management fee, directors would necessarily award a successor adviser a lower fee than its predecessor received, since a significant part of the compensation paid the outgoing adviser would have been justified on the basis of providing it with reasonable entrepreneurial reward. The successor, despite undertaking by definition an equal amount of risk, would have as its vice the principal portion of its risk in the form of capital, rather than effort.

Such a diminution in the available risk profit stream would have significant economic effects upon succession. Since an advisory position would bring income only slightly more than adequate to reimburse reasonable expenses and pay a reasonable wage, no opportunity would exist to earn a return on the succession fee capital expenditure. The desire of potential successors to pay an outgoing adviser for the opportunity to succeed to an advisory position would be severely dampened. In effect, management of a fund would become nearly internalized. Admittedly, efficiency would permit higher net earnings. Ongoing operation risks of management would entitle successors to remuneration higher than that offered in similar jobs of commensurate responsibility where tenure and income are more secure. Moreover, superior portfolio performance would properly increase compensation, perhaps by means of a performance fee.247 But these three potential sources of additional compensation would probably not provide enough oppor-

245 The list is reprinted in Hearings, supra note 55, at 8.
247 See id. at 246.
tunity for profit to justify economically a succession fee without a significant discount. That discount would of course be roughly equal to the present value of the future income proscribed by S. 4071.

This nearly complete elimination of succession fees would indicate that the unfair burden test would correspondingly prohibit the imposition of any such direct cost upon a fund in the sale transaction itself and permit only those intangible burdens which might be associated with the unsettling aspects of an adjustment to new management. A narrower interpretation would leave the phrase essentially meaningless since almost all of a succession fee paid to a retiring adviser, regardless of its form, would constitute a lost opportunity for a fund and would have to be repaid eventually by shareholders through subsequent management fees or less extensive services.

4. Entrepreneurial Reward

The elimination of the bulk of post-sale entrepreneurial reward profit streams raises two questions. Is payment of such reward solely through management fees a viable business alternative? More fundamentally, is entrepreneurial reward a valid consideration in determining management fees?

Mutual fund sponsors should be rewarded for entrepreneurial risk. Sponsors usually incur initial operating losses when establishing a fund. They absorb the expenses shareholders would be forced to shoulder if the fund were internally managed.248 By permitting these

248 The organization of an open-end investment company and the operation of it until it earns its own way involves the expenditure of substantial sums of money, running into many thousands of dollars. This money must be supplied by someone. It cannot be provided by the stockholders of the fund; most of it must be spent before there are any public stockholders. Even with the proposed requirement of $100,000 initial capital, the organization and development expense must come from outside of the investment company itself, since no reputable distributor would offer securities of a company whose initial balance sheet shows a large capital deficit—due to organization expenses. Such a security could not be qualified under the “blue sky” laws of most States.

The expense of organization and development, therefore, is borne by the so-called sponsors who expect to and usually do manage the company after it has procured capital for investment. There is nothing nefarious about this; there is not the slightest indication that people who organize open-end investment companies are not qualified to manage them. On the contrary, organization—which includes the distribution of securities—can be accomplished only by those in whose management the public has ultimate confidence.

Hearings, supra note 188, at 587 (statement of Senator Long). Long went on to argue that the statutory termination of all management contracts after two years did not permit these losses to be recouped by “honest management.” Id. He prophesized that the mandatory short term would restrict the field to men “bent upon ... recovery ... by ... dishonest practices.” Id. Long, like the drafters, apparently did not foresee the reluctance of fund directors to seek new advisers.
losses to be recouped in the profit margin in later years when the asset base is broader, more shareholders share the out-of-pocket expenses of their investment vehicle, and initial performance is not hindered by large organizational expenses. In arguing for the payment of reward for entrepreneurial risk William Nutt has reasoned:

The adviser typically sustains a loss when starting a new fund or group of funds and must recoup these losses through its profit margin in later years. Although these losses cannot be considered after they have been recouped, they can be an element of a reasonable profit. Some advisers have created funds through an initial public offering and almost immediately generated a net asset base sufficient to assure a reasonable profit. If this technique becomes prevalent, the independent directors should not reward an adviser who does not or cannot employ these techniques, and who thus sustains initial losses, by returning these losses in the form of a higher advisory fee.249

Although Nutt properly expresses concern that entrepreneurial reward not become a convenient rubric by which to justify unreasonable fees, his analysis erroneously makes no allowance for the promotional risk of failure an adviser takes and the ongoing risks of operation its successor assumes. Instead, he limits his definition of entrepreneurial risk to essentially promoter expenses. The entrepreneurial risk that mutual fund sponsors bear, however, goes beyond initial operating expenses. Sponsors are not assured income enough to provide a wage commensurate with their efforts. They run the risk that their organizational and promotional efforts will not result in sufficient funds under management ever adequately to reward their services. True, some of this risk is properly borne by the sponsors; they should shoulder the risk that their talents will not meet the demands of the industry. But when these efforts are successful, shareholders are provided unique investment vehicles not otherwise available, and are guaranteed that regardless of sales resistance, massive redemptions, or market declines they will not incur costs and expenses above a relatively low ceiling.250 For bearing these risks and developing funds, pioneering sponsors should be rewarded by the fund shareholders.

Successors also assume some ongoing risks of operation, although their undertakings are not as extensive as those of the original sponsors.

249 Nutt, supra note 47, at 245-46.
250 Many states impose annual expense limitations on mutual funds. Most permit no more than 1.5% of net asset value to be used for all expenses, including brokerage, taxes, transfer agency fees, and management compensation. Advisers must assume all costs in excess of these limits. See Baron & Ellis, Mutual Fund Expense Limits, 4 REV. SEC. REG. 881 (1971).
For example, an adviser must bear the risk of general industry-wide investor dissatisfaction or disinterest in mutual funds, with a consequent reduction in sales and an increase in redemptions. Such dissatisfaction may be caused by extraneous considerations, such as an economic recession, rather than by poor performance. Although the amount rewarded for these entrepreneurial risks would not equal that given the pioneering principals, ongoing risks are an element of a reasonable management fee.

Two arguments might be advanced in support of prohibiting any reward for entrepreneurial risk. Drawing on the Rosenfeld case, a plaintiff might argue that all entrepreneurial reward should be proscribed since mutual fund boards have the power to discontinue the advisory relationship with the present adviser and either contract with a new adviser or internalize management, two alternatives which would probably result in lower management costs. Thus, any payment above the cost of mere management is evidence of an adviser using its influence and control to profit at the expense of the fund.

Another argument can be based on the Act's proscription of cheap stock. A disgruntled shareholder could argue that the denial of this method of earning entrepreneurial reward was in fact intended to outlaw all such profit. Since payment for more than mere management indirectly accomplishes the same result, it is impliedly prohibited. However, in the face of suggestions to require internalization of all mutual fund management, Congress has twice permitted the external management pattern to continue, perhaps in order to provide a means to achieve such reward. Moreover, since the existence of external management does shift the entrepreneurial risk often shared by shareholders in other industries from mutual fund investors to advisers, the decision of Congress to permit entrepreneurial reward is appropriate. Thus, after the enactment of S. 4071 directors can properly consider risk in their deliberations with respect to the size of management compensation.

The removal of succession fees as a means to reward entrepreneurial risk by S. 4071 will permit increased shareholder protection but will not remove the financial incentive necessary for the creation of new mutual funds or the continued management of established ones. Since succession fees can conceptually be considered capitalized entrepreneurial risk profit streams within management fees, consideration of the efficacy

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251 In 1940 and 1970 suggestions were made to require internalization of all investment companies. See Hearings, supra note 188, at 252-54 (remarks of D. Schenker, SEC counsel); Rottenberg, supra note 17, at 310.
of both methods of payment—management fees alone or management and succession fees—can center solely on whether entrepreneurial reward should be paid continually over the existence of a fund or only for a finite period.

Each method has both advantages and disadvantages. Payment throughout the existence of a fund will make possible postponement of payment, potential beneficial tax consequences, equitable distribution of costs, and lubrication for adviser self-removal. When entrepreneurial reward is paid without regard to a specific termination date or occurrence, the amount rewarded each year to the sponsor can be lower, since the payment of a succession fee will, both conceptually and as a practical matter, complete the reward for the risks undertaken. Although the amount of the succession fee will, of course, be repaid to the successor by a fund, by paying a succession fee a successor in effect finances the debt of a fund, permitting a longer payment schedule.

Payment of a portion of the total sponsor entrepreneurial reward in the form of a succession fee may permit a fund to make a smaller total outlay. The succession fee may be considered for tax purposes as capital gain, especially when a transfer occurs in the form of a sale of management company stock. To the extent total entrepreneurial reward is taxed at capital gain rates instead of higher ordinary income rates, a fund will be able to make a smaller total outlay without a sponsor receiving less after-tax dollars.

Continual payment would also mean that every shareholder would share the cost and risk of organization and tenure regardless of when he purchased or sold his shares. A reward scheme that terminated entrepreneurial profit at some specific point in time would, on the other hand, permit subsequent shareholders to use the investment vehicle without assuming any of its start-up costs, and, consequently, would require the initial shareholders to shoulder the entire burden.

Finally, advisers that should retire would do so more readily if they could receive a succession fee. Directors are more likely to be alerted by an adviser about the possibility of a change when that adviser knows it will be able to receive a succession fee upon its departure.

Some of these advantages depend on succession fees being received by outgoing advisers. It is conceivable that an entrepreneurial reward profit stream could be retained over the life of a fund while succession fees are banned, but a total prohibition against succession fees in such an instance would result in windfalls to successors. They would receive compensation reflecting an assumption of risk which they had not
undertaken, either in the form of capital or effort. Moreover, unless the management fee rate was gauged to reward a sponsor adequately during its tenure, the sponsor would never be fully recompensed for its efforts. In contrast, a higher rate set to reward a sponsor completely would force a fund to pay at least twice for its creation. In sum, a total ban of succession fees coupled with continuous payment would produce anomalous results while providing only the continual payment advantages of equitable cost distribution and, in the case of lower fees, postponement of payment. Possible beneficial tax treatment of entrepreneurial reward and the stimulus for adviser self-removal would not be available.

A second alternative to continual payment and succession fees paid to sponsors might be to have succession fees paid to funds rather than to retiring advisers. This, of course, is the result mandated by Rosenfeld. This method would retain two of the advantages outlined above, but it would remove the economic carrot for self-removal. Moreover, the payment of a succession fee at the largely fortuitous moment of succession would distribute the promotional costs inequitably between investors. Only those who were shareholders at the time a change of management took place would receive the benefit of the payment; shareholders who redeemed prior to that instant or who purchased their interests after succession would not have the net asset value of their shares similarly enlarged. Finally, this alternative would require the guesswork of financial appraisal to allocate the ex-fund going concern value and worth of the net assets to the sellers and the succession fee to the fund. This allocation process is unavoidable in cases where succession fees have already been paid; from a prospective viewpoint, however, a method which avoids this guesswork should be preferred. As the drafters of the proposed legislation recognized, a system in which natural market factors allocate these components to the proper recipients is preferable. In many other respects, this alternative is quite similar in economic effect to payment of entrepreneurial reward for a definite period, because the original sponsor would be the primary recipient of entrepreneurial reward and would be fully recompensed through the advisory fee structure upon its departure. Nevertheless, these drawbacks eliminate this alternative.

The primary advantage that payment of entrepreneurial reward for a definite period would provide is the one which so heavily influenced the Rosenfeld court: no conflicts of interest would exist between a retiring adviser and a fund in the choice of a successor. True, a conflict of interest would exist as to the desirability of seeking a successor, but
that conflict would exist under any payment method, since discontinuation of an advisory relationship for poor performance or inadequate services is a risk all advisers must take. Even under a continual payment plan in which an adviser would be permitted to receive a succession fee when it retires on its own initiative, it would be improper for a board to require the successor of its choice to pay a succession fee to a deposed sponsor which had to be replaced by the board for failure to provide adequate management services.

The absence of succession fees might, as a prospective matter, produce more dedicated mutual fund advisers. Promoters who would organize a fund in order to sell quickly their management company stock for a profit would be deterred. Only investment advisers that desired to enter long term advisory relationships would organize mutual funds.

The amount paid as entrepreneurial reward in such a method would more likely be commensurate with the benefits shareholders derive from fund organization rather than with the sponsor's promotional success. When a management fee component is paid as a percentage of assets in the formative years, only the organizational success of a fund is used as a measure, not later fund growth which produces little, if any, material benefit to pre-existing shareholders. To the extent that reward is based on benefits derived by fund shareholders instead of the value of the opportunity to a successor, the total reward reflects its justification for existence.

There are three ways in which entrepreneurial reward could be paid for a limited term. First, payment might be made for the tenure of an original sponsor, however unpredictable that tenure may be. Second, a specific term of years could be prescribed. Finally, these two methods could be combined. The initial difficulty of a preset term of years would be the determination of the appropriate length of the payment period. However, under any compensation method similar difficult decisions must be made with regard to the compensation rate. The value of the assumption of risk is generally conceptualized as a percentage of investment (of either capital or effort). Theoretically it is incapable of finite quantification. The determination of a payment term and a compensation rate are two aspects of the same problem. The determination of an appropriate period would pose no new difficulties. Ideally, both these figures would be preset at the inception of a fund in order to provide advisers with incentive goals. This is the time, unfortunately, when unaffiliated members of a board are most subject to influence from an adviser, both because they have been selected by
it and because the joint interests they share in successfully launching a fund tend to obscure the acute conflicts of interest inherent in such a determination. Thus, if a period of years is used, the term should not be rigidly fixed until after several years of operation.

Additional problems arise upon termination of an advisory relationship prior to the expiration of the payment term. Unless the profit stream were to be discontinued at either the termination of the relationship or the completion of the term, a successor would receive an inflated management fee. In the case of voluntary withdrawal by the sponsor, payment of a succession fee would produce the undesirable conflicts of interest which accompany bargaining for the highest price.

Payment for the tenure of the founding sponsor would obviate these objections. No succession fee would be present to jeopardize the selection of a successor, and an immediate reduction in advisory fees would reward a successor appropriately for its services and commitment.252

A limited time span method with payment extending no longer than the tenure of the initial sponsor, like the one produced by S. 4071, is the best method to reward entrepreneurial risk. By removing the conflicts of interest that succession fees produce, the protection of investors would be improved. In addition, the development of truly autonomous boards would be advanced, improving the advisory relationship. This, in turn, should ensure higher quality successor advisers and ultimately increased investor confidence in the mutual fund form of investment. If succession fees were absolutely necessary to provide entrepreneurial reward, their presence would be justifiable because entrepreneurial reward is essential to provide incentives for the continued creation of these useful investment vehicles. Fortunately, however, entrepreneurial reward can be adequately included in the annual management compensation.

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252 It might be suggested that in combination with a term of years, this method could remove some of the unwillingness of mediocre or otherwise undesirable advisers to permit discontinuation of the relationship. The expiration of the predetermined period and consequent diminution in the management fee rate might remove this impediment. However, it should be remembered that if no opportunities existed elsewhere, a controlling shareholder might desire to remain in office in order to continue to receive a fair wage for his services. This is still permitted, even with internalized management fee rates, and is considered by all courts to be a permissible emolument of control. See Bayne, The Non-investment Value of Control Stock, 45 Ind. L.J. 317 (1970); Bayne, The Investment Value of Control Stock, 54 Minn. L. Rev. 1265, 1269-88 (1970). Thus, the disincentive to leave the relationship would be only reduced, not eliminated, by payment for a present term. Moreover, any reduction in disincentive would not redound to the benefit of the fund until the term is completed.
Admittedly, there are disadvantages to this form of payment. First, the entire amount of entrepreneurial reward will be taxed to advisers at ordinary rates. But with the total limited to a finite term, the overall outlay may be less, despite the less advantageous tax consequences, because successors need not be paid for financing a substantial portion of the total. Second, there would be no economic inducement to entice successors to retire voluntarily. This disadvantage might be offset, however, by the development of a new breed of mutual fund advisers which are content to earn their entrepreneurial rewards through long term, dedicated portfolio management. The most serious drawback would be the unequal distribution of costs between shareholders. Those investors who joined a fund after the retirement of the original adviser would escape the costs of promotion and development. The original shareholders would shoulder the entire expense. This more burdensome treatment of the initial shareholders, however, would be somewhat ameliorated by the reduced likelihood that their chosen investment adviser would retire, disappointing their investment expectations. Of course, when the relationship is severed, the likelihood of securing a high quality successor is greatly enhanced.

D. Summary

S. 4071 will be a valuable addition to the 1940 Act, since it codifies the Rosenfeld principle that an advisory relationship is not an asset of an adviser. The analysis of its method for payment of entrepreneurial reward offered here suggests that should it be enacted, courts would further its purpose by interpreting its provisions as follows:

1) “Unfair burden” should be defined to encompass any payment for the value of an advisory position with a fund.

2) The express approval of the receipt of “any amount or benefit” should be held to permit only a fair compensation for a retiring adviser’s assets, including ex-fund going concern value, and not to allow payment for its use of influence or for the value of an advisory relationship.

These two interpretations are the only ones which are consistent with elimination of succession fees through proscription of post-sale board consideration of the price paid to retiring advisers.

CONCLUSION

Reward for entrepreneurial risk is essential to promote the continued establishment of new mutual funds—useful investment vehi-
icles for small investors. Succession fees, despite their long use as one source of entrepreneurial reward, pose too great a threat to investor expectations of high quality portfolio management and low costs. Whenever advisers or their shareholders are permitted to capitalize on a mutual fund advisory relationship, they necessarily increase the cost and may endanger the quality of future investment management.

Fortunately, another avenue for reward for entrepreneurial risk remains as a viable alternative. Advisory fees can and should contain an element specifically designated for such reward. Payment of a segregated portion of periodic management fee rates preserves promoter incentive, yet contains few dangers to management quality. Possible abuse does lie in determination of a reasonable amount of reward. This danger, however, is a creature of the conflicts of interest inherent in the industry-wide external management form of organization. Independent directors, significantly aided by an incremental evaluation of management compensation, and S. 4071, providing possibilities for self-perpetuation and numerical control of proxy machinery, should be able to restore much of the balance of bargaining power which the Act envisions and which is necessary if funds are to guard against the adviser's self-interested dominance.

Rosenfeld correctly saw the hazards of selection and the undisclosed costs succession fees necessarily inflict on mutual fund shareholders. Its holding was a significant step toward purging advisory relationships of those dangers. But judicial decisions must deal with the particular facts at hand and can give only partial answers to broad-ranging questions. In retrospect, Rosenfeld's chief contribution, due in large part to its unusual factual setting, may lie in bringing widespread attention to the problem. The naked sale of Lazard's position presented a court for the first time with a clearly isolated succession fee and permitted exposure of its makeup and rationale.

Legislation can deal more comprehensively with a multifaceted problem such as this one. The thrust of S. 4071 offers a promising and constructive solution. Principally independent boards of directors and an immediate elimination of most of an entrepreneurial reward management fee component upon the initial statutory assignment of a fund's advisory contract provide novel, yet necessary, means to guard against unreasonable adviser profits and undesirable successors while providing entrepreneurial incentive. Several additional amendments to the Act are needed, however, to permit the bill to meet this goal more readily. S. 4071, including the minor alterations proposed herein, should be given serious congressional consideration.