

Introduction

Collective Investment outside the United States

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This is the tenth conference that Bob Litan and I have organized under the general rubric “Is there a better way to regulate mutual funds?”

The conference today will focus on how collective investment vehicles are structured and regulated in a few developed countries outside the United States—Canada, the UK, France and Luxembourg.

It turns out that the United States is unusual in the sense that it permits only one basic structure for managed collective investment—a corporate structure which can be either a corporation or a business trust. In that structure, the corporation or trust holds the assets of the fund and a board of directors or trustees has responsibility for the management of the corporation’s assets and the carrying on of its administrative functions.

Almost all mutual funds outsource these management and administrative functions through a contract with an investment manager. This structure is said to give rise to a conflict of interest—the adviser wants to make as much profit as possible from the relationship to the fund, and is thus in a position to take advantage of the relationship to the detriment of the shareholders.

The board of the fund—acting for the shareholders—is supposed to make sure the fund is fairly treated. However, there is nothing particularly unusual about this conflict of interest; all corporate managements, whether they are internal or external, have interests that diverge from those of the shareholders. Economists call this the “agency problem”—the difficulty of making sure that an agent acts in the interests of his principal instead of his own interests. One of the principal duties of the board of directors of any corporation is to control the consequences of these conflicts of interest by supervising management on behalf of the shareholders.

Under standard U.S. corporate law, the board of directors of a corporation has a fiduciary duty, in general, to assure that management’s compensation is fair and reasonable, that it is not imposing unreasonable or unnecessary costs on the corporation, and that the corporation is performing well as a profit-making entity. The board of directors of U.S. mutual funds is no different and has all the same responsibilities—to assure that the investment manager charges a reasonable fee, does not impose excessive costs on the corporation, and manages the fund’s portfolio well.

In general, foreign collective investment vehicles are not limited to this corporate structure. In many countries they are in something that might be called a contract form. That is, the investor contracts directly with the adviser to manage the investor’s funds collectively with those of others.

In the contract form, the investment manager seems to have a more direct relationship to the investor, not to an intervening corporation as is true in the United States—where, as we have seen, the investor is in a sense an indirect beneficiary of a contract between the fund and the investment manager.

In some structures, investment manager owes duties formally to a trust or corporation that actually holds the assets that are managed, but that entity does not have authority to determine the fee of the investment manager or perhaps even the costs that are charged to the fund.

Does the contract form really make any difference in reality?

Yes, to some extent. Because when the relationship between the investor and the investment management is thought of as a contractual relationship rather than an investment relationship, there is no need or reason for an intervening body such as a corporate board to concern itself with the fairness of the advisory fee and perhaps even other expenses of the fund.

The investor can decide for himself whether he wants to accept the adviser's terms for the contract relationship, including the fee that the adviser sets for managing the assets and the costs—in addition to the advisory fee—that the fund manager may charge to the fund.

This is very much like the contractual relationships we see in every other area of our daily lives in which we pay a fee for service. In each case, the same conflict of interest exists; the seller of the service wants to maximize his profit and the buyer wants to get the lowest price. The buyer simply decides whether the service is worth the all-in cost. We don't normally require a board of directors to intercede for us and protect us when we engage in these everyday transactions.

Thus, other developed countries have adopted structures in which the process of collective investment can be treated as something like an everyday fee-for-services transaction, while we in the United States treat it as a special case, in which investors need special assistance and protection.

This does not necessarily mean that investors in other countries are not adequately protected against conflicts of interest on the part of the manager. In most other countries there are a variety of forms—from government regulation to independent depositories acting like trustees managing a trust corpus—that are supposed to prevent overreaching by investment advisers and control their conflicts of interest.

These may or may not be as effective as a board of directors in addressing conflicts of interest and holding down costs. That's one of the things we will try to determine in this conference.

Interposing a board of directors is probably the most expensive way of protecting investors, but it may be that these additional costs produce necessary additional protection for U.S. investors. On the other hand, the contractual structures used elsewhere ultimately may do just as well.

Today's conference will give us an opportunity to assess this question.