

The most plausible explanation of the high levels and relative inflexibility of mutual fund management fee rates rests on the structural characteristics of the industry and the resultant limitations on the effectiveness of competition. One relevant structural characteristic of the industry is the domination of the typical fund by a separate legal entity, the investment adviser, with whom the fund enters into a management contract. Given the origination of the fund by advisory personnel, and the crucial and active role of the dominant individuals associated with the adviser, the terms of the management contract have not ordinarily been a product of arms-length bargaining. The independent director requirement has not altered the situation in this regard, and there is little reason to believe that a tightening of the now hopelessly inadequate definition of an independent director will solve this problem.

A second important structural aspect of this industry relates to the buyers of fund shares: typically they are not very affluent and they buy only a few thousand dollars worth of shares, which has made for a wide diffusion of fund shares. Furthermore, these small investors are not well informed on investment alternatives, including differences among the funds themselves. These buyer characteristics of the industry have made salesmanship important in the merchandising of fund shares; and this, in turn, has led to a de-emphasis on price in approaches to the buyer. The salesman could hardly stress differences in management fee rates (under 1%) without raising questions about differences in the much higher sales charge (8% or more). He therefore prefers to stress fund performance over the last 20 years, the virtues of equity investment and diversification, and the redemption privilege.

The net result of the absence of arms-length bargaining in fixing fee rates, the wide diffusion of fund shares among relatively uninformed buyers, the de-emphasis of price by fund salesmen, and the possibility of redemption if dissatisfied, is that little pressure exists either within funds or between them to reduce management fee rates. The downward pressure on fee rates within the past decade seems to have been a result mainly of stockholder suits and publicity generated from outside the industry.

I would like to note here that the buyer characteristics of the mutual fund market, and the importance of personal selling, make overall numbers of funds and national concentration ratios, very misleading in assessing the degree of competition in the industry. Every serious study of concentration—including those by Kaysen and Turner, and by Bain—stress the importance of the market definition in giving meaning to a concentration ratio. And the market must be defined in terms of both seller and buyer alternatives. If 10 different encyclopedias are being sold door-to-door, if a salesman for one of them knocks at somebody's door, the quality and price of 10 different encyclopedias are not likely to be at issue. If the seller of fund X approaches a householder, there may be only one fund that is offered as a plausible option. The fact that there are 350 funds in existence is likely to be quite irrelevant to the contracting process involved in personal selling, which often approximates bilateral monopoly with an imbalance in bargaining position.

The main policy alternatives that have been put forward to deal with the management fee are as follows:

(1) Do nothing, on the grounds that the problem is not serious, or that market adjustments will correct any abuses in the long run. I would reject this view because, while the problem is not of the first order of importance, it does not strike me as trivial (with management fees now approximately \$150 million a year); and there is little evidence that in this area the market mechanism will operate more effectively in the future than it has up to now.

(2) Reorganize the industry's structure by requiring each fund to be internally managed. Since internally managed funds have a simpler structure and tend to have lower fee rates, this would probably accomplish something; but it is not clear how much would be achieved, given the fact that structural conditions would still be unfavorable to competition on the management fee. Since this would be a drastic action, especially in view of the widespread public sale of the stock of outside advisory companies, I doubt if this change would be worth the resultant disruption.

(3) A third possibility would be the redefinition of an "independent director", or the use of other devices, to make some of all of the directors truly "independent" and capable of bargaining effectively with the external management firm. The SEC proposes a change in the definition of the independent director,