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THE DEMAND FOR MONEY MARKET MUTUAL FUNDS

As discussed in previous chapters, the Investment Company Act was designed to protect investors from financial abuse of their interests by advisers of mutual funds. One important dimension of the perceived need for such regulation was the determination of the fees charged by mutual fund advisers. It has been suggested that advisers are in the enviable position of being able to set fees that are excessively high with little or no risk of driving their customers away. Underlying this view is the perception that the nature of the contract between the investment adviser and the mutual fund denies investors the opportunity to replace the adviser if his behavior is unacceptable. This view assumes implicitly that mutual fund shareholders are either unable or unlikely to discipline the adviser by shopping around for the most attractive place to invest their money.

Economists, of course, are naturally suspicious of arguments based on the premise that government intervention is called for because individuals are not sufficiently astute to protect their own interests, although there do exist circumstances in which such concerns are well founded. In the arena under discussion, economists generally proceed on the presumption that individuals select mutual funds, among other considerations, on the basis of the relative expected rates of return offered by the various funds. When this presumption is
consistent with the facts, all else being equal, individual advisers who attempt to exercise market power by raising and maintaining fees above competitive levels face the very real prospect that market forces will penalize their conduct, since higher fees necessarily lead to a lower net yield.

This view of market discipline was eloquently expressed by Judge Pollock in the First District Court case, Gartenberg v. Merrill Lynch, when he noted

Money market shareholders hold the key to the continuance of the adviser in charge of their funds. They can terminate the relationship simply by writing a check and redeeming at once. This is the strongest kind of bargaining power against compensation that is improper.

As we have seen, among courts, this view is distinctly in the minority. More typically, economic arguments of this sort have either been ignored or dismissed. For example, as noted, the Appellate Court in Gartenberg v. Merrill Lynch opined that advisers' fees are relatively small for each shareholder and therefore "do not figure significantly in the battle for investor favor."

This divergence of opinion amounts to an empirical dispute about the degree of shareholder sensitivity to the level of net yield offered by a mutual fund. Thus, rational resolution of the dispute requires recourse to empirical evidence, and that evidence is what this chapter undertakes to provide. We begin with a general discussion of measures of the sensitivity (elasticity) of customer demand to variations in the financial terms on which a good or service is offered, and then report the results of a statistical study of shareholder demand for MMFs. The central point of the study is to determine whether or not investors' demands are sufficiently sensitive to small differences in the yields of different funds to constitute a substantial business threat to those advisers who overcharge for their services. We restrict our attention to MMFs, since this area, exclusively, has been the battleground for disputes over advisory fees since the amendments to the ICA were adopted in 1970.