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Rethinking the Regulation of Securities Intermediaries

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ARTICLE

RETHINKING THE REGULATION OF SECURITIES INTERMEDIARIES

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This Article argues that existing regulation of mutual funds has serious shortcomings. In particular, the Investment Company Act, which is based primarily on principles of corporate governance and fiduciary duties, fails to support—and in some cases impedes—market forces. Existing evidence suggests that retail investing behavior and the dominance of sales agents with competing financial incentives further weaken market discipline.

As a solution, this Article proposes that funds should be treated primarily as financial products, rather than corporations; correspondingly, investors should be treated primarily as consumers, rather than corporate shareholders. To implement this approach, the Article proposes the creation of a new federal agency that would develop standardized financial products coupled with corresponding disclosure principles. Sellers of retail financial products would be required either to conform their products to these standards or to explain material differences. The goal is to enhance market discipline while making retail funds less complicated and more understandable for individual investors.

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INTRODUCTION

The collapse of the capital markets, following a series of corporate governance scandals, has led to a variety of proposals for regulatory reform.[1] Largely absent from the public debate, however, is a response to the changing role and dramatically increased importance of intermediaries to the securities markets.[2] The ownership of public

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[1] *See, e.g.*, U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf (detailing President Obama's proposal for financial regulatory reform); Press Release, House Comm. on Fin. Servs., Financial Services Committee Approves Legislation to Regulate Derivatives (Oct. 15, 2009), *available at* http://www.house.gov/apps/list/press/financialsvcs_dem/pressder_101509.shtml (describing legislation that would establish comprehensive regulation of over-the-counter derivatives).

[2] The Treasury Department released proposed legislation on July 10, 2009, the Investor Protection Act of 2009, which addresses, among other things, mutual fund sales practices and broker conflicts of interest. *See* Investor Protection Act of 2009, *available at* http://www.treas.gov/press/releases/docs/tg205071009.pdf; *cf.* Investor Protection Act of 2009, H.R. 3817, 111th Cong. (2009) (proposing the Treasury Department's draft legislation in the House of Representatives). Some of the Treasury Department's proposals are included in the mammoth Wall Street Reform and Consumer Protection Act of 2009 approved by the House of Representatives on December 11, 2009. *See* H.R. 4173, 111th Cong. (2009) (containing over 1000 pages of proposed reforms to financial regulation). The extent to which final legislation will address these issues remains unclear.

equity has shifted substantially from retail to institutional investors since Congress enacted the federal securities laws in the 1930s. As of the end of the third quarter of 2009, institutional investors held approximately fifty percent of total U.S. corporate equities,[3] while retail investors ("the household sector") held thirty-eight percent.[4] This trend is exacerbated for the largest companies; as of the end of 2007, institutional investors owned an unprecedented 76.4% of the largest 1000 corporations.[5] Although the market collapse reduced these figures, as of the end of 2006, institutional investors still controlled assets totaling $27.1 trillion, a ten-fold increase from 1980.[6]

Many institutional investors are intermediaries in that they invest a pool of capital contributed by other investors, most frequently retail investors.[7] The mutual fund is the dominant form of intermediated investment.[8] At the end of 2008, even after much of the market collapse,[9] equity mutual funds held over $3.7 trillion in assets, ninety-two percent of which were contributed by the household sector.[10] In addition to mutual funds, retail money is invested through other intermediaries including exchange-traded funds (ETFs), pension funds, and

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[3] BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDINGS THIRD QUARTER 2009, at 92 tbl.L.213 (2009), *available at* http://www.federalreserve.gov/releases/z1/Current/z1.pdf (after June 10, 2010, see http://www.federalreserve.gov/releases/z1/20100311). Institutional investors included in the Federal Reserve's data include banks, savings institutions, insurance companies, private pension funds, government retirement funds, mutual funds, closed-end funds, exchange-traded funds, and brokers and dealers.

[4] *Id.*

[5] CONFERENCE BD., THE 2008 INSTITUTIONAL INVESTMENT REPORT 26 tbl.18 (2008). The report defines institutional investors as pension funds, investment companies, insurance companies, banks, and foundations. *Id.* at 10 tbl.2.

[6] *Id.*

[7] *See, e.g.*, Brian Cartwright, Gen. Counsel, SEC, The Future of Securities Regulation, Address Before the University of Pennsylvania Law School Institute for Law & Economics (Oct. 24, 2007), http://www.law.upenn.edu/academics/institutes/ile/webcasts.html#content (transcript available at http://www.sec.gov/news/speech/2007/spch102407bgc.htm) (explaining that retail stock "ownership now is increasingly intermediated by mutual funds and other collective vehicles").

[8] At the end of 2008, there were almost 9000 mutual funds in the United States. INV. CO. INST., 2009 INVESTMENT COMPANY FACT BOOK 15 fig.1.9 (49th ed. 2009), *available at* http://www.icifactbook.org/pdf/2009_factbook.pdf. "Investment companies as a whole were the largest group of investors in U.S. companies, holding 27 percent of their outstanding stock at year-end 2008." *Id.* at 11.

[9] The dollar value invested in mutual funds (including equity funds, bond funds, hybrids, and money markets) peaked at approximately $12 trillion at the end of 2007. *Id.* at 164 tbl.55. Equity funds alone accounted for approximately $6.5 trillion of that amount. *Id.*

[10] *Id.*

money market funds. Although institutions own most U.S. equity, the number of households that are exposed to the capital markets has increased dramatically, fueled in part by growth in various forms of retirement savings, which account for a substantial portion of household investment.[11] Tax advantages and changes in pension regulation have increasingly thrust individual investors into mutual funds and other intermediated investments.[12]

A growing percentage of ordinary citizens are invested in the capital markets through intermediaries, and those investments represent an increasing percentage of their wealth. Small investors who participate in the markets through mutual funds, money market funds, and retirement accounts may be financially unsophisticated and of limited means. At the same time, the number and complexity of intermediated products continue to increase, creating growing challenges for retail investors.

The financial crisis highlighted these concerns. Many individual investors suffered dramatic losses,[13] requiring them to make sacrifices such as deferring retirement or taking second jobs.[14] Many of those who lost money did so because they were invested in unsuitable products, because they did not fully appreciate the risks associated with their investments, or because they received inadequate financial advice. Going forward, policymakers must target consumer protection with respect to these investments as a distinct regulatory objective.[15]

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[11] According to the Investment Company Institute, "Americans held $13.4 trillion in retirement assets at the end of the first quarter of 2009, accounting for 33 percent of all household financial assets in the United States . . . ." Press Release, Investment Company Institute, Retirement Assets Total $13.4 Trillion in First Quarter (Aug. 10, 2009), *available at* http://ici.org/pressroom/news/09_news_q1_ret_assets.

[12] *See, e.g.*, Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 CARDOZO L. REV. 1419, 1428 (2002) (explaining how the shift from "defined contribution" to "defined benefit" pension plans fueled growth in mutual fund investment).

[13] *See, e.g.*, Sam Mamudi, *Wealth Creators vs. Wealth Destroyers*, WALL ST. J., Mar. 3, 2010, at C15 (reporting results of a Morningstar study showing that mutual fund giants Janus Capital, Putnum, AllianceBernstein, and Invesco Aim each posted billion-dollar negative returns to investors from 2000 to 2009 on an asset-weighted basis).

[14] *See, e.g.*, Adam Shell, *Stock Losses Take a Personal Toll*, USA TODAY, Mar. 24, 2009, at 1B, *available at* 2009 WLNR 5513140 (recounting stories of "pain and dashed dreams" among retail investors).

[15] Intermediation raises a distinct set of concerns with respect to the objectives of securities intermediaries as capital market participants. In particular, intermediaries may employ investment and governance strategies that reduce capital market discipline. *See, e.g.*, Jill E. Fisch, *Securities Intermediaries and the Separation of Ownership from Control*, 33 U. SEATTLE L. REV. (forthcoming 2010) (manuscript at 6-8, on file with author) (describing examples in which intermediary objectives may not be consistent with maximization of firm value).

Both the Securities and Exchange Commission (SEC) and Congress have directed reform efforts to retail investment products, but these reforms have been slow, piecemeal, and often delayed reactions to pervasive problems.[16] More problematically, the reforms have not altered the fundamental regulatory approach adopted by the Investment Company Act of 1940 (ICA),[17] which relies on corporate governance, fiduciary principles, and a disclosure approach modeled upon the regulation of investments in operating companies. This Article argues that the ICA approach is conceptually flawed. Governance mechanisms applicable to operating companies do not translate well to intermediated financial products. Empirical research suggests that capital market discipline does not adequately constrain the sponsors of these products and that the structure of these products and the manner in which they are sold precludes the operation of traditional market forces. As Judge Posner, long a champion of market discipline, recently observed, "The governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide . . . ."[18] Fees, moreover, are only part of the story—the evidence suggests that many intermediated investments are confusing, misleading, and excessively risky, and that existing regulation creates incentives for the creation of products that are deliberately complex.

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[16] For example, regulators have long been concerned about sales agent conflicts of interest. In 2004, the SEC proposed rules that would have required brokers to provide customers with targeted information at the point of sale regarding conflicts of interest. Confirmation Requirements and Point of Sale Disclosure Requirements for Transactions in Certain Mutual Funds and Other Securities, Securities Act Release No. 8358, Exchange Act Release No. 49,148, Investment Company Act No. 26,341, 69 Fed. Reg. 6438 (proposed Feb. 10, 2004) (to be codified at 17 C.F.R. pts. 239, 240, 274). After receiving input from investors and industry groups, the SEC revised its proposals and reopened the comment period for the proposal in 2005. Point of Sale Disclosure Requirements and Confirmation Requirements for Transactions in Mutual Funds, College Savings Plans, and Certain Other Securities, Securities Act Release No. 8544, Exchange Act Release No. 51,274, Investment Company Act No. 26,778, 70 Fed. Reg. 10,521 (proposed Mar. 4, 2005) (to be codified at 17 C.F.R. pts. 239, 240, 274). In 2008, then–SEC Chairman Christopher Cox indicated an intention to revisit point-of-sale disclosure. Judith Burns & Kara Scannell, *Cox May Revise Rules in His SEC Swan Song*, WALL ST. J., June 13, 2008, at C2. To date, the proposal has remained dormant. Point-of-sale disclosure is one of the components of the Wall Street Reform and Consumer Protection Act of 2009, but as it is currently proposed, the Act would require the SEC to conduct a study of retail investors and products prior to adopting any such rules. H.R. 4173, 111th Cong. § 7104 (2009).

[17] 15 U.S.C. §§ 80a-1 to -64 (2006).

[18] Jones v. Harris Assocs., 537 F.3d 728, 732 (7th Cir. 2008) (Posner, J., dissenting from denial of rehearing en banc), *denying reh'g to* 527 F.3d 627 (7th Cir. 2008), *vacated* No. 08-586 (U.S. Mar. 30, 2010), http://www.supremecourt.gov/opinions/09pdf/08-586.pdf.

This Article offers a bold alternative: rejecting the ICA framework—including its corporate governance requirements and reliance on fiduciary principles—in favor of an integrated product-based approach: "conform or explain."[19] Conform or explain would require a new regulatory agency, the Consumer Investment Regulatory Authority (CIRA), to promulgate specifications for standardized or plain-vanilla versions of the most common intermediated investment products. CIRA's standards would include benchmarks, as well as information about risk, asset allocation, product characteristics, investor suitability, and cost.

Unsophisticated investors or those who want to minimize their research costs could purchase compliant products with the knowledge that these products conform to industry norms. In other words, investors would know that the product had the specified characteristics and that its fees, risk, etc., were within a standard range. Firms would be free to market other products, but would be required to disclose the manner in which their products differ from the standard, including differences in investment strategies, fees, and fee structures. CIRA would also oversee the sales practices used to market nonconforming products and would be free to impose additional regulation on selling agencies, such as disclosure of conflicts of interest. By retaining the freedom for firms to develop new financial products while better tailoring disclosure, this model would increase consumer protection without sacrificing innovation. More importantly, by providing meaningful transparency to often opaque and complex products, conform or explain would enhance market discipline while retaining the range of investment choices available for sophisticated investors.

The Article proceeds as follows. Part I provides an overview of the existing regulatory structure applicable to mutual funds and related intermediated investments—money market funds, ETFs, and 401(k) plans. Part II considers the effectiveness of market discipline and of-

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[19] Although the terminology "conform or explain" superficially resembles the "comply or explain" approach introduced by the Cadbury Commission and subsequently incorporated into U.K. corporate law, the U.K. approach is based on the premise that the objective is full compliance with the designated standards. *See, e.g.*, THE COMM. ON THE FIN. ASPECTS OF CORPORATE GOVERNANCE, REPORT OF THE COMMITTEE ON FINANCIAL ASPECTS OF CORPORATE GOVERNANCE 54 (1992), *available at* http://www.ecgi.org/codes/documents/cadbury.pdf ("The boards of all listed companies registered in the UK should comply with the Code of Best Practice . . . . As many other companies as possible should aim at meeting its requirements."). In contrast, this Article envisions a scenario in which the regulatory standard is a benchmark, rather than a norm.

fers some reasons why market forces may not effectively constrain fund companies. Part III identifies critical weaknesses in existing investment company regulation, focusing on the regulation of corporate governance and disclosure. In Part IV, the Article introduces its proposal—product regulation under a conform-or-explain model administered by CIRA—and demonstrates why this approach is superior to the alternatives.

I. REGULATION OF RETAIL INVESTOR MARKET INTERMEDIARIES

A. *Mutual Funds*

A mutual fund is a pooled investment vehicle,[20] regulated by the SEC pursuant to the Investment Company Act of 1940 (ICA).[21] Mutual funds are typically organized as corporations or business trusts under state law.[22] The ICA requires a mutual fund, whether or not it is organized as a corporation, to have a board of directors or trustees elected by the shareholders and consisting of at least forty percent independent directors.[23] Certain SEC exemptive rules extend the ICA's independence requirement; to qualify for these exemptions, fund boards must have a majority of independent directors.[24] The board is responsible

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[20] The SEC explains that "[a] mutual fund is a company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, or other securities." SEC, Mutual Funds, http://www.sec.gov/answers/mutfund.htm (last visited Apr. 15, 2010).

[21] 15 U.S.C. §§ 80a-1 to -64. In addition to mutual funds, the ICA regulates other types of pooled investment vehicles. The term "investment company" includes closed-end funds and unit-investment trusts. *See* 15 U.S.C. § 80a-3 (defining "investment company"). The details of mutual fund regulation under the ICA are extensive. Additional components not detailed in this Article include regulation of mutual fund investments, conflicts of interest, pricing requirements, and standardized terms for redeemability, as well as relatively new requirements that mutual funds disclose their voting in portfolio companies. For a more comprehensive discussion of mutual fund regulation, see TAMAR FRANKEL & CLIFFORD E. KIRSCH, INVESTMENT MANAGEMENT REGULATION (3d ed. 2005).

[22] The ICA permits a mutual fund to be organized as "a corporation, a partnership, an association, a joint-stock company, a trust, a fund, or any organized group of persons whether incorporated or not . . . ." 15 U.S.C. § 80a-2(a)(8). As Philip Newman explains, prior to 1988, some mutual funds were organized as limited partnerships, but changes to tax law eliminated the practicality of that business structure. Philip H. Newman, *Legal Considerations in Forming a Mutual Fund*, ALI-ABA COURSE OF STUDY, July 16-18, 2008, at 7, 9, *available at* WL SP019 ALI-ABA 7. Today most mutual funds are organized as Massachusetts business trusts, Delaware statutory trusts, or Maryland corporations. *Id.*

[23] 15 U.S.C. § 80a-10(a).

[24] *See* Role of Independent Directors of Investment Companies, Securities Act Release No. 7932, Exchange Act Release No. 43,786, Investment Company Act Release No. 24,816, 66 Fed. Reg. 3734, 3736 (Jan. 16, 2001) (codified as amended at scattered

for approving the fund's contract with its investment advisor,[25] pricing the fund's assets,[26] and overseeing compliance with the fund's investment policies.[27] The ICA also vests shareholders with the right to vote on alterations to the advisory contract (such as fee increases)[28] and certain changes to the fund's investment objectives or policies.[29]

The mutual fund is a distinct legal entity that holds title to the fund's assets, but the fund itself is simply a pool of liquid assets with no independent operations or employees. Mutual funds are typically managed externally. An investment advisor makes the fund's investment and trading decisions pursuant to an advisory contract. The mutual fund procures other services, such as custodian services and recordkeeping, through third party contracts.

The SEC has sought to protect the relatively unsophisticated investors who purchase mutual funds through variations on its traditional disclosure-based approach. Mutual funds are required to register with the SEC[30] and provide disclosure to investors akin to that provided by public companies, both at the time of an initial sale and on a periodic basis.[31]

Although these rules have undergone frequent modifications, the basic structure requires that investors receive disclosure at the time of purchase through a statutory prospectus. Under rules adopted in 2009, the information that the SEC views as most important must be included in a "summary prospectus," which appears at the front of the mutual fund prospectus.[32] This information, which must be disclosed

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parts of 17 C.F.R.) (requiring, among other things, that fund boards have a majority of independent directors for the funds to qualify for certain exemptive rules). In 2004, the SEC amended its rules to require funds relying on these exemptions to have boards with at least seventy-five percent independent directors. Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378, 46,381, 46,389 (Sept. 7, 2004) (codified at 17 C.F.R. pt. 270). The Court of Appeals for the D.C. Circuit invalidated this rule in *Chamber of Commerce of the United States v. SEC*, 412 F.3d 133, 144-45 (D.C. Cir. 2005).

[25] 15 U.S.C. § 80a-15(c).

[26] 17 C.F.R. § 270.22c-1 (2009).

[27] *See* Inv. Co. Inst., Overview of Mutual Fund Governance, http://www.ici.org/idc/policy/overview_fund_gov_idc (last visited Apr. 15, 2010) ("In fulfilling their oversight responsibilities, directors seek to ensure that the adviser is managing the fund in a manner consistent with the fund's stated investment objectives.").

[28] 15 U.S.C. § 80a-15(a).

[29] *Id.* § 80a-13(a).

[30] *Id.* § 80a-7(a), a-8.

[31] *Id.* § 80a-29(a)–(b) (requiring periodic disclosure).

[32] *See* Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Securities Act Release No. 8998, In-

in a standardized order and form, includes "(1) [i]nvestment objectives; (2) costs; (3) principal investment strategies, risks, and performance; (4) investment advisers and portfolio managers; (5) brief purchase and sale and tax information; and (6) financial intermediary compensation."[33] The rules permit a mutual fund to satisfy the prospectus-delivery requirement with a summary prospectus as long as it posts the full statutory prospectus on its website.[34] The SEC appears to believe that the summary prospectus, which it expects to consist of three to four pages, will provide investors with sufficient information to make an informed investment decision.[35]

The full statutory prospectus contains more detailed disclosure about the items in the summary prospectus, financial highlights, and additional information about the portfolio manager.[36] The prospectus is supplemented by a third document, the Statement of Additional Information (SAI), which contains, according to the SEC, information that "is not necessarily needed by investors to make an informed investment decision, but that some investors find useful."[37] Among the categories of information contained in the SAI, but not the prospectus, are information about the compensation of the portfolio manager, information about service providers, certain fund investment policies (such as a fund's derivative policy), and the brokerage commissions

vestment Company Act Release No. 28,584, 74 Fed. Reg. 4546, 4549 (Jan. 26, 2009) (to be codified at scattered parts of 17 C.F.R) [hereinafter Summary Prospectus Rule] (stating that the summary prospectus contains "key information that is important to an informed investment decision"). The SEC adopted the current rule in response to complaints that mutual fund prospectuses were too long and difficult for investors to use. *See id.* at 4547. Discussing the revised disclosure requirements, the director of the SEC's Division of Investment Management stated that "[m]any investors often find current fund prospectuses to be lengthy, legalistic and confusing. This mutual fund disclosure framework will provide information that is easier to use and more readily accessible, while retaining the comprehensive quality of the mutual fund information available today." Press Release, SEC, SEC Improves Disclosure for Mutual Fund Investors (Nov. 19, 2008), *available at* http://www.sec.gov/news/press/2008/2008-275.htm.

[33] Summary Prospectus Rule, *supra* note 32, at 4552.

[34] *Id.* at 4559-60.

[35] *Id.* at 4549.

[36] *See id.* at 4552-58 (describing additional prospectus requirements).

[37] SEC, Information Available to Investment Company Shareholders, http://www.sec.gov/answers/mfinfo.htm (last visited Apr. 15, 2010) ("The SAI generally includes the fund's financial statements and information (or additional information) about: the history of the fund; some fund policies (such as on borrowing and concentration policies); officers, directors and persons who control the fund; investment advisory and other services; brokerage commissions; tax matters; and performance measures, such as, average annual total return.").

paid by the fund.[38] Funds are not required to deliver the statutory prospectus or SAI to investors, but these documents must be available upon request and without charge. New rules require that funds post these documents on the Internet and use available technology to make the documents user-friendly.[39]

Like public operating companies, mutual funds are also subject to periodic disclosure requirements. Mutual funds must file a form N-Q with the SEC on a quarterly basis[40] and must provide annual and semiannual reports to shareholders.[41] Shareholder reports must include significant portfolio holdings, fund financial statements with an explanation of relevant accounting treatments, and detailed performance information.[42] Funds are also required to include a management discussion of fund performance (MDFP), which is analogous to the management discussion and analysis (MD&A) required in the annual report of a public operating company.[43] As the SEC explains, the MDFP requires the fund "to provide substantive discussion of the factors that affected the fund's performance during the reporting period."[44] Finally, funds must disclose the manner in which they have voted their portfolio securities on Form N-PX, which they file annually with the SEC.[45]

The ICA also imposes substantive regulation on mutual funds. Funds are restricted in their use of leverage.[46] This limitation extends

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[38] *Id.*

[39] *See* Summary Prospectus Rule, *supra* note 32, at 4566-69 (describing technology requirements, including that fund filings contain hyperlinks to enable investors to move easily between documents).

[40] *See* Form N-Q, 17 C.F.R. §§ 249.332, 274.130 (2009) (providing the form investment companies use to file schedules of portfolio holdings for first and third quarters).

[41] *See* Form N-CSR, 17 C.F.R. §§ 249.331, 274.128 (providing the form investment companies use to file certified semiannual shareholder reports).

[42] *See, e.g.*, Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Securities Act Release No. 8393, Exchange Act Release No. 49,333, Investment Company Act Release No. 26,372, 69 Fed. Reg. 11,244, 11,248 (Mar. 9, 2004) (codified as amended in scattered parts of 17 C.F.R.) (adopting a requirement that funds disclose a summary portfolio schedule to shareholders and provide a complete portfolio schedule, free of charge, upon request).

[43] *Id.* at 11,254. The fund's principal executive and financial officers must certify the MDFP, pursuant to the Sarbanes-Oxley Act and Rule 30a-2. *Id.*

[44] *Id.*

[45] *See* 17 C.F.R. § 270.30b1-4 ("Every registered management investment company . . . shall file an annual report . . . containing the registrant's proxy voting record for the most recent twelve-month period . . . ."); *see also* Form N-PX, 17 C.F.R. § 274.129 (providing the form for funds to disclose their proxy voting record).

[46] *See* Andrew J. Donohue, Dir., Div. of Inv. Mgmt., SEC, Investment Company Act of 1940: Regulatory Gap Between Paradigm and Reality?, Address at the American Bar

to short selling, which the SEC views as borrowing.[47] Funds are limited to holding a maximum of fifteen percent of their portfolios in illiquid assets[48] and are also regulated in their use of options and other derivative products.[49] Funds must disclose their use of these investment techniques—both in their names and in the descriptions of their investment policies—and must "cover [their] position[s] with segregated assets or an offsetting hedge."[50]

Investment companies typically compensate their advisors with a percentage of assets under management. An asset-based fee structure may include breakpoints, in which the percentage paid decreases at specified fund asset levels.[51] Although funds may compensate their advisors based on performance, the ICA prohibits the general use of incentive fee structures.[52] Rather, the only type of performance fee

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Association Spring Meeting (Apr. 17, 2009), *available at* http://www.sec.gov/news/speech/2009/spch041709ajd.htm (describing the ICA requirement that mutual funds maintain an asset coverage ratio of 300%). The ICA explicitly limits the ability of a mutual fund to issue senior securities. 15 U.S.C. 80a-18(f)(1) (2006). The SEC has consistently interpreted borrowing as analogous to issuing senior securities, in violation of Section 18. *See, e.g.*, Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10,666, 44 Fed. Reg. 25,128, 25,129 (Apr. 27, 1979) ("Section 18(f)(1) . . . by implication . . . treats all borrowings as senior securities.").

[47] *See, e.g.*, Andrew J. Donohue, Dir., Div. of Inv. Mgmt., SEC, Remarks Before the 4th Annual Hedge Funds and Alternative Investments Conference (May 23, 2007), *available at* http://www.sec.gov/news/speech/2007/spch052307ajd.htm (explaining that mutual fund regulatory limits allow "funds to leverage up to one-third the value of their assets and to engage in short sales as high as 50% of assets"). These limitations led to the creation of so-called 130/30 funds, which use a long/short trading strategy while conforming to the limitation on leverage by selling short $30 worth of assets for every $130 invested long. *See, e.g.*, David Blitz, 130/30 Investing: Just Another Hype or Here to Stay? 2 (May 14, 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=1132940 (explaining the development and use of 130/30 funds).

[48] Revisions of Guidelines to Form N-1A, Securities Act Release No. 6927, Investment Company Act Release No. 18,612, 57 Fed. Reg. 9828, 9828 (Mar. 20, 1992).

[49] *See* Donohue, *supra* note 46 (identifying provisions regulating the use of derivatives).

[50] *Id.*

[51] Breakpoint fees are designed to enable the mutual fund to capture some of the economies of scale associated with providing advisory services to a larger fund. On a percentage basis, a large fund should be cheaper to operate than a small fund, and a breakpoint fee requires the advisor to share some of these savings with the fund. *See* SEC, Breakpoints, http://www.sec.gov/answers/breakpt.htm (last visited Apr. 15, 2010) (explaining breakpoint fees).

[52] The prohibition is contained in section 205 of the Investment Advisors Act, which regulates the compensation of an advisor to an investment company. *See* 15 U.S.C. § 80b-5(a)(1) (2006) (prohibiting the use of "compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds"); *see generally* Factors to be Considered in Connection with Investment Company Advisory Contracts Containing Incentive Arrangements, Investment Company Act Release No. 7113, Investment Advisors Act Release No. 315, 37 Fed. Reg. 7690 (Apr. 6,

permitted is a "fulcrum" fee.[53] A fulcrum fee is based on the fund's performance relative to a designated index and is adjusted depending upon whether the fund outperforms or underperforms the index.[54] Critically, the fulcrum fee must be symmetrical—the downward adjustment for underperformance must be the same as the upward adjustment for outperformance.[55]

Policymakers have long expressed concern about the potential for excessive mutual fund fees and the inability of market forces to constrain those fees adequately. In 1966, the SEC submitted a report to Congress identifying excessive costs to mutual fund investors as a critical issue requiring Congress's attention.[56] In particular, the SEC noted that "neither competition nor the 'few elementary safeguards' against conflict of interest deemed sufficient in 1940 and contained in the Investment Company Act, presently provide" adequate protection against "excessive costs in the acquisition and management of [mutual fund] investments."[57] The SEC noted a particular problem with respect to small investments by "family men of moderate income," who were charged front-end loads of as much as fifty percent of their first year's investment.[58]

Congress responded to these concerns with the Investment Company Amendments Act of 1970, amending the ICA to strengthen fee-related disclosure and oversight of fees by the board of directors.[59] Congress required that forty percent of directors be independent[60] and that those directors act independently to evaluate and approve the fund's contract with its investment advisor.[61] Congress also im-

1972) (describing the regulation and the assessment of an appropriate fulcrum fee). An exemption is available to mutual funds that limit their investors to "qualified clients." 17 C.F.R. § 275.205-3(a) (2009). Qualified clients include natural persons with a net worth of more than $1.5 million. 17 C.F.R. § 275.205-3(d)(1)(ii)(A) (2009).

[53] *See* 15 U.S.C. § 80b-5(b)(2) (permitting a contract that "provides for compensation based on the asset value of the company or fund under management averaged over a specified period and increasing and decreasing proportionately with the investment performance of the company or fund over a specified period in relation to the investment record of an appropriate index of securities prices").

[54] *Id.*

[55] *Id.*

[56] SEC Submits Report to Congress on Investment Companies, Investment Company Act Release No. 4766 (Dec. 2, 1966), *available at* 1966 SEC LEXIS 377.

[57] *Id.* at *4.

[58] *Id.* at *5-6.

[59] Pub. L. No. 91-547, 84 Stat. 1413 (1970) (codified as amended in scattered sections of 15 U.S.C.).

[60] 15 U.S.C. § 80a-10(a) (2006).

[61] *Id.* § 80a–15(c).

posed, in section 36(b) of the ICA, a fiduciary duty upon investment advisors in connection with their compensation.[62]

The SEC, in turn, has engaged in a variety of rulemaking and administrative decisions addressing fee disclosure and regulation of fee types, including loads and 12b-1 fees, as well as regulation of fund advertising.[63] The SEC describes its goal as "eliminating impediments to vigorous price competition, increasing investor understanding of total investment costs, promoting cost comparability among funds, and easing restrictions so that funds may experiment with distribution arrangements that make costs more explicit."[64] Today, mutual funds must disclose all fees borne by investors in a standardized tabular format.[65]

Despite these actions, critics continue to attack mutual fund fees as excessive. Advisory fees—the fees funds pay to their investment advisors—have received particular criticism. The SEC observed that between 1959 and 1966, fund shareholders brought over fifty lawsuits against their mutual fund advisors challenging the size of the advisory fees paid.[66] Fee litigation has continued to the present day.

On March 30, 2010, the Supreme Court announced the appropriate test for evaluating investor claims of excessive advisory fees under section 36(b) of the ICA.[67] Most lower courts interpreting section 36(b) had applied the test, articulated in *Gartenberg v. Merrill Lynch As-*

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[62] Section 36(b) provides, in pertinent part, the following:

> For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser.

Id. § 80a-35(b).

[63] *See* DIV. OF INV. MGMT., SEC, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 293-98 (1992) (describing various SEC initiatives to regulate mutual fund fees).

[64] *Id.* at 297. Fee disclosure remains imperfect, however. *See infra* Section III.B. (discussing the limited transparency associated with fee disclosure).

[65] *See, e.g.*, SEC Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, Securities Act Release No. 8393, Exchange Act Release No. 49,333, Investment Company Act Release No. 26,372, 69 Fed. Reg. 11,244, 11,246-48 (Mar. 9, 2004) (codified as amended at scattered parts of 17 C.F.R.) (updating and standardizing fee disclosure requirements); SEC, Invest Wisely: Mutual Funds, http://www.sec.gov/investor/pubs/inwsmf.htm (last visited Apr. 15, 2010) (describing shareholder fees and SEC disclosure rules).

[66] SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. Rep. No. 89-2337, at 83 (1966), *as reprinted in* FRANKEL & KIRSCH, *supra* note 21, at 213.

[67] Jones v. Harris Assocs., No. 08-586 (U.S. Mar. 30, 2010), http://www.supremecourt.gov/opinions/09pdf/08-586.pdf.

set Management, Inc., that for an advisory fee to violate the statute, "the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[68] *Gartenberg* was premised on the concern that competition among fund advisors may be "virtually non-existent."[69]

The Seventh Circuit rejected this analysis in favor of a market-oriented view.[70] The court reasoned that because advisory fees are a substantial component of a mutual fund's overall expenses, and because expenses, in turn, substantially affect mutual fund returns, competition over mutual fund purchases should constrain advisory fees, so long as the mutual fund industry is competitive—despite the "incestuous[]" relationship between a fund and its advisor.[71]

Dissenting from the Seventh Circuit's denial of rehearing en banc, Judge Posner questioned the extent to which market forces in the mutual fund industry can be trusted to produce reasonable fees.[72] Citing recent criticisms of the market for executive compensation, Judge Posner observed that market competition may not solve the problem of excessive fees if all mutual funds operate subject to the same system of incentives.[73] In essence, absent adequate competition, high fees will not "drive investors away."[74]

The Supreme Court did not fully resolve this disagreement, premising its adoption of the *Gartenberg* test on the text of the ICA and its view that *Gartenberg* "has provided a workable standard for nearly three decades."[75] The Court explicitly noted that the debate in the Seventh Circuit over the adequacy of the mutual fund market in constraining advi-

[68] 694 F.2d 923, 928 (2d Cir. 1982); *see also Jones* slip op. at 7 (describing the *Gartenberg* standard as reflecting "something of a consensus").

[69] *Gartenberg*, 694 F.2d at 929.

[70] *See* Jones v. Harris Assocs., 527 F.3d 627, 632 (7th Cir. 2008) (stating that *Gartenberg* "relies too little on markets"), *reh'g denied*, 537 F.3d 728 (7th Cir. 2008), *and vacated*, No. 08-586 (U.S. Mar. 30, 2010).

[71] *See Jones*, 527 F.3d at 631, 634-35 ("[I]nvestors can and do protect their interests by shopping, and . . . regulating advisory fees through litigation is unlikely to do more good than harm.").

[72] *See Jones*, 537 F.3d at 730-32 (Posner, J., dissenting from denial of rehearing).

[73] *Id.* at 730-31 (noting that "fund directors and advisory firms that manage the funds hire each other preferentially based on past interactions," exacerbating agency problems (quoting Camela M. Kuhnen, *Social Networks, Corporate Governance and Contracting in the Mutual Fund Industry*, 64 J. FIN. 2185, 2185 (2009))).

[74] *Id.* at 731.

[75] *Jones*, No. 08-586, slip op. at 17.

sory fees was "a matter for Congress and not the courts."[76] Part II below considers the questions *Jones* left unresolved about the operation of the mutual fund market and the effect of that market on advisory fees.

B. *Money Market Funds*

Technically, money market funds are a subset of mutual funds. Unlike most mutual funds, however, money market funds are managed in an effort to maintain a stable one-dollar share price. In essence, they seek to provide (but not guarantee) that investors will not lose money on their investment. Money market funds are specially regulated by the SEC. SEC Rule 2a-7 specifically allows money market funds to use the amortized cost method of valuation, which enables them to sell and redeem shares at one dollar rather than, like other mutual funds, at net asset value (NAV).[77] Rule 2a-7 attempts to address the safety of money market fund investments by requiring that money market funds invest in safe, diversified, and liquid securities, such as high-quality commercial paper, repurchase agreements, and certain short-term bonds.[78]

Investors commonly use money market funds as an alternative to bank accounts; they provide near-immediate liquidity, as well as services like check-writing and ATM access. As such, money market funds are extremely popular. According to the SEC, as of June 2009, 750 money market funds, holding $3.8 trillion in assets collectively, were registered with the SEC, and money market funds "account for approximately 39 percent of all investment company assets."[79]

Money market funds have traditionally competed with each other—and with traditional bank accounts—on the basis of yield. As with most investments, higher yield is typically associated with greater risk. Investors may or may not recognize that a money market fund is

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[76] *Id.*

[77] 17 C.F.R. § 270.2a-7 (2009).

[78] *Id.*; *see also* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 698-700 (1999) (describing the SEC's adoption of 1991 amendments to Rule 2a-7 in response to commercial paper defaults).

[79] Money Market Fund Reform, Investment Company Act Release No. 28,807, 74 Fed. Reg. 32,688, 32,689 (proposed July 8, 2009) [hereinafter Proposed Money Market Fund Reform]. As of February 2010, these numbers had decreased. *See* Money Market Fund Reform, Investment Company Act Release No. 29,132, 75 Fed. Reg. 10,060, 10,060 (Mar. 4, 2010) [hereinafter Final Money Market Fund Reform] ("Money market funds have over $3.3 trillion dollars in assets under management, and comprise over 30 percent of the assets of registered investment companies.").

riskier than a traditional bank account because the one-dollar-per-share net asset value is not assured and the account is not backed by federal deposit insurance. It is difficult for investors to evaluate the risk associated with a particular money market fund even if they are aware of it. A fund's risk is based on the quality of its fixed income holdings, and that quality is not particularly transparent to fund investors. In addition, because of the short-term nature of a money market fund's holdings, a fund's risk profile can change rapidly. Under the SEC's required quarterly disclosure of mutual fund portfolio holdings,[80] disclosure to the public of such a change could be substantially delayed.

The risk associated with money market funds gained visibility in September 2008 when the $66 billion Reserve Primary Fund announced that it was "breaking the buck" and reducing its share price to ninety-seven cents.[81] Commentators subsequently observed that the Reserve Primary Fund's situation was predictable: the Fund had invested in a host of risky assets that offered higher yields and, as a result, paid as much as 4.04%, compared to the average 2.75% money market yield as reported by Morningstar.[82] Specifically, the Reserve Primary Fund was forced to write off $785 million of Lehman Brothers debt when Lehman declared bankruptcy.[83]

The Reserve Primary Fund was only the second fund to break the buck in history.[84] Nonetheless, its announcement, coupled with the stock market decline and other components of the financial crisis, generated a widespread fear of investor panic.[85] To allay this fear, the federal government announced a temporary guarantee of money

[80] *See supra* note 40 and accompanying text.

[81] *See* Final Money Market Fund Reform, *supra* note 79, at 10,061 (describing the announcement made by the Reserve Primary Fund).

[82] Matthew Schifrin & Joshua Lipton, *Hell Bent Innovator*, FORBES.COM, Sept. 22, 2008, http://www.forbes.com/2008/09/22/reserve-primary-bent-pf-ii-in_ms_0922money_inl.html.

[83] Christopher Condon, *Reserve Primary Money Fund Falls Below $1 a Share (Update4)*, BLOOMBERG.COM, Sept. 16, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=a5O2y1go1GRU.

[84] *See id.* ("The only other money-market fund to break the buck was the $82.2 million Community Bankers Mutual Fund in Denver, which liquidated in 1994 because of investments in interest-rate derivatives.").

[85] *See* Final Money Market Fund Reform, *supra* note 79, at 10,061 ("During the week of September 15, 2008, investors withdrew approximately $300 billion from taxable prime money market funds, or 14 percent of the assets held in those funds."); Kara Scannell & Eleanor Laise, *SEC Commissioners Talk Money Funds*, WALL ST. J., June 25, 2009, at C9 ("[I]nvestors suddenly started pulling cash out of the $3.7 trillion money-market fund industry, causing damaging knock-on effects in a range of other financial markets.").

market fund assets.[86] The government guarantee averted a run on money market funds.

In February 2010, the SEC adopted rules to increase the safety and liquidity of money market funds.[87] The rules tightened the risk-limiting conditions of Rule 2a-7.[88] The changes included an increase in the required quality of the securities in which money market funds may invest, a reduction in the maximum weighted-average maturity of those securities from ninety to sixty days, and a variety of liquidity requirements aimed at ensuring that funds have sufficient liquidity to handle heavy redemption demands.[89] The rules enhanced investors' ability to monitor fund risk by increasing the frequency with which funds report their portfolio holdings from quarterly to monthly.[90] The SEC also floated a proposal that money market funds trade at floating net asset values rather than the stable one dollar per share;[91] this proposal did not receive widespread support and has not been adopted to date.[92]

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[86] *See* Press Release, U.S. Dep't of the Treasury, Treasury Announces Guaranty Program for Money Market Funds (Sept. 19, 2008), http://www.treas.gov/press/releases/ hp1147.htm ("For the next year, the U.S. Treasury will insure the holdings of any publicly offered eligible money market mutual fund . . . that pays a fee to participate in the program.").

[87] *See* Final Money Market Fund Reform, *supra* note 79, at 10,062 (to be codified at 17 C.F.R. pts. 270, 274) (explaining that the adopted rules limit risks by requiring maintenance of liquidity buffers and provide the SEC with stronger oversight power).

[88] *Id.*

[89] *Id.* at 10,062-80.

[90] *See id.* at 10,081 (explaining a new requirement that funds disclose portfolio holdings on their websites on a monthly basis); *id.* at 10,082 (requiring that funds make more detailed disclosures, on a monthly basis, to the SEC).

[91] *See* Proposed Money Market Fund Reform, *supra* note 79, at 32,716-18 (to be codified at 17 C.F.R. pts. 270, 274) (requesting comment on amending money market fund regulation to require a floating net asset value).

[92] *See* Final Money Market Reform, *supra* note 79, at 10,062 (describing the proposal and indicating that SEC staff continues to explore this and other regulatory changes); *see also* Memorandum from Jennifer B. McHugh, Senior Advisor to the Chairman, SEC, to File No. S7-11-09 (Dec. 2, 2009), *available at* http://www.sec.gov/comments/s7-11-09/s71109-163.pdf (describing the meeting between SEC officials and representatives of the Investment Company Institute and indicating the ICI's "lack of support for [the] idea of floating net asset values for money market funds"). The SEC adopted a rule requiring funds to report market-based value to the SEC and to the fund's board, but in response to concerns raised by commentators, provided that public availability of this "shadow NAV" would be delayed for sixty days after the end of the reporting period. Final Money Market Reform, *supra* note 79, at 10,083; *see also id.* at 10,061 ("One of the most important [procedural requirements] is the requirement that the fund periodically 'shadow price' the amortized cost net asset value of the fund's portfolio against the mark-to-market net asset value of the portfolio.").

Fund expenses strongly affect money market fund yields and the expense ratios for money market funds are relatively high.[93] These costs may be a function of transaction-related expenses, such as check-writing and ATM access. In addition, money market funds may face high costs because of the limited supply of securities in which they may invest, a supply that will become more limited as a result of the amendments to rule 2a-7.

These high expenses are, at the moment, coupled with a limited ability to generate returns due to low interest rates. Many money market funds responded to the financial crisis by temporarily waiving some or all of their fees in an attempt to maintain attractive returns.[94] More recently, however, most money market funds have paid little or no return to investors.[95] It is not clear, under current interest rates, whether the business model of the money market fund is sustainable, in part because their expenses are high relative to current interest rates and in part because the flight to safety has restricted the range of instruments in which they can invest.[96] With the huge importance of money market funds as an investment vehicle, maintaining such funds is critically important. Regulatory interventions designed to reduce fund risk may interfere with their economic viability.

C. *Exchange-Traded Funds*

Exchange-traded funds, or ETFs, are closely related to mutual funds. ETFs have been generally marketed since the mid-1990s.[97] Originally, ETFs were limited to tracking a specific index, much like an in-

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[93] *See, e.g.*, Leslie Scism, *How Well Do You Know . . . Money-Market Funds?*, WALL ST. J., Nov. 3, 2008, at R3 (reporting that in 2008, "the average of all money-market funds [was] 0.58% of assets, [although] the average for the 25 largest [funds was] 0.24%").

[94] *See* Joan Goldwasser, *Money-Market Funds Waive Fees to Boost Yields*, WASH. POST, Feb. 22, 2009, at F3 ("Some 60 percent of money-market funds already waive a portion of their fees; others may follow."); Chuck Jaffe, *Money Fund Yields So Low That Banks Are Better Idea*, BOSTON HERALD, Jan. 10, 2010, at 23 (reporting that Charles Schwab "is losing over $100 million per quarter in revenues because it is waiving fees so that its money funds stay positive"); Laura Bruce, *Look Beyond Yield when Buying Money Market Funds*, BANKRATE.COM, June 3, 2003, http://www.bankrate.com/brm/news/money_market/20030603a1.asp (observing that many money market funds have high expense ratios and funds are subsidizing some expenses to maintain positive yields).

[95] *See, e.g.*, Jaffe, *supra* note 94 (reporting that Vanguard was paying .01 percent on one of its money market funds).

[96] *See id.* (predicting that fund companies would exit the market if yields did not increase).

[97] *See* Exchange-Traded Funds, Securities Act Release No. 8902, Investment Company Act Release No. 28193, 73 Fed. Reg. 14,618, 14,619 (proposed Mar. 18, 2008).

dexed mutual fund,[98] but they have subsequently expanded to include a variety of short, leveraged, and actively managed investment options.[99]

An ETF is typically organized as an open-end fund or unit investment trust.[100] Like mutual funds, ETFs hold a pool of securities that conforms to the terms of the ETF's prospectus. The pool is assembled by the ETF sponsor from creation units—packets of stock that can range from 10,000 to 600,000 shares (although, according to the SEC, most creation units consist of 50,000 or more shares).[101] The ETF shares are then sold and subsequently traded on the secondary market. ETFs offer stock-like trading rather than mutual fund–type redemptions; investors are able to trade and price their investment on an intra-day basis and can use limit orders and options.

Unit investment trusts and open-end funds are both regulated as investment companies, but ETFs differ from traditional mutual funds in several ways.[102] The most important difference is that ETF shares are not redeemable at NAV except in creation units through in-kind exchanges.[103] Ordinary ETF shares trade at negotiated prices in the secondary market. These features, among others, require new ETFs to obtain exemptive orders from the SEC in order to operate.[104] Existing exemptive orders have been based on a variety of conditions, including disclosure by the ETF of its holdings on a daily basis (either on its website or through the publicly available website of an index

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[98] *See* Actively Managed Exchange-Traded Funds, Investment Company Act Release No. 25,258, 66 Fed. Reg. 57,614, 57,615 (proposed Nov. 15, 2001) ("A fundamental characteristic of all existing ETFs traded in the United States is that they are based on specific domestic and foreign market indices.").

[99] *See id.* (requesting public comment on the authorization of actively traded ETFs).

[100] *Id.* at 57,614. *But see* Exchange-Traded Funds, 73 Fed. Reg. at 14,623 (explaining that the SEC has not received an exemptive application for an ETF organized as a unit investment trust since 2002).

[101] Exchange-Traded Funds, 73 Fed. Reg. at 14,649 n.316.

[102] *See, e.g.*, *In re* iShares Trust, Investment Company Act Release No. 25,111, 75 SEC Docket 1464 (Aug. 15, 2001) (granting exemptions from various provisions of the ICA to authorize an ETF sponsor, among other things, "to issue shares of limited redeemability [and] permit secondary market transactions in the shares of the portfolios at negotiated prices on the national securities exchange").

[103] *See* Exchange-Traded Funds, 73 Fed. Reg. at 14,624 ("The principal distinguishing feature of open-end funds is that they offer for sale redeemable securities.").

[104] *See id.* at 14,624-27 (describing SEC conditions). The SEC's practice, since 2000, has been to authorize sponsors to create new ETFs without further exemptive relief, so long as the ETFs meet the terms and conditions of the original exemptions. *See, e.g.*, *In re* Barclays Global Fund Advisors, Investment Company Act Release No. 24,451, 72 SEC Docket 1082 (May 12, 2000) (describing conditions and permitting creation of additional compliant ETFs).

provider), listing the ETF on a national securities exchange, and regular dissemination, by those exchanges, of the ETF's intra-day value.[105] The SEC has also exempted broker-dealers from the prospectus delivery requirement for most secondary market transactions in ETFs.[106] In 2008, the SEC proposed ICA Rule 6c-11, which would codify the exemption for ETFs that meet the foregoing conditions, eliminating the need for sponsors to obtain individual exemptions.[107] To date, the SEC has not adopted that rule.

The inability of investors to redeem ETF shares at NAV means that, in theory, ETF shares can trade at a premium or discount to NAV, like closed-end mutual funds.[108] The potential for such a gap is reduced by the fact that financial institutions can purchase and sell creation units at each day's NAV. The transparency of the ETF's portfolio facilitates these transactions by enabling investors to identify any difference between market price and NAV. The resulting arbitrage opportunity causes the ETF's market price to remain at or close to NAV.[109]

Traditional indexed ETFs have competed successfully with indexed mutual funds. Like mutual funds, ETFs offer investors easy diversification and transparency. In many cases, ETFs offer lower expenses, greater trading convenience, and tax advantages.[110] The ETF structure proved particularly advantageous during the market volatility of the last several years because the absence of redemption rights means that ETF returns are not reduced by net outflows during a market down-

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[105] *See* Exchange-Traded Funds, 73 Fed. Reg. at 14,624-27 (identifying these conditions as requirements of prior exemptive orders).

[106] *Id.* at 14,630. In the 2009 amendments to the ICA, the SEC adopted specific disclosure requirements for an ETF prospectus, including an explanation that investors may pay brokerage commissions that are not reflected in the ETF's reported expenses, as well as information regarding the creation units. Summary Prospectus Rule, *supra* note 32, at 4558.

[107] *Id.* at 14,621 (to be codified at 17 C.F.R. pts. 239, 270, 274).

[108] The SEC recently adopted a requirement that an ETF prospectus disclose the number of trading days during the most recent year and quarters when the ETF's trading price was greater or less than the ETF's NAV. *See* Summary Prospectus Release, *supra* note 32, at 4559.

[109] Exchange-Traded Funds, 73 Fed. Reg. at 14,620. *But see* Sam Mamudi, *Bond ETF Buyers Must Stay on Guard for Hidden Risks*, WALL ST. J., Mar. 1, 2010, at C7 (reporting that prices in non–Treasury bond ETFs are deviating significantly from NAV).

[110] Significantly, however, ETFs raise similar issues to mutual funds in that their fees vary to a degree that produces material differences in performance, even between comparable passively managed products. *See, e.g.*, John Jannarone, *Getting a Fair Share from ETFs*, WALL ST. J., Jan. 8, 2010, at C10 (identifying differences in ETF fees as well as the allocation of stock-lending fees).

turn—outflows that may require mutual fund managers to sell low (and correspondingly, during market increases, buy high).[111]

These advantages and the growing popularity of ETFs led fund sponsors to introduce actively managed ETFs.[112] The SEC approved exemptive orders permitting the sale of the first actively managed ETFs in 2008.[113] Actively managed ETFs offer additional regulatory challenges. First, because an actively managed ETF does not track an index, it is more difficult to maintain transparency of the ETF's portfolio. Reduced transparency makes it harder for financial institutions to arbitrage actively managed ETFs. As a result, the price of ETF shares may diverge substantially from NAV. Alternatively, mandating comparable transparency to that required of index ETFs may allow other market participants to identify and copy an ETF's investment strategy. Although the SEC's most recent release contemplates applying its general exemptive rules to actively managed ETFs, the rules would apply only to those ETFs that are fully transparent.[114]

Beyond the introduction of actively managed ETFs, the variety of investment strategies employed by ETFs has proliferated. A substantial number of ETFs currently use sampling and derivatives transactions to duplicate the returns associated with a particular index, rather

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[111] *See* REFLOW, HOW SHAREHOLDER FLOW DAMAGES FUND PERFORMANCE (2009), *available at* http://www.reflow.com/flowdamages.htm (describing how shareholder inflows and outflows can damage mutual fund performance).

[112] *See* Scott Burns, *Actively Managed ETFs Are (Finally) Here*, MORNINGSTAR, Jan. 15, 2009, http://news.morningstar.com/articlenet/article.aspx?id=271218 (describing the introduction of actively managed ETFs as a response to "investor demands for transparency, liquidity, and tax efficiency").

[113] *See In re* Barclays Global Fund Advisors iShares Trust, Investment Company Act Release No. 28,173 (Feb. 27, 2008) (granting an actively managed ETF's requested exemption); Barclays Global Fund Advisors, et al.; Notice of Application, Investment Company Act Release No. 28,146, 73 Fed. Reg. 7771 (Feb. 11, 2008) (providing notice of the requested exemptions); *SEC Approves Actively Managed Exchange Traded Funds*, STAY CURRENT (Paul, Hastings, Janofsky & Walker LLP, Los Angeles, CA), Feb. 2008, at 1, *available at* www.paulhastings.com/assets/publications/855.pdf?wt.mc_ID=855.pdf (reporting the SEC's issuance of public notices indicating its imminent decision to grant applications from several actively managed ETFs). The SEC had long been considering allowing actively managed ETFs but had noted several distinctive concerns. *See* Exchange-Traded Funds, 73 Fed. Reg. at 14,621-23 (describing the SEC's promulgation of its 2001 Concept Release, Actively Managed Exchange-Traded Funds, Investment Company Act Release No. 25,258, 66 Fed. Reg. 57,614 (proposed Nov. 15, 2001), and comments submitted in response to that release).

[114] *See* Exchange-Traded Funds, 73 Fed. Reg. at 14,620 (noting the benefits of ETF transparency in facilitating arbitrage).

than actually purchasing the securities that constitute the index.[115] ETFs use borrowing and derivatives to offer leveraged and inverse products—using debt to multiply market-based returns and using derivatives to create synthetic short positions.[116] Unlike traditional ETFs, nontraditional ETFs typically reset daily.[117] Because of their extensive use of derivatives, ETFs' returns over time may differ from the performance of the underlying securities or index in ways that are difficult for investors to evaluate.[118] As a result, the Financial Industry Regulatory Authority (FINRA) recently warned brokers that "inverse and leveraged ETFs typically are not suitable for retail investors who plan to hold them for longer than one trading session, particularly in volatile markets."[119]

Finally, since 2003, investors have been able to purchase commodity ETFs as well as equity and bond ETFs.[120] ETFs that invest in commodities or currency are not regulated as investment companies. Commodity ETFs allow investors to invest in foreign currencies, commodity indexes and specific sectors. These ETFs greatly expand the investment and diversification options available to retail investors. Many commodity ETFs, however, are artificially constructed through derivative products, which can cause their returns to vary substantially from the price of the underlying commodities.[121]

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[115] *See, e.g.*, Guillermo Cano et. al, *ETFs, Swaps, and Futures: Trade at Index Close (TIC) and the Coevolution of Financial Markets*, 2009 INST. INV. J. (EIGHTH ANN. GUIDE TO EXCHANGE-TRADED FUNDS & INDEXING INNOVATIONS), Fall 2009, at 50, 50-51 (describing the use of swaps and futures by ETFs and explaining how the use of swaps can create tracking error and lead to counterparty risk).

[116] *See, e.g.*, Jonathan Spicer, *Short ETFs Under Microscope as SEC Pounces*, REUTERS, Apr. 14, 2009, http://www.reuters.com/article/idUSTRE53D7GU20090414 ("Leveraged inverse ETFs are considered 'synthetic' because they use a formula of options and other derivatives to yield two or even three times the profit when the underlying assets fall.").

[117] *See FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds*, Reg. Notice 09-31 (FINRA, Washington, D.C.), June 2009, at 2, *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p118952.pdf (describing daily reset and accompanying compounding).

[118] *See id.* (providing examples).

[119] *Id.* at 3.

[120] Commodity ETFs are regulated by the Commodity Futures and Trading Commission (CFTC), not the SEC, and have recently been the focus of increased regulatory attention. *See, e.g.*, Brian Baskin, *Small Investors Face Big Hit in ETF Push*, WALL ST. J., Aug. 22, 2009, at B1 (describing the growth and regulation of commodity ETFs).

[121] *See, e.g.*, John Jannarone, *Exchange-Traded Funds Miss Oil Gusher*, WALL ST. J., Sept. 16, 2009, at C16 (explaining that, because they purchase derivatives, oil ETFs have underperformed the market even though spot oil prices rose by 54%).

D. *401(k) Plans*

Retirement accounts reflect an ever-increasing percentage of investment funds, particularly investments by retail investors. Several factors account for this growth, including the tax advantages of certain types of retirement accounts, the move from defined benefit pension plans to defined contribution plans,[122] increases in life expectancy and improvements in the health of retirees that make retirement savings more important, and the decreasing ability of government and employer-provided retirement payments—including social security—to meet the needs of retirees. Although retirement accounts may be invested directly or through one or more of the intermediaries described above, the retirement account creates an additional layer of intermediation and agency costs. The remainder of this Section highlights the particular issues raised by 401(k) plans.

Employer-sponsored 401(k) plans are employee-directed defined contribution retirement plans. Pursuant to section 401(k) of the Internal Revenue Code (for which they are named),[123] 401(k) plans' tax treatment enables employees to defer recognition, and consequently taxation, of a portion of their income until retirement. Employers also receive favorable tax treatment for their matching contributions. The amount of assets invested in 401(k) accounts grew from $385 billion in 1990 to approximately $2.4 trillion at the end of 2008.[124] These plans account for approximately seventeen percent of the U.S. retirement plan market.[125]

The applicable tax laws establish the rules governing 401(k) plans in the first instance. The Internal Revenue Code limits the total dollar amount of contributions that is exempt from current taxation,[126] precludes plans from discriminating in favor of highly compensated employees,[127] and specifies the terms and conditions upon which funds may be withdrawn from a plan.[128]

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[122] *See, e.g.*, Paul J. Donahue, *Plan Sponsor Fiduciary Duty for the Selection of Options in Participant-Directed Defined Contribution Plans and the Choice Between Stable Value and Money Market*, 39 AKRON L. REV. 9, 11 (2006) (describing the shift in popularity from defined benefit plans to defined contribution plans).

[123] I.R.C. § 401(k)(2006).

[124] Inv. Co. Inst., Frequently Asked Questions About 401(k) Plans, http://www.ici.org/faqs/faqs_401k (last visited Apr. 15, 2010). The total value of assets invested in 401(k) plans exceeded $3 trillion before the financial crisis of 2008. *Id.*

[125] *Id.*

[126] I.R.C. § 402(g)(1).

[127] *Id.* § 401(k)(3), (12).

[128] *Id.* § 401(k)(13)(D)(iii).

Because 401(k) plans are an employee benefit, the Benefits Security Administration of the U.S. Department of Labor regulates their operation, pursuant to the Employee Retirement Income Security Act of 1976 (ERISA).[129] Under ERISA, an employer offering a 401(k) plan owes fiduciary duties to plan participants.[130] These fiduciary duties require that the employer use plan assets for the exclusive purpose of providing benefits to plan participants and paying the associated costs of the plan. As with mutual funds, the largest component of plan fees is the cost of investment management services. The Department of Labor has explained that plan "fiduciaries have a responsibility to ensure that the services provided to their plan are necessary and that the cost of those services is reasonable."[131] ERISA also requires that plan assets be segregated and held in trust.[132]

Importantly, however, an employer's fiduciary duties under ERISA are limited. Section 404(c) of ERISA exempts employers from liability for investment losses when plan participants control the investment of their contributions.[133] To qualify for the 404(c) exemption, employers must offer their employees a range of diversified investment options and must make certain required disclosures.[134] To the extent that the investment options include mutual funds, the requirements incorporate the disclosure mandated by the SEC under the ICA. For example, when the SEC adopted the summary prospectus option, the Department of Labor issued a bulletin indicating that a summary prospectus would satisfy the disclosure requirements of section 404(c).[135]

Employers typically outsource the operation of their 401(k) plans to a plan provider or trustee that selects, in the first instance, the investment alternatives available to employees and oversees the administration of the plan, including record keeping, deposits, investor relations, and so forth.[136] The provider's selection of investment options is

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[129] 29 U.S.C. §§ 1001–1461 (2006).

[130] *See* Donahue, *supra* note 122, at 12-19 (explaining that a sponsor's fiduciary duty under ERISA extends "to the selection of investment options for Participant-directed DC Plans").

[131] U.S. DEP'T OF LABOR, UNDERSTANDING RETIREMENT PLAN FEES AND EXPENSES 1 (May 2004), *available at* http://www.dol.gov/ebsa/pdf/undrstndgrtrmnt.pdf.

[132] 29 U.S.C. § 1103(a)–(b).

[133] *Id.* § 1104(c).

[134] 29 C.F.R. § 2550.404c-1 (2009).

[135] U.S. DEP'T OF LABOR, FIELD ASSISTANCE BULLETIN 2009-03, DELIVERY OF A SUMMARY PROSPECTUS IN AN ERISA §404(C) PLAN (2009), *available at* http://www.dol.gov/ebsa/regs/fab2009-3.html.

[136] *See, e.g.*, Hecker v. Deere & Co., 556 F.3d 575, 578-79 (7th Cir. 2009) (describing Fidelity Trust's responsibilities as Trustee for 401(k) plans offered by Deere & Company).

subject to the employer's approval. Depending on the size of the employer, the employer's fiduciary obligations may be vested in a retirement plan committee or board.[137]

Existing law imposes relatively limited obligations on the employer and the plan provider. Neither is required to offer a specific menu or number of investment options beyond the minimal requirement in section 404(c) of ERISA that plans offer at least three diversified investment options with "materially different risk and return characteristics."[138] In fact, 401(k) plans typically offer an average of seventeen investment choices.[139] This average has increased over the past several years,[140] but the number can vary tremendously.[141] At the end of 2008, nearly half of 401(k) assets were invested in mutual funds, primarily stock mutual funds.[142] Many 401(k) plans also offer guaranteed investment contracts, company stock, or direct brokerage accounts as investment options.[143]

Existing law does not require an employer or plan provider to maximize return or minimize fees in selecting investment options. Legislation pending in Congress would impose more extensive obligations by requiring plan providers to disclose to employers both the total amount of plan fees and the breakdown of those fees by category.[144] The proposal would also require disclosure of fee information to plan participants.[145] The Department of Labor has issued proposed regula-

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[137] *See, e.g.*, Complaint at 18-19, Braden v. Wal-Mart Stores, Inc., No. 08-3109 (W.D. Mo.) (Mar. 27, 2008) (describing the Wal-Mart Retirement Plans Committee as the named fiduciary for the 401(k) plan).

[138] 29 C.F.R. § 2550.404c-1(b)(3)(i)(B).

[139] *See The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2008*, RES. FUNDAMENTALS (Inv. Co. Inst., Washington, D.C.), Aug. 2009, at 17 n.10 [hereinafter *Economics of 401(k)*], *available at* http://www.ici.org/pdf/fm-v18n6.pdf (citing survey results reporting averages ranging from twelve to eighteen investment options).

[140] *See 401(k) Plans: A 25-Year Retrospective*, RES. PERSP. (Inv. Co. Inst., Washington, D.C.), Nov. 2006, at 17, *available at* http://www.ici.org/pdf/per12-02.pdf (reporting that in 1995, 401(k) plans offered an average of six funds, and that by 2005, the average had increased to fourteen).

[141] *See, e.g.*, Emily Brandon, *How Many 401(k) Investment Options Do You Want?*, U.S. NEWS & WORLD REPORT, Oct. 2, 2009, http://www.usnews.com/money/blogs/planning-to-retire/2009/10/2/how-many-investment-options-do-you-want-in-a-401k.html (stating that most plans have between ten and nineteen options, but some have more than twenty-five).

[142] *Economics of 401(k)*, *supra* note 139, at 1.

[143] *Id.* at 9.

[144] *See* Kelly K. Spors, *Small 401(k) Plans Often Pay Big Fees*, WALL ST. J., Aug. 3, 2009, at R3 (describing the proposed disclosures). The legislation would also require providers to disclose conflicts of interest such as any relationships they have with financial advisors. *Id.*

[145] *See id.* (explaining that "employees in 401(k) plans would get a more specific breakdown" of the fees they pay).

tions that would require comparable disclosure to employers under ERISA section 408(b)(2) and to plan participants under sections 404(a) and (c).[146] To date, these regulations have not been adopted.[147]

ERISA also imposes disclosure obligations upon employers.[148] The plan administrator must provide a summary plan description to plan participants.[149] In addition, the plan must file an annual report describing its financial condition and operations.[150] The IRS, the Pension Benefit Guarantee Corporation (PBGC), and the Department of Labor have jointly determined the required disclosures that must be made in the annual report, Form 5500.[151] These disclosures describe various plan features and are accompanied by schedules that include financial statements and information on service providers.[152] In 2007, in response to ongoing concerns about conflicts of interest, the Department of Labor increased the Form 5500 disclosure requirements concerning compensation provided by the plan to service providers.[153]

II. THE MARKET FOR MUTUAL FUNDS AND RELATED PRODUCTS

A. *Evidence on the Effectiveness of Market Discipline*

At the core of *Jones v. Harris Associates* are the operation of the mutual fund market and the question of whether competitive forces are sufficient to discipline fund fees.[154] Commentators have debated this

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[146] *See* Reasonable Contract or Arrangement Under Section 408(b)(2), 72 Fed. Reg. 70,988 (proposed Dec. 13, 2007) (to be codified at 29 C.F.R. pt. 2550) (proposing disclosure for 408(b)(2) plans); Fee and Expense Disclosures to Participants in Individual Account Plans, 72 Fed. Reg. 20,457 (proposed Apr. 25, 2007) (to be codified at 29 C.F.R. pt. 2550) (proposing disclosure for 404(a) plans).

[147] *See* EBSA Unified Agenda Fact Sheet, Service Provider Disclosure to Plan Fiduciaries, http://www.dol.gov/ebsa/regs/unifiedagenda/ebsafall2009/1210-AB08fs.html (last visited Apr. 15, 2010) (stating intention to publish a final regulation in May 2010).

[148] 29 U.S.C. §§ 1021–1024 (2006).

[149] *Id.* §§ 1021(a), 1024(b).

[150] *Id.* §§ 1021(b)(1), 1023. Plans are also required to file supplemental and terminating reports. *Id.* §§ 1023(b)(2)–(c).

[151] *See* 29 C.F.R. § 2520.104b-10(d) (2009) (providing the form for annual reports).

[152] *See, e.g.*, IRS, 2009 INSTRUCTIONS FOR FORM 5500 7-12 (2009), *available at* http://www.irs.gov/pub/irs-pdf/i5500.pdf (setting out disclosure requirements).

[153] Annual Reporting and Disclosures, 72 Fed. Reg. 64,710 (Nov. 16, 2007) (codified at 29 C.F.R. § 2520).

[154] No. 08-586 (U.S. Mar. 30, 2010), http://www.supremecourt.gov/opinions/09pdf/08-586.pdf.

point extensively.[155] At a minimum, the mutual fund market presents some anomalies to those who would characterize it as competitive. The analysis in this Article focuses on the retail market for mutual funds. As commentators have explained, the mutual fund market is segmented—institutional investors can purchase different funds, generally with lower expenses, than can retail investors.[156]

As of the end of 2008, the average annualized cost to a retail investor of an equity mutual fund was approximately 0.99 percent.[157] According to the Investment Company Institute,[158] this cost reflects a substantial and persistent downward trend in fee levels—in 1980, the average stock fund cost an investor 2.32 percent per year.[159] Fees vary considerably depending on fund type.[160] Actively managed funds charge higher fees than indexed funds.[161] Equity funds typically cost more than bond funds.[162] Funds involving non-U.S. securities[163] or small-capitalization companies cost more than funds investing in large-capitalization domestic issuers.[164]

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155 *Compare* Brief of Robert Litan et al. as Amici Curiae Supporting Petitioners at 5, Jones v. Harris Assocs., No. 08-586 (U.S. Mar. 30, 2010) ("[M]arket forces cannot be relied upon to constrain the fees charged by mutual funds to competitive levels."), *with* John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151, 163 (2007) ("[T]he mutual fund industry's market structure is consistent with competition providing strong constraints on advisory fees.").

156 *See* Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1032-33 (2005) (examining evidence suggesting market segmentation and noting that the presence of sophisticated investors does not protect the less sophisticated if the market is segmented); *cf.* Jones v. Harris Assocs., 527 F.3d 627, 634 (7th Cir. 2008) ("The sophisticated investors who do shop create a competitive pressure that protects the rest."), *vacated*, No. 08-586 (U.S. Mar. 30, 2010).

157 INV. CO. INST., *supra* note 8, at 60-61.

158 The Investment Company Institute is a private membership organization of U.S. investment companies. Its membership includes "SEC-Registered funds, their investment advisers, underwriters and fund directors." Inv. Co. Inst., About ICI: Membership, http://www.ici.org/about_ici/membership (last visited Apr. 15, 2010).

159 INV. CO. INST., *supra* note 8, at 60-61.

160 *See id.* at 64-67 (summarizing expense ratios by fund type).

161 *See id.* at 64, 67.

162 *Id.* at 64.

163 *Id.* at 64, fig.5.4.

164 *See id.* at 64 ("[S]mall- and mid-cap stocks tend to be more costly to manage."); *see also* DIV. OF INV. MGMT., SEC, REPORT ON MUTUAL FUND FEES AND EXPENSES tbl.9 (2000) (comparing relative fees across fund categories).

The most substantial component of most mutual fund fees, and the component most commonly criticized as excessive,[165] is the management fee—the fee paid to the fund's investment advisor. As indicated above, concerns about excessive management fees led Congress to adopt statutory changes mandating independent director oversight and imposing a fiduciary duty on investment advisors in connection with their compensation.[166] *Jones* concerns the manner in which courts should evaluate whether the applicable fees meet the fiduciary duty test of ICA section 36(b). Although the Supreme Court adopted the *Gartenberg* multifactor test,[167] it is unclear how an advisor's fee can be excessive if it is set by competitive market forces.

In a highly influential article, John Coates and R. Glenn Hubbard argue that the mutual fund market is, in fact, highly competitive.[168] To support their claim, they cite the substantial number of mutual funds; the lack of industry concentration; the ability of new funds and fund families to enter the market; the extensive distribution channels through which funds are sold; the decline, over time, in average fees; and, perhaps most important, investor responsiveness to fees through investment decisions.[169] Specifically, Coates and Hubbard find that "holding other factors constant, investors shift substantial amounts of assets out of high-fee funds and into low-fee funds."[170] This responsiveness suggests effective market discipline over fees.[171]

Indeed, by most standard measures, the mutual fund market appears highly competitive. The industry currently boasts approximately 9000 mutual funds offered by approximately 700 different sponsors.[172] Entry into the market is easy, as evidenced by the fact that new en-

[165] Notably, however, a fund's management fee is often proportionate to the other fees, which are typically subjected to far less scrutiny. *See, e.g.*, PETER J. WALLISON & ROBERT E. LITAN, COMPETITIVE EQUITY 79-80 (2007) (suggesting that fund advisors have little incentive to minimize other fund expenses because directors typically analyze management fees on a "cost-plus" basis).

[166] *See supra* notes 56-62 and accompanying text.

[167] Jones v. Harris Assocs., No. 08-586, slip op. at 17 (U.S. Mar. 30, 2010), http://www.supremecourt.gov/opinions/09pdf/08-586.pdf.

[168] *See* Coates & Hubbard, *supra* note 155, at 153 ("[P]rice competition is in fact a strong force constraining fund advisors . . . .").

[169] *Id.* at 163.

[170] *Id.* at 180.

[171] The growth of the Vanguard Group, known for its low fees, into one of the largest fund families also suggests effective market discipline. Significantly, a recent Morningstar study found that the Vanguard Group created $189 billion of wealth for its shareholders over the 2000–2009 time period. Mamudi, *supra* note 13.

[172] INV. CO. INST., *supra* note 8, at 13 fig.1.6, 15 fig.1.9.

trants have successfully attracted billions of dollars in assets.[173] Mutual funds are marketed through a variety of channels, including brokers, fund supermarkets, direct advertisements, and sales to investors.[174] The market share of fund complexes has changed substantially and continually over time. As the Investment Company Institute observes, "of the largest 25 fund complexes in 1985, only 10 remained in this top group in 2008."[175] Finally, although large fund complexes increasingly dominate,[176] the overall level of industry concentration is consistent with a competitive industry.[177]

Competition also appears to have reduced fund fees. Data collected by the Investment Company Institute shows the average expense ratio for an equity mutual fund declined from 2.32% in 1980 to 0.99% in 2008.[178] Products that are widely offered face stiff price competition. Over the past several years, two major mutual fund companies—Fidelity and Charles Schwab—both reduced fees on their popular equity index funds, seemingly in an effort to compete with Vanguard, which has historically been known for its low expense ratios.[179] Mutual funds also face increasing competition from ETFs.

Yet the story is incomplete. First, the evidence that fees are decreasing is not clear-cut. The SEC found that average expense ratios rose during most of the period from 1979 to 1999, although it noted that growth in fund size, an increase in the number of specialized funds, and changes in distribution and sales fees created methodological issues that impeded direct comparisons.[180] Alan Palmiter reports that "[w]eighted average expense ratios for *equity funds* grew from 0.64% in

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173 *See* Coates & Hubbard, *supra* note 155, at 168 tbl.4 (listing the twenty largest equity funds in 2004 that did not exist in 1994).

174 *See id.* at 170-71 (examining distribution channels).

175 INV. CO. INST., *supra* note 8, at 21.

176 *See id.* ("The share of assets managed by the largest 25 firms increased to 75 percent in 2008 from 68 percent in 2000. In addition, the share of assets managed by the largest 10 firms in 2008 was 53 percent, up from the 44 percent share managed by the largest 10 firms in 2000.").

177 "The mutual fund industry ha[d] a Herfindahl-Hirschman index number of 433 as of December 2008." *Id.* Numbers of less than 1000 indicate an unconcentrated industry. U.S. DEP'T OF JUSTICE & THE FED. TRADE COMM'N, HORIZONTAL MERGER GUIDELINES 15 (1997), *available at* http://www.justice.gov/atr/public/guidelines/hmg.pdf.

178 INV. CO. INST., *supra* note 8, at 60-61.

179 *See, e.g.*, David Bogoslaw, *Behind Schwab's Fee-Cutting Frenzy*, BUSINESSWEEK.COM, May 6, 2009, http://www.businessweek.com/investor/content/may2009/pi2009056_885433.htm (reporting on Fidelity's decision to cut fees in March 2005 and Charles Schwab's reduction of fees in May 2009).

180 DIV. OF INV. MGMT., *supra* note 164 (noting comparisons over time).

1980 to 0.92% in 2004."[181] Most recently, fund fee rates have increased an average of five percent in the wake of the stock market decline.[182]

Second, in a competitive market, prices of similar products tend to converge. Yet, as Peter Wallison and Robert Litan reveal, fee differentials within the mutual fund industry persist, and the level of dispersion is surprisingly high.[183] Even among funds that seem to offer similar products, the range of fees is substantial, with some funds charging fees that are almost three times those of their competitors.[184] Perhaps more surprising, the dispersion of expense ratios in the U.K. mutual fund market is far smaller, although its market contains fewer funds.[185]

Third, it is unclear what justifies the existing fee differentials. Coates and Hubbard argue that price dispersion in the mutual fund industry can be explained by product differentiation and search costs. But are the mutual funds that charge different fees really different? Although the large number and wide variety of mutual funds may make price comparisons difficult, price variation appears among products that are readily identified as substantially similar. Vanguard's Equity Index 500 fund, for example, has an expense ratio of 0.18%,[186] while UBS's S&P 500 Index fund, class C, has an expense ratio of 1.45%.[187] Wallison and Litan detail the variation in fees for indexed mutual funds, which do not require professional stock-picking

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[181] Alan R. Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 165, 190 (2006).

[182] Allan Roth, *Mutual Fund Fees Jump 5 Percent*, CBS MONEYWATCH.COM, Aug. 17, 2009, http://moneywatch.bnet.com/investing/article/mutual-fund-fees-jump-5-percent/331641. Concededly, these rates were applied to a smaller asset base as a result of the stock market decline.

[183] *See* WALLISON & LITAN, *supra* note 165, at 8-9 (explaining that the mutual fund industry "does not appear to conform to the 'law of one price'").

[184] *Id.* at 9 (reporting a difference in cost of almost 300 percent within a sample of 811 actively managed equity funds).

[185] *Id.* at 10. Wallison and Litan attribute this phenomenon to differences in the regulatory structure. *See id.* ("In the United Kingdom, mutual funds are generally contractual arrangements between advisers and investors; intervening corporate structures . . . have no voice in the setting of fees and expenses of advisers . . . ."). Interestingly, the size of mutual fund fees varies significantly by country. *See* Ajay Khorana, Henri Servaes & Peter Tufano, *Mutual Fund Fees Around the World*, 22 REV. FIN. STUD. 1279, 1280 (2008) (explaining that the average expense ratio of equity funds by country varies from 1.05% to 2.56%). Canadian investors pay some of the highest fees—an average of 2.56% at the time of the Khorana et al. study. *Id.*

[186] THE VANGUARD GROUP, VANGUARD 500 INDEX FUND PROSPECTUS: INVESTOR SHARES & ADMIRAL SHARES 3 (Apr. 29, 2009).

[187] UBS GLOBAL ASSET MGMT., UBS S&P 500 INDEX FUND PROSPECTUS 6 (Sept. 28, 2009), *available at* www.ubs.com/2/e/us_library/mutual/sp500_prospectus.pdf. The UBS S&P 500 Index Fund is currently being liquidated. *Id.* at 10.

talent and which should exhibit identical performance.[188] Similarly, Edwin Elton et al. find that costs for S&P 500 index funds can vary by more than two percent per year.[189]

Are investors paying for differentiated advisory services? Classic efficient market theory suggests that, in the long term, mutual fund managers should not systematically beat the market.[190] Indeed, empirical evidence suggests that mutual fund returns tend to converge to the mean.[191] This does not mean, however, that all managers are equally talented. The empirical literature is in disagreement on the extent to which mutual fund managers exhibit stock-picking ability or market timing, but recent studies identify a subset of managers who are able to outperform the market.[192] In most cases, however, even

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[188] *See* WALLISON & LITAN, *supra* note 165, at 121 n.8 (asserting that fee differentials exist among essentially identical funds).

[189] *See* Edwin J. Elton et al., *Are Investors Rational? Choices Among Index Funds* 1 (N.Y.U., Working Paper No. SC-AM-02-08, 2002), *available at* http://ssrn.com/abstract=1300816 (finding differences in costs and returns despite the fact that the funds hold the same portfolios).

[190] *See, e.g.*, Christine Benz, *What the Data Say on Active vs. Passive Funds*, MORNINGSTAR.COM, Mar. 5, 2010, http://www.morningstar.com/cover/videocenter.aspx?id=328998 (interviewing Morningstar's John Rekenthaler, who states that "two-thirds of fund managers will underperform over a long period of time"); *see also*, D. Bruce Johnsen, *Myths About Mutual Fund Fees: Economic Insights on* Jones v. Harris 7 (George Mason Univ. Law & Econ. Research Paper Series, Paper No. 09-49, 2009) *available at* http://ssrn.com/abstract=1483862 ("Regardless of the level of the advisory fee . . . any expected abnormal return to a manager's superior stock-picking skill will be competed away by investors chasing the prospect of capturing the associated rents.").

[191] Although a variety of scholars have studied persistence in mutual fund returns, the general consensus, consistent with the findings in Mark Carhart's influential article, is that superior returns do not persist in the long term. *See* Mark M. Carhart, *On Persistence in Mutual Fund Performance*, 52 J. FIN. 57, 79-81 (1997) (finding that expenses and transaction costs explain some degree of persistence, but that the evidence does not support the existence of skilled portfolio managers who can consistently beat the market). Carhart does find consistent underperformance by the worst performing mutual funds. *Id.* at 80; *see also* HOSSEIN KAZEMI ET AL., CTR. FOR INT'L SEC. & DERIVATIVES MKTS., PERFORMANCE PERSISTENCE FOR MUTUAL FUNDS: ACADEMIC EVIDENCE 13 (2003), *available at* http://cisdm.som.umass.edu/research/pdffiles/performancepersistence.pdf (finding little support for performance persistence or stock-picking ability from 1997 to 2002); Nicolas P. B. Bollen & Jeffrey A. Busse, *Short-Term Persistence in Mutual Fund Performance*, 18 REV. FIN. STUD. 569, 594-95 (2004) (finding that persistence in mutual fund returns is a short-term phenomenon); Ronald N. Kahn & Andrew Rudd, *Does Historical Performance Predict Future Performance?*, FIN. ANALYSTS J., Nov.–Dec. 1995, at 43, 49-50 (finding "no evidence of persistence for performance among equity mutual funds").

[192] *See, e.g.*, Robert Kosowski et al., *Can Mutual Fund "Stars" Really Pick Stocks? New Evidence from a Bootstrap Analysis*, 61 J. FIN. 2551, 2553 (2006) (finding that a sizeable minority of mutual fund managers pick stocks well enough to cover their costs); Malcolm Baker et al., Can Mutual Fund Managers Pick Stocks? Evidence from Their Trades Prior to Earnings Announcements 3 (Nov. 13, 2007) (unpublished manu-

superior performance on a precost basis does not lead to superior investor returns once costs are taken into account.[193]

Moreover, even if managers have different abilities to generate returns, so long as there are decreasing returns to scale,[194] inflows to talented managers should eventually reduce returns to competitive levels.[195] This reduction means that, although skilled managers may earn economic rents from their ability, investors do not earn superior returns.

Because mutual fund advisors are typically compensated as a percentage of assets under management, skilled managers achieve these rents by attracting investment into their funds. Studies convincingly demonstrate that the largest factor influencing fund inflows is the fund's past performance.[196] Although fund inflows will reward the manager for superior past performance by increasing assets under management, if that performance does not persist, entering investors will not beat the market. As a result, investors should not be willing to pay higher fees, on a percentage basis, based on the fund's past performance.

More importantly, whether or not a subset of fund managers can consistently outperform the market, most do not. Therefore, most investors will not be able to select a mutual fund that provides superior

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script), *available at* http://ssrn.com/abstract=570381 (finding evidence that fund managers do have some degree of stock-picking skill); Yong Chen et al., *Measuring the Timing Ability and Performance of Bond Mutual Funds* 30, (Nat'l Bureau of Econ. Research, Working Paper No. 15318, 2009), *available at* http://www.nber.org/papers/w15318 (finding that a number of bond fund managers demonstrate investment ability, but that "investment fees and trading costs absorb the superior returns (and then some)").

[193] *See* Chen et al., *supra* note 192, at 31 (finding no significant positive performance by bond mutual funds after controlling for costs).

[194] *See, e.g.*, Joshua M. Pollet & Mungo Wilson, *How Does Size Affect Mutual Fund Behavior?* 30 (H.K. Univ. of Sci. & Tech. Bus. Sch., Research Paper No. 07-06, 2007), *available at* http://ssrn.com/abstract=918250 (providing "evidence that the proximate cause of diminishing returns to scale for mutual funds is the inability to scale an investment strategy as the fund becomes large").

[195] *See* Jonathan B. Berk & Richard C. Green, *Mutual Fund Flows and Performance in Rational Markets*, 112 J. POL. ECON. 1269, 1271 (2004) ("New money flows to the fund [with superior managers] to the point at which expected excess returns going forward are competitive.").

[196] *See, e.g.*, Richard A. Ippolito, *Consumer Reaction to Measures of Poor Quality: Evidence from the Mutual Fund Industry*, 35 J.L. & ECON. 45, 56 (1992) (finding a statistically significant relationship between fund growth and past performance); Prem C. Jain & Joanna Shuang Wu, *Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows*, 55 J. FIN. 937, 939 (2000) (finding that funds advertising higher returns subsequently attracted significantly more inflows than the control groups); Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FIN. 1589, 1619 (1998) (finding that consumers base their decisions on past fund performance, but do so asymmetrically).

returns and will be unlikely to benefit from investing on the basis of a fund's historical performance.

Instead, as empirical studies have repeatedly shown, the most consistent predictor of a fund's return to investors is the fund's expense ratio.[197] Funds with high expense ratios underperform their peers on an after-cost basis.[198] Vanguard founder, John Bogle, observed that "industry experts and academics have been saying for decades . . . 'that expenses are the most powerful indicator of a fund's performance.'"[199] This correlation is due in part to the simple fact that fees reduce the investors' net returns and in part to the effect of compounding on long-term investor returns.[200] Even before costs are reflected in returns, however, there is little evidence that higher fees are correlated with increased performance.[201] Despite these studies, which have been widely reported in the news media, investors apparently persist in believing the opposite: that higher fees result in higher performance.[202]

In sum, the empirical data are mixed. Although Coates and Hubbard cite the inflow of money into funds with lower costs or better performance,[203] money continues to flow into funds with higher costs

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[197] *See, e.g.*, Roth, *supra* note 182 ("[T]he only factor that is predictive of a fund's relative performance against similar funds is fees."). Significantly, however, these empirical studies often focus on expense ratios rather than management fees. One recent study finds some evidence that funds with the highest management fees outperform their peers. *See* John A. Haslem et al., *Identification and Performance of Equity Mutual Funds with High Management Fees and Expense Ratios*, J. INVESTING, Summer 2007, at 32, 50 (suggesting that "higher management fees may add value to active portfolio management and contribute to improved performance measures").

[198] *See, e.g.*, Haslem et al., *supra* note 197, at 50 (finding that higher expense ratios correlate negatively with performance).

[199] John C. Bogle, A New Order of Things—Bringing Mutuality to the "Mutual Fund," Manuel F. Cohen Memorial Lecture at the Georgetown University Law Center (Feb. 19, 2008) (quoting Morningstar), *in* 27 REV. BANKING & FIN. L. 471, 492 (2008).

[200] *See, e.g.*, Roth, *supra* note 182 (explaining the effect that compounding can have on returns).

[201] *See* Javier Gil-Bazo & Pablo Ruiz-Verdú, *The Relation Between Price and Performance in the Mutual Fund Industry*, 64 J. FIN. 2153, 2154 (2009) ("[F]unds with worse before-fee risk-adjusted performance charge higher fees."); *see also* Press Release, Standard & Poor's, Funds with Low Expense Ratios Outperforming Their More Expensive Peers over Long Term, Says S&P (June 11, 2003), *available at* http://www2.standardandpoors.com/spf/pdf/media/expenseratios.pdf (finding that funds with below-average expense ratios outperformed funds with above-average expenses "over a one, three, five, and ten-year annualized basis").

[202] *See, e.g.*, Neil Weinberg, *Fund Managers Know Best*, FORBES, Oct. 14, 2002, at 220 (reporting that eighty-four percent of respondents surveyed believe higher fees result in higher performance).

[203] *See* Coates & Hubbard, *supra* note 155, at 183-85 (finding total assets "very responsive to fees").

and poor performance as well. Investors fail to respond to chronic poor performance by withdrawing their funds, allowing some of the worst performing mutual funds to survive.[204] The mutual fund market offers extensive evidence of the long-term survival of funds that consistently underperform the market and simultaneously charge higher relative fees. Indeed, the very factors that Coates and Hubbard cite as evidence of market competition—easy access to fund performance and expense information, multiple distribution channels, and so forth—pose a puzzle as to why such funds persist.[205]

The data do not conclusively establish either a competitive market or its absence, but they present anomalies that appear inconsistent with a standard market explanation. Problematically, while the empirical evidence suggests that investors cannot outperform the market through their choice of funds, the existing market structure, which includes a choice of almost 10,000 intermediated retail products with a wide range of fees, offers evidence that investors continue to seek outperformance.[206] In addition, as detailed further below, regulatory constraints, methodological challenges, and a lack of transparency frustrate efforts to assess the degree to which management adds sufficient value to justify the cost associated with actively managed products.

B. *Methodological Challenges to Studying the Mutual Fund Market*

Methodological challenges limit the ability of investors and researchers to evaluate fund performance and to identify relationships

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[204] *See* Jonathan B. Berk & Jing Xu, Persistence and Fund Flows of the Worst Performing Mutual Funds 16 (Oct. 2004) (unpublished manuscript), *available at* http://finance.wharton.upenn.edu/department/Seminar/2004Fall/MicroFall2004/micro-berk-paper2-persist-120204.pdf (finding that investors in the worst performing funds are unwilling to withdraw their money).

[205] Coates and Hubbard point to the existence of persistent prices differences in other product markets and attribute that persistence to differences in buyer preferences. Coates & Hubbard, *supra* note 155, at 195-97. Although buyers might well be willing to pay a higher price when purchasing a large screen television in order to patronize a local vender or enjoy the services of a full service retailer, it is not clear that comparable differences characterize the mutual fund market. Moreover, the authors provide no evidence that those funds that charge higher fees offer differentiated services.

[206] Indeed, the industry markets these products on the premise that they can deliver superior returns to a low-cost indexed fund or ETF. *Compare* Charles Schwab & Co., *Actively Managed Funds: Seeking Competitive Performance*, ON INVESTING, Spring 2010, at 33, 33 (advising potential investors "looking to beat the market . . . to consider including actively managed mutual funds in [their] portfolio[s]"), *with* Johnsen, *supra* note 190, at 44 ("It is clear that what investors own when they buy fund shares does not include an expectation of sharing in any abnormal returns to an active fund manager's superior stock picking skill.").

between performance and fees.[207] Fund performance is highly time sensitive.[208] The choices of time period and start date have a substantial effect on one fund's performance relative to that of another. Even when examined over three-, five-, and ten-year periods, funds may shift their relative positions. Part of the reason for these differences is that fund returns vary based on risk, investment horizon, and asset allocation.[209] The percent of cash held by a fund, for example, can cause the fund to lag a bull market but outperform during a bear market. As Ross Miller observes, Jeff Vinik's badly timed decision to move more than a quarter of the Magellan fund's assets into fixed income securities caused the fund to lag its benchmark by over ten percent for 1996.[210] Similarly, a substantial number of stock-focused mutual funds were holding unusually high levels of cash in April 2009, as the stock market hit its low.[211] For some of these funds, the cash holdings reduced the impact of the market downfall, but it is unclear whether the cash positions reduced the profitability of the subsequent market rebound as well.

In addition, because investor money flows into and out of funds continuously, a fund's reported return over a given time period does not necessarily reflect the return achieved by individual investors who entered and exited the fund during that time period.[212] Mutual funds typically report (and empirical studies typically use) time-weighted returns, which reflect the return on the fund's assets averaged over time. If the total amount of the fund's assets varies substantially over the time

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[207] *See, e.g.*, Eero J. Pätäri, *Do Hot Hands Warm the Mutual Fund Investor? The Myth of Performance Persistence Phenomenon*, INT'L RES. J. FIN. & ECON., Dec. 2009, at 117, 134 (concluding that efforts to evaluate performance persistence are highly sensitive to sample selection and methodology).

[208] *See, e.g.*, Benz, *supra* note 190 (quoting John Rekenthaler as stating that, when funds beat their relevant index, "[t]hose tend to be accidents of a time period").

[209] *See infra* note 350 and accompanying text (detailing the importance of asset allocation).

[210] Ross M. Miller, Stansky's Monster: A Critical Examination of Fidelity Magellan's "Frankenfund" 1 (Feb. 22, 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=964824.

[211] Diya Gullapalli, *More Stocks Funds Declare Cash King*, WALL ST. J., Apr. 9, 2009, at C9 (warning that "cash-laden stock funds risk alienating investors if the market rallies and they still are on the sidelines").

[212] *See, e.g.*, MORNINGSTAR, FACT SHEET: MORNINGSTAR INVESTOR RETURN (2006), *available at* http://corporate.morningstar.com/us/documents/MethodologyDocuments/FactSheets/InvestorReturns.pdf (explaining the concept of investor return); *see also* Ilia D. Dichev, *What Are Stock Investors' Actual Historical Returns? Evidence from Dollar-Weighted Returns*, 97 AM. ECON. REV. 386, 386 (2007) (distinguishing between dollar-weighted performance and buy-and-hold performance).

period, however, the average investor may earn substantially more or less than the time-weighted average. This alternative measure of return—investor-weighted or dollar-weighted return—is particularly important if strong mutual fund performance attracts investment inflows because, even if the return on newly invested dollars is low, the fund's time-weighted return may remain positive for a substantial period of time.

Russel Kinnel offers an example: the volatile CGM Focus Fund has one of the highest returns for a large-cap growth fund, providing a ten-year annualized return of around nineteen percent (ranking it first in its Morningstar category).[213] It achieves this return by making big and risky sector bets.[214] When those bets pay off, the Fund does well and attracts new money.[215] That new money may arrive just in time to experience the large losses that are equally likely with a risky investment strategy. Kinnel observes that while the CGM Focus Fund earned a ten-year annualized return of 17.8% during the period he examined, its investors suffered an annualized 16.8% loss during that same time period.[216] A recent article extends this analysis and finds that individual investors engage in mutual fund trading strategies that generate poor performance even if the funds themselves are performing well.[217] Even if some fund managers exhibit short-term stock-picking skill, "it is clear that the higher returns earned at the short horizon are not effectively captured by individual investors."[218]

That a fund's reported expense ratio does not always capture its total costs further impedes evaluation of the relationship between cost and performance.[219] The type of cost most commonly excluded from the expense ratio is the fund's trading costs or commissions.[220] Trad-

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[213] Russel Kinnel, *Why Your Results Stink*, KIPLINGER'S PERS. FIN., Nov. 2009, at 35.

[214] *Id.*

[215] For example, the Fund's assets under management grew from less than a billion in 2004 to slightly over two billion in 2006. CAPITAL GROWTH MGMT., CGM FOCUS FUND 47TH QUARTERLY REPORT 7 (2009), *available at* http://cgmfunds.com/pdf/2009-06-30-focus-quarterly.pdf. In 2007, the fund reported an eighty percent return, and by year-end, its assets under management had grown to over five billion. *Id.*

[216] Kinnel, *supra* note 213.

[217] Andrea Frazzini & Owen A. Lamont, *Dumb Money: Mutual Fund Flows and the Cross-Section of Stock Returns*, 88 J. FIN. ECON. 299, 319 (2008).

[218] *Id.*

[219] In addition to trading costs, funds may incur interest costs and costs associated with maintaining short positions, among others. These costs are particularly significant for funds that use leverage or aggressive trading strategies.

[220] John M.R. Chalmers et al., An Analysis of Mutual Fund Trading Costs 10-11 (Nov. 23, 1999) (unpublished manuscript), *available at* http://ssrn.com/abstract=195849. The SEC does not require mutual funds to disclose trading commissions as a

ing costs are not easy to extract from a mutual fund's mandated disclosures,[221] but a careful examination of trading costs in 2001 concluded that, for large equity funds, trading costs averaged forty-three percent of the funds' expense ratios.[222] A slightly older study examined a sample of equity mutual funds and found that trading costs averaged 0.78% of fund assets per year.[223]

The significance of trading costs varies from fund to fund. Although funds may pay different commission rates, depending on their size or business relationships, the most significant component of total trading cost is turnover. Fund turnover rates vary substantially[224]: the CGM Focus Fund reported a turnover rate of 504% in 2008,[225] while the turnover rate for the Vanguard S&P 500 index fund was 6%.[226] Karceski et al. found that, for funds with the highest turnover rates, brokerage commissions alone averaged 1.67% of assets.[227] In some cases, a fund's trading cost exceeded its expense ratio.[228] Even index

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percentage of assets under management. According to the SEC, trading commissions are not included in fund expense ratios

> because under generally accepted accounting principles they are either included as part of the cost basis of securities purchased or subtracted from the net proceeds of securities sold and ultimately are reflected as changes in the realized and unrealized gain or loss on portfolio securities in the fund's financial statements.

Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs, Securities Act Release No. 8349, Exchange Act Release No. 48,952, Investment Company Act Release No. 26,313, 68 Fed. Reg. 74,820 (Dec. 24, 2003); *see also* Summary Prospectus Rule, *supra* note 32, at 4554 (rejecting the suggestion that trading costs be included in expense ratio). Instead, funds must disclose their turnover ratio and the total dollar amount of brokerage commissions they paid. *See id.* (adopting a requirement that funds report their turnover ratios, but not actual trading costs, in the summary prospectus).

[221] The dollar amount of brokerage commissions is not even included in the mutual fund prospectus. To obtain this information, an investor must consult a separate document: the "Statement of Additional Information." *See* SEC, *supra* note 37.

[222] Jason Karceski et al., Mutual Fund Brokerage Commissions 9 (Jan. 2004) (unpublished manuscript), *available at* http://www.zeroalphagroup.com/news/ZAG_mutual_fund_true_cost_study.pdf.

[223] Chalmers et al., *supra* note 220, at 11.

[224] The turnover rate is typically much higher for actively managed funds, but it can vary for a variety of reasons, including management strategy, the percentage of institutional ownership, and the frequency with which investors enter and exit the fund.

[225] CAPITAL GROWTH MGMT., *supra* note 215, at 8.

[226] VANGUARD GROUP, *supra* note 186, at 15.

[227] Karceski et al., *supra* note 222, at 8.

[228] *See id.* at 10 ("In some cases, the total costs of trading are more than double the level of the expense ratio.").

funds can have trading costs that vary enough to lead to significant differences in performance.[229]

The foregoing suggests that fund costs may be higher than they appear—but costs can be lower as well. In particular, funds often reduce fees below those to which they are contractually entitled through voluntary fee waivers.[230] As Bruce Johnsen observes, "forty percent of equity funds from 1998 to 2004 waived fees annually."[231] Because fee waivers reduce the actual costs below those reflected in the fund prospectus, the amounts reflected in empirical studies may be overstated.[232]

C. *The Effect of Selling Agents on Market Discipline*

Why might a market with easy entry and extensive competition nonetheless show signs of market failure? One possible explanation, suggested above, is inadequate transparency. If investors lack adequate information to evaluate the costs and performance of mutual funds, they may make poor investment decisions.[233] Another factor may be the transaction costs associated with exit. The sale of a mutual fund is a recognition event that requires an investor to pay income tax on any capital gain. Investors who hold mutual funds in taxable accounts may be reluctant to shift their holdings to another fund because of the impact of this tax. Back-end loads—fees charged to withdraw or redeem fund holdings—if applicable, are another cost of exiting.

Commentators have also attributed failure of the mutual fund market to limitations on investor rationality. Donald Langevoort has warned that consumer decisionmaking in the mutual fund context does not appear to be consistent with rational behavior.[234] Jim Cox

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[229] *See* Anne Tergesen & Lauren Young, *Index Funds Aren't All Equal*, BUSINESSWEEK, Apr. 19, 2004, at 122 (reporting that in 2003, eighty percent of index funds tracked by Morningstar "fell short of the performance ideal of a plain-vanilla index fund: to deliver the benchmark's return, minus the fund's expense ratio").

[230] The use of fee waivers, which effectively mask price competition, is imposed on the market by the governance requirements associated with advisory contracts. Fund managers require shareholder approval, through a vote on a new advisory contract, to raise fees, but managers can voluntarily lower fees without shareholder approval. As a result, the contractual rate may be higher than that which would occur in the absence of regulatory constraints. I am grateful to Eric Roiter for this observation.

[231] Johnsen, *supra* note 190, at 36.

[232] *See, e.g.*, Gil-Bazo & Ruiz-Verdú, *supra* note 201, at 2155 n.3 (acknowledging that, because of fee waivers, "the loads typically reported in databases . . . can often overestimate effective loads").

[233] The SEC has repeatedly reexamined mutual fund disclosure requirements. The result of these efforts is considered in Section III.B., *infra*.

[234] Langevoort, *supra* note 156, at 1042-55.

and John Payne argue that mutual fund purchasers exhibit bounded rationality.[235] Although an extensive examination of the literature is beyond the scope of this Article, empirical studies provide support for these concerns. Studies show, for example, that investors largely ignore cost information and focus instead on past performance information,[236] and that they rely heavily on advertising[237] and brand name (identification with a fund family).[238] One well-known study documents that investors respond to mutual fund name changes, moving money into funds with names that reflect a "hot investment style," even when these changes are purely cosmetic and reflect no changes in fund strategy or performance.[239]

This Article focuses on another factor: the importance of sales agents in the market for retail investments. The Investment Company Institute reports that, of investors owning mutual funds outside of employer-based retirement accounts, "77 percent own fund shares through professional financial advisers."[240] Investors purchase their

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[235] James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 WASH. U. L.Q. 907, 930-35 (2005).

[236] *See* Brad M. Barber et al., *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows*, 78 J. BUS. 2095, 2107 (2005) (demonstrating that mutual fund inflows are generally unrelated to fund expenses); Beth A. Pontari et al., *Regulating Information Disclosure in Mutual Fund Advertising in the United States: Will Consumers Utilize Cost Information?*, 32 J. CONSUMER POL'Y 333, 336-49 (2009) (demonstrating the insignificance of cost information in fund advertising); Daniel Bergstresser & James Poterba, Do After-tax Returns Affect Mutual Fund Inflows? 1-3 (Feb. 2000) (unpublished manuscript), *available at* http://ssrn.com/abstract=253914 (citing studies showing net fund inflows are positively related to past fund performance and demonstrating that after-tax returns outperform pretax returns in explaining inflows); *see also* Alan R. Palmiter & Ahmed E. Taha, *Mutual Fund Investors: Divergent Profiles*, 2008 COLUM. BUS. L. REV. 934, 981-90 (2008) (discussing additional research showing the relative unimportance of cost information to fund investors).

[237] *See, e.g.*, Michael A. Jones & Tom Smythe, *The Information Content of Mutual Fund Print Advertising*, 37 J. CONSUMER AFF. 22, 24-25 (2003) (documenting the importance of mutual fund advertising and arguing that effective regulation of such advertising is difficult).

[238] *See, e.g.*, Vikram Nanda et al., *Family Values and the Star Phenomenon: Strategies of Mutual Fund Families*, 17 REV. FIN. STUD. 667, 668-69 (2004) (finding that mutual fund families with at least one star performer draw disproportionate inflows to other funds within the family).

[239] Michael J. Cooper et al., *Changing Names with Style: Mutual Fund Name Changes and Their Effects on Fund Flows*, 60 J. FIN. 2825, 2853 (2005).

[240] INV. CO. INST., *supra* note 8, at 68; *see also* Brian K. Reid & John D. Rea, *Mutual Fund Distribution Channels and Distribution Costs*, INVESTMENT COMPANY INST. PERSP., July 2003, at 1, 5 (reporting that, as of 2001, only fifteen percent of households made their primary purchases of mutual funds directly or through a discount broker or fund supermarket). The selection of mutual funds in 401(k) plans raises analogous problems that are discussed below.

funds through investment professionals despite the ability to purchase most mutual funds directly, often at lower cost, from the fund sponsor or through a fund supermarket.[241]

This manner of compensating brokers creates an obvious conflict of interest—the brokers' incentive is to maximize their compensation, not to offer the investor the best mutual fund option. The funds that compensate brokers most highly are those that charge higher loads and 12b-1 fees, but these higher fees, in turn, reduce investor returns. Complex fee structures heighten the conflict. Two-thirds of mutual funds have more than one share class, each of which has a different fee structure.[242] In most cases brokers have monetary incentives to sell the class of shares that is least advantageous to investors.[243] Indeed, FINRA recently warned investors that brokers might be improperly recommending an inappropriate class of shares because the brokers would receive higher commissions.[244]

Brokers receive additional compensation for selling preferred funds through soft-dollar arrangements and revenue sharing. Soft dollars involve institutional money managers paying for services—typically research services—indirectly through brokerage commissions, rather than directly.[245] The brokerage commissions normally exceed the rates that the institutions would pay and have the effect of bundling together the payments for execution services and for research. The advantage of soft dollars for fund advisors is that soft dollars both mask the cost of purchased research and pass that cost through to investors in the mutual fund. If the research were purchased separately, it would either reduce the advisor's profit[246] or increase fund expenses, which are reported to investors. Commissions, however, as discussed earlier, are not reported as part of the disclosure of fund expenses. For brokers, soft dollars represent an additional source of revenue, making it more attractive for

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[241] *See* IN. CO. INST., *supra* note 8, at 68 (explaining that investors compensate these professionals through the payment of loads and 12b-1 fees).

[242] *Id.* at 27.

[243] *See* Edward S. O'Neal, *Mutual Fund Share Classes and Broker Incentives*, FIN. ANALYSTS J., Sept.–Oct. 1999, at 76, 83 (highlighting "the obvious conflict of interest between mutual fund brokers and investors").

[244] FINRA Investor Alerts, Class B Mutual Fund Shares: Do They Make the Grade?, http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/MutualFunds/p005975 (last visited Apr. 15, 2010).

[245] *See* Jill E. Fisch, *Does Analyst Independence Sell Investors Short?*, 55 UCLA L. REV. 39, 50-52 (2007) (describing the use of soft dollars).

[246] *See, e.g.*, Jeffrey D. Spill, *Regulation of Mutual Funds: What You Don't Know Can Hurt You*, N.H.B.J., Spring 2005, at 50, 52 (2005) (explaining that the advisor can increase its profit by avoiding paying for research services out of its contracted advisory fee).

them to direct investor assets to funds that use soft dollars. Despite these potential conflicts, the SEC has confirmed the legality of soft dollars, pursuant to certain guidelines.[247]

Mutual fund companies also pay brokers for shelf space.[248] As one court explained, "[A] shelf-space agreement occurs when a mutual fund pays [additional compensation] in exchange for the broker-dealer preferentially marketing its shares."[249] The additional compensation is typically, in addition to any commission applicable at the time of the initial sale, an ongoing payment based on a percentage of assets that continue to be invested in the mutual fund. Preferential marketing can include more frequent recommendations, including the funds on a preferred list, and naming them on the brokerage firm's website.

Revenue sharing can be a major component of a brokerage firm's overall income, although most brokers do not disclose the precise dollar amounts they receive. Edward Jones's disclosure in connection with the settlement of an SEC enforcement action is an indication of the magnitude of revenue sharing.[250] Edward Jones disclosed income from revenue sharing, for the year ending December 31, 2009, of $94.2 million.[251] Its total net income for the same period was $164.3 million.[252]

If the economic incentive to recommend funds that engage in revenue sharing was not sufficient, some brokers explicitly exclude fund families that do not participate in revenue sharing from accessing their registered representatives and promoting their funds. As

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[247] *See* Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 54,165, 71 Fed. Reg. 41,978, 41,978 (July 24, 2006) (recognizing and interpreting the scope of the safe harbor for fund managers under the Securities Exchange Act of 1934, § 28(e), 15 U.S.C. § 78bb(e)). *But cf.* D. Bruce Johnsen, *The SEC's* 2006 Soft Dollar Guidance*: Law and Economics*, 30 CARDOZO L. REV. 1545, 1548 (2009) (describing the SEC's guidance as "a laundry list of legally arbitrary and economically irrelevant formalisms").

[248] Previously, mutual funds also compensated brokers for preferential treatment through directed brokerage, which involved a mutual fund directing its trades (and the resulting commissions) to a brokerage in exchange for preferred marketing. *See, e.g.*, Spill, *supra* note 246, at 52 (describing directed brokerage as a "polic[y] and procedure[] . . . structured to benefit the adviser instead of the shareholder"). In 2004, the SEC amended Rule 12b-1 under the ICA to prohibit directed brokerage. 17 C.F.R. § 270.12b-1(h)(1) (2009).

[249] People v. Edward D. Jones & Co., 65 Cal. Rptr. 3d 130, 133 (Cal. Ct. App. 2007) (alteration in original) (internal quotation marks omitted).

[250] *See* Press Release, SEC, Edward Jones to Pay $75 Million to Settle Revenue Sharing Charges (Dec. 22, 2004), *available at* http://www.sec.gov/news/press/2004-177.htm.

[251] Edward Jones, Disclosure Information, http://www.edwardjones.com/en_US/disclosures/rev_sharing/disclosure_information/index.html (last visited Apr. 15, 2010).

[252] *Id.*

Morgan Stanley explains, "Fund families that do not remit revenue-sharing payments typically will not be provided such access [to branch offices and advisors] and will not participate in or receive other promotional support."[253]

Empirical evidence suggests that brokers' monetary incentives—rather than fund costs or performance—drive recommendations. Studies show that brokers direct most investment dollars into higher-cost load funds[254] and that "broker-dealers typically market load funds to their less sophisticated customers."[255] Studies find that broker-directed mutual fund investments result in lower returns to investors than funds acquired through direct purchases. Daniel Bergstresser et al., for example, find that "[f]unds sold by brokers underperform those sold through the direct channel, even when returns are calculated on a pre-distribution-fee basis."[256] They also find "no evidence that, in aggregate, brokers provide superior asset allocation advice that helps their investors time the market."[257]

Research also shows that broker-directed load funds have higher operating expenses.[258] This result extends even to index funds that do not attempt to beat the market or to differentiate themselves based on the stock-picking talent of portfolio managers.[259] Thus, the broker role in selling mutual funds to retail investors offers a convincing explanation, by itself, of why market forces may not operate to control fees or to select efficient or high performing funds. Broker intermediation operates in direct opposition to the disciplinary capacity of

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[253] Morgan Stanley Smith Barney, Mutual Funds: Revenue Sharing Fund Families, http://www.smithbarney.com/products_services/mutual_funds/investor_information/revenueshare.html (last visited Apr. 15, 2010).

[254] *See* Daniel Bergstresser et al., *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry*, 22 REV. FIN. STUD. 4129, 4153 (2009) (reporting that broker clients pay loads that are as much as 417 basis points higher than those that direct purchasers pay).

[255] Barbara Black, *Are Retail Investors Better Off Today?*, 2 BROOK. J. CORP. FIN. & COM. L. 303, 328 (2008).

[256] Bergstresser et al., *supra* note 254, at 4140.

[257] *Id.* at 4146.

[258] *See, e.g.*, Todd Houge & Jay Wellman, *The Use and Abuse of Mutual Fund Expenses*, 70 J. BUS. ETHICS 23, 24 (2007) (arguing that load fund investors pay higher operating expenses for having funds "marketed to them" with no corresponding increase in quality).

[259] *See id.* at 27-28 (finding that no-load index funds had an average expense ratio of nineteen basis points, compared to fifty-five basis points for load funds); *see also* Mercer Bullard & Edward S. O'Neal, The Costs of Using a Broker to Select Mutual Funds 2 (Nov. 30, 2006) (unpublished manuscript), *available at* http://www.zeroalphagroup.com/studies/113006_Zero_Alpha_Group_Fund_Democracy_Index_Funds_Report.pdf (finding that brokers directed investors into load index funds that had higher operating expenses than no-load funds, before counting brokers' fees).

market forces. The role of the broker is particularly troubling in light of the fact that the least-informed investors may rely on brokers due to their inability to sort and select mutual fund investments directly. Moreover, the role of brokers may explain, in part, the unusually high level of management fees paid by investors in Canadian mutual funds—eighty-five percent of those funds are sold through a financial advisor rather than through direct marketing.[260]

The SEC has apparently recognized the potential conflict of interest implicated by revenue sharing, but its response has been minimalist. In its most recent amendments to the prospectus disclosure requirements, the SEC adopted a requirement that mutual funds disclose that they may compensate brokers for the sale of fund shares and that this compensation may create a conflict of interest.[261] Funds are not required to disclose the amount or structure of this compensation. In defending the rule, the SEC stated that it was sufficient to put investors on notice of the potential conflict.[262]

When investors purchase mutual funds through 401(k) plans, the agency costs and conflicts of interest are similar. Under ERISA section 404(c), employees in a 401(k) plan choose their investments, but they are limited in that choice to the investment alternatives offered by the plan. These alternatives are selected by the plan provider. Importantly, although plans may offer employees different types of funds, they do not typically offer multiple funds with the same investment strategy.[263] Thus, a plan may offer investors a choice between a

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[260] E-mail from Joanne De Laurentiis, President & CEO, The Inv. Funds Inst. of Canada, to Peter Tufano, Professor of Fin. Mgmt., Harvard Bus. Sch., et al. (Oct. 27, 2006), *available at* http://randsco.com/_img/blog/0702/ific_response.pdf.

[261] The SEC's specific language is:

> If you purchase the Fund through a broker-dealer or other financial intermediary (such as a bank), the Fund and its related companies may pay the intermediary for the sale of Fund shares and related services. These payments may create a conflict of interest by influencing the broker-dealer or other intermediary and your salesperson to recommend the Fund over another investment. Ask your salesperson or visit your financial intermediary's Web site for more information.

Summary Prospectus Rule, *supra* note 32, at 4557.

[262] *See id.* at 4558 ("[W]e are adopting a statement that will alert investors generally to the payment of compensation and the potential conflicts arising from that payment. An investor could then obtain further detail from his or her salesperson or the intermediary's Web site.").

[263] Some plans offer participants substantially broader choices by including a brokerage window as an investment option. Through that window, investors can purchase stocks and mutual funds directly, as with a standard brokerage account.

money market fund, an equity index fund, and various domestic and international actively managed funds. An investor who prefers an index fund, however, is limited to the provider's choice of fund. As a result, plan participants are limited to choosing among fund types and, within a given category, cannot choose the lowest-cost alternative.

Fees charged by mutual funds in 401(k) plans vary tremendously.[264] According to a recent Deloitte survey, the average "all-in" fee was 0.93% of assets per year,[265] which is slightly less than the average mutual fund expense ratio.[266] The sampling methodology in the Deloitte study has been criticized, however, and some commentators argue that fees as high as 3% are common.[267] Fees at small firms tend to be much higher; the Deloitte study found that plans with fewer than 100 participants pay an average of 2.03% of the plans' assets in annual fees.[268]

401(k) plans introduce an additional layer of revenue sharing because of the role of the plan provider or trustee. It is common practice for the mutual funds selected for inclusion in a 401(k) plan to share a portion of the revenues they collect from plan participants with the plan provider.[269] In turn, the plan provider may reduce the administrative expenses charged to the plan. As a result, the employees bear the costs of running the plan but pay those costs indirect-

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[264] *See, e.g.*, Anne Tergesen, *Does Your 401(k) Cost Too Much?*, BUSINESSWEEK.COM, June 7, 2004, http://www.businessweek.com/magazine/content/04_23/b3886145.htm (reporting that in 2004, plan fees ran as high as three percent); Press Release, Inv. Co. Inst., A Number of Factors Impact Retirement Plan Fees, ICI-Deloitte Study Finds Plan Size, Contribution Rates, and Auto Enroll Associated with Lower Fees (Apr. 14, 2009), *available at* http://www.ici.org/pressroom/news/09_news_dc_401k_fee_study (reporting that, among 130 plans studied, the median fee "was 0.72 percent of assets, within a range from 0.35 percent (the 10th percentile) to 1.72 percent (the 90th percentile) of assets").

[265] DELOITTE, DEFINED CONTRIBUTION/401(K) FEE STUDY 18 (2009), *available at* http://www.ici.org/pdf/rpt_09_dc_401k_fee_study.pdf.

[266] Significantly, neither the average mutual fund expense ratio nor the all-in fee in the Deloitte study includes trading costs. *See id.* at 16 (describing components of the all-in fee).

[267] *See* Posting of Ryan Alfred to Bright Scope Blog, Reconciling the 401k Fee Estimates of the ICI and Its Critics, http://www.brightscope.com/blog/2009/05/13/reconciling-the-401k-fee-estimates-of-the-ici-and-its-critics/ (May 13, 2009, 18:23 EST) (identifying sampling problems in Deloitte study).

[268] DELOITTE, *supra* note 265, at 20; *see also* Spors, *supra* note 144 (reporting on possible legislation to respond to high fees for small 401(k) plans).

[269] *See, e.g.*, Lynn O'Shaughnessy, *A 401(k) Picks a Mutual Fund. Who Gets a Perk?*, N.Y. TIMES, Feb. 15, 2004, at BU5 (citing Michael Weddell, a retirement consultant at Watson Wyatt Worldwide, as stating that 90% of 401(k) plans engage in revenue sharing); *see also* Braden v. Wal-Mart Stores, 588 F.3d 585, 590 (8th Cir. 2009) (explaining that a trust agreement between the employer and the plan trustee required them to keep the amounts of the revenue sharing payments confidential).

ly through the fees charged to them by the participating mutual funds. In many cases, neither plan participants nor the employer itself know the amount of revenue sharing that occurs.[270]

As with broker-directed mutual fund sales, revenue sharing in 401(k) plans creates two problems. First, the hidden nature of the payments may mislead participants to believe that their investment costs are lower than they actually are. Second, and more problematic, the potential for compensation may influence the plan provider's selection of investment alternatives. As the *Wall Street Journal* put it, "At issue . . . is whether companies managing the plans are receiving payments in return for including certain fund companies in their plans."[271] Such payments might cause employers to include inferior funds in their plans and to spurn strong performers that do not engage in revenue sharing. According to press reports, for example, fund administrators have refused to include Vanguard funds in their plans upon learning that Vanguard "won't pay to play."[272]

The importance of fund selection in retirement plans is heightened because it can influence investor decisions outside of the plans. Studies suggest that mutual fund investors demonstrate brand loyalty and will purchase multiple funds from a single fund family.[273] Moreover, a majority of households purchase their first mutual fund through an employer-sponsored retirement plan.[274] As a result, their employers' selection of plan options is likely to influence their subsequent investment decisions.

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[270] *See, e.g.*, Tom Lauricella, *Spitzer Aims at Another Mark: Fee Disclosure*, WALL ST. J., Oct. 10, 2006, at C1 (explaining that employers and plan participants are often "kept in the dark" as to the exact amount of revenue sharing).

[271] *Id.*

[272] Editorial, *The Benefits Aren't Mutual*, STAR-NEWS (Wilmington, N.C.) Feb. 22, 2004, at 6E, *available at* 2004 WLNR 17445525. Vanguard seems to have overcome this problem by becoming one of the largest 401(k) plan administrators. *See, e.g.*, Ross Kerber, *More Dip Early into Funds for Retirement*, BOSTON GLOBE, June 6, 2008, at 1A, *available at* 2008 WLNR 10690503 (describing Fidelity Investments, CitiStreet, and Vanguard as the three largest administrators of 401(k) plans).

[273] *See* Nanda, *supra* note 238, at 668-69 (explaining how star funds attract new money growth for fund families). Investing in a single family is likely to be a poor strategy. *See* Edwin J. Elton et al., *The Impact of Mutual Fund Family Membership on Investor Risk*, 42 J. FIN & QUANT. ANALYSIS 257, 274-75 (2007) (finding that funds within a single fund family have a higher correlation than funds selected from different families, thereby exposing investors to higher risk).

[274] *See Characteristics of Mutual Fund Investors, 2009*, RES. FUNDAMENTALS (Inv. Co. Inst., Washington, D.C.), Dec. 2009, at 9, *available at* http://www.ici.org/pdf/fm-v18n8.pdf (stating that sixty-two percent of mutual fund–holding households purchased their first fund through an employer-sponsored retirement plan).

Therefore, the conflicts and incentives faced by selling agents—including brokers, financial advisors, and 401(k) plan sponsors—have the potential to influence their investment choices, and empirical data suggest that these conflicts impact investor welfare. Selling agents face limited accountability, however, for their choices and recommendations.

Regulators have engaged in some enforcement of broker suitability obligations in the mutual fund context. FINRA has brought several enforcement actions focusing on broker recommendations of inappropriate share classes.[275] FINRA has also fined several brokers for shelf-space violations.[276] The New York State Attorney General's Office and the SEC have also investigated specific instances of revenue-sharing in an effort to determine whether the practice has crossed the line and turned into the payment of kickbacks.[277]

Private litigation has had limited success. Courts have generally held, for example, that retail brokers are not fiduciaries for their customers unless they possess investment discretion.[278] Indeed, when Congress passed the Investment Advisers Act, it explicitly exempted brokers, despite the knowledge that brokers might have business interests or conflicts of interest that could bias their recommendations.[279]

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[275] *See, e.g.*, Press Release, FINRA, FINRA Fines Banorte Securities International $1.1 Million for Improper Sales of Class B Mutual Fund Shares (Oct. 16, 2008), *available at* http://www.finra.org/Newsroom/Newsreleases/2008/P117233 (reporting settlement of FINRA enforcement action involving sales of inappropriate share class); Press Release, FINRA, NASD Files Enforcement Actions Involving Unsuitable Sales of Mutual Funds (Aug. 12, 2003), *available at* http://www.finra.org/Newsroom/Newsreleases/2003/p002885 (announcing that the National Association of Securities Dealers (NASD), later consolidated into FINRA, brought enforcement actions based on brokers' recommendations of unsuitable class B shares).

[276] *See* Thomas Derpinghaus, *Two Brokerage Firms Will Pay Fines*, WALL ST. J., Feb. 23, 2005, at C19 (reporting that the NASD fined two brokers "for giving preferred sales treatment to mutual funds in exchange for brokerage commissions and other payments").

[277] *See, e.g.*, Phyllis Feinberg, *SEC's Investigation Shines Light on DC Fee Practices*, PENSIONS & INVESTMENTS, July 12, 2004, at 4 (describing the SEC's request to mutual funds for "detailed answers about how revenue-sharing fees are structured"); Anne Kates Smith, *Shedding Light on 401(k) Fees*, KIPLINGER'S PERS. FIN., Feb. 2007, at 19 (observing that "[s]ome forms of revenue sharing bear an unsettling similarity to kickbacks" and describing regulatory concerns).

[278] *See* Jill E. Fisch, *Fiduciary Duties and the Analyst Scandals*, 58 ALA. L. REV. 1083, 1094-95 (2007) (citing authority for this determination); *cf.* O'Malley v. Boris, 742 A.2d 845, 849 (Del. 1999) ("[B]rokers must act in the customer's best interests and must refrain from self-dealing unless the customer consents, after full disclosure.").

[279] *See* Fisch, *supra* note 278, at 1094 (noting that when the exemption was created, brokers "were known to provide . . . 'brokerage house advice'"). Pending legislation would explicitly establish a fiduciary duty for brokers, akin to that of investment advi-

Instead, customers alleging broker misconduct or conflicts of interest must generally rely on the rules of the self-regulatory organizations (SROs). The suitability requirement[280] and the know-your-customer rule[281] obligate brokers to recommend only investments that are suitable in light of their customers' investment objectives.[282] Private enforcement of these rules is problematic. Most courts have dismissed suitability claims, at least to the extent that they do not plead fraud, holding that investors lack a private right of action under SRO rules.[283] In addition, claims by retail investors against their brokers are typically subject to FINRA-controlled arbitration pursuant to the standard terms of retail brokerage agreements.[284] Although arbitration proceedings may, in some cases, allow investors to recover, the arbitration process has been challenged as unprincipled, arbitrary, and biased against the customer.[285] Moreover, most arbitrations are resolved in secret.[286] Judicial review, even of published awards, is "severely limited."[287]

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sors. *See* The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009).

[280] FINRA Rule 2310, the suitability rule, permits brokers "to recommend a securities transaction to a customer *only* if the recommendation suits the customer's investment portfolio, financial situation and needs." *See* FINRA, BrokerCheck FAQ, http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/P015174 (last visited Apr. 15, 2010).

[281] New York Stock Exchange Rule 405 requires brokers to "[u]se due diligence to learn the essential facts relative to every customer." NYSE Rule 405(1), N.Y.S.E. Guide (CCH) ¶ 2405 (2002).

[282] *See generally* Bradley J. Bondi, *Securities Arbitrations Involving Mortgage-Backed Securities and Collateralized Mortgage Obligations: Suitable for Unsuitability Claims?*, 14 FORDHAM J. CORP. & FIN. L. 251 (2009) (exploring these obligations).

[283] *See, e.g.*, Hoxworth v. Blinder, Robinson & Co., 903 F.2d 186, 200 (3d Cir. 1990) ("NASD regulations do not give rise to a private right of action."); Jablon v. Dean Witter & Co., 614 F.2d 677, 681 (9th Cir. 1980) (finding no private right of action under either the suitability rule or the know-your-customer-rule).

[284] *See, e.g.*, Stephen Choi, Jill Fisch & A.C. Pritchard, *Attorneys as Arbitrators*, 39 J. LEGAL STUD. 109, 112-16 (2010) (describing arbitration provisions in customer agreements).

[285] *See, e.g.*, Bondi, *supra* note 282, at 268 (describing arbitrators as applying a "flexible" standard); Choi, Fisch & Pritchard, *supra* note 284, at 116-19 (summarizing claims of arbitrator bias); Dan Solin, *FINRA: A Wily Fox Guarding Your Nest Egg*, HUFFINGTON POST, Dec. 29, 2009, http://www.huffingtonpost.com/dan-solin/finra-a-wily-fox-guarding_b_403552.html (describing FINRA as a "shill for the securities industry").

[286] Choi, Fisch & Prichard, *supra* note 284, at 116 (observing that seventy to eighty percent of arbitration claims are settled or resolved through means other than an arbitrator decision and noting that no public information is available on these claims).

[287] *See* Bondi, *supra* note 282, at 269 (explaining that most arbitration decisions are unpublished and "under the Federal Arbitration Act, a court generally may not vacate

Apart from procedural impediments, private litigation suffers from a more general problem—the difficulty of establishing that a broker recommendation of a specific mutual fund is unsuitable. Although as a general matter, suitability claims by brokerage customers are common,[288] they are typically filed for complex and high-risk investments such as collateralized mortgage obligations and credit default swaps. Mutual funds are, by contrast, diversified, low cost, and relatively safe, which is why regulators and commentators have identified them as suitable investments for retail investors. Absent outright fraud, it is difficult for an investor to demonstrate lack of suitability simply by demonstrating that an alternative fund has lower fees or historically higher returns. Even when a broker's recommendation is both inappropriate and based on personal financial incentives, an investor must establish a causal connection between the conflicts of interest and the investor's loss.[289] Finally, courts are unlikely to impose liability, even where an investor relies on a broker, if the investor could have ascertained the relevant information from fund disclosures.[290]

Recent litigation involving 401(k) plans illustrates these problems. Plan participants have brought a number of lawsuits alleging that revenue sharing and other conflicts of interest have led employers and plan providers to offer inappropriate investment choices, rather than lower-cost and better-performing alternatives.[291] Plaintiffs claim that because of these arrangements, they have paid excessive fees and received inferior returns on their contributions. To date, plaintiffs have not succeeded at establishing a breach of fiduciary duty based on

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an arbitration award because the arbitrator made erroneous findings of fact or misapplied the law").

[288] *Id.* at 257 (reporting that in 1998, ninety-five percent of broker liability insurance filings were based on suitability claims).

[289] *See, e.g.*, Castillo v. Dean Witter Discover & Co., No. 97-1272, 1998 U.S. Dist. LEXIS 9489, at *13-20 (S.D.N.Y. June 25, 1998) (dismissing a claim that, because of financial incentives, a broker pushed certain in-house mutual funds "regardless of suitability, market conditions, or customer need" because the plaintiff had not alleged a causal connection between these recommendations and subsequent losses).

[290] *See, e.g.*, DeBenedictis v. Merrill Lynch & Co., 492 F.3d 209, 216 (3d Cir. 2007) (rejecting a suit alleging that a broker recommended an inappropriate share class due to a conflict of interest on the basis that "investors could calculate on their own whether one class of shares [was] more economically attractive than another").

[291] *See, e.g.*, Hecker v. Deere & Co., 556 F.3d 575, 578 (7th Cir. 2009) (claiming that defendants provided poor investment options and failed to disclose the plan's fee structure); Taylor v. United Techs. Corp., No. 06-1494, 2009 U.S. Dist. LEXIS 19059, at *30-35 (D. Conn. Mar. 3, 2009), *aff'd*, No. 09-1343, 2009 U.S. App. LEXIS 26068 (2d Cir. Dec. 1, 2009) (claiming that the plan offered mutual funds with unreasonably high fees and expenses and paid excessive compensation to its recordkeeper).

these allegations.[292] The court's decision in *Hecker v. Deere* is typical. In addition to rejecting claims that Fidelity Trust (the plan trustee) and Fidelity Research (the advisor to the funds in the 401(k) plan) owed fiduciary duties to the plan beneficiaries,[293] the court concluded that the plan's selection of twenty mutual funds could not be improper where plaintiffs had the option of selecting alternative funds through a brokerage link.[294]

A recent decision by the Eighth Circuit offers plaintiffs some hope. In *Braden v. Wal-Mart Stores, Inc.*, the court concluded that the plaintiff's allegations[295]—which it described as amounting to an assertion that the $9.5 billion Wal-Mart 401(k) plan[296] offered a limited menu of inferior investment options that "were chosen to benefit the trustee at the expense of the participants"[297]—were sufficient to state a claim for breach of fiduciary duty.[298] Specifically, the court stated that the allegations, if substantiated, could show that "the process by which appellees selected and managed the funds in the Plan would have been tainted by failure of effort, competence, or loyalty."[299]

Even if plaintiffs succeed in some of these cases, it is unlikely that litigation will have a significant impact on plan policies. As with other claims of mismanagement, any claim of improper fund selection is likely to be effectively rebutted by a showing that the defendants engaged in a diligent process—meaning that they received and evaluated

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292 Recently, however, Caterpillar announced that it had settled a lawsuit challenging the fees in its 401(k) plan for $16.5 million. *See* Emily Lambert, *Caterpillar Suit Could Lower 401(k) Fees*, FORBES.COM, Nov. 11, 2009, http://www.forbes.com/2009/11/11/caterpillar-pension-lawsuit-personal-finance-retirement-plan.html (suggesting settlement may "set a precedent for other companies to follow").

293 *Hecker*, 556 F.3d at 584.

294 *Id.* at 581.

295 The plaintiff alleged that the plan offered employees a small group of investment options that charged unreasonably high fees and expenses and fell short of the indices that they were designed to track. Braden v. Wal-Mart Stores, Inc., 588 F.3d 585, 590 (8th Cir. 2009). The plaintiff alleged that the defendants imprudently offered only retail-class mutual fund shares despite the fact that, because of the size of Wal-Mart's 401(k) plan, they had access to lower cost alternative investment options. *Id.* Finally, the complaint alleged that the funds included in the Plan made revenue-sharing payments to the trustee, Merrill Lynch, and that these payments were not made in exchange for services rendered, but rather were a quid pro quo for inclusion in the Plan. *Id.*

296 Mark Bruno, *Wal-Mart Suit Hits 401(k) Fees*, FINANCIALWEEK.COM, Apr. 28, 2008, http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080428/REG/156632963/1028.

297 *Braden*, 588 F.3d at 596.

298 *Id.* at 591.

299 *Id.*

appropriate information concerning the plan's investment options.[300] In addition, to show damage, plaintiffs must be able to demonstrate that the plan's offerings were clearly inferior and that a causal relationship exists between plan deficiencies and an actual investment loss. The methodological challenges identified above will impede these showings. Absent the imposition of more rigorous obligations on plan providers in connection with the selection of plan options, the agency costs inherent in the 401(k) structure are likely to persist.

III. LIMITATIONS OF THE EXISTING REGULATORY STRUCTURE

The mutual fund market is characterized by extensive regulatory intervention, but it is unclear that this regulation is effective in improving market discipline and protecting investors. This Part identifies critical limitations in the effectiveness of the existing regulatory structure—in particular the corporate governance and disclosure requirements—in meeting these objectives.

A. *Corporate Governance*

As described in Part I, the ICA regulates mutual funds in a manner similar to the regulation of operating companies. The statute requires mutual funds to use traditional corporate governance mechanisms, including shareholder voting and oversight by a board of directors. The board is required to monitor the investment advisor—similar to the way an operating company's board monitors the CEO—and to review potential conflicts of interest, such as the investment advisor's execution obligations and use of soft dollars.[301] Importantly, the SEC has established a variety of exemptive rules that permit mutual funds to engage in otherwise prohibited transactions subject to the approval of the board or, in some cases, the independent directors.[302] The board is also responsible for approving the investment ad-

[300] *See* Taylor v. United Techs. Corp., No. 06-1494, 2009 U.S. Dist. LEXIS 19059, at *28 (D. Conn. Mar. 3, 2009) ("[T]he undisputed facts detail the evaluation and analytical process or 'appropriate consideration' by which UTC selected the mutual funds.").

[301] *See, e.g.*, Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices, Securities Exchange Act Release No. 58,264, Investment Company Act Release No. 28,345, Investment Advisers Act Release No. 2763, 73 Fed. Reg. 45,646, 45,649-56 (proposed Aug. 6, 2008) (proposing guidance for fund directors in overseeing investment advisors' use of soft dollars).

[302] *See, e.g.*, Role of Independent Directors of Investment Companies, Securities Act Release No. 7932, Exchange Act Release No. 43,786, Investment Company Act Release

visor's compensation. The ICA imposes fiduciary duties on the directors in performing these obligations.[303] In addition, mutual fund shareholders, like shareholders of operating companies, exercise voting rights. Specifically, the shareholders elect the directors. Shareholders must also approve major structural changes, such as the conversion of a fund from open-end to closed-end (or vice versa), a change in the fund's concentration classification or other investment objectives, and material changes in the advisory contract.

The utility of applying these corporate governance mechanisms to the mutual fund context is unclear. Many commentators have argued that the mutual fund board is worthless because it has no effective power over the investment advisor.[304] In an operating company, the board's power to monitor management is premised on the board's statutory authority to hire and fire the CEO and other executives.[305] In recent years, boards have increasingly exercised this power to remove underperforming CEOs. Although mutual fund directors can, in theory, terminate the advisory contract pursuant to their authority under the ICA, such a decision is of little practical value because it effectively terminates the fund.[306] The advisor provides all the operational components of the mutual fund; without it, the fund is simply a pool of assets. The absence of an effective mechanism for influencing

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No. 24,816, 66 Fed. Reg. 3734 (Jan. 16, 2001) (codified at C.F.R. pts. 239, 240, 270, 274) (amending exemptive rules in a manner designed to increase fund directors' independence and efficacy).

[303] Commentators have criticized the SEC for failing to enforce these fiduciary duties adequately. *See, e.g.*, H. Norman Knickle, *The Investment Company Act of 1940: SEC Enforcement and Private Actions*, 23 ANN. REV. BANKING & FIN. L. 777, 792 (2004) ("[T]he Commission has not frequently filed 1940 Act charges against fund directors, advisers, and officers for breach of fiduciary duties . . . ."); *see also In re* Hammes, Securities Act Release No. 8346A, Investment Company Act Release No. 26290A, (Jan. 7, 2004) (Campos, Comm'r, dissenting), *available at* http://www.sec.gov/litigation/admin/33-8346a.htm (criticizing an SEC settlement for failing to impose adequate sanctions on outside directors).

[304] *See, e.g.*, William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401, 1448-51 (2006) (describing the lack of board power over investment advisors and portfolio managers); Caroline J. Dillon, Note, *Do You Get What You Pay For? A Look at the High Fees and Low Protections of Mutual Funds*, 2006 COLUM. BUS. L. REV. 281, 288 (2006) ("[T]he board's negotiating power is so limited that the investment adviser essentially can dictate the terms of the [advisory] agreement.").

[305] *See* Birdthistle, *supra* note 304, at 1449 (noting that, although firing a CEO is difficult, it is far easier than terminating an advisory contract).

[306] *See* Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923, 928 (2d Cir. 1982) ("[A] mutual fund cannot, as a practical matter sever its relationship with the adviser." (quoting S. REP. NO. 91-184 (1970), *reprinted in* 1970 U.S.C.C.A.N. 4870, 4901)).

the advisor's behavior imposes a critical limit on a director's ability to act as an effective fiduciary.[307]

Commentators have also questioned the ICA requirement that the independent fund directors approve advisory fees. Wallison and Litan make perhaps the strongest case, arguing that this requirement displaces market forces and produces a form of rate regulation analogous to public utilities' rate-setting process.[308] As they explain, boards see their role as limiting the size of the advisor's profit[309] and, consequently, perform a type of cost-plus analysis in which they judge the size of the management fee by reference to the fund's administrative costs. This "utility-like" process, they argue, "reduces or eliminates the incentive of an adviser to reduce its costs."[310] Wallison and Litan also evaluate the board's role in addressing conflicts of interest and argue that a trustee-custodian could perform this monitoring equally well and more cost-effectively.[311]

Despite these concerns, other commentators argue that the mutual fund board has value. Donald Langevoort argues that the board offers at least the potential for a measure of fiduciary obligation as a counterweight to the market pressures felt by mutual fund managers and sponsoring firms.[312] Empirical research is even more positive,[313] identifying correlations between board independence and board effectiveness.[314] Studies have found, for example, that boards with more

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[307] *See, e.g.*, Langevoort, *supra* note 156, at 1041 ("Whatever the merits of the debate in corporate law generally, the influences in the mutual fund marketplace are too weak simply to presume that directors will act as faithful fiduciaries in the strong, legal sense of the term.").

[308] WALLISON & LITAN, *supra* note 165, at 77.

[309] Wallison and Litan explain that this approach is required by the Second Circuit's decision in *Gartenberg*, which precludes boards from relying on comparisons with the fees charged by other advisors. *Id.* To be fair, it is not clear that *Gartenberg* goes this far; it simply holds that a board cannot rely on "prevailing industry advisory fees." *Gartenberg*, 694 F.2d at 929.

[310] WALLISON & LITAN, *supra* note 165, at 80.

[311] *Id.* at 107-16.

[312] *See* Langevoort, *supra* note 156, at 1040 ("One can have relatively moderate expectations for the performance of disinterested directors and still believe that the strategy adds *some* value, and there is a body of evidence to support this.").

[313] Not all the studies find evidence that independence is valuable. *See, e.g.*, Stephen P. Ferris & Xuemin (Sterling) Yan, *Do Independent Directors and Chairmen Matter? The Role of Boards of Directors in Mutual Fund Governance*, 13 J. CORP. FIN. 392, 393 (2007) (finding no evidence that an independent board or an independent chair correlates with the probability of a fund scandal or superior fund performance).

[314] *See generally* Memorandum from Chester Spatt, Chief Economist, Office of Econ. Analysis, SEC, to Inv. Co. File S7-03-04, Literature Review on Independent Mutual Fund Chairs and Directors (Dec. 29, 2006), *available at* http://www.sec.gov/rules/

independent directors tend to negotiate lower fees,[315] merge underperforming funds more quickly,[316] and are more likely to remove fund managers who have performed poorly.[317] Camelia Kuhnen constructs a more rigorous measure of independence using business connections between directors and fund advisors and finds that these business connections are positive predictors of expense ratios and advisory fees.[318]

A significant limitation of the empirical literature is its inability to determine causation.[319] Rather than causing better performance or operations, an independent board may be the result of a fund advisor or a fund family's commitment to best operational practices and good governance. An independent board may signal that the fund family is attentive to its fiduciary obligations and seeks to minimize conflicts of interest. It may also operate as a bonding or commitment device in that, once an advisor has selected the initial independent directors, those directors, and not the advisor, will choose the subsequent independent directors. Under this view, independent directors may well be attentive and vigilant, but it is the advisor's willingness to subject itself to this oversight, and not the oversight itself, that accounts for the empirical results.

It is also worth noting that some of the empirical results identified above are consistent with the interests of the advisory firm itself, if not the individual portfolio manager. An advisory firm does not wish to suffer the outflows that may result from an underperforming fund, nor does it want the fund family to suffer possible damage to its repu-

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proposed/s70304/oeamemo122906-litreview.pdf (summarizing the empirical literature on board effectiveness).

[315] *See, e.g.*, Peter Tufano & Matthew Sevick, *Board Structure and Fee-Setting in the U.S. Mutual Fund Industry*, 46 J. FIN. ECON. 321, 323 (1997) ("[L]ower fees are charged by funds whose boards are smaller, whose boards have a larger proportion of independent members, and whose board members sit on a larger fraction of other boards for the same sponsor.").

[316] *See* Ajay Khorana et al., *Board Structure, Mergers and Shareholder Wealth: A Study of the Mutual Fund Industry*, 85 J. FIN. ECON. 571, 573 (2007) ("[F]und mergers . . . are significantly more likely when the target underperforms *and* its board is composed primarily of independent directors . . . .").

[317] *See* Bill Ding & Russ Wermers, Mutual Fund Performance and Governance Structure 25 (Dec. 9, 2005) (unpublished manuscript), *available at* http://ssrn.com/abstract=687273 ("For . . . underperforming funds, it appears that the number of independent directors, proxied by the total number of directors, is the most important predictor of replacement . . . .").

[318] Camelia M. Kuhnen, *Business Networks, Corporate Governance and Contracting in the Mutual Fund Industry*, 64 J. FIN. 2185, 2186-89 (2009).

[319] *See* Spatt, *supra* note 314, at 12-18 (identifying other problems with empirical methodology in these studies).

tation from a poor performer. Merging the fund or replacing the portfolio manager does not discipline the advisory firm, but rather benefits it. Indeed, it is unclear why fund families of any significant size would require board action to replace a poorly performing portfolio manager—the only funds for which replacement is unlikely are those in which the portfolio managers are sufficiently powerful within the advisory firm itself. This explanation is consistent with the finding that fund outflows were more likely to lead to the replacement of the portfolio manager.[320]

The rationale for providing mutual fund shareholders with voting rights is even less compelling. The high percentage of small retail investors[321] magnifies the traditional constraints on voting as an effective corporate governance mechanism: collective action problems and rational apathy. The significance of these constraints is also increased by the opportunity for shareholders to exit readily at NAV. That these constraints are, in fact, operating is evidenced by the low percentage of mutual fund shares that are voted by their beneficial owners. As the Investment Company Institute noted in a 2005 report, only thirty-two percent of mutual fund shares held in street name were voted by beneficial owners.[322] Commentators have observed that mutual funds must engage in frequent and costly resolicitations because of their regular inability to obtain a quorum.[323] Soliciting the proxies of mutual fund investors is costly and investors ultimately bear the cost through increased expense ratios.

Because of the cost of proxy solicitation, most mutual funds do not even hold regular annual meetings. Many do not hold meetings at all unless there is an issue for which shareholder approval is required.[324] The absence of regular annual meetings highlights the in-

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[320] *See* Ding & Wermers, *supra* note 317, at 4 ("[F]unds with outflows are more likely to replace underperforming managers.").

[321] Self-Regulatory Organizations, Exchange Act Release No. 60,215, 74 Fed. Reg. 33,293, 33,303 (July 10, 2009) (describing mutual funds as having a "disproportionately large retail shareholder base").

[322] INV. CO. INST., COSTS OF ELIMINATING DISCRETIONARY BROKER VOTING ON UNCONTESTED ELECTIONS OF INVESTMENT COMPANY DIRECTORS 6 (2006), *available at* http://www.ici.org/pdf/wht_broker_voting.pdf.

[323] *See, e.g.*, Richard M. Phillips, *Deregulation Under the Investment Company Act—A Reevaluation of the Corporate Paraphernalia of Shareholder Voting and Boards of Directors*, 37 BUS. LAW. 903, 908-09 (1982) (describing the problematic need for frequent and costly resolicitations).

[324] *See* Letter from Jennifer S. Taub, Lecturer & Coordinator of the Bus. Law Program, Isenberg Sch. of Mgmt., Univ. of Mass., Amherst, to Elizabeth M. Murphy, Sec'y,

significance of shareholder voting rights. Indeed, in its recent approval of the New York Stock Exchange's elimination of discretionary broker voting for uncontested director elections, the SEC authorized an exemption for investment company elections.[325] Consequently, even when a mutual fund holds a meeting to elect directors, the result is largely the product of broker votes. Given the financial ties between brokers and mutual funds, this practice effectively ensures approval of any proposed director candidates.

Unlike operating companies, mutual funds do not offer the potential for increased voting power in the event of a control contest. There is no takeover market for mutual funds because there is no economic justification for paying a premium for shares that trade at NAV. Similarly, the absence of arbitrage opportunities prevents hedge funds and other activist shareholders from engaging in proxy contests.[326]

The SEC has specifically described the ICA as preserving "shareholder participation in key decisions."[327] Yet in reality, apart from the toothless power to elect directors, mutual fund shareholder voting power is generally limited to approving significant changes in investment policy[328] and material changes in the advisory contract.[329] Although the SEC has interpreted the scope of the statute broadly—requiring fund sponsors to take many issues to the shareholders[330]—as a practical matter, shareholder voting on these issues is unimportant, given shareholder power to exit a fund at NAV upon an announced change in investment policy. At its best, shareholder voting with re-

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SEC (Aug. 13, 2009), *available at* http://www.sec.gov/comments/s7-10-09/s71009-127.pdf (describing the infrequency of shareholder meetings).

[325] *See* Self-Regulatory Organizations, 74 Fed. Reg. at 33,303.

[326] *See, e.g.*, Donald C. Langevoort, *The SEC as a Lawmaker: Choices About Investor Protection in the Face of Uncertainty*, 84 WASH. U. L.R. 1591, 1617 (2006) (identifying the absence of arbitrage opportunities in the mutual fund market).

[327] Self-Regulatory Organizations, 74 Fed. Reg. at 33,303.

[328] These include changing the fund's concentration policy, borrowing money, and ceasing to be an investment company. 15 U.S.C. § 80a-13(a) (2006). In addition, mutual funds must also adopt fundamental policies with respect to key investment activities. *See Id.* § 80a-8(b) (2006) (listing the policies that must be reported for fund registration). These policies can be changed only by a shareholder vote. *Id.* § 80a-13(a).

[329] Shareholders must approve the initial advisory contract. *Id.* § 80a-15(a) (2006); 17 C.F.R. § 270.12b-1(b)(4) (2010). Following that approval, board approval can be substituted for a shareholder vote. 15 U.S.C. §§ 80a-15(a) to (b), 80a-13(a). Sections 80a-15(a)(3) and 80a-15(a)(4) also provide shareholder voting rights with respect to a new management contract following the board's termination of a management contract and any assignment of the contract. *Id.* § 80a-15(a)(3) to (4) (2006).

[330] *See, e.g.*, Phillips, *supra* note 323, at 903-04 (describing how the SEC has imposed "the corporate paraphernalia of shareholder voting").

spect to these issues provides value in that the proxy solicitation requirements alert investors to such changes. At its worst, shareholder voting impedes fund flexibility. Contractual fee rates in advisory contracts may, for example, be set higher than they otherwise would be because of the requirement that fund shareholders approve any attempt by managers to raise fees, but not to lower them.[331]

B. *Disclosure*

Perhaps the biggest failure of existing regulation is the scope and structure of the disclosure requirements. Like the corporate governance provisions, mutual fund disclosure obligations are modeled after those of operating companies. Purchasing a mutual fund, however, is not the same as investing in an operating company.

The disclosures of operating companies provide investors and the market with sufficient information about the issuer to value the company and its securities. Information about the issuer's past performance, financial condition, and management team enable the market to predict future cash flows, and discounting those future cash flows leads to a determination of an appropriate market price.

For operating companies, the determination of market price enables the application of market discipline. Investors adjust the price at which they will trade in response to changes in the issuer's behavior and performance, and any failure of the market to respond is addressed through arbitrage. Poorly performing firms face a higher cost of capital and, in some cases, are taken over. Operating performance is likely to persist to a large degree from one period to the next, at least to the extent that the firm's assets, products, and policies remain consistent.

Unlike operating companies, the prices of mutual fund shares are fixed at NAV. Investors do not use discounted cash flow or other methodologies to value fund shares, and fund prices do not respond to changes in fund performance, management, or investment objectives. Although these changes may affect investor demand for shares, changes in investor demand do not affect share price. Because share price is fixed, it does not serve as a vehicle for the exercise of market discipline. Similarly, investors cannot sell mutual fund shares short and, even if hostile takeovers were possible, fund pricing is incompat-

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[331] Raising fees is a modification of the advisory contract that requires shareholder approval. Managers can lower fees through a voluntary fee waiver. *See supra* note 230 and accompanying text (describing fee waivers).

ible with a takeover premium. Finally, for most, if not all, mutual funds, performance is not likely to persist. As a result, the primary factors relevant to the investment decision include cost, risk, asset allocation, and diversification.

In order to evaluate these factors, mutual fund investors need information about fund structure, investment strategy, and expenses. Investors choosing among mutual funds should be able to determine readily the types of securities in which the fund invests and the extent to which the fund is committed to specific asset types and classes (e.g., foreign versus domestic, debt versus equity, and small- versus large-cap) or retains discretion to shift among asset classes in response to market conditions. Investors also should be able to ascertain the extent to which the fund concentrates its investments within a limited number of securities or industries and whether the fund uses leverage or derivatives in its trading strategy. Investors should have access to complete information about fund costs, including the incentive structure created by the fund's payments to its portfolio managers, selling brokers, and other service providers. Most importantly, investors should be presented with information on the characteristics that distinguish a particular fund from its competitors.

Existing regulation allows, and in some cases creates affirmative incentives, for funds to obscure this information. As indicated above, although the SEC has repeatedly revised the provisions concerning disclosure of fund expenses, those disclosures remain incomplete and confusing. Investors report that they do not find these disclosures helpful, and most do not even read them.[332]

One example is operating expenses. Although the SEC has finally mandated in its most recent amendments that fund turnover be included in the summary prospectus, it has not required disclosure of brokerage commissions or other operating costs, and the turnover disclosure provided does not furnish a ready mechanism for quantifying those costs in a manner comparable to other fees.[333] The use of

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[332] According to the Investment Company Institute's 2006 investor survey, only thirty percent of recent mutual fund investors consulted shareholder reports before their most recent purchase, and only thirty-four percent used the fund prospectus. INV. CO. INST., UNDERSTANDING INVESTOR PREFERENCES FOR MUTUAL FUND INFORMATION 12 (2006), *available at* http://www.ici.org/pdf/rpt_06_inv_prefs_full.pdf. In a 1996 survey, only fifteen percent of investors reported reading the mutual fund prospectus in its entirety. *Id.* at 25.

[333] *See supra* notes 219-32 and accompanying text (discussing incomplete disclosure of fund operating costs).

soft dollars also masks a fund's true operating expenses.[334] In light of the demonstrated importance of both quantifying and adequately categorizing fund expenses, this lack of transparency is problematic. At the same time, increasing investor attention to fund expenses creates competitive pressure for funds to structure costs in ways that allow their exclusion from the reported expense ratios, as the use of soft dollars highlights.

Vague disclosure also reduces competition by preventing shareholders from evaluating the extent to which mutual funds differ along critical factors such as diversification, asset allocation, and risk. In turn, shareholder confusion may contribute to the degree of price dispersion in the market. For example, although funds are required to disclose their investment objectives, regulation does not require funds to be specific or to explain how their approach differs from that of their competitors. This leads to a situation in which hundreds of funds, with very different investment strategies, disclose that their investment objective is "long-term capital growth." [335]

So-called "closet index funds" offer an example in which a lack of disclosure leads to investor confusion.[336] Many actively managed mutual funds hold portfolios that do not differ significantly from the relevant index-fund benchmark.[337] This strategy reduces the risk that the fund will underperform the index; at the same time, the fund's returns are unlikely to differ from a comparable index fund, but come at a higher cost. Investors who purchase closet index funds pay a premium for active management while receiving index fund returns.[338] The

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[334] *See supra* notes 245-47 and accompanying text (describing use of soft dollars).

[335] *See, e.g.*, AM. CENTURY INV., SUMMARY PROSPECTUS: DISCIPLINED GROWTH FUND 1 (2009), *available at* http://prospectus.americancentury.com/summary.asp? doctype=spro&clientid=amercentll&fundid=02507M675 (reporting such an objective).

[336] *See, e.g.*, Tom Lauricella, *Professors Shine a Light into 'Closet Indexes,'* WALL ST. J., Aug. 18, 2006, at C1 (describing characteristics and returns of closet index funds).

[337] *See, e.g.*, Lewis Braham, *How to Spot A Closet Index Fund*, BUSINESSWEEK, Sept. 6, 2004, at 108 (describing the Putnam Voyager Fund, which purports to be actively managed and has a one percent annual expense ratio, as a closet index fund because of the similarity between its holdings and those of the Russell 1000 Growth Index); K.J. Martijn Cremers & Antti Petajisto, *How Active is Your Fund Manager? A New Measure That Predicts Performance* 3 (Yale Int'l Ctr. for Fin., Working Paper No. 06-14, 2009), *available at* http://ssrn.com/abstract=891719 (finding an increase in closet indexers during the 1990s).

[338] Indeed, because of the higher costs, closet index funds typically provide lower returns than their indexed counterparts. *See* Braham, *supra* note 337, at 108 (explaining that, after subtracting its management fees, Voyager's performance lags behind that of the benchmark index); Cremers & Petajisto, *supra* note 337, at 3-4 (finding that

problem could be addressed by more detailed requirements concerning the number of portfolio holdings or the degree to which the portfolio differs from its relevant benchmark.[339]

Incomplete disclosure of fund investment objectives and strategy is one possible explanation for investors' reliance on fund names.[340] The SEC has explicitly acknowledged that "investors may focus on an investment company's name to determine the company's investments and risks," and that "the name of an investment company may communicate a great deal to an investor."[341] In light of the potential for investors to be misled by a fund's name, the SEC adopted a rule in 2001 providing that if a fund's name suggests that it focuses on a particular investment type, the fund must invest at least eighty percent of its assets in that type.[342] This requirement, however, is only partially effective. First, it still enables a fund to invest twenty percent of its assets elsewhere, allowing the fund's risk and return profile to deviate substantially from that suggested by its name.[343] Second, it applies only to names that connote a generally accepted meaning.[344] The impor-

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closet indexers charge comparable fees to actively managed funds but tend to underperform both true actively managed funds and their benchmarks).

[339] There are a variety of measures that can be used to assess the degree to which a fund mirrors an index. Cremers & Petajisto offer a new measure of active investing in their recent paper, which "decompos[es] any portfolio into a 100% position in its benchmark index plus a zero-net-investment long-short portfolio on top of that." Cremers & Petajisto, *supra* note 337, at 1-2. An alternative approach looks to the fund's R^2, which is a measure of the degree to which a fund's performance can be explained by the benchmark's performance. *See* Braham, *supra* note 337, at 109. Morningstar provides R^2 statistics under modern portfolio statistics in its "ratings and risk" section. *See, e.g.*, Morningstar, Fidelity Magellan Report, http://quicktake.morningstar.com/FundNet/RatingsAndRisk.aspx?symbol=FMAGX&country=USA (last visited Apr. 15, 2010) (reporting an R^2 for the Magellan fund of ninety compared to the S&P 500).

[340] *See supra* notes 237-39 and accompanying text.

[341] Investment Company Names, Securities Act Release No. 7933, Exchange Act Release No. 43,845, Investment Company Act Release No. 24,828, Investment Advisers Act Release No. 1917, 74 SEC Docket 313, 314-15 (Jan. 16, 2001).

[342] 17 C.F.R. § 270.35d-1 (2009).

[343] *See* SEC, *supra* note 65 (warning investors that one-fifth of securities may not correspond to the fund name and may be risky as a result).

[344] *See* Mercer Bullard, *Despite SEC Efforts, Accuracy in Fund Names Still Elusive*, THESTREET.COM, Jan. 30, 2001, http://www.thestreet.com/story/1282823/despite-sec-efforts-accuracy-in-fund-names-still-elusive.html (explaining how "value" may not be covered by SEC restriction); *see also* Donohue, *supra* note 46 (identifying examples of fund names that conveyed use of derivatives in the fund's strategy, including "income," "floating rate," "high yield," and "short term").

tance of fund names is evidenced by the surprising frequency with which funds continue to change them.[345]

Limited transparency also reduces shareholder oversight. Because shareholders must approve significant changes in a fund's investment objectives, a fund can avoid the need for a shareholder vote by keeping its disclosure vague or by disclosing that it retains the discretion to use a variety of strategies.[346] Fidelity's Magellan Fund offers an example:

> Fidelity Management & Research Company (FMR) normally invests the fund's assets primarily in common stocks. FMR may invest the fund's assets in securities of foreign issuers in addition to securities of domestic issuers. FMR is not constrained by any particular investment style. At any given time, FMR may tend to buy "growth" stocks or "value" stocks, or a combination of both types. . . . FMR may also use various techniques, such as buying and selling futures contracts and exchange traded funds, to increase or decrease the fund's exposure to changing security prices or other factors that affect security values.[347]

If a fund is not required to commit itself to a specific strategy or allocation of assets, then fund managers can shift their investment style and respond to trends without any advance notice.[348] As a result, funds may drift significantly from the holdings, investment style, and risk level that the investors initially selected.[349] Even in benign cases, these shifts are problematic if they are not transparent. Asset alloca-

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[345] *See, e.g.*, Diya Gullapalli & Shefali Anand, *The Bull Market in Mutual-Fund Name Changes*, WALL ST. J., Feb. 10, 2006, at C1, (reporting that 719 funds changed their names in 2005).

[346] *See, e.g.*, NAKOMA MUTUAL FUNDS, NAKOMA ABSOLUTE RETURN FUND PROSPECTUS 2 (2009), *available at* http://www1.nakomafunds.com/portal/LinkClick.aspx?link=NARFX+Prospectus_20090925_CURRENT.pdf&tabid=498&mid=1356 ("The Fund's investment objective and strategies are not designated 'fundamental policies' within the meaning of the [ICA], and may be changed by the Fund's Board of Trustees . . . without shareholder approval.").

[347] FIDELITY INVS., FIDELITY MAGELLAN FUND PROSPECTUS (2009), *available at* http://content.members.fidelity.com/epro/PROS/316184100/?format=HTML&part=FRAMESET&app=RETAIL&consent=Y. Significantly, despite this broad disclosure, the extent to which the Magellan Fund currently uses an active investing strategy is unclear. *See* Braham, *supra* note 337, at 108 (describing Magellan as a "closet" index fund).

[348] The Magellan Fund is frequently cited for style drift. *See, e.g.*, Jerry Morgan, *Style Sticklers: Pension Consultants Policing Fund Managers to See That They Invest as Advertised*, L.A. TIMES, Dec. 10, 1996, at D9 ("Magellan started 1995 as a diversified growth fund, then invested more than 40% of its assets in technology stocks. Then it sold the tech shares and jumped into government bonds in a big way.").

[349] *See, e.g.*, Karen Hube, *The Drifters*, WALL ST. J., June 2, 2008, at R7 (reporting that style drift among stock mutual funds has ranged from thirty-two to forty-six percent, with increases during market shifts); *see also* Moon Kim et al., *Mutual Fund Objective Misclassification*, 52 J. ECON. & BUS. 309, 311 (2000) (finding that over fifty percent of mutual funds are misclassified and thirty-three percent are severely misclassified).

tion policy is a critical determinant of fund performance.[350] Disclosure of asset allocation enables an investor to evaluate the fund's performance in context as well as to determine the stability of the fund and how it fits within the investor's overall portfolio.[351] For these reasons, services like Morningstar categorize funds and compare funds within designated categories, such as "large-cap stock fund,"[352] but the utility of this information is undermined by style inconsistency and drift.

In the most problematic cases, managers may take an approach that causes a fund's risks to be very different from those perceived by investors.[353] Research suggests that agency problems are a likely factor in explaining shifts in style, and that the resulting shifts are likely to damage fund performance.[354] Although funds are required to disclose the composition of their portfolios, disclosure is only required on a quarterly basis,[355] allowing the opportunity for a substantial amount of drift between reporting periods, even assuming that investors monitor composition when it is disclosed.[356]

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[350] *See, e.g.*, Gary P. Brinson et al., *Determinants of Portfolio Performance*, FIN. ANALYSTS J., July–Aug. 1986, at 39, 39 (documenting the overwhelming importance of asset-allocation policy); Gary P. Brinson et al., *Determinants of Portfolio Performance II: An Update*, FIN. ANALYSTS J., May–June 1991, at 40, 40 (reporting that asset allocation explains, on average, 91.5% of the variation in quarterly fund returns); Roger G. Ibbotson & Paul D. Kaplan, *Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance?*, FIN. ANALYSTS J., Jan.–Feb. 2000, at 26, 26 (finding that asset allocation "explained forty percent of the variation of returns among funds [and] virtually 100 percent of the level of fund returns").

[351] *See* Letter from Laura Paulenko Lutton, Senior Mutual Fund Analyst, Morningstar, Inc., to Nancy M. Moris, Sec'y, SEC (Feb. 27, 2008), *available at* http://www.sec.gov/comments/s7-28-07/s72807-74.htm (advocating that the SEC require funds to disclose asset allocation over the preceding three years).

[352] *See* Wells Fargo, Morningstar Category Descriptions, https://www.wellsfargo.com/investing/mutual_funds/morningstar_desc (listing Morningstar mutual fund categories and descriptions).

[353] *See, e.g.*, Kathryn A. Holmes & Robert W. Faff, *Style Drift, Fund Flow and Fund Performance: New Cross-Sectional Evidence*, 16 FIN. SERVS. REV. 55, 56 (2007) (explaining that style drift may expose investors to different risk levels or types than what they were expecting).

[354] *See* Jennifer Huang et al., *Risk Shifting and Mutual Fund Performance* 25-26 (Univ. of Tex. at Austin McCombs Sch. of Bus. Research Paper Series, Working Paper No. FIN-04-08, 2009), *available at* http://ssrn.com/abstract=1108734 (suggesting "agency problems play a role in explaining risk shifting behavior"); *see also* Keith C. Brown et al., Staying the Course: The Role of Investment Style Consistency in the Performance of Mutual Funds (Mar. 2, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1364737 (finding that funds that maintain consistent styles outperform less style-consistent funds on a risk-adjusted basis).

[355] 17 C.F.R. §§ 249.331, 249.332, 274.128, 274.130 (2009).

[356] *See, e.g.*, Hube, *supra* note 349 (explaining that fund drift is difficult to monitor because "information on fund holdings is not available to investors on a real-time basis").

A prominent recent example of lack of transparency involves target date funds. Target date funds are a relatively new type of mutual fund, marketed primarily for retirement investing. Specifically, target date funds offer investors professional allocation of their assets by shifting from an equity portfolio in the early years toward an increasing percentage of fixed income securities both leading up to and following the target date, a shift that is termed the fund's "glide path."[357] As a result, the funds purport to meet the increasingly conservative investment needs of consumers as they age and approach retirement.

Target date funds received an explicit regulatory blessing in 2006 when Congress authorized them as the default investment option for 401(k) investments, thereby exempting from liability employers that invested in target date funds on behalf of employees who did not designate an alternative investment choice.[358] This regulatory seal of approval, coupled with the apparent simplicity of target date funds, allowed them to accumulate $168 billion in aggregate assets by February 2008.[359]

Yet things did not work out as planned. Initially, during the bull market of the mid-2000s, some commentators criticized target date fund investment allocations as unduly conservative.[360] These criticisms, coupled with pressure to generate high returns, led some target date funds to invest substantial portions of their portfolios in riskier investments. Some funds allocated as much as ninety-four percent of their portfolios to equities.[361] This strategy backfired when the market crashed in 2008. The market downtown revealed that many target date funds were far riskier than investors had expected. According to the SEC, funds with target dates of 2010 had as much as seventy-nine percent of their investments in stock when the market crashed, causing some of these funds to lose more, on a percentage basis, than the

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[357] *See, e.g.*, Sarah N. Lynch, *SEC Takes on Target-Date Funds*, WALL ST. J., May 5, 2009, at C3 (explaining the "glide path" concept).

[358] *See* Leslie Wayne, *Mutual Funds with Targets, and Misfires*, N.Y. TIMES, June 25, 2009, at B1 (describing the "safe harbor" for employers who automatically sent employee 401(k) money to target date funds).

[359] Bob Frick, *Target Funds Under Fire*, KIPLINGER'S PERSONAL FINANCE, Feb. 2008, at 34, 34.

[360] *See, e.g.*, Steven Goldberg, *Target Funds Are Simply Flawed*, KIPLINGER.COM, June 7, 2005, http://www.kiplinger.com/columns/value/archive/2005/va0608.htm (criticizing Vanguard and Fidelity target date funds as "too conservative").

[361] *See* Frick, *supra* note 359, at 34 ("In an effort to improve performance and break from the pack, many target-date funds have boosted their holdings in riskier investments.").

S&P 500.[362] The public and media responded to these revelations by attacking target date funds as insufficiently conservative.

It appears that target date funds suffered from several problems.[363] First, and most important, although the products that they offered varied tremendously, differences in investment objectives and asset allocation were not disclosed to investors. Funds with the same target date could differ dramatically, making it difficult for investors to compare them.[364] Thus, an investor could not simply assume that all 2010 target date funds were equivalent or would meet the needs of an investor planning to retire in 2010.

In addition, many investors appeared to expect that the target date reflected a date by which the majority of fund assets would be invested in conservative, fixed income securities.[365] In contrast, fund managers were making allocation decisions that reflected a longer time horizon, with the objective of enabling fund assets to continue to appreciate over the course of what might be an extended period of retirement. These glide paths differed from one fund to another.

Perhaps most problematically, the funds were generally marketed to investors with very limited investment expertise and were portrayed as safe investments for retirement accounts.[366] The appeal of the target fund was the investor's ability to delegate allocation decisions to

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[362] Wayne, *supra* note 358.

[363] Similar issues have been raised by 529 plan funds, which are supposed to provide a vehicle for college savings. *See, e.g.*, Shefali Anand & Craig Karmin, *Oregon Sues Over Risks Taken in Its '529' Fund*, WALL ST. J., Apr. 14, 2009, at C1 (describing litigation alleging that the Oppenheimer Core Bond fund, which was billed as conservative, became unduly risky); Jane J. Kim, *Investors to Recover '529' Losses*, WALL ST. J., June 13-14, 2009, at B2 (describing a tentative settlement of the litigation).

[364] *See, e.g.*, Wayne, *supra* note 358, (quoting SEC Chairman Mary Schapiro as stating that 2010 target date funds had anywhere from twenty-one percent to seventy-nine percent of their holdings invested in stocks).

[365] *See, e.g.*, Robert Powell, *Target-Date Funds Under the Microscope*, MARKETWATCH, June 4, 2009, http://www.marketwatch.com/story/target-date-funds-under-the-microscope ("Folks on the cusp of retirement who purchased 2010 funds apparently assumed that such funds would have little or no assets invested in stocks, but they got a rude awakening . . . .").

[366] *See, e.g.*, Lisa Shidler, *Target Date Funds Increase Equity Exposure*, INVESTMENT NEWS, June 16, 2008, *available at* http://www.investmentnews.com/article/20080616/REG/310303540 (describing target date funds as less transparent and difficult to understand, but quoting investment advisors as stating that such funds are suitable for persons who lack investment expertise).

expert fund managers, yet the broad differences among funds frustrated this objective.[367]

Target date funds offer an example of disclosure failure, but they raise a further question: to what extent is disclosure sufficient? Many intermediated investments are complex financial products. Even with extensive disclosure, evaluating their structure is difficult. Mutual fund alternatives range from long-only index funds to products that use leverage and derivatives to mimic hedge fund strategies. Examples of more complex mutual funds include the Nakoma Absolute Return Fund, which uses the long/short strategy of a traditional hedge fund to seek "positive absolute returns with low volatility independent of market conditions,"[368] and the Direxion mutual funds, which offer double the return, or double the inverse of the return, for a variety of standard market indexes, such as the S&P 500 and the NASDAQ 100.[369] Several fund sponsors—of which Direxion and Proshares are the best known—are marketing an array of leveraged and leveraged-inverse ETFs, some of which offer as much as three times the daily returns of various indexes, sectors, and commodities.

Although some Internet and media sources have touted these products to retail investors, understanding their performance is complicated. First, leverage makes funds far more volatile than the indexes they track. Significant market movements can rapidly wipe out a highly leveraged ETF investment. In the highly volatile market during the spring of 2009, for example, shares of the Direxion Daily Financial Bear 3X fund fell eighty-five percent between January and June.[370]

Second, and more important, most leveraged ETFs track market performance and are rebalanced on a daily basis.[371] Daily compound-

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[367] *See, e.g.*, John Prestbo, *Behind the Target*, MARKETWATCH, July 8, 2009, http://www.marketwatch.com/story/target-date-funds-need-better-aim?pagenumber=2 ("[T]he potpourri of offerings needs some standardization and benchmarking to be more transparent to investors.").

[368] Nakoma Mutual Funds, http://www1.nakomafunds.com/portal/nf/Home/tabid/456/Default.aspx (last visited Apr. 15, 2010).

[369] Direxion Fund Information Overview, http://www.direxionfunds.com/products.html (last visited Apr. 15, 2010).

[370] Daisy Maxey, *FINRA Urges Caution on Leveraged Funds*, WALL ST. J., June 23, 2009, at C9.

[371] Direxion appears to have responded to the concerns addressed in this Section by shifting the investment objective of its leveraged mutual funds to monthly, rather than daily, returns. *See, e.g.*, Direxion Monthly S&P 500 Bull 2x Fund, http://www.direxionfunds.com/funds/sp500_bull.html?performance;funds=dxslx (last visited Apr. 15, 2010) ("As of 9/30/2009, the Bull Fund's investment objective has changed from seeking daily investment results, before fees and expenses, of 250% of the price per-

ing means that, over the long term, leveraged ETFs need not mimic the performance of the associated index and frequently do not. As the holding period extends, the returns of the leveraged product will differ increasingly from those predicted by the movement of the index,[372] and may even move in the opposite direction.[373] Academic research demonstrates that these effects are due to the structure of the leveraged products and that, over time, leveraged ETFs (in either direction) will underperform the benchmark index.[374] This underperformance will increase with the volatility of the underlying index.[375]

Faced with litigation claiming inadequate disclosure,[376] many funds now provide extensive and specific warnings about their risks and indicate that they are not appropriate for investors who do not understand those risks.[377] Regulators, including the SEC and FINRA,

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formance of its benchmark to seeking monthly investment results, before fees and expenses, of 200% of the price performance of its benchmark."). Direxion's ETFs continue to reflect an investment objective based on daily returns. Direxion, ETF Information, http://www.direxionshares.com/etfs (last visited Apr. 15, 2010).

[372] *See, e.g.*, Tom Lauricella, *ETF Math Lesson: Leverage Can Produce Unexpected Returns*, WALL ST. J., Jan. 5, 2009, at R1 (explaining how daily compounding produces this result).

[373] *See, e.g.*, The Riskiest ETFs on Earth—3X Sector ETF Short/Long, http://www.darwinsfinance.com/riskiest-etfs-earth-3x-returns/ (May 22, 2009) (citing two examples in which the underlying index, the leveraged ETF, and the leveraged inverse ETF all lost money over a six-month and a seventeen-month holding period); *see also* CANADIAN FOUND. FOR ADVANCEMENT OF INVESTOR RIGHTS, HEADS YOU LOSE, TAILS YOU LOSE: THE STRANGE CASE OF LEVERAGED ETFS 2 (2009), *available at* http://faircanada.ca/wp-content/uploads/2008/12/etfs-may-14pm-etf-sw-final-final1.pdf (reporting findings that, over a twelve-month study period, four of nine pairs of leveraged commodity ETFs lost money in both their bull and bear positions).

The Canadian study offers the case of gold-mining stocks as a dramatic example:

> The Canadian gold sub-index gained 1% for the 12 months ending March 31, 2009. The HBP S&P/TSX Global Gold Bear Plus ETF did not lose 2%, as its 2X inverse would indicate. It actually lost 87%. Its pair, the inverse Global Gold Bull Plus ETF, should have gained 2%. Instead, it lost 46%.

Id. at 1.

[374] Lei Lu et al., Long Term Performance of Leveraged ETFs 14-15 (August 1, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1344133.

[375] *Id.*

[376] *See, e.g.*, Daisy Maxey, *ProShare Draws Suit Over a Leveraged ETF*, WALL ST. J., Aug. 7, 2009, at C11 (describing litigation alleging that ProShare improperly failed to disclose the risks of its Ultrashort Real Estate ETF, "including the risk of a 'spectacular tracking error'").

[377] *See, e.g.*, DIREXION, PROSPECTUS 4-7 (2009), *available at* http://www.direxionfunds.com/pdfs/Prospectus_Except_1208.pdf. Direxion warns that, among other things, the funds "are very different from most mutual funds," "are not suitable for all investors," "should be utilized only by sophisticated investors," and that "a Fund could theoretically lose an amount greater than net assets in the event of a move-

have stated that these products are not suitable for all investors.[378] Some firms have responded by restricting the sale of leveraged ETFs.[379] It remains unclear, however, whether regulators should intervene by requiring more precise labeling and disclosure of product risks, by banning funds that offer a high degree of volatility or risk, or at least by precluding unsophisticated retail investors from purchasing them.[380] On the other hand, concern about liability and regulation, in the absence of explicit regulatory guidance, may lead firms to ban these products despite their utility to some investors.[381]

IV. REFORMING REGULATION

If existing regulation is inadequate, how can it be fixed? Pending congressional proposals include a number of reforms to the regulation of mutual funds and other retail investments. The Wall Street Reform and Consumer Protection Act of 2009 contains, within its

ment of its target index in excess of 50% in a direction adverse to the Fund . . . . In short, the risk of total loss exists." *Id.*

[378] *See, e.g.*, Ross Kerber, *SEC Warns Investors on Leveraged ETF Holdings*, REUTERS, Aug. 18, 2009, http://reuters.com/article/idustre57h64620090818 (describing a joint warning by the SEC and FINRA). FINRA also imposed increased margin requirements on leveraged ETFs. *See Increased Margin Requirements for Leveraged Exchange-Traded and Associated Uncovered Options*, REG. NOTICE 09-53 (FINRA, Washington, D.C.), Aug. 2009, (effective date Dec. 1, 2009), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p119906.pdf.

[379] *See* Don Dion, *Leveraged ETFs: A Call for Coordination*, THESTREET.COM, Aug. 10, 2009, http://www.thestreet.com/story/10569383/1/leveraged-etfs-a-call-for-coordination.html (describing decisions by several firms to restrict the sale of leveraged ETFs).

[380] *See id.* (calling for CFTC, FINRA, and the SEC to join forces in requiring that traders be identified as sophisticated before being allowed to purchase leveraged ETFs); Scott Burns, *Time for Derivative ETFs to Comply*, MORNINGSTAR, June 12, 2009, http://news.morningstar.com/articlenet/article.aspx?id=295136 (arguing that ETFs that use derivatives should be regulated like derivatives, and investors should be required to get approval before purchasing them). The SEC also imposes wealth/income and sophistication requirements on purchasers of hedge funds and private equity. *See generally* 17 C.F.R. § 230.501(a) (2009) (defining "accredited investor"). The SEC has also considered tightening these restrictions to prevent the "retailization" of the market for such investments. *See, e.g.*, Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Securities Act Release No. 8766, Investment Advisers Act Release No. 2576, 72 Fed. Reg. 400, 400-03 (proposed Jan. 4, 2007) ("[M]any individual investors today may be eligible to make investments in privately offered investment pools as accredited investors that previously may not have qualified as such for those investments.").

[381] *See, e.g.*, Ron DeLegge, *Is the Backlash Against Leveraged ETFs Warranted?*, ETF-GUIDE.COM, July 31, 2009, http://www.etfguide.com/commentary/581/Is-the-Backlash-against-Leveraged-Etfs-Warranted? (challenging brokerage firms' bans of sales of leveraged ETFs, but criticizing regulators' failure to regulate these instruments properly by insisting on appropriate names and disclosure).

thousand-plus pages, proposed legislation that would create an investor advisory committee, explicitly authorize the SEC to engage in consumer testing, establish a fiduciary duty for broker-dealers, and authorize the SEC to pass rules requiring point-of-sale disclosure.[382] If adopted, these reforms will respond to a number of the concerns detailed in this Article. The problem, however, is that these proposals, like prior reform efforts, represent a reactive and piecemeal approach that is largely modeled on the existing regulatory structure. More importantly, the reforms do not correct the fundamental deficiencies in market structure. To a large extent, both the existing and proposed regulations impede, rather than enhance, market forces by misdirecting investment choice, constraining product variation, and creating inappropriate incentives for revenue sharing, product manipulation, and strategic complexity.

This Article proposes an alternative—replacing the ICA with a conceptually distinct method of regulating retail investment products. First, this Article proposes a product-based approach to the regulation of mutual funds, ETFs, and similar consumer-directed investments. Second, it calls for the creation of a new regulator, the Consumer Investment Regulatory Authority (CIRA), to administer this approach, with the authority to regulate both intermediated investment products and the processes by which they are sold.

For products, the Article introduces a new, market-enhancing regulatory approach: conform or explain. Under this approach, CIRA would collect data and provide information on standardized investment products. Rather than being limited to specific product structures, as with existing law, product sponsors would be free to innovate and offer alternatives to the standardized products, subject to the requirement that they explain the ways in which their products differ from the standards.

With respect to the sales process, this Article rejects the generalized constraints of the "know your customer" and suitability requirements, as well as their administration under the opaque oversight of FINRA. Instead, this Article argues for conduct-based regulation of retail sales practices. In particular, the Article proposes that brokers be required to document their disclosures to investors about asset allocation, performance, and costs, as well as the justification for advising unsophisticated retail clients to purchase higher-cost and nonconforming products.

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[382] Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. §§ 7101–04 (2009).

A. *Product Regulation—Conform or Explain*

As Part III has shown, the corporate governance components and the disclosure requirements of the existing regime are flawed. Even well-intentioned independent directors lack the tools to provide a meaningful evaluation of the fairness of transactions involving conflicts of interest—from soft dollars to management fees—and the application of fiduciary principles through litigation burdens directors who act properly and is unlikely to constrain directors who do not. At best, fiduciary principles drive directors toward documenting their processes and deliberations more carefully but offer little counterweight to the market incentives operating upon the investment advisor. Shareholder voting provides limited value to shareholders who have the option of ready exit at NAV,[383] and the procedural adjustments that would be required to make shareholder voting meaningful cannot be justified in terms of their costs.

At the same time, there is evidence of substantial failures in the market for mutual funds. Existing disclosure requirements operate imperfectly, in part due to differences between the traditional capital markets and the market for mutual funds. Market checks, such as pricing, arbitrage, and the market for corporate control, do not operate on mutual funds. To eliminate wasteful governance mechanisms, the regulatory structure must be strengthened to improve market discipline.

The solution is a shift in focus. Mutual funds and comparable alternatives should be regulated as products, not investments. In particular, the approach of the ICA, which compels investment companies to be organized as distinct legal entities subject to designated corporate governance and which characterizes funds as clients subject to the fiduciary protection of the Investment Advisers Act, should be eliminated. Regulation should instead treat those investments as consumer products and treat fund advisors as the producers of such products.[384]

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[383] *See, e.g.*, John Morley & Quinn Curtis, *Exit, Voice, and Fee Liability in Mutual Funds*, 120 YALE L.J. (forthcoming 2010) (manuscript at 2), *available at* http://ssrn.com/abstract=1547162) (arguing that the ability of shareholders to exit for cash virtually eliminates shareholders' incentives to impose accountability through director elections or fee litigation).

[384] Other commentators have, in general terms, endorsed this approach. *See, e.g.*, Harvey L. Pitt, *Over-Lawyered at the SEC*, WALL ST. J., July 26, 2006, at A15 (faulting "the 60-year-old legislation the SEC administers" for "treat[ing] mutual funds as companies when the economic reality is that they are products").

In theory, product regulation can take various forms. Regulators can ban products that are unduly complex or risky. The FDA bans a variety of products on this basis.[385] Regulators can limit product sales to qualified purchasers, as the SEC does with hedge fund investments, or require that an intermediary operate as a gatekeeper who controls access to risky products, as the FDA does with prescription pharmaceuticals. A regulator can also require a product to meet certain specifications or to have particular characteristics that are designed to make it safe for consumers. One variation of this approach is to mandate standardization, as reflected in proposals to require certain types of "plain vanilla" consumer credit products such as credit cards or residential mortgages. Regulators can also require disclosure of product dangers, such as the FDA-mandated warnings on cigarette packages.

This Article proposes a different approach to enhance market function: standardization as a baseline to structure and simplify disclosure. Rather than relying on regulators to identify appropriate products, the proposal relies on investor choice, facilitated by improved transparency. At the same time, the proposal advocates regulatory identification of standardized products to simplify investment decisions for unsophisticated consumers.

In moving toward product regulation, regulators should reject the analogy to common stock. Investors are not attempting to determine the going concern value of productive assets when they evaluate mutual funds or ETFs. Returns from a mutual fund will not, for the average mutual fund shareholder, be based on managerial talent—and even if they are, investors are unlikely to be able to select for this. Accordingly, investors should be actively discouraged, through disclosure regulation, from focusing on historical performance data or managerial expertise.

Instead, returns will be based on the structure of the product. Investors need, and should receive, disclosure of investment strategy, including asset allocation, leverage, and diversification, as well as the costs associated with this strategy. Investors should receive specific da-

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[385] *See, e.g.*, Gardiner Harris, *F.D.A. Threatens to Ban Caffeinated Alcoholic Drinks*, N.Y. TIMES, Nov. 14, 2009, at A11 (describing the FDA's announcement that it would ban caffeinated alcoholic beverages unless manufacturers proved they were safe). Regulatory error can result in the banning of useful products. Moreover, a product may be useful to only a subset of users. *Cf.* Anup Malani et al., *Accounting for Differences Among Patients in the FDA Approval Process* 26 (Univ. of Chi. Law Sch. John M. Olin Law & Econ. Working Paper (2d Series), Working Paper No. 488, 2009), *available at* http://ssrn.com/abstract=1492909 (observing that FDA policy leads it to deny "approval for drugs that benefit some patients, but not the average patient").

ta on the extent to which these factors represent committed product characteristics or may be modified at management's discretion. Most importantly, investors need this information on a comparative basis.

Conform or explain, the key component of this Article's proposed approach, centers on this need for comparative information. In selecting among close to 10,000 competing products, investors with limited time and sophistication need more than information in a standardized form—they need standardized reference points. No retail investor can compare 10,000 products along multiple dimensions. Instead, regulators should provide investors with guidance about standardized products and their features, and identify the most important dimensions across which products differ.[386] Regulation should, in effect, provide the framework for rational investor choice.

Conform or explain would require CIRA to collect data on existing retail investment products and, using this data, to construct a menu of standardized, or "plain vanilla," products involving mainstream investment options and simple product structures. These standardized options might include an S&P 500 index fund, an actively managed domestic small-cap fund, a long-term bond fund, and so forth.[387] The regulator would specify certain features of these products to maximize simplicity, such as the absence of loads or 12b-1 fees, and an investment strategy that did not employ leverage or the use of derivatives. The regulator would publish benchmark numbers or ranges for typical product features such as asset allocation, average expense ratio, turnover rates, and returns.

Conform or explain would then provide a mechanism for structuring market-based disclosure. Unlike substantive regulation, conform or explain would not limit product features or require firms to offer plain vanilla products. Instead, sponsors would have two alternatives. If they chose to *conform* their product to the specifications of the

[386] Standardized products limit information costs by reducing investors' choices to a more limited menu of options. *See* Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The* Numerus Clausus *Principle*, 110 YALE L.J. 1, 38-42 (2000) (arguing that standardization can reduce the information and transaction costs that excessive individual tailoring causes). Because the optimal degree of standardization in the mutual fund market is unknown, and because of the risk of regulatory effort, this Article does not propose any limit on the sale of alternatives to the standardized products.

[387] The Morningstar mutual fund categories might provide an initial list of products, and CIRA could then identify qualifying characteristics. *See* Wells Fargo, *supra* note 352 (describing mutual fund categories). Some existing products would likely qualify under CIRA's criteria. *See* CHRISTINE BENZ, MORNINGSTAR GUIDE TO MUTUAL FUNDS: FIVE-STAR STRATEGIES FOR SUCCESS 103 (2d ed. 2005) (explaining that some fund families, such as Putnam and T. Rowe Price, offer "style-pure" funds).

plain vanilla product, they could simply disclose the relevant product category with no additional point-of-purchase disclosure required. Investors could rely on the product category without the need to determine whether the product had unanticipated characteristics or features.

The second alternative would be for sponsors to *explain* their products' distinguishing features. Sponsors would be unrestricted as to product form and structure as long as they explained the relevant differences. Disclosure requirements for nonconforming products would require sponsors to provide the published information on the most closely analogous standardized product, as well as an explanation of each feature in which the offered product varied from the standard.[388] For example, an actively managed large-cap equity fund that held fewer securities than the standard product, employed strategies that included the use of futures and options, and had a higher expense ratio would have to identify and explain each of these features. Finally, sponsors would be free to modify characteristics of investment products on an ongoing basis, but any material modification would require notice to shareholders—akin to the 8-K notifications of material events provided by operating companies.[389] Thus, shareholders would receive an affirmative warning if a fund shifted its style or asset allocation, as the Magellan fund did.[390]

Conform or explain would have several advantages over the current disclosure system. As indicated above, the disclosure would focus on information important to a rational shareholder decision and would structure that information in a way that facilitates consumer choice. Commentators have repeatedly urged the SEC to mandate the disclosure of comparative information for investors, arguing that investors cannot evaluate information on fees, returns, and risks without understanding how the fund compares to similar funds.[391] Important-

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[388] Regulations would provide a list of relevant features, which would include expenses, asset allocation, leverage, derivatives, short selling, and discretion to alter the fund's investment strategy.

[389] A reporting company must file an 8-K within two days after the occurrence of specified material events. 17 C.F.R. § 240.13a-11 (2009); SEC, Current Report (Form 8-K), *available at* http://www.sec.gov/about/forms/form8-k.pdf.

[390] Because shareholders can exit mutual funds at NAV, notice of modifications is sufficient protection; requiring shareholders to approve such changes is unnecessary.

[391] *See, e.g.*, Letter from David Certner, Legislative Counsel and Dir. of Legislative Policy, AARP, to Nancy M. Morris, Sec'y, SEC (Feb. 28, 2008), *available at* http://www.sec.gov/comments/s7-28-07/s72807-114.pdf (stating that the SEC should require comparative information because, "absent this kind of comparative information, it is difficult to know whether fees and expenses, for example, are reasonable for

ly, conform or explain would structure comparative information in a way that would render it useful. In contrast, under existing regulation, funds may provide comparative information to a wholly dissimilar product or benchmark, rendering the comparison highly misleading.[392]

Comparative information facilitates investor choice because it is consistent with consumer decisionmaking strategies in other contexts. Although the literature on this subject is extensive, a few principles stand out. First, consumer evaluations are largely comparative in nature.[393] Rather than assessing a product option in absolute terms, consumers weigh the product against various alternatives along one or more preference dimensions.[394] Second, in making complex choices, consumers often act with bounded rationality, limiting the dimensions along which they compare competing products.[395] Third, consumers tend to be heavily influenced by the information presented to them, making their preferences both context-dependent and subject to manipulation.[396]

These principles suggest that the retail investor is likely to compare product alternatives along the dimensions that the funds present for comparison. If mutual funds present performance data, the consumer will attempt to choose the best performing fund. If funds

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the fund in question"); Letter from Mercer Bullard, Founder and President of Fund Democracy, et al., to Nancy M. Morris, Sec'y, SEC 8 (Feb. 28, 2008), *available at* http://www.sec.gov/comments/s7-28-07/s72807-108.pdf [hereinafter Bullard Comment Letter] ("Nothing would promote comparison shopping and competition in the fund industry more than a mandatory fee comparison in the fund fee table.").

392 *See, e.g.*, Bullard Comment Letter, *supra* note 391 (observing that the SEC allows Internet funds to use the S&P 500 as a benchmark for performance); Letter from Joseph A. Franco, Professor, Suffolk Univ. Law School, to Nancy M. Morris, Sec'y, SEC 2 (Feb. 28, 2008), *available at* http://www.sec.gov/comments/s7-28-07/s72807-113.pdf (observing that the Janus website compared the Contrarian Fund to the S&P 500 Index, despite the fact that forty-four percent of the Contrarian Fund's holdings were foreign securities and forty-eight percent were small-cap stocks).

393 *See, e.g.*, Ravi Dhar et al., *Trying Hard or Hardly Trying: An Analysis of Context Effects in Choice*, 9 J. CONSUMER PSYCHOL. 189, 192-93 (2000) (suggesting that bias in consumer choice results from consumers making too many comparisons).

394 *See, e.g.*, Amos Tversky & Itamar Simonson, *Context-Dependent Preferences*, 39 MGMT. SCI. 1179, 1182 (1993) (explaining how the presentation of alternative choices can alter consumer preferences).

395 *See, e.g.*, James R. Bettman et al., *Constructive Consumer Choice Processes*, 25 J. CONSUMER RES. 187, 187 (1998) (describing bounded consumer rationality).

396 *See, e.g.*, Mukesh Bhargava et al., *Explaining Context Effects on Choice Using a Model of Comparative Judgment*, 9 J. CONSUMER PSYCHOL. 167, 168-69 (2000) (explaining that consumers may lack stable preferences when they have limited information and consequently construct preferences by comparing attributes of available alternatives); Dhar et al., *supra* note 393, at 190 (exploring why consumers focus on "the comparative aspects of the choice alternatives").

present data on expenses, the consumer will focus on expenses. If funds emphasize risk, the consumer will evaluate that characteristic.[397] The studies suggest that the presentation of information is critical to consumer choice among investment alternatives.[398]

This literature readily explains why investors rely so heavily on performance data—fund disclosures tell them to. The funds' mandated disclosure documents and marketing materials present performance as the single most important fund characteristic.[399] The trend toward greater sensitivity to mutual fund expenses is also unsurprising;[400] recent regulatory changes have increased the detail and visibility of expenses in mandated fund disclosure. The importance of presentation highlights the significance of the SEC's decisions to limit the requirement that funds disclose trading costs. Even if investors can ascertain such costs by researching funds' additional disclosure documents, consumer evidence suggests that fund purchasers will be un-

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[397] Commentators have suggested that the SEC affirmatively mandate standardized disclosure of mutual fund risks. *See, e.g.*, Press Release, BARRA Inc., BARRA Offers SEC Recommendations on Standard Mutual Fund Risk Disclosure (Sept. 11, 1995), *available at* LEXIS, BWIRE file (describing a proposal that the SEC adopt a fund's standard deviation as the measure of fund risk). Some private service providers, such as Morningstar, offer risk ratings. *See, e.g.*, Morningstar.com, Fidelity Magellan Report, http://quicktake.morningstar.com/FundNet/RatingsAndRisk.aspx?symbol=FMAGX&country=USA (last visited Apr. 15, 2010) (providing standard deviation, sharpe ratio, beta, Morningstar risk rating, and other numbers for Magellan Fund). Problematically, however, mutual fund risk can be measured in a number of ways. *See, e.g.*, Brenda Buttner, *Which Mutual Fund Risk Measures Really Matter*, THESTREET.COM, July 20, 1998, http://www.thestreet.com/story/31848/which-mutual-fund-risk-measures-really-matter.html (detailing five ways of quantifying mutual fund risk). In addition, it is unclear whether standard finance measures of risk capture the dominant concerns of retail investors. *See, e.g.*, Paul Schott Stevens & Amy Lancellotta, *Improving Mutual Fund Risk Disclosure*, INVESTMENT COMPANY INST. PERSP., Nov. 1995, at 1, 2, *available at* http://www.idc.org/pdf/per01-02.pdf (opposing a proposal that the SEC mandate a single standardized numerical risk measurement because the proposal "ignores that risk is multifaceted, necessarily having different meanings for different investors"). Moreover, efforts to quantify risk can be misleading. *See* L. Gordon Crovitz, Opinion, *The 1% Panic*, WALL ST. J., Oct. 13, 2008, at A17 (discussing shortcomings of the VaR (value at risk) model). Accordingly, this Article proposes increased comparative disclosure, rather than an effort to quantify risk precisely.

[398] *See, e.g.*, James R. Bettman et al., *supra* note 395, at 202 ("The organization of information displays can have a major impact on consumer choices.").

[399] *See, e.g.*, INV. CO. INST., UNDERSTANDING INVESTOR PREFERENCES FOR MUTUAL FUND INFORMATION 3 (2006), *available at* http://www.ici.org/pdf/rpt_06_inv_prefs_full.pdf (reporting survey results indicating that sixty-nine percent of investors reviewed historical performance prior to purchase).

[400] *Id.* at 3 (reporting that seventy-four percent of investors reviewed fund fees and expenses prior to purchase).

likely to undertake such research or to make the conversions necessary to integrate those costs into the funds' expense ratios.[401]

Standardization would have the benefit of reducing the number of options by enabling investors to group product alternatives in a meaningful way based on the standard categories.[402] It would also reduce the dimensions along which investors compare competing products to a manageable number and focus investors on those dimensions that are most important.[403] Finally, for those investors without sufficient interest or sophistication to evaluate fund-specific differences, standardization would allow them to choose a mainstream product and avoid being misled into selecting a product with above-average costs or risks.

In contrast to alternative regulatory approaches, conform or explain permits market competition to operate as a check on regulatory error. If a regulator incorrectly identifies certain features as nonstandard, a review of fund disclosures will identify the error. Unlike the current system, funds will have the opportunity to demonstrate to the market the value of alternative structures and features, such as incentive-based compensation for fund advisors. Finally, because regulators will proactively evaluate existing products and their disclosures, they should be in a position to detect features of new products that should be disclosed, such as the glide paths of target date funds and the daily compounding of leveraged ETFs.

Perhaps most important, product regulation would reduce the need to apply fiduciary principles to fund operations. Viewing fund shares as products weakens the conception of a fund as a discrete legal entity that is entitled to invoke fiduciary principles. Instead, the advisor is offering an investment product for sale. Like any product, the fund must be advertised accurately and be free from design defects. But producers do not owe fiduciary obligations to their products. Similarly, regulatory oversight over many affiliated transactions that current law heavily restricts would be reduced because the transactions would not

[401] *See* Bettman et al., *supra* note 395, at 202 (describing the "concreteness" principle, according to which decisionmakers "will use only that information that is explicitly displayed and will use it in the form it is displayed, without transforming it").

[402] *See* Dhar et al., *supra* note 393, at 199 (highlighting the importance of product categories in influencing consumer choice).

[403] Commentators have suggested a similar approach in the home mortgage context. *See* MICHAEL BARR ET AL., NEW AM. FOUND., BEHAVIORALLY INFORMED FINANCIAL SERVICES REGULATION 10 (2008) (arguing that offering a standardized default option would help anchor the consumer, as well as provide some expectations regarding the factors relevant to the choice of product).

involve conflicts of interest. Although some practices might be sufficiently problematic to require regulation,[404] the primary check on conflicts that make a product less attractive would be market competition.

This Article's proposal has particular implications for excessive fee cases like *Jones v. Harris Associates*.[405] Improved transparency with respect to products and selling processes would enhance market discipline and eliminate the need for post hoc judicial review under a problematic fiduciary standard.[406] Although there is no guarantee that average fees would decrease under this proposal—indeed, they might well increase in the presence of more informative disclosure—a functional market would justify a court's reliance, as Judge Easterbrook suggested in the Seventh Circuit's opinion in *Jones*.[407]

B. *Intermediary Regulation*

Conform or explain also offers a template for a conduct-based approach to the regulation of brokers, financial advisors, 401(k) plan sponsors, and other intermediaries. Existing law takes two approaches, neither of which is satisfactory. On the one hand, courts have generally held that brokers do not act as fiduciaries when they make investment recommendations to customers, leaving their conduct to the limited constraints of the SRO rules.[408] On the other hand, directors, investment advisors, and 401(k) plan sponsors are all subject to fiduciary duties. Those duties are then subject to uncertain and inconsistent judicial enforcement, which creates the prospect of liability exposure without predictable standards of conduct.

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[404] It is unclear whether some of the practices currently treated as conflicts could survive under a meaningful conception of product regulation. If, for example, an ETF represents an ownership share of a pool of securities, it is difficult to see how interest earned on lending those securities could belong to anyone other than the owners of ETF shares. An investment advisor's retention of such interest would not be a "conflict of interest;" it would be stealing. *See, e.g.*, John Jannarone, *Getting a Fair Share from ETFs*, WALL. ST. J., Jan. 8, 2010, at C10 (stating that iShares kept fifty percent of the stock lending fees its Dow Jones US Financial ETF earned). Many of these transactions, which fund boards of directors currently oversee, could be monitored by compliance officers.

[405] No. 08-586 (U.S. Mar. 30, 2010), http://www.supremecourt.gov/opinions/09pdf/08-586.pdf.

[406] *See* M. Todd Henderson, *Justifying* Jones, 77 U. CHI. L. REV. (forthcoming 2010) (manuscript at 10-13), *available at* http://ssrn.com/abstract=1499410 (arguing that the *Gartenberg* standard, at issue in *Jones*, creates the risk of costly and inefficient litigation).

[407] Jones v. Harris Assocs., 527 F.3d 627, 632 (7th Cir. 2008) ("[W]e are skeptical about *Gartenberg* because it relies too little on markets.").

[408] *See supra* notes 280-83 and accompanying text (identifying difficulties with private enforcement of SRO rules).

In lieu of either approach, this Article proposes that intermediary regulation focus on sales practices. The starting point should be the mandated disclosure described above.[409] Intermediaries would be required either to recommend or choose a standardized product for their clients or to make an informed determination that an alternative product is superior. Intermediaries—including brokers and employers sponsoring 401(k) plans—would be required to evaluate their clients' needs, understand the distinctive components of nonstandardized products, and make an informed decision. Compliance with these obligations would require explicit consideration of the distinguishing features of the nonstandard product but would not require the intermediary to demonstrate the superiority of its chosen product, either ex ante or ex post; it would be sufficient for the intermediary to determine that the product was a reasonable choice.

Point-of-sale disclosure to investors would include the same explanatory information. The intermediary would be required to disclose a product's nonconforming attributes and to document the rationale for recommending the product. In addition, the intermediary would be required to disclose the existence and amount of any revenue sharing or other incentives associated with the product.

To provide meaningful accountability, these requirements would be enforceable both by CIRA and through an explicit private right of action.[410] To minimize the cost of liability exposure, however, intermediaries that demonstrate procedural compliance, an informed process, and the absence of undisclosed conflicts of interest would be protected by a statutory safe harbor permitting prediscovery dismissal of any litigation, including litigation alleging fraud or breach of fiduciary duty.

C. *The Consumer Investment Regulatory Authority*

The final component of conform or explain is the creation of a new agency, the Consumer Investment Regulatory Authority (CIRA). Like the SEC and the Consumer Financial Protection Agency (CFPA) currently under congressional consideration,[411] CIRA would be struc-

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[409] *See supra* Section IV.A. (explaining the disclosure element of conform or explain).

[410] Consideration of the details of this cause of action is beyond the scope of this Article.

[411] As currently proposed, the CFPA would not exercise jurisdiction over mutual funds or retirement accounts but would focus its attention on credit cards, mortgages, and similar products. *See* Consumer Financial Protection Agency Act of 2009, H.R. 3126, 111th Cong. § 101(8) (2009) (proposing the creation of a Consumer Financial Protection Agency).

tured as an administrative or independent agency[412] and would be charged with the regulation of retail investment products, including mutual funds, money market funds, and ETFs,[413] whether purchased directly or through employer-sponsored retirement accounts. CIRA would also have the authority to regulate intermediaries, including brokers, financial advisors, and 401(k) plan sponsors with respect to retail transactions involving these products. Pursuant to this charge, CIRA would be vested with rulemaking authority, enforcement power, and the resources to collect information about the market.

The preceding two Sections partially described CIRA's responsibilities. Understanding the retail investment market is critical to these responsibilities. CIRA should not have to rely on studies conducted by outside researchers and organizations, but should engage in ongoing internal data collection and analysis.[414] In carrying out these responsibilities, CIRA should be structured and staffed to facilitate product research and to analyze consumer decisionmaking. Accordingly, CIRA personnel should not be limited to lawyers but should include economists who can analyze the data CIRA collects on existing market products and provide insight into the factors that influence performance and risk. CIRA should also employ experts in consumer behavior who can study, on an ongoing basis, the effect of the disclosure mandates on consumer choice.

Concededly, political barriers may render the creation of a new agency difficult.[415] In principle, the SEC could implement and administer the regulatory structure detailed in this Article. The SEC has long been understood as the champion of investor protection.[416] CI-

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[412] *Cf.* Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 98-99 (2008) (advocating reliance on an administrative agency rather than targeted legislation or ex post judicial intervention).

[413] Although CIRA would have jurisdiction over retail investment products, jurisdiction need not be limited to those products discussed in this Article. Indeed, the regulatory model this Article proposes could readily be extended to broaden retail investor access to pooled investment products, such as hedge funds and private equity funds, that have traditionally been restricted to accredited investors.

[414] CIRA would be able to conduct studies and collect data without incurring the claims of industry bias that are sometimes raised against organizations like FINRA and the Investment Company Institute. Notably, under the existing regulatory structure, industry organizations are virtually the only sources of information about the market and existing products.

[415] *See, e.g.*, Damian Paletta, *Consumer-Protection Agency in Doubt*, WALL ST. J., Jan. 15, 2010, at A4 (identifying political opposition to the creation of a stand-alone agency).

[416] *See, e.g.*, Arthur Levitt, Chairman, SEC, Remarks at the Commonwealth Club (May 17, 1996), *available at* http://www.sec.gov/news/speech/speecharchive/1996/

RA's mission, as described herein, is sufficiently extensive to warrant separate regulatory authority, however, and a new regulatory approach may be most effective when administered by an agency that is not invested in the old regulatory apparatus. Moreover, there are additional justifications for establishing a new regulator.

First, CIRA's creation would signal the importance of retail investor protection as a regulatory priority. Commentators have criticized the existing regulatory agencies for focusing on other priorities and paying insufficient attention to consumer needs. Although existing reform proposals seek to address consumer injuries with respect to mortgage and credit card products, nothing on the table is designed to restore consumer confidence in the capital markets or to deal with the forward-going need for consumers to act as effective investors.[417]

Second, CIRA's creation would recognize and legitimate the split between capital market regulation and retail investor protection. The "deretailization" of the capital markets and the explosion of institution-only products and markets highlight a dichotomy between two regulatory goals: market protection and retail investor protection.[418] The financial crisis has demonstrated that market protection is a critically important regulatory objective, and the SEC's existing regulatory regime is well suited to obtaining the information necessary to inform debt and equity prices; yet, as this Article has demonstrated, the methodologies for protecting the traditional capital markets may not address the specialized needs of retail purchasers of intermediated products.[419]

Third, CIRA would centralize authority for retail investor protection. Existing regulatory authority over mutual funds, ETFs, and retirement accounts is split among the SEC, the CFTC, the Department of Labor's Employee Benefits Security Administration (EBSA), and

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spch101.txt ("For the last 62 years, the protection of investors has been the primary goal of the Commission.").

[417] Proposals to privatize social security would dramatically increase this need. *See generally* Karen C. Burke & Grayson M.P. McCouch, *Privatizing Social Security: Administration and Implementation*, 58 WASH. & LEE L. REV. 1325 (2001) (exploring the administrative implications of privatization proposal trade-offs between limiting risk and facilitating individual control).

[418] *See* Cartwright, *supra* note 7 (describing the growth of institution-only markets and asset classes that do not involve disclosure or regulatory oversight other than antifraud remedies).

[419] *See, e.g.*, Jill E. Fisch, *Top Cop or Regulatory Flop? The SEC at 75*, 95 VA. L. REV. 785, 819 (2009) ("Many of the SEC's most glaring deficiencies . . . have centered on intermediary oversight."); Donald C. Langevoort, *The SEC, Retail Investors and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1081 (2009) ("The SEC is the retail investor's champion only in a bounded way.").

FINRA. A single regulator would clarify regulatory responsibility and prevent the Department of Labor from relying on the SEC to regulate 401(k) disclosure or the SEC from relying on FINRA to monitor broker-dealer sales practices.[420] Centralizing regulatory authority would limit efforts to structure products for the purpose of evading regulation—so-called regulatory arbitrage. By addressing both the product and the sales practice, a single regulator could identify relationships between the two, such as the extent to which broker advice benefits from or counteracts the effects of consumer-directed disclosure. Finally, concentrating authority within a single regulator would allow the development of expertise with respect to disclosure effectiveness, cognitive biases, and other issues of particular relevance to the protection of retail investors.

This last point suggests a valuable extension of CIRA beyond the administration of conform or explain. Regulators and commentators have identified a need for improved investor education,[421] a need that has expanded as a result of the growth in consumer-directed investment through retirement accounts, education accounts, and elsewhere. Yet retail investors today demonstrate investment behaviors that, even in the face of the best products, limit their ability to maximize their returns, including poor asset allocation, misguided efforts at market timing, performance chasing, and herding. Early evidence suggests, in particular, that retail investors will suffer disproportionately from the market turmoil of the last few years because of the poor timing of their investment decisions.[422] An agency that developed ex-

[420] The SEC has been repeatedly criticized, most recently in connection with the Madoff scandal, for delegating regulation of broker-dealers to FINRA. *See, e.g.*, Fisch, *supra* note 419, at 800-03 (identifying shortcomings in FINRA's regulation of broker-dealers and protection of customers); Posting of Shepherd Smith Edwards & Kantas to Stockbroker Fraud Blog, http://www.stockbrokerfraudblog.com/2009/09/sec_nasd_finra_sipc_new_sec_report_card_on_madoff_catastrophy_furhter_reveals_that_investor_protection_is_severely_flawed.html (Sept. 3, 2009) (describing FINRA as "a non-profit corporation owned by securities firms, with a charter similar to that of a country club").

[421] *See, e.g.*, Black, *supra* note 255, at 307 (highlighting the need for retail investors to receive sufficient education to evaluate their brokers' recommendations); James A. Fanto, *Comparative Investor Education*, 64 BROOK. L. REV. 1083, 1084-86 (1998) (calling for increased attention to investor education in light of developments in how retirement accounts are managed).

[422] As the market reached its trough in March 2009, retail investor money was rapidly exiting equity funds. *See, e.g.*, Shell, *supra* note 14 (reporting that, during the week ending March 11, 2009, "investors yanked a net $22.1 billion out of stock funds"). Retail investors remained on the sidelines as the market rebounded during the remainder of 2009. *See, e.g.*, Tomoeh Murakami Tse, *Many Small Investors Have Sat Out Rally*, WASH. POST, Oct. 15, 2009, at A18 (reporting that most small investors stayed out

pertise in retail investors and their investment behavior would be well positioned to tailor investor education to these problems.

CONCLUSION

Mutual funds and other intermediated retail investment products offer the potential for consumers to participate in capital market growth, protect their savings from the effects of inflation, and build a nest egg for education, retirement, and other financial goals. This potential has led an increasing number of investors—including many of limited means and sophistication—to purchase such products. It is time for regulators to respond to these developments through a regulatory approach tailored to the needs of those retail investors.

Although the SEC has endeavored to protect retail investors pursuant to the ICA, an examination of the market for retail investment products suggests deficiencies in that approach. At the same time, the regulatory and governance components of the ICA are costly and limit innovation. This Article has argued that an alternative approach premised on giving investors the choice of standardized financial products or comparative disclosure of product differences could reduce compliance costs and protect investors.

Conform or explain couples increased transparency, through the promulgation of standardized products, with a set of objective and predictable sales practices that would enhance consumer protection while limiting excessive liability exposure. Conform or explain enables providers of retail investment products to innovate and to differentiate their products from those of competitors with the assurance that market forces can adequately evaluate such innovations. Finally, conform or explain provides a template for CIRA, a new agency, to structure regulation and to develop expertise in the retail market that can facilitate future developments in investor education.

It is difficult to predict the effect this proposal would have on existing products and fee structures. Conform or explain may dramatically reduce the number of retail investment products as improved disclosure unmasks limited product differences and strategic complexity. Alternatively, new products and product structures may emerge as fund

of the market as it rose 53% between March and October 2009). Subsequently, after the market recouped much of what it had lost, retail money began to flow back into the market. *See, e.g.*, Jeff Cox, *Are Average Investors Getting Too Optimistic About Stocks?*, CNBC.COM, Jan. 4, 2010, http://www.cnbc.com/id/34688573 (reporting that retail investment into equity funds "soared" in the week ending December 22, 2009).

sponsors are freed from existing regulatory constraints on leverage, compensation structure, liquidity, and concentration. The critical component of the proposal is that it does not depend on regulatory omniscience to determine which products are suitable for investors but instead unleashes market forces to make these choices.