

## RECONCEPTUALIZING INVESTMENT MANAGEMENT REGULATION

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### INTRODUCTION

The value of investments in mutual funds, hedge funds, and similar financial products fell by trillions of dollars in the economic crisis that unfolded in the fall of 2008.<sup>1</sup> While financial swings are inevitable, fund investors would have been better positioned to bear these losses had their participation in financial markets through fund intermediaries been guided by a more narrowly tailored and well-reasoned regulatory scheme. Currently, the regulation of the fund industry is a study in contrasts. Holding approximately \$9.6 trillion in assets,<sup>2</sup> mutual funds are the industry centerpiece. These funds, in which all investors may participate, are required to supply reams of disclosure and comply with detailed restraints that strike at the foundation of the way such businesses are run.<sup>3</sup> Meanwhile, hedge funds and other private pools of capital, which now manage significant assets themselves and wield tremendous influence on capital markets, are free from substantive securities-law oversight as long as they strictly limit both who they do business with and how they market to them.<sup>4</sup>

This Article analyzes this two-tiered structure. It finds that this regulatory scheme is not responsive to public-welfare concerns, while at the same time, it alters the competitive landscape of the fund marketplace in a way that undermines the interests of the common investor.<sup>5</sup> In light of this analysis, I suggest that the public would be better served if this regulatory scheme was reformed in a manner consistent with the ideas of libertarian

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<sup>1</sup> James Sterngold, *Unimaginable Collapses Became Commonplace in 2008*, SEATTLE TIMES, Jan. 4, 2009, available at [http://seattletimes.nwsource.com/html/business/technology/2008587364\\_bad\\_year04.html](http://seattletimes.nwsource.com/html/business/technology/2008587364_bad_year04.html).

<sup>2</sup> INV. CO. INST., TRENDS IN MUTUAL FUND INVESTING DECEMBER 2008, [http://www.ici.org/stats/mf/trends\\_12\\_08.html#TopOfPage](http://www.ici.org/stats/mf/trends_12_08.html#TopOfPage).

<sup>3</sup> See *infra* Parts II.C-D.

<sup>4</sup> See *infra* Parts II.A-B.

<sup>5</sup> See *infra* Part II.

paternalism—that rules should seek to foster better consumer decisionmaking without sacrificing freedom of choice.<sup>6</sup>

The Securities and Exchange Commission (“SEC”) and commentators alike have looked at various aspects of investment management regulation,<sup>7</sup> but they have yet to consider the scheme as a whole, and the various analyses of this area have lacked an explicit normative framework. This piece adds to the literature by taking a broader perspective and grounding the analysis in welfarist principles. Namely, I conceptualize mutual funds, hedge funds, and similar pooled investments as making up a single market. The regulatory scheme can then be seen as government intervention into this market and judged according to welfare-economics principles that are widely relied upon to consider the probity of public intervention into private markets. The central idea behind the welfare-economics inquiry is that society fares best when markets are competitive.<sup>8</sup> Regulation is therefore justified to the extent it corrects for failures in the market that hinder competition and does so in a cost-effective manner.<sup>9</sup>

In the fund industry, the primary market-failure concerns revolve around consumer fallibility—that fund investors potentially lack the information and know-how to properly make investing decisions without regulatory intervention.<sup>10</sup> The structure of the regulatory regime, however, appears to be at best an awkward response to these issues. The primary concern is the difficulty investors may have in deciding how to allocate their money among funds, yet the regime does not appear to provide investors with the most effective tools for making that decision. The rules are meant to assist investors by requiring that mutual funds provide copious disclosures.<sup>11</sup> But the required documentation appears to contain too much information, while failing to clearly address the central issues of fund investing.<sup>12</sup>

Instead of sharpening its focus on helping investors make better choices, the SEC has chosen to make certain decisions on their behalf. Those investors who fail to meet certain wealth criteria may only invest in funds

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<sup>6</sup> See RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE* 4-6 (2008) [hereinafter THALER & SUNSTEIN, *NUDGE*]; Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 1159, 1159 (2003) [hereinafter Sunstein & Thaler, *Libertarian Paternalism*].

<sup>7</sup> See, e.g., Paul F. Roye, Dir., Div. of Inv. Mgmt., Sec. & Exch. Comm’n, *Priorities in Investment Management* (Oct. 17, 2002) (transcript available at <http://www.sec.gov/news/speech/spch592.htm>) (discussing SEC achievements and priorities in the various aspects of investment management regulation).

<sup>8</sup> See WILLIAM J. BAUMOL & ALAN S. BLINDER, *ECONOMICS: PRINCIPLES AND POLICY* 221-22 (8th ed. 2001) (explaining how perfect competition achieves efficiency).

<sup>9</sup> See Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 911 (1994).

<sup>10</sup> See *infra* Part I.

<sup>11</sup> See *infra* Part II.C.

<sup>12</sup> See *infra* Parts II.C.1-3.

that comply with strict restrictions on fund governance, charge only certain types of fees, and comply with various rules regarding investing strategy and fund liquidity.<sup>13</sup> These rules, however, appear to be poorly theorized in that they either take away investor autonomy when this step appears unnecessary or in that the mandated structures fail to truly assist shareholders.<sup>14</sup> Moreover, the rules reshape the fund marketplace to the disadvantage of the common investor. Among other things, the regulations make it harder for smaller and newer firms to compete within the mutual-fund market, while incentivizing talented managers to offer their services solely to elite investors.<sup>15</sup>

I suggest that a revised regulatory structure—one rooted in Richard Thaler's and Cass Sunstein's regulatory philosophy of libertarian paternalism—would undo the anticompetitive aspects of the regime, while likely providing greater benefits to investors.<sup>16</sup> Rules envisioned under this paradigm are paternalistic in the sense that they attempt to steer people toward choices that are in their own best interests, but they are libertarian because individuals remain free to actually make the decisions on their own.<sup>17</sup> This ideology is deeply rooted in behavioral economics findings, which suggest that people often make choices that are objectively flawed.<sup>18</sup> Concerns about consumer decisionmaking form the primary justification for regulatory intervention in the first place, and the fallibility of regulators is part of what counsels the limited nature of the intervention.<sup>19</sup>

Libertarian-paternalist principles can serve as the basis for more narrowly tailored and potentially more effective investment management regulation. To improve investor decisionmaking, the current hefty disclosure requirements could be streamlined and the SEC could take a more direct role in providing useful information to investors.<sup>20</sup> At the same time, to restore freedom of choice to the industry, the SEC could abandon its current rigid compartmentalization of investors and instead allow funds to offer a range of products subject to varying levels of regulation.<sup>21</sup> Investors themselves could then choose funds subject to the regulatory scheme where they

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<sup>13</sup> See *infra* Part II.

<sup>14</sup> See *infra* Part II.D.

<sup>15</sup> See *infra* Parts II.D.2.a, III.D.

<sup>16</sup> See *infra* Part III.

<sup>17</sup> THALER & SUNSTEIN, NUDGE, *supra* note 6, at 4-6. For a broad exploration of libertarianism, see DAVID BOAZ, LIBERTARIANISM: A PRIMER (1997). On the other hand, for more on paternalism, see Thaddeus Mason Pope, *Counting the Dragon's Teeth and Claws: The Definition of Hard Paternalism*, 20 GA. ST. U. L. REV. 659 (2004).

<sup>18</sup> THALER & SUNSTEIN, NUDGE, *supra* note 6, at 5.

<sup>19</sup> *Id.* at 5, 10. In justifying regulation based on the propensity of individuals to error, this theory is related to "soft" paternalism, which sees paternalistic measures as only appropriate in circumstances where individual decisionmaking is likely suspect. See Pope, *supra* note 17, at 667-69.

<sup>20</sup> See *infra* Part III.A.1.

<sup>21</sup> See *infra* Part III.

feel most comfortable. One important step along these lines would be the establishment of a new type of investment fund that is permitted to use strategies currently reserved for hedge funds and the like, but is subject to restraints that ease concerns about the capability of less sophisticated investors to wisely navigate this new sector of the marketplace.<sup>22</sup> This revised scheme responds directly to worries about flawed investor decisionmaking without imposing artificial constraints on the market.<sup>23</sup> By doing so, it likely represents the best way to reach society's goal of a highly competitive fund industry.<sup>24</sup>

The first part of this Article sets out the normative welfare-economics framework that forms the basis of both my critique of the current regulatory structure and my agenda for reform. The second holds the current regulations up to scrutiny under this paradigm, which allows the problematic aspects to shine through. In the next part, I set forth my reform proposal—one that grants investors greater autonomy while improving their ability to fend for themselves. Finally, the Article briefly addresses the real-world problem of moving from policy analysis to implementation. Specifically, I look at the potential that regulatory capture not only is part of the explanation for the current oftentimes anticompetitive regulatory structure, but that it also could pose an obstacle to meaningful change. Drawing on recent social-science scholarship, I note that, while interest-group influence is a valid concern, reform proposals have the most chance of success when the populist appeal of reform is too strong for interest groups to counter—and that although securities regulation rarely garners the spotlight, the current political environment likely poses a rare policy window. Recent financial turbulence and a growing consensus that the current regulation of Wall Street is inadequate has put the prospect of re-regulating the investing community squarely at the center of public debate,<sup>25</sup> which means the coming months potentially offer an opportunity to enact meaningful change.

## I. NORMATIVE FRAMEWORK FOR CONSIDERING INVESTMENT MANAGEMENT REGULATION

SEC rulemaking and academic commentary with respect to investment management regulation has so far proceeded without a satisfying theoretical structure. The agency's most frequent defense of regulation is "investor

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<sup>22</sup> See *infra* Part III.B.

<sup>23</sup> See *infra* Part III.D.

<sup>24</sup> See *infra* Part III.D.

<sup>25</sup> See, e.g., Peter Grier, *Fallout from Madoff Scandal: New Safeguards?*, CHRISTIAN SCIENCE MONITOR MAG., Jan. 7, 2009, at 1, available at 2009 WLNR 262851; Damian Paletta et al., *Paulson Plan Begins Battle Over How to Police Market; Amid Crisis, a Bid to Shuffle Powers; Fast Fixes Unlikely*, WALL ST. J., Mar. 31, 2008, at A1.

protection,”<sup>26</sup> but this justification carries little analytical depth. Just because a regulation protects investors does not necessarily mean it is wise. Academics have drilled down deeper in critiquing existing regulations and suggesting reforms, but the focus has been on individual rules and the works have failed to address the regulations through the prism of a precise normative benchmark.<sup>27</sup> A welfare-economics framework can provide a backbone to regulatory analysis in this area, focusing the discussion and yielding new insights into both the probity of the regulatory scheme as a whole and the ways in which it could be reformed.

This theory conceptualizes regulation as public interference in private markets and sets forth a paradigm for judging when intervention is appropriate. The basic premise is that if a freely competitive market is functioning efficiently, then there is no need for government intervention.<sup>28</sup> As firms compete to offer the best goods and services to consumers, a virtuous circle ensues. The Supreme Court set forth this theory nicely in a discussion of the Sherman Act, explaining that the Act is based on the premise that:

[U]nrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress, while at the same time providing an environment conducive to the preservation of our democratic political and social institutions.<sup>29</sup>

Free competition, however, may not always yield such a utopian result. If the market itself is flawed, then it may be unwise to rely solely on the invisible hand to bring about societal progress. Regulation, therefore, may be justified when a market suffers from such structural imperfections—so-called market failures.<sup>30</sup>

Early incarnations of this justification for regulation utilized a narrow conception of the market-failure concept. Markets could fail if they involved the provision of public goods or caused harmful third-party effects (so-called negative externalities).<sup>31</sup> This rigidity, however, has given way as attention in economics has shifted to problems of information and cogni-

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<sup>26</sup> See, e.g., Roel C. Campos, Comm’r, Sec. & Exch. Comm’n, Mutual Fund Governance-Response to the Remand (June 29, 2005) (transcript available at <http://sec.gov/news/speech/spch062905rcc.htm>); Paul F. Roye, Director, Div. of Inv. Mgmt., Sec. & Exch. Comm’n, Proactive Initiatives to Protect Mutual Fund Investors (May 23, 2003) (transcript available at <http://www.sec.gov/news/speech/spch052303pfr.htm>).

<sup>27</sup> See, e.g., John P. Freeman, *The Mutual Fund Distribution Expense Mess*, 32 J. CORP. L. 739 (2007); Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. ECON. PERSP. 161 (2004).

<sup>28</sup> See Paul Joskow & Roger Noll, *Regulation in Theory and Practice: An Overview*, in STUDIES IN PUBLIC REGULATION 4 (Gary Fromm ed., 1981).

<sup>29</sup> *N. Pac. Ry. v. United States*, 356 U.S. 1, 4 (1958).

<sup>30</sup> See Macey, *supra* note 9, at 911.

<sup>31</sup> Tyler Cowen & Eric Crampton, *Introduction to MARKET FAILURE OR SUCCESS: THE NEW DEBATE 3* (Tyler Cowen & Eric Crampton eds., 2002).

tion. Research has arisen that studies the harm that may result when market participants act with imperfect information or make decisions under conditions of bounded rationality.<sup>32</sup> If consumers have flawed information, they may be unable to allocate their spending to the products that best suit their needs.<sup>33</sup> This not only hurts the individual who makes the faulty purchase, but can undermine the competitive structure of the marketplace.<sup>34</sup> If information problems are pervasive, they could lead to the phenomenon of adverse selection—where goods of different quality are sold at the same price because buyers are not sufficiently informed about the true value of the item they wish to purchase.<sup>35</sup> Economic theory predicts that adverse selection leads to a predominance of low quality products as high quality ones are pushed out of the market because they are not being rewarded for their high quality.<sup>36</sup>

The fact that individuals do not make fully rational decisions carries similar market-failure implications. It is by now well-documented that individuals suffer from a range of decisionmaking flaws that undermine the deliberative process.<sup>37</sup> People systematically make cognitive errors and rely on heuristics (mental shortcuts that may lead down the wrong path) to reach decisions.<sup>38</sup> In addition, the decisionmaking process requires work, and it may be irrational for individuals to incur the costs of uncovering and analyzing all of the information that must be digested in order to render a perfect decision.<sup>39</sup> The presence of these so-called search costs lead individuals to “satisfice”—that is, seek to make decisions that are “good enough” rather than perfect.<sup>40</sup> The existence of these imperfections in information accumulation and processing, whether rational or irrational, conscious or unconscious, can undermine people’s ability to make correct decisions.<sup>41</sup> These errant choices directly injure the individuals who make them and potentially compromise market competition.<sup>42</sup>

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<sup>32</sup> See *id.* at 3-5 (discussing theories with respect to imperfect information); John Conlisk, *Why Bounded Rationality?*, 34 J. ECON. LIT. 669, 669-700 (1996) (discussing bounded rationality).

<sup>33</sup> See George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488, 489-90 (1970).

<sup>34</sup> See *id.*

<sup>35</sup> See *id.*

<sup>36</sup> See Cowen & Crampton, *supra* note 31, at 7. This phenomenon is commonly referred to as the “lemons” problem in reference to Akerlof’s seminal piece. See generally Akerlof, *supra* note 33.

<sup>37</sup> Conlisk, *supra* note 32, at 670 (listing out the results of numerous studies).

<sup>38</sup> *Id.*

<sup>39</sup> *Id.* at 686-92.

<sup>40</sup> Herbert A. Simon, *Rational Decisionmaking in Business Organizations*, 69 AM. ECON. REV. 493, 502-03 (1979).

<sup>41</sup> See THALER & SUNSTEIN, NUDGE, *supra* note 6, at 6-8.

<sup>42</sup> See *id.* at 79; Jeffrey J. Rachlinski, *The Uncertain Psychological Case for Paternalism*, 97 NW. U. L. REV. 1165, 1186-87 (2003); cf. Russell Korobkin, *The Efficiency of Managed Care “Patient Protection” Laws: Incomplete Contracts, Bounded Rationality, and Market Failure*, 85 CORNELL L.

If bounded rationality, or any other market failures are present, then there is the potential that the free market is not, on its own, leading to the proper allocation of resources, and this opens the door for government regulation.<sup>43</sup> In crafting an apt response to market failure, regulators choose from a range of alternative modes of intervention. Their goal should be to select the most efficient regulatory mechanism—the one that appears most likely to maximize the benefits of regulation in terms of its potential positive effect on the market relative to the direct and indirect costs it imposes on society.<sup>44</sup> At its best, therefore, regulation is a well-reasoned and narrowly tailored response to market failure.

This approach to the study of regulation began with economists, but has since gained wide acceptance.<sup>45</sup> It has transcended the academic world, finding expression as a central component of Executive Order 12,866, which sets forth guidelines for regulatory analysis by executive agencies,<sup>46</sup> and Circular A-4, a more recent document that fleshes out how best to comply with the requirements of the order.<sup>47</sup> As a result, welfare-economics analysis is used heavily by governmental entities such as the Environmental Protection Agency and the Occupational Safety and Health Administration.<sup>48</sup> The SEC, as an independent agency, is exempt from these guidelines,<sup>49</sup> but there have been calls recently for the SEC to strengthen its analysis along these lines. A recent rule regulating mutual-fund governance was overruled, for instance, because the SEC failed to adequately consider its costs.<sup>50</sup>

This pressure from the courts is bolstered, not only by the precedent for this type of analysis within other U.S. governmental agencies, but also by its use in the finance context abroad. Specifically, the United Kingdom's securities regulator, the Financial Services Authority, recently put in place

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REV. 1, 56-59 (1999) (exploring the implications of bounded rationality in the market for managed care).

<sup>43</sup> See Macey, *supra* note 9, at 911.

<sup>44</sup> See W. KIP VISCUSI, JOHN M. VERNON & JOSEPH E. HARRINGTON, JR., *ECONOMICS OF REGULATION AND ANTITRUST* 667 (2d ed. 1995). These costs can come in many forms. Some are overt. Regulators consume resources erecting and maintaining the regulatory apparatus and the industry expends the necessary sums to comply. But regulation also has costs that are more hidden, including the negative impact it often has on competition—a feature of regulation that is a focus of this Article. See Macey, *supra* note 9, at 911.

<sup>45</sup> See Cowen & Crampton, *supra* note 31, at 3.

<sup>46</sup> Exec. Order No. 12,866, 3 C.F.R. 638 (1993), *reprinted in* 5 U.S.C. § 601 (2000).

<sup>47</sup> Office of Mgmt. & Budget, Executive Office of the President, OMB Circular A-4, Regulatory Analysis, at 3-5 (2003), *available at* <http://www.whitehouse.gov/OMB/circulars/a004/a-4.pdf>.

<sup>48</sup> Edward Sherwin, *The Cost-Benefit Analysis of Financial Regulation: Lessons from the SEC's Stalled Mutual Fund Reform Effort*, 12 STAN. J.L. BUS. & FIN. 1, 4-5 (2006).

<sup>49</sup> *Id.* at 10-11.

<sup>50</sup> Chamber of Commerce of the U.S. v. SEC, 412 F.3d 133, 144 (D.C. Cir. 2005).

guidelines for market-failure analysis.<sup>51</sup> All of this suggests that viewing regulation through an economic paradigm is much in line with contemporary and evolving thought on when and how best to regulate.

It is also an apt fit to the study of investment management regulation. All funds are essentially the same in that they pool investor money for re-investment according to a predetermined strategy. That being the case, mutual funds, hedge funds, and the remaining fund-types can be seen as making up one market—a market with potential failures. Once viewed in this way, regulation can be scrutinized in terms of its responsiveness to these potential shortcomings in the marketplace.

Doing so provides structure to regulatory analysis in this area. This abstract conception of how best to pursue societal goals allows us to consider the more traditional and tangible justifications often given for regulatory intervention in this market on a more consistent and deeper level. For instance, the current rules offer at least some protection from fraud, conflicts of interest, and poor investing decisions.<sup>52</sup> It is incomplete, however, to defend a regulation merely by pointing to one or another of these benefits. A rule may be bad because it provides too little or even too much investor protection along these lines. Absent some overarching framework, it is difficult to take into account all of the relevant factors that go into whether the rules are truly appropriate.

The market-failure paradigm cuts through this haze. A response to a conflict of interest, for instance, only withstands scrutiny if it addresses a market failure that renders the conflict harmful, and does so in an efficient manner. Imposing this structure on the analysis forces us to take into account the power of the market and the relationship between the market and regulatory intervention, both of which could get lost in a rudderless evaluation. To see this, consider again conflicts of interest. These are often cited as grounds for regulation, yet alone the presence of a conflict is an insufficient justification. Absent a market failure, a competitive market will adjust. Firms will develop monitoring mechanisms to decrease the chance of abuse and consumers will take the risk of harm into account in their decisionmaking. This aspect of the issue could get lost in a discussion that fails to explicitly consider the self-correcting ability of a well-functioning market. The respect for competitive markets also draws our attention to the anticompetitive impacts of regulation. One of the ironies of regulation is that rules, even if well-intentioned, almost inexorably have a negative impact on competition.<sup>53</sup> For example, educational requirements for attorneys may be beneficial in setting a minimum professional standard, but they also pose a barrier to entry, thereby reducing competition for legal services.

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<sup>51</sup> FINANCIAL SERVICES AUTHORITY, A GUIDE TO MARKET FAILURE ANALYSIS AND HIGH LEVEL COST BENEFIT ANALYSIS (2006), available at [http://www.fsa.gov.uk/pubs/other/mfa\\_guide.pdf](http://www.fsa.gov.uk/pubs/other/mfa_guide.pdf).

<sup>52</sup> See Investment Company Act, 15 U.S.C. § 80a-1 to a-64 (2000).

<sup>53</sup> STEPHEN BREYER, REGULATION AND ITS REFORM 194 (1982).

Since society should be encouraging competition rather than squelching it, the regulation's impact on the market should always be carefully taken into account.<sup>54</sup>

In the sections that follow, I look at the current outline of investment management regulation through a market-failure paradigm. A comprehensive analysis along these lines potentially involves rigorous quantification of both the costs and benefits of regulatory intervention.<sup>55</sup> Agencies conducting this inquiry typically spend \$1 to \$2 million per study.<sup>56</sup> While such an analysis may be a beneficial step before regulatory overhaul, at this preliminary stage, a more theoretical inquiry is sufficient to at least shift the burden of persuasion to those who would defend the status quo.

This Article builds on the approach to market-failure analysis that then-Professor (now Justice) Stephen Breyer sets forth in his noted book, *Regulation and Its Reform*.<sup>57</sup> Breyer's framework is based on the intuitive idea that regulations should "match" market failures that justify intervention.<sup>58</sup> The idea of regulatory match encompasses two concepts, which are illustrative of the Janus-faced nature of regulation. On the one hand, for regulation to be a good fit, it must appear to be well-designed to ameliorate the market failure that concerns us.<sup>59</sup> On the other hand, because rules that seek to foment competition can actually undermine it, for a regulation to be considered a correct match we must also be comfortable that its ameliorative impact on market failure is not outweighed by side effects that undermine the broader competitive framework.<sup>60</sup> A rule therefore withstands scrutiny under this framework as long as it is a well-reasoned response to market failure that does not significantly disrupt the market.<sup>61</sup> This focus on regulatory fit directly addresses the central public-policy question: whether the chosen form of regulation is the most appropriate mechanism for the market failure that justifies government action, or in costs-benefits language, whether it is the one that maximizes the potential benefits of regulatory intervention relative to costs.

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<sup>54</sup> The social costs of anticompetitive regulation are explored in Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 W. ECON. J. 224 (1967). See also Jonathan R. Macey, *Transaction Costs and the Normative Elements of the Public Choice Model: An Application to Constitutional Theory*, 74 VA. L. REV. 471, 477-80 (1988).

<sup>55</sup> For a description of this type of analysis, see E.J. MISHAN, *COST-BENEFIT ANALYSIS* (Routledge 2007); Matthew D. Adler & Eric A. Posner, *Rethinking Cost-Benefit Analysis*, 109 YALE L.J. 165, 177-87 (1999).

<sup>56</sup> MATTHEW D. ADLER & ERIC A. POSNER, *NEW FOUNDATIONS OF COST-BENEFIT ANALYSIS* 80 (2006).

<sup>57</sup> BREYER, *supra* note 53.

<sup>58</sup> *Id.* at 191-96.

<sup>59</sup> See *id.*

<sup>60</sup> See *id.* at 194-95.

<sup>61</sup> See *id.*

Going through this two-pronged analysis reveals the shortcomings in the current regulatory structure, including the ways in which it squelches competition. It also points to the benefits of a libertarian paternalist reform agenda. Libertarian paternalism's focus on aiding consumer decisionmaking without sacrificing investor choice performs well under both stages of this inquiry. Reforms along these lines directly address the central market failures in this area without deleterious market consequences.

## II. MARKET-FAILURE ANALYSIS OF INVESTMENT MANAGEMENT REGULATION

The investment management industry is subject to a complex web of regulations. The analysis in this section suggests that the major components of this structure only loosely fit potential market-failure justifications, while altering the structure of the competitive landscape to the disadvantage of ordinary investors.

### A. *Regulatory Structure*

The regulatory regime governing this area is at times very intrusive and at other times relatively laissez faire. The structure begins by regulating investors. It divides them into two categories: those who meet minimum criteria for wealth and those who do not.<sup>62</sup> Funds that shield themselves from those in the latter category and comply with other particulars in specific regulatory exemptions are thereafter free from the vast majority of securities regulation.<sup>63</sup> Hedge funds, private equity funds, and venture capital funds fall into this category.<sup>64</sup> If funds wish to reach outside the financial elite, that is when they come under the auspices of the Investment Company Act ("ICA"),<sup>65</sup> which forms the basis of a pervasive regulatory regime. In exchange for access to ordinary investors, mutual funds subject themselves to the multi-faceted requirements of the ICA and related statutes.<sup>66</sup>

This framework for fund industry regulation can be seen as consisting of three central components, each of which is explored in the sections below. At the heart of the regulatory regime are the exemptive rules that channel ordinary investors to highly regulated mutual funds, while leaving

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<sup>62</sup> See *infra* Part II.B.

<sup>63</sup> See *infra* Part II.B.

<sup>64</sup> DIV. OF INV. MGMT., SEC. & EXCH. COMM'N, STAFF REPORT TO THE U.S. SEC. & EXCH. COMM'N: IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS viii (2003) [hereinafter HEDGE FUND REPORT].

<sup>65</sup> 15 U.S.C. § 80a-1 to a-64 (2000).

<sup>66</sup> Mutual funds are also subject to the Securities Act of 1933, *id.* § 77a-77aa, the Securities Exchange Act of 1934, *id.* § 78a-78mm, and the Investment Advisers Act of 1940, *id.* § 80b-1 to b-21.

funds that do not court this group outside the regulatory sphere.<sup>67</sup> Regulation of mutual funds is then approached from two opposite directions. On the one hand, these funds must produce detailed and lengthy disclosure documents.<sup>68</sup> This can be seen as a relatively mild form of intervention because, instead of mandating certain terms, the rules leave it to investors to decide, based on standardized disclosures, which terms are appropriate for them. On the other hand, however, the rules include myriad substantive mandates that dictate fund operations, rather than leave it to investor choice.<sup>69</sup> Three of the most impactful substantive regulations are explored in this Article: those that mandate fund governance, fund fees, and fund liquidity practices. These rules, as well as those that govern fund disclosure, will be looked at after first addressing the exemptive rules used to partition the fund marketplace.

#### B. *Exempting Privately Placed Funds from Regulatory Oversight*

A central dividing line in fund industry regulation is drawn by the rules that separate mutual funds from hedge funds and the like. The regulations that permit the latter to operate free of substantive restrictions are tied into those that allow corporations to privately place their securities.<sup>70</sup> Like traditional issuers, funds exempt themselves from hefty regulatory requirements if they restrict both how they market their shares and to whom they are marketed. Immunity from the ICA, the base of the vast majority of investment fund regulation, is achieved through compliance with either of two ICA exemptions: section 3(c)(1)<sup>71</sup> or 3(c)(7).<sup>72</sup>

Section 3(c)(1) requires that a fund (1) has fewer than one-hundred investors and (2) that it does not presently propose to make a public offering of its securities.<sup>73</sup> The latter half of the rule is met as long as the fund complies with section 4(2) of the Securities Exchange Act.<sup>74</sup> This can be done by meeting the requirements of one of the several safe-harbor rules contained in Regulation D.<sup>75</sup> Under Rule 506, which is most commonly relied upon, the fund may sell shares to an unlimited number of “accredited inves-

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<sup>67</sup> See *infra* Part II.B.

<sup>68</sup> See *infra* Part II.C.

<sup>69</sup> See *infra* Part II.D.

<sup>70</sup> See 15 U.S.C. § 77d (exempting private placement transactions from the Securities Act registration requirements); *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125-27 (1953) (holding that to qualify as a private placement, the issuer must establish that the security offerees can fend for themselves and have access to the kind of information that registration would disclose).

<sup>71</sup> 15 U.S.C. § 80a-3(c)(1) (2000).

<sup>72</sup> *Id.* § 80a-3(c)(7).

<sup>73</sup> *Id.* § 80a-3(c)(1).

<sup>74</sup> HEDGE FUND REPORT, *supra* note 64, at 12.

<sup>75</sup> *Id.*

tors.”<sup>76</sup> The rules list out those who qualify under this standard. Most importantly, the list includes institutions with at least \$5 million in assets, as well as individuals whose net worth is at least \$1 million or who have earned at least \$200,000 in each of the two most recent years (\$300,000 if spousal income is included) and have a reasonable expectation of earning the same in the year of the investment.<sup>77</sup> Moreover, in selling their shares to these investors, funds are not permitted to engage in advertising or general solicitation.<sup>78</sup>

Funds seeking exemption through compliance with section 3(c)(7) face similar requirements. The paradigmatic way a fund meets this test is by refraining from public marketing and selling shares only to “qualified purchasers.”<sup>79</sup> Essentially, qualified purchasers are individuals owning at least \$5 million in investments or institutions with investments of at least \$25 million.<sup>80</sup>

### 1. Analysis of Responsiveness to Market Failure

To withstand scrutiny under the market-failure paradigm, the decision to exempt from regulatory oversight those funds that adhere to the criteria set out in sections 3(c)1 and 3(c)(7) should be explainable as part of the government’s response to shortcomings in the fund marketplace.<sup>81</sup> Though these rules do not directly respond to market failures, they would nevertheless pass muster to the extent they result in a more narrowly tailored regulatory regime—focusing the regulatory apparatus where needed, clearing it away where the rules would merely pose unnecessary costs. We can, therefore, judge these exemptive rules by looking at whether they appear well-

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<sup>76</sup> 17 C.F.R. § 230.506 (2008). For the definition of “accredited investor,” see *id.* § 230.501.

<sup>77</sup> *Id.* § 230.501(a). In addition, a fund may sell to thirty-five unaccredited investors as long as the fund reasonably believes that each of these purchasers either alone or with an adviser is capable of evaluating the prospective investment. *Id.* § 230.506(b). In this case, certain descriptive information must be provided. *Id.* § 230.502(b). Hedge funds generally have not made use of this exception. See Willa E. Gibson, *Is Hedge Fund Regulation Necessary?*, 73 TEMP. L. REV. 681, 690 (2000).

<sup>78</sup> 17 C.F.R. § 230.502(c); HEDGE FUND REPORT, *supra* note 64, at 16. The SEC has proposed to amend this exemption so that in addition to the above, a fund would only be able to sell to an individual if that person is an “accredited natural person,” which is defined as someone with at least \$2.5 million in investments. Prohibition of Fraud by Advisers to Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Securities Act Release No. 33-8766, Investment Advisers Act Release No. 2576, 72 Fed. Reg. 400, 405 (proposed Jan. 4, 2007) (to be codified at 17 C.F.R. §§ 230.216(a), .509(a)) [hereinafter Accredited Investor Release].

<sup>79</sup> 15 U.S.C. § 80a-3(c)(7) (2000); HEDGE FUND REPORT, *supra* note 64, at 12-13.

<sup>80</sup> 15 U.S.C. § 80a-2(a)(51)(A)(i), (iv). Even though section 3(c)(7) of the ICA would permit funds to sell to as many qualified purchasers as they want, funds usually limit themselves to 499 such investors so as to avoid regulation under the Securities Exchange Act of 1934. HEDGE FUND REPORT, *supra* note 64, at 13.

<sup>81</sup> See *supra* text accompanying notes 29-44.

designed to effectively accomplish this task without undue market disruption.

One argument for this set of exemptions is that they serve as a proxy to identify a niche investing community, with respect to which regulation is unnecessary. For instance, in a 2003 study of hedge funds, the SEC explained that “Section 3(c)(1) reflects Congress’s view that privately placed investment companies owned by a limited number of investors do not rise to the level of federal interest under the Investment Company Act.”<sup>82</sup> According to this line of thought, the exemptions are, at least in part, based on the notion that private funds represent a small corner of the industry, where the costly apparatus of federal regulation is out of place.

This, however, is antiquated logic. Though private-fund investing may have been a niche when the regime was adopted in 1940, it is certainly not today. The regulatory structure may have slowed, but did not prevent, the emergence of an important industry outside the bounds of direct regulation. Today thousands of funds managing over a trillion dollars avoid regulation through use of these exemptions.<sup>83</sup> The size of the industry, therefore, does not validate steering regulation away from private funds.

Perhaps this investment community is different, however, not because of its size but because of the financial sophistication of those investors who participate. The wealth thresholds at least may be defensible as a proxy for financial savvy and access to sufficient investing information. In theory, those who possess these traits may be less susceptible to bounded rationality and information imperfections, the primary market-failure justifications for intervention into the fund marketplace.<sup>84</sup> It, therefore, may make sense to leave such investors free from onerous investing restrictions.<sup>85</sup>

The persuasiveness of this line of thought hinges on how well the wealth-based proxy is able to correctly sort out those who can fend for themselves from those who can not. If the rule accurately sends investors to

<sup>82</sup> HEDGE FUND REPORT, *supra* note 64, at 11-12.

<sup>83</sup> In a report to the President’s Working Group on Financial Markets in April 2008, it was estimated that there were 8,000 hedge funds managing \$2 trillion. REPORT OF THE ASSET MANAGERS’ COMM. TO THE PRESIDENTS WORKING GROUP ON FINANCIAL MKTS., BEST PRACTICES FOR THE HEDGE FUND INDUSTRY *i* (2008). These figures have shrunk since then, but remain sizeable. Matthew Goldstein, *The Humbling of Hedge Funds*, BUS. WK., Dec. 28, 2008, at 26 (estimating hedge-fund assets to be \$1.5 trillion).

<sup>84</sup> See *supra* text accompanying notes 32-43.

<sup>85</sup> This SEC appears to embrace this viewpoint. See Accredited Investor Release, *supra* note 78, at 404 (“We adopted the \$1,000,000 net worth and \$200,000 income standards . . . based on our view that these tests would provide appropriate and objective standards to meet our goal of ensuring that only such persons who are capable of evaluating the merits and risks of an investment in private offerings may invest in one.”); HEDGE FUND REPORT, *supra* note 64, at 46 n.161 (“Rule 506 does not require that issuers provide any specific written information to accredited investors. This reflects the Commission’s view that accredited investors are sophisticated enough and have enough bargaining power to obtain any information they need from an issuer in making an investment decision.”).

the right level of protection, it would appear to contribute to a narrow tailoring of the regime. The less faith we have in this proxy, however, the more difficult it is to defend.

There is undoubtedly some truth to the notion that wealth correlates with financial savvy and better information. Institutional investors who manage billions of dollars and spend months researching private investments certainly are more sophisticated and have more access to information than those with fewer resources.<sup>86</sup> At the other end of the spectrum, there is empirical evidence that those of lesser means are more likely to make poor financial decisions.<sup>87</sup> It also makes sense to think that they would be unlikely to have the pull to get important information from funds otherwise unmotivated to provide it.

Where it gets dicey is in between these two points. There is no empirical evidence that suggests that wealth, financial savvy, and access to information are closely linked at various levels of income. We do not know the exact nature of this relationship. That being the case, there is nothing to suggest the current rules represent a reasonable tipping point, where the costs of further regulation are unjustified because of the investor traits of those in the unprotected group—the chosen wealth limits, in a sense, seem arbitrary.

Moreover, even if we accept some broad correlation between wealth and the ability to make better investment decisions, there is certainly nothing to suggest that those under the wealth thresholds need an extensive regulatory framework, while those above it need no protection from potential market failures. The largely unproven relationship between wealth, financial savvy, and access to information does not seem to justify the all-or-nothing approach of the current framework. At best, the difference between the two groups in terms of the impact of market failures appears to be a matter of degree.

First, consider the argument that wealthier investors have better access to information, thereby alleviating the need for mandated disclosure. This is at best true only in part. The incentives that may lead to corporate underdisclosure exist irrespective of the financial savvy of their customers.<sup>88</sup> Thus, even if we assume that wealthy investors are more sophisticated and we, therefore, assume that they will ask the right questions, this still does not mean that they will necessarily get better information. Because funds have incentives to be less than forthright, asking good questions does not always lead to straight answers. Perhaps wealthier investors have more leverage and therefore are better at prying information out. While this might be true, what information funds are willing to provide depends on a mix of

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<sup>86</sup> See HEDGE FUND REPORT, *supra* note 64, at 47 & n.162 (describing investigative steps taken by hedge-fund investors).

<sup>87</sup> See John Y. Campbell, *Household Finance*, 61 J. FIN. 1553 *passim* (2006).

<sup>88</sup> See *infra* Part II.C.

factors, and it is highly questionable what role a particular investor's financial situation plays in the fund's broader calculus. Finally, the SEC itself has acknowledged that "[i]n practice, even very large and sophisticated investors often have little leverage in setting terms of their investment and accessing information about hedge funds and their advisers."<sup>89</sup>

Likewise, those who are more financially sophisticated are not necessarily more rational. Investing brings out a range of decisionmaking flaws. For instance, investors are known to be overconfident in their investment abilities. Instead of analyzing the complexities of a financial decision, they trust innate ability.<sup>90</sup> In addition, they suffer from the availability heuristic, overreacting to recent and traumatic events, like well-publicized financial scandals, instead of staying the course.<sup>91</sup> These and other errors are not only made by unsophisticated investors. As Professors Stephen Choi and A.C. Pritchard have explained, "[b]ecause no unifying theory explains why we suffer from behavioral biases, we cannot predict which investors suffer from biases, nor can we gauge the magnitude of these biases."<sup>92</sup> They conclude that "[w]ithout some underlying theory of biases, we cannot say whether the magnitude of biases afflicting [financial] experts is greater (or lesser) than the biases of ordinary investors."<sup>93</sup>

In addition, we see that sophisticated investors routinely err. Professor Donald Langevoort has looked at what he describes as "a significant segment of suboptimal investment decision making by otherwise sophisticated investors,"<sup>94</sup> explaining the phenomenon in part by "a sophisticated investor's optimistic, self-serving schema of competence and expertise."<sup>95</sup> A recent study went even further, concluding that, contrary to intuition, "highly educated consumers and those who demonstrated greater knowledge of basic finance made poorer, not better, [fund allocation] decisions than their less financially savvy counterparts."<sup>96</sup>

There is clearly room for more empirical study, but we can at least say that the link between financial savvy and sound investing is more complex than it first appears. Sophisticated investors likely fare better than ordinary investors in a couple of ways—they are probably less likely to be victims of outright deception and they may stand a better chance of understanding investment strategies. Nevertheless, sophisticated investors, like all inves-

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<sup>89</sup> HEDGE FUND REPORT, *supra* note 64, at 47.

<sup>90</sup> Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 11-12 (2003).

<sup>91</sup> *Id.* at 12.

<sup>92</sup> *Id.* at 59.

<sup>93</sup> *Id.*

<sup>94</sup> Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics about Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 699 (1996).

<sup>95</sup> *Id.* at 639-40.

<sup>96</sup> Ronald T. Wilcox, *Bargain Hunting or Star Gazing? Investors' Preferences for Stock Mutual Funds*, 76 J. BUS. 645, 658 (2003).

tors, suffer from a range of decisionmaking flaws and, as a result, are often mistaken. The universality of errant investing suggests that treating sophisticates as a distinct class far removed from ordinary investors does not reflect reality.

Exemptions such as these should act as a mechanism for appropriately tailoring regulation to meet the needs of different investors. These rules, however, by rigidly categorizing investors according to wealth and then using this categorization as the basis for two vastly different regulatory structures, appear to fall far short of this goal. The awkwardness of this exemptive structure is particularly troubling because the rules significantly tilt the investing marketplace against the interests of ordinary investors.

## 2. Analysis of Adverse Market Impacts

Because these rules preclude ordinary investors from participating in unregulated private funds, they impose a rigid structure that adversely impacts the marketplace. First, dividing investors in this way protects mutual funds from competition from related investment schemes. Despite their potential appeal, hedge funds, private equity funds, and venture capital funds are statutorily put out of reach from most of the investing public.<sup>97</sup> With these funds no longer relevant, mutual funds need not worry as much about generating and implementing innovative investment ideas or assuring investors the lowest fees. To the extent these regulations weaken competition in this manner, they hurt ordinary investors.

Common investors are also injured because the exemptive rules take away from their ability to fully diversify, which forces them to assume a greater degree of portfolio risk.<sup>98</sup> Traditional mutual funds allow an investor to spread risk among equities, bonds, and cash instruments.<sup>99</sup> But participation in a broader array of investments has the potential to further strengthen a portfolio.<sup>100</sup> Many hedge funds, for instance, seek absolute returns—profits whether stocks, and the economy as a whole, are doing well or poorly.<sup>101</sup> This strategy helps shore up a portfolio when returns from more traditional investments are lackluster.<sup>102</sup> Private equity funds and venture capital

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<sup>97</sup> See *supra* text accompanying notes 62-80.

<sup>98</sup> For a basic discussion of the relationship between diversification and risk, see WILLIAM J. CARNEY, *CORPORATE FINANCE: PRINCIPLES AND PRACTICE* 103-05 (2005).

<sup>99</sup> See MEIR KOHN, *FINANCIAL INSTITUTIONS AND MARKETS* 435-38 (1994) (discussing mutual funds' evolution).

<sup>100</sup> See HEDGE FUND REPORT, *supra* note 64, at 5.

<sup>101</sup> *Id.* at vii.

<sup>102</sup> See Gaurav S. Amin & Harry M. Kat, *Hedge Fund Performance 1990-2000: Do the "Money Machines" Really Add Value?*, 38 J. FIN. & QUANTITATIVE ANALYSIS 251, 273 (2003) (conducting an empirical analysis showing that hedge funds contribute to an efficient portfolio when allocated 10 to 20 percent of the portfolio's assets); FINANCIAL STABILITY FORUM, REPORT OF

funds, meanwhile, also invest in unique opportunities, which means they too have the potential to contribute to a fully diversified portfolio. By limiting investor opportunities, therefore, the current rules actually prevent investors from making the most of their savings.

One could argue that the potential harms of the regulatory limits on choice have eased somewhat because of recent innovations that allow ordinary investors to invest in hedge-fund-like instruments. The public may now purchase registered shares in hedge fund management companies that have gone public<sup>103</sup> and invest in so-called alternative strategy mutual funds that seek to mimic hedge fund strategies without running afoul of regulatory restrictions.<sup>104</sup>

There is good reason, however, to be weary of these innovations. The new investing options are troublesome because they need not compete with true hedge funds. As the sole alternative for unaccredited investors seeking the diversification offered by hedge-fund strategies, there is a greater danger that these funds will exploit anxious investors, rather than offer a constructive portfolio addition.

Consider public hedge funds. A hedge fund that has launched an IPO is likely one that has run its course. In the public markets, a secondary offering is known to depress the stock price of the issuer because the market reads this as a sign that the company does not foresee robust gains in the near-term (if heady profits were expected, the company would have raised money by issuing debt, so that current shareholders would not have to share

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THE WORKING GROUP ON HIGHLY LEVERAGED INSTITUTIONS 79 (2000), available at [http://www.fsforum.org/publications/r\\_0004a.pdf](http://www.fsforum.org/publications/r_0004a.pdf) (concluding that “hedge funds may provide substantial diversification benefits, because their returns typically have relatively low correlation with standard asset classes”). In contrast to traditional mutual funds, hedge funds actually gained during the 2000-2002 bear market. See SCOTT J. LEDERMAN, HEDGE FUND REGULATION § 1:3 (2009). Though hedge funds as a whole did not deliver positive returns in the 2008 bear market, they did manage to avoid the steep drop that befell global equities. The All-Country MSCI, a global equities index, fell 44.7 percent in 2008, while the Global HFRX, a global hedge fund index, fell 23.2 percent. *Markets*, ECONOMIST, Jan. 3, 2009, at 76. In addition, approximately one in three hedge funds posted gains in 2008, while one in fifty was up over 30 percent. Louise Story, *What Crisis? Some Hedge Funds Are Gaining*, N.Y. TIMES, Nov. 10, 2008, at B1. See also Ellen Nakashima, *The Year Hedge Funds Got Hit*, WASH. POST, Jan. 6, 2009, at D01 (“Though hedge funds are suffering, they have lost only about half as much value as stocks, which declined 38 percent last year, as measured by the Standard & Poor’s 500-stock index.”), available at 2009 WLNR 253364.

<sup>103</sup> In early 2007, Fortress Investment Group was the first of these in the U.S. Yael Bizouati, *Hope Floats: Fortress’ Impressive IPO Has the Hedge Fund Community Eyeing Similar Flotations*, INV. MGMT. WKLY., Feb. 26, 2007, available at 2007 WLNR 3704355.

<sup>104</sup> See SCOTT J. LEDERMAN, HEDGE FUND REGULATION § 1:5 (2008) (discussing “hybrid mutual funds that incorporate some of the strategies pursued by hedge funds”); cf. Brent Shearer, *Mutual Funds to Mimic Hedge Strategies: But for Now, Subprime Crisis Could Dampen Convergence*, MONEY MGMT. EXEC., Nov. 19, 2007, available at 2007 WLNR 22747495 (noting that while there has been convergence between hedge fund and alternative mutual fund investment strategies, this movement has been slowed by the subprime crisis).

the gains).<sup>105</sup> The same logic applies here. The owners of a fund complex would not let the public share the wealth if they anticipated growing returns. A testament to this theory is that public equity in hedge funds has done poorly.<sup>106</sup>

Alternative strategy mutual funds are also structurally flawed. The substantive limits that make these funds “mutual funds” prevent them from acting like true hedge funds.<sup>107</sup> This hinders their ability to achieve the same returns.<sup>108</sup> Moreover, as discussed in a later section, those who are the most successful at executing absolute return strategies have strong monetary incentives to manage hedge funds instead.<sup>109</sup> The investing acumen of those who choose to run these funds is therefore in doubt. In the end, though it is too early to dismiss these ersatz hedge funds completely, it does appear that they are at best imperfect replacements and at worst, simply bad investments.

The exemptive rules illustrate a considerable danger inherent in directly paternalistic regulation—that taking choice away from consumers has the potential to distort the marketplace, perhaps severely. Here, the ICA exemptions dilute competition in the mutual-fund arena and force investors to give up the broader diversification offered by private funds. These downsides would potentially be acceptable if it looked like the exemptive rules were the best way to narrowly tailor the regulatory regime. Because these rules do not coherently direct regulation towards the areas where it is most needed, however, they appear in need of reform.

As I discuss in Part III, society would likely be better served if we gave up on the idea of limiting investor options via government proxy, and instead left investors free to decide on their own. First, however, let us consider the specific mutual-fund rules designed to help investors make informed choices within the market to which they are confined.

### C. *Mutual-Fund Disclosure Requirements*

Mutual funds are required to comply with a mind-numbingly detailed and complex disclosure regime. The central mandated disclosure document is the fund prospectus.<sup>110</sup> However, funds are also required to draft a length-

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<sup>105</sup> See Clifford W. Smith, Jr., *Raising Capital: Theory and Evidence*, in *THE REVOLUTION IN CORPORATE FINANCE* 242, 244, 248-49 (Joel M. Stern & Donald H. Chew, Jr. eds., 4th ed. 2003).

<sup>106</sup> Emma Trincal, *Lackluster IPO for Och-Ziff*, *HEDGEWORLD DAILY NEWS*, Nov. 15, 2007, available at 2007 WLNR 22560830.

<sup>107</sup> See *infra* note 253 and accompanying text.

<sup>108</sup> See Vikas Agarwal et al., *Hedge Funds for Retail Investors? An Examination of Hedged Mutual Funds* 1-3 (Ctr. for Fin. Research, Working Paper No. 07-04, 2007), available at <http://www.cfr-cologne.de/download/workingpaper/cfr-07-04.pdf>.

<sup>109</sup> See *infra* Part II.D.2.a.

<sup>110</sup> The prospectus is required pursuant to 15 U.S.C. § 77j (2000).

ier document called the statement of additional information (“SAI”),<sup>111</sup> as well as provide investors with annual and semi-annual reports.<sup>112</sup> These materials include information with respect to the key factors in fund investing, such as strategy, risk, expenses, and returns.<sup>113</sup> But they also go into detail about a litany of other items. For instance, as part of the SEC’s response to the recent stale-price arbitrage scandals, the agency put in place requirements that each fund disclose the risks posed by such activities,<sup>114</sup> as well as certain information about its management personnel, including details about their compensation, ownership interest in the fund, and potential conflicts of interest.<sup>115</sup>

In the abstract, disclosure potentially makes sense as a response to imperfect information. Investors can be expected to make flawed choices if left to base their decisions on faulty or insufficient data.<sup>116</sup> These poor decisions hurt the investors who make them. More broadly, if investors are not able to accurately choose among funds, the better ones may exit.<sup>117</sup> Theoretically, mandated disclosures could thwart this vicious circle.

To determine whether the current disclosure regime is a well-reasoned attempt to do just that, we must first pinpoint where, if anywhere, the unfettered market would likely fail to provide adequate information without government intervention, and then judge whether current rules adequately plug those gaps. As to the former, in order to out-compete their rivals, quality funds should reveal certain information about themselves indicative of their worth.<sup>118</sup> Funds could, for example, advertise their history of fiscal and moral integrity. Or, funds could seek to gain a competitive advantage by creating detailed disclosures regarding their investment strategies and expenses. The market on its own, therefore, can be expected to provide a good amount of information.

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<sup>111</sup> Form N-1A details what must be included in both the prospectus and the SAI. *See* Form N-1A, OMB No. 3235-0307, *available at* <http://www.sec.gov/about/forms/formn-1a.pdf> [hereinafter Form N-1A]. It also notes the SAI delivery requirements. *Id.* at Item 1(b).

<sup>112</sup> *See* 17 C.F.R. § 270.30e-1 (2008); Form N-CSR, Certified Shareholder Report of Registered Management Investment Companies, OMB No. 3235-0570, *available at* <http://www.sec.gov/about/forms/formn-csr.pdf>.

<sup>113</sup> *See, e.g.*, Form N-1A, *supra* note 111, at Items 2-4.

<sup>114</sup> *Id.* at Item 6(e)(1); Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings; Final Rule, Securities Act Release No. 33-8408, Investment Company Act Release No. 26,418, 69 Fed. Reg. 22,300, 22,301 (Apr. 23, 2004) (codified at 17 C.F.R. pts. 239, 274).

<sup>115</sup> Form N-1A, *supra* note 111, at Item 15; Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, Securities Act Release No. 33-8458, Exchange Act Release No. 34-50227, Investment Company Act Release No. 26533, 69 Fed. Reg. 52,787, 52,788-93 (Aug. 27, 2004) (codified at 17 C.F.R. pts. 239, 249, 270, 274).

<sup>116</sup> *See supra* notes 32-36 and accompanying text.

<sup>117</sup> *See supra* notes 32-36 and accompanying text.

<sup>118</sup> *See* FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 280 (1991).

Market-based self-interest, however, only goes so far. Drilling down more closely on market incentives reveals that, although there may be good reason to divulge many things, relying solely on competitive forces would likely lead to disclosure that is inadequate in several respects. There is reason to believe that the quantity, quality, and dispersion of information could be improved through regulation.

A primary concern is that, without regulation, funds may omit key information or bury it in the fine print.<sup>119</sup> Harmed investors may have common-law or securities-law remedies, but court costs may weaken the deterrent value of these legal safeguards. Damage to reputation may be likewise inadequate as an inherent protection if the deception is difficult to detect or the fund is only interested in short-term gains. Standardizing disclosures, therefore, may be called for to make sure investors are not subtly misled.<sup>120</sup>

Similarly, without government intervention, funds may collude to distract customers from the information most useful to them, rather than focus on it.<sup>121</sup> Breyer illustrates this point with the automotive and airline industries. He posits that the industries tacitly agreed not to advertise comparative safety because focusing on safety itself was damaging to the industries overall.<sup>122</sup> Similarly, there may be certain pieces of information the fund industry would prefer to see kept out of the spotlight.

Consider fund fees. If funds relentlessly advertised low-cost pricing, this could trigger a race to the bottom, where, in the end, all funds would be less profitable. It would, therefore, be best for the industry if this information remained in the background. That being the case, it is worth thinking about whether funds could implicitly conspire to steer clear of this topic. This proposition is made more worrisome in light of evidence from the Swedish fund industry, which shows that instead of focusing on fees, perhaps the most important attribute of any particular investment vehicle, funds advertise their past performance, which, as discussed further below, is of limited relevance to investing decisions.<sup>123</sup> The possibility that industry pressure may prevent the dissemination of important information suggests that the SEC could engender greater competition by taking it upon itself to ensure that the key aspects of the fund investing decision reach investors, irrespective of whether consumer possession of this information is good for industry profits.

If left to the industry, other components of a well-functioning market may also fail to materialize. For a market to function efficiently, consumers

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<sup>119</sup> See BREYER, *supra* note 53, at 27-28.

<sup>120</sup> See *id.*; cf. Langevoort, *supra* note 94, at 659-62 (discussing why brokers may be willing to cheat their clients notwithstanding injury to reputation).

<sup>121</sup> See BREYER, *supra* note 53, at 28.

<sup>122</sup> *Id.*

<sup>123</sup> See Henrik Cronqvist, *Advertising and Portfolio Choice* 1, 22 (July 26, 2006) (working paper), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=920693](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=920693); see *infra* Part II.C.2.

must be able to easily compare competing products.<sup>124</sup> Absent government intervention, however, companies in general, and funds in particular, may not take steps to foster ready comparison. The very reason that comparison is good for consumers makes it potentially bad for suppliers—if customers can easily compare products, it makes it easier for them to consider, and potentially switch to, a competitor.<sup>125</sup> Thus, if left to their own devices, funds may fail to settle upon uniform ways of disclosing important information, such as fees and performance. Along the same lines, even if aspects of a product are comparable, companies may not jump at the chance to offer direct comparisons with their competitors.<sup>126</sup> Consumers may rely on the comparative information to buy or sell the competitor's product, rather than purchase the product of the disclosing company. Because disclosing companies would not be able to internalize all of the gain from disclosure, they may under-disclose in this respect.<sup>127</sup> In the fund context, therefore, there may be a role for government not only in standardizing disclosure of key aspects of fund investing, but also in presenting comparative information.

Finally, regulation has the potential to lead to disclosure that is better designed and more widely distributed. In order for information to have its maximum impact, it must be clearly presented to investors. Funds lack adequate incentive, however, to devote resources to devising the best possible way to present information, because if they are successful in doing so, their format could simply be copied by other industry participants.<sup>128</sup> The government, by itself undertaking the task of devising the optimal layout for disclosure, can help funds overcome this collective action problem.<sup>129</sup> In addition, mandated disclosure could ensure that there is equal access to such information.<sup>130</sup> Pursuant to government rules, all investors would have relevant fund data presented to them—not just those savvy enough to ask the right questions. This would help to ensure that more investors allocate their money appropriately.

When all of these considerations are taken into account, it becomes apparent that fund disclosure requirements can play a specific and crucial role in bringing about a more ideal informational landscape. To plug the gaps in market-based incentives to disclose, an apt disclosure mandate would require the presentation of clear, comparative information regarding the material aspects of fund investing.

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<sup>124</sup> BREYER, *supra* note 53, at 26.

<sup>125</sup> See EASTERBROOK & FISCHER, *supra* note 118, at 291.

<sup>126</sup> *See id.*

<sup>127</sup> *See id.* at 290-92.

<sup>128</sup> *See id.* at 291-92.

<sup>129</sup> *See id.* at 292.

<sup>130</sup> *See id.* at 297-98. The authors dismiss this as a poor rationale in an efficient securities market, but since, as discussed *infra* at Part II.C.1, the mutual fund market is not efficient, it still may be a valid justification in this context. See EASTERBROOK & FISCHER, *supra* note 118, at 297-98.

The sections below judge the current disclosure rules against this rubric. When this is done, the current regime appears unsatisfying because it likely calls for too much information, and its requirements with respect to the key aspects of fund investing appear too often to fail to meaningfully assist investor decisionmaking.

### 1. Length and Complexity of Fund Disclosure

Theoretically, government-mandated disclosure is appropriate where self-interest may lead businesses to fail to adequately disclose material information in the best format. Because there is no exact definition of what terms are “material” in the fund arena, this logic could be stretched to justify the forced disclosure of many pieces of information. There is a point, however, where over-zealous reliance on disclosure becomes counterproductive. An analysis of the current disclosure framework suggests that the SEC has crossed this line.

Included in the prospectus, for instance, is information about myriad technical details. One disclosure that funds must include is a financial highlights table.<sup>131</sup> Though there may be some intriguing nuggets buried within it, those who are not market professionals would have great difficulty unearthing them. While there is an argument that financial information should be open for review for anti-fraud reasons, it is difficult to justify providing it to each would-be investor. It is hard to picture average investors scrutinizing this, and other similarly technical disclosures, in order to make their investment decisions.

In fact, mandating the presentation and dissemination of such subtle information appears to belie an underlying premise of the investment management regulatory framework. In theory, the exemptive structure precludes ordinary investors from investing in private funds, in part, because of their inability to understand them.<sup>132</sup> If this is the case, then it makes little sense to then foist highly technical jargon upon that same group. It would appear that the information would fall on deaf ears.

Moreover, mandating presentation of such information leads to disclosure documents of daunting length, which can undermine the overall effectiveness of the requirements. By having so much information, it makes it more difficult for investors to focus on the truly relevant data.<sup>133</sup> In addition, there have been studies that show that when people are overloaded with information they are more likely to make poor decisions.<sup>134</sup> Thus, it

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<sup>131</sup> Form N-1A, *supra* note 111, at Item 8.

<sup>132</sup> *See supra* Part II.B.1.

<sup>133</sup> *See* Troy A. Parades, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 440-42 (2003).

<sup>134</sup> *Id.* at 441.

seems that for the paradigmatic fund investor, these disclosures are either ignored or actually disruptive.<sup>135</sup>

It is possible, however, that they are not the ones for whom such information is intended. The securities laws require that public companies disclose an overwhelming amount of complex information,<sup>136</sup> which likely is far over the head of the investing public. It has been argued that the complexity is justified in this context, however, because the intended readers are sophisticated market professionals, who theoretically pore over the minutia of disclosure documents in the hopes of uncovering information that would give them an investing edge. When they buy, sell, or even adjust their reservation price based on this information, the price of such securities moves to a point that reflects the valuation as surmised by these informed investors. Since the market price incorporates the research of market professionals, common investors are protected. Even though they may not read or understand the complex disclosures, the efficiency of the market ensures that they will pay a price for a security that is in line with what market professionals believe is its market value.<sup>137</sup> Thus, in theory, the disclosure regime, by facilitating information gathering by professionals, contributes to the efficient pricing of securities, which ensures that investors are afforded the protection of complex disclosures without ever reading them.<sup>138</sup>

The question is whether similar logic supports the presentation of complex mutual-fund disclosure. For more detailed mutual-fund disclosures to be justified, there must be an argument that they contribute to efficiency

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<sup>135</sup> The SEC recently took a step to address this concern in that it now allows mutual funds to satisfy their prospectus-delivery obligations by providing a “summary prospectus,” so long as the more detailed version remains available for review. See 17 C.F.R. § 230.431 (2008); Enhanced Disclosure and New Delivery Option for Registered Open-End Management Investment Companies; Final Rules, Securities Act Release No. 8998, Investment Company Act Release No. 28584, 74 Fed. Reg. 4546, 4560 (Jan. 26, 2009) [hereinafter Enhanced Disclosure Release]. Those who receive only the leaner document would be less likely to suffer from information overload.

<sup>136</sup> Parades, *supra* note 133, at 418.

<sup>137</sup> EASTERBROOK & FISCHER, *supra* note 118, at 18-19; SUSAN M. PHILLIPS & J. RICHARD ZECHER, THE SEC AND THE PUBLIC INTEREST 30 (1981); William J. Carney, *Signalling and Causation in Insider Trading*, 36 CATH. U. L. REV. 863, 879-80 (1987); Henry T.C. Hu, *The New Portfolio Society, SEC Mutual Fund Disclosure, and the Public Corporation Model*, 60 BUS. LAW. 1303, 1355 (2005); cf. Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 737-40 (2006) (arguing that the disclosure regime facilitates information gathering by market professionals).

<sup>138</sup> Whether securities regulation is truly necessary to inculcate efficiency in the public securities markets has been questioned on empirical grounds. See EASTERBROOK & FISCHER, *supra* note 118, at 311-14 & nn.20-21 (“[T]here have been three detailed studies of returns to investors before and after the 1933 act; none found evidence of substantial benefits.”); PHILLIPS & ZECHER, *supra* note 137, at 112-14; Henry G. Manne, *Economic Aspects of Required Disclosure Under Federal Securities Laws*, in WALL STREET IN TRANSITION 23, 79 (Henry G. Manne & Ezra Solomon eds., 1974) (“Economists have now shown that information of various kinds is integrated into a security’s price before public announcement of the information is made.”).

in the market for the funds themselves—the actual pooled investment vehicles, not the securities in which they invest.

Along these lines, it could be argued that there is a small group of sophisticated mutual-fund investors who actually do read and understand fund disclosures, and that they, in effect, police the market for everyone else. It may only take a small group of diligent investors who allocate their money in accordance with what they read in the fine print in order for the more technical attributes of the disclosures to impact fund behavior and fund fees.<sup>139</sup> Egregious practices may be eliminated and fees potentially lowered so as not to lose this one group, especially if this group is made up of brokers who pass this information along to multiple clients. If the market is functioning in this way, then the current abstruse disclosures may benefit mutual-fund investors as a whole even if they have a narrow readership.

The practical evidence bearing on this theory, however, indicates that it is likely not the case. First, it does not appear that brokers are parsing fund documents in search of the best deal for their clients, and thereby serving as a conduit for this information. If they were, we would hope to see their clients benefiting from the service. The opposite, however, appears to be true: mutual-fund investors without brokers tend to have better returns.<sup>140</sup> Moreover, assuming other financially savvy investors are paying attention, their decisions do not appear to be fomenting competition. Much evidence suggests that in the mutual-fund arena price does not indicate quality as it would in a competitive market. In fact, the relationship between price and quality in the mutual-fund market is the inverse of that which you would find if the industry were competitive—higher price has been found to correlate with *worse* performance.<sup>141</sup> Moreover, the law of one price fails dramatically in the case of index funds—there is a panoply of index funds of-

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<sup>139</sup> 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, 1033 (2005) (“[C]onventional economic analysis teaches that the less sophisticated consumer will be protected so long as the producer realizes that it must persuade enough sophisticated consumers to purchase the same product.”); Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387, 1405-06 (1983) (“A market can be in competitive equilibrium even though the ratio of comparison shoppers to all consumers is much less than one.”).

<sup>140</sup> See Daniel Bergstresser et al., *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry 2* (Harvard Bus. Sch. Finance Working Paper No. 616981, 2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=616981](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=616981). This is the case even though the two groups appeared to be similar in needs and investing ability. *Id.* at 14 (“By any standard . . . fund investors in both [groups] are disproportionately drawn from upper ranks of wealth, income and educational attainment.”).

<sup>141</sup> See Martin J. Gruber, *Another Puzzle: The Growth in Actively Managed Mutual Funds*, 51 J. FIN. 783, 785 (1996) (finding that “high fees are associated with inferior rather than superior management”); Brad M. Barber et al., *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows*, 78 J. BUS. 2095, 2099 (2005) (“Several academic studies have documented a negative relation between a fund’s operating expense ratio and performance.”).

fering a nearly identical service, yet charging vastly disparate prices.<sup>142</sup> These examples strongly suggest that the fund market lacks a mechanism by which the efforts of diligent investors trickle down to the less well-informed. That being the case, it is difficult to justify the massive dissemination of myriad technical details. While it may help a few investors, it likely makes fund investing more intimidating and difficult for the many.

## 2. Disclosure of Risks and Returns

The risk-return profile of a particular mutual fund is a central, yet easily misunderstood, component of the investing decision. The SEC, therefore, by mandating the presentation of clear information regarding risks and returns, could likely render the fund marketplace more competitive. At first glance, the fund disclosure system appears to do a reasonable job of standardizing presentation of these features. The primary mechanism through which these attributes are shown is a bar chart representing the fund's returns for each of its previous ten years (or the length of the fund's existence, if shorter).<sup>143</sup> The prospectus also mandates disclosure of the fund's highest and lowest returns for a quarter over that period—an intuitive description of standard deviation.<sup>144</sup>

This approach, however, while it has superficial appeal, suffers from several flaws that undermine its utility. The central problem is that the mandated simplistic disclosure of past performance is out of step with recent empirical research that shows that looking at a specific fund's past performance in isolation is not an accurate indicator of that fund's future performance.<sup>145</sup> A record of stellar returns does not signal that the same will be true over time. The SEC hints at this in the prospectus, telling investors that past performance “is not necessarily an indication of how the Fund will perform in the future.”<sup>146</sup> But this understates the care with which this information should be treated.

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<sup>142</sup> See Mahoney, *supra* note 27, at 170 (finding that excluding 12b-1 fees, expense ratios for S&P 500 index funds ranged from eight to eighty-five basis points); Ali Hortacsu & Chad Syverson, *Product Differentiation, Search Costs, and Competition in the Mutual Fund Industry: A Case Study of S&P 500 Index Funds*, 119 Q. J. ECON. 403, 406 (2004) (finding index-fund fees ranging from 9.5 to 268 basis points).

<sup>143</sup> Form N-1A, *supra* note 111, at Item 2(c)(2)(ii).

<sup>144</sup> *Id.*

<sup>145</sup> See Wilcox, *supra* note 96, at 651 (“[W]ithin the finance literature there is weak and controversial evidence that past performance has much, if any, predictive ability for future returns.”); cf. Prem C. Jain & Joanna Shuang Wu, *Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows*, 55 J. FIN. 937 *passim* (2000) (finding that advertised funds did well prior to the advertisement and poorly thereafter).

<sup>146</sup> Form N-1A, *supra* note 111, at Item 2(c)(2)(i).

Moreover, by mandating that past-performance information be provided and then vaguely warning investors to disregard it, the SEC is sending mixed messages without an indication to investors about how they should be untangled. This lack of any guidance would appear to undermine the usefulness of the disclosure.

Even more troubling, this disclosure scheme may actually lead investors down the wrong path. Studies have shown that individuals have difficulty purposefully disregarding information.<sup>147</sup> Thus, once the information with respect to past returns has been presented, it is unlikely people will then be able to just discount it. Moreover, the past-performance bar chart is particularly salient—its clean appearance makes it stand out from the legalese that marks the remainder of the prospectus. This plays into yet another investor bias, which is the tendency “to pay more attention to information that is cognitively accessible . . . and ignore features or attributes that are difficult to evaluate.”<sup>148</sup> Thus, the current deceptively simplistic disclosure of past performance may actually contribute to one of the many disturbing empirical findings with respect to investor decisionmaking—that they systematically overweight past returns in their investment decision.<sup>149</sup>

The current disclosure regime is laudable to the extent it provides clear information regarding past performance to investors. Unfortunately, the value of the present rules is undermined because the way past returns are displayed plays into the all-too-attractive notion that a fund’s history of stellar performance foreshadows long-term riches, rather than exposes it as largely fantasy.

### 3. Expense Disclosure

The other primary piece of information that funds are required to give to investors is the expense ratio, which is the percentage of fund assets that goes to management fees, 12b-1 fees, and other administrative fees.<sup>150</sup> This disclosure is helpful, but the way fee information is presented to investors is likely deficient in several respects.

First, while settling on a uniform presentation of fee information is useful because it facilitates comparison, the rules do not help investors with

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<sup>147</sup> See, e.g., Hollyn M. Johnson, *Processes of Successful Intentional Forgetting*, 116 PSYCHOL. BULL. 274 *passim* (1994).

<sup>148</sup> Wilcox, *supra* note 96, at 650.

<sup>149</sup> See *id.* at 654; cf. Annette L. Nazareth, Comm’r, U.S. Sec. & Exch. Comm’n, Remarks Before the Mutual Fund Directors Forum Seventh Annual Policy Conference (Apr. 12, 2007) (transcript available at <http://www.sec.gov/news/speech/2007/spch041207aln.htm>) (“Investors . . . tend to focus intently on the past performance of mutual funds rather than giving proper weight to the effect of fees and expenses on that performance.”).

<sup>150</sup> Form N-1A, *supra* note 111, at Item 3 (in Item 3, the expense ratio is referred to as the “total annual fund operating expenses”).

the crucial next step—they never give investors an idea of how a fund's fees compare to other funds. Instead, investors are left to fend for themselves in this regard. Second, there are issues with the expense ratio itself. One problem is that this ratio is somewhat misleading because it leaves out costs incurred by the fund when it buys and sells securities on the fund's behalf. These transaction costs include, among other things, brokerage commissions, which are separately reported on the SAI,<sup>151</sup> and the presence of bid-ask spreads, which go unreported. Excluding these figures causes the expense ratio to understate—at times fairly significantly—the actual costs incurred by investors.<sup>152</sup>

Moreover, the expense ratio is an abstract conception of fee data that tends to hide the actual impact of fees on returns. The majority of mutual funds charge fees that cluster within a range of only a few percentage points,<sup>153</sup> giving the impression that most funds charge pretty much the same thing. What appear to be small differences in fees, however, make a big difference over time.<sup>154</sup>

To understand the impact that a couple of percent can mean, an investor must understand and manipulate this data. To get a true picture, an investor can translate the percentage to dollar terms by using a web-based calculator, and plugging in the relevant information—the amount that person plans to invest, the anticipated rate of return, and the holding period. Alternatively, an investor can get a rough estimate by turning to SEC-mandated disclosures. In the prospectus, funds are required to provide a table showing the fees an investor would pay with a \$10,000 investment over a one, three, five, and ten year period, assuming fund returns of 5 percent per year.<sup>155</sup> By making expenses more tangible, this table likely benefits investors. Nevertheless, it still requires that investors manipulate the data to get a sense of what the table means for the amount they plan to invest and the returns they expect.

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<sup>151</sup> *Id.* at Item 16(a).

<sup>152</sup> See Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs; Proposed Rule, Securities Act Release No. 33-8,349, Exchange Act Release No. 34-48,952, Investment Company Act Release No. 26,313, 68 Fed. Reg. 74,820, 74,822 (proposed Dec. 24, 2003) (codified at 17 C.F.R. pt. 270) [hereinafter Transaction Costs Release] (citing various studies of the impacts of transaction costs); Hu, *supra* note 137, at 1326 (same).

<sup>153</sup> See PETER J. WALLISON & ROBERT E. LITAN, COMPETITIVE EQUITY: A BETTER WAY TO ORGANIZE MUTUAL FUNDS 65 (2007) (compiling expense-ratio data for various classes of mutual funds).

<sup>154</sup> SEC. & EXCH. COMM'N, INVEST WISELY: AN INTRODUCTION TO MUTUAL FUNDS (2008), <http://www.sec.gov/investor/pubs/inwsmf.htm> (providing an example showing that after twenty years a 1 percent difference in fees translated into just over an \$11,000 difference in returns, given a \$10,000 initial investment and 10 percent annual returns).

<sup>155</sup> Form N-1A, *supra* note 111, at Item 3.

Studies have shown, however, that individuals do not like manipulating data.<sup>156</sup> Instead, they tend to draw conclusions from information as presented.<sup>157</sup> This suggests that under the current disclosure rules, where the abstract and under-inclusive expense ratio is prominently featured, it is unlikely that investors will draw the proper conclusions about the significant corrosive impact fees have on returns over time.

This gloomy conclusion is reinforced by empirical studies. Broadly speaking, it has been shown that investors routinely underweight the impact that fees have on returns.<sup>158</sup> More specifically, in a study specifically designed to measure the effect of fee disclosure on behavior, Harvard employees, Harvard undergraduate students, and Wharton MBA students were asked to make investment decisions based on certain information, including the fund prospectus.<sup>159</sup> When given only the prospectus and asked to choose where to allocate their money among S&P 500 index funds—essentially a commodity—hardly anyone in the test group pursued the financially rational course of minimizing fees.<sup>160</sup>

In sum, though disclosure may be justified by the lingering presence of imperfect information in the fund market, the regulatory response is open to question. An efficient disclosure scheme would demand clear description of terms material to an investment decision and seek to foster comparative shopping. The current regime deviates substantially from this paradigm in that it asks for excessive information, while at the same time, its requirements with respect to the key attributes of fund investing are at best incomplete and at worst fairly misleading.

#### 4. Analysis of Adverse Market Impacts

A benefit of disclosure is that it does not fundamentally alter the marketplace in the same manner as regulation that actually supplants investor decisionmaking. For instance, as discussed previously, the exemptive rules distort the competitive landscape by precluding ordinary investors from

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<sup>156</sup> See James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 WASH U. L.Q. 907, 931-32 (2005).

<sup>157</sup> *Id.* at 932.

<sup>158</sup> See Alan R. Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 165, 196-97 (2006) (collecting empirical evidence on shareholder apathy with respect to fees); Barber et al., *supra* note 141, at 2098 (“[T]here is at best no relation, and at worst a perverse positive relation, between fund flows and operating expenses [for the time period studied].”).

<sup>159</sup> James J. Choi et al., *Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds* 3-4 (Nat’l Bureau Econ. Research, Working Paper No. 12261, 2008), available at <http://www.som.yale.edu/faculty/jjc83/fees.pdf>.

<sup>160</sup> *Id.* at 4.

taking part in private funds.<sup>161</sup> Disclosure, however, does not replace individual decisionmaking in this way, and thus, generally speaking, has fewer significant anticompetitive impacts.<sup>162</sup>

But disclosure is not above reproach in this regard. In fact, the current mutual-fund disclosure regime may have a pronounced adverse impact on competition. The current expansive disclosure mandate appears to weaken competition in that it favors established players and long-standing business practices over newer entrants, smaller firms, and innovation. For one, established players actually benefit from the substantial costs of complying with the current rules.<sup>163</sup> This is because the expenses paid out in connection with meeting disclosure requirements are relatively more burdensome for smaller and newer firms.<sup>164</sup> Because all funds face the same disclosure requirements, the compliance costs are proportionately larger for those funds with fewer assets. Similarly, compliance costs recede once the preparation has become routine. Funds new to the industry are forced to expend disproportionate resources when first formulating their compliance methodologies. Therefore, the more disclosure, the more difficult it is for less wealthy and less experienced firms to compete.

The breadth of the disclosure favors established players in another respect as well. Over-disclosure brought about by regulation may chill innovation with respect to those items where disclosure is mandated. Certain business processes or investing strategies may only be profitable if kept secret; these advances will not evolve in an environment in which they must be disclosed.<sup>165</sup> To build on this thought, the more minutia that the SEC requires be set forth for public consumption, the less opportunity there is for firms to distinguish themselves. One aspect of the current rules that is particularly disconcerting in this regard is the requirement that funds periodically disclose their portfolio holdings.<sup>166</sup> This allows free-riding funds to copy other funds' strategies. One study, in fact, documented the potential for such copy-cat funds to produce returns that rival the funds they imitate.<sup>167</sup>

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<sup>161</sup> See *supra* Part II.B.2.

<sup>162</sup> Cf. BREYER, *supra* note 53, at 163 (describing the increased flexibility of disclosure-based regulation).

<sup>163</sup> Using SEC estimates, the fund industry spends approximately \$250 million per year merely mailing and printing prospectuses and annual reports. See Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Securities Act Release No. 33-8861, Investment Company Act Release No. 28064, 72 Fed. Reg. 67,790, 67,810 nn.160-62 (proposed Nov. 30, 2007).

<sup>164</sup> Cf. PHILLIPS & ZECHER, *supra* note 137, at 49 (finding that smaller firms had to devote a much larger portion of assets to SEC-mandated periodic disclosures than larger firms).

<sup>165</sup> See EASTERBROOK & FISCHER, *supra* note 118, at 310-11.

<sup>166</sup> 15 U.S.C. § 80a-29(e) (2000).

<sup>167</sup> Mary Margaret Frank et al., *Copycat Funds: Information Disclosure Regulation and the Returns to Active Management in the Mutual Fund Industry*, 47 J.L. & ECON. 515 *passim* (2004).

The disclosure rules also potentially stymie the growth of what is perhaps the key mutual-fund innovation—the index fund. Each of these funds, which track indexes of securities rather than attempting to beat the market, offers investors a return that mimics the index it tracks.<sup>168</sup> In addition, index funds generally charge lower fees than actively managed funds.<sup>169</sup> Over the long term, this combination usually offers better after-cost returns than their actively managed counterparts.

Several factors go into making index funds so attractive. The first is a matter of arithmetic. As Nobel Laureate William Sharpe has explained:

Over any specified time period, the *market return* will be a weighted average of the returns on the securities within the market . . . . Each passive manager will obtain precisely the market return, before costs. From this, it follows (as the night from the day) that the return on the average actively managed dollar *must* equal the market return. Why? Because the market return must equal a weighted average of the returns on the passive and active segments of the market. If the first two returns are the same, the third must be also.<sup>170</sup>

In sum, the average actively managed dollar must, by definition, be average. This means that when their higher costs are taken into account, the average actively managed dollar under-performs a passively managed index of securities.

This logic certainly suggests that investors are better off putting their money in index funds. But the math is only part of the story. This account leaves open the possibility that some actively managed funds will beat the market. If the average actively managed dollar is average, it means that some stock-pickers will be above average and some will be below. If an investor can pick the better managers, then there is no reason for this person to settle for index-fund returns.

Much, however, conspires against the average investor picking out consistently above-average performers. The efficiency of the securities markets in which funds invest is one factor. For instance, as discussed earlier, the widely accepted view of the market for public equities is that, because of the activities of sophisticated traders, the price of securities nearly instantaneously reflects all currently available information about such securities.<sup>171</sup> An active mutual-fund manager is one of these sophisticated traders that helps the market work efficiently.<sup>172</sup> The problem is that their jobs are self-defeating—the more of them there are, the more efficient the mar-

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<sup>168</sup> Donald R. Lichtenstein et al., *Why Consumers Choose Managed Mutual Funds Over Index Funds: Hypotheses from Consumer Behavior*, 33 J. CONSUMER AFF. 187, 189 (1999).

<sup>169</sup> *Id.* (citing estimates that the cost difference between active and passively managed funds is approximately 1.7 percent).

<sup>170</sup> William F. Sharpe, *The Arithmetic of Active Management*, 47 FIN. ANALYSTS J., Jan.-Feb. 1991, at 7.

<sup>171</sup> See *supra* Part II.C.1; e.g., EASTERBROOK & FISCHER, *supra* note 118, at 18-19.

<sup>172</sup> EASTERBROOK & FISCHER, *supra* note 118, at 18.

ket, but the more difficult it is for any single one of them to consistently beat the rest to some revenue-generating snippet.<sup>173</sup> Investing in an actively managed mutual fund is betting on one horse in a very crowded field. Moreover, the race is essentially rigged. Because managers can make more running a hedge fund, that is where the best are likely to go.<sup>174</sup>

Empirical evidence confirms how difficult it is to pick long-term winners from among actively managed mutual funds. It is the exception for one of these funds to generate returns in excess of the market for any sustained period of time.<sup>175</sup> According to one study, over a fifteen year period, 84 percent of actively managed mutual funds failed to yield returns in excess of the stock market as a whole.<sup>176</sup>

If investors realized that the prospect of earning higher returns through actively managed mutual funds was largely chimerical, then the forces of competition would likely cause the majority of these funds to drift toward extinction. The mutual fund industry would consist largely of index-fund administrators—a much less flashy and profitable undertaking, but one that is a better reflection of competitive forces. This evolution, however, has not occurred. Investors are not switching en masse to index funds. Instead, actively managed funds continue to dominate,<sup>177</sup> so much so that one study concluded that investors “waste” \$10 billion per year in active management fees.<sup>178</sup>

Even though there appears to be a troubling information gap between financial research and consumer behavior, the current regulations do not respond to this issue. In fact, they arguably make it worse. The impenetrable clauses and daunting length of fund documents play into the notion that investing is best delegated to financial experts, which renders it more likely that investors will turn to brokers for advice. Investor reliance on brokers stalls the growth of index funds because these intermediaries tend to push investors toward high-cost actively managed funds, the group who pays them the most to sell their shares.<sup>179</sup>

<sup>173</sup> See *id.* at 19.

<sup>174</sup> See Leonard Kostovetsky, *Brain Drain: Are Mutual Funds Losing Their Best Minds?* (Sept. 2007) (unpublished manuscript, on file with the Princeton Univ. Bendheim Ctr. for Fin.), available at <http://www.princeton.edu/~bcf/Seminar0708/KostovetskyPaper.pdf> (studying the “brain drain” in mutual funds and its negative impact on, among other things, returns in the industry); see *infra* Part II.D.2.a.

<sup>175</sup> See Wilcox, *supra* note 96, at 651; Gruber, *supra* note 141, at 783 (finding that “the average actively managed fund has negative performance compared to a set of indices”); Scott Burns, *Mutual Funds Beset by Costs*, SAN ANTONIO EXPRESS-NEWS, Oct. 5, 1997, at 1H.

<sup>176</sup> Burns, *supra* note 175, at 1H.

<sup>177</sup> Lichtenstein et al., *supra* note 168, at 189 (“[T]he high majority of equity mutual fund dollars continue to flow into managed mutual funds.”).

<sup>178</sup> Choi & Pritchard, *supra* note 90, at 19 & n.88 (citing an empirical study for this figure).

<sup>179</sup> See Bergstresser et al., *supra* note 140, at 18; Lichtenstein et al., *supra* note 168, at 191.

The benefits of index funds are also hidden by the omission of transaction costs from the expense ratio. Failing to include these costs creates a depiction of fees that under-represents the difference in shareholder expenses incurred in connection with index funds as compared to actively managed funds. Since index funds do not actively trade, their shareholders do not incur these fees to the same extent. But this cost differential does not show up in the expense ratio, even though this figure is portrayed as a cumulative depiction of annual fees. Mandated disclosures should make it easier for important information to reach the public; instead, this structure actually hides the benefits of an important industry innovation from investors, potentially chilling market forces in the process.

Like the exemptive framework, the disclosure scheme appears to be problematic in a number of ways. The central market-failure justification for disclosure is that it has the potential to assist consumer decisionmaking, a result which benefits individual investors and potentially leads to a more efficient market. The current rules broadly align with this goal, but seem to be focused more on the quantity of disclosure than its quality. For disclosure to have a real-world impact, the information presented must be understood and applied by investors. But the rules appear to take little account of how the disclosures will be used in the often-flawed decisionmaking process that investors employ.

As a result, the rules have failed to create an informed investor population or foster real competition. The most important things to know about fund investing are the importance of fees, the difficulty in beating the market, and the limited predictive value of a particular fund's past performance. Yet investor behavior demonstrates a failure to internalize these lessons; investors systematically invest in high-cost actively managed funds and chase past returns. Moreover, since price does not indicate quality in fund investing, unsophisticated investors are not protected by those who are savvier, which means that these investors suffer the full impact of their flawed decisionmaking.

As discussed in Part III, much can be done through improved disclosure and other mechanisms to foment a more hospitable environment. Improving the operation of the competitive market, however, is not the focus of the remaining aspects of mutual fund regulation. Instead, in an effort to protect investors, the rules take away investor autonomy. The immediately following sections discuss the most important areas where the market mechanism has been supplanted by government mandate. The choices that were made illustrate the difficulty inherent in selecting proper rules of business operations a priori, rather than allowing business practices to arise in a competitive market.

#### D. *Substantive Regulation of Mutual-Fund Operations*

##### 1. Mutual-Fund Governance

Mutual funds are required to adopt a governance structure based on the corporate paradigm.<sup>180</sup> To comply with the statutory regime, these funds organize so that their assets are overseen by boards of directors (or an equivalent supervisory body)<sup>181</sup> and mutual-fund shareholders are granted fairly broad voting rights.<sup>182</sup> Thus, at a high level of generalization, mutual-fund governance is similar to that of the paradigmatic corporation.

This similarity, however, evaporates upon closer inspection. The unique nature of mutual funds shapes the somewhat distinctive role of governance in this context. The mutual-fund entity itself is traditionally structured as a shell corporation.<sup>183</sup> Fund investors own shares in this corporation, but because the entity's only asset is the portfolio it holds, the value of their shares in the fund is simply the value of their portion of the fund's portfolio.<sup>184</sup> Nearly all of the affairs of the fund are managed by its investment adviser, an outside company with its own group of shareholders who demands profits from the firm's management activities.<sup>185</sup> The return that these shareholders earn comes from the management fees that fund shareholders are charged for the management company's services.<sup>186</sup>

The fund board's primary responsibility is to oversee this manager. Its power in this regard is by virtue of its veto authority over the management contract. This agreement, which governs the fund's relationship with the management company, must be approved by the board each year.<sup>187</sup> In addition, the rules require that 40 percent of a fund's board be independent of

<sup>180</sup> See Victoria E. Schonfeld & Thomas M.J. Kerwin, *Organization of a Mutual Fund*, 49 BUS. LAW. 107, 114-15 (1993) (discussing organizational alternatives for mutual funds).

<sup>181</sup> *Id.* at 120.

<sup>182</sup> See DIV. OF INV. MGMT, SEC. & EXCH. COMM'N, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION 260-62 (1992) [hereinafter PROTECTING INVESTORS REPORT].

<sup>183</sup> See David E. Riggs & Charles C.S. Park, *Mutual Funds: A Banker's Primer*, 112 BANKING L. J. 757, 763 (1995).

<sup>184</sup> Share price in a mutual fund is essentially calculated by totaling the value of its assets and dividing that figure by the number of shares outstanding. See 15 U.S.C. § 80a-5(a)(1) (2006) (defining open-end companies (i.e., mutual funds) as those that issue "redeemable" securities); *id.* § 80a-2(a)(32) (defining a "redeemable security"); 17 C.F.R. § 270.2a-4(a) (2008) (providing for calculation of net asset value of redeemable securities).

<sup>185</sup> Riggs & Park, *supra* note 183, at 765-66; A. Joseph Warburton, *Should Mutual Funds Be Corporations? A Legal & Econometric Analysis*, 33 J. CORP. L. 745, 750 (2008).

<sup>186</sup> See Riggs & Park, *supra* note 183, at 769.

<sup>187</sup> 15 U.S.C. § 80a-15(a).

the investment adviser,<sup>188</sup> and that a majority of the independent members consent to the management contract as well.<sup>189</sup>

Like corporate shareholders, those who own stock in mutual funds have the right to elect the board members.<sup>190</sup> In the fund context, however, elections need not take place each year and, in fact, only happen occasionally.<sup>191</sup> But if mutual-fund shareholders are displeased with their management company, they are not restricted to voicing their concerns through electoral power. Pursuant to ICA rules, the shareholders themselves may vote to reject the management contract at any time—in essence firing the management company directly, rather than waiting for board action.<sup>192</sup>

a. *Analysis of Responsiveness to Market Failure*

Although the governance structure that mutual funds are forced to adopt is based on the corporate example, fund regulations, by mandating such a specific arrangement, are actually a significant departure from the securities laws that govern public companies more generally. While a more aggressive stance is potentially justified in the mutual-fund context, there is substantial evidence that the actual setup of the governance system is poorly conceived.

If sound corporate governance is beneficial, then it should evolve in a competitive market. Companies should adopt such practices to differentiate themselves, and these companies would be rewarded with higher prices. An equilibrium would develop where competing entities provide differing levels of corporate governance and shareholders choose the company that best fits their preferences. Information problems and bounded rationality may stand in the way of this evolution, however. The value of good governance is difficult to communicate and abstract, and therefore, ordinary investors may lack the patience or ability to absorb it.

With respect to ordinary business corporations, the securities laws take a rather hands-off approach to this issue. Though public companies tend to take the corporate form, this is not the result of SEC fiat. Moreover, though these companies share basic structural similarities, the details of shareholder rights vary from company to company. The rules permit public companies to have preferred shares and various classes of equity with different financial and voting rights.<sup>193</sup> If shareholders lack information about the

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<sup>188</sup> *Id.* § 80a-10(a).

<sup>189</sup> *Id.* § 80a-15(c).

<sup>190</sup> *Id.* § 80a-16(a).

<sup>191</sup> Schonfeld & Kerwin, *supra* note 180, at 122.

<sup>192</sup> 15 U.S.C. § 80a-15(a)(3).

<sup>193</sup> See Paul S. Atkins, Comm'r, Sec. & Exch. Comm'n, Corporate Governance in the USA Against the Background of Recent Developments, Remarks to the 7th German Corporate Governance

nuances of a company's capital structure or fail to understand its importance, the securities market would not be perfectly efficient. The regulations, however, do not respond to the potential for market failure by mandating a certain governance structure; instead disclosure is deemed sufficient.<sup>194</sup> This is in contrast to the mutual-fund context, where the details of corporate governance are set by the regulations.

Though seemingly at odds, it is possible to justify this disparate treatment. In neither the public securities market nor the mutual fund market would we expect the mass of investors to study the nuances of fund governance and properly incorporate them into their decisionmaking process. But if the public securities market is as efficient as widely believed, then available information with respect to the details of a company's governance structure is priced into its securities. Thus, ordinary investors, though they may end up purchasing stock with truncated voting rights without knowing it, are protected because the price of the stock is discounted to reflect this increased risk.<sup>195</sup> If mutual-fund shareholders were protected by a similar mechanism, then simply requiring disclosure of fund governance would serve to protect ordinary investors.

As discussed previously, however, there does not appear to be a similar mechanism by which the efforts of the few trickle down to the many.<sup>196</sup> That being the case, a regulatory regime that calls for disclosure alone appears insufficient to bring about the accurate pricing of shareholder-friendly governance. This means that a market supplanting mechanism may be called for—mandating it may be the only way that good governance inures to the benefit of the investing public as a whole.

The problem is that it appears the regulators did a poor job when selecting the oversight scheme to which all funds are subject—the mandated structure appears to offer few, if any, tangible benefits to shareholders. To see the problems with the board-centric governance structure, it is useful to begin with a brief discussion of its importance in general corporate law, and then to note why the same logic that arguably makes this structure important ordinarily speaking does not necessarily translate to the mutual-fund context.

The argument for sound corporate governance, in particular one centered on a shareholder-elected board, is that it can overcome the inefficiencies that accompany passive investing.<sup>197</sup> One issue is that agency costs

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Code Conference (June 27, 2008) (transcript available at <http://www.sec.gov/news/speech/2008/spch062708psa-eng.htm>).

<sup>194</sup> *Id.*

<sup>195</sup> *See supra* Part II.C.1.

<sup>196</sup> *See supra* Part II.C.1.

<sup>197</sup> *See* Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 4-5 (2002).

arise whenever ownership is separated from control.<sup>198</sup> In the corporate context, although shareholders are the true owners of a venture, they have delegated to management authority to run the venture on their behalf. The problem is that leadership may not fully internalize the profit-maximizing goal of the shareholders. They have the incentive to pursue their own pecuniary interests or shirk their management responsibilities at shareholder expense.<sup>199</sup> One way to counteract the efficiency lost because of these incentives, the so-called agency costs, is to closely watch the management team.<sup>200</sup>

It is difficult, however, for the shareholders to monitor management effectively. For one, it is an expensive undertaking to keep an eye on management. Watching their every move takes time, and ferreting out subtle or well-hidden abuses can be difficult. For another, management oversight is a public good in the sense that each shareholder who undertakes to watch over management will bear all the costs in connection with such oversight, but the increase in corporate revenue that would result from such efforts would be shared pro rata with all shareholders.<sup>201</sup> That being the case, corporate oversight is likely to be under-provided.<sup>202</sup> The theory is that centralizing the oversight responsibility in a board helps shareholders overcome these agency-cost issues.<sup>203</sup>

Its monitoring role, however, is only one way the board assists its shareholder constituents. As the primary beneficiaries of the corporate enterprise, it is ultimately up to the shareholders to decide broad issues of corporate policy. Although it may be best to make decisions in this regard by consensus, the ability to operate under this decisionmaking rule becomes impractical as the number of shareholders increases.<sup>204</sup> That being the case, it is better to delegate authority to a central decision-maker, in this case, to the board, which is expected to represent the interests of the larger group.<sup>205</sup> According to this logic, the board is a useful intermediary for passive investors, helping them to overcome problems of collective action, not only with respect to monitoring, but with respect to policy-setting as well.

Mutual funds, however, are not sufficiently analogous to general business corporations for these rationales to fully carry over. First, there is no role for the board to play as policy-setter. Mutual-fund shareholders choose

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<sup>198</sup> Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308-09 (1976).

<sup>199</sup> *See id.*

<sup>200</sup> *See* Bainbridge, *supra* note 197, at 7-8.

<sup>201</sup> *See* John C. Coffee, Jr., *The Folklore of Investor Capitalism*, 95 MICH. L. REV. 1970, 1976 (1997).

<sup>202</sup> *Id.*

<sup>203</sup> *See* Bainbridge, *supra* note 197, at 7.

<sup>204</sup> *Id.* at 4-5.

<sup>205</sup> *See* Stephen M. Bainbridge, *Participatory Management Within a Theory of the Firm*, 21 J. CORP. L. 657, 664-67 (1996).

a fund based on, among other things, the investment strategy that the manager is bound to comply with. It would be out of place for the board to question this strategy.

The board still may be relevant, however, as a monitor of fund management. Since the fund is a shell, there are no internal management employees for the board to monitor. But the external adviser faces similar incentives to pursue goals contrary to shareholder wishes. In fact, it appears that the adviser's personnel have conflicting obligations—both to serve mutual-fund shareholders who wish for maximum investment returns and to serve the investment adviser's shareholders who seek to maximize the returns from the very fees that reduce mutual-fund returns.<sup>206</sup> It could be argued that the board's role is really to manage this conflict over fees, in addition to the broader behavior of the external manager. By delegating responsibility to the board, the mutual-fund shareholders can overcome the cost and collective action problems associated with monitoring management on their own.

This line of thought, however, is incomplete. A fund board's oversight responsibility can be broken down into two categories. Its secondary responsibility is to keep an eye on management—policing conflict-of-interest transactions and overseeing management compliance with its legal and contractual obligations.<sup>207</sup> This is a role where it is easy to see how a specialized body could benefit the larger shareholding public. The board's primary oversight role, however, is to watch over management fees, the central area where the interests of the management company conflict with the fund shareholders.<sup>208</sup> And it is in this area where the costs and collective action problems that traditionally justify board governance no longer carry the same weight. It is not as if it is particularly costly to figure out how much a particular fund charges. Watching fund expenses is not akin to policing for management abuse, which requires significant expertise and resources. Similarly, since each shareholder fully internalizes the gain from monitoring fees, there is no collective action problem.

With the conventional rationales unconvincing, if the board does have utility as a fee-monitor, there must be some other justification. We need not look far for a potential candidate in this regard. Like so many other aspects of fund regulation, a board may be defensible as a response to bounded rationality. As discussed above, investors do not understand the importance

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<sup>206</sup> See generally Jeff Schwartz, *Mutual Fund Conflicts of Interest in the Wake of the Short-Term Trading Scandals: Encouraging Structural Change Through Shareholder Choice*, 2 N.Y.U. J.L. & BUS. 91 (2005) (analyzing this conflict and suggesting reforms).

<sup>207</sup> See PROTECTING INVESTORS REPORT, *supra* note 182, at 259-60; Wallace Wen Yeu Wang, *Corporate Versus Contractual Mutual Funds: An Evaluation of Structure and Governance*, 69 WASH. L. REV. 927, 993-98 (1994).

<sup>208</sup> See PROTECTING INVESTORS REPORT, *supra* note 182, at 255-56.

of fees.<sup>209</sup> Even though it is in their own self interest, investors are not parsing the daunting fund disclosure documents or conducting enough research to become adequately informed.<sup>210</sup> Moreover, because the mutual-fund market is inefficient, those who are apathetic with respect to fees are not protected by a pricing structure made competitive by the efforts of the well-informed. A board, therefore, may be justified as a way to protect investors from their own lack of diligence.

Thus, the board may have a role to play. It can assist shareholders, not only by monitoring management, but by making sure they are paying a fair price. The trouble is that the board is ill-positioned to fulfill either of these roles. Inherent in this structure is the possibility of capture. Like regulators, the board may take actions that favor those who reward and punish its behavior, even if that is not the group that it is supposed to serve.<sup>211</sup> Thus, if management is truly in charge of who gets on the board, who stays on the board, and how much board members make, then the board may look out for management's interest, rather than those of the fund shareholders.<sup>212</sup>

Capture is an issue in the paradigmatic public corporation, but takes on special significance in the fund context. The board of a public company may have an incentive to cozy up to management.<sup>213</sup> This leaning, however, is counteracted because there are several checks on the management-board relationship that do not exist in the mutual-fund arena, chief among them being the presence of institutional shareholders, like mutual funds, that actively oversee board governance.<sup>214</sup>

Shareholder activism, however, is unheard of in the mutual-fund arena. The shareholders have technical authority over the board members, but in reality, it is the management company that is attuned to their performance.<sup>215</sup> Merely garnering enough interest to muster a quorum at annual shareholder meetings is a chore.<sup>216</sup> This indifference toward fund governance is what makes capture particularly worrisome in the mutual-fund context.

Such disinterest among mutual-fund investors is unsurprising, however, given the primary market-failure justification for board governance in

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<sup>209</sup> See *supra* note 158 and accompanying text.

<sup>210</sup> See *supra* Part II.C.

<sup>211</sup> See *infra* Part IV.

<sup>212</sup> The SEC attempts to combat capture by requiring that there be independent directors. See *supra* Part II.D.1. But the above incentives take hold irrespective of whether the directors are actual employees of the management company or nominally independent.

<sup>213</sup> Bainbridge, *supra* note 197, at 7.

<sup>214</sup> See Langevoort, *supra* note 139, at 1031-32.

<sup>215</sup> See 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, 909 (1981) (“[T]here have been virtually no shareholder attempts to elect nominees to the board in opposition to the management nominees . . .”).

<sup>216</sup> PROTECTING INVESTORS REPORT, *supra* note 182, at 272 n.82.

this context in the first place—shareholder apathy with respect to fees. If shareholders are not paying attention to fees, then there is even less hope that they are going to actively monitor their board of directors. Without this oversight, however, the mechanism itself potentially loses its value.<sup>217</sup> Thus, when the rationale for board intervention shifts to shareholder apathy, the usefulness of the mechanism itself potentially collapses.

Empirical study of the board's impact supports the notion that it, in fact, does little, if anything, to aid fund shareholders. In a recent critique of fund governance, Professor Alan Palmiter summarized the empirical evidence of board performance with respect to fees as telling "a consistent and disturbing story of the failure of fund boards to negotiate lower fees in the face of economies of scale generated by rising fund assets and enhanced computer and telecommunications technologies."<sup>218</sup> And with respect to the board's broader oversight role, recent anecdotal evidence is similarly troubling. Fund boards raised no red flags with respect to the market timing practices that led to the recent industry scandals, even though the practice was an open secret known to be harmful to fund shareholders.<sup>219</sup>

This analysis reveals that board governance is potentially justified not based on a clean analogy from corporate law, but primarily as a response to the concern that, because investors are failing to take fees into proper account, funds are not priced competitively. Both theory and empiricism suggest, however, that the board is ill-suited to address this worry.

#### b. *Analysis of Adverse Market Impacts*

The fund board potentially weakens competition in a couple of respects. For one, investors may be less likely to pay attention to fees under the assumption that someone else is looking out for them. This may be tolerable if the board is actually filling this role, but here, where there is little evidence that the board has any appreciable impact, it raises the concern that the governance mechanism may lead to more misallocation of resources and higher prices as opposed to more competition.

The board may also indirectly support higher prices because it is a false bonding mechanism. In a competitive market, funds would be incentivized to adopt sound governance practices as a signal to investors that they run their affairs with a degree of integrity that withstands focused scru-

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<sup>217</sup> As discussed *infra* Part II.D.3, mutual fund shares may be sold back to the mutual fund at any time. This ease of redemption would appear to further undermine the efficacy of fund governance: it makes much more sense for those who believe the fund is mismanaged to simply exit, rather than mount any type of internal challenge.

<sup>218</sup> Palmiter, *supra* note 158, at 189-90; *see also id.* at 190-96 (summarizing empirical findings).

<sup>219</sup> *See* Eric Zitzewitz, *Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds*, 19 J.L. ECON. & ORG. 245, 249 (2003).

tiny.<sup>220</sup> These funds would give up flexibility to run their affairs as they please, but this cost may be more than offset by the increased price or increased popularity that may come from sending this signal. The current board structure, however, sends the signal of stewardship to the investing community without actually delivering it. This means that shareholders may be paying a premium for good governance, but receiving little, if anything, in return.

It is worth noting that a large group of shareholders may not fall into these traps. Despite receiving periodic mailings containing proxy materials, many shareholders may remain blissfully unaware of the board's existence. With respect to this group, the above worries about misevaluating the board's impact are moot. Even if we assume, however, that a number of investors are uninformed, the potential for harm to remaining shareholders still exists, and further draws the wisdom of an already suspect governance structure into doubt.

## 2. Regulation of Mutual-Fund Fees

For their services, mutual-fund managers may collect fees based primarily on the percentage of assets under management. The regulations only allow two types of fees—a flat fee or a so-called fulcrum fee.<sup>221</sup> Under the former arrangement, the fee is a set percent of fund assets, while under the latter, a fund charges a base fee that rises or falls based on the fund's performance against a benchmark index of securities.<sup>222</sup> The adviser may charge increased fees if the fund outperforms its benchmark, but it also must proportionally lower its fee when it underperforms.<sup>223</sup> Thus, if a fund receives a ten basis point bonus for outperforming its index by 1 percent, it must incur a ten basis point penalty for underperforming by that amount.

These rules effectively quash the use of robust fees based on how the fund performs (so-called performance fees or incentive fees). The vast majority of funds favor the flat-fee structure.<sup>224</sup> Moreover, the mechanics of the fulcrum structure ensure that even when funds adopt this option, the incentive component of these fees remains relatively small (they must be less than the flat component so the manager does not end up owing the investors money in a bad year).<sup>225</sup>

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<sup>220</sup> See EASTERBROOK & FISCHER, *supra* note 118, at 96.

<sup>221</sup> 15 U.S.C. § 80b-5(b)(1) (2000) (describing flat fee structure); § 80b-5(b)(2) (describing fulcrum fee structure).

<sup>222</sup> *Id.* § 80b-5(b)(2).

<sup>223</sup> *Id.*

<sup>224</sup> See Sophia Grene, *Fund Management: A Cautious Embrace of Performance Fees*, FIN. TIMES, Jan. 7, 2008, at 9 (stating that just 2 percent of funds charge a fulcrum fee).

<sup>225</sup> Edwin J. Elton et al., *Incentive Fees and Mutual Funds*, 58 J. FIN. 779, 781 (2003).

a. *Analysis of Regulatory Fit*

The often-cited justification for these guidelines is that they protect investors from risk-loving managers.<sup>226</sup> This issue is thought to arise when funds charge an asymmetric incentive fee,<sup>227</sup> which is the common practice in hedge funds and the like. In this context, funds paradigmatically charge a 1 to 2 percent flat fee, plus a 20 to 25 percent incentive fee on the fund's profits.<sup>228</sup> The concern is that under this arrangement, managers are rewarded for doing well, but not punished for doing poorly.<sup>229</sup> While the investors could potentially lose money if the fund underperforms, the managers merely forfeit the incentive portion of their fee. Since management would not fully internalize investor losses, the fear is that they will take on overly risky strategies.<sup>230</sup>

The presence of this conflict of interest alone, however, does not justify intervention. Although this incentive is a valid concern, it is potentially something the market could sort out. Funds could compete with various fee structures, and investors could choose the one that fits them best. An asymmetric performance fee may incentivize too much risk taking, but it also incentivizes fund managers to vigorously seek out profitable investments. This may be a perfectly rational trade-off. Indeed, the fact that this structure predominates in the private-fund market suggests that it is. Moreover, in this context, the market itself has found a partial solution to this problem. It is commonplace for private-fund managers to invest alongside their clients; this way everyone suffers together when things go poorly.<sup>231</sup>

This market mechanism, however, may not function if investors, for lack of information or understanding, fail to appreciate the implicit conflict. And this is likely a valid concern. While funds likely would disclose their asymmetric incentive fee structure, they would be unlikely to draw attention to the perverse incentive that comes with it. Meanwhile, without specific disclosure, it seems reasonable to believe that this troubling aspect of the device would slip past many fund investors. Moreover, even with disclosure, if no limits are placed on the types of incentive fees funds may charge, they may take advantage of the limited financial knowledge of some investors, and provide for incentive schemes that are clearly inappropriate. Taking all of this into account, some type of regulatory intervention appears to be called for. One option would have been to focus on measures

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<sup>226</sup> See PROTECTING INVESTORS REPORT, *supra* note 182, at 237.

<sup>227</sup> See *id.*

<sup>228</sup> Jenny Anderson, *Hedge Funds Flirt with Heresy: Going Public*, N.Y. TIMES, Sept. 15, 2006, at C1.

<sup>229</sup> See PROTECTING INVESTORS REPORT, *supra* note 182, at 237-38.

<sup>230</sup> See HEDGE FUND REPORT, *supra* note 64, at 62 & n.213; PROTECTING INVESTORS REPORT, *supra* note 182, at 237-38.

<sup>231</sup> See HEDGE FUND REPORT, *supra* note 64, at 62.

to assist investors in identifying and understanding the risks of performance-based compensation. Instead, however, regulators chose to rid the market of asymmetric incentive fees and ensure that any incentive fees that were charged were merely ancillary compensation.

On the one hand, this is an apt response to the potential market failures—by narrowing their options, the rules eliminate the possibility that investors could mistakenly invest in funds with tricky performance fees. But this interventionist path is nevertheless a questionable match because it has several potentially troubling market impacts. The first is that ordinary investors are denied the advantages of performance-centric compensation based on the private-fund paradigm, which, despite its faults, does heavily incentivize management to attempt to distinguish itself from the crowd by making forward-thinking investments.<sup>232</sup>

Also problematic is that the mandated replacement to performance fees are far from perfect. When compensation is focused on assets under management as is the case under the current rules, then those running the fund are subject to an equally perverse, and perhaps even more harmful, incentive than the one inherent in the structure the rules forbid. The focus has been taken off performance and onto asset-gathering. Under the permitted structures, the most profitable funds will be the ones that grow the largest; not necessarily the ones that provide the highest returns. Providing high returns does lead to growth.<sup>233</sup> But as discussed previously, it is immensely difficult to consistently beat the market.<sup>234</sup> A better way to increase market share is to enhance brand recognition<sup>235</sup>—and this is where significant fund resources go.<sup>236</sup> It is far from clear whether it is better to have a management company that perhaps takes too many risks in its quest for high returns or one that is distracted by its quest to hire the best brand consultant.

Further troubling is that by mandating largely asset-based fees, the restrictions likely drive away the most talented managers. If a manager is one of the few who can consistently beat the market, or at least has the potential

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<sup>232</sup> Cf. Sanjiv Ranjan Das & Rangarajan K. Sundaram, *Fee Speech: Signaling, Risk Sharing, and the Impact of Fee Structure on Investor Welfare*, 15 REV. FIN. STUD. 1465 *passim* (2002) (finding superiority of asymmetric performance fee structure to fulcrum fee structure).

<sup>233</sup> See Jain & Wu, *supra* note 145, *passim* (finding that investors allocate their money to funds with strong recent performance); Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FIN. 1589 *passim* (1998) (same).

<sup>234</sup> See *supra* Part II.C.4.

<sup>235</sup> See Steven Gallaher et al., *Madison Avenue Meets Wall Street: Mutual Fund Families, Competition and Advertising* 6 (Working Paper, 2006) available at <http://ssrn.com/abstract=879775> (“High relative levels of advertising are significantly related to high fund flows.”); Jain & Wu, *supra* note 145, at 957 (“[A]dvertised funds attract significantly more money in comparison to the funds in a control group with similar characteristics.”).

<sup>236</sup> See Cronqvist, *supra* note 123, at 1 (stating that about \$6 billion per year is spent on mutual-fund advertising); see also J.R. Brandstrader, *Paging Mr. Whipple—Can Mutual Funds Be Sold Like Toilet Tissue or Toothpaste?*, BARRON’S, July 8, 1996, at F8 (discussing fund branding efforts).

and drive to do so, it only makes sense that this person would want to reap the benefits that go along with robust performance-based compensation. Thus, the regulatory mandate makes it likely that fund managers will not only lack strong incentive to focus their efforts on beating the market, but that they will also lack the talent to do so.

Those who do enter the market will also face regulatory impediments to their success. By outlawing substantial performance fees, the regime forbids a device that could enable small or new firms to threaten the dominance of the established players. The ability to allocate money in a way that generates above-market returns is a unique individual skill. Because the market is so difficult to beat, many who try will fail. This means, however, that those who succeed will be in high demand. A new fund run by an entrepreneur with exceptional ability could grow quite rapidly if able to collect a 20 percent fee on fund profits. This money could then be channeled into advertising, and a new industry player will have emerged. Such rapid growth is rendered much more difficult if a new manager is constrained to the more mundane flat-fee or fulcrum-fee structures.

Moreover, because there are well-documented economies of scale in the fund industry,<sup>237</sup> fees based on assets rather than returns ensure that bigger funds will also be more profitable. Keying profitability to assets in this way creates a competitive advantage for the largest funds (because smaller funds must charge a higher fee to earn the same profits, they have difficulty competing on price).<sup>238</sup> This may not be that great of a detriment, because as discussed previously, investors pay little attention to fees anyway.<sup>239</sup> Perhaps more importantly, however, given the true focal points of competition in the mutual fund arena, the increased profits of the larger funds can be put into advertising and brand development, further solidifying their leading market position.

A less intrusive approach, where the emphasis is on giving investors the tools to understand the issues with incentive fees, would erase the anti-competitive effects and, if properly designed, could ameliorate the market failures at issue. With respect to investor liquidity, which is discussed below, the SEC seems to have acted in a similarly overly paternalistic manner.

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<sup>237</sup> John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Costs of Conflicts of Interest*, 26 J. CORP. L. 609, 621-22 (2001).

<sup>238</sup> Tim Gray, *Investing; In a Land of Giants, Little Funds Find an Audience*, N.Y. TIMES, Nov. 2, 2003, at 37 (noting the relatively higher expense ratios for smaller funds), available at 2003 WLNR 5636986.

<sup>239</sup> See *supra* note 158 and accompanying text.

### 3. Regulation of Fund Liquidity

Mutual-fund shares are not traded among investors. Instead, when investors wish to cash out, they turn to the fund itself, which is required to buy back the shares at their present value.<sup>240</sup> A key aspect of mutual fund regulation is the mandate that shares be redeemed and paid for by the fund within seven days of an investor's request.<sup>241</sup> Moreover, to help to ensure that funds are able to keep up with such requests, the SEC requires that funds not place more than 15 percent of their assets in illiquid securities.<sup>242</sup>

The requirement of immediate redemption ensures that investments in mutual funds are highly liquid. If investors do not like the way their fund is being run, they can quickly withdraw their money and reinvest it with a new fund—perhaps one with lower costs or with a different investment strategy. The flexibility to move one's money is valuable to any investor. In addition, it has the potential to make for a more competitive industry. Since shareholders can rapidly move their money to competing funds, the expectation would be that members of the industry would be more attuned to their interests. All else being equal, therefore, quick redemptions benefit the investing community.

In order for regulation to fit the public interest, however, there must be some market failure to which it responds. In a well-functioning market, certain funds could offer terms that catered to investors who demanded high liquidity, while others offered alternative benefits. Investors could then choose the fund that suits them. The only reason not to let the market sort this out would be out of fear that lack of disclosure regarding redemption policies or bounded rationality would lead investors to miscalculate this aspect of the investing decision.

It is possible to see how some baseline disclosure requirement could be helpful to address these concerns. Lacking this, perhaps funds could bury unfriendly liquidity terms in the fine print. Investors, therefore, could be caught off-guard when seeking to redeem their shares in case of emergency. Beyond this, however, it is difficult to see why investors need additional assistance. When properly disclosed, the terms on which redemption is available should not lay beyond the grasp of ordinary investors. Mandatory immediate redemption, therefore, appears to be overkill.

Further, it is unlikely that this structure accurately represents the interests of fund shareholders. Mutual funds are designed as long-term investments. The fact that such funds held \$4.6 trillion in retirement plan savings

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<sup>240</sup> See *supra* note 184 (discussing the pricing of mutual fund shares).

<sup>241</sup> See 15 U.S.C. § 80a-22(e) (2000).

<sup>242</sup> Revision of Guidelines to Form N-1A, Securities Act Release No. 33-6927, Investment Company Act Release No. 18612, 57 Fed. Reg. 9,828, 9,829 (Mar. 20, 1992).

at the end of 2007 testifies to this.<sup>243</sup> One would think that if assets are being invested in funds for the long-term, immediate redemption would rank low on the list of investor demands. And this intuition appears to be true. Studies show that the average shareholder redeems only infrequently.<sup>244</sup>

What is troubling is that investors are potentially giving up a lot for a privilege that they rarely use. The average investor rarely redeems, but this does not mean that redemptions are rare.<sup>245</sup> In fact, the average percentage redeemed on a yearly basis from mutual funds is rather high. In 2007, for instance, 27 percent of fund assets were redeemed.<sup>246</sup> In 1987, the year during which the famed October sell-off known as Black Monday occurred, redemptions from stock mutual funds totaled 73 percent.<sup>247</sup> The current financial crisis has also been marked by significant redemptions—in October 2008 a record \$86 billion was taken out of mutual funds.<sup>248</sup> The ease of redemption allows for such an unpredictable asset base, and the volatility hurts the long-term shareholders.

Frequent redemptions cause mutual funds to be constantly adjusting their portfolios. That means they incur increased transaction costs, which are passed on to fund shareholders.<sup>249</sup> Moreover, the unpredictability of redemptions can have a direct impact on performance.<sup>250</sup> Because a fund must have enough cash on hand to accommodate redemption requests, it cannot fully capitalize on its investment strategy. In particularly rough times, funds may be forced to sell assets during an unfavorable market environment in order to meet demands for redemption, in which case fund returns take an additional hit.<sup>251</sup>

Further troubling is that, in addition to its direct impact on fund shareholders, this regulatory requirement dampens competition. First, it creates a burden on newer industry entrants and smaller funds. To be able to immediately process redemptions requires a substantial investment in administra-

<sup>243</sup> INV. CO. INST., 2008 INVESTMENT COMPANY FACT BOOK 99 (48th ed. 2008) [hereinafter FACT BOOK].

<sup>244</sup> Wilcox, *supra* note 96, at 653; Investment Company Institute, *Redemption Activity of Mutual Fund Owners*, in 10 FUNDAMENTALS 1, 3 (2001), available at <http://www.ici.org/pdf/fm-v10n1.pdf> [hereinafter *Redemption Study*].

<sup>245</sup> See *Redemption Study*, *supra* note 244, at 1.

<sup>246</sup> FACT BOOK, *supra* note 243, at 134 (excluding redemptions from money market funds).

<sup>247</sup> *Id.*

<sup>248</sup> Sam Mamudi, *Mutual-Fund Assets Fall 21% in 5 Months*, WALL ST. J., Nov. 26, 2008, at C15.

<sup>249</sup> See Transaction Costs Release, *supra* note 152, at 74,826.

<sup>250</sup> See Roger M. Edelen, *Investor Flows and the Assessed Performance of Open-End Mutual Funds*, 53 J. FIN. ECON. 439, 441 (1999) (attributing the inability of mutual-fund managers to beat the market to the liquidity feature of such funds).

<sup>251</sup> Traders who move quickly in and out of funds in an attempt to time market shifts amplify these problems. To account for this, the SEC now permits funds to assess a 2 percent redemption fee on short-term traders. This fee is paid back into the fund, and thus, partially makes amends for the increased costs. See 17 C.F.R. § 270.22c-2 (2008); Mutual Fund Redemption Fees; Final Rule, Investment Company Act Release No. 26,782, 70 Fed. Reg. 13,328, 13,331 (Mar. 18, 2005).

tive personnel and equipment, which is a significant hurdle for those wishing to enter the industry.<sup>252</sup> Second, a wildly fluctuating asset base makes it difficult for a smaller fund to execute a consistent investment strategy, let alone stay in business. An economic downturn could lead to mass redemptions, which could easily lead smaller funds to be redeemed out of existence. A large mutual fund, on the other hand, has the resources to bear considerable outflows without significant impact.

Finally, new entrants will have difficulty figuring out ways to distinguish themselves given the need for quick redemption and, in particular, the corollary rule requiring that at most 15 percent of fund assets be held in illiquid securities. By confining mutual funds to liquid investments, the regulations render many of the creative strategies employed by hedge funds, private equity funds, and venture capital funds difficult, if not impossible, to pursue.<sup>253</sup> The strategies these funds employ often require significant lock-up periods and investment in illiquid assets.<sup>254</sup> Because these mechanisms are off limits for mutual-fund advisers, it makes it more difficult for newcomers to compete by offering innovative investment schemes. Would-be entrants are largely confined to the various types of plain-vanilla long-only strategies, the permutations of which have been fully explored by the industry's elite.<sup>255</sup> Moreover, as discussed above, the rare individual that can out-compete the remainder of the industry even within a long-only investing paradigm could make more money doing so as a hedge-fund manager.

Thus, competition based on either the type of product or unique talent is rendered less likely by the constraints on fees and liquidity. The primary challengers to established market players are likely to be funds with long-only investing strategies run by those of average skill—hardly the type of new blood that makes for a vigorous competitive marketplace. By giving mutual funds greater flexibility, this rigid structure can be unwound, opening the door to more spirited competition, without reintroducing a worrisome risk of market failure.

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<sup>252</sup> See Gray, *supra* note 238 (citing a mutual-fund administrator's estimate that a fund needs at least \$12 million in assets to cover expenses).

<sup>253</sup> Other regulations that make these strategies difficult to employ are the limits on leverage and the use of derivative instruments. See 15 U.S.C. § 80a-18(f)(1) (2000) (disallowing the issuance of senior securities and permitting bank borrowing only if 300 percent asset coverage); Mutual Funds and Derivative Instruments, SEC No-Action Letter, 1994 WL 16515036, at \*23 (Sept. 26, 1994) (stating SEC's position that investing in derivative instruments is permitted only so long as the fund's position is adequately covered).

<sup>254</sup> See *Hedge Funds: All Locked Up*, *ECONOMIST*, Aug. 4, 2007, at 40.

<sup>255</sup> A long-only fund is one that earns a profit only when the assets in which it invests, stocks for instance, rise in value. While it may be possible for a mutual-fund adviser to differentiate by launching an alternative strategy mutual fund, for example, one that provides returns even when stocks lose value, there appears to be little entrepreneurial incentive to do so. One could launch a private fund along these lines, have none of the regulatory requirements, and earn a higher fee.

E. *Summary of Normative Analysis*

Once the current regulations are conceptualized in terms of their fit to industry market failures, we can make a few observations. As a threshold matter, the primary justification for regulatory intervention in this marketplace is that funds may not offer investors sufficient or well-designed information on which to base their decisions and, even with this information, investors may still make mistakes. Regulation can step in to help investors overcome these issues.

The present regime is aligned with these market-failure justifications in that it contains mechanisms that could potentially make up for the fallibility of investor decisionmaking. Detailed review, however, uncovers reason to believe that these mechanisms are inapt. Consider the disclosure rules. While the mandated disclosures give investors much information, they do not appear particularly well-designed to truly help investors decide among funds.<sup>256</sup> One indication of the current regime's fecklessness is that investors do not evidence shrewd investing skills: they fail to properly weigh past performance and fees, while flocking to actively managed funds.<sup>257</sup>

The other key components of the regulatory regime are the limitations on investor choice.<sup>258</sup> The accredited investor standard channels ordinary investors to mutual funds, where their only options are funds with mandated governance structures that follow strict restraints with respect to strategy, redemption, and fees. Theoretically, such restraints could protect investors from their own inadequacy. These mechanisms, however, consistently appear ill-advised or unnecessary from a market-failure perspective. This awkwardness is particularly troublesome because this rigid mutual-fund template cuts off investor-friendly alternatives and, in doing so, restrains competition. Among other things, these rules create barriers to entry, discourage innovation, make it more difficult for small funds to compete, and create an incentive for the most talented managers to seek employment with private funds.

The idea of regulation should be to engender a more robust competitive marketplace. The current rules, however, do not align well with this goal. Investors are not provided with the type of information that in their possession would force funds to compete on price and quality. At the same time, by foreclosing investor options, the rules disrupt competition, rather than foment it.

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<sup>256</sup> See *supra* Part II.C.

<sup>257</sup> See *supra* Parts II.C.2-4.

<sup>258</sup> See *supra* Part II.D.

### III. A LIBERTARIAN-PATERNALIST REFORM PROPOSAL

The idea of libertarian paternalism is that regulators should take steps to improve investor decisionmaking without undermining investor autonomy.<sup>259</sup> This principle can serve as the basis for a reformed investment management regulatory structure that appears likely to do a far better job of serving society's interests. Below I describe a three-tiered regulatory structure for the fund marketplace, where investors are free to choose the tier of regulation that fits them best, but are guided in their decisions by a more robust investor education system.

#### A. *The First Tier: Mutual Funds*

Under the less paternalistic framework I propose, investors would not be confined to mutual funds. That said, however, much could be done to improve how the current regulatory structure responds to imperfect information and bounded rationality in the mutual-fund context. This section suggests that investors would be better off if the current disclosure mandate was trimmed down and the SEC took a more active role in bringing financial knowledge to investors, mandated board governance was replaced by mandated independent third-party monitoring, and the liquidity and fee restrictions were eased.

##### 1. Improving Investor Decisionmaking through Better Disclosure and Direct SEC Commentary

The breadth of the current disclosure regime is difficult to justify. As discussed in Part II, ordinary investors likely pay little attention or are overwhelmed by the minutia currently presented, and expert analysis of these disclosures, even if it exists, does not seem to be engendering competition. Meanwhile, the administrative burden copious disclosure places on the industry disproportionately impacts newer and smaller funds, which impedes their ability to compete.<sup>260</sup>

The key to reform is a disclosure scheme that is more narrowly targeted and demands less compliance resources. Moving in this direction would do more to assist decisionmaking, while lessening the strain on nascent competitors. As a baseline, the SEC could require funds to prepare a brief document, much shorter than the current prospectus, that centers on

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<sup>259</sup> See *supra* note 17 and accompanying text.

<sup>260</sup> See *supra* Part II.C.4.

the essential aspects of fund investing—strategy, fees, risks, and returns.<sup>261</sup> It is failure to understand these attributes that has the most potential to undermine individual decisionmaking and competition in the market. It, therefore, makes sense to concentrate regulatory efforts on these areas.

If a document with a narrower focus is created along these lines, the question arises as to what to do with all the information that is cut out. Certain investors may benefit from the more nuanced data currently available in the prospectus and SAI. As long as this information is broken out in a document separate from that provided to everyone else, then there is no longer a concern about overwhelming less demanding investors. If extended information is provided in a second document, however, the compliance cost issue remains. The key is to balance the benefits of more detailed disclosure with concern about the anticompetitive impacts of compliance costs. One creative tactic recently formulated by the SEC, which only months ago adopted disclosure-simplification measures very much along these lines, is to permit funds to make more detailed information available only on the Internet, unless an investor specifically requested it in paper form or via e-mail.<sup>262</sup> Thus, curious investors would have access, but costs would be reduced.

This appears to be a fair compromise solution. Ideally, however, it would only be the first step. This move dodges the tougher issue, which is to what extent disclosure can actually be reduced, rather than merely displaced. The SEC staff's failure to consider peeling back disclosure likely stems in part from the endowment effect, a human trait that causes us to value items more if we have them, than if we were to consider the item in the abstract.<sup>263</sup> This leads to the proliferation of mass off-site storage centers where families store seldom used belongings, and in this case, potentially to internet storage of disclosure items nobody truly is looking at.

Thus, in addition to moving technical disclosure away from the presentation of key terms, the SEC should study whether disclosure can be reduced. Moving detailed information to the Internet could be followed by carefully scrutinizing the internet-only terms for those provisions particularly expensive to provide or unlikely to draw the attention of even the most concerned investor. In fact, this multi-layered system of disclosure even lends itself to a costs-benefits analysis into whether continuing to provide the background information is justified. The number of investors that click through to the information or otherwise request it could be tracked to judge

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<sup>261</sup> As discussed *supra* note 135, the SEC quite recently signaled a move in this direction, allowing funds to meet their prospectus-delivery requirement by providing investors with a summary prospectus, so long as the full-length version remained accessible.

<sup>262</sup> See Enhanced Disclosure Release, *supra* note 135, at 4560.

<sup>263</sup> Sunstein & Thaler, *Libertarian Paternalism*, *supra* note 6, at 1181; *The endowment effect: It's mine, I tell you*, *ECONOMIST*, June 21, 2008, at 95-96 (considering the endowment effect from an evolutionary perspective).

the impact of these continued disclosure efforts, which could be compared to the costs of providing it.

Aside from looking to scale back the disclosure of background terms, the SEC should also focus on how information is presented in the brief disclosure document that would likely be the focus of the vast majority of investors. Care should be taken to reconfigure the description of key traits so as to maximize investor ability to understand the information presented and compare among funds. Moreover, the idea of disclosure, especially from the perspective of libertarian paternalism, is not only to provide useful information, but to provide it in a way that guides people towards decisions that are in their own best interests.<sup>264</sup> Thus, in drafting disclosure mandates, the regulator is more than just a passive conduit for information.

First, consider fund fees. These disclosures should seek to inculcate an understanding of the importance of fees and thereby encourage investors to choose low-cost funds. A step in the right direction would be to require funds to compare their fees to like funds and related index funds. Access to clear comparative information makes it easier for investors to determine whether the fund they are considering is an expensive one, a necessary precondition if investors are to choose less expensive alternatives. One way to present comparative information in an intuitive fashion would be through a graphical display: a range of fees from least to most could be represented by a horizontal line labeled “ongoing fund expenses” and the particular fund’s expense ratio could be plotted along that line.<sup>265</sup> This would give investors a visual depiction of the particular fund’s fees as compared to other funds. In addition, this information could be presented in written form. A prospectus could inform investors that “this fund is more expensive than 75% of its peer funds” and “25% more expensive than related index funds.”

These steps would likely do much to foster comparative analysis of fees. The effect would be limited, however, because as long as fees are expressed in terms of the expense ratio, they remain abstract. If this is the case, investors may not realize the importance of the comparative fee information. To render this information concrete, it should also be presented

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<sup>264</sup> See Sunstein & Thaler, *Libertarian Paternalism*, *supra* note 6, at 1183 (discussing how disclosure and the presentation of information can be utilized to promote welfare).

<sup>265</sup> See James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 WASH U. L.Q. 907, 935-37 (2005) (calling for disclosure along these lines as it is in accord with judgment and decisionmaking research). The SEC should endeavor to include all ongoing fees in this disclosure, including transaction costs, which, as previously discussed, can significantly impact returns. See *supra* Part II.C.3. At this time, brokerage commissions can be included. But there is no consensus on how the remaining transaction costs can be estimated. See Hu, *supra* note 137, at 1327. That being the case, the prospectus could include comparative information about the extent to which a fund turns over its portfolio in a year, with an explanation that the greater the turnover, the higher the transaction costs. The current rules provide for the disclosure of portfolio turnover, with no explanation of its relevance. See Form N-1A, *supra* note 111, at Item 8(a).

in terms of dollars, a metric that is more clearly relevant to investors. One way to foster comparative decisionmaking in dollar terms would be to make greater use of the prospectus fee table. As discussed above, the prospectus fee table states costs in dollar terms for a \$10,000 investment under certain assumptions.<sup>266</sup> This information would be more helpful if funds were required to take the fee information calculated in the prospectus fee table and compare it to other funds. Disclosure of costs is more likely to hit home if the prospectus informs investors that “according to the table above, over the course of a ten year period, this fund will cost \$5,000 more than related index funds.”

This logic could even be extended a step further. Investors could be provided with dollar-denominated fee information that corresponds with their actual investment. An estimate could be provided at the point of sale by plugging in the assets an individual plans to invest into a calculator programmed with the assumptions about returns and holding period on which the calculations in the fee table are based. This could happen automatically when investors fill out an online form, or brokers could be required to calculate this information for investors before executing a transaction. The calculation could even show how this fee estimate compares to the broader fund market.

Moreover, long after the original purchase, steps could be taken to keep fee information salient, rather than letting it fade away.<sup>267</sup> If investors are kept abreast of this information, then they would likely be more apt to reevaluate their investments in costly funds. To this end, the rules could require that shareholder account statements show the amount an investor paid in dollar terms over the relevant period.<sup>268</sup> Funds could also be required to keep a running tally of the fees each investor has paid over time and report to each investor their own aggregate expenses. Better initial disclosure and follow-up along these lines would serve to situate fee information closer to the forefront of people’s minds, which would hopefully lead to more cost-conscious decisionmaking and even fund competition based on price.

Improving how investors take fees into account is an important step in creating a better decisional landscape for investors. A further step in this direction would be to improve disclosure of past performance. As discussed above, the past performance of a particular fund is a poor indicator of future

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<sup>266</sup> See *supra* text accompanying note 155.

<sup>267</sup> See THALER & SUNSTEIN, NUDGE, *supra* note 6, at 98-99 (discussing how individuals focus on salient information).

<sup>268</sup> The Government Accountability Office has also recommended this step. *Oversight Hearing on Mutual Funds: Hidden Fees, Misgovernance and Other Practices That Harm Investors: Hearing Before the Subcomm. on Financial Management, the Budget, and International Security of the S. Comm. on Governmental Affairs*, 108th Cong. 13-14 (2004) (testimony of Richard J. Hillman, Director, Financial Markets and Community Investment, Government Accountability Office).

performance, but the SEC requires that such information be provided with only a tepid warning as to the limitations of this piece of data.<sup>269</sup> Under this disclosure framework, investors do not appear to be internalizing the subordinate role that a snapshot picture of fund performance should play in their investment decision.<sup>270</sup>

Modern finance has a lot to say about how to view past performance. Instead of attempting to boil it down to a warning that past performance “is not necessarily an indication” of the future,<sup>271</sup> the SEC should attempt to pass this information along to investors by creating simplified disclosures that encourage investor decisionmaking consistent with financial insight. To see how this can be done, it helps to first drill down on what it means to say that past performance is not a good indicator of future performance. This statement hides a good deal of nuance, and implies that there is no way for investors to know what they are getting themselves into with a particular fund, which is not the case. Past performance is useful when it is used to describe the asset class in which a fund invests and it is linked to risk. We know that various asset classes, like stocks, bonds, and cash instruments, have historically earned a certain return, while carrying a certain risk.<sup>272</sup> As the risk goes up, so do historical returns.<sup>273</sup> These figures can not foretell the future, but they provide perhaps the best guidance we have.<sup>274</sup> On the other hand, the fact that a particular fund has favorable risk-adjusted performance when compared to its asset class does not reliably indicate a future of such heady returns.<sup>275</sup>

Properly incorporating past performance into the selection process for choosing a mutual fund, therefore, involves essentially three tasks: (1) identifying which asset class is preferable; (2) seeing how the fund under consideration deviates in terms of risk and reward from the profile of its asset class; and (3) understanding the caution with which relative performance information should be treated. The trimmed down prospectus could give investors the tools for undertaking this analysis. The difficulty here is in providing enough information for investors to be reasonably well-informed without overwhelming them. The best way to walk this line is likely to make use of both visual presentation of risk and returns as well as plain-English narrative. For instance, assume an investor is considering an actively managed fund that invests in large-company stocks. The first relevant piece of information would be the risk and returns of large-company stocks

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<sup>269</sup> See *supra* Part II.C.2.

<sup>270</sup> See *supra* note 149 and accompanying text.

<sup>271</sup> See *supra* note 146 and accompanying text.

<sup>272</sup> See IBBOTSON ASSOCIATES, STOCKS, BONDS, BILLS AND INFLATION: 2006 YEARBOOK 31 (2006).

<sup>273</sup> See *id.*

<sup>274</sup> See Hu, *supra* note 137, at 1317-19 (discussing the dominant role that asset class plays in determining returns).

<sup>275</sup> Wilcox, *supra* note 96, at 651.

over time. This information could be presented to investors in narrative form. A prospectus, for instance, could inform investors that since 1926 this asset class has had average returns of 12.3 percent per year.<sup>276</sup> Risk could be described in a similarly straightforward fashion. The key measure of risk is standard deviation, but to avoid financial jargon, the prospectus could lay out standard deviation in layman's terms; in other words, that "two out of three years, large-company stocks have had returns between 32.5 percent and negative 7.9 percent, and that in the other year, the returns were greater or lesser than these figures."<sup>277</sup> It could also explain that this is a relatively "high degree of volatility" as compared to other traditional investments.

This long-term asset class information then needs to be related to the particular fund. A chart with one line tracing the ups and downs of the fund over time and another line in this chart showing the same information for the asset class would seem to accomplish this goal. This would intuitively show whether the fund has a history of adding value.

To assist investors in interpreting the relative performance information, this graph could be accompanied by two disclosures. The first disclosure would communicate that even though a fund appears to perform well by comparison to its related index, this does not mean it will continue to outperform. This could be followed by the related statement that on average actively managed funds perform worse than index funds that track the fund's associated asset class.<sup>278</sup> In this way, disclosures can foster an understanding that today's hot fund will likely fall back to earth, and hopefully cause investors to rethink their practice of chasing fund-specific returns. At the same time, when investors see that the fund they are considering underachieves, they will be reminded of the index-fund alternative. Disclosures along these lines have the potential to foster a more grounded consideration of past performance and savvier fund allocation decisions. The exact contours of this scheme could be further developed, but what I hope to show with this outline is that it is possible to lead investors toward more informed deliberation regarding past performance without getting mired in complexity.

Even the most well-constructed disclosure documents, however, will be ignored or misunderstood by some investors. Moreover, there is only so much that can be communicated in dry government-mandated disclosures. Forcing funds to compare their fees to index funds, for instance, may send an implicit message to investors that the latter is a more appropriate place for their money, but falls short of clearly and directly communicating the benefits of index funds. These quandaries illustrate the inherent limitations

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<sup>276</sup> This figure is as of 2005. IBBOTSON ASSOCIATES, *supra* note 272, at 31.

<sup>277</sup> *See id.* The standard deviation for the large-company stocks is 20.2 percent. *Id.* The above calculation is based on the statistics behind standard deviation, which tell us that 68 percent of the time a result will fall within one standard deviation of the mean.

<sup>278</sup> *See supra* note 175 and accompanying text.

in relying on disclosure as the primary means of communicating with investors. It is at best an incomplete mechanism for providing them with important information.

To address this concern, the SEC could offer direct commentary on fundamental investing issues. Relying on financial scholarship, the agency could take positions on how investors should be allocating their money, instead of merely calling for disclosure and hoping for the best. The SEC could, for instance, directly comment on the importance of costs and the difficulty in beating the market. It could even comment on the superiority of low-cost index funds to those that pursue a strategy of active trading, and therefore charge more for their services. To get its message across, the agency could produce brief brochures that brokers and 401(k) plan fiduciaries would be required to distribute to investors. It could even fund an advertising campaign hitting on these issues. While such actions would be a fairly severe departure from the SEC's normally passive countenance, this more active role would make up for the deficiencies in disclosure as a mechanism to close information gaps.

This role would also fill a void in the investing marketplace. Investors often seek third-party advice on investing, but the investment advisory industry is riddled with conflicts of interest.<sup>279</sup> Because trustworthy third-party advisers are difficult to find, the SEC may be in the best position to provide investors with honest information.

A new framework for targeting information problems and bounded rationality in the industry along these lines would likely better serve the public interest. If the central disclosure document is cut down to include only key information, and this information is presented in an intuitive manner that steers investors to sound decisionmaking, then investors would be better situated to make good choices. Reinforcing this document with SEC commentary on sound investing would provide investors with further assistance. Admittedly, these proposals may be resource intensive; redesigning disclosures, tracking comparative information so funds can include such data, and speaking directly to the public all cost money. These costs, however, may very well be justified as they are all motivated by the libertarian-paternalist goal of improving investor decisionmaking, the fallibility of which is the key impediment to a competitive mutual-fund market.<sup>280</sup>

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<sup>279</sup> See *supra* note 140 and accompanying text; see *supra* note 179 and accompanying text; Freeman, *supra* note 27, at 789-96 (discussing conflicts of interests among fund sellers, fund advisers, and fund shareholders).

<sup>280</sup> One thing to keep in mind with respect to this proposal is that the up-front expenditures, while salient, would pale in comparison to the cost savings and increased returns that would accrue to investors over time if the reforms succeed in leading them to more savvy investment decisions.

## 2. Improving Management Oversight: From Fund Board to Outside Monitor

Mutual-fund investors are notoriously apathetic toward fees and they lack the tools to closely monitor fund managers, which leaves them potentially subject to abuse.<sup>281</sup> The fund board can be seen as a mechanism to fill this void, but evidence suggests that it has not been successful in this regard.<sup>282</sup> The question that arises is whether a better mechanism can be devised to police fees and oversee the relationship between the fund and its management company or if, instead, these issues should be left to the market.

Consider first the board's role as an oversight mechanism. Theoretically, market forces could be relied upon to lead to the evolution of different structures that would ably serve this role for fund shareholders. In reality, however, mutual-fund investors likely lack the ability or at least the desire to accurately assess whether funds are providing adequate safeguards, which means that a well-functioning market with respect to this term would be unlikely to emerge.<sup>283</sup> This suggests that investors may be best served if the SEC chose an appropriate oversight structure on their behalf.

This conclusion may at first seem to run contrary to the libertarian-paternalist concern for investor autonomy. And this would be true if ordinary investors were only permitted to take part in mutual funds, as is the case today. But if investment in funds without a mandated oversight structure is permitted along the lines I suggest below, then whatever structure is required for mutual funds would merely be the default. Those investors that have confidence in their ability to judge this aspect of investing on their own would be free to choose without government oversight. In this way, investor autonomy is preserved, while those investors that would be better served if the SEC chooses the best device on their behalf are also able to benefit. Libertarian paternalism recognizes that many individuals are not equipped or do not care to make complicated choices. But this does not hold true for everyone. The response to this dilemma is to design regulatory schemes that help the less sophisticated without overly burdening those who wish to fend for themselves.<sup>284</sup> In this way, mandating a certain oversight structure in the mutual-fund context not only appears logical, but is also consistent with the libertarian-paternalist viewpoint.

The next question, therefore, is what should be the board's replacement. In most other countries, mutual funds do not have boards of direc-

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<sup>281</sup> See *supra* Part II.D.1.

<sup>282</sup> See *supra* Part II.D.1.a.

<sup>283</sup> See *supra* Part II.D.1.a.

<sup>284</sup> See THALER & SUNSTEIN, *NUDGE*, *supra* note 6, at 4-14.

tors.<sup>285</sup> Frequently, management oversight is instead provided by a government body, a trustee, or some combination of the two.<sup>286</sup> In the United Kingdom, for instance, the manager is overseen by an independent trustee.<sup>287</sup> It is likely worth considering switching to an oversight structure along these lines.

The value in this structure is that it allows for the creation of rules that foster greater independence. Under the corporate paradigm, we have a board made up of management employees and a minority of outsiders, who are supposed to watch over management, even though the shareholders are not paying attention to their activities.<sup>288</sup> This is not a recipe for vigilant oversight.<sup>289</sup> An independent trustee, on the other hand, may be a more trustworthy guardian of shareholder interests—so long as it is subject to certain restraints. At a minimum, it should be required that an entity given responsibility to oversee a mutual-fund manager be unaffiliated with the management entity and have no brokerage or other types of business relationships with the fund manager that could create a conflict of interest. Moreover, to fight the development of an overly cozy relationship once selected, there could be a requirement that these monitors be rotated on a regular basis and that the actions of these trustees be subject to SEC review. At least to a certain extent, capture is inevitable in this context—it is impossible to ensure that any oversight body will fully internalize shareholder interests. It seems, however, that as opposed to a board, an outside monitor, when properly regulated, is an institution that is better suited to take seriously its fiduciary role.

This outside monitor, however, should have no role in setting fees. Instead of hoping, as we do today, that a special body will protect investors from high fees, we could, in libertarian-paternalist fashion, let investors fend for themselves, having given them the best tools possible with which to do so. With better disclosure and a more education-minded SEC, investors should not need an outside entity to weigh fees on their behalf. In the end, therefore, investors would likely be better served if a third-party watched for management abuse—while leaving fees alone.

### 3. Easing Substantive Restrictions on Mutual-Fund Activities

Mutual funds may not charge asymmetric performance fees; nor may they delay redemption of fund shares.<sup>290</sup> As discussed in Part II, it looks like

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<sup>285</sup> Palmiter, *supra* note 158, at 205-07.

<sup>286</sup> Wang, *supra* note 207, at 950-56.

<sup>287</sup> *Id.* at 955.

<sup>288</sup> *See supra* Part II.D.1.

<sup>289</sup> *See supra* Part II.D.1.

<sup>290</sup> *See supra* notes 221, 241 and accompanying text.

these outright restrictions may have been regulatory overkill. This is problematic because, by completely forbidding these activities, these rules, among other things, make it more difficult for smaller funds to compete, stifle innovation, and drive away the very best managers.<sup>291</sup> Consideration, therefore, should be given to unwinding these restraints.

The issue of how quickly funds should redeem their shares could likely be left to the marketplace. It makes sense for the SEC to mandate that redemption terms be clearly disclosed (lest managers attempt to bury this item in the fine print), but further steps appear unnecessary.

Recall that as a complement to the immediate redemption rule, the SEC requires that mutual funds invest 85 percent of their assets in liquid instruments.<sup>292</sup> Repealing the mandate of immediate redemption calls into question whether this rule should remain in place. Potentially, the rule could be repealed, or at least made only applicable to those funds offering immediate redeemability.

Under the revised framework I propose, however, this limitation would remain in place. This is because the rule serves to define what mutual funds are. By restricting fund investments, it prevents mutual funds from acting like true hedge funds. This is important because the designation that a particular fund is a “mutual fund” should be a signal that this fund is a highly regulated long-only investment, appropriate for those who do not wish to expend the resources required to select a more individualized product. In fact, so that this message is clearer than it is today—where the mutual fund designation is conveyed on alternative strategy funds even though they try to imitate hedge funds—the other rules that restrict fund strategy could be tightened to the point where mutual funds are synonymous with long-only investing. This way, investors would clearly know, just from the designation, that a mutual fund is following a conventional investing paradigm. If some prefer to invest in more esoteric devices, they are free to do so by taking part in funds that are more lightly regulated along the lines described in the sections that follow. The role of mutual funds in the regulatory scheme, however, would be clear.

These additional restrictions creating a more distinct mutual-fund category could be combined with liberalized rules with respect to asymmetric performance fees. Because the use of these incentive fees could lure good fund managers to the mutual-fund business,<sup>293</sup> it is worth considering allowing this device. Going down this path, however, would likely be most fruitful if this more permissive structure was reinforced by a few safeguards. In order to ameliorate the risk that mutual-fund shareholders would underappreciate the fact that managers compensated in this way are incentivized to follow higher-risk strategies, the SEC could require that the fee structures

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<sup>291</sup> See *supra* Part II.D.

<sup>292</sup> See *supra* note 242 and accompanying text.

<sup>293</sup> See *supra* Part II.D.2.a (discussing, among other things, the draw of such fees).

be disclosed, and that such disclosures include a warning that these incentive fees “encourage fund managers to pursue aggressive trading strategies.” This warning is unlikely outside an investor’s realm of understanding. Moreover, the regulations could require that the managers have a certain percentage of their own assets invested with the fund. This way, ordinary shareholders could have the benefits of this compensation scheme with the protection that sophisticated investors have bargained for. Finally, it could be required that the incentive fee only kick in once the manager outperforms a related index of securities. The fee would be a percentage of the gains in excess of that hurdle rate. If it was not required that asymmetric performance fees be tied to this benchmark, investors could be tricked into paying such fees for index-fund returns.

By permitting asymmetric performance fees and delayed redemptions, the SEC could likely better assist fund shareholders. The greater flexibility would lend itself to a more competitive fund marketplace, where smaller firms are better able to compete and skilled stock-pickers are rewarded for their abilities. At the same time, investors would no longer be forced to subsidize the redemptions of active traders if all they wish for is a long-term investment. Finally, the risks of this strategy appear minimal. Providing investors more choice along these lines with the safeguards described above appears unlikely to cause appreciably more investing errors.

#### B. *The Second Tier: Absolute Return Funds*

Investors have various degrees of financial savvy. The current rules take this into account by channeling investors below certain wealth criteria to highly regulated mutual funds, while allowing those above these criteria to take part in largely unregulated asset pools, which may engage in potentially riskier and more complex investing strategies.<sup>294</sup> The earlier analysis of this structure suggested that these rules lacked either sound theoretical or empirical support, and that they potentially had a deleterious impact on the mutual-fund market, by among other things, shielding mutual funds from competition from private funds and their creative investing techniques.<sup>295</sup>

Reform of the exemptive structure could proceed along either of two paths. One avenue would be to search for a better way for the government to divine investing ability, and then channel investors to the level of regulation the government deems appropriate. In the alternative, we could allow investors to self-identify their level of sophistication, and invest in accordance with their own comfort level. In this section, I suggest that the search for better sorting criteria is likely unproductive and offer a proposal that, in

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<sup>294</sup> See *supra* Part II.A.

<sup>295</sup> See *supra* Part II.B.

libertarian-paternalist fashion, would give ordinary investors the ability to take part in private-fund strategies if they so desired.

It is possible to conceive of criteria other than wealth that may serve as a better proxy for sophistication—investing experience and level of education come to mind. But while these proxies may be intuitively appealing, it is possible that they are nearly as imperfect as wealth as indicators of investment savvy. An inexperienced investor may do enough research to invest wisely; an experienced investor may have gained little knowledge from it.<sup>296</sup> Education is likewise problematic. It is not clear what level of education should suffice or what degrees unrelated to finance tell us about investing acumen.

A further alternative, one offered by Stephen Choi in connection with a proposal to reform securities law more generally, would be to require that investors demonstrate their investing acumen by passing a test.<sup>297</sup> Successful exam performance would entitle the investor to a license that allows this person to partake in less regulated investments.<sup>298</sup>

This more radical approach seems to have the potential, at least in the abstract, to better identify which investors need protection from market failures. But designing an accurate test to sort investors would appear to be a difficult task. Who is to say how much one needs to know to invest in more advanced instruments? Moreover, even assuming such a test could be created, it is still questionable whether improved accuracy in identifying capable investors is justified by the costs of moving over to this fundamentally different system. This framework potentially imposes heavy costs on the SEC in administering and designing a test and investors would have to expend time and energy to pass the exam.<sup>299</sup> It is not clear it is worth the effort when we could simply allow investors to sort themselves.

In the end, there may be no good way for the government to sort investors with a high degree of accuracy. Indeed, it seems very possible that the entire concept of categorizing investors a priori is flawed. What makes for a wise investor may be too complicated to narrow down to a simple proxy or exam. Which brings us to the other alternative: rather than trying to identify an investor's ability from the outside, we could allow for investor autonomy.

One option would be to simply repeal the exemptive structure and provide some type of warning on unregulated funds letting investors know that they are largely on their own. Market forces could then determine the

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<sup>296</sup> Cf. Choi & Prichard, *supra* note 90, at 8 n.28 (citing conflicting evidence of the relevance of experience in investment-analyst forecasts).

<sup>297</sup> Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279, 310-13 (2000).

<sup>298</sup> See *id.* at 285-90 (describing the “self-tailored” regulatory regime pertaining to “issuer-level investors”).

<sup>299</sup> Professor Choi acknowledges these concerns. *Id.* at 312-13.

range of unregulated alternatives available to investors of more limited wealth. Such a move, however, likely takes things too far; information problems and bounded rationality would likely prevent this market from functioning efficiently.

But we need not simply dismantle the exemptive structure in order to expand investor options. Instead, we can create a more narrowly tailored regulatory regime. One step would be the creation of a new class of investment funds, which I will refer to as “absolute return funds.” These funds would be open to all investors, but certain regulations would be in place to ensure that ordinary investors do not suffer as a result of the likely inequity in information and financial savvy between these investors and fund managers. So that everyone could gain exposure to broader investing schemes, this class of funds would have none of the mutual-fund limitations on investing strategy, use of leverage, fees, or how often investors must be able to cash-out.<sup>300</sup> To make up for investor shortcomings, however, these funds would be subject to several important regulatory requirements designed to combat potential abuse and ensure investors get sound information on which to base their decisions.

As to the latter, funds could be required to provide a brief disclosure document setting out the risks of these more complex strategies and elucidating the key terms of the investment decision. The SEC could also require that these funds be prominently labeled as more advanced instruments. In addition, just as with mutual funds, the SEC could take an active role as a conduit for financial information, providing investors with salient information from financial research, rather than leaving them solely to their own devices or overly dependent on the advice of often biased third parties. Along these lines, the SEC could conduct investor education regarding the costs and benefits of investing in funds with an absolute return strategy. The staff could even draw upon recent financial analysis, and recommend to investors that they not put more than 10 to 20 percent of their assets in such funds, as that amount is likely sufficient to adequately balance their portfolios.<sup>301</sup>

At the same time, to supply investors with some protection from abuse these funds could come with essential investor-protection terms built in. For example, the regulations could require that these funds open their books to independent auditors and allow for independent third-party oversight of the valuation of fund assets. Moreover, the regulations could mandate that these

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<sup>300</sup> In light of the recent financial crisis, which stemmed at least in part from ill-considered risk-taking by hedge funds and other financial institutions, it is worth considering whether there should be some outside limits placed on certain fund activities, leverage for instance, which pose systemic risk. See Mortimer B. Zuckerman, *Wall Street's Day of Reckoning*, U.S. NEWS & WORLD REPORT, Sept. 29, 2008, at 94. What shape these would take and, indeed, whether such limitations would in fact be wise, is, unfortunately, beyond the scope of this Article.

<sup>301</sup> See Amin & Kat, *supra* note 102, at 273.

funds cooperate with SEC audits and that fund managers charging an asymmetric performance fee invest a portion of their assets alongside the fund's investors. Because these protections would come with the fund, ordinary investors would get a product with adequate safeguards, even if they would not have known to bargain for such terms.

Thus, under this intermediate regulatory structure, decisions with respect to the salient investing terms would be left to investors, while the background investor-protection terms would be set by the SEC. This appears to be an apt division of labor—the SEC is probably in the best position to design rules that address nuanced conflicts of interest and the potential for fraud stemming from fund structure, while, with SEC guidance, investors are likely in the best position to choose the strategy that is right for them.

Offering this new category of funds would appear to provide several improvements over the current restrictive framework. First, under the revised scheme, if investors want alternative-strategy funds, they would be there for the taking, whereas under the current system they instead have to turn to awkward imitations.<sup>302</sup> It would also create a more competitive fund marketplace because mutual funds would now be forced to compete for ordinary investors' dollars with funds offering a broader array of strategies. Finally, investors currently able to participate in private funds would also benefit. They would now be able to participate in investments using private-fund strategies without incurring the transaction costs and uncertainty involved in the market for such funds today, where what they get depends solely on how well they negotiate.

The primary risk of creating this new broadly accessible class of absolute return funds is that unsophisticated investors would invest in these funds when, in fact, they are truly beyond their expertise. In fact, as mentioned earlier, one finding of behavioral economics is that investors tend to overestimate their investing ability.<sup>303</sup> While this is a valid concern, it is not a reason to shrink away from the idea of giving investors such autonomy. Even accounting for their tendency for inflated self-perception, it stands to reason that investors are better at assessing their own competence than a simple proxy, and since these funds would remain subject to an intermediate regulatory scheme, it is not as if unsophisticated investors would be leaving themselves wide open for abuse. Moreover, disclosures could be designed to counteract this bias. For example, a prospectus for these funds could give extra attention to warning investors of the risks that they entail, and the importance of truly understanding them. In the end, no amount of investor education could ensure that investors find their way to the perfectly appropriate category of funds. Even so, this approach is potentially more accurate than the status quo and comes without the market distortion.

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<sup>302</sup> See *supra* Part II.B.2.

<sup>303</sup> See *supra* note 90 and accompanying text.

C. *The Third Tier: Lightly Regulated Sophisticate Funds*

The final step would be to bring private funds under the regulatory umbrella and broaden access to them as well. As discussed in Part II, the private-fund marketplace is exempt from direct securities regulation, even though there is reason to believe that wealthy and sophisticated investors still face information problems and suffer from bounded rationality.<sup>304</sup> Thus, there is good reason to consider some regulatory intervention.

The challenge here is to subject such funds to regulation that is effective against market failure, but does not unduly burden the marketplace. A private equity fund that is courting several large institutional investors does not need to be subject to the same regulations as a mutual fund designed primarily for 401(k) plans or an absolute return fund targeting mainstream investors. This private equity fund and its would-be investors have the expertise and resources to, for the most part, bargain effectively. It likely makes sense to mandate well-targeted disclosures with respect to the salient features of such investments, because even sophisticates have trouble getting comprehensible comparable information.<sup>305</sup> Moreover, these disclosures should draw attention to the potential risks involved in complex, less-regulated funds, as even the most experienced investors, including those responsible for institutional assets, have been known to under-appreciate the risks and nuances of abstruse schemes.<sup>306</sup> It would appear best, however, to leave the terms of these deals to private ordering.<sup>307</sup> In this way, these funds could serve as an opt out option for those who wish to give up or alter the investor-protection terms that would be built into mutual funds and absolute return funds. If, for instance, an investor is willing to forgo the comfort of knowing that a fund is subject to the chance of an SEC audit, as would be required for the more highly regulated alternatives, in exchange for a lower fee, that deal could be made with this type of fund. By allowing flexibility in this regard, those with the capability and willingness to enter into nuanced investing arrangements would not have their ability to do so hampered.

This lightly regulated group of funds would be meant for the most sophisticated investors, but nobody would be precluded a priori. Those who think they are sophisticated enough to prosper in this environment can choose to take part. It should be made clear—through disclosures and SEC statements—that this group of funds is not for everyone, but the final decision would be left to the investor. As discussed above, there is the risk that unsophisticated investors would overestimate their abilities, and as a result,

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<sup>304</sup> See *supra* Part II.B.1.

<sup>305</sup> See *supra* note 89 and accompanying text.

<sup>306</sup> See Langevoort, *supra* note 94, at 655-58.

<sup>307</sup> The investing strategies of these funds, however, would potentially be subject to substantive regulations designed to address concerns regarding systemic risk. See *supra* note 300.

foolishly seek to participate in this market. With ready alternatives in mutual funds and absolute return funds, however, it would appear that there would be little motivation for individuals to do so.<sup>308</sup> Expanding access to these funds, therefore, likely does little to endanger ordinary investors. At the same time, lightly regulating them assists presumably sophisticated ones by putting them in a better position to make sound decisions.

#### D. *Summary of Reform Framework*

The current regulatory structure lacks any type of consistent motivating purpose. This Article suggests that the SEC should focus on responding to market failure, and doing so in a manner consistent with libertarian paternalism. By reforming the regulations as I propose, regulators can respond to the problems of information and cognition that legitimize government intervention without sacrificing freedom of choice.

Responding in this way cures many of the ills created by the current regulatory framework, in particular its tendency to weaken competition. Under the revised regime, barriers to entry and innovation would be eased, and the most talented managers would no longer be routed by regulation to elite investors. At the same time, the new rules, by putting investors in a better position to make decisions, lay the groundwork for a more competitive, and therefore, more socially beneficial fund marketplace. As with all forms of intervention, this framework imposes resource demands. But because this scheme emphasizes doing the most to foster healthy competition, while doing the least to disrupt it, the outlay would likely be money well spent.

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<sup>308</sup> There is the risk that unscrupulous fund managers would purposefully attempt to lure unsophisticated investors to this market, where they could be exploited, either through use of disguised ponzi schemes or simply by charging high fees for banal investment strategies. We currently have regulations on the books, however, designed to protect investors from such abuse, including rules that restrict deceptive and high-pressure sales practices. See THOMAS L. HAZEN, *LAW OF SECURITIES REGULATION* § 12 (2009) (describing anti-fraud rules); *id.* § 14.8 (describing certain rules with respect to high-pressure sales tactics); THOMAS L. HAZEN & JERRY W. MARKHAM, *23A BROKER-DEALER OPERATIONS SECURITIES & COMMODITIES LAW* § 10 (2008) (describing regulation of broker-dealer sales practices); *id.* at § 11.17 (describing regulation of telemarketing practices); GERALD T. LINS ET AL., *HEDGE FUNDS AND OTHER PRIVATE FUNDS: REGULATION AND COMPLIANCE* §§ 5:9-5:10 (2008) (explaining that many hedge funds use broker-dealers to market their shares and the rules governing their activities). The application of these rules to this category of funds should partially ameliorate this risk. Though outside the scope of this Article, it is an open question whether the current investor protection scheme in this regard is satisfactory—or whether it needs reform as well to better shield investors from abuse.

## IV. INTEREST-GROUP IMPLICATIONS

The primary goal of this Article is to analyze current regulation and suggest reform. In going through this analysis, however, a disturbing trend emerges—one which has implications for any potential reform efforts in this area. The regulatory scheme seems to evidence a pattern: the central components of the regime are difficult to defend in market-failure terms, yet provide potentially significant benefits to interest groups. Established mutual-fund companies appear to be the primary beneficiaries—they do not have to compete with private funds for the dollars of ordinary investors, there is little room to innovate, and the rules make life difficult on smaller and newer funds.<sup>309</sup> It could be argued that it is highly unlikely that this combination of troublesome regulations and interest-group benefits exists by chance, rather than as a result of special-interest influence.

In this way, the analysis presented is consistent with capture theory, which posits that regulation is oftentimes strongly influenced by interest-group pressures.<sup>310</sup> Based on my static analysis of today's regulations, it is difficult to tell to what extent the regulations under review stem from misguided yet well-intentioned policy, an interest group agenda, or, most likely, a little bit of both. Given the anticompetitive nature of the regulations, however, it would be naïve to ignore the role interest groups potentially play in this area.

Recognizing the political reality of interest groups has a couple of implications. The first is that it suggests the need for further research into the SEC regulatory process. Evidence that the framework was adopted, or at least kept in place, at the behest of the industry would lend more support to a capture thesis. Such a showing would suggest the need for institutional reform to go along with regulatory reform.<sup>311</sup>

Moreover, the specter of interest-group influence gives rise to the question of whether publicly spirited procompetitive measures have a chance of enactment. If the industry has been able to lobby for the ratification and continuation of the current pro-industry scheme, this suggests they would be a formidable opponent to any efforts contrary to their interests.

Just as with mutual-fund returns, however, past performance does not necessarily predict the future. There are multiple examples of public-

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<sup>309</sup> See *supra* Part II.

<sup>310</sup> The seminal works in this area include George Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976); Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371 (1983).

<sup>311</sup> For a discussion of the normative side of capture theory, see Geoffrey Brennan & James M. Buchanan, *Is Public Choice Immoral? The Case for the "Nobel" Lie*, 74 VA. L. REV. 179 *passim* (1998) and Macey, *supra* note 54 *passim*.

regarding regulation,<sup>312</sup> and it would be premature to assume that investment management regulation is destined never to join them on the pantheon. Research related to capture theory, in fact, suggests when such a transformation may be possible.<sup>313</sup> The key is public attention. The more a regulation is in the public spotlight, the less power interest groups possess.<sup>314</sup>

This insight gives reason for guarded optimism. Recent financial turmoil has led to renewed interest in the regulation of Wall Street. Even before events took a sharp downward turn in the fall of 2008, the Treasury Department had released a proposal that envisioned a substantial restructuring of securities oversight,<sup>315</sup> and the chairman of the House Financial Services Committee, Representative Barney Frank, had made public his desire to spearhead significant changes to business regulation.<sup>316</sup> More recently, the momentum behind significantly changing financial rules has only accelerated.<sup>317</sup> Meanwhile, SEC actions are front-page news and retirement savings are vanishing in the troubled financial markets.<sup>318</sup> In this charged environment, if politicians and regulators were to embrace a publicly spirited reform agenda, the fund industry would likely be ill-positioned to resist. That being the case, we may be in a policy window where meaningful re-

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<sup>312</sup> See Steven Kelman, "Public Choice" and Public Spirit, 87 PUB. INT. 80, 86 (1987) ("[T]he growth of health, safety, and environmental regulation during the late 1960s and early 1970s . . . were adopted against the wishes of well-organized producers," and in fact "were intended for the benefit of poorly organized consumers and environmentalists."); Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335, 353 (1974) (describing the lack of interest-group explanation for such rules); KAY LEHMAN SCHLOZMAN & JOHN T. TIERNEY, ORGANIZED INTERESTS AND AMERICAN DEMOCRACY 402 (1986) ("At various times and under various circumstances, various governmental institutions and actors have adopted the causes of the less advantaged and broad publics"); cf. Sam Peltzman, *The Economic Theory of Regulation After a Decade of Deregulation*, in BROOKINGS PAPERS ON ECONOMIC ACTIVITY: MICROECONOMICS 1, 39 (Martin Neil Baily & Clifford Winston eds., 1989) (finding that the deregulation of trucking and long-distance telecommunications was inconsistent with capture theory).

<sup>313</sup> See Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORG. 167, 191-94 (1990).

<sup>314</sup> See *id.* at 194 ("If the issue is or can be gotten on to the public agenda, we should predict general-interest policies or acts instead of capture."); cf. BREYER, *supra* note 53, at 317-40 (describing the political process behind airline deregulation).

<sup>315</sup> See DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008), available at <http://www.treas.gov/offices/domestic-finance/regulatory-blueprint/>.

<sup>316</sup> See Robert Gavin, *Frank Urges Overhaul of Business Regulation*, BOSTON GLOBE, Mar. 21, 2008, at C3.

<sup>317</sup> For example, Congress has held a series of hearings on the underpinnings of the recent financial crisis, including one specifically addressing potential regulation of hedge funds. Hedge Funds and the Financial Market: Hearing Before the Comm. on Oversight & Gov't Reform, 110th Cong. (2008), available at <http://oversight.house.gov/story.asp?ID=2271>. See also Grier, *supra* note 25 (describing calls for reform following the SEC's failure to spot Bernard Madoff's \$50 billion financial fraud).

<sup>318</sup> See Eleanor Laise, *Big Slide in 401(k)s Spurs Calls for Change*, WALL ST. J., Jan. 8, 2009, at A1.

form, not only to the regulations, but even to the institutions themselves, may be realistic.

#### CONCLUSION

Society fares best when firms compete vigorously to offer the best products. However, if consumers are ill-informed or their choices ill-considered, this competitive process may break down. Such concerns justify regulatory intervention in the fund marketplace, but the current rules appear to be a poor response. Current disclosure rules, which have the potential to bolster investor decisionmaking, are not well-crafted to achieve this end. At the same time, those rules that limit ordinary investors to funds that follow pre-approved business practices create a rigid industry structure that likely does more to hurt competition than help it. The result is that ordinary investors routinely make suboptimal choices in a marketplace overrun with mediocrity.

To better respond to failures in the fund marketplace, I recommend a reform agenda grounded in the libertarian-paternalist idea that regulations should foster better decisionmaking without undermining individual autonomy. So that investors are better situated to make sound decisions, the SEC itself could take a more active role in investor education and, at the same time, enact a streamlined disclosure mandate designed to elucidate key fund information and guide investors down the right path. Meanwhile, those rules that limit investor options could be unwound, replaced by a regulatory structure that allows investors the freedom to choose from among funds with varying regulatory safeguards. This new oversight structure has the potential to realize the goal of regulatory intervention by bringing about the type of robust competition foundational to societal welfare.