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The Scope and Jurisprudence of the Investment Management Regulation

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D R A F T

Essay

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Abstract

This Essay reviews three periods of investment company regulation by the Securities and Exchange Commission. It focuses on the period of 1975to 2000 in which the Commission granted exemptions on conditions, thus deregulating and reregulating, case by case and finally codifying the exemptions in an exemptive rule. The Essay analyses this form of rule-making and compares it to prosecution, settlements, and initial rule-making that typifies the recnet years. The Essay concludes that the common law method of legislation, especially when it involves a "bargain" between the regulators and law-abiding regulated institutions who wish to innovate, is likely to lead to optimal rules, provided the conditions (re-regulation) are rigorously enforced.

Introduction

The recent avalanche of Securities and Exchange Commission's Rules is no usual initiative. Rather, it is a turning point in the history and the jurisprudence of investment management regulation. Three periods emerge in the regulation of investment companies and their advisers. The first period, from 1940 to about 1975, starts with the passage of the Investment Company Act (1940 Act) and Investment Advisers Act (Advisers Act). The period can be characterized as a strict regulatory period, beginning with setting the house in order and then applying and enforcing the acts. The Commission engaged mostly in individual exemptions, and on a rare occasion it passed a regulation, such as adjusting the 1940 Act to insurance companies' separate account and variable annuities.[1]

The 1975 to 2001 period was a period of cooperation between the Commission and mutual fund managers (Managers). It was a period of encouraging innovations, of deregulation coupled with re-regulation. Most exemptive rules during those years adjusted the 1940 Act and the Advisers Act in response to requests by the industry for new arrangements, new forms of funds, and new financial offerings. Few releases were interpretative in nature, such as Release 1092 interpreting the Advisers Act and its application to financial planners.[2] Congress reviewed the 1940 Act and the Advisers Act periodically, and some of the Commission's rules were incorporated and codified in these acts.[3] During this period there developed a remarkable staff scholarship, which contained historical materials, empirical research and theoretical analysis.[4]

The exemptions during that period contained conditions. The conditions imposed three main types of constraints: Disclosure, such as Form NA-1 under the 1940 Act and Form ADV under the Advisers Act. On its face, the disclosure was similar to that of the Securities Act of 1933.[5] Substantively, the disclosure followed not the model of a sales contract but the model of fiduciary law. As discussed below, disclosure reflected the principle that Managers are fiduciaries, on whom the clients rely. Therefore Managers should offer information that is relevant to the clients rather than wait for the clients to ask them for this information. Form ADV reflects clearly this trend when it requires advisers to disclose not only their fees but also whether these fees are extraordinarily higher than the normal fees, setting the maximum at 3% of the managed assets.[6]

The second type of conditions in the exemptions are conditions that impose structural changes in the mutual funds, focused mainly on internal controls. For example, Rule 12b-1 requires the approval of the disinterested board of directors to a plan that would allow the Managers to charge funds under management up to a certain percentage of fund assets for the purpose of financing the sale of funds' shares and providing services to investors.[7]

In addition, however, the rule introduces a structural change by increasing the number of the disinterested directors.[8] While the necessary approval of the board relates to the particular rule 12b-1 plan, the requirement to increase the percentage of disinterested directors changes the structure of the board not only for the particular decision, but for all board decisions as well. The board consists of more disinterested directors in all other matters and decisions.

The structural conditions, however, applied to other exemptive rules that have appeared during the period concerning conflict of interest transactions. Unlike corporate law, which authorizes the independent directors to approve conflict of interest transactions, the 1940 Act prohibited such conflicts, subject only to exemptions by the Commission. During the period of 1975-2000, the Commission provided a number of exemptions from the conflict of interest prohibitions in the 1940 Act, and required the majority of the disinterested directors rather than the Commission to grant exemptions, under certain conditions.[9]

To be sure, until the recent changes in the New York Stock Exchange Rules, independent directors under corporate law were merely directors who had no personal stake in the conflict of interest transaction at issue. Under the 1940 Act, however, a disinterested director is not only independent in this sense, but must also satisfy a status requirement of independence from the Adviser and its affiliates.[10] A recent New York Stock Exchange rule has imposed such "status conflict of interest prohibitions" on directors of corporations whose shares are traded on the Exchange.

The reason for shifting the decision from the Commission to the board is not hard to find. The 1940 Act prohibits any conflict of interest transactions without an exemption by the Commission. In the 1980s, the number of mutual funds increased significantly and with it the number of exemption requests. The immediate solution was to delegate the decision regarding some conflicts to the fund boards under certain conditions. Sometime later the delegation was accompanied by a required increase in the number of disinterested directors, as in the case of Rule 12b-1.

The third kind of conditions consisted of direct and specific regulation of the funds' investments and activities. For example, Rule 2a-7[11] contains detailed limitations on permissible investments of money market funds. The conditions were based on the policy of preventing misleading impressions, not merely by disclosure, but also by ensuring that money market funds will likely be able to meet the investors' justified expectations. If a share looked like a bank deposit, it had to be backed by conservative investments to ensure that the implied promise of low risk would in fact be met.

In addition to ensuring that money market funds will meet their implied obligations, the rule was based on a systemic concern. Like bank demand deposits, money market funds offer very quick redemptions. Similar to "money in the bank" investors could view the shares of these funds as a promise to receive on redemption at least the amount of dollars that the investors invested. Therefore, if the funds "broke the dollar," that is, if the funds paid investors less than the amounts that the investors invested in the funds, the funds were exposed to a greater possibility of investor "runs.". Legally, investors were not entitled to receive the dollars they invested in these funds. Their investments were shares, not bonds or notes. But because the funds looked and appeared to be like bank deposits the investors' expected the funds to provide them with assured repayment of the money they put into the funds. And fund managers were just as concerned about "runs" if the investors were disappointed on this count. Thus, the regulation of money market funds ensured that the less concerned managers will not be permitted to compete by providing higher returns at higher risk. In such situations the managers could bring about a run (a cascade) not only on their money market funds but also on other money market funds that have not broken the dollar.

The period starting in 2001 marks a different approach. The Commission did not retreat to the 1940s. Neither did it remain in the recent past. This article explores the nature of the new type of regulation, its origins and reasons, and its new form and approach. I conclude that, in light of the size of the mutual funds and the period of 1990s there was no escape from this new regulatory era. I also conclude that the new type of regulation, although it is likely to be more effective than that of the past, may not solve the deep-seated problem of the investment management profession.

Money managers, of whatever sort, follow the current culture of financial and corporate management. Academia has helped strengthen this culture by providing the intellectual tools and theories that supported this trend and offered legitimacy for management's control. The issue is no longer the separation of ownership from control. The issue is separating control of a few dollars from control of aggregate amounts of dollars. After all, each investor puts into the "pot" a far smaller amount than the aggregate amount of all investors, which the advisers control. No investor owns the control over the aggregate amount. Who owns control of the pool of all the small controls which the investors can claim as their own?

America seems to be leaving old-fashioned Capitalism and entering a period described by some as "managerial capitalism." Like all important issues, this issue is not new. Managerial capitalism parallels "Office." "Office" used to be a species of property.[12] It could be delegated, sold, given as a gift, and bequeathed. With the rise of democracy, office became "power in trust." It was shorn of its property rights. It cannot be delegated, sold, given as a gift or bequeathed.

If control over other people's money is not based on returning to the notion of "office" as property, then control must be based on the contribution of the managers to the shareholders' wealth. That is indeed an entitlement. But in a capitalist system this entitlement stems from the explicit consent of the contributors of capital, that is, the investors. The labor of providing services, no matter how valuable, does not provide a right to the fruits of the labor. That is Capitalism as we know it. The owner of the property takes all, unless he agrees to pay the one who gives service (or if a court holds that the use of the service is unfair unless paid for). Managers, who assert that they are ***entitled*** to the fruits of their services in controlling the aggregate amount of investors' money, can argue that no single investor ever had such control. Therefore managers may assert that Capitalism in its pure form is unfair. Indeed, there are a number of theories and arguments that point to the direction of "managerial capitalism."[13]

The rule that I propose does not require debate. It is based on one principle. Regardless of who owns the aggregate amount of the investors' dollars and regardless of who owns the control over these dollars, the principle is that managers own neither. It is not their money. It is not their control. In this respect and to this extent I follow traditional Capitalism. Therefore, the managers' contributions do not make the investors' aggregate money their money. Neither do the managers' contributions make the control over the investors' aggregate money their control. The new regulation of mutual funds offers a chance of turning back from "managerial capitalism" without necessarily determining who owns and who is entitled to control the aggregate amount of all shareholders' contributions. The point I am making is that the managers are not entitled to either the money or the control of the money except for the benefit of others and according to the directives of others.

From 1940 to 1975: Establishing the Regulatory System

Throughout the 25 year period from 1940 to 1975 the Commission issued ---rules. Of these rules --- were definitional. --- rules detailed the forms which applicants should use. One rule contained a clarification; and the rest provided exemptions from various sections of the 1940 Act---[14] It is important to note that during the entire period the investment management profession did not exceed ----- funds, ---- advisers, and ----- dollars under management. The rules indicate the Commission's approach. It received significant authority of a unique kind and was setting the regulatory house in order. During this period, it did not provide many permissions for innovative activities that conflicted with the provisions of the 1940 Act and the Advisers Act.

By and large, regulation did not interfere much in market activities, and when it did, it took the form of limiting market activities and requiring strict adherence to the letter of the law. Thus, periodic payment plans – the sale of mutual fund shares by installment -- died when the Commission limited the incentives of the salespersons to sell such plans to people who could not continued payments, and who lost their initial payments by the sales load.[15] The Commission did not act to revive the number of face-amount certificate companies. The number has shrunk as other more attractive plans emerged.

This does not suggest that the profession did not innovate. It suggests that the innovations were possible within the parameters of the acts. It also suggests that the Managers were engaged in maintaining and strengthening their weak position as financial intermediaries. During that period advisers were engaged in protecting their turf. Through their organization, the Investment Company Institute, they fought in the courts for the maintenance of the Glass Steagall Act that prevented the banks from advertising the services of bank trust department as investment management entities, and engaging in mutual fund-like businesses.[16] The Commission was active as well. It asserted its jurisdiction over separate accounts, created by life insurance companies to offer variable annuities and variable life insurance policies.[17]

Few innovations required changes in the law and few innovators sought the Commission's exemption. One basis for this conclusion is the relatively few requests for no-action letters, especially at the beginning of the period. Not only were they few, but they were also not well publicized. The publication of the no-action letters started only at the beginning of the 1970s. No-action letters did not gain the power of precedent until later, when lawyers and clients realized that no-action letters give the actors a partial protection for activities that would otherwise be legally too risky.

These no-action letters provide a semi-declaratory judgement for a new venture. That protection became even stronger when the courts gave the letters credence against claims by private plaintiffs.[18] The Commission announced its support for these letters and promised to avoid, as much as possible revoking the letters even prospectively.[19] The staff encouraged requests for letters as a means of learning about proposed market innovations, as a mechanism of reducing undesirable activities, and a method of expressing the staff's interpretation about the law.[20]

The only two path-breaking innovations that took place during that period were the introduction of variable annuities by investment companies, and the creation of money market funds. In the case of variable annuities the Commission fought to assert its jurisdiction of the new creations.[21] In the case of money market funds the Commission supported the innovation.[22] The support was direly needed. The profession and its mutual funds were subjected to the volatile securities markets. In both cases the model of mutual funds and the advisory profession, had rubbed shoulders with the established financial intermediaries: the insurance companies and the banks. And in both cases inflation or the concern about inflation, and regulation of insurance and banking helped. The insurance companies wanted to enter the field when they were losing market share.[23] The banks were losing depositors because they were not allowed to pay more than 5 ¼% on their savings account (and the savings and loan associations were not allowed to pay more than 5 ½%) during a period of double digit inflation.[24] The Commission retained its jurisdiction over variable annuity contracts, and helped advisers establish and develop money market funds—alternatives to bank deposits, including shares that could be redeemed by the stroke of a pen over a bank check.

Investors were active in the courts. The issues are familiar today. The 1950s brought cases on the fees charged by advisers to mutual funds.[25] The 1960s brought cases on "give ups" and other pressures to enhance and finance the sale of mutual fund shares.[26] In the 1970s section 36(b) was added by Congress relating to fees.[27] In sum, the first twenty five years of the Commission's reign are characterized by a weak and small management advisory profession, relatively few mutual funds, and the Commission's support of two important innovations by granting conditional exemptions.

From 1975 to 2001

Regulation for Growth

Some fundamental changes occurred in the mutual funds area during the 1975 to 2001 period. One change was the enormous increase of the number of mutual funds (and closed end funds) and the magnitude of the assets under management.[28] At the peak of the market bubble in the 1990s the amount reached $12 trillion. After the market crash of 2000 it reached $7 trillion.[29] The causes of this growth are not easy to pin point, or prove.

One may speculate that mutual fund growth was tied to the new resources that became available to finance the broker dealers and underwriters who sold fund shares. Former rules that limited these financing sources were changed to allow more money resources to flow to the sellers of mutual fund shares. The changed rules were based on a number of theoretical innovations. For example, the principle guiding the advisers' fee measures has changed. Before the change advisers were viewed as professionals whose compensation reflected the value of their services. On this basis advisers were not able to use part of their fees to pay brokers who sold fund shares. If the advisers would spend part of the fees on compensating brokers who sold fund shares or on paying solicitors for business, it meant that the advisers were willing to accept a lower fee for their services. Hence, the amount of fees they were charging was excessive.

This view has changed. The advisers are viewed as operating a business. As businesses they are entitled to profits. With their profits they can do whatever they wish, including payment to brokers for the sale of fund shares. Therefore, even if they made such payments they did not necessarily charge excessive fees.[30] That theory released some of the advisory fees for payment to brokers who sold fund shares. With increased financing, the funds and the assets under management grew.

In 1981, a new source of paying brokers who sold fund shares opened up: that is the assets of the funds themselves. Rule 12b-1 allowed the boards of fund directors to approve a program which financed the sale of the funds' shares.[31] Even a fund that closed its doors to new investors could, arguably, continue to charge the fees. The Commission's staff agreed that under certain conditions Rule 12b-1 could allow funds that closed their doors to new shareholders to continue payment of funds' assets to brokers. Presumably, the sales were necessary to offset redemptions.

More recently there has been the change in the formula under which brokers who sold fund shares would be paid. Not only commissions, but also part of the advisory fees could be, and did, pass to the salespersons.[32] In 1986 small brokers (who sold fund shares) could provide advisers with soft dollar benefits, which they could purchase. Having provided the soft dollars these brokers could receive brokerage business, which they could then farm out to other brokers who could perform the task (and show their gratitude to the small brokers by a discount). Currently, advisers pay brokers for "shelf space," that is a prominent space in the brokers' display of funds to their clients.[33] In sum, during this period, the amount of money that flowed to brokers who sold mutual fund shares increased dramatically, as did the amounts of assets under advisers' management.

The Open Door to Innovations

Throughout the period from 1975 to 2001 the Commission adopted ---- rules.[34] --- rules relaxed the provisions of the acts, subject to conditions, thus allowing advisers to change the sales and redemption cost allocations and payments by investors.[35] In addition, the rules allowed for new investment arrangements, periodic repurchase by closed end funds of their shares,[36] and creating Exchange Trade Funds, which are a new form of fund, part open end and part closed end.[37] Strict prohibitions on fund of funds structures were relaxed,[38] as were investments that could be interpreted as leverage (prohibited in the Act).[39] Market timing was left loosely to disclosure and prohibited discrimination, and the strict prohibitions were relaxed to overcome "stale pricing" and administrative problems in collating orders of thousands of investors in 401(k) plans and others.[40] The recognition of "funds" that have no specific legal form as investment companies, as held in Prudential Insurance Co. v. the SEC[41] was expanded in a no-action letter to "tracking stocks" that may have had just the effect of informal separate accounts.[42]

The Commission recognized new entities that fell within the definition of an investment company, but were not traditional investment companies, and granted exemptions that culminated later in rules, such as rule 3c-8 under the 1940 Act.[43] A significant number of exemptions by rules were promulgated to authorize the boards of directors to approve conflicts of interest transactions under certain circumstances .[44]

A number of reasons can explain the cooperative environment between the Commission and the advisers. One reason was the growing strength of the profession. Another was the deregulation of banks, the acquisition of one type of financial intermediary by another, and the competition among the various financial intermediaries (and sometimes their regulators). Yet another reason for cooperation was the general atmosphere of encouraging innovations that required freedom from constraining regulation, and the trust in market discipline to protect investors. The burden on the regulators and the regulated was shifting from "show me why an exemption should be granted" to "show me why not?"

Controls Over Temptation

While the amounts under management have grown enormously, and the activities of the advisory profession have become increasingly varied, the system of controlling temptations and the resources devoted to controls over the Advisers remained more or less the same. In 1996, the regulation of smaller advisers was relegated to the states, and the Commission remained mostly in charge of advisers that managed no less than $30 million.[45] The Commission's Compliance Office refined its supervision by selective examinations targeted to danger signals that it developed based on statistical data. But the Office has not fundamentally changed the manner in which the examinations were carried out nor did Congress increase significantly the number of examiners. Mutual funds were required to establish a Code of Ethics that targeted mainly insider trading by employees of the mutual funds.[46] But basically the monitoring and enforcement of the law remained the same throughout the period.

Interpretation of the Law

One of the additional changes that have occurred throughout this period is the approach to interpretation of the 1940 Act and the Advisers Act. Past interpretations followed a line of questions, such as: (1) What was the problem that the law was designed to prevent or reduce? (2) How is a "problem" defined, that is, what is bad about the certain behavior? (3) What options were open to Congress and the Commission? and (4) What option was chosen and why? New situations were interpreted in light of the answers, and the Commission attempted to allow certain activities so long as the problems which Congress envisioned were reduced or eliminated in some other way.

Since the mid-1980s and especially during the 1990s a different approach has developed in interpreting the law. The words of the acts were interpreted sometimes by resorting to the dictionary, sometimes by seeking the interpretation in precedents. If the words did not prohibit a certain behavior, then the behavior would be permitted. The tendency was to seek specificity of rules. Gray areas would be inefficient and create uncertainty. Gray areas may impose legal risks and thus limit the ability of the Advisers and other fiduciaries to create value for themselves. To be sure, they should not cross the line to a prohibited behavior, but anything that is not prohibited should be permitted. This approach led to the style of specific regulation. Details were increased and activities that involve discretion were addressed by regulation more specifically. Whatever was not addressed, however, would be permitted, or in the case of doubt, there was a good argument that the behavior should be permitted.

This approach led to efficiencies in the benefits to fiduciaries, but to great inefficiencies in enforcing the prohibitions on fraud. Indeed, when the gray areas were eliminated, the rules offered more value to the fiduciaries. But having eliminated the gray areas, the rules made enforcement enormously expensive.[47] Market timing, which has achieved so much notoriety, is a perfect example. The practice hurt the portfolio managers by making it more difficult to plan investment policies. The practice also reduced the advisers' fees by the funds' less optimal performance. These considerations were sufficient to require the funds to disclose their policies concerning market timing, and leaving the Advisers to enforce their disclosed rules.[48] But if no disclosure was made, there were lawyers and other advisers who assumed that the practice was fine. Advisers benefited from contracts offering preferred client to market time and causing expense to the remainder of the investors. Most importantly, some advisers also assumed that their organization and even they personally may benefit from this practice.

Paradoxically the approach of specificity has blurred the fundamental and very simple principle; the principle on which all fiduciary rules are based: The money which the managers manage is **other people's money**. All benefits from controlling and managing the money do not belongs to the managers, except the amounts that are specifically allocated to the managers by a specific clear agreement. If there is no such agreement, there is no benefit to the managers. Specificity of interpretation shifted attention from the reason of the rules to the words of the rules, and from the words of the rules to the world outside the words—a vast expanse of opportunities for the advisers and fiduciaries to benefit from their managerial power.

In addition, the simple principles, that managers are not the owners of the money they manage was turned on its head. The principle was refocused. The emphasis was no longer that the managers do not own the money they manage. The emphasis was refocused on the investors' -- "other people's" entitlement. Were these other people really the owners? Or were they lenders of risk capital? When attention is focused on who owns the money instead of on the principle that the managers do not own the money a wide vista of possibilities to satisfy temptations arises.

This change was supported by an academic movement that redefined fiduciary duties as contracts. The relationship between the manager and the investor was recast as a contract, in which the manager undertakes certain duties. The duties may be described in more or less general terms. The important part is once the money is handed over to the manager its ownership changes hands. The corporation that received the money and the manager who acts for the corporation is the owner. By this metamorphosis, the managers ceased to hold the investors' money and became the holders of the corporation's money. They cease to owe fiduciary duties to the investors. Investors are creditors with entitlement under a contract only. Managers owed duties to the corporation -- that they managed. Most importantly, if the managers breached their duties to the investors, the breaches were far less reprehensible. No accounting for profits and no stigma of abuse of trust. Besides, the managers represent the corporation that would be hurt by their own actions. Their accountability for their actions is presumably left for the markets.

In sum, there were two major developments throughout this period: First, the managers were liable only for violating specific rules. The principles underlying the rules were abandoned. Second, the investors were no longer beneficial owners of the money they handed to the managers. They became lenders of risk capital. They were entitled to contract remedies but no trust remedies. They had to depend on the market for security of their money. In this environment and theoretical underpinnings, managers may indeed benefit from the money that is handed over to them so long as the investors receive something which the Seventh Circuit in one case called "market return."[49]

From 2002 to the Present

The first scandal related to mutual funds concerned market timing. But at first blush, many did not consider it "a scandal." Under some conditions market timing is permissible. The wrongful practices were not embezzlement or direct cheating. The problem, however, loomed large when it occurred to many that what counted was not the amount that the managers indirectly (by kickback) or directly took from their investors. It was that the managers benefited from money that was entrusted to them. Knowing human nature, starting small is just the beginning. Starting by one rogue unregulated manager, the practice was followed by dozens of regulated fund managers. A permissive culture in the advisers' organization can frighten some investors. It did.[50]

Throughout the past three years the Commission has issued rules, and is proposing more rules that address the enforcement of the law. The rules are structured in a number of innovative techniques, and their proposed enforcement controls offer a number of innovative approaches. The first rules addressed the issue of market timing. Internal controls requirements were tightened, including the appointment of a compliance officer who will have significant authority and direct access to the board.[51] The Commission's compliance staff encourages these internal compliance officers to keep in touch, giving them access to the Commission and perhaps increasing their prestige. Advisers must prepare and enforce a code of ethics, similar to the code required under the 1940 Act, and in both cases the coverage of the code is more extensive than the historical one.[52]

Other rules aimed at changing the power balance and the structure of mutual funds. They increase the number of disinterested directors to 75% of board membership and require that the chairperson of the board be a disinterested director.[53] They increase the ability of the disinterested directors to hire their own staff and lawyers, and to caucus among themselves. Disinterested directors have been tasked with a more active supervisory role. The balance of power has been changed between the advisers, who promote and manage mutual funds and view them as their business, and the directors who have a more ambivalent role of representing and guarding the shareholders' interests. The intrusion into the advisers' management brought to the fore difficult issues that are not yet resolved.

Changes towards heightened directors' surveillance is not new. The rules have moved constantly towards greater directors' power, but never have they reached the current level of independence and power. So long as the shareholders do not read the prospectuses and do not make their own minds, they must rely on advisers. If these advisers such as financial planners, brokers, and analysts are paid in one way or another by the funds' managers, the advisers will tend to recommend to the investors the funds that pay them most. Thus, the successful funds are not necessarily those that are best managed but those whose managers pay most for the recommendations and sales of these fund shares. So long as the sales pressure continues, the pressure will continue on directors to independently and objectively evaluate the performance of the fund managers and their fees. That is not necessarily a happy result. For effective management, the managers and the directors should cooperate.

Another important change is the manner in which the rules are fashioned. To be sure, some of the rules are detailed, as they were in the past. For example, the imposition of registration requirement on hedge fund advisers is quite detailed.[54] But with respect to controls and the establishment of honesty, the Commission's approach is somewhat different than in the past.

The rules provide advisers and directors with principles, and then require them to disclose the practices that they have established to implement these principles. Rather than micro-manage, the Commission has invited the advisers to manage controls in a way that would comply with and enforce the principles. The Commission identified the responsible parties and left to them the implementation of the principles, which it has established.

On its face, the fundamental principle that underlies all the laws is not complicated nor hard to understand. It can be summarized in four words: "It's not your money." All the rules, interpretations, and processes are aimed at enforcing this principle. The principle does not require advisers to give the investors anything that belongs to the advisers. It requires that the advisers do not succumb to the temptation to take what does not belong to them, regardless of who the owners are.

Yet, this principle is not as simple to implement as it seems. The issue involves the status of those who deal with other people's money: brokers who advise, financial planners who plan for others, fund managers, and their compliance officers, lawyers, and accountants. In this day and age all these actors occupy a dual position. They are professionals. They operate businesses. There is a difference between the two positions. Professionals perform a public service first, and strive to make a living second. Businesses strive to make a living and maximize profits. As compared to businesses, competition among professionals used to be far more restrained. After all, all professionals had the public as their client. Self restraint and self regulation was more prevalent in the professional area.[55]

These practices and self-image have changed throughout the past thirty years. Professions have become more business-oriented and professional organizations have become more like trade organizations fighting to protect their turf and increase the members' profits. Prestige came with more pay and competition increased for higher profits. When the measure of professional rewards is money, and when no other reward is imagined, there is hardly any limit to the drive for more. And when public service does not bring money and requires limits on profits, it is natural to ignore it.

Professionals should not be surprised that their public service orientation is now imposed on them by the government, the compliance officers, the directors, and the requirements for codes of ethics and alike. If self-restraint is abandoned, coercive restraint is come from outside.

There are those who question the value of honesty in the mutual fund business. Investors, they say, do not value honesty. Investors value the money that they receive, that is, performance, regardless of how it is achieved. To be sure, there are probably investors who care not about honesty. And yet, if they are rational, investors would like to reduce the risk of direct or indirect dishonesty. Besides, poor performance can be linked to dishonesty such as unconscionable fees and practices that benefit some shareholders and managers unfairly at the expense of others. If the source of poor performance is unknown, it could arise from dishonest management. Therefore, at least some rational investors might value honesty even if today they benefit by dishonesty; tomorrow they might lose by dishonesty.

Not all managers value honesty either. The following story is demonstrative. It was rumored that Securities and Exchange Commission's examiners would form monitoring groups. These groups would sit at the offices of large mutual funds managers, and supervise their operations, the way FDIC agents sit at large bank offices. Asked for a reaction to this action I was told that a senior manager in one large fund complex reacted. He said something like: "That is sheer waste of money. No one would speak to these monitors and they will be put in a box and forgotten." I was astounded. Here was a golden opportunity to gain the best guarantee of honesty at no cost. It was an opportunity to show the world and the regulators that this fund complex had nothing to hide. I expected the managers to receive the government monitors with open arms, show them around, and offer them a comfortable office from which to supervise and hopefully report and advertise the fund complex' compliance with the law. This manager did not expect the investors to value trust.

The Virtue of the Common Law Approach

If investors read their prospectuses they would exert market pressure on their advisers and substitute for government interference. How can the Commission ensure that investors receive truthful information and convince investors to read it and exert market pressure on advisers? The objective, after all, is to inform investors without influencing them one way or another, and let their make up their own mind. Yet, by definition, information influences, and can be true to some readers and misleading to others. And investors do not do their homework and continue to rely on others.

How can law strengthen the directors' supervision over the advisers without harming the cooperation among them? The objective is to render the advisers accountable but also create an on-going, non-hostile, cooperative environment among the two parties for the benefit of the investors and the advisers. Yet, by definition, supervision and cooperation are rarely fully compatible, especially when the advisers bear the cost of restrictions on their profitability.

How can internal controls be established in an environment of competition among the mutual fund advisers? The objective, after all, is not to reduce competition but to eliminate or at least restrict competition by dishonest behavior. Yet, legitimate and legal competition on one hand, and dishonest behavior on the other hand, are not always clearly distinguishable.

And how can the law and the government induce advisers not only to prepare codes of ethics but also to inculcate their organizations with a culture of self-limiting honesty. Such a culture is the most efficient, for it does not involve enforcement costs. Yet, it is the hardest to achieve and maintain.

We do not know the answers to these questions. Permissive rules or lax enforcement can fail. Strong intrusive rules and strict enforcement may not be optimal either. They can induce the advisers to "go underground," or go abroad, or use political pressure to relax the rules. Much can depend on the particular individuals, the history of the organizations, and the talents of the managers and actors. The same rules may be effective for some fund complexes and ineffective for others. The costs of these rules may differ. Optimal rules that apply to all may be different from custom-made rules, and less costly.

To be sure, the Commission can enact a rule, and then conduct empirical studies to uncover its defects, costs and benefits, and adjust the rule accordingly. But even this method is not likely to bring the desired results. The actors are not frozen in time. Their behavior changes continually, not only by the rule but also by new events, different environments, and other internal and external conditions. Therefore, the effects and costs of new rules as compared to previous rules will be highly speculative.

Historically, the Commission used a number of mechanisms that produced results like those of the common law. The approach resulted in relatively optimal rules (even if their enforcement was not optimal). These mechanisms facilitated flexible, case by case, experiments and decisions, which culminated in rules. The Commission's staff issued no-action letters on a case by case basis. When the no-action letters contained interpretations of the law they served as precedents and guidance to lawyers and often to judges as well. The Commission issued interpretations, or supported the staff's interpretation. Exemptions by the Commission were granted to applying parties, case by case. Rules were enacted only after many, sometimes hundreds, of exemptions were granted. In the years 1975 to 2000, these mechanisms allowed the Commission to test and re-test its exemptions (relief from the law) and its conditions (imposition of restrictions), and then generalize relief by rule.

Today these mechanisms are not as easy to use for a number of reasons. That is not because there are rules in place. After all, in 1940, two acts were passed that were quite detailed, and many of the details do not fit tday's environment. The difference between the previous regulatory environment and today's environment is in the Commission's ability to create law by exempting advisers from the acts on a case by case basis.

The exemptions and the rules in the 1975 to 2000 period deregulated and re-regulated. Much of the regulation in the 1975 to 2000 period was found in conditions to exemptive relief. The process reflected an exchange. Advisers received exemptions from constraints of the existing law in exchange for different legal limitations. It is not surprising that when the Commission tightened the internal controls within the advisers' organizations, it had to amend the conditions that it imposed in a number of important exemptions. It is not surprising that the advisers are challenging the amendments. After all, the practice in the past was to receive something (relief from current law) in return for restrictions. None were offered in the recent amendments to the conditions that imposed stricter requirements rather than relax them. The Commission's explanations of the amended conditions emphasized the revelations of abuse and the need for stricter regulation. But it was a one-sided regulation with no de-regulation. This produces resistence, sometimes intense, to the regulation.

Further, in the 1975 to 2000 period, when the advisers sought relief from legal constraints, they provided the Commission with information about their operations, costs and objectives. The staff of the Commission could also request (and usually receive) additional information on these items. The information was reliable. It was offered by the most knowledgeable sources, and was accompanied by a sanction on inaccuracies. Inaccurate information was likely to be refuted, either before the grant of exemption or thereafter (by competitors, for example). Providing the Commission with misleading information carried with it loss of credibility (a long-term sanction). Therefore, the probabilities were very high that the information would be true and robust (either initially or after staff questioning).

In contrast, the information that accompanies investigations and prosecution is far more limited. Information that accompanies rules aimed at tightening regulation is not likely to be offered by advisers voluntarily, and comments on proposed rules could be sharply conflicting, depending on whether they are offered by the advisers or by representatives of the investors. Thus, in today's environment the Commission initiates restrictive rules, and does not have the quality information that it has historically received from the industry.

In addition, in 1975 to 2000, most of the requests for relief (combined with new regulatory conditions) came from the advisers. They sought permission for new activities or designs or transactions in which they desired to engage. The Commission's initiative was usually limited to codifying no action letters in a release,[56] and codifying exemptions in a rule.[57] In the new recent period the initiative came from the Commission rather than from the advisers. And the regulation had to apply generally, by rules, at the outset.

The Commission does, however, have today, as it did in the past, mechanisms to test various regulatory conditions, case by case. But these mechanisms are very different from the historical ones. Today, the mechanism the Commission uses to experiment derives from the cases it brings against the violators of the law. And its information is derived from the facts and arguments produced in the judicial proceedings. It also gleans information during the negotiations for settlement with the accused. Ultimately, these settlements can shape informal rules. True, the Commission prosecuted violators in the past as well. However, the balance between exemptive regulation and prosecutorial regulation has changed. There is less exemptive conditional regulation and far more prosecutorial and settlement regulation.

This system of rule-making highlights the difference between regulation by exemptions and regulation by prosecution. Regulation by exemption aims at all the actors in the profession. Prosecution aims at the violators. Regulation by exemption is usually affected by, and sometimes is based on, a measure of consensus by the regulated. Prosecution is usually affected by the financial constraints on the prosecutors, public pressure, and negotiated settlements, or judicial decisions. To the extent that judicial decisions and settlements are used as precedents or incorporated in rules, they could then apply to the larger family of advisers. Yet, rules that have their origins in reaction to profitable violations of the law are likely to have a different orientation from the historical rules that have had their origins in requests for profitable permissible innovations. The rule makers know the actions of the violators but not their impact on other members of the adviser community. They do not know whether these actions are likely to be isolated incidents or the drivers of a cascade. In addition, the decisions to prosecute and settle are not well known as the exemptions and no-action letters. There is little publicity about the policies that lead to the decisions to prosecute and the guidelines to settle. There are few indications on the steps which the Commission should take to tighten the application of the law in order to eliminate a widespread abuse of trust, resurrect investors' trust, and achieve this purpose at the lowest cost to honest advisers.[58]

Perhaps in this new era the staff would start to issue no-action letters on proposed steps that the advisers are planning to take in order to implement the Commission's directives. The staff might provide comfort to advisers who are unsure about the reach of prohibiting rules. Or the Commission could approve guidelines of not-for-profit organizations, such as the Independent Directors Forum, and indirectly to directors who want to perform their job well. The new era may require the Commission to periodically review its regulations. Among others, the reviews might focus on the regulations that are either violated more often or are subject to increasing requests for exemptions.

The settlements that the Commission and the state enforcement agencies are reaching with accused organizations and persons can become a source of small "step by step" experiments. Contacts between the Office of Compliance at the Commission and the Chief Compliance Officers at the advisory organizations that focus on particular issues and events, may be an effective preventive "common law" enforcement mechanisms that can culminate in general guiding rules for future. While the principles can be broadly announced, the details can be worked out case by case to be tested and to provide the substance of future rules and guides to implement them.

Can corproate America benefit from a case by case system along the same lines of this model? In fact, the Sarbanes-Oxley Act can offer a testing ground and a tentative answer. The Act has been a source of loud complaints by a number of larger and small corporations. Since it applies to those that were guilty of fraud and those who were not, it is sometimes hard to justify a full imposition of the provisions of this act. If the Securities and Exchange Commission were granted power to exempt from the act under certain very broad guidelines, as it was granted under the 1940 Acts then such as system may develop, This is just an idea to be pursued in another writing. But I believe that it can potentially reduce the problems of general rules imposed on business that may prove too broad or too narrow.

Thes current era poses great legal risk for fiduciaries. For them, the common law approach of trying and testing seems to be riskier than specifying rules. The trying and testing approach creates a gray area of uncertainty. And yet, most advisers could restrain their competitive drive, avoid the gray areas, and follow safe legal actions, especially if they knew that their competitors must self-impose similar limitations. The benefit of this common law approach is that it avoids costly and disruptive rules. Advisers could then give the Commission practical information to guide its regulatory actions. In the last analysis, the common law "legislative" approach may be the better way to go, not only for the regulators and the investors but for the advisers as well.

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[1] 17 C.F.R. § 270.6e-2 (2005).
[2] Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release No. 1092 (Oct. 8, 1987), 52 Fed. Reg. 38,400 (Oct. 16, 1987).
[3] 15 U.S.C. §§ 80a-1 to -64 (2000); 15 U.S.C. §§ 80b-1 to –21 (2000).
[4] DIVISION OF INVESTMENT MANAGEMENT, UNITED STATES SECURITIES AND EXCHANGE COMMISSION, PROTECTING INVESTORS: A HALF CENTURY OF INVESTMENT COMPANY REGULATION (1992).
[5] 15 U.S.C. §§ 77a to 77aa (2000).
[6] *See* Charles Meyer, SEC No-Action Letter (Aug. 5, 1975) (noting staff position).
[7] 17 C.F.R. §§ 270.12b-1 (2005).
[8] 17 C.F.R. §§ 270.12b-1 (2005).
[9] See Appendix B
[10] 15 U.S.C. §§ 80a-2(a)(19)(a) (2000).
[11] 17 C.F.R. S 270.2a-7 (2005).
[12] Tamar Frankel, *Fiduciary Duties as Default Rules,* 74 OR. L. REV. 1209, 1272 (1995).
[13] *See* Martin Lipton & Jay W. Lorsch, *A Modest Proposal for Improved Corporate Governance,* 48 BUS. LAW. 59 (1992) (noting that "the historian Alfred Chandler declared in 1977 that America had created a system of 'Managerial Capitalism'").
[14] *See* Appendix A.
[15] *See* 4 TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS § 28.01, at 28-5 (2001 & Supp. 2005).
[16] *See* Testimony of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, Concerning Proposed Revision to Rules Governing Bank Common Trust Funds, Before Subcomm. On Telecommunications and Finance of the Comm. On Energy and Commerce, 101st Cong. (1990).
[17] Prudential Ins. Co. v. SEC, 326 F.2d 383 (3d Cir. 1964) (holding that a separate account established by the insurance company to fund variable annuities was subject to the Investment Company Act of 1940).
[18] *See* 1 TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS § 2.12[D]-[E], at 2-80 to –86 (2001).
[19] *See* Tamar Frankel, *The Internet, Securities Regulation, and Theory of Law,* 73 CHI.-KENT L. REV. 1319, 1352-53 (noting precedential value SEC and staff place on no-action 1etters).
[20] *See* Tamar Frankel, *The Internet, Securities Regulation, and Theory of Law,* 73 CHI.-KENT L. REV. 1319, 1351 (1998).
[21] Prudential Ins. Co. v. SEC, 326 F.2d 383 (3d Cir. 1964).
[22] 17 C.F.R. § 270.2a-7 (2005).
[23] Tamar Frankel, *Variable Annuities, Variable Insurance, and Separate Accounts,* 51 B.U. L. REV. 173, 177-79 (1971).
[24] Regulation Q, 12 C.F.R. § 217.7 (1986) (expired 1986).

[25] Saxe v. Brady, 184 A.2d 602 (Del. 1962); *see* 2 TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS § 12.03[D], at 12-76 to –97 (2001) (citing cases).
[26] *See* 2 TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS § 12.03[C], at 12-71 (2001) (noting give-ups).
[27] 15 U.S.C. § 80a-35(b) (2000).
[28] For the number of investment companies and the amounts that they managed throughout the years see Appendix A.
[29] For the number of investment companies and the amounts that they managed throughout the years see Appendix A.
[30] *See* 2 TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS § 12.03[C], at 12-71 (2001) (noting payments to brokers).
[31] 17 C.F.R. § 270.12b-1 (2005).
[32] Securities; Brokerage and Research Services, Securities Exchange Act Release No. 23,170 (Apr. 23, 1986), 51 Fed. Reg. 16,004 (Apr. 30, 1986).
[33] *See, e.g.,* Point of Sale Disclosure Requirements and Confirmation Requirements for Transactions in Mutual Funds, College Savings Plans, and Certain Other Securities, and Amendments to the Registration Form for Mutual Funds, Investment Company Act Release No. 26,778 (Feb. 28, 2005), 70 Fed. Reg. 10,521, 10541 n.86 (Mar. 4, 2005) (noting recent enforcement actions against advisers for failure to disclose shelf space arrangements).
[34] *See* Appendix B.
[35] *See* Appendix B.
[36] 17 C.F.R. §270.23c-3 (2005).
[37] *See* Appendix B.
[38] *See* Appendix B.
[39] *See* Appendix B.
[40] *See* Appendix B.
[41] Prudential Ins. Co. v. SEC, 326 F.2d 383 (3d Cir. 1964).
[42] Comdisco, Inc., SEC No-Action Letter (Oct. 25, 2000) (the tracking stocks did not promise buyers much but allowed the boards to grant them more. The staff, however, increased the risk of such structures by announcing that it will no longer offer no action letters on the structures).
[43] *See* Appendix B.
[44] *See* Appendix B.
[45] National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, sec. 303(a), § 203A, 110 Stat. 3416, 3437 (codified at 15 U.S.C. § 80b-3a (2000)).
[46] Prevention of Certain Unlawful Activities with Respect to Registered Investment Companies, Investment Company Act Release No. 11,421 (Oct. 31, 1980), 45 Fed. Red. 73, 915 (Nov. 7, 1980) (codified as amended at 17 C.F.R. §270.17j-1 (2005)).
[47] *See* the forthcoming book, Tamar Frankel, "Trust and Honesty. America's Culture at a Cross Road" (Oxford University Press).
[48] *See*Tamar Frankel & Lawrence A. Cunningham, *The Mysterious Ways of Mutual Funds: Market Timing* (Feb. 2005) (on file with author).
[49] The fact that the managers benefited (for example, by receiving additional $260 million to manage) was not enough to create a remedy under fiduciary law.
[50] *See, e.g., Quality Funds in a Post-Scandal World,* BUS. WK. ONLINE, May 18, 2004, LEXIS, Mews Library, Allnws File (noting that investors are avoiding scandal-plagued funds).
[51] Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26,299 (Dec. 17, 2003), 68 Fed. Reg. 74,714 (Dec. 24, 2003) (codified at 17 C.F.R. §§ 270.38a-1, 275.206(4)-7 (2005)).
[52] Investment Adviser Codes of Ethics, Investment Advisers Act Release No. 2256 (July 2, 2004), 69 Fed. Reg. 41,696 (July 9, 2004) (codified at 17 C.F.R. § 275.204A-1 (2005)).
[53] Investment Company Governance, Investment Company Act Release No. 26,520 (July 27, 2004), 69 Fed. Reg. 46,378 (Aug. 2, 2004) (codified in scattered sections of 17 C.F.R. Part 270).
[54] 17 C.F.R. §§ 270.203(b)(3)-1, -2 (2005) The rule allows the advisers an escape route, such as imposing a two year bar on investors' withdrawal of their money from the hedge fund. If their investors may withdraw their money only after two years and one day, the advisers to hedge funds might escape registration.
[55] *See* Trust and Honesty. America's Culture At A Cross Road, Forthcoming Oxford University Press 2005.
[56] *See* Appendix B.
[57] *See* Appendix B.
[58] The Commission has also established an internal mechanism to uncover and highlight "red flags." It uses statistical data and "watch dogs" within its Divisions. When such red flags appear, steps are taken to address the problems case by case. What is unknown is how the Commission reacts to these discoveries, and the kind of internal policies it establishes for the reaction.