A System of Fiduciary Protections for Mutual Funds

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Abstract

The regulation of mutual funds in the United States arguably contains the world's most extensive system of fiduciary protection, buttressed by elaborate liability rules and a host of procedural protections and mandatory disclosure requirements designed to facilitate investor protection and choice. The intensity of this regulatory structure is a subject of perennial debate, as public officials and policy analysts attempt to balance the cost of compliance and oversight against benefits to investors. Over time, government officials have made numerous supervisory accommodations to ameliorate the system's costs and facilitate industry innovations. But, the burdens of this enhanced system of fiduciary protections for mutual funds remain significant and have encouraged industry participants to evade these legal requirements in a number of ways, such as the creation of alternative vehicles for collective investments (including insurance products and managed accounts of various sorts) and the imbedding of regulated mutual funds into other legal structures that escape the full application of the enhanced systemic of fiduciary protections for mutual funds. Technological innovations, such as robo-advising, are likely to accelerate this trend. In this chapter, I explore this important illustration of regulatory arbitrage and suggest areas where aspects of mutual fund regulation might appropriately be extended to functionally similar investment vehicles.

* James S. Reid, Jr., Professor of Law, Harvard University. In preparing this chapter, I benefitted from suggestions of participants at the Harvard Law School Corporate Group Luncheon, as well as helpful comments from Paul Cellupica, Deborah DeMott, Clifford Kirsch, Arthur Laby, Patricia McCoy, Eric Roiter, Jacob Russell, and Susan Wyderko. This chapter builds on a taxonomy of fiduciary duties in financial regulation previously introduced in Howell E. Jackson & Talia B. Gillis, *Fiduciary Law in Financial Regulation*, in OXFORD HANDBOOK OF FIDUCIARY LAW (Even J. Criddle, Paul B. Miller & Robert H. Sitkoff eds., 2019). A number of pending SEC proposals in mid-2020 implicate issues discussed in this chapter, some but not all of which are addressed in the text and footnotes. As it relates to the subject matter of this chapter, I would note that I am an independent trustee of CREF and affiliated TIAA-CREF Mutual Funds. The views expressed in this chapter, however, do not reflect the opinion of that organization. Additional information on my outside activities is available at https://helios.law.harvard.edu/Public/Faculty/ConflictOfInterestReport.aspx?id=10423.

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INTRODUCTION

Fiduciary duties are most familiar in the context of the responsibilities owed by a single legal entity (for example, a trustee) to another (such as a beneficiary). But fiduciary duties also exist within more elaborate regulatory structures, creating what I describe in this chapter as a system of fiduciary protections: that is, an interconnected network of legal requirements centered on a limited number of specific fiduciary duties reinforced by disclosure requirements, portfolio restrictions, and investor approval mechanisms. These fiduciary systems are often overseen by an active cohort of government supervisors and supplemented in certain domains with private litigation operating under unique liability rules. The mutual fund industry in the United States, as I outline in Part I of this chapter, operates under just such a system of fiduciary protections. Over time, as explained in Part II, this system has evolved through a series of supervisory adjustments and accommodations, but the essence of a legal regime grounded on fiduciary protections remains robust and extensive. In part as a result of the intensity and cost of this system's operation, I argue in Part III, industry participants have adjusted their product offerings to create alternative vehicles for offering investors collective investment opportunities that escape the full application of fiduciary protections designed for mutual funds, sometimes escaping that regime entirely. This exercise of regulatory arbitrage likely reduces costs and satisfies client demands, but also raises a number of challenging questions for policy-makers, some of which I sketch out in Part IV. Beyond outlining the structure of the system of fiduciary protections that governs mutual funds in the United States, the goal of this chapter is to encourage government officials and legal scholars to consider whether aspects of that system of protections—most likely disclosure obligations related to performance and fees—should be extended to the increasingly large number of financial products that are functionally similar to mutual funds, but that are structured to fall, in part or entirely, outside of the system of fiduciary protections described in this chapter.

I. TRADITIONAL MUTUAL FUND REGULATION AS THE APOTHEOSIS OF FIDUCIARY DUTIES

The system of supervisory oversight established under the Investment Company Act of 1940 (1940 Act) and the Investment Advisers Act of 1940 (Advisers Act), along with supporting obligations arising under other federal securities laws as well as the requirements of self-regulatory organizations represents what is likely the world's most elaborate system of fiduciary protections for investors. Throughout this chapter, I refer to this collection of legal obligations as mutual fund regulation. The regime consists of an intricate set of portfolio restrictions, open-ended standards of conduct, disclosure requirements, shareholder consent or approval mechanisms, liability regimes, and strict price regulation for exit and entry. The structure is administered by phalanxes of lawyers and compliance officers as well as several different government agencies backed up by a well-staffed financial press and an aggressive

network of plaintiff attorneys. Without question, the regime is costly and intrusive, but it also safeguards much of the financial wealth of working and middle class America.[1]

In this Part, I sketch out the key components of mutual fund regulation, concluding with a short defense of my characterization of the entire regime as embracing a comprehensive system of enhanced fiduciary protections. My descriptions are necessarily summary, but hopefully are sufficient to give a flavor of the scope of the regime and the internal logic connecting its components.

A. Mandatory Independent Board Members

A central and distinctive feature of U.S. mutual fund regulation is the requirement that each fund be overseen by a board of directors, of whom a substantial number must be independent of the fund's investment adviser.[2] These directors, typically supported by separate counsel for independent directors, serve as fiduciaries for mutual fund investors, and have numerous statutory and regulatory obligations to safeguard those investors' interests. Among other things, mutual fund boards must make annual determinations about the appropriateness of management fees paid to fund advisors, sign off on major corporate actions, and oversee a host of operational details. Several decades ago, when the European Union adopted an alternative approach to policing collective investment vehicles—an approach that lacked analogous board oversight—SEC staff briefly considered and promptly rejected a proposal to permit exceptions from board oversight in U.S. mutual funds, reasoning that the E.U.'s more "contractual . . . structure is fundamentally incompatible with the regulatory philosophy of the [1940] Act, which relies on boards of directors to monitor investment company operations and resolve conflicts of interests."[3]

B. Fiduciary Obligations of Investment Advisers

The second font of fiduciary protections for mutual fund investors comes from the federal courts' interpretation of the Advisers Act as imposing a fiduciary duty on investment advisers to their clients, including their mutual fund clients.[4] This obligation extends to all actions taken by an adviser with respect to a mutual fund, such as the provision of ancillary services and the best execution of portfolio trades. These Advisers Act obligations are supplemented for investment advisers to mutual funds in section 36(b) of the 1940 Act, which imposes a specific and novel form of fiduciary duty for advisers of investment companies with respect to compensation, a duty that is enforceable by a fund shareholder on behalf of the fund that has

[1] *See* INVESTMENT COMPANY INSTITUTE, INVESTMENT COMPANY FACT BOOK: 2019, at 23, 28 (2019) (hereinafter "ICI 2019 FACT BOOK") (reporting net assets of regulated mutual funds in the United States to be $21.1 trillion as of year-end 2018, representing 21 percent of U.S. household wealth).

[2] The statutory requirement is for 40 percent of the directors to be independent, but SEC exemptive relief (discussed below) effectively raises that requirement to a super majority , and many funds have an even greater number of independent directors. For a discussion of these requirements, *see* MICHAEL S. BARR, HOWELL E. JACKSON & MARGARET E. TAHYAR, FINANCIAL REGULATION: LAW AND POLICY 1060-65 (2d ed. 2018) (hereinafter "BARR-JACKSON-TAHYAR"). For an excellent overview of mutual fund governance requirements, *see* Eric D. Roiter, *Disentangling Mutual Fund Governance from Corporate Governance*, 6 HARV. BUS. L. REV. 1 (2016).

[3] *See* SEC Division of Investment Management, Protecting Investors: A Half Century of Investment Company Regulation 254 (May 1992).

[4] *See* Investment Advisers Act of 1940 § 206, 15 U.S.C. § 80b-6 (2018). *See also* Investment Company Act of 1940 § 36(a), 15 U.S.C. § 80a-36(a) (2018) (authorizing SEC civil actions against, among others, investment advisers to mutual funds for fiduciary breaches). For a recent overview of Investment Adviser duties, *see* SEC Commission Interpretation Regarding Standard of Conduct by Investment Advisers, 84 Fed. Reg. 33,669, 33,669 (July 12, 2019) ("The Advisers Act establishes a federal fiduciary duty for investment advisers."). *But see* Statement of SEC Commissioner Robert J. Jackson on Final Rules Governing Investment Advise (June 5, 2019), *available at* https://www.sec.gov/news/public-statement/statement-jackson-060519-iabd (criticizing aspects of the Commission's interpretation).

been the subject of considerable litigation, as well as academic commentary, and was formalized into the Second Circuit's *Gartenberg* test, substantially endorsed by the Supreme Court several years ago.[5] Critically, a mutual fund's board of directors plays a central role in policing an adviser's obligations under section 36(b), largely accomplished through annual contract renewals required under section 15(c) of the 1940 Act.[6] The board also has more general obligations to review all outside services to mutual funds as a check for potential conflicts of interest.[7] In addition, under Rule 12b-1, a mutual fund board must satisfy specific regulatory obligations before a fund adviser can make use of fund assets to finance the costs of distribution.[8] In short, mutual fund regulation doubles up on fiduciary duties with the belt of the adviser's obligations being shored up by the suspenders of oversight from a fund's board.[9]

C. Extensive Portfolio Restrictions

Mutual fund regulation also imposes a number of stringent portfolio restrictions, supplemented in critical respects by the requirements of the Internal Revenue Code. Diversification requirements, liquidity rules (recently enhanced), and severe limitations on leverage and complex capital structures, all impose substantial restrictions on the operations of mutual funds.[10] In addition, Section 17 of the 1940 Act establishes strict limitations on transactions between mutual funds and affiliate parties, restrictions designed to eliminate the kinds of tunneling and sweetheart deals that plagued investments companies in the 1920s and 1930s.[11] These restrictions substantially constrain the scope of mutual fund operations, but are susceptible to – and, as I will shortly discuss, have been markedly ameliorated through -- SEC exemptive relief.[12]

D. Mandatory Shareholder Approvals

Notwithstanding the presence of statutorily imposed fiduciary duties on both fund boards and investment advisers, mutual fund regulation also delegates a number of specific responsibilities to fund shareholders. For one thing, a majority of fund directors must, at any time, be elected by shareholders, and the ability of the current board to fill vacancies is

[5] *See* Investment Company Act of 1940 § 36(b), 15 U.S.C. § 80a-36(b) (2018), *interpreted in* Jones v. Harris Assoc., 559 U.S. 335 (2010) (adopting the standard articulated in Gartenberg v. Merrill Lynch Asset Mgt., 694 F.2d 923 (2d Cir. 1982)). For an overview of the *Jones* litigation and additional background on the *Gartenberg* standard, *see* BARR-JACKSON-TAHYAR, *supra* note 1, at 1053-60.

[6] Investment Company Act of 1940 § 15(c), 15 U.S.C. § 80a-15(c) (2018). The thoroughness of these annual contract review measures, particularly with respect to independent trustees, are an important factor in claims brought under section 36(b).

[7] *See* SEC Division of Investment Management, IM Guidance Update No. 2016-01, at 3-4 & note 17 (Jan. 2016), *available at* https://www.sec.gov/investment/im-guidance-2016-01.pdf.

[8] SEC Investment Company Act of 1940 Rule 12b-1, 17 C.F.R. § 270.12b-1 (2019).

[9] Of course, the fiduciary obligations of investment advisers are necessarily compromised by the inherent conflicts between adviser interests and those of mutual fund shareholders, justifying the additional fiduciary obligations at the mutual fund level, For a helpful exploration of fiduciary duties in this context, *see* Arthur B. Laby, *The Fiduciary Structure of Investment Management Regulation*, in RESEARCH HANDBOOK ON THE REGULATION OF MUTUAL FUNDS (John D. Morley & William A. Birdthistle eds., 2018).

[10] For an overview of these restrictions and their logic, *see* BARR-JACKSON-TAHYAR, *supra* note 1, 1023-24, 1065-72.

[11] Investment Company Act of 1940 § 17, 15 U.S.C. § 80a–17 (2018). *See also* BARR-JACKSON-TAHYAR, *supra* note 1, at 1019-21. *See also* Investment Company Act of 1940 § 17(d), 15 U.S.C. § 80a–17(d) (2018) (restrictions on joint transactions between funds and affiliates).

[12] For contrasting views on the relationship between portfolio shaping rules and fiduciary duties *compare* Mercer Bullard, *The Fiduciary Study: A Triumph of Substance over Form?*, 30 REV. OF BANKING & FIN. L. 175 (2011) (arguing that formal rules of conduct displace fiduciary duties), *with* Laby, *supra* note 9 (contending that rules of conduct do not, at least in U.S, practice, fully displace fiduciary duties).

contingent upon shareholder election of two-thirds of the board.[13] Shareholder approval is also required for changes in fundamental investments policies,[14] the ratification of new advisory contracts when the adviser experiences a change in control,[15] as well as major corporate events, including many fund mergers.[16] In addition, shareholders must sign off on increases in advisory fees[17] as well as increases in certain other charges, such as from the adoption of 12b-1 fees.[18] As all of these events are typically preceded by approval of a fund's board of directors, these shareholder approvals afford a potential (albeit rarely exercised) opportunity for fund investors to override board decisions on important matters.

E. Elaborate Disclosures Regime

To assist mutual fund investors (as well as third party service providers, such as Morningstar and Broadridge) in monitoring mutual fund operations, federal laws establish an elaborate system of disclosure obligations for mutual funds. Building off the Securities Act of 1933 and the Securities Exchange Act of 1934, mutual fund regulation requires a comprehensive system of prospectus, registration statement, annual report, and proxy statements for mutual funds.[19] These disclosure forms bear only passing resemblance to the disclosures required of ordinary corporate issuers and include a host of disclosure provisions targeted at specific features of mutual fund regulation. For example, the disclosure items regarding mutual fund board approval of advisory fees track the *Gartenberg* test closely for compliance with section 36(b).[20] In addition, the disclosure rules for mutual funds—as well as the associated FINRA rules governing mutual fund advertising—have elaborate requirements designed to ensure standardized reporting of past investment performance and mutual fund fees.[21] Moreover, and of particular relevance to later discussions, the regulatory regime has elaborate rules for factoring in the underlying fees for a mutual fund organized as a "fund-of-funds," that is, a

[13] Investment Company Act of 1940 § 16(a), 15 U.S.C. § 80a–16(a) (2018). Notwithstanding these election requirements, annual election of board members is not customary for mutual funds as these vehicles are typically organized under state laws that do not require regular elections. *See also infra* Section II.C (discussing other corporate governance accommodations).

[14] Investment Company Act of 1940 § 13(a), 15 U.S.C. § 80a–13(a) (2018).

[15] Investment Company Act of 1940 § 15(a), 15 U.S.C. § 80a–15(a) (2018).

[16] *See* MUTUAL FUND DIRECTORS FORUM, PRACTICAL GUIDANCE FOR FUND DIRECTORS ON MUTUAL FUND MERGERS (2019). *See also* SEC Investment Company Act of 1940 Rule 17a-8, 17 C.F.R. § 270.17a-8 (2019) (exempting certain affiliate fund mergers from shareholder approval requirements).

[17] This requirement derives from the specification in section 15(a) of the Investment Company Act that shareholder-approved advisory contracts for mutual funds must "precisely describe[] all compensation to be paid thereunder." Investment Company Act of 1940 § 15(a), 15 U.S.C. § 80a–15(a) (2018). *Cf.* INVESTCO, SEC No-Action Letter, , 1997 WL 434442 (Aug. 5, 1997) (providing no-action relief for sub-advisory contracts where adviser fees are reallocated from investment adviser to sub-adviser, causing no net increase in expenses charged to shareholders).

[18] SEC Investment Company Act of 1940 Rule 12b-1, 17 CFR § 270.12b-1 (2019). *See* DIVISION OF INVESTMENT MANAGEMENT, REPORT ON MUTUAL FUND FEES AND EXPENSES (Dec. 2000) ("Pursuant to rule 12b-1 under the Investment Company Act, a fund may adopt a 12b-1 plan to provide for the payment of distribution expenses. Because of the possible conflicts of interest involved in a fund's payment of distribution expenses, the Commission requires funds to follow procedures similar to those required by the Investment Company Act for the approval of an investment advisory contract.").

[19] Investment Company Act of 1940 § 8, 15 U.S.C. § 80a–8 (2018). For an overview of SEC reporting requirements, *see* Investment Company Registration and Regulation Package (modified Dec. 21, 2004), *available at* https://www.sec.gov/investment/fast-answers/divisionsinvestmentinvcoreg121504htm.html.

[20] For the SEC release adopting these requirements, *see* SEC Final Rule on Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, 69 Fed. Reg. 39,798 (June 30, 2004).

[21] For an overview of FINRA review procedures for mutual fund advertising and other matters, *see* FINRA Mutual Funds Rules & Guidance (visited July 5, 2020), *available at* https://www.finra.org/rules-guidance/key-topics/mutual-funds. For an overview of performance investment in mutual fund reports, *see* SEC OFFICE OF INVESTOR EDUCATION AND ADVOCACY, HOW TO READ A MUTUAL FUND SHAREHOLDER REPORT, *available at* https://www.sec.gov/files/ib_readmfreport.pdf (viewed May 5, 2020). Mutual funds are also required to make disclosures on portfolio holdings on a periodic basis.

mutual fund that invests in other mutual funds.[22] These rules are designed to ensure that when an investor considers purchasing the top level of a fund-of-funds, the fee information includes all of the costs of operating the underlying funds.[23] Target date funds—typically picked as default investments for retirement savings plans—are often organized as funds-of-funds and so the rules for funds-of-funds are of particular importance in today's markets, especially for retirement savings.[24]

F. NAV Requirements for Entry and Exit with Board Oversight

A final, but arguably critical, safeguard for mutual fund investors is the right to enter or exit mutual funds on at least a daily basis at a regulated price designed to equal the net asset value of fund assets (NAV).[25] NAV pricing is itself overseen by fund boards on a number of dimensions most notably with respect to the fair valuation of securities when a market price is not readily available,[26] and offers an essential protection for investors who become dissatisfied by fund performance.[27] Among other things, NAV pricing grants fund investors a daily put option for fund shares at regulated prices, in effect, a continuously operating right of appraisal. NAV pricing also protects current shareholders from dilution by ensuring that new shareholders pay an adequate price for their investments.

G. A Comprehensive System of Fiduciary Protections

Let me now attempt to defend my characterization of this elaborate system of mutual fund regulation as a regime of enhanced fiduciary protections. Quite clearly, there are fiduciary protections at the core of this regulatory requirement, embracing both boards and investment advisers. But, one might object, the other components of mutual fund regulation—like disclosure requirements imposed under more general federal securities laws or the portfolio restrictions imposed under the 1940 Act—are simply other kinds of protections that happen to apply to mutual funds in addition to fiduciary obligations of boards and advisers.

While I do not deny that many of these other regulatory requirements could be could be conceptualized as fully separate, many are closely related to fiduciary duties and thus are, in my view, better denominated as part of that system. A prime example, discussed above, are disclosure rules that directly pick up fiduciary obligations, such as those imposed under the *Gartenberg* test. But even more general disclosure requirements for mutual funds have a fiduciary valence if one takes into account the mandatory election requirements for fund directors and the number of major issues for which shareholder approval is required. In

[22] The SEC recently issued a proposal to consolidated its past exemptive relief and rule-making with respect to fund of funds. *See* SEC Proposed Rule on Fund of Funds Arrangements, 84 Fed. Reg. 1286 (Feb. 1, 2019) (hereinafter SEC Fund of Funds Proposal).

[23] *See* SEC Final Rule on Fund of Fund Investments, 71 Fed. Reg. 36,640, 36,640 (June 27, 2006) ("The[se] amendments improve the transparency of the expenses of funds of funds by requiring that the expenses of the acquired funds be aggregated and shown as an additional expense in the fee table of the fund of funds.").

[24] *See* ICI 2019 Fact Book, *supra* note 1, at ch. 8.

[25] Investment Company Act of 1940 § 22(c), 15 U.S.C. § 80a–22(c) (2018); SEC Investment Company Act of 1940 Rule 22c-1(a) , 17 CFR § 270.22c-1(a) (2019).

[26] Investment Company Act of 1940 § 2(a)(41), 15 U.S.C. § 80a–2(a)(41) (2018) (mandating, when market quotations not readily available, "fair value as determined in good faith by the board of directors"); SEC Investment Company Act of 1940 Rule 2a-4, 17 CFR § 270.2a-4 (2019). The SEC's new liquidity rule, requiring that 85% of funds be marketable without a significant change in value within seven days, is intended to further safeguard NAV protections. *See* SEC Investment Company Act of 1940 Rule 22e-4, 17 CFR § 270.22e-4 (2019).

[27] For an overview of the importance of NAV determinations, *see* SEC Proposed Rule: Good Faith Determinations of Fair Value, 85 Fed. Reg. 28,734, 28,735 (May 15, 2020) (hereinafter SEC Proposal on Fair Valuation). *See also* John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84 (2010) (emphasizing the centrality of NAV exit rights for investors in mutual funds); Roiter, *supra* note 2 (stressing importance of exit to mutual fund governance).

traditional fiduciary law, fiduciaries are required to disclose to their beneficiaries a good deal of information about certain matters and some conduct is permissible only if ratified by the beneficiary with informed consent. The shareholder approval requirements of mutual fund regulation perform exactly the same function, with the disclosure rules (emanating from both federal securities laws and FINRA advertising requirements) create a highly formalized analog to the less well-defined disclosure and consent duties of traditional trustees, providing a critical component to this fiduciary system. Indeed, it is the heightened formality of mutual fund regulation that makes this apparatus a system of fiduciary protections and not just a straightforward application of fiduciary law.

While portfolio restrictions might not commonly be characterized as fiduciary obligations, these restrictions substantially constrain the operations of mutual funds— establishing a set of non-waivable obligations—that restrict the activities of investment advisers and the monitoring responsibilities of fund boards. As I explored with Talia Gillis in an earlier piece, one of the complexities of applying traditional fiduciary duties in a regulated context is determining when those duties actually proscribe certain conduct.[28] The portfolio restrictions of mutual fund regulation solve that problem by defining the boundaries of permissible fund activities; there are certain things that investment advisers just cannot do with respect to their management of 1940 Act funds, even with Board approval and informed shareholder consent. For example, NAV pricing adds another mandatory term enhancing beneficiary authority for self-help in the face of poor fiduciary performance. The nexus between these portfolio restrictions and fiduciary obligations is nicely illustrated by the SEC's practice in a host of exemptive actions to condition the relaxation of many portfolio restrictions on fiduciary oversight of the terms of relaxation in the hands of fund trustees. In these cases, portfolio restrictions and fiduciary duties are tightly interwoven. But even when the SEC has not conditioned regulatory accommodations on board oversight, there is a general obligation on fund boards to ensure that funds and adviser have in place "written policies and procedures reasonably designed to prevent violation of the Federal Securities Laws."[29] Through this obligation to review and approve compliance policies and protections, the fiduciary duties of fund trustees extend into all aspects of fund operations.

While it is certainly possible and perhaps more familiar to conceptualize the components of mutual fund regulation as a discrete collection of distinct regulatory strategies, and other scholars have done so with considerable cogency,[30] it is also defensible—and for me more useful—to conceptualize them together as an enhanced system of fiduciary protections.

II. SUPERVISORY ACCOMMODATIONS OVER TIME

The overarching fiduciary structure of mutual fund regulation can be, I think, more clearly seen in the ways in which the SEC and, in some instances, Congress have adjusted regulatory requirements for mutual funds over time. The supervisory accommodations, I argue, ameliorate excessively rigid and costly requirements of those outlined above, but simultaneously maintain basic investor protections of the regime. In this section, I review some of the most prominent examples of these accommodations, highlighting both the extent

[28] *See* Jackson & Gillis, *supra* note *.
[29] *See* SEC Investment Company Act of 1940 Rule 38a-1, 17 CFR § 270.38a-1 (2019).
[30] *See* Laby, *supra* note 9.

to which the adjustments relax statutory requirements while preserving the underlying logic of fiduciary protections. I also flag several instances in which the SEC has been reluctant to acquiesce to industry efforts to obtain more aggressive cutbacks that might, in fact, undermine the overall regime. At several points, I flag on-going debates that reflect the continuing dynamic of adjusting fiduciary duties in this area of the law. By and large, these accommodations leave the basic structure of mutual fund regulation in place, but smooth out some of its rougher (and costlier) edges while safeguarding investor interests.

A. Exemptive Relief from Statutory Restrictions

The best and more prominent example of supervisory accommodations comes in the elaborate system of exemptive relief that the SEC has adopted over the years with respect to mutual fund regulation. One of the distinctive features of the original 1940 Act was the delegation of expansive powers to the SEC to adopt exemptive relief, and the Commission has exercised that authority with considerable frequency.[31] Indeed, the modern mutual fund complex could not exist were it not for these accommodations. In many cases, these exemptive rules permit a practice—such as cross-trading between affiliated mutual funds—that is formally prohibited under the 1940 Act, but is now authorized under exemptive relief, typically with an elaborate set of substantive guardrails and the requirement of some degree of enhanced fiduciary oversight by the fund board of directors. For example, many instances of exemptive relief require a higher percentage of independent directors than the 40 percent imposed under the 1940 Act itself. Rule 12b-1, mentioned earlier, which allows advisers to use mutual fund assets to finance distribution costs, utilizes this approach. Exemptive relief of this sort relaxes prophylactic requirements, but within the confines of a system of fiduciary protections, as oversight is typically delegated to the fund board, which serves as an overarching fiduciary.

Within the mutual fund industry, there is now considerable discussion whether the accumulation of exemptive relief orders, with the many obligations they impose on mutual fund directors, might have come to impose excessive burdens on fund directors, requiring them to engage in "check-the-box" exercises that provide little value to investors and distract from more important work. Dalia Blass, current director of the Division of Investment Management, has focused particularly on this issue[32] and has started to push through several reforms designed to diminish the routine work assigned to fund directors and to allow directors to focus more on larger policy questions. For example, boards are now allowed to rely more heavily on compliance personnel to review cross-trades and to play a less active role in this aspect of fund operations.[33] In effect, these additional accommodations demote these activities from the fiduciary obligations of fund boards and into the regime of compliance, which boards

[31] For an overview of the scope of board governance aspects of the SEC's exemptive relief, *see* SEC Final Rule on Investment Company Governance, 69 Fed. Reg. 46,378 (Aug. 2, 2004), *vacated in* Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005). *See also* SEC Investment Company Act of 1940 Rule 0-1(a)(7), 17 CFR § 270.0-1(a)(7) (2019) (defining Fund governance standards). These standards are often (and accurately) characterized as efforts on the part of the Commission to improve corporate governance of mutual funds, but the point made here is to emphasize the extent to which exemptive relief applying these governance standards substitutes more stringent fiduciary oversight for relaxed mandatory rules. The development of exchange traded funds (ETFs) is itself a product of exemptive orders. *See* BARR-JACKSON-TAHYAR, *supra* note 2, ch.10.2.

[32] *See* Speech of Dalia Blass, Keynote Address: ICI Securities Law Developments Conference (Dec. 7, 2017), *available at* https://www.sec.gov/news/speech/blass-keynote-ici-securities-law-developments-conference-2017. *See also* Letter from Amy Lancellotta, Managing Director, Independent Directors Council, to Dalia Blass, Director, SEC Division of Investment Management (Oct. 16, 2017) (encouraging "modernization" of fund director responsibilities).

[33] *See* Lori L. Schneider et al., SEC Staff No-Action Letter Eases Board's Burden in Reviewing Affiliated Transactions, K&L Gates Investment Management Alert (Nov. 1, 2018). The Commission's recent proposal regarding the board's role in Fair Valuation procedures is similarly in this vein. *See* SEC Proposal on Fair Valuation, *supra* note 27.

must still oversee but not themselves manage. Accommodations of this sort soften, but do not eliminate, the over-arching fiduciary framework.

B. Statutory Adjustments for Soft Dollar Practices

Sometimes it is Congress that provides accommodations. A good case in point is the relief provided by soft dollars under Section 28(e) of the Securities Exchange Act of 1934. Back in the waning days of the NYSE's fixed commission era, the securities industry developed various techniques for giving rebates on commissions paid by institutional clients with large orders. There followed a series of lawsuits alleging that mutual fund advisers and mutual fund boards were violating their fiduciary duties (among other legal obligations) by not passing on these rebates to mutual fund shareholders. In 1975, Congress passed legislation ending the fixed commission era, but also adopted Section 28(e) specifying that it would not be a violation of fiduciary duty (under federal or state law) for investment advisers of mutual funds (as well as other clients) to use trading commissions to finance the purchase of research and certain other services.[34] The amendment thus narrowed the fiduciary obligations of mutual fund advisers (among others) on the view that the safe harbor would promote the production of research with positive externalities for capital markets. This tailored narrowing of fiduciary protections has been in the news in recent years as the E.U.'s MiFID II banned the practice of bundled commissions and questions have been raised as to whether the U.S. should follow suit.[35] For current purposes, however, Section 28(e) represents a prominent adjustment of fiduciary duties, creating an exemption within a larger regime of fiduciary responsibilities.[36]

C. Accommodations with Respect to Corporate Governance

Another example of accommodations comes with respect to the election procedures required for board directors. Practically speaking—and as noted above—the 1940 Act requires that a majority of fund directors be elected by fund shareholders. But, SEC interpretations have diminished the actual control that fund shareholders have over the election of directors for their own funds. To begin with, fund elections are typically organized around a "series" of funds.[37] That is, the electorate for fund elections are not the shareholders invested in a single investment company (as defined under the 1940 Act), but a series of investment companies, typically organized as a business trust with a large number of investment mandates and separate portfolios. For matters that affect only one portfolio—like changes in investment policies—fund shareholders vote on their own, but when an issue put to shareholders is of common concern, like the election of directors, the votes of all shareholders in the series are aggregated.[38] That structure substantially diminishes the control over shareholder elections should problems arise with the management of a specific investment company, such as poor investment performance. Of course, the operation of modern fund complexes, with a single (or only a couple) of boards for potentially hundreds and hundreds of funds located in multiple series, makes the removal of individual directors for a particular investment company, or even

[34] *See* Securities Exchange Act of 1934 § 28(e), 15 U.S.C. § 78bb(e) (2019). The history outlined in this paragraph is recounted in BARR-JACKSON-TAHYAR, *supra* note 2, ch. 10.2.

[35] *See* Howell E. Jackson, Jeffery Y. Zhang & John Rady, "Nobody is Proud of Soft Dollars": The Impact of MiFID II on U.S. Financial Markets (draft of Mar 2, 2020) (on file with authors).

[36] When investment advisers engage in activities that fall outside the scope of section 28(e), the fiduciary duties articulated in pre-1975 case law presumably still apply.

[37] *See* K&L Gates, Organizing a Mutual Fund 5-6 (2013), *available at* http://www.klgates.com/files/Upload/DC_IM_03-Organizing_Mutual_Fund.pdf. For an excellent recent overview of the evolution of series funds, *see* Joseph A. Franco, *Commoditized Governance: The Curious Case of Investment Company Shared Series Trusts*, 44 J. CORP. L. 233 (2018).

[38] *Id.*

series of investment companies, a practical impossibility. Still, at least nominally, fund directors are subject to shareholder election so a semblance of shareholder supremacy in this domain remains.[39]

D. Adjustment to Definition of Fundamental Investment Policies and Use of Sub-Advisers

Another illustration of marginal accommodations to a full-throated approach to policing fiduciary duties in the context of mutual fund regulation over the years relates to the 1940 Act's requirement that any changes in fundamental investment polices be subject to shareholder approval.[40] Over the years, SEC staff has made modest adjustments to the definition of "fundamental investment policies," and a common law of fund practice has grown up around which kinds of investment policy changes can be implemented without shareholder approval.[41] Industry groups have recently lobbied for further relaxation of these shareholder approval requirements.[42] Similarly, the 1940 Act itself contemplates delegation of investment authority to a new sub-adviser would require shareholder approval, but SEC orders have provided exemptive relief for so-called "Managers of Managers" which allows for the creation and amendment of advisory arrangements without shareholder approval.[43]

E. Two Counter-Examples: Full Elimination of Fund Boards and Reluctance to Eliminate Board Oversight on Fair Valuation

Finally, it bears emphasizing a few areas in which the SEC staff has been slow to accept proposals to weaken fiduciary protections for mutual fund investors. The first, already recounted, are proposals to eliminate board directors. While in practice shareholder control over the election of fund directors is limited, the Commission has been unwilling to eliminate that role entirely. Indeed, as mentioned earlier, the Commission tends to rely so heavily on fund directors to police conflicts of interest that the SEC staff is now focused on slimming down those obligations to reduce the boardroom's burdens and free up mutual fund directors for more important issues.[44]

A second area where the SEC has been slow to relax board obligations has been the role of directors in valuing securities when market quotations are not readily available. Such valuations are necessary when a security is distressed or it ceases to trade for some other reason. With respect to foreign securities, fair valuation may be needed if superseding events occur after the home market closes, but before the NYSE closes. Under section 2(a)(41) of the 1940 Act, in such circumstances, "fair value [is to be] determined in good faith by the board of directors."[45] In practice, fair valuation is nowadays accomplished, to a considerable degree,

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[39] *See* Alan R. Palmiter, *Mutual Fund Board*, 1 BROOK. J. CORP. FIN. & COM. L. 165, 169-71 (2008) ("When the election of directors does occur, the process is 'largely ritualistic.'"). Responding to the challenges in gaining quorum in matters put to shareholders of mutual funds and the costs of proxy solicitation more generally, the Investment Company Institute recently recommended the SEC further adjust the procedural requirements for mutual fund shareholder approvals in all contexts. *See* Letter from ICI President Paull Schott Stevens to Vanessa Countryman, SEC Acting Secretary, on SEC Roundtable on the Proxy Process (File No. 4-725) (June 11, 2019) (hereinafter "ICI Proxy Letter") (recommending, among other things, a lowering of quorum requirements accompanied by offsetting safeguards on shareholder approval rates (75 percent) and board support (unanimity)).

[40] *See* Investment Company Act of 1940 § 13(a), 15 U.S.C. § 80a–13(a) (2018), which cross references Investment Company Act of 1940 § 8(b)(3), 15 U.S.C. § 80a–8(b)(3) (2018). *See also* Stradley Ronon Stevens & Young, LLP SEC No-Action Letter (June 24, 2019), https://www.sec.gov/investment/stradley-062419 (accommodations from shareholder approval requirements triggered by changes in composition of stock indices that otherwise would otherwise make funds non-diversified).

[41] *See*, e.g., SEC Investment Company Act of 1940 Rule 35d-1, 17 CFR § 270.35d-1 (2019).

[42] *See* ICI Proxy Letter, *supra* note 39, at 7-9.

[43] For a discussion of these provisions along with a recommendation that they be codified for general use, *see* ICI Proxy Letter, *supra note* 39, at 9.

[44] See *supra* notes 31-33.

[45] 15 U.S.C. § 80a–2(a)(41) (2018).

through matrix pricing models and other fair valuation services that rely on various kinds of algorithmic practices. How directors are supposed to engage in the required "good faith" determinations, and how much those determinations can and should be delegated to expert service providers overseen by management personnel and compliance officers, has been hotly contested among mutual fund practitioners in recent years and the Commission staff has been subject to considerable criticism for not reconciling arguably inconsistent pronouncements on the subject.[46] For current purposes, however, the important point is that the SEC staff has been reluctant to allow for a complete delegation of this board function in the face of substantial external pressure, and recently put forward a proposal that acknowledges the reality that day-to-day responsibility of implementing a system of fair valuation necessarily falls to management but that retains considerable oversight responsibilities at the board level.[47] To the extent that accurate fair valuations are critical to the creation of daily NAVs and that accurate NAVs are critical to safeguard mutual fund shareholders ability to exit on appropriate terms, one can sympathize with the reluctance of SEC staff to weaken board oversight of this linchpin for investor protection. Industry representatives, however, clearly also have a point that even the best intentioned of mutual fund directors must rely to considerable extent on the efforts of others to handle the implementation of fair valuation processes on a daily basis, making it difficult to square practice with the 1940 Act requirement that fund boards "determine" fair value.

III. NEW CHALLENGES TO REGULATORY BOUNDARIES

I now turn from traditional supervisory accommodations within the basic structure of mutual fund regulation to another manner in which industry participants have reduced the costs of mutual fund regulation: instances in which industry innovations have moved a portion, or in some cases all, of a pooled investment vehicle outside of the structure of mutual fund regulation, reducing compliance costs, but also engaging in a form of regulatory arbitrage.[48] As will be seen, some of the cases I discuss have generated litigation or enforcement actions, but a number simply illustrate accepted practices whereby industry participants are understood to have found lawful ways in which to avoid the full application of mutual fund regulation to financial products that are functionally equivalent to pooled investment vehicles, often designed for retail customers. For current purposes, I do not focus on the most familiar path away from mutual fund regulation, the 1940 Act exemptions for private funds, as these exemptions are both well-understood and targeted primarily at institutional investors and extremely wealthy individuals.[49] For the most part, I also do not touch upon the emergence of

[46] *See*, e.g., Letter of Robert E. Buckholz, Chair of Federal Regulation of Securities Committee, ABA Business Law Section, to Dalia Blass, Director, and Paul G. Cellupica, Deputy Director and Chief Counsel, SEC Division of Investment Management, on The Role of Fund Directors in Fair Valuation (July 22, 2019).

[47] *See* SEC Proposal on Fair Valuation, *supra* note 27. *See* Clifford J. Alexander, et al., SEC Proposes New Fair Value Rule 2a-5, NAT'L L. REV. (May 6, 2020).

[48] Some time ago, I wrote an essay exploring the tendency of industry participants (or in some cases plaintiff counsel) to attempt to relocate financial functions away from their presumptive regulatory regimes. *See* Howell E. Jackson, *Regulation of a Multisectored Financial Services Industry: An Exploratory Essay*, 77 WASH. U.L.Q. 319 (1999). There, I identified mutual fund regulation as the presumptive U.S. regulatory regime for pooled investment vehicles and discussed several examples of functionally similar products being located in other legal regimes. *See id*. at 379-97. Some of the practices discussed in the text are analogous to examples discussed in that essay, but many represent subsequent developments.

Within the academic literature, there is an extensive literature on the topic of regulatory arbitrage, generally focusing on the costs and consequences of allowing functionally equivalent activities moving outside of a well-defined regulatory perimeter. *See*, e.g., Annelise Riles, *Managing Regulatory Arbitrage: A Conflicts of Law Approach*, 47 CORNELL INT'L L.J. 63 (2014); Victor Fleischer, *Regulatory Arbitrage*, 89 Tex. L. Rev. 227, 229 (2010) (defining regulatory arbitrage as "a perfectly legal planning technique used to avoid taxes, accounting rules, securities disclosures, and other regulatory costs").

[49] For an overview of the regulation of private funds, *see* BARR-JACKSON-TAHYAR , *supra* note 2, ch. 10.5.

functionally similar insurance products that have been designed to comply with section 3(a)(8) of the Securities Act of 1933, as the courts, with acquiescence of Congress, have interpreted this provision to grant these insurance products full exemption from federal securities laws, including mutual fund regulation.[50] What I examine here are innovations in distribution practices that allow for mutual funds and similar investment vehicles to bypass, at least in part, the enhanced system of fiduciary protections that mutual fund regulation affords.

A. Omnibus Accounts

My first example is fairly prosaic: the use of omnibus accounts by brokerage houses to hold their clients shares of mutual funds.[51] In traditional distribution arrangements for mutual funds, retail customers would hold shares directly at a transfer agent hired by the fund and overseen by the associated investment fund complex. For a fee known as a transfer agent fee, the transfer agent would handle communications with the investor, keep track of account balances, and administer financial transactions and the distribution of disclosure materials. With an omnibus account, the retail investor does not engage directly with a fund's transfer agent, but rather interacts with the brokerage firm as a sub-transfer agent. The sub-transfer agent holds shares in an omnibus account with the fund's transfer agent and that account aggregates the holdings of all the brokerage firm's clients. So, the real work of shareholder administration is handled by the brokerage firms as a sub-transfer agent and for that the brokerage firms receive a negotiated fee from the fund, with the transfer agent presumably receiving a lower fee than would have been earned had the fund shares all been held directly.

In recent years, sub-transfer agent fees have been the subject of SEC enforcement actions and considerable examination scrutiny.[52] The problem here is sometimes referred to as "distribution in guise." The SEC's concern is that these sub-transfer agency fees are being used to pay for distribution efforts rather than fund administration and thus constitute a violation of Rule 12b-1, which (as discussed earlier) establishes specific procedures that must be followed if fund assets are to be used to finance distribution costs. These enforcement actions are symptomatic of the phenomenon I am describing in this chapter. By relying on outside brokerage firms to distribute fund shares and then also moving out of the fund complex an

[50] The jurisdictional divide between securities and insurance products has been a contested one since the Supreme Court determined that some insurance products should be subject to federal securities regulation. *See* SEC v. VALIC, 359 U.S. 65 (1959). *See also* Prudential Insurance Co. v. SEC, 326 F.2d 383 (3rd Cir. 1964). In the recent past, the SEC reentered the fray and attempted to exert jurisdiction over fixed income annuities by adopting a new regulation narrowing the scope of Securities Act of 1933 § 3(a)(8), 15 U.S.C. § 77c(8) (2018). The D.C. Circuit struck down the regulation on procedural grounds in American Equity v. SEC, 613 F.2d 166 (D.C. Cir. 2010), and shortly thereafter Congress adopted the Harkin Amendment, effectively barring the Commission from revisiting the matter. *See* Section 989J of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010) (instructing the SEC how to treat certain insurance products under section 3(a)(8) of the Securities Act of 1933). While beyond the scope of this chapter, the jurisprudence in this area depends on the so-called supererogation theory, which presumes that insurance products exempt under section 3(a)(8) are fully outside the scope of federal securities laws as opposed to exempt only under the limited terms provided by section 3(a)(8). *See* Tcherepnin v. Knight, 389 U.S. 332, 342 & n.30 (1967) (discussing, in dicta, the supererogation theory as applied to insurance products). This interpretive approach, however, is inconsistent with modern practice, especially when extended to the Securities Exchange Act of 1934, which has a quite narrowly exemption for insurance products. *See* Securities Exchange Act of 1934 § 12(g)(2)(G), 15 U.S.C. § 78*l*(2)(G) (2018). Accordingly, while the matter is not free from doubt, the SEC, or a disgruntled purchaser of certain insurance products, could plausibly seek redress under the 1934 Act for fraudulent sales practices in connection with such products. Even without such a revisiting of federal securities jurisdiction, state insurance commissioners could model disclosure and reporting standards in lines with suggestions made below.

[51] For an introduction to the evolution towards omnibus accounts, *see* Gwendolyn A. Williamson, *Tackling Mutual Fund Risks in the Omnibus Channel*, THE INVESTMENT LAWYER, July 2017 ("two-thirds of mutual fund shareholders invested outside of an employer-sponsored retirement plan, approximately 80 percent own fund shares through financial intermediaries.").

[52] For an overview of the SEC's work in this area, *see* SEC Division of Investment Management Guidance Update No. 2016-01 (Jan. 2016).

administrative function like sub-transfer agency services, the risk arises that fees nominally designated for one purpose (shareholder administration) are actually being used for another (distribution), but without the safeguards that SEC Rule 12b-1 demands.[53] In other words, enforcement efforts in this area are intended to prevent the evasion of one element of the system of mutual fund fiduciary protections by moving one service—sub-transfer agency—beyond direct oversight of the mutual fund and its board.[54]

B. Distribution of Funds Through Individual Accounts

Another industry development in this area has also produced enforcement actions,[55] andis almost certainly of greater significance. Increasingly, brokerage firms and investment advisers are in the business of allocating retail investor accounts into mutual funds of various sorts, as opposed to positions in individual securities, into which securities firms traditionally steered their customers.[56] Thus, these firms represent both important distribution channels for a mutual fund complex and are, effectively, asset allocators for retail investors. In many cases, securities firms follow common investment strategies for many customers, based on a limited number of considerations, such as risk-return preferences, projected length of investment holdings, and tax considerations. The automation of this process is even more pronounced with robo-advisers that rely heavily on algorithmic models and very little on personal discretion. As a functional matter, what these securities firms are offering their clients is a financial product that is similar to a fund-of-funds mutual fund.[57] While the underlying mutual funds may be held in the account of an individual customer, these investments are actually aggregated at the omnibus account level and generate very similar, if not identical, returns for a large number of retail investors with similar risk-return preferences and other characteristics.

But, of course, the regulation of these mutual fund allocation accounts is quite different from the regulation of a fund-of-funds mutual fund. Among other things, there is no independent board overseeing the operation of allocation accounts or ensuring that the total fees charged by the account managers are reasonable. Perhaps even more importantly, the regulatory requirements of brokerage firms do not demand clear and consistent disclosures of aggregate fees (including both securities firm level fees and underlying fund fees) nor are these brokerage accounts subject to standardized disclosures of past performance as measured against

[53] *See*, *e.g.,* In the matter of First Eagle Investment Management, et al., Investment Company Act Release No. 4199 (Sep. 21, 2015) (a widely publicized SEC action against an investment adviser found to have caused a fund to pay a sub-transfer agent for distribution related activities outside of Rule 12b-1).

[54] More recently, SEC staff has focused its attention on the use of revenue sharing by investment advisers used to support distribution efforts through intermediaries. As these payments do not constitute the direct application of fund assets for distribution expenses, Rule 12b-1 does not come into play. The staff's enforcement efforts here focus rather on the adequacy of disclosures made to investors about these practices and the possibility that such payments might induce intermediaries to steer investors towards mutual fund share classes with higher costs, a concern at the heart of Regulation BI. *See* Carmen Germaine, *SEC Case Takes Revenue-Sharing Rules in a Completely New Direction,* IGNITES (Aug. 9, 2019).

[55] *See* SEC Press Release: SEC Share Class Initiative Returning More than $125 Million to Investors (Mar. 11, 2019), https://www.sec.gov/news/press-release/2019-28.

[56] For an overview of these developments, *see* Jennifer L. Klass & Eric Perelman, The Evolution of Advice: Digital Investment Advisers as Fiduciaries (Oct. 2016), *available at* https://www.morganlewis.com/-/media/files/publication/report/im-the-evolution-of-advice-digital-investment-advisers-as-fiduciaries-october-2016.ashx?la=en&hash=7A28D9586FD8ACADC9731733BFE4281F4E6FEB49. Even before the rise of robo-advisers, there was empirical evidence that investment advisers tended to structure their clients' portfolios in a similar and not especially efficient manner. *See, e.g.*, *Retail Financial Advice: Does One Size Fit All?*, 72 J. FIN. 1441 (2017) (offering evidence that an adviser's own asset allocation strongly predicts the allocations of its clients).

[57] Notwithstanding these functional similarities, investment advisory programs enjoy a broad safe harbor exemption under Investment Company Act of 1940 Rule 3a-4, 17 CFR § 270.31-4 (2019). Wrap accounts are also subject to special disclosure requirements under Investment Advisers Act of 1940 Rule 204(c)(3)(d), 17 CFR § 275.204(c)(3)(d) (2019).

benchmark indices. Indeed, FINRA and SEC disclosure rules actually discourage reporting of past performance on individual accounts in marketing literature.[58]

Though not often framed in this way, the Department of Labor's now defunct fiduciary rule and SEC's recent adoption of Regulation BI and associated guidance can be seen as attempts to impose a more rigorous regulatory structure primarily around the distribution of mutual fund shares of various classes to retail investors. The DOL rule attempted to resolve the problem by elevating the fiduciary obligations of broker-dealers to preclude certain sales practices and force firms to distribute "clean" share classes with lower fees and also lower-priced index funds. The SEC's Regulation BI and associated guidance rely more heavily on disclosure rules for potential conflicts but address essentially the same problem. Neither approach attempts to bring allocated accounts up to the same level of disclosure of funds-of-funds and neither approach imposes the kind of gatekeeper protections that mutual fund boards provide. To be sure—and as is explored below—replicating mutual fund regulation at the broker-dealer or investment adviser level would face non-trivial challenges.[59] But with the likely growth of robo-advisers, functionally similar pooled investment vehicles consisting largely, if not exclusively, of allocations to mutual fund investments are destined to become a serious competitor to funds-of-funds, but a competitor operating under a quite different regulatory regime.[60]

C. Managed Accounts

Another common substitute for mutual funds as a pooled investment vehicle is the managed or separate account. Often times, investment advisers will offer clients with large balances the opportunity to invest through these accounts rather than through mutual funds.[61] In many instances, the managed accounts will have precisely the same investment strategy and portfolio of securities as existing mutual funds. Indeed, asset managers often use their mutual fund performance as a marketing vehicle to attract institutional investors, and in some instances wealthy clients, to managed accounts. This practice, which is widespread in the financial services industry, demonstrates how relatively simple it is for asset managers to replicate the performance of mutual funds in other pooled vehicles. To the extent that managed accounts have traditionally been distributed in the institutional market and towealthy individuals, issues of investor protection may not have been especially acute in this context.[62] Sophisticated parties can insist on getting performance reports, possibly demanding GIPS

[58] For an overview of SEC regulation of performance advertising by registered investment advisers and broker dealers, *see* SEC STAFF STUDY ON INVESTMENT ADVISERS AND BROKER DEALERS 30, 71 (Jan. 2011). *See also* SEC Office of Compliance and Examinations, *The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations on Investment Advisers*, NATIONAL EXAM PROGRAM RISK ALERT (Sept 14, 2017); SEC Proposed Rule on Investment Adviser Advertisements, 84 Fed. Reg. 67,518 (Dec. 10, 2019).

[59] Interestingly, however, some analysts have suggested that robo-advisers should in some instances be regulated as mutual funds *See, e.g.*, Melanie L. Fein, Robo-Advisors: A Closer Look 16 (June 30, 2015), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2658701. (stating that "[r]obo-advisors may be acting as unregistered investment companies in violation of the Investment Company Act of 1940 and SEC regulations thereunder" and questioning whether they meet the requirements of Rule 3a-4 "to the extent they do not manage client accounts on the basis of each client's financial situation and clients do not have reasonable access to personnel who are available to consult with the client").

[60] For a flavor of the competitive pressures from these new automated distributions channels, *see* Carmen Germaine, *Direct Platforms Steadily Encroach on Advisors' Turf,* IGNITES (Jan. 18, 2019). For a recent article exploring ways in which to enhance the disclosure obligations of robo-advisers, *see* Nicole G. Iannarone, *Rethinking Automated Investment Adviser Disclosures*, 50 U. TOL. L. REV. 433 (2019).

[61] *See, e.g.*, Legg Mason, A Guide to Separately Managed Accounts at 4 (visited May 11, 2020), *available at* https://www.leggmason.com/content/dam/legg-mason/documents/en/insights-and-education/brochure/investor-education-sma.pdf (comparing separately managed accounts to mutual funds and noting, among other things, the lower administrative costs of SMAs).

[62] Of course, to the extent that financial services firms lower the minimum balances required for separately managed accounts, there is the possibility that more individuals without a high net worth or investing sophistication will be drawn into those investment

compliance,[63] and also seek detailed information on fees and other expenses. The choice of asset managers to place these larger customers into managed accounts is often justified as reducing compliance costs for the managed accounts as opposed to those costs associated with mutual fund regulation (presumably with savings shared at least in part with managed account customers).[64] The allure of such savings in regulatory costs encourages asset managers to avoid, if possible, the burdens of mutual fund regulation in other contexts as well, including distribution channels where the ultimate investor is an unsophisticated individual.[65] It is to those other contexts that I now turn.

D. Placement of Mutual Fund Shares in Other Pooled Vehicles for Retail Investors

There are a host of contexts in which mutual fund shares are distributed to retail investors through pooled vehicles not directly subject to mutual fund regulation. These "outer wrappers" are often trusts or other legal entities with different and less onerous regulatory requirements. Investment advisers—either directly or more commonly through affiliated entities—often charge additional fees for these outer wrappers and those fees are not, as currently structured, subject to mutual fund board oversight or the kinds of enhanced fiduciary protections that mutual fund regulation affords.

i. Collective Investment Trusts. One economically significant example of this phenomenon is the collective investment trust, which many 401(k) plans now feature on their retirement platforms, often for their default investment option.[66] Unlike traditional target date funds (organized as funds-of-funds), these collective investment trusts are not regulated as 1940 Act investment companies, even though their underlying holdings may consist entirely, or almost entirely, of mutual funds and are often designed to replicate comparable target-date funds

vehicles. *See* Legg Mason, *supra* note 60 (reporting $50,000 minimum balance requirements for separately managed accounts). In that case, separately managed accounts begin to resemble some of the other pooled investment vehicles discussed below.

[63] For an overview of GIPS performance standards, *see* ACA Compliance Group & BNY Mellon, Practical Guidance: the GIPS® Standards for Asset Owners, at 3 (visited May 11, 2020), *available at* https://www.bnymellon.com/_global-assets/pdf/our-thinking/practical-guidance-the-gips-standards-for-asset-owners.pdf ("The popularity and worldwide adoption of the Global Investment Performance Standards (GIPS) by investment management firms is largely due to demand by asset owners. In order to trust investment performance when hiring an outsourced manager, asset owners increasingly require investment managers to comply with the GIPS standards."). *See also* CFA Institute, Global Investment Performance Standards (visited July 5, 2020), *available at* https://www.gipsstandards.org/standards/2020/Pages/asset_owners.aspx.

[64] One context in which managed account programs interact with mutual fund regulation is in the annual section 15(c) procedures where mutual fund boards assess the reasonableness of fund fees and may consider, among other things, the fees charged by investment advisers to other customers. Often times, lower prices charged on managed accounts are a subject of discussion and the issue of differences in regulatory costs is often a factor advanced as a justification for the differentials. *See* Jones v. Harris, 559 U.S. 335, 349-51 & n.8 (2010) (recognizing pricing differentials between mutual funds and institutional accounts). As one astute reader of an earlier draft of this chapter notes, the point I am making here turns the *Jones v. Harris* litigation on its head, in that managed accounts are not here being introduced as evidence that mutual fund fees are too high, but rather to raise the possibility that the relatively lax supervisory safeguards underlying managed accounts may raise issues of regulatory concern.

[65] Indeed, one can see this process at work in a recent trend of employer-sponsored 401(k) plans to "transition" participants from target-date funds into customized managed accounts at a certain age. *See* Carmen Germaine, *Schwab Planning Hybrid Target-Date Fund, Managed Account Service*, IGNITES (Nov. 15, 2019) ("Managed accounts were available in 59% of defined contribution plans in 2018, up from just 36% in 2016 . . . [a]nd DC plan assets in managed accounts grew by more than 80% in the five years ended with 2018 . . . "). In this hybrid model, the underlying investments in the managed accounts can remain the same mutual fund products, but with customized rebalancing to reflect investor characteristics and with additional fees charged at the managed account level. *See* Anne Tergesen, *How Your 401(k) Could Imitate Netflix*, WALL ST. J. (Feb. 14, 2019) (reporting fees at the managed account level of 8 to 23 basis points, in addition to the underlying investment fees). These hybrid products function in a manner quite similar to robo-advised accounts (discussed earlier) with automated allocations to mutual funds. This form of managed account is conceptually similar to the retail products analyzed in the next subsection, although the design components—limiting access to retirement accounts of older workers—suggests that many investors in these accounts will have substantial balances and, in many instances, qualify as accredited investors and thus arguably constitute wealthy households traditionally targeted for separately managed accounts.

[66] *See* Cerulli Press Release: CITs Offer Major Cost Advantages, But Education and Transparency will be Essential (Aug. 2019) ("CIT assets stood at $3 trillion as of year-end 2018. The vehicle exhibited a compound annual growth rate (CAGR) of 7.25% over the five-year period ended 2018.").

offered by the sponsoring asset manager.[67] In other instances, the collective investment trusts may be customized based on employer specification, but they remain functionally similar to target date funds operated as funds-of-funds. The collective investment trusts are governed by ordinary trust principles and, if the trustee is a regulated entity, such as a bank, may also be subject to additional regulatory obligations.[68] But legal protections at the collective investment trust level are not fully comparable to mutual fund regulation, and, again, one of the justifications for moving to this structure is a lowering of regulatory costs. Even proponents of CITs recognize the need to improve product transparency, including more comprehensive disclosure of all in-costs.[69]

ii. ERISA Pension Plans. Even without collective investment trusts, investment advisers and their affiliates often provide services to retirement plans at the plan level—such as recordkeeping and other administrative services—and charge the plan sponsor fees for those services. In some cases, and increasingly, the plan sponsors will then deduct those fees (or a portion thereof) from employee retirement accounts. As a matter of legal design, these affiliated services and fee arrangements all take place outside of mutual fund regulation and are primarily regulated by the Department of Labor under ERISA.[70] Over the past decade, the Department has examined the economic relationship between asset managers and ERISA retirement plan, primarily focusing on accurate and complete disclosures, include fee disclosures and revenue sharing practices.[71] But the relationship of this practice in terms of mutual fund regulation has not, as best I can tell, been carefully examined. Adding a layer of fees (paid to investment advisers or their affiliates) at the plan level is in certain respects analogous to the sub-transfer agency fee problem discussed earlier. If those charges were imposed at the mutual fund level, they would be subject to a high degree of board scrutiny and regulation under mutual fund disclosure and performance rules. But when those charges are moved out to the ERISA retirement plan level, their regulation changes and, on many critical dimensions, weakens. This differential encourages asset managers to lower mutual fund fees distributed through ERISA retirement plans and bulk up plan level charges. And, of course, the retail investor faces the

[67] *See* Robert Powell, *Retirement: Everything You Need to Know About Collective Investment Trusts*, THE STREET (July 30, 2018) ("The trustee of the CIT is on the hook for everything to do with the CIT, including deciding who is going to make the day-to-day investment decisions. Sometimes it is the trustee of the CIT themselves, but often they will hire a sub-adviser to pick the stocks or bonds that will be held in the CIT. When the trustee decides to own one or more mutual funds in a CIT, they are by default outsourcing the day-to-day investment decisions to the portfolio manager of the mutual fund(s). The trustee of the CIT would then only be responsible for deciding which mutual funds (and the allocation to each if more than one), although the trustee would hire yet another investment professional to do that also.").

[68] For an overview of the operations and regulation of CITs, *see* COALITION OF COLLECTIVE INVESTMENT TRUSTS, WHITE PAPER ON COLLECTIVE INVESTMENT TRUSTS (Mar. 31, 2015) (describing legal structure including OCC regulations, 12 C.F.R. Part 9 (2019) (Fiduciary Activities of National Banks). On some dimensions, such as ERISA coverage, CITs may actually be more heavily regulated than mutual funds.

[69] *See* Cerulli Press Release, *supra* note 66 ("Another challenge that CIT providers face is addressing investors' expectations for transparency."). *See also* Cerulli Associates, CIT Provider Survey 7 (2019) (reporting that less than a quarter of CIT providers report to the public on all-in costs).

[70] For a discussion of the relationship between ERISA's regulation of investment vehicles and the broader landscape of fiduciary duties, *see* Arthur B. Laby, "Trust, Discretion, and ERISA Fiduciary Status," ch. __ (this volume).

[71] These DOL disclosure requirements relate both to service-provider disclosures to plan fiduciaries and fiduciary disclosures to plan participates. *See* DOL EMPLOYEE BENEFITS SECURITY ADMINISTRATION, RETIREMENT PLAN FEE DISCLOSURES (visited May 11, 2020), *available at* https://www.dol.gov/agencies/ebsa/key-topics/retirement/retirement-plan-fee-disclosures. For current purposes, it is the latter category of disclosure that is relevant. According to Fidelity, participant fee disclosures extend to "two broad types of information: (1) plan information, including administrative and individual expenses that may be charged against an individual's account; and (2) investment-related information for the plan's designated investment alternatives." *See* Fidelity Participant Summary of Disclosure Regulations (visited July 5, 2020), *available at* https://www.fidelity.com/retirement-ira/small-business/participant-disclosure-regulations-summary. For an insightful overview of revenue sharing practices under ERISA, *see* Dana Muir, *Revenue Sharing in 401(k) Plans: Employers as Monitors*, 20 CONN. INSUR. L.J. 485 (2014).

challenge of having to combine fee disclosures at two different levels in order to get a clear picture of fund costs.

iii. Other Examples. Once one is attuned to this phenomenon, one can find illustrations of mutual funds being distributed in less regulated outer layers with separate fees in a variety of contexts. Two prominent examples are two-tier variable annuity products, where the investment level is regulated as a mutual fund, but the outer layer is an insurance product not subject to mutual fund regulation and subject to separate and, in many cases quite substantial, additional fees.[72] Tax-favored 529 plans for education savings also have this structure. In many cases, these plans are limited to investing in underlying mutual funds, but are wrapped at the plan level by another legal entity with separate pricing arrangements, often offsetting fee changes at the underlying fund level, but with additional charges imposed outside the purview of mutual fund regulation.[73]

IV. POLICY CONSIDERATIONS GOING FORWARD

What are the policy implications of these developments? To be sure, the evolution of industry practices described could be viewed simply as a nice example of regulatory arbitrage. Quite naturally, asset managers have an incentive to organize their operations to minimize regulatory costs and maximize operational flexibility. In many contexts—especially where the client at issue is truly a sophisticated institutional investor with its own money at risk—the regulatory arbitrage may be socially desirable with few adverse consequences.[74] Conceivably, as industry gets more experience with less regulated pooled investment vehicles, the SEC might want to consider relaxing some obligations required of funds-of-funds and other investment companies under mutual fund regulation in light of industry innovations in analogous contexts if only to maintain a level playing field. On the other hand—and especially where the ultimate ownership of investments is at the retail level—policy makers might have legitimate concerns that the movement of pooled investment accounts outside of mutual fund regulation has deleterious consequences for individual investors. Moreover, the creation of a multi-tiered system of federal regulation for these vehicles could create pressures for more assets to move out into these hybrid arrangements and away from full compliance with mutual fund regulation. Without attempting to offer a definitive answer to these complex issues of regulatory design, I conclude this chapter with a few thoughts on what I think are some of the key issues.

A. Integrated Disclosure for Mutual Funds Distributed to Retail Investors through Other Pooled Vehicles

A major concern about the propagation of outer wraps outside the reach of mutual fund regulations is that individual investors in ERISA pension plans or some other pooled collective

[72] For a recent overview of the regulation of two-tier variable annuities, *see* Gary O. Cohen, *SEC Proposes Summary Prospectus for Variable Insurance Products*, 52 R. SECURITIES & COMMODITIES REGULATION 143 (June 19, 2019).

[73] The Municipal Securities Rulemaking Board (MSRB) has jurisdiction over 529 Plans. For an overview of the Board's requirements and fee disclosures, *see* MSRB Investor's Guide to 429 Savings Plans (visited May 11, 2020), *available at* http://www.msrb.org/msrb1/pdfs/MSRB-529-Investor-Guide.pdf. ("There are certain fees and charges assessed under a 529 savings plan that you may pay directly and indirectly. The fees and charges that you may pay directly are charged at the account or investment option level.").

[74] The caveat that the institutional investor must put itself at risk is an important one. While this may typically be true of managed accounts for some institutional investors, like defined benefit plans and insurance companies, it may not be true for defined contribution retirement plan arrangements, such as 401(k) plans or 529 plans. In those contexts, investment risk is borne by an employee and the employer/sponsor of the plans may well have an incentive to shift fees to plan participants. *See* Howell E. Jackson, *The Trilateral Dilemma in Financial Regulation*, in IMPROVING THE EFFECTIVENESS OF FINANCIAL EDUCATION AND SAVINGS PROGRAMS (Anna Maria Lusardi ed., 2008).

vehicles will be misled about the costs of investing in these funds because they will focus on the fee information in underlying fund prospectuses and not consider the additional costs imposed at the wrapper level. Omitting these outer wrapper fees will also tend to overstate reported performance. This is a disclosure problem that the SEC has addressed with considerable care in the context of fund-of-funds disclosures. A comparable approach could be developed for other pooled vehicles, perhaps drawing on industry standards for GIPS reporting. In many cases, however, the requirements would need to be imposed by other regulatory authorities, such as the Department of Labor for ERISA retirement plans and bank regulators for trusts with bank trustees. State law would presumably be required to address 529 plans disclosures and two-tier insurance annuity products.[75]

Differences in fiduciary oversight of mutual fund fees and charges as opposed to fees leveled on non-mutual fund pooled vehicles is a slightly more challenging problem. As noted, the 1940 Act's approach to mutual fund fees is highly stylized and relies on boards of directors with independent members and a supporting system of enhanced fiduciary obligations. Conceivably, some attention could be given to expanded fiduciary obligations on other parties, but precise or even approximate alignment with the mutual fund regime would be difficult to achieve. One modest accommodation could be addressed through traditional mutual fund regulation in the context of annual section 15(c) reviews of investment adviser fees. Among the criteria that board members are required to consider in assessing the reasonableness of advisory fees under the *Gartenberg* test are the profitability of the fund to the adviser as well as any "fall out" benefits the adviser obtains as a result of advising the fund. Fees and other revenue sources associated with the management of an outer wrapper used to distribute mutual funds could (and arguably should) be factored expressly into the consideration of these *Gartenberg* criteria.[76] Such an approach would put at least a modest constraint on fees and other charges imposed in the outer wrapper, at least when the underlying investments are made through registered funds and the outer wrapper is managed by, or contractually connected to, affiliated entities.[77]

B. Aligning Regulation of Allocated Accounts for Individual Retail Investors

The challenges of aligning regulation of discretionary accounts managed for retail investors are thornier but perhaps even more pressing. As technological developments and consumer preferences promote the growth of robo-advising, one can easily imagine steady growth of discretionary accounts—primarily invested in mutual funds through automated allocation software—replacing an ever larger share of retail investment. This process could even extend to a large fraction of the retirement savings space through brokerage platforms available on many ERISA retirement plans. As a legal matter, regulation governing these accounts has traditionally been rules designed for broker-dealers and registered investment advisers making recommendations with respect to specific securities. And, in certain respects, the SEC's recent efforts to clarify the duties of broker-dealers and investment advisers can be understood as

[75] The SEC does have specialized disclosure rules for variable insurance products and the 1940 Act itself does impose some soft obligations with respect to the reasonableness of overall fees on variable insurance products, but these standards do not replicate the kind of oversight or disclosure requirements for funds of funds. *See* Investment Company Act of 1940 § 26(f)(2)(A), 15 U.S.C. § 80a-26(f)(2)(A) (2018); SEC Final Rule on Updated Disclosures Requirements and Summary Prospectus for Variable Insurance Products and Variable Life Insurance Contracts, 85 Fed. Reg. 25,964 (May 1, 2020).

[76] *See* Krinsk v. Fund Asset Management, Inc., 715 F. Supp. 472, 494-95 (S.D.N.Y. 1988) (discussing primary and secondary fall-out benefits).

[77] An alternative and more heavy-handed approach would be to bring all of these outer-wrapper charges into approval procedures of the sort required for Rule 12b-1 fees.

stiffening the legal obligations of those firms to act in the best interest of clients invested in pooled vehicles.[78] But, as argued above, the financial products increasingly being offered through these distribution channels are functionally similar to personalized funds-of-funds, which are fully subject to mutual fund regulation. How might the rules for broker-dealers and investment advisers be aligned in this context?

As mentioned earlier, performance data and comprehensive fees data (that is fee data including not just wrapper fees, but underlying mutual fund fees and commissions) is not something that broker-dealers and registered investment advisers are typically required to report to the public. While a limited body of academic research suggests that returns on retail brokerage accounts are not good and perhaps should be better publicized,[79] there are practical difficulties in requiring brokerage firms to produce these disclosures. Assembling the data could be complicated on an individual level and it is not entirely clear how a brokerage house or registered investment adviser would report results for their entire client base. Would they report on the median or average customer or the distribution of all customers? The administrative difficulties have been daunting, which perhaps explains why reforms such as the SEC's Regulation BI and associated guidance have gravitated towards softer standards of conduct and disclosure obligations. On the other hand, one might legitimately worry whether these softer protections will create the same degree of protections (and market place discipline) that standardized disclosures and more rigorous fiduciary protections have afforded mutual fund investors in recent decades.

The rise of robo-advisers and algorithmic allocation models, while exacerbating the problem, also allows for new solutions.[80] For one thing, the automation inherent in robo-advising almost certainly diminishes the administrative challenges of producing standardized reports of all-in performance and total fees at the individual account level. More importantly, the standardization of investment advice from robo-advisers makes it possible to imagine the SEC developing a handful of model client profiles with stylized risk-return preferences, investment time horizons, and tax positions. Firms offering allocated accounts to individual investors could be required to report on the historic performance that their accounts would have earned for each model for standardized periods of time (e.g., one, three, five and ten year horizons) along with

[78] *See supra* notes 58_- 59 (discussing Regulation BI). To be sure, these enhancements may have a positive impact on investors and may focus examination personnel on the selection of mutual fund share classes and best execution practices in discretionary connects. But the question remains whether the articulation of open-ended duties in this context – which are apt to be diluted over time by disclosures and safe-harbor relief – will offer as effective protections for investors and consistent performance and total fee reported of the sort I advocate here.

[79] The evidence that individual investment portfolios under-perform the stock market averages is fairly substantial. *See* Bard Barber & Terrance Odean, *Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors*, 60 J. FIN. 773 (2000). *See also* Brad Barber & Terrance Odean, *The Behavior of Individual Investors*, in 2 HANDBOOK OF ECONOMICS OF FINANCE, (George Constatinides, Hilton Harris, & Rene Stulz eds., 2013). The extent to which this underperformance derives from poor investment advice is less well established, but certain a number of recent empirical studies point in that direction. *See, e.g.*, Juhani Linnainmaa et al., *The Misguided Beliefs of Financial Advisors* __ J. FIN. __ (forthcoming) (poor performance in personal accounts of advisers replicated in accounts recommended for their clients); Mark Egan et al., *The Market for Adviser Misconduct*, 127 J. POL. ECON. 233 (2019) (empirical study of adviser misconduct suggest that some financial firms specialize in misconduct and catering to unsophisticated customers).

[80] For a recent paper exploring new approaches to the regulation of robo-advisers, *see* Nicole G. Iannarone, *Rethinking Automated Investment Adviser Disclosure*, 50 U. TOL. L. REV. 433 (2019). *See also* Braiden Colman et al., *Man Versus Machine: A Comparison of Robo-Analyst and Traditional Research Analyst Investment Recommendations* (Feb. 2020), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3514879 (offering evidence that robo-advisers outperform traditional analysts).

information on total fees for comparable periods and prospectively.[81] This would replicate the fund-of-funds approach to disclosure and also generate the kinds of information that outside vendors, like Morningstar and Broadridge, could use to rank quality and promote effective competition. While this approach would not replicate the fiduciary oversight afforded under mutual fund regulation, it would substantially align market oversight.

V. CONCLUSION

Some degree of regulatory arbitrage is inherent in our fragmented system of financial regulation. Arbitrage can—and perhaps often does—facilitate beneficial innovation. Many of the boundary crossings documented in this chapter are likely of this character. But, regulatory arbitrage can evade important regulatory protections. That almost certainly was the case with money market mutual funds, an exercise of regulatory arbitrage with considerable consumer benefits in the 1990s and substantial negative externalities in the Financial Crisis of 2008. How much government officials should allow pooled investment vehicles for retail investors to escape the requirements of mutual fund regulation is an important and unresolved question in today's financial markets. At a minimum, it calls out for informed public debate and thoughtful regulatory consideration.

[81] Recently, the SEC signaled its openness to revisiting performance advertising in the context of investment advisers. See SEC Proposed Rule on Investment Adviser Advertisements; Compensation for Solicitations, 84 Fed. Reg. 67,518 (Dec. 10, 2019).