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# Investment Company as Instrument: The Limitations of the Corporate Governance Regulatory Paradigm

Anita K. Krug
*University of Washington School of Law*



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# INVESTMENT COMPANY AS INSTRUMENT: THE LIMITATIONS OF THE CORPORATE GOVERNANCE REGULATORY PARADIGM

ANITA K. KRUG*

## ABSTRACT

*U.S. regulation of public investment companies (such as mutual funds) is based on a notion that, from a governance perspective, investment companies are simply another type of business enterprise, not substantially different from companies that produce goods or provide (noninvestment) services. In other words, investment company regulation is founded on what this Article calls a "corporate governance paradigm," in that it provides a significant regulatory role for boards of directors, as the traditional governance mechanism in business enterprises, and is "entity centric," focusing on intraentity relationships to the exclusion of super-entity ones. This Article argues that corporate governance norms, which came to dominate U.S. investment company regulation as a result of the unique history of U.S. investment companies, are poorly-suited to achieve the goals of investment company regulation. In particular, the corporate governance paradigm has given rise to a number of regulatory weaknesses, which stem from investment advisers' effective control over investment company boards of directors and courts' deference to state corporate law doctrine in addressing investors' grievances. Accordingly, investment company regulation should acknowledge that investment companies are*

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*not merely another type of business enterprise with the same challenges and tensions arising from the separation of ownership and control that appear in the traditional corporate context. Toward that end, this Article contends that policymakers should view, and regulate, investment companies as an avenue through which investment advisers provide financial services (investment-advisory services, in particular) to investors—and should view investment company shareholders more as advisory customers than as equity owners of a firm. This "financial services" model of regulation moves past the entity focus of corporate governance norms and, therefore, permits dispensing with governance by an "independent" body such as the board of directors. More importantly, if adopted, this model would remedy some of the more significant problems plaguing U.S. investment company regulation.*

TABLE OF CONTENTS

# I. INTRODUCTION

Imagine, if you will, a corporation that has directors and shareholders but that neither produces any products nor provides any services. The corporation also has no employees: there is no CEO in charge of the corporation's activities, no CFO to mind the corporation's balance sheet, and no managers, salespersons, or administrative assistants carrying out the corporation's day-to-day activities.[1] Yet the corporation is far from inert. It takes on liabilities and earns income and, if all goes well, shows a healthy profit at the end of each accounting period. One might wonder how, with no personnel at all, this corporation is able to accomplish anything, much less generate returns for its shareholders. The answer is that this corporation is able to pursue its activities through having submitted itself to the control of another firm, a vendor of sorts that the corporation has contractually engaged, much as any firm might engage an accounting firm or a law firm. That other firm is the corporation's investment adviser, without which the corporation would not exist, let alone function. The corporation is a public investment company, also commonly (and somewhat inaccurately) known as a "mutual fund."[2]

Perhaps the foremost goal of investment company regulation is making the investment adviser accountable to the investment company and, specifically, obligated to further the investment company's interests over the adviser's own interests.[3] In the United States, that regulation has assumed a peculiar form, however—one that ultimately undermines its objectives. In particular, U.S. investment company regulation reflects a presumption that investment companies are business enterprises, not essentially different, from a governance perspective, from Procter & Gamble, Microsoft, or Facebook.[4] Regulation turns on the fact that a company is the regulatory subject, rather than that the company exists

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1. *See infra* note 37 and accompanying text. This absence of personnel stands in sharp contrast to typical companies, in which "the managers are full-time employees working for the benefit of the company's owners." *See* John P. Freeman, *The Mutual Fund Distribution Expense Mess*, 32 J. CORP. L. 739, 746 (2007).

2. *See infra* note 24 and accompanying text.

3. *See* Investment Company Act of 1940, 15 U.S.C. § 80a-1(b) (2006); Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights*, 34 J. CORP. L. 843, 857 (2009) (observing that investment company regulation attempts to address perceived abuses through "mandated disclosure to investors, prohibitions on self-dealing transactions, governance structure requirements, limitations on leveraging of fund assets, and bans on other transactions that would allow the fund sponsor (the Adviser) to siphon off investor money," and through "the requirement of mutual fund shareholder consent before changes are made to the fund objectives").

4. *See infra* Part II.

solely to facilitate the provision of investment advice to its shareholders.[5] By virtue of that focus, regulation bestows the primary regulatory role on investment company boards of directors, and thereby pursues its objectives through board control and oversight.[6] In other words, U.S. investment company regulation embodies a "corporate governance" regulatory paradigm.

This Article argues that the corporate governance regulatory fiction that investment company regulation embraces underlies many, if not most, of the significant problems that have come to overshadow the immense potential of the U.S. investment company industry. Among the oft-cited problems are that boards lack the expertise necessary to effectively monitor regulatory compliance and uphold shareholders' interests;[7] that shareholder apathy and complacency impede their exiting poorly managed funds;[8] that investment company management fees charged by investment advisers are excessive;[9] that investment companies are not sufficiently subject to the forces of competition and market discipline;[10] and that, overall, investment company shareholders are subject to abuse at the hands of those controlling and investing their assets.[11] This Article contends that such problems could be substantially mitigated if the norms guiding U.S. investment company regulation more accurately reflected the nature of the relationship between investment advisers, on one hand, and investment company shareholders, on the other.[12]

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5. As Alan Palmiter points out, although the U.S. investment company regulatory regime "effectively assumes that mutual funds will be organized as (or along the lines of) a corporation," it does not require investment companies to assume the corporate form. Alan R. Palmiter, *The Mutual Fund Board: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 165, 167–68 (2006). Some investment companies, for example, are formally organized as statutory trusts, rather than as corporations. However, regardless of whether the fund is structured as a corporation or as a trust, "[t]here must be a board of directors (or its equivalent) to oversee fund operations," as well as "shareholder voting to elect board members and approve fundamental changes." *Id.* at 168–69 (footnotes omitted).

6. *See* 15 U.S.C. § 80a *passim*.

7. *See infra* note 78 and accompanying text.

8. *See* Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1035–36 (2005) (observing that "[m]oney does not exit poorly performing funds with the same velocity" as it enters well-performing funds).

9. *See* A. Joseph Warburton, *Should Mutual Funds Be Corporations? A Legal & Econometric Analysis*, 33 J. CORP. L. 745, 753 (2008).

10. *See* Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and Gartenberg at Twenty-Five*, 61 VAND. L. REV. 497, 505–06 (2008) (arguing that a number of factors limit the ability of competition to bring down the fees imposed on investors).

11. *See infra* Parts II.B, III.A.

12. The difficulties apparent in U.S. investment company regulation are all the more acute given the backdrop of an increasingly global investment arena, in which investment companies (regardless of

The reform project this Article undertakes is critical.[13] Among the institutional investors that have come to dominate securities investing, investment companies are the primary repositories of the investment capital of retail investors, serving as intermediaries between those investors and securities of public companies in which investors seek to hold economic interests.[14] Indeed, a significant percentage of U.S. households hold investments in mutual funds and other publicly offered and traded investment companies, whether directly or through employee pension funds.[15] In an institutionalized investment universe, therefore, investment companies should be a core regulatory focus because securities regulation (appropriately) is more concerned with retail investors than with "sophisticated" investors, however "sophistication" may be defined. Accordingly, investment company regulation should also be a primary focus of creative thinking about securities regulatory reform.

In making its case for a markedly revised U.S. investment company regulatory regime, this Article departs from the literature to date on the

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the jurisdictions in which they are based and by which they are regulated) are pursuing international investment opportunities, seeking to attract international investors, and, more generally, striving to remain competitive with their foreign counterparts. It is conceivable that the U.S. regulatory embrace of the corporate governance paradigm constitutes an impediment to coordinated investment company regulation that, in turn, may hinder cross-border investment company activity. The prospect of coordinated investment company regulation is a prospect for more efficient investment processes, more robust global investment activity, and more significant capital formation. *See* Anita K. Krug, Assistant Professor, Univ. of Wash. Sch. of Law, Multilateral Convergence in Investment Laws and Norms, Presentation at the Asian International Economic Law Network 2011 Conference, University of Hong Kong (Jul. 15, 2011) (on file with author).

13. That recent U.S. financial regulatory reform efforts paid relatively little attention to investment company regulation is not particularly significant because the primary goal of that reform—systemic risk mitigation and prevention—is not the traditional goal of securities regulation, including investment company regulation, which was, and remains, investor protection. *See, e.g.*, Alan W. Avery, Kathleen A. Scott & Lindsey Carson, *Dodd-Frank Act Attempts to Curtail Systemic Risk*, 127 BANKING L.J. 766, 766 (2010) ("One of the most cited impetuses behind the Dodd-Frank Wall Street Reform and Consumer Protection Act . . . has been the need to curtail the systemic risk potentially posed by large, interconnected firms . . . ."); Amir N. Licht, *Genie in a Bottle? Assessing Managerial Opportunism in International Securities Transactions*, 2000 COLUM. BUS. L. REV. 51, 104 ("[T]he very root of the mandate for securities regulation [is] investor protection.").

14. *See* Brian G. Cartwright, *Whither the SEC Now?*, 95 VA. L. REV. 1085, 1090–92 (2009).

15. The Investment Company Institute reports that, in 2008, "[a]mong households owning mutual funds, the median amount invested in mutual funds was $100,000," and, for 69 percent of households owning mutual funds, those holdings "represented more than half of household financial assets." *Frequently Asked Questions About Mutual Fund Shareholders*, INV. CO. INST., http://www.ici.org/faqs/faq/faqs_mf_shareholders#significance (last visited Oct. 31, 2012); Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 1963 (2010) ("The mutual fund is the dominant form of intermediated investment. At the end of 2008, even after much of the market collapse, equity mutual funds held over $3.7 trillion in assets, ninety-two percent of which were contributed by the household sector.").

shortcomings of, and prescriptions for, investment company regulation by arguing that truly coherent regulation can be achieved only by extricating it from corporate governance norms and placing it firmly within the auspices of securities regulation—which need not heed boundaries imposed by notions of corporate personhood. The management of investment companies must be seen as simply another means through which investment advisers provide services to others, different in degree but not in kind from an adviser's provision of services to institutional or individual clients, pension plans, or hedge funds. In other words, regulation should reflect that an investment adviser has a financial services relationship to investment company shareholders—a relationship that resembles the adviser's relationships to investors that engage the adviser directly (rather than indirectly, as is the case when investors buy shares of an investment company the adviser manages).

The result of this analysis is that an investment adviser should be accountable for its actions not to an "independent" board of directors that the adviser played a role in selecting and with whom it has too close a relationship but, rather, to the securities regulator charged with maintaining the integrity of the securities markets and to the shareholders who have placed their capital under the adviser's management. Notably, however, this Article's proposal for investment company regulatory reform is not a proposal for additional regulation. It is a proposal for better regulation—regulation that is more coherent and more effective in furthering the investor protection objectives of securities regulation. Put another way, this Article's point of departure is that there exists a market failure necessitating regulation of investment companies. It focuses solely on how best to address that market failure and, in that regard, asserts that, as between an investment company and its investment adviser, regulation should be more directly aimed at the latter.

Part II of this Article delves into the nature and history of U.S. regulation of investment companies and how that history informed and continues to reinforce a corporate governance mode of securities regulation. It asserts that, by maintaining the fiction that an investment company is just another business enterprise that is to be evaluated and regulated based on traditional corporate governance norms, U.S. investment company regulation employs the wrong paradigm, to the detriment of regulatory coherence. Part III explores how the relationship between investment advisers, on one hand, and investment companies and their boards of directors, on the other hand, renders boards not only dependent on investment advisers in carrying out their oversight functions, but also conflicted and beholden to investment advisers—a difficulty that is exacerbated to the extent directors lack industry expertise. Part IV explores additional difficulties arising from the corporate governance regulatory model that stem from courts' deference to state corporate law principles in evaluating not only shareholder fiduciary duty claims but also claims alleging securities fraud. Part V introduces an alternative model of investment company regulation—a "financial services" model—which eschews reliance on corporate governance principles in favor of more direct regulation of investment advisers, as investment companies' primary decisionmakers. Part V also asserts that regulation would better serve its objectives by acknowledging that investment companies are another means through which financial services providers (namely, investment advisers) provide their services to investors (namely, investment company shareholders).

## II. THE CORPORATE GOVERNANCE PARADIGM

### A. HISTORY (AND DEVOLUTION) OF INVESTMENT COMPANY REGULATION

The U.S. Congress set about to establish a regulatory regime governing investment companies in the 1930s and completed the task with the passage of the Investment Company Act of 1940 ("ICA").[16] At that time, a good number of investment companies in existence resembled, in many respects, business enterprises that produced goods or provided (noninvestment) services—which this Article refers to as "operating companies."[17] They had officers, employees, and other personnel, all of whom performed particular functions for the enterprise and were paid salaries out of revenues earned by the company.[18] The difference between an investment company and an operating company was simply that the former's assets were largely devoted to holding ownership interests in other corporations. Given this blurring of companies providing products or services and those investing in other companies, "investment company" came to be defined in the ICA simply as a company as to which "more than one-half of its assets, other than cash and United States Government

16. *See* Investment Advisers Act of 1940, 15 U.S.C. §§ 80a-1 to a-64 (2006). For a summary of the history and background of U.S. investment company regulation, see Jerry W. Markham, *Mutual Fund Scandals—A Comparative Analysis of the Role of Corporate Governance in the Regulation of Collective Investments*, 3 HASTINGS BUS. L.J. 67, 69–79 (2006).

17. *See* SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES REPORT, PART ONE, H.R. Doc. No. 707, at 65–97 (3d Sess. 1938) [hereinafter SEC CLASSIFICATION REPORT].

18. *See id.*

securities, consisted of securities other than securities of subsidiary companies which were not investment companies."[19]

To be sure, there were variations in the structure and operations of companies falling within the definition. In the mid-1930s, the SEC, in a report to Congress on the need for regulation covering investment companies, chronicled a number of permutations of the investment company structure.[20] As the SEC noted in that report,

> The lack of a crystallized financial opinion respecting the function of investment companies and the absence of virtually any governmental supervision or legal restrictions specifically applicable to their sponsorship or formation, to the distribution of their securities or to their management and operations explain in large part the wide diversity of type . . . .[21]

For example, some investment companies had previously been industrial, utility, or financial companies that departed from their previous areas of operations, refocusing on investment activities while maintaining generally the same body of shareholders.[22] Some investment companies pursued the sorts of activities that operating companies pursued—deploying their assets to buy capital equipment, pay suppliers, and compensate employees—but also, as part of their activities (and unrelated to their other business activities), devoted a portion of their operating capital to ownership positions in other companies for investment purposes.[23] Still other investment companies were more fundamentally investment oriented.[24]

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19. *See id.* at 19.

20. *See id.* at 21–34.

21. *Id.* at 35.

22. *See id.* at 83–85; Markham, *supra* note 16, at 71 (chronicling the history of U.S. investment companies and describing the Massachusetts Hospital Life Insurance Company, which, though originally chartered as an insurance company, began to operate similarly to an investment trust).

23. *See* SEC CLASSIFICATION REPORT, *supra* note 17, at 76–83.

24. For these companies, as suggested above, it was often the case that investment decisionmakers pursued their role as managers of the organization (rather than as third-party independent contractors) and were compensated much in the manner that a CEO or other executive of an operating company would be compensated. *See* John C. Bogle, *Re-Mutualizing the Mutual Fund Industry—The Alpha and the Omega*, 45 B.C. L. REV. 391, 391–92 (2004) [hereinafter *The Alpha and the Omega*] ("The mutual fund industry began in 1924 with the formation of a truly *mutual* mutual fund: one organized, operated, and managed, not by a separate management company with its own commercial interests, but by its own trustees; compensated not on the basis of the trust's principal, but, under traditional fiduciary standards, its income."). Those companies were the true "mutual" funds, a name that remains attached to U.S. investment companies, notwithstanding how radically different today's investment companies are structured. *See id.* at 392. Indeed, "the phrase *mutual funds* does not appear in the [ICA]." John C. Bogle, *A New Order of Things—Bringing Mutuality to the "Mutual Fund,"* 27 REV. BANKING & FIN. L. 471, 472 (2008).

Despite this operational diversity, the SEC's report revealed the extent to which investment companies were beholden to the operating company form. Like operating companies, these companies generally assumed a corporate form of organization.[25] They were largely organized "under the general corporation laws of the several states, and not under any special acts like those governing banks or insurance companies."[26] Therefore, as with operating companies, investment companies were governed by boards of directors. In addition, and importantly, most of the early investment companies were of the "closed-end" type, meaning that shareholders did not have the right, at their election, to redeem their shares on demand, in exchange for the net asset value of those shares.[27] Rather, as was (and remains) the case for publicly traded operating companies, shareholders could dispose of their shares only by selling them in the open market on an organized stock exchange.[28] Conversely, investors that wished to "participate in the enterprise" after its initial offering of securities could do so only by purchasing those securities in the open market or over the counter.[29]

Each incarnation of "investment company" that Congress may have considered as it formulated the ICA, then, was in some sense derivative of operating companies. Particularly without any regulation governing them, investment companies were likely seen as different in degree from operating companies, rather than different in kind, contours that the ICA came to follow rather than challenge. Presumably because investment companies appeared to have emerged from operating companies, Congress's consideration of them, like the SEC's, was entity centric. Policymakers contemplated investment companies' investor-protection shortcomings by asking, first, about what types of investment companies existed and what their activities were and, only second, about the sponsors, brokers, investment-advisory firms, banks, and others that were involved in their operations.[30] Indeed, the SEC's almost singular focus in its report to

25. *See* SEC CLASSIFICATION REPORT, *supra* note 17, at 22.

26. *Id.*

27. *See id.* at 26.

28. *See* Markham, *supra* note 16, at 74 (noting that investors in early U.S. investment companies "bought and sold shares in investment companies through a secondary market after the initial distribution of the shares").

29. SEC CLASSIFICATION REPORT, *supra* note 17, at 26–27. To be sure, there were exceptions, with some investment companies organized as business trusts and/or assuming an open-end structure that allowed shareholders to come and go, similar to the model that prevails today. *See id.*

30. *See, e.g.*, *id.* at vi–vii (showing, in its table of contents, that the SEC focused first on the "nature and classification of investment trusts and investment companies" and, only after that preliminary discussion, turned to a discussion of the "origins of the investment trust and investment

Congress was on defining and classifying investment companies based on its survey of the industry, as opposed to the alternative approach of cataloguing and classifying those who formed and managed investment companies and their incentives for doing so.[31] Because the entity, rather than its organizers, was policymakers' starting point, and because policymakers may not have perceived a distinct line between "operating company" and "investment company," it should be no surprise that investment company regulation came to be modeled on corporate governance norms.

The ICA is reminiscent of corporate codes, specifying the roles and responsibilities of boards of directors vis-à-vis shareholders. The ICA also provides that boards play a significant role in the ICA's regulatory structure, charging them with oversight of investment company regulatory compliance.[32] Through providing that role for directors, moreover, the ICA constitutes a model of self-regulation.[33] Rather than tasking the SEC with formulating specific rules and restrictions governing all details of an investment company's operations, the ICA sets standards and principles that the board of directors must uphold in overseeing the investment company's activities and, in particular, approving or disapproving any particular conduct that the company's officers and managers may wish to pursue.[34] To the extent that regulation based on self-regulation is effective—in the sense of achieving the regulation's goals—then the advantages are evident. More self-regulation means less government involvement in private activities and, more importantly, fewer government resources devoted to oversight in the form of examinations, investigations, and enforcement actions.[35] The critical question regarding any form of self-regulation, of course, is also evident: Is it effective?

Whatever the answer to that question may have been at the outset, given the transformation of the investment company industry in the intervening seventy-two years, it now must be "no." Much has changed in

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company movement in the United States," which mentioned "organizations influencing the early form and growth of investment companies," such as savings banks and security affiliates, and the development of "sponsor interest" in investment companies).

31. *See supra* text accompanying notes 20–24.

32. *See* Investment Advisers Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (2006).

33. *See* Warburton, *supra* note 9, at 750 ("The board of directors is intended to be a monitor, protecting the interests of mutual fund investors in situations where the investment adviser could exploit them.").

34. *See id.*

35. *See* IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE 110–13 (1992).

terms of investment company activities and relationships. As noted,[36] today, unlike operating companies, investment companies have no officers.[37] They have no employees. They have no administrative staff. They do, however, have an investment adviser. That investment adviser is not "internal" to the investment company but, rather, may be thought of as a third-party service provider, and the terms of the relationship between the company and the adviser are set forth in an investment-advisory contract.[38] It is the investment adviser that has employees and administrative personnel, some or all of whom may be involved with carrying out the investment company's day-to-day functions.[39] In other words, the investment company effectively "contracts out" for its personnel. In its role, the investment adviser essentially dominates an investment company's activities, from the decisions about director nominees, to the decisions about who will be the company's administrator, auditor, transfer agent, and brokers, to the decisions about what securities the company will buy and sell.[40] So much has changed, from a structural perspective, that the corporate governance model seems extremely outdated and incongruent with the way in which today's investment companies operate.[41]

Without more, of course, the role of the investment adviser need not have significant implications for the relationship of management (that is, the investment company's board of directors) to shareholders or for management's effectiveness in upholding shareholder interests. After all, much as the board of an operating company may terminate and replace the company's CEO or other personnel, so could the board of directors of an

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36. *See supra* Part I.

37. An investment company's board may nominally appoint officers, such as a president, a treasurer, or a secretary, and is required, pursuant to the SEC's regulations under the ICA, to appoint a "chief compliance officer." 17 C.F.R. § 270.38a-1(a)(4) (2012). However, those officers are typically employees of the investment company's investment adviser. *See* INDEP. DIRS. COUNCIL, FUNDAMENTALS FOR NEWER DIRECTORS 4 ( 2011).

38. *See* Johnson, *supra* note 10, at 503 ("Management of investment company assets . . . is not provided internally but by an external investment adviser pursuant to an advisory contract negotiated and approved by the fund's board of directors.").

39. *See id.* ("[The investment] adviser establishes and 'sponsors' the investment company and provides all necessary personnel, facilities, and expertise."); Tannenbaum v. Zeller, 552 F.2d 402, 405 (2d Cir. 1977) (observing that the investment adviser is "an independent entity which generally organizes the fund and provides it with investment advice, management services, and office space and staff").

40. *See, e.g.*, Jones v. Harris Assocs., L.P., 130 S. Ct. 1418, 1422 (2010) (noting in its description of "mutual funds" that "[a] separate entity called an investment adviser creates the mutual fund, which may have no employees of its own," and that "[t]he adviser selects the fund's directors, manages the fund's investments, and provides other services") (citations omitted).

41. *See* Langevoort, *supra* note 8, at 1031 ("Mutual funds are not enough like business corporations for there to be any more than a facile analogy.").

investment company terminate the contract between the company and the investment adviser, replacing the adviser with a more suitable substitute.[42] There is, however, "more." The critical aspect of the relationship between an investment adviser and "its" investment company is that the investment adviser is not analogous to an officer or employee that the board can hire and fire.[43] That is because, as suggested above, the investment adviser typically is the company's raison d'etre, without which the investment company would not exist.[44] A decision by an investment company's board of directors to terminate the investment-advisory contract is effectively a decision to terminate the directors' position on the board and, indeed, the company itself.[45] As discussed in Part III, this relationship of the investment adviser to the investment company, and to its directors in particular, effectively undermines the efficacy and coherence of investment company regulation.[46] It is also why righting the ship of investment company regulation requires more than tweaking a few regulatory provisions here and there.

## B. CORPORATE GOVERNANCE NORMS ≠ SECURITIES REGULATION

That a corporate governance model of investment company regulation may produce dysfunctions of the scope apparent in the U.S. investment company industry is also evident from a second, more theoretical, perspective. The laws and norms structuring any system of corporate governance have a purpose different from the purpose behind securities regulation. Securities regulation exists to ensure that investors are

42. *See* Investment Advisers Act of 1940, 15 U.S.C. § 80a-15(c) (2006) ("[I]t shall be unlawful for any registered investment company . . . to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors . . . .").

43. *See* Warburton, *supra* note 9, at 752 ("[I]nstances of a board choosing to replace the fund's adviser are rare.").

44. *See Jones*, 130 S. Ct. at 1422.

45. *See* Warburton, *supra* note 9, at 752 ("Given [the] special relationship between an adviser and its fund, it is unrealistic to expect an independent director to sever that relationship, particularly since most directors are initially selected by the adviser.").

46. Of course, we might also say that an operating company's board is similarly influenced or implicitly controlled by the company's CEO (or other of management), so as to restrain the board's discretion in terminating that person or altering the terms that person's relationship with the company. *See* Lucian Arye Bebchuck, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 768–69 (2002). Accordingly, the observations made here as to the overwhelming influence of investment advisers on investment companies, and their effect on the efficacy of investment company regulation, may be apt also in the operating company context and, in particular, regarding the conditions that foster good corporate governance. That question, however, lies beyond this Article's scope.

adequately protected from potential opportunistic behavior by securities market counterparties, whether they be issuers or broker-dealers or other market participants.[47] It seeks to force those counterparties to internalize the costs of their activities and to correct power and information imbalances, such as those between management and shareholders.[48] In other words, the purpose of securities regulation is to correct a perceived market failure: investors, in policymakers' perceptions, are not capable of fully protecting their interests given the natural information disparities between investors and those who would be the target of or intermediary for their investment capital.[49]

Corporate governance norms, by contrast, exist independently of market failures. They do not constitute regulation at all but instead comprise a default legal framework for structuring private relationships.[50] This framework might, indeed, be characterized as a variation of contract law. Although U.S. corporate governance norms developed over decades and are a product of historical practices, judicial decisions, and statutory laws and rules, they nonetheless may be said to have a "purpose"—that being to foster efficient economic growth and production.[51] And they are, one might say, constitutive in nature, in the sense that corporate statutes are generally enabling rather than restrictive.[52] Of course, by virtue of corporate statutes' (largely default) governance rules and imposition of a (largely unwaivable) fiduciary duty of loyalty on boards of directors and controlling shareholders, these statutes help ensure that management remains accountable to shareholders.[53] It remains the case, however, that the motivation behind corporate governance norms is enabling private parties to function in a manner that is socially useful.

With that distinction in mind, moreover, we can say that a system of corporate governance is structural, grounded in notions of private law,

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47. *See* Licht, *supra* note 13, at 104.

48. *See* STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 89 (2d ed. 2008) (noting that securities markets are characterized by an "information asymmetry" between insiders and outsiders and that "[i]f . . . insiders and professionals are free to exploit that informational advantage, outsiders will be reluctant to participate in the market").

49. *See id.*

50. *See* CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS 15–17 (6th ed. 2010).

51. *See id.* at 15 (observing that organizing as a firm helps avoid transaction costs and permits "allocation of resources at the direction of the entrepreneur").

52. *Id.* ("Most of the off-the-rack rules found in each state-provided standard form are 'enabling' in the sense that they provide parties with default rules that govern the relationship if the parties do not provide otherwise.").

53. *Id.* at 265, 277.

whereas a "system" of securities regulation is simply that: regulatory, functioning in the name of public-law objectives. Deploying a structural legal regime to do the work of a regulatory regime is almost intuitively misguided by dint of the relatively mundane fact that market failures arise where a structure already exists but where supplemental rules and enforcement are necessary. Conversely, in light of the structural objectives of corporate governance laws and norms, to the extent those laws and norms seem unable to speak to the needs and goals of securities regulation, that circumstance perhaps should not be particularly surprising. Put another way, although investment companies, or at least many of them, are corporations,[54] regulation of them and their management (investment advisers) lies beyond the reach of corporate law objectives, focused as they (necessarily) are on the entity and its internal governance mechanisms. Securities regulation, by contrast, need not be so limited.

To be sure, pursuing securities regulatory goals through supplementing or deploying corporate norms is neither unique to the investment company context nor necessarily problematic. Among other things, beginning with the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934, policymakers and regulators have sought to amplify securities regulatory mechanisms applicable to public companies through supplementing state corporate statutes with significant additional federal obligations. Indeed, today, corporate governance "is a matter of significant federal as well as state concern."[55] The "federalization of corporate governance" has been increasing, moreover, particularly in the aftermath of spectacular and well-publicized failures by corporate management to pursue corporate interests, where those failures destroyed shareholder value.[56] The Sarbanes-Oxley Act of 2002, for example, established federal corporate governance rules to address investor protection concerns that arose in the wake of the Enron bankruptcy.[57]

Sarbanes-Oxley is expressly predicated on the determination that, as to publicly traded companies, more shareholder protection is needed.[58] Among other things, the statute imposes requirements that corporations—

54. *See* Palmiter, *supra* note 5, at 167–69.

55. D. GORDON SMITH & CYNTHIA A. WILLIAMS, BUSINESS ORGANIZATIONS: CASES, PROBLEMS, AND CASE STUDIES 449 (2d ed. 2008).

56. *See id.* (internal quotation marks omitted).

57. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15, 18, and 28 U.S.C.).

58. Pursuant to its preamble, the purpose of the Sarbanes-Oxley Act of 2002 is "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws . . . ." *Id.*

meaning their boards of directors and officers—follow specific procedures in carrying out their management activities and oversight functions. Boards of directors must appoint audit committees that satisfy certain membership and operational requirements.[59] Boards must also follow certain procedures in evaluating internal controls.[60] These are matters traditionally within the realm of corporate governance that, absent the harm to shareholders as a result of corporate governance failures, we might otherwise expect would be left to private ordering and internal decisionmaking procedures.[61] Of course, because Sarbanes-Oxley mandates specific procedures in the name of investor protection, there is nothing particularly constitutive about this supplemental regulation. That is, its setting forth mandatory rules for the furtherance of securities regulatory goals means that it does not comprise the sort of gap-filling default rules characteristic of corporate codes.[62] It is securities regulation achieved through pulling the levers of corporate governance. That fact is not, by itself, an independent basis of criticism: depending on the efficacy of Sarbanes-Oxley in achieving investor protection without unduly burdening corporate governance, the statute may demonstrate a productive synergy between corporate governance norms and securities regulation.

Corporate governance norms are apparent also in securities regulatory contexts beyond crisis policymaking. Regulators deploy those norms, for example, in the private-fund context—that is, in the regulation of investment advisers to hedge funds, private equity funds, and the like. Under that regulatory regime, investment advisers are to regard the funds they manage—rather than the investors in those funds—as their "clients" for purposes of complying with their regulatory obligations.[63] That determination derives from a corporate governance paradigm, in that the investment adviser owes its duties to the entity (the hedge fund, for example) rather than to the entity's investors, much as the board of directors owes its fiduciary obligations to the corporation rather than to any of the corporation's shareholders. Employing corporate governance norms for the furtherance of securities regulation in this context is problematic

59. *Id.* § 301.

60. *Id.* § 404.

61. Lisa McCauley Parles, Susan A. O'Sullivan & John H. Shannon, *Sarbanes-Oxley: An Overview of Current Issues and Concerns*, 27 REV. BUS. 38, 42 (2007) ("With the enactment of Sarbanes-Oxley, the Federal government has stepped into many areas that were previously controlled in-house or traditionally regulated by state legislatures and state courts.").

62. *See* O'KELLEY & THOMPSON, *supra* note 50, at 15–17.

63. Anita K. Krug, *Institutionalization, Investment Adviser Regulation, and the Hedge Fund Problem*, 63 HASTINGS L.J. 1, 27–31 (2011).

because its result is that the investment adviser does not owe its obligations to those who have effectively engaged the adviser to provide advisory services—fund investors.[64] However, because the regulatory structure governing private funds contemplates no formal role for boards of directors, it is more malleable than the regulatory structure for investment companies. Accordingly, to the extent private-fund regulation insufficiently protects fund investors, those concerns could be addressed through implementing additional protective measures sounding in securities regulation.

As the next two parts elaborate, the regulatory role of investment company boards, and the consequent formal (if not actual) control boards exert over investment companies' operations, either are ineffective in furthering the investor protection goals of securities regulation or, worse, affirmatively militate against furthering those goals. Part III delves into the conflicts of interest embedded in the relationship between investment company boards of directors, on one hand, and investment advisers, on the other, and the effects of those conflicts in muting boards' regulatory efficacy. Part IV then shows how, in investment company jurisprudence, the corporate governance paradigm leads courts both to defer (inappropriately) to state corporate governance norms and to import those norms into the investment company regulatory structure, similarly countering the ICA's regulatory objectives.

## III. CONFLICTING INTERESTS

If regulation of investment companies should promote the stability, effectiveness, and competitiveness of the investment company industry, then, as much of the literature on investment company regulation in recent years has pointed out, there is substantial room for improvement on that front.[65] Indeed, myriad scholars and other commentators have variously observed that investment company regulation and management are fraught with problems, almost all of which fall within the heading of "management's" failing to uphold its obligations to the investment company and its shareholders.[66] A number of these problems are traceable

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64. *Id.*

65. John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151, 154 & n.2 (2007) ("In the last five years, mutual fund industry critics have spoken out frequently and sharply about what they perceive to be the industry's shortcomings.") (citations omitted).

66. *See, e.g.*, Bogle, *The Alpha and the Omega*, *supra* note 24, at 418–21 (arguing that the interests of fund managers are favored too heavily at the moment); John C. Coffee, Jr., *A Course of*

to the investment company structure itself, in which the personnel responsible for the investment company's operations are "located" within the investment adviser, and to the special relationship between the board of directors and the adviser—and, in particular, that the investment company is effectively a creature of the adviser's making.[67] These factors both suggest that a board of directors is unable to act as an independent voice on shareholders' behalf and, importantly, foster conflicts on the adviser's part, as well as the board's. The board, in carrying out its oversight function, must depend on the investment adviser to bring matters to its attention, yet the adviser's incentives may hinder the necessary flow of information. Meanwhile, where the board is called upon to take action on a particular matter, it is arguable, if not likely, that it cannot do so truly independent of the adviser's wishes.[68] Characterizing these conflicts, respectively, as "structural" and "relational," this part discusses each in turn.

### A. STRUCTURAL CONFLICTS

The corporate governance paradigm requires that investment company boards of directors perform the same control functions as the board of any corporation.[69] Accordingly, an investment company board has two primary management responsibilities, which are complementary to one another; two sides of the same coin. First, the board has formal responsibility for making affirmative decisions on the investment company's behalf.[70] In the

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*Inaction: Where Was the SEC When the Mutual Fund Scandal Happened?*, 2004-APR LEGAL AFF. 46, 46–48 (2004) (explaining how the "self-interest of the fund manager" helped cause the recent waves of financial scandals); Freeman, *supra* note 1, at 746–52 (noting that the investment company's interests frequently conflict with shareholders' interests); Thomas R. Hurst, *The Unfinished Business of Mutual Fund Reform*, 26 PACE L. REV. 133, 134–39 (2005) (outlining the various management failings that contributed to recent scandals); Palmiter, *supra* note 5, at 165–66 (arguing that fund boards have "failed to respond to the 'cognitive biases' of fund investors"); Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 CARDOZO L. REV. 1419, 1439–40 (2002) (noting that many observers "doubt whether the mutual fund industry is taking seriously its voting function").

67. *See supra* text accompanying note 40.

68. *See* Jones v. Harris Assocs., L.P., 130 S. Ct. 1418, 1422 (2010) (observing that "[b]ecause of the relationship between a mutual fund and its investment adviser, the fund often cannot, as a practical matter[,] sever its relationship with the adviser" and that, as a result, "the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy") (internal quotation marks omitted). Because of advisers' dominance of most aspects of the investment companies they manage, the ICA's requirement that no more than 60 percent of an investment company's directors be affiliated with the investment adviser arguably has not provided the intended safeguard functions. *See* Investment Advisers Act of 1940, 15 U.S.C. § 80a-10(a) (2006)

69. *See* Warburton, *supra* note 9, at 751.

70. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996) (noting that negligent or ill-advised decisions resulting in losses mark one of the "two distinct contexts" in

investment company context, these include decisions to appoint a new distributor or other service provider, to pay the investment adviser at a particular fee rate, and to approve the policies and procedures that investment companies are required to implement under the ICA.[71] Second, the board has formal responsibility outside of the decisionmaking context and, in particular, is charged with overseeing the company's operations and practices.[72] In carrying out this function under traditional corporate governance norms, the board has a responsibility to ensure that there exists a reporting system such that the board receives adequate and timely information about the company's activities—with "adequate" being evaluated based on the company's particular business activities and risks.[73] An effective system should permit the board to become aware of, and take action regarding, any material matters that may arise.[74]

Although one might envision a wide range of information that should flow to the board of any company, certainly included in that spectrum is information about the company's and its personnel's compliance with applicable laws and regulations, whatever they may be.[75] An investment company board, however, cannot achieve exactly that type of oversight, given that, as discussed above, the investment company itself typically does not have officers or other personnel and, instead, relies on the investment adviser and its personnel for carrying out its day-to-day activities.[76] From that circumstance arises the conclusion that, for investment company boards of directors, equivalent oversight means obtaining information about the investment adviser's and its personnel's compliance with applicable laws and regulations, as well as the adviser's

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which "[d]irector liability for a breach of the duty to exercise appropriate attention" may arise).

71. *See* Warburton, *supra* note 9, at 750 (observing that, under the ICA, the board is responsible for, among other things, "evaluating fees for services provided to the fund, policing operational conflicts, permitting certain transactions in the absence of SEC review, and establishing the fund's investment objective and policy").

72. *See In re Caremark*, 698 A.2d at 967 ("Second, liability to the corporation for a loss may be said to arise from an *unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss.").

73. *See id.* at 970 (observing that directors' failure to implement an "adequate" information and reporting system may "render a director liable for losses caused by non-compliance with applicable legal standards").

74. *Id.*

75. *Id.* (holding that directors must be "assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance").

76. *See supra* text accompanying notes 36–41.

activities as they relate to or potentially affect the investment company's best interests. Indeed, if the investment company board were to focus its oversight attention solely on the inner workings of the investment company, there would be little, if anything, to oversee, rendering the board's oversight function nigh illusory.

Assuming the board should instead direct its oversight focus to the investment adviser and its activities, however, it is not apparent that the board's oversight capability becomes any more meaningful. That is a product of the investment company structure and, specifically, the board's position within it. Because the investment adviser, rather than the investment company itself, is the locus of investment company personnel and day-to-day management functions, boards are effectively charged with exercising oversight of an entity in which they have no formal role. For an investment company board, therefore, performing its oversight function is equivalent to overseeing a veritable black box—that being the investment adviser, whose operations are not readily accessible to the board, either as a matter of corporate governance or (predictably) investment company regulation, relying as it does on corporate governance norms. As a result, in carrying out its oversight responsibilities, an investment company board cannot ensure the requisite flow of information through implementing its own system but, instead, must rely on the investment adviser to bring matters to its attention. That is a considerably more passive stance for the board than what corporate governance norms contemplate as necessary for effective management.[77]

Accordingly, the way in which investment companies are structured, with the investment adviser being a separate business enterprise, places the efficacy of board oversight into question. This structural obstacle, moreover, is exacerbated to the extent that directors have limited understandings of possible compliance weaknesses.[78] Nonetheless, the

77. *See supra* text accompanying notes 70–75.

78. As some scholars have observed, even under more accommodating structural circumstances, oversight that may have curtailed certain problematic activities, such as "market-timing" activities of various larger investment company shareholders, may not have been a function that investment company boards, largely comprised of independent directors, are well equipped to do. Under the ICA and the SEC's rules under the ICA, a majority of an investment company's directors must be "independent" of the company's investment adviser. Investment Company Governance, 69 Fed. Reg. 46,378, 46,378–79, 46,381 (Aug. 2, 2004) (codified at 17 C.F.R. pt. 270). This requirement came about as a measure to help reduce conflicts of interest within the board. *See id.* Of course, given the investment company structure described in this Article, it is questionable whether, in fact, even independent directors are unconflicted in connection with their activities on behalf of the company. *See supra* text accompanying notes 42–46. Beyond that, however, many independent directors may have lacked the expertise in the investment company industry that would have enabled them to seek out the

structural circumstances that render board oversight problematic in the investment company context could be mitigated if investment advisers took it upon themselves to ensure the flow of information to investment company boards. The primacy of the corporate governance paradigm means that there is no guarantee that that will occur.

For one thing, because the investment adviser is a separate entity, with its business and operations distinct from the investment company's, there is no structural mandate for the flow of information from the adviser, as one independent entity, to the investment company, as another.[79] Compounding this structural impediment is that investment advisers simply may not have adequate incentives to seek to overcome the entity-based divide. An investment adviser's interests, after all, though presumably not dramatically opposed to those of the investment company, arguably are not aligned with them either. In particular, investment advisers, especially those with the size and capabilities to manage an investment company, typically manage a number of accounts, of which the investment company's account is only one.[80] Although investment advisers owe fiduciary duties to each of their clients,[81] numerous (and perhaps competing) sources of obligation make the prospect of conflicts of interest unavoidable: an adviser's obligations to one client may affect its carrying out obligations to other clients.[82] From there, it is but a short step to

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sort of information necessary to know whether illegal or other ill-advised practices were afoot. Martin E. Lybecker, *Enhanced Corporate Governance for Mutual Funds: A Flawed Concept that Deserves Serious Reconsideration*, 83 WASH. U. L.Q. 1045, 1086 (2005). Lybecker paints a particularly bleak picture of independent directors' competence regarding the intricacies of investment company practices:

> With respect, it is very hard indeed to understand how a mutual fund's board of directors with seventy-five percent independent directors, with an independent chair, meeting separately once a year, conducting an annual self-assessment, and having access to experts can bring the necessary skill set, surveillance tools, and adequate time to do due diligence to the tasks of (i) rooting out a determined late-trader, (ii) understanding the nuances of stock prices in a country facing a natural disaster that has imposed restrictions on repatriating profits, or (iii) anticipating a change in the Commission's position on the payment of brokerage commissions for executing portfolio transactions to a broker-dealer to which it is also selling shares of that mutual fund.

*Id.* at 1085. *See also* Margaret A. Bancroft, *Knowledge Is Power: What Went Wrong in the Mutual Fund Industry*, 1 J. BUS. & TECH. L. 145, 148–49 (2006).

79. This conclusion arises by (negative) implication from courts' analyses of directors' duty of oversight. *See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967–70 (Del. Ch. 1996).

80. Indeed, a premise of the Investment Advisers Act of 1940 ("Advisers Act"), the federal statute that governs investment advisers, is that advisers manage the accounts of multiple clients. *See* Investment Advisers Act of 1940, 15 U.S.C. § 80b-3 (2006); *infra* note 81 and accompanying text.

81. *See* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 191–92 (1963).

82. One objective of federal regulation of investment advisers is to control advisers' potential conflicts. *See, e.g.*, 17 C.F.R. § 275.206(3)-2 (2012) (requiring that an adviser obtain written client consent for transactions that the adviser might wish to effect between client accounts—known as "agency-cross transactions").

suppose that these conflicts may dampen advisers' motivations to provide operational transparency to the investment company's board—at least of the sort that a corporate board would, and should, otherwise expect.[83]

## B. RELATIONAL CONFLICTS

That an investment company's adviser is responsible for the company's existence and the identity of its board members means that boards are dependent on the adviser for the information that enables them to fulfill their oversight responsibilities. They are also beholden to the adviser—and, therefore, are not truly independent of it—particularly if they wish to have a board position with investment companies the adviser may form and manage in the future. This dynamic may be discerned in a number of contexts, foremost among which is the process by which advisory fees are established. In particular, a recurring argument has been that the fees advisers charge the investment companies they manage are, in some cases, excessive relative to the services provided and, therefore, harmful to shareholders.[84] To the extent that fee rates are too high, it is not difficult to discern how the board's relationship to the adviser may be responsible. After all, the board is the counterparty in the fee negotiations, acting on the investment company's (and, indirectly, the shareholders') behalf.[85] However, the board-adviser relationship means that the directors may be deemed interested in transactions the adviser proposes, including that the investment company be subject to a particular fee rate.[86] Therefore, the directors may not act as strong fiduciaries in negotiating the adviser's fees.[87] As described below, other contexts likewise suggest boards'

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83. *See* Warburton, *supra* note 9, at 750 ("Because the adviser is a legally distinct entity from the fund and must seek higher profits for its owners, it has objectives that differ from those of mutual fund investors . . . .").

84. Although investment company shareholders have, on occasion, pursued this argument (under § 36(b) of the ICA), "there has not been a single adjudication of excessive fees since [§ 36(b)'s] enactment." James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 WASH. U. L.Q. 907, 923 (2005).

85. Coates & Hubbard, *supra* note 65, at 158 ("The fees that an adviser charges a fund for the adviser's services require approval by the fund's board of directors . . . ."); Johnson, *supra* note 10, at 504 (noting that an investment company's board of directors negotiates and approves the contract with the investment company's adviser).

86. *See* Coates & Hubbard, *supra* note 65, at 158 (observing that an investment company's adviser appoints the fund's initial board of directors and that, according to critics of the investment company industry, advisers "control the fee approval process").

87. *See* William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401, 1423–26 (2006); Johnson, *supra* note 10, at 530–31. Of course, this circumstance might not be particularly problematic if investment companies were subject to market discipline, which might be imposed through shareholder activism (as one might expect in the

conflict-based deficiencies, both in preventing harm to shareholders and in encouraging activities beneficial to them.

1. Shareholders as Arbitrageurs

One example in recent years has been shareholder arbitrage practices, in which hedge funds and other institutional investors have transacted in investment company shares in order to take advantage of information that becomes known to the market but that is not reflected in the price of the shares.[88] One of the practices has involved buying shares at the day's closing valuation for those shares, which is determined at 4:00 p.m. each day, when information that would increase the price of those shares has become available after 4:00 p.m. (so-called late-trading arbitrage).[89] Having bought the shares at a price determined prior to the time the market-moving information became available, the arbitrageur can sell them the next day (or some other later point) at a price that has come to reflect the new information.[90] Another arbitrage practice has involved buying shares of an investment company whose strategy revolves around trading in international stocks during a day in which U.S. stock prices have increased.[91] In that circumstance, the arbitrageur's expectation is that the prices of the international stocks will also increase once international markets resume trading, with the result that the investment company's share prices will increase as well the next day (so-called pricing arbitrage).[92]

Arbitrage activity increased rather significantly about a decade ago, likely a product of a number of factors, including heightened competition

operating company context) or redemptions. However, there are dramatically divergent analyses and conclusions as to whether market forces effectively monitor or counter the fee rates that investment advisers charge the investment companies they manage. Although some scholars have contended that, yes, market discipline thrives in the investment company context, others have concluded that competitive forces do not serve a disciplining function. *See* Coates & Hubbard, *supra* note 65, at 153–54 (yes); Johnson, *supra* note 10, at 506 (no). Still others have concluded that the evidence points in both directions. *See* John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 111–12 (2010).

88. *See* William A. Birdthistle, *The Fortunes and Foibles of Exchange-Traded Funds: A Positive Market Response to the Problems of Mutual Funds*, 33 DEL. J. CORP. L. 69, 100–03 (2008).

89. Mercer E. Bullard, *The Mutual Fund as a Firm: Frequent Trading, Fund Arbitrage and the SEC's Response to the Mutual Fund Scandal*, 42 HOUS. L. REV. 1271, 1279–84 (2006).

90. *Id.* at 1279–80.

91. *Id.*. at 1285–90.

92. *Id.* In other words, in the latter instance, the arbitrageurs are able to buy investment company shares valued on stock prices that, in light of the activity in the U.S. markets, have become "stale," with the objective of selling those shares once the valuation reflects the (delayed) increase in the value of the international stocks in which the investment company has invested. *Id.*

among investment companies (which may lead investment companies to welcome even short-term, arbitrage-related investments), an increasing number of ready and willing arbitrageurs (such as hedge funds), and ever more volatile securities markets, particularly in the wake of the dot-com crash.[93] That increased activity brought more intense regulatory scrutiny, including a number of SEC enforcement actions against investment companies or their advisers.[94] Thus blossomed the market-timing scandal, a relatively well-trod topic in the academic literature on investment companies.[95] Lest there be any question about what, exactly, was the scandalous aspect of arbitrage, it was this: arbitrage results in the unfair dilution of the investment company's longer-term shareholders, who must share gains from increases in the value of the company's investment portfolio with arbitrageurs who bought shares with the knowledge that the shares' price was likely to increase.[96] In other words, arbitrageurs unfairly take value away from the investment company's more stable base of shareholders.[97]

93. *Id.* at 1288–90.

94. *See* William A. Birdthistle, *Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence*, 2010 U. ILL. L. REV. 61, 65 ("In 2003, state and federal regulators unleashed scores of investigations of investment advisors whom they accused of mismanaging clients' funds.").

95. *See generally, e.g.*, Stephen Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals*, 87 B.U. L. REV. 1021 (2007) (examining investor response to mutual fund scandals from 1999–2004); Jeff Schwartz, *Mutual Fund Conflicts of Interest in the Wake of the Short-Term Trading Scandals: Encouraging Structural Change Through Shareholder Choice*, 2 N.Y.U. J.L. & BUS. 91 (2005) (arguing that market-timing scandals are evidence that the mutual fund industry is in need of reform).

96. *See* Coffee, *supra* note 66, at 47 (noting that the "extraordinary rate of return" earned by arbitrageurs "comes at the expense of long-term mutual fund holders" whose gains "are diluted because they must be shared with . . . arbitrageurs" and whose mutual funds "must maintain an artificially high cash level . . . to handle the [arbitrageurs'] predictable redemptions"); Bullard, *supra* note 89, at 1280, 1286; Mercer E. Bullard, *Insider Trading in Mutual Funds*, 84 OR. L. REV. 821, 828–31 (2005) [hereinafter *Insider Trading*]; Markham, *supra* note 16, at 89.

97. Arbitrageurs are able to realize gains from portfolio stock price increases that they expect to occur "after hours" (as is the case with pricing arbitrage) or that have already occurred but that are not yet reflected in the investment company's shares (as is the case with late-trading arbitrage) because of the once-a-day pricing mechanism. *See* Bullard, *Insider Trading*, *supra* note 96, at 827 n.28. When investment company shareholders buy or redeem their shares, they do so at the price per share determined for the day on which the transaction occurs. *See id.* at 826–28. That price is equal to the fair market value of the investment company's net assets determined for that day, divided by the number of outstanding shares. *See* Morley & Curtis, *supra* note 87, at 102–03. The price, therefore, does not take into consideration any expectations as to whether the value of those assets will increase or decrease going forward, based on all available information. *See id.* at 103–05. The significance of that circumstance is more apparent when one compares it to the mechanism by which a shareholder of a publicly traded operating company is able to buy or dispose of shares. Such a shareholder generally may buy or sell shares only through transactions in the open market, and the price will reflect the market's expectations about the company's future performance, which may fluctuate continuously. Accordingly, whereas the investment company pricing mechanism raises the prospect of transactions at

For present purposes, the interesting aspect of arbitrage activity lies in the board's role in permitting it. In at least some instances, would-be arbitrageurs sought permission for their arbitrage practices from the targeted investment companies (and their investment advisers).[98] Yet boards' evaluations of arbitrage practices, quite possibly already numbed by insufficient industry expertise, may have been muted still further by the board-adviser relationship. Specifically, even were we to assume that a board considering such a proposal would undertake an independent evaluation of it, it was plausible that the board would not have discerned a problem with the proposed arrangement—at least not unless one of the board members "understood what this new form of market timing entailed, why it worked, what the dynamics of the daily pricing of fund shares were," and the "fundamental genesis" of the SEC's rule that prohibits an investor's buying shares "at an older, lower, and obviously stale price."[99] As suggested above, however, the prospect that directors did not have that degree of understanding is at least a reasonable one.[100] To be sure, independent directors of operating companies may be similarly limited in their firm-specific expertise.[101] The problem is exacerbated in the investment company context, however, precisely because there is reason to question the hypothetical assumption above regarding the board's undertaking an independent evaluation. That, again, is a product of an adviser-board relationship that perversely incentivizes boards to defer to the investment adviser in acting on matters before them.[102]

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"stale" prices, the operating company pricing mechanism does not. *See id.*

98. Advisers were prone to countenance arbitrage arrangements, despite the possible administrative costs they might impose on the relevant investment company, if, for example, the arbitrageur agreed to invest significant long-term capital in the investment company, which would benefit the adviser through the fees payable on those long-term assets. *See* Birdthistle, *supra* note 94, at 76 ("[S]everal investment advisors—in contravention of their statements expressly prohibiting market timing in their own prospectuses—countenanced such trading by institutional investors" on the basis that, "as a quid pro quo for market timing one mutual fund, the institutional investors would typically park 'sticky assets' in a related but separate mutual fund").

99. Bancroft, *supra* note 78, at 147–48 ("[F]amiliarity with the mechanics of mutual fund share pricing and the policies underlying Rule 22c-1, as well as with the new market-timing strategy afoot, would have been essential to understanding the issues . . . .").

100. *See supra* note 78 and accompanying text.

101. *See* Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 874–75 (1991) ("[O]utside directors lack the time, expertise, staff, and information to challenge management . . . .").

102. *See supra* text accompanying notes 39–46 & 65–68.

2. Investment Company (In)Activism

A second example of investment companies' conflict-based deficiencies may be discerned in their relative "inactivism" as shareholders of companies in their portfolios. Beyond taking positions on corporate questions through voting proxies, investment companies, like any portfolio company shareholder, may have the desire or inclination to pursue incremental governance changes through more aggressive modes of corporate involvement, such as through seeking to influence particular decisions of portfolio company boards of directors, proposing proxy initiatives or alternative slates of board candidates, or coordinating with other shareholders on voting decisions—and possibly acquiring large blocks of stock in order to pursue those ends better.[103] Indeed, investment companies are better suited to assume activist shareholder roles than are smaller, more dispersed shareholders.[104] Among other things, they have greater resources to deploy toward challenging corporate management and, importantly, they (meaning the investment advisers managing them) have more expertise in evaluating companies and management as compared with their smaller, and arguably less sophisticated, counterparts.[105]

To be sure, it is an open question as to whether investment companies' assuming a more activist role vis-à-vis corporate management is normatively desirable. As one might expect, there is disagreement on that point. For one thing, it may be that the balance between managerial authority and accountability that the present corporate-structural regime has achieved is appropriate and best furthers investors' interests.[106] If that is the case, then there is little need for the additional monitoring that activist investment companies might bring to the table. Second, even if the accountability / authority balance is not presently optimal, with managers' discretion insufficiently constrained by their obligations to shareholders, it may be that investment companies are not the best candidates for filling the monitoring void.[107] That might be so, for example, either if the shareholder activism that investment companies pursue serves only the investment companies' interests without also furthering the interests of the investment companies' fellow shareholders or, perhaps worse, if the activism serves

103. *See* Robert C. Illig, *The Promise of Hedge Fund Governance: How Incentive Compensation Can Enhance Institutional Investor Monitoring*, 60 ALA. L. REV. 41, 48–49 (2008).

104. *See id.*

105. *See id.*

106. *See id.* at 53 ("[M]any conservative legal scholars are fairly sanguine about the current state of corporate accountability and so oppose any efforts to reform America's governance system.").

107. *Id.* at 54.

only the interests of the investment advisers managing the activist investment companies without also furthering the interests of the investment companies' shareholders.[108]

The important point in all of this, however, is that, regardless of the potential for or desirability of investment companies' greater shareholder activism, investment companies have in fact not been particularly activist shareholders, especially when compared with their private equity and hedge fund counterparts.[109] Rather, investment companies have tended to express their dissatisfaction with corporate management by simply selling their shares and moving on,[110] forgoing action that potentially could benefit not only their own shareholders but also fellow portfolio company shareholders. One plausible reason for investment companies' inactivism is that investment companies have no particular incentive to be activist—or, more accurately, their investment advisers have no particular incentive to cause them to be activist.

From the investment adviser's perspective, the most that activism can achieve is to increase the investment company's net asset value and, therefore, the incremental fee payable to the adviser.[111] That is, unlike advisers to private equity funds, for example, the adviser is not itself entitled to a portion of the profit an investment company earns as a result of its activism.[112] That incremental increase in assets presumably does not give the adviser sufficient incentive for activism, both because the same increase could be achieved, at lower expense and with less risk, by causing the investment company to seek out investments in other portfolio companies and because performance may not play a significant role in attracting new shareholders.[113] However, if, in fact, a more activist investment approach could have substantial effects on a portfolio company's performance, thereby benefitting the investment company's current shareholders (even if only incrementally), one might reason that the investment company board of directors is aptly positioned to step in to

108. *See id.* (noting that one concern about activism by institutional investors is that those investors "would cause corporations to pursue policies that would be detrimental to investors whose time horizons, risk tolerances, and political goals differ").

109. *See id.* at 42.

110. *See id.* (noting that "most institutional investors [have] remained largely passive in their investment outlook" and that, when a portfolio company fails to perform, they "typically exit the investment rather than seek to translate their influence into better performance").

111. Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 231–32 (2007).

112. *Id.* at 231.

113. *See id.* at 322–30.

evaluate pursuing that approach. Although further exploration of this prospect is warranted, the conclusion may well be that the board's voice is not, and cannot be, an effective, independent check on the adviser's.[114]

## IV. COURTS AND CORPORATE GOVERNANCE NORMS

As Part III suggests, directors' and advisers' interests are conflicted. On one hand, advisers are fiduciaries to the investment company; on the other hand, they operate businesses apart from the investment company and have fiduciary duties to other advisory clients.[115] On one hand, boards are fiduciaries to the investment company; on the other hand, they are incentivized to accede to the investment adviser's wishes, whether that be to allow a favored investment company shareholder to trade the company's shares more frequently than other shareholders or to eschew activist activities that may redound to the benefit of the company's portfolio.[116] These conflicts of interest, however, constitute only one way in which the corporate governance paradigm militates against securities regulatory objectives. As this part elaborates, the corporate governance paradigm produces additional adverse consequences by virtue of authorizing, if not encouraging, courts to apply corporate law principles that arguably are inconsistent with those objectives. This may occur in two contexts: First, in evaluating shareholder claims involving corporate governance questions, courts afford excessive deference to answers supplied by state corporate law.[117] Second, in evaluating shareholder claims of securities fraud or other securities regulatory matters, courts deploy an entity-centric analysis deriving from corporate governance norms, ignoring that investment

114. Of course, to the extent that investment advisers are driven by particular incentives, one might assume that investment company boards of directors could be similarly motivated. Boards of directors of operating companies, for example, may be incentivized to play a strong fiduciary role toward the company and its shareholders to the extent they receive stock or stock options or other forms of compensation that are tied to the company's performance over time. Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer*, 45 WM. & MARY L. REV. 1055, 1085 (2004) ("[S]tock options, restricted stock, and other forms of incentive-based compensation . . . encourage directors and officers to maximize corporate profits."). Directors owning stock options should have incentives to prevent or at least question actions by executives and other personnel that seem adverse to shareholder interests, to make major board-level decisions in a manner that increases value, and to implement oversight procedures designed to give them an accurate picture of the company's compliance with applicable laws and regulations. *See id.* In the investment company context, however, directors' compensation necessarily consists primarily of cash. *See infra* text accompanying notes 174–76.

115. *See supra* Part III.A.

116. *See supra* Part III.B.

117. *See infra* Part IV.A.

companies are effectively super-entity enterprises.[118]

### A. COURTS' DEFERENCE TO CORPORATE LAW

Exacerbating the effects of investment adviser domination of investment company boards is the judiciary's apparent eagerness to refer to state corporate law to determine shareholder rights in the absence of express ICA rules.[119] Two prominent examples come to mind: First, the standards courts apply in determining the reasonableness of fees charged by investment advisers derive from state corporate law principles.[120] Second, in shareholder derivative lawsuits, courts have deferred to state corporate law to determine the threshold question of whether plaintiffs should be required to make demands on boards of directors before proceeding with the litigation.[121] As this section describes, in both of these circumstances, courts' decisions have been based on the corporate governance foundation of investment company regulation rather than—as should have been the case—that regulation's investor protection objectives.[122]

#### 1. Evaluating Advisory Fees

In *Jones v. Harris Associates, L.P.*, the Supreme Court evaluated the standard by which courts should evaluate whether an investment adviser breached its "fiduciary duty with respect to the receipt of compensation for services," which § 36(b) of the ICA imposes on investment advisers.[123] Section 36(b) is a relatively new provision of the ICA, which Congress adopted in 1970 to bolster the Act's protection of shareholders.[124] In *Jones*, investment company shareholders claimed that the fees charged by the investment adviser were too high, in that they were "disproportionate to the services rendered."[125] At issue for the Court was whether the test for

118. *See infra* Part IV.B.

119. *See* Langevoort, *supra* note 8, at 1026–27 (noting that the Supreme Court looks "to state law where the matter is not specifically addressed in the [ICA]" because "there is no federal common law of corporations for mutual funds").

120. *See infra* Part IV.A.1.

121. *See infra* Part IV.A.2.

122. *See* Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 108–09 (1991) (holding that federal courts should apply state law governing the authority of independent directors); Burks v. Lasker, 441 U.S. 471, 486 (1979) (same).

123. Jones v. Harris Assocs., L.P., 130 S. Ct. 1418, 1422 (2010) (quoting 15 U.S.C. § 80a-35(b)) (internal quotation marks omitted).

124. *See id.* (explaining that the 1970 amendments also required that not more than 60 percent of an investment company's directors be affiliated with the company's investment adviser).

125. *Id.* at 1424.

evaluating investment company fees developed by the Second Circuit twenty-five years ago was the appropriate one.[126] Under that test—dubbed the *Gartenberg* standard—an investment adviser breaches its § 36(b) obligations by "charg[ing] a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[127] Applying that standard, the District Court for the Northern District of Illinois had granted summary judgment to the adviser.[128] Although the Seventh Circuit affirmed, it did so by rejecting *Gartenberg* and formulating a new test based on fiduciary principles under trust law.[129] Under the Seventh Circuit's test, provided an adviser has made full disclosure to the board and otherwise has "play[ed] no tricks," the amount an adviser charges is relevant only if it is "so unusual as to give rise to an inference that deceit must have occurred, or that the persons responsible for [the] decision have abdicated."[130]

Justice Alito began the Court's analysis with the history of § 36(b), observing that its fiduciary standard reflected "a delicate compromise."[131] In particular, prior to Congress's adoption of § 36(b) in 1970, a challenge under state law to the fees charged by an investment adviser needed to meet "common-law standards of corporate waste, under which an unreasonable or unfair fee might be approved unless the court deemed it unconscionable or shocking."[132] Moreover, such a challenge brought under the ICA could succeed only with a showing of "gross abuse of trust."[133] In an effort to provide shareholders with greater recourse, Congress considered a provision empowering the SEC to challenge fees that it deemed unreasonable.[134] After investment company industry representatives expressed concerns that such an approach would effectively give the SEC "ratemaking authority," Congress adopted a fiduciary standard as a compromise approach.[135] The *Jones* Court, acknowledging that § 36(b)'s

126. *Id.* at 1425–26 (citing Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928–30 (2d Cir. 1982)).

127. *Gartenberg*, 694 F.2d., at 928 (citation omitted).

128. *Jones*, 130 S. Ct. at 1424.

129. *See id.*

130. *Id.* (quoting Jones v. Harris Assoc., L.P., 527 F.3d 627, 632 (2008)) (internal quotation marks omitted).

131. *Id.* at 1423.

132. *Id.* (quoting Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 540 n.12 (1984)) (internal quotation marks omitted).

133. *Id.* (quoting *Daily Income Fund*, 464 U.S. at 538).

134. *Id.*

135. *Id.* (quoting *Daily Income Fund*, 464 U.S. at 538).

reference to advisers' fiduciary duties regarding fees was "hardly pellucid," nonetheless concluded that *Gartenberg* correctly articulates what § 36(b) requires.[136]

The Court reasoned that the *Gartenberg* standard "reflects § 36(b)'s . . . relationship to the other protections that the [Investment Company] Act affords investors"—particularly the protections provided by the board of directors:[137]

> Under the Act, scrutiny of investment adviser compensation by a fully informed mutual fund board is the "cornerstone of the . . . effort to control conflicts of interest within mutual funds." The Act interposes disinterested directors as "independent watchdogs" of the relationship between a mutual fund and its adviser. . . .
>
> In recognition of the role of the disinterested directors, the Act instructs courts to give board approval of an adviser's compensation "such consideration . . . as is deemed appropriate under all the circumstances."[138]

Based on this formulation, the Court concluded both that the "appropriate measure of deference [to a board's judgment] varies depending on the circumstances" and that the *Gartenberg* standard "heeds these precepts."[139] For example, under *Gartenberg*, "where the board's process was deficient or the adviser withheld important information, the court must take a more rigorous look" at the amount of the fee.[140] With that, the Court seemed to suggest more rigorous scrutiny of advisory fees than what is implied by the Seventh Circuit's "full disclosure" approach.

Yet, in explicating the *Gartenberg* standard, the Court came precariously close to endorsing the Seventh Circuit's approach, at least in substance. Specifically, recalling Congress's rejection of a "reasonableness" requirement, the Court noted that the § 36(b) standard for fiduciary breach "does not call for judicial second-guessing of informed

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136. *Id.* at 1426.

137. *Id.* at 1427.

138. *Id.* at 1427–28 (quoting Burks v. Lasker, 441 U.S. 471, 482 (1979)) (internal quotation marks omitted).

139. *Id.* at 1428. ("*Gartenberg* advises that 'the expertise of the independent trustees of a fund, whether they are fully informed about all facts bearing on the [investment adviser's] service and fee, and the extent of care and conscientiousness with which they perform their duties are important facts to be considered in deciding whether they and the [investment adviser] are guilty of a breach of fiduciary duty in violation of § 36(b).'") (quoting Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 930 (2d Cir. 1982)).

140. *Id.* at 1430.

board decisions."[141] Accordingly, although boards' conflicting interests may "justify some restraints" on directors' unfettered discretion in negotiating an adviser's fees, those conflicts "do not suggest that a court may supplant the judgment of disinterested directors apprised of all relevant information, without additional evidence that the fee exceeds the arm's-length range."[142] Therein lies the difficulty, however: the relationship between advisers and boards means that there necessarily is no way to determine what fee levels fall within arm's-length range—particularly because the Court did not provide any guidance on that point, other than to confirm that courts need to consider "all relevant factors."[143] It is difficult to discern, then, how courts might ever conclude that an adviser has breached its fiduciary duties with respect to fees, so long as the board's process in reviewing the fee was not "deficient,"[144] however that might be defined. Indeed, the deference suggested by this analysis seems strikingly similar to the (substantial) deference bestowed on boards by the business judgment rule under state corporate law norms.[145]

2. Derivative Shareholder Litigation

A second prominent example of courts' deference to state corporate governance norms arises in the context of more general shareholder claims of breach of fiduciary duty. More particularly, there has arisen the question of whether those claims should be brought as derivative claims on behalf of the investment company rather than as direct claims of shareholders. Under state corporate law, such claims generally are brought derivatively on the basis that the harm alleged is to the company.[146] Accordingly, the company

141. *Id.*

142. *Id.* (citing *Burks*, 441 U.S. at 481)

143. *See id.* at 1428 (citing § 80a-35(b)(2) (2006)). The Court expressly rejected suggestions that comparisons to the fees an adviser charges other funds or clients or fees charged to investment companies by other advisers are probative on the "arm's-length" question. *Id.* at 1429. Indeed, it pointed out that "[e]ven if the services provided and fees charged to an independent fund are relevant, courts should be mindful that the [ICA] does not necessarily ensure fee parity between mutual funds and institutional clients." *Id.* at 1429. By the same token, the Court thought that comparing fees charged other investment companies is "problematic because these fees . . . may not be the product of negotiations conducted at arm's-length." *Id.*

144. *Id.* at 1430.

145. At the least, the Court appeared strikingly unconcerned with the conflicts of interest that inhere in board-adviser relationships—conflicts that, in the operating company context, would arguably suggest duty of loyalty concerns and remove the analysis from the umbrella of the business judgment presumption. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) ("When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.").

146. O'KELLEY & THOMPSON, *supra* note 50, at 398 (identifying a derivative claim as "an action on behalf of the corporation for harm to it") (quoting Joy v. North, 692 F.2d 880, 887 (2d Cir. 1982)).

has the cause of action, rather than its shareholders.[147]

The distinction between direct and derivative litigation is important because of the so-called "demand" requirement. In some states, if a claim is derivative in nature, shareholders are able to pursue it on the company's behalf only if they first requested that the board of directors pursue the claim, and the board refused to do so.[148] This is a "universal demand" requirement, which, as its name suggests, requires that all would-be plaintiffs ask the board to proceed with the lawsuit before they are able to move forward derivatively.[149] In other states, including Delaware, shareholders generally are required to make demand on the board but are excused from doing so in circumstances of demand futility—that is, where shareholders allege with particularity that the board lacks the independence or disinterestedness necessary to objectively consider the demand.[150] The prospect of demand futility means that demand has become a threshold query in most derivative lawsuits, one that often halts shareholder litigation in deference to the board's managerial role.[151]

So it is in the investment company context as well. Courts considering claims by investment company shareholders have generally determined (based on state corporate law principles) that those claims are derivative, rather than direct, on the basis that the harm arising from a breach is harm to the investment company rather than to its shareholders.[152] Moreover, in a 1979 case, *Burks v. Lasker*, the Supreme Court determined that, in evaluating derivative claims brought by investment company shareholders, courts should, in conducting demand analysis, defer to the corporate law of the state in which the investment company was incorporated.[153] In reaching

147. *See id.*

148. *See id.* at 399.

149. *Id.*

150. *See, e.g.*, Scalisi v. Fund Asset Mgmt., L.P., 380 F.3d 133, 139 (2d Cir. 2004) (quoting Werbowsky v. Collomb, 766 A.2d 123, 144 (Md. 2001) (explaining that under Maryland's statute, demand will be deemed futile only if the plaintiffs' allegations clearly demonstrate that making demand would cause irreparable harm to the corporation or that "a majority of the directors are so personally and directly conflicted or committed to the decision in dispute that they cannot reasonably be expected to respond to a demand in good faith and within the ambit of the business judgment rule").

151. *See* Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball*, 77 MINN. L. REV. 1339, 1362–65 (1993) ("The plaintiff must overcome the business judgment rule's presumption that management acted properly in rejecting the shareholder demand.").

152. Langevoort, *supra* note 8, at 1025–26 ("By and large, courts have found most claims of breach of fiduciary duty under the [ICA] to be ones where the harm is to the fund rather than shareholders and hence must be brought derivatively, which is consistent with corporate law as generally understood.").

153. Burks v. Lasker, 441 U.S. 471, 777–78 (1979). *See also* Kamen v. Kemper Fin. Servs., Inc.

its conclusion, the *Burks* Court focused on the ICA's role in investment companies' operations: "Since the ICA does not purport to be the source of authority for managerial power but instead functions primarily to impose controls and restrictions on the internal management of investment companies, the ICA . . . do[es] not require that federal law displace state laws governing the powers of directors . . . ."[154] Despite recognizing the role of state corporate law in investment company governance, however, the *Burks* Court also recognized that state corporate law should not be deployed to thwart the ICA's regulatory objectives.[155] Accordingly, it articulated an important caveat—namely, that state corporate law should not be applied to the extent it permits actions that the ICA prohibits or if "[its] application would be inconsistent with the federal policy underlying the cause of action."[156] Indeed, according to the Court, "federal courts must be ever vigilant to insure that application of state law poses no significant threat to any identifiable federal policy or interest."[157]

Barring the courts' ability or willingness to create federal common law on the point,[158] the *Burks* caveat seems necessary, given that "so much of the [ICA] rests on a repudiation of the traditional protections of state corporate law."[159] That might seem particularly the case in light of the special circumstances of directors' service on investment company boards of directors. An investment company's adviser typically manages more than that one investment company and, indeed, usually manages a number of investment companies—a "complex" or a "family" of funds, in the jargon of the industry.[160] And, typically, the investment adviser will appoint the same persons as board members for many, if not all, of the investment companies that the adviser manages.[161] In the parlance of the industry, a board serving in that capacity for multiple, related investment companies is a "unitary" board.[162] As one might expect, to the extent

500 U.S. 90, 90 (1991) ("A court entertaining a derivative action under the ICA must apply the demand futility exception as it is defined by the law of the State of incorporation.").

154. *Burks*, 441 U.S. at 471–72.

155. *See id.* at 479.

156. *Id.* (quoting Johnson v. Ry. Express Agency, 421 U.S. 454, 465 (1975)).

157. *Id.* (quoting Wallis v. Pan Am. Petroleum Corp., 384 U.S. 63, 68 (1966) (internal quotation marks omitted)).

158. *Id.* at 477 (noting that, although "in certain areas we have held that federal statutes authorize the federal courts to fashion a complete body of federal law," corporate law "is not such an area").

159. Langevoort, *supra* note 8, at 1027.

160. *See* Brown v. Calamos, 664 F.3d 123, 130 (7th Cir. 2011) ("Like most advisors Calamos Advisors runs multiple funds . . . .").

161. *See id.* (noting that the adviser "uses the same six-member board of trustees, five of whom are 'independent' within the meaning of the [ICA], to oversee all the funds").

162. *Id.*

shareholders' claims are against the investment adviser, the adviser's role in selecting board members may create conflicts for board members in evaluating the shareholders' demand. After all, if a board member desires to continue to serve as such for other investment companies managed—and to be managed in the future—by the investment adviser, the board member arguably may be reluctant to support bringing a lawsuit against the investment adviser.[163] Yet this special circumstance is not one that courts have countenanced as permitting a conclusion that demand was futile.[164]

Indeed, any chastening effect that the ICA, combined with *Burks*, may have had on courts' analyses of shareholder derivative claims has been minimal (at best). Rarely has a court evaluating whether shareholder-plaintiffs should have made demand on the board of directors determined that demand was futile,[165] and only rarely have courts so much as mentioned the *Burks* caveat.[166] Accordingly, dogged application of corporate governance norms has effectively meant that shareholders will encounter substantial difficulty showing that directors were sufficiently interested as to be unable to evaluate a demand. That means that investment company shareholders stand on more or less the same ground as operating company shareholders in terms of their ability to pursue fiduciary duty claims on behalf of the company. Yet, if investment company regulation exists because state corporate governance norms, by themselves, are insufficiently protective of investors, then, at the least, courts should pause before reverting to those norms when doing so accomplishes nothing more than impeding shareholders' ability to enforce the ICA's protections.

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163. *See, e.g.*, Alexander v. Allianz Dresdner Asset Mgmt. of Am. Holding, Inc., 509 F. Supp. 2d 190, 196–97 (D. Conn. 2007) ("The plaintiffs allege that the trustees are interested because each of the trustees was appointed by the Investment Adviser Defendants and is therefore 'beholden to the Investment Adviser Defendants for his or her position and substantial compensation as a Director.'").

164. *See, e.g.*, Seidl v. Am. Century Cos., Inc., 713 F. Supp. 2d 249, 261 (S.D.N.Y. 2010), *aff'd*, 427 Fed. Appx. 35 (2d Cir. 2011) ("[W]here, as here a derivative suit brought on behalf of one fund might have some adverse impact on other funds managed by the same investment adviser and overseen by the same board of directors, it cannot be held that, as a matter of law, directors are so personally conflicted that they could not consider a demand in good faith and within the ambit of the business judgment rule."); *Alexander*, 509 F. Supp. 2d at 197 ("[S]ervice on multiple boards is common practice and not a basis for finding a trustee 'interested.'").

165. *See, e.g.*, Scalisi v. Fund Asset Mgmt., L.P., 380 F.3d 133, 140 (2d Cir. 2004) ("*Werbowsky* sets forth . . . Maryland's standards for determining whether demand on a corporation's directors is excused. We see no reason to believe that Maryland would depart from those standards in the case of a registered investment company."); *Seidl*, 713 F. Supp. 2d at 258 n.12 (noting the absence of authority to support the plaintiff's suggestion that "a more lenient standard for proving demand futility should apply to the directors of mutual funds").

166. *See* Strougo v. Bassini, 282 F.3d 162, 169 (2d Cir. 2001) ("We must fill a gap in the ICA with rules borrowed from state law unless . . . application of those rules would frustrate the specific federal policy objectives underlying the ICA.").

Additional concerns have arisen from the courts' demand analysis. Specifically, the Seventh Circuit, in evaluating a failure of complaining shareholders to make a demand on the board, has gone so far as to suggest that the fiduciary duties boards of directors owe investment companies are less robust than those boards owe to operating companies. Under Judge Posner's reasoning, directors of any one investment company must be mindful of their (possibly) competing obligations to other investment companies in the same family—including investment companies that do not yet exist:[167]

> [A] unitary board [is] responsible to the entire family of funds, including future funds because the present value of an enterprise is the discounted value of its future earnings. This responsibility may require the board to make tradeoffs to the disadvantage of investors in one of the funds for the sake of the welfare of the family a whole.[168]

With that, Judge Posner suggests that any particular investment company, in fact, is not really an enterprise unto itself but, rather, is but a piece of a larger enterprise that must be considered in its totality. As discussed below, that analysis, on its own, is compelling.[169] However, when deployed for the purposes of heightening standards shareholders must meet to move forward with their claims, it militates against the federal policy motivating the ICA—and turns the *Burks* caveat on its head. The upshot is that if courts should consider the ICA's policy objectives in applying state corporate law, it is difficult to discern that that is actually happening. This is not to say that allegations of conflicts based on a unitary board structure should always or in any particular case be deemed sufficient to allow plaintiffs to proceed with their claims. However, courts' failure to evaluate the concern with more than a passing reference to strict standards mandated by the applicable state law at least suggests an additional weakness in the investment company regulatory regime. It is, moreover, another weakness that derives from the intrusion of the corporate governance paradigm in securities regulatory objectives.

Judge Posner's conclusion that an investment company "enterprise" includes all of the investment companies, present or future, within the same family suggests doctrinal avenues that are more protective of shareholders, provided we put aside the corporate governance paradigm. In particular, if we move beyond the entity focus of that paradigm, we should be able to move beyond the notion that shareholder lawsuits to enforce fiduciary

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167. Brown v. Calamos, 664 F.3d 123, 130 (7th Cir. 2011).

168. *Id.* (citations omitted)

169. *See infra* text accompanying notes 171–78.

duties need ever be derivative in nature. Indeed, some plaintiff-shareholders have raised this prospect, arguing that the court should regard their claims as direct because investment companies are "mere shell[s]."[170] Because the net asset value of investment company shares, unlike that of operating company shares, is calculated on a daily basis,[171] the argument goes, "any increase or decrease in fund assets is immediately passed on directly to the fund investors."[172] Courts have swiftly rejected such arguments on the basis that they do not, in fact, demonstrate a distinction between investment companies and operating companies. For example, one such court, acknowledging that increases and decreases in an investment company's net assets "may be calculated on a nearly continuous basis as the per share net asset value," nonetheless concluded that "such a calculation is no different than the fluctuating daily prices of shares held by stockholders of publicly traded corporations" and, in any event, assets of either type of company are those of the company until distributed to shareholders.[173]

Not surprisingly, when the corporate governance paradigm is at play, arguments supporting direct shareholder claims have little purchase. However, if the analysis is not confined by its entity-centric perspective, it becomes evident that investment companies are different in kind from operating companies, for the reasons that the plaintiffs noted above have suggested. That is a combination of the three characteristics of investment companies on which their argument relies. First, an investment company's shares are valued on a daily basis based solely on the value of the securities the investment company holds—rather than the prospects for future appreciation in those shares.[174] Second, shareholders may redeem their

170. *See* Tannenbaum v. Zeller, 552 F.2d 402, 405 (2d Cir. 1977) ("A mutual fund is a 'mere shell,' a pool of assets consisting mostly of portfolio securities that belongs to the individual investors holding shares in a fund.").

171. *See* Stegall v. Ladner, 394 F. Supp. 2d 358, 365–66 (D. Mass. 2005). To determine an investment company's "per share net asset value" on any particular day, the company's liabilities (which largely are fees payable to the investment adviser) are subtracted from the market value of the company's portfolio securities (plus any other assets the company holds), and the result is divided by the number of shares outstanding. *Id.*

172. Everett v. Bozic, 2006 U.S. Dist. LEXIS 55824, at *12 (S.D.N.Y. Aug. 3, 2006) (emphasis omitted). *See also Stegall*, 394 F. Supp. 2d at 365 (reciting plaintiff-shareholders' argument that injury caused by an investment adviser's breach of fiduciary duty "flows by its nature directly to shareholders"); Strigliabotti v. Franklin Resources, Inc., 2005 U.S. Dist. LEXIS 9625, at *25 (N.D. Cal. Mar. 7, 2005) ("[T]he financial harm from overcharges is harm to the individual investors, who own the Funds' assets and bear its expenses directly . . . .").

173. *Everett*, 2006 U.S. Dist. LEXIS, at *13. *Accord Stegall*, 394 F. Supp. 2d at 366.

174. *See supra* note 97 and accompanying text.

shares at any time at the current daily net asset value.[175] Finally, investment companies' assets comprise simply the aggregate capital contributed by their shareholders (as that capital, invested in securities, may appreciate or depreciate), meaning that no portion of an investment company's assets is attributable to equipment, inventory, intellectual property, or any other assets that often appear on operating companies' balance sheets.[176] Those three characteristics render investment companies "transparent" in the sense that, but for the interposition of the entity that is the investment company, there is nothing about an investment company that is additive to what shareholders seek from it—namely, investment of their capital by an adviser they have selected. Derivative litigation principles of corporate law and the entity-centric focus of corporate governance are based on the notion that the entity's interests are not necessarily coextensive with those of its owners. That is a considerably more difficult case to make in the case of investment companies, and, therefore, there is a much stronger case for allowing direct claims by investment company shareholders.

### B. CORPORATE GOVERNANCE AND SECURITIES FRAUD

The entity centrism of the corporate governance paradigm may be discerned also in the 2011 Supreme Court decision, *Janus Capital Group, Inc. v. First Derivative Traders*.[177] The facts in *Janus* are relatively straightforward: shareholders of Janus Capital Group, Inc. ("JCG") filed a class action against the firm, alleging that Janus Capital Management, LLC ("JCM"), a wholly owned subsidiary of JCG, violated § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 under that Act in connection with statements made in the prospectus of an investment company managed by JCM, Janus Investment Fund ("Janus Fund").[178] The relationship among these Janus entities was typical of investment company complexes. In particular, JCG, a publicly traded firm, created the Janus Fund (as well as other investment companies), which engaged JCM as its investment adviser and administrator.[179] Like any other investment company, the Janus Fund was a legal entity separate from both JCG and JCM—and, like any other investment company, its shareholders were

175. *See* Palmiter, *supra* note 66, at 1433 ("The dominant mutual fund form, the open-end fund, must be able to redeem investors' shares overnight on demand.").

176. *See* Morley & Curtis, *supra* note 87, at 92 ("A mutual fund is a pool of investment securities that . . . is composed almost entirely of debt or minority equity holdings in many companies.").

177. Janus Capital Group, Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011).

178. *Id.* at 2299.

179. *Id.*

investors who contributed capital for investment purposes.[180] Moreover, like any investment company, JCM, as the investment adviser, provided investment-advisory services to the Fund, which included "the management and . . . operation of Janus Fund."[181]

In its action under Rule 10b-5, which forbids "any person . . . [t]o make any untrue statement of a material fact in connection with the purchase or sale of securities,"[182] First Derivative Traders ("First Derivative"), representing the plaintiff class, alleged that JCG and JCM made false statements in the Janus Fund prospectus by virtue of representations that the Fund "w[as] not suitable for market timing."[183] First Derivative further alleged that the allegedly false statements ultimately adversely affected the price of its JCG stockholdings.[184] Specifically, the New York attorney general had brought an action against JCG and JCM alleging that JCG had "entered into secret arrangements to permit market timing in several funds run by JCM."[185] When those allegations became public, Janus Fund shareholders withdrew significant amounts of capital from the Fund. As a result of the diminution in the Janus Fund's assets, JCM received substantially less compensation because that compensation was based on the amount of Fund assets. Because the fee compensation earned by JCM "comprised a significant percentage of JCG's income," JCG's stock price suffered a significant reduction in value.[186]

First Derivative argued that JCM and JCG should be liable for the losses JCG shareholders suffered on the basis that JCG and JCM "caused mutual fund prospectuses to be issued . . . and made them available to the investing public, which created the misleading impression that JCG and JCM would implement measures to curb market timing in the Janus [Fund]."[187] First Derivative asserted that, if the truth had been disclosed, the Janus Fund "would have been less attractive to investors, and consequently, JCG would have realized lower revenues," with the result that JCG's shares would have traded at a commensurately lower price.[188] At issue, then, was whether JCM, in light of its relationship to the Janus Fund—which, again, was typical of adviser-investment company

180. *Id.*

181. *Id.* (alterations omitted) (internal quotation marks omitted).

182. *Id.* at 2301 (quoting 17 C.F.R. § 240.10b-5(b) (2010)) (internal quotation marks omitted).

183. *Id.* at 2300.

184. *Id.*

185. *Id.*

186. *Id.*

187. *Id.* (alterations omitted) (internal quotation marks omitted).

188. *Id.* (alterations omitted) (internal quotation marks omitted).

relationships—could be deemed to have made statements disseminated by and about the Janus Fund.[189] The District Court for the District of Maryland had dismissed the complaint on the basis that it failed to state a claim on which relief could be granted.[190] However, the Fourth Circuit Court of Appeals reversed, reasoning that First Derivative "had sufficiently alleged that 'JCG and JCM, by participating in the writing and dissemination of the prospectuses, *made* the misleading statements contained in the documents.'"[191]

Determining that JCM did not "make" the material misstatements in the Janus Fund prospectus, Justice Thomas, writing for the Supreme Court, concluded that JCM could not be held liable for losses arising from those misstatements.[192] The rule on which the Court based its conclusion was that "the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."[193] According to the Court,

> JCM did not "make" any of the statements in the Janus Investment Fund prospectus; Janus Investment Fund did. Only Janus Investment Fund—not JCM—bears the statutory obligation to file the prospectuses with the SEC. The SEC has recorded that Janus Investment Fund filed the prospectuses. There is no allegation that JCM in fact filed the prospectuses and falsely attributed them to Janus Investment Fund. Nor did anything on the face of the prospectuses indicate that any statements therein came from JCM rather than Janus Investment Fund—a legally independent entity . . . .[194]

The First Derivative argument had emphasized the relationship between JCM and the Janus Fund[195] and the circumstance that investment advisers play a—if not "the"—primary role in formulating the disclosure

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189. *See id.* at 2301.

190. *Id.*

191. *Id.* (quoting another source). The Fourth Circuit also found that JCG could be liable only as a "control person" of JCM under § 20(a) of the Securities Exchange Act of 1934 because, while JCG shareholders would infer that JCM "played a role in preparing or approving the content of the Janus fund prospectuses," they would not infer the same about JCG. *Id.* (citations omitted) (quoting another source). Accordingly, before the Supreme Court, First Derivative sought to hold JCG liable only as a control person of JCM, while continuing to assert that JCM made the allegedly false statements. *See id.*

192. *Id.* In reaching its conclusion, the Court observed that it must be careful not to expand the private right of action implied under § 10(b). *Id.* at 2301–02.

193. *Id.* at 2302.

194. *Id.* at 2304–05 (citations omitted).

195. In his dissent, Justice Breyer described that relationship in greater detail: "[JCM] . . . manages the purchase, sale, redemption, and distribution of the [Janus] Fund's investments. [JCM] prepares, modifies, and implements the Janus Fund's long-term strategies. And [JCM] . . . carries out the Fund's daily activities." *Id.* at 2306 (Breyer, J., dissenting).

made by the investment companies they manage, just as advisers control most aspects of investment companies' operations.[196] The Court paraphrased First Derivative's argument as follows:

> First Derivative suggests that the "well-recognized and uniquely close relationship between a mutual fund and its investment adviser" should inform our decision. It suggests that an investment adviser should generally be understood to be the "maker" of statements by its client mutual fund, like a playwright whose lines are delivered by an actor.[197]

First Derivative's claim that JCM made statements in the Janus Fund's prospectus merely recognized that investment advisers and the investment companies they manage are integral, if not inseparable, components of the same enterprise: providing discretionary investment-advisory services to a group of investors. However, retreating to the fact that "corporate formalities were observed," that JCM and the Janus Fund were "legally separate entities," and that the Janus Fund's board "was more independent than the statute requires," the Court "decline[d] [First Derivative's] invitation to disregard the corporate form."[198]

The Court foreshadowed its holding in its observation that the relationship between an investment company and its adviser is similar to the relationship between a speechwriter and a speaker. "Even when a speechwriter drafts a speech," Justice Thomas observed, "the content is entirely within the control of the person who delivers it."[199] Like a speechwriter, JCM may have helped the Janus Fund craft the content of the prospectuses, but the Janus Fund was the speaker who actually made the statements in the prospectuses.[200] Or, put more generally, the investment company is the independent, autonomous being making a statement on its own behalf, even though it had assistance in determining what to say.

Characterized in this way, of course, the relationship of an investment adviser to an investment company is effectively the inverse of a playwright-actor relationship. Accordingly, whereas First Derivative viewed the investment company (the speaker) as merely an agent acting on behalf of and under the control of the investment adviser (the writer), Justice Thomas viewed the investment company (the speaker) as a principal whose investment adviser (the writer) acts on the investment company's behalf and under its control. Presumably Justice Thomas

196. *See id.* at 2304.
197. *Id.* (citations omitted).
198. *Id.*
199. *Id.* at 2302.
200. *Id.* at 2305.

preferred the speechwriter-speaker analogy over the playwright-actor analogy because it supports corporate personhood and the distinction between corporate beings. On the basis of that comparison, the Court was able to characterize an adviser's role in preparing a misleading prospectus to that of aiding and abetting—activities that do not give rise to a private right of action under Rule 10b-5.[201]

The Court's holding in *Janus* derives from, and further supports, the corporate governance paradigm, to the detriment of investor protection. In his dissent, Justice Breyer highlighted the potential anomalies wrought by the Court's decision, describing a not implausible scenario in which "guilty management [that is, the investment adviser] writes a prospectus (for the board) containing materially false statements and fools both board and public into believing they are true."[202] In light of the rule the majority articulated, noted Justice Breyer, in those circumstances "*no one* could be found to have 'ma[d]e' a materially false statement."[203] Indeed, that would seem to be the potential consequence of the Court's holding: the adviser cannot be liable under Rule 10b-5 because it did not formally issue the prospectus, and the investment company itself cannot be liable either because the board deferred to the adviser, who—as the repository of the investment company's "outsourced" personnel—was the only party with the requisite information about the matters to be disclosed in the prospectus. In other words, the Court's holding does not recognize that, in the investment company context, the corporation "making" the statements is not a freestanding entity unto itself. Rather, a component of the director-officer-shareholder corporate law triumvirate is housed in a different entity entirely (the adviser), and together the investment adviser and the company constitute the equivalent of a single corporate person. By not acknowledging the adviser-investment company relationship, *Janus* imports to securities regulation considerations of formalities and separateness that are at home only in the corporate governance realm.[204]

201. *See id.* at 2302 ("[S]uits [] against entities that contribute 'substantial assistance' to the making of a statement but do not actually make it [] may be brought by the SEC . . . but not by private parties.") (citations omitted).

202. *Id.* at 2310 (Breyer, J., dissenting).

203. *Id.*

204. The dissent appropriately eschewed reliance on the corporate governance paradigm but did not fully articulate the special relationship between adviser and investment company. In particular, Justice Breyer compared an adviser's relationship to the investment company to that between corporate managers and the corporation. *See id.* at 2307 ("The English language does not impose upon the word 'make' boundaries of the kind the majority find determinative. Every day, hosts of corporate officials make statements with content that more senior officials or the board of directors have 'ultimate authority' to control."). Accordingly, just as an executive can make statements attributable to the

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Parts III and IV set forth (very different) ways in which the corporate governance paradigm thwarts the objectives of securities regulation. The paradigm produces ineffective investment company management and oversight, inappropriate judicial reliance on state corporate governance norms, and undue emphasis on the sanctity of the entity—all to the detriment of investment company shareholders. The theme that may be distilled from the this discussion is that regulatory reliance on the corporate governance paradigm is counterproductive: boards of directors are ineffective in carrying out their decisionmaking and oversight functions, at least relative to their operating company counterparts, largely because they are dependent on, and defer excessively to, investment advisers. Investment advisers, for their part, may be motivated as much—if not more—by desires to maintain or increase fee levels as by achieving strong long-term performance. Finally, shareholders, fully aware that "selling" their shares means nothing more than selling them back to the issuer without any prospect of realizing a control premium, arguably perceive scant reward in monitoring their investment company positions.[205] If this state of affairs is not corporate governance at its best, it surely cannot be securities regulation at its best.

## V. AN ALTERNATIVE MODEL OF REGULATION

The corporate governance model of investment company regulation is one possible regulatory approach. That model relies on the circumstance that investment companies are formally structured like operating companies, in that they are governed by boards of directors who, as fiduciaries, represent and speak for the investment company, including in negotiating an advisory contract with the company's investment adviser, overseeing the adviser's activities, and monitoring the adviser's potential conflicts of interest relating to the company.[206] Regulation in this model specifies how directors' monitoring functions are to be carried out and the constraints on investment advisers' discretionary activities, all with a view

corporation that employs him, an investment company's statements can be attributable to its investment adviser. *See id.* at 2312. With that comparison, however, Justice Breyer suggested that an investment company is, in some sense, an agent of the investment adviser—or, in First Derivative's framework, the actor speaking the playwright's words. That analogy is likewise inapt, however, because it squarely contradicts the adviser's actual, formal status as an agent of the investment company.

205. Langevoort, *supra* note 8, at 1031 (observing that "in the world of mutual funds" neither "power of institutional investors who can actually threaten to exercise their voting rights" nor "a reasonably active market for corporate control" exist in any meaningful way).

206. *See supra* text accompanying notes 69–74.

toward ensuring that, in this assumed business enterprise, those in control are adequately accountable to those in the position of passive owner.[207] This model seeks to achieve the goals of securities regulation through a regulatory regime grounded in the rules and norms of corporate governance—rather than securities regulation—and fails in that effort.[208] Accordingly, as this part discusses, better regulation of investment companies could be achieved by recognizing that that regulation should be placed within the auspices of securities regulation.

## A. THE FINANCIAL SERVICES PARADIGM

As discussed above, the prospect that corporate law may not be the appropriate model for investment company regulation becomes evident when we evaluate how investment companies have shed their operating company roots and today hardly resemble their predecessors.[209] In that regard, perhaps most important is the relatively straightforward matter of how an investment company comes to be, particularly as compared with the inception process for operating companies. In the operating company context, one or more entrepreneurs determine to organize production through a corporation, which, governed by corporate law, generally involves a governing board of directors and one or more shareholders, who may be active participants in the business or passive investors.[210] From that basic determination almost naturally derives corporate governance concerns and decisions, involving maintaining a balance between the firm's ability to adapt to new circumstances and its accountability to shareholders.[211] On an ongoing basis, shareholders evaluate their continued holdings in the company based on its particular activities—the services it provides or the products it produces—and its management's ability to exploit those activities to the company's best financial advantage.[212] Shareholders' analyses revolve around what the company is and does that sets it apart from its competitors or from other potential investments (generally thought to be evident in the company's share price).[213]

207. *See supra* text accompanying notes 32–35.

208. *See supra* Parts III & IV.

209. *See supra* text accompanying notes 36–41.

210. O'KELLEY & THOMPSON, *supra* note 50, at 153–58.

211. *See id.* at 15.

212. *See* Lawrence A. Cunningham, *A New Legal Theory to Test Executive Pay: Contractual Unconscionability*, 96 IOWA L. REV. 1177, 1187 (2011) ("For centuries, shareholders have been seen as interested in maximization of firm profits and managerial performance was evaluated in those terms.").

213. *Id.* ("Beginning in the 1960s, it became fashionable to . . . see stock market price as a proxy for both the shareholder interest and firm value.").

In the investment company context, whether in the United States or elsewhere, the "entrepreneur" is typically the investment adviser, with hopes of managing an investment company with substantial assets and, therefore, the ability to generate sizable fees. In the United States, that investment adviser then forms the investment company and effectively sets the terms under which the company will operate (subject, of course, to compliance with the ICA and SEC regulations).[214] Among other things, therefore, the investment adviser chooses the company's name, selects its board of directors, determines its share class structure, and dictates the content of its certificate of incorporation or other constitutive document.[215] Beyond that, the adviser also selects the other service providers to the company—its auditor, distributor, and administrator, for example—negotiates their services contracts on behalf of the company, and oversees the service providers' performance of their responsibilities.[216] However, the adviser has no real role within the enterprise given that that the adviser does not occupy one of the three defining roles within a company: it is neither a director, nor an officer, nor a shareholder. Rather, the adviser's relationship with the company is merely contractual in nature, governed by the investment-advisory agreement between the adviser and the company, the terms of which are largely proposed by the adviser and formally ratified by the board of directors.[217]

Moreover, the relationship between the entrepreneur and the shareholders differs from that in the operating company context. Shareholder analysis of an investment company does not depend on what the company does or produces, as it neither does anything nor produces anything that is not reducible to the controlling influence of the investment adviser. The investment company's success depends on the ability of the investment adviser to achieve the goals established for the investment company, including to make decisions that increase, rather than reduce, the value of the assets that shareholders have invested.[218] That means that the

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214. *See* Burks v. Lasker, 441 U.S. 471, 480–81 (1979) (quoting S. REP. NO. 91-184, at 5 (1969), *reprinted in* 1970 U.S.C.C.A.N 4897, 4901) ("[M]utual funds, with rare exception, are not operated by their own employees. Most are formed, sold, and managed by external organizations, [called 'investment advisers,'] that are separately owned and operated . . . .").

215. *Cf. id.* at 481 (noting that the investment adviser of a "typical" investment company provides the company "with almost all management services").

216. *Cf.* Tannenbaum v. Zeller, 552 F.2d 402, 405 (2d Cir. 1977) ("The adviser . . . operates or supervises most of the . . . phases of the fund's business.").

217. *See supra* text accompanying notes 42–46.

218. *See Tannenbaum*, 552 F.2d at 405. ("The management of [an investment company] is largely in the hands of an investment adviser . . . . [which] either selects or recommends the fund's investments and rate of portfolio turnover . . . .").

entity itself is subordinate to the role of the investment adviser—and, with the diminished significance of the entity and its activities, there arises a more direct connection between the investment adviser and shareholders. Shareholders invest their capital in an investment company because of the investment adviser, whether on the basis of its reputation or its performance or, perhaps, its popularity; the investment adviser, in turn, provides services to those shareholders.[219] To be sure, those services are provided indirectly, through an intermediating entity (the investment company), but the entity serves merely a facilitating function. It is but an instrument.

Accordingly, a shareholder's investment in an investment company effectively establishes a services relationship between the shareholder and the investment adviser that manages the company (even though the adviser does not have a direct or personal relationship with each shareholder to whom it provides its services). As discussed further below, that characterization also suggests that the investment constitutes something different than the shareholder's simply buying a financial product, akin to a certificate of deposit or a credit-default swap. Moreover, with that characterization in mind, one might be less inclined to think that an approach based on the legacy of operating companies is an ideal approach. Instead, it would seem that regulation of investment companies should pay greater attention to investment advisers' responsibilities, including to manage client assets in accordance with the relevant investment objectives, to place client interests ahead of their own, to manage and mitigate conflicts of interest, to disclose material facts to clients, and to provide clients with information about their portfolio holdings on an ongoing basis.[220]

219. *See* Craig S. Tyle & Young Seo, *The Revolution in Investment Company Governance: New SEC Rules & the Challenge of Implementation*, *in* PRACTICING LAW INST., MUTUAL FUND CORPORATE GOVERNANCE 563, 584 (2004) (observing that "[w]hen investors become shareholders of a fund, they have already made a deliberate decision to select an investment manager whom they believe will implement their investment strategy and provide shareholder services suitable to their needs at an acceptable cost" and that "[i]nvestors do not expect the fund's directors to choose a new manager for them except in very unusual circumstances"); Ben L. Fernandez, *The Duties of Mutual Fund Trustees With Respect to the Investment Advisory Fee* 41-APR B.B.J. 12, 13 (1997) ("[Mutual fund] shareholders effectively choose the investment adviser by investing in the fund.").

220. This approach is consistent with sentiments expressed by industry professionals, including Eric Roiter, in his capacity as a senior vice president of Fidelity Management & Research Company:

> Mutual funds, although taking separate legal form as corporations or business trusts, do not produce goods or deliver services. Rather, mutual funds are the vehicles *through which* investors consume a service. That service is collective investment management provided by the fund's adviser. A mutual fund, while having a separate legal existence, in its most fundamental sense is essentially a means by which consumers jointly obtain the services of an investment adviser. In contrast to distinct groups of shareholders and customers of an

If those responsibilities should be the focus of investment company regulation, then we are directed toward a model of regulation that substantially resembles the regulation governing investment advisers' relationships with "clients" that are not investment companies (or investment company shareholders) but that instead are individuals or institutions that have engaged the adviser to directly manage their assets (in a nonpooled manner), separately from the assets of any other client. In the direct-client context, the obligations fall squarely on the shoulders of the investment adviser.[221] Applied to investment companies, this model would render the adviser responsible for its own actions and inactions, including its engaging in "conflict" transactions with or on behalf of the investment company or its charging the investment company a fee in excess of what is normal in the market. The adviser, moreover, would be directly answerable to regulators for its missteps, and possibly also to shareholders, to the extent that the regulatory regime endows them with a private right of action. In this picture, the board of directors has been excised, as has any possibility that the investment adviser may engage in questionable activities or transactions simply by virtue of having obtained official board approval or ratification of them.

In such an alternative approach, then, whether the investment company has a board of directors and, presumably, the structure of the investment company, would be irrelevant. Instead, the investment adviser would be the sole repository of investment company governance, and regulation would focus on the position of the investment adviser vis-à-vis the investment company's shareholders and, more importantly, the nature of the adviser's relationship to the investment company. Ultimately, this approach would regard that relationship as just one type of relationship among many in which an investment adviser provides services to "clients," with the clients in this case (functionally, if not formally) being the shareholders that invest, collectively, in a "pool" that the adviser then manages as a single account. With that understanding of the adviser's role as the basis of regulation, regulatory requirements should be directed

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operating company, there is complete convergence among shareholders and customers of a mutual fund. They are one and the same group.

Eric D. Roiter, Senior Vice President and Gen. Counsel of Fidelity Mgmt. & Research Co., An Apology for Mutual Funds: Delivering Fiduciary Services to Middle and Working Class Investors, Remarks Before the Annual Review of Banking and Financial Law Annual Dinner (March 29, 2004), *in* 23 ANN. REV. BANKING & FIN. L. 851, 860 (2004).

221. *See* Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (2006) (requiring investment advisers to register with the SEC, with that registration subject to suspension or revocation for improper behavior, prohibiting them from effecting certain types of transactions, and imposing various other obligations).

almost exclusively toward the investment adviser and specify what is to be done and what is not to be done in connection with the adviser's managing the investment company's assets, communicating with shareholders, engaging in personal securities transactions, managing other client accounts, and so forth.

To be sure, this alternative approach to regulation—which may aptly be called a "financial services" approach and which prevails in the European Union[222]—embodies certain similarities to the U.S. corporate governance approach. For example, both recognize and impose on investment advisers certain transaction-related restrictions designed to mitigate or eliminate conflicts of interest.[223] However, the models are largely dissimilar overall, given the importance that the corporate governance model places on oversight by boards of directors and the fact that the financial services model would provide no regulatory role for boards of directors. For example, the European Union's regulation of UCITS (essentially, publicly offered, open-end investment companies[224]) makes no mention of directors, nor does it suggest that investment companies themselves (through a board of directors or other governance mechanism) should play a role in management-type activities. Indeed, the E.U. Directive setting forth investment company regulation notes that investment companies need not even be structured as "companies."[225] Rather, "[s]uch undertakings may be constituted according to law, either under the law of contract (as common funds managed by management companies) or trust law (as unit trusts) or under statute (as investment companies)."[226]

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222. The financial services regulatory approach has been embraced by other countries as well. *See* Palmiter, *supra* note 5, at 205 (observing that "[t]he regulatory focus [in most other countries] is on the management firm, not the investment pool or its legal supervisor" and, further, that, in those countries, regulation of fees, management services, custodial arrangements, and fund marketing "is a matter of government agency supervision, with residual oversight by self-regulatory organizations and courts under a regime of fiduciary duties that fall on the management firm").

223. *See* 15 U.S.C. § 80b-6(3) (prohibiting transactions on behalf of clients where the investment adviser acts as a principal for its own account, unless the adviser first obtains the clients' written consent); Council Directive 85/611, On the Coordination of Laws, Regulations, and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS), art. 5f § 2, 1985 O.J. (L 375) 3 (EC), at *11 (as amended) [hereinafter E.U. Directive], *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1985L0611:20080320:EN:PDF ("Each management company the authorisation of which also covers . . . discretionary portfolio management service[s] . . . shall not be permitted to invest all or a part of the investor's portfolio in units of unit trusts/common funds or of investment companies [the management company] manages, unless it receives prior general approval from the client.").

224. *See* E.U. Directive, *supra* note 223, art. 2 § 1, at *5.

225. *See id.* art. 1 § 3, at *3.

226. *Id.*

The Directive speaks only in terms of the "management company" (the investment-advisory firm that manages the investment company), the investment company itself, and the unitholders (shareholders) of the investment company.[227] The management company, which must be authorized as such by its member country,[228] bears the primary regulatory compliance obligations, as specified by the relevant member country. Those obligations must, among other things, require authorized management companies to maintain adequate administrative and accounting procedures and trading policies governing transactions by management company affiliates and to take steps to minimize conflicts of interests between the management company and its clients.[229] The obligations to which the investment companies themselves are subject, by contrast, consist largely of investment restrictions—for example, requirements that an investment company invest only in transferable securities and certain other instruments, concentration limitations, and prohibitions on borrowing.[230] Those activities are, by definition, controlled by the relevant management company. Accordingly, it is effectively the management company's responsibility to ensure the investment company's compliance with the company's regulatory obligations.

Although it may at first appear that eliminating the independent check on management actions would exacerbate regulatory difficulties, in fact the opposite would likely hold in practice. After all, no independent voice would mean that regulators would not rely on investment company "self-regulation" as a mechanism of client (investor) protection but, rather, would signify that, as with any other investment-advisory "client," the investment adviser is responsible to the regulatory authority for its actions in relation to the persons whose assets it manages. So, for example, unable to rely on an independent (albeit controlled) board of directors for the formal approval of the fees an investment adviser desires to charge the investment companies it manages, the adviser would be forced to adhere to applicable laws and regulations regarding excessive fees. In other words, it would not be able to hide behind the shield of authorization of independent fiduciaries. Similarly, in questions about the appropriateness of shareholders' proposed arbitrage transactions, investment advisers would be held directly accountable for the arrangements that they make with those shareholders and for the conflicts of interest on which those arrangements

227. *See, e.g.*, *id.* art. 1a § 2, at *4.
228. *Id.* art. 5 § 1, at *6.
229. *See id.* art. 5f § 1, at *10.
230. *See id.* art. 19, at 20–23.

are based.

## B. BUILDING ON THE CONCEPTUAL FRAMEWORK

The financial services paradigm recognizes that the regulation of investment companies is not a matter of corporate governance. Under the financial services approach, the investment adviser is obligated to carry out its activities relating to an investment company in compliance with applicable laws and rules, which set forth obligations not unlike those governing an adviser's management of accounts held by individuals, foundations, endowments, pension plans, and others who are not investment companies. This approach does not attempt to attribute to the investment company a regulatory or governance "voice" independent of the investment adviser's. The appeal of this regulatory approach is that it is more coherent, and ultimately would be more effective, than regulation based on the corporate governance paradigm. Based on the contours of the financial services model outlined so far, however, the nature of the shareholder's relationship to the investment company, on one hand, and to the adviser, on the other, is not necessarily apparent. Accordingly, this section further builds the model's conceptual framework.

### 1. Investment Company and Shareholder

In the name of securities regulatory goals, this Article has critiqued the corporate governance model of regulation and proposed to eliminate the regulatory role of boards of directors in favor of more direct regulation of investment advisers. Without more, it is not apparent that this alternative model of regulation fits any more comfortably within the "securities regulation" fold than does the corporate governance model. Indeed, others who have proposed dismantling the corporate governance mode of regulation by eliminating boards' role and directing regulation at advisers would have investment company regulation instead be a form of product regulation, rather than securities regulation. In particular, John Morley and Quinn Curtis, in their own critique of U.S. investment company regulation, endorse product-style regulation based on their observation that investors transact in investment company shares much as they act as consumers of auto tires or breakfast cereal.[231] Conceptually, the difference between the two modes of regulation—product and securities—lies in the role provided

231. *See* Morley & Curtis, *supra* note 87, at 112. *Accord* Fisch, *supra* note 15, at 2028–30 (arguing that "[m]utual funds and comparable alternatives should be regulated as products, not investments" and proposing product-like regulation based on a "conform or explain" approach).

for shareholders: whereas securities regulation is premised on the importance of investor monitoring and, toward that end, supplying information to investors about how their capital is deployed and by whom, product-style regulation envisions that investors (as "consumers") have no ongoing monitoring role or informational needs.

In reaching their conclusion, Morley and Curtis focus on shareholders' exit rights and, in particular, the circumstance that the redemption price for investment company shares reflects only the shares' current net asset value and does not take into account the investment company's expected returns.[232] Accordingly, they note, shareholders in investment companies with relatively low expected returns will have no incentive to seek to improve the company's returns through exercising voting rights or suing the investment adviser under the ICA for excessive fees.[233] Rather, they will prefer to redeem their shares and move to an investment company with a higher expected return.[234] Because investment company shareholders do not use fee liability and voting rights, in Morley and Curtis's alternative conception of regulation, any role for shareholders would be excised. Shareholders would have neither voting rights nor the ability to bring actions for excessive fees (outside of the contexts of fraud, misconduct, or inadequate disclosure).[235] Such elimination of any role for shareholders is consistent with viewing investment companies as products and a necessary predicate for product-style regulation. After all, according to Morley and Curtis, "If . . . it was believed that the price of certain auto tires was too high or the quality was too low, the sensible solution would not be to allow tire consumers to sue for excessive prices or to empower them to set prices and quality by vote."[236] Instead, they contend, regulation should address quality directly (through direct regulation of investment advisers) and encourage price competition, through encouraging shareholders' effective

232. *See* Morley & Curtis, *supra* note 87, at 89. As the authors note, the net asset value does include the expected returns of the securities the investment company holds in its portfolio, but does not include the expected return of the investment company itself, "which includes expected fees and expected changes to the fund's portfolio as well as the expected returns of the securities already in the portfolio." *Id.* at 103.

233. *See id.* at 89.

234. *Id.*

235. *See id.* at 142. Donald Langevoort also uses the product analogy but in a descriptive, rather than a prescriptive, fashion. In particular, he observes that board passivity may be attributed to boards' regarding investment company investments as products that consumers are able to effectively evaluate based on the available information. Langevoort, *supra* note 8, at 1031–40. In that world of consumer sovereignty, Langevoort observes, boards do not regard themselves as having robust fiduciary obligations, with the predictable result that they are less active shareholder advocates than would be the case in the operating company context. *Id.*

236. Morley & Curtis, *supra* note 87, at 131.

exercise of exit rights.[237]

Morley and Curtis's conception of regulation rightly rejects reliance on corporate governance norms and, therefore, correctly eschews the entity centrism of the corporate governance model. However, it overstates the case for removing any role for shareholders. The foundation for their argument is the notion that investment company shareholders are at an advantage in exiting an investment company, as compared with operating company shareholders wishing to dispose of their shares, because the former may redeem and purchase shares at prices that do not reflect expected returns.[238] If expected returns were reflected in share prices, then redemption prices in a low expectation investment company would be low, and purchase prices in a high-expectation investment company would be high, even if the net asset values of the two companies were the same.[239] To place such weight on the circumstance that shareholders receive no more and no less than the current net asset value of their shares requires as a premise that shareholders base their decisions to invest in or exit any particular investment company on the company's past returns and the amount of advisory fees the company pays. With that premise, it is not difficult to view investment companies as products and to seek to regulate them accordingly, including by removing any role for shareholders.

That premise is questionable at best, however, because it assumes that the investment adviser is wholly irrelevant. That is, the notion that the only relevant factors for shareholders are what they "get" from an investment company in terms of returns and low fees counterfactually ignores the fundamental role of investment advisers in creating investment companies and marketing them as avenues through which investors may obtain the benefit of the advisers' services and expertise. Investment company shareholders, not unlike investment advisers' direct clients, choose where to place their capital at least in part based on what adviser will be managing it, as well as the adviser's reputation, investment strategies, track record, management team, and so on.[240] Unlike buying a product, when investors place capital in an investment company, they are putting that capital at risk, and one basis for evaluating that risk is information about the adviser into

237. *Id.* at 131–32, 142.

238. *See supra* note 97 and accompanying text.

239. *See* Morley & Curtis, *supra* note 87, at 89.

240. *See* William J. Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. PA. L. REV. 179, 223 (1971) ("[M]ost independent directors believe that fund shareholders have purchased a package of investment management services based upon the strength of a particular adviser's reputation."); Tyle & Seo, *supra* note 219, at 584.

whose hands the capital will be (indirectly) placed.[241] In other words, once investors put capital in an investment company, they have done something different from buying a tire. They have engaged a financial services professional to manage their assets on their behalf. That act can be seen as having established an advisory relationship between shareholders and adviser, albeit one that is attenuated (yet also enabled) by the investment company itself.

In addition to returns and fee rates, the ups and downs of that mediated services relationship inform shareholders' decisions to redeem shares. When a shareholder believes the advisory services provided are no longer well suited to the shareholder's financial needs, the shareholder may terminate the services relationship by redeeming the shares, much as a direct advisory client may terminate the contract with the adviser at any time. Because of the critical role the investment adviser plays in the investment company structure, including as a component of shareholders' evaluation of investment alternatives, exit rights arguably do not do the work that would allow resorting to a product-style regulatory model. The investment adviser should be the subject of regulation for the purpose of providing services to the investment company directly and to shareholders indirectly. The flip side of that coin is that the shareholders should have certain rights, as shareholders, such as to receive disclosure about, and to have a say in, how their invested capital is faring under the adviser's management. In other words, the shareholders should be entitled to protections as investors, which is the hallmark of securities regulation.

2. Investment Adviser and Shareholder

The comparison between direct advisory clients and investment company shareholders allowed by the financial services model may reasonably raise questions about the identity of the adviser's "client" for purposes of regulation governing investment advisers. Beyond investment advisers' role in the investment company regulatory structure, after all, investment advisers are regulated as investment advisers in connection with all of their advisory activities (whether or not involving investment companies).[242] In that regulation, advisers' obligations are owed to those who are their "clients"—and, under the corporate governance paradigm, an

241. That principle is reflected, among other places, in the SEC's rules under the Advisers Act, which require that investment advisers provide to their clients comprehensive disclosures about themselves and their operations, both at the time of the initial engagement and on an annual basis thereafter. 17 C.F.R. § 275.204-3(a), (c) (2009).

242. Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21 (2006).

investment company (and not its shareholders) is deemed to be the advisory client.[243] This Article has attempted to establish that more effective investment company regulation would result from establishing a more direct regulatory relationship between investment advisers and investment company shareholders and by eliminating the regulatory role of boards of directors. Accordingly, it is worth considering whether that rearrangement of relationships implies that the investment company should be disregarded altogether for regulatory purposes and that shareholders should be deemed the adviser's clients, as though there were in fact a direct and unintermediated relationship between adviser and shareholders.

If only intuitively, that would seem an impossible result, given that advisers to investment companies typically have no direct relationships with shareholders and that investment companies—being public—are not limited in the number of shareholders they may have.[244] Indeed, at any given time, an investment company may have hundreds, if not thousands, of shareholders.[245] Fortunately, then, as the rest of this section elaborates, this Article's analysis need not affect the who or the what that is deemed the client of the investment adviser to an investment company—but not for the reasons one might suppose. In particular, and resonating with the intuition articulated above, one formidable obstacle to a shift to viewing shareholders as the adviser's clients may at first seem to be the oft-repeated notion that an investment adviser's advice is necessarily personal, tailored to the particular needs and circumstances of each client. This notion has taken hold in regulatory lore, particularly given language in judicial decisions and regulatory releases that appear to support it.[246] For example, the Supreme Court, in *Lowe v. SEC*, observed, based on its understanding of the Investment Advisers Act of 1940 ("Advisers Act") and its history, that the Act was "designed to apply to those persons . . . who provide

243. *E.g.*, Definition of "Client" of Investment Adviser for Certain Purposes Relating to Limited Partnerships, 50 Fed. Reg. 8740, 8741 (Mar. 5, 1985) (codified at 17 C.F.R. pt. 275) ("[A]n investment company organized as a corporation, rather than each of its stockholders, is generally regarded as the client of the company's investment adviser.").

244. Alan L. Kennard, *The Hedge Fund Versus the Mutual Fund*, 57 TAX. LAW. 133, 133 (2003) ("A mutual fund . . . usually has an unlimited number of investors [and] is available to the general public . . . .").

245. Lawrence W. Waggoner, *The Case for Curtailing Dead-Hand Control: the American Law Institute Declares the Perpetual-Trust Movement Ill Advised* (Univ. of Mich. Pub. Law Working Paper No. 199, 2010), *reprinted in* RAYMOND H. YOUNG, ALI-ABA, REPRESENTING ESTATE AND TRUST BENEFICIARIES AND FIDUCIARIES *11, *13 (ALI-ABA Continuing Legal Educ. Course of Study SS004 ALI-ABA 791, 2010) (observing that a "mutual fund" may have "thousands upon thousands of shareholders").

246. *See* Krug, *supra* note 63, at 44–51.

personalized advice attuned to a client's concerns."[247]

In other contexts involving "pools" of capital where we might consider who should appropriately be deemed the adviser's client for regulatory purposes, this understanding of the adviser-client relationship is not formidably challenged (though, to be sure, has to be addressed). For example, in the context of regulation of advisers to hedge funds, private equity funds, and other private funds—that is, investment companies that are not registered as such under the ICA—the fund, rather than the investors holding interests in it, has traditionally been regarded as the "client" for purposes of the advisers' obligations under the Advisers Act.[248] However, a private fund, in offering its interests, must comply with the private-placement rules under Regulation D of the Securities Act of 1933, which means the fund may offer interests only to persons meeting specified wealth or income thresholds and with whom the fund (through its adviser or general partner or other control person) has a preexisting relationship.[249] The need for the offering to meet the requirements of the private-placement rules means that the fund's adviser, as the person that controls and speaks for the fund, typically has a personal relationship with each person who buys interests in the fund and thereby becomes an investor.[250]

Given certain anomalies that arise from regarding the fund as the "client," combined with the relationship that typically exists between the fund's adviser and the fund's investors, there are good reasons for regulation to regard the investors, rather than the fund, as the clients of the adviser, at least for purposes of the adviser's compliance with a number of obligations under the Advisers Act.[251] In a sense, the adviser-investor relationship in the private-fund context is not particularly different from the relationship that adviser might have to those with whom it has a direct advisory relationship (that is, where no fund is involved).[252] However, that is not the situation in the context of publicly registered investment companies because those investment companies need not comply with the

247. Lowe v. SEC, 472 U.S. 181, 182, 207–08 (1985).

248. *See, e.g.*, 17 C.F.R. § 275.203(b)(3)-1 ("A limited partnership or limited liability company is a client of any general partner, managing member or other person acting as investment adviser to the partnership or limited liability company.").

249. *See* 17 C.F.R. §§ 230.501(e)(1)(iv), 230.506.

250. Abraham J.B. Cable, *Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups*, 13 U. PA. J. BUS. L. 107, 134 (2010) (noting that the SEC's approach to the Regulation D "safe harbor" "focuses on whether [the issuer has] a preexisting relationship with each offeree" of securities).

251. *See* Krug, *supra* note 63, at 27–36.

252. *See id.* at 27–31.

private-placement rules and, accordingly, neither an investment company nor its investment adviser needs to have any preexisting relationship or other personal connection with any particular person that may want to buy interests in the investment company.[253] This means that, in thinking about the identity of the investment adviser's client under the financial services model of investment company regulation, questions concerning the extent to which an adviser's investment adviser needs to be "personal" and "tailored"—and, indeed, whether the adviser need have any relationship at all with its "clients"—are more acute.

This author, for one, has argued that, at least in the United States, in light of the history of U.S. regulation of investment advisers and the text of the Advisers Act, adviser-client relationships in fact need not be personal relationships and that an adviser may effectively establish an advisory relationship with persons to whom it merely distributes impersonal reports and analyses.[254] Whether that analysis extends to the relationship between an adviser and investment company shareholders such that shareholders should be deemed advisory clients seems a dubious proposition, however. For one thing, regardless of the extent to which an adviser's advice need be "personal" or tailored to the specific needs of each of its clients, intuitively there has to be, at the least, a channel of recognition and awareness between adviser and client. In the private-fund context, that relationship is readily established.[255] It is a more difficult case to make in the (public) investment company context, however, given the public nature of the company and the fact that, ultimately, shareholders engage the adviser indirectly, by purchasing shares through the investment company's distributors.

Conceivably, the current structure could be modified to create a more direct connection between advisers and shareholders. Ultimately, however, the efficacy of the financial services model does not require it. Focusing regulation on the investment adviser (and leaving the board out of the picture) has no necessary implications for the identity of the adviser's client for purposes of the adviser's own regulatory obligations. It means only that the adviser is now the direct target of those obligations, with no self-regulatory role provided by a board of directors. Under both the corporate

253. *See supra* text accompanying notes 245–46.

254. *See* Krug, *supra* note 63, at 44–51; Arthur B. Laby, SEC v. Capital Gains Research Bureau *and the Investment Advisers Act of 1940*, 91 B.U. L. REV. 1051, 1081–82 (2011) (observing that Congress, in formulating the Advisers Act, recognized that not all investment company advisory relationships were "personalized, confidential relationships").

255. *See supra* text accompanying notes 251–52.

governance and the financial services models, however, those obligations—the purpose of the regulation—are for the benefit of the investment company, as an aggregation of capital contributed by the company's disparate shareholders. In the private-fund context, given that, by definition, only the investment adviser, and not the fund itself, is the focus of regulatory obligations,[256] there necessarily remains a concern about investors' rights and entitlements as such—for example, rights to periodic disclosures and voting and consent rights. In that context, therefore, it is appropriate to consider whether fund investors should be regarded, at least in some respects, as clients of the fund's adviser. However, and importantly, that concern is more readily dispensed with in the (public) investment company context, where investors' rights and entitlements can be articulated, to any degree of specificity deemed appropriate, as part of the investment company regulatory structure.[257]

## VI. CONCLUSION

The corporate governance paradigm has given rise to a number of regulatory weaknesses, which stem most directly from investment advisers' control over investment company boards of directors. Boards have failed to exert meaningful dissent to the manner in which advisers carry out investment company operations or to specific requests that advisers make, such as regarding the fees they charge and special redemptions rights for favored shareholders. Moreover, in the investment company context, the traditional oversight function of a corporate board does not exist—not because boards are incompetent but, rather, because that function cannot exist given how investment companies are structured. Investment companies are not simply another type of business enterprise. They effectively outsource all services and responsibilities. The result is that boards do not technically oversee anything but instead simply react to matters that others (investment advisers) have deemed important enough to report to the board for consideration. We might say that investment company boards of directors provide "oversight" of a veritable black box.

The U.S. investment company regulatory regime should recognize the

256. The exemptions on which private funds rely are set forth in § 3(c)(1) and § 3(c)(7) of the ICA. *See* Investment Advisers Act of 1940, 15 U.S.C. §§ 80a-3(c)(1), (c)(7) (providing an exemption from the definition of "investment company" for purposes of ICA's registration requirements for funds that do not offer their securities publicly and meet certain other requirements); Krug, *supra* note 63, at 4 n.12.

257. *See, e.g.*, 15 U.S.C. § 80a-29 (setting forth periodic disclosures required of mutual funds and other registered investment companies).

distinction between investment companies and operating companies. It should recognize that investment companies are an instrument that investment advisers use to provide investment advice to those who seek it. Toward that end, this Article proposes the dismantling of corporate law constructs in investment company regulation as a means of producing more effective regulation and, therefore, more effective protection of investors, which remains the primary objective of securities regulation. In particular, regulation should be based on the financial services model, both to avoid the infirmities of an "independent" board and to foster greater coherence in securities regulation. Importantly, however, this Article makes no claims about what the substantive obligations of that regulation under that model should be—either regarding substantive regulatory requirements governing investment advisers or the types of activities in which investment companies are able to engage.