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Mutual Funds Scandals - Comparative Analysis of the Role of Corporate Governance in the Regulation of Collective Investments

Jerry W. Markham

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I. INTRODUCTION

The mutual fund market timing and late trading scandals initiated by New York Attorney General Eliot Spitzer in 2003 led to settlements from industry participants that totaled over $4.25 billion. However, Spitzer’s actions were controversial and undercut the role of the Securities and Exchange Commission (“SEC”), which had been given pervasive regulatory authority over mutual funds by the Investment Company Act of 1940. The SEC had been embarrassed by earlier Spitzer prosecutions of financial analyst conflicts on Wall Street and by a spate of accounting scandals at Enron and elsewhere. The individuals and companies involved in those scandals had all been under the SEC’s purview, but that agency did nothing to prevent or uncover those problems. Spitzer’s actions against the mutual funds made the SEC look even more ineffective. In order to restore its tarnished image, the SEC imposed additional regulations on mutual funds, including a requirement that they increase the number of outside directors on their boards and split the role of chairman and chief executive
The actions taken by the SEC were highly politicized, and critics noted that there was no empirical evidence that such a requirement would have prevented the mutual fund scandals or assured better performance results. Adding further embarrassment to the agency, those corporate governance rules were struck down twice by the District of Columbia Court of Appeals. An effort by the SEC to regulate hedge funds because of their role in the late trading and market timing scandals met the same fate. The SEC’s proposals were, in all events, nothing more than face-saving gestures. There already existed a pervasive regulatory scheme for mutual funds under the Investment Company Act of 1940, including requirements for outside directors. However, those restrictions provided little or no protection to mutual fund shareholders, and adding more bells and whistles will not produce a better result. The corporate governance model for mutual funds simply failed. This raises the issue of whether other governance structures would be more effective in providing shareholder protection or would at least serve equally as well. Are mutual fund investors really shareholders in a traditional sense who need the protection of a board of directors and attending fiduciary duties? Alternatively, are they simply consumers who base their investment decisions on product price in the form of investment returns after expenses?

This article will examine the SEC’s response to the late trading scandals and provide a comparative analysis of alternate mechanisms for regulating collective investments. The article first traces the growth and development of mutual funds and their regulation. This includes a description of the early history of investment companies, the development of the open-end mutual fund in the 1920s, the problems encountered by investment companies in that era and the regulation that followed under the Investment Company Act of 1940. The article next describes the late

3. This saga is described in Jerry W. Markham, A Financial History of Modern U.S. Corporate Scandals, From Enron to Reform, 400-34 (2006).
7. See infra Part II.C and accompanying text.
8. The American Enterprise Institute for Public Policy (‘AEl’) and the Brookings Institute have conducted a joint policy initiative on this issue. See Ronald A. Cass & Henry G. Mann, SEC à la Donaldson, WALL ST. J., July 1, 2005, at A8, available at http://www.aei-brookings.org/policy/page.php?id=220. AEl has also conducted a number of conferences on alternative regulations of mutual funds that are co-moderated by Peter Wallison, AEl Resident Fellow, and Robert E. Litan, a Brookings Institute fellow. This paper is based in part on a presentation at one of those conferences, and I want to especially thank Peter Wallison for inspiring and commenting on this article.
9. See Paula Tkac, Tinker, Tailor, Mutual Fund Adviser, WALL ST. J., April 12, 2006, at A14 (concluding that mutual funds are simply consumer transactions).
trading and market timing scandals and the SEC’s response, as well as the role of hedge funds in those scandals. Alternative regulatory schemes for collective investments are then examined, including hedge funds, commodity pools, common trust funds, collective investment funds for pensions, endowments and insurance company reserves. Some other alternative regulatory and market schemes are also considered, including unitary investment funds, unit investment trusts and trust indentures. None of the latter mediums provide shareholder status for the persons supplying the funds that are under management and some do not provide the protections of fiduciary duties. The article concludes that alternative mechanisms, even those that do not have a board of directors, would serve equally as well as the current regulatory structure for mutual funds, which has proved to be overly costly, complex, and ineffective.

II. INVESTMENT COMPANY REGULATION

A. BACKGROUND AND HISTORY

“The investment company concept dates to Europe in the late 1700s,” according to K. Geert Rouwenhorst in The Origins of Value, “when ‘a Dutch merchant and broker . . . invited subscriptions from investors to form a trust . . . to provide an opportunity to diversify for small investors with limited means.” The trust was created by Abraham van Ketwich and was called the Eendraght Maakt Magt. It sold 2,000 shares to subscribers whose funds would be collectively invested in “bonds issued by foreign governments and banks and in plantation loans in the West Indies.” The sponsor was paid a fee of 0.5 percent of the subscriptions plus an annual fee of 2,000 guilders. An annual accounting was required, and the sponsor was monitored by two independent trustees.

The Societe Generale de Belgique, a Belgium trust originally created in 1822 by King William of the Netherlands, was another collective investment enterprise that initially invested in foreign government loans and later in commercial businesses. The Societe Generale de Credit Mobilier was organized in France in 1852 to supply new enterprises with

11. Id.
12. Id. at 254, 257.
13. E.C. HARWOOD & ROBERT L. BLAIR, INVESTMENT TRUSTS AND FUNDS FROM THE INVESTOR’S POINT OF VIEW 12 (1937); THEODORE J. GRAYSON, INVESTMENT TRUSTS 11 (1928). A decade or so later, the Societe Generale Pour Favoriser l’Industrie Nationale Des Pays-Bas, initially a Belgian firm, converted loans to defaulting businesses into stocks of those firms and later sold the stock into the public market. That enterprise formed another investment trust with the Rothschilds in 1836 called the Societe Des S Capitalistes Reunis Dans un But de Mutualite Industrielle, which held shares in various companies. RONDON CAMERON, FRANCE AND THE ECONOMIC DEVELOPMENT OF EUROPE 147-48 (2d ed. 1961).
banking facilities. It invested in railroad projects in France and in joint stock companies. The Credit Mobilier, which effectively operated as a closed-end investment company, was not without controversy. Critics charged that it was actually a giant stock-jobber that was manipulating the market for the companies in which it invested.

The creation of investment companies became popular in London in the 1860s. They operated as limited liability companies upon the enactment of the English Companies Act in 1862. Their numbers included the London Financial Association and the International Financial Society. Those investment companies sought to pool small investors’ funds and provide for expert management, but both companies failed.

Investment trust companies were formed in London in the 1870s as a medium for the purchase of American corporate securities. The American Trust Company in London was one such enterprise. Robert Fleming, the grandfather of the creator of the James Bond novels, was said to be founder of the Scottish investment trusts that were popular in the 1870s. Fleming’s Scottish American Investment Trust was managed by a board of advisors and invested funds for about 500 clients. By 1886, there were twelve investment trusts that were trading on the London Stock Exchange.

16. Money Affairs on the Continent, N.Y. TIMES, October 3, 1837, at 2. The French Credit Mobilier became a model for the Credit Mobilier railroad construction company that caused so much scandal in the United States over the building of the Union Pacific Railroad. See generally MAURY KLEIN, UNION PACIFIC, THE REBIRTH (1987) (describing the building of the Union Pacific railroad and the role of the Credit Mobilier). The American entity was used to loot the Union Pacific and its officers bribed numerous politicians in order to protect the company’s interests. Representatives Oak Ames of Massachusetts and James Brook of New York were censured by Congress for accepting those bribes and the career of Vice President Schuyler Colfax was destroyed. ROBERT V. REMINI, THE HOUSE, THE HISTORY OF THE HOUSE OF REPRESENTATIVES 219-221 (2006).
17. MARKHAM, supra note 14, at 323.
18. Id.
19. HARWOOD & BLAIR, supra note 13, at 13-15; GRAYSON, supra note 13, at 1-2. The Foreign and Colonial Government Trust, which was formed in London in the 1860s, was a global trust that purchased securities in several foreign countries. It promised to redeem a portion of its shares through an annual drawing. That arrangement was held to be an illegal lottery. CHARLES RAW ET AL., DO YOU SINCERELY WANT TO BE RICH? THE FULL STORY OF BERNARD CORNFELD AND IOS 33 (1971).
20. Typically, an English investment trust would set aside one half percent of the first £500,000 of capital and one quarter percent above that amount for expenses. This included payments to directors. HARWOOD & BLAIR, supra note 13, at 14.
21. Id.
22. HARWOOD & BLAIR, supra note 13, at 14.
23. MARKHAM, supra note 14, at 323.
24. RAW ET AL., supra note 19, at 28; DIANA B. HENRIQUES, FIDELITY’S WORLD 51 (Simon & Schuster, 1995).
B. AMERICAN INVESTMENT COMPANIES

Although the model for American investment companies is the English investment trust, there were some collective investment schemes in America that predated those ventures.26 The Massachusetts Hospital Life Insurance Company ("MHLIC") was originally chartered in 1818 as an insurance company. It soon began to operate "somewhat similar to a trust company, but the funds deposited were commingled rather than kept as separate trusts, and it was, therefore, more like a modern investment trust."27 MHLIC used its trust powers to invest money for annuities.28 MHLIC also accepted investments in excess of $500 from subscribers for a fee.29 MHLIC agreed to repay the deposit and any gains, less any loss by debt or investment, usually at the death of the investor.30 Other nineteenth century investment trusts in America included the United States Mortgage Company that was organized in New York in 187131 and the New York Stock Trust that was formed in 1890.32 The Boston Personal Property Trust that was formed in 1893 was a collective investment fund that was invested in a diversified group of securities. In fact, it was a tontine scheme that was to terminate twenty years after the death of the last survivor. The trustees were paid five percent of the gross income of the trust plus other fees.33

25. Those investment companies experienced heavy losses during the Baring Panic in 1890. GRAYSON, supra note 13, at 14-17. Subsequent investigations revealed some questionable practices by those investment trusts, including schemes in which the depreciated securities in their portfolios were sold to new trusts and sold to the public at inflated values. LAWRENCE M. SPEAKER, THE INVESTMENT TRUST 13 (1924).


28. Supporters of Secretary of State Daniel Webster purchased an annuity for $37,000 from MHLIC that provided Webster with an annual income of $1,000. ROBERT V. REMINI, DANIEL WEBSTER, THE MAN AND HIS TIMES 601 (1997). This slush fund raised some ethical questions, and "someone remarked that the proposition was 'indelicate' and he wondered how Mr. Webster would take it? 'How will he take it?' snorted [Harrison Gray] Otis. 'Why, quarterly, to be sure!'" SAMUEL ELIOT MORISON & JOHN PAUL JONES, A SAILOR'S BIOGRAPHY 359 (1959).

29. MARKHAM, supra note 14, at 324.

30. SECURITIES AND EXCHANGE COMMISSION, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC. NO. 75-707, at 42 (1939). MHLIC managed a portion of the funds that had been placed by Benjamin Franklin into his "Franklin Fund." Franklin wanted those funds to be invested and accumulated for 100 years, distributed in part and the remainder accumulated again for another 100 years. MHLIC was eventually able to distribute some $800,000 from the investments made from the $16,000 that MHLIC had been given to invest for the Franklin Fund. KROOSS & BLYN, supra note 27, at 59.

31. LAWRENCE CHAMBERLAIN & WILLIAM WREN HAY, INVESTMENT AND SPECULATION 106 (1931).

32. HARWOOD & BLAIR, supra note 13, at 24.

33. H.R. DOC. NO. 75-707, at 45. Another form of investment company was the "commercial
"Popularization of the investment company as a medium for investment in a diversified portfolio of securities, particularly common stocks, began only in 1921." Investment companies were then promoted as a way for small investors to diversify their security holdings. It was said that this investment medium provided investors with "the opportunity of investing small amounts in a large number of securities, diversified according to undertaking, geographical location, and type of security." The investment companies offered expertise in the management of the investors' funds. "During the 1920's the type of investment company which was almost exclusively organized was the closed-end management investment company." Funds were raised by those entities through common and preferred stock offerings and bond issues.

The American investment trusts in the 1920s differed from the British investment trusts by the fact that the latter took long-term positions in securities and did not actively trade their portfolios. In contrast, the American investment trusts of the 1920s "were founded in speculative desire and dedicated to capital appreciation rather than investment return." Recognizing that the investment trusts were often speculative enterprises, the Investment Bankers Association successfully advocated that the term "investment company" should be substituted for "investment trust," the latter term connoting a more conservative investment approach. Otherwise, regulatory efforts to deal with the speculative operations of investment companies were fitful at best. New York authorities warned that the investment trusts were being used to defraud investors. Nevertheless, an effort to adopt legislation in 1927 to regulate the investment trusts failed in that state. Although California, Utah and other states did adopt some regulations, they had no effect on the burgeoning number of investment companies.

See In re James, Inc., 30 F.2d 555, 556 (2d Cir. 1929) (describing such operations). Mortgage bond houses were also operating in the 1920s that allowed investors to participate in a portfolio of commercial mortgage bonds. MARKHAM, supra note 26, at 147.

34. H.R. Doc. No. 75-707, at 114.
35. GRAYSON, supra note 13, at 7.
37. WAGNER, INVESTMENT COMPANY ACT OF 1940 AND INVESTMENT ADVISERS ACT OF 1940, S. REP. NO. 76-1775 at 3 (1940).
38. MARKHAM, supra note 26, at 141-42.
40. FLETCHER, STOCK EXCHANGE PRACTICES, S. REP. No. 73-1455, at 339 (1934).
41. HARWOOD & BLAIR, supra note 13, at 33. The term investment trust "seems a misnomer coined for the gullible. The so-called 'trusts' are simply holding companies for various kinds of stocks whose selection is intrusted to the directors thereof—hardly the common interpretation of the word 'trust.'" United States v. Weinberger, 4 F. Supp. 892, 892 (D.N.J. 1933).
42. MARKHAM, supra note 26, at 142-43.
43. HARWOOD & BLAIR, supra note 13, at 30.
The investment companies sold their shares to the public as a means to diversify their investments, but the investment trusts frequently acquired "concentrated holdings in particular industries, thereby subjecting the investor to the very risk he was seeking to avoid." Many of the investment companies gave shareholders only a general description of their investment strategies. Preceding Eliot Spitzer by decades, a New York deputy attorney general charged that investment companies were "merely blind pools engaging in speculation." They were viewed as blind pools because shareholders did not know what stocks management were selecting for investment. There were other abuses. Sponsors of investment trusts retained warrants that allowed them to profit from the investment trust with no risk. The investment trusts were used as a place to dump securities underwritten by their sponsors for investment banking clients. The investment trusts often raised funds through bond sales, which gave them leverage that was magnified by buying stocks on margin. Self-dealing was common and investment companies often changed their trading strategies without informing their shareholders.

A "veritable epidemic of investment trusts afflicted the Nation" before the Stock Market Crash of 1929. By 1924, over $75 million had been invested in investment companies, up from less than $15 million in the prior year. In 1925, investment trusts holdings doubled to $150 million. Some 140 investment companies were formed between 1921 and 1926. A new investment company was being created every other day in 1928. "[B]y 1929 they were being created at the rate of almost one a day." The assets of investments companies rose to over $1 billion in 1928. Another $2.1 billion was added in 1929. Between those two years, the number of

44. S. Rep. No. 73-1455, 438 (1933).
45. Markham, supra note 26, at 143.
47. HARWOOD & BLAIR, supra note 13, at 34.
48. HARWOOD & BLAIR, supra note 24, at 59.
50. WAGNER, INVESTMENT COMPANY ACT OF 1940 AND INVESTMENT ADVISERS ACT OF 1940, S. REP. No. 76-1755, at 7 (1940).
51. FLETCHER, STOCK EXCHANGE PRACTICES, S. REP. No. 73-1455, at 339 (1934).
52. Id. at 334.
53. HARDWOOD & BLAIR, supra note 13, at 30.
54. SECURITIES AND EXCHANGE COMMISSION, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H. Doc. No. 75-707, at 64 (1939).
56. INVESTMENT COMPANY ACT OF 1940 AND INVESTMENT ADVISERS ACT OF 1940, S. REP. No. 76-1755, at 3 (1940).
57. HARWOOD & BLAIR, supra note 24, at 58. The NYSE had proclaimed in 1924 that its members should avoid being involved with investment trust that did not protect investors. E.C. HARWOOD & ROBERT L. BLAIR, supra note 13, at 29. Nevertheless, the NYSE began listing investment trusts in 1929.
investment company shareholders increased from 55,000 to over 500,000.58

Almost all of these enterprises were “closed-end” investment companies that invested in securities rather than producing a product or service. Otherwise, they operated like any other corporation in the distribution and sale of their securities. Investors bought and sold shares in investment companies through a secondary market after the initial distribution of the shares.59 The “open-end” mutual funds, which dominate the market today, were not created until 1924.60 “None of them, however, achieved great importance in the investment company field before 1927.”61 “This type of company allowed shareholders to have their shares redeemed at any time upon giving a prescribed notice.”62 The redemption was based on the net asset value (“NAV”) of the shares, less a charge, which was usually $2.63 The open-end mutual funds continually offered and redeemed their own shares. Instead of a secondary trading market, owners of mutual funds purchased and sold their ownership interests from and to the mutual fund.64 Those purchases and redemptions were based on the NAV of the fund’s shares as calculated at the end of the day on which the redemption or purchase order is received.65

58. HENRIQUES, supra note 24, at 63.
59. As noted by the Supreme Court:

[A] mutual fund is an investment company, which, typically, is continuously engaged in the issuance of its shares and stands ready at any time to redeem the securities as to which it is the issuer; a closed-end investment company typically does not issue shares after its initial organization except at infrequent intervals and does not stand ready to redeem its shares. Because open-end investment companies will redeem their shares, they must constantly issue securities to prevent shrinkage of assets. In contrast, the capital structure of a closed-end company is similar to that of other corporations; if its shareholders wish to sell, they must do so in the marketplace. Without any obligation to redeem, closed-end companies need not continuously seek new capital.

60. The first open-end mutual fund was the Massachusetts Investors Trust that was created by Edward G. Leffler in Boston. George Putnam formed another open-end fund, Incorporated Investors, in 1925. The State Street Investment Corporation, which was originally formed by Paul Cabot, Richard Saltonstall and Richard Paine in 1924, became an open-end company in 1927. H. Doc. No. 75-707, at 101-103; JOHN BROOKS, THE GO-GO YEARS 129 (1973).
62. Id. at 105.
63. Id.
65. Quoting from an SEC study, the Supreme Court has noted that:

Mutual fund shares are not traded on exchanges or generally in the over-the-counter market, as are other securities, but are sold by the fund through a principal underwriter, and redeemed
The investment companies were especially hard hit by the Stock Market Crash of 1929. The United Founders Corp. and the American Founders Corp. were the largest investment trusts operating in the 1920s. The price of American Founders Corp. stock dropped from $30 to 38 cents. The stock of the United Founders Corp. fell from a high of over $75 to 25 cents a share. Another very popular investment company, the Goldman Sachs Trading Corporation, was trading at $1.75 per share in 1932, down from a high of $326. A spin off of that company, the Blue Ridge Corporation, witnessed a drop in its share from a high of $100 to 63 cents. The assets of the Kidder, Peabody investment companies declined in value from $85 million to $20 million.

C. THE INVESTMENT COMPANY ACT OF 1940

Investment companies were regulated under a belated piece of New Deal legislation that arose from the Stock Market Crash of 1929 and the subsequent Great Depression. A study by the SEC of the operations of

by the fund, at prices which are related to ‘net asset value.’ The net asset value per share is normally computed twice daily by taking the market value at the time of all portfolio securities, adding the value of other assets and subtracting liabilities, and dividing the result by the number of shares outstanding. Shares of most funds are sold for a price equal to their net asset value plus a sales charge or commission, commonly referred to as the ‘sales load,’ and usually ranging from 7.5 to 8.5 percent of the amount paid, or 8.1 to 9.3 percent of the amount invested. A few funds, however, known as ‘no-load’ funds, offer their shares for sale at net asset value without a sales charge. Shares of most funds are redeemed or repurchased by the funds at their net asset value, although a few funds charge a small redemption fee. The result of this pricing system, it is apparent, is that the entire cost of selling fund shares is generally borne exclusively by the purchaser of new shares and not by the fund itself. In this respect the offering of mutual fund shares differs from, say, the offering of new shares by a closed-end investment company or an additional offering ‘at the market’ of shares of an exchange-listed security, where at least a portion of the selling cost is borne by the company selling the shares.

Cartwright, 411 U.S. at 548 (1973) (citing SEC REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. No. 88-95, pt. 4 (1963)).

66. MARKHAM, supra note 26, at 155.
67. Id.
68. Id.
69. Id.
70. Id. The Goldman Sachs Trading Corporation stock was a “hot issue.” Priced initially at $104, its shares were soon trading at $136.50. Five days later, its price had reached $222.50. This was twice the value of its assets. The Goldman Sachs Trading Corporation created the Shenandoah Corporation, which sold its shares at $17.50. Those shares more than doubled in price on the first day of trading to $36. Shenandoah Corporation in turn sponsored the Blue Ridge Corporation, which sold securities totaling $142 million to the public. LISA J. ENDLICH, GOLDMAN SACHS, THE CULTURE OF SUCCESS 45-46 (1999).
71. MARKHAM, supra note 26, at 155.
72. In 1932, the New York Stock Exchange had unsuccessfully tried to discourage investment in “unit” or “group” plans in which a portfolio manager bought a diversified group of stocks and then sold a “package” of those securities to individual investors at an excessive markup. Pirnie, Simons & Co., Inc. v. Whitney, 259 N.Y.S. 193, 213 (1932). Another entity bought shares in the Standard Oil companies that were deposited with a trustee and then units in those trusts sold to investors. Standard Oilshares,
investment companies was authorized by the Public Utilities Holding Company Act of 1935. The SEC investigation, which discovered a number of abuses, resulted in the passage of the Investment Company Act of 1940. That legislation has rightly been said to be "the most intrusive financial legislation known to man or beast." It places substantive restrictions on virtually every aspect of the operations of investment companies; their valuation of assets, their governance and structure, their issuance of debt and other senior securities, their investments, sales and redemptions of their shares, and, perhaps most importantly, their dealings with service providers and other affiliates.

The Investment Company Act throws its net over a range of investment company formats, classifying them into three categories: "face amount certificates," "unit investment trusts," and "management companies." The first two do not actively manage or trade components in their portfolios. Instead, they have fixed portfolios in one form or another. The third group, management companies, was sub-classified into

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Inc. v. Standard Oil Group, Inc., 150 A. 174, 176 (Del. Ch. 1930). One court held that outside directors of an investment company were liable for not monitoring the company's president who looted its assets. O'Connor v. First Nat'l Investors' Corp. of Va., 177 S.E. 852, 860 (Va. 1935).


74. As the Supreme Court has noted: The Investment Company Act of 1940 originated in congressional concern that the Securities Act of 1933, 48 Stat. 74, 15 U.S.C. § 77a et seq., and the Securities Exchange Act of 1934, 48 Stat. 881, 15 U.S.C.§ 78a et seq., were inadequate to protect the purchasers of investment company securities. Thus, in § 30 of the Public Utility Holding Company Act, 49 Stat. 837, 15 U.S.C. § 79z-4, Congress directed the SEC to study the structures, practices, and problems of investment companies with a view toward proposing further legislation. Four years of intensive scrutiny of the industry culminated in the publication of the Investment Trust Study and the recommendation of legislation to rectify the problems and abuses it identified. After extensive congressional consideration, the Investment Company Act of 1940 was adopted.


78. Face amount certificates are agreements to pay investors a stated amount in the future. The investor pays for that investment through installment payments. See generally SEC v. Mount Vernon Mem'l Park, 664 F.2d 1358 (9th Cir. 1982) (describing the basis for regulating these instruments). The unit investment trust holds a fixed group of securities in its portfolio and does not trade those securities.
closed and open-end investment companies and further sub-divided into “diversified” and “non-diversified” companies. To obtain diversified status, an investment company could invest no more than five percent of its assets in the stock of any one company and could hold no more than ten percent of the voting securities of any one company.\textsuperscript{79}

Non-exempt investment companies were required to register their offerings to the public under the Securities Act of 1933.\textsuperscript{80} They were also required to register with the SEC under the Investment Company Act of 1940.\textsuperscript{81} The latter registration requirement then became the hook for the substantive regulation of those companies. Not all collective investment mediums were required to register under the Investment Company Act. Among those exempted from registration, and hence regulation, under that statute were insurance companies, banks, and “any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of monies contributed thereto by the bank in its capacity as a trustee, executor, administrator or guardian.”\textsuperscript{82} Also exempted were any qualified “employees’ stock bonus, pension, or profit sharing trust.”\textsuperscript{83}

Investment companies registered under the Investment Company Act were required to provide the SEC with periodic financial reports.\textsuperscript{84} Those requirements are similar to those imposed on other issuers of securities, but the Investment Company Act goes far beyond that pattern with other provisions. Among other things, that statute creates a minimum net worth requirement,\textsuperscript{85} a practice long abandoned in state incorporation laws.\textsuperscript{86} It governs the capital structure of investment companies, limiting the amount of their indebtedness acquired through “senior securities.”\textsuperscript{87} The act further regulates dividend polices of investment companies, a matter normally left to state regulation.\textsuperscript{88} The Investment Company Act seeks to dictate the manner of investment company governance in other ways. It prohibits securities law violators from serving as an employee or director or


\textsuperscript{79} Id. § 80a-5(b)(1).
\textsuperscript{80} Id. § 80a-24.
\textsuperscript{81} Id. § 80a-8.
\textsuperscript{83} Id.
\textsuperscript{84} 15 U.S.C. § 80a-29 (2000). Sales literature must also be submitted to the SEC. Id. § 80a-24(b).
\textsuperscript{85} Id. § 80a-14.
\textsuperscript{86} As a court noted with respect to one such statute: “One may start business on a shoestring in Kentucky, but if it is a corporate business the shoestring must be worth $1,000.” Tri-State Developers, Inc. v. Moore, 343 S.W.2d 812, 816 (Ky. 1961).
\textsuperscript{88} Id. § 80a-19(a).
otherwise being affiliated with an investment company. Shareholder approval is required where an investment company changes its status from a diversified to non-diversified investment company, where its investment plan changes, or where it decides to deviate from previously stated investment policies. The act also regulates the election of directors to the board of investment companies.

Even more intrusively, the Investment Company Act requires that at least forty percent of investment company board of directors be independent outside directors. The requirement for outside directors was expanded to a majority requirement by the SEC in 2001. That majority outside director requirement was added through the back door by the SEC by requiring such a board before investment companies become eligible for exemptions from SEC conflict of interest rules. Among other things, those exemptions permit mutual funds with majority outside directors to purchase securities in an initial public offering in which an affiliated broker-dealer is acting as an underwriter; permit the use of fund assets to pay distribution expenses; allow securities transactions between a fund and another client of the fund’s adviser; and permit funds to issue multiple classes of voting stock. The SEC also used its exemption authority as a stick for creating other governance requirements including how board meetings are to be conducted.

This pervasive regulation is sought to be justified on the ground that “Unlike most business organizations . . . mutual funds are typically organized and operated by an investment adviser that is responsible for the day-to-day operations of the fund.” “Investment advisers generally organize and manage investment companies pursuant to a contractual arrangement with the company. In return for a management fee, the adviser selects the company’s investment portfolio and supervises most

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89. Id. § 80a-9.
90. Id. § 80a-13(a).
91. Id. § 80a-16(a).
92. Id. § 80a-10(a). The Investment Company Act also provides a safe harbor for the sale of an advisory business if directors who are not interested persons of the adviser constitute at least seventy-five percent of a fund’s board for at least three years following the assignment of the advisory contract. 15 U.S.C. § 80a-15(f)(1)(A) (2000).
93. Those independent directors were also required to nominate other independent directors and legal counsel for the outside directors was required to be independent. Role of Independent Directors of Investment Companies, 66 Fed. Reg. 3,734, 3,736 (Jan. 16, 2001) (to be codified at 17 C.F.R. pts. 239, 240, 270, and 274).
94. Id.
95. See, e.g., 17 C.F.R. § 270.15a-4(b)(1)(i) (2006) (stating that directors participating in board meeting by phone must be able to communicate with other directors). Such requirements are normally governed by state law. See, e.g., DEL. CODE ANN. tit. 8 §141(i) (2006) and Revised Model Bus. Corp. Act § 8.20(b) (2000).
aspects of its business.”97 “In most cases, the investment adviser is separate and distinct from the fund it advises, with primary responsibility and loyalty to its own shareholders. The ‘external management’ of mutual funds presents inherent conflicts of interest and potential for abuses . . . .”98 The role of investment advisers was deemed so sensitive that another statute was layered on top of the already intrusive regulation of mutual funds—the Investment Advisers Act of 1940.99 That act imposes a registration requirement, imposes books and records and disclosure regulations and places limits on the fees that may be imposed by the adviser.

III. LATE TRADING AND MARKET TIMING

A. BACKGROUND

Mutual funds were not really the target of the Investment Company Act of 1940. They were simply too young to have played any significant role in the abuses that led to that legislation. However, mutual funds became popular investment mechanisms beginning in the 1940s and soon replaced the closed-end fund as the investment vehicle of choice for most individual investors. In 1970, some 360 mutual funds held $47 billion in assets in the United States.100 Their growth exploded with the invention of the money market mutual fund.101 By 1995, there were 5,700 mutual funds

98. Role of Independent Directors of Investment Companies, 66 Fed. Reg. at 3,736. As the Supreme Court has noted:
Congress consciously chose to address the conflict-of-interest problem through the Act’s independent-directors section, rather than through more drastic remedies such as complete disaffiliation of the companies from their advisers or compulsory internalization of the management function. . . .
Congress’ purpose in structuring the Act as it did is clear. It “was designed to place the unaffiliated directors in the role of ‘independent watchdogs,’” who would “furnish an independent check upon the management” of investment companies. This “watchdog” control was chosen in preference to the more direct controls on behavior exemplified by the options not adopted. Indeed, when by 1970 it appeared that the “affiliated person” provision of the 1940 Act might not be adequately restraining conflicts of interest, Congress turned not to direct controls, but rather to stiffening the requirement of independence as the way to “remedy the act’s deficiencies.” Without question, “[the] function of these provisions with respect to unaffiliated directors [was] to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs.”

101. Henry B.R. Brown and Bruce R. Bent were the inventors of the money market fund. Their creation allowed investors to receive a higher rate of return on their cash holdings than was available
holding about $2.8 trillion in investor funds. As the new century began some 8,000 mutual funds were holding almost $7 trillion in assets for ninety-five million investors. However, the bursting of the market bubble in 2000, resulted in a sharp drop in the NAV of equity based mutual funds. Mutual funds trading equities experienced a $1.4 trillion drop in the value of their assets between 2000 and 2002.

The drop in NAV also reduced mutual fund fees that were based on amounts under management. Mutual funds were also facing competition. Closed end funds had record years for attracting investor funds in 2002 and 2003. Those securities could be traded at any time when a market was open, unlike mutual funds that could only be bought or sold based on day’s end NAV. Another threat was the newly created exchange traded funds (“ETFs”) that began with SPDRs (Standard & Poor’s Depository Receipts) or “spiders.” The ETF is the equivalent of a diversified mutual fund but allows the investor to buy and sell their holdings at any time during the trading day at then current market prices. In contrast, mutual funds may

under the interest rate ceilings set by bank regulators at that time. Those interest rate ceilings were later dropped, but the money market fund remained popular. 3 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES 6 (2002).

102. INVESTMENT COMPANY INSTITUTE, supra note 100, at 105. Those mutual funds gave investors a broad range of investment opportunities:

An investor seeking to invest in fixed income instruments could choose among mutual funds investing in money market instruments, municipal securities of most states and many subunits, federally insured bonds, mortgage-backed securities, and corporate bonds with sub choices of convertible bonds, global bonds and with differing maturities, and ratings grades down to and including junk bonds. Equity investors could pick from index funds on a broad range of indexes, funds that invest in a particular business sector such, option funds, growth funds and aggressive growth funds. Funds for contrarians trade against popular investment views; for the internationally inclined, there are global equity funds and emerging market funds for stocks of companies in lesser developed countries. Balanced funds (with varying balances) invest in both fixed income and equity securities, while “quant” funds use computer programs to make stock picks, and vulture funds invest in failing companies. There are even mutual fund portfolios for politically correct investors that invest in environmentally friendly companies and avoid tobacco stocks. For those interested in politically incorrect investments, the Vice Fund was investing in tobacco, alcohol, gambling and other sin stocks.

MARKHAM, supra note 3, at 424-25.

103. INVESTMENT COMPANY INSTITUTE, supra note 100, at 107. This reduction in NAV was due in large measure to reduced portfolio values from the drop in stock prices during the downturn. That downturn also caused many investors to pull their assets out of long term mutual funds. The number of redemptions from such mutual funds increased from an annual rate of 21.7% in 1999 to 27.9% in 2002. Id. at 126.

104. The assets held by closed-end investment companies increased from $147 billion in 1999 to $213 billion in 2003. INVESTMENT COMPANY INSTITUTE, supra note 100, at 145.

105. MARKHAM, supra note 3, at 426. “Exchange traded funds as we know them today were launched in 1993 by State Street Global Advisors, though similar products traded in both the U.S. and Canada in years prior to that.” History of ETFs: From Institutions to Individuals, WALL ST. J., Oct. 14, 2006, at R2.

106. The SEC has noted that:
be bought and sold only every 24 hours at NAV price set on closing prices at 4:00 p.m.

Their trading flexibility and certain tax advantages made ETF’s almost instantly popular.\(^\text{107}\) The ETFs had assets valued at $464 million in 1993, the year they first started trading.\(^\text{108}\) By 2006, the number of ETFs had increased to 205 and their assets were valued at $315 billion, an increase of $259 billion over the prior year.\(^\text{109}\) That amount paled in comparison to the trillions held in mutual funds, but their rapid growth was a growing competitive threat to mutual fund fees.\(^\text{110}\) In order to boost their fees and to better compete with those closed-end companies and ETFs, mutual funds began to allow market timing and late trading by hedge funds, which were using SEC restrictions to engage in “regulatory arbitrages.” This was not a new problem for the mutual fund industry, although the angle of attack had changed. Prior to the adoption of the Investment Company Act of 1940 there existed a “two-price system” system for mutual fund shares that created an active secondary market in those shares that was being abused.

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Exchange traded funds (“ETFs”) are investment companies that are registered under the Investment Company Act as open-end management investment companies or unit investment trusts. However, unlike typical open-end funds or unit investment trusts, ETFs do not sell or redeem their individual shares at NAV. Instead, ETFs sell and redeem their shares at NAV only in large blocks, generally in exchange for a basket of securities that mirrors the composition of the ETF’s portfolio, plus a small amount of cash. Shares of ETFs are listed on national securities exchanges for trading, which allows investors to purchase and sell individual ETF shares among themselves at market prices throughout the day.


110. The mutual funds knew well how competition could damage a franchise. Government regulations in the 1970s had prevented banks from paying market rates on deposits. The money market mutual fund was invented to take advantage of that disability and drained massive amounts of deposits from the banks. Indeed, within ten years of their first appearance, money market funds were the most popular investment in America. MARKHAM, supra note 101, at 6-7. At the end of 2003, there was $2.051 trillion held in money market funds. *INVESTMENT COMPANY INSTITUTE, supra note 100, at 107. The percentage of funds held by American households as bank deposits was cut in half between 1979 and 1999 as a result of money market competition. MARKHAM, supra note 101, at 298.
Most funds computed their net asset values daily on the basis of the fund's portfolio value at the close of exchange trading, and that figure established the sales price that would go into effect at a specified hour on the following day. During this interim period two prices were known: the present day's trading price based on the portfolio value established the previous day; and the following day's price, which was based on the net asset value computed at the close of exchange trading on the present day. One aware of both prices could engage in 'riskless trading' during this interim period.\textsuperscript{111}

Most investors could not take advantage of that situation because of sales loads, but insiders were able to purchase shares without paying the load and could purchase shares for immediate redemption at the appreciated value. It was claimed that this diluted the equity of the existing shareholders. "The existing shareholders' equity interests were diluted because the incoming investors bought into the fund at less than the actual value of the shares at the time of purchase."\textsuperscript{112}

Section 22 of the Investment Company Act\textsuperscript{113} was employed to prevent those and other trading abuses by authorizing the National Association of Securities Dealers, Inc. ("NASD") and the SEC to regulate the distribution and trading in mutual fund shares. They both adopted rules that were thought to have put an end to riskless trading in mutual fund shares.\textsuperscript{114} The SEC was thought further to have sealed the fate of such trading in 1968 when it enacted a "forward pricing" rule\textsuperscript{115} that required redemptions and purchases to be priced after receipt of the order from the customer—"generally using the closing price for the stocks that were set at the end of that trading day."\textsuperscript{116}

There were other concerns with using mutual funds for quick in-and-out-trading seeking short-term profits (market timing). The SEC had long sought to prevent mutual fund salesmen from recommending market timing in mutual funds to retail customers because sales loads and time and place disadvantages made such trading unsuitable for them.\textsuperscript{117} However, market

\textsuperscript{111} United States v. Nat'l Ass'n of Sec. Dealers, Inc., 422 U.S. 694, 707 (1975). "It was possible . . . for a knowledgeable investor to purchase shares in a rising market at the current price with the advance information that the next day's price would be higher. He thus could be guaranteed an immediate appreciation in the market value of his investment . . . ." \textit{Id}.  

\textsuperscript{112} \textit{Id.} at 708 n.17.  


\textsuperscript{114} \textit{Nat'l Ass'n of Sec. Dealers, Inc.}, 422 U.S. at 709-10.  

\textsuperscript{115} 44 Fed. Reg. 29,644, 29,647 (May 22, 1979) (to be codified at 17 C.F.R. § 270.22c-1(a)).  


\textsuperscript{117} The SEC thus prohibited the practice of "switching" mutual fund investors in and out of different mutual funds in order to generate commissions. Such transactions were usually accompanied by promises of short-term profits from trading opportunities that sought to anticipate favorable market moves and make quick-in-and-out profits. Such "market timing" was not appropriate for small investors because of the large sales loads associated with some mutual fund classes. Further, as noted
Timing transactions in mutual funds by professional traders was not viewed by the SEC to be a matter of concern since the professionals could look after themselves or the investors whose money they were managing.\footnote{118} Further, the restriction on buying and selling mutual fund shares at their net asset value was a practical barrier to market timing even by professional traders. Nevertheless, during the 1980s, there were some fifty money managers who specialized in market timing mutual funds for even small investors in amounts as low as $2,000.\footnote{119} These market timers charged fees of two percent or more on assets under management, which was in addition to any mutual fund sales loads.\footnote{120}

\textit{Money Magazine} conducted a study in 1988 of the five-year performance of market timing by mutual fund money managers.\footnote{121} It found that clients of J.D. Reynolds Co. experienced compound returns of more than twenty percent. Most market timing managers were not that successful, but two-thirds of those managers did better than the Lipper mutual fund average. They were particularly successful in preserving investor capital during market downturns. However, these earlier market timers were not over night arbitrageurs like those involved in the Spitzer-generated scandals. For example, J.D. Reynolds Co. engaged in less than four market timing transactions per year.\footnote{122} This was because the goal of the market timers in the 1980s was to move investment funds between equity and fixed income funds in anticipation of changes between those two markets. For example, if interest rates were expected to increase and equities to decline, the market timer would move money out of stocks and into bonds.\footnote{123}

These market timers were not popular with mutual fund sponsors because "[w]hen market-timing money managers move millions of dollars at a time in or out of funds, as they often do, they force mutual fund managers to buy or sell large blocks of stock at inopportune moments. Hence, fund organizations view timers as disruptive."\footnote{124} Several no-load
mutual funds (a mutual fund that does not charge an investment management fee) sought to discourage market timers by limiting the number of switches that an investor could make, so the market timers moved to load funds which charged management fees and were less likely to impose such restrictions because of the incentive of those fees. That was only a temporary solution. Market timers became more active during the 1990s and again aroused the ire of the mutual funds that had to deal with their liquidations. Some mutual funds imposed redemption fees on traders engaged in market timing in order to discourage such activity. Those fees had been allowed by the SEC, up to two percent, since 1979. The number of funds imposing such fees increased substantially in the 1990s when the market run up was encouraging day trading and other speculative trading. Some mutual funds threatened to suspend the redemption privileges of traders engaged in market timing. “Fair value pricing” was also used to discourage market timers in international funds that presented arbitrage opportunities because foreign markets might still be open when NAV was computed. Fair value pricing sought to set a fair price on foreign holdings at the close of trading in the United States in order to reduce those arbitrage opportunities.

These attempts at curbing market timing were described in mutual fund prospectuses. To an outside viewer of those disclosures, it appeared that the mutual funds were opposed to market timers because they were disruptive and harmful to the funds. As the new century began, however, a new market timer appeared—the hedge fund—that found a way to entice mutual funds into welcoming their trading.

125. Id. at 85-86.
129. See Tim Quinson, Mutual Funds Install Fees to Deter Those Who Cash Out Quickly, DALLAS MORNING NEWS, June 13, 1999, at 11H (describing the increased use of such fees).
131. Hedge funds take many forms but are essentially a pool of funds collected from wealthy investors and managed aggressively for big returns. As noted by the District of Columbia Court of Appeals: “Hedge funds” are notoriously difficult to define. The term appears nowhere in the federal securities laws, and even industry participants do not agree upon a single definition. The term is commonly used as a catch-all for “any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public.” Goldstein v. SEC, 451 F.3d 873, 874-75 (D.C. Cir. 2006).
B. THE SCANDALS

Politically ambitious New York Attorney General Eliot Spitzer saw opportunity in the widespread publicity given to the financial scandals occurring after the market downturn in 2000. He made headlines with sensational charges against prominent financial analysts that resulted in a massive $1.4 billion settlement with the firms where they worked. Spitzer struck again in September 2003, when he charged Edward J. Stern and a hedge fund he managed, Canary Capital Partners, LLC, with improperly market timing and late trading in shares of the Strong mutual fund complex. Canary Capital Partners was required to pay $40 million to settle this problem, part of which was to be used for restitution to mutual fund investors. Edward Stern also agreed not to trade in mutual funds or manage any public investment funds for ten years. Spitzer brought several other suits against mutual funds and others for allowing or engaging in market timing and late trading, resulting in more publicity and extraordinarily large fines.

The charges filed by Spitzer ignited much controversy since it was not entirely clear why a state attorney general was seeking to regulate mutual funds that were under the pervasive regulatory control of the SEC. Indeed, "because of perceived inefficiencies inherent in dual state and federal securities registration schemes, Congress passed the National Securities Markets Improvement Act of 1996 ("NSMIA"), primarily to preempt state ‘Blue Sky’ laws that required issuers to register many securities with

133. The financial analysts’ scandals began after Eliot Spitzer revealed that a Merrill Lynch analyst, Henry Blodget, had called stocks he was promoting to public investors “crap” and a “piece of junk” in private emails. The scandal widened when it was revealed that Sandy Weill, the head of Citigroup Inc., had his bank make a $1 million contribution to an elite preschool as a part of an elaborate scheme to acquire control of Citigroup, as well as to acquire the investment banking business of AT&T. Conflicts of interests on the part of analysts were found to be widespread. Among other things, financial analysts were being compensated for promoting their firm’s investment banking business, undercutting their independence as analysts. Spitzer was also attacking share “spinning” schemes in which underwriters allocated shares in hot issue IPOs to executives of large companies in order to gain investment banking business. In December 2002, ten investment banking firms agreed to a $1.4 billion settlement with Eliot Spitzer and other state, federal, and self-regulatory organizations over the analysts’ conflicts. See MARKHAM, supra note 3, at 405-20 (describing those scandals).
136. See MARKHAM, supra note 3, at 421-39 (describing the mutual fund scandals). See also The Associated Press, Bear Stearns to Pay Fine Over Mutual Fund Trades, N.Y. TIMES, Mar. 17, 2006, at 13 C3. (Bear Stearns agreed in March 2006 to pay $250 million to the New York Stock Exchange and the SEC to settle late trading charges in its mutual funds.).
state authorities prior to marketing in the states.\textsuperscript{138} That legislation specifically exempted from state regulation shares of investment companies registered with the SEC,\textsuperscript{139} but provided that the states "shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions."\textsuperscript{140} Spitzer was using that loophole by claiming fraud in his late trading or market timing prosecutions. However, those claims were premised largely on the SEC's forward pricing rule for mutual funds under the Investment Company Act of 1940, which was for the SEC to enforce rather than Spitzer.\textsuperscript{141}

Spitzer created more controversy when he began affirmatively regulating mutual fund by requiring them to reduce their fees as a part of their market timing and late trading settlements.\textsuperscript{142} Those fees had previously been regulated under the Investment Company Act by the NASD under the oversight of the SEC as mandated by Congress.\textsuperscript{143} Spitzer simply ignored that congressional mandate and created his own public utility regulatory program governed solely by his personal views on what constitutes appropriate fees. Further criticism was directed at Spitzer for criminalizing what were common business practices. In that regard, the fact that market timing was occurring in mutual funds was known before Spitzer's charges.\textsuperscript{144} Spitzer admitted as much when he cited in his

\begin{itemize}
  \item \textsuperscript{138} Dabit v. Merrill Lynch, Pierce, Fenner & Smith Inc., 395 F.3d 25, 32 n.3 (2d Cir. 2005).
  \item \textsuperscript{139} 15 U.S.C. § 77r(b)(2) (2000).
  \item \textsuperscript{140} Id. § 77r(c).
  \item \textsuperscript{142} Heather Timmons, 2 Fund Groups Agree to Pay $450 Million To End Inquiry, N.Y. TIMES, Sept. 8, 2004, §C, col. 5.
  \item \textsuperscript{143} As noted by one author:
    The NASD Rules of Fair Practice place a ceiling on the 'sales load,' or the sales commission, for transactions in shares of open-end companies that an NASD member may charge to investors. The limits placed on mutual fund sales loads are in sharp contrast to the free competition with regard to brokers' commissions generally. The ceiling on sales loads is in accordance with [Investment Company Act] section 22(b)'s mandate that the price allowed by NASD rules 'shall not include an excessive sales load but shall allow for reasonable compensation for sales personnel, broker-dealers, and underwriters and for reasonable sales loads to investors.' Under these rules a fund is limited to a maximum sales charge of 7.25 percent, subject to mandatory quantity discounts, unless it offers additional services which in the aggregate carry a maximum additional 1.25 percentage point value.
complaint against Canary Capital Partners a study published a year earlier at Stanford University that claimed mutual funds were losing billions to market timers. Another article published almost three years earlier made a similar complaint. In 1998, David Dubofsky, a professor of finance at Virginia Commonwealth University, published a paper on market timing and notified the SEC of his findings. Dubofsky began following market timing practices after a student alerted to him to such trading after the Stock Market Crash of 1987.

Another weakness in Spitzer’s crusade was that no court had ruled on the validity of his claims. The only proceeding to contest his charges was a criminal trial brought against Theodore Charles Sihpol III, an employee of Banc of America Securities LLC. Sihpol was in charge of the “most extensive” of Canary Capital’s late trading and market timing relationships and arranged a $300 million line of credit for Canary Capital to use in such trading. The evidence against Sihpol was rather dramatic. He created an electronic trading platform that allowed Canary Capital Partners to trade late. Tape recordings also revealed that Sihpol was time stamping order

at H-1 ("Professor John Coffee Jr. of Columbia University, who specializes in the study of white-collar crime, said an SEC survey found that 25 percent of brokers allowed the practice.").


146. Id. at ¶ 23 n.2.


tickets in advance in order to conceal that the late trades had been entered after 4:00 p.m.\textsuperscript{151} Nevertheless, his criminal trial resulted in a not guilty verdict on twenty-nine counts and a hung jury (11-1 in favor of acquittal) on the four remaining counts. Spitzer initially announced that Sihpol would be retried on the charges on which the jury was hung, but backed off that decision after receiving much criticism, and the criminal charges were dropped.\textsuperscript{152} Separately, NYSE arbitrators entered a $14 million award against Merrill Lynch for firing three brokers who had engaged in late trading. Apparently, the arbitrators were also un convinced that late trading was the crime of the century.\textsuperscript{153}

So was there fraud involved in these practices? Spitzer’s civil suit against Canary Capital Partners LLC charged that the late trader was defrauding long term mutual fund shareholders by “diluting” their holdings because the late trading arbitrageur’s profits come “dollar for dollar” from the mutual fund. Those profits “would otherwise have gone completely to the fund’s buy and hold investors.”\textsuperscript{154} Spitzer noted that late trading was exploiting the SEC’s forward pricing rule for mutual fund purchases and redemptions and charged that such conduct was fraudulent in violation of the New York Martin Act.\textsuperscript{155} Spitzer’s press release accompanying the Canary Capital Partners complaint stated that: “Allowing late trading is like allowing betting on a horse race after the horses have crossed the finish line” and that market timing trading “is like a casino saying that it prohibits loaded dice, but then allowing favored gamblers to use loaded dice, in

\textsuperscript{153} Susanne Craig, Merrill Brokers Fired In Scandal Win $14 Million, WALL ST. J., Jan. 6, 2006, at C1 (Merrill Lynch is appealing that decision.). Craig & Lauricela, supra note 1, at A1. An NASD arbitration panel awarded $3.8 million to a broker fired by the Wachovia bank after it came under investigation by Eliot Spitzer. The broker asserted that his market timing trades for hedge funds had been approved by management at Prudential Securities, which merged with Wachovia. Bloomberg News, Wachovia Must Pay Broker It Fired $3.8 million, N.Y. TIMES, Sept. 26, 2006, at C9.
\textsuperscript{155} N. Y. Gen. Bus. Law §§ 352-53 (Consol. 2005). That statute allows the New York Attorney General to investigate and prosecute any person that: employs, or is about to employ, any deception, misrepresentation, concealment, suppression, fraud, false pretense or false promise, or shall have engaged in or engages in or is about to engage in any practice or transaction or course of business relating to the purchase, exchange, investment advice or sale of securities or commodities which is fraudulent or in violation of law and which has operated or which would operate as a fraud upon the purchaser, or that any broker, dealer, or salesman . . . .

Id. § 352.
return for a piece of the action."\textsuperscript{156}

Late trading involves the entry of a purchase or redemption of a mutual fund share after 4:00 p.m., the time at which the NAV is computed for the forward pricing of orders received earlier in the day.\textsuperscript{157} The late trader is using the mutual fund as a hedge to lock in price disparities that occur in the one or two hour window used for late trading, but just how are the holdings of other owners of the mutual fund diluted? If the price increase in the alternate market carries over to the close of trading on the following day, there seems, on its face, to be no harm and hence no foul because the long term mutual fund investors will enjoy the same profit as the late trader. If prices go up or down between the NAV computations on succeeding trading days, the status of the late trader and the mutual fund’s long term investors remain the same. However, the late trader paid cash on the day when he bought the mutual funds at their 4:00 p.m. NAV. That cash may not be invested in time to capture the fluctuation in value. The other mutual fund holders will have to bear the cost of that fluctuation.\textsuperscript{158}

Market timing is more problematic as a basis for claiming fraud. According to Spitzer’s complaint against Canary Capital Partners, such trading is made possible by the fact that some mutual funds use "stale" prices to compute NAV.\textsuperscript{159} Spitzer did concede that market "[t]iming is not

\textsuperscript{156} Press Release, Office of N.Y. State Attorney Gen. Eliot Spitzer, State Investigation Reveals Mutual Fund Fraud, (Sept. 3, 2003), available at http://www.oag.state.ny.us/press/2003/sep/sep03a_03.html. Spitzer’s claim concerning market timing was based on the fact that many mutual fund prospectuses stated that they discouraged market timing.

\textsuperscript{157} Roberta S. Karmel, Mutual Funds, Pension Funds, Hedge Funds and Stock Market Volatility—What Regulation by the Securities and Exchange Commission is Appropriate?, 80 NOTRE DAME L. REV. 909, 930 (2005). Lawyers for the mutual funds had concluded that trading could continue as late as 5:45 p.m. eastern time because, even though mutual funds were supposed to price funds at 4 p.m., the funds did not actually report their pricing until 5:30 p.m., or later. The lawyers thought that a 5:45 p.m. cutoff would prevent anyone from taking advantage of information to profit from knowledge of the fund pricing and events occurring after the close of trading. However, sophisticated traders could price the NAV themselves at the 4 p.m. close. David Hechler, Suit Highlights Issue of Legal Advice to Brokers, N.Y. L. J., Sept. 30, 2004, at 5.

\textsuperscript{158} Late traders could also sell the stocks underlying the portfolio of a mutual fund short when the fund’s NAV is under priced. N.Y. ATT’Y GEN. ELIOT SPITZER, CANARY CAPITAL PARTNERS COMPLAINT 17, 25 (2003), http://www.oag.state.ny.us/press/2003/sep/canary_complaint.pdf. (describing complex arrangements under which such transactions were effected).

\textsuperscript{159} As noted in his complaint:

A typical example is a U.S. mutual fund that holds Japanese shares. Because of the time zone difference, the Japanese market may close at 2:00 a.m. New York time. If the U.S. mutual fund manager uses the closing prices of the Japanese shares in his or her fund to arrive at an NAV at 4:00 p.m. in New York, he or she is relying on market information that is fourteen hours old. If there have been positive market moves during the New York trading day that will cause the Japanese market to rise when it later opens, the stale Japanese prices will not reflect them, and the fund’s NAV will be artificially low. Put another way, the NAV does not reflect the true current market value of the stocks the fund holds. On such a day, a trader who buys the Japanese fund at the “stale” price is virtually assured of a profit that can be realized the next day by selling. This and similar strategies are known as “time zone
entirely risk free . . . . For example, the timer has to keep his or her money in the target fund for at least a day, so he or she may enjoy additional gains or incur losses, depending on the market.”

Nevertheless, Spitzer charged that the activity diluted the holdings of other mutual fund owners and imposed transaction costs on them. Spitzer also focused on the fact that mutual fund prospectuses warned that market timers were unwelcome and that their redemption privileges could be suspended. He claimed that this misled other investors into believing that such trading was prohibited.

Actually, market timing seemed less like illegal activity and more like mutual fund inefficiency, since the mutual funds could use “fair value” pricing to prevent the 4:00 p.m. NAV from being stale. Some mutual funds did use fair value pricing in their international funds in order to prevent traders from arbitraging its funds, but critics claimed that such pricing was arbitrary and resulted in differing values on the same assets because of varying methodologies in making the valuations. Fair value pricing posed other problems. Garrett Van Wagoner, a popular mutual funds manager, was charged by the SEC with improperly using fair value pricing to improve his funds performance. A subsequent SEC inquiry into fair value pricing also resulted in industry comments which asserted that fair value pricing alone would not prevent market timing.

As noted, some mutual funds imposed redemption fees and even had “market timing police” to detect and prevent such trading. However, those restrictions were waived for large hedge fund traders. There was an incentive for such waivers. The hedge funds engaged in market timing increased the amount of funds under management by many millions of

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160. Id. at 9.
161. Id. at 12.
162. Id. at 10.
166. See id.
dollars, which resulted in higher fees to mutual fund sponsors because NAV was the basis for their compensation. The hedge funds also provided the liquidity needed for market timing in the form of "sticky assets," which were substantial long-term commitments of capital to the mutual fund. Those sticky assets were to be used to meet the increased costs of market timing liquidations and could be used to hedge against the deleterious effects of such trading on the mutual fund. However, those sticky assets were "typically long-term investments made not in the mutual fund in which the trading activity was permitted, but in one of the fund manager's financial vehicles (e.g., a bond fund or a hedge fund run by the manager) that assured a steady flow of fees to the manager."

C. THE SEC RESPONDS

The SEC’s reputation had been badly blemished by the accounting scandals at Enron Corp. and several telecoms, including WorldCom Inc. Despite its pervasive and intrusive regulations and reputation for being an aggressive regulator, the SEC had failed to prevent or detect those problems. The agency had literally read about those scandals in the press before becoming involved. Spitzer added to the SEC’s growing aura of incompetence with his spectacular charges against the financial analysts that were also regulated by the SEC and by the late trading and market timing scandals. Spitzer even began taunting the SEC and other federal agencies, stating that they had been so “beaten down” and “neutered” and diminished that they had been “rendered incapable of fulfilling their fundamental mandate” and that they had “been sapped of the desire to regulate.”

In an effort to regain some credibility, the SEC filed its own suits for late trading and market timing, often in tandem with Spitzer. Even with
the pressure from Spitzer, the SEC’s charges on market timing were somewhat hesitant. The SEC thus conceded that market timing was not “illegal per se,” but argued that

Market timing could damage the mutual fund because (a) it can dilute the value of their shares if the market timer is exploiting pricing inefficiencies, (b) it can disrupt the management of the mutual fund’s investment portfolio, and (c) it can cause the targeted mutual fund to incur costs borne by other shareholders to accommodate the market timer’s frequent buying and selling of shares. 175

The SEC was more emphatic about late trading, charging that such “trading violates Rule 22c-1(a) under the Investment Company Act,” 176

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176. This rule states in part that:

No registered investment company issuing any redeemable security, no person designated in such issuer’s prospectus as authorized to consummate transactions in any such security, and no principal underwriter of, or dealer in, any such security shall sell, redeem, or repurchase any such security except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security . . . .

defrauds innocent shareholders in those mutual funds by giving to the late trader an advantage not available to other shareholders, and harms shareholders when late trading dilutes the value of their shares."

The SEC's claims against market timers and late traders were encountering resistance in the courts. In SEC v. Pimco Advisors Fund Management, LLC, a federal district court dismissed the SEC's fraud claims involving Canary Capital's late trading and market timing because scienter had not been properly alleged. The court stated that

"The market timing agreement with Canary, standing alone, could not be considered per se a fraudulent device intended to defraud investors. The SEC does not allege, nor could it, that market timing practices are per se illegal, since many individual and institutional investors, as part of not uncommon investment strategies, continue to attempt to time markets with varying degrees of success."

In another action, a federal district court dismissed SEC charges against two senior executives at Columbia Funds Distributors, Inc. Those executives had allowed market timing in mutual funds that were being sold under prospectuses which stated that such trading was barred by the mutual fund. The court stated that "market timing arrangements are not the kind of sham transactions which have been held to qualify as schemes to defraud." The SEC subsequently amended its complaint in that action to charge that investors were misled by fund prospectuses that claimed the funds were hostile to market timing. However, a survey by the Investment Company Institute found that most investors did not read their mutual fund prospectuses and those that did were focused on other issues.

In another case, a federal district court dismissed aiding and abetting charges brought by the SEC over market timing. However, that court and two other district courts allowed fraud claims against defendants who had used subterfuges and deceptive devices to avoid mutual fund restrictions on

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177. In re Theodore Charles Sihpol III, Securities Act Release No. 8624, Securities Exchange Act Release No. 52,591, Investment Company Act of 1940 Release No. 27113, 2005 SEC LEXIS 2633 (Oct. 12, 2005). The SEC complaint in the Sihpol case charged that, while the Investment Company Act and SEC rules did not require a 4:00 p.m. hard cutoff in trading, mutual fund prospectuses had represented that such time would be the normal point for orders received before that time: "Orders received after the end of a business day will receive the next business day's net asset value per share."


179. Id. at 468.


such activity.\textsuperscript{183} Motions to dismiss class action and derivative suits have been denied where the defendants were charged with violations in connection with late trading and market timing. Nevertheless, several aspects of those claims were dismissed.\textsuperscript{184}

D. SEC RULES

Despite their lack of success in Court, the SEC and Spitzer were able to obtain settlements totaling over $4.25 billion in penalties, disgorgement and reduced mutual fund fees by the end of 2005.\textsuperscript{185} The SEC also began adopting proposed regulations that its staff thought would prevent market timing and late trading. That effort was less than successful. One regulatory fix proposed by the SEC for the mutual fund and late trading problem was the adoption of a rule requiring a “hard close” of mutual funds that would prevent the filling of any purchase or redemption requests after 4:00 p.m. Orders received after that time would have to be filled at the next day’s NAV. That approach proved to be too complex.\textsuperscript{186} Another proposal requiring mandatory redemption fees also stalled,\textsuperscript{187} and the SEC adopted a rule that “allowed” but did not require a two percent redemption fee.\textsuperscript{188} Even this approach proved to be too complex when raised and the SEC staff was examining the rule for amendment.\textsuperscript{189} Other rules were adopted that, among other things, required mutual funds to disclose the effects of market timing.\textsuperscript{190}


\textsuperscript{184} In re Mut. Funds Inv. Litig., 384 F. Supp. 2d 845, 873 (D. Md. 2005).

\textsuperscript{185} Craig & Lauricella, supra note 1, at A1. That total continued to grow in 2006. See, e.g., Landon Thomas Jr., Prudential to Pay Fine in Trading, N.Y. TIMES, Aug. 29, 2006, at C1 (reporting that Prudential Financial Inc. agreed to pay $600 million and admitted to criminal fraud under a deferred prosecution agreement); Bloomberg News, Money Manager Agrees to Settle Regulators’ Market-Timing Case, N.Y. TIMES, July 25, 2006, at C1 (reporting that firm agreed to pay $52 million to settle market timing claims and to cut fees by $25 million).


\textsuperscript{189} Judith Burns, SEC Floats Changes to Market-Timing Restraints, WALL ST. J., Mar. 4, 2006, at B6. The SEC waited until October 2006 to adopt the rule amendments requiring mutual fund boards to consider whether to impose a fee of up to two percent on redemptions within seven days of purchase. 71 Fed. Reg. 58257 (Oct. 3, 2006). Those amendments further required mutual funds to enter into agreements with broker-dealers holding shares on behalf of other investors in omnibus accounts. Those agreements must allow the mutual funds to access information about transactions in those accounts in order to enforce restrictions on late trading and market timings. \textit{id}.

A particularly controversial rule adopted by the SEC required the chairman of mutual fund boards to be independent from the chief executive officer and increased the majority requirement for outside directors to seventy-five percent. Those outside directors would have to meet in separate sessions at least quarterly and be allowed to have their own staff. Although there was no evidence that such a corporate governance structure was more efficient or provided greater shareholder protection, the SEC had long pursued efforts to increase participation by outside directors in public corporations as a check on management excesses. This has also been a popular cause for corporate reformists over the last quarter century. Their efforts stepped up after the Enron Corp. scandal, leading the New York Stock Exchange ("NYSE") and Nasdaq to require that at least a majority of the board of directors of their listed companies be composed of outside directors and that nominating and compensating committees be composed entirely of such directors. However, audit committees at public companies had been required since 1977 to be composed entirely of outside directors, but that requirement did nothing to check the audit-based scandals at Enron and elsewhere that arose after the market downturn in 2000.

There is also no empirical evidence to support requirements for majority outside director boards:

An important article by Professors Sanjai Bhagat and Bernard Black reviews the results of 112 empirical studies of various aspects of corporate governance, from the 1980s and 1990s. On the basic question whether independent directors improve economic performance, they conclude that ‘studies of overall firm performance have found no convincing evidence that firms with majority independent boards perform better than firms without such boards.’ Indeed, firms with a majority of inside directors ‘perform about as well’ as firms with a majority of independent directors.
Bhagat and Black also concluded that “firms with supermajority-independent boards [i.e., those with only one or two inside directors] might even perform worse, on average, than other firms.” Anecdotal evidence also suggests that increasing the number of outside directors added nothing to good governance. The boards of directors at Enron and WorldCom and other centers of scandal were comprised of large percentages of prominent outside directors who were unable to do anything to prevent the problems at those companies. In addition, most outside directors are not selected by shareholders. Rather, their nomination comes from the chief

197. Consider the troubling case of Eastman Kodak Co.: [It was] among the one percent of companies receiving a perfect score for corporate governance in a survey of public corporations by an international governance rating body. Kodak’s board of directors consisted of eleven outside directors and only one inside director. . . . [Yet, despite this politically correct structure] Eastman Kodak is possibly the worst managed company in America. For decades, shareholders there were pummeled by management blunders. The company first lost out to foreign film makers and then completely misjudged the digital revolution in cameras. The price of Eastman Kodak stock dropped from $76 in 1999 to $25 in April 2004, after the company cut its dividend from $1.80 to fifty cents and slashed 16,000 jobs . . . [bringing the total to over 100,000 employees being laid off since 1988, twenty times the number of jobs lost at Enron.] [Kodak] was taking accounting charges of over $1.3 billion and was dropped from the list of stocks included in the Dow Jones Industrial Average in the new century. . . . [It also announced a further $1.3 billion loss in the third quarter of 2005].

In contrast, Berkshire Hathaway, one of the most successful companies in the country in recent years, had one of the most politically incorrect board of directors until the Enron era reforms. The members of its board included Warren Buffett, his wife (before her death), his son, his longtime business partner and an insider who was a co-investor. . . . Berkshire Hathaway itself existed at all only because of a loophole in the Investment Company Act of 1940 administered by the SEC. Were it required to register as an investment company, Berkshire Hathaway’s decidedly non-independent board would have to be restructured and its operations terminated. ‘Berkshire Hathaway escapes the 1940 Act only by folding its strategic investment activities into an insurance subsidiary, and exploiting Nebraska’s permissive insurance statute in a fashion that no other company can be expected to duplicate.’
198. MARKHAM, supra note 3, at 341-42, 261 (2006). A massive accounting scandal also occurred at Fannie Mae that had a board of directors composed largely of outside directors who were unable to detect or prevent manipulations by managers. Peter Wallison, $1.5 Trillion of Debt, WALL ST. J., Mar. 7, 2006, at A12.
executive officer who often chooses them because they are golfing buddies or have some other social relationship with that officer.\textsuperscript{199} There was thus little empirical support for the corporate governance reforms that were added after the Enron and WorldCom scandals.\textsuperscript{200}

Adding more outside directors to mutual fund boards as a way of stopping future scandals in that industry has an even shakier foundation. The requirement for a majority of outside directors that was already in place did nothing to prevent the late trading or market timing scandals.\textsuperscript{201}

\textsuperscript{199} Landon Thomas, Jr., A Path to a Seat on the Board? Try the Fairway, N.Y. TIMES, Mar. 11, 2006, at A1 (describing several such relationships).

\textsuperscript{200} As one author notes with respect to reforms contained in the Sarbanes-Oxley Act ("SOX"):

\begin{quote}

The fact that the literature indicates that the corporate governance provisions in SOX are ill conceived raises the puzzling question of why Congress would enact legislation that in all likelihood will not fulfill its objectives. Simply put, the corporate governance provisions were not a focus of careful deliberation by Congress. SOX was emergency legislation, enacted under conditions of limited legislative debate, during a media frenzy involving several high-profile corporate fraud and insolvency cases. These occurred in conjunction with an economic downturn, what appeared to be a free-falling stock market, and a looming election campaign in which corporate scandals would be an issue. The healthy ventilation of issues that occurs in the usual give-and-take negotiations over competing policy positions, which works to improve the quality of decision making, did not occur in the case of SOX. That is because the collapse of Enron and its auditor, Arthur Andersen, politically weakened key groups affected by the legislation, the business community and the accounting profession. Democratic legislators who crafted the legislation relied for policy guidance on the expertise of trusted policy entrepreneurs, most of whom were closely aligned with their political party. Insofar as those individuals were aware of a literature at odds with their policy recommendations, they did not attempt to square their views with it. Nor did legislators of either party follow up on the handful of comments that hinted at the existence of studies inconsistent with those recommendations. Republican legislators, who tended to be more sympathetic to the regulatory concerns of accountants and the business community, dropped their bill for the Democrats', determining that it would be politically perilous to be perceived as obstructing the legislative process and portrayed as being on the wrong side of the issue.


\textsuperscript{201} Indeed, several other mutual funds scandals emerged in the wake of the late trading and market timing cases involving "shelf space" payments to sales staff to prefer one mutual fund over another in their recommendations to customers; failure to disclose breakpoints (commission discounts based on the size of the investment); and lavish entertainment provided to investment advisers as an incentive to direct mutual fund trades to broker-dealers. See Markham, supra note 3, at 437-40 (discussing those problems). For shelf space cases, see e.g., In re PA Fund Mgmt. LLP, Securities Exchange Act Release No. 50384, Investment Company Act Release No. 26598, 2004 SEC LEXIS 2085 (Sep. 15, 2004); In re Mass. Fin. Services Co., Investment Advisors Act of 1940 Release No. 2224, Investment Company Act Release No. 26409, 2004 SEC LEXIS 734 (Mar. 31, 2004); In re Rudney Associates, Inc., Investment Advisors Act of 1940 Release No. 2300, 2004 SEC LEXIS 2147 (Sep. 21, 2004). Edward Jones paid $75 million to settle claims that it was sharing revenues with a group of mutual funds in 2004 and another $127 million in 2006 over shelf space payments. Edward Jones Agrees to Settle 9 Lawsuits, WALL ST. J., Sept. 1, 2006, at C2. Morgan Stanley agreed to pay the SEC $50 million to settle charges in connection with its sale of mutual funds. Among other things, that firm was directing customers to mutual funds based on commissions paid for those funds, rather than the appropriateness of the investment for the customer. Certain "preferred" funds paid higher commissions to Morgan Stanley.
A study by the Fidelity mutual funds submitted in response to the SEC's request for comment on its then-proposed 75 percent outside director requirement actually showed there was empirical evidence to the contrary. That study was given "short shrift" by the SEC. The SEC gave similar treatment to legislation passed by Congress in response to the agency's then-proposed requirement for splitting the role of chairman and chief executive officer at mutual funds. In a highly unusual move, Congress required the SEC to provide "justification" for such a requirement. The SEC did not do so. Instead it passed the independent chairman and seventy-five percent outside director rule by a 3-2 vote that was highly politicized along party lines.

The SEC mutual fund governance rule was promptly challenged by the U.S. Chamber of Commerce and was set aside by the District of Columbia Court of Appeals. The court concluded that the SEC had the authority to adopt such a proposal, but held that the SEC had not adequately considered its costs or available alternatives. The SEC shrugged off that ruling by readopting the same rule only one week after it was stricken, without even awaiting the mandate of the Court of Appeals. The re-passage of the rule was also once again highly politicized, being approved once again over the dissenting votes of two Republican commissioners, one of whom apologized to the Court of Appeals for the majority's high-handed approach. The new rule was challenged and was set aside once again by the Court of Appeals. The Court held that the SEC should have sought public comment before adopting the rule so quickly after the Court's prior ruling. The Court did stay its judgment for ninety days in order to allow the SEC to seek public comment, which the


205. Chamber of Commerce of the U.S., 412 F.3d at 136.

206. Investment Company Governance, 70 Fed. Reg. 39,390, 39,398 (July 7, 2005) (to be codified at 17 C.F.R. pt. 270). Hasty action was necessary because SEC chairman William Donaldson was leaving the SEC and there would no longer be a majority of activist commissioners to readopt the rule. That act set off a storm of controversy and did even further damage to the already tarnished reputation of the SEC. Id.

207. Chamber of Commerce of the United States v. SEC, 443 F.3d 890, 909 (D.C. Cir. 2006).
agency proceeded to do.\textsuperscript{208}

More embarrassment to the SEC followed after a Harvard Business School study in 2006 revealed that mutual funds were still wrongly pricing their mutual fund assets.\textsuperscript{209} The study found that, while most mutual funds calculated NAV by using the closing price on the day of the pricing, they applied that value to the shares held on the previous day. That could result in substantial differences in pricing, depending on market conditions.\textsuperscript{210} In all events, the intrusive regulation mandated by the Investment Company Act of 1940 had failed completely in preventing scandal. Hampered by that regulation, mutual fund performance was less than impressive.\textsuperscript{211} Market studies found that mutual funds on an overall basis were lagging behind the market.\textsuperscript{212} Depending on the study, the lag in performance ranged from severe to moderate.\textsuperscript{213} Some 6.5 percent of equity funds were also closed or merged each year in order to boost mutual fund complex trading records.\textsuperscript{214}

E. HEDGE FUNDS

The hedge funds were at the center of the market timing and late trading scandals because they were the ones engaging in that trading. The hedge fund is a relatively new entrant into the financial world, tracing its history back to A.W. Jones & Co., a firm that was founded in 1949 by

\textsuperscript{208} In the meantime, the SEC staff was restructuring mutual fund governance through settlements in enforcement proceedings, a process that the \textit{Wall Street Journal} has called "Governance at Gunpoint" in the context of shareholder lawsuits. Phyllis Plitch, \textit{Governance at Gunpoint}, \textit{Wall St. J.}, Oct. 17, 2005, at R6. The Federated funds thus recently agreed to pay $72 million to settle late trading and market timing charges. It was also forced to hire an independent chairman; to take no board action without approval of a majority of outside directors (which must comprise a minimum 75 percent of the board); and to hire an "Independent Compliance Consultant" approved by the SEC staff who will decide how the company should be managed in the future. \textit{In re} Federated Investors, Inc., Securities Exchange Act Release No. 52,839, Investment Company Act Release No. 27167, 2005 SEC LEXIS 3038 (Nov. 28, 2005). \textit{See also In re} Strong Capital Mgmt., Inc., Securities Exchange Act Release No. 49,741, Investment Company Act Release No. 26,448, 2004 SEC LEXIS 1044 (May 20, 2004) (imposing similar governance changes).


\textsuperscript{210} Peter Tufano et al., \textit{supra} note 209, at 24.

\textsuperscript{211} Former directors of the SEC's Division of Investment Company Regulation have expressed concern that the maze of requirements and expense associated with mutual fund regulation is barring new entrants who might provide competition and reduce investor costs. \textit{Four Former SEC Directors Agree Mutual Fund Industry Overregulated}, 38 SEC. REG. & L. REP. (BNA) 376 (Mar. 6, 2006).

\textsuperscript{212} Markham, \textit{supra} note 3, at 425.

\textsuperscript{213} Id. Not all mutual funds were bested by the market. Bill Miller, the manager of Legg Mason Value Trust Fund, did beat the S&P 500 for the fifteenth straight year in 2005. \textit{Legg Mason Value Trust Beats S&P Index for the 15th Year}, \textit{Money Marketing}, Jan. 5, 2006, at 1.

\textsuperscript{214} Eleanor Laise, \textit{Mutual-Fund Mergers Jump Sharply}, \textit{Wall St. J.}, Mar. 9, 2006, at D1 (noting that such mergers are sought to be justified as creating cost savings).
Alfred Winslow Jones. That company rewarded its managers with an incentive fee of 20% of the profits gained from the collective investment of its clients' funds. By 1961, Jones's hedge fund had obtained a 21% annual rate of return, with gains of over 1,000 percent in one ten year period. Even so, Jones's fund operated in obscurity until an article published in 1966 in *Fortune* magazine described its operations. It then became the model for other funds.\(^{215}\) By 1969, there were about 150 hedge funds operating in the United States. Those funds held some $1 billion invested by about 3,000 investors. The funds used borrowed money to obtain leverage, engaged in exotic derivative and other complex transactions and often sold short.\(^{216}\) By 1994, some 800 hedge funds were holding $75 billion in assets.\(^{217}\) The number of hedge funds had jumped to 6,000 as the new century began, and they were managing some $600 billion.\(^{218}\) In 2004, there were some 7,000 hedge funds managing an estimated $850 billion.\(^{219}\) Assets under management by hedge funds reached an estimated $1.2 trillion in 2006.\(^{220}\)

Hedge fund corporate governance sought to place investment decisions in the hands of its managers. Investors are not treated as shareholders in the enterprise who have a say in governance. As one court noted:

Another distinctive feature of hedge funds is their management structure. Unlike mutual funds, which must comply with detailed requirements for

\(^{215}\) MARKHAM, supra note 26, at 358.
\(^{216}\) Id. at 358-59.
\(^{217}\) MARKHAM, supra note 101, at 218.
\(^{218}\) Id. at 358-59.
\(^{219}\) Id. at 358-59.
\(^{220}\) The SEC noted at the end of 2004 that:

It is difficult to estimate precisely the size of the hedge fund industry because neither we nor any other governmental agency collects data specifically about hedge funds. It is estimated that there are now approximately $870 billion of assets in approximately 7000 funds. What is remarkable is the growth of the hedge funds. In the last five years alone, hedge fund assets have grown 260 percent, and in the last year, hedge fund assets have grown over 30 percent. Some predict the amount of hedge fund assets will exceed $1 trillion by the end of the year. Hedge fund assets are growing faster than mutual fund assets and already equal just over one fifth of the assets of mutual funds that invest in equity securities.


220. Deborah Solomon, Congress May Let Hedge Funds Manage More Pension Money, WALL ST. J., July 28, 2006, at A1. Pending legislation in Congress would encourage even further growth by allowing hedge funds to manage more pension money without being treated as a fiduciary under the Employee Retirement Security Act. Id. However, SEC Chairman Christopher Cox has suggested that the SEC may increase qualification requirements for accredited investors who may invest in hedge funds. Zachery Kouwe, SEC Chief Talks Tough on Hedge-Fund Controls, N.Y. POST, July 26, 2006, at 31.
independent boards of directors, and whose shareholders must explicitly approve of certain actions, domestic hedge funds are usually structured as limited partnerships to achieve maximum separation of ownership and management. In the typical arrangement, the general partner manages the fund (or several funds) for a fixed fee and a percentage of the gross profits from the fund. The limited partners are passive investors and generally take no part in management activities. 221

Hedge funds sometimes posed problems. Several hedge funds experienced large losses when bond prices dropped abruptly in 1994. More serious were the losses that occurred at Long-Term Capital Management ("LTCM"), a hedge fund that lost ninety percent of its $4.8 billion in capital in September of 1998 as a result of its trading positions. LTCM employed twenty-five Ph.D.s on its payroll, including some academic superstars, to guide its "market-neutral" trading. 222 LTCM’s problems were of such a size that concern was raised that its failure would pose a systemic risk to the American economy. 223 That concern resulted in a rescue arranged by the Federal Reserve Board. 224

The SEC, until the market timing and late trading scandals, had resisted the regulation of hedge funds. Initially, those funds avoided regulation under the Investment Company Act through a provision that exempted investment companies with less than 100 investors. That exemption applied regardless of the amount of money under management,

222. LTCM was engaged in "convergence" trading. In one instance, it borrowed Brady bonds, selling them short and buying non-Brady bonds issued by the same countries. LTCM anticipated a narrowing of the price gap between the Brady bonds and the non-Brady bonds. If the prices widened between these two securities, however, LTCM lost money. Another LTCM investment involved total return swaps in which it agreed to pay an institution a fixed interest rate on the amount it would cost to buy a block of stock. The institutional investor agreed to pay LTCM an amount equal to the dividends generated by the stock during the period of the swap, as well as any increase in the price of the stock. LTCM had to pay any decrease in value in the stock. MARKHAM, supra note 101, at 317-8.
224. Tiger Management, another high profile hedge fund that had $23 billion under management, lost $2.1 billion in September and $3.4 billion in October of 1998. That hedge fund lost $2 billion from currency trading losses in the latter month. But, even with that loss, the hedge fund showed a positive performance for the year. Another hedge fund experiencing trouble in October of 1998 was Ellington Capital Management. George Soros’s $20 billion Quantum Group suffered large losses when the Russian government defaulted in August of 1998. Soros then announced that he was shutting down a $1.5 billion emerging markets hedge fund that was a member of his Quantum hedge fund group. MARKHAM, supra note 101, at 317. A $5 billion loss in one week by Amaranth Advisors in September 2006 was also raising eyebrows. Ann Davis, How Giants Bets on Natural Gas Sank Brash Hedge-Fund Trader, WALL ST. J., Sept. 19, 2006, at A1. See also Landon Thomas Jr., A $700 Million Hedge Fund, Down From $3 Billion, Says It Will Close, N.Y. TIMES, Oct. 31, 2006, at C3 (withdrawals cause hedge fund operated by two former Salomon Brothers traders to close).
provided that the company was not making a public offering of its securities.\textsuperscript{225} "The National Securities Markets Improvement Act of 1996\textsuperscript{226} gave more flexibility to hedge funds. It allowed investment companies to act without registration, if their investors were qualified purchasers – that is, large, sophisticated investors – without limitation as to the number of persons."\textsuperscript{227}

The treatment of hedge funds in the futures industry was markedly different. Many hedge funds trade regulated commodity futures contracts. As a CFTC commissioner has noted, the "commodity pool industry... which includes many of the largest hedge funds, plays an extremely important role in the functioning of the futures markets in the United States as well as the rest of the world."\textsuperscript{228} That trading activity initially required those funds to register with the CFTC as commodity pool operators ("CPOs") and commodity trading advisers ("CTAs") under the Commodity Exchange Act of 1936.\textsuperscript{229} However, "[i]n 1992, the CFTC adopted a key liberalizing measure, Rule 4.7, which preserved CPO registration requirements but provided an exemption from most regulatory

\begin{footnotes}
\footnote{225. 15 U.S.C. § 80a-3(c)(1) (2000).}
\footnote{227. MARKHAM, supra note 101, at 218-19. A "qualified" investor would include someone owning $5 million in investments. 15 U.S.C. § 80a-2(51)(A) (2002). As one court noted: The Investment Company Act of 1940, directs the Commission to regulate any issuer of securities that "is or holds itself out as being engaged primarily... in the business of investing, reinvesting, or trading in securities." Although this definition nominally describes hedge funds, most are exempt from the Investment Company Act's coverage because they have one hundred or fewer beneficial owners and do not offer their securities to the public, or because their investors are all "qualified" high net-worth individuals or institutions. Investment vehicles that remain private and available only to highly sophisticated investors have historically been understood not to present the same dangers to public markets as more widely available investment companies, like mutual funds. Goldstein v. SEC, 451 F.3d 873, 874 (D.C. Cir. 2006).}
\footnote{229. 7 U.S.C. § 1 (2000). As a CFTC commissioner has noted: Based on data collected by the CFTC with help from the NFA, the number of Institutional Investor's Platinum 100 largest hedge funds that were registered as Commodity Pool Operators (CPOs) under the CFTC's delegated authority grew from 55 in 2002, to 65 of the top 100 funds in 2003, and we have continued to see growth in 2004. In addition, 50 out of the 100 largest hedge funds were also registered with the CFTC as Commodity Trading Advisors (CTAs) in 2003 and this has also grown in 2004. Among the 25 largest hedge funds, the proportions get even higher, with 68% registered as CPOs in 2003. Thus, a significant proportion of the hedge fund industry is duly registered with the CFTC and this number is growing.}
\end{footnotes}
requirements for pools offered only to highly accredited investors,” which composed most of those persons investing in hedge funds.230

Similar relief was not given for CTA registration. In measuring whether the exemption from registration for advisers with less than fifteen clients is available under the Commodity Exchange Act where a corporation or other business entity was being advised,231 the CFTC had looked through to count the number of clients of the separate corporation or entity. The CFTC’s look-through position was upheld by the Ninth Circuit Court of Appeals in an early challenge on that issue.232 At about the same time, the Second Circuit Court of Appeals made a similar ruling with respect to investment advisers under the Investment Advisers Act of 1940, holding that a general partner of a limited partnership was an adviser to the limited partners rather than to the limited partnership as an entity.233 However, in 1985, the SEC adopted a rule234 that “permitted advisers to count each partnership, trust or corporation as a single client,” allowing “advisers to avoid registration even though they manage large amounts of client assets and, indirectly, have a large number of clients.”235

The CFTC’s look-through position swept up a lot of hedge funds as CTAs even though those entities were advising only wealthy and sophisticated clients. In contrast, the SEC’s rule excluded those hedge funds from the Investment Advisers Act registration requirement.236 “By

230. Susan C. Ervin, Letting Go: The CFTC Rethinks Managed Futures Regulation, 24 Futures & Derivatives L. Rep. 1 n.5, 8 (May 2004). Several hedge funds remained registered with the CFTC as CPOs, including Long Term Capital Management (“LTCM”). See Brooksley Born, International Regulatory Responses to Derivatives Crises: The Role of the U.S. Commodity Futures Trading Commission, 21 NW. J. Int’l L. & Bus. 607, 635 (2001) (describing registration of LTCM). It has been noted that:
any hedge fund that uses the markets under CFTC’s jurisdiction, even if their advisors qualify for an exemption from registration, continue to fall under the legal definition of a CPO or CTA, meaning that certain of the CFTC’s rules and provisions of the Commodity Exchange Act—such as those proscribing fraud or manipulation—continue to apply.


232. In CFTC v. Savage, 611 F.2d 270, 268 (9th Cir. 1979), the Ninth Circuit held that clients of a separate entity would be counted for purposes of determining whether CTA registration was required under the CEA.


236. As one author has noted:
Ever since hedge funds became participants in the securities markets in the 1950s, they have endeavored to operate as unregulated entities and the SEC has been uncertain about how, if at all, to regulate them. Most hedge funds in the United States are formed as limited partnerships in order to obtain flow-through tax treatment. The general partner of the partnership falls within the definition of an “investment adviser” under the Investment Advisers Act of 1940 (Advisors Act), but if the hedge fund is counted as only one client, the
regulating commodity pools of all shapes and sizes and treating investment funds as the sum of their individual investors, the CFTC became, by default, the only active regulator of any portion of the hedge fund marketplace.237 However, the CFTC began rethinking its regulatory role after the enactment of the Commodities Futures Modernization Act of 2000.238 That statute was a statutory reflection of a CFTC decision to deregulate the commodity markets for transactions in which only wealthy and sophisticated investors are involved. The CFTC was, therefore, receptive to a petition from the “Managed Funds Association . . . , a trade association for hedge fund managers and CPOs” that sought “a ‘sophisticated investor’ exemption” from registration as a CTA for advisors advising only wealthy and sophisticated clients.239 That exemption was adopted by the CFTC on August 8, 2003.240 It was designed to conform to the SEC position on not looking through entities to count clients for purposes of registration as an adviser.241

One commentator predicted that, as a result of that and other changes made to CFTC rules, “the CFTC’s regulatory role in the managed futures markets will shrink to a fraction of its former size and this development may well presage a new regulatory map in which the . . . [SEC] exercises regulatory oversight over the hedge fund marketplace, including commodity pools and trading advisors previously regulated by the CFTC.”242 Indeed, that process was already underway at the SEC where the staff was considering whether regulation of hedge funds was needed as a result of their involvement in the market timing and late trading at the mutual funds. Not surprisingly, government being what it is, the SEC staff study concluded that regulatory control over the hedge funds was needed, seeking to have them register as investment advisers.243 The SEC staff was additionally seeking corporate governance reforms in its settlements with

entity is exempt from registration because it has fewer than fifteen clients and it does not hold itself out to the public as an adviser.

Karmel, supra note 157, at 923.

237. Ervin, supra note 230, at 3.


239. Ervin, supra note 230, at 3.


hedge funds involved in the late trading and market timing cases.244

Some sixteen months after the CFTC acted to adopt the SEC’s approach on looking-through entities to count clients, the SEC changed its position and adopted the old CFTC view and began looking through hedge funds to count the number of clients in order to require the registration of hedge funds as investment advisers.245 That action was taken after another highly politicized vote of 3-2 by the SEC commissioners. That rule required hedge fund advisers to register with the SEC as investment advisers by February 1, 2006.246 Predictably, that requirement was to become the basis for more regulation after every new hedge fund scandal.247 As it was, registered hedge funds would be subject to SEC audits, would be required to maintain specified books and records, and would be required to hire a compliance officer and establish a compliance program. Those hedge funds would also be required to disclose the amount of money under management.248

The hedge fund investment adviser registration requirement was challenged in the District of Columbia Court of Appeals. That court concluded that the SEC had acted arbitrarily in defining clients to include hedge fund participants.249 The Court stated: “That the Commission wanted a hook on which to hang more comprehensive regulation of hedge funds may be understandable. But the Commission may not accomplish its objective by a manipulation of meaning.”250 That action was another embarrassment to the SEC’s efforts to dictate corporate governance in the financial services industry.251

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246. Excepted from the registration requirement were hedge funds that required clients to keep their funds invested in the hedge fund for at least two years, absent extraordinary circumstances. 17 C.F.R. § 275.203(b)(3)-1(d)(2) (2006). About 1,100 hedge fund advisers were registered with the SEC prior to the rule. Its adoption resulted in almost another 1,000 registrations. Kara Scannell, Making Hedge Funds Less Secret, WALL ST. J., Feb. 3, 2006, at C1.


248. Scannell, supra note 246, at C1.


250. Id. at 882.

251. After this debacle a former SEC chairman charged that lawyers at the SEC were trying to dictate economics through its mutual fund and hedge fund rules. Harvey L. Pitt, Over-Lawyered at the SEC, WALL ST. J., July 26, 2006, at A15. A congressional investigation of hedge fund regulation in
IV. Regulation of Commodity Pools

A. The Role of Commodity Pools

The SEC’s failures in regulating mutual funds gave rise to the question of whether alternative regulatory schemes for collective investments might be preferable. One such alternative is the commodity pool operator regulated by the CFTC under the Commodity Exchange Act of 1936 ("CEA"). A commodity pool is the commodity futures industry’s analogue to an investment company, but it is regulated under a regime that varies significantly from the one employed under the Investment Company Act of 1940. A commodity pool is essentially an entity soliciting funds from a group of customers and trading those funds in commodity futures contracts through a single collective account.

"The advantage of a commodity pool is that individuals who would not otherwise have the time or expertise to devote to futures trading may receive the benefits of expert advice from the commodity pool operator or its commodity trading adviser." The separate corporate existence or, most frequently, the use of limited partnerships is common to commodity pools. This is done to limit liability to the amount of the investment in June 2006 embarrassed the SEC once again after a SEC lawyer claimed that he was discharged from the agency for pressing an investigation of a hedge fund too aggressively. The hedge fund under investigation was Pequot Capital Management which had $7 billion under management. Walt Bogdanich & Gretchen Morgenson, S.E.C. is Reported to Be Examining a Big Hedge Fund, N.Y. TIMES, June 23, 2006, at A1. The SEC lawyer claimed that he was fired because he insisted on subpoenaing John Mack, an executive at the hedge fund who was being appointed as the new head of Morgan Stanley. David Wighton, Mack to be Questioned by SEC in Pequot Case, FINANCIAL TIMES (London), July 22, 2006, at 9.

In any event, the credit rating agencies are expanding their coverage on hedge funds, which will impose some informal regulation. Anuj Gangahar, Rating Agencies to Draw Uphedge [sic] Fund Criteria, FINANCIAL TIMES (London), Aug. 24, 2006, at 1.

253. Roberta Romano, A Thumbnail Sketch of Derivative Securities and Their Regulation, 55 Md. L. Rev. 1, 28 (1996) (commodity pool operators are “the futures analogy to a mutual fund”); Rosenthal & Co. v. CFTC, 802 F.2d 963, 965 (7th Cir. 1986) (“A commodity pool is the commodity-futures equivalent of a mutual fund; the investor buys shares in the pool and the operator of the pool invests the proceeds in commodity futures.”); Frank A. Camp, Note, The 1981 Revisions in the CFTC’s Commodity Pool Operator Regulations, 7 J. CORP. L. 627, 630 (1982) (earlier in their history commodity pools were referred to as “commodity mutual funds”).
254. As noted in one treatise:
To summarize, a commodity pool is typically an organization that raises capital through the sale of interests in it, such as shares or limited partnerships, and uses that capital to invest either entirely or partially in commodity contracts. In its features, the typical commodity pool bears a strong resemblance to mutual funds and similar investment companies that have operated for decades in the securities industry.
255. 13 JERRY W. MARKHAM, COMMODITIES REGULATION 17A-8 to 9 (2005).
256. Id. at 17A-9.
contrast to the unlimited liability of an individual trader. In addition, the commodity pool provides diversification and eliminates margin calls on its investors.\footnote{257}

Like hedge funds, the commodity pool is a relatively new entrant to the field of regulation. Little has been written about them, their history is obscure, and the basis for their regulation is uncertain. "Legislative history regarding the derivation of the concept of the commodity pool operator is sparse indeed.\footnote{258} What is known is that a run up in commodity market prices in the 1970s gave rise to concerns at the Commodity Exchange Authority (a now-defunct bureau in the Department of Agriculture) that registration of CPOs and CTAs was needed "in order to eliminate practices that had enticed unsuspecting traders into the markets with, far too often, substantial loss of funds."\footnote{259}

Some commodity exchanges had already adopted rules requiring disclosures concerning the affiliation of commodity pools with the exchanges in order to assure that investors were not misled. The commodity exchanges also imposed special margin requirements that were needed because of the limited liability of the commodity pool owners and the size of the pool positions.\footnote{260} Those rules were deemed inadequate by Congress when it overhauled the CEA\footnote{261} through the passage of the Commodity Futures Trading Commission Act of 1974.\footnote{262} CPOs were required to register with the CFTC,\footnote{263} a process now administered by the

\footnote{257. JOHNSON & HAZEN, supra note 254, at 1-251.  
259. JERRY W. MARKHAM, THE HISTORY OF COMMODITY FUTURES TRADING AND ITS REGULATION 64 (1987) (quoting H.R. REP. 93-975, at 79 (1974)). The House Report also stated that the legislation was needed to protect "unsophisticated traders." Id.  
260. JOHNSON & HAZEN, supra note 254, at 1-251.  
263. The CEA defines a "commodity pool operator" as: any person engaged in the business which is of the nature of an investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds securities or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market, but does not include such persons not within the intent of this definition as the Commission may specify by rule or regulation or by order. 7 U.S.C. § 1(a)(4) (2000). This definition has been interpreted by the courts: Those courts which have raised the issue require the following factors to be present in a commodity pool: (1) an investment organization in which the funds of various investors are solicited and combined into a single account for the purpose of investing in commodity futures contracts; (2) common funds used to execute transactions on behalf of the entire account; (3) participants share pro rata in accrued profits or losses from the commodity futures trading; and (4) the transactions are traded by a commodity pool operator in the name of the pool rather than in the name of any individual investor.}
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National Futures Association ("NFA"), a self-regulatory organization much like the National Association of Securities Dealers, Inc. ("NASD"). "Associated persons" of those entities are also required to register.

There are presently some 3,500 commodity pools managed by CPOs, with approximately $600 billion in assets. Most of those commodity pools are privately placed and would fall into the category of hedge funds that are sold only to institutions such as pension plans, university endowments and other sophisticated investors. However, a relatively small number of commodity pools are publicly offered and registered with the SEC under the Securities Act of 1933 and the Securities Exchange Act of 1934.

B. COMMODITY POOL REGULATIONS

The CFTC opted for a disclosure approach in regulating CPOs. "This is one of the few areas where the CFTC had sought specific disclosures in other than a very summary form" as a part of its regulation of registrants. The CFTC requires CPOs to provide clients with a brochure...
containing specified information.272 A key part of that document is a “risk disclosure statement” that warns in stark terms of the high risk of derivatives trading, the effects of restrictions on the withdrawal of investor funds and the substantial fees that may attach to investments in commodity pools.273 The use of such summary risk disclosure requirements was adopted after the CFTC rejected the “suitability” rule in the securities industry that prohibits a broker-dealer from recommending a security that is not suitable in light of the particular investments needs and objectives of the customer.274 The CFTC risk disclosure statement tells customers that they should themselves carefully consider whether commodity futures trading is suitable for their own investment interests.275

The CFTC further requires the CPO brochure to provide substantive disclosures such as background information on the CPO and its CTAs.276 Disclosure is required of the “principal risk factors” associated with participation in the pool, including the use that will be made of the proceeds obtained from investors, a description of the instruments to be traded, and the investment programs and police to be followed by the pool.277 In addition, a summary description of the pool’s CTA is required.278 Disclosure is required of restrictions on transfer of pool

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275. The differences in the regulatory approaches of the SEC and CFTC is evidenced by the risk disclosure statement required for single stock futures over which the SEC was given joint regulatory control with the CFTC. Instead of the brief warning used by the CFTC for high risk futures contracts, the disclosure statement for single stock futures became a long, complex, mini-prospectus, negating its value as a warning to unsuspecting investors. 67 Fed. Reg. 64,162 (Oct. 17, 2002). See also MARKHAM, supra note 3, at 359.


278. 17 C.F.R. §4.24. The following is a summary of the disclosures required in the CPO brochure: the name and main address of the commodity pool operator and each of its principals as well as their business commodity pool operator and each of its principals as well as their business background for the preceding five years; the business background, for the same period, of any commodity trading advisor to the pool (and its principals); any actual or potential conflict of interest in regard to the pool by the operator or manager, major commodity trading advisor (or their principals), or service provider (or their principals or introducing brokers); ... whether the operator, commodity trading advisor, or any principal has a beneficial interest in the pool and, if so, the extent of that interest; an identification of all
ownership interests, distribution policies and the federal income tax effects of distributions. Redemption policies must also be disclosed. Redemption policies vary, but a cursory survey of several public commodity pools suggest that most CPOs allow redemptions at NAV at month end, often requiring from five to ten days advance notice. This effectively prevents market timing in those pools. In order to further discourage market timers, many CPOs require funds to be held in the pool for eleven months or more before withdrawal. Other CPOs impose a redemption fee varying from 3 percent or more where a withdrawal is made before the end of such a period.

“The centerpiece of the disclosure document is the ‘track record’ types of expenses and fees that were incurred by the pool in the preceding fiscal year and are expected to be incurred in the current year; information regarding any minimum or maximum contribution requirements and, if applicable, what will be done with the funds until trading begins; how the pool will fulfill its margin requirements on transactions, and how it will use funds in excess of margin requirements; any restrictions upon transfer or redemption of interests in the pool; the extent to which pool participants may be liable in excess of their capital contributions; the pool’s distribution policy with respect to profits or capital, and its federal income tax effects for the participants; any “material” administrative, civil, or criminal action against the operator, commodity trading advisor, or a principal in the preceding five years; any fee payable by the operator, commodity trading advisor, or a principal for soliciting capital contributions to the pool; whether the operator, commodity trading advisor, or a principal trades (or intends to) and, if so, whether participants will be permitted to inspect those trading records; a statement that all participants will receive monthly or quarterly account statements and either a certified or uncertified annual financial report; and on the cover page of the disclosure document, a disclaimer that the Commission has neither reviewed nor passed on the accuracy or completeness of that document.

JOHNSON & HAZEN, supra note 254, at 1-257-58.


280. 17 C.F.R. §4.24(r) (2006). Federal income tax treatment has driven the use of limited partnerships as the format for commodity pools because otherwise there would be a double tax, one at the pool level and one at the investor level. Smith, supra note 274, at 296-297. There is no double tax exemption such as the one available for mutual funds. 26 U.S.C. §§ 851-852 (2000). A “publicly traded partnership” is also subject to a double tax because they are taxed as corporations. 26 U.S.C § 7704 (2000). However, double taxation can be avoided if the limited partnership is not considered to be publicly traded. That is accomplished by imposing restrictions on transfers of limited partnership interests, which many publicly owned commodity pools have done. Avoiding the status of a publicly traded partnership also allows deduction of the pool’s losses up to the extent of the investor’s taxpayer’s basis in the pool. See e.g., Rogers Int’l Raw Materials Fund, L.P., Prospectus, 2,000,000 Units of Limited Partnership Maximum at 51-57 (Mar. 31, 2005) (discussing those issues). The taxation of gains from commodity futures contracts was changed by the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 §§ 501-09, after a massive tax shelter scandal in the futures markets. See Jerry W. Markham, Prohibited Floor Trading Activities Under the Commodity Exchange Act, 58 FORDHAM L. REV. 1, 22-29 (1989) (discussing those scandals and the tax law changes). Gains from regulated futures contracts are taxed at a mixture of the 60% long term capital gains rate and 40% short term rates, regardless of the holding period. Open positions are marked-to-market and any gains taxed at those rates, which can cause some cash flow issues. 26 U.S.C. § 1256 (2000).


282. Compare Rogers Int’l Raw Materials Fund, L.P., supra note 280, at 42-43 (explaining that 10 days notice before end of month is required for redemption but no redemption fee is charged).
provision, which requires that the disclosure document set forth the actual performance record in mandated form for the pool, other pools operated by the commodity pool operator, and commodity interest accounts directed by the pool’s commodity trading advisor.\textsuperscript{283} This requires disclosure of past trading performance,\textsuperscript{284} including the actual trading performance of the pool and its CTAs for the preceding five years. That performance must be in a form specified by CFTC regulations which require, among other things, disclosure of the “worst peak-to-valley drawdown during the most recent five calendar years.”\textsuperscript{285} This requirement is a recognition that commodity pool investors are consumers who are seeking a product with the best performance after costs and fees.

CFTC regulations prohibit CPOs from co-mingling the funds of a pool with any other person.\textsuperscript{286} Participants in larger pools must be given monthly account statements in the form of a statement of income and a statement of changes in net asset value computed in accordance with generally accepted accounting principles.\textsuperscript{287} Pool participants must be given an annual report containing financial statements certified by an independent public accountant.\textsuperscript{288} CFTC regulations also contain a Sarbanes-Oxley Act of 2002\textsuperscript{289} type requirement that requires each account statement and annual financial report to contain a “signed oath or affirmation of the sole proprietor, general partner of a partnership, or chief executive or chief financial officer of a corporate pool that these reports are accurate and complete to the best of his or her belief.”\textsuperscript{290}

C. COMMODITY POOL GOVERNANCE

“A significant provision under the 1940 [Investment Company] Act, but absent from the commodity pool regulatory structure, is the role of independent directors.”\textsuperscript{291} Moreover, the outside director requirements adopted by the New York Stock Exchange after the Enron scandal were not applied to limited partnerships because of their “unique attributes.”\textsuperscript{292} It is

\begin{itemize}
  \item 283. Rosen, supra note 258, at 982.
  \item 286. 17 C.F.R. § 4.20(c) (2006).
  \item 287. 17 C.F.R. § 4.22 (2006).
  \item 290. JOHNSON & HAZEN, supra note 254, at 1-260, referencing 17 C.F.R. §4.22(h).
  \item 291. Smith, supra note 274, at 290.
  \item 292. That rule mandated that at least a majority of the board of directors of listed companies be composed of outside directors and that nominating and compensating committees be composed entirely of such directors. However limited partnerships were exempted from those requirements. See N.Y. STOCK EXCH., NYSE LISTED COMPANY MANUAL § 303(A) (2004), available at
\end{itemize}
also "noteworthy that the CEA [Commodity Exchange Act], unlike the Investment Company Act, does not mandate a corporate form for CPOs, and thus permits a contract form of governance and greater flexibility than the Investment Company Act in advisory arrangements."

"Commodity pools are not subject to specific governance procedures under the CFTC regulations. Rather, the relationship between the pool and the pool participants is based on state law depending on the form of entity." For tax reasons, "the limited partnership is the most common form of commodity pool, although the limited partnership is often set up with a corporation acting as the general partner." The governance structure of limited partnerships is regulated by state law, usually some form or another of the Revised Uniform Limited Partnership Act. Those statutes require the limited partnership to file a statement before commencing business, with the Secretary of State or some other state functionary. Usually, that statement must contain the name and address of the general partner and little else.

The general partner manages the limited partnership's business while the limited partners play a passive role. Unlike the limited partners, the general partner does not have limited liability but may shield its owners by incorporating. Most general partners in large CPO limited partnerships


294. Smith, supra note 274, at 291.

295. Camp, supra note 253, at 630. Pools operating as corporations were initially so rare that the CFTC had to make a special exemption for them under its regulations. Rosen, supra note 258, at 951.

296. See THOMAS LEE HAZEN & JERRY W. MARKHAM, CORPORATIONS AND OTHER BUSINESS ENTERPRISES 64-75 (2d ed. 2006) (describing advantages and disadvantages of limited partnerships).

297. See, e.g., REVISED UNIFORM LIMITED PARTNERSHIP ACT §2001 (1997). New York law is more expansive in the information to be filed with the county clerk by limited partnerships, requiring a statement of the term of the limited partnership, a description of the contributions of limited partners, and policies for making distributions to limited partners. N.Y. P'SHIP LAW § 91 (Consol. 1977).

298. HAZEN & MARKHAM, supra note 296, at 64-66.

299. See, e.g., Frigidaire Sales Corp. v. Union Properties, Inc., 562 P.2d 244, 245 (Wash. 1977). The limited liability of a corporate general partner has led the Office of the Comptroller of the Currency to "permit a wholly-owned subsidiary of a national bank to act as sole general partner and commodity pool operator to trade, invest in, and hold forward, option, and futures contracts that are permissible for a national bank to purchase and execute either for their own account or for the account of their customers." Steven McGinity, Symposium on Derivative Financial Products: Derivatives-Related Bank
are incorporated.300 This means that, "[u]nlike a traditional corporate entity whose managers are natural persons, a pool’s managers are typically corporations or other entities."301

A general partner of a limited partnership owes fiduciary duties under state law to limited partners but their scope and application is uncertain.302 CFTC regulations also seem "to recognize that commodity trading advisers and commodity pool operators owe greater duties to their customers and that their customers need special protection."303 Of particular concern to the CFTC has been the fees charged to pool participants. It had initially considered "adopting a restriction on the amount of management and advisory fees a commodity pool might charge. After considering such a measure and the negative comments received, however, the Commission decided not to impose such a rule."304

Another contrast between the securities and futures industry is their treatment of incentive fees paid on the basis of profits from trading. The CFTC rejected a prohibition on incentive fees from trading profits such as the one contained in the Investment Advisers Act of 1940.305 That decision was made after the CFTC Advisory Committee on Commodity Futures Trading Professionals concluded that the Investment Advisers Act’s prohibition on incentive fees was due to the fact that Congress thought that such arrangements resulted in undue risk taking.306 The advisory committee believed that concern was inapplicable to futures trading because speculation and risk-taking are an accepted part of the futures industry.307

Instead of the more parental restrictions used by the Investment

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301. Smith, supra note 274, at 287.

302. Hazen & Markham, supra note 296, at 64-66.

303. Markham, supra note 271, at 237.

304. Rosen, supra note 258, at 959. The CFTC has also struggled with commission and fee disclosure requirements for commodity futures commission merchants, the futures industry analogue to the broker-dealer in the securities industry. The agency has required disclosure of fees where they are material but rejected claims that an excessive fee or commission is inherently fraudulent. An issue raised periodically is whether, in addition to their amounts, disclosure of the effects of excessive fees and commissions is required. See Markham, supra note 255, at § 8:10.


306. A Senate report to that legislation likened such arrangements to a “heads I win, tails you lose” investment approach. S. Rep. No. 76-1775, at 22 (1940).

Advisers Act, the CFTC opted for its disclosure approach. This includes disclosure in the CPO brochure of management fees, brokerage commissions, trailing commissions, allocations from the pool to any person, trading adviser fees, clearing fees, and professional and administrative fees, including legal fees.\textsuperscript{308} The CPO must provide in tabular format an analysis of the pool's break even point and that analysis must include all fees and commissions. Certain additional and specific disclosures are required for incentive fees.\textsuperscript{309} Some of those incentive fees can be significant. In addition to management and brokerage fees ranging from around 2\% to 65\% of NAV, a 20\% incentive fee based on profits is common.\textsuperscript{310}

Another concern based on fiduciary principles is reflected in the CFTC regulations that require disclosure in the CPO brochure of "any actual or potential" conflicts of interest.\textsuperscript{311} This includes disclosure of arrangements in which any person might benefit from the maintenance of the pool's account with a particular futures commission merchant or its introduction by an introducing broker. This would include payments for order flow or soft dollar arrangements,\textsuperscript{312} which have also raised concerns at the SEC.\textsuperscript{313} Another disclosure required by the CFTC that is also popular with the SEC is that of related party transactions.\textsuperscript{314} The CFTC requires disclosure of costs to the pool of transactions (for which there is no publicly disseminated price) between the pool and any affiliated persons.\textsuperscript{315} Where the CPO, CTA or their principals plan to trade for their own account, disclosure must be made of that fact and any written policies governing such trading. In addition, disclosure must be made as to whether pool participants will be allowed to inspect the trading records of the persons engaging in such trading.\textsuperscript{316}

D. OVERLAPPING SEC JURISDICTION

The SEC has maintained a regulatory role over commodity pools through the backdoor of the Securities Act of 1933 and the Securities

\textsuperscript{308} 17 C.F.R. § 4.24(i) (2006).
\textsuperscript{309} 17 C.F.R. § 4.21(i)(3) (2006).
\textsuperscript{310} See, e.g., The Beacon Financial Futures Fund L.P., Prospectus at 13 (May 13, 2005) (disclosing 20\% percent incentive fee); JWH Global Trust, Prospectus at 31-32 (Nov. 1, 2004) (disclosing 20\% incentive fee and 6.5\% annual brokerage fee).
\textsuperscript{311} 17 C.F.R. § 4.24(j) (2006).
\textsuperscript{312} 17 C.F.R. § 4.24(k) (2006).
\textsuperscript{313} Id. at § 6:13 (describing payment for order flow issues). See MARKHAM & HAZEN, supra note 117, at § 5:8. (describing soft dollar restrictions and SEC enforcement cases).
\textsuperscript{314} The scandal involving the Enron Corp. was occasioned by the disclosure of certain suspect related party transactions involving the company's chief financial officer, Andrew Fastow. MARKHAM, supra note 3, at 82.
\textsuperscript{315} 17 C.F.R. § 4.24(k) (2006).
\textsuperscript{316} 17 C.F.R. § 4.24(m) (2006).
Exchange Act of 1934. The SEC claims those ownership interests are "securities" subject to its regulation. Whether the SEC had jurisdiction over such securities was in doubt after the CFTC was created because the latter agency was given "exclusive" jurisdiction over the regulation of futures trading.\(^{317}\) Clouding the picture further was the issue over whether discretionary commodity futures accounts were securities subject to SEC regulation.\(^{318}\) The courts are divided on the issue of whether such accounts are securities, an issue that hinges on whether "vertical" commonality, as opposed to "horizontal" commonality, meets the investment contract definition established by the Supreme Court in *SEC v. W. J. Howey Co.*\(^{319}\) The majority of the courts seem to have concluded that discretionary accounts are not securities subject to SEC jurisdiction,\(^{320}\) but there is more horizontal commonality in commodity pools so the result might have been different for investments in those entities.

The CFTC early in its history asserted exclusive jurisdiction over the operation and investment activities of pools, and the SEC did not challenge that claim. Therefore, even publicly offered commodity pools are not subject to the Investment Company Act of 1940 unless they are also trading securities and do not otherwise fall within in an exemption to that statute. However, the CFTC declined to decide whether the solicitation of funds by commodity pool operators were within its exclusive jurisdiction or whether the SEC had concurrent jurisdiction over such solicitation under the Securities Act of 1933 or the Securities Exchange Act of 1934.\(^{321}\) As a consequence of this uncertainty most commodity pools registered their public offerings with the SEC under the Securities Act of 1933, but not the Investment Company Act of 1940. Nevertheless, the issue of what regulations applied remained open because the SEC and CFTC were locked in a jurisdictional war from their inception over their respective regulatory roles for futures type instruments that involved securities.\(^{322}\)

The SEC got the worst of its jurisdictional fights with the CFTC in the Seventh Circuit,\(^{323}\) and it entered into a demarche with the CFTC in 1981


\(^{320}\) MARKHAM, supra note 255, at § 21:3.


\(^{323}\) Bd. of Trade of the City of Chicago v. SEC, 677 F.2d 1137, 1167 (7th Cir. 1982), vacated as
that allocated jurisdiction between the two agencies. That agreement was
called the Shad-Johnson Accords in honor of the chairmen of those
agencies who negotiated the agreement. The Shad-Johnson Accords did
not end the jurisdictional turf battles between the SEC and CFTC,324 but did
lead to legislation that defined the boundaries for futures and options
trading.325

The Shad-Johnson Accords also addressed the regulation of
commodity pools. In order to resolve the uncertainty in this area, those
Accords sought legislation that would provide that nothing in the CEA
would affect the applicability of the Securities Act of 1933 and the
Securities Exchange Act of 1934 with respect to securities issued by
commodity pools. “Moreover, in appropriate circumstances, commodity
pools and persons managing them may be subject to the Investment
Advisers Act of 1940 and, if a pool conducts not only a commodities
business but also acts as an investment company, the Investment Company
Act of 1940.”326 In seeking this amendment, however, the agencies made
clear that they did not intend to “imply that the Investment Company Act of
1940 and the Investment Advisers Act of 1940 are applicable to the
activities of commodity pools, commodity pool operators, and commodity
trading advisors when such entities or persons purchase commodity futures
contracts (or options thereon) based on securities or give advice as to the
purchase and sale of futures contracts (or options thereof) based on
securities.”327

In response to that request, the CEA was amended in 1982 by
Congress during a periodic CFTC reauthorization process, “so that the
CEA now reflects that the Securities Act of 1933 and the Securities
Exchange Act of 1934 apply to solicitations for investments in a
commodity pool.”328 However, as the House Agriculture Committee report
to that legislation noted, the Investment Company Act of 1940 would not
apply to the CFTC regulated instruments,329 “giving the CFTC exclusive

324. See e.g., Chicago Mercantile Exchange v. SEC, 883 F.2d 537, 550 (7th Cir. 1989) and Bd. of
Trade of the City of Chicago v. SEC, 187 F.3d 713, 726 (7th Cir. 1999) (both cases rejecting expansive
claims by the SEC to jurisdiction over futures instruments).
328. Horwitz & Markham, supra note 321, at 75.
& Markham, supra note 321, at 75. As the SEC has somewhat confusingly noted:
It appears, therefore, that without regard to whether futures on securities or options on such
futures are securities, an entity investing in such interests is not subject to the jurisdiction of
the SEC under the Investment Company Act of 1940 unless such entity is otherwise an
investment company under the Investment Company Act, in which case the person advising
the investment company about its investments in futures may be an ""investment adviser" of
jurisdiction over the form of the pool, fee setting practices, and trading conduct,” while subjecting sales of investment interests to SEC regulation under the Securities Act of 1933 and the Securities Exchange Act of 1934.330

Oddly, given their history, there has been very little tension between the SEC and CFTC over the joint regulation of commodity pools. This is apparently due to the fact that many commodity pools would be exempt from SEC registration requirements in any event because their offerings are limited to sophisticated wealthy investors.331 In addition, the disclosures mandated by the CFTC for registered CPOs are not substantially different from those required by the SEC under the Securities Act of 1933.332 Further, the financial reports required by the CFTC for registered pools can be readily conformed to meet the reporting requirements created by the SEC under Section 13 of the Securities Exchange Act.333

To the extent that a commodity pool invests in securities instead of commodity instruments, concerns arise over whether the pool becomes an investment company, subjecting the CPO to the provisions of the Investment Company Act of 1940 and the CTA to the Investment Advisers Act of 1940.334 However, there are several exemptions available under

an investment company” under section 2(a)(20) of the Investment Company Act and its contract subject to the provisions of section 15 of the Investment Company Act. A person giving advice concerning the making of investments in futures on exempted securities (other than municipal securities) or in futures on indices of securities as permitted pursuant to the Futures Trading Act of 1982, or as previously approved by the CFTC, or on options on such futures is excluded by the CEA from being subject to the jurisdiction of the SEC under the investment Advisers Act of 1940 unless the person provides advice about investing in securities, otherwise than by advising about such futures or options on such futures or about certain securities which may be termed, generally, United States government securities.


330. Commodity pools making public offerings disclose in their prospectuses filed under the Securities Act of 1933 that they are not registered under the Investment Company Act of 1940. For example, the prospectus of one high profile commodity pool states: “The Index Fund is not a regulated investment company or ‘mutual fund’ subject to the Investment Company Act of 1940. Therefore, you do not have the protections provided by that statute.” Rogers Int’l Raw Materials Fund, L.P., Prospectus, 2,000,000 Units of Limited Partnership Maximum, at p. 4 (March 31, 2005).

331. Many such offerings use Rule 506 in SEC Regulation D to avoid registration under the Securities Act of 1933. That regulation allows offerings to be made in an unlimited amount to an unlimited amount of “accredited investors.” 17 C.F.R. § 230.506 (2006).

332. Smith, supra note 274, at 281 (comparing the disclosure requirements mandated by the SEC for securities offerings and the CFTC for CPOs).


334. Thus, “in appropriate circumstances, commodity pools and persons managing them may be subject to the Investment Advisers Act of 1940 and if a pool conducts not only a commodities business but also acts as an investment company, the Investment Company Act of 1940.” H.R. REP. No. 97-626, pt. II, at 14 (1982). The IRS is challenging mutual funds that use swaps, threatening to revoke their mutual fund pass-through tax treatment if swaps exceed a certain portion of assets. Eleanor Laise, Investors Are Cautioned to Review Fund Strategies Amid IRS Ruling, WALL ST.J., Dec. 21, 2005, at D2.
those statutes. For example, the Investment Company Act will not apply if the CPO does not hold itself out as being "primarily" engaged in the business of investing or trading in securities and does not own investment securities in value exceeding forty percent of the pool’s total assets (exclusive of cash and government securities) on an unconsolidated basis. Conversely, mutual funds may avoid registration as CPOs under the exemption granted by the CFTC.

E. COMMODITY POOL ISSUES

Regulatory problems involving traditional commodity pools regulated by the CFTC have been relatively moderate. Of recent interest are the public commodity pools that traded through Refco, Inc. That firm was a large futures commission merchant that failed two months after its initial public offering when it revealed that its chief executive officer had hidden $430 million in obligations from its auditors. That was a failure of the SEC’s full disclosure regime, but a commodity pool sponsored by celebrity commodity trader James B. Rogers had $362 million on deposit with Refco, and its bankruptcy placed those funds at risk. The Rogers Fund sued Refco claiming that the monies in that commodity pool should have been held at the CFTC regulated arm of Refco where they would be immune from claims of other Refco creditors. Refco has denied that claim.

337. 17 C.F.R. § 4.5 (2006). Investment companies engaged in futures trading have encountered some esoteric issues over whether the leverage in those contracts and the posting of margin creates a "senior security" that is subject to some special restrictions in the Investment Company Act of 1940. Export, Individual Validated, Special and Reexports Licensing General Policies and Procedures, 37 Fed. Reg. 12,790 (June 9, 1972) (to be codified at C.F.R. pt. 370-374). Meeting margin requirements for futures contracts also required the creation of "safekeeping" accounts, but that requirement was later dropped because it was largely redundant of CFTC segregation requirements. MARKHAM & HAZEN, supra note 117, at § 5:8.
338. The CFTC could not resist the temptation of involving itself in the mutual fund late trading and market timing scandals. In Veras Investment Group, LLC, Comm. Fut. L. Rep. (CCH) ¶ 30,162 (C.F.T.C. 2005), the CFTC, by consent, found that a hedge fund that was registered with it as a CPO and CTA had created a number of subsidiaries to evade market timing restrictions imposed by several mutual funds. The CFTC charged that this "deceptive technique" was not disclosed to pool participants and that such information was material to those investors. The CFTC further found that the respondent had claimed that it was using complex models to exploit mispricings in mutual fund shares when in fact it was late trading on the basis of stale NAV pricings.

339. Rogers was co-founder of the Quantum Fund with George Soros, the billionaire hedge fund manager. Rogers was also a popular business talk show commentator, and he had written a book advocating commodity investments as a profitable alternative to stocks and other investments. Published before the Refco bankruptcy, the book noted that his funds were up 165% and included the best performing index fund in the world in any asset class. See MARKHAM, supra note 3, at 577-80 (describing the Refco scandal and Rogers’ funds).

For CFTC regulated CPOs and CTAs, the use of hypothetical instead of actual trading results to profile trading systems without proper disclosures has also been a recurring problem, and books and records violations are not uncommon. In other instances, the disclosure brochure given to clients was either false or its stated policies were not followed. The worst abuses have involved fly-by-night operators using high pressure sales tactics to downplay risks and overstate the likelihood of profits. Such pools are usually unregistered and are simply Ponzi schemes, looting customer assets before finally collapsing. Since these same problems have been plaguing the securities industry in even greater magnitude for years, it is hard to assign blame on the basis of the regulator involved. However, those fraud schemes are now being carried out under the hedge fund banner because stories of large hedge fund profits are attracting unsophisticated investors.

As the SEC has noted, “[t]he growth in hedge funds has been

conflicting claims by the Rogers Funds and Refco lawyers).

341. See MARKHAM, supra note 255, at §§7:7 and 24:15 (describing these CPO and CTA regulatory problems).

342. Id. at § 24:15 (describing these CPO and CTA regulatory problems). Some scandals have also involved registered CPOs and their CTAs. See, e.g., United States v. Sawyer, 799 F.2d 1494, 1540 (11th Cir. 1986); CFTC v. Chilcott Portfolio Management, Inc., 713 F.2d 1477, 1480 (10th Cir. 1983) (“An FBI investigation disclosed evidence that, from 1975 to 1981, Chilcott had attracted nearly $80 million in investments for a commodities pool from approximately 400 persons. The FBI estimated that in 1981 the commodities pool had only about $8 million in liquid assets, over one-half of which were held by Chilcott in his own name. The remainder was allegedly diverted by Chilcott into personal ventures or lost in speculative trading.”).

343. To cite a few examples, the Republic of New York Securities Corp. pleaded guilty to two felony counts of securities fraud and agreed to pay $606 million in restitution as the result of looting conducted through its facilities by Martin Armstrong. He had been running a Ponzi scheme that cost Japanese institutional investors about $700 million. In another Ponzi scheme, Martin Frankel looted about $200 million before fleeing. Frankel was arrested in Germany with twelve passports in different names and diamonds worth millions of dollars. Patrick Bennett was the architect of one of the largest Ponzi schemes in American history. He defrauded investors of $700 million. InverWorld, Inc. defrauded clients in Mexico of $475 million. J.T. Wallenbrock & Associates sold promissory notes to over 6,000 investors, raising over $230 million in that Ponzi scheme. Reed E. Slatkin bested that fraud with a $600 million Ponzi scheme. Over $250 million of that amount could not be recovered. Kevin Leigh Lawrence pleaded guilty for his involvement in a $100 million Ponzi scheme. D. W. Heath & Associates Inc. and others defrauded some 800 elderly investors out of $60 million. Eric Stein defrauded 1,800 investors of $34 million through a Ponzi scheme targeting those over age fifty. Even bigger was the sale of by Kenneth Kasarjian of over $800 million in lease assignments that had already been assigned or which did not exist. Terry L. Dowdell was the mastermind of a $120 million scheme involving what he claimed were foreign bank trading instruments that provided a return of 160%. David and James Edwards and others raised $98 million from 1,300 investors through a prime bank scheme. The Credit Bancorp. Ltd. (CBL) defrauded investors of $210 million. That scheme was master minded by Richard J. Blech. See MARKHAM, supra note 3, at 487-89 (describing this pandemic of Ponzi schemes). See also lanthe Jeanne Dugan, Failed Hedge Fund Haunts Celebrities, WALL ST. J., Aug. 22, 2006, at C1 (celebrities, including Sylvester Stallone, were sued after taking profits before a hedge fund running a Ponzi scheme collapsed); Randall Smith & Ian McDonald, Suits Target Early Pullouts, WALL ST. J., Aug. 22, 2006, at C3 (non-celebrities being sued on the same grounds after the collapse of another hedge fund running a Ponzi scheme).
accompanied by a substantial and troubling growth in the number of our hedge fund fraud enforcement cases. In the last five years, the Commission has brought 51 cases in which we have asserted that hedge fund advisers have defrauded hedge fund investors or used the fund to defraud others in amounts our staff estimates to exceed $1.1 billion." However, the amount of losses cited by the SEC from hedge fund frauds was only a small percentage of the $870 billion managed by over 7,000 hedge funds in the United States and constitutes just a small proportion of the funds looted in Ponzi schemes in the securities industry.

Among the hedge funds committing fraud was the Manhattan Investment Fund managed by Michael Berger. Investors there lost $350 million. In Naples, Florida, David Mobley's Maricopa Index Hedge Fund turned out to be a Ponzi scheme that defrauded some 300 wealthy investors of over $120 million between 1993 and 2000. Mobley used the money for personal extravaganzas, including expensive real estate in Naples and a fleet of luxury automobiles. On the opposite coast, another hedge fund, the KL Group, defrauded wealthy Palm Beach investors of an estimated $200 million. Another hedge fund, Bayou Securities LLC, which had $450 million under management was found to be missing large amounts of those funds after its founder, Samuel Israel III, announced that he was retiring at age forty-six in order to spend more time with his family. Israel and his chief financial officer, Daniel Marino later pleaded guilty to criminal charges of fraud.

345. That would be .001149%.
346. MARKHAM, supra note 3, at 441.
The CFTC charged another hedge fund, Tradewinds International II LP, with overstating the value of its assets. The hedge fund claimed assets of over $18 million when the actual amount was $1.1 million and gains of twelve percent when it was actually experiencing losses. The fund’s manager, Charles L. Harris, used monies not lost in trading to buy himself luxury cars, a house in Florida and a yacht. Harris sent his investors a DVD of himself confessing to improper trading while fleeing authorities in his yacht. He was later caught.\textsuperscript{349}

The CFTC’s approach to the regulation of commodity pools has defaulted to the full disclosure approach used by the SEC for any other public offering. The CFTC, however, has not used its exclusive jurisdiction over the operations of commodity pools to adopt the intrusive regulatory schemes found in the Investment Company Act or the Investment Advisers Act. There is no evidence that the CFTC’s hands off regulatory approach for CPO governance and operations has provided any less investor protection than that available for mutual fund investors or that the intrusive SEC regulations provide any greater protection from fraud.\textsuperscript{350}

V. BANK COMMON TRUST FUNDS

A. BACKGROUND

Another mechanism for collective investments is the common trust fund in which the funds of several individual trusts are pooled for...
collective investment by bank trust departments. Although the management of those funds raised conflict of interest concerns, they have not been regulated in the same manner as mutual funds, largely as a matter of history and the separate regulatory structure created for banks. Banking regulation is pervasive, but it has not focused on corporate governance as the basis for regulating common trust funds. Rather, common law fiduciary principles have been its guiding force. Those principles were at first constraining but have adapted to modern portfolio theory. Still, the strictures of trust investment requirements and their illiquidity have been other constraints that prevented banks from competing directly with mutual funds. Instead, as will be seen, the dropping of restraints on bank mutual fund activities led the banks to sponsor their own mutual funds and even covert their common trust funds into mutual funds.

The operation of collective investments by banks has a long history that traces back to the introduction of the trust fund concept from England early in our history. The trustees appointed to administer trusts were often family members or some other individual known and trusted by the creator of the trust. A problem with such appointments was that the trustee might die before the completion of the objects of the trust. That event would require the appointment of another individual, but the creator of the trust was also often deceased, and the new appointment might not have met with his approval. Another concern was that friends and relatives of the creator often did not have the expertise to invest the trust funds. Those problems were solved by the trust companies that began appearing in America as early as 1818. One such company formed in that year commingled trust funds for collective investment.

The trust companies, which engaged in a wide variety of financial activities, met competition in their trust operations from insurance companies that acted as trustees, as well as underwriting and selling insurance. For example, the New York Life Insurance and Trust was formed in 1830 and was followed by similar enterprises. The United States Trust Company was the first company to act exclusively as a trustee for trust funds. It was formed in 1853. As custodian of customer funds, banks were in a natural position to serve as trustees for trusts, but regulatory restrictions limited such activity; the trust companies operated outside of most bank regulatory structures in the nineteenth century. Some

351. Banks held almost $1 trillion in assets for trusts and estates in 2009, but that was only a small portion of the total of $23 trillion held under other custodial arrangements such as pension funds. FEDERAL DEPOSIT INSURANCE CORPORATION, ASSET DISTRIBUTION BY TYPE OF ACCOUNT (2001), http://www2.fdic.gov/structure/trust/tables00/00tablea2.txt.
352. The trust concept was given explicit recognition in England in 1536 with the adoption of the Statute of Uses. Markham, supra note 271, at 208.
353. MARKHAM, supra note 14, at 375.
354. Id.
banks formed their own trust companies to compete with the trust companies.

Gradually, banks were allowed to manage trusts internally. That business had developed to the point that the American Banking Association created its own Trust Department in 1897 so that members could keep themselves informed of developments in that area of their business. That business was largely concentrated in state banks, but the stock market crash in 1907 resulted in a boost in trust business for national banks. That crash was triggered by the failure of the Knickerbocker Trust Company and set off a long running investigation by a Senate committee that resulted in the creation of the Federal Reserve Board in 1913. Section 11(k) of the Federal Reserve Act of 1913 also authorized the Federal Reserve Board to grant of trust powers to national banks. The exercise of such powers was subject to state laws governing the operation of trusts and the responsibilities of trustees.

B. FIDUCIARY DUTIES

State laws governing trusts imposed fiduciary duties of loyalty and care on trustees. The duty of loyalty prohibited self-dealing and other conflicts of interest on the part of trustees. The duty of care sought to assure careful consideration by trustees in investing trust fund assets. That duty of care received its most famous explication in the 1830 decision in Harvard College v. Amory, where the Massachusetts court created the "prudent man" rule. That rule required trustees to act in the same manner "as men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."
The prudent man rule was disliked by trustees because it was uncertain in scope and a breach resulted in personal liability to the trustee who was surcharged for imprudent investments. To relieve that concern, many states passed statutes creating so-called “legal lists” that specified certain securities that a trustee could safely invest in as a prudent man.\(^{361}\) Those legal lists were supplanted in recent years by modern portfolio theory that is based on a strategy of diversification that might even include some speculative investments in the portfolio.\(^{362}\)

Another development was the adoption of statutes that permitted the commingling of funds of several trusts into one or more common trust funds.\(^{363}\) As in the case of single trusts, state laws required periodic accountings in a judicial proceeding for common trust funds that tested the investments made by the trustee for prudence.\(^{364}\) Those proceedings were binding and relieved the trustee of any liability for investments approved by the court.\(^{365}\) The easing of investment restrictions led to the creation of “discretionary common trust funds,” which were no longer restricted to investments on the state legal list.\(^{366}\)

Common trust funds were boosted in 1936 by the addition of provisions in the Internal Revenue Act of 1936, which granted pass-through tax treatment to the beneficiaries of trusts participating in a common trust fund, an advantage enjoyed by mutual funds as well.\(^{367}\) The Federal Reserve Board amended its regulations in 1937 to allow national

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362. Markham, supra note 271, at 213-14.

363. As the Supreme Court has noted:

Mounting overheads have made administration of small trusts undesirable to corporate trustees. In order that donors and testators, of moderately sized trusts, may not be denied the service of corporate fiduciaries, the District of Columbia and some thirty states... have permitted pooling small trust estates into one fund for investment administration. The income, capital gains, losses and expenses of the collective trust are shared by the constituent trusts in proportion to their contribution. By this plan, diversification of risk and economy of management can be extended to those whose capital standing alone would not obtain such an advantage.


364. Class action lawsuits were also used to challenge whether particular investments made by bank trustees for common investment funds were in accordance with fiduciary standards. See First Alabama Bank of Montgomery, N.A. v. Martin, 425 So. 2d 415, 429 (Sup. Ct. Ala.), cert. denied, 461 U.S. 938 (1983).


bonds to operate common trust funds for “bona fide fiduciary purposes” and not “solely” for investment purposes. The Investment Company Act exempted common trust funds from its reach, and the Securities Act of 1933 and the Securities Exchange Act of 1934 were amended in 1970 to exclude those collective investments from their reach.

The Office of the Comptroller of the Currency (“OCC”) dropped the limitation on bona fide fiduciary purpose requirement in 1963 in an unsuccessful effort to allow banks to operate their own mutual funds. In 2001, in another effort to expand national bank trust fund activities, the OCC amended its regulations to allow national banks to engage in multi-state trust operations. The OCC asserted that the states could restrict those operations only to the extent that state imposed restrictions on state chartered trustees. The OCC also proposed a rule that would have created uniform standards of care for national bank trust departments. That proposal met with opposition, and its adoption was deferred.

C. MUTUAL FUND COMPETITION

The common trust fund is often likened to a mutual fund, but there are some significant differences between those two forms of investments. Mutual fund shareholders may select their own investment strategy, while the bank will, for the most part, make the investment decision for trust beneficiaries. The investor in a mutual fund may freely redeem his holdings at NAV, while the trust beneficiary is subject to the terms of the trust, rendering the investment illiquid. Interestingly, some banks invested their common trust funds into mutual funds, which somewhat diminished their money management role. The breakdown in the restrictions in the

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368. 15 U.S.C. § 80a-3(c)(3) (2000). The exemption is available only where:

1. such fund is employed by the bank solely as an aid to the administration of trusts, estates, or other accounts created and maintained for a fiduciary purpose;
2. except in connection with the ordinary advertising of the bank’s fiduciary services, interests in such fund are not advertised or offered for sale to the general public.


372. 66 Fed. Reg. 34,792, 34,792 (July 2, 2001) (to be codified at 12 C.F.R. pts. 5 and 9). In response to that action, the Conference of State Bank Supervisors adopted a Model Multi-State Trust Institutions Act that was adopted in whole or part by several states. BROOME & MARKHAM, supra note 361, at 759.


375. In re Onbank & Trust Co., 649 N.Y.S.2d 592, 594 (N.Y. App. Div. 1997), a New York court considered a claim that a national bank had improperly delegated its discretionary trust powers by...
Glass-Steagall Act’s prohibitions on investment banking activities by commercial banks before its repeal by the Gramm-Leach-Bliley Act in 1999 witnessed some aggressive efforts by banks to enter into the mutual fund business on their own. Those efforts were not always successful. In Investment Company Institute v. Camp, the Supreme Court held that a commingled managing agency account authorized by the OCC for national banks was actually a mutual fund that was not a permissible investment for nation banks. Undeterred by that defeat, national banks began marketing mutual funds through “independent” sponsors and then began sponsoring their own mutual fund complexes. The banks were also authorized by legislation enacted in 1996 to convert their common trust funds into mutual funds, thereby providing liquidity for the underlying trusts. The banks investing trust assets in mutual funds. The court noted that, under OCC regulations, state law would control that determination. The court held such investments were permissible because the bank trustee retained control of the investment decision by selecting mutual funds that conformed with the investment objectives of the underlying trusts. However, the court concluded that it was improper for the trustee to charge what in effect amounted to a double fee for the management of the trust assets, i.e., the trustee’s fee and that of the mutual fund. The New York legislature then acted to specifically authorize mutual fund investments by a bank common trust fund, and the New York Court of Appeals dismissed the case. In re Onbank & Trust Co., 688 N.E.2d 245 (N.Y. 1997).

379. That plan was described by the court as follows:
Under the plan the bank customer tenders between $10,000 and $500,000 to the bank, together with an authorization making the bank the customer’s managing agent. The customer’s investment is added to the fund, and a written evidence of participation is issued which expresses in “units of participation” the customer’s proportionate interest in fund assets. Units of participation are freely redeemable, and transferable to anyone who has executed a managing agency agreement with the bank. The fund is registered as an investment company under the Investment Company Act of 1940. The bank is the underwriter of the fund’s units of participation within the meaning of that Act. The fund has filed a registration statement pursuant to the Securities Act of 1933. The fund is supervised by a five-member committee elected annually by the participants pursuant to the Investment Company Act of 1940. The actual custody and investment of fund assets is carried out by the bank as investment advisor pursuant to a management agreement. Although the Investment Company Act requires that this management agreement be approved annually by the committee, including a majority of the unaffiliated members, or by the participants, it is expected that the bank will continue to be investment advisor.

Id. at 622-623.
380. By 1987, over 200 mutual funds were being distributed through banks. MARKHAM, supra note 101, at 239. Concord Holding Group and some sixteen other entities were handling bank mutual funds by 1993. Id. In 1994, federal bank regulators adopted an inter-agency directive requiring banks to maintain written procedures governing their sales of mutual funds and other non-deposit services that included requirements of disclosures to customers. Id. at 239.
381. MARKHAM, supra note 101, at 239-40.
382. Those conversions were facilitated by the Small Business Jobs Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755, which amended the tax treatment of conversions into mutual funds under Section 584 of the Internal Revenue Code of 1986. More recently, one commentator has noted that: We’re now starting to see the banks having second thoughts about whether it was a good idea to convert their collective funds to mutual funds. And some of them are going back and
then began competing with the traditional sponsors of mutual funds for that business.  

The banks were in turn receiving "competition in their trust activities from other financial services firms such as Vanguard, Fidelity and MetLife. A survey showed that banks and savings and loans held only about forty percent of the trust services market in 2002." 

D. GOVERNANCE CONCERNS

“A bank is the corporate trustee of the common trust fund. There is no other governing body. The underlying assumption is that the bank will be responsible for making all decisions." That arrangement is in contrast to the arrangement for mutual funds in which the investment adviser actually manages fund assets. OCC Regulation 9 supplements state regulations governing trusts. With respect to corporate governance, that regulation states that a “national bank’s fiduciary activities shall be managed by or under the direction of its board of directors. In discharging its responsibilities, the board may assign any function related to the

reconverting them back to collective funds. We're starting to see a movement where investment advisors are teaming up with bank trust departments and creating collective funds as investment options for 401(k) plans because the world has changed. Back then, collective funds did not have daily valuation. Today, you can get daily valuation in a collective fund. The values of a collective fund are not published in the newspaper, but any participant has easy access on the internet to go to a website and find the daily valuation of its interest in its collective fund. And while you cannot move the interest in your collective fund to another, to an IRA if a participant leaves its plan, leaves the employer, that seems to be of less concern today than the fact that the collective funds come in at lower costs than the mutual funds. And there’s lots of debate as to why the collective funds are less expensive to maintain, whether they have less regulatory costs, whether they’re—they don’t have a distribution network in place and are less of a retail oriented product. Nevertheless, we see collective funds being offered at where the asset management fee and the other fees are less than comparable mutual funds. And that’s providing significant competitive opportunity for these collective funds.


384. BROOME & MARKHAM, supra note 361, at 766. The Gramm-Leach-Bliley Act narrowed “the exemption from Investment Company Act registration for bank common trust funds; under the Act, the exemption will continue to be available only to those bank common trust funds that are not advertised or offered to the general public except in connection with the ordinary advertising of the bank’s fiduciary services.” Paul J. Polking & Scott A. Cammarn, Overview of the Gramm-Leach-Bliley Act, 4 N.C. BANKING INST. 1, 23 (2000).


exercise of fiduciary powers to any director, officer, employee, or committee thereof.387 Annual or "continuous" audits of the bank’s trust operations are required. Those audits must be conducted under the direction of a "fiduciary audit committee.388 Written procedures are required to assure that the bank trustee meets its fiduciary responsibilities389 and recordkeeping requirements are imposed.390

Banks operating a common trust fund are paid fees by the individual trusts. They normally do not charge a separate fee for the management of the common trust fund.391 "If the amount of a national bank’s compensation for acting in a fiduciary capacity is not set or governed by applicable law, the bank may charge a reasonable fee for its services."392 In addition, certain self-dealing and conflict-of-interest transactions are prohibited such as purchasing the bank’s own stock for trust accounts.393 Custody safeguards are required for trust assets.394

The banks are also regulated intensively on safety and soundness issues. That regulation includes loan limits, capital requirements and regular inspections by bank examiners.395 Some officer and director conflicts are also addressed, such as limitations on loans to officers.396 Until recently, there were no particular outside director requirements. Following the general hysteria surrounding the Enron scandal, however, Sarbanes-Oxley required audit committees of publicly traded companies to be staffed by outside directors,397 a requirement previously imposed by the

388. 12 C.F.R. § 9.9 (2006). The fiduciary audit committee: must consist of a committee of the bank’s directors or an audit committee of an affiliate of the bank. However, in either case, the committee:
   (1) Must not include any officers of the bank or an affiliate who participate significantly in the administration of the bank’s fiduciary activities; and
   (2) Must consist of a majority of members who are not also members of any committee to which the board of directors has delegated power to manage and control the fiduciary activities of the bank.

Id.
395. BROOME & MARKHAM, supra note 361, at chs. 5, 7, & 8.
396. BROOME & MARKHAM, supra note 361, at chs. 331-332. The Sarbanes-Oxley Act prohibits loans to officers of publicly traded companies but exempts bans from that prohibition where the loans are in accordance with bank regulatory requirements. Id. at 332.
397. Pub. L. No. 107-204, § 301, 116 Stat. 745 (2002). Bank regulators announced that they would extend that requirement to non-public banks with assets of more than $500 million. Bill Stoneman,
New York Stock Exchange and Nasdaq.\textsuperscript{398} Those self-regulatory bodies also require that nominating and compensation committees be composed of outside directors, as well as requiring a majority of all board members to be independent.\textsuperscript{399}

E. \textbf{BANK PROBLEMS}

The banks were heavily involved in the late trading and market timing scandals through their mutual funds, but had not previously experienced much scandal in their money management activities. One case of interest involved a proxy fight over the merger of Hewlett-Packard and Compaq in 2002. Walter B. Hewlett, a family member of one of the company’s founders, challenged that vote in the Delaware chancery court. He claimed that Carelton (Carly) Fiorina, the Hewlett-Packard chief executive officer, bought votes by threatening Deutsche Bank with a loss of Hewlett-Packard business, if its money mangers did not vote the stock they controlled in favor of the merger. Banks usually form a committee that votes proxies for stocks held in their common trust fund portfolios. They often use the services of corporate governance firms to decide how to vote those proxies. The money mangers at Deutsche Bank, under some slightly irrational theory of fiduciary duties, were planning to vote Compaq shares under their management in favor of the vote, while voting the Hewlett-Packard shares they managed against the merger.

The Delaware court dismissed Hewlett’s charges even though Fiorina had placed much pressure on Deutsche Bank executives to change their opposition votes. In one phone call to one of her own executives that was taped Fiorina stated that “you and I need to demand a conference call, an audience, etc., to make sure that we get them in the right place. . . . get on the phone and see what we can get, but we may have to do something extraordinary for those two to bring ‘em over the line here.” After leaving that message, Fiorina called the Deutsche Bank officials, and they switched their vote on seventeen million of the twenty-five million shares they had under management in favor of the Hewlett-Packard-Compaq merger. The Delaware judge found no misconduct in that call, which had been taped without Fiorina’s knowledge.\textsuperscript{400} The SEC was not so forgiving; the investment advisory unit of the Deutsche Bank was fined $750,000 by that agency. The SEC claimed conflicts of interest because the advisory unit failed to disclose that it had worked for Hewlett-Packard and that it was

\footnotesize\textsuperscript{398} See supra, note 193.
\footnotesize\textsuperscript{399} HAZEN \& MARKHAM, supra note 296, at 194.
\footnotesize\textsuperscript{400} Hewlett v. Hewlett-Packard, No. 19513-NC, 2002 Del. Ch. LEXIS 35, at *64 (Del. Ch. Apr. 27, 2002).
intervening in the voting process. Another concern with common trust fund management is the misuse of inside information from the bank’s commercial banking operations. To avoid such problems, the OCC requires national banks to maintain written procedures designed to ensure “that fiduciary officers and employees do not use material inside information in connection with any decision or recommendation to purchase or sell any security.” Banks create Chinese Walls to isolate common trust fund managers from their commercial banking colleagues’ activities. There apparently have been few leaks through those walls, but the financial analysts scandals exposed by Eliot Spitzer evidenced that the Chinese Walls employed by the SEC that separated the analysts and the investment bankers at broker-dealers were quite porous.

VI. PENSION FUNDS

A. PRIVATE PENSION FUNDS

Related to the common trust fund are collective investment funds that manage pension plan assets. Private sector pension funds in America trace their beginning to a retirement plan created in 1875 by the American Express Co. for its employees. Thereafter, some large railroad companies, such as the B&O Railroad began offering pension plans that included both employer and employee contributions. By 1905, about one-third of railroad employees in the country were participating in pension schemes. The Illinois Railroad allowed its employees to buy the company’s stock. The Proctor & Gamble Co. created a profit-sharing plan for its employees in 1886. Nearly 200 companies were offering employee pensions as the 1920s began. They were holding almost $90 million in assets to support those obligations. The number of pension plans doubled in the next few years after the Revenue Act of 1921 exempted employer contributions to pension plans from taxation. By the middle of the 1920s, some 4 million workers were covered by pension plans.

The Investment Company Act of 1940 excluded from its reach

\[\text{\scriptsize 402. 12 C.F.R. § 9.5 (2006).} \]
\[\text{\scriptsize 403. MARKHAM, supra note 3, at 406-16 (describing Chinese walls and analysts’ conflicts with investment banking activities of their firms).} \]
\[\text{\scriptsize 405. MARKHAM, supra note 14, at 325-26.} \]
\[\text{\scriptsize 406. MARKHAM, supra note 26, at 90.} \]
\[\text{\scriptsize 407. Id. at 124.} \]
“employees stock bonus, pension, or profit sharing plans” that met certain provisions in the Internal Revenue Code. This spurred further growth. By 1950, the number of pension plans had expanded to 2,000, holding about $8 billion in assets. By the end of that decade, 14 million employees were participating in pension plans that were holding assets valued at $22 billion. The growth of the labor movement resulted in increased demands for pensions. In particular, John L. Lewis, the head of the United Mine Workers of America fought for and succeeded in creating a broad pension scheme in the coal industry. In 1947, the Taft-Hartley Act allowed the creation of union pension funds jointly managed by the unions and contributing employers.

Pension fund growth accelerated in the 1960s, adding assets at a rate exceeding $3.5 billion per year. Early pension plans had largely invested their assets in corporate bonds, but by the 1960s many plans were investing in common stock after General Motors announced that it would be making such investments for company pension plans. Morgan Guaranty Co. had $9 billion in pension funds under management in 1968. In 1970, collective investment trust funds maintained by banks for the collective management of pension funds were excluded from the provisions of the Investment Company Act of 1940. Banks were then able to expand their role as professional managers of some pension funds. By 1982, banks and other professional advisers were managing about one half of the pension fund assets that totaled almost $570 billion. Pension plans were then holding about twenty percent of publicly traded securities.

B. ERISA

Management of defined benefit plans were subjected to regulation

409. MARKHAM, supra note 26, at 318.
411. MARKHAM, supra note 26, at 357.
413. MARKHAM, supra note 101, at 98.
414. Pension plans are broadly broken down into two categories; “defined benefit” and “defined contribution” plans:

In the often opaque morass of pension terminology, the distinction between defined benefit and defined contribution plans is surprisingly clear. A defined benefit pension, as its name implies, specifies an output for the participant. Traditionally, such plans defined benefits for particular employees based on the employees' respective salary histories and their periods of employment. Thus, for example, a prototypical defined benefit formula specifies that a participant is entitled at retirement to an annual income equal to a percentage of her average salary times the number of years of her employment with the sponsoring employer.
under the provisions of Employment Retirement Income Security Act in 1974 ("ERISA"). That statute was passed in response to the failure of the Studebaker Corp., an automobile company that failed and left 4,000 employees with unfunded benefits. ERISA created the Pension Benefits Guaranty Corporation ("PBGC") to insure the "vested" rights of workers participating in defined benefit plans from such failures. ERISA also imposed some incredibly complex regulations on the activities of plan administrators and fiduciaries, including record keeping requirements, disclosure obligations, investment standards and conflict of interest regulations.

Among other things, the common law of trusts was engrafted by ERISA onto the requirements imposed on plan fiduciaries, which included the fiduciary duties of loyalty and care (prudence). The statute adopted the prudent man standard for investment decisions made by plan fiduciaries. The Secretary of Labor, who was given administrative authority over the application of ERISA, adopted regulations that recognized modern portfolio theory, which assesses portfolio performance on an overall basis, rather than the common law standard that examined each investment for prudence.

In contrast, a defined contribution arrangement, as its equally apt moniker indicates, specifies an input for the participant. Commonly, the plan defines the employer's contribution for each participant as a percentage of the participant's salary for that year. Having made that contribution, the employer's obligation to fund is over because the employee is not guaranteed a particular benefit, just a specified input. In a defined contribution context, the participant's ultimate economic entitlement is the amount to which the defined contributions for her, plus earnings, grow or shrink.


420. 20 C.F.R. § 2550.404a-1(b)(2) (2006). However, the scope of investment discretion by a plan fiduciary may be limited by the terms of the plan. 29 U.S.C. § 1104(a)(1)(D) (2000). Applying modern portfolio theory, the Fifth Circuit ruled in Laborers National Pension Fund v. Northern Trust Quantitative Advisors, Inc., 173 F.3d 313, 323 (5th Cir. 1999), cert. denied, 526 U.S. 967 (1999), that the purchase of high risk "interest only" payments stripped from mortgage pools was not an imprudent investment and in accordance with that plan's investment guidelines. The standard of performance for plan fiduciaries is thus process based. The courts will look for whether the investment was permitted by modern portfolio theory and that it was in accordance with the plan's guidelines. The courts then consider whether due care was used in selecting the investment. If those tests are met, no liability will
ERISA proved to be a costly failure. The liabilities imposed on the PBGC became massive and the Retirement Protection Act of 1994 was passed to shore up the PBGC and provide greater supervision over underfunded plans. That had a positive effect for a time, but the market downturn in 2000 increased liabilities. By the end of 2005, PBGC had a $23 billion negative position and the total funding gap for liabilities from private sector pensions was estimated to be $450 billion. The costs and liabilities imposed by ERISA on defined benefit plans led to their abandonment by many employers.

Several large corporations tried to establish “cash balance” plans that were designed to reduce those liabilities and costs. However, those plans were successfully challenged in the courts, and they too are now being dropped by employers. For example, after its cash balance plan was held to violate age discrimination laws, IBM announced on January 6, 2005 that it was freezing its cash balance pensions and turning to Section 401(k)
defined contribution accounts.\textsuperscript{427} Even before that action, almost ten percent of existing defined benefit plans had frozen participation in their defined benefit plans.\textsuperscript{428} Large companies in the automobile and airline industries were also seeking to reduce retirement and other defined benefits that were bankrupting those industries.\textsuperscript{429}

C. DEFINED CONTRIBUTION PLANS

Starting in 1962 with legislation allowing private retirement accounts for the self-employed, Congress has been continually adding legislation encouraging individual tax-advantaged retirement and savings accounts that are self-directed by the employee. Those plans include Individual Retirement Accounts ("IRAs") created by ERISA, Simplified Employee Pension Plans ("SEP" accounts), Money Purchase Plans, Target Benefit Plans, Roth Accounts, Section 401(k) Plans and so-called "Education IRAs" (that include 529 Plans and Coverdell Accounts).\textsuperscript{430} These plans proved to be popular with employees and became the pension plan of choice for many employers. The number of defined benefit plans dropped by sixty percent between 1979 and 1999, while the number of participants in defined contribution plans more than doubled between 1980 and 2000.\textsuperscript{431} "Indeed, between 1984 and 1993 alone, defined contribution plans have grown by almost 900%.”\textsuperscript{432} By 2003, individual retirement accounts were holding a total of $3 trillion in assets.\textsuperscript{433}

Defined contribution plans are only lightly regulated under ERISA\textsuperscript{434} because, for the most part, they are self-directed, which eliminates concern with conflicts of interest on the part of a plan adviser.\textsuperscript{435} Indeed, ERISA

\textsuperscript{427} Mary Williams Walsh, \textit{I.B.M. to Freeze Pension Plans To Trim Costs}, N.Y. TIMES, Jan. 6, 2006, at A1.
\textsuperscript{429} MARKHAM, supra note 3, at 544.
\textsuperscript{430} MARKHAM & HAZEN, supra note 422, at 945-47.
\textsuperscript{431} MARKHAM, supra note 4, at 102.
\textsuperscript{434} ALICIA H. MUNNELL & ANNIKA SUNDEN, COMING UP SHORT: THE CHALLENGE OF 401(K) PLANS 9 (2004) (the main thrust of ERISA is defined benefit plans).
\textsuperscript{435} As has been noted:
Under ERISA section 404(c), if a defined contribution plan permits each employee to direct the investment of the funds in his own account, the plan's trustee bears no liability to the employee for investments, on the apparent assumption that the employee is deciding for himself. Such participant direction of plan investments is not feasible in the defined benefit context because the defined benefit participant has no discrete subset of assets earmarked to
has even blocked employers from providing investment advice on employee choices for their Section 401(k) accounts, but recent legislation that allows such advice has caused much controversy.\textsuperscript{436} There are in fact some dangers in employer promoted investments as illustrated by the losses in employee Section 401(k) retirement accounts at the Enron Corp. when that company collapsed. The holdings of employees there were heavily concentrated in Enron stock that became worthless when Enron became bankrupt.\textsuperscript{437} Such concentration was a risky investment strategy but was widespread in other companies and sometimes generated huge gains as in the case of Microsoft, where over 20,000 employees became millionaires as the result of investments in that company’s stock.\textsuperscript{438} Professional management would undoubtedly introduce greater diversification into individual retirement accounts, lessening losses such as those experienced at Enron and reducing gains such as those realized at Microsoft.\textsuperscript{439}

The problems at Enron have given rise to concerns that employees do not have sufficient sophistication to manage their own financial affairs. There is “a substantial consensus that many (perhaps most) employees in self-directed defined contribution arrangements are poor investors, regardless of how much is spent educating and advising them.”\textsuperscript{440} That consensus concern may be unwarranted.\textsuperscript{441} Most American households (almost seventy percent) own their own homes and automobiles and are otherwise capable of handling their own finances.\textsuperscript{442} Moreover, most stock
(eighty-five percent as the new century began) was held through mutual fund shares, thereby providing at least some degree of professional management once the employee sets his or her investment goals. Nevertheless, the need for professional management of defined contribution plans led to some collective investment mechanisms for self-directed retirement plans.

In 1986, the District of Columbia Court of Appeals held in *Investment Company Institute v. Conover*, that national banks could be authorized by the OCC to manage individual IRA accounts through a common trust fund. That decision was followed by other circuits. The OCC has also adopted a regulation to govern the operation of collective investment funds. That regulation requires a written plan by the bank governing the operation of such funds, as well as audits and financial reports. Certain conflicts of interests are prohibited and management fees are required to be reasonable.

The SEC has been struggling for some time in separating the roles of broker-dealers in providing investment advice to their customer in connection with brokerage activities and as acting as advisers in more formal financial planning roles, as for example in retirement planning. The SEC ultimately adopted a rule requiring separate investment adviser regulation where fees are charged specifically for investment advice and not as a part of execution activities.

D. GOVERNMENT PENSION PLANS

Another collective investment involves government pension plans. The federal government first entered the pension forum on a large scale basis after the Civil War. The Civil Service Retirement System was

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443. Id. at 4.
447. Id. at § 9.18(b). The written plan must contain the following:
   (i) Investment powers and policies with respect to the fund;
   (ii) Allocation of income, profits, and losses;
   (iii) Fees and expenses that will be charged to the fund and to participating accounts;
   (iv) Terms and conditions governing the admission and withdrawal of participating accounts;
   (v) Audits of participating accounts;
   (vi) Basis and method of valuing assets in the fund;
   (vii) Expected frequency for income distribution to participating accounts;
   (viii) Minimum frequency for valuation of fund assets;
   (ix) Amount of time following a valuation date during which the valuation must be made;
   (x) Bases upon which the bank may terminate the fund; and
   (xi) Any other matters necessary to define clearly the rights of participating accounts.
created in 1920 for federal employees.\textsuperscript{450} It was followed by a pension plan for Federal Reserve Board employees in 1924.\textsuperscript{451} The Civil Service Retirement System was a defined plan that ultimately proved to be too expensive for even the federal government and was privatized in the 1980s. Civil service employees were then shunted into a defined contribution program with a fairly wide and sophisticated choice of investment funds.\textsuperscript{452} There are some 3 million federal government employees covered by this plan.\textsuperscript{453} The federal government also manages the Social Security System. That collective investment program operates much like a Ponzi scheme and is heading toward bankruptcy, making it a poor model for other collective investments.\textsuperscript{454}

State and municipal pension plans hold large amounts of funds for collective investment for the defined benefit plans they operate. The first of those funds was the New York City pension fund for policemen that was created in 1857.\textsuperscript{455} In recent years, many state pension funds have become corporate governance gadflies, using their large equity holdings to demand governance reforms by publicly traded companies.\textsuperscript{456} As noted by one court, the New York City Employees’ Retirement System uses its shareholder status as a “bully pulpit.”\textsuperscript{457} The most prominent of those institutions is the California Public Employee Retirement System (“Calpers”). Their demands on corporate management are sometimes conflicted, as when Calpers used its status as a shareholder of the Safeway grocery store chain to try and aid a strike of a union that had been headed by

\textsuperscript{450} 5 U.S.C. §§ 8331-8351.
\textsuperscript{451} MARKHAM, supra note 26, at 124.
\textsuperscript{452} As noted elsewhere:
This retirement program is called the Federal Thrift Savings Plan. It is managed by a Federal Retirement Thrift Investment Board that is composed of three members appointed by the President with the advice and consent of the Senate and in consultation with certain House leaders for two of those appointments. The Board is advised on investment policy by the Employee Thrift Advisory Council composed of fourteen representatives of employee organizations. An Executive Director is given overall responsibility for implementing investment policy, and the Board is barred from interfering with specific investment decisions of the Executive Director. Fiduciary duties are imposed on the Executive Director and to private sector advisers investing funds.
Markham, supra note 449, at 807 n.318 (citations omitted). Civil Service employees may contribute up to a maximum of $10,000 of pretax earnings to the Federal Thrift Savings Plan, and the federal government makes matching contributions of up to five percent. THIRT SAVS. PLAN, TSP FEATURES FOR CIVILIANS, http://www.tsp.gov/features, at chs. 1 and 3.
\textsuperscript{454} Markham, supra note 449, at 756 n.48.
\textsuperscript{455} MARKHAM, supra note 14, at 325.
\textsuperscript{457} New York City Employees’ Retirement Sys. v. SEC, 45 F.3d 7, 9 (2d Cir. 1995).
Calpers' president.\textsuperscript{458}

These institutions have also become professional plaintiffs under the federal securities laws, suing every public corporation that has a financial problem. Institutional investors were given preferred plaintiff standing in class action lawsuits under the Private Securities Litigation Reform Act of 1995 ("PSLRA").\textsuperscript{459} These lawsuits are billed as reform efforts but are really an effort to increase the pension plans returns over what would be received from a diversified portfolio under modern portfolio theory.\textsuperscript{460} In any event, the managers of those plans, which are often controlled by union officials or state functionaries, have proved to be less than successful in their management. One estimate concludes that the total underfunding for all state pension funds may be as high as $460 billion.\textsuperscript{461} The West Virginia Teachers Retirement System is underfunded by seventy-eight percent.\textsuperscript{462} The Illinois pension system is underfunded by $38 billion.\textsuperscript{463} These losses suggest that this is not a collective investment management system that should be emulated.\textsuperscript{464}

E. TIAA-CREF

The Teachers Insurance and Annuity Association ("TIAA") was founded in 1918 by the Carnegie Foundation as a means to provide

\textsuperscript{458} MARKHAM, supra note 3, at 644.
\textsuperscript{460} One study concluded that pension plans were being over-compensated in these lawsuits because of their diversification and that small, undiversified investors were being under-compensated. Kenneth M. Lehn, Private Insecurities, WALL ST. J., Feb. 15, 2006, at A16.
\textsuperscript{462} Id. at 63.
\textsuperscript{463} Id. As a New York Times editorial noted: "Public employee pension plans are a financial time bomb in many states and localities. Now New York City's independent actuary says his calculations suggest a potential future shortfall of up to $49 billion." Editorial, Public Pensions in Trouble, N.Y. TIMES, Aug. 22, 2006, at A18.
\textsuperscript{464} Reform efforts have commenced in the form of proposed uniform state legislation for state and municipal pension funds:

In July, 1997, the Uniform Law Commissioners approved the final text of an Act designed to bring uniformity to some aspects of public pension fund management. The Uniform Management of Public Employee Retirement Systems Act ("UMPERS Act") contains a tightly interconnected set of reforms focused on two important aspects of pension fund management, fiduciary duties, and disclosure obligations. First, the Act articulates the fiduciary duties of those who control public pension systems. These duties apply in all areas, but particularly in the areas of investment and financial management. In this regard, the impetus for the Act was the set of profound changes that have occurred in our understanding of the investment process during the past generation. This knowledge is generally called 'modern portfolio theory' ("MPT"). The UMPERS Act follows in the path of other Uniform Law Commission products and other revisions elsewhere in the law that are designed to permit and encourage the use of MPT.

annuities to teachers. It was managed like an insurance company in investing reserves. Subsequently the College Retirement Equity Fund ("CREF") was created as a means for teachers to invest in equities and operates as a defined contribution plan that operates like a mutual fund. The two now act as a combined entity ("TIAA-CREF"). In 1997, TIAA-CREF was holding the pension funds of some 1.5 million educators and had total assets of $125 billion. By 2004, those numbers had grown to over two million covered employees and assets of $340 billion, making it one of the largest retirement plans in the world. Almost all TIAA-CREF accounts are defined contribution plans that provide participants with a number of investment choices in the equivalent of mutual funds. Those funds are managed in-house by TIAA-CREF.

TIAA-CREF performance record shows a 4.5% return on its retirement annuities for 2005, with a five year average return of 6.4%. Its supplemental retirement annuities showed a lower 4% return in 2005 with a five-year average of 5.9%. TIAA-CREF lost its tax exempt charitable status in 1997, but continues to manage retirement assets for teachers. TIAA-CREF claims low costs in its management of teacher retirement funds and has developed a squeaky clean image, supporting social investing and good corporate governance.

465. MARKHAM, supra note 26, at 90.
466. MARKHAM, supra note 101, at 319-20.
468. The TIAA-CREF website asserts that:
TIAA-CREF has developed a uniform investment approach for its stock accounts (except for those which are fully indexed or use social screens). Its Dual Investment Management Strategy integrates two equity management techniques: Active Managers select specific stocks that they believe represent more potential for growth, while Quantitative Managers build an overall portfolio designed to reflect the basic financial and risk characteristics of the fund’s benchmark index. Quantitative Managers may also attempt to boost performance by slightly varying the amount of certain holdings versus the index, based on proprietary scoring models designed to identify over- and underperforming stocks. The Dual Investment Management Strategy seeks to achieve higher returns over each Fund’s benchmark index, while attempting to maintain a risk profile for each Fund similar to its benchmark index.

471. It has, however, encountered a corporate governance scandal of its own. TIAA-CREF’s chief executive officer, Herbert M. Allison, Jr., who was being paid a generous $9 million per year, failed to inform the TIAA-CREF board of a business arrangement between two TIAA-CREF trustees and the TIAA-CREF auditor, Ernst & Young, to jointly market a method for expensing employee stock options in order to comply with accounting changes made in the wake of the Enron scandal. That arrangement was a violation of the SEC’s auditor independence requirements. The two trustees resigned at the demand of the SEC staff. MARKHAM, supra note 3, at 641.
F. ENDOWMENTS AND CHARITABLE FOUNDATIONS

Another collective investment of no small size is the endowments funds managed by universities, charities and not-for-profit organizations such as ballets, symphony orchestras and think tanks. Harvard University’s endowment fund, the largest, reached $25.47 billion in 2005. Total university endowments totaled over $100 billion. Total university and college endowments exceeded $300 billion. A survey of 746 higher education endowment funds showed an average return of 9.3% in 2005, with a five-year average of 3.3% and a ten-year average of 9.3%. The university endowments with over $1 billion did much better than those averages. Harvard had a return of 19.2% in 2005 and an average return over the prior ten year period of 16.1%. Yale’s numbers for those periods respectively were 22.3% and 17.4%. The average hedge fund returned only 7.61% in 2005 and had a five year average of 7.94%.

The significant returns on large endowments reflect the fact that those funds are aggressively managed in the same manner as a hedge fund. Indeed, the Harvard endowment was managed by Jack Meyer who left that position after a compensation dispute and started his own hedge fund. In 2005, Stanford had 50% of its funds invested in equities, 16% in real estate and only 12% in fixed income instruments. Investments by university endowments grew to include junk bonds, venture capital startups and exotic derivative instruments. In one instance, the Class of 1960 Trust, settled by members of that graduating class for the benefit of Harvard, was using companies it created to securitize airline travel credit card receivables. Such risk-oriented investment strategies were made possible by uniform state legislation adopted by many states that allows the use of modern portfolio theory in endowment and other charitable investments.

472. Yale University has the second largest endowment, which totals $15.2 billion. Jason Singer, Ivy Leave: Yale Parts Ways With Hedge Fund, WALL ST. J., Mar. 29, 2006, at Cl.
475. Hechinger, supra note 473. Yale was choking on risk in one hedge fund. The university removed $500 million from the Children’s Investment Fund Management (U.K.) LLP after it doubled investor’s monies. Singer, supra note 472.
479. Letter from Marc Weitzen to SEC Office of Chief Counsel, Division of Investment Management (Aug. 8, 1986) (on file with the author).
480. As one author has noted: Before the 1960s, educational endowment managers were extremely conservative in their
Risk and diversification did lead to large drops in the value of many endowment fund assets when the market bubble burst in 2000. Nevertheless, the investment policies of endowments and other charitable trusts have received little regulatory attention. Rather, the principal concern raised with their operations has centered on their spending programs. For example, massive litigation is under way at Princeton where donors are challenging the use of endowment funds. A matter of larger concern has been whether the endowment funds are being spent fast enough. Many endowments limit such expenditures to assure their perpetuity.

Federal tax law has sought to curb some abuses by charitable foundations, particularly with respect to self-dealing transactions. There

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483. One scandal involved the use by the Red Cross and the United Way of donations made in the wake of the September 11, 2001 terrorist attacks to unrelated causes. Markham, *supra* note 3, at 46.


485. In that regard:

Jack Meyer, the president of the Harvard Management Company, asserts: ‘We have to keep pace with or outperform the growth in university expenses each year, and in addition disburse between 4.5 and 5 percent of the fund’s capital value each year.’ Under such a strategy, Harvard spent $322 million from its endowment in the year ended June 30, 1996, during which time it earned $1.8 billion. The amount of Harvard’s unspent endowment return could just about have covered its total annual budget of $1.5 billion!


486. As one author notes:

For example, prior to the enactment of minor reforms in 1950 and more significant ones in 1969, private foundations were free to make asset purchases from and sales to a donor, the donor’s family members, and the donor’s controlled corporations; they could accumulate income in the discretion of their trustees, thereby deferring indefinitely the distribution of any
are few corporate governance requirements placed on endowments and foundations. However, New York Attorney General Spitzer has prepared a booklet for charitable foundations that advocates a broad number of corporate governance requirements including internal controls, audit committees composed of outside directors, independent accountants, codes of ethics and conflict of interest policies. Spitzer also became a champion for not-for-profit organizations, even suing Richard Grasso, the retiring head of the New York Stock Exchange for receiving excessive compensation.

VII. INSURANCE COMPANY RESERVES

A. BACKGROUND

Insurance companies keep massive amounts of reserves to meet probable losses from their insured risks. Those funds are managed collectively by the individual insurance companies for investment returns. Massachusetts required such reserves in 1837, which it called an "unearned

value to charitable ends; and they could operate businesses, sometimes on terms that were thought to provide an unfair advantage over competing firms that were organized as profit-seeking entities.


489. Grasso had been paid a retirement package of $187.5 million. The New York Stock Exchange subsequently became a for profit corporation, which meant that any recovery would go to the immensely wealthy members of the exchange. MARKHAM, supra note 3, at 498, 505. An earlier scandal of a similar ilk involved William Aramony, president of the United Way of America, who was jailed in the 1990s for fraud and income tax violations after it was revealed that he was receiving a salary of $463,000 and flying on the Concorde. See Brody, supra note 482, at 454-55.

490. As the Supreme Court has noted:

The term "reserve" or "reserves" has a special meaning in the law of insurance. In general it means a sum of money, variously computed or estimated, which with accretions from interest, is set aside, "reserved," as a fund with which to mature or liquidate, either by payment or reinsurance with other companies, future unaccrued and contingent claims, and claims accrued, but contingent and indefinite as to amount or time of payment.

[Reserves] are held not only as security for the payment of claims but also as funds from which payments are to be made. The amount "reserved" in any given year may be greater than is necessary for the required purposes, or it may be less than is necessary for the required purposes, or it may be less than is necessary, but the fact that it is less in one year than in the preceding year does not necessarily show either that too much or too little was reserved for the former year. It simply shows that the aggregate reserve requirement for the second year is less than for the first, and this may be due to various causes.

premium fund. New York imposed a similar requirement in 1853. That regulation spread to other states, but not to the federal government because the Supreme Court ruled in 1868 that insurance was not interstate commerce and could be regulated by the states as if it were an entirely local business.

The insurance business increased by almost 600 percent between 1870 and 1905. That growth led to criticism from Louis D. Brandeis who stated in 1905 that insurance companies were “the greatest economic menace of today” and that as “creditors of [the] great industries,” they used their power “selfishly, dishonestly [and] inefficiently.” Brandeis’s criticism was supported by a scandal at the Equitable Life Assurance Company where its leader, James Hyde’s, extravagant spending in New York society led to an investigation by the insurance industry by the New York Superintendent of Insurance. The Superintendent was concerned that Hyde was using the company’s reserves to sustain his flamboyant lifestyle.

The New York legislature also appointed an investigating committee headed by Senator William W. Armstrong. Among other things, the Armstrong Committee expressed concern with the fact that insurance company reserves were increasingly being invested in the stocks. Before 1890, life insurance companies had only small equity holdings—about two percent—but that profile changed quickly as the amount of equity holdings increased. The Armstrong Committee viewed this to be a speculative and dangerous practice and recommended the prohibition of insurance companies’ investment in stocks. The New York legislature thereafter restricted the ability of insurance companies to invest in common stocks.

Because insurance companies were forced out of common stock investments, they were able to avoid the excesses of the 1920s and escaped federal regulation. An effort was made to impose such regulation during a study by the Temporary National Economic Committee (TNEC), which was studying the concentration of wealth in America just before World War I.

491. Id. at 348.
493. Lissa L. Broome & Jerry W. Markham, Banking and Insurance: Before and After the Gramm-Leach-Bliley Act, 25 J. Corp. L. 723, 730 (2000). The insurance companies were then financial giants: At the beginning of the twentieth century, the largest American financial institutions were not banks, which today have aggregate assets far exceeding any other type of financial institution, but insurance companies. Insurers were larger than banks by not just a hair; the largest insurance companies were twice as large and were already moving into adjacent financial areas. They were underwriting securities. They were buying bank stock and controlling large banks. They were assembling securities portfolios with the power to control other companies. The three largest insurers were fast growing and on the verge of becoming huge financial supermarkets.


War II. The insurance companies caught that committee’s attention, and the SEC joined in with a proposal for federal regulation of that industry. However, both the Democratic and Republican Party platforms had pledged that supervision of insurance companies would be left to the states, and the SEC proposal was rejected.\footnote{495}

TNEC did express concern with the enormous size of life insurance reserves, which had grown by over eight hundred percent between 1906 and 1938. TNEC asserted that the “investment policies and practices of the legal reserve life insurance companies admittedly influence practically every phase of this country’s economic life.”\footnote{496} Another concern was that these reserves were largely concentrated in fixed income instruments, rather than equities. TNEC believed this was “in effect sterilizing the savings funds received and preventing them from flowing into new enterprises or undertakings where the element of venture or risk is present. Thus the small businessman or average industrialist is denied access to this more important capital reservoir.”\footnote{497} In addition, the demand for bonds was causing companies to issue more debt, thereby unbalancing debt-to-equity ratios and reducing interest rate returns. TNEC wanted more equity investments, a reversal of the Armstrong Committee’s efforts. Insurance companies, however, successfully argued that their avoidance of equity investments had prevented the insurance industry from being devastated by the stock market crash of 1929.\footnote{498}

The insurance company thus dodged the New Deal bullets of regulation that were imposed on other financial services. However, the Supreme Court ruled in 1944 that insurance companies were subject to the federal antitrust laws.\footnote{499} Congress responded by passing the McCarran-Ferguson Act in 1945,\footnote{500} which granted immunity from federal antitrust laws to the extent an insurance company was regulated by state law. That picture changed a bit after the Supreme Court ruled that securities-based variable annuities and other variable insurance products were securities subject to SEC regulation. Those instruments were created to compete with mutual funds that were draining funds away from whole life and annuity insurance.\footnote{501} Variable insurance products shifted the risk of the rate of return to the investor based on investments through payment into accounts that operated like mutual funds. Those assets had to be held in

\begin{itemize}
\item \footnote{495}{Id. at 732.}
\item \footnote{496}{Investigation of Concentration of Economic Power: Hearing Before the Temp. Nat’l Econ. Comm., 76th Cong., Monograph No. 28, at 378 (1940).}
\item \footnote{497}{Id.}
\item \footnote{498}{Broome & Markham, supra note 493, at 733-34.}
\item \footnote{499}{United States v. S.E. Underwriters Ass’n, 322 U.S. 533, 594 (1944).}
\item \footnote{500}{15 U.S.C. § 1012(b) (2000).}
\end{itemize}
"separate accounts" that were subject to SEC requirements. Otherwise reserve requirements remained with the states, which required life insurance companies to maintain reserves "based on the type of contract, age of issue, and mortality and interest assumptions involved."

Insurance companies doubled their assets in the ten years following adoption of the McCarran-Ferguson Act. Life insurance companies remained the largest single lender in the corporate bond market, but they were seeking alternate sources of investment, including commercial buildings. Investments in common stock increased as state law restrictions on such investments were eased. Assets of life insurance companies tripled between 1945 and 1960 and continued to be invested mostly in fixed income investments, often in the form of private debt placements. Insurance companies were managing about half of all pension fund assets in the 1970s. Insurance company assets exceeded $1.75 trillion in 1988 and increased to $1.182 trillion in 2004. Those investments were heavily weighted in favor of fixed income instruments; less than twenty percent were held in equities. The mix of investments was changing. Mortgage holdings were less than ten percent, "the lowest percentage since record keeping began in 1890. In 1998, Kentucky and Minnesota allowed life insurers to invest up to twenty percent of their assets in common stock. The limit was ten percent in Arkansas, Ohio, and Indiana." New York limited the common stock holdings in life insurance company reserves to five percent of total assets.

Investment programs for insurance company reserves are now affected by capital requirements imposed by state insurance regulators. This regulation began in the 1990s when the states began to modify their approach to regulation. Those regulators began using risk-based capital standards that were determined by a risk assessment of the assets held by the insurance company. That effort was in response to a number of insurance company failures. The adoption of risk-based capital

504. BROOME & MARKHAM, supra note 361, at 735-736.
505. Id. at 739.
507. BROOME & MARKHAM, supra note 361, at 741.
508. Id. at 737.
509. Id. at 740.

In 1988, Congress began hearings to determine whether federal regulation was needed, but no legislation resulted. After forty multi-state insurance companies failed in 1992, the Federal Insurance Solvency Act (FISA) was introduced. It sought to create a Federal Insurance Solvency Commission (FISC) that would establish national standards for financial
requirements had a dramatic effect on the corporate structure of many large insurance companies. It placed pressure on insurance companies to increase their capital, a task that was difficult for many insurance companies because they operated as mutual companies that were owned by their policy holders. In order to alleviate that problem, New York adopted legislation permitting mutual life insurance companies to convert to stock companies in order to allow mutual companies to raise capital by converting to a stock based entity. This idea quickly spread and many large mutual companies became conventional shareholder-owned corporations. For example, the Equitable Life Assurance Society demutualized in 1992. It was joined five years later by the Mutual Life Insurance Company of New York, company that had operated in a mutual form for 150 years. Prudential, the largest insurance company in the country that was founded a mutual company some 130 years earlier, demutualized, as did the Metropolitan Life Insurance Company and many others.510

B. REGULATION OF RESERVES

The states provide pervasive regulation over insurance companies. They have sought to provide some uniformity in regulation through the National Association of Insurance Commissioners ("NAIC"), which was created in 1871. Among other things, NAIC created a joint reporting and surveillance system for large interstate insurance companies.511 As an example of state regulation, insurance companies operating in New York are subject to audit by the Superintendent of Insurance512 and must file annual audited financial reports with the Superintendent.513 New York statutes set governance and voting procedures for mutual companies514 and regulate the conduct of board members on insurance companies that have a corporate form.515 New York law sets reserve requirements; in the case of life insurance, those reserves are based on approved mortality tables and interest rates.516 New York also has a legal list of investments permitted by insurance companies that places limits on the percentage of investments in

soundness and solvency of insurance companies. The legislation was beaten back by the industry and state insurance administrators that would have created a Federal Insurance Solvency Commission charged with setting standards for financial soundness and solvency of insurance companies. That legislation was not passed.

Id. at 739.
510. Id. at 745-746.
511. Id. at 739.
512. N.Y. Ins. Law § 310 (McKinney 2000).
514. N.Y. Ins. Law § 1211 (McKinney 2000).
515. Among other things, New York requires a director to vacate his office if he fails to attend board meetings for an eighteen month period. N.Y. Ins. Law § 1215 (McKinney 2000).
516. N.Y. Ins. Law § 1304 (McKinney 2000).
such things as real estate and equities. New York has raised limits on investments in equities to a maximum of twenty percent of reserve assets. 517

This regulation reflects a view that insurance reserves are a form of trust fund for the insured and should be protected from undue risk. The viewpoint is based on an early nineteenth century concept that the capital of a corporation is a trust fund for creditors. 518 Such an approach is inconsistent with investors seeking to maximize their returns and reflects an earlier era of prudence standards that has largely been replaced by modern portfolio theory for other collective investments. 519 This restrictive regulation also did not prevent scandal in New York. Indeed, Attorney General Eliot Spitzer set off another wave of controversy when he began attacking large insurance companies for bid rigging and manipulating their accounts to enhance their financial picture and artificially increase their reserves. One large firm so targeted, Marsh & McLennan Corp., agreed to pay $850 million to settle Spitzer’s charges. 520

Spitzer also attacked the American International Group Inc. and its head, Hank Greenberg, which led to another brawl in the courtroom and newspapers over its accounting practices for reserves. 521

The Wall Street Journal weighed in with an editorial claiming that business practices attacked by Spitzer were normal and customary business practices. 522 Once again, the SEC was caught flat-footed by Spitzer’s charges that publicly traded companies were manipulating their financial


518. Wood v. Dummer, 30 F. Cas. 435, 436 (C.C.D. Me. 1824) (No. 17, 944) (The capital of a corporation “is deemed a pledge or trust fund for the payment of debts.”).

519. Risk based capital requirements for insurance companies resulted in a disruption in the hybrid securities markets after the National Association of Insurance Commissioners ruled that such instruments were to be treated as common stock. A hybrid security has both elements of debt and equity. Aparajita Saha-Bubna, Ruling Shakes Up Hybrid Securities, WALL ST. J., Mar. 24, 2006, at C8.

520. MARKHAM, supra note 3, at 507. Zurich American Insurance Co. later agreed to pay $171.7 million to settle claims by nine states that it engaged in improper bid rigging practices in its commercial insurance contracts. Liam Pleven, Zurich Financial Unit to Settle Bid-Rigging Case with 9 States, WALL ST. J., Mar. 20, 2006, at C3.

521. John C. Whitehead, former chairman of Goldman Sachs, criticized Eliot Spitzer in an Op-ed piece in the Wall Street Journal for publicly accusing Hank Greenberg of having committed fraud before any charges were proven or even filed. Spitzer then called Whitehead and threatened him. According to Whitehead, Spitzer said:

Mr. Whitehead, it’s now a war between us and you have fired the first shot. I will be coming after you. You will pay the price. This is only the beginning and you will pay dearly for what you have done. You will wish you had never written that letter.

John C. Whitehead, Scary, WALL ST. J., Dec. 22, 2005, at A14. Whitehead remarked that this conversation was “a little scary.” Id.

522. MARKHAM, supra note 3, at 507-513.
statements. It was then forced to join in Spitzer's actions. In the event, after firing Greenberg, AIG agreed to pay $1.64 billion to settle charges brought by Spitzer and the SEC. Three executives of General Re (an insurance unit of Berkshire Hathaway) and one AIG executive were also indicted for their operation of an accounting scheme between the two companies that was alleged to have been used to inflate the reserves of the American International Group, Inc. by $500 million.

VIII. ALTERNATIVE COLLECTIVE INVESTMENTS

A. UNITARY INVESTMENT FUNDS

There are some other alternative mediums available for collective investments. One is the unitary investment fund ("UIF") that is widely employed outside the United States. This "is a contract type entity which is not independent of its sponsor or manager," as is the case for the open end mutual fund. The UIF may allow redemption of investments, but "[i]ts design and operation and its success or failure is entirely the responsibility of its sponsor-manager." The UIFs have an "all in" annual management fee plus transaction costs. "They existed in 1940 and in fact were the preferred form in Boston" and were grandfathered by the Investment Company Act "with limited corporate democracy imposed by permitting the unit holders to remove the trustee by a two-thirds vote." "The benefits of a unitary form are realism and the elimination of large amounts of administrative work at the state and federal level involved with the corporate governance structure, to say nothing of the internal administration and legal work involved."

In 1978, the SEC staff examined whether the UIF concept was appropriate for wider use. As a part of that study, the use of such entities in England was examined. The SEC staff and the Investment Company Institute then sought to draft model legislation for UIFs. The SEC also sought public comment on the concept in 1982, but "[m]ost commentators opposed the UIF, based largely on concerns about the adequacy of investor protections for UIF investors and unresolved questions about how the

523. Id.
526. West, supra note 293, at 64.
527. Id.
528. Id.
529. Id. at 65.
530. Id. at 66.
That response cooled interest in the UIF for a time but a study conducted for the Investment Company Institute by Stephen K. West in 1990 advocated the adoption of a UIF structure. The SEC staff rejected that recommendation in 1992, concluding that, while the UIF approach to fees "generally is sound," cost savings appeared to be "minimal." The SEC staff further contended, without any empirical support, that "there is no practical substitute for the oversight of boards of directors regarding investment company operations." The issue was revisited in 2005 by the American Enterprise Institute as a part of a series of conferences that considered the issue of whether there is a better way to regulate mutual funds. Stephen West appeared at one of those conferences with a revised proposal that would create a UIF with a board of directors.

B. Unit Investment Trusts

The UIF proposal apparently will not go away. The effort to push it by including a board of directors may help gain SEC support, but is a board of directors really necessary? Such a management form is permitted by the Investment Company Act for unit investment trusts ("UITs"). Those entities hold a fixed group of securities in its portfolio for investors, providing expertise in the selection of those securities and a degree of diversification that reduces default risks. The UIT ownership interests are redeemable but usually trade in a secondary market. UITs do not have a board of directors or an investment advisor, thereby allowing them to escape most of the onerous corporate governance provisions of the Investment Company Act of 1940. Rather, UITs are sold under a trust indenture agreement that spells out the rights of the unit holders. That indenture also defines the obligations of the sponsor and trustee holding the UIT's portfolio securities. The Investment Company Act imposes some minimal obligations on trustees and sponsors, and it allows the trustee to

533. SEC Div. of Inv. Mgmt., supra note 531, at 283.
534. Stephen K. West, Sullivan & Cromwell, Remarks at Presentation Before the American Enterprise Institute for Public Policy and Research: Is There a Better Way to Regulate Mutual Funds? (Sept. 26, 2005), transcript available at http://www.aei.org/events/filter.all, eventId.1149/transcript.asp. Mr. West also noted that CI Investments Inc., a Canadian mutual fund complex, was already planning to offer funds with a single forward looking fee. Id.
535. United States Trust Co. v. Alpert, 10 F. Supp. 2d 290, 297 (S.D.N.Y. 1997), aff'd sub nom. United States Trust Co. v. Jenner, 168 F.3d 630 (2d Cir. 1999). A third party evaluator is used to price the UIT interests for the sponsor. Id.
536. Id. at 309.
537. Harmon, supra note 78, at 1048.
charge such fees as may be provided in the trust indenture agreement.\textsuperscript{538}

Unlike open end mutual funds, UITs do not trade or manage their portfolios, but that distinction should not preclude their use for managed accounts. The fact that managed funds have boards of directors did not prevent abuses in the 1920s and did not stop the late trading and market timing practices that were the center of the Spitzer-generated scandals. Indeed, some unit investment trusts were originally formed in the 1920s because of concerns with abuses by managed-investment companies that had boards of directors.\textsuperscript{539}

C. TRUST INDENTURE AGREEMENTS

Vast amounts of funds are also invested under a contractual arrangement used for corporate bonds that is only lightly regulated, at least as compared to mutual funds. There are $5$ trillion in corporate bonds outstanding.\textsuperscript{540} Large amounts of that debt are sold as "debentures" under "trust indenture agreements" that specify the rights and obligations of the debenture holders, the issuer and the trustee that acts as a custodian for principal and interest payments. The corporate issuer of those debentures has a board of directors, but that board is not there for the protection of corporate debtors. Absent unusual circumstances, the fiduciary duties of corporate board members run to equity owners and not lenders.\textsuperscript{541}

A corporate bond "represents a contractual entitlement to the repayment of a debt and does not represent an equitable interest in the issuing corporation necessary for the imposition of a trust relationship with concomitant fiduciary duties."\textsuperscript{542} A bondholder "acquires no equitable interest, and remains a creditor of the corporation whose interests are protected by the contractual terms of the indenture."\textsuperscript{543} Moreover, "[a]n indenture is, of course, a contract. Unless the indenture trustee has deprived the debentureholders of a right or benefit specifically provided to them in the indenture, there is no violation of the implied covenant of good faith and fair dealing."\textsuperscript{544} This also means that, "unlike those of an ordinary

\textsuperscript{538} 15 U.S.C. § 80a-26 (2000). The role of the UIT trustee is limited.

The trustee, usually a major bank, is unlike a trustee in most other contexts in that it typically performs only "ministerial duties," collecting and distributing the interest and dividends due on the portfolio securities and providing the unit holders with periodic reports concerning the interest received, amounts distributed and securities in the portfolio.

United States Trust Co. v. Alpert, 10 F. Supp. 2d at 297.

539. Harmon, supra note 78, at 1088.


543. Id. at 304.

trustee, the duties of an indenture trustee are generally defined by and limited to the terms of the indenture.\footnote{Harriet & Henderson Yarns, Inc. v. Castle, 75 F. Supp. 2d 818, 830 (W.D. Tenn. 1999).}

There is some federal regulation of corporate bonds. Unless exempted, corporate debt offerings to the public must be registered with the SEC under the Securities Act of 1933, bringing those securities into the SEC’s full disclosure regime. Such offerings are also regulated under the Trust Indenture Act of 1939.\footnote{15 U.S.C. §§ 77jjj-rrr (2000).} The latter statute was the result of an SEC study in 1936 that found that the indenture trustee was often aligned with the issuer and the trustees were often protected from liability through broad exculpatory clauses.\footnote{Zeffiro v. First Pa. Banking & Trust Co., 623 F.2d 290, 292 (3d Cir. 1980), cert. denied, 456 U.S. 1005 (1982).} They included “ostrich” clauses that allowed indenture trustees to assume that there was no default on the debentures unless it received notice from at least ten percent of the debenture holders who were often widely dispersed and unorganized so that any such notice was unlikely.\footnote{MARKHAM & HAZEN, supra note 422, at 190.} “Rather than allow the SEC direct supervision of trustee behavior and thereby provide for a more overt intrusion into capital markets, the Act... is structured so that... the indenture... must be ‘qualified’ by the SEC.”\footnote{MARKHAM & HAZEN, supra note 422, at 181.} To be qualified, the indenture may not relieve the trustee from liability for negligence in carrying out its duties under the indenture, and the trustee’s duties, which are normally only ministerial, are broadened in the event of a default.\footnote{MARKHAM & HAZEN, supra note 422, at 190.} The SEC has no enforcement authority under the Trust Indenture Act once the registration statement becomes effective for a trust indenture.\footnote{15 U.S.C. §§ 77jjj-rrr (2000).}

D. STRUCTURED FINANCE

Another collective investment vehicle is found in structured finance where special purpose entities (“SPEs”) are used to “securitize” cash flows from assets placed in the SPEs. Ownership interests in the SPEs are sold to investors and the proceeds from that sale are paid to the owner that transferred the assets to the SPE. Such entities are formed as limited partnerships, limited liability companies, partnerships and business trusts. SPEs have no operational role, nor do they utilize boards of directors. The SPE’s only function is to hold the assets and to collect and make any required payments from the assets’ income streams.\footnote{The SPE arrangement will often employ various custodians and a “servicer” that acts like an indenture trustee in collecting and distributing the cash flow. Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, \textit{Structured Financing}}

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548. MARKHAM & HAZEN, \textit{supra} note 422, at 181.
549. See \textit{Zeffiro}, 623 F.2d at 293.
551. MARKHAM & HAZEN, \textit{supra} note 422, at 190.
552. The SPE arrangement will often employ various custodians and a “servicer” that acts like an indenture trustee in collecting and distributing the cash flow. Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, \textit{Structured Financing}}
SPEs were often used to enhance the credit rating on the SPE obligations because the assets are isolated from the creditors of the entity transferring the assets to the SPE. Such isolation could be achieved, however, only if certain accounting requirements were met. Specifically, Financial Accounting Standard 140 (FAS 140) allowed the assets and liabilities of an SPE to be removed from a company’s balance sheet only if an outside investor controlled, and had a substantial investment in, the SPE. The SEC’s Office of Chief Accountant opined that, in order to achieve the required independence, the outside investor would have to have at least a three percent substantive equity ownership interest in the SPE. Another characteristic common to the securitization of assets was that the assets sold to the SPE would produce an income stream that could be used to pay back the investors buying interests in the SPE.\(^{553}\)

The SPE was initially used to package and resell mortgages and such investments are now a common part of finance.\(^{554}\) The concept then spread to other instruments or obligations that created a stream of payments, such as credit card receivables\(^{555}\) and even song royalties.\(^{556}\) The use of the SPE was extended beyond limits by the Enron Corp. after it began using mark-to-market accounting for certain of its assets. That accounting method resulted in an increase in reported income when those assets were appreciating but hurt revenue when they began to decline at the end of the last century. To deal with that decline, Enron sought to “monetize” those assets by selling them to a SPE. Enron created some 3,000 such entities to carry out those sales. However, Enron’s bankruptcy examiner found that several Enron SPEs did not have the requisite true sale status because Enron retained control of the assets and continued to have liability for decreases in their value, as well as control over the ultimate disposition of the assets.\(^{557}\) That scandal resulted in an increase by the Financial

\(^{553}\) Techniques, 50 BUS. LAW. 527, 528 (1995).

\(^{554}\) These instruments were popularized by the GNMA pass-through certificates in which mortgages were pooled and interests in those pools sold to investors. See First Nat’l Bank of Chicago v. Jefferson Mortgage Co., 576 F.2d 479, 482 n.1 (3d Cir. 1978) (describing GNMA pass-through certificates). Such arrangements were also used to sell privately originated mortgages. See Sec. Indus. Ass’n v. Clarke, 885 F.2d 1034, 1052 (2d Cir. 1989), cert. denied, 493 U.S. 1070 (1990) (describing such programs). See generally Edward L. Pittman, Economic and Regulatory Developments Affecting Mortgage Related Securities, 64 NOTRE DAME L. REV. 497 (1989) (describing mortgage-backed pools).

A more exotic instrument, the collateralized mortgage obligation, divided the payment streams from pooled mortgages into various tranches which, among other things, has interest only and principal only payment streams. MARKHAM & HAZEN, supra note 422, at 611-12. These complicated instruments were often difficult to value and could cause substantial losses. See Banca Cremi, S.A. v. Alexander Brown & Sons, Inc., 132 F.3d 1017, 1038 (4th Cir. 1997) (describing some such losses).

\(^{555}\) MARKHAM & HAZEN, supra note 422, at 621-22.


\(^{557}\) MARKHAM, supra note 3, at 70-71.
Accounting Standards Board ("FASB") in the independent investor requirement to ten percent.\(^{558}\)

E. LIMITED LIABILITY COMPANIES

Another entity that may operate without a board of directors is the limited liability company ("LLC"). They were created as the result of the realization that traditional corporate governance structures were often too unwieldy for small businesses. Wyoming was the first state to enact legislation allowing such entities in 1977, and other states soon followed.\(^{559}\) The LLC authorized by those statutes allowed complete flexibility in capital structure and management. They are also tax advantaged because the Internal Revenue Service has allowed pass through tax treatment for the owners of LLCs.\(^{560}\) Ownership interests in an LLC that are marketed to passive investors may be required to register under the federal securities laws unless exempted.\(^{561}\)

The interests of the members of the LLC were not represented by traditional stock that was governed by the corporate laws of the state of incorporation. Rather, their ownership rights are spelled out in an "operating agreement" that governs the operations and management of the LLC. The operating agreement may be quite detailed on how the affairs of the company were to be managed and may permit management structures outside the traditional board of directors.\(^{562}\) The courts are currently wrestling with the issue of when fiduciary duties will apply to the managers of an LLC and whether the operating agreement may define those duties.\(^{563}\)

IX. CONCLUSION

An alternative is needed to the intrusive and expensive regulatory scheme under the Investment Company Act of 1940 that has failed to protect investors. The SEC’s fixation on the use of outside directors to guard against conflicts of interest on the part of investment advisers to mutual funds has proved to be ineffective. That obsession is being pursued without empirical support for the agency’s claim that increasing outside directors has any effect on the efficacy of a mutual fund or any other corporate governance structure. Outside directors did not prevent or detect the scandals uncovered by Spitzer. Outside directors have no way in the future to prevent misconduct because the investment adviser and sponsor

\(^{558}\) Id. at 471.
\(^{560}\) HAZEN & MARKHAM, supra note 296, at 82.
\(^{561}\) JAMES D. COX & THOMAS L. HAZEN, CORPORATIONS §1.11 (2d ed. 2003).
\(^{562}\) HAZEN & MARKHAM, supra note 296, at 82.
\(^{563}\) HAZEN & MARKHAM, supra note 296, at 86.
control all information flows. Outside directors, no matter how numerous, have no way to gain independent access to that flow. Indeed, it seems strange that the SEC and corporate governance advocates would want to place management of mutual funds and other corporations into the hands of outside directors who have no day-to-day knowledge of the business.

Hedge funds have become one of the most successful investment mediums in the country without SEC regulation. The hedge funds have conflicts of interest but have dealt with them adequately without a mandated number of outside directors. The hedge fund's cousin, the commodity pool, has operated successfully as limited partnerships that have no board of directors. Trust indentures, unit investment trusts, structured finance and limited liability companies also operate quite well without boards of outside directors. Conflicts of interest are handled by disclosures and contractual restrictions. The trust indenture is a good example of how those conflicts can be managed by negative covenants and other restrictions. Insurance companies are regulated intensively but have no seventy-five percent outside director requirement such as that imposed by the SEC on mutual funds.

Without intruding too far into the debate over market efficiency between the Chicago and behavioral schools of thought, there are market disciplines available. The trust indenture is negotiated under that discipline. As one court noted, "those indentures are often not the product of face-to-face negotiations between the ultimate holders and the issuing company. What remains equally true, however, is that underwriters ordinarily negotiate the terms of the indentures with the issuers. Since the underwriters must then sell or place the bonds, they necessarily negotiate in part with the interests of the buyers in mind." The UIF operates abroad without the SEC corporate governance restrictions. Its forward looking fee removes many of the conflicts of interest generated by mutual funds using a fluctuating backward looking NAV fee. Contractual restrictions can be added to reduce other conflicts.

Of course, there is no such thing as a foolproof regulatory or contractual structure. UIF operators will still have incentives to inflate their returns in order to attract investors, which could lead to destructive

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564. Some mutual funds are even seeking to copy the high risk activities of hedge funds in order to increase returns. Eleanor Laise, Mutual Funds Adopt Hedge-Fund Tactics, WALL ST. J., Feb. 21, 2006, at D1.


effects when high risk investments are acquired to boost those returns. Nevertheless, consumers should be given a choice of a managed investment company that does not have a traditional board of directors or one that is staffed by a mandatory number of outside directors with little or no knowledge of the day-to-day business. At the end of the day, consumers will choose the medium that will provide the greatest after-fee return.