Introduction to the *Research Handbook on the Regulation of Mutual Funds*

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Mutual funds are the way Americans invest today. In legal theory, the platonic ideal of a corporate relationship may still be the one between shareholder and firm, but, increasingly, that fundamental dyad is being intermediated by an investment fund. Whereas institutional investors owned less than 10 percent of the stock of America's largest 1,000 public companies in the 1950s, now investment funds hold more than 50 percent of public equity.[1] Some of those holdings rest in the hands of hedge funds and private equity funds, whose exotic deals and outrageous fortunes capture the public imagination. But the most ubiquitous investment vehicles—particularly for ordinary American households—are mutual funds, which today hold $22 trillion in the United States and almost $50 trillion globally.[2] The assets of these funds have long been important to the funds' shareholders, of course, but in recent years the gravitational force of mutual funds has waxed sufficiently powerful to begin to shape the broader American economic landscape and the governance of companies in which mutual funds invest.

The rise of mutual funds owes much to the shift, over the past 40 years in the United States, from defined benefit pension plans to defined contribution accounts. Since Section 401(k) was added to the Internal Revenue Code in 1978, eponymous 401(k) accounts have grown to hold more than $5 trillion dollars.[3] And within those accounts, the leading investment choice on the menu has become the mutual fund. While the defined benefit pensions that dominated retirement savings in the mid-twentieth century are overseen by relatively small groups of professional asset managers, decision-making power over defined contribution accounts such as the 401(k) and 403(b) lies in the hands of ordinary American workers. And this great mass of workers has turned to the mutual fund industry to help them carry the burden of decision-making. As 57 million American households have come to hold mutual funds not just for retirement, but also for children's education and home down payments,[4] the strengths and weaknesses of these funds have become more deeply manifest in American society.

[1] The Conference Board, What Is the Optimal Balance in the Relative Roles of Management, Directors, and Investors in the Governance of Public Corporations? 9–10 (2014).

[2] Investment Company Institute, 2017 Investment Company Fact Book i (2017) (hereinafter "ICI Fact Book").

[3] Investment Company Institute, Frequently Asked Questions about 401(k) Plan Research, available at www.ici.org/policy/retirement/plan/401k/faqs_401k.

[4] See *supra* note 2, ICI Fact Book at i.

Mutual funds manage so much money that they are now critical investors in broad swathes of the US economy. To understand how the United States—and, indeed, the world—invests, one must understand mutual funds and their related investment vehicles. This *Handbook* covers several topics that fall into at least four major categories central to the legal regulation of mutual funds today.

1 FIDUCIARIES AND FEES

Every student of business law in the United States quickly comes to learn of the critical importance of fiduciary duties to American corporations. Crudely put, in exchange for broad and far-reaching powers to direct the management of corporations, their directors and officers (and occasionally controlling shareholders) owe shareholders duties of loyalty and care, and perhaps a few other duties depending on the particular jurisdiction. Like the structural scaffolding of constitutional law, the relative powers of these branches of corporate governance determine many of the most important questions in business law.

Mutual funds are, of course, businesses also. But because of their peculiar structure—in which investors are shareholders of a mutual fund, but not necessarily of the investment adviser managing the fund—it is not obvious what duties an investment adviser owes to the fund's investors. In 1970, Congress created further confusion by imposing a fiduciary duty specific to advisory fees through the addition of Section 36(b) to the Investment Company Act of 1940. That provision states that "the investment adviser of a registered investment company [mutual fund] shall be deemed to have a fiduciary duty with respect to the receipt of compensation of services." This grafting on of a relatively new and artificial duty raises many questions that directly affect the welfare of mutual fund shareholders. Perhaps none of those questions is more important than this one: to what extent are fund managers constrained from charging high fees to fund investors?

Inasmuch as fees are the most important determinant in the returns achieved by mutual funds and, accordingly, the success or failure of shareholders' investments, the scope of the Section 36(b) fiduciary duty in mutual funds—and the efficacy of litigation to vitiate that duty—are key legal issues for funds and their investors today.

2 INVESTOR SOPHISTICATION

Investors in mutual funds can be arranged along a spectrum that spans a gulf of experience, wealth, and knowledge, ranging from large institutions at one end to small individuals at the other. Many purchasers of fund shares may naturally fall between these extremes, and their place on the spectrum may determine how well they can protect themselves in a market full of complex terms and self-interested investment advisers. Understanding the capacity of different investors to protect themselves and to manage their investments is critical to regulating the mutual funds that cater to them.

The rise of research in behavioral finance, in particular, is being embraced by scholars of mutual funds to analyze the strengths, weaknesses, intuitions, and biases of investors and then to theorize about the extent to which those behavioral tendencies may contradict more traditional assumptions of classical legal economics built into our current regulatory edifice. Where existing assumptions may be outdated, revisions to our regulatory system may be prudent.

3 FUNDS AS INVESTORS

The reach of mutual funds—and their structural cousins, such as money market funds and exchange-traded funds—continues to grow as the American and international investing public continually seeks newer and better investing tools. As these new types of funds have grown, however, they have been increasingly affecting and at times displacing existing financial ecosystems.

The systemic importance of mutual funds became clear during a pivotal moment in the financial crisis of 2008, when a money market mutual fund, the Reserve Primary Fund, dramatically failed. That fund's breaking of the buck—its inability to return 100 cents on every dollar invested—triggered a run by investors to withdraw their money not only from that fund but from many other similar funds. That stampede of investors fleeing money market funds then threatened to starve American corporations of the ready loans in the market for commercial paper upon which they rely to meet critical needs, such as regular payroll.

Scholars are exploring how funds operate in the shadow banking world and how they may affect other participants in the financial sector. Perhaps the largest public policy issue influenced by mutual funds today is the extent to which Americans are saving effectively for their retirement. Federal legislators regularly consider—though rarely enact—programs such as the Thrift Savings Plan, which is a defined contribution plan for millions of federal employees. Recently, however, state legislators have taken a more active role in enacting plans to stimulate retirement saving among broader pools of Americans. This regulatory conflict and federalist foment among states and between states and the national government is an increasing focus of attention for observers who fear that workers may not have sufficient tools to save prudent amounts for their later years.

4 INTERNATIONAL EXPANSION AND INNOVATION

Finally, the landscape of investment funds has changed dramatically since the passage of the two defining pieces of federal legislation in 1940, in at least two prominent ways: via innovation, and via international expansion.

Investment advisers are continually experimenting with new ideas for the structure and investing approach of funds, perhaps none more notable than the introduction of exchange-traded funds ("ETFs") in 1993. ETFs, which are essentially mutual funds that can be traded continuously on stock exchanges (rather than just redeemed or purchased from the issuing fund once a day, as is the case with traditional mutual funds), have attracted massive new inflows from institutional investors such as hedge funds seeking short-term havens for assets that retain exposure to equity returns and individual investors seeking lower fees and possible tax benefits.

The growth of mutual funds has been a truly global phenomenon and deserves a broad international analysis. Though other countries may not share the regulatory history of the United States, with its outsized emphasis on 401(k) plans, many have seen a similar decline in the importance or centrality of pension or government savings plans. Into that vacuum have stepped mutual funds or, in foreign jurisdictions, broadly equivalent pooled investment vehicles.

Just as local conditions might have spurred the growth of mutual funds at different times, so too have local political economies and legal regimes created different regulatory preferences for the oversight of these funds. Increasingly, money is moving across international borders, and money managers are operating in different jurisdictions. Academics, public officials, and legal practitioners wishing to understand the global investing environment need an appreciation of the general manner in which the investing laws in countries differ. And for the largest and most influential fund economies—such as the United Kingdom, Ireland, Liechtenstein, and Australia—specific details on local legal regimes are particularly illuminating.

5 AN OVERVIEW OF CHAPTERS IN THIS *HANDBOOK*

This *Handbook* addresses these and several other issues concerning mutual funds. The contributors—who are leading scholars in the field of investment law and who come from a number of different countries—provide a current legal analysis of funds from a variety of perspectives and using an array of methodologies.

In Part I, we consider some fundamental and large questions governing the role and regulation of investment funds. John Morley opens the volume with an inquiry into why investment companies are regulated so differently from every other kind of company. The multitude of other companies across our diverse spectrum of business endeavors—from software design to clothing retail to food service, and so forth—are regulated by a generic body of securities regulations. Morley asks what exactly makes an investment company so different from every other kind of company that it alone deserves special securities regulation. He concludes that, whatever the historical rationales for investment company regulation, the most compelling rationale for investment company regulation today is an investment company's unique organizational structure. An investment fund almost always has a separate legal existence and a separate set of owners from the managers who control it. A fund investor thus relates to her managers in a radically different way from an investor in every other kind of company.

Mercer Bullard then explores the rise and fall of the mutual fund brand, beginning with the observation that growth in the mutual fund industry has stagnated relative to the industry's dramatic rise in the preceding two decades. Bullard suggests that both that stagnation and the previous growth may be attributable to government policies. Specifically, he identifies a suspension of the SEC's program of aggressive regulatory innovation and the agency's inaction in the face of threats to the mutual fund brand. Bullard calls for the Commission to reclaim its role as a regulatory entrepreneur by using its broad exemptive authority to stave off the prospect of the mutual fund brand stagnating and withering in the vacuum of SEC paralysis. This chapter evaluates the efficiency of mutual fund regulation from a market perspective by considering whether investor preferences for potential market substitutes for mutual funds (e.g., hedge funds, separate accounts, CITs, mini-accounts) provide insights into whether mutual fund regulation is responsive to such preferences.

Deborah DeMott also considers the effect of the highly prescriptive regulatory structure of the Investment Company Act of 1940, focusing her attention upon the contours of fiduciary duties in mutual funds. In her chapter, DeMott advances the point that assessment of the role and significance of fiduciary obligations regarding investment funds, both mutual and private, turns on their distinctive characteristics, including those prescribed by regulation. DeMott notes that the population of investment advisers now registered with the SEC includes many who advise at least one private fund, and their actions during the financial crisis suggest that advisers' practices call into question whether they are acting consistently with their fiduciary duties.

In his chapter, Arthur Laby also examines the fiduciary structure of investment management regulation. Specifically, he addresses the relationship between investment managers' fiduciary obligations and regulators' efforts to control the investment management industry through rules and enforcement actions that constitute the bulk of fund law. Laby argues that much of that body of law is a response by regulators to the uncertainties inherent in the fiduciary obligation. On a broad series of issues, Laby contends, regulators attempt to specify the precise fiduciary obligations of managers as they exercise their duties to clients.

In Part II, we turn our attention to the identity and behavior of investors in mutual funds and their sophistication relative to one another and to investment advisers. Alan Palmiter begins this exploration by attempting to compile an investor profile that describes who mutual fund investors are. He concludes that this portrait of investors, painted by academic and governmental studies, is disturbing. Fund shareholders, who are in charge of making their own investment decisions, are ignorant of important characteristics of the funds in which they invest, inattentive to risks, and insensitive to fund fees. Palmiter ends with a "trillion-dollar question": whether the legal regime charged with protecting fund investors and ensuring the viability of our private retirement system is up to the task.

Lyman Johnson considers how best to protect investors in mutual funds. In his chapter, he examines the variety of approaches taken on investor protection since 1940 and argues that making efforts on many fronts is the best—and probably the only politically viable—regulatory strategy. Specifically, Johnson considers board-centered, investor-centered, SEC-centered, and market-centered solutions. Though he finds that all are flawed by themselves, and that each could be improved, the medley of their combined effect may be the best protection for investors.

Quinn Curtis looks specifically at the history and current state of mutual fund fee litigation under Section 36(b) of the Investment Company Act. He finds little evidence that lawsuits are effective in lowering the fees of funds managed by defendant advisers of sued targeted funds or that plaintiffs target particularly expensive mutual funds. In his chapter, Curtis attempts to situate new developments in fee litigation within the larger context of the Section 36 legislation. Many problems afflicting the operation of Section 36(b) are traceable, he argues, to the compromises, limitations, and ambiguities that resulted from the competing efforts of the SEC and the Investment Company Institute during the adoption of the 1970 amendments to the Company Act.

In the next chapter, Anita Krug contemplates possible ways to improve the governance of mutual funds, focusing specifically on a new model. In this new governance model, multiple funds in a common family are not managed by a single investment adviser but rather by numerous advisers, each managing one or a small number of funds within the organization. Krug contends that although the new model produces novel risks, there are reasons to believe that it is as least as effective as the traditional model, and may in fact be superior in some ways. Specifically, because the new model produces fewer sources of conflicts of interest than the traditional one, it may strengthen the board's ability to uphold its fiduciary duties to fund investors.

Finally, James Fanto focuses on the burgeoning field of regulatory compliance, as it relates to mutual funds. Specifically, he examines three major developments: (1) the continuing confusion over potential supervisory liability for compliance officers; (2) the increasing use of technology by these officers; and (3) the possible integration of the compliance function into risk management, rather than compliance remaining as a standalone control function. Fanto argues that, although these developments highlight the importance and achievements of compliance in the fund area, each in its own way discourages arguably the most valuable contribution of compliance officers, the provision of advice and counsel. He thus contends that, rather than passively watching and accepting these developments as they unfold, compliance officers and others with a stake in effective compliance should examine the developments critically to preserve the effectiveness of regulatory compliance.

In Part III, we turn our attention to less orthodox funds, such as money market funds, ETFs, and private funds. To begin, Jill Fisch considers money market funds and the shadow banking debate by tracing their evolution from their inception in the 1970s. Fisch focuses particularly on the events of September 2008, when the bankruptcy of Lehman Brothers caused the Reserve Primary Fund to "break the buck" and triggered investors' redemptions from money market funds. She explains the political interplay among government regulators regarding the need for reform and the ensuing regulations adopted by the SEC. Fisch closes by offering thoughtful observations about the likely structure of the money market fund industry in the future.

Eric Roiter conducts a comprehensive analysis of exchange-traded funds. Specifically, he explores the design of ETFs, traces their growth, and reviews their trading and investment strategies. He then considers the newest development in the world of ETFs, the advent of "actively managed" ETFs. Finally, Roiter considers ETFs more broadly, to determine whether they pose a risk to the financial system that warrants greater regulation by the SEC and the Federal Reserve Board.

William Birdthistle explores the possibility of a new public or eleemosynary infrastructure to support private investment in funds. Specifically, Birdthistle proposes and explores the concept of an investment fund provided to citizens as a service with zero investment advisory fees. The viability and advisability of free funds turn on three large questions: first, whether mutual funds with no fee are financially viable; second, whether they ought to exist; and third, who or what entities should serve as their sponsor. Birdthistle argues that free funds are theoretically plausible, inasmuch as funds with very low expense ratios could offset remaining net expenses with revenues from operations such as securities lending. In light of the central role of private investing today, he argues for experimentation with pilot fund, under the aegis of a nonprofit or governmental sponsor.

Finally in this section, Wulf Kaal considers the growth of the hedge fund industry and retail alternative funds. He finds there is an emerging confluence of the two, which will have implications in various areas of the financial industry.

Part IV focuses on the regulation of mutual funds in jurisdictions other than the United States. Dirk Zetzsche begins by providing a comprehensive analysis of pan-European investment law. By providing an overview of European Union sources of law and regulatory objectives, he offers a thorough introduction to a large and growing market that rivals the United States in global economic importance. Zetzsche explores the unique features of the two key pillars of European fund governance: UCITS (broadly corresponding to public funds like mutual funds in the United States) and Alternative Investment Funds (broadly corresponding to private US funds, such as hedge or private equity funds). Importantly, Zetzsche explains the European Passport, the license to engage in cross-border fund distribution and fund management in Europe, and the feature that first created the investment fund market in the European Union and European Economic Area. The type of passport for a collective investment scheme depends on whether the scheme meets the UCITS or AIF definition. Zetzsche also offers an analysis of the future trajectory of European investment fund law.

Blanaid Clarke and Mark White then consider governance aspects of mutual funds in Ireland, a disproportionately important international jurisdiction for wealth management. They examine the variety of attributes that make Ireland an attractive domicile for funds and asset managers, including the country's infrastructure, technology, and investment expertise, as well as its well-developed common law and legal system that provides parties with legal certainty. Ireland also offers a 12.5 percent corporate tax rate and no taxes on funds or investors. Clarke and White close by considering the possible effects of Brexit arising from the large financial market across the Irish Sea.

Iris H-Y Chiu provides another comprehensive country-specific analysis with her chapter on the regulation of collective retail investment funds in the United Kingdom. In discussing the market for such funds, Chiu argues that their regulatory framework has been shaped largely by European market integration and the need to brand pan-European collective investment products. She reflects on the need for a coherent regulatory framework for non-Undertakings for Collective Investment in Transferable Securities ("UCITS") and unconventional retail investment schemes, particularly in the wake of the great uncertainties unleashed by the United Kingdom's vote to leave the European Union.

In the final chapter, Pamela Hanrahan and Ian Ramsay look outside Europe to analyze the unique legal and regulatory framework for collective investments, including mutual funds, that Australia has developed over the past two decades. The Australian framework is built around a single "responsible entity" that combines the role of fund sponsor and adviser with that of the trustee. Hanrahan and Ramsay explain three key features of this system: the fiduciary duties imposed on the responsible entity and its officers; the limited role of an independent party to monitor or oversee the responsible entity's conduct of the fund; and the availability of investor "self-help" mechanisms, including information rights, voting rights, enforcement rights, and exit rights.

We would like to thank all the authors for their fine contributions to this volume.