1. Why do investment funds have special securities regulation?

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America's securities laws are generic. We have only a single body of securities law for all types of companies. The two centerpieces of American securities regulation, the Securities Act of 1933 and the Securities Exchange Act of 1934, regulate almost every industry imaginable, from software making to clothing retail to food service, banking, coal mining, insurance, for-profit higher education, hotels, book publishing, art dealing, and real estate investing. American securities regulation contains multitudes.

Except, that is, for one very special industry: the investment company industry. Unlike all other companies, mutual funds, closed-end funds, hedge funds, and private equity funds have their own special securities regulatory regime in the form of the Investment Company Act of 1940. This act is administered by the Securities and Exchange Commission, the same agency that administers the other securities laws, but it imposes a different body of regulation in place of (and sometimes on top of) the generic securities regulation that applies to every other kind of company. No other large industry has a special securities regulatory scheme of this scope and magnitude.[1] The investment company industry is one of a kind.

But why? What exactly makes an investment company so different from every other kind of company that it alone deserves special securities regulation? Surprisingly, the answer has never been very clear and (in living memory, at least) even the question has never been directly posed.

This chapter tries to find an answer. My conclusion is 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. Though this pattern of organization is often efficient in investment funds, it is

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[1] To be sure, other industries are subject to distinctive regulation, and financial industries such as banking and insurance are subject to regulation of financial disclosures. But these industry-specific regulations are different from securities regulation. Industry-specific regulations are designed to protect customers or third parties rather than investors. And none of these industry-specific regulatory regimes supplants the regular securities regime. An insurance company, a travel agency, and a pet store chain each face different industry regulations, but they nevertheless all make the same annual and quarterly disclosures to their investors under the Securities Exchange Act. Not so for a registered investment company, which has its own special disclosure regime under the ICA.

nevertheless often imperfect and it poses an array of serious problems that call out for regulation. The special job of the Investment Company Act is to provide that regulation.

Before we consider what makes a fund's organization so special, though, let us first turn to some other possible accounts of why an investment fund deserves special regulation. I will review several of these alternatives before arguing for the importance of organization.

1 SECURITIES OWNERSHIP

On first impression, the main thing that seems to make an investment company different is its tendency to *invest*. An investment company doesn't operate businesses; it invests in them. The trouble with this intuition, though, is that every company invests in something—whether land, factories, or brands. And so investing is not distinct to an investment fund. The next impulse is thus usually to take the intuition about investing and extend it a bit further to say that although an investment company may not be the only kind of business that invests, it is nevertheless the only kind of business that invests in a particular kind of asset, namely *securities.* On this telling, the thing that differentiates the Fidelity Magellan mutual fund from, say, Microsoft is that the Magellan fund invests in the securities of other companies, whereas Microsoft invests in branding and intellectual property.

This focus on securities gains support from no less an authority than the Investment Company Act of 1940 (the "ICA"), which is the special securities regulatory statute that supplants the regular securities regulatory regime for investment companies. The ICA regulates publicly registered mutual funds and closed-end funds as well as private investment vehicles, such as hedge funds and private equity funds.[2] Though the ICA uses the technical term "investment company," it regulates most of the vehicles that we commonly call "investment funds."

Section 3(a)(1) of the ICA is consistent with the securities-based definition of an investment company, because it tells us that an investment company is a business that "is … engaged primarily … in the business of investing … in securities." Section 3(a)(2) alternatively gives a bright-line test that looks explicitly at securities ownership, saying that a company can also be an investment company if it "owns … investment securities having a value exceeding 40 per centum of the value of such issuer's total assets." To simplify, a company is an investment company if its assets or intentions consist largely of investments in securities.

This focus on securities ownership seems to provide an answer to the question that began this chapter—why regulate investment companies differently—but the policy logic of this answer is dubious. Securities make sense as a focus of regulation only if there is something truly special about securities. There has to be some characteristic of securities, in other words, that is not also shared by other kinds of assets, such as food, machinery, or trademarks. What could that be?

[2] Of course, private vehicles can avoid complying with the ICA by virtue of their private status. Investment Company Act, Pub. L. No. 76-768, §§ 3(c)(1), (7), 54 Stat. 789 (1940) (codified as amended at 15 U.S.C. §§ 80a–1 to 80a–64 (2012)).

The answer is not clear, but one could imagine a few possibilities. One is that securities are highly liquid—they can be easily bought and sold. Another is that securities are hard to value. Yet another is that perhaps there is something unique about the way securities are owned and accounted for that poses special risks.

The trouble with each of these possible accounts of security specialness is that none of them is either unique or universal to securities. Many other kinds of assets exhibit these features, and many securities do not.

Consider liquidity. Liquidity is not unique to securities. Cash is even more liquid than securities, and many businesses hold vast amounts of cash. In 2016, Apple, the computer and smartphone maker, was sitting on some $230 billion in cash and cash equivalents, which exceeds the total assets of any mutual fund in America. See Tepper, "Apple's cash on hand decreased for the first time in nearly two years," *TechCrunch* (2016); "Performance for the 25 Largest Mutual Funds," *Lipper Performance Report* (2017). So should Apple be regulated as an investment company? Besides not being *unique* to securities, liquidity is also not *universal* to securities. Some of America's largest mutual funds invest primarily in corporate and government bonds, which can be very difficult to sell.

Difficulty in valuation is also neither unique nor universal to securities. It isn't unique to securities, because other assets are hard to value, too. An iron mine, for example, is as hard to value as almost any security. And difficulty in valuation isn't universal to securities, because securities are often quite easy to value. The stock of an iron mining company is paradoxically much easier to value than the iron mine itself, because the stock may be publicly quoted on a stock exchange every millisecond.[3] Difficulties in accounting are also neither unique nor universal to securities. Other assets also exist primarily in electronic ledgers—many businesses work on the electronic credit of their customers—and difficulties in accounting are so widespread that we already have an elaborate body of rules to address them: the Generally Accepted Accounting Principles, or GAAP.

Whatever special features we might imagine for securities thus appear on deeper reflection not to be so special after all. And even if these features were special, it is difficult to see why they would merit a full-blown special regulatory system. Even if securities did pose special problems, they would surely not be the only assets to do so. Every asset is at least a little bit special, but they do not all warrant their own separate securities regulations. Even if we accepted that a feature such as liquidity was unique to securities, for example, we could also imagine other features of seemingly similar importance that are unique to other kinds of assets. Copyright protections are uniquely important for book publishers, and spoilage is a special problem for meat processors. So do book publishers and meat producers deserve special securities regulation? Surely not. Every asset has its risks, and the risks of securities are not spectacularly special.

A further problem with basing investment company regulation on securities ownership is that even the bare fact of securities ownership is not unique or universal to investment companies. Securities ownership is not unique to investment companies,

[3] Of course, the valuation of the stock just raises the question of the valuation of the underlying asset. But at least for the kinds of ministerial purposes that concern regulation—accounting and disclosure—the valuation of a public company's stock is quite simple.

because many businesses invest in securities—often in huge amounts. In the early days of Microsoft, Bill Gates raised millions of dollars in cash to fund the company's research and development activities. It took a while before Gates could spend this hoard, so while he was waiting to use it on research, he invested it—where else?—in securities.[4] At the time that Microsoft made these investments, however, it had few other assets on its balance sheet besides these securities, since its business then consisted only of speculative interests in software that had no accounting value. There was thus a point early in Microsoft's history when a huge portion of its accounting value consisted of securities, making it indistinguishable from a closed-end bond fund. Microsoft nevertheless asked the SEC for a special exemption from the ICA and the SEC gave it, though the SEC was incapable of offering reasons other than Microsoft's own representations that it intended to run a business—which, of course, just begged the question about what it meant to run a business as distinct from an investment fund.

Further, not only are securities not unique to investment funds, but they are also not universal to investment funds. Consider the SPDR Gold Shares Exchange Traded Fund. The fund's marketing materials describe the fund as an "exchange-traded fund" and the fund is commonly ranked by the financial press as one of the largest ETFs in the world. See "SPDR Gold Shares," *State Street Global Advisors*, available at www.spdrgoldshares.com (accessed July 29, 2017); also see "Largest ETFs: Top 100 ETFs by Assets," *ETFdb.com* (accessed June 23, 2017); Murphy, "The 15 Most Important ETFs," *ETF.com* (2015). But the fund is not technically an "investment company" within the meaning of the ICA, because it does not invest in securities; it invests in physical bars of gold. And so even though almost everyone—including the fund's managers—considers Gold Shares a "fund," the ICA does not apply, and the fund is regulated only by the ordinary securities laws that apply to General Motors and Amazon.

Over the years, Congress and the SEC have sewn on various patches to smooth over the mismatch between the ICA's emphasis on securities ownership and our deeper intuitions about what makes a business an investment fund. In the late 1990s, for example, the SEC adopted a special rule exempting companies such as Microsoft from the Investment Company Act even if they also own large quantities of securities, so long as they spend large amounts of money on research and development.[5] And when Congress first passed the Investment Company Act in 1940, it added a special provision exempting businesses that invested in securities representing control stakes rather than minority stakes, so as to exclude industrial conglomerates like PepsiCo.[6]

These patches, however, are just that—patches. They are ad hoc bits of duct tape and superglue that no one can fully justify if we take seriously the notion that securities ownership is the measure of an investment fund. The exemption for Microsoft-style tech companies, for example, is plainly unprincipled, because it singles out only one

[4] See in the Matter of Microsoft Corporation c/o Martin E. Lybecker, Esquire Ropes & Gray, Release No. IC-16,467, 41 SEC Docket 472 (July 5, 1988) (order granting exemption); Microsoft Corp.; Application, Release No. IC-16,430, 41 SEC Docket 205 (June 10, 1988) (notice of application for order).

[5] 17 C.F.R. § 270.3a-8.

[6] Investment Company Act, Pub. L. No. 76-768, § 3(b).

kind of business—a research and development company—for special exemption from the ICA, even though many other kinds of businesses face the same problems. Movie studios, clothing companies, and sharing economy businesses would all like to raise cash and invest it in securities while they wait to spend it, but for some reason the SEC has given this privilege only to companies that invest in research and development. Why? No one can provide a principled answer.

A further problem is that a focus on securities ownership cannot explain why the Investment Company Act of 1940 does not apply to pension funds. Pension funds are pools of money that invest in securities for the purpose of paying out retirement benefits to the employees for whose benefit the money was originally contributed. Examples include the California Public Employees Retirement system pension fund and the large pension funds run by unions such as the Teamsters. If what we care about is securities ownership, then these pension funds should clearly be regulated by the same statute as mutual funds and other investment companies, since the assets of pension funds and many ICA-registered mutual funds are essentially identical.

One might argue that pension funds should not be regulated by the ICA, because pension funds have their own distinct regulatory statute in the Employee Retirement Income Security Act (ERISA). But this just raises the question *why* pension funds have a different regulatory statute. The answer cannot have to do with securities investing, because although there are surely important differences between a pension fund and a mutual fund, securities investing is not one of them. The real difference between a pension fund and a mutual fund must be something other than securities ownership, which suggests that maybe securities ownership is not the real motivation for investment company regulation.

2 SMALL INVESTORS

Another theory of what makes an investment company special is the small size and limited sophistication of its investors. Some mutual fund investors are large, sophisticated institutions, but many others are small investors who lack professional expertise in investment. Mutual funds thus arguably need a special regulatory regime to ensure that shrewd investment managers do not take advantage of their small and unsophisticated clients.

This theory is consistent with some of the evidence about who owns mutual funds. Recent data show that mutual funds are popular in the portfolios of household savers. Small investors commonly invest in mutual funds through their 401(k) and other tax-preferred retirement accounts. Small investors also commonly invest directly in mutual funds to meet non-retirement savings goals, such as home down payments and college tuition. Mutual funds have become so popular with small investors that they now account for almost a quarter of household financial assets and half of all retirement assets. See "2017 Investment Company Fact Book," *Investment Company Institute* (2017), pp. 11–12.

An emphasis on the importance of small investors is useful because it explains why the Investment Company Act differentiates between *public* and *private* funds. Sections 3(c)(1) and 3(c)(7) of the ICA provide that only funds that sell securities widely to the general public are subject to regulation under the Act. Funds that sell securities only to small numbers of wealthy individuals and institutions, such as private equity and hedge funds, are not required to comply with the ICA's many demands, even though they would otherwise fit the definition of an investment company.[7]

The problem with this focus on small investors as a justification for the special regulation of investment companies is that small investors are not unique to investment companies. Just like the ICA, the Securities Act of 1933 and the Securities Exchange Act of 1934 draw a line between public and private companies based on the number and size of their investors, and a company that chooses to comply with these laws can go public by accepting investment from anyone. A small investor with only $100 to spare can thus invest her money not just in the Vanguard 500 mutual fund, but also in General Electric and Microsoft. Small investors are thus a universal feature of all public companies.

One might reply that although small investors can buy stock in ordinary operating companies *in theory*, these investors *in fact* tend to invest disproportionately in investment companies. There is a great deal of truth to this claim, but it has a number of problems. One is that the facts that motivate it are of remarkably recent vintage. The mutual fund industry did not come close to its present popularity with small investors until the 1990s—a decade or two after the rise of 401(k) and IRA accounts transformed retirement saving, and more than 50 years after the ICA was passed.[8] And even now, many household investors still dabble in direct investing through brokerage accounts and similar devices. And so although it may be true that small investors invest primarily through investment companies nowadays, this was not the case for most of the history of investment company regulation and it is not universally the case even now.

3 COLLECTIVE BRANDING

Investment company regulation may be useful not just for protecting investors, but also for protecting the industry that markets to them. Like almost any regulation, the regulation of investment companies reflects the lobbying efforts of the industry it regulates. As I have argued elsewhere (Morley 2011), when the Investment Company Act was first passed in 1940, the investment company industry vigorously supported it. Congress voted to approve the act while the German army was blitzing across France, and the only way the industry could divert Congress' attention long enough to pass the act was by pleading with Congress to vote for it.

I have argued that the industry's motivation, at least in part, was to build what I have called a "collective brand": a single way of doing business that would come to define

[7] Similarly, some newer ICA administrative regulations, such as the ones applicable to money market funds, now differentiate between institutional and retail investors. See "SEC Adopts Money Market Fund Reform Rules: Rules Provide Structural and Operational Reform to Address Run Risks in Money Market Funds," *U.S. Securities and Exchange Commission* (2014).

[8] In 1980, only 5.7 percent of American households held shares in a mutual fund. In 1990, the number was 25.1 percent and in 2016 it was 54.9. See "2017 Investment Company Fact Book," *Investment Company Institute* (2017), p. 112 fig. 6.1.

the entire industry and give it a single image in the eyes of the investing public (Morley 2011). In seeking to build a collective brand, the investment company industry wanted to make sure that the public associated all investment companies with a single mode of operation, so that a small, unsophisticated investor would not be scared away from investing in an investment company by the risk that she might be confused into investing in something unusual. The largest players in the industry had a vision of what most small investors wanted, and although some investors might rationally have preferred something else, the largest players wished to ensure that the industry offered a single cohesive brand that catered to the majority of investors' preferences.

The clearest example of this branding impulse was borrowing. Although some investors might reasonably have preferred for their funds to borrow large amounts of money—this is now a core strategy of private equity and hedge funds—the investment company industry's largest players nevertheless lobbied for tight restrictions on borrowing in order to project an industry-wide image of caution and conservatism. The industry feared that if some investment companies borrowed too much, investors might come to associate borrowing with the entire industry and might avoid investing in the entire industry, for fear that they might not be able to sort the funds that borrowed from those that did not. The industry's goal was thus not simply to ensure the basic trustworthiness and honesty of a varied and diverse investment company industry, but to legislate a specific and contestable vision of what an investment company ought to be.

This industry politics-based explanation of ICA regulation goes further than the securities- and investor-based explanations in accounting for the existence of the ICA, but it still has limits. One is that it does not account for why the industry was able to form a sense of identity as a distinct industry. Saying that the "industry" wanted regulation presupposes that we know what the "industry" was. We can only believe that regulation served the purposes of a group of funds if we can identify the funds and their common purposes. But we still have not seen a clear concept of what could define a fund and what could unite the sponsors of different funds.

A further limitation of the industry politics account is that it is purely descriptive, rather than normative. It tells us how the ICA came into being, but not whether this was a good thing. It leaves open the question whether we, as rational policy designers today, should continue to want the entire industry to be forced into a single narrow vision of what an investment company should be.

And there are reasons to doubt the value of collective branding as a normative matter. The trouble is that the brand imposed by the ICA might be inconsistent with what many investors want. Even if most investors want a fund that complies with the ICA, some might want something else—especially now that the rise of 401(k) accounts has so dramatically expanded interest in mutual funds and changed the purposes for which people invest. Indeed, a desire to invest outside of the ICA is what has motivated the massive rise of ICA-exempt private equity and hedge funds. The ICA thus has the effect of making it impossible for many investors to get what they want—and may very well make them worse off as a result.

The normative desirability of collective branding thus rests on conjecture about how closely the desires of the investment company industry in 1940 conform to the desires of investors today. If the degree of conformity is high, the case for collective branding is strong. If the degree of conformity is low, the case is weak. Sadly, this empirical conjecture is extremely difficult to verify.

4 SYSTEMIC RISK

In trying to build a collective brand, the industry sought to benefit itself and its investors. But investment company regulation may also be justified by the benefits it offers to an entirely different set of people and institutions: the participants in the broader financial system. Like all large financial institutions, some of the biggest investment funds arguably pose risks to the financial system. Like the collapse of a large bank, the collapse of a large investment fund could, under the wrong conditions, send contagion spreading through the financial system, with consequences for a vast array of people who may never have interacted with the fund at all. Investment companies, in other words, may pose a problem of externalities.

Aspects of investment company regulation seem to have been designed to address this concern. The most relevant restrictions appear in Section 18 of the ICA, which limits how much an investment company can borrow.[9] Closed-end funds can issue only three classes of securities—preferred stock, bonds, and common stock—and only in fairly limited amounts. Open-end funds can issue only one class of security—common stock. Open-end funds can also borrow from banks, but the extent of the permissible borrowing is limited. The SEC has thickened these restrictions in recent years by trying to limit investment companies' investments in derivative securities that resemble borrowings and also by limiting open-end funds' investments in illiquid securities.[10]

Though the systemic risk-based justification for investment company regulation may seem at first to be compelling, its problems are myriad. The first and most obvious is that it does little to explain the great bulk of the ICA, which has nothing to do with borrowing, liquidity, or systemic risk. A concern for systemic risk offers no justification for limiting conflict of interest transactions or requiring disclosure of fees, for example. Systemic risk is, at most, a justification for Section 18 of the ICA and nothing more.

A further problem is that a concern for systemic risk is deeply at odds with the distinction in the ICA between public funds and private funds. As noted above, the ICA exempts so-called "private funds," which would otherwise qualify as investment companies, but do not have to comply with the ICA because they accept investments only from a small number of wealthy investors and institutions. The exemption for private funds relieves these funds from all of the requirements of the ICA, including the restrictions on borrowing. Thus, under the ICA, a private fund can borrow indiscriminately.

This free pass for private funds makes sense if the logic of the public/private distinction is to protect a fund's investors, since the original thinking behind the public/private distinction was that it was the investors in public funds who were most

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[9] For a description of the rules, see Morley (2013).

[10] See Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 FR 80883 (proposed Dec. 28, 2015) (to be codified at 17 C.F.R. §§ 270, 274); Investment Company Liquidity Risk Management Programs, 17 C.F.R. §§ 210, 270, 274 (2016).

vulnerable to exploitation. But if, as we have stipulated here, the concern is not about small investors but about the broader *financial system,* then the distinction no longer makes any sense. The number and sophistication of equity investors in a particular fund is irrelevant if our real concern is about the vast community of financial actors who may never have directly dealt with a fund at all. And a private fund poses just as much risk to the financial system as a private fund. A billion dollars of borrowed money poses more or less the same threat to the financial system whether it was borrowed by a private investment company or a public one. Systemic risk is often compared to environmental pollution in its tendency to damage third parties through externalities. And what we have in the ICA, essentially, is a system that says only rich people can dump toxins into rivers. If we were to take seriously the notion that systemic risk regulation is the rationale for regulating investment funds, therefore, we would have to apply the same regulations to hedge funds and private equity funds that we apply to mutual funds.[11]

A still further problem with systemic risk as a theory of investment company regulation is that, like the other concerns we have already addressed, systemic risk is not unique to investment companies. Though it would certainly be bad for the financial system if a large mutual fund were to go bankrupt, it would be bad for the financial system if *any* large company were to go bankrupt. When Enron collapsed in 2001, it sent shockwaves through the financial system, as did Chrysler when it filed for bankruptcy in 2009 and Puerto Rico when it began its slow motion implosion in 2015. So unless we can identify something truly distinctive about the capital structure of an investment company, the argument for regulating borrowing by a registered investment company boils down to nothing more than the argument for regulating borrowing by any large institution.

5 ORGANIZATIONAL STRUCTURE

A final possibility—and the one that seems most compelling—is that investment companies are distinct because of their organizational structure. Every type of investment company in the ICA orbit adopts a peculiar pattern of organization that I have elsewhere called the "separation of funds and managers" (Morley 2014). It is perhaps this pattern, more than anything else, that attracts the bulk of the ICA's concern.

An investment company is distinct because it separates its fund from its managers. It does so by establishing the fund and the managers as distinct legal entities with distinct groups of owners that are related to each other solely (or primarily) by contract. In the Fidelity asset management complex, for example, the manager is Fidelity itself. Fidelity is a corporation, owned privately by its founding family. Fidelity earns its money by charging management fees to hundreds of different funds, including mutual

[11] It is still uncertain how the new SIFI designations will affect private investment companies, but it remains clear that whatever restrictions emerge for hedge funds and private equity funds will likely be much less severe than the restrictions that the ICA imposes on registered investment companies.

funds, hedge funds, and private equity funds. Fidelity established each of these funds at various times, and each has its own distinct corporate existence and its own distinct group of owners, who were recruited by Fidelity's marketing efforts. Fidelity makes money by causing each fund early in its life—when it is wholly owned by Fidelity—to sign a contract with Fidelity under which Fidelity controls every aspect of the fund's operations. The fund has no ability to fire individual employees of a manager and (in a hedge fund or private equity fund) may not even have the ability to remove the management as a corporate entity. The net effect is that the funds each own their own investments, but have no employees or operational assets and no meaningful authority to manage their own affairs.

This pattern of organization is common to virtually everything we think of as part of the investment company regulatory system. Hedge funds, private equity funds, mutual funds, exchange-traded funds, and closed-end funds all adopt some variant of this pattern of organization.

Elsewhere, I have explained why this pattern is uniquely efficient in investment funds. See Morley (2014). The reasons are complicated, but they boil down to the way that this pattern limits a fund investor's involvement in the business of the management company and the management company's other funds. Because a fund investor does not own the management company, she cannot control the management company. And because a fund's assets do not belong to the same entity as a management company, the fund's investors do not face any risk of loss or gain from the management company's debts and cash flows. These limits on a fund investor's involvement in the management business tend to make sense because fund investors tend to have other rights that substitute for control over the management (such as the right to redeem), and also tend to have uniquely strong desires for precision in the tailoring of risk. The separation between funds and managers thus generally tends to be the most efficient pattern of organization available to most investment funds. See Morley (2014).

The separation of funds and managers nevertheless poses major challenges for regulators. Although this pattern tends to be the *most* efficient way to organize an investment fund, it is nevertheless not a *perfectly* efficient way to organize an investment fund. The value of separating a fund from its manager can vary from fund to fund and circumstance to circumstance. And although the separation of funds and managers may be the best available form of organization for many funds, it is not divinely ordained, and it can break down whenever the conditions that make it efficient fail to materialize. The main job of investment company regulation is thus to address the many risks that the separation of funds and managers inevitably poses and to single out for regulatory scrutiny the situations where these risks are most profound.

The risks are numerous. One is that a manager's many funds may come into conflict with one another. The legal separation between a fund and its manager permits the manager simultaneously to operate dozens or even hundreds of different funds at the same time, raising difficult questions about how the manager should allocate scarce resources among these different clients. When Fidelity comes across an opportunity to invest in a hot technology start-up, for example, Fidelity has to decide which of its hundreds of funds will get the opportunity. A related problem is the constant possibility that a manager may mix its clients' assets with its own. A fund manager is like a lawyer who might be tempted to dip into a trust account that actually belongs to a client. An even more serious problem is the risk that exit rights will break down. Because the separation of funds and managers cuts off a fund investor's right to control the management company, many investment funds compensate by offering their investors redemption rights, periodic liquidations, and other rights that permit them to remove their money from a manager's control. If an investor cannot control her manager, she can at least take away her money. But what happens if these exit rights cease to work? What if investors lack the sophistication or knowledge to redeem, or what if a manager suddenly decides to suspend the right of redemption? Or what if, like a closed-end fund, a fund offers no right to redeem or liquidate at all?

These and myriad other problems call out for regulation, and the job of the ICA is to provide it. The ICA has a provision to address each one of these and many other problems that arise from the separation between funds and their managers. Organizational structure thus offers a holistic explanation of what makes an investment company distinct and why the ICA might be necessary to regulate it.

An investment fund's peculiar pattern of organization does not just pose a particular kind of business risk—it sets up an altogether different way of relating to a company. This pattern of organization thus warrants a distinct body of securities regulation, because securities regulation is, after all, about governance. Securities law is fundamentally a way of regulating how shareholders relate to their companies. And so if shareholders relate to their companies in a radically unusual way, they may very well need a special form of securities regulation to protect them.

This focus on organization helps resolve a number of difficulties in how we understand the ICA. Among other things, a focus on organization explains why mutual funds are regulated differently from pension funds.[12] As we have seen, mutual funds and pension funds both tend to own large amounts of securities, and so if we focus only on securities ownership, a mutual fund and a pension fund look the same. But if we focus instead on organization, the difference becomes obvious, because pension funds do not have a separate corporate existence from their managers. Pension fund investors also lack the package of rights—such as redemption rights—that often makes the separation of funds and managers efficient in mutual funds and other vehicles regulated by the ICA. Pension funds have their own distinctive pattern of organization, which warrants its own distinctive regulatory statute.

The peculiar pattern of organization we find in investment companies is thus the central concern of investment company regulation. And many of the other possible accounts of fund regulation make more sense when we view them through the lens of organization. Consider, for example, the desire to protect small investors that we considered earlier. Small investors are a common focus of all securities statutes, but the Investment Company Act may be necessary to address a particular kind of problem faced by small investors. Unlike the other securities laws, for example, the ICA places numerous restrictions on conflicts of interest, requires advisory fees to be disclosed in a specified format, and restricts how much a manager of an open-end fund can limit redemptions. Obviously, these requirements exist to protect small investors, but their main effect is to protect small investors *from the peculiar risks of investment company*

[12] Pension funds are excluded from the ICA. Investment Company Act, Pub. L. No. 76-768, § 3(c)(11).

organization. The only reason a manager faces so many conflicts of interest, for example, is because the manager simultaneously works for so many different funds. And the only reason an advisory fee can be stated as a single number is because a fund does not directly cover the wide variety of operating expenses that would make it impossible to express expenses in a single number. Instead, a fund covers its expenses by paying a single fee to an external service provider. In other words, the ICA regulates the special set of risks to small investors that come from investing in such an unusually structured organization.

Stepping back, we can see that one way to understand the ICA is to say that it is not a form of securities regulation at all—it is actually a form of product or service regulation. This analogy makes sense mainly because of the importance of exit rights in investment funds. In many funds that adopt the separation of funds and managers, exit rights cause investors to look more like customers than regular equity holders. Recall that in order to compensate for the restrictions on control rights introduced by the separation of a fund from its manager, many investment funds give their investors strong exit rights, such as the power to withdraw their money by redeeming. And many funds also strongly restrict or even eliminate their investors' voting rights. As a result, an investor in an open-end mutual fund tends to relate to her fund in much the same way that a customer relates to an ordinary company selling products or services. In the same way that a customer of H&R Block, the consumer tax preparation service, can decide every year whether or not to hire the company again, so too can an investor in a mutual fund decide every day whether or not to leave her money with the fund and its management. And so in the same way that an H&R Block customer is protected by contract and regulation rather than by the right to elect the firm's directors, so too is a mutual fund investor protected mainly by contract, regulation, and fiduciary duty rather than by the right to vote for the directors of the fund's advisor.[13] The ease of exit enjoyed by customers has often been used in economic theory to define who counts as a customer (rather than an investor) and to explain why a customer receives different protections than an investor. See Hansmann (2000); Williamson (1983).

The product/service analogy is useful because it addresses the question that began this chapter, which is why investment companies deserve their own distinct body of regulation. If we view investment company regulation as a form of securities regulation, then carving out a special regime for investment companies looks quite unusual, since securities regulation is otherwise so monolithic. But if instead we view investment company regulation as a form of product or service regulation, then it seems quite ordinary, because unlike securities regulation, product and service regulation is highly variable. Though we have a single body of securities regulation for almost every kind of company, we have dozens—maybe hundreds—of different bodies of regulation for

[13] Mutual fund investors technically have a right to vote for directors in their own funds, but they do not have a right to vote for directors in their advisor. And even the right to vote for directors in their own funds is meaningless, because mutual fund investors never use it. Small investors do not vote, because they lack the sophistication; and large investors do not vote, because they lack the incentive. A large investor who becomes dissatisfied with a fund will almost always choose to redeem, rather than to vote. The net effect is that no director election has ever been contested by shareholders in the nearly 90-year history of the open-end mutual fund industry. See Morley & Curtis (2010).

products and services. Insurance companies, car makers, bakeries, cable TV providers, hospitals and computer manufacturers each have the same securities regulation but different product regulations. Product and service regulation is almost as varied as the industries it regulates.

6 CONCLUSION

When we ask why American law provides a distinct body of securities regulation for investment funds and not other businesses, the most obvious answers fail us. The tendency of investment funds to own securities, the small size of fund investors, the industry's need for collective branding, and the threat the industry poses to the financial system all prove inadequate to make sense of the special status of investment funds under American law. The most compelling answer thus turns out to be a surprising feature of investment funds that was only recently identified: their peculiar pattern of organization. An investment fund's tendency to maintain a distinct corporate existence and a distinct set of owners from its management radically transforms how investors relate to their managers and warrants a special body of regulation quite different from the rest of American securities law.

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